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The Office of Tax Simplification Capital Gains Tax report

UHY's insights and perspective

Helping you prosper

This summary paper details the 11 recommendations made in the OTS report of 11 November 2020 into the simplification of the Capital Gains Tax regime and offers our UHY view on those recommendations. It then sets out, in the form of some anticipated FAQ's, the thought processes we think our clients might adopt in light of the OTS report.

Whilst the recommendations are neither published government policy nor draft legislation, the fact the report was commissioned by and delivered to the Chancellor, the blunt and unambiguous nature of the recommendations and the wider context of the need for tax increases to pay for COVID support packages lead us to take the report seriously and to view it as a decent barometer for the direction of travel in capital taxes.

The OTS recommendations are copied word for word, with the UHY view shown after each recommendation.

Recommendations

1. Alignment with Income Tax

"If the government considers the simplification priority is to reduce distortions to behaviour, it should either:

- consider more closely aligning Capital Gains Tax rates with Income Tax rates, or
- consider addressing boundary issues as between Capital Gains Tax and Income Tax."

The first of these doesn't take a lot of dissecting. Headline Capital Gains Tax rate of 20% whilst income is taxed at 20%/ 40%/ 45% and the report quoting Professor Freedman that "the sharper the difference in treatment between capital and income, the greater is the opportunity for arbitrage".

The potential for increased rates of Capital Gains Tax is clear and the implementation is both easy and likely to be much more popular with the public at large than, say, increases to income tax or NI.

The second bullet point is more subtle, but the report focusses on greater efforts to tax both share based rewards to employees and the retained profits of owner managed businesses – see point 4.

2. Inflation, companies and losses

"If the government considers more closely aligning Capital Gains Tax and Income Tax rates it should also:

- consider reintroducing a form of relief for inflationary gains,
- consider the interactions with the tax position of companies, and
- consider allowing a more flexible use of capital losses."

Previous systems of inflationary relief have been indexation relief (which was the better of the two for pure investors) and taper relief (which more favoured entrepreneurs and owner managers), and the way in which life assurance gains reflect the time period over which gains build up is through top-slicing relief. Each system has pros and cons, and any form of relief might soften the blow of starkly increased headline tax rates.

The reference to companies (and the report dwells particularly on family investment companies) suggests that seeking to sidestep any changes through incorporation might bring only short lived advantage.

More flexible use of losses (presumably to offset against income) seems a reasonable proposition if gains and income are taxed in-a like manner.

3. Number of Capital Gains Tax rates

"If there remains a disparity between Capital Gains Tax and Income Tax rates and the government wishes the simplification priority is to make tax liabilities easier to understand and predict, it should consider reducing the number of Capital Gains Tax rates and the extent to which liabilities depend on the level of a taxpayer's income."

On the one hand this is a genuine simplification, removing the lower rate (10% generally, 18% for residential property) of tax on gains which remain within a taxpayer's unused basic rate band for income tax. On the other hand the most likely alignment method is to just remove that lower rate of tax, leaving lower earning taxpayers who make one off gains taxed more stiffly than is currently the case.

4. Owner Managed Businesses and share-based rewards

"If the government considers addressing Capital Gains Tax and Income Tax boundary issues, it should:

- Consider 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 accumulated retained earnings in smaller companies, at Income Tax rates."

These are both worrying suggestions for our clients. Starting with share based payments, most unstructured transactions in employment related shares are already exposed to income taxes. Those which are not taxed in that way are ones to which specific tax advantaged schemes, designed to promote employee engagement in their employer business, apply. The report takes a broad view across approved and unapproved share schemes as well as variants like the use of growth shares. Our view is that implementation of this recommendation is likely to both add complexity to an already hugely complex area of tax law and to reduce the opportunities to use tax stimulated measures to retain and motivate key employees.

As to taxing accumulated retained earnings of owner managed businesses, the report considers the alternatives of building on existing anti-phoenixism and anti-moneyboxing rules. For instance taxing retained profits on sale or liquidation as dividends, or returning to something akin to close company apportionment (for older readers) whereby profits of close companies, which are retained rather than paid out as dividends, are taxed more aggressively within the company.

5. Annual exemption

"If the government's policy is that the Annual Exempt Amount is intended mainly to operate as an administrative de minimis, it should consider reducing its level."

