PRIVATE CLIENT ALERT

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Capital Gains Tax: How will you be taxed in future?

The Office of Tax Simplification has proposed the alignment of income tax and CGT rates. In this note, we review its recent Report, look at a possible future CGT landscape and suggest why now may be an appropriate time for a conversation with your Rawlinson & Hunter LLP adviser.

The Office of Tax Simplification (OTS) has published its report (dated November 2020) entitled "Capital Gains Tax review – first report: Simplifying by design" ("the Report").

The Report follows the Chancellor's request, in July this year, to the OTS to review Capital Gains Tax (CGT) and to consider how CGT distorts behaviour or fails to meet policy intent. The Report focuses on policy design and principles and makes 11 recommendations. A second report will be issued early in 2021 focusing on key technical and administrative issues.

The OTS is the independent adviser to Government on simplifying the tax system. It is perhaps a sad reflection on our tax system that the Report itself comprises over 130 pages. The Report is based on over 1,000 responses to an online survey and 96 formal written responses to a call for evidence.

Given the present focus on Government finances as a consequence of Covid-19, the Report has received particular publicity amidst concerns it may provide clues as to what future CGT changes may look like and, in particular, concerns that CGT rates might rise to match income tax rates.

There is no doubt that the Report is an important document which should be studied closely by taxpayers and their advisers. To assist in this, this note comprises the following:

i. Appendix One in which we summarise the OTS's 11 recommendations;

ii. Appendix Two in which we summarise the main points in each of the Report's 6 Chapters. Time may not permit everyone to read the Report in full but the Report gives important indicators as to what the future may hold. We hope our summary will provide insight into its critical thinking and a possible flavour of what might arrive in Budgets ahead;

iii. Appendix Three in which we suggest what taxpayers should be doing now. As explained in our separate note on possible future tax changes ***[view publication here]***, pre-emptive action can often be a mistake but the Report provides food for thought and, as noted in Appendix Three, a review may be appropriate.

While there is much to admire in the OTS's work, it is important to remember that it is only a report and the Government may choose to ignore all or any part of it. Moreover, many of the more radical suggestions (such as the abolition of the CGT tax free uplift

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on death) would, as the Report recognises, require much deeper thought. The Chancellor will not be able to simply adopt the OTS's recommendations as his own work when he next delivers a Budget. The Report must be read as what it is: a series of thoughts and recommendations by the OTS and not Government policy. There is no commitment to tax rises, but there is speculation and the Report does present a case for aligning CGT and Income Tax rates.

It is difficult to avoid the conclusion that change lies ahead and that a review now of personal balance sheets would be time well spent.

APPENDIX ONE

Summary of Recommendations

The Report contains 11 recommendations. It is important to remember that the Government is free to ignore or adopt all or any of them.

Rates and Boundaries

1.
   - Consider more closely aligning CGT rates with Income Tax rates, or
   - Consider addressing boundary issues as between CGT and Income Tax.

2.
   - Consider reintroducing a form of relief for inflationary gains,
   - Consider the interaction between CGT and the tax position of companies,
   - Consider allowing a more flexible use of capital losses.

3.
   - Consider reducing the number of CGT rates and the extent to which liabilities depend on the level of a taxpayer's income.

4.
   - Consider whether employees' and owner-managers' rewards from personal labour (as distinct from capital investment) are treated consistently,
   - Consider taxing more of the share-based rewards arising from employment, and of the accumulated retained earnings in smaller companies, at Income Tax rates.

The Annual Exempt Amount

5.
   - Consider reducing the level of the Annual Exempt Amount.

6.
   - If the Government does reduce the Annual Exempt Amount, also consider reforming the current chattels exemption by introducing a broader exemption for personal effects, with only specific categories of assets being taxable,
   - Consider formalising the administrative arrangements for the real time capital gains service, and linking up these returns to the Personal Tax Account,
   - Consider requiring investment managers and others to report CGT information to taxpayers and HMRC, to make tax compliance easier for individuals.

Capital Transfers

7. Where a relief or exemption from Inheritance Tax ('IHT') applies, the Government should consider removing the capital gains uplift on death, and instead provide that the recipient is treated as acquiring the assets at the historic base cost of the person who has died.

8. In addition, the Government should consider removing the capital gains uplift on death more widely, and instead provide that the person inheriting the asset is treated as acquiring the assets at the historic base cost of the person who has died.

9. If the Government does remove the capital gains uplift on death more widely, it should:
   - consider a rebasing of all assets, perhaps to the year 2000, and
   - consider extending Gift Holdover Relief to a broader range of assets.

