Capital Gains Tax (CGT) **2023**

timeline
MONEY FOR LIFE

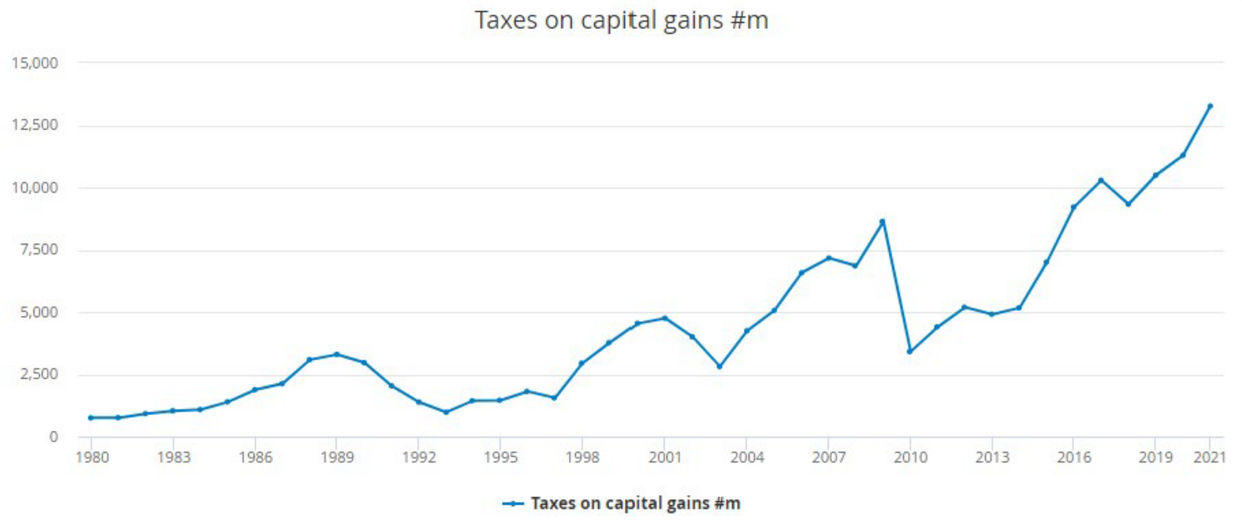
Important Regulatory Information

Past performance is no guarantee of future return. The value of investments and the income from them can go down as well as up. You may get back less than you invest. Transaction costs, taxes and inflation reduce investment returns.

For Financial Advisers only.

CGT

Tax efficient income planning for individuals is a key aspect of most financial advisers' propositions for their clients. The continuous changes in government legislation make this aspect of the role increasingly more difficult, creating a moving target on how to achieve the best client outcomes over the longer term. This challenge is particularly prevalent with the recent reduction in the Capital Gains Tax (CGT) exemption from £12,300 to £6,000 on the 6th of April 2023. Whilst a 50%+ reduction seems difficult enough, a further 50% reduction to £3,000 on the 6th of April 2024 provides a further obstacle. The Office for Budget Responsibility[1] has estimated that in the 2023-2024 tax year, capital gains tax will raise £17.8 billion in receipts which is the equivalent to £620 per household. These trends indicate that this number will only grow with time.



Source: ONS (2023)

Previously, CGT was only considered an issue for those in the higher tax brackets who make the highest gains. In the 2020-2021 tax year, HMRC estimated that 45% of CGT came from those who made gains of £5 million or more. This group also only represents less than 1% of CGT taxpayers each year. With this decreased limit, those who were previously unaffected, or who paid marginal tax, may now push themselves into a tax bracket that they were previously well clear of.

In their report, the Office Tax Simplification mentioned that a main theme for capital gains tax (CGT) is that 'many people have a limited awareness or understanding of CGT, of when it arises, or of their reporting and paying obligations when it does.' In their report, HMRC estimated[2] that by halving the capital gains tax exemption, an additional 235,000 people will need to report their capital gains. The issue is further exacerbated as under 100,000 of these individuals routinely file self-assessment tax returns. With the lack of knowledge in the area, it seems like an obvious advice gap that needs to be filled.