Within the body of the report a sweet spot of £2,000 - £4,000 is considered. Most people view the annual exemption not as an administrative de minimis but as the capital equivalent to the income tax personal allowance. Whilst it is true that many people 'using' their exemption each year will simply modify their behaviour, a reduction such as this would represent a noticeable tax hike for those who make taxable gains.

6. Exemptions, real time and automated reporting

"If the government does reduce the Annual Exempt Amount, it should do so in conjunction with:

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

It's hard to get too excited about the first bullet point. The current rules are not well understood and have been eroded by inflation to the point of near obsolescence. A re-write would be welcome albeit every exemption creates a grey area as to what is and isn't included and rules changes wipe out useful case law precedent as a reference point.

The other two bullet points are much more in line with current trends towards acceleration, digitisation and automation of the tax system. Since 6 April 2020 the sale of residential property must be reported (and tax paid) within 30 days of sale and recommendations in that vein are likely to be popular with the Treasury.

Where accelerated reporting leads, accelerated payment follows and these recommendations could be the thin end of a wedge which ultimately sees tax withholdings on capital transactions.

7. Inheritance Tax on businesses and farms

"Where a relief or exemption from Inheritance Tax 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."

After the 2019 OTS review of Inheritance Tax, this suggestion was one we fully expected to see in the report. Far from simplification it flies in the face of other recommendations of the 2019 report on record keeping and time periods. But nonetheless the logic for it is sound. The idea of the uplift (whereby those inheriting assets are treated as acquiring them at probate value) is to prevent both Capital Gains Tax and IHT being paid on the same asset. The idea of BPR and APR (the reliefs sheltering certain assets from IHT) is to prevent businesses and farms from having to be sold to pay IHT. So why should the death offer both a relief to prevent sale and a relief from taxing such a sale?

To a certain extent this proposal moves to align transfers on death with those made during lifetime (under holdover relief) and whilst not welcome, it is not unreasonable.

8. Inheritance Tax on everything else

"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."

This is best illustrated with an example, we think. Take Yasmin who, as well as having a home worth £1m, bought shares in Zoom five years ago for £1m and died still owning those shares when they were worth £2m. Under this proposal her children inherit those shares and have a 40% Inheritance Tax bill of £800,000 to pay on them. They are not an asset on which instalments of tax are available and so the only way the tax bill can be funded is to sell the shares. Selling crystallises the £1m gain built up over Yasmin's 5 year ownership period and with Income Tax and Capital Gains Tax rates harmonised that gain is taxed at (say) 40%, another £400,000.

Call us cowards, but we don't fancy being the ones to tell the grieving children that of their £2m shareholding they're only getting £800,000 as the other £1.2m is going to the taxman. Nor that if Yasmin had stuck her £1m cash in a tin under the mattress five years ago, whilst she'd have lost the £1m investment growth the tax bill on her death and the sale of the shares would have been £800,000 lower.

We concede to being slightly unfair in this example – the report proposes an IHT reduction to reflect the pregnant Capital Gains Tax liability existing in the assets at date of death and makes attempts to ensure the Capital Gains Tax free status of the deceased's home is preserved. But notwithstanding those points, the concept of both Capital Gains Tax and IHT being payable on the same value, we think, will be a worrying thought for readers.

9. Gift Relief and asset rebasing

"If government does remove the capital gains uplift on death more widely, it should:

- consider a rebasing of all assets, perhaps to the year 2000
- consider extending Gift Holdover Relief to a broader range of assets"

Rebasing refers to the gain pregnant in an asset held by its owner before a certain date being wiped out, with only growth in value since that date being taxed on a sale. Current rebasing applies to assets held since March 1982. Whilst not an unwelcome notion, we doubt it will go any distance towards making up for the double IHT and Capital Gains Tax charge proposed under heading 8.

Gift Holdover Relief is a deferral relief currently only available for (in the main) business assets. It is true that the crystallisation of capital gains tax bills on the lifetime gifting of assets within a family is often an impediment to such successions and that making holdover relief more widely available ought to remove that impediment. This feels very much like the carrot to the stick of bullet point 8, and taken together they would not only stop discouraging lifetime transfers of assets but would strongly push taxpayers towards such lifetime transactions.

10. BADR (Entrepreneurs' Relief as was)

"The government should consider replacing Business Asset Disposal Relief with a relief more focussed on retirement."

