

DRAFT LEGISLATION CAPITAL GAINS TAX SIMPLIFICATION

BACKGROUND

The Pre-Budget Report of October 2007 contained proposals for the radical reform and simplification of the Capital Gains Tax (CGT) rules. The centrepiece of these was the proposal to introduce a flat 18% rate of CGT and, controversially, to abolish taper relief, introduced in 1998 by the Labour Government to encourage entrepreneurial activity. Predictably, the proposed abolition of taper relief was met with a storm of protest from the business community and the private equity industry for whom the loss of relief for business assets, (delivering an effective 10% CGT rate after a two year ownership period), was a serious blow. The draft legislation was finally published on 24 January, along with a Treasury press release containing, presumably in partial response to the intense lobbying activity, outline details of a new 'tax relief for entrepreneurs', the draft legislation for which is expected in February.

The principal points are:

1. The introduction of a new relief for entrepreneurs, delivering an effective rate of 10% on the first £1,000,000 of cumulative gains on certain business assets.
2. Subject to the above, the introduction of a flat 18% rate of CGT for disposals after 5 April 2008.
3. The reduction of the maximum rate of CGT on gains of non-resident trusts attributed to UK resident beneficiaries from 64% to 28.8%.
4. The abolition of taper relief for disposals after 5 April 2008.
5. The abolition of indexation relief for disposals after 5 April 2008.
6. The abolition of the 'kink test' for assets held on 31 March 1982 for disposals after 5 April 2008.
7. The abolition of 'halving relief' for disposals after 5 April 2008.
8. Simplification of the identification rules for the sale of shares and other 'fungible assets' after 5 April 2008.
9. The repeal of certain anti-avoidance provisions which a flat rate of 18% makes superfluous.

Further detail on each of these changes is provided below.

RELIEF FOR ENTREPRENEURS

It appears that in announcing this new relief, the Chancellor has been swayed by concerns about the damaging effects of the abolition of business asset taper relief expressed so persuasively by the business community. The details released so far are sketchy and one major area of uncertainty is whether the £1,000,000 cumulative limit on the relief commences with disposals after 5 April or whether it will be necessary to take into account earlier disposals which qualified for business asset taper relief. However, the basic features of the relief are as follows:

- An effective rate of 10% on cumulative qualifying gains, achieved by applying a 4/9 reducing fraction to the gain and then charging the reduced gain at the 18% flat rate.
- The relief applies to business assets. This covers disposals of interests in a business or partnership, and shares and securities in a trading company in which the person making the disposal is a director or employee who has at least 5% of the ordinary voting share capital.
- This relief is a lifetime allowance capped at £1,000,000. It has yet to be confirmed that it will not be reduced by certain disposals of business assets before 6 April 2008.
- It seems that trustees may also be eligible for the relief if they own an interest in a business or partnership which a beneficiary with an interest in possession is involved in running, or they own a greater than 5% interest in a trading company of which the beneficiary is a director or employee.

It is clear from these skeleton details that the relief will not be available for small shareholdings held by employees, whether in listed or unlisted trading companies. Nor is it likely that it will be of benefit to managers of private equity funds. Many UK tax payers in the business world will see this limited concession as a significant disappointment and will regard the abolition of business asset taper relief as a retrograde step which will discourage entrepreneurial activity.

FLAT RATE 18% CAPITAL GAINS TAX

A flat CGT rate of 18% will apply to disposals of all other types of asset after 5 April 2008. It should be noted that this rate applies to individuals and trustees, and not to companies which will continue to pay Corporation Tax at the appropriate rate on corporate gains. The CGT rate for disposals up to 5 April 2008 is determined by the rate which would apply to the individual if the gains were income. Therefore, gains in excess of the annual exemption, as reduced by capital losses, are taxed at 10%, 20%, 40% or a combination of these rates depending on income levels. In reality, many tax payers paying CGT will have been paying income tax, and consequently CGT, at the 40% rate and the introduction of an 18% flat rate with effect from 6 April 2008 will be a significant improvement.

The introduction of the 18% rate for gains means that

there is now a substantial difference between the taxation of gains, and that of income, taxed at a top rate of 40%. In consequence, there is an incentive for tax payers to maximise gains at the expense of income. Any structure or financial product which seeks to convert income to capital gain can be expected to attract scrutiny. It is revealing that HM Treasury published a consultation document on 6 December 2007 entitled 'Principles-based approach to financial products avoidance', the focus of which were two generic products intended to deliver an income asset in the form of a gain. The hypothesis of the document was that tax should be applied having regard to the underlying asset rather than the legal structure containing the asset. It is possible that such a principle, if adopted, could be applied more broadly.

