PRIVATE CLIENT ALERT

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CGT Under The Microscope: The Second Report Of The OTS

In July 2020, the Government requested the Office of Tax Simplification (the OTS) to carry out a review of Capital Gains Tax (CGT).

The first report of the OTS was published in November 2020 and considered the policy design of CGT. Our comment on that report can be viewed here.

In May 2021 the OTS published its second report. This report focused on key practical and administrative issues arising from the CGT system. In this briefing, we review this second report ("the Second Report"). The Second Report reviews issues across areas such as divorce, homes and business matters.

As for the first report, it is important to note that the Second Report of the OTS is not part of Government policy and the Government may chose simply to ignore the recommendations made. Nevertheless, this new report provides a useful insight into the workings of CGT and the OTS recommendations will be of interest, both to those who pay CGT and those who advise on the tax.

The Second Report is divided into seven chapters and we summarise the main contents of each chapter in the Appendix to this note.

The Second Report covers a wide range of issues, in many cases focusing on discrepancies in the CGT world which have been drawn to the attention of the OTS. As a consequence, the Second Report often lacks full detail on how changes can be achieved, preferring instead simply to highlight thoughts for consideration by the government.

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This lack of a hard edge to some of the conclusions might be thought to increase the risk of the Second Report just languishing in an in-tray, as fuller work would be required to transform the Second Report from recommendations into change.

The Second Report's commentary can be divided into a number of broad categories:

A. First, practical recommendations to make the administration of CGT smoother or fairer. For example, from 6 April 2020 UK residents must report a gain on the sale of a UK residential property within 30 days of completion. The OTS recommend that this "challenging deadline" be extended to at least 60 days. Similarly, the OTS recommends that the period in which the "no gain, no loss" rule operates when spouses or civil partners separate should be extended.

B. Second, suggestions to HMRC that their guidance in certain areas (e.g. on debts) be improved or that forms be introduced to assist taxpayers (e.g. in relation to which of two homes should qualify for the main residence exemption).

C. Third, topics (which are less numerous than one might have expected) where the OTS makes firmer suggestions for change – for example to the pooling rules which apply to listed shares, or to how a taxpayer should calculate his or her gains on the disposal of foreign assets.

D. Finally, "traps" – those areas where the CGT legislation can result in unexpected tax charges which seem unfair in a wider policy context. Examples here include the use of management companies to hold freeholds of flats, and the situation where downsizing families build a new smaller house in the garden of their home. In such cases, the Second Report suggests the government should strive to find more equitable solutions.

The Second Report provides a useful discussion of some of the flaws in the CGT system and it may be hoped that at least some of its suggestions will result in tangible improvements. However, if taxpayers and tax advisers could have one wish for the Second Report, it is that the government heeds the recommendation in relation to the Enterprise Investment Scheme (EIS). The intent of the legislation is often defeated by technical points, which reach beyond the avoidance technique a particular statutory provision was designed to negate. As a consequence, EIS can often fail to deliver to innocent tax payers the benefit it should. The OTS asks that the government "should provide taxpayers with a measure of flexibility in relation to non-substantive technical issues which risk invalidating claims".

If the Second Report were to deliver the above change, it would rightly take its place in the history of tax literature. The fear is that instead it will gather dust on the shelf of good intentions.

APPENDIX

Chapter One: Awareness and Administration

In the first chapter of the Second Report, the OTS look at the profile of CGT and some aspects of its administration.

Awareness

The OTS concluded that CGT has a low public profile and it impacts on relatively few people – in 2017/18 only 265,000 people paid CGT. This compares with the 31 million people who paid income tax. In addition, people tend not to pay CGT on a regular basis and so lack the knowledge and experience that comes from dealing with something regularly. The Second Report notes areas (e.g. on the enterprise investment scheme) where HMRC could assist by improving their guidance on the topic.