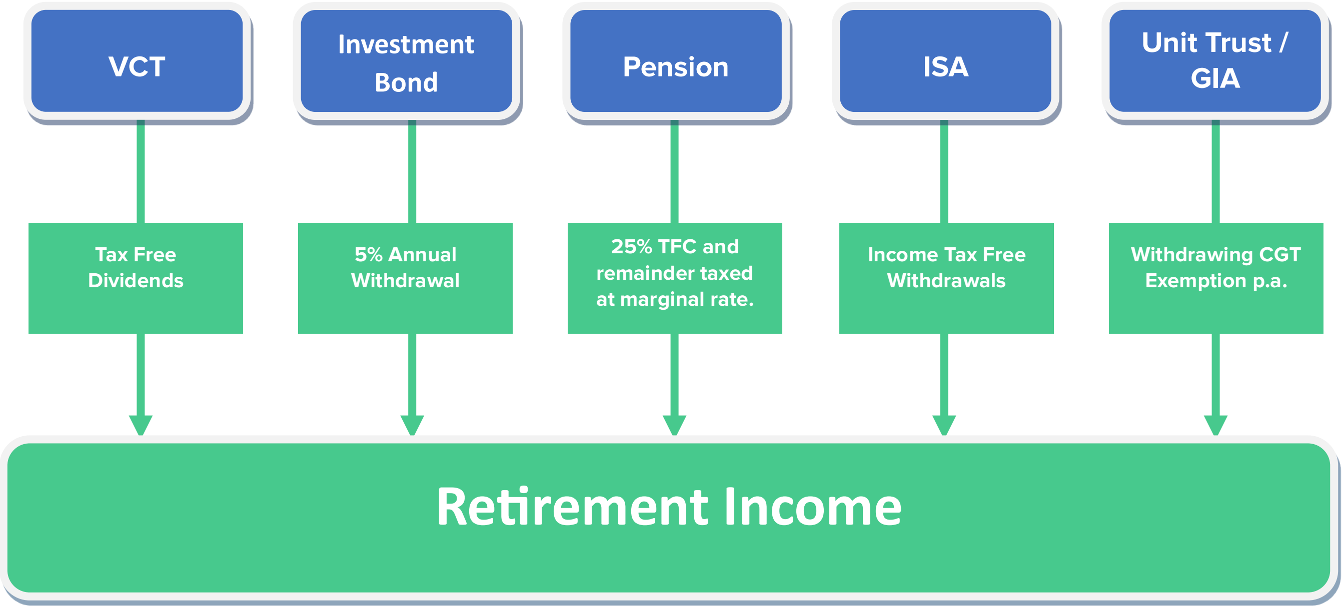
The reduction in the allowance means a number of financial plans will have to adapt to the new environment.

[1] https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/capital-gains-tax/#:~:text=CGT%20is%20paid%20by%20individuals,per%20cent%20of%20national%20income
[2] Office of Tax Simplification, Capital Gains Tax Review – first report: Simplifying by design, November 2020.

So, what's the damage?

The phased reduction of the CGT exemption leads to issues for clients and advisers. The most obvious implication is that clients who previously used their exemptions each year for share dealing, will now find themselves in an increasingly problematic situation when they look to liquidate funds in a taxable portfolio.

This can have a knock-on effect on the remainder of an individual's income drawing, especially for those in retirement unable to accumulate further. In my previous life as a financial adviser, we used to propose a structured income draw in retirement made up of investment vehicles/tax allowances in order to minimise an individual's overall tax rate. An example below:



As you can see from the graphic above, for some clients their retirement income has now taken a potential knock of £6.3k and a total of £9.3k next tax year. Whilst not every individual will use this income drawing strategy, it may affect the behaviour of those who do. Individuals may lean more on pension pots previously used for inheritance tax planning as an example to avoid paying an increased level of CGT.

This being said, there are some solutions that a number of advisers will have proactively taken to help minimise the impact of the exemption reduction.

Discretionary Fund Managers – increased headache or stress reliever?

Many IFAs use DFM services to decrease the management stress of their clients' funds both in the active and passive landscapes. As every DFM will have a different process for managing their client assets, the CGT implication will vary between each provider. It may lead to questions regarding the implications on the end client and what tax may now arise in rebalancing.

With the changes to CGT exemptions and the nature of DFMs, will this affect IFAs placing GIAs and other CGT-liable assets on these services? Will more advisers look to manage the funds themselves to prevent potential CGT implications for the end client? Do adviser's have the operational resources required to manage their own portfolios?

Whilst we can't speak for other DFM services, Timeline has not changed our investment management approach in light of these changes. This is particularly relevant in line with our drift tolerance approach to rebalancing. Using over 100 years of data, we have found this is the optimal rebalancing method is to allow portfolio asset allocations to drift by up to 10%. This begs the question: How often will a portfolio be rebalanced and what are the potential tax implications of this method?