ATTRIBUTED GAINS OF NON-RESIDENT TRUSTS

Under UK anti-avoidance provisions, capital gains realised by certain categories of non-resident trust are subject to CGT at an effective rate of up to 64% when 'attributed' to UK resident tax payers. Most commonly but not exclusively, these tend to be trusts created by a UK domiciled individual before 19 March 1991 which initially escaped the 'settlor attribution' provisions, introduced on that date. Rather than being charged to CGT on the UK resident settlor, gains of such trusts only became subject to CGT when a UK resident and domiciled beneficiary received a payment of capital or a benefit from the trust. Under complex matching rules, gains realised previously by the trust were then attributed to the beneficiary, earlier gains being matched in priority to later gains. Provisions were introduced to increase the rate of CGT payable where there was a delay between the Trustees' realising the gain and their decision to confer a benefit or provide a capital sum. These were designed to discourage delays by providing a 10% increase in the normal rate of CGT for each year of delay, capped at a 60% increase after a six year gap (thereby increasing the 40% rate by a further 24%). There are currently many trustees of such trusts who feel inhibited from distributing capital to UK resident beneficiaries at such rates.

It has now been confirmed that the 18% base rate will apply to capital payments made to beneficiaries after 5 April 2008, even though they may be matched with gains that have been realised by the trustees before 6 April 2008, possibly calculated with the benefit of taper relief. This means that the maximum rate which could apply to a capital payment after 6 April 2008 will be 28.8%, where a payment or benefit is matched to a trust gain realised more than six years previously. This is a huge reduction of 35.2% and many trustees in this position will now wish to take advice on the improved tax analysis of payments to beneficiaries in the UK.

THE ABOLITION OF TAPER RELIEF

Gains on disposals which take place after 5 April 2008 will be computed without taper relief. As observed above, this means that there will in effect be an increase of 8% in the top rate of CGT for individuals disposing of assets which would formerly have

qualified as business assets under the taper relief provisions. Those planning a sale of their business over the next year or so will need to consider carefully whether their position might be improved by triggering a disposal by 5 April 2008 through a transfer to a connected party, such as a trust, if an external sale of the business cannot be achieved by that date. This would at least ensure that the benefit of business asset taper relief would be secured on the connected party transfer, so that the 18% rate would only apply to the uplift in value between the date of transfer and the external sale. There will be those who have already sold their business in exchange for loan notes which are 'non-qualifying corporate bonds', with or without an 'earn out' element which itself may be satisfied by the issue of a loan note. People in this position should take advice on whether it would be advantageous to assign or seek early repayment of the loan note by 5 April 2008, and should consider making an election to disapply the automatic roll over provisions applying to the earn out with a view to crystallising business asset taper relief. There are a number of important issues to address in relation to this type of planning, including the IHT consequences, and detailed advice will be essential.

Taper relief for non-business assets provided no reduction for assets owned for less than three years, and only a 40% reduction over the following seven years. In consequence, higher rate tax payers could reduce their effective rate of CGT from 40% down to a minimum of 24% after an ownership period of ten years. The application of a flat rate 18% to gains realised after 5 April 2008, without regard to period of ownership, is therefore a considerable improvement for those investors and is more in line with rates of tax on gains in other mainstream jurisdictions, such as the United States.

THE ABOLITION OF INDEXATION ALLOWANCE

Gains arising to individuals and trustees after 5 April 2008 will be computed without the benefit of indexation allowance (although it will continue for companies). When taper relief was introduced for individuals and trustees from April 1998, indexation allowance was frozen at that date. For any disposal after April 1998, indexation allowance was applied from the date of acquisition of the asset (or from 31 March 1982 if later) only up to April 1998.

Abolition of the indexation allowance will have a significant effect on the base cost of assets which were held at 31 March 1982 and sold after 5 April 2008. Currently, in computing the gain on disposal, the value of an asset on 31 March 1982 can be substituted for its original cost, and the application of the indexation allowance for the sixteen years from March 1982 to April 1998 has the effect of more than doubling the base cost. The abolition of indexation allowance will more than halve the allowable expenditure (on a disposal after 5 April 2008) of such assets. There will be some who are holding assets which, if sold on 5 April 2008 would give rise to a (non-allowable) loss but, if sold a day later, would give rise to a substantial CGT liability. Individuals who are still holding assets which were valuable on

31 March 1982 should review their options in this regard.

THE ABOLITION OF THE 'KINK TEST'

For disposals of assets after 5 April 2008 which were held on 31 March 1982, it will be mandatory to adopt the value of the asset on 31 March 1982 as the computational base cost. For disposals up to 5 April 2008, it is necessary to prepare two computations, one by reference to the 31 March 1982 value and the other by reference to the earlier cost of the asset. The calculation which gives rise to the smaller gain or the smaller loss is the one which is adopted, and if one calculation gives rise to a gain and the other a loss, then neither a gain nor a loss is treated as having arisen. The mandatory adoption of the value of the asset on 31 March 1982 therefore represents a simplification of the present process, but may prejudice some tax payers.

