Tax briefing

TRAVERS SMITH

Pre-Budget Report

Implications of changes to CGT regime

The Chancellor announced a very significant change to the capital gains tax regime in the PBR on 9 October. Taper relief was abolished and replaced with a flat CGT rate of 18%. Although this was described in his speech as a measure to tackle the private equity industry, it was far more wide ranging than that and in fact represents a fundamental change to the capital gains tax regime.

The changes relate to capital gains tax only. They do not affect corporation tax on chargeable gains, so only where disposals are made by individuals are they in point.

Taper relief was one of Gordon Brown's first big tax innovations as Chancellor. It was introduced in 1998, ostensibly as a means of disincentivising short termism. The taper relief regime initially provided that the CGT rate on most assets tapered to 24% over a ten year period of ownership, whilst for "business assets" the taper took the rate down to 10% in four years. In 2002 business asset taper was accelerated to 10% after two years, where it has remained since.

The definition of business assets has been adjusted on a number of occasions. Where the assets are shares, in summary the rules currently state that all shares in companies that have no securities listed on a recognised stock exchange (in the UK, the Official List but not AIM) are business assets, whilst shares in fully listed companies are only business assets in the hands of officers and employees of those companies.

Whilst the 10% tax rate was a great benefit to those it targeted, and may (although this has never been proved) have boosted investment and entrepreneurship in the UK, the rules were fiendishly complicated - especially given the relatively small number of taxpayers to which the regime applied. In that sense the change is a welcome simplification, although those who previously qualified for the 10% rate will of course not see it like that.

The most obvious headline effects of the change are:

- a tax increase for most investors in private company and AIM listed shares, who would previously have paid only 10% CGT after holding for two years;

- a similar tax increase for directors and employees of listed companies holding shares in their employers;

- a tax cut for ordinary investors in listed company shares, who would previously only have benefited from non-business asset taper relief and paid 24% CGT after holding for ten years;

- a tax cut for owners of second homes and buy to let properties, who would also previously only have qualified for non-business asset taper; and

- a tax cut for managers of property funds on their carried interests, which previously only attracted ordinary taper relief rather than business asset taper due to the nature of the underlying assets.

As will be apparent, from the above, an important competitive advantage for AIM over the full list has been removed. Previously AIM listed shares benefited from the much more advantageous business asset regime, whilst fully listed shares did not. Now there is no difference as the CGT rate is 18% for both. There remains an inheritance tax advantage to holding unlisted shares, but the increase in IHT thresholds will have reduced the value of that in many cases.

The abolition of taper relief and its replacement with the flat rate will be effective for disposals on or after 6 April 2008. This appears to be a cliff edge, with no transitional arrangements.

There are a number of less obvious consequences of the changes, many of which arise from this cliff edge effect:

Transaction timings

We must anticipate that sellers will be extremely keen to conclude sales by 5 April in order to secure a CGT rate of 10% rather than 18%. This is likely to lead to a rash of private company sales, and in particular secondary buyouts, to beat the deadline.

Lockins on floats

Already we are seeing these become more contentious, with directors on new transactions being reluctant to agree to hold shares pregnant with gain past 5 April into the higher tax regime. We also expect that directors on old transactions may seek permission to sell at least some of their shares early to take advantage of the 10% rate. In some cases we are trying to crystallise gains now by, for example, inserting a new holding company in a way which enables the directors to cash out and reinvest rather than rolling their existing gain into locked in shares.

Rollovers

Most private company sellers are likely to become less keen on rollovers in the period before April. Whatever the nature of the securities rolled into, if the disposal of the rolled over asset is after 5 April the 18% rate will apply. Two year plus shareholders may well therefore prefer to realise their gain now and reinvest, taking advantage of the 10% rate. On the other hand, shareholders who have held their shares for less than a year will still be keen to rollover, as absent this they would pay the untapered rate of 40%. The effect will be marginal for shareholders who have held their shares for between one and two years, whose rate under the existing regime would be 20% - they will probably prefer to take cash in hand rather than saving 2% tax and being forced to hold a loan note with an ungenerous rate of interest.

