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Office for Tax Simplification (OTS) – first report on capital gains tax

November 2020

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IN BRIEF

The first report on capital gains tax (CGT) issued by the Office of Tax Simplification (OTS) on 11 November 2020 includes a number of recommendations on the future application of CGT. This briefing note covers the recommendations as they relate to employee share schemes, although the report itself has a wider context.

Background

Current UK tax legislation provides potential exemptions from income tax and NIC for certain tax-advantaged employee share scheme awards including Save As You Earn ("SAYE"), Company Share Option Plan ("CSOP") and Employee Management Incentive ("EMI") schemes. Broadly, to the extent that the necessary conditions are met, the exercise of share options under these schemes is exempt from income tax and NIC, with the gain on the subsequent sale of the shares being liable to CGT.

Many public and private companies operate share schemes, which allow employees to invest in company shares, with any resultant gain being subject to CGT.

The current rates of CGT are considerably lower than the equivalent rates of income tax. Normally capital gains on share disposals are taxed at 20% for higher and additional rate taxpayers (10% for basic rate taxpayers), whereas the current UK rates of income tax are 20% basic rate, 40% higher rate and 45% additional rate.

Introduction

The Chancellor Rishi Sunak asked the OTS to conduct a review of how individuals and small businesses are taxed on capital gains. The Chancellor specifically asked the OTS to "identify and offer advice about opportunities to simplify the taxation of capital gains, to ensure the system is fit for purpose and makes the experience of those who interact with it as smooth as possible".

On 11 November 2020 the OTS published their first report on CGT policy design and the principles underpinning CGT. A second report will explore key tax technical and administrative issues and is due to be published in early 2021.

TAX RATES AND ANNUAL EXEMPTION

The OTS consider one of the main sources of complexity to be the disparity between income tax and CGT rates and therefore recommends greater alignment between these rates. The implication would be that CGT rates would either be aligned with or be close to income tax rates (albeit with a suggestion that some level of indexation or other relief in respect of inflationary gains would need to be reintroduced if rates were aligned).

If there continues to be a difference between income tax and CGT rates, the OTS comment that CGT would be simpler if there were fewer CGT rates and if the link to taxable income level to determine CGT rates was removed.

Currently each UK taxpayer can realise a certain level of capital gains in each tax year that are exempt from CGT. This is referred to as the CGT annual exemption that is currently £12,300 for the 2020/21 tax year. The OTS comment that if the government consider the purpose of the annual exemption to be administrative (i.e. reducing the number of people required to file personal self-assessment tax returns for small amounts of tax), they should consider reducing its level. The OTS consider that “a true de minimis level lies in the range between £2,000 and £4,000”.

BOUNDARY LINE BETWEEN INCOME AND CAPITAL GAINS

Alternatively, the OTS suggest consideration be given to the boundary between income and capital gains. Notably, the OTS recommend that government consider whether employees' rewards from personal labour are treated consistently and, in particular, suggest that they consider taxing more of the returns from share-based rewards arising from employment at income tax rates.

The OTS report contrasts the taxation of shares acquired at the outset, such as Growth Shares, where the gain realised is normally charged to CGT on disposal, with a share option, which is exercised to acquire shares. Often, the shares acquired on option exercise are sold straightaway, so that the whole gain is subject to income tax and very often NIC. The report highlights that if the Growth Shares have a very limited value at the date of acquisition (so that a limited price is paid to acquire the shares or a limited amount of income tax/NIC is paid on acquisition) then economically there is little difference between the two alternatives, but the tax outcome is very different.

The OTS report acknowledges that, where employees and external investors are acquiring shares on the same terms and same price (such as in fundraising situations), and hence are exposed to the same risk, it is not unreasonable that both should be taxed in the same way i.e. under CGT.

The OTS report highlights some of the conflicting studies in connection with the effectiveness of employee share schemes, including the HMRC tax-advantaged plans. The report explains that a separate case can be made for the all-employee schemes, such as SAYE, as those who benefit from them include many individuals with relatively low incomes and the policy justification is as much social as economic. However, the OTS question whether tax-advantaged share schemes are the most cost effective approach to helping people save or encouraging long-term share ownership, recognising that many millions of lower paid employees (including those in the public sector, employed by professional partnerships or certain private equity backed companies) cannot have access to them.

The OTS report acknowledges that if the boundary line between income and capital gains was changed this would introduce its own complexity.

KEY FINDINGS AND RECOMMENDATIONS IN OTS REPORT

BUSINESS ASSET DISPOSAL RELIEF

The OTS report also covers Business Asset Disposal Relief (BADR – formerly Entrepreneurs' Relief). The relief provides a 10% CGT rate on disposals of assets, including shares, where the relevant conditions are met. In particular, the relief is available in respect of shares acquired through EMI share options where the relevant conditions are met.

THE OTS MAKE THE FOLLOWING RECOMMENDATIONS

If BADR's purpose is to stimulate business investment and risk-taking, it is "mistargeted". The OTS report mentions that the comments they received suggest that the most effective way to achieve these aims is for reliefs to apply on investment in the business, rather than on an eventual disposal of shares.