The past couple of years have taught us that the unexpected can happen in the markets, so we can't say definitively when a portfolio will need to be rebalanced. However, we have put together a scenario which can help shed some light on potential implications for a client portfolio.

Based on a client starting with the below parameters, we forecast at what point (based on previous growth figures) they would need to rebalance and what CGT liability this may trigger for the client:

- Portfolio – 80% Equity/20% Fixed Income
- Annualised Performance (Equity) 11.88%
- Annualised Performance (Fixed Income) 5.96%[3]
- Portfolio size - £100k
- Portfolio Investment Horizon – 15 years

Growth and performance of assets within the portfolio over 15 years:

	Equity	Fixed Income
Split	80%	20%
Annual Performance	11.8%	5.96%
Total Performance	538.63%	238.3%

Drift Tolerance Breach at year 15 – based on performance of funds		
Equity	£430,900.36	90.04%
Fixed Income	£47,660.57	9.96%
	£478,560.93	100%

[3] These figures are the long term average annualised return of equities and fixed interest in the Timeline portfolios.

Rebalance to 80/20 Split		
Equity	£382,848.74	80%
Fixed Income	£95,712.19	20%
	£478,560.93	100%

Tax Implications

The tax implications of the rebalance at year 15 would be as follows based on the client being a higher/additional rate taxpayer:

Total Gain	£48,051.61
CGT Exemption	£3,000
Net Gain	£45,051.61
20% CGT Bill	£9,010.32

As you can see, whilst there would be some liability that would come with a rebalance, it is relatively manageable in terms of time scale. Timeline's drift approach allows clients to benefit from positive movements in the equity markets without worrying about timescales influencing rebalances. Whilst managing tax for clients is extremely important, it is almost impossible to completely mitigate out. It's also worth considering that with the constantly changing rules surrounding tax rates, the underlying CGT legislation may well have changed by the time it comes to a rebalance.

Some Obvious Solutions

The question that advisers are facing now is 'How do we reduce this impact going forward?'. Whilst there is not a 'catch-all' solution, there are a few easy-to-implement strategies that some advisers might be using with their client banks.

Keeping it in the family

The first may cause arguments amongst couples, but an obvious choice and solution could be interspousal transfers. Transfers of shares between spouses is free from CGT implications and can mean that if one spouse is in a higher tax bracket than the other, they can transfer assets into the name of the individual with the lower tax bracket. Moreover, this allows a couple to double their annual exemption to £12k this tax year rather than £6k should a sale of shares happen under an individual rather than a couple.

Investment Opportunities

For more sophisticated investors with a higher capacity for loss, there are also other higher-risk investments that can help defer capital gains. These are known as Enterprise Investment Schemes (EIS) (and Seed Enterprise Investment Schemes (SEIS)). These investments allow an individual to either defer gains indefinitely or help relieve up to 50% of taxable capital gain (dependent on investment value). EIS can help defer gains via investment and then reinvestment for an indefinite amount of time. This creates a waterfall effect, helping to realise and use CGT exemptions in various years to reduce the tax payable. The hope for some advisers is that deferring the gain long enough may mean that gains fall into a year where the allowance is higher, helping to mitigate any tax payable compared to paying the tax outright.

The other unique feature of these investments is that they qualify for business property relief (BPR). This means that they are IHT-free if they are held for 2 years prior to death, which may help those impacted by a reduction in pension allowances pass on assets to family members in an efficient manner.

Again, these investments are high-risk and not for the average investor. Those who do invest require a high capacity for loss as well as a high attitude to risk.

Taking advantage of losses

Whilst the aim of investment is for capital to appreciate over the longer term, losses are sometimes inevitable. In the current CGT climate, however, they can be an effective and efficient tool to help offset large gains in certain tax years. Losses should not be wasted for clients who are in the fortunate position of having a CGT-heavy portfolio. There are a couple of factors that are worth considering first:

- Current legislation dictates that capital losses that arise in a tax year must be offset against any capital gains for that tax year.
- This can have a knock-on effect for individuals where in certain circumstances, their annual exempt amount for that tax year may be lost.
- As long as the losses are declared in the relevant tax year, any unused losses can be carried forward indefinitely to offset future tax year gains.
- Capital losses are offset in the current tax year before any previous losses are carried forward.
- Capital losses cannot be carried back to earlier tax years.

Whilst managing losses can be a complicated and tricky exercise, it allows individuals the opportunity to not let losses go to waste in their tax-efficient planning.

