Capital Gains Tax Review - First Report - Transactions implications

General

In July 2020, the Chancellor asked the Office of Tax Simplification (OTS) to carry out a review of Capital Gains Tax (CGT). The stated purpose was 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'.

The First Report, published on 11 November 2020 has recommended material and wide-ranging changes to CGT, more significant than many had expected based on the July request for evidence. The First Report notes that a second report will follow early next year exploring key technical and administrative issues.

Importantly, the First Report is not a proposal from the Chancellor or the Treasury. The Chancellor will review the recommendation of the OTS and consider what, if any, policy changes should be made. There is no fixed timetable for introduction of any of these recommendations, should Government accept them. The earliest likely point for their introduction would be in the Spring Budget 2021.

The First Report contains a historical and economic analysis of CGT. Controversially, it cites with approval research findings which question the very basis on which business owners are taxed, for example "…Several respondents argued that it was difficult from an economic point of view to see why the capital return on investment should general bear a lower tax burden than an income return on investment. The OTS has also been told that it can incentivise companies to maximise short term profit and cut back on larger term investment in order to boost their immediate value in the run up to a sale…" (p. 35).

Key points relevant to Transactions

Recommendations of relevance to M&A and transactional activity are as follow:

General alignment of CGT and Income Tax?

- The First Report does not insist the Government necessarily increases CGT rates to current income tax rates. However, it notes that a greater alignment of rates would reduce the need for complex rules to police the boundary between income and gains
- Should there be an increase in CGT rates, it recommends that the Government should accompany this with a re-introduction of relief for inflationary gains to conform with the indexation relief for companies, and potentially consider more flexible relief for capital losses against income sources
- The First Report does not appear to have taken forward the suggestion in the July call for evidence for a distinction between short term and long term capital gains. Irrespective of whether the Government adopts a general alignment of rates, there are specific recommendations for changes in two areas – share-based rewards, and small controlled companies, when in each case disposal gains reflect, in whole or in part, the value of retained earnings from labour

Specific change A: Management equity – tax more as income

- The First Report specifically highlights "growth shares" which are defined very broadly as shares designed to benefit only from increases in the company's value from the date on which they are created or a future date
- This could encompass management equity in institutionally backed holding structures, and also incentive shares issued to managers in private companies
- The First Report recommends to Government considering whether "more of the share-based rewards" should be taxed at income tax rates
- Potentially, looking back to the March 2020 changed to Entrepreneurs' Relief, this could lead to a c. 35% increase in the rate of disposal taxation on sweet equity as compared with last year, should these recommendations be accepted
- It is not entirely clear whether non-growth shares, such as shares held by the original entrepreneur, potentially rolled into a leverage acquisition structure would be wholly protected from these changes

Tax-advantaged share schemes

As part of addressing boundary issues between CGT and Income Tax, the Government is invited to consider whether a greater proportion of share-based rewards arising from employment should be taxed at income rates

Specific change B: Taxing retained earnings in small, controlled companies

- The First Report questions whether it is right that owner controlled businesses may retain earnings in a company, which are then included in the disposal value on sale, and taxed at CGT rates, also deferring the timing of taxation.
- Alternatively, under current law the proceeds may be extracted by a liquidation, potentially obtaining CGT treatment
- The First Report suggests that any changes might apply to "Small" companies under the Micro Entity company filing requirements. It also indicated that before changes are made in this area it would require a Government investigation of the types of businesses and taxpayers which are affected by the boundary between CGT and Tncome Tax
- Whilst the scope of any changes are not yet known, it is possible that shareholders of Owner Managed Businesses may experience a difference in the effective rate of tax when they sell or liquidate their company, irrespective of any wider alignment of CGT and Income Tax rates

Carried interests

Although no express recommendation is made in respect of carried interest, it appears likely that the logic put forward for growth shares and tax-advantaged share schemes is likely to extend to the taxation of carried interest.

Changes to disposal reliefs

- There is a proposal to abolish Business Asset Disposal Relief (the recent less generous version of Entrepreneurs' Relief) and replace with a relief more focused upon retirement. Already the relief was greatly limited in March 2020 so that the cap on lifetime gains benefited was £1m. However, now it is proposed to introduce any of the following further requirements:
  - Increase the minimum holding percentage e.g. to 25%;
  - Increase the holding period e.g. to 10 years; or
  - Introduce a minimum age limit to make more targeted retirement situations
- The abolition of Investors' Relief is proposed, the First Report's findings that take-up has been limited. This could have a material impact on non-institutional multi-investor structures, where relief is frequently relied upon

Other changes proposed

A variety of other recommendations are made, of reduced relevance to M&A activity. Among these are:

Capital Transfers

- Abolition of CGT uplift on death, to reduce incentives to defer disposal of assets that can be better put to use by unrelated persons
- Expansion of Gift Holdover Relief, to encourage the gifting of a broader range of assets during lifetime

General exemptions & reliefs

- Reduction of the Annual Exempt Amount, currently set at £12,300 for tax year 2020/2021 to a lower level which would bring more taxpayers and disposals within the charge of CGT
- Only if there is greater alignment of CGT and Income Tax rates, enabling capital losses to be utilised more widely to offset against income for tax purposes

There are also proposals to simplify the administration of CGT, should the Annual Exempt Amount be reduced, with many more taxpayers required to self-assess CGT. This could include formalising the administrative arrangements for the "real time" capital gains service and linking up these returns to the Personal Tax Account and exploring whether investment managers (and others) should be required to report CGT information to taxpayers and HMRC, to ease compliance for individuals.

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