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Capital Gains Tax – what lies ahead?

In November 2020, following a request from the Chancellor, the Office of Tax Simplification ("OTS") published its review of the capital gains tax regime.

This first report is part of a wide-ranging review of capital gains tax, which considers high level views on policy design and the principles underpinning the tax. A further report is expected to be published early this year, which will consider more detailed technical matters and the future operation of capital gains tax.

If acted upon by the Government, the OTS's recommendations could result in fundamental changes to the regime and substantially more revenue for the Exchequer.

The proposals cover three headline matters: rates and boundaries, the interaction of capital gains tax with inheritance tax, and business assets relief.

Rates and boundaries

The OTS reports that if the Government's overriding objective is to simplify the tax system and reduce distortions to decision making, it should either:

- Consider more closely aligning capital gains tax rates with income tax rates. For higher rate taxpayers, this could mean an increase in capital gains tax from 20% (28% for residential property sales) to 40%; or
- Consider addressing boundary issues between capital gains tax and income tax.

The two key boundary pressure points mentioned in the report are the use of share-based remuneration and the accumulation of retained earnings in owner-managed businesses.

1. Share option schemes are used to incentivise key employees and, for tax advantaged schemes such as the Enterprise Management Incentive ("EMI") scheme, there are significant tax benefits which result in much lower rates than equivalent cash bonuses. The OTS did acknowledge, however, that there are justifications for non-neutrality with tax advantaged all-employee share schemes.
2. Business owners are taxed at lower rates of tax if they retain profits and realise the benefit on a sale or liquidation, as opposed to extracting those profits as dividends over a period of time. One suggestion is to tax some or all of the retained earnings on a sale or liquidation at dividend tax rates, rather than capital gains tax.

If the Government chooses to more closely align capital gains tax and income tax, other recommendations to address potential issues are:

- Consider reintroducing a form of relief for
- inflationary gains, similar to indexation relief that was removed to simplify capital gains tax when the rates were reduced. This will be welcome news if capital gains tax rates increase.
- Consider allowing a more flexible use of capital losses. Currently, most capital losses can only be set against capital gains arising in the same tax year or future tax years. This will likely only be adopted if gains are taxed at income tax rates.

If the Government instead wishes to address capital gains tax and income tax boundary issues, it should consider whether employees' and business owners' rewards from personal labour, as opposed to capital investments, are treated consistently and are taxed at income tax rates.

In addition to suggesting an alignment of capital gains tax and income tax, the OTS recommends a reduction in the tax-free annual exemption from £12,300 to £5,000. This will result in many individuals who use their annual exemption as part of their investment portfolio planning suffering more tax.

Interaction of capital gains tax with inheritance tax

There is currently a capital gains tax-free uplift in the value of assets inherited from a deceased person's estate. Beneficiaries are treated as acquiring those assets at their probate values and capital gains tax is only payable on any uplift in value from the date of death to the subsequent disposal of those assets.

The OTS recommends that, where relief or exemption from inheritance tax applies, the Government should consider removing the capital gains tax-free uplift on death. Instead, the beneficiary would be treated as acquiring the assets at the historic base cost of the person who has died.

This could have a significant impact on business owners and family succession since most trading businesses currently attract 100% relief from inheritance tax.

Thus, on the owner's death there is no inheritance tax payable and the beneficiary is treated as acquiring the business at its market value at the date of death. The OTS's recommendations, if implemented, would create substantial additional tax liabilities for most second or third generation business owners.

In addition, the OTS report states that the Government should consider removing the capital gains uplift more widely (i.e. on assets not qualifying for inheritance tax relief or exemption). The potential impact is illustrated:

Example

Assuming the deceased's historic base cost of an asset is, say, £1, but the market value at the date of death is £100. Inheritance tax at a rate of 40% would be £40. If it is necessary for the beneficiary to sell the asset to pay the inheritance tax, there would be a capital gain of £99 (i.e. £100 market value less £1 base cost).

Assuming the capital gains tax rate is also aligned with income tax, an additional rate taxpayer would have £45 to pay in capital gains tax, leaving the beneficiary with £15 (i.e. 15% of the value of the inherited asset).

The OTS recommends that if the capital gains uplift is removed more widely, the Government should consider a rebasing of all assets, perhaps to the year 2000 and to extend the availability of gift holdover relief on a broader range of assets.

Finally, the Chancellor substantially changed Entrepreneurs' relief in the last budget, reducing the relief from £10 million to £1 million per person as well as renaming it Business Asset Disposal Relief. The OTS have gone further and recommended that the relief should only apply on a retirement and that the Government should completely abolish another relief named 'Investors Relief' which currently taxes qualifying gains at a rate of 10% .

It is also suggested that the proposed 'retirement relief' applies to shareholdings of at least 25%, whereas the minimum shareholding for Business Asset Disposal Relief to apply is currently at least 5%.

Whilst the OTS' recommendations are not binding on the Government, there is the potential to raise billions of pounds to help fund the Government's response to the coronavirus pandemic. This will inevitably create uncertainty in the market and some people may decide to sells assets before the next Budget on 3 March 2021.

The next step

If we can be of any assistance or would like to discuss anything within this guide, do please get in touch with with Helen Cowley or contact your usual UHY adviser.

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