Office of
Tax Simplification

Capital Gains Tax – second report:

Simplifying practical, technical and administrative issues

May 2021

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Simplifying practical, technical and administrative issues

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As the OTS explored in its Reporting and Payment Review, an online digital platform is a modern way for a taxpayer to report income to HMRC and receive information about their tax affairs from the tax authority.[4] However, it is not clear at what stage Capital Gains Tax will be included in this ambitious program.

HMRC should integrate the different ways of reporting and paying Capital Gains Tax into the Single Customer Account, making it a central hub for reporting and storing Capital Gains Tax data (recommendation 1).

There are three main ways of reporting a capital gain – through Self Assessment, the UK Property tax return, and the 'real time' Capital Gains Tax service.

The OTS recommends changes to each of these but the overarching recommendation is that these should be brought together in the Single Customer Account. This could ease the administrative burden for all of the 500,000 or so people who file returns of disposals in any given year.[5]

This modern and fully integrated Single Customer Account would log relevant information for the taxpayer and act as a gateway to pay the tax in the most appropriate way. Agents should have access to the information in it, with the taxpayer's approval.

It would be a central hub to claim and keep track of Capital Gains Tax information, such as capital losses, main residence nominations and enterprise investments, so it is relevant for many of the other recommendations in this report. It would also help those who struggle to pay, by making it easier to be aware of what tax may have to be paid.

This will require sustained investment over a number of years, building on the £68 million committed for the Single Customer Account and Single Customer Record in Budget 2021.[6]

Private Residence Relief nominations

Private Residence Relief is estimated to benefit 1.5 to 2 million homeowners annually and to have cost the Exchequer £25 billion in tax year 2019-20.[7] It is intended to relieve main homes from the scope of Capital Gains Tax, so generally only one property can be covered at a time.

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4 Tax reporting and payment: Simplifying tax for self-employed people and residential landlords https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/843531/OTS_Tax_reporting_and_payment_review.pdf Tax reporting and payment: Simplifying tax for self-employed people and residential landlords. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/843531/OTS_Tax_reporting_and_payment_review.pdf

5 HMRC have advised the OTS that approximately 500,000 individuals submitted a Capital Gains Tax filing for the tax year 2017-18. This is higher than the number of taxpayers liable to Capital Gains Tax in that year (265,000) because it includes individuals with no liability, such as those claiming to offset a loss and those reporting transactions where the proceeds exceed the reporting threshold of four times the value of the Annual Exempt Amount.

6 FST speech to HMRC virtual stakeholder conference.

https://www.gov.uk/government/speeches/speech-to-hmrc-virtual-stakeholder-conference

7 Non-structural tax reliefs. See Annex D.

https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs

Where a taxpayer (and their spouse) have more than one eligible home, they can choose which home they wish to benefit from the relief by making a nomination to HMRC within 2 years of acquiring or disposing of an additional home. If no nomination is made they must decide which is in fact their main home, based on a number of factors such as how long they spend there or where their family lives.

There is no realistic alternative to a process involving nominations. To remove them and require all homeowners with more than one home to decide which of their homes is their main home based on the facts would be challenging both for homeowners and for HMRC.

The nomination system favours those who are better informed or professionally advised as they are more likely to be aware that they have an option to nominate and so less likely to miss deadlines. It is also peculiar that taxpayers have to consider nominations when only renting rather than owning their second home, so that no capital gain can arise.

The government should review the practical operation of Private Residence Relief nominations, raise awareness of how the single rules operate, and in time enable nominations to be captured through the Single Customer Account (recommendation 6).

Any change should aim to create more parity between individuals who have a tax adviser and those who do not receive professional advice – which could be achieved through either advancing awareness around nominations or allowing nominations to be made on disposal.

One way of increasing awareness would be for the government to require estate agents and conveyancers to distribute information to purchasers of a new home. This information could include HMRC guidance on potential tax charges, nominations and administration requirements such as the UK Property tax return. The theme of raising awareness is considered again later in this report and this recommendation should be considered alongside recommendation 3.

Removing the need to consider short term rentals will remove the need for all those renting second homes from having to make a nomination. The definition of short term rentals could be aligned with the existing definition used in the legislation to remove the time limit for making nominations in relation to such properties, which would include assured shorthold tenancies but not leases with any capital value.

These changes to nominations would ideally be supported through the new Single Customer Account.

Deferred proceeds: Capital Gains Tax when a business is sold

The proceeds from the sale of a business or land can be received in several different ways.

Sometimes the proceeds of a sale might be paid over a number of years, or the proceeds could be a combination of cash and other assets such as shares. In addition, a business can be sold for an uncertain price that depends on future events.

The OTS has heard some of these more complex types of business and land sales can create several different practical issues. These include that they are difficult for

ordinary taxpayers to understand, they can result in upfront tax on cash that has not yet been received, and the differences in tax treatment can distort commercial decision making.

The government should consider whether Capital Gains Tax should be paid at the time the cash is received in situations where proceeds are deferred, such as on the sale of a business or land, while preserving eligibility to existing reliefs (recommendation 8).

Although it may only affect a relatively small number of taxpayers the economic effect is likely to be more significant due to the entrepreneurial nature of the individuals and businesses affected.

The government would have to consider whether there are wider situations where similar treatment should apply and give thought to practical compliance issues (such as those related to an individual becoming non-UK resident) to minimise any unintended consequences.

The government should also consider ensuring that future proceeds payable in forms other than cash (such as corporate bonds) could qualify for Business Asset Disposal Relief.

Standalone recommendations

The next four recommendations are standalone measures where it may be possible to deliver practical benefits for taxpayers though discrete and relatively uncontentious changes.

Share pooling

Share holdings of a particular type are normally grouped together or 'pooled' as a whole for Capital Gains Tax purposes when they are sold.

This usually operates as a simplification measure which means taxpayers do not have to keep track of which of their identical assets they have sold. However it can result in greater complexity in some situations, such as where an individual has more than one investment manager.

The government should consider whether individuals holding the same share or unit in more than one portfolio should be treated as holding them in separate pools (recommendation 4).

This will relieve the relatively small number of individuals with more than one investment manager from having to perform calculations based on the interpretation of a complex range of financial statements and help to facilitate better use of third-party data.

Private Residence Relief and garden developments

The OTS considers that the scope of Private Residence Relief is generally fit for purpose and adequately supports its policy objective.

However, the rules on use of gardens can produce unexpected and distortionary outcomes. For instance, homeowners who sell their garden to a developer can usually receive full Private Residence Relief on the sale. However, homeowners who choose to split their own land, and build a new home for themselves to move into,

may not receive full Private Residence Relief on the new home in relation to the period before the house was built.

The government should consider adjusting Private Residence Relief to cover developments in a taxpayer's garden which the taxpayer subsequently occupies (recommendation 5).

This would make self builds, which are not uncommon, more tax-neutral.

Divorce and Separation

Married couples or civil partners can transfer assets between each other without triggering an immediate Capital Gains Tax charge. The transfers are made on a 'no gain no loss' basis, which means that the base cost of the asset transferred from the previous owner is inherited by the new owner.

Divorcing or separating couples continue to get the same treatment as married couples in this respect in the tax year of their separation. However, from the following tax year transfers take place at market value in accordance with the normal Capital Gains Tax rules.

All the respondents to the OTS Call for Evidence who considered this issue agreed that the length of time given to separating couples was inadequate - the average time between applying for and securing a divorce in England and Wales in 2020 being 53 weeks.[8]

The government should extend the 'no gain no loss' window on separation to the later of:

- the end of the tax year at least two years after the separation event
- any reasonable time set for the transfer of assets in accordance with a financial agreement approved by a court or equivalent processes in Scotland (recommendation 7)

This recommendation may only impact a small percentage of separating couples but is nonetheless important. It is unrealistic to expect separating couples to have resolved their affairs by the end of the tax year of their separation, in part because financial agreements are relevant for a third of divorces,[9] and it is unfair to those without tax advisers.

Debts

One type of company debt is a known as a corporate bond. It is likely that a significant proportion of the 43,300 medium and large companies use corporate bonds.[10]

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8 Family Court Statistics Quarterly: October to December 2020. https://www.gov.uk/government/statistics/family-court-statistics-quarterly-october-to-december-2020/family-court-statistics-quarterly-october-to-december-2020

9 Law Society Call for Evidence response.

10 Figure represents businesses with 50 or more employees. https://www.gov.uk/government/statistics/business-population-estimates-2019/business-population-estimates-for-the-uk-and-regions-2019-statistical-release-html

When a company is sold it is possible to defer the tax on any part of the proceeds received in the form of a corporate bond until the corporate bond is repaid.

How the corporate bond is treated for Capital Gains Tax purposes is effectively a choice determined by the absence or inclusion of specific terms in the loan documentation which generally have no other commercial significance.

The government should consider enabling an irrevocable provision in the documentation for a corporate bond to specify that it is subject to Capital Gains Tax, and for the absence of such a provision to mean that it is exempt (recommendation 9).

This would remove the need for confusing and complex clauses to be included in loan documentation, purely for tax purposes.

Additional Recommendations

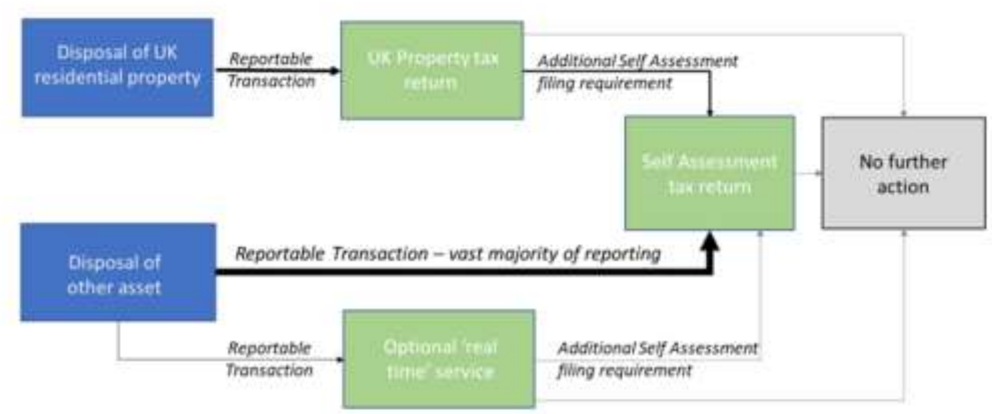
Reporting and paying Capital Gains Tax

There are currently several different ways UK resident individuals report Capital Gains Tax transactions to HMRC. In some cases, this involves disposals being reported more than once.

1. The most common way to report a disposal is through **Self Assessment**
2. The next most common way to report a gain is via the **UK Property tax return**
3. A very small minority of people choose to report gains early through the **'real time' Capital Gains Tax service**

The interaction between different ways of reporting disposals is illustrated in a simplified way below.

Diagram A: Diagram showing different ways of reporting capital disposals



Source: OTS

The OTS considers that the 'real time' Capital Gains Tax service has room for improvement. Although voluntary the very low number of people using it - only 1,670 in tax year 2018-19[11] - is disappointing in the context of HMRC's long-term

[11] 1,670 taxpayers used it to report disposals of assets other than residential property. See Annex D.

aspiration to reduce the number of taxpayers needing to complete a Self Assessment tax return.[12]

The government should formalise the administrative arrangements for the 'real time' Capital Gains Tax service, effectively making it into a standalone Capital Gains Tax return that is usable by agents (recommendation 2).

It would then be governed by defined rules, with clear enquiry and filing deadlines. The scope of the service should also be expanded to include agents.

This change could facilitate earlier payment by more of the 250,000[13] or so taxpayers who pay Capital Gains Tax each year, and in doing so it would save them time and improve their tax reporting and paying experience.

UK Property tax return

The requirement to report taxable gains on a UK residential property disposal within 30 days is a very ambitious target for many taxpayers – as indicated by the fact that a third of the initial returns received took longer than 30 days to arrive.[14] This concern was also reflected in the overwhelmingly negative response that this policy received in the Call for Evidence.

Many taxpayers only find out about their obligations after they have sold their property. But even with adequate awareness and preparation the OTS considers that 30 days is still a challenging deadline.

The government should consider extending the reporting and payment deadline for the UK Property tax return to 60 days, or mandate estate agents or conveyancers to distribute HMRC provided information to clients about these requirements (recommendation 3).

Either approach would give the approximately 150,000 individuals who report a disposal of a residential property in a typical year[15] more time to consider whether they have a taxable gain, and for the 85,000 of those who do have a taxable gain to file a UK Property tax return. The former approach would simply create a longer window, and the latter more subtly by making taxpayers aware of their obligations earlier on and so giving them more time to prepare in advance of the sale.

The predicted cash flow effect on the Exchequer in the 2021-22 tax year of extending the deadline to 60 days in estimated to be approximately £105 million. The cost would come down significantly in subsequent tax years, and this figure needs to be considered in the context of the £935 million that this policy change raised in tax year 2020-21.[16]

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12 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/413975/making-tax-easier.pdf

13 Average 254,000 individual taxpayers over four tax years from 2015-16 to 2018-19 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/908647/Table_1.pdf

14 HMRC data 6 April 2020 – 6 January 2021. See Annex D.

15 HMRC have advised the OTS that approximately 85,000 individuals paid Capital Gains Tax on a disposal of residential property for tax year 2018-19 (out of 150,000 reporting a disposal of residential property).

16 HMRC data 2020-21 & 2021-22. See Annex D.

Enterprise investment schemes

The Enterprise Investment Scheme together with the Seed Enterprise Investment Scheme are intended to provide financial support for growth investment in start-up and early-stage companies. Over 40,000 taxpayers use an enterprise investment scheme every year.[17]

Both reliefs have restrictive eligibility criteria which requires specific clearance from HMRC but provide a complete exemption from Capital Gains Tax as well as upfront Income Tax relief.

The OTS has heard from several respondents to the Call for Evidence that the rules are overly limiting or cause practical problems for genuine applicants.

The OTS has also identified a number of specific areas that regularly cause practical concern which if addressed could better enable the relief to achieve its policy objectives. These include the short deadlines for issuing shares, the interaction with Business Asset Disposal Relief, the potential for abuse with low value investments, a cumbersome application process, and the link between eligibility for Capital Gains Tax and Income Tax.

The government should review the rules for enterprise investment schemes, with a view to ensuring that procedural or administrative issues do not prevent their practical operation (recommendation 10).

There is evidence to suggest that tax incentives for venture capital investment generates a number of positive macroeconomic benefits[18] and business investment will be all the more important as the economy recovers from the effects of COVID-19.

These changes could remove a range of anomalies that can currently frustrate the uptake of these schemes and so facilitate more financial support for start-up and early-stage companies.

Equally, the government should continue to monitor whether the reliefs are being used for investments that are not in keeping with their original intention.

Foreign assets

When foreign assets are bought or sold their costs and proceeds are converted into sterling when they are incurred or received in order to calculate the gain. This means that their absolute gains or losses in the foreign currency are ignored for Capital Gains Tax purposes.

This approach can be complicated as it requires historical exchange rate conversions of both the acquisition cost and any enhancement expenditure.

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[17] EIS statistical data, Tables 8.5 and 8.15.

https://www.gov.uk/government/statistics/enterprise-investment-scheme-seed-enterprise-investment-scheme-and-social-investment-tax-relief-statistics-may-2020

[18] Effectiveness of tax incentives for venture capital and business angels to foster the investment of SMEs and start-ups 2017, PricewaterhouseCoopers LLP, Center for Social and Economic Research, & Institute for Advanced Studies, produced for the European Commission, p9.

https://ec.europa.eu/taxation_customs/sites/taxation/files/final_report_2017_taxud_venture-capital_business-angels.pdf

The government should consider whether gains or losses on foreign assets should be calculated in the relevant foreign currency and then converted into sterling (recommendation 11).

This would be simpler for those taxpayers who operate foreign bank accounts and more intuitive for those regularly buying and selling assets in foreign currencies, though the government would also have to consider the implications for those who operate mainly in sterling.

HMRC information indicates that one in ten UK taxpayers have an offshore financial interest so this recommendation has wide relevance.[19]

Rollover Relief in compulsory purchase situations

Although owners of 'let' land are not normally eligible to claim rollover relief on its sale, special rules allow for such a claim where the let land has been compulsorily purchased.

However, there are restrictions around such claims which the OTS understands present particular challenges for owners of farming land.

For example, it is hard to see the economic rationale for restricting Rollover Relief reinvestment to a 'like for like' basis if a more commercially rational decision would be to buy new agricultural buildings rather than replacement land. Acquiring replacement neighbouring land may also be very difficult due to an increasingly thin land market.

There are also a number of technical problems with Rollover Relief in compulsory purchase situations, around for example, time limits, provisional claims, and willingness to sell.

The government should expand the specific rollover relief rules which apply where land and buildings are acquired under Compulsory Purchase Orders (recommendation 12).

This issue is expected to grow over coming years. The total number of compulsory purchases is unknown but 50,000 compulsory purchase notices are expected to be issued between 2017 and 2023 in relation to Phase One of the High Speed 2 programme alone.[20] Many of these will relate to owners of agricultural land.

Expanding the relief may free up owners of agricultural land to reinvest in more economically efficient improvements.

The OTS is mindful that there may also be parallels with the way other sectors or ownership models operate so any solution could apply more widely than to agricultural landowners.

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[19] No Safe Havens 2019: responding appropriately.
https://www.gov.uk/government/publications/no-safe-havens-2019/no-safe-havens-2019-responding-appropriately

[20] Investigation into land and property acquisition for Phase One (London – West Midlands) of the High Speed 2 programme, National Audit Office, p4. https://www.nao.org.uk/wp-content/uploads/2018/09/Investigation-into-land-and-property-acquisition-for-the-Phase-One-Full-report.pdf

Flat Management Companies

Leases are a form of time-limited property ownership where ultimate control of the property is shared with, and limited by, the person holding the underlying freehold interest in the property.

Ministry of Housing, Communities and Local Government statistics indicate there were about 4.5 million residential leasehold properties in England in the 2018-19 financial year, of which 69% - around 3.1 million - were flats.[21]

Many freeholds are owned by third parties, but some are owned by a company owned by the leaseholders of flats in the building. These leaseholders are often described as owning a share of the freehold.

If a leaseholder owns the freehold and extends their own lease, they could be faced with a tax charge on their own lease extension even where no payment is made for that extension.

The government should consider exploring ways of removing inappropriate Corporation Tax or Capital Gains Tax charges where a freeholder is in effect only extending their own lease (recommendation 13).

While the majority of leaseholders are unlikely to be affected, as they have either extended their lease already or do not own a share of the freehold, resolving this could save the minority who are affected significant amounts of Corporation Tax.

HMRC Guidance

Finally, the report makes a number of practical and positive suggestions about how HMRC could boost awareness and understanding through improved guidance in order to provide a better experience for taxpayers. These suggestions are woven into the relevant chapters and support several of the recommendations above.

HMRC should improve their guidance in the following specific areas (recommendation 14):

- the UK Property tax return
- lodgers and people working from home
- when a debt is a debt on a security
- when a loan to a business becomes irrecoverable
- when Business Asset Disposal Relief could apply to farmers or others looking to retire over a period of time
- enterprise investment schemes
- land assembly arrangements
- flat management companies

[21] Leasehold and commonhold reform: Trends in leasehold tenure. https://commonslibrary.parliament.uk/research-briefings/cbp-8047/

List of Recommendations

Awareness and Administration (Chapter 1)

1 HMRC should integrate the different ways of reporting and paying Capital Gains Tax into the Single Customer Account, making it a central hub for reporting and storing Capital Gains Tax data.

2 The government should formalise the administrative arrangements for the 'real time' Capital Gains Tax service, effectively making it a standalone Capital Gains Tax return that is usable by agents.

3 The government should consider extending the reporting and payment deadline for the UK Property tax return to 60 days, or mandate estate agents or conveyancers to distribute HMRC provided information to clients about these requirements.

4 The government should consider whether individuals holding the same share or unit in more than one portfolio should be treated as holding them in separate share pools.

Main homes (Chapter 2)

5 The government should consider adjusting Private Residence Relief to cover developments in a taxpayer's garden which the taxpayer subsequently occupies.

6 The government should review the practical operation of Private Residence Relief nominations, raise awareness of how the rules operate, and in time enable nominations to be captured through the Single Customer Account.

Divorce and separation (Chapter 4)

7 The government should extend the 'no gains no loss' window on separation to the later of:

- the end of the tax year at least two years after the separation event
- any reasonable time set for the transfer of assets in accordance with a financial agreement approved by a court or equivalent processes in Scotland.

Business issues (Chapter 5)

8 The government should consider whether Capital Gains Tax should be paid at the time the cash is received in situations where proceeds are deferred such as on the sale of a business or land, while preserving eligibility to existing reliefs.

9 The government should consider enabling an irrevocable provision in the documentation for a corporate bond to specify that it is subject to Capital Gains Tax, and for the absence of such a provision to mean that it is exempt.

Investor issues (Chapter 6)

10 The government should review the rules for enterprise investment schemes, with a view to ensuring that procedural or administrative issues do not prevent their practical operation.

11 The government should consider whether gains or losses on foreign assets should be calculated in the relevant foreign currency and then converted into sterling.

Land and property issues (Chapter 7)

12 The government should expand the specific Rollover Relief rules which apply where land and buildings are acquired under Compulsory Purchase Orders.

13 The government should consider exploring ways of removing inappropriate Corporation Tax or Capital Gains Tax charges where a freeholder is in effect only extending their own lease.

HMRC guidance

14 HMRC should improve their guidance in the following specific areas:

- the UK Property tax return (para 1.101)
- lodgers and people working from home (para 2.114)
- when a debt is a debt on a security (para 5.80)
- when a loan to a business becomes irrecoverable (para 5.81)
- when Business Asset Disposal Relief could apply to farmers or others looking to retire over a period of time (para 5.88)
- enterprise investment schemes (para 6.41)
- land assembly arrangements (para 7.87)
- flat management companies (para 7.118)

Chapter 1
Awareness & Administration

Awareness

1.1 A persistent theme running through many of the responses the OTS has received to the Call for Evidence is that many people have limited awareness or understanding of Capital Gains Tax, of when it may arise, or of their reporting and paying obligations where it does.

1.2 None of this absolves taxpayers from their responsibility to pay tax. But it does mean that it would be particularly helpful if the technical and administrative rules, and the supporting HMRC guidance and processes, were as intuitive as possible. Alongside this it is important that the rules and guidance are regularly updated so that they remain in tune with the way people live.

1.3 This report highlights several areas where more could possibly be done to raise awareness and makes a number of practical suggestions about how HMRC could help taxpayers to meet their Capital Gains Tax obligations.

Levels of awareness

1.4 Two particular reasons for the generally low levels of awareness are that:

- the tax affects relatively few people every year - in tax year 2017-18[1] only 265,000 people paid Capital Gains Tax in contrast with the 31 million people who paid Income Tax[2]
- those who do pay Capital Gains Tax do so infrequently - over 70% of all those who paid Capital Gains Tax in the eleven tax years to 2017-18 did so only once in that period[3]

1.5 However, the tax impacts many more people than these figures might suggest.

1.6 Over the period of eleven tax years from 2007-08 to 2017-18, a total of 1.5 million different individual taxpayers reported taxable gains (in excess of amounts covered by the Annual Exempt Amount). But many more people

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1 HMRC Capital Gains Tax statistical tables. See Annex D.

2 HMRC's Income Tax liabilities statistics tables, Table 2.1: https://www.gov.uk/government/statistics/income-tax-liabilities-statistics-tax-year-2017-to-2018-to-tax-year-2020-to-2021.

3 HMRC CGT statistics 2017/18. This information is included and explained in the OTS's first report on Capital Gains Tax: https://www.gov.uk/government/publications/ots-capital-gains-tax-review-simplifying-by-design.

are required to interact annually with Capital Gains Tax than the number of those who actually pay it - in tax year 2017-18 over 500,000 returns were made.[4]

1.7 Many of those affected do not have high incomes – over half of them paid no Income Tax or did so only at the basic rate in tax year 2017-18.[5] In addition, as the OTS's first report on Capital Gains Tax explored, Capital Gains Tax tends to affect taxpayers on a one-off basis so they do not readily pick up the knowledge and experience that comes from dealing with something regularly.[6]

1.8 Also, unlike Stamp Duty Land Tax (another tax people typically engage with on a one-off basis), many Capital Gains Tax payers interact directly with HMRC rather than it being very common to rely on an intermediary such as a tax agent or lawyer.

Professional advisers

1.9 Professional advisers play an important role in helping taxpayers to meet their tax obligations and are engaged by about three quarters of those who pay Capital Gains Tax.[7] Responses to the OTS online survey suggest that people quite often engage an agent to help them with Capital Gains Tax because they have limited understanding of the rules and lack confidence in the support offered by HMRC.

HMRC awareness strategy

1.10 Investing in providing help and guidance and so increasing levels of awareness is central to any attempt to improve tax administration. It may increase administration costs in the short term but will reduce compliance costs both for taxpayer and HMRC over the long term. Greater public awareness is also valuable in itself to improve and maintain confidence in the integrity of the system.

1.11 HMRC's commitment to investing in raising awareness of Capital Gains Tax rules is evident through their newsletters, post Budget updates, Twitter, agent working groups, and webinars. They also provide fliers for specific professional groups to hand out, such as for non-residents disposing of UK residential property. In addition, HMRC maintain over 60 pages of guidance on GOV.UK and support many more pages of detailed technical guidance.[8]

1.12 The OTS welcomes this commitment and in this report suggests ways for developing and improving things still further in this area.

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4 See note 5 on page 6: HMRC have advised that approximately 500,000 individuals submitted a Capital Gains Tax filing for the tax year 2017-18.

5 HMRC's Capital Gains Tax statistical tables, Table 3 (151,000 out of 265,000 had taxable income of between £0 and £32,000). See Annex D.

6 Although there are a few people who make gains every year, in an 11-year sample period 72% of taxpayers paid only once.

7 HMRC have advised that approximately 74% of individual taxpayers who reported a Capital Gains Tax liability for tax year 2018-19 included details of an agent in their Self Assessment tax return.

8 HMRC Capital Gains Tax manual https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual

Awareness in the context of other OTS reports

1.13 This lack of awareness of Capital Gains Tax chimes with what the OTS found in its *Taxation and Life Events* report. Despite the range of accessible and engaging 'Tax Facts' material HMRC has produced for schools, and HMRC deterrence campaigns, it seems that the level of knowledge and awareness about tax matters is lower than it is widely felt would be desirable.[9]

1.14 In addition, a recent YouGov survey commissioned by Deloitte on the Tax Education Gap confirmed that tax knowledge is important, as tax affects so many economic and family choices[10] and without it people may not understand the implications of particular decisions.

1.15 Tax knowledge also has an impact on the tax gap (the difference between the amount of tax that should be paid, and what is actually paid). Addressing this wider issue could give HMRC greater ability to tackle evasion and avoidance and reduce the level of unintended error.

1.16 The recommendations in the *Taxation and Life Events* report are also relevant here:

- HMRC should collaborate more with relevant external bodies, including schools and in further and higher education, seeking to improve the public's understanding of tax and finance, when seeking to extend the reach of their own tax education materials
- HMRC should extend their collaboration with academic researchers to quantify the effect of HMRC's tax education programme and explore the potential for a cost/benefit measure to allow HMRC to prioritise and target their tax education resources[11]

HMRC guidance

1.17 As noted in paragraph 1.2, it is important for HMRC guidance to be regularly updated. The OTS has identified a number of specific areas where the Capital Gains Tax rules are particularly complex and where responses to the Call for Evidence show that expanded or clearer HMRC guidance would be welcome. These areas are listed below and considered in more detail elsewhere in the report as indicated.

Recommendation 14

The OTS has identified the following specific areas where HMRC could improve their guidance:

- the UK Property Tax return (para 1.101)

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[9] Taxation and Life Events: Simplifying tax for individuals, OTS, p14. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/838130/Taxation_and_life_events_Oct_2019.pdf.

