JAMES HAY
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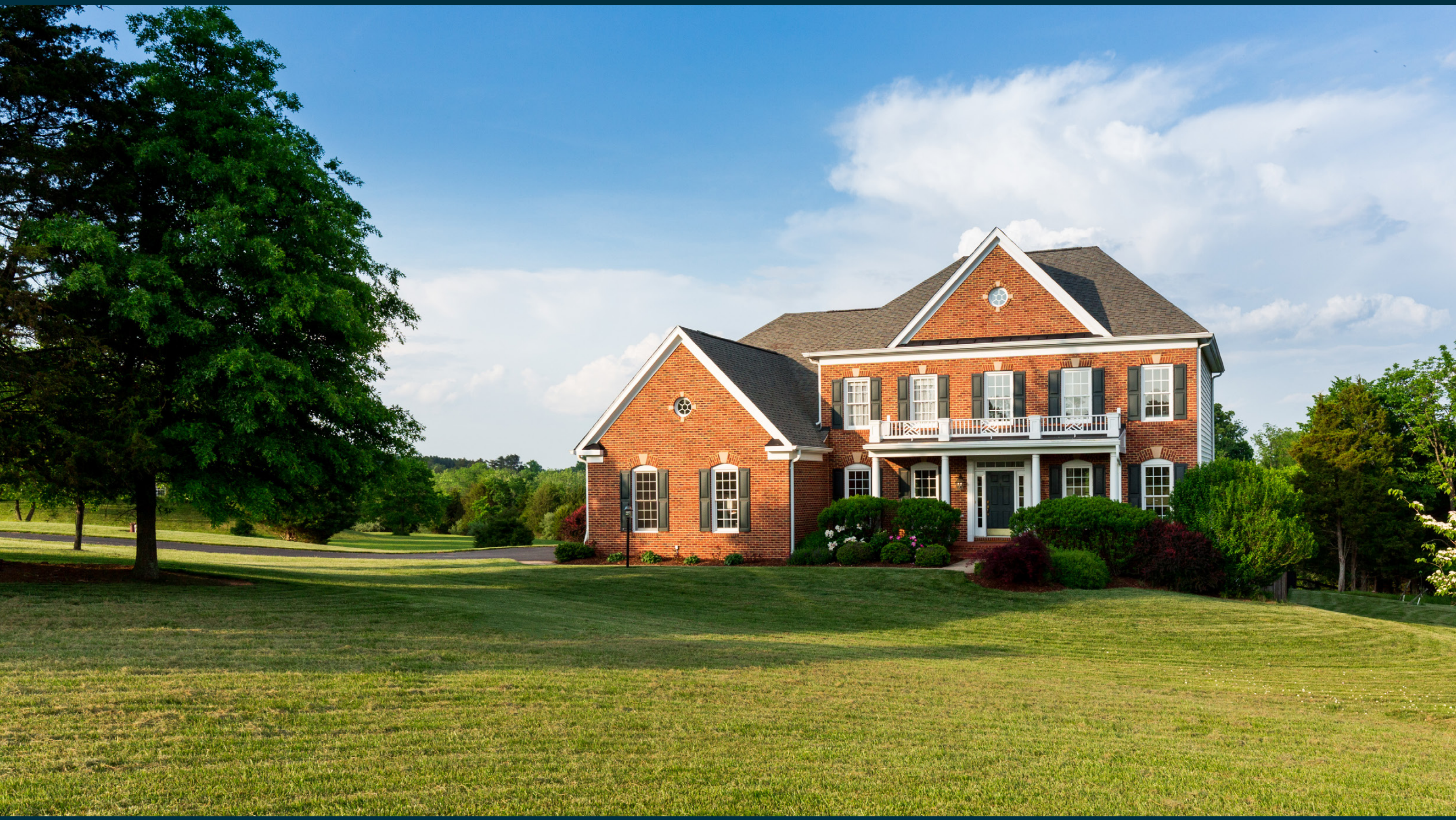

Office of Tax Simplification's Capital Gains Tax Review

The first of the Office of Tax Simplification (OTS) two reports on its Capital Gains Review was published on 11 November. The report covers the policy design and principles underpinning Capital Gains Tax (CGT) and recommends some major changes which advisers should be aware of.

The second report, which will follow early next year, will explore key technical and administrative issues.

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For professional advisers only

History of CGT rates

CGT was introduced in 1965 by Chancellor James Callaghan who said at the time that *'...gains confer much the same kind of benefit on the recipient as taxed earnings... [and]... the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator.'* Between 1965 and 1998 it remained at the flat rate of 30%.