I'm starting to wonder whether the members of the OTS wear rose tinted glasses, with yet another of their proposals sounding familiarly like the tax policy of the 1970s-1990s. When the Entrepreneur's Relief (as it then was) lifetime limit was cut from £10m to £1m earlier this year our first thought was that we were watching 'slash then abolish' tactics, and the OTS now seem to be promoting that abolition. The report talks of a replacement requiring 25% ownership (currently 5%), 10 years eligibility (currently 2) and a minimum age threshold (currently none).

The relief currently offers up to £100,000 of tax saved where it used to offer up to £1m of tax saved, and so is rather a less sought after a relief than it used to be. Nonetheless, a successful young business owner thinking of selling their self-made £10m tech company would a year or two ago have been looking at a tax bill of £1m and could now be looking at a tax bill of £4m or more.

11. Investors' Relief

"The government should abolish Investors' relief."

Short and sweet, that one. And we're not inclined to disagree with the comment in the report that "The OTS has received many responses…The message was almost unanimous – almost no-one has shown any interest in this relief or is using it". And as long as the EIS and SEIS schemes exist (how would you prefer your investment? A tax free gain and some income tax relief, or a 10% taxed gain and no income tax relief?), why would they?

Anticipatory FAQs

Tax rates are going up, so should I be selling my investments now?

Those with investments standing at a gain should also be taking stock. Crystallising the gain and paying a 20% charge may be unwelcome, but might prove a sensible mid-term decision, especially if the cashing in frees up investment strategy decision making during these tumultuous times.

As a business owner, how does this affect me?

There are a number of ways you could be affected:

- the type of close company apportionment being discussed could lead to higher taxes charged on retained profits. This might influence your approach to dividend payments, other profit withdrawal mechanisms, or even the ownership of the business within the family
- the changes in tax rate and proposals to end BADR are almost certain to mean higher taxes on any sale of the business
- lifetime transfers of business ownership are likely to become more tax favoured than retaining a business and letting it pass on death, which may impact your succession plans
- certain types of business might encounter higher taxes on sales of assets (investments, real estate etc) if rules to more closely align corporate and personal gains are introduced.

In all cases the effects will be circumstance dependent and general guidance will not be a substitute for individual advice.

I own buy to let properties in place of a pension. Am I going to suffer because of this?

These seem exactly the types of asset likely to suffer most at the hands of a system that charges both inheritance tax and capital gains tax on the same assets. But even without these new proposals it is likely that your buy to let portfolio could lead to a substantial inheritance tax exposure, and that you'd benefit from reviewing the situation to see what improvements could be made whilst preserving sufficient monies for your income needs into retirement.

As a business owner planning my retirement, how does this affect me?

Business owners with an imminent sale or retirement should be re-assessing their situation. Locking into current tax rates and £1m of BADR is a good incentive to accelerate or complete transactions and the threat of being charged income tax on retained earnings brings a second layer of jeopardy to delaying.

I'm selling my business at the moment. What should I do?

As above, locking into current tax rates and £1m of BADR is a good incentive to accelerate or complete transactions and the threat of being charged income tax on retained earnings brings a second layer of jeopardy to delaying.

I've been reading about Family Investment Companies. Are they the simple solution?

In a word, no. The report makes significant reference to reviewing company tax to reduce the scope of disparate treatment of similar investments made via a company and in a personal capacity. That's not to say family investment companies are now defunct, and they may offer a range of tax, control, protection and administrative benefits to families whose circumstances suit their use.

We've hung onto our family business even though it's now run by the children. Are we worse off because of these changes?

The changes aim to remove the perceived Capital Gains Tax impediment to lifetime transfers of assets. It's possible that lifetime transfers and transfers on death will become treated more equally, but for non trading (i.e. investment holding entities) it is equally possible that transfers on death will become punished when compared to lifetime transfers. What seems most unlikely is that a lifetime transfer will leave you (in tax terms) worse off. Of course, commercial and family needs ought to drive any succession decision, tax being just one factor. It sounds like you should be taking advice on your situation and your family and business aspirations.

This is bad news for farmers, isn't it?

Being agricultural specialists, you were one of the first groups of people we thought of. We've even put together a dedicated rural version of this guidance, here.

Should we be gifting our family home to our children?