[10] The Tax Education Gap – is it time to talk tax?, Deloitte, p1. https://www2.deloitte.com/uk/en/pages/tax/articles/tax-education-gap.html/.

[11] Taxation and Life Events: Simplifying tax for individuals, OTS, p14. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/838130/Taxation_and_life_events_Oct_2019.pdf.

- lodgers and people working from home (para 2.114)
- when a debt is a debt on a security (para 5.80)
- when a loan to a business becomes irrecoverable (para 5.81)
- when Business Asset Disposal Relief could apply to farmers or others looking to retire over a period of time (para 5.88)
- enterprise investment schemes (para 6.41)
- land assembly arrangements (para 7.87)
- flat management companies (para 7.118)

Administration

Reporting and paying Capital Gains Tax

1.18 There are currently several different ways taxpayers can report capital disposals to HMRC. In some cases, the same disposal must be reported more than once. As many individuals make capital disposals infrequently, they may only make a report once in, say, a 10 year period.

1.19 The most common way to report disposals is through the main **Self Assessment tax return** on the Capital Gains Tax supplementary pages (SA108).

1.20 An individual will need to include details of their capital disposals on a Self Assessment tax return if the total gains arising are above the Annual Exempt Amount, or if the proceeds received are more than four times the Annual Exempt Amount.

1.21 If an individual has Capital Gains Tax to pay and has not been issued with a Self Assessment tax return (and the tax has not been paid in full under either of the other two options outlined below), then they must notify HMRC by 5 October following the end of the tax year so that a Self Assessment tax return can be made.

1.22 The next most common way to report gains is through the **UK Property tax return**. This return is also known as the '30 day online service'.

1.23 From 6 April 2020, UK residents, individuals, trustees or personal representatives with a gain arising on the disposal of UK residential property (on which there is Capital Gains Tax to be paid) must report it via the new UK Property tax return within 30 days of completion. The main exemption is if it is reported on a Self Assessment tax return within that 30 day period.

1.24 A small minority of people also choose to report gains early, through the voluntary **'real time' Capital Gains Tax service**.

1.25 Taxable gains on the disposal of any assets other than UK residential property (for example commercial property, shares or 'chattels' such as paintings) can be reported in this way. This is completely optional.

1.26 These options are not always mutually exclusive. If an individual is required to complete the main Self Assessment tax return because, say, they are

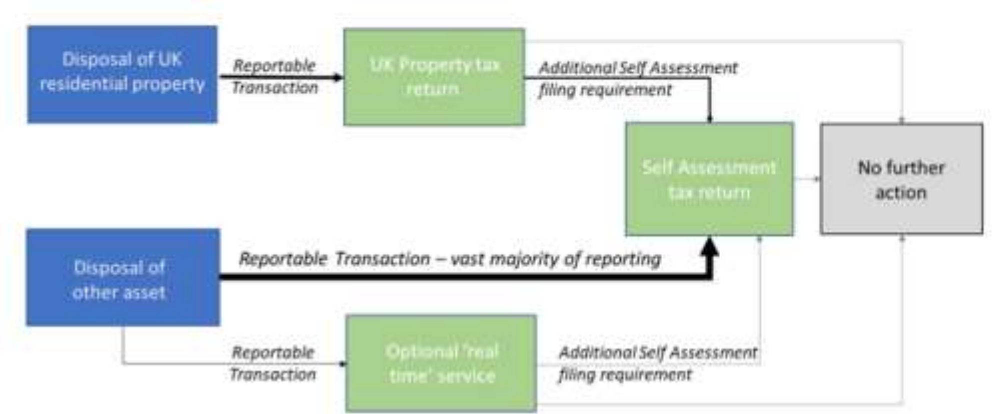
required to report income, then they must include disposals (and will receive a credit for the tax paid) previously reported through the UK Property tax return or the 'real time' Capital Gains Tax service. However, for some taxpayers their obligations can start and end with the UK Property tax return or the 'real time' Capital Gains Tax service if all the tax has been correctly paid in one of those ways.

1.27 It should be noted that the filing requirement for the UK Property tax return is within 30 days of completion of the sale, whereas the relevant date for including a property disposal in a Self Assessment tax return is the date of exchange.

1.28 Of the 1,200 or so respondents to the OTS Capital Gains Tax online survey, 22% said that they used accounting software to help them calculate or pay Capital Gains Tax.[12]

1.29 The interaction between different ways of reporting disposals is illustrated in a simplified way below.

Diagram 1.A: Diagram showing different ways of reporting capital disposals



Source: OTS

Losses

1.30 Individuals must notify HMRC of capital losses, within four tax years, if they want to offset them against gains. If a taxpayer is completing a Self Assessment tax return, including the Capital Gains Tax pages, then this is relatively straightforward. Any losses made in that tax year would be included and offset against gains, with any unused amount carried forward to a future tax year.

1.31 However, if a Self Assessment tax return is not being completed, the loss must be claimed by writing to HMRC. If the reason for not completing a return is because the gains, are below the Annual Exempt Amount, then only the current year losses that are not used against those current year gains are available to be claimed and offset against future gains.

12 See Annex D, under subheading '*OTS Survey*'.

Record keeping and information gathering

1.32 In order to report a tax liability a taxpayer must first have the information available to calculate the tax. This could involve finding evidence of base costs, enhancement expenditure, losses, or nominations made many years ago.

1.33 Record keeping and information gathering are of central importance to the taxpayer experience of Capital Gains Tax. It is telling that approaching half of the 1,200 or so respondents to the OTS Capital Gains Tax online survey said that these took them the longest part of the Capital Gains Tax process.[13]

Table 1.A: Table showing responses to OTS CGT survey 2020

What aspects of the Capital Gains Tax process took you the longest?	
Keeping records or gathering information	40%
Calculating base costs	17%
Understanding reliefs or exemptions	12%
Understanding and completing the forms	10%
Understanding whether needed to report	7%
Obtaining valuations	5%
Following up with HMRC	3%
Other	7%

Source: OTS CGT Survey

1.34 This suggests that when HMRC consider how to improve their Capital Gains Tax infrastructure they should prioritise changes that will most support taxpayers with record keeping and information gathering.

Personal Tax Accounts and Single Customer Accounts

Background – how it works at the moment

1.35 Over 19 million taxpayers have signed up for a Personal Tax Account,[14] which will ultimately be replaced by the Single Customer Account.

1.36 The Single Customer Account features strongly in HMRC's Tax Administration Strategy:[15]

'A [Single Customer Account] for all taxpayers that is easily accessible and secure is a key component of the government's vision. This will bring together data across different taxes and different data sources in order to provide personalised services

13 See Annex D, under subheading '*OTS Survey*'. Due to rounding the table adds up to 101%

14 Overview of HMRC's annual report and accounts 2018 to 2019. https://www.gov.uk/government/publications/hmrc-annual-report-and-accounts-2018-to-2019/overview-of-hmrcs-annual-report-and-accounts-2018-to-2019.

15 Building a trusted, modern tax administration system. https://www.gov.uk/government/publications/tax-administration-strategy/building-a-trusted-modern-tax-administration-system.

for taxpayers, and at the same time improve parallel services for their agents or representatives working towards HMRC's vision for agents to be able to see and do what their clients can, and designing in agent access from the outset. It will help HMRC to learn more about what taxpayers need and want from their services, in turn helping them build better services and more targeted guidance for taxpayers in a wider range of different circumstances. Better and more real-time information would also enable the government to design more targeted taxes and reliefs.'

1.37 The government committed £68 million for the first year of development of the Single Customer Account and the Single Customer Record in Budget 2021.[16]

1.38 The Single Customer Record sits behind the Single Customer Account to bring together the different taxes and data sources associated with a particular taxpayer, enabling HMRC to deliver a more personalised and joined up service.

Observations – challenges with this approach

1.39 The OTS is encouraged that a Single Customer Account for all taxpayers that is easily accessible and secure is a key component of the government's vision.

1.40 As the OTS explored in its Reporting and Payment Review, an online digital platform is a modern way for a taxpayer to report income to HMRC and receive information about their tax affairs from the tax authority.[17]

1.41 However, the Personal Tax Account does not currently include all taxpayers (such as trusts or personal representatives) and it is not clear at what stage Capital Gains Tax will be included in the ambitious programme for the Single Customer Account.

Specific challenges

1.42 The Personal Tax Account as a free-standing system falls short of its potential, and some tools HMRC have built do not directly interact with it.

1.43 There is no interaction between the Personal Tax Account and the 'real-time' Capital Gains Tax service or the UK Property tax return. These operate on parallel systems that require separate registration.

1.44 It does not allow taxpayers to report information in a centralised and consistent way. Instead taxpayers are forced to interact directly with HMRC to make holdover claims, claim capital losses, or make main residence nominations.

1.45 It does not record the information that the taxpayer has already provided which may be useful later. So, for example, it does not record the capital loss claims that have already been made by the taxpayer and flag up when they

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[16] FST speech to HMRC virtual stakeholder conference.
https://www.gov.uk/government/speeches/speech-to-hmrc-virtual-stakeholder-conference.

[17] Tax reporting and payment: Simplifying tax for self-employed people and residential landlords, OTS, p5.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/843531/OTS_Tax_reporting_and_payment_review.pdf.

can be utilised. This is particularly relevant as it can be easy to lose track of capital losses especially when changing advisers.

Conclusions – how the system could be improved

1.46 A future modern and fully integrated Single Customer Account would log relevant information for the taxpayer, interact with other Capital Gains Tax filings by the taxpayer and act as a gateway to pay the tax.

1.47 This would ease the administrative burden for potentially all of the 500,000[18] or so people who file returns of capital gains in any given year. It would also help those who struggle to pay, by making it easier to be aware of what tax may have to be paid. Agents should have access with the taxpayer's approval.

1.48 The OTS recognises that a fully integrated system will be expensive and take time and more resources to create.

Specific improvements

1.49 As the OTS's first report on Capital Gains Tax stated, the Single Customer Account could be a central hub to claim losses.[19] It could also hold details of main residence nominations, and ultimately it could be at the core of the effective implementation of many of the recommendations that follow in this report, but the OTS accepts that it may have to be developed in stages.

1.50 So the OTS has also considered interim improvements alongside wholesale reform, such as the following:

- the Single Customer Account could link to the UK Property tax return and the 'real-time' Capital Gains Tax service
- the system could also be used to give prompts about other areas where there may be low awareness, such as the disposal of moveable items such as chattels by way of sale or gift
- in addition, as outlined in Chapter 6, it could be a space where enterprise investments could be notified to HMRC

Recommendation 1

HMRC should integrate the different ways of reporting and paying Capital Gains Tax into the Single Customer Account, making it a central hub for reporting and storing Capital Gains Tax data.

[18] See note 5 on page 6: HMRC have advised that approximately 500,000 individuals submitted a Capital Gains Tax filing for the tax year 2017-18.

[19] OTS Capital Gains Tax Review: Simplifying by design. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/935073/Capital_Gains_Tax_stage_1_report_-_Nov_2020_-_web_copy.pdf.

'Real time' Capital Gains Tax service

Background – how it works at the moment

1.51 The 'real time' Capital Gains Tax service gives UK resident individuals the option to report and pay Capital Gains Tax earlier, as well as removing the requirement to complete a Self Assessment tax return if there is no other need to complete one and all the tax due is paid via this service. It is a voluntary service, with the deadlines for reporting and payment of the tax linked to the normal Self Assessment rules.

1.52 The service was introduced as there are taxpayers who, having perhaps made only one disposal, want to declare and pay the tax right away. This way all the compliance work can be dealt with at the time of the transaction and the tax paid out of the proceeds received.

1.53 It also means that taxpayers who do not otherwise need to complete a Self Assessment tax return only have to provide HMRC with the details of this single transaction. If this service were not available, they would have to complete a Self Assessment tax return and report their income, as well as the gain, even if there was no Income Tax to pay (for example because it was all paid under Pay As You Earn or was less than the Personal Allowance of £12,500).

1.54 Once the taxpayer has provided the information under this service, HMRC issue a reference number and instructions on how to pay the tax. Although the statutory due date for payment is still 31 January following the end of the tax year, this service gives an opportunity for the tax to be paid earlier. A taxpayer must use this service before 31 December following the end of the tax year, in order that HMRC have time to issue the payment instructions before the statutory due date. It is possible to make an amendment under this service.

1.55 The 'real time' Capital Gains Tax service is not widely used. HMRC data shows that in the 2018-19 tax year, which was before the UK Property tax return was introduced, only 5,010 returns were made using the 'real time' Capital Gains Tax service, with just 1,670 returns relating to the disposal of assets than were not residential property. Furthermore, 1,360 of individuals using this service also filed a Self Assessment tax return including the Capital Gains Tax pages.[20] Since 6 April 2020 the disposal of UK residential property is now reported via the UK Property tax return.

Observations – challenges with this approach

1.56 The OTS Tax Reporting and Payment: simplifying tax for self-employed people and residential landlords report found that allowing many people to pay Income Tax early could help them plan and predict their tax affairs.[21] This principle also holds for Capital Gains Tax, if to a lesser extent.

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[20] HMRC data 2018-19. See Annex D.

[21] Tax reporting and payment: Simplifying tax for self-employed people and residential landlords, OTS. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/843531/OTS_Tax_reporting_and_payment_review.pdf.

1.57 Any measures that mean that taxpayers do not have to complete a Self Assessment tax return where they are not otherwise required to do so are also helpful. So, in principle, the 'real time' Capital Gains Tax service is a step in the right direction.

1.58 However, the OTS considers that the 'real time' Capital Gains Tax service is an area where there is much room for improvement.

1.59 In particular, the very low number of people using it is disappointing given HMRC's long-term aspiration to reduce the numbers of taxpayers that have to complete a Self Assessment tax return.[22] If this service was improved these taxpayers would be more inclined to use this service, rather than complete a Self Assessment tax return.

Specific challenges

1.60 The main challenges of the 'real time' Capital Gains Tax service are as follows:

- low levels of awareness – 67% of respondents to the OTS online survey had not heard of it[23] and it is disappointing that there were only 1,670 users of the service for disposal of assets that were not residential property in the 2018-19 tax year,[24] as compared with the 250,000 or so people who pay Capital Gains Tax each year[25]
- the lack of integration with, or a link to, the Personal Tax Account
- the service does not work for all users of the tax system. Agents cannot access the service on behalf of their clients, and it is not immediately obvious how digitally excluded taxpayers can access paper returns
- its legal status – the current 'real time' Capital Gains Tax service is not formalised as a return and several respondents to the OTS Call for Evidence questioned whether it has a sufficiently robust legislative framework which may discourage some from using it

Conclusions – how the system could be improved

1.61 The OTS considers that there would be benefit in formalising the administrative arrangements for the 'real time' Capital Gains Tax service by effectively making it into a standalone Capital Gains Tax return.

1.62 A formalised return would be then governed by defined rules, with clear enquiry and filing deadlines. This would still allow taxpayers to report and pay Capital Gains Tax earlier, which was one of the main reasons for introducing this service.

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22 Making tax easier: The end of the tax return, HMRC. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/413975/making-tax-easier.pdf.

23 See Annex D, under subheading '*OTS Survey*'.

24 HMRC data 2018-19. See Annex D.

25 Average 254,000 individual taxpayers over four tax years from 2015-16 to 2018-19. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/908647/Table_1.pdf.

1.63 It should then be integrated into the new Single Customer Account, so that taxpayers would no longer be required to tell HMRC about the gain again through a Self Assessment tax return unless they need to complete one because they had other income or gains to report.

1.64 The scope of the service should be expanded to include agent access.

1.65 It would be all the more important to improve things in this area if the government were minded to reduce the Annual Exempt Amount, or freeze it beyond the 2025-26 tax year (announced by the Chancellor in the March 2021 Budget), as more taxpayers would then have taxable gains to report.[26]

Recommendation 2

The government should formalise the administrative arrangements for the 'real time' Capital Gains Tax service, effectively making it into a standalone Capital Gains Tax return that is also usable by agents.

UK Property tax return

Background – how it works at the moment

1.66 Lack of awareness of the UK residential property rules presents a particular problem for taxpayers.

1.67 Approximately 150,000 individuals reported a disposal of residential property in tax year 2018-19, of whom 85,000 had a Capital Gains Tax liability.[27] (The requirement to report a disposal under Self Assessment goes wider than situations in which there is Capital Gains Tax to pay).

1.68 From 6 April 2020, taxable capital gains on disposals of UK residential property,[28] by UK-resident individuals, trustees or personal representatives must be reported to HMRC and the tax paid within 30 days of the completion date for the disposal.

1.69 This is primarily an online service but there is a facility for a paper return to be made for digitally excluded taxpayers.

UK Property tax return take up

1.70 The total number of returns made in the 9 month period from 6 April 2020 (6 May being the first due date for these returns) to 6 January 2021 is illustrated in the chart below.

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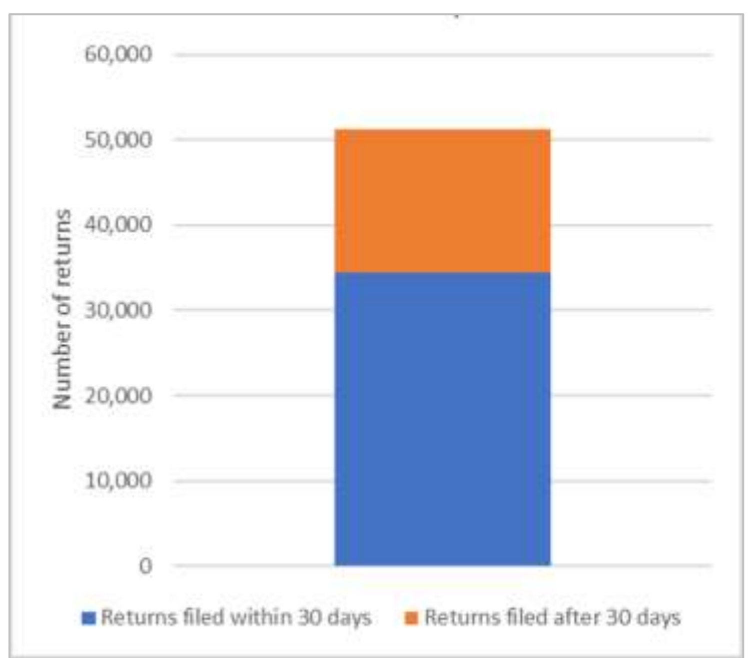
[26] Capital Gains Tax: Simplifying by Design, OTS.
https://www.gov.uk/government/publications/ots-capital-gains-tax-review-simplifying-by-design.

[27] HMRC have advised that approximately 85,000 individuals paid Capital Gains Tax on a disposal of residential property for tax year 2018-19 (out of 150,000 reporting a disposal of residential property).

[28] HMRC guidance. https://www.gov.uk/guidance/capital-gains-tax-for-non-residents-uk-residential-property#direct-disposals

Chart 1.A: Chart showing UK Property tax returns filed 6 April 2020 to 6 January 2021



Source: HMRC statistics. Data collection period 6 April 2020 – 6 January 2021. [29]

1.71 The chart shows that 67% were filed within 30 days and 33% filed outside of 30 days.

1.72 HMRC extended the deadline to 31 July 2020 for disposals with completion dates between 6 April 2020 to 30 June 2020 which will have affected the timing of some returns.

1.73 There may however be some taxpayers who have not completed a UK Property tax return at all when they should have done, due to a lack of awareness of the new system. The numbers affected should become clearer once Self Assessment tax returns are made for the 2020-21 tax year (which are due by 31 January 2022).

1.74 Ordinarily, any analysis would try to gauge such figures by making a comparison with the overall level of UK residential property disposals in previous years, but this is not feasible given the impact of COVID-19 on the number of property transactions during the 2020-21 tax year.

UK Property tax return process

1.75 In order to use the UK Property tax return system, within the 30 day period the taxpayer must create a Government Gateway user ID (if they don't already have one) and set up a UK property account. If using an agent, even if there is already an authorisation in place for the agent to deal directly with HMRC, a new authorisation has to be put in place. Emerging evidence from HMRC suggests that about 40% of UK Property tax returns are filed by agents.[30]

[29] See Annex D.

[30] See Annex D.

1.76 To be able to correctly complete the return and calculate the tax payable a taxpayer will need the following information:

- the price paid for the property (or its value when received as a gift or inheritance)
- the cost of any capital improvements
- the third party costs of acquisition and disposal, such as legal fees
- the extent to which Private Residence Relief applies to any part of the gain
- details of any capital losses from earlier disposals in the tax year or any available Annual Exempt Amount to offset against the gain
- details of any capital losses brought forward from previous tax years
- an estimate of their income for the whole tax year to determine which tax rate or rates are likely to apply

1.77 If it is not possible to obtain this information in the 30 day period, or the taxpayer chooses not to form a view about their wider income and capital gain or loss position for the tax year, then the tax paid is effectively a payment on account and only an estimate of the tax payable. Any further tax payable (or repayable) would follow either an amendment of the UK Property tax return or in the Self Assessment tax return.

Observations – challenges with this approach

1.78 Some of the problems experienced by taxpayers are likely to reduce over time as the new system beds in and awareness improves.

1.79 The government may need to wait until February 2022 when Self Assessment tax returns have been filed for the tax year of this measure being introduced to fully understand the number of UK Property tax returns that were either late, not submitted at all or inaccurately estimated. However, it is clear that the challenges are more than just 'teething' troubles.

Temporary challenges

1.80 HMRC have continued to develop the digital service and functionality has improved since it was first introduced. However, there are still some issues, including in relation to personal representatives administrating an estate, who can submit a return but are then unable to view it, make amendments or obtain online payment details.

The 30 day period

1.81 For many taxpayers, 30 days is a very ambitious target – and it is clearly a cause for concern that a third of the returns that were filed took longer than 30 days to arrive.[31] This was strongly reflected in the negative responses that this policy area received in the OTS Call for Evidence.

[31] HMRC data 6 April 2020 – 6 January 2021. See earlier footnote and Annex D.

1.82 In theory taxpayers could start to prepare for the submission of the return before the 30 day period starts, as they will know about their intended disposal in advance. However, this presupposes better general awareness of this obligation than is indicated by current evidence.

1.83 Even with adequate awareness and preparation the OTS considers that 30 days is still a challenging deadline for many taxpayers, who will not dispose of properties often, to gather the information that they need to calculate the tax due and, if they have a tax liability, to register in order to fulfil their obligations.

1.84 The OTS has also been told that the timeframe presents a particular challenge for separating couples who may not receive their share of the money to pay the tax until any divorce settlement is finalised.

Systems challenges

1.85 In addition, the new system itself is complex.

1.86 This is particularly true for agents - one professional adviser told the OTS they had produced a 30 page guide on how to operate the new system.

1.87 The challenge agents face does not start with the new system. HMRC are in the process of modernising their systems and processes, but one of the areas that currently falls short is agent registration which is also a complex and a time-consuming process as authorisation permissions cannot be neatly rolled over from one tax head to another.[32]

1.88 This issue goes much wider than Capital Gains Tax, but it is particularly relevant here due to the short timeframe within which the UK Property tax return has to be made.

Finalising the tax position

1.89 If the taxpayer does not have all the information required to calculate the tax at the time, they will need to make estimates, so the tax paid will be not final. The taxpayer will then be required to amend the return to correct the position, which may mean that further tax should have been paid within the 30 days or too much tax has been paid. The UK Property tax return generally cannot be amended because of subsequent events, such as the realisation of a capital loss on a share portfolio, so in such cases a Self Assessment tax return would need to be completed.

1.90 Also, if the taxpayer has a Self Assessment filing requirement, they must include the disposal again in this tax return, with a credit for the tax paid, irrespective of whether any amendment is required to the original information filed. Furthermore, the disposal is only included if the date of exchange falls within the tax year. For example, if the date of exchange is 1 March 2021 and completion on 10 April 2021, the transaction will need to be included in the 2020-21 tax return.

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[32] The tax administration framework: Supporting a 21st century tax system, p16. https://www.gov.uk/government/consultations/call-for-evidence-the-tax-administration-framework-supporting-a-21st-century-tax-system.

1.91 The enquiry window for a UK Property tax return is the same as under Self Assessment, as it relates to the tax year. So the length of the enquiry window on a property disposal will be longer if the disposal is made earlier in a tax year.

Guidance challenges

1.92 There is no guidance on whether an amendment to the UK Property tax return must be made when the estimate is confirmed or only corrected when the disposal is reported on the Self Assessment tax return (if one is being made).

1.93 The OTS received comments that it was not clear from HMRC's guidance in what circumstances, if any, late interest would be charged, particularly in relation to what HMRC would consider to be reasonable in estimating the tax due. This could be significant as interest can potentially apply for a period of up to 20 months.

Conclusions – how the system could be improved

Extending the 30 day period

1.94 One option would be for the government to extend the reporting and payment deadline to say 60 or 90 days, to give taxpayers more time to fulfil their tax obligations. In this scenario, alongside considering other factors such as the fact that a third of the initial returns took longer than 30 days to arrive, the government would need to consider the Exchequer implications.

1.95 When the measure was first introduced there was positive cash flow for the Exchequer estimated as £935 million for the 2020-21 tax year. The Exchequer effect in the 2021-22 tax year of moving to 60 days or 90 days in that tax year would be approximately £105 million or £210 million respectively - although the cost would come down significantly in subsequent tax years.[33]

Raising awareness

1.96 Alternatively, the government could raise early awareness through providing property professionals such as estate agents, conveyancers or auctioneers with an HMRC-approved standard information pack.

1.97 These professionals could then be required to pass on such information packs to taxpayers when a residential property is placed on the market or instructions given to a conveyancer. This could help ensure that these taxpayers have the opportunity to gather information in advance of the sale and therefore well in advance of the 30 day time period starting.

1.98 Careful thought would need to be given to whether the information should be distributed by estate agents, conveyancers, or both. In order to minimise the additional effort and spare those without tax expertise from having to interpret their clients tax affairs, the OTS envisages that intermediaries would distribute generic HMRC-provided information rather than anything which takes account of the specific circumstances of their client.

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[33] HMRC data 2020-21 & 2021-22. See Annex D.

Non legislative improvements

1.99 In any event, HMRC should continue to invest in improving the user experience through measures such as:

1.100 Integrating the UK Property tax return into the new Single Customer Account so taxpayers are readily directed to this reporting service and have access to previous returns.

1.101 Improvements to HMRC guidance (**recommendation 14**) to:

- include in the information checklist that a taxpayer will need to know their annual income as well as realised gains and losses
- include examples of what constitutes a reasonable estimate of the Capital Gains Tax payable and the circumstances when HMRC would seek to charge interest
- provide guidance on when an amended UK Property tax return should be filed if estimated figures are used
- include screenshots to take taxpayers through the process in the simplest way possible
- refer to gifts of properties as well as to 'sales' (or disposals)

1.102 An enhanced agent experience, including improved agent registration and access.

1.103 Although broader than just Capital Gains Tax, ideally once an agent is registered with HMRC for a client they should be able to act across the full range of taxes unless the client specifies otherwise, rather than needing to register separately every time for different things.

The role of property professionals

1.104 Some respondents to the OTS Call for Evidence suggested that property professionals could play a greater role in calculating any tax owing and handing it over directly to HMRC much as they are expected to do with Stamp Duty Land Tax.

1.105 However, the OTS does not consider this a realistic option as these professionals are not tax specialists and calculating Capital Gains Tax is more complex than calculating Stamp Duty Land Tax. This reflects the fact that Capital Gains Tax does not relate purely to the proceeds of a disposal.

1.106 For instance, there may be a need to take enhancement expenditure into account, as well as the taxpayer's personal tax position generally. Understanding the taxpayer's personal tax position would inevitably involve an assessment of their level of income, any available Annual Exempt Amount, and any capital losses which would reduce tax payable.