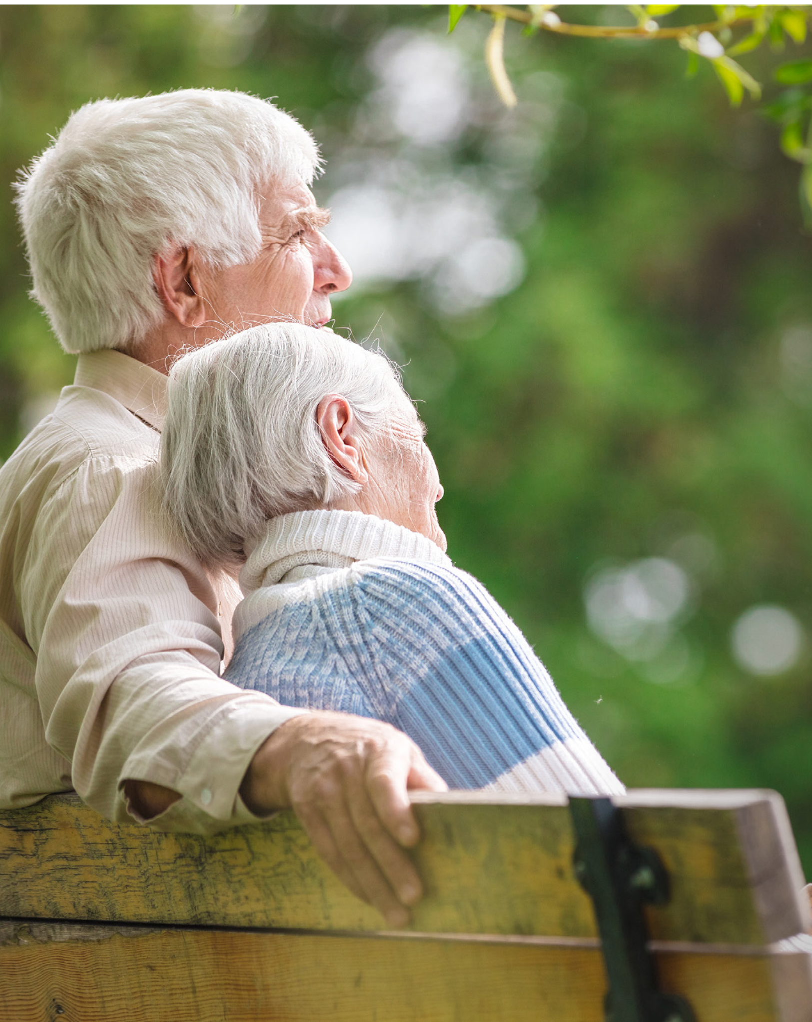
A threshold for taxing gains has been around in some form since 1977, when the Government exempted annual gains below £1,000. This exemption was renamed the annual exempt amount in 1980 and increased to £3,000; and in 1982 it was increased again to £5,000. The law now provides that the annual exempt amount is adjusted annually in line with the Consumer Prices Index. For the 2020/21 tax year the annual exempt amount is £12,300.

In 1982 the indexation allowance was introduced. This ensured that gains were adjusted to take out the growth in the value of the asset due to general inflation.

In 1988 the CGT rates were aligned with those of income tax (IT). The Chancellor at the time, Nigel Lawson, said, when aligning the rates with those for IT, that there is *'little economic difference between income and capital gains'* so income and gains should be treated along similar lines.

In 1998 the indexation allowance was replaced by Taper Relief which reduced the percentage of the chargeable gain to 25%, over time reducing the rate of tax from 40% to 10% for a higher rate taxpayer. At the time Chancellor Gordon Brown said, the *'capital taxation system should better...reward risk taking and promote enterprise.'*