Administration

The Second Report notes that there are several different ways taxpayers can report capital disposals to HMRC:

a. Via a self-assessment tax return, which is required if the total gains arising are above the annual exempt amount (£12,300 for 2021/22) or if the proceeds received are more than four times that amount.

b. The UK property tax return. From 6 April 2020, UK residents, with a gain arising on the disposal of a UK residential property (on which there is CGT to be paid) must report it via the new UK property tax return within 30 days of completion. The evidence suggests that about 40 per cent of returns are filed by agents on behalf of taxpayers. The OTS considered the 30 days' time limit a "challenging deadline" and recommended it be extended to 60 days and that the HMRC guidance in this area should be improved.

c. The voluntary 'real time' CGT service which provides UK resident individuals with the option to report and pay CGT earlier, possibly avoiding the need to complete a self-assessment tax return if there is no other need to complete one. The OTS notes this service is not widely used – in 2018/19 only 5,010 returns were made – and that "there is much room for improvement". Its failings include its uncertain legal status, the fact that agents cannot access the service and the low level of awareness of it. Addressing these concerns would be of increased importance if the government were to reduce the Annual Exempt Amount.

Personal Tax Accounts (PTA) and Single Customer Accounts (SCA)

Over 19 million taxpayers have signed up for a PTA (which will ultimately be replaced by a SCA), an online digital platform designed to be easily accessible and secure. The Second Report notes, however, that "it is not clear at what stage CGT will be included" and that "there is no interaction between the PTA and the 'real-time' CGT service or the UK Property tax return". The Second Report, noting that a fully integrated system will be expensive, recommends that the SCA should become "a central hub for reporting and storing CGT data".

Share Pooling

The Second Report notes that in 2017/18, net gains on the disposal of listed shares (after allowing for losses) totalled £12.4 billion and accounted for 21 per cent of total net gains of £58.9 billion. The Second Report discusses the CGT pooling rules, whereby an average base cost per share in the pool is used instead of matching each share that is sold to its specific acquisition cost. This system does not avoid further difficulties where taxpayers have more than one portfolio with different investment advisers. As digital technologies improve, and we move towards the possibility of financial institutions reporting taxpayer data direct to HMRC, the Second Report suggests that where individuals hold the same share in more than one portfolio, they should be treated as holding them in separate share pools.

Chapter 2: Main Homes

For many taxpayers, their main capital asset is their home. The second chapter looks at the CGT relief, which normally means that a sale of a home is tax free and some related property issues.

The relief, known as Private Residence Relief (PRR), which exempts the gain on the sale of an individual's main home from CGT is estimated to benefit 1.5 to 2 million homeowners each year and cost the Exchequer £25 billion in 2019/20.

The Second Report reviews the scope of PRR, including case law on the meaning of a 'residence' (which it does not think should be codified) and the date when occupation starts for these purposes (which it concludes has now been confirmed by the recent case of Higgins v IRC 2019). The Second Report, does, however, recommend that PRR be adjusted to cover fully property development in a taxpayer's garden, which results in a property that the taxpayer then moves into. This change is recommended to address circumstances (such as the example in the Second Report) where a family live in a house with a large garden (within the permissible 0.5 hectares). The parents decide to downsize when their children leave home. If they sold the garden, it would be covered by PRR. However, if instead, they build a smaller bungalow in the garden, which they move into and then sell ten years later, then the history of the land's previous use as a garden is ignored in the PRR computation.

Second homes

Around 1.4 million people own a second home and they can nominate which home should qualify for the PRR. The Second Report states that the nomination process should continue, but that HMRC needs to increase awareness of its availability and to introduce a standard form for nominations.

The Second Report reviews the circumstances in which PRR deals with periods of absence from the property (e.g. for employment and which are summarised in a helpful table on page 45 of the Report) and notices the rules are inconsistent. The Second Report does not reach any firm conclusions but simply recommends that "the government should reflect on whether the ancillary reliefs for living or working elsewhere continue to meet their policy objectives".

Non-Residential Use

The Second Report considers the position where:

i. A home is used partly for “home working” – obviously very topical at the moment. It concludes that there will not normally be a restriction on PRR in these circumstances (as this requires a stringent test to be satisfied) but concludes that HMRC guidance should be made clearer.

ii. A homeowner takes a lodger into their home where normally PRR is not restricted. However, the HMRC guidance requires the lodger to take meals with the family. The Second Report concludes that this requirement is “outdated” and should be removed.

Chapter 3: Tangible Moveable Property

Chapter 3 considers the CGT treatment of tangible moveable property a phrase which, perhaps surprisingly, the OTS likes and recommends its continued use.