Recommendation 3

The government should consider extending the reporting and payment deadline for the UK Property tax return to 60 days, or mandate estate agents or conveyancers to distribute HMRC provided information to clients about these requirements.

Collection and use of Capital Gains Tax data

Background – how it works at the moment

1.107 The Capital Gains Tax summary form (SA108) filed under Self Assessment requires certain details of transactions, which can include the dates of acquisition and disposal of the asset, to be entered in either a free text box or as a separate attachment. Before the removal of taper relief in 2008, these dates were entered into pre-formatted boxes on the forms.

Observations – challenges with this approach

1.108 The OTS considers that when specific data is required by HMRC, whether to establish eligibility or to aid compliance or policy analysis, it may end up being a poorer taxpayer experience to have to enter details in a free text box or separate computation than to be able to use an embedded pre-formatted box.

1.109 Requiring data to be captured in free text means that it is more likely to be omitted, and where is it included it is less likely to be comprehensive or as useful, especially if disposals attracting different reliefs are aggregated together.

1.110 It is also then more difficult for HMRC analysts to carry out reliable or comprehensive data analysis, for example in respect of holding periods or reliefs, to inform policymaking. For example, during its work on the first Capital Gains Tax report the OTS learned that the quality of data relating to holding periods after 2008 had reduced, after pre-formatted boxes were removed.

Conclusions – how the system could be improved

1.111 Ideally, where possible, the Capital Gains Tax summary form should allow for transaction details such as dates of acquisition and disposal or clearance references to be entered into pre-formatted boxes in future, and claims relating to different reliefs kept separate from each other.

Share pooling

Background – how it works at the moment

Characteristics of listed shares

1.112 Shares that are listed on a stock market are a liquid investment, meaning that they can be readily bought and sold. The prices of individual shares are usually quite small, so it is not unusual for people to buy hundreds or even thousands at once, or to build up a shareholding by buying more shares over a period of time.

1.113 Listed shares and other comparable securities[34] are by nature fungible assets. This means that any one share is identical to any other and worth the same amount. It makes no commercial difference to an investor which 500 of their 1,000 shares of a particular type they sell and which 500 they keep.

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[34] Such as shares AIM-listed companies, open-ended investment companies and funds, and units in unit trusts.

1.114 The following analysis relates to listed shares and similar securities. Recommendation 4 is not intended to cover other fungible assets such as cryptocurrencies.

Share pooling

1.115 Share pooling is a simplification to the usual tax rules which is applicable to shareholdings which have been acquired in tranches over time and at different prices.

1.116 When there is a disposal of some of the shares, the total cost of acquiring all of the shares is apportioned, so that the base cost of the shares sold is based on the average acquisition price of all of the shares.

Size and frequency of gains on disposal of listed shares

1.117 In the tax year 2017-18, net gains on the disposal of listed shares (after allowing for losses) totalled £12.4 billion and accounted for 21% of total net gains of £58.9 billion.[35]

1.118 In that tax year, a total of around 195,000 individuals reported gains on the disposal of listed shares.[36] Of these, around 90,000 individuals paid Capital Gains Tax on a total of around 843,000 disposals of shares,[37] which is an average of around nine disposals by each taxpayer. Each disposal represents a shareholding in a particular company.

1.119 Multiple disposals of different shareholdings by the same taxpayer are to be expected, as most investors in listed shares invest in a number of different shareholdings within a portfolio (a broad term for a collection of investments), to mitigate the risk of any one company's shares falling in value. A small number of individuals hold more than one portfolio.

1.120 A share portfolio can be held directly or through a platform or broker acting on an 'execution only' basis. In these cases the taxpayer controls the decisions to buy and sell shares.

1.121 A share portfolio can also be held with a discretionary manager, in which case an independent third party makes those decisions, or the broker can act in an advisory capacity with the taxpayer maintaining control.

The share pooling calculation

1.122 The pooling calculation is used to calculate the base cost of a shareholding when only part of that shareholding is sold (subject to an anti-avoidance rule that applies when shares are acquired on the same day as the sale or in the 30 days following). This means that an average base cost per share is used instead of having to match each share that is sold to its specific acquisition cost.

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35 HMRC's Capital Gains Tax statistical tables, Table 7. See Annex D.

36 HMRC data. See Annex D.

37 HMRC's Capital Gains Tax statistical tables, Table 7. See Annex D.

1.123 Share pooling also means that the taxpayer (or portfolio manager) only has to keep track of the total base cost of a shareholding in any particular company.

Example 1 – selling pooled shares

Theodora owns 15,000 shares in Rome plc. She first acquired 5,000 shares ten years ago for £0.20 each, then another 6,000 shares five years ago for £1.50 each and then another 4,000 shares three years ago for £2.00 each.

In total, Theodora's holding in Rome plc has cost £18,000 (an average of £1.20 each per share).

Theodora sells half of her shareholding – 7,500 shares – for £2.10 each, receiving proceeds of £15,750. To calculate her gain, she needs to deduct the base cost of the shares.

It makes no difference to Theodora which specific shares she sells. The share pooling rules mean Theodora takes the average base cost – effectively half of £18,000 in this case – and deducts this against the proceeds. So her gain is calculated:

£15,750 – £9,000 = £6,750

The remaining shares have a total base cost of £9,000 (£1.20 each).

Observations – challenges with this approach

1.124 In cases where the taxpayer only has a single shareholding, share pooling is an effective simplification, as it allows the holding to be treated as one and there is no need to match specific shares to specific records. So the accounting records needed are simpler.

1.125 However, the requirement to pool can result in greater complexity in situations where an individual has more than one portfolio held with different service providers (such as investment managers or platforms). Then, all holdings of the same shares in a particular company have to be aggregated and pooled, even though they are held by separate parties.

Complexity

1.126 Investment managers usually produce statements for their clients that include details of the acquisition cost and sales proceeds and may also include a calculation of a gain or loss. However, where there are multiple portfolios with holdings of the same shares, the base cost of any disposals must be recalculated pooling all of the shares, even if the disposal was clearly only out of one discrete holding. This takes additional time, allows more room for error and generally requires the taxpayer to engage a professional agent.

1.127 In practice, the OTS has been told by investment managers and tax agents that multiple portfolios are relatively rare and limited to wealthy taxpayers who would tend to have an agent anyway. However, there is a wider

advantage to removing the pooling requirement, in facilitating automated reporting, which is being considered as part of the OTS's current work on making smarter use of third party data.[38]

Future reporting

1.128 In the future, as digital technologies are increasingly used to improve the taxpayer experience, HMRC may wish to enable or require financial institutions and platforms to report taxpayer data directly, with a view to pre-populating tax records and removing some of the administrative burden of Self Assessment.

1.129 Where there are multiple portfolios, such reporting would be very difficult because of the need for someone to carry out a calculation involving data drawn from each of the organisations' records, which would not ordinarily be shared with others.

Conclusions – how the system could be improved

1.130 The OTS considers that the government should explore whether individuals holding more than one portfolio with different investment managers or platforms could be treated as holding each in a separate share pool.

1.131 This would save taxpayers and their agents from having to bring together and analyse information from several different investment managers and so reduce the risk of errors arising in their tax return.

1.132 It is in principle possible that, by removing the requirement to pool for all portfolios, taxpayers might be able to manipulate the rules. However, the OTS notes that this is not possible in the case of discretionary-managed portfolios, as the managers make the decisions to buy and sell. Even if the taxpayer controls multiple portfolios, they would need several portfolios with sizeable holdings in the same shares, under the control of a taxpayer who was minded to manipulate the rules, in order to derive any tax benefit.

1.133 The OTS considers that the compliance benefit of facilitating reporting is likely to outweigh the risk of manipulation, particularly if this underpins automated reporting by third parties, which would be a significant step in countering error, omission and evasion. This is being considered in detail in the OTS's work on making smarter use of third party data.[39]

Recommendation 4

The government should consider whether individuals holding the same share or unit in more than one portfolio should be treated as holding them in separate share pools.

[38] Third Party Data Reporting Review Scoping Document, OTS. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/945431/Third_party_data_scoping_document_Dec_2020.pdf.

[39] Third Party Data Reporting Review Scoping Document, OTS. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/945431/Third_party_data_scoping_document_Dec_2020.pdf.

Chapter 2
Main homes

Overview

2.1 Homeowners who sell their main home are usually not subject to Capital Gains Tax on the sale.

2.2 This is the result of Private Residence Relief which, broadly, provides full relief for gains arising on a main home and has been an important feature of Capital Gains Tax since it was introduced in 1965.

2.3 The number of individuals who pay Capital Gains Tax each year is around 250,000[1], which is less than 1% of the adult population.[2] Without a relief for main homes, many more of the estimated 1.2 million[3] residential property sales each year would fall within the scope of Capital Gains Tax.

2.4 Private Residence Relief is estimated to benefit 1.5 to 2 million homeowners annually and to have cost the Exchequer £25 billion in tax year 2019-20.[4]

Policy objective

2.5 Niall MacDermot MP, the Financial Secretary to the Treasury when Capital Gains Tax was introduced in 1965, explained the policy intention in this way:

'The reasons for our exemption are to encourage home ownership, to avoid any feeling of resentment there might be - and I think that it would be widespread if this was subject to tax -and, also, from a social point of view, to assist greater mobility, which is an important matter from a labour point of view. The effect of it, as I say, is to make home ownership very attractive from the investment point of view.'[5]

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1 Average 254,000 individual taxpayers over four tax years from 2015-16 to 2018-19. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/908647/Table_1.pdf

2 The adult population of the UK was estimated to be 52.7 million in 2019. https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/datasets/populationestimatesforukenglandandwalesscotlandandnorthernireland

3 Monthly property transactions completed in the UK with value of £40,000 or above, HMRC. https://www.gov.uk/government/statistics/monthly-property-transactions-completed-in-the-uk-with-value-40000-or-above

4 Non-structural tax reliefs, HMRC. Refer to Annex D.

https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs

5 Hansard Thursday 27 May 1965.

https://hansard.parliament.uk/Commons/1965-05-27/debates/949dc344-f31c-4644-85db-78f9892d9948/Clause28%E2%80%94(PrivateResidences)

2.6 While debating recent amendments to Private Residence Relief, the Rt Hon Jesse Norman MP, the current Financial Secretary to the Treasury, gave an insight into the current government's thinking about the focus of the relief:

'The government are committed to keeping family homes out of Capital Gains Tax, through Private Residence Relief. The reforms make Private Residence Relief fairer by better targeting relief at owner-occupiers.'[6]

Introduction to Private Residence Relief

2.7 It is not enough for an individual to own a property for it to qualify for Private Residence Relief. It must also be a 'residence' of theirs.

2.8 The meaning of the term 'residence' has evolved through caselaw. There generally must be a degree of permanence and the quality of occupation is more important than the length of occupation.[7]

2.9 Most homeowners will live in their home throughout their period of ownership and will receive full Private Residence Relief. Short periods away from home, such as for holidays, are ignored.

2.10 Where a homeowner lives away from their home for some or all the period of ownership, the period is split into two parts; the part that qualifies for Private Residence Relief and the part that does not qualify. The gain is time apportioned between the two, with Private Residence Relief available for the amount attributable to the qualifying part.

2.11 It is estimated that just over 9,000 people paid Capital Gains Tax on a property disposal that received only partial Private Residence Relief in tax year 2018-19.[8] This is small in comparison with the number of property sales completed in that tax year, which was over 1.2 million.[9]

Ancillary reliefs

2.12 Private Residence Relief is supported by a range of ancillary reliefs (see Diagram 2.A) which cater for a small number of specific circumstances, such as renovating the home for habitation, a delay in selling at the end of occupation, letting out a property, or moving elsewhere for work.

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6 Hansard Tuesday 9 June 2020.

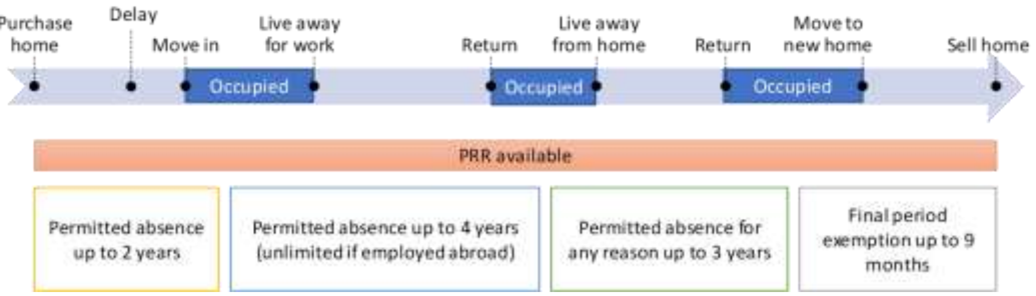
https://hansard.parliament.uk/Commons/2020-06-09/debates/5927b7da-9829-4504-b795-7657d95cdd1a/FinanceBill(ThirdSitting)

7 'sufficient degree of permanence, continuity or expectation of continuity to justify its description as residence' Goodwin v Curtis [1988] STC 475.

8 HMRC estimate. See Annex D.

9 Monthly property transactions completed in the UK with value of £40,000 or above, HMRC. https://www.gov.uk/government/statistics/monthly-property-transactions-completed-in-the-uk-with-value-40000-or-above

Diagram 2.A: Timeline of Principal Residence Relief and ancillary reliefs on a main home



Source: OTS

2.13 There is also an exemption for homeowners who live away from their home in job-related accommodation. This removes restrictions to the relief for members of the armed forces, members of the clergy and others who must live away from their main home.

Scope of Private Residence Relief

Background – how it works at the moment

Gardens and grounds

2.14 Private Residence Relief is automatically available in full if the area of the garden and grounds of a main residence does not exceed 0.5 hectares.

2.15 If the garden and grounds exceed this area then relief may be available for a larger area if that larger area is required for the reasonable enjoyment of the home, having regard to its size and character.

Home built in garden

2.16 Private Residence Relief is available on a home used as a main residence 'at any time' during the period of ownership (subject to the rules about absences), but is available for a garden associated with a home only if it is used as a garden at the time that it is sold. Any history of the land's having previously been used as a garden is irrelevant.

2.17 As a result, where a new house is built at the end of someone's garden, Private Residence Relief is not available for any period before the new house was built on it.[10]

Example 2 – Private Residence Relief over time

The Vinney family home was purchased in 1990 and has a large garden.

Once the Vinney children have left home, the Vinney parents decide to downsize. They separate off a section of the garden to build a bungalow to live in. They continue to live in the family home until construction of their bungalow is complete.

[10] Henke v HMRC [2006] Special Commissioners 550.

In 2010, they move into the bungalow and sell the family home.

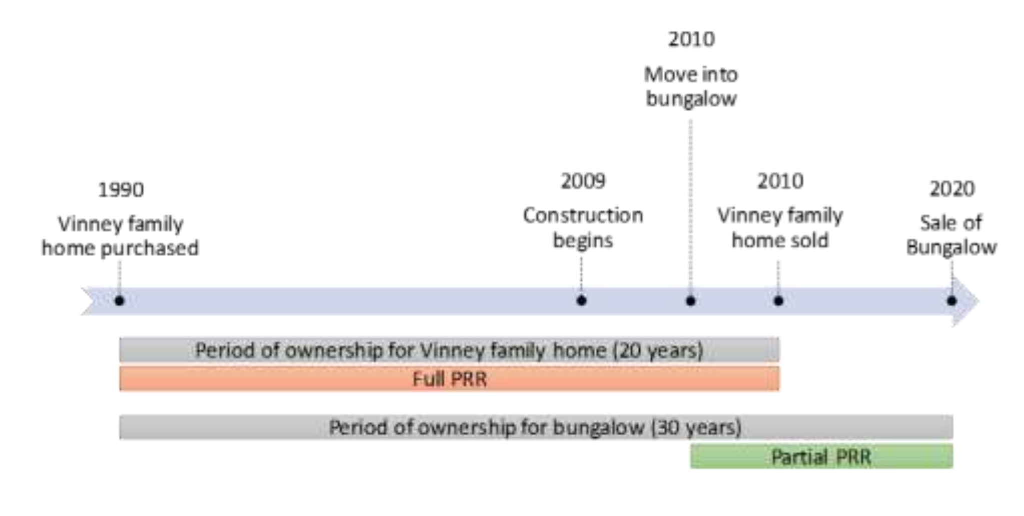
In 2020, they sell the bungalow.

Private Residence Relief allowed:

In 2010 – Full Private Residence Relief available on the Vinney family home

In 2020 – Partial Private Residence Relief available on the bungalow.

The relief is available only for one third of the period over which the capital gain has arisen, as it is not available for the 20 year period before the house was built. The history of the land's previous use as a garden for the family home is ignored, even though relief would have been available had it been sold separately in 2010.



Period of occupation

2.18 Eligibility for Private Residence Relief begins on the date of completion of the purchase of the property and runs to the date of completion of its sale.

2.19 This can be contrasted with the calculation of the capital gain on the property, which runs from the date of exchange of contracts for the purchase to the date of exchange of contracts for the sale.

Observations – challenges with this approach

What is a residence

2.20 The OTS has been told that the case law in this area is well developed and understood.

2.21 It has however been suggested to the OTS that it could be helpful to codify the caselaw into statute, to reduce to the number of tribunal cases in this area.

2.22 The OTS agrees that statutory tests can be well suited to some areas of tax legislation, such as the statutory test for whether an individual is UK resident for tax purposes. However, the OTS does not believe this is such an area given the variety of personal situations that can arise and change over time. A case law approach allows a contemporaneous assessment of the facts of

each case on its merits, rather than a judgement against a pre-determined set of criteria, with the risk of hard cases.

Gardens and grounds

2.23 The position for a small number of homeowners where gardens or grounds exceed 0.5 hectares, as HMRC acknowledge in its guidance, is 'a common area of disagreement between HMRC and taxpayers.[11]

Homes built in the garden

2.24 The OTS observes that the mechanics of the legislation create an unexpected tax result when a homeowner builds a new home in their existing garden and moves into it.

When ownership begins

2.25 Some respondents have said that there is a lack of clarity in the legislation about when ownership begins, when purchasing a home. This has been clarified by a recent case – the period of ownership of a home begins when a house purchase is completed, as before this date it is usually not possible for the homeowner to occupy the home.[12]

2.26 This clarification may need time to bed down, but it is not a source of complexity as the court judgement is clear and HMRC are not seeking to challenge the judgement.

Conclusions – how the system could be improved

2.27 The OTS considers that the scope of Private Residence Relief is generally fit for purpose and adequately supports its policy objective.

2.28 However, the OTS suggests that it is an anomaly that the mechanics of the rules provide an incentive for homeowners to sell their garden to a developer in preference to building another home to move into on their own land themselves, as outlined in the Vinney family home example above. The OTS expects many homeowners who should receive partial relief rather than full relief are not aware there is a potential tax liability and may fall within the tax gap.

2.29 The OTS considers that the rules should be changed to remove this distortion, as such situations are not uncommon.

2.30 In principle this could be done by changing the rules to remove relief for homeowners who sell their garden to a developer, however, this is inherently challenging as it is easy to sell the entire home instead of sectioning off the garden with development potential, which would prevent a restriction based on homeowners who sell to developers.

2.31 The OTS suggests, rather, that the government consider adjusting Private Residence Relief to fully cover developments in a taxpayer's garden which the taxpayer then moves into. One way of achieving this could be by changing

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11 HMRC Capital Gains Tax manual, Private residence relief: permitted area: procedures. https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg64803

12 Higgins v R & C Commrs [2019].

the start date of the period of ownership for tax purposes in this situation. This would make self builds more tax-neutral and also cover other similar anomalous situations.

Recommendation 5

The government should consider adjusting Private Residence Relief to cover developments in a taxpayer's garden which the taxpayer subsequently occupies.

Owning more than one home

Background – how it works at the moment

2.32 Private Residence Relief relieves a gain arising on a home lived in by the homeowners as an only or main residence. For most people this is relatively simple – it is the one house they own and live in. However, the 1.4 million people who own second homes[13] are able to nominate which home should qualify.

2.33 It is clear that the relief is intended to cover one main home and successive governments have sought to minimise opportunities for doubling up relief on two properties, indicating this is a desired policy objective.

Nominating a main home

2.34 Homeowners resident in the UK and have more than one home which qualifies as a residence can write to HMRC to nominate the home to which they wish Private Residence Relief to apply.

2.35 The ability to nominate which home will receive Private Residence Relief allows homeowners to make the choice which is likely to be the most beneficial to them in the future.

2.36 Making a nomination is optional. If the homeowner does not nominate then the relief will apply to the home which is in fact their 'main' residence. This is sometimes easy to determine but can be open to interpretation. It is based on a range of factors such as how long they spend there or where their family live. However, a nomination can override this.

2.37 A nomination must be made within two years of the date the individual started or ceased to have an additional home or a new combination of residences. The nomination can then be amended at any time in the future.

2.38 Each time there is a new combination of residences, a new election should be made within two years as the original election ceases to have effect. A nomination should still be made even if the new election confirms that the same home remains the homeowner's main residence.

2.39 The nomination does not need to follow the reality of how the homeowner splits their life between their homes and no account needs to be made of how much time is spent in each home, as long as each home is a residence.

[13] Game of Homes: The rise of multiple property ownership in Great Britain, Resolution Foundation, p7. https://www.resolutionfoundation.org/app/uploads/2019/06/Game-of-Homes.pdf

2.40 Couples who are married or in a civil partnership and who live together can only have one main home for these purposes. Other couples can each individually have a separate main home.

Observations – challenges with this approach

2.41 Homeowners who are well informed or well advised will benefit the most from this feature of the Private Residence Relief legislation as they will be able to assess the tax impact of the different choices over time in a way that others may not appreciate.

2.42 It is clear that awareness of the nomination rules is far from ideal. Of the 1,200 or so respondents to the OTS Capital Gains Tax online survey, 42% indicated that they have had a second home at some point. Of these second home owners, only 33% indicated that they had submitted a nomination.[14]

2.43 In addition, the OTS has identified a number of smaller issues with the way the existing nominations regime operates.

'Flipping' properties

2.44 It is possible to make a protective nomination within the 2-year time limit and then amend the nomination at any time. The amendment can be backdated from up to two years before it is sent to HMRC. This allows a wide scope for homeowners to 'flip' their nomination between properties depending on their circumstances and the respective value of their homes.

No prescribed format

2.45 There is no prescribed format to a nomination. A letter notifying HMRC is sufficient. While not an insurmountable barrier, making what is essentially a binary nomination should not have to require writing a bespoke letter.

Cohabiting couples

2.46 Cohabiting couples, who are not married or in a civil partnership, are treated separately for income tax and Capital Gains Tax purposes. In particular they can nominate separate homes as main residences, so can potentially benefit from relief on two properties for the same period.

2.47 This clearly can result in disparities, and potentially distortions, in family decision-making. This raises wider issues in the tax system and in society generally, beyond the scope of this report.

Use of nominations to receive relief on a holiday home

2.48 The OTS observes that the nominations process can be used to nominate a holiday home or second home, so long as it meets the definition of a residence.

2.49 The main home, which may be of much greater in value than the holiday or second home, can be kept until the homeowner dies. As the first OTS report on Capital Gains Tax explored it would then receive a tax-free uplift.

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14 See Annex D, under subheading '*OTS Survey*'.

Collectively these rules could result in no Capital Gains Tax being payable on either property.

Short term rental properties as a main home

2.50 A short term rental property[15] with negligible capital value for the tenant can meet the definition of a main home and so acquiring one can create a new combination of residences. This includes assured shorthold tenancies. This triggers the need, or ability, to make a nomination which it is easy for those affected to overlook.

> ### Example 3 – renting a second home
>
> Ada owns a family home with her partner in Manchester. She works in Aberdeen and rents a flat to live in during the week. At the weekend, she returns home to Manchester.
>
> The rented flat could result in a new combination of residences. If Ada does not make a nomination it is possible that 'on the facts' the flat could be deemed to be Ada's main home and Private Residence Relief could be lost or restricted on the home that she owns.

2.51 The government have removed the time limit in these circumstances so a nomination can be made at any point. This has the effect of reducing the risk of homeowners losing Private Residence Relief on the main home that they own.

2.52 However, it is peculiar that a rented home can be deemed to be the home that should receive Private Residence Relief, as it is not possible for the tenant to sell the rented home and realise a gain on which to use the relief.

Conclusions – how the system could be improved

2.53 The OTS considers that there is no realistic alternative to a process involving nominations. To remove nominations and require homeowners to decide which of their homes is their main home based on the facts would be challenging for homeowners and administratively difficult for HMRC.

Awareness

2.54 The OTS recommends that the government take steps to advance awareness around nominations to create more parity between individuals who have a tax adviser and those who do not receive professional advice. Individuals with a professional adviser are currently more likely to be aware of the rules and accurately predict which property is more likely to appreciate most in value.

2.55 One way of increasing awareness would be for the government to require estate agents and conveyancers to distribute information to purchasers of a new home. This information could include HMRC guidance on potential tax charges, nominations and administration requirements such as the UK

[15] The OTS uses the term 'short term rental property' to refer to a property in which the tenant does not hold an interest of more than a negligible market value.

Property tax return (and so should be considered alongside recommendation 3).

Nominations on disposal

2.56 Alternatively the government could instead consider allowing nominations to be made on disposal.

2.57 This would bring the rules into line with the current treatment for individuals who are not UK resident and for individuals who have more than one residence but only one residence with any capital value (as in Ada's case above).

2.58 Any change in this area should not create additional opportunities for doubling up on relief – which is available only in very limited circumstances (see paragraphs 2.71-2.73 below). Consideration would need to be given to whether such nominations could allow homeowners to split relief between their homes or whether, for example, one home would need to be chosen to receive relief for the entirety of an available period prior to its disposal.

Administrative improvements

2.59 The OTS also suggests that the government consider improving the process for making nominations by allowing nominations to be made through a standard form or letter template. As explored in Chapter 1 this should be done through the new Single Customer Account.

2.60 These changes would simplify the practical experience of the 1.4 million people who own second homes[16] when they come to dispose of one of their homes.

Short term rental properties as a main home

2.61 The government should also consider whether short term rentals could by default be treated as not being a taxpayer's main home. So where they had two residences, one owned and one rented, the owned one would be considered to be their main home without any need to nominate.

2.62 Removing the need to consider short term rentals will prevent adverse outcomes for a small number of taxpayers and remove the need for all those renting second homes from having to make a nomination.

2.63 The definition of short term rentals could be aligned with the existing definition used in the legislation to remove the time limit for making nominations for these homeowners, which would include assured shorthold tenancies but not leases with any capital value.

Recommendation 6

The government should review the practical operation of Private Residence Relief nominations, raise awareness of how the rules operate, and in time enable nominations to be captured through the Single Customer Account.

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[16] Game of Homes: The rise of multiple property ownership in Great Britain, Resolution Foundation, p7 https://www.resolutionfoundation.org/app/uploads/2019/06/Game-of-Homes.pdf

Living away from home

Background – how it works at the moment

2.64 While Private Residence Relief is targeted at owner-occupation, it can be retained if a homeowner lives away from their main home for a period of time, depending on the circumstances and nature of the absence.

2.65 A summary of the kinds of absences which do not affect the amount of Private Residence Relief available is given in the table below.

Table 2.A: Table showing types of absence that do not affect the amount of Private Residence Relief available

Relief	Maximum time away	Requirement to reoccupy	Overlapping relief available
Delay in occupation due to: 1 Delay in selling home 2 Renovation, or 3 Construction	2 years	Yes	Yes
Final period exemption for all main homes	9 months	No	Yes
Final period exemption for individuals who are disabled or resident in a care home	3 years	No	Sometimes
Absence for any reason	3 years	Yes	No
Employed outside the UK	Unlimited	Sometimes	No
Working elsewhere (employed or self-employed)	4 years	Sometimes	No

Source: OTS

Occupational requirements

2.66 An absence can only fall within these reliefs if the homeowner lives in their home at some point and it qualifies as an only or main residence.

