TAXREP 4/00

CAPITAL GAINS TAX TAPER RELIEF

Memorandum submitted in January 2000 to the Revenue by the Tax Faculty of the Institute of Chartered Accountants in England and Wales

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GENERAL COMMENTS

1. We welcome the opportunity provided by the review of taper relief announced on 9 November 1999 for us to contribute our recommendations on how taper relief could be improved. As presently enacted, taper relief demonstrates the difficulties that can arise where a new tax regime is enacted without detailed consultation. Many of these effects may not yet be apparent, but over time will increase in importance. The Government needs to take radical action to overhaul taper relief before the anomalies and distortions become serious problems. We would appreciate an early meeting to discuss our comments and suggestions.

2. We have never been convinced of the rationale for replacing indexation relief. One criticism often levelled at indexation is that it is too complicated. In our view this criticism is not justified as indexation is conceptually simple to understand and apply. Although the taper relief rules may at first sight appear simpler than the indexation rules, this is not the case. Taper relief has introduced many new complications and anomalies and has added many complications to a personal and trust capital gains tax regime that is already extremely complex.

3. For example, a taxpayer disposing of business assets has to identify whether the assets have been business assets (as defined) during his period of ownership and, if so, identify periods of non-business usage, ascertain the impact of any rollover and holdover claims and then consider whether any anti-avoidance rules apply. Taper is also more complicated than indexation for the non-business investor owning a portfolio of securities. The matching rules mean that it is necessary to identify the dates that assets were acquired instead of merely reduce a pool, thus considerably complicating the calculations where shares in a company are brought and sold.

4. Conceptually, taper relief is flawed, as, rather than encourage long term holding, it distorts commercial decision making. This is because, all things being equal, it encourages investors to:

   * retain assets until the one or three year periods before taper applies have elapsed;
   * dispose of assets on which no further taper will accrue; and
   * avoid realising losses which can only be set against gains with a large amount of taper.

5. In addition, the taper matching rules influence the investment decisions of portfolio investors.

6. These distortions appear to present serious long-term problems. In particular, the point in the previous paragraph appears to us to be a crucial. If portfolio investors begin switching into collective investments, which they surely will over time, then, given the preponderance of investments owned by fund managers over those owned by individual investors, the existence of taper relief may increase short-term investment as compared to long term investment, the exact opposite of what is, we

believe, the Government's intention.

7. In our letter dated 15 October 1999 to the Chancellor of the Exchequer setting out our recommendations for Budget 2000 (published as TAX 28/99) we expressed the view that the tax system is now so complicated that only the well advised are able to comply with the rules. We also expressed concern about distortions in the tax system and its loss of integrity owing to attempts by the Government to use it to influence actions by taxpayers, and referred to taxpayers' increasingly questioning their moral responsibility to comply. In our subsequent discussion paper 'Towards a better tax system' (published in October 1999 as TAXGUIDE 4/99) we set out ten tenets that we consider should underlie a good tax system. We have assessed taper relief against these tests and our conclusion is that taper relief fails to satisfy most of the tenets.

8. We recommend that during the review of taper, which we have been informed by the Government will be accompanied by detailed consultation, the opportunity should be taken to address many of the anomalies, the most important of which are set out below.

DETAILED COMMENTS

IMPACT OF SHORTENING BUSINESS ASSET TAPER PERIOD

9. We welcome the announcement on 9 November 1999 that the Government intends to shorten business asset taper relief from ten years to five years, subject to detailed consultation.

10. We should welcome confirmation that all business assets will be eligible for business asset taper relief at the same rate; for example, that the 5 year relief will also apply to business assets used by an entrepreneur's company or business but owned by the entrepreneur outside the company or business/partnership.

11. We should be grateful also for clarification of the date from which disposals of assets will be subject to the new rates of taper. Reports suggest that transactions are being delayed. In order not to impede commerce, we recommend that the enhanced rate apply with effect from 9 November 1999 with other changes to be introduced with effect from 6 April 2000, and that an announcement to this effect be made as soon as possible.

12. We should welcome confirmation that the 1997/98 bonus year will be able to be taken into account for disposals which will be subject to the five-year taper relief period.

QUALIFYING COMPANIES

13. We welcome the announcement by the Government that it is assessing the case for lowering the threshold above which shares qualify for taper relief as business assets. We presume that the policy purpose is to encourage long-term investment, whether the investor works in the company or not.

14. If this is the case, then the requirement that a full-time working investor and a non-working investor need to own at least 5% and 25% respectively of the voting rights to

claim business asset taper relief is onerous. We consider that the thresholds in Schedule A1 of the Taxation of Chargeable Gains Act ('TCGA') 1992 should be abolished for full-time working investors and reduced to 10% for non-working investors.

15. In the event that such wholesale reductions are considered unacceptable, then we suggest two instances where steps should be taken to relieve unfairness caused by these high thresholds.