Offering a loan note alternative is still likely to be attractive in a public bid context even after April, as for companies with a lot of small shareholders an important part of the benefit is offering the ability to stagger disposals in successive tax years and so take advantage of more than one annual exempt amount. The ability to do this is unaffected by the changes. Also, in the months to April a loan note alternative will enable non-employee shareholders of fully listed companies to move into the 18% regime from the non-business asset taper regime, and so is likely to be expected by well-advised shareholders.

Earnouts

As with conventional rollovers, the effect of deferring payment by an earnout will be to push the earnout receipts into the 18% regime when an upfront payment would be taxed at 10%. This may cause sellers to resist earnouts, or at least to rebalance the consideration away from them.

Depending on the numbers and the earnout duration it is also possible that sellers may look for cash rather than loan note earnouts. Whilst at present this is considered inefficient since it requires tax to be paid on the market value of the earnout right up front with correcting adjustments later, this may be a more attractive result when the upfront gain is taxed at 10% instead of 18%. To the extent that the amount eventually received under the earnout exceeded its assumed market value on sale, the excess would be taxed at 18%. Whether this is a good plan will depend on the size of the earnout relative to the upfront payment (ie how seriously does the tax on the contingent element eat into the sale receipts) and how long the earnout is for (ie how long are you out of the money for in respect of the tax on a sum you haven't received yet).

EMI schemes

One of the biggest benefits of EMI schemes was that the taper clock ran from the grant, not the exercise, of the option. Optionholders could therefore take advantage of the 10% rate on an exit without ever funding an equity stake in the company. With taper relief gone, the treatment of EMI options will effectively be the same as that of approved options, although they will still permit a greater value of options to be held by a single optionholder and not be constrained by a minimum period after grant before CGT treatment can be obtained.

"Bed and breakfasting"

There are existing provisions designed to stop "bed and breakfasting" - the practice of selling an asset and then reacquiring it or an equivalent asset immediately afterwards having crystallised your gain. These would appear to be effective to prevent you crystallising a gain at 10% and then going forward in the 18% regime. However their operation is not straightforward (or entirely loophole-free), so when we get the actual legislation on the CGT changes (promised before the end of the year) it may be that there are opportunities.

Private equity - the dog that didn't bark, or at least not very loudly

Despite a lot of references in the Chancellor's speech to closing loopholes and making private equity pay its fair share, there have been no measures specifically targeted at the industry. Carried interest profits will remain capital, the "base cost shift" to carry holders remains (with the result that their effective rate of tax will generally stay in single figures) and no new restrictions on interest deductibility will be introduced. For now, the Government appears to believe that the increase in the CGT rate applicable to shareholdings in private companies is sufficient to address the political problem of what to do about private equity.

REITs - an almost certainly unintended consequence

REITs have not been a great success with retail investors thus far. The changes will have the effect of making them (even) less attractive than alternative forms of property investment.

Under the current rules a direct investment in property, or an investment structured through a tax transparent partnership or similar vehicle, gives rise to capital gains taxed at 40% subject to non-business asset taper. When a REIT makes a gain, if it is distributed to its shareholders it forms part of the REIT dividend and so is taxed as rental income at 40%. Minimal tax is therefore lost by UK investors due to the interposition of the REIT.

Under the new rules, the gain on the direct investment will be taxed at only 18%. The interposition of the REIT therefore results in 22% more tax arising on distributed gains as against alternative structures. This puts UK investors in the same position as overseas investors, who have always been disadvantaged by paying basic rate income tax of 22% on distributed gains as against zero tax on gains on direct investment.

If you require any further information on any of the changes outlined in this note, please contact Simon Yates on 020 7295 3414 or your usual contact at the firm.

Travers Smith
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10 Snow Hill, London EC1A 2AL
Tel: +44 (0)20 7295 3000 Fax: +44(0)20 7295 3500
www.traverssmith.com