2.67 The relief for 'one absence for any reason' depends on the homeowner living in the home both before and after the absence. However, the work-related absence relief rules do not require reoccupation if this is prevented by the homeowner or their spouse's work.

Use of multiple reliefs

2.68 Homeowners can use each of the absence reliefs consecutively which allows those who are well-advised to maximise the Private Residence Relief available despite long periods away from their home. For example, it is possible to live

away from home for an unlimited period (in the case of an absence for employment abroad), to never return, and to still receive full relief.

Soft and hard limits

2.69 If the delay in taking up occupation extends beyond 24 months, no Private Residence Relief will be allowed for the delay. Private Residence Relief will be given from the date the individual moves into their home (and it qualifies as a residence).

Example 4 – refurbishment before occupation

Harry bought his home in April 2019 and he chose to carry out major refurbishment work before moving in. Work started straight away but, due to the COVID-19 pandemic, building work was delayed and was not completed until May 2021, when he was able to move into his home.

Private Residence Relief allowed:

April 2019 - May 2021 – No relief due

May 2021 onwards - only or main residence

2.70 The limits for the working elsewhere absence and the absence for any reason reliefs create softer cliff edges. Homeowners who are away from their home for longer than the limit are still able to receive relief for the maximum period allowed. Private Residence Relief is only restricted for the time away from home which exceeds the limit.

Example 5 – absence

The Taylors bought their home in June 2010. They occupied it as their only residence until July 2012. In that month they won a lottery jackpot and decided to travel the world. They were away until December 2016 when they returned to their home until they sold it in March 2020.

Private Residence Relief allowed:

June 2010 - July 2012 - only or main residence

July 2012 - July 2015 - 3 years for any reason

July 2015 - December 2016 - No relief due

December 2016 - March 2020 - only or main residence.

Overlap in relief

2.71 The absence reliefs at the beginning and end of the period of occupation can enable an overlap in relief. Where there is an overlap it is possible for more than one home to qualify for Private Residence Relief for the same period.

2.72 HMRC guidance is explicit that this overlap between residences is permissible and explains that when there is an overlap, a nomination is not required as Private Residence Relief will be available on both residences for the overlapping period.[17]

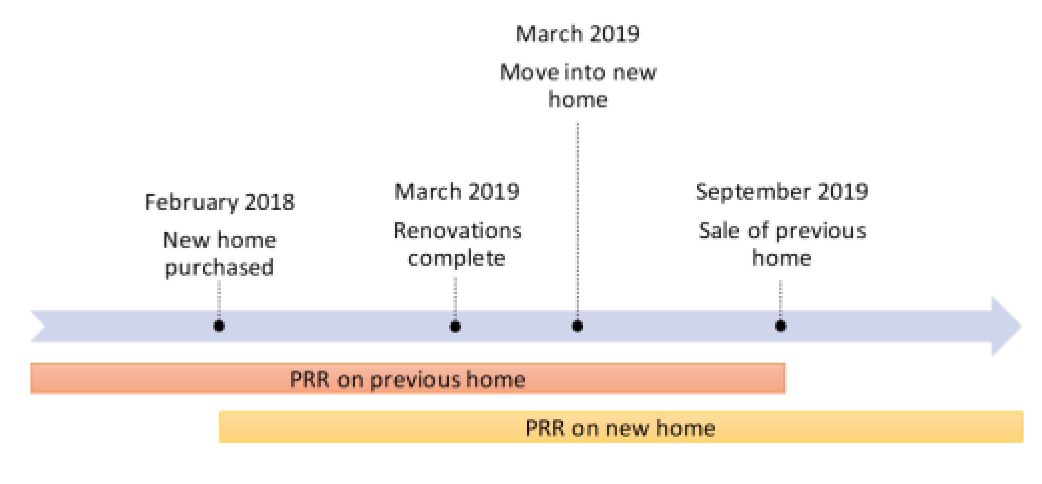
Example 6 – building in the garden

Petal bought a new home in February 2018. The home required extensive refurbishment and Petal remained living in her previous home. In March 2019, after some building delays, Petal moved into her new home.

The sale of Petal's previous home took some time and it was let out for 6 months prior to the sale, which completed in September 2019.

Private Residence Relief is available on both the new and old home during the delay in moving into the new home.

Private Residence Relief is also available on both the new and old home while the old home is let out as this period is less than the maximum final period exemption.



2.73 By contrast, for the work-related absence reliefs and the absence for any reason relief, where the homeowner has more than one home, a nomination may need to be made to keep relief on their main home and the rules will prevent a potential overlap in relief.

Job related accommodation

2.74 Homeowners such as members of the armed forces, who live in accommodation that is job-related and may also own their own home that they intend to live in in the future, do not need to consider the absence reliefs. They should receive full Private Residence Relief on their home (subject to the other conditions of the relief), even if they never actually live there.

[17] HMRC Capital Gains Tax manual, Private residence relief: relief for two dwelling houses for same period. https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg65013

Employment

2.75 The unlimited permitted absence for being employed abroad is not available to individuals who are self-employed. This is inconsistent with the more limited permitted absence for working away from home which allows both employment and self-employment.

Observations – challenges with this approach

2.76 The OTS recognise the value of the absence rules in supporting labour mobility, which was one of the original policy objectives of Private Residence Relief. However, the way the reliefs operate is complex.

Scope of the reliefs

2.77 The OTS observes that the absences reliefs are widely drawn and allow generous relief to some homeowners who live away from home for long periods.

2.78 The reliefs at the beginning and end of occupation allow for an overlap in relief. This allows up to 2 years and 9 months of relief on two properties at the same time.

2.79 The work-related absence reliefs and the absence for any reason relief can be combined together to cover an extended period away from home. In the case of a homeowner living away from home for work (within the UK), relief is available for up to 7 years if the two available reliefs are combined. This can allow a homeowner up to 7 years of tax free growth in the value of a property that is rented out.

2.80 The unlimited relief for homeowners who are employed abroad is more generous as it could allow for unlimited tax free growth on a UK property that is rented out. The benefit of the relief is available to anyone who purchases a home in the UK, even if they have only lived in the UK for a short period and subsequently leave permanently for employment elsewhere.

2.81 The OTS observes that the unlimited relief for homeowners who are employed abroad covers a wide range of circumstances, some of which may be considered more deserving of relief than others.

Inconsistencies

2.82 It is not clear what the rationale is for the different limits. The non-neutrality between the four year limit for working away from home and the unlimited relief for being employed abroad is particularly curious.

2.83 It is also not clear why the unlimited absence for working abroad is only available for individuals who are employed and not for individuals who are self-employed. It is curious that employment is deemed to be more deserving of relief than self-employment in this circumstance.

2.84 As shown in Table 2.A some absences require reoccupation, others do not.

Cliff edges

2.85 The time limits create undesirable cliff edges which can result in two homeowners receiving different treatment even though they have very

similar circumstances. Cliff edges can distort behaviour as homeowners will inevitably try to arrange their affairs to fall on the right side of the cliff edge.

2.86 The limit to the delay in taking up occupation can create situations where homeowners narrowly miss out on receiving relief for a delay. Although this is a difficult situation for those homeowners, the OTS understands the need to keep a hard restriction on this relief to limit the situations where Private Residence Relief is available for two homes for the same period.

Conclusions – how the system could be improved

2.87 The OTS observes that the government should reflect on whether the ancillary reliefs for living or working elsewhere continue to meet their policy objectives.

2.88 For instance, the government could reflect on whether it is intended for unlimited Private Residence Relief to be available to a homeowner who becomes permanently non-UK resident after purchasing a home in the UK. This would enable full relief against the Capital Gains Tax on a residential property.

Keeping pace with modern lifestyles

Background – how it works at the moment

2.89 Private Residence Relief is aimed at owner-occupiers and is not generally available to landlords who rent out a home to others. However, there are allowances for homeowners who have an element of commercial use of their home.

Non-residential use

2.90 Private Residence Relief is not available for any part of a home that is used exclusively for the purposes of a trade, business, profession or vocation.

2.91 Any part of the home that is used mostly for business but is very occasionally used for a non-business or personal purpose is not affected by this. For example, part of a house that is used as a home office would normally be entirely covered by Private Residence Relief.

2.92 When there is a part of the home which is used exclusively for business purposes, the capital gain is apportioned between the residential and non-residential parts of the property. Capital Gains Tax is payable only on the amount of the gain attributable to the non-residential part.

2.93 HMRC guidance is clear that the exclusive use test is a stringent one and that Private Residence Relief should not be restricted where there is 'some measure of regular residential use'.[18]

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[18] Capital Gains Manual, Private residence relief: non residential use: part of house used exclusively for business.

https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg64663

Renting out a home

2.94 If a home that was previously lived in as a main home is subsequently rented to tenants, Private Residence Relief is not available for the period for which it is let.

2.95 When the home is sold, the capital gain is time apportioned between the period for which it was the owner's main home and the period it was let, with adjustments for any permitted absences. Capital Gains Tax is payable on the amount attributable to the period that does not quality for Private Residence Relief.

2.96 If a part of the home is rented to tenants and the homeowner lives in the other part of the home so that there is shared occupation, then Private Residence Relief is restricted. Relief is available only on the amount of the gain attributable to the part of the home that is occupied by the homeowner.

2.97 The amount of the gain which does not qualify for Private Residence Relief may nevertheless qualify for lettings relief. Lettings relief is available where there is shared occupation and is restricted to the lower of:

a) £40,000

b) the amount of Private Residence Relief available, and

c) the amount of any gain attributable to the letting

Lodgers

2.98 If a homeowner takes a lodger into their home, Private Residence Relief is not restricted.

2.99 'Where a lodger lives as a member of the owner's family, sharing their living accommodation and taking meals with them, no part of the accommodation is treated as having ceased to be occupied as the owner's main residence, and the exemption is not restricted at all.'[19]

2.100 In this instance, lettings relief does not apply as full Private Residence Relief is available.

Observations – challenges with this approach

Non-residential use

2.101 It is not unusual for people to reconfigure their homes to create dedicated working spaces, and some will have created home offices in their gardens. This is likely to have become more prevalent since the start of the COVID-19 pandemic and is likely to continue.

2.102 The OTS has heard that it is widely assumed by taxpayers and their advisers that Private Residence Relief will not be restricted in these circumstances as it is rare for part of the home to meet the exclusive use test.

[19] Statement of Practice 14 (1980) https://www.gov.uk/government/publications/statement-of-practice-14-1980/statement-of-practice-14-1980

2.103 There are however two particular ways in which HMRC guidance is unclear about how the use of a home for work impacts the availability of Private Residence Relief. These are:

1. the limit on the amount of the home that can be used as an office before Private Residence Relief is restricted
2. the amount of personal use which is sufficient to prevent exclusive business use

2.104 On the first point, the legislation provides that if part of a residence is used for the purpose of the owners' office or employment then it should not result in Private Residence Relief being restricted.

2.105 However, the guidance[20] includes the suggestion that if a substantial part of the home is used as an office then relief should be restricted. No further description is given for what the meaning of substantial is in this context, though the OTS understands that cases in this category are rare.

2.106 On the second point, the guidance is clear that the exclusive use test is stringent and says that 'occasional and very minor residential use should be disregarded'.

2.107 However, this wording is subjective and could create unnecessary worry for homeowners. The example of a doctor leaving personal items in their surgery which is attached to the family home is given for 'occasional and very minor residential use' but it is not clear how this very specific example can be applied to other circumstances.

2.108 The OTS has been told that it is unclear whether home office arrangements would meet the requirements of the legislation without individuals exaggerating the extent of their personal use.

The definition of a lodger

2.109 The definition of a lodger in HMRC's guidance requires the lodger to take meals with the family in their family home.

2.110 This guidance is over 40 years old and is outdated as it is no longer common for lodgers to share meals with the homeowner. The OTS understands that in practice HMRC are flexible and pragmatic in applying the rules. However, that lack of detail or up to date guidance can cause unnecessary worry.

2.111 HMRC guidance also says that while Private Residence Relief is not restricted where there is a lodger, but it may be restricted where there is more than one lodger.[21]

2.112 The OTS has heard that limiting full relief to circumstances where there is only one lodger can theoretically preclude the following situations:

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[20] HMRC Capital Gains Tax manual, Private residence relief: non residential use: part of house used for owner's office/employment

https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg64690

[21] HMRC Capital Gains Tax manual. Private residence relief: letting: lodger.

https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg64702

- when a home is shared with a couple
- when a home is shared with a single parent and their children
- where multiple rooms are let to children who were previously living under the foster care of the homeowner

Lettings relief

2.113 The changes to lettings relief made by Finance Act 2020 have restricted its use to a very narrow set of circumstances. For lettings relief to apply, the homeowner must let out a part of their home while still occupying the other part of their home and the part that is let must not be entirely separate. Real life examples of this situation are difficult to find but could include a homeowner with a studio apartment in their attic which is let to a tenant.

Conclusions – how the system could be improved

Guidance

2.114 The OTS recommends that HMRC should update their guidance across a number of areas (**recommendation 14**).

2.115 HMRC's manuals include examples of situations where relief will be restricted. These include the examples of a doctor's office, a public house and a farmhouse. Additional examples should be added to reflect common home working arrangements. It should be clear in the guidance that homeowners can work full time from home, in a home office (including home offices built in the garden) without relief being restricted.

2.116 The definition of a lodger in HMRC guidance[22] is outdated and HMRC should consider removing the requirement that a lodger must share meals with the family.

Potential legislative improvements

2.117 The OTS observes that the government should also consider reviewing the following areas:

- the single lodger limit does not cater for cases such as a foster family letting rooms to multiple foster children after they have left foster care at the age of 18,
- the law could be updated to ensure all common home working arrangements are excluded from the 'exclusive use' test to reflect the pragmatic approach already taken by HMRC to home offices.

Relationship to Stamp Duty Land Tax

2.118 Both Capital Gains Tax and Stamp Duty Land Tax make use of definition of residential property.

2.119 Capital Gains Tax does so to establish the permitted area of the garden and grounds surrounding a residence so the extent to which both Private Residence Relief and the higher rates of tax should apply. Stamp Duty Land

[22] HMRC Capital Gains Tax manual. Private residence relief: letting: lodger.
https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg64702

Tax does so to establish whether or not the full extent of the home counts as residential property which also influences the rate applied.

2.120 The OTS has heard that the different definitions between the Capital Gains Tax and Stamp Duty Land Tax cause confusion and can produce anomalous results. This is not so much a matter of guidance as a matter of there being different legislative definitions.

2.121 There are differences in the situations involved, as Capital Gains Tax needs to consider the history and use of the property over a period of time, and Stamp Duty Land Tax applies at a moment in time. However, it is an area which would benefit from wider consideration.

Chapter 3

Tangible moveable property

Overview

3.1 Items of tangible moveable property ('chattels') that are subject to Capital Gains Tax are usually personal possessions. Paintings, items of jewellery, furniture, televisions and antique vases are all chattels but so are some tools and machines used by businesses.

3.2 As a broad rule all chattels are subject to Capital Gains Tax except for 'wasting assets' (see below). There is also a specific exemption designed to keep low value disposals of chattels out of the scope of the tax.

3.3 Chattels are not specifically captured in the Self Assessment tax return but HMRC estimate that, for the 2017-18 tax year, a total of £15 million in Capital Gains Tax was paid in respect of disposals of chattels, by around 300 taxpayers.[1] This is less than 0.2% of the total Capital Gains Tax yield for that year.

Background – how it works at the moment

Low value chattels

3.4 Low value chattels have been exempt from Capital Gains Tax since this tax was first introduced, initially with a £1,000 threshold but with a higher threshold of £6,000 from tax year 1989-90.

3.5 Some level of de minimis is essential to ensure taxpayers do not need to make returns on disposals of everyday items. The threshold relates to the proceeds from a sale or the market value of a gift, and is applied per item disposed of, subject to anti-fragmentation rules in relation to the break-up of sets and collections.

3.6 Disposals where the acquisition cost and sale proceeds are both £6,000 or less are exempt from Capital Gains Tax entirely and those where they both exceed £6,000 are treated in the usual way.

3.7 When an asset that costs more than £6,000 is sold for £6,000 or less, the allowable loss is restricted to the difference between the sale proceeds and £6,000.

3.8 When an asset that costs £6,000 or less is sold for more than £6,000, the taxable gain is restricted to the difference between the sale proceeds and

[1] HMRC estimate based on Capital Gains Tax data for 2017-18. Refer to Annex D for further details.

£6,000, multiplied by 5/3. This is called the 'marginal relief' calculation and is demonstrated below.

Example 7 – marginal relief

Martina

Martina buys an antique vase for £1,000. She sells it for £13,000, making a gain of £12,000. Martina's taxable gain is restricted to:

Proceeds £13,000 - £6,000 = £7,000 x 5/3 = £11,667

Martina's gain is £11,667 because the restricted amount is lower than the actual gain.

Marcel

Marcel buys a painting for £4,000. He sells it for £13,000, making a gain of £9,000. Marcel's gain is restricted to:

Proceeds £13,000 - £6,000 = £7,000 x 5/3 = £11,667

Marcel's gain is £9,000 because the actual gain is lower than the restricted amount.

3.9 The ways these calculations work means that there is no effect on gains made on disposals for more than £15,000, above which disposals are taxed in the usual way. The overall effect is to prevent a 'cliff edge', as otherwise a disposal for say £6,001 could produce a very different level of chargeable gain from a disposal for £6,000.

Wasting assets

3.10 Certain types of chattels known as 'wasting assets' are exempt from Capital Gains Tax. Wasting assets are those which are not expected to last more than 50 years, such as racehorses, clocks, and cars.

3.11 Any assets defined as 'plant and machinery' are automatically treated as wasting assets unless they have been used in a trade and capital allowances have been claimed. Even items of plant and machinery that may have a useful life of 50 years or more are classed as wasting assets and exempt from Capital Gains Tax.

3.12 One reason for the exemption is that wasting assets are more likely to generate losses than other chattels, so exempting them from Capital Gains Tax protects the Exchequer. This is because, typically, a wasting asset's value is realised through use rather than through onward sale (as with, for example, computer equipment or a washing machine).

Observations – challenges with this approach

Awareness and compliance

3.13 One of the main challenges with the taxation of chattels is that of awareness. For tax to be collected, the taxpayer must be aware of their liability and disclose it.

3.14 In particular, individuals giving away chattels may not intuitively see the gift as an event that triggers a tax liability, as no money has changed hands.

3.15 The OTS has heard from respondents that one barrier to this is the word itself, 'chattels' being considered an outmoded and poorly understood term. That said, the OTS notes that HMRC guidance on chattels generally refers to 'tangible, moveable property', which is clearer.

3.16 The OTS has also heard that there is nothing to prompt a taxpayer to consider taxes when disposing of chattels, particularly by way of gift. This includes there being no specific reference to chattels in the main Self Assessment tax return or the Personal Tax Account.

Low value chattels

3.17 The £6,000 threshold has been the same since 6 April 1989. Over time, a frozen threshold could result in more disposals of personal possessions being brought into the charge to Capital Gains Tax. However, this is not borne out by the data indicating that approximately only 300 taxpayers declared gains on chattels in the 2017-18 tax year and generally these were substantial transactions, generating a mean Capital Gain Tax liability for each taxpayer of about £50,000.

3.18 In practice, the OTS has heard that the marginal relief calculation is an inconvenience because it is mandatory and rarely achieves a better result for the taxpayer.

3.19 At most, and in very exceptional circumstances, the gain can be reduced by £6,000 and a saving of £1,200 of Capital Gains Tax made.[2] To obtain this maximum saving, all three of the following circumstances are required:

- the taxpayer disposes of an asset for £6,001 that had an acquisition value of nil
- the taxpayer's other gains for the same tax year exceed the Annual Exempt Amount
- their income exceeds the higher rate band

3.20 Given the small number of taxpayers who pay Capital Gains Tax on chattels and the relatively large average liability[3], it is unlikely that the marginal relief calculation would benefit many taxpayers in practice. It is still less likely that it would create a material benefit, given the value of the potential saving has

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[2] The full £1,200 saving would only happen if the proceeds were just over the £6,000 and the base cost was nil or negligible, such that a gain of approximately £6,000 was reduced to a negligible amount.

[3] The mean Capital Gains Tax liability on chattels only per taxpayer of about £50,000 compares with a mean average Capital Gains Tax liability on all assets per taxpayer of £32,000.

effectively reduced since 1989 as, although the value of chattels has not grown by inflation, the value of money has.

3.21 Some respondents have suggested to the OTS that the chattels exemption is not high enough and should be increased to as much as £15,000. There are two potential justifications:

- this would cover all the gains currently covered by the marginal relief calculation, and could facilitate removing this calculation
- the present day value of £6,000 in 1989, when the exemption was last increased, is approximately £15,000

3.22 However, the OTS notes there are counter arguments for both of these points. Firstly, simply raising the exemption and removing the marginal relief requirement creates a 'cliff-edge', as described above, where there is not one currently.

3.23 Secondly, although inflation has affected the value of money since 1989, this is not reflected in the prices of typical chattels, as better technology reduces the cost of many household items. It is still unusual for a household to own a single taxable item of tangible moveable property worth more than £6,000. (Note that cars are specifically exempt from Capital Gains Tax and other 'wasting assets' are also exempt, as described below.)

Wasting assets

3.24 It is not clear that the boundary between what it taxable and what is not makes sense, nor that it is understood by many.

3.25 Equally, those that do understand it may be able to exploit it. This is particularly evident in the treatment of certain items classed as plant and machinery, which can be exempt from Capital Gains Tax even if they are held as investments, by contrast with seemingly similar items which are taxable as shown in Table 3.A below.

Table 3.A: Table showing some similar items that are either taxable or exempt

TAXABLE	**EXEMPT**
Jewellery	Watches
Antique furniture	Antique clocks
Acoustic guitar	Electric guitar

Source: OTS

3.26 The definition of plant and machinery relies on case law but, broadly speaking, automated or mechanical components, such as a watch mechanism, are the key differentiator. In cases where an asset like a Swiss watch may be expected to outlast a 50-year useful life and increase in value over time, this can result in counter-intuitive outcomes.

Conclusions – how the system could be improved

3.27 While it is challenging to recommend material changes in this area the OTS considers the following may be fruitful areas for the government to explore.

Awareness and compliance

3.28 The Self Assessment tax return and accompanying guidance could include a question about whether a taxpayer has sold or made a gift of any personal possessions worth over £6,000 and then add the description 'tangible, moveable property' with examples (avoiding the use of the word 'chattels').

3.29 Alternatively, the more general notes accompanying the Self Assessment tax return might replicate the longer definition of chargeable assets contained in the specific notes to the Capital Gains Tax pages.

Low value chattels

3.30 The OTS does not consider there is a case for changing the low value chattels rules significantly. Although they seem dated, they continue to serve the administrative and simplification purpose of keeping most taxpayers and their domestic affairs outside of the scope of Capital Gains Tax, as demonstrated by the low frequency and high value of taxable disposals.

3.31 The marginal relief rules are complex and inconvenient in practice, with evidence suggesting they are rarely applied in practice. However, the OTS does not consider this evidence is sufficient to warrant recommending its withdrawal, particularly in the light of the cliff-edge that it would create.

3.32 The government may wish to explore further the impact of marginal relief.

Wasting assets

3.33 The OTS had considered, in Chapter 4 of its first report on Capital Gains Tax, whether it might be preferable to exempt personal possessions generally but only taxing certain types of asset (such as jewellery, artwork and precious metals) with a value over a threshold. This could potentially be simpler to understand and taxpayers would only need to be aware of what is taxable and when, as opposed to understanding a general rule with many seemingly complex exceptions.

3.34 However, following further work and researching international comparisons and markets in 'tax-free investments', it has become apparent that such an approach could open up distortions, creating markets for whatever asset types could make good investments that were not within the scope. It does not appear to solve the jewellery versus watches problem but would simply push the boundary elsewhere.

3.35 There is also a risk to the Exchequer in extending the scope of Capital Gains Tax to volatile markets which can create significant allowable losses as well as gains that are potentially capable of being realised strategically.

3.36 That said, the government could consider whether, in particular, the definition of machinery is appropriate, as it gives automatic exemption under the wasting assets rule to potentially valuable assets that may in fact be appreciating and for which there is a market, such as watches. This has the

potential to distort investment decisions as it can result in non-neutral tax outcomes for similar investments.

Chapter 4
Divorce and separation

Background – how it works at the moment

4.1 Married couples or civil partners can transfer their assets between each other without triggering an immediate Capital Gains Tax charge. This recognises the extent to which many such couples' finances are integrated and that their assets likely to be effectively jointly owned.

4.2 The tax mechanism for handling such transfers is known as 'no gain no loss' which means that the base cost of the asset transferred from the previous owner is inherited by the new owner. For example, if a spouse transferred a buy to let property originally acquired for £100,000 but currently worth £200,000 to her husband she would not have to pay tax at that time but he would be required to use her base cost of £100,000 if he later decided to sell.

4.3 Separating couples continue to get the same treatment as married couples in their (tax) year of permanent separation and transfers can continue to be made on a 'no gain no loss' basis for the rest of that year. Evidence about the permanence of their separation can be derived from a court order or formal deed of separation or more usually from the specific circumstances of the particular couple.

4.4 However, if the transfer is made in the next tax year then the transfer is treated as taking place at market value and there could be a capital gain even if no cash has changed hands. So, if a couple separate on 4 April 2022 they would only have until 5 April 2022 to transfer their assets without triggering a tax charge.

4.5 There were just over 91,000 divorces in 2018.[1] For the 2018-19 tax year, HMRC analysts identified £8 million of Capital Gains Tax that had been paid by fewer than 300 taxpayers citing divorce or separation in the free text on their Self Assessment tax returns. These figures should be considered indicative only as customers are not required to declare divorce as part of their returns so the data may be incomplete.[2]

[1] Divorce, ONS
https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/divorce

[2] HMRC data 2018-19. See Annex D.

4.6 In apportioning assets in the event of a divorce a court would consider the mix of assets in the round, including any potential tax liabilities that may arise if they are sold.

Interaction with Private Residence Relief

4.7 The rules on separation also need to be considered in the context of Private Residence Relief.

4.8 Married couples and civil partners are treated as inheriting the occupation history of their spouse if a home is transferred from one to the other.

4.9 So if a taxpayer buys a property, occupies it on their own, gets married, lives there with their spouse and transfers half of their property to them, and they sell; then both parties qualify for Private Residence Relief in relation to the period the taxpayer occupied it before the transfer, as well as the period in which they subsequently lived in the property together.

4.10 If the couple separate and one party moves out then the spouse that moves out may still receive Private Residence Relief if:

- they transfer their share of the property to their former spouse, or
- it's their final 9 months of ownership (as outlined in Chapter 3 on main homes)

4.11 However, as illustrated in the example below the non-occupying spouse would not continue to qualify for Private Residence Relief if they sold the house to a third party.

Example 8 – one spouse moves out before property sale

Simon and Sarah separate, and Simon moves out of their shared home on 30 March 2018. Sarah continues to live there.

They retain their shares of the home until 30 March 2019, at which point it is sold to a third party to fund the divorce settlement, resulting in a capital gain.

Sarah gets full Private Residence Relief as she lived there for the full period.

However, Simon does not get full Private Residence Relief. He gets relief until 30 March 2018 as he was living there and relief for his final 9 months of ownership. But he does not get relief for the 3 months between 31 March 2018 and 30 June 2018.

Alternatively, if Simon had instead sold his share of the property to Sarah within 9 months of moving out he would get full Private Residence Relief.

Observations – challenges with this approach

4.12 All the respondents to the OTS Call for Evidence commenting on this issue agreed that the length of time given to separating couples was inadequate.

4.13 Having separated, the point at which people are ready to address their finances varies considerably. There are several legitimate reasons why people

do not resolve their finances within the tax year in which separation occurs. Moreover, to prevent a Capital Gains Tax charge, they do not only need to reach agreement, but to actually transfer the assets.