16. First, where shareholdings are divided amongst a family, usually where a husband and wife each own shares in a company. We consider that in respect of family shareholdings, business asset taper relief should be available where a taxpayer can demonstrate that he and members of his family can exercise not less than 10% of the voting rights.

17. Secondly, we support the case for encouraging employees who participate in a management buy-out, but who receive less than 5% of the shares. This situation is quite common, and in order not to penalise the employee-shareholder who receives only a small proportion of shares, we consider that any shares acquired by employees in such circumstances should be treated as qualifying assets for business asset taper relief.

PARTNERSHIPS

Part of trade carried on through a company

18. The 25% threshold can cause problems in practice where, for example, a trade is carried on in partnership but part of the trade is carried on through a company. A typical example is a professional practice where investment advice and/or management consultancy services are carried on through a separate company or companies owned by the partnership. Although in reality the company's trade is an extension of the professional partnership business, the shares in the company do not qualify for business taper relief except in the hands of a partner who has a profit share of 25% or more.

19. We suggest that in cases such as this, all partners should be entitled to business asset taper relief on shares owned by the partnership, regardless of the size of their profit shares.

Changes in partnership profit shares and admission and departure of partners

20. Where a partner's profit share decreases or a partner retires, technically this gives rise to a disposal for the purposes of capital gains tax, and a partner whose profit shares increases or who joins the partnership acquires chargeable assets. However, in practice no adjustment is usually made to the partnership accounts to reflect the current market value of the firm where chargeable assets such as goodwill and real property are carried in the accounts at cost. In these circumstances, paragraph 4 of Statement of Practice D12 provides that there is no chargeable gain or loss at that time. This practice was extended to include indexation by Statement of Practice 1/89.

21. We would welcome confirmation that taper relief applies to any disposals by a partner from the time he first acquires an interest in the partnership, and where he has increased his fractional share by way of an acquisition of another partner's share so that the cost of the increase represents enhancement, the period of ownership for the purposes of taper relief runs on that increase from the date on which the original fractional share was acquired notwithstanding any changes in his profit shares.

Trustees trading in partnership

22. We would welcome confirmation that business asset taper relief is available on assets used wholly or partly for the purposes of a business carried on by trustees trading in partnership.

23. Paragraph 5(3)(a) of Schedule A1, TCGA 1992 allows business asset taper relief on assets used wholly or partly for the purposes of a trade carried on by the trustees of a settlement. Section 111, Income and Corporation Taxes Act 1988 provides that, unless the contrary intention appears, a partnership shall not be treated as an entity separate from the persons carrying on the trade or profession. Taken together, we think it is clear that trustees are entitled to business asset taper relief if they carry on a business in partnership.

INTERACTION WITH ROLLOVER AND HOLDOVER RELIEFS

24. The interaction of taper relief with rollover and holdover reliefs has created many anomalies which need to be addressed as part of the review, the most important of which are set out in the paragraphs below.

25. Where capital gains tax rollover relief is claimed on the replacement of a qualifying business asset under section 152, TCGA 1992 et seq, taper relief operates on the ultimate disposal of the new asset only by reference to the period for which the new asset is held, and there is no taper relief for the period of ownership of the first asset.

26. Similarly, where an asset that is disposed of consists of shares obtained in exchange for assets of a business which was incorporated (section 162, TCGA 1992) or business assets on which holdover relief for gifts of business assets was claimed under section 165, TCGA 1992, taper relief applies only by reference to the period of ownership of the asset being disposed of. A similar restriction applies to the relief for gifts on which inheritance tax is chargeable (section 260, TCGA 1992).

27. The object of the sections 152, 162 and 165 reliefs is to neutralise the fiscal impact of restructuring businesses, the way in which businesses are owned, or, as the case may be, replacing business assets so that businesses can be operated in the most commercially-efficient manner, for example by moving to bigger premises. However, the adverse impact of taper means that the fiscal cost of undertaking transactions may outweigh the commercial benefit. An example of this is in the Annex. We are not aware of any technical or anti-avoidance reason for restricting the period of ownership eligible for taper to the final asset or owner.

28. We understand that the reason that taper was restricted to periods after the transactions giving rise to the rollover and holdover claims was that the Government

wished to minimise the difficulties of tracing the past history when calculating the ultimate gains.

29. Whilst we appreciate the Government's concern, these perceived difficulties can be overcome in practice. In the case of the sections 152 (rollover relief on the replacement of a qualifying business asset) and 162 (incorporation) reliefs, the owner is the same person and so should have the necessary records. In the case of the sections 165 (holdover relief for gifts of business assets) and 260 (relief for gifts on which inheritance tax is chargeable) reliefs, except where the donee is a trustee, the claim is entered into by both parties to the gift and so the transferee should be able to obtain the necessary information from the transferor at the time of signing the claim.

30. We consider therefore that in all these cases taper relief should apply to the combined periods of ownership of all the assets by all the owners party to the rollover/holdover claims.