Almost certainly not. The recommendations seek to accommodate the tax free status of a person's only or main residence despite the proposed double charge IHT and Capital Gains Tax being proposed. Gifting the property whilst remaining in occupation seems likely to both start building taxable growth in value where such growth is currently (capital gains) tax free, whilst not achieving any inheritance tax advantage due to existing loophole closing legislation.

When will these changes come into effect?

At present these are just recommendations by the OTS. To be brought into law they would need to be (usually) announced at a budget and then incorporated in draft legislation, typically a Finance Bill. It is unusual, but not unheard of, to have a mid-year change in Capital Gains Tax rate (happened last in 2010 after the general election) but we'd anticipate announcements no earlier than the Spring 2021 budget with changes effective no earlier than 6 April 2021.

I've already inherited an asset. Will there now be extra Capital Gains Tax if I sell it?

We won't know until any announcements are made / legislation is published, but we'd be extremely surprised if there weren't grandfathering provisions such that only deaths on or after the announcement date were affected by any new rules. Any deaths prior to that would be expected to be taxable under the current rules.

I paid Capital Gains Tax on the gift of an asset recently. Will I be able to recover it if holdover becomes more widely available?

As above, we'd be very surprised if the new legislation doesn't apply only to transactions entered into after it has been announced. So no, if you've already transacted under current rules you are almost certain to be taxed according to those current rules and won't be able to make a holdover claim under any new rules.

You've referred to real time Capital Gains Tax reporting. What is that and does it affect me?

Historically all capital gains tax reporting was done as part of an end of year self-assessment tax return (the one covering year to 5 April and due for filing by the following 31 January). Whilst that is still the case for most of our clients;

- Sales of residential property also need reporting through an online return within 30 days of sale
- Sales of any real estate and certain companies need reporting within 30 days if the seller is non UK tax resident
  - For details of both, see our flyer
- People not otherwise needing a tax return and making a one off gain can use a real time online Capital Gains Tax return service instead of registering for a self-assessment return for this purpose alone.

With plans for 'Making Tax Digital for income tax' back on the government agenda, this type of digitised and automated real time tax reporting is very much in fashion and we can expect to see more and more of it as time move on.

Aren't recommendations 1 and 3 contradictory?

Yes. And they're offered as an either/or by the report for that reason. The government are invited to choose between them by deciding whether understandability and predictability are more important than reducing distortions in behaviour.

I've got brought forward capital losses. Will I now be able to reduce my income tax bill with these?

We doubt it. When corporation tax losses were made more flexible it became necessary to ring fence pre April 2017 losses from post April 2017 losses, each having its own set of rules. So if this proposal were introduced we're likely to have a two tier system for losses.

I've already made capital gains this year. Will my tax bill increase because of this?

As above, we'd be extremely surprised if any changes had retrospective effect. If you've already transacted you should consider yourself locked in to today's rules.

I sold my family company shares in December 2018, with part of the consideration being in loan notes, and I was advised that the gain I made in respect of the loan note element would not be taxed until the loan notes are repaid. Can I do anything to make sure that the those gains do not suffer the new higher rates of CGT?

For you and others like you who have received shares or loan notes in respect of a sale of shares and have had the benefit of holding over some or all of the gain arising, now may be the time to review the position and consider making an election to opt out of the holdover regime, whilst you are still able. The time limit for making elections for transactions undertaken in 2018-19 is 31 January 2021, so you may want to seek detailed advice sooner rather than later. For 2017-18 and earlier tax years, that opportunity has passed. For 2019-20 the opportunity still exists, but anyone with heldover gains on paper for paper transactions should think about reviewing their position ahead of any Spring 2021 Budget, just in case there are any anti-forestalling provisions announced.

Can any new legislation be retrospective?

Ordinarily only transactions undertaken either from the start of a new tax year or, in some cases, from the date of the Budget will be affected by new legislation. However, sometimes there has been some uncertainty and speculation about law changes and taxpayers have sought to take action to mitigate possible adverse impacts. For instance, this could be by exchanging contracts, the usual effective date for CGT, on a transaction ahead of Budget day, but completing, or failing to complete, after Budget day when the new rules are known about. In these circumstances, legislation sometimes includes anti-forestalling provisions, amongst which could be shifting the CGT-effective date of a contract to completion for certain transactions. This would give an element of retrospection compared with usual CGT rules.

The next step

If you would like further information on how this may affect you and to discuss how we might be able to provide guidance and support, please speak to your usual UHY contact or one of our specialists.

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