4.14 In addition, the point at which people separate can be nebulous. The OTS understands that family lawyers routinely agree between themselves the most appropriate date of permanent separation for their clients. And the OTS has heard examples of people seeking to evidence a later date of separation after the tax implications of a particular separation date were explained to them.

4.15 Some respondents felt that this meant that the rules were unfair to those without professional advisers as they would be less likely to successfully navigate the rules.

4.16 In practical terms these issues are most significant for people in two particular circumstances.

4.17 First, a homeowner selling their family home to a third party after separation may lose out on full Private Residence Relief if they no longer live there. As noted in Chapter 1 in relation to the UK property tax return this can present a particular challenge for separating couples who may not receive their share of the money to pay the tax until the divorce settlement is finalised.

4.18 Second, there may be Capital Gains Tax charges on share reorganisations in family businesses. Again, there might not be cash immediately available to pay the tax and raising extra money may be difficult.

4.19 The government guidance on separation and divorce[3] does not contain any upfront practical information on tax and does not link directly or indirectly to the more helpful HMRC helpsheet on Capital Gains Tax for civil partners and spouses.[4]

4.20 The government's proposed changes to divorce[5] could speed up the overall process of getting a divorce, which in some situations could limit opportunities to agree a mutually acceptable date of separation.

Conclusions – how could the system be improved

4.21 The OTS considers that the current approach is unsatisfactory and recommends that the government should look at extending the 'no gain no loss' window to the later of:

- the end of the tax year at least two years after the separation event

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3 Separating or divorcing: what you need to do guidance, Get a divorce guidance. https://www.gov.uk/separation-divorce, https://www.gov.uk/divorce

4 HS281 Capital Gains Tax civil partners and spouses (2021) https://www.gov.uk/government/publications/husband-and-wife-civil-partners-divorce-dissolution-and-separation-hs281-self-assessment-helpsheet/hs281-capital-gains-tax-civil-partners-and-spouses-2021

5 Family Procedure Rule Consultation https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/945018/fprc-Consultation_Paper_and_Covering_Letter.pdf

- at any reasonable time in accordance with a financial agreement approved by a court or equivalent event in Scotland on how a couple should rearrange their affairs

4.22 This change would give people the time they need during what can already be very difficult circumstances.

4.23 The average time between applying for and securing a divorce in England and Wales in 2020 was 53 weeks. Separating and starting the legal process of divorce are not the same thing but the OTS expects that two years after the separation event will cater for most situations, though there is scope for a reasonable debate about the appropriate time horizon.

4.24 As financial agreements may be relevant for a third of divorces[6] the additional flexibility of a non-time limited financial agreement is also likely to be helpful. Even if the court rules within the two-year time horizon there may be good reasons why the transfer does not take place until later - such as retaining the family home until children have left.

4.25 There is a precedent for this approach in how divorce and separation are catered for by the Stamp Duty Land Tax rules.[7] It does create the theoretical risk that some people postpone their financial agreement for tax reasons but the OTS does not expect tax to be a significant factor in most situations.

4.26 The slightly different approach for Scotland is necessary to facilitate a similar outcome as the courts are not automatically involved in the divorce process there.

4.27 This change could potentially cost the Exchequer much of the £8 million of Capital Gains Tax currently paid by divorcing couples each year described in paragraph 4.5,[8] but as it does not remove the need to pay Capital Gains Tax on a subsequent disposal the long-term revenue implications will be smaller.

4.28 Any change would need to be made with sufficient notice and communication in order to ensure that individuals and courts fully understood the implications of new rules before applying them. The OTS understands that this should not result in unfair outcomes for one party or the other as a court will consider tax liabilities in deciding how any assets are allocated.

Interaction with Private Residence Relief

4.29 To support the recommendation above, an extended time horizon could also apply in relation to eligibility for Private Residence Relief. This would ensure the relief continued to apply to both parties until the later of these two criteria has been met.

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6 Law Society Call for Evidence response

7 Stamp Duty Land Tax: transfer ownership of land or property guidance, If you transfer property because of divorce, separation or the end of a civil partnership.

https://www.gov.uk/guidance/sdlt-transferring-ownership-of-land-or-property#if-you-transfer-property-because-of-divorce-separation-or-the-end-of-a-civil-partnership

8 HMRC data 2018-19. See earlier note and in Annex D.

4.30 This could preserve Private Residence Relief for a former spouse in a situation where they retained an interest, but a court prevented the family home from being sold until any children had reached 18. It would also create more parity between those transferring their share of the property to their former spouse (a situation already catered for) and those selling to a third party.

4.31 To ensure that neither party obtains Private Residence Relief on two properties (say the former family home and a new flat) at the same time it would be possible to require the taxpayer to nominate in line with the changes to the nomination rules proposed in Chapter 2. This would mean that the extended time horizon could not be manipulated to provide more relief than if the couple had remained together.

Divorce toolkit

4.32 In addition, it would be helpful if the government could produce an integrated divorce toolkit for separating couples and courts looking to regulate their affairs to use. The 'Registering a death' toolkit could serve as a helpful starting reference point as tax issues are embedded into this.[9] At the very least the existing general guidance on divorce should link to the (more helpful) tax specific guidance.[10]

Recommendation 7

The government should extend the 'no gain no loss' window on separation to the later of:

- the end of the tax year at least two years after the separation event
- any reasonable time set for the transfer of assets in accordance with a financial agreement approved by a court or equivalent processes in Scotland

[9] Register the death guidance

https://www.gov.uk/after-a-death

[10] https://www.gov.uk/government/publications/husband-and-wife-civil-partners-divorce-dissolution-and-separation-hs281-self-assessment-helpsheet/hs281-spouses-civil-partners-divorce-dissolution-and-separation-2016

Chapter 5
Business issues

Deferred proceeds: Capital Gains Tax

Background – how it works at the moment

5.1 Deferred proceeds arise where an asset is sold and payment of a proportion of the sale price is delayed for a period of time, which may be dependent on a future event. Deferred proceeds most often arise on the sale of an unincorporated business (such as a sole trader or a partnership), unlisted shares or of land.

5.2 There are some circumstances where the proceeds on the sale of businesses and land are taxed as income rather than as capital gains. However, this chapter focuses on the taxation of the capital receipt of deferred proceeds in relation to the sale of unlisted shares. These issues equally apply in relation to the capital receipt of deferred proceeds on any disposal.

5.3 Gains on the sale of unlisted shares totalled £27.8 billion for tax year 2017-18 (which was almost half of the gains subject to Capital Gains Tax).[1] A large proportion of these relates to sales of shares in private companies, on which the proceeds can be received in several different ways.

5.4 The way the payment of the proceeds is structured affects how much Capital Gains Tax is payable and when. This chapter explores the main alternatives and their differing tax effects.

5.5 An example of deferred proceeds is where a company is sold for an upfront amount of cash with further proceeds paid over a number of years. The proceeds may be a combination of cash and other assets such as shares in the buyer's company. In addition, a company can be sold for an uncertain price that depends on future events.

5.6 There are often good commercial reasons for using the different options outlined above.

5.7 For instance, if a buyer and seller cannot agree on a sale price, proceeds that are dependent on future profits provide an opportunity to reflect the true value of the company. Or the purchaser may not have the cash required to buy the company outright and be dependent on the future profits to buy out the previous owner.

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[1] HMRC Capital Gains Tax statistical tables, Table 7. See Annex D.

5.8 In relation to the 2018-19 tax year, HMRC identified around 1,400 individuals who may have had to calculate Capital Gains Tax where the proceeds may have been deferred. Collectively they had a total liability of £240 million in that tax year although the amount they paid may be revised up or down over the coming years.[2]

5.9 If the change from Entrepreneurs' Relief to Business Asset Disposal Relief is factored in, being a reduction in the amount taxed at 10% from £10 million to £1 million, this figure would increase to £320 million. There is uncertainty in this analysis as taxpayers are not required to declare deferred consideration in a consistent way in Self Assessment tax returns and so these figures should be considered indicative only.[3]

5.10 In the context of the challenging economic conditions stemming from the COVID-19 pandemic it is possible that the use of deferred proceeds on a sale of a company could become more common in future.

Simple company sales

5.11 To calculate the capital gain a taxpayer needs to know the price paid on acquisition (which may be nominal if the company was set up by the taxpayer) and the proceeds, which they can then use to pay the tax.

Example 9 – known proceeds

Owen sells his company for £1.2 million to be paid in cash. Owen set up the company himself without incurring any allowable costs.

Owen is taxed on the capital gain of £1.2 million.

5.12 In this example the proceeds were cash, but this isn't always the case. Owen could have potentially received other assets, such as shares, which he may be required to hold for a specified period of time and therefore he cannot readily realise the cash. All non-cash proceeds are subject to tax just as cash proceeds are.

Company sales where the proceeds are deferred

5.13 Another possibility is that the sale proceeds are paid over a number of years. Where the value of the deferred proceeds is known they are often referred to as 'ascertainable'. In this situation Capital Gains Tax is due on the full proceeds at the time of the sale regardless of when the proceeds are handed over.

[2] HMRC data 2018-19. See Annex D.

[3] HMRC data 2018-19. See Annex D.

Example 10 – known proceeds deferred

Owen sells his company for £1.2 million to be paid in cash. £1 million will be paid upfront and £200,000 will be paid in 2 years' time.

Owen is taxed on the gain of £1.2 million at the time of the sale. No allowance is made for the delay in paying over the final £200,000 and all of the tax is due at the same time.

5.14 If Owen ultimately receives a lower amount (say if the buyer defaulted), he can make a claim for an adjustment to the original tax calculation to obtain a tax repayment. A taxpayer has four tax years to do this from the time it becomes certain that the full agreed proceeds will not be paid. The final position is that Owen is ultimately taxed on what he receives.

Instalment Option

5.15 There is a facility to pay the tax in interest-free instalments where known proceeds are to be received over a period of time exceeding 18 months which ends after the normal due date of payment of the Capital Gains Tax.

5.16 An application must be made to HMRC to agree the payment arrangements, which can never be over a period of more than eight years. It is not necessary for the taxpayer to show that they will have difficulty in paying the tax. There is no data available, but the number of applications is thought to be no more than a handful.

5.17 This is separate from the normal Time to Pay Arrangements which are available for taxpayers who are unable to pay taxes owed. If the amount owed is more than £30,000, then the payment terms will need to be agreed with HMRC and are based on the taxpayer's ability to pay and therefore their specific financial circumstances will be reviewed. Interest also then applies to the late payment of the tax.

5.18 One reason the instalment option for deferred proceeds is rarely used in practice is the mechanics of how this works. On the initial proceeds, and each time the taxpayer receives a payment, they normally have to pay 50% of the amount received towards the tax due until it has been paid in full. As the rate of Capital Gains Tax is either 10% or 20% this limits the effective application of this option as illustrated in the example below.

Example 11 – instalment option

Owen's upfront proceeds are £1 million.

Owen is entitled to Business Asset Disposal Relief, so the Capital Gains Tax payable, assuming the Annual Exempt Amount has been used up elsewhere, is £140,000 (£1 million at 10% plus £200,000 at 20%).

The tax cannot be paid under the instalment option as it is less than 50% of the initial proceeds of £1 million. In his circumstances, the instalment option

would be available to Owen only if the initial proceeds were less than £280,000.

5.19 Furthermore, the Capital Gains Tax due under the instalment option may have been paid well in advance of the full proceeds ultimately being received as illustrated in the example below.

Example 12 – instalment option

Poppy's proceeds are £2 million payable in eight equal annual instalments of £250,000 each.

Poppy is entitled to Business Asset Disposal Relief, so the Capital Gains Tax payable, assuming the Annual Exempt Amount has been used up elsewhere, is £300,000 (£1 million at 10% plus £1 million at 20%).

On the receipt of each instalment, Poppy pays over £125,000 in tax. By the time the third instalment has been received, Poppy has paid all the Capital Gains Tax due. So, although the proceeds are paid over a period of eight years, the tax is being paid over only three years.

Company sales where proceeds are deferred and unknown

5.20 Sometimes the proceeds include a future payment determined by an agreed formula based on future profits, which cannot be known at the time of the sale. This is often referred to as an "earn-out" and for tax purposes is known as "unascertainable" proceeds.

5.21 In this situation Capital Gains Tax is due both on the upfront cash proceeds paid and the present estimate of the value of the proceeds that will be received in the future. This is because Capital Gains Tax is payable on proceeds whether they are received in the form of money or money's worth. So, depending how the overall proceeds for the sale are structured, the taxpayer may be paying tax on an element of the proceeds that they have not yet received.

5.22 The figure put on the estimated proceeds is the value of the right to receive the future proceeds.[4] A professional valuation is normally required to determine this figure. When the right is later exchanged for cash this disposal is a taxable event in its own right - it is not related to the original share disposal. The base cost is the original valuation of the right and the proceeds the amount of cash received. There will be multiple such taxable events if the proceeds are received over a number of tax years.

[4] This approach to handling such rights is the result of the 1980 Marren v Ingles case.

Example 13 – unknown proceeds deferred

Louise sells her company for £1 million plus 10% of the profit in the next 12 months to be paid in two years' time.

If the future proceeds are estimated to be valued at £200,000, then Louise is taxed on total proceeds of £1.2 million in the year of disposal.

There is a second Capital Gains Tax event when Louise receives those future proceeds in a subsequent tax year.

If Louise in fact receives £250,000, she has made a further capital gain of £50,000 which is taxable in the year of receipt. If Louise receives only £150,000, she has made a capital loss of £50,000. In the case of a loss, Louise can elect to carry back the loss against the original gain and she will receive a tax repayment.

5.23 If the future proceeds are never received, then a tax repayment can be made but this requires an election to carry back the loss to the original year of disposal to receive the tax refund. This is an exception to the normal rules, which do not allow a capital loss to be carried back. In relation to the 2018-19 tax year, indicative analysis suggests there were around 80 taxpayers who had deferred proceeds and used losses against an earlier year's capital gain.[5] Ultimately, this election means that a taxpayer will pay tax on what they receive.

5.24 If the deferred proceeds are received before the filing date for the tax return for the tax year of sale then strictly a taxpayer should file their return using the value of the right to the future proceeds and then adjust the position in the next tax year when the cash is received. However, it is likely that a taxpayer will in practice just file on the basis of the actual amount received.

5.25 Based on a sample of tax returns the majority of transactions are adjusted within four years of the initial disposal.[6]

Company sales where the proceeds are deferred and paid in other assets

5.26 Non-cash proceeds are taxed in the same way as cash proceeds, as noted above. However if the proceeds are deferred and payable in the form of specified assets, such as new shares in the buyer's company or in return for a formally constituted debt owed to them, the taxpayer can normally postpone the taxation of the deferred proceeds until the disposal of the new shares or settlement of the debt, subject to certain conditions being satisfied. Where the amount of this type of deferred proceeds is not known, this also means there is no need to value the right to the future proceeds.

5.27 A formally constituted debt is commonly referred to as a loan note, loan stock, debenture or (as in this report) a corporate bond. If the use of a corporate bond is to be effective as a means of deferring the point at which

[5] HMRC data 2018-19. See Annex D

[6] HMRC data 2018-19. See Annex D

the proceeds are taxed it is generally accepted that the debt needs to have a life of at least six months[7] - which means that there will be a delay in receiving that part of the proceeds.

5.28 The tax treatment of a corporate bond is different depending on whether or not it is a qualifying corporate bond. See paragraph 5.63 below.

Example 14 – deferred proceeds paid in corporate bonds

If Owen's or Louise's future proceeds are payable to them as corporate bonds, and not cash, then regardless of whether the amount is known or unknown, they will be taxed only on the upfront cash payment of £1 million in the tax year of the disposal.

A further tax charge will arise only when the additional cash is ultimately received on the redemption of the corporate bond.

Interaction with Business Asset Disposal Relief

5.29 If the proceeds involve a deferral in the charge to tax, the taxpayer often loses eligibility to Business Asset Disposal Relief on the deferred amount.

5.30 If, for example, they receive shares in the buyer's company they would need to hold at least 5% of the shares and be an employee or director for any gain on a subsequent sale to qualify.

5.31 Or if, for example, proceeds relating to an earn-out are received in the form of corporate bonds, then the Capital Gains Tax event for those bonds is at the time they are redeemed.

5.32 In examples 9, 10 and 13 above, Owen and Louise could claim Business Asset Disposal Relief on the proceeds of £1.2 million that they are taxed on in the year of sale of their shares.

5.33 If, as in example 13, Louise received further proceeds of £250,000, Business Asset Disposal Relief would not apply to the additional £50,000 as the tax is payable on the redemption of the corporate bonds.

5.34 In example 14, Business Asset Disposal Relief would apply only to the upfront initial proceeds of £1 million. An election could be made so that Business Asset Disposal Relief could apply to the deferred proceeds of £200,000, but that involves being taxed on this amount upfront, even though no cash has been received, which may take away one of the purposes of having the deferred proceeds paid in corporate bonds.

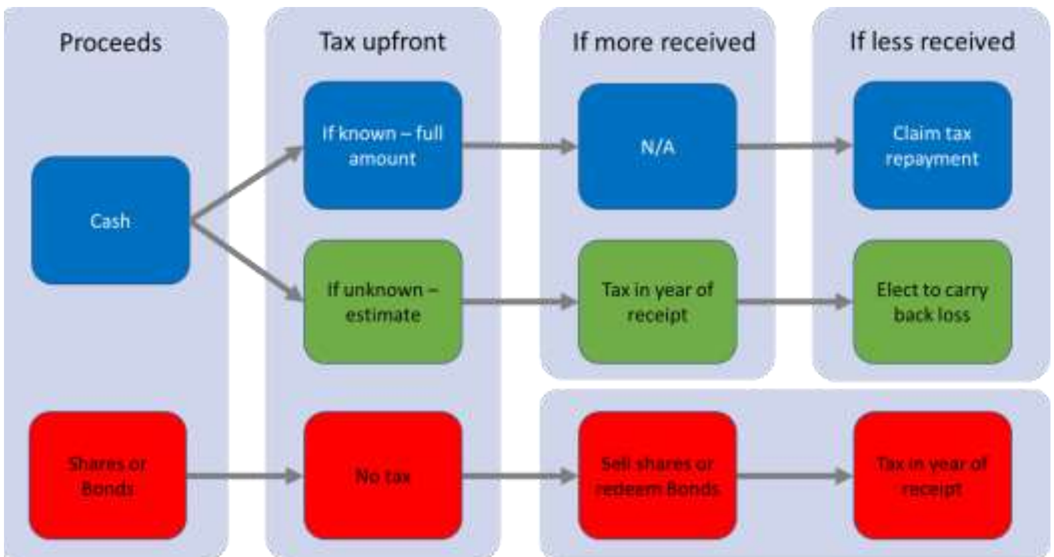
5.35 There are also other, separate, issues relating to Business Asset Disposal Relief (specifically in relation to the timing of disposals on retirement). These issues are covered later in this chapter (see paragraph 5.82).

[7] Capital Gains Manual, Share exchange: examples.
https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg52570

Overview

5.36 The following diagram illustrates the different tax treatments which can arise, depending on how the proceeds are structured on the sale of a company.

Diagram 5.A: Diagram showing different tax treatments on the sale of a company



Source: OTS

5.37 The flow chart shows that however the proceeds are structured on the sale of a company the taxpayer is ultimately taxed on the actual final cash proceeds that they receive. The difference is largely in when the tax is paid.

Observations – challenges with this approach

5.38 There are a number of ways in which the existing situation is unsatisfactory:

It is very hard for taxpayers to understand and the process is not intuitive

5.39 The OTS has heard that understanding the tax rules in this area is beyond even the most sophisticated non-professional taxpayers. This is as much the product of the mechanics of the process as the outcome. Even when the outcome is broadly tax neutral there are unnecessary steps that take time and increase costs for taxpayers. For instance, if the amount received is lower than was estimated either an election has to be made to carry the loss back against the original gain, or a claim made for a tax repayment.

It can result in tax charges on proceeds before they are received

5.40 The rules can result in tax being charged upfront on cash that has not yet been received and may never be received.

The facility to pay the tax in instalments is ineffective

5.41 This facility is rarely used in practice as it requires a bespoke agreement and the instalments are not appropriately matched to the way the proceeds are received. In cases of hardship, Time to Pay Arrangements would be more flexible and effective.

The required valuation of future proceeds can be challenging

5.42 The valuation of a right to receive future proceeds can be complex and requires professional input. This can be subjective and is inevitably based on a range of factors. Coming to a conclusion takes time and money and seems unnecessarily complicated if the actual proceeds may be known within a short to medium time frame and available to be used instead.

It can create uneconomic distortion

5.43 The differences in tax treatment can be distortive, by pushing taxpayers away from arrangements that make most commercial sense.

Reliefs apply inconsistently

5.44 Some of the issues outlined above do not arise if the future proceeds are payable in shares or corporate bonds as the tax is paid on receipt of the cash. However, Business Asset Disposal Relief is often not available even where it would have been if the company had been sold for a known amount of cash or an unknown amount of cash (at least on the value of the right to the unknown cash).

Conclusions – how the system could be improved

5.45 There is no single way forward that avoids all these pitfalls without creating further issues. However, there are number of approaches that the government could take to improve the position so that the tax position is the same for all taxpayers however their proceeds are paid, and so that they pay tax on the actual proceeds on receipt of the cash rather than having to make future claims or elections to correct the position.

Capital gains on a receipt basis

5.46 Capital Gains Tax could be charged on a 'receipts' basis, the tax being paid when the proceeds of sale are actually available or received and therefore quantifiable. This would have a number of benefits:

- the tax would be paid out of the cash that the taxpayer has received without any need to make a claim or an election if less is received than anticipated
- there would be no need to value the right to future proceeds which can be complex and expensive
- there would be no need to structure a disposal using corporate bonds to defer the payment of tax on proceeds that have not been received. So the tax treatment of examples 10 and 13 would mirror example 14.

5.47 The government would however have to consider the Exchequer implications, as there would be a delay in payment of Capital Gains Tax. There could also be a reduction in overall tax revenue due to the spreading of the gain across multiple tax years, as more than one Annual Exempt Amount will be available - though taxpayers could structure this under the current rules, say, by partial redemption of corporate bonds.

Detailed policy design

5.48 If the government were to make changes in this area then consideration would need to be given to the following issues:

5.49 The computation of the Capital Gains Tax due on the overall transaction. For example, whether all of the base cost should be allocated to the initial proceeds, which would reduce the first tax payment, or be proportionally spread across each receipt. The latter would be fairer to the Exchequer but would create additional complications as multiple part disposal computations (and valuations of the remaining proceeds) would be required.

5.50 The position if the taxpayer subsequently becomes non-UK resident, dies or assigns (or sells) the right to the future proceeds to another person. These events could trigger the immediate payment of the tax based on the known or unknown proceeds. There are similar provisions already in the legislation to tax gains on which gift hold-over relief has been claimed where the person in receipt of the asset leaves the UK.

5.51 A restriction of this approach to sales to third parties where there are deferred proceeds to prevent avoidance where, say, there is a gift so there are no proceeds, or the proceeds are other non-cash assets. Furthermore, the OTS suggests applying a maximum period over which the tax can be paid, of say, five years.

5.52 Consideration should also be given to ensuring that future proceeds payable in forms other than cash (such as corporate bonds) do not compromise the availability of Business Asset Disposal Relief. To ensure the relief does not then apply to any increase in the value of shares attributable to the new company owner, such an extension of this relief could apply only to the deferred gain arising on the redemption of corporate bonds and shares where the shareholders does not otherwise qualify for the relief.

Wider issues

5.53 If the government considered such changes in the tax treatment of deferred proceeds in relation to the sale of a business then it should also consider the application of those changes to other transactions where there are deferred proceeds, such as in relation to disposals of land.

5.54 In addition, the government should consider removing the existing facility to pay the Capital Gains Tax in instalments on deferred proceeds. This would save taxpayers and their advisers from having to explore what is usually a dead end in practice.

Recommendation 8

The government should consider whether Capital Gains Tax should be paid at the time the cash is received in situations where proceeds are deferred, such as on the sale of a business or land, while preserving eligibility to existing reliefs.

Debts

Background – how it works at the moment

5.55 Where an amount is owed to an individual this is an asset for Capital Gains Tax purposes, and when it is repaid there is a disposal of that asset for the amount received.

5.56 Where one person has just lent money to another and this is repaid this is known as a 'simple debt'. Simple debts are specifically outside of the scope of Capital Gains Tax so that neither a taxable gain nor an allowable loss can arise. This applies only when the debt remains in the hands of original lender.

Example 15 – simple debt

Alice lends £20,000 to Betty.

If Betty repays £18,000 to Alice, Alice will not make an allowable loss as this is a simple debt.

If Alice sells the debt to Charlie for £17,000 and Betty repays £18,000, Charlie is taxed on the gain of £1,000 as it is now a second-hand debt and not exempt from Capital Gains Tax.

5.57 The reasoning behind this is that when an individual makes a loan, they will generally be repaid either the same amount or less; it is unlikely they will be repaid more. By making them exempt, there is no allowable loss if the funds repaid are less than the original amount. However, second-hand simple debts are within the charge to Capital Gains Tax as they are often acquired with the expectation of making a profit.

5.58 If a debt is not a simple debt, then it is within the scope of Capital Gains Tax and is generally known as a 'debt on a security'. This is not the same as a secured debt (that is, a debt secured on an asset such as a mortgage).

Type of debt

5.59 Whether the debt classified as a simple debt or a debt on a security is not always obvious.

5.60 A debt on a security is a debt with added characteristics which generally enable it to be realised at a profit or a loss. These characteristics are based on case law and include, for example, that the debt is marketable, held as an investment, capable of being realised at a profit, and is at a commercial rate of interest.[8] Not all of these characteristics need to be present and whether the debt is marketable is considered to be the main one. Just because a debt is documented in writing doesn't necessarily mean it is a debt on a security.

[8] The leading case is W T Ramsay Ltd v CIR 54TC101.

5.61 The criteria must be applied to determine the type of debt and therefore whether or not it is within the charge to Capital Gains Tax.

Corporate bonds

5.62 Corporate bond is a generic term for debts or securities issued by a company to raise finance.

5.63 There are different tax treatments depending on whether the corporate bond is what is termed a qualifying or a non qualifying corporate bond. Qualifying corporate bonds can generally be described as a debt which is on normal commercial terms, is expressed in sterling and where there is no provision for conversion or redemption into another currency. Qualifying corporate bonds are exempt from Capital Gains Tax whereas those that are non qualifying are taxable. A similar exempt status applies to gilts which are issued by the government.

5.64 This distinction is only relevant for Capital Gains Tax purposes as any debts within the charge to Corporation Tax are subject to a different treatment.

5.65 As discussed in paragraphs 5.26 and 5.27, the proceeds on the disposal of a company can include corporate bonds. When corporate bonds form part of the proceeds this can defer the tax on that part of the proceeds until the bonds are redeemed and the cash received.

5.66 Where the bonds issued are qualifying, their exempt status applies in such a way that the gain deferred from the earlier disposal is triggered on redemption, with any gain or loss attributed to the qualifying corporate bond itself not being within the scope of Capital Gains Tax. This can create an anomaly if the buyer cannot pay the funds due on the bond, for example where the company has gone bankrupt.

Example 16 – qualifying corporate bond

Peter sold his company to Beta Limited for £500,000 realising a gain of £100,000. This is not immediately chargeable to tax as the proceeds will be paid in the form of qualifying corporate bonds in 2 years' time.

Beta Limited is later put into liquidation, and Peter will not in fact receive the £500,000.

On the liquidation there is a deemed disposal of the qualifying corporate bond and Peter's gain of £100,000 becomes taxable, even though he has not received any proceeds.

This tax charge does not arise if the qualifying corporate bond is given to a charity before the liquidation.

5.67 Although non qualifying corporate bonds are within the charge to Capital Gain Tax it is considered that their tax treatment is generally favourable as, where they are issued on the sale of a company, deferred gains would not be triggered in the situation illustrated in example 16.

