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SIGNIFICANT CHANGES PROPOSED TO TAXATION OF INDIVIDUALS

A significant reform of one or more elements of the taxation of individuals seems to have been on the cards for a number of years. Substantial changes to the taxation of UK resident non-domiciliaries have already been implemented and a number of reports into the taxation of all UK individual taxpayers were commissioned even before the current pandemic arose.

Chancellor Rishi Sunak has promised there will be no tax rise "horror show", yet the huge cost to the economy of dealing (directly and indirectly) with COVID-19 inevitably makes radical changes seem like a realistic option, with potentially reduced political and social opposition.

INHERITANCE TAX

In January 2020, the All-Party Parliamentary Group for Inheritance & Intergenerational Fairness (APPG) published an informal report into inheritance tax (IHT) which made a number of radical recommendations over the abolition of the tax in its current form, to be replaced with a new system based on the taxing of gifts made during lifetime and on death.

Overview of the recommendations

IHT is almost universally disliked by the public as it is perceived to be too complex and unfair. Following two recent reviews by the Office of Tax Simplification (OTS) into potential reforms to the tax, the APPG report suggests replacing the current IHT regime with a flat-rate gift tax payable on both lifetime transfers and on death at a rate of 10%, increasing to a rate of 20% on death for estates in excess of £2m.

All gifts over £30,000 would trigger an immediate 10% tax charge

In addition to this sweeping change, all current IHT reliefs other than the spouse exemption and charity exemption would be abolished, including the complete removal of Business Property Relief (BPR) and Agricultural Property Relief. The ability under the current regime to make lifetime gifts to individuals without triggering IHT (subject to a "tail" if the donor dies within seven years of the gift) would also be removed. Instead, any gifts made in excess of an annual allowance of £30,000 would be subject to an immediate charge to tax at 10%, with all gifts in excess of £10,000 requiring compulsory electronic reporting. The annual £30,000 allowance would replace all of the other small allowances, including gifts out of excess income. This single annual allowance may provide simplicity but could significantly curb lifetime planning opportunities, particularly for high earners.

The "nil rate band" (presently £325,000) which can currently be set against gifts made in the last seven years of life and on death would no longer be available. This would be replaced

with a death allowance at a similar level to ensure that small estates not currently paying IHT would remain unaffected by the changes.

Together with changes to the IHT regime, the report suggests that the current tax free rebasing of assets at death for capital gains tax (CGT) purposes should be removed. Assets would instead pass on death at their original acquisition cost. This is likely to cause practical difficulties in ascertaining the original cost of long held assets.

The rules for trusts would also be simplified. A transfer to a trust would trigger a 10% charge (if over the £30,000 annual allowance) – there would be no nil rate band to mitigate this charge. An annual charge would be levied on assets held in discretionary trusts and when property comes out of discretionary trusts. The level of these charges is not addressed in the report.

Who would this affect most?

It would no longer be possible for entrepreneurs to gift business assets without an upfront tax charge

The abolition of BPR is particularly controversial and will have significant ramifications for current business owners. The APPG recommends that where tax arises on business assets, there should be an option to pay this in instalments over a 10 year period. This is likely to be of little comfort to those that this will affect. If the proposals are implemented, entrepreneurs will no longer be able to gift business assets without triggering upfront tax charges and so they should consider whether gifting would be appropriate while this option remains available.

The report also suggests that the concept of domicile should be abolished as a connecting factor for IHT. Instead, all individuals who have been resident in the UK for 10 of the preceding 15 years would be subject to UK IHT on their worldwide assets. When coupled with the report's proposed changes to trusts established by non-domiciliaries, this is likely to bring a lot of people within the UK IHT net for the first time and may have a material impact upon planning opportunities.

CAPITAL GAINS TAX

On 11 November 2020 the OTS published its report on CGT which was commissioned by the government in July 2020. Like the APPG in relation to IHT, the OTS has proposed sweeping changes to the current structure of CGT which, if implemented, would change the face of the tax and the current planning opportunities it affords.

Overview of the recommendations

The OTS's starting point is that CGT is an inefficiently designed tax because it is "counter-intuitive, creates odd incentives, or creates opportunities for tax avoidance."

The OTS recommends that CGT and income tax rates should be more closely aligned

The recommendations are intended to create a more neutral tax which does not lead to distortions. It recommends that the rates of tax for CGT and income tax should be more closely aligned (at the higher income tax rates rather than the lower CGT rates). Alternatively, or in addition, the report recommends that further work should be done to establish the boundaries between the two taxes. This would prevent much of the tax planning that can currently be undertaken to classify transactions as capital rather than income in nature. One notable example given is to consider taxing more share-based employment remuneration schemes at income tax rates. For individuals who would thereby end up paying income tax at the highest rate, this could mean a 45% tax rate as opposed to the current 20% for CGT. To relieve some of the associated pain, the report does include a recommendation for a relief from tax on inflationary gains.