Business Reliefs

10. The Government should consider replacing Business Asset Disposal Relief with a relief more focused on retirement.

11. The Government should abolish Investors' Relief.

APPENDIX TWO

Report Highlights

In this Appendix we review the content of the Report, highlighting in particular points which will be of practical interest.

Chapter 1: Introduction to CGT

Chapter 1 of the Report briefly considers the role and the different justifications for CGT. It notes that one rationale for the tax is that there is "little economic difference between income and capital gains" so that income and gains should be treated along the same lines. The Report notes that:

"the logical conclusion of this approach, which not all who favour this rationale would advocate, would be the full integration of Income Tax and CGT".

The Report adds, however, that:

"even those who take this view of capital gains often accept that there are practical issues around taxing them in exactly the same way as income."

This might suggest that the precise alignment of income tax and CGT rates is not to be anticipated.

Chapter 1 also includes a number of interesting statistics about the reach and incidence of the tax. These statistics may give an insight into future thinking.

In 2017/18 the total amount of CGT paid was £9.0 billion : This contrasts with income tax receipts of £180 billion.

Whereas around 60% of UK adults paid income tax in that year, only 0.5% paid CGT.

The Report notes that this is because most gains are not taxed because of key reliefs including main home relief, the relief for personal possessions with a value under £6,000 and the annual exempt amount.

The bulk of gains relates to a small number of taxpayers reporting very large gains. This trend is growing with gains becoming more concentrated among fewer taxpayers each year. In terms of what assets gains are being paid on, the Report notes that a small number of successful business owners account for the vast majority of revenues. In this context, the impact of Entrepreneurs Relief (now Business Asset Disposal Relief) was noted. This relief is now restricted to a lifetime limit of £1 million. The Report notes that for non-business assets (e.g. listed share portfolios) timing can help reduce the tax take – e.g. by the effective use of the Annual Exempt Amount.

The Report notes (in Chapter 2) the "relatively high level of the Annual Exempt Amount".

CGT is not a young person's tax. Taxpayers between the ages of 45 to 74 accounted for 78% of gains in 2017/18.

Chapter 2: Capital Gains Tax Rates

Chapter 2 considers the case for greater convergence of tax rates on income and gains. It notes this may "create a more neutral tax system", "reduce the need for complex rules to police the boundary between income and gains" and "minimise distortions to peoples' choice and behaviour".

It is suggested that the alignment of CGT rates with Income Tax rates could in theory raise £14 billion a year but that in practice "nothing like this amount" would accrue due to behavioural effects. Raising rates, the Report notes, would also lead to increased avoidance and "lumpy" gains where a significant gain has accumulated over a period but is realised in one tax year. The Report suggests an averaging relief (looking at the precedent in the taxation of insurance bonds). It might be questioned, however, how that would sit with the desire for "simplification".

The Report notes that increased rates encourage taxpayers to hold on to assets ("the lock in effect"), a factor amplified by the tax free uplift on death. The Report notes:

"if rates were increased it would make sense for the government to consider a return to some form of indexation and to reduce other incentives to retain assets."

The Report clearly favours a form of relief for inflationary gains, especially if CGT rates are to be increased. The OTS thinks many of the historic complexities of inflation can be addressed by "integrated software and modern technology".

Recent times have seen an increase in the use of family investment companies (FICs) whereby taxpayers hold their investments via a UK resident company so as to take advantage of the lower corporation tax rates. FICs have generally been used to hold assets producing an income return but the Report notes that:

"If Capital Gains Tax rates were more closely aligned with Income Tax Rates, there would be an additional incentive…to hold assets in a company".

The Report notes FICs may distort taxpayer behaviour and that the Government would need "to consider any associated changes that might be desirable". Those contemplating the establishment of a FIC may therefore need to consider if they are likely to remain tax efficient in the longer term.

Losses

On capital losses the Report sees:

"merit in the government considering some increased flexibility…whether by way of carry back or an extension of the range of situations in which capital losses can be offset against income".

Chapter 3: Boundary Issues

Chapter 3 reflects further on the "boundary issues" caused by having different Income Tax and CGT rates, with particular reference to employee share schemes and the accumulation of retained earnings within owner managed companies.

Share Schemes

The Report reviews the various share schemes (including growth shares) and the different tax treatments.

The Report concludes that:

“the OTS questions whether tax advantaged share schemes are the most cost effective approach to helping people save or encouraging long term share ownership…”

Retained earnings in close companies

The Report considers the position where shareholders in small businesses can accumulate earnings in a company and then seek to realise them as a capital gain when they sell or liquidate the company. The Report notes that the present rules “distort behaviour, pushing taxpayers towards incorporation, where they might otherwise have preferred to remain self-employed”.