5.68 To ensure non qualifying status, the conditions for qualifying status must not be met. One way of achieving this is to include in the formal documentation for the bond a provision that it can be redeemed in a foreign currency or to allow for additional corporate bonds to be issued. Such legal provisions generally have no other purpose.

Relief for irrecoverable debts

5.69 Where an individual has made a loan to a trader which is a simple debt, any loss would not normally be allowable. However, there is a specific relief which can allow an individual to claim a capital loss on a debt, the main conditions being that the monies lent are used wholly for the purposes of the trade and all or part of the monies loaned have become irrecoverable.

5.70 For example, if a loan of £500,000 to a trading business becomes irrecoverable this relief gives the taxpayer a capital loss to offset against other capital gains.

Observations – challenges with this approach

5.71 There are a range of specific challenges with the way debts currently operate.

Type of debt

5.72 The OTS has heard that it can be a complex exercise for professionals to determine whether a debt is a debt on a security as there is no definition in the legislation, and it is determined by case law. HMRC guidance outlines the characteristics required based on the case law but is limited in scope and provides few examples.[9] It is possible to submit a non-statutory clearance to HMRC where it is difficult to determine which type of debt it is.

Corporate bonds

5.73 As illustrated, there are often disadvantages to having qualifying corporate bonds as part of the proceeds for a business sale. Securing the intended Capital Gains Tax status of corporate bonds is unduly complex and requires the insertion of provisions in the legal documentation which generally have no other purpose other than to ensure the preferred tax treatment. The insertion of these provisions is confusing for taxpayers, as well as professionals such as commercial lawyers.

Relief for irrecoverable debts

5.74 Relief is not available if there was no realistic chance of the debt being repaid when it was initially made (for example if the business was in such difficulties at the time of the loan that it was irrecoverable from the outset). HMRC guidance specifically direct its officers to consider this if there is a small time gap between the loan being made and the loss claim.[10]

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[9] HMRC Capital Gains Manual.
https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg53422

[10] HMRC Capital Gains Manual.
https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg65951

5.75 The OTS has heard that this can be a subjective assessment by HMRC of the commercial position at the time the loan was made, and of whether the taxpayer was reasonable in their view that it was recoverable. The taxpayer is in a position that they have lost funds and may not have certainty about whether tax relief will be available.

Conclusions – how the system could be improved

5.76 The OTS has a number of suggestions for improving the taxation of debts.

Corporate bonds

5.77 The OTS recommends that it should be possible for the choice about the tax status of a corporate bond to be made by the inclusion of a permanent irrevocable upfront provision in the legal documentation for the bond.

5.78 This would avoid the need to insert complex clauses which normally have no other purpose and make it difficult for the parties concerned to know which type of corporate bond they have, and avoids any mistakes being inadvertently made.

5.79 If no provision is made the default position should be that the corporate bond is qualifying and therefore exempt from Capital Gains Tax. This outcome is more intuitive for taxpayers and reflects that there are wider uses of corporate bonds beyond company sales.

Type of debt

5.80 HMRC should consider improving their guidance on when a debt is within the charge to Capital Gains Tax by including examples that cover complex borderline characteristics and outlining the issues that have arisen when a non-statutory clearance has been submitted (**recommendation 14**).

Relief for irrecoverable debts

5.81 HMRC should consider improving their guidance about when it will be considered that relief is not permitted on the basis that it was not reasonable for the taxpayer to consider a debt was recoverable at the time the loan was made. The guidance should include relevant case studies of situations which are definitely within the rules to bring further clarity for taxpayers (**recommendation 14**).

Recommendation 9

The government should consider enabling an irrevocable provision in the documentation for a corporate bond to specify that it is subject to Capital Gains Tax, and for the absence of such a provision to mean that it is exempt.

Timing issues in relation to Business Asset Disposal Relief on retirement

Background – how it works at the moment

5.82 As set out in the OTS's first Capital Gains Tax report, some form of Capital Gains Tax relief for disposals on retirement has always been available since Capital Gains Tax was introduced. Initially this took the form of Retirement

Relief, later overtaken by Taper Relief, Entrepreneurs' Relief and Business Asset Disposal Relief.[11]

5.83 Respondents to the Call for Evidence have highlighted a specific issue relating to the timing of the disposal of business assets on retirement where the date of cessation does not naturally fit with the disposal of the assets.

5.84 The legislation specifies that where at the time a business ceases there is a disposal of one or more business assets, Business Asset Disposal Relief may be claimed as long as the disposal is made within the three year period beginning with the date of cessation.

Observations – challenges with this approach

5.85 However, the OTS has been told that this requirement to sell when or after the business ceases may not reflect some common retirement scenarios. For example, a farming business could be sold but the farmer may continue to harvest existing crops after the sale, or a retail business may need to continue for some time after the retail premises are sold. However, a strict interpretation of the legislation could lead to the relief being forfeited if trading continues after exchange of contracts for the sale of a business.

5.86 The specific awkwardness of the timing of business asset disposals in relation to Entrepreneurs' Relief (now Business Asset Disposal Relief) used to be covered by a formal HMRC concession; however, this has been withdrawn.[12]

5.87 Despite the reassurance given by HMRC in published correspondence with the Institute of Chartered Accountants in England and Wales,[13] the OTS has been told that to mitigate the risk of losing the relief, some businesses are seeking other practical 'ways round' the legislation, such as the use of cross (put and call) options between vendor and prospective purchaser.

Conclusions – how the system could be improved

5.88 HMRC should include more detailed examples in their manuals about how they interpret the legislation in certain situations where the date of cessation is unclear to help and reassure farming businesses and others looking to retire over a period of time (**recommendation 14**).

5.89 In particular, it would be helpful if the interpretation set out in the open correspondence referred to above could be more clearly confirmed within HMRC's own guidance manuals.

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11 OTS Capital Gains Tax Review: Simplifying by design. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/935073/Capital_Gains_Tax_stage_1_report_-_Nov_2020_-_web_copy.pdf

12 Extra Statutory Concession D31 was declared obsolete in January 2004. It read: "For the purposes of section 163 and 164, and Schedule 6 TCGA (sections 69 and 70 and Schedule 20 FA 1985) (Capital Gains Tax retirement relief) the Inland Revenue are prepared to accept the date of completion as the date of disposal where, pending completion, business activities continue beyond the date of unconditional contract. This treatment applies for all purposes of Capital Gains Tax retirement relief where the date of disposal is relevant."

13 Entrepreneur's Relief – Practical Points, Chartered Accountants in England and Wales, p9. https://www.icaew.com/-/media/corporate/archive/files/technical/tax/taxguides/taxguide-1-12-er-final-at-25-jan-12.ashx

Chapter 6
Investor issues

Enterprise investment schemes

Background – how it works at the moment

6.1 The Enterprise Investment Scheme and the Seed Enterprise Investment Scheme are intended to provide support for growth investment in start-up and early-stage companies by giving generous tax reliefs to investors who subscribe in cash for new shares in those companies. The objective of the reliefs is to encourage medium term investment into higher-risk trading companies that might otherwise struggle to raise capital through conventional bank finance.

6.2 Since the Enterprise Investment Scheme first started in 1994, more than 31,365 companies have received investment through the scheme and over £22 billion of funds have been raised. The Seed Enterprise Investment Scheme was launched in the 2012-13 tax year and since then more than 12,040 companies have received investment, raising over £1 billion of funds.[1]

6.3 In the 2018-19 tax year there were 34,145 Enterprise Investment Scheme and 7,480 Seed Enterprise Investment Scheme investors claiming tax relief totalling £1,409 million.[2]

Economic implications

6.4 Although investing in early-stage companies is very high risk, with a high chance of failure, many successful companies (including household names such as Gousto, Money Dashboard[3] and Bloom & Wild[4]) have used enterprise investment schemes as part of their early-stage funding. As, despite the risks, there is an opportunity for an investor to make a

[1] Enterprise Investment Scheme, Seed Enterprise Investment Scheme and Social Investment Tax Relief statistics: May 2020. This does not include investors claiming though PAYE or those who didn't claim Income Tax relief.

https://www.gov.uk/government/statistics/enterprise-investment-scheme-seed-enterprise-investment-scheme-and-social-investment-tax-relief-statistics-may-2020

[2] Enterprise Investment Scheme, Seed Enterprise Investment Scheme and Social Investment Tax Relief statistics: May 2020. This does not include investors claiming though PAYE or those who didn't claim Income Tax relief.

[3] https://www.cityam.com/eis-hall-of-fame/

[4] https://mindfulinvestor.co/stories/bloomwild/

substantial capital gain on a successful investment, the Capital Gains Tax exemption is a key relief for many investors.

6.5 A 2017 report by PricewaterhouseCoopers LLP, the Centre for Social and Economic Research and the Institute for Advanced Studies for the European Commission found that tax incentives for venture capital and business angel investment generates a number of positive macroeconomic benefits, such as job creation and productivity gains.[5]

6.6 The OTS understands that the benefits of enterprise investment schemes may be particularly important in the current economic climate, where new start-up businesses should be encouraged and also where existing early-stage businesses recovering from the effects of COVID-19 will need new sources of funding.[6]

Eligibility

6.7 Both the Enterprise Investment Scheme and the Seed Enterprise Investment Scheme have intentionally restrictive eligibility criteria and require specific clearance from HMRC that the criteria are met.

6.8 In exchange they provide generous Income Tax relief when the investment is made, provided that the eligibility criteria continues to be met for a further period of at least three years, together with complete exemption from Capital Gains Tax where shares are disposed of after this time and the Income Tax relief has not been reduced or withdrawn.

6.9 The Capital Gains Tax exemption flows from the Income Tax treatment: it is not available unless Income Tax relief has been claimed and relief given.

6.10 The Enterprise Investment Scheme currently has a 'sunset clause' and investments after 5 April 2025 will not be eligible for relief. This date can be amended by Treasury order.

Observations – challenges with this approach

6.11 The OTS has heard from several respondents to the Call for Evidence that some features of the rules are overly limiting or cause practical problems for genuine applicants. One experienced member of the tax profession called them 'elephant traps that seem more designed to help generate fees for advisers than to block misuse'.

6.12 There have been many legislative changes to the enterprise investment schemes over the years and although HMRC have comprehensive guidance,

[5] Effectiveness of tax incentives for venture capital and business angels to foster the investment of SMEs and start-ups 2017, PricewaterhouseCoopers LLP, Center for Social and Economic Research, & Institute for Advanced Studies, produced for the European Commission, p9.

https://ec.europa.eu/taxation_customs/sites/taxation/files/final_report_2017_taxud_venture-capital_business-angels.pdf

[6] 40% of businesses said that their turnover had decreased from a sample taken mid-March 2021, Business insights and impact on the UK economy: 8 April 2021, ONS https://www.ons.gov.uk/businessindustryandtrade/business/businessservices/bulletins/businessinsightsandimpactontheukeconomy/8april2021

there is no doubt this is a complex area to navigate – although in part this is to prevent abuse of what are significant reliefs.

6.13 The OTS has heard that the impact of this is to deter individuals and companies from using the schemes, potentially damaging take up and holding back investment from start-up companies. As the OTS pointed out in the Business Lifecycle report 'digitisation and relaxation of legislative inflexibilities could also contribute to faster turn-arounds, which in turn would better enable companies to attract venture capital'.[7]

6.14 The OTS has identified a number of specific areas that regularly cause concern and which, if addressed, would better enable the relief to achieve its policy objectives. These areas include:

- short deadlines for issuing shares
- interaction of the re-investment reliefs with Business Asset Disposal Relief
- the rules not keeping pace with modern commercial practices
- a cumbersome application process
- the link between Income Tax relief and Capital Gains Tax relief

Deadlines for issuing shares

6.15 Currently, shares in companies that qualify for enterprise investment schemes have to be issued when, or shortly after, any funds are received. If payment for the shares is even one day late, the whole investment is ineligible for tax relief.[8] This can collapse deals and deter people from using the schemes - perhaps simply because of a timing delay within the banking system which is beyond investors' control.

6.16 While it is important to ensure a direct link between a company raising funds and issuing new shares, requiring everything to happen on the very same day is commercially unreasonable.

6.17 The OTS has heard of several instances where investors have been denied tax relief on this basis and it is a particular problem for those without access to expensive specialist tax advice - for example early-stage start-up companies using the Seed Enterprise Investment Scheme.

Interaction of reinvestment reliefs with Business Asset Disposal Relief

6.18 Investors using the schemes who make capital gains on unrelated assets and reinvest those gains into their Enterprise Investment Scheme or Seed Enterprise Investment Scheme shares, can claim relief on those gains.

6.19 One particular aspect of the reinvestment reliefs differs depending on whether relief is claimed in relation to reinvestments into Enterprise Investment Scheme shares (where the original gain is deferred until a specified event occurs, such as the shares being sold), or into Seed Enterprise Investment Scheme shares (where some or all of the original gain is

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7 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/699972/OTS_Business_Lifecycle_report_final.pdf

8 This strict interpretation follows decided cases, such as Blackburn v Anor (2009)

conditionally exempt and can be revived in some circumstances, such as the sale of the shares within the first three years).

6.20 With Enterprise Investment Scheme shares, if Entrepreneurs' Relief or Business Asset Disposal Relief was available on the original deferred gain, equivalent relief is still available if or when that deferred gain is brought back into charge.

6.21 By contrast, a revived gain under the Seed Enterprise Investment Scheme can no longer benefit from Business Asset Disposal Relief, even if it would have originally qualified for that relief (or for Entrepreneurs' Relief).

Modern commercial practices

6.22 The OTS has been told that the requirements of enterprise investment schemes are so strict that many modern commercial practices can cause the schemes to fail.

6.23 There is, however, a tension between what may appear to be restrictive requirements and the need to ensure that enterprise investment schemes are not being exploited – for example the OTS has heard that some companies have devised investment strategies which require only very minimal investment of, say, £1 with the aim of the investor simply getting the Capital Gains Tax relief rather than, as is the policy intention, providing the company with financial support.

Application process

6.24 The current process for applying to HMRC for approval that the schemes criteria have been met - or for 'advance assurance' that the criteria are likely to be met - is quite cumbersome.

6.25 The application forms themselves are difficult to complete online as, although they can be completed on screen, there is no scope for saving partly completed forms. This can be burdensome, as the forms require quite detailed information, but until each page of the form is accessed it is not possible to tell what information will be needed.

6.26 The Seed Enterprise Investment Scheme is intended for very early-stage companies with a maximum overall investment of £150,000 and yet the information required for that scheme is substantially the same as for the Enterprise Investment Scheme (where investment limits are much higher). This can be onerous and expensive for these early-stage companies as they will find it difficult to complete the forms without help from an adviser.

6.27 Improving the functionality of the forms and better linkage to HMRC guidance would simplify the clearance and application processes. As just one example, although the advance assurance instructions include a very comprehensive and useful checklist of required documentation, including links to relevant HMRC guidance, neither the EIS1 or SEIS1 forms (the compliance forms which must be completed after the shares have been issued by the company) have similar supporting comprehensive checklists.

Link between Income Tax relief and Capital Gains Tax relief

6.28 One specific requirement of the enterprise investment schemes exemptions is that Income Tax relief must have been claimed and been given on all or part of the original investment. If it is not - perhaps because the claimant had an Income Tax loss so there was no need for them to claim the relief, or the investment was relatively small so it was thought not worth claiming, then there is no Capital Gains Tax exemption when the shares are sold.

6.29 The exemption is also unavailable or only provides partial relief where the Income Tax relief originally attributable to the shares has been reduced or withdrawn due to either the company's or the investor's failure to continue to meet the qualifying conditions during the minimum three year qualifying holding period.

6.30 This mechanism was built into the design of enterprise investment schemes on the basis that the investor's qualifying status would be tested at the point of investment, with this, rather than the occasion of the later disposal, being the trigger point for any HMRC compliance work.

6.31 Additionally, as Income Tax relief is only given on the basis of various qualifying conditions continuing to be met for the qualifying holding period, the logic is that if the upfront Income Tax relief has been given on the investment and has not been reduced or withdrawn it would demonstrate that the investment met the purposes of the scheme and that the Capital Gains Tax exemption would be due.

6.32 However, it is an odd outcome for an individual to be denied Capital Gains Tax relief if they did not have a liability to pay Income Tax when they first made that investment. In some cases this can be addressed by forgoing a portion of the personal allowance (although this can be an administratively difficult process for the taxpayer), but this would not be a solution if the investor had no income or if all of the investor's income is fully covered by income tax losses.

Conclusions – how the system could be improved

6.33 The OTS has identified a number of technical and administrative improvements to address the issues identified above.

6.34 Any of these changes could encourage more taxpayers to use the enterprise investment schemes. In practical terms this could mean that more investment reaches early-stage trading companies which might otherwise struggle to access funding. This is likely to be especially important as the economy recovers from the effects of COVID-19.

Flexibility for taxpayers

6.35 The OTS considers that the government should provide taxpayers with a measure of flexibility in relation to non-substantive technical issues which risk invalidating claims where the substance of the transaction meets the policy objectives of the relief.

6.36 The following are examples of areas which the government and HMRC should consider addressing, through a combination of legislative and administrative changes.

Deadlines for issuing shares

6.37 It would be particularly helpful to allow a short period of grace between a company receiving funds and issuing the shares.

Interaction of the reinvestment reliefs with Business Asset Disposal Relief

6.38 Consideration should be given to aligning the treatment of revived deferred gains for the Enterprise Investment Scheme and revived Seed Enterprise Investment Scheme reinvestment relief gains so that Business Asset Disposal Relief can be claimed on the latter as well as the former, as there seems to be no underlying reason for this mis-match.

Modern commercial practices

6.39 While the OTS recognises that strict criteria are essential for this very valuable relief, it would be helpful if the requirements are reviewed on an on-going basis to ensure they can be reasonably met in practice and do not unduly restrict the company's commerciality.

6.40 Equally, the government should continue to monitor if the reliefs are being used for investments that are not in keeping with their original intention. If there is clear evidence of exploitation through investments with a nominal value, the government may wish to consider reinstating a minimum investment requirement (until the 2012-13 tax year the Enterprise Investment Scheme had a minimum investment value of £500).

Application process

6.41 In addition, HMRC should improve the functionality of the forms and their guidance in consultation with professional bodies and adviser groups. The current forms and guidance, despite recent improvements, are still confusing and are a barrier to accessing the relief, particularly for unadvised very early-stage companies (**recommendation 14**).

Link between Income Tax relief and Capital Gains Tax relief

6.42 The government should explore whether Capital Gains Tax relief should still be accessible by the investor even when Income Tax relief has not been claimed. This would smooth out an odd outcome for taxpayers who have made Income Tax losses – which could be a particular issue in the current COVID-19 economic situation.

6.43 The OTS recognises that giving Income Tax relief is a convenient trigger point for HMRC's compliance work and that the enterprise investment schemes' Income Tax and Capital Gains Tax reliefs are currently structurally combined, so this is not a simple proposal to deliver.

6.44 However, alongside the necessary legislative changes, this could be facilitated by an adaptation to the existing claim process (such as a separate stand-alone notification, or information about the investment being included in Self Assessment tax returns even where no tax relief is available). The new Single Customer Account, outlined in Chapter 1, could also be used to notify

such information to HMRC. This would be particularly helpful for investors not in Self Assessment, and who do not complete tax returns.

Recommendation 10

The government should review the rules for enterprise investment schemes, with a view to ensuring that procedural or administrative issues do not prevent their practical operation.

Foreign Assets

Background – how it works at the moment

6.45 When a UK resident taxpayer buys or sells a foreign asset their acquisition cost and proceeds are converted into sterling at the respective point in time in order to calculate the gain. This means that their actual gain or loss in the foreign currency asset is ignored for Capital Gains Tax purposes.

6.46 HMRC statistics suggest that approximately one in ten people in the UK have foreign assets.[9]

Example 17 – no change in foreign currency, gain in sterling

Richard owns a second home in France which he bought for €120,000 in January 2012. The exchange rate then was £1: €1.2 so the sterling equivalent was around £100,000. Richard sells the house for what he paid for it being €120,000 in January 2021 when the exchange rate was £1: €1.1, the sterling equivalent being about £109,000.

Richard has made a taxable gain of £9,000 even though the value of the property in France has not increased.

6.47 As illustrated in Example 17, the current system means that a tax liability can arise when there is a gain as a result of foreign currencies appreciating against sterling. Equally a taxable loss could arise due a weakening of sterling against the foreign currency as illustrated in Example 18.

Example 18 – no change in foreign currency, loss in sterling

Richard's second home is instead in Australia which he bought for AUD150,000 in January 2012. The exchange rate was £1: AUD1.50 so the sterling equivalent was £100,000. Richard sells the house for what he paid for it being AUD150,000 in January 2021 when the exchange rate was £1: AUD1.75, the sterling equivalent being £85,715.

Richard has made an allowable loss of £14,285 even though the value of the property in AUD has not decreased.

[9] No Safe Havens 2019: responding appropriately

https://www.gov.uk/government/publications/no-safe-havens-2019/no-safe-havens-2019-responding-appropriately

6.48 Furthermore, if foreign currency is spent on the foreign asset to improve it, and these improvements are reflected in the asset's final value, then these amounts must also be converted at each date that the expenditure was incurred.

Foreign currency bank account

6.49 Unlike the treatment for most foreign assets outlined above, there is specific Capital Gains Tax exemption for foreign exchange gains or losses that arise from movements of money in a foreign currency bank account.

6.50 Without this exemption, when funds are added to the bank account or removed from it, there would be a disposal for Capital Gains Tax purposes. The exemption was introduced to remove the complexity and number of the computations that would otherwise be required. The outcome is that as well as capital gains not being within the charge to tax, capital losses are not allowable.

6.51 When individuals acquire foreign assets, they may use a foreign bank account to pay for them. For these individuals, although they are not taxed on the movement of funds within that bank account, they do have to determine the sterling equivalent when working out the acquisition cost of the foreign asset when they come to sell it.

Observations – challenges with this approach

Taxation of exchange rate gain

6.52 These rules can create odd outcomes for taxpayers if they are reinvesting their proceeds in other foreign property. For example, if Richard used the proceeds of his second home to buy another similarly priced second home in another part of France he may reasonably wonder why he has to pay tax in the UK at all when he has not made a gain in France. Richard has tax to pay purely as a result of the exchange rate movement while he held the asset.

6.53 The outcome may be different to those outlined above if, say, the proceeds from the sale of the foreign asset were immediately converted back to sterling for investment in the UK or another foreign asset in a different country. This is illustrated in the following examples.

Example 19 – gain in foreign currency, loss in sterling

Kiran invests £10,000 in US shares in March 2020 and received shares worth $12,800 (exchange rate £1: $1.28). Kiran sells the shares in March 2021 when they have increased in value to $13,600. Kiran wants to invest in the UK so converts the funds and receives £9,785 (exchange rate £1: $1.39).

Although the US shares have increased in value by $800 (£575), Kiran does not have a taxable gain under the current system but an allowable loss of £215.

6.54 As illustrated in example 19, although the US stock has increased in value, as Kiran has converted the funds back to sterling, she has made a real loss. If

Kiran was to reinvest the funds into another US stock, she would not suffer this financial loss.

Example 20 – no change in foreign currency, gain in sterling

Carys invests £10,000 in Australian shares in March 2020 and received shares worth AUS$19,600 (exchange rate £1: AUD$1.96). Carys sells the shares in March 2021 for the same price and receives the sterling equivalent of £10,950 (exchange rate £1: AUD$1.79).

Although the value of the shares has not moved, Carys is taxed on a gain of £950.

6.55 If Carys did not convert the funds to sterling and reinvested in the same currency, then she would not make a financial gain.

6.56 As illustrated the current system seeks to tax the movement in the exchange rate as well as the change in value of the asset.

Foreign currency bank accounts

6.57 It is inconsistent to tax exchange rate fluctuations arising from foreign assets but not those from foreign currency bank accounts.

6.58 In the examples 17, 18 and 20, neither Richard nor Carys would have a taxable gain or an allowable loss for Capital Gains Tax purposes were it not for the exchange rate movement.

Conversion

6.59 This approach to foreign assets can be complicated as it requires historical exchange rate conversions of both the acquisition cost and, if any, enhancement expenditure.

6.60 In practical terms, it is not clear from HMRC guidance whether the taxpayer should use the actual sterling amounts paid, is required to use HMRC's official currency exchange rates or indeed any other published exchange rate guide. If a taxpayer were to use HMRC official exchange rates these are difficult to find in the guidance and for dates prior to 2014 taxpayers are referred to the National Archives.

6.61 If a taxpayer operates solely in sterling and makes a payment to acquire the foreign asset, or to enhance the value of the property, then it should be relatively simple for them to record the sterling amount debited, though they will still need to review historical bank statements from the time when the asset was acquired or funds spent to improve it.

Conclusions – how the system could be improved

6.62 On balance the OTS considers it would generally be simpler if the calculation of gains and losses arising on the disposal of a foreign asset were carried out in the foreign currency, and then converted to sterling at the exchange rate on the date of disposal.

6.63 The mechanical implications of this are demonstrated below.

Implications for examples 17 to 20

Example 17 - Richard would no longer have a taxable gain as he has not made a gain in the local currency.

Example 18 - Richard would no longer have an allowable loss as he has not made a loss in the local currency.

Example 19 - Kiran would now be taxed on £575 as she has made a gain in the foreign currency.

Example 20 - Carys would no longer have a taxable gain as she has not made a gain in the local currency.

6.64 This change would remove the need to determine the sterling equivalent of the acquisition cost and of any subsequent enhancement expenditure. This would be simpler for those taxpayers who operate foreign bank accounts and more intuitive for those reinvesting into foreign assets in the same country. For instance, Richard in example 17 would be free to continue investing in French assets without paying tax on a house that had not risen in value in the currency that he may largely operate in.

6.65 It would also bring the position into line with the treatment with foreign currency bank accounts where taxpayers are not taxed on currency gains.

6.66 It would not add extra complexity for those individuals operating only in sterling although it could sometimes produce less intuitive outcomes for those individuals. For instance, if Richard regularly bought and sold both UK and foreign assets and made a large sterling gain on his French second home which he then used to reinvest in UK assets then it could appear anomalous to exempt him from paying UK Capital Gains Tax.

6.67 The OTS accepts that in exploring this the government will need to consider the number of people affected and the relative balance of winners and losers as well as the Exchequer implications.

Recommendation 11

The government should consider whether gains or losses on foreign assets should be calculated in the relevant foreign currency and then converted into sterling.

Chapter 7
Land and property issues

Agricultural issues

Background – how it works at the moment

Introduction

7.1 Farming businesses are often small rural businesses run by unincorporated traders and partnerships. They tend to hold land and related assets long term, passing on the business from one generation to the next. Statistics from the Department for Environment Food & Rural Affairs show that in 2019 72% of the total land in the UK was used for farming, employing a labour force of approximately 476,000 people.[1]

7.2 Generally, the same Capital Gains Tax rules apply equally to farming as to other businesses. However one particular area of interest is that land used in a trading business is often treated more favourably for tax purposes than land held for investment purposes (often described as 'let' land). This has particular implications for diversified farming businesses where a farmer holds both types of land, or the use made of the land changes over time.

7.3 Several respondents to the OTS Call for Evidence explained that these rules have particular implications for modern farming businesses, which are diversifying to maximise business opportunities.[2] However, in so doing they may inadvertently jeopardise important Capital Gains Tax or Inheritance Tax reliefs, which are seen as especially important for this sector in supporting longer term business investment, restructuring and succession.