Tangible moveable property is more commonly known at present as ‘chattels’ – for example, paintings, jewellery and antique watches. HMRC estimated that in 2017/18 CGT paid in respect of chattels was less than 0.2 per cent of the total CGT paid.

The Second Report reviews the existing rules for low value chattels (disposals where the acquisition costs and sale proceeds are both £6,000 or less, are exempt from CGT) and wasting assets (being assets which are expected to last less than 50 years and which are also normally exempt).

The Second Report notes that “it is not clear that the boundary between what is taxable and what is not makes sense, nor that it is understood by many”. However, the OTS thought it to be “challenging to recommend material changes”. It did, however, identify a number of “fruitful areas for the government to explore”:-

i. Tax returns could include a question about tangible moveable property.

ii. The impact of marginal relief.

iii. Whether the definition of machinery is appropriate (as any assets defined as ‘plant and machinery’ are automatically treated as wasting assets) as it can apply to potentially valuable assets – such as watches, which may in fact appreciate in value.

Chapter 4: Divorce and Separation

Chapter 4 reviews the CGT rules which come into operation at the time of divorce and separation.

For 2018/19, HMRC analysts identified £8m of CGT paid by fewer than 300 taxpayers citing divorce or separation in the free text on their tax returns.

Transfers between spouses (or civil partners) living together are CGT free (the "no gain, no loss" rule). This status continues throughout the tax year in which the parties separate. However, a transfer made in the next tax year is treated for CGT purposes as being made at market value. The Second Report suggests the present position to be unsatisfactory and that the "no gain, no loss" rule should be extended to the later of:-

i. The end of the tax year at least two years after the separation event.

ii. At any reasonable time in accordance with a financial agreement approved by a court.

Chapter 5 – Business Issues

This chapter of the report focuses on the taxation of capital receipts from the sale of shares. Gains on the sale of unlisted shares totalled £27.8 billion in 2017/18 and this amounted to almost half of the gains subject to CGT.

The Second Report reviews the ways in which a sale of a private company can be structured, including the use of earn outs and receipt of ascertainable consideration, which can be taxed before it is received. The Report considered the position to be unsatisfactory as the law is not readily understood by non-professional taxpayers resulting in cash flow disadvantages, and the ability to pay the tax in instalments is considered by the Second Report to be ineffective. In addition, the valuation of the right to receive future proceeds (where there is earn out for example) can be complex and requires professional input. The Second Report notes that there is "no single way forward that avoids all these pitfalls without creating further issues". However, the Report reviews a number of approaches that the government might take to improve the position, such that taxpayers pay tax on the actual proceeds on receipt of the cash, rather than having to make future claims or elections to correct the position.

For example, the Report suggests that CGT could be charged on a "receipts" basis, the tax being paid where the proceeds of sale are actually available or received and therefore quantifiable. The report notes, however, that this could result in a reduction in the overall tax revenue due to the spreading of the gain across multiple tax years.

Debts

The Second Report reviews the CGT position in relation to debts. Simple debts are specifically outside the scope of CGT. More complex debts are generally known as a "debt on a security" and within the scope of the legislation.

The Second Report also comments on corporate bonds and notes the distinction between qualifying and non-qualifying corporate bonds. Qualifying corporate bonds can generally be described as a debt on normal commercial terms, expressed in sterling and where there is no provision for redemption in another currency. Qualifying corporate bonds are exempt from CGT.

The Report notes there are a range of specific challenges with the way the rules on debts currently operate. The report makes a number of suggestions for improving the taxation of debts. It recommends that it should be possible for the choice about the tax status of a corporate bond to be made by the inclusion of a permanent "revocable" upfront provision in the legal documentation for the bond. Where no provision is made, the recommendation would be that the default position is that the corporate bond is qualifying and therefore exempt from CGT.

The Second Report recommends that HMRC should consider improving their guidance on when a debt is within the charge to CGT, including examples that cover complex debts with borderline characteristics.

The report also suggests that HMRC should consider improving their guidance about when it will be considered that loss relief is not permitted on the basis that it was not reasonable for the taxpayer to consider a debt as recoverable at the time the loan was made. (Since, at present, relief is not available for a bad debt if there was no realistic chance of it being repaid when it was initially made).