While there are already anti-avoidance rules in this area (the phoenixing and money boxing provisions) the Report considers them inconsistent and suggests a solution whereby one would:

“tax some or all of the retained earnings remaining in the business on liquidation or sale at dividend rates – in effect shifting the boundary between CGT and Income Tax in these situations.”

Chapter 4

The Annual Exempt Amount (AEA) (the threshold below which gains chargeable to CGT are not taxed) gets a chapter of the Report to itself. The Report notes the use of the AEA by the holders of listed share portfolios.

The Report notes the possibility of reducing the level of the AEA “so that it mainly operates as an administrative de minimis threshold”, but notes too that a significant reduction would increase reporting requirements. The Report suggests that “a true de minimis level could lie in the range between £2,000 and £4,000”. The Report reflects on the possibility of a higher AEA for taxpayers with low levels of gains.

The following suggestion will be of interest to those with quoted share portfolios:

“…investment managers can report in very different ways. This could be addressed through greater standardisation in how such information is reported to taxpayers, and the potential for investment managers to report such information directly to HMRC.”

Chapter 5 Capital Transfer

Chapter 5 considers CGT and IHT which the OTS do not consider to fit together coherently.

The Chapter considers in detail, because of its obvious link with IHT, the present tax free CGT uplift on death. This the OTS noted is one reason why “60% of respondents to the OTS survey said that CGT was a barrier to passing on assets”.

An alternative to the uplift on death would, the Report notes, be a “no gain, no loss approach” (which finds favour in Australia and Germany). The OTS considers there to be a “good case” for exploring this and that it could on average raise between £470 million and £900 million but notes that this would also increase the need for an indexation relief.

Such a change would, however, also have to have regard to the IHT position. Four possibilities are mooted:

(i) Charge IHT and CGT on death separately.

(ii) The value of the estate for IHT purposes could be reduced by the amount of the capital gains that would be chargeable if the asset had been sold at the time of death.

(iii) The full rate of IHT could be paid up front with a credit then being applied against the eventual sale of the asset.

(iv) Reintroducing CGT on death as an alternative to IHT. This would result in about £3.8 billion of tax being lost so the Report does not consider this idea further.

The OTS seems attracted by these ideas, although it is difficult to see that they would not result in extra complexity.

The OTS notes that a move to a "no gain, no loss" approach might require historic valuations to be available or obtained with attendant problems. This might, the Report suggests, be addressed by a rebasing. This it is thought, could cost between £200 million and £500 million per annum.

Lifetime Gifts

If a "no gain, no loss" approach were to be introduced on death, the Report favours expanding the existing Gift Holdover Relief to include non-business assets.

Chapter 6: Reliefs and Losses

Chapter 6 considers the impact of:

(i) Business Asset Disposal Relief, where the Report moots the possibility of increasing the minimum shareholding from 5% to 25%, increasing the minimum share holding period to 10 years and having an age limit, perhaps linked to the age limits in pension freedoms.

(ii) Investors' Relief. The Report's recommendation is to abolish this relief on the basis it is not being used.

(iii) Loss Relief. The Report notes that total losses reported for 2017/18 were £5.0 billion with a significant proportion relating to the disposal of listed shares. The OTS thought that the existing loss regime was "fit for purposes" and did not propose any structural changes (although if the rates of CGT and income tax were to be aligned, the Report notes that more flexibility in the use of losses may be required).

APPENDIX THREE
What To Do Now?

Is the Report a call to arms? Should taxpayers be taking urgent action in case the Chancellor acts on the recommendations in the Report?

In our opinion, a kneejerk reaction to the Report would be the wrong one. The recommended actions in the Report may never see the light of day and those that do will require more detailed thought before they can become legislation.

That said, it is an optimistic adviser who does not see tax rate rises down the track and the Chancellor will be attracted by the headline that the alignment of Income Tax and CGT rates could deliver up to £14 billion a year.

The Report turns the spotlight on particular aspects of the CGT system and we consider that the most prudent approach is to consider the contents of the Report closely (see Appendix Two to this note) and then review your personal position in the light of these "spotlight areas". Some re-alignment may be appropriate and it may be beneficial to discuss the position with your usual Rawlinson & Hunter tax adviser.

Potential areas for spotlight include the following:

1. Annual Exempt Amount (AEA)

The Report recommends a reduction in the AEA. Taxpayers should look to ensure that they have used the AEA (£12,300 for 2020/21) and consider transferring assets to a spouse, so their spouse may make a disposal if the spouse has not otherwise used his/her exemption. The Report proposes no change to the rules relating to the use of capital losses, but again prudence would suggest using these as soon as possible. The Report recognises how extensive the practice is of taking gains on quoted investments to use losses and the AEA and so it is possible the Chancellor's eye might be drawn to making this practice more difficult.