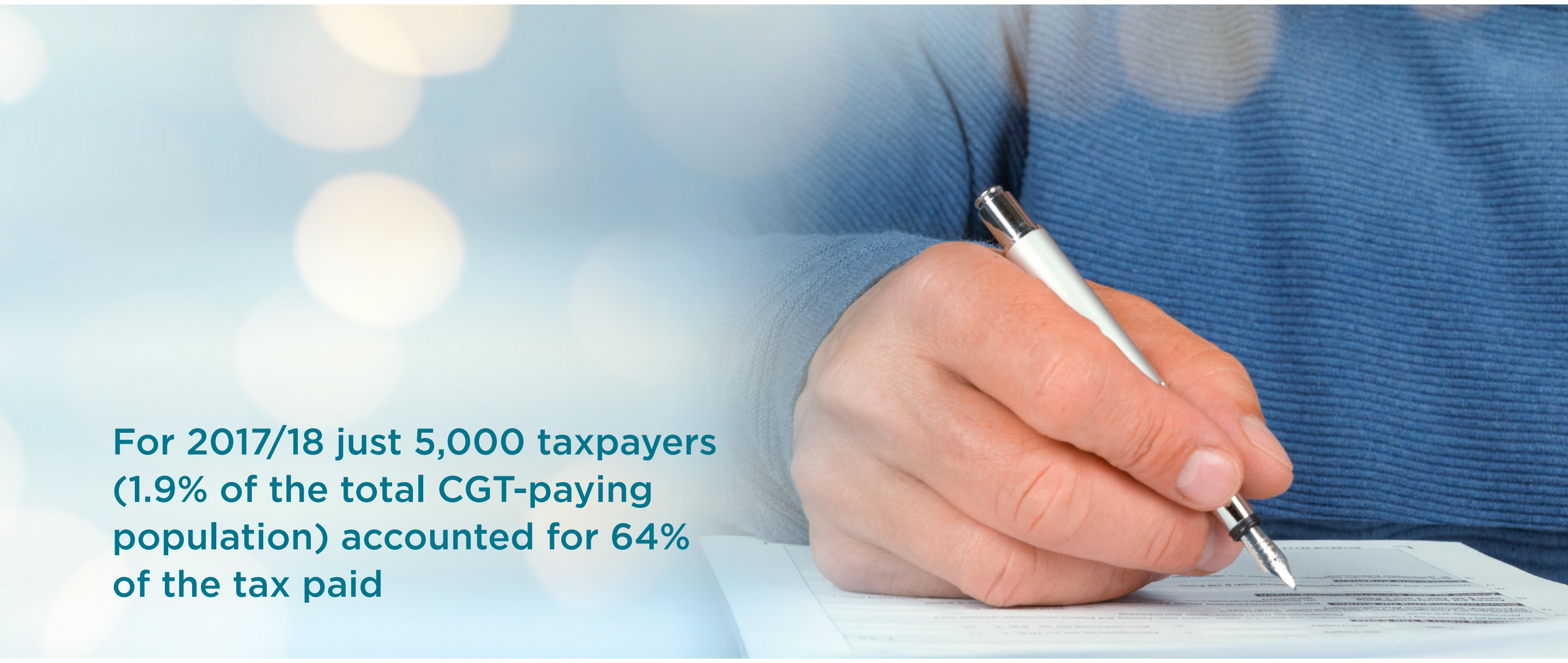
From 2008 to 2010 CGT reverted to a single, though a much lower, flat rate of 18% and since 2010 it has been loosely connected to IT bands but set at lower rates. The rates currently applicable are 10%, 18%, 20% & 28%.



So why consider making changes now?

The report highlights how the CGT rules can distort behaviour and do not meet their policy intent, including their interaction with IT and Inheritance Tax (IHT). For example, an individual may defer passing a business down the family line until death as it avoids CGT and IHT. This delay is driven by the tax consequences and not necessarily what is best for the future of the business. Another example is the lower rates of CGT can act as a motivator for owner managed companies to retain accrued income within their company in the hope they can benefit from these lower rates on selling or winding up the business.

It's also worth noting that whilst increasing government revenues is outside of the OTS's remit, their recommendations can create the opportunity to do so. Based on the current need to boost the Treasury's coffers the timing of this report, which was rushed through, has led many commentators to take the view that this may well be the precursor for change.



For 2017/18 just 5,000 taxpayers (1.9% of the total CGT-paying population) accounted for 64% of the tax paid

So what changes are recommended?

The OTS recommendations cover four areas for consideration by the Government:

1. **Rates and boundaries** The Government should consider more closely aligning CGT rates with IT rates as has been done in the past. This would likely also mean reintroducing a form of relief for inflationary gains (indexation allowance).

   The alignment of CGT rates with IT rates could raise an estimated additional £14 billion a year for the Exchequer. However, it is unlikely that this amount would be raised in practice, due to behavioural effects such as people delaying disposals and other changes that might be made such as allowing for inflation. For 2017/18 just 5,000 taxpayers (1.9% of the total CGT-paying population) accounted for 64% of the tax paid. This important minority are likely to take advice and can normally afford to defer disposing of assets, so their behaviors will have a major impact on the amount of additional tax revenue that can be raised.

   If the rates are to be closely aligned, the OTS sees a case for considering a more flexible use of capital losses, in particular an extension of the range of situations in which they can be offset against income.

It's also worth noting that a closer alignment of rates would also reduce the need for complex rules to police the boundary between income and gains.