7.4 Some representatives of such farming businesses have been consistently arguing that the tax system should be modernised to help farmers to address these and other diversification issues. One suggested approach to such

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[1] Farming Statistics Final crop areas, yields, livestock populations and agricultural workforce At June 2019 – United Kingdom, Department for Environment Food & Rural Affairs, p7. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/865769/structure-jun2019final-uk-22jan20-rev_v2.pdf

[2] Country Land & Business Association, Single Rural Business report, 2020. https://www.cla.org.uk/sites/default/files/Rural%20Business%20Unit%20Report%20FINAL_%20%2804%29.pdf

modernisation is presented by the Country Land & Business Association in their single 'Rural Business Unit' paper.[3]

Environmental policy issues

7.5 The UK's recent departure from the EU will lead to significant changes as the common agricultural policy, which has for decades provided direct support to agricultural businesses across the EU, will be replaced with domestic agricultural policies in each of the devolved nations of the UK.

7.6 In England, direct agricultural support payments will be phased out over a transitional period between 2021-2027, with a new system of payments introduced to support environmental goals. These changes will form part of the government's wider long-term plan for environmental improvement.

7.7 To help meet the objectives of its '25 Year Environment Plan',[4] the government is offering financial incentives to English agricultural landowners through its new 'Environmental Land Management Scheme',[5] which provides for a contractual mechanism between the government and rural landowners for the delivery of public goods, such as wildlife and habitat, clean water and air, climate change mitigation, landscape and heritage, in addition to other support such as farm productivity and sustainable farming payments.

7.8 In Scotland, Wales and Northern Ireland, governmental financial support is being offered through separate environmental schemes from each devolved administration.[6]

7.9 The OTS has been told that it is not yet clear exactly how some of these changes could affect the tax position of rural businesses, including their trading status for Income Tax purposes and their eligibility for Capital Gains Tax and other tax reliefs. This is understandable as the detailed policy design of these environmental schemes has not yet been finalised.

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[3] Country Land & Business Association, Single Rural Business report, 2020. https://www.cla.org.uk/sites/default/files/Rural%20Business%20Unit%20Report%20FINAL_%20%2804%29.pdf

[4] A Green Future: Our 25 Year Plan to Improve the Environment, Department for Environment Food & Rural Affairs, p10. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/693158/25-year-environment-plan.pdf

[5] The Path to Sustainable Farming: An Agricultural Transition Plan 2021 to 2024, Department for Environment Food & Rural Affairs, p6. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/954283/agricultural-transition-plan.pdf

[6] Written Statement: Publication of the Agriculture (Wales) White Paper

https://gov.wales/written-statement-publication-agriculture-wales-white-paper;

Scottish Rural Development Programme.

https://www.mygov.scot/scottish-rural-development/;

Environmental Farming Scheme (EFS) Northern Ireland.

https://www.daera-ni.gov.uk/topics/rural-development/environmental-farming-scheme-efs

Rollover Relief in compulsory purchase situations

7.10 In normal circumstances, Rollover Relief allows the gain arising on the sale of a qualifying business asset to be deferred where the proceeds are reinvested into another qualifying business asset in the same or an ancillary trade.

7.11 For these purposes, land which farmers occupy for their own trade will qualify for relief, but land they rent out ('let' land) will not usually qualify. This reflects the wider approach of the tax system, which treats trading assets more generously than investment assets.

7.12 There is an exception to this rule where land is compulsorily purchased. Here the party from whom the land is purchased can replace that land (like for like) without incurring a tax charge, so, in these circumstances, a gain arising on the sale of 'let' land can be rolled over, but only into new land, rather than into (say) new buildings on land already owned.

7.13 This new land must be purchased within the period of one year before to three years after the date of disposal, though HMRC can extend this timeframe in appropriate circumstances.

Observations – challenges with this approach

Diversification

7.14 Several respondents to the OTS Call for Evidence explained that the different rules for trading and investment activities have challenging implications for modern farming businesses, as modern farms increasingly diversify to maximise economic and business opportunities.[7] That is because they may inadvertently jeopardise important Capital Gains Tax or Inheritance Tax reliefs. The OTS were told that these reliefs were seen as especially important for this sector as they supported longer term business investment, restructuring and succession.

7.15 Some representatives of such farming businesses have argued that the tax system should be modernised to help farmers to address these and other diversification issues. One suggested approach to such modernisation is presented by the Country Land & Business Association in their single 'Rural Business Unit' paper.[8]

Environmental policy issues

7.16 Several representatives of farming businesses who the OTS spoke to expressed concern that particular changes in land use, such as some of those set out in certain Environmental Land Management schemes, could jeopardise their eligibility for Capital Gains Tax reliefs.

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[7] The future farming and environment evidence compendium - September 2019 edition, Department for Environment Food & Rural Affairs, p15.

https://www.gov.uk/government/publications/the-future-farming-and-environment-evidence-compendium-latest-edition

[8] Country Land and Business Association, Single Rural Business report, 2020, p1-2.

https://www.cla.org.uk/sites/default/files/Rural%20Business%20Unit%20Report%20FINAL_%20%28004%29.pdf

7.17 For example, for Income Tax and Capital Gains Tax purposes the trade of farming is defined as "the occupation of land wholly or mainly for the purposes of husbandry". While it is expected that many aspects of the Environmental Land Management scheme and equivalent devolved policies are likely to fall within the meaning of "husbandry", there is a concern that a few of the more passive activities envisaged under the scheme may not.

7.18 This could mean that certain income could potentially fall outside of the farming trade and certain gains on the land could potentially be treated as from an investment for Capital Gains Tax purposes.

7.19 While there is no difficulty with activities normally recognisable as farming such as growing crops and the raising of farm livestock, the guidance relating to the meaning of 'husbandry' in HMRC manuals does 'presuppose a connection between the activity and the occupation of land which goes beyond the mere use of the land as a site for the activity'.[9]

7.20 There is a concern among some of those the OTS spoke to that certain land and activity might come to be seen as having moved out of 'trading' if it is being passively managed with the environmental outcome being the only output from the land. This could potentially mean that some options for land management could leave the landowner unable to qualify for Rollover Relief or Holdover Relief on such land. There is also a perceived risk that even if only part of a business is used in this way that this could deny a whole business access to Business Asset Disposal Relief for Capital Gains Tax purposes if this component were significant.

7.21 There is a wider risk that these tax issues or concerns could deter participation in certain such agreements, making it more difficult for the government's environmental targets to be met.

Rollover Relief in compulsory purchase situations

Reinvestment asset qualification

7.22 It is hard to see the economic rationale for restricting reinvestment to a 'like for like' basis if the wider farming business sector would benefit more or as much from new agricultural buildings on land already held for the purposes of the business than from replacement land.

7.23 Even if the owner of farming land wants to reinvest in new farming land on a like for like basis the OTS heard that it is quite likely there will be no suitable land available within a reasonable distance of their remaining holding.

7.24 The OTS understands that the land market is now approximately half the size that it was at the introduction of the current Rollover Relief,[10] and in 2019

9 HMRC Business Income Manual.
https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim55100

10 Savills Market Survey UK Agricultural Land 2014, p4.
http://pdf.savills.com/documents/Savills-ALMS-Feb-2014.pdf

less than 50,000 hectares were sold in the UK.[11] This is out of a total farmed area of over 9,200,000 hectares in England alone.[12] The OTS has been told that finding land in a specific locality can be a once in a lifetime opportunity.

7.25 In particular the OTS has been told that the effect of many landowners simultaneously losing land in the same area, for example in relation to major infrastructure projects such as 'High Speed 2', then looking for replacement land in competition with each other, creates an imbalance in the supply and demand of available land, forcing land prices upwards and making like for like reinvestment unaffordable.

7.26 National Audit Office figures show that around 7,000 hectares of land will need to be acquired along the route of Phase One of the High Speed 2 programme alone, with up to 50,000 compulsory purchase notices expected to be issued between 2017 and 2023.[13]

Compensation received for the devaluing of neighbouring or contiguous land

7.27 In certain situations, the purchasing authority may also make a compensation payment to a landowner specifically to reflect the fact that the value of the land near to but outside of the actual compulsory purchase area will be negatively impacted by an infrastructure project.

7.28 However, because this neighbouring land is not actually disposed of, the compulsory purchase legislation cannot be applied, and there is currently no provision for the deemed gain arising from such a compensation sum received to be rolled over, say into expenditure to improve the remaining land and buildings in some way.

Time limits

7.29 Many farming groups that the OTS met felt strongly that looking at the statutory defined date of disposal did not reflect the reality in many compulsory purchase situations.

7.30 In respect of the government's schemes such as High Speed 2, all affected land is 'safeguarded' for the scheme from the date of the Secretary of State's announcement of the scheme.

7.31 However, the statutory date of disposal of the relevant land for Rollover Relief purposes could be several years away, meaning that any early reinvestment may not qualify for relief as it is more than one year before the disposal.

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[11] The Farmland Market, January 2021, Savills – 2019 sales, p4.
https://pdf.euro.savills.co.uk/uk/rural---other/spotlight---the-farmland-market---2021.pdf

[12] Defra Statistics: Agricultural Facts - Total farmed area p7.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/972103/regionalstatistics_overview_23mar21.pdf

[13] Investigation into land and property acquisition for Phase One (London – West Midlands) of the High Speed 2 programme, Department for Transport and HS2 Ltd, p4.
https://www.nao.org.uk/wp-content/uploads/2018/09/Investigation-into-land-and-property-acquisition-for-the-Phase-One-Full-report.pdf

7.32 The statutory date of disposal for Rollover Relief purposes is the time at which the compensation for the acquisition is agreed or otherwise determined by a tribunal. The OTS has been told that the final amount of compensation is normally agreed or determined after completion of the infrastructure project, which may be many years after the land has been acquired by the relevant authority.

7.33 This can add complexity and uncertainty where the owner is seeking to meet the statutory deadlines. The OTS understands that HMRC have significant discretion to extend the time limits,[14] but although HMRC do make use of this discretionary power, many taxpayers must reinvest without knowing if relief will be available.

Provisional claims

7.34 In view of the timescale for reinvestment there is a facility to make a provisional claim to relief. A taxpayer who sells an asset and intends to re-invest before the three year re-investment time limit may claim provisional relief, which means that no immediate tax charge will arise when the asset is sold.

7.35 However, HMRC do not have powers to extend a provisional claim, so it is possible even where an extension to the reinvestment period has been agreed, for a temporary tax charge to arise in the interim period between the time a provisional claim lapses and the reinvestment being made. Although this Capital Gains Tax will ultimately be repayable, the OTS has been told that having to meet a charge arising just at the time that the money is needed for the reinvestment can have a significant effect on cash-flow and ability to re-invest.

Willingness to sell

7.36 The government guidance requires acquiring authorities to use compulsory purchase powers only as a last resort after seeking a sale by agreement with the landowner first. However, the Rollover Relief rules specify that relief will not be given in compulsory purchase situations where the landowner has shown a 'willingness to sell' in advance of the order.

7.37 Although the relief expressly accommodates disposals to authorities that have compulsory powers but haven't actually had to exercise them, some landowners have expressed concern as to whether entering into early negotiations with such purchasing authority could potentially jeopardise their relief.

7.38 As a related issue, the OTS has been made aware that the purchasing authority may not itself be incentivised to enter into early negotiations, because when purchasing the land it can claim Stamp Duty Land Tax relief only where a compulsory purchase order is in fact issued.

7.39 The OTS understands that in practice the risk of a landowner losing Rollover Relief in this way is largely theoretical as HMRC appear to have a narrow

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[14] HMRC Capital Gains Manual, Reliefs: Replacement of Business Assets (Roll-over Relief): Time Limit for Reinvestment.

https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg60300

interpretation of the 'willingness to sell' condition; however, the fact that both parties are potentially incentivised to 'hold out' for a compulsory purchase order seems likely to act as a barrier to early negotiations, which is a different, wider concern, and a potential distortion to the timing of sales more generally.

Conclusions – how the system could be improved

Environmental policy issues

7.40 Successfully designing and implementing a comprehensive new agricultural policy across all the constituent parts of the UK will not be achieved overnight so it is challenging to speculate on how such a policy will interact with the current tax rules at this stage.

7.41 The government will need to do further work over the coming years to understand how certain tax rules and environmental payment schemes interact. For example, some changes in land use could affect the trading status of a farming business.

7.42 It is not for the OTS to recommend that the government change its policy in this area, but where certain tax rules and environmental objectives create different incentives this should be a deliberate decision rather than an accidental one. Failure to coordinate effectively could create unnecessary barriers to wider environmental policy aims.

Rollover Relief in compulsory purchase situations

7.43 Where land is sold under compulsory purchase, the asset reinvestment classes could be extended to allow the owner of farming land to reinvest receipts into constructing or improving farm buildings on their remaining let agricultural land, or to allow wider diversification into other activities within their farming business.

7.44 The legislation could also be expanded to allow the deemed gain arising on the receipt of a compensation payment for the devaluing of land near to the compulsory purchase area to be rolled over.

7.45 While maintaining HMRC's discretion to extend the statutory time limits, formal timeframes for reinvestment could also be extended to better reflect the reality of compulsory purchase situations for owners of farming land, for example to commence when the safeguarding decision is made and to end say 5 years after the final compensation is paid.

7.46 In addition, where the circumstances are such that HMRC would be prepared to extend a formal Rollover Relief claim, it is not clear why HMRC should not be able to extend a provisional claim.

7.47 The HMRC guidance relating to the 'willingness to sell' point could be clarified to give more certainty to owners of farming land in compulsory purchase situations. Alternatively, given the issue seems to be largely theoretical, the 'willingness to sell' clause could potentially be removed altogether for Capital Gains Tax purposes, at least in relation to discussions with authorities possessing compulsory purchase powers.

7.48 In exploring this relief through an agricultural lens, the OTS is conscious there may also be parallels with the way other sectors or ownership models operate. The government should accordingly remain open to wider solutions where there is clear evidence that any of the issues raised above affect non-agricultural businesses to a similar extent.

Recommendation 12

The government should expand the specific Rollover Relief rules which apply where land and buildings are acquired under Compulsory Purchase Orders.

Land pooling arrangements

Background – how it works at the moment

7.49 Land assembly is the process by which landowners join forces to bring a large site together for development purposes before the land is sold and construction starts. There are several ways in which land can be assembled in this way - one method is commonly referred to as 'land pooling'.

7.50 Land pooling involves a collaboration between multiple landowners to assemble separate areas of land into a cohesive whole which is suitable for development, so that planning permission can be secured and infrastructure put in place before the sale to the developer.

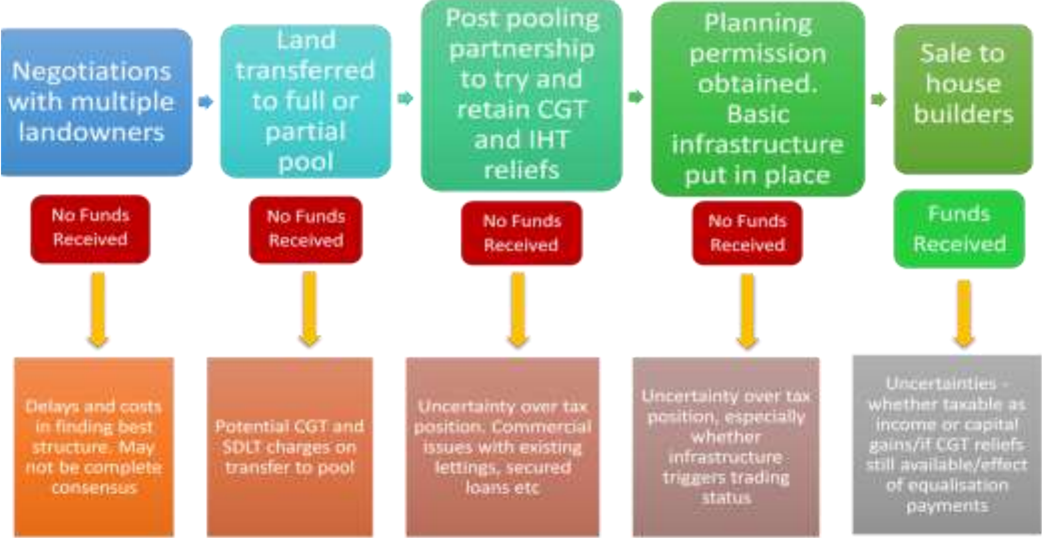
7.51 A land pooling agreement often involves a separate 'vehicle' such as a company, a partnership or a trust. This can facilitate the planning process and indeed is often a requirement of the local authority planning department. It can also lead to a more structured and considered approach. In particular, such an approach can benefit landowners as it equalises value across the land as a whole, for example as between land which ends up being used as green space and land used for high-value housing.

7.52 However, the current tax treatment of land pooling agreements can give rise to a range of Capital Gains Tax and Stamp Duty Land Tax issues well before any land is sold and the proceeds are available (see Diagram 7.A below). As a result it can lead to complex and expensive structures being put in place to try and avoid those charges.

7.53 The main alternative to land pooling is the current 'traditional' method of assembling land from multiple owners which entails a series of separately negotiated option agreements between the individual landowners and the developer, to enable matters to be kept open until is it clear on what basis an overall deal can proceed.

7.54 This gives more certainty over the tax outcome for the landowner, but can involve protracted disputes over individual land values and may lead to a short term approach for the development project as a whole, with infrastructure and environmental issues potentially overlooked or side-lined in the desire to maximise immediate value.

Diagram 7.A: Simplified representation of the current tax position for land pooling arrangements



Source: OTS

Policy context

7.55 There are, of course, a range of wider policy issues for the government to consider in relation to the housing market and development more generally.

7.56 The consultation document 'Fixing Our Broken Housing Market' published in February 2017 by the Ministry of Housing, Communities and Local Government (MHCLG)[15] explored the challenges of increasing the supply of all types of housing, including sustainable and affordable housing at all levels of the market.

7.57 Research undertaken in 2019 by Heriot Watt University and the National Housing Federation suggests that 340,000 new homes are needed each year in England for the period 2016 to 2031.[16] However the MHCLG's House Building report for December 2020 estimated the figure for completed new build dwellings for the year to 31 December 2020 was only 148,630.[17] Although new build levels for 2020 will have been impacted by COVID-19 restrictions, the comparable figure for the year to 31 December 2019 was 178,310 which still falls well short of the suggested requirement level.

7.58 One of the potential barriers to meeting this demand was explored in 'Fixing our Broken Housing Market' which asked whether a land pooling

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15 https://www.gov.uk/government/publications/fixing-our-broken-housing-market

16 Housing supply requirements across Great Britain for Low Income Households and Homeless People, Heriot Watt, May 2019, p10. https://pureapps2.hw.ac.uk/ws/portalfiles/portal/24741931/HousingSupplyMay2019.pdf,

17 Housing supply: indicators of new supply, England: October to December 2020, Ministry of Housing, Communities & Local Government, p6.
https://www.gov.uk/government/statistics/housing-supply-indicators-of-new-supply-england-october-to-december-2020

mechanism would facilitate the assembly of land, for example by local authorities for long term development projects.[18] There were 689 replies to this question and in their 2018 response the government confirmed these were being taken into account in considering the best way to help bring land forward for development.[19]

Observations – challenges with this approach

7.59 The OTS has been told that there is tension between what is the best approach commercially and what is the most tax efficient.

7.60 For instance, a land pooling approach which would be simpler for the developer, and ease some of the current difficulties and delays in assembling land, can currently lead to perverse tax outcomes. This chapter goes on to explore some more specific situations where this tension is felt most keenly.

7.61 Some respondents to the OTS Call for Evidence have gone as far as saying that the net effect potentially hinders the government's wider objectives on housebuilding.

7.62 Although it may only affect a relatively small number of taxpayers the economic effect is likely to be significant due to the values involved.

Equalisation payments

7.63 It has been explained to the OTS that, currently, land collaboration agreements 'can more than double the tax liability for landowners'. This is because equalisation payments from one landowner to another are not usually allowable Capital Gains Tax deductions for the payer, but they result in taxable gains for the recipient.

Example 21 – equalisation payments

John and Yuki are farmers who agree to pool the proceeds of their land for housing development purposes, to make the planning process easier.

John's land is closer to the road so James the developer buys that first. In line with their agreement John transfers half the proceeds to Yuki. However, because money contracted to go to Yuki is not an allowable deduction, John is taxed on 100% of what he receives. Conversely the 50% of the proceeds which Yuki receives from John is also taxable.

The reverse happens when Yuki sells her land and transfers half the proceeds to John. Collectively this means that between them they would be taxed on double the amount they actually receive.

[18] Fixing our Broken Housing Market, Ministry of Housing, Communities & Local Government, p80. https://www.gov.uk/government/publications/fixing-our-broken-housing-market

[19] Government response to the housing White Paper consultation: Fixing our broken housing market, Ministry of Housing, Communities & Local Government, p16. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/685297/Government_response_to_the_housing_White_Paper_consultation.pdf

7.64 This double taxation for equalisation payments appears unfair and contrary to the basic principles of Capital Gains Tax.

7.65 To avoid this double taxation, landowners need to consider other more complex structures such as a land pooling vehicle, cross options or a special purpose company, all of which present significant taxation and commercial challenges.

7.66 The current challenges affect all levels of housing development projects. Although the effect is more obvious with large-scale projects, the OTS has also heard that smaller developments are less likely to be able to pay for expensive advice to create the required structures and these projects are therefore more likely to fail or to have onerous tax charges.

Upfront tax charges

7.67 As the 2020 Building Better, Building Beautiful Commission explained, currently 'landowners pooling their land…with other landowners may well create tax liabilities before they have received major receipts'.[20]

7.68 These liabilities potentially affect all types of land pooling structures and can include upfront Capital Gains Tax or Stamp Duty Land Tax charges many years ahead of money being generated by house sales. In addition, the long development time horizon means such charges can severely limit taxpayers' willingness to assemble large sites.

7.69 So in the example above, if John and Yuki pooled their land through a company they might have to pay Capital Gains Tax and Stamp Duty Land Tax on the transfer to the company. If the site development is particularly complex, it could be several years before they can recoup these costs from the eventual sale to James.

Loss of reliefs

7.70 With a pooling arrangement, Capital Gains Tax reliefs such as Business Asset Disposal Relief or Rollover Relief may not be available to the same extent when the land is sold unless a post-pooling partnership is set up, which adds further tax and commercial complexities.

7.71 For example, a landowner owning 100 acres (representing 10% of the overall collaboration area of 1,000 acres) would, on pooling, transfer 90% of that interest to the others involved, in return for a 10% interest in their land. The landowner now owns 10% of their original land together with10% of the other land. Business reliefs on the landowner's original land are therefore significantly restricted (as only 10% of that original land is still owned by them) and there would be no entitlement to business reliefs on the 10% interest in the other 900 acres (as it is not used in that landowner's own business).

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[20] Living with Beauty, Building Better Commission, January 2020, p84. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/861832/Living_with_beauty_BBBBC_report.pdf

7.72 Again, turning to John and Yuki, if they transfer their land directly to James they could potentially benefit from Business Asset Disposal Relief or Rollover Relief as they are selling business assets. However, if they transfer to a new structure and sell after say five years when the deal has been finalised they are likely to have significantly restricted tax reliefs, even if they have continued to farm the same land in the same way until sale.

Failed collaborations

7.73 Another important consideration is the ability for the pooling arrangement to be reversed if one or more of the participants wishes to withdraw or the planning application is unsuccessful.

7.74 If a pooling structure is set up, there can be tax charges if the land is withdrawn from that structure. If John and Yuki's project failed to obtain planning permission, they could face additional Capital Gains and Stamp Duty Land Tax charges in extracting the land from the pooling structure.

7.75 The current lack of flexibility in being able to withdraw from failed collaborations without onerous tax charges is one of the issues which give rise to a preference for using options in land collaborations - which can then lead to what many regard as a less desirable short-term approach to land development.

Capital/income divide

7.76 If land owned by a taxpayer for many years is sold it would usually be considered a capital transaction subject to Capital Gains Tax. However, if that land was improved by the landowner and subsequent development-related activities took place (such as installing access roads), it could be that there is a new trade (of land development) - which would be subject to Income Tax.

7.77 Given the difference between Capital Gains Tax and Income Tax rates, landowners are cautious about anything that could change the tax status of their assets. This can distort their decision making towards quick sales of the land rather than working to improve it ahead of a subsequent sale, even if that otherwise made the most commercial or environmental sense.

7.78 HMRC acknowledge in their Business Income Manual that this boundary can be 'ambiguous.'[21] Moreover, some of the examples given appear to be contradictory. One page explains that the development of infrastructure alone is not sufficient to push the development towards Income Tax while an example in another part of HMRC's guidance appears to suggest the opposite.[22] Many housebuilding companies will, particularly for larger developments, insist on a level of infrastructure before agreeing to buy the land so clarity on this point would be welcome.

21 https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim60065

22 https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim60806

Conclusions – how the system could be improved

7.79 In this context, the OTS considers that the government should explore ways to make land assembly more tax neutral.

7.80 The OTS has considered a number of potential approaches that have been suggested to address these challenges.

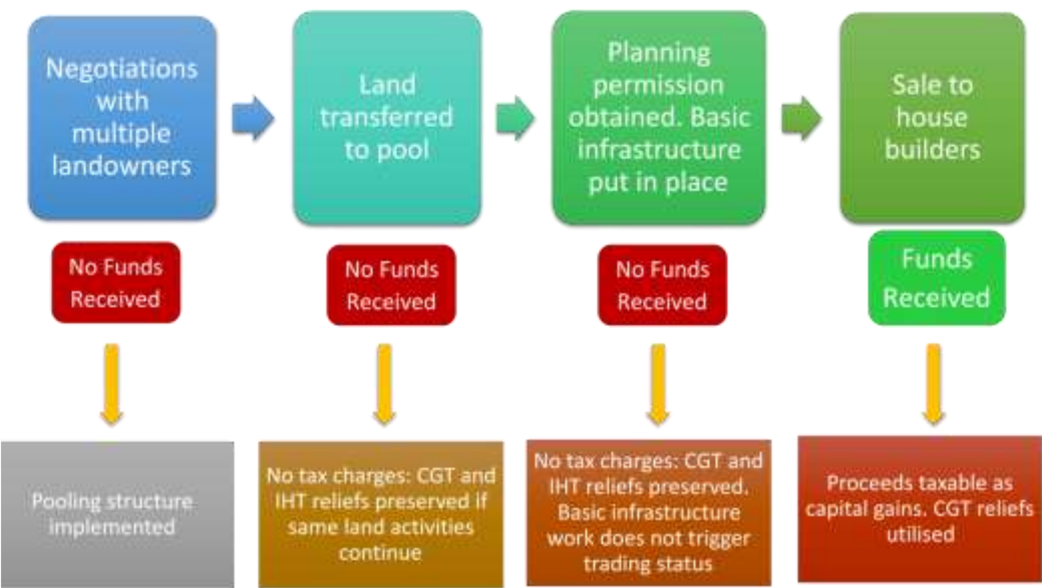
7.81 One approach, which would be relatively easy to understand, could be to allow equalisation payments between landowners to be tax deductible. This would of course require careful consideration of the circumstances in which such a rule should apply.

7.82 Alternatively, it could be possible to create a specific (and regulated) type of land pooling vehicle, that would freeze the tax status of the land at the point of entry. This would ideally apply more widely than Capital Gains Tax, to include Stamp Duty Land Tax and potentially Inheritance Tax. While this could potentially address both the upfront tax and double taxation issues it would undoubtably be complex and involve definitional challenges.

7.83 Such a pooling vehicle would need to allow land to be sold with a neutral tax outcome. If it was too prescriptive it might inhibit use and if it were too loose it could facilitate avoidance.

7.84 An example of how this structure might look is demonstrated below.

Diagram 7.B: Simplified representation of an alternative approach for land pooling agreements



Source: OTS

7.85 The OTS has not arrived at a developed recommendation at this stage on the ultimate merits or detailed policy design of either of these potential approaches. They could potentially simplify the current position and remove existing distortions and have a positive effect on housing developments, but this is a complex area with no obvious or easy solutions.