Chapter 6 – Investor Issues

Chapter 6 looks at the operation of the enterprise investment scheme. Since its inception in 1994, more than 34,365 companies have received investment through the scheme and over £22 billion of funds have been raised. In 2018/19 there were 34,145 EIS and, 7,480 Seed Enterprise Investment Scheme investors claiming tax relief totalling £1,409 million.

The Second Report notes that it is a complex area to navigate, which can deter individuals or companies from using the schemes. The areas which the Report suggests could benefit from improvement include:

i. The short deadline for issuing shares. Currently, the shares in companies that qualify for enterprise investment schemes have to be issued when, or shortly after, any funds are received. If payment for the shares is even one day late then the whole investment is ineligible for tax relief.

ii. The application process. The current process for applying to HMRC for approval, including advance assurance, is quiet cumbersome and the Second Report thinks there should be improvements in the functionality of the forms and better linkage to HMRC guidance.

The Second Report notes that "the OTS considers that the government should provide taxpayers with a measure of flexibility in relation to non-substantive technical issues, which risk invalidating claims where the substance of the transaction meets the policy objectives of the relief".

Foreign assets

At present, when a UK resident taxpayer buys or sells foreign assets, the acquisition costs and proceeds are converted into sterling at the respective point in time in order to calculate the gain. This means that the taxpayer's actual gain or loss in the foreign currency asset is ignored for CGT purposes. HMRC statistics suggest that approximately one in ten people in the UK have foreign assets. The Second Report notes that these rules can produce odd outcomes for taxpayers.

The report states that it would generally be simpler for the calculation of the gains and losses arising on the disposal of foreign assets to be carried out in the foreign currency and then converted to sterling at the exchange rate on the date of disposal. This would bring the position in line with the treatment of foreign currency bank accounts, where taxpayers are not taxed on currency gains.

The Second Report acknowledges, however, that the government would need to consider the number of people affected and the relative balance of the winners and losers, as well as the Exchequer implications.

Chapter 7 – Land and Property Issues

Chapter 7 focuses on CGT and land.

Agricultural Issues

The Second Report notes that in 2019, 72 per cent of the total land in the UK was used for farming, employing 476,000 people. The Report notes that land used in a trade is often treated more favourably for tax purposes than land held for investment purposes, and that this distinction can be of particular importance for diversified farming businesses. The OTS had received representations to the effect that the tax system required modification to help farmers address these issues. For instance, in relation to the Rollover Relief, which allows a gain arising on the sale of qualifying business assets to be deferred where the proceeds are re-invested into another qualifying business asset in the same, or an ancillary trade, which would apply to land which farmers occupy for their own trade, but not normally for let land.

The Second Report refers to the "25-year Environment Plan'' pursuant to which the government is offering financial incentives to English agricultural landowners via its 'Environmental Land Management Scheme'. The Report notes that "the government will need to do further work over the coming years to understand how certain tax rules and environmental payment schemes interact'' and that "failure to co-ordinate effectively could create unnecessary barriers to wider environmental policy aims''.

Land Pooling Arrangements

The second part of the Chapter considers land assembly, where landowners join forces to bring a large site together, often for development purposes. One method of doing this is "land pooling". The Second Report reviews the complications where taxpayers attempt to pool land and suggests that "the government should explore ways to make land assembly more tax neutral". One possibility would be to allow equalisation payments between landowners to be tax deductible. The alternative would be to create a specific and regulated type of land pooling vehicle.

Flat Management Companies

There were 4.5 million residential leasehold properties in England in 2018/19, of which two thirds were flats. The Second Report notes the CGT problems which can arise in the common situation where flat owners (with leases of individual flats) form a management company to collectively own the freehold.

The Second Report provides an example, where five leaseholders wish to extend their leases to 120 years and each owns a 20 per cent share in the management company. The nominal taxable value of each extension in the example is £20,000, but no money changes hands. However, for CGT purposes the leaseholders and the company are connected persons and, as a consequence, there is a deemed gain of £100,000 and the company has to pay corporation tax at 19 per cent on the gains. The Second Report states "it seems odd that (the connected person rules) should also apply in this situation where the individual is only, effectively, connected with themselves".

The Second Report notes that the present problems could be exacerbated if the government were to reinvigorate common hold (a form of ownership where each flat owner directly owns their share of the freehold) as an alternative to the long leasehold system.

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