If there is to be no such alignment then to make CGT liabilities easier to understand and predict, the OTS recommended that reducing the number of rates and the extent to which liabilities depend on the level of a taxpayer's income.

There would also be a need to address the boundary issues between CGT and IT. It is apparent that the value of the shares in a trading company derives, at least in part, from work performed by its employees or by owner-managers. There are two key areas in which at least some of the reward for such labour is capable of being deferred and accumulated into the value of shares the gains on which, when sold, are subject to CGT rather than to IT. So, if there is to be no alignment of rates the Government should considers addressing CGT and IT boundary issues, by:

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

2. **The annual exempt amount** The OTS believes that the relatively high level of the annual exempt amount distorts investment decisions. In tax year 2017/18, around 50,000 people reported net gains close to the threshold demonstrating that using the annual exempt amount as part of tax planning is standard practice.

   The OTS think that the annual exempt amount should be reduced to a level so that it operates only as an administrative de minimis.

   HMRC estimates show the administrative and revenue impacts for tax year 2021/22 of reducing the annual exempt amount to a lower threshold, would mean that:

   - a reduction to £6,000 would result in 235,000 more individuals needing to report a capital gain and could generate £480 million in additional revenues in the first year.
   - a reduction to £2,500 would result in 360,000 more individuals having a requirement to report a capital gain and could generate £835 million in additional revenues in the first year.

   Based on the data presented in this report, a true de minimis level could lie in the range £2,000 to £4,000, below which the extra administrative burden begins to increase more steeply.

   If the Government does reduce the annual exempt amount, it should do so in conjunction with:

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

3. **Capital transfers** Where a relief or exemption (for businesses, farming businesses, and assets passing to a surviving spouse) from IHT applies, the OTS have previously expressed the view that the capital gains uplift on death should be removed, and instead provide that the recipient is treated as acquiring the assets at the historic base cost of the person who has died (no gain no loss basis). They now suggest going further by widening the removal of the capital gains uplift on death even where IHT is payable.

   The reasoning behind this is that the OTS considers that at present the way the two taxes interact is incoherent and distortionary. Comparable transactions can lead to situations where either one, both or neither of the taxes arise. For example, an individual can pass shares, which are pregnant with gains, to their spouse on a no gain no loss basis. If the recipient spouse was terminally ill at the time and subsequently died, and if the shares were then inherited by the spouse there is no IHT due as the spousal exemption and the gains on the share portfolio are wiped out with no CGT implications.

   Gifting assets can attract CGT. The OTS has heard that this can impede intergenerational transfers and is a barrier to the economic use of some assets. So, if the Government removed the CGT uplift on death, the OTS consider it should also extend Gift Holdover Relief to a broader range of assets.

   While a no gain no loss approach on death would reduce a major distortion, it would increase the range of occasions on which there would be an administrative challenge in calculating historic base costs. So, if the capital gains uplift on death was removed, the OTS considers the Government should look at a rebasing of all assets, perhaps to the year 2000.

4. **Business reliefs** The government should consider replacing Business Asset Disposal Relief (BADR) with a relief more focused on retirement.

   The OTS considers that there is still a strong case for the existence of a CGT relief in relation to retiring business owners, particularly those who founded or scaled up their company. However, BADR is currently broader than this, and so would require reform were it to specifically address this objective.