THE ABOLITION OF 'HALVING RELIEF'

The rules permitting a tax payer to calculate gains by reference to the value of the asset on 31 March 1982 were introduced in 1988. The intention was to ensure that any gain attributable to the period of ownership before March 1982 was exempt from CGT. However, these changes were prejudicial to tax payers who had received assets by way of gift before April 1988 under a hold over election from a donor who had owned the asset on 31 March 1982. The gain held over would have been computed on pre-1988 principles so that the donee effectively inherited the pre-March 1982 base cost of the donor. A later sale of the asset by the donee would thus trigger a gain computed by reference to an old historic cost, rather than the value of the asset on 31 March 1982. In an attempt to rectify this, the donee was permitted to increase his base cost by 50% of the gain held over on the transfer. This is what is known as 'halving relief'.

Halving relief is to be abolished for disposals with effect from 6 April 2008. This will not, however, disturb the base cost of an asset which has already been the subject of a holdover relief election where the gain held over has been computed with the benefit of halving relief (and indexation).

SIMPLIFICATION OF IDENTIFICATION RULES

The abolition of the 'kink test', indexation allowance and taper relief for disposals after 5 April 2008, and the introduction of the mandatory use of the 31 March 1982 value for assets held at that date, mean that it is no longer relevant to identify the date of acquisition of fungible or pooled assets, such as shares. Complex identification rules currently apply to the sale of shares, particularly where a portfolio shareholding has built up over a significant period sometimes with a history of multiple acquisitions and disposals. At present, it is necessary to identify a sale of shares with acquisitions in the following order of priority:

- shares acquired on the same day
- shares acquired in the 30 days following the sale (the 'bed and breakfast' anti-avoidance provisions)
- shares acquired since 6 April 1998, when taper relief was introduced, on a 'last in first out' basis
- shares acquired between 1 April 1982 and 5 April 1998, which were pooled
- shares acquired between 7 April 1965 and 31 March 1982, which were pooled
- shares held on 6 April 1965, on a 'last in first out' basis

For disposals of 'fungible' assets after 5 April 2008, a rationalised and simplified process of matching will replace the complex identification rules described above. Such disposals will be matched first with same day acquisitions and acquisitions in the subsequent 30 days, as above, but will then be matched with shares in a single pool with an aggregated pool cost. A straight forward pro rata basis will apply in apportioning pool cost to disposals.

Although the objective of simplification is no doubt laudable, the adoption of these rules will work particularly unfavourably for those holding fungible assets acquired at progressively escalating cost over time. Under the current rules, these individuals will have expected that disposals would be matched first with the assets purchased most recently (and at higher cost). The effect of pooling all acquisitions from 6 April 2008 will mean that the individual will have lost the flexibility to make modest gains through partial realisations. In some cases, the effects of this can be acute and unfair. This was pointed out to HMRC in the consultation process prior to the publication of draft legislation, and it was hoped that there might be the facility for an individual to elect to retain the old identification rules in relation to certain asset classes (such as partnership goodwill, shares in private trading companies etc). Clearly, this has fallen on deaf ears and any one for whom this change will create significant difficulties will need to take advice before 6 April 2008.

REPEAL OF ANTI-AVOIDANCE RULES

In consequence of the introduction of a flat 18% rate of CGT, certain anti-avoidance provisions relating to UK resident trusts have been rendered otiose and have therefore been repealed. There are currently provisions whereby the gains of UK resident trustees are attributed to and taxed on the settlor in circumstances where the settlor, the settlor's spouse or civil partner, or the minor children of the settlor are beneficiaries of the trust. Since the rate of 18% applies both to individuals and trustees, there is no difference between the CGT which the settlor and the trustees of a settlor-interested trust would pay. Capital gains which would have been attributed to the settlor under the current provisions will be taxed on the trustees for disposals after 5 April 2008.

NOTA BENE

This briefing is written in response to newly published material dealing with highly complex issues.

The information contained in this briefing does not constitute advice and is intended solely to provide the reader with an outline of the provisions. It is not a substitute for specialist advice in respect of individual situations.

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