CHANGES IN ACTIVITY OF A CLOSE COMPANY

31. Where there has been a change of activity by a close company which comes within the definitions in paragraph 11 of Schedule A1, TCGA 1992 (broadly, a change from trading to investment or vice versa or commencing to trade for the first time), taper relief on a disposal of the shares in the company runs only from the date of the change in activity.

32. This rule is anomalous and unfair, because if there had been no change in the defined activities, the shares in a company would have qualified for taper relief for the whole period, not just the period after the change.

33. We suggest therefore that taper relief should be allowed for the entire period of ownership, but the period should be divided into two parts. Thus, taper relief should be available at business rates for the period when the company is trading and at non-business rates for the period when the company is an investment company or not trading.

SALES OF BUSINESSES

34. We have in the past drawn attention to the problems caused by Marren v Ingles [1980] STC 500 regarding the taxation of disposals of businesses where the consideration is in the form of an 'earn-out', based usually on a formula linked to future profits, which is treated for tax purposes as a chose in action.

35. This gives rise to problems where the profits are less than forecast, because a capital loss may arise that is unrelievable, as it cannot be set against amounts charged to capital gains tax in earlier years. Whilst this problem is not a taper relief point, the review of taper relief provides an opportunity to recify this unfairness and we reiterate our view expressed on previous occasions that, in these circumstances, losses arising in later years on what is effectively a single transaction should be able to be offset against previously-assessed gains on the same transaction. This could be given effect in the same way as for the carrying back of personal pension contributions, ie by giving relief against current year's tax at the tax rate(s) ruling in the year(s) of gain.

36. However, taper relief has introduced a further, and serious, problem, which arises because the deferred consideration is treated as a chose in action. This presented no particular difficulty under indexation (other than the problem referred to in the previous paragraph), but with taper, the chose in action does not qualify as a business asset. Instead, it ranks as a non-business asset qualifying only for the less favourable taper rates. Thus, an earn out is treated less favourably than a straightforward disposal. We are aware that the Government wishes to encourage entrepreneurship and suggest that chose in action which arises in such circumstances should be treated as an asset qualifying for business asset taper relief and its period of ownership should run from the date of acquisition of the business that was disposed of.

INTERACTION WITH LOSSES

37. Whilst disposals of assets that give rise to losses are not directly subject to taper, losses brought forward or arising in the same year as other disposals are brought into account in calculating gains subject to taper arising in the year. Taper relief is applied after the deduction of allowable losses in such a way as results in the largest reduction in the amount chargeable to CGT (section 2A(6), TCGA 1992). Whilst on an initial reading of the legislation this treatment of losses appears generous, it is fraught with uncertainty, as the extent to which a taxpayer will benefit from losses will depend upon the gains made by the taxpayer in the year. This will not be known until the end of the year and will depend upon which assets are disposed of in the year.

38. For taxpayers with a portfolio of securities, the calculations necessary to determine the tax position are considerable. The interaction is particularly capricious in respect of losses brought forward, where the benefit of those losses will depend upon subsequent gains made. If a taxpayer sells at a loss an asset that he has held for say 2-3 years it may wipe out the taper that he has accrued on a asset on which he has made a gain that he has held for 9-10 years. In summary, the result of the taper rules for losses is that only the well advised who can plan their disposals and perform 'what-if' calculations will be able to obtain relief for their losses in a fair and equitable manner.

39. We suggest that taper should be applied independently to each gain without reference to losses. Total gains after taper relief should then be aggregated with losses to arrive at total assessable gains for the year

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ANNEX

INTERACTION OF TAPER RELIEF AND ROLLOVER RELIEF: EXAMPLE

Smith acquired freehold offices for his trading business in September 1995 at a cost of £100,000.

Six years later, in September 2001, Smith finds that he needs larger premises. He can either:

a) extend his existing offices at a cost of £150,000; or

b) sell his offices for £350,000 and spend £500,000 on suitable replacement premises.

On the assumption that Smith retires in May 2006, receiving £880,000 for the premises, how will his choice of action in September 2001 affect his eventual chargeable gain?

Extend existing offices

Smith's chargeable gain will be computed as follows:

		£	£
Sale proceeds			880,000
Less:	Cost	100,000	
	Enhancement expenditure	150,000	
			250,000
			630,000
Less:	Indexation allowance		
	£100,000 x 8%		8,000
			622,000
Less:	Taper relief (67.5%) [9 yrs inc bonus]		419,850
GAIN			£202,150

Sell and replace offices

In this case, Smith's gain will be:

Original offices

		£	£
Sale proceeds			350,000
Less:	Cost		100,000
			250,000
Less:	Indexation allowance £100,000 x 8%		8,000
GAIN TO BE ROLLED OVER			£242,000

Replacement offices

			£	£
Sale proceeds				880,000
Less:	Cost		500,000	
	Less:	Rolled over gain	242,000	
				258,000
				622,000
Less:	Taper relief (30%)			186,000
GAIN				£435,400

Conclusion

The first option would be a more tax-efficient course of action for Smith.