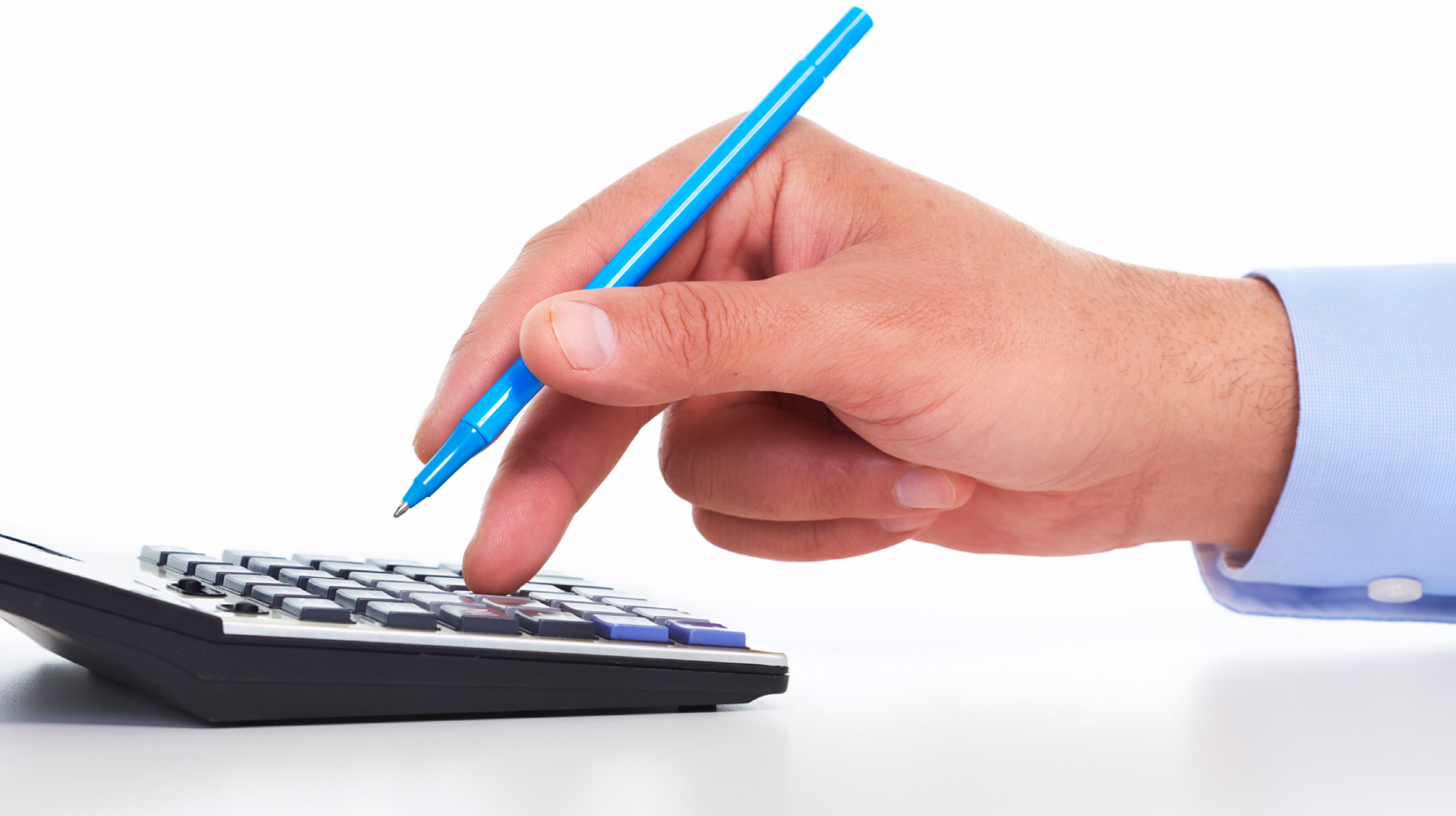
   The OTS suggests that the Government start by considering:

   - increasing the minimum shareholding to perhaps 25%, so that the relief goes to owner-managers rather than more passive investors
   - increasing the holding period to perhaps 10 years, to ensure the relief only goes to people who have built up their businesses over time
   - reintroducing an age limit, perhaps linked to the age limits in pension freedoms, to reflect the intention that it should mainly benefit those who are retiring.

Investors Relief was announced at the 2016 Budget with the aim of incentivising external investors to invest in unlisted trading companies.

The OTS recognises that Investors' Relief is a new relief, which investors have been able to claim only in relation to investments made from April 2016 onwards and disposed of from April 2019 onwards. Evidence relating to the extent to which relief has been claimed to date is therefore limited. However, the OTS has received many responses advising that this relief is simply not being used. These responses came from a wide range of people including investor groups, accountants, lawyers and individuals and their message was virtually unanimous – almost no-one has shown any interest in this relief, or is using it. This evidence is further supported by the results of the OTS's online survey, with only 5% of those responding indicating that they would envisage using this relief.

If the relief is not being used, then the relief is not having its stated policy effect (to enable unlisted trading companies to secure additional investment) and so the Government should abolish it.



Conclusions

With the Treasury looking at ways to meet the cost of funding the financial support given during the pandemic, CGT has always been seen as a potential target. The speed at which this report has been produced has added fuel to the fire.

The potential prospect of CGT rates increasing, a reduction in the annual exempt amount and the loss of capital gains uplift on death will provide challenges for future tax planning. It may also encourage, whether wisely or not, individuals to decide to create gains now and be taxed under the current rules rather than risk paying higher rates in the future.

But it's not all bad news. The potential to offset capital losses against income in a wider range of situations, the ability to gift assets pregnant with gains and claim Gift Holdover Relief and a return to a form of retirement relief all create new opportunities.

It's important to remember that none or only some of these changes may come into play. What is key for advisers is that where their clients may be impacted by such changes, they are made aware and a rational discussion on what action, if any, should be considered.

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