Alternatively, the OTS comment that another understood purpose of BADR is to provide relief on retirement, since business owners may use their business as an alternative to a pension. If this is one of the purposes of BADR, the OTS suggest that the government consider i) changing the qualifying conditions for the relief; ii) increasing the minimum holding period to qualify for relief from two years to a longer period, perhaps to ten years, and iii) introducing an age limit for relief, perhaps linked to the age at which people can usually access their pension (which is currently 55, though this is due to increase to 57 in 2028).

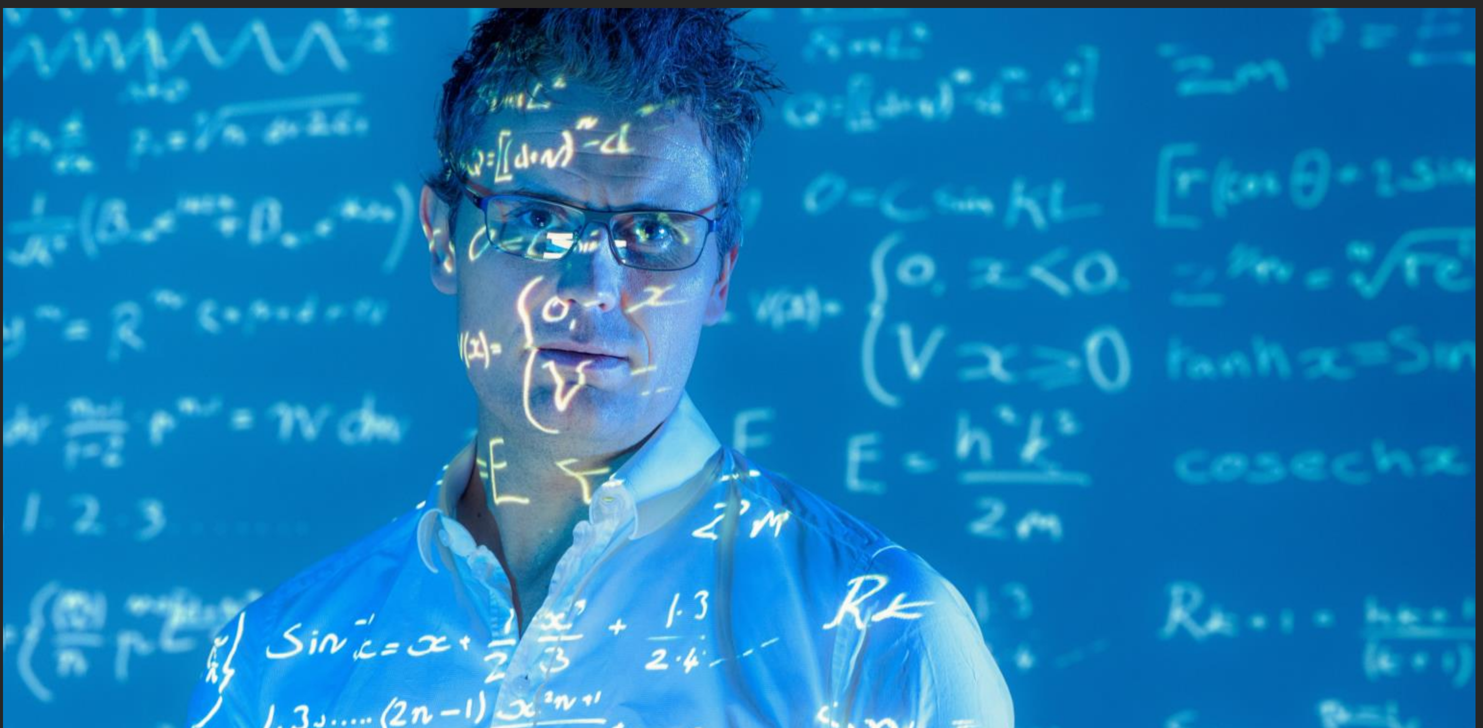
At this stage it is not clear how any such changes would apply to EMI share options.

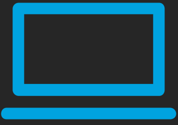
Deloitte’s view

The OTS is an independent adviser to the government and makes recommendations for the government to consider. Ultimately, any decision on tax changes will be for the government to make. The government has not indicated if, how or when they may respond to this OTS report, although assuming there is a Budget in March 2021, this would give the government a natural opportunity to consider any measures.

Whilst we welcome the detailed thought and consideration that has gone into the report, it does potentially offer more questions than answers. Could the UK break with much of G20 world in moving towards aligned CGT and income tax rates and would it be opportune to do this in the likely economic scenario in 2021, with the twin issues of COVID-19 and Brexit still impacting business? Although there may well be limited increased tax revenue from the measures as a proportion of total tax revenues (CGT currently accounts for approximately £8.3bn of tax revenue compared to £180bn of income tax revenue per year), would action here combat the perceived unfairness in the operation of the CGT regime?

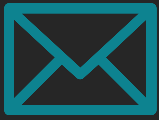
As the report notes the UK has one of the lowest capital gains tax rates in Western Europe (in particular, among nations with no Wealth Tax), so with the current cost of government COVID-19 measures CGT rates look a reasonable target for some increased revenue raising. However, whether the government wishes to move to the more radical end of the spectrum, such as an alignment of CGT and income tax rates, or removing the ability of employee shareholders to benefit from CGT rates, very much remains to be seen.





FIND OUT MORE...

The OTS report can be viewed at https://deloi.tt/32CPMNk.



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