7.86 Careful thought would been to be given to any change, so it did not open up opportunities for avoidance or merely provide a tax break for landowners. If the government were to explore changes in this area it should work collaboratively with landowners, developers, industry experts and tax professionals to design something that works in most situations.

7.87 However, there is in any event clear potential for better and more comprehensive HMRC guidance in this area - currently there is no specific guidance on land pooling issues - and for a greater facility for a clearance procedure (**recommendation 14**).

Flat Management Companies

Background – how it works at the moment

7.88 Leases are a form of property ownership which is time-limited (typically to a fixed period of years, such as with a flat held on a 99-year lease), where the ultimate control of the property is shared with, and limited by, the person holding the underlying freehold interest in the property.

7.89 While almost any type of property can be leased, leasehold ownership is strongly associated with flats.

7.90 Government statistics suggest that there were 4.5 million residential leasehold properties in England in the 2018-19 financial year of which 3.1 million – over two thirds – were flats.[23]

7.91 Many flat freeholds are owned by third parties, but some are owned by the leaseholders of flats in the building. These leaseholders are often described as owning a share of the freehold.

7.92 The flat owners with a share of the freehold owns two separate assets - their leasehold interest and also their interest in the underlying freehold of the building. The freehold ownership is often structured through a separate management company in which the leaseholders own shares.

7.93 The OTS has particularly had drawn to its attention one common situation which produces unexpected tax results for leaseholder-owned flat management companies.

Tax implications of extending a typical lease where the freehold is owned by a third-party investor

7.94 If a leaseholder extends the length of their lease this ordinarily creates a tax charge for the owner of the freehold, for example, the flat management company. This follows from the fact that the company has sold a lease at a gain and company gains are taxed to Corporation Tax.

23 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/898194/Leasehold_Estimate_2018-19.pdf

Example 22 – simple lease extension

Sali lives in a flat in Brighton - one of five in a large converted Georgian house. She pays £20,000 to FlatManCo Ltd (which is owned by a local property investor) to extend the lease to 120 years.

FlatManCo Ltd pays 19% Corporation Tax on the £20,000 it has received.

Tax implications of extending a lease on a leaseholder-owned flat management company

7.95 However, the tax outcome is similar if the leaseholders do not actually pay the flat management company for the lease extension - which is a common situation where the leaseholder and freeholder are effectively the same person.

7.96 This tax treatment is a consequence of anti-avoidance provisions concerning transactions between 'connected persons' that, because the leaseholders and flat management company have a close connection, treat the transaction as being made at market value. So the company is taxed on the full market value of the lease extension, whether or not it receives any money.

Example 23 – lease extension where the leaseholder also owns the freehold

Sali and the other four leaseholders in her building want to extend the leases on their flats to 120 years. Each owns a 20% stake in FlatManCo Ltd and no money changes hands. The nominal taxable value of each extension is £20,000.

FlatManCo Ltd is deemed to have made a gain on the full £100,000 and therefore has to pay Corporation Tax at 19% on the gain.

Sali and the other four leaseholders in her building have to put money into the company to fund the tax payment.

7.97 Well-advised leaseholders - particularly in the situation where they are exercising a collective 'right to buy' their freehold - will have extended their leases at the same time they buy the freehold, and the flat management company will only hold the freehold as nominee for the leaseholders. In that situation the leaseholders do effectively own both the leasehold and freehold and there are no tax implications if the leases are extended further (as the flat management company doesn't own the freehold outright, it just manages it on behalf of the freeholders).

Position of the leaseholder on a lease extension

7.98 As well as the Corporation Tax charge on a deemed gain for the flat management company, a leaseholder may also have a Capital Gains Tax

liability as in tax terms they are selling their old lease before acquiring the new, extended lease.

7.99 If, perhaps because property prices have increased, the value of the old lease has risen over time, then the 'sale' of the old lease to the flat management company will trigger a capital gain as the transaction will be at market value.

7.100 If the leaseholder is an owner-occupier the gain may be covered by Private Residence Relief, but if the property is, say, a buy to let investment, the gain may well result in a tax liability. Again, this is without any money changing hands.

7.101 HMRC's Extra Statutory Concession D39[24] disregards this disposal and reacquisition where full market value is paid for the lease extension, but the OTS understands that this concession does not extend to the situation where the leaseholder pays nothing (or less than the market value) for the new lease.

7.102 There is also a further issue for the leaseholder as the flat management company, by granting a lease extension at less than its market value, may be treated as having paid a 'dividend' to the leaseholder/shareholder, which will be their taxable income.

Leasehold and commonhold reform proposals

7.103 More widely, the government is currently taking forward a range of reforms to restrict and regulate the use of leases in the future.[25] These reforms include looking to reinvigorate commonhold as an alternative to the long leasehold system, and to improve the process for buying a freehold or extending a lease.

7.104 Although currently used very infrequently, commonhold is a form of ownership, introduced in 2004 for multi-occupancy development, where each flat owner directly owns their share of the freehold. Wider use of commonhold could simplify the tax position of the owners as it does not involve granting leases.

7.105 However, if flat owners wish to adopt commonhold ownership, the tax position of the transfer of the freehold from a flat management company to commonhold is currently unclear. It seems very likely, however, that the market value disposal rules would apply to the transfer.

7.106 This therefore gives rise to similar tax issues for the flat management company to those described above, as there would be a market value disposal of the freehold by the flat management company which could give

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24 D39 Extension of leases, p48. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/733377/Extra_Statutory_Concessions.pdf

25 Government response to the Housing, Communities and Local Government Select Committee report on Leasehold Reform https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/814334/CCS0519270992-001_Gov_Response_on_Leasehold_Reform_Web_Accessible.pdf

rise to a capital gain even though, again, nothing has been paid to the company by the leaseholder/shareholder.

7.107 This potential capital gain and the resulting Corporation Tax charge for the flat management company (which would have to be funded by the shareholders) could act as a disincentive to adopting commonhold reform in these circumstances.

Observations – challenges with this approach

7.108 While to be expected that the company will be taxed on profits arising from disposals to third parties, it is an odd outcome for a flat management company to be taxed on a deemed gain which arises purely from a lease extension by one of its own shareholders who is also in effect the owner of the freehold concerned.

7.109 The potential capital gain for leaseholders who are not owner-occupiers also seems anomalous, as does the added Income Tax issue of the company being treated as having paid a dividend.

7.110 One respondent to the Call for Evidence suggested that this situation was incompatible with the government's wider objectives on leasehold reform.

7.111 The existing situation is particularly unfortunate for leaseholders (and their respective freehold companies) who did not extend their leases at the same time as they bought their freehold.

7.112 It may be the case that where leaseholders are buying a share of the freehold through a flat management company, it is more difficult or more expensive to extend the lease at that time – so they intend to do it 'eventually'. If they had bought and extended at the same time and also arranged for the company to simply act as their nominee, the upfront costs may have been slightly more but they would not have these tax issues further down the line.

7.113 There is also little guidance from HMRC on this issue. While accepting that the connected persons rules should apply between, for example, family members or business partners, it seems odd that they should also apply in this situation where the individual is only, effectively, connected with themselves.

Conclusions – how the system could be improved

7.114 For a flat management company owned by the leaseholders, the OTS suggests that the government should explore whether the rules could work on the basis that the freeholder company is acting as nominee for the leaseholder. This would remove the capital gains charges for the freeholder company and the leaseholder and also remove the potential for a company to be treated as paying a dividend in this situation.

7.115 This would require further definition but would broadly cover the situation where leaseholders are also freeholders and no payments are made for lease extensions. This would not apply where payments are made for lease extensions or the flat management company is owned by a third party.

7.116 While the majority of leaseholders are unlikely to be affected, as they have either extended their lease already or do not own a share of the freehold,

resolving this could save the minority who are affected significant amounts of tax.

Recommendation 13

The government should consider exploring ways of removing inappropriate Corporation Tax or Capital Gains Tax charges where a freeholder is in effect only extending their own lease.

7.117 Further consideration also needs to be given to the potential tax implications of a transfer of freeholds owned by flat management companies to commonhold to ensure this does not give rise to unintended and unexpected tax charges.

7.118 If commonhold becomes more widely used, the OTS suggests that the tax implications of adopting commonhold should be considered in more detail. In the meantime, HMRC should create new guidance to illustrate this area (**recommendation 14**).

Annex A
Scoping Document

This scoping document was published on 14 July 2020.

Capital Gains Tax Simplification Review

Capital Gains Tax is charged on the chargeable gains of individuals and trusts. Chargeable gains made by companies are charged to corporation tax. Both taxes were introduced in 1965 and have a common core of rules, while having changed and diverged from each other somewhat since then.

The Chancellor of the Exchequer has requested that the Office of Tax Simplification (OTS) carry out a review of Capital Gains Tax and aspects of the taxation of chargeable gains. The review will identify, and offer advice to the Chancellor about, simplification opportunities relating to administrative and technical issues affecting individuals, partnerships, and unincorporated or single entity owner-managed companies, as well as areas where the present rules can distort behaviour or do not meet their policy intent.

The OTS has touched on aspects of Capital Gains Tax and the taxation of chargeable gains in some previous reports, but this is the first time the OTS will have looked more widely at this area.

The OTS will publish a call for evidence and may publish more than one report on its findings.

Scope of review

The review will consider Capital Gains Tax and the taxation of chargeable gains in relation to individuals and smaller businesses and develop recommendations for simplification including reducing distortions from both an administrative and technical standpoint.

This will include consideration of general areas such as:

- the overall scope of the tax and the various rates which can apply
- the reliefs, exemptions and allowances which can apply, and the treatment of losses
- the Annual Exempt Amount and its interactions with other reliefs
- the position of individuals, partnerships and estates in administration
- the position of unincorporated businesses and stand-alone owner-managed trading or investment companies, including the setting up, selling or winding up of such businesses or companies

- any distortions to taxpayers' personal or business investment decisions
- interactions with other parts of the tax system such as Income Tax, Capital Allowances, Stamp Taxes and Inheritance Tax, including potentially different definitions for similar transactions/events.

It will also look at more specific areas such as administrative or technical issues relating to

- clearance and claims procedures
- chargeable gains on shares and securities, including holdings of listed shares
- the acquisition and disposal of property
- the practical operation of principal private residence relief
- consideration of the issues arising from the boundary between Income Tax and Capital Gains Tax in relation to employees
- valuations, record-keeping, calculating any tax payable and making returns, including claiming losses
- the information HMRC have and can use to help them reduce administrative burdens, improve customer experience and ensure compliance.

In keeping with the focus on smaller businesses and individuals, this review will, in particular, not extend to issues specific to corporate groups, such as substantial shareholding exemption, company reorganisations or demergers.

Further guidance for the review

In carrying out its review, the OTS will

- research widely among all stakeholders
- have regard to the effect of the tax and its reliefs on investment and the productive use of assets
- consider the likely implications of recommendations on the Exchequer, the tax gap and compliance
- take account of relevant international experience
- establish a Consultative Committee to provide support and challenge
- liaise with HMRC's Administrative Burdens Advisory Board
- consider the implications of devolution of tax powers and different legal systems within the UK
- be consistent with the principles for a good tax system, including fairness and efficiency
- be mindful of the effect of taxpayer trust in the operation of the tax system

Annex B
Consultative Committee

The OTS normally establishes a Consultative Committee, chaired by the Tax Director, for reviews requested by the Chancellor under section 186 of FA 2016. Two meetings of the Committee were held during the work on this report.

The purpose of the Committee is to facilitate confidential consultation to provide input and challenge during the course of the review. Committee members serve in a personal capacity, rather than on behalf of any organisation to which they may belong.

We are very grateful for the time and support of our Consultative Committee members.

The report's content and recommendations remain the responsibility of the OTS.

Arun Advani	University of Warwick
Paul Aplin	Freelance tax writer and consultant
John Barnett	Burges Salmon LLP
Isobel d'Inverno	Brodies LLP
Andrew Jackson	Fiander Tovell
Emma McGuire	HM Revenue & Customs
Pete Miller	The Miller Partnership
Michael Parker	The National Farmers Union
Andy Richens	Freelance tax training consultant
Lisa Spearman	Mercer & Hole
Donald Stark	HM Treasury
Andy Summers	London School of Economics
Gemma Tetlow	The Institute for Government
Helen Thornley	The Association of Taxation Technicians

Annex C
Organisations Consulted

The OTS has listed below the wide range of organisations who gave their time to provide evidence to this review. The OTS is grateful to these organisations and to the large number of individuals who gave their time to provide evidence either in writing or through the online survey. Individual names have not been published here.

A J Bell

Agricultural Law Association

Agricultural Representative Bodies Group

Alvarez & Marsal Taxand UK LLP

Association of Accounting Technicians

Association of British Insurers

Association of Taxation Technicians

BDO

Boodle Hatfield LLP

British Property Federation

British Venture Capital & Private Equity Association

Central Association of Agricultural Valuers

Charles Russell Speechlys LLP

Chartered Accountants Ireland

Chartered Institute of Taxation

Country Land and Business Association

Crowe UK LLP

Deloitte

Department for Environment, Food & Rural Affairs

Duncan & Toplis

Employee Ownership Association

Ensors

Enterprise Investment Scheme Association

Estates Business Group

Freshfields

Hardcastle Burton LLP

Hargreaves Lansdown

Herbert Smith Freehills LLP

Highways England

Historic Houses

HM Revenue & Customs

HM Treasury

Hunters Law LLP

Institute for Family Business

Institute of Certified Bookkeepers

Institute of Chartered Accountants in England and Wales

Institute of Chartered Accountants of Scotland

Investment & Life Assurance Group

Knight Frank

KPMG

Law Society

Law Society of Scotland

Law Commission

Lombard Odier

Low Incomes Tax Reform Group

Marcussen Consulting

Meridian Private Client LLP

Ministry of Housing, Communities & Local Government

National Farmers' Union

National Residential Landlords Association

Non Resident Collective Investment Vehicle Association

Old Mill Accountancy LLP

Penningtons Manches Cooper LLP

Personal Investment Management and Financial Advice Association

Pett, Franklin & Co LLP

Premier Sales and Lettings

ProShare

PwC

Quoted Companies Alliance

Resolution

RSM

Saffery Champness

Sapphire Business Services (Banbury) Ltd

Scottish Government

Scottish Land & Estates

Scrutton Bland

Share Plan Lawyers

Society of Trust and Estate Practitioners

Taylor Wessing LLP

The Investing and Saving Alliance

The Investment Association

The Jonathan Lea Network

The Lothbury Partnership

The Stewardship Initiative

UK Individual Shareholders Society

UK Platform Group

UK Shareholders' Association

YBS Share Plans

Annex D
Data sources used in this report

D.1 This Annex contains the HMRC data and projections that are referred to, or published for the first time, in this report.

D.2 Throughout this report, unless specified otherwise, HMRC's Capital Gains Tax statistical data for tax year 2017-18 data is used. The Capital Gains Tax statistical tables can be found at https://www.gov.uk/government/statistics/capital-gains-tax-statistical-tables.

D.3 Where relevant, both here and in the body of the report, there are references to the specific tables from which data has been used.

D.4 Estimates are on an accruals basis unless otherwise stated. This means they relate to the period the Capital Gains Tax liability arises rather than when HMRC receives it.

D.5 In addition, the estimates are on a static basis only. This means they do not take into account the potential impact of any changes to people's behaviour as a result of the considered policy change.

D.6 This means that the estimates of making some of these changes may overestimate or underestimate any potential Exchequer yield. Where the report refers to an 'average', this refers to an arithmetic mean unless otherwise specified.

Chapter 1 – Awareness and Administration

Chart 1.A: Chart showing UK Property tax returns filed 6 April 2020 to 6 January 2021

Source: HMRC statistics. Data collection period 6 April 2020 – 6 January 2021

D.7 Chart 1.A shows HMRC management information on the number of UK Property tax returns filed in the nine month period from 6 April 2020, when the requirement was introduced, to 6 January 2021. The total number of returns filed was 51,300.

D.8 Of the returns filed, 34,500 (approximately two thirds) were filed within 30 days. These are represented by the colour blue in the chart. The colour orange represents the 16,800 returns that were filed late, meaning after 30 days. It should be noted, however, that for returns due up to and including 30 June 2020, the deadline for reporting was extended to 31 July 2020; as such, some of the 'late' returns will not have been treated as such and it is possible they would have been filed within 30 days had the extension not been granted.

D.9 It should also be noted that the total of 51,300 is a total of the returns that were filed, as in received by HMRC, in the period. The total of returns due was unknown at the time of preparing this report and could not be estimated reliably due to changes in the property market resulting from the COVID-19 pandemic. It is, however, virtually certain that some returns that were due to have been filed by 6 January 2021 were not filed, either because they were late or because of a failure to file.

D.10 HMRC have announced plans to publish statistics on disposals of residential property where CGT is due within 30 days of completing the disposal. These statistics are intended for release in August 2021. Further details can be found on page 8 of the Capital Gains Tax Statistics Commentary.

Paragraph 1.55

"HMRC data shows that in the 2018-19 tax year, which was before the UK Property tax return was introduced, only 5,010 returns were made using the 'real time' Capital Gains Tax service, with just 1,670 returns relating to the disposal of assets than were not residential property. Furthermore, 1,360 of individuals using this service also filed a Self Assessment tax return including the Capital Gains Tax pages."

D.11 HMRC management information shows that, for the 2018-19 tax year (before the introduction of UK Property tax returns), the total number of reports made using the 'real time' Capital Gains Tax service was 5,010. Excluding residential property the total number of optional reports was 1,670. Since 6 April 2020, gains on UK residential property must be reported using UK Property tax returns.

Paragraph 1.75

"Emerging evidence from HMRC suggests that about 40% of UK Property tax returns are filed by agents."

D.12 Of the 51,300 total UK Property tax returns filed between 6 April 2020 and 6 January 2021 and featured in the Chart above, 20,000 (39%) were submitted by agents acting on behalf of taxpayers.

Paragraph 1.95

"The Exchequer effect in the 2021-22 tax year of moving to 60 days or 90 days in that tax year would be approximately £105 million or £210 million respectively - although the cost would come down significantly in subsequent tax years."

D.13 The figures cited in this sentence are estimates prepared by HMRC analysts of the cost to the Exchequer of extending the deadline for reporting and payment of Capital Gains Tax on gains on residential properties from 30 days to 60 or 90 days.

D.14 The proposed extension, in effect, only delays the revenue rather than reducing it. However, it does have a cost to the Exchequer because revenues are accounted for in the tax year in which the payment is due, so the proposed extensions would push approximately one or two months' revenues respectively into the subsequent tax year.

D.15 The impact would mostly be felt in the first year but there would be an ongoing, smaller cost annually, due to the fact that revenue forecasts predict growth year on year, and a part of this growth would be pushed back.

D.16 The table below shows the estimated impact over five years if the measure were implemented with effect from the 2021-22 tax year:

	Receipts £m						
	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	**Total**
Static cost of starting payment window in 2020 - 30 day payment window	935	285	95	110	125	120	**1670**
Additional static cost for 60- day payment window	0	-105	-15	-10	-10	-10	**-150**
Additional static cost for 90- day payment window	0	-210	-30	-15	-20	-15	**-295**

D.17 The figure of £935m in the upper left corner of the table represents the initial increase in revenues estimated to result from the 30 day reporting and payment window being introduced in the first place. The other figures in that row represent the estimated increase for subsequent years, which is anticipated to stabilise as, once the system is established, the ongoing benefit is the consequence of bringing forward the effect of growth. The estimated adverse effect of extending the deadline follows the same pattern of having most effect in the year of introduction and then stabilising.

D.18 These estimates are 'static' in the sense that they do not factor in any behavioural changes that could arise as a result of the policy change. The estimates are based on the Office for Budget Responsibility's economic projections as of autumn 2020.

Paragraphs 1.117 – 1.118

"In the tax year 2017-18, net gains on the disposal of listed shares (after allowing for losses) totalled £12.4 billion and accounted for 21% of total net gains of £58.9 billion.

In that tax year, a total of around 195,000 individuals reported gains on the disposal of listed shares. Of these, around 90,000 individuals paid Capital Gains Tax on a total of around 843,000 disposals of shares, which is an average of around nine disposals by each taxpayer. Each disposal represents a shareholding in a particular company."

D.19 Total net gains means gains after allowing for losses offset but before allowing for the Annual Exempt Amount. The total is taken from Table 7 of the Capital Gains Tax National Statistics, as is the figure for 843,000 disposals subject to Capital Gains Tax.

D.20 The total number of individual customers of 195,000 is taken from data provided by HMRC analysts, which indicates that around 105,000 taxpayers (just over half) declared gains on listed shares but were not liable for Capital Gains Tax in that tax year, while 90,000 declared gains on listed shares and were liable for Capital Gains Tax in that year.

D.21 The 'average' cited of nine disposals by each taxpayer is a mean, meaning it is calculated by dividing the total number of disposals subject to Capital Gains Tax of 843,000 by the total number of taxpayers of 90,000.

Chapter 2: Main homes

Paragraph 2.4

"Private Residence Relief is estimated to benefit 1.5 to 2 million homeowners annually and to have cost the Exchequer £25 billion in tax year 2019-20."

D.22 The figure of £25 billion is from a published estimated costing prepared by HMRC analysts for the 2019-20 tax year and is included in its Estimated Cost of Non Structural Tax Reliefs. As sales that qualify for full Private Residence Relief are not reportable, the estimate is based on residential property transfer data recorded in the Stamp Duty Land Tax database (this is a tax paid by the purchaser on acquiring a property).

D.23 The figure of 1.5 to 2 million taxpayers is an estimate based on national statistics relating to owner occupation of properties and number of owners per property.

Paragraph 2.11

"It is estimated that just over 9,000 people paid Capital Gains Tax on a property disposal that received only partial Private Residence Relief in tax year 2018-19."

D.24 The figure of 9,000 is based on an HMRC costing, which analysed the tax returns of individuals claiming relief from Capital Gains Tax in 2018-19 under one of the following categories (as entered in the return):

D.25 PRR – Private Residence Relief where Letting Relief does not apply.

D.26 LET – Private Residence Relief where Letting Relief applies (note the data pre-dates changes to Lettings Relief introduced in April 2020).

D.27 MUL – multiple categories, where more than one category applies.

D.28 The returns with claims for relief under multiple categories were further analysed and only those with a reference to either Private Residence Relief or Letting Relief in the free text section of the tax return were included in the results. There is some uncertainty in this free text analysis as it does not take into account additional documents that customers may have provided in which they claim Private Residence Relief.

Chapter 3: Tangible moveable property

Paragraph 3.3

"Chattels are not specifically captured in the Self Assessment tax return but HMRC estimate that, for the 2017-18 tax year, a total of £15 million in Capital Gains Tax was paid in respect of disposals of chattels, by around 300 taxpayers. This is less than 0.2% of the total Capital Gains Tax yield for that year."

D.29 This estimate was prepared by HMRC analysts based on a representative sample of Capital Gains Tax returns. There is some uncertainty in this estimate as the Capital Gains Tax pages of the Self Assessment tax return do not include a specific section for chattels and they are, instead, captured as "Other property" alongside different types of assets including those that qualify for Business Asset Disposal Relief. The estimate is therefore based on

an analysis of the free text returns provided to HMRC by customers which is necessarily more judgment based and therefore uncertain.

Chapter 4: Divorce and separation

Paragraph 4.5

"For the 2018-19 tax year, HMRC analysts identified £8 million of Capital Gains Tax that had been paid by fewer than 300 taxpayers citing divorce or separation in the free text on their Self Assessment tax returns. These figures should be considered indicative only as customers are not required to declare divorce as part of their returns so the data may be incomplete."

D.30 HMRC analysts were asked to identify Capital Gains Tax liabilities that might be connected with a divorce. There is no requirement to say whether a transfer relates to a divorce and nor is there a requirement to state marital status or disclose a divorce in the Self Assessment tax return. The analysts performed a text search on the free text section within the tax returns of taxpayers disclosing a chargeable gain in tax years 2016-17, 2017-18 and 2018-19. They searched for nine phrases including 'divorce' and 'separation', with the following results:

Tax Year	**Number of Individuals with a "divorce related term" in SA108 free text**	**Of which are CGT liable**	**Total CGT**
2016-17	390	210	£7m
2017-18	410	230	£10m
2018-19	420	**240**	**£8m**

D.31 The figures in bold are those that are cited in the report.

D.32 These figures are only indicative as individual returns were not reviewed in depth. There are a number of factors that could affect these estimates, most notably:

- Some of the tax paid by the taxpayers identified may not have related to transfers between the divorcing spouses; and
- Tax paid on a divorce will not have been identified where there was not a disclosure in the free text or when search terms were included in separate attachments provided by individuals as part of their return.

D.33 The figures are broadly consistent over three consecutive tax years and therefore have been taken as an estimate of the annual revenue that may be associated with divorce.

Chapter 5: Business issues

Paragraphs 5.8-5.9

"In relation to the 2018-19 tax year, HMRC identified around 1,400 individuals who may have had to calculate Capital Gains Tax where the proceeds may have been

deferred. Collectively they had a total liability of £240 million in that tax year although the amount they paid may be revised up or down over coming years.

If the change from Entrepreneur's Relief to Business Asset Disposal Relief is factored in, being a reduction in the amount taxed at 10% from £10 million to £1 million, this figure would increase to £320 million."

D.34 These figures were obtained through another exercise in free text analysis, as described above, because there is no requirement or facility to specify deferred proceeds elsewhere in the Self Assessment tax return. The following were the results returned from five phrases, including 'deferred consideration' and should be considered indicative only given the uncertainties associated with the free text analysis:

Tax year	Number of Individuals with a "deferred consideration term" in SA108 free text	Of which are Liable	Total CGT	Adjusted for BADR cap of £1m
2016-17	1340	890	£185m	£260m
2017-18	1340	930	£270m	£350m
2018-19	1420	**920**	**£235m**	**£320m**

D.35 As with the tax on divorce statistics, it is possible that not all of the tax relates to disposals featuring deferred consideration. It is also impossible to verify that all taxpayers in receipt of deferred consideration have been included where there was not a disclosure in the free text or when search terms were included in separate attachments provided by individuals as part of their return.

D.36 The adjusted figures show the estimated tax that would have been paid if, instead of the £10 million lifetime limit on gains qualifying for Entrepreneurs' Relief that applied before April 2020, the limit was £1 million as it is now for Business Asset Disposal Relief. This is a static estimate of the cost, and so does not capture any behavioural changes that may have occurred.

D.37 The figures in bold are those that are cited in the report.

Paragraphs 5.23 and 5.25

"In relation to the 2018-19 tax year, indicative analysis suggests there were around 80 individuals who had deferred proceeds and used losses against an earlier year's capital gain."

"Based on a sample of tax returns the majority of transactions are adjusted within four years of the initial disposal."

D.38 As part of the above-mentioned free text analysis, a subset of individuals was established that had no liability to Capital Gains Tax in the tax year and had reported a loss on disposals of shares.

D.39 Further analysis of the free text identified those who mentioned an adjustment or loss and referred to offsetting the loss against an earlier gain on the initial transaction. The number of individuals identified in this way were:

Tax year	No. of individuals
2016-17	<30
2017-18	40
2018-19	80

D.40 Based on analysis of tax years in the free text, a sample of returns was identified for further analysis. The majority of returns sampled included elections for losses occurring within one to four years from the initial transaction. As with the earlier free text analysis this should be considered indicative only due to limitations with the data used and the inferences that may be drawn from it.

OTS online survey

D.41 Some figures cited in the report are from the OTS Capital Gains Tax survey, opened to the public on 14 July 2020. These figures are not statistical taxpayer data and are considered to be indicative – not necessarily representative – of the taxpayer experience.

D.42 The OTS Capital Gains Tax online survey asked questions to assess the respondents' level of understanding of the tax and the practical barriers they faced in paying it. The survey was completed by nearly 1,200 people and revealed a wide range of views. It is important to highlight that the survey was open to all who wished to take part and, as the respondents were only those who chose to complete the survey, it did not form a representative sample of society.