2. Family Investment Companies (FICs)

FICs are widely used to enable taxpayers to invest via an UK resident company so that their investment growth is subject to corporation tax rates and not the higher Income Tax rates. FICs were already coming under scrutiny from HMRC and the Report places further attention on them and their increasing use. This may prompt the Chancellor to legislate against their use and so taxpayers may want to review their FICs or possibly think about whether now is the right moment to launch one.

3. How to Behave

Much of the Report focuses on how the present structure of CGT may influence how taxpayers behave. The tax free uplift on death (which prompts taxpayers to hold onto assets) is seen as a particular example of this and the Report suggests its possible abolition.

Nobody is suggesting that taxpayers die now to avoid this change (and one couldn't rule out HMRC arguing that was tax avoidance even if they did!) but it may be prudent to review the ownership of assets at this time. Are there assets which it may be appropriate to pass to family members now – e.g. because their values are at a low point or they qualify for CGT gift relief and can be free from IHT if the donor survives 7 years? It is noteworthy that the Report did not propose that the removal of the CGT uplift on death be accompanied by the abolition of IHT and so lifetime giving may now be more attractive.

4. Going Offshore

Some taxpayers comfort themselves with the thought that if tax rates get too high for their taste they can move offshore to escape the taxman's reach. The Report contains a potential concern here for individuals with such plans. When reviewing the possibility of higher CGT rates the Report notes that:

"Anti-avoidance rules, particularly around the residency regime and people coming to and leaving the UK, would need to be reviewed."

This is again just a suggestion but if individuals know for sure they will want to spend time overseas for tax purposes they will need to keep an eye on timing in case the Chancellor considers the introduction of a CGT exit charge for individuals, to match the existing ones for trustees and companies.

5. Trusts

The Report has no special comments on Trusts but trustees will wish to consider the potential change in tax rates (see below) and possibly advance distributions (e.g. those within the capital payments regime for off-shore trusts) or disposals before rates rise.

6. Making a Plan

The Report notes that wealthy taxpayers in particular can often regulate the timing of their disposals to achieve the optimal tax position. Now may be the time to review personal balance sheets and consider which assets are "hold" and which assets might be disposed of in the short to medium term. Perhaps consider moving assets into trust in the present CGT regime. The Report considers the re-introduction of a possible mechanism to deal with inflationary gains and a possible rebasing of values if the CGT uplift on death is removed. It may be therefore that the tax position on longer term assets could be improved by new reliefs (albeit there is no indication when the rebasing/inflation proofing would apply from).

7. Main homes

There has been much speculation that the exemption from CGT on the sale of a main home (the principal private residence (PPR) relief) might fall prey to the Chancellor's axe. The Report discusses a number of reliefs and exemptions but is silent on PPR. Given the political nature of such change, the Chancellor may find the Report gives him further justification not to alter the PPR rules (which, in any event, have been restricted in recent times).

8. Family Companies

The Report notes that a very significant part of the Chancellor's revenues from CGT come from private company sales. Shareholders in private companies where an exit or liquidity event is on the horizon may therefore wish to review the position with their tax advisers. The Report proposes change to Business Asset Disposal Relief (formerly Entrepreneurs Relief) including making it more closely aligned to retirement and reducing the number of shareholders who qualify. It may be prudent, in some cases, to consider the use of the relief now (e.g. by a gift to a family trust). The Report also reviews the CGT treatment of share schemes and so company owners may wish to consider the introduction of these now in case (should there be change) there is a grand- fathering of schemes introduced before any change in the rules. The Report also notes the possibility of closely held companies retaining earnings so these can ultimately be extracted by a CGT event such as a sale or liquidation. Recent years have seen a raft of anti-avoidance legislation but the Report might prompt more, so shareholders in such a position should review their strategy.

9. Tax Rates

We have left the biggest question to last. Will Income Tax and CGT rates be made the same? The Report suggests the Government consider more closely aligning CGT rates with Income Tax Rates (while noting the impact on behavioural issues) but does not say they should be in complete alignment.

Where to set the rate of CGT has proved a question Chancellors have battled with over the years. The Report will not present Rishi Sunak with the answer. Nor can we answer this question. The correct solution, however, must be to plan prudently now and to review balance sheets and plans to ensure tax efficiency.

Please contact your usual Rawlinson & Hunter contact should you require further information or assistance with the above, or any of those listed below.

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