The report considers the annual exempt amount (currently £12,300 per annum) and its intended purpose, noting that it is not clear what exactly this is – whether an administrative de minimis, or a relief akin to the personal allowance for income tax. Assuming it to be an attempt at an administrative de minimis, the OTS concludes that this is too high, and should more realistically be set at around £2,000 - £4,000 per annum. The OTS does, however, note that in order to deal with the far higher number of CGT returns that would subsequently be made, the administrative processes would need to be significantly improved.

The OTS concludes that the interaction between CGT and IHT is "incoherent and distortionary"

A key criticism of CGT by the OTS is in relation to its interaction with IHT, which was concluded to be “incoherent and distortionary”. At present, the question of whether either, both or neither taxes is payable in relation to a certain transaction depends on the timing of the transaction (i.e. during lifetime or on death), the nature of the asset and whether any reliefs are available, and the recipient of the asset. The OTS recommends that, certainly where an IHT relief or exemption applies, and potentially in all cases, the current capital gains “uplift” on death (whereby the recipient acquires the asset at the value on the date of death, without paying any CGT, thereby effectively rebasing it to the value at the date of death) should be abolished, and that the recipient should be treated as acquiring the asset with its historic base cost. To counteract some of this added tax burden - as well as some of the difficulty in ascertaining these historic base costs - the report suggests a rebasing of all assets, potentially to the year 2000.

The report also takes aim at two key reliefs from CGT: Business Asset Disposal Relief (BADR – formerly Entrepreneurs’ Relief) and Investors’ Relief. The OTS considers that, as an attempt to stimulate business investment, BADR is “mistargeted” and recommends that it should be replaced with a different relief which is targeted at assisting individuals with businesses when they retire (i.e. those whose business is effectively an alternative to a pension). The relatively newly introduced Investors’ Relief is given even less backing, with a conclusion that no-one is interested in using it and it should therefore be abolished.

Who would this affect most?

In its report the OTS notes that, in comparison to income tax, CGT is paid by far fewer people (265,000 against 31.2m in the 2017/18 tax year) but with a mean liability of over five times as much (£32,000 against £5,800, again in the 2017/18 tax year). It seems likely, therefore, that changes to the structure and rates of CGT will affect relatively few people in terms of the population as a whole, but those who are affected may well face significant tax bills.

In particular, owner-managed companies as well as companies and employees who make use of share-related remuneration structures would see significant shifts in the tax landscape and potentially far higher rates of tax. In addition, individuals inheriting certain assets (particularly business assets) would pay more tax on a subsequent disposal, while owners of business investments may wish to consider reviewing their asset base while BADR exists in its current form (and Investors’ Relief exists at all).

Individuals should take stock of their current asset base, any holding structures and general estate planning in readiness for potential change

NEXT STEPS

While neither report is an official publication from government, they do both show a potential direction of travel which, with the growing need to bolster the Treasury’s balance sheet, seems increasingly likely to be implemented to some extent by the government.

In addition, a Wealth Tax Commission was established in Spring 2020 to consider proposals for a possible UK wealth tax. The Commission’s final report was published on 9 December 2020. While the notion of such a sea-change in the UK tax landscape may have seemed unthinkable a year or two ago, it is now a real possibility with the Commission recommending a wide-reaching one-off wealth tax encompassing all of an individual’s assets including primary residences and pensions, which might previously have been thought of as untouchable. See our briefing note “Wealth Tax Commission Report – A Potential Tax on Wealth Takes Shape” for more information.

Substantive changes to legislation (or wholesale new legislation in the case of a wealth tax) would usually be accompanied by a consultation. However, pressure to start rebalancing the finances of the country (and to reduce the scope for individuals to take action to avoid falling with the scope of any new or altered taxes) could see changes implemented sooner rather than later, particularly where they will affect higher net wealth individuals more than those seen as less able to afford it. As such, we recommend that individuals start to take stock of their asset base and gather together what records they can so that they are in the best possible position for these to be reviewed as and when more details are known.

KEY CONTACTS

For further information about any of the issues raised in this guide, please contact:

Daryl Fox
Partner
T: +44 (0)1483 401253
M: +44 (0)7795 158179
E: daryl.fox@stevens-bolton.com

Rosie Todd
Partner
T: +44 (0)1483 406967
M: +44 (0)7557 677046
E: rosie.todd@stevens-bolton.com

James Hardaker
Partner
T: +44 (0)1483 406989
M: +44 (0)7825 873902
E: james.hardaker@stevens-bolton.com

STEVENS&BOLTON

Wey House, Farnham Road
Guildford, Surrey, GU1 4YD
Tel: +44 (0)1483 302264
Fax: +44 (0)1483 302254
DX 2423 Guildford 1
www.stevens-bolton.com

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