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An analysis of the OTS Capital Gains Tax report

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Tax analysis: Frederick Bjørn, partner at Payne Hicks Beach, analyses the Office for Tax Simplification's (OTS) report on Capital Gains Tax (CGT), reviewing its suggestions, next steps and the likelihood of legislative adoption.

What is the background to the publication of the OTS report?

The OTS was asked to review CGT to 'identify opportunities relating to administrative and technical issues as well as areas where the present rules can distort behaviour or do not meet their policy intent'. This report, published in November 2020, is the first of two reports that the OTS will produce and covers policy choices and principles to simplify CGT. The second report will consider the technical detail.

What are the main recommendations in the report?

The OTS makes 11 recommendations by reference to four areas where there are policy choices for the government to make. These are the rates of income tax and the boundaries between income and gains, the annual exempt amount, capital transfers and business reliefs. They are intended to reduce distortion, simplify administration and make CGT easier to understand.

What are the OTS's suggestions in relation to CGT rates?

The OTS identifies that having lower CGT rates than income tax rates can distort decision-making and result in an unfair tax burden.

The OTS suggests increasing the CGT rates to align more closely with income tax rates. While this could raise substantial tax, there would also potentially be behavioural issues, in that CGT is only payable on a disposal of assets and in that respect is 'voluntary'.

If the rates become more closely aligned, the report sets out further suggestions including a relief for inflationary gains (which is not a new concept). It also raises the need to consider the interaction with corporation tax (which is currently 19%) as there would be an incentive to hold assets through companies. The report also says that if disparity between the rates remains, the number of CGT rates should be reduced to two.

The OTS then proposes an alternative, which is to address the boundary issues between what is considered an income or a gain. It identifies two key areas in relation to this: the use of share-based remuneration; and the accumulation of retained earnings in smaller owner-managed companies.

What reforms does the OTS suggest to the annual exempt amount?

The OTS identifies three possible purposes of the annual exempt amount (which is currently £12,300)—as an administrative de minimis, as a relief comparable to the personal allowance for income tax, or as a way to compensate for inflation.

If the government decides the purpose of the annual exempt amount is as an administrative de minimis then the OTS calculates that it should be reduced to between £2,000 and £4,000. The report recognises that more people would be liable to pay CGT and so makes further recommendations to simplify the administration, most notably in relation to disposals of personal effects.

Why is the OTS in favour of removing the CGT uplift on death, and how would this work in relation to an individual's main residence?

The OTS is in favour of removing the CGT uplift on death because it found that the way IHT and CGT interact is incoherent and can lead to double, or no, taxation on comparable transactions. It is significant as 90% of wealth transfers on death. The OTS recommends removing the CGT uplift on death so that the person inheriting is treated as acquiring the assets at the historic base cost of the person who has died. The report suggests that a rebasing of all assets to the year 2000 would make such a change administratively simpler. The OTS also recommends widening CGT holdover relief to include non-business assets.

While this is understandable where there is no inheritance tax or IHT (such as on transfers to a spouse or on assets which qualify for business property relief), it could result in a situation where the same asset suffers both 40% IHT and a CGT charge at up to 45% on sale (which may be a necessity to pay the IHT!).

In relation to an individual's main residence, the OTS states that if the government adopts the approach above, the gains arising before death on a main residence should continue to be exempt. It could be achieved by ensuring the exemption continues where a sale is made by personal representatives or beneficiaries.

What does the OTS say about business asset disposal relief and investors' relief, and why?

The OTS proposes abolishing investors' relief as it is rarely used and does not appear to have had its stated policy effect, which was to assist unlisted trading companies in obtaining additional investment.

In relation to business asset disposal relief (or BADR, formerly entrepreneurs' relief), the OTS states that it is not effective in promoting entrepreneurship or stimulating investment and risk-taking. The report proposes using the relief specifically for when business owners retire (to acknowledge investment in a business rather than in a pension). Again, this is not a new idea.

In summary, the OTS suggests increasing the minimum shareholding for BADR to 25%, increasing the holding period to ten years and reintroducing an age limit.

What are the next steps for the OTS and for the government?

There is no obligation on the government to follow the recommendations. In any case, there will be a further OTS report exploring key technical and administrative issues. Also, the impact of any proposed changes will need to be considered in relation to trusts, which would be a significant hurdle due to the varying taxation between different types of trusts.

In your view, is it likely that all or any of the recommendations will become law, and what would be the likely timescale for this?

The most likely change would be an alignment, or at least an increase, in the CGT and income tax rates at the end of the 2020–21 tax year. The OTS clearly demonstrates the limited revenue raised by CGT when compared to income tax in its report, but the government needs to raise money. Any increase would make sense politically as it would raise money and is only likely to impact the wealthy.

The other recommendations are more likely to be considered in conjunction with a further IHT review, given the interaction between the taxes and the complexities of over-hauling the system. Although it is unlikely that the OTS's recommendations will be implemented exactly, the issues need addressing and are likely to be factored in to further reforms.

If all of the recommendations were enacted, which do you consider would have the greatest impact on taxpayers?

If all of the recommendations were to be enacted, it is likely that a loss of CGT uplift on death, while retaining a 40% IHT rate, would have the most serious impact.

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