

Implications of the proposed changes to Capital Gains Tax (CGT)

Overview

The changes to CGT proposed in the pre-Budget report are a lot more far-reaching than many commentators have suggested. In effect, this is going back to CGT as it was decades ago, except that the rate is 18% not 30%.

Some notes and ideas have already been circulated from other sources about the CGT implications. I'm hoping here to cover issues that weren't dealt with by other people's notes, or at least not so well.

Warning! Disclaimer

We don't have full information about how the changes to CGT will work. We are left to make some assumptions, or even to speculate. The contents of this document should not be taken to be definitive advice, but simply as a call to action, to be aware of potential issues.

Big losers — business assets

For owners of business assets the new rules mean a large rise in the tax. We always said that with taper relief the rate was 10%, but with the benefit of the annual exemption in practice it often worked out a lot less than that. For many owners of business assets, effective CGT rates will have more or less doubled.

What can they do? If they don't want to pay CGT at the new rate, there is an option: crystallise a gain before 5 April 2008, and pay CGT at the current rate.

Say, for example, you have a company you're expecting to sell in a year to 18 months for a £5m gain. You'd been expecting to pay £500k tax. However, it now looks like either you have to bring the sale forward (but you're not ready for it) or pay £900k tax.

There is a solution. Say you transfer your shares to a trust, now (you're a beneficiary). The value is taken to be £4m, because it won't be as much as the final price that will be achieved. What about IHT? There isn't any on the gift to the trust because it qualifies for BPR.

You'll pay CGT on the current value, of about £400k. And on the sale a bit later, there will be a further £1m gain (from £4m to £5m), taxed at 18%, or £180k. Total tax is £580k — £320k less than if you'd done nothing.

Bringing a tax bill forward is risky. If the sale never happens, you end up with a tax bill and no money to pay it.

For individuals who were expecting to liquidate companies to get their gains at 10%, the answer may be to start the liquidation sooner rather than later. Anthony Harris is all set for a rush of pre 5/4/08 liquidations to exploit the end of taper relief.

More losers — big base costs

The new regime gets rid of all indexation.

Suppose you have assets with a large base cost and a large indexation figure up to 1998. The loss of all that indexation could make a huge difference to the CGT.

One solution is to crystallise a gain as described above, and create a tax bill and an uplifted base cost. This is OK for a business asset, but for a non-business asset it may not make so much sense because the gain brought forward is taxed at a higher rate.

A variation on the theme is this. It may be possible to engineer a disposal where holdover relief is possible. The attraction is that the base cost for the recipient is equal to the cost plus indexation. In other words the indexation is crystallised.

Holdover isn't possible where the donor can benefit from the gift in some way. So it really requires a complete gift or a sale at undervalue to a connected party (usually a trust), possibly as part of an IHT planning scheme. But in the right circumstances, where the indexation is valuable, we can "bank" it.

More losers — rollover and CGT deferral

Anyone who has rolled over the gain on a business asset, expecting the gain to reappear to be taxed at 10%, would appear to have stored up a problem. When the gain reappears it will presumably be taxed at a higher rate than expected.

Anyone who used EIS to defer CGT on a business asset may also lose out (although a gain on a non-business asset will probably still be OK — in fact it may end up being taxed at lower rates when it reappears). We don't know exactly how deferral will interact with the new rates of tax.

We'll need to identify and highlight these cases to make sure that we revoke any elections where it's possible and desirable.

Business sales and deferred consideration — a problem?

If you're selling a company, you need to watch out if there is any sort of deferred consideration. Normally this is in the form of securities of some sort. When it is cashed in, the CGT may not be simple.

If there is an earn-out, in the form of securities as described, and the idea is (or at least was) to cash the securities in after 6 April 2008, it looks on the face of it as though the new rates will apply and this will probably be disadvantageous. Anyone who already has securities from a sale that has already happened may want to look at cashing them in early.

But it may not be that simple. We don't have draft legislation, and we don't know for sure how the gains stored up in certain kinds of securities (mainly Qualifying Corporate Bonds) will be taxed when they reappear. It may even be that, if the new legislation doesn't think about this issue, there could even be an advantage, but we probably won't know until it's too late to do much about it.

The upshot is that, if there is to be a sale before 5/4/08 and if there is to be some sort of deferred consideration, there may be complications with certain forms of deferred consideration — but we don't know yet. The simple advice is to try to avoid deferred consideration.

Cleaning up companies

We've been doing a nice line in demerging companies that contain a mixture of trading and investment activities into two new companies.

We do this for two reasons at the moment:

To ensure we get business asset taper relief on the trade part at least (actually, you need to get business asset status in order to be able to do holdover elections as well, and so there is a secondary CGT benefit); and

To ensure we get BPR for IHT on the trade part at least.

The first of those conditions was harder to achieve, as the degree of non-business activities acceptable was lower. But you can get the BPR for IHT on companies with up to 50% of investment activity, if you've got slightly over 50% being trading.

If you've got a company which is mixed business and non-business activities, and were thinking of splitting them, curiously it may now make sense, in some circumstances, to leave them as they are. There are few CGT downsides, and it may enable you to get non-business assets exempted from IHT by combining them with business assets.

Non-business assets — both winners and losers

For non-business assets, you can't say in simple terms whether people are going to be worse off or better off. The effective CGT rate will be less, although the way that taper relief interacted with annual exemption means it's not that simple. And the loss of indexation of pre 1998 assets may

cost more than the tax saved by having lower rates. So it will need to be reviewed on a case by case basis.

The money-box company

The idea was to get a company to make profits, build them up in the company, and then liquidate it to take out the profits at CGT rates rather than income tax rates.

Under the current rules, if you did it right with a trading company, you could effectively do this every couple of years or so. You'd have paid Corporation Tax in the company and then CGT at about 10% on the accumulated post-tax profits, allowing you to get the profits out at what was a total tax charge of perhaps 28% or so. (if you took the profits out by way of dividend, the interaction of Corporation Tax and higher-rate income tax tended to make the total tax cost about 40%.)

The CGT rates are now going to be 18%. The effective tax cost of going down this route therefore will be about 35% after allowing for the changes to Corporation Tax rates. It may still be worthwhile, but the savings will be much more marginal.

If you think you or your clients might be affected by the proposed changes and you are looking for intelligent ways to limit your CGT liability please contact Gerry Jackson on 01865 261100 or email gjackson@critchleys.co.uk