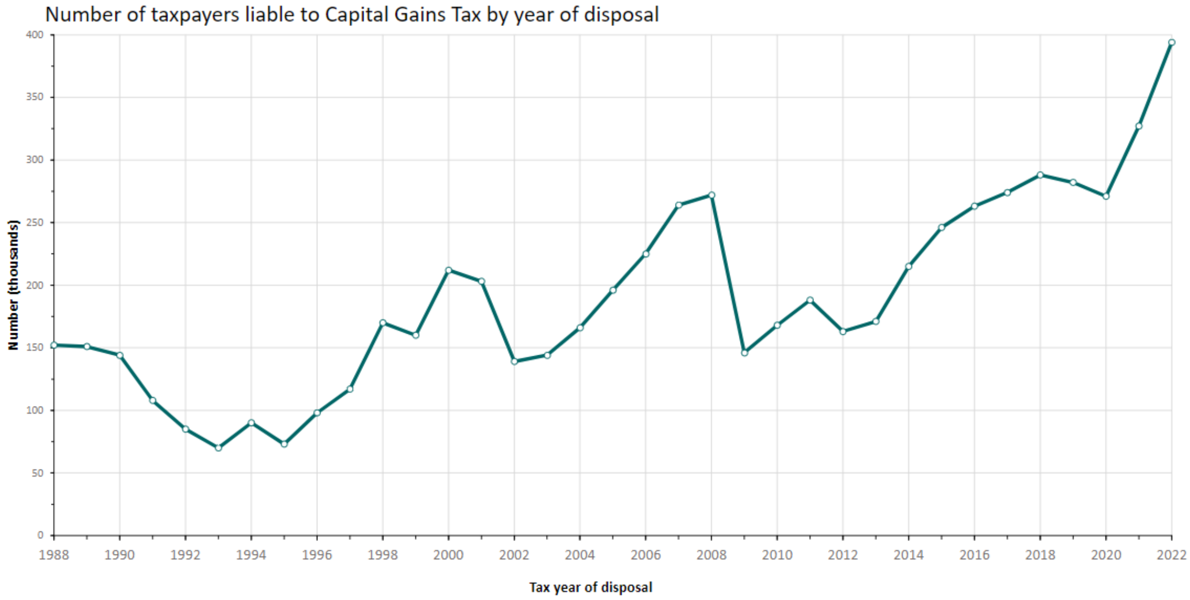
Death and Taxes

As Benjamin Franklin eloquently put it, ‘nothing is certain except death and taxes.’ Whilst a morbid reminder that the best thing to do is spend your accumulated assets in life, (never mind the tax implications!) it can also provide an extremely helpful solution. CGT is rebased on death, meaning that should an individual die with a CGT-heavy portfolio, those who inherit it will have whatever the current value is as a new base for any future gains. This paired with interspousal transfers creates a way for the surviving spouse to take advantage of a portfolio that would have previously had a 10% or 20% tax liability. Prior to death, one would need to transfer the assets into the spouse’s name and then it would be inherited upon death with limited tax implications.

The solutions mentioned above are client-dependent and therefore will not be applicable for everyone. It should draw salience to the point that financial advice is more vital than ever in the ever-changing world of legislation.

Who is likely to be impacted?

The first phase of the CGT raid started in 2020 with the reduction of lifetime allowance for Business Asset Disposal Relief (from £10M to £1M). This reduction meant that for individuals looking to sell their companies to fund their lifestyle or retirement using the proceeds, their CGT bills increased exponentially. 45% of CGT receipts come from sales of £5M or more, which will encompass this group of individuals more than others. However, with this exemption reduction, the number of individuals with simple tax affairs who will trigger gains will increase. HMRC has seen a sharp uptick in the number of individuals paying CGT over the past 3 years and there seems to be no sign this upward trend will change anytime soon.



Source: HMRC (2023)

Change of Legislation

This article tries to provide some insight into shifting patterns in financial advice, Timeline understands that legislation changes are frequent and sometimes unexpected. Under the current government, CGT rules have already drastically changed, with Business Asset Disposal relief being dramatically cut from £10m to £1m, affecting a demographic of small to medium business owners.

The recent reduction in the annual exemption has been speculated to be a preamble to the government fully dissolving the CGT allowances for individuals. Previous government reports have also recommended raising CGT tax rates in line with income tax, which would void the benefits of holding investments such as Unit Trusts due to their current favourable tax rate. These two scenarios have been proposed under the Conservative regime, leading more extreme proposals to emerge from the Labour camp should they gain power in the next election.

Whilst all speculation, it is clear change in this space will be frequent in the coming years. During this time, it will be vital for individuals in all stages of their lives to seek financial advice, so they are not met with unexpected and unaffordable tax bills.

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