

Tax perceptions

Recent HMRC research looked into people's perceptions of capital gains tax and why they create trusts.

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EVER WONDERED WHAT HMRC spends our hard-earned tax on? Well apart from index-linked pensions for civil servants, HMRC like to conduct research into tax-related subjects. They recently produced reports on capital gains tax and another on trusts. It would be interesting to know the real motivation behind this research, particularly the one on trusts given the Treasury's Finance Act 2006 changes to their tax treatment. Is it really to confirm HMRC's apparent belief that every taxpayer's move is governed by the desire to pay less tax? If so, they are likely to be disappointed because the research shows that people's actions tend to be governed by need first, tax later.

The capital gains survey

HMRC commissioned Ipsos MORI to carry out research into the impact of the changes to capital gains tax in 1998. These changes were:

- freezing of indexation allowance and replacing it with taper relief;
- distinguishing between business and non-business assets;
- the phasing out of retirement relief and reinvestment relief;
- increased deferral relief via the enterprise investment scheme.

The reasons for carrying out the research were as follows:

- to discover the public's awareness of capital gains tax and the 1998 reforms;
- to see if the changes had worked, for example, to reward entrepreneurs, long term and risky investment, as well as making the tax easier to understand;

KEY POINTS

- What is the impact of capital gains tax on taxpayers?
- Role of avoidance.
- Main reasons to sell business are commercially driven rather than tax driven.
- Are trusts set up to avoid tax?
- Control of assets is main reason for a trust.
- What is the value of research?

- to examine taxpayers' attitudes towards paying capital gains tax;
- to understand the role of capital gains tax in investment decision making;
- to find out why taxpayers use agents to deal with capital gains tax;
- to assess the compliance costs of capital gains tax.

The survey interviewed 948 capital gains taxpayers and 200 agents between November 2005 and January 2006. Of the taxpayers questioned, the most common types of assets held by them were quoted shares and residential let property.

Perhaps unsurprisingly, rate of return and personal considerations most influenced taxpayers' investment decisions. However, when asked specifically, 34% of taxpayers said that capital gains tax affected their decisions with regard to acquiring assets and 48% said that it affected their decisions over whether or not to sell. The main consideration was for the gains to be within the annual exempt amount. Approximately half said that they would not have proceeded with sales if the capital gains tax had been higher, and a third said that they would not have disposed of assets if the holding period required to maximise taper relief had been longer.

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Knowledge of the enterprise investment scheme and venture capital trusts was relatively low among the taxpayers, but where taxpayers did use these schemes, tax incentives, especially deferral, were crucial in their decision making.

The taxpayers mostly (95%) said that they knew something about capital gains tax, although this was not detailed knowledge. 29% of taxpayers knew nothing about the 1998 changes, compared with 24% who did know about them.

It was good news for HMRC that most taxpayers considered it important to pay tax, although 94% confessed that this being so, they disliked paying it. 93% thought it fair to tax people on their income, but only 45% believed it fair to tax capital gains. Some saw the capital gains tax system as unfair double taxation or a discouragement to investment. Nearly half thought that capital gains tax was complicated, a factor which led 75% of taxpayers to employ an agent to help them.

The cost of compliance varied widely among capital gains taxpayers. 60% said that they spent less than five hours a year dealing with their capital gains tax liability,

but 5% said that it took over 40 hours a year. The combined estimated cost of taxpayers and agents dealing with capital gains tax amounted to £130 million.

Overall, taxpayers who used agents felt that agents' fees had increased, with a third ascribing this increase to complexity.

Avoidance

Naturally the research was interested in tax planning. It did not specifically refer to avoidance, but asked taxpayers instead about 'schemes to organise their investments so they minimise the amount of capital gains tax that they have to pay'. This excluded Government incentive schemes, such as enterprise investment schemes but included arrangements designed to reduce liability, e.g. moving overseas.

13% of taxpayers said that they had used avoidance schemes which have to be disclosed on tax returns, and 9% said that they had used 'loss schemes'. Not unsurprisingly, those who had taken advantage of enterprise investment schemes and with larger gains, were more likely to have used avoidance schemes in respect of other gains. 18% of taxpayers with capital gains of between £100,000 and £1 million and who used an agent said that they had used a scheme that had to be disclosed, with 19% of those with gains of over £1 million.

Enterprise investment scheme claimants with larger gains were more likely to have used 'loss purchases', i.e. 18%

Keen to sell

According to a poll of owner managed businesses conducted by Robert James Partnership, small business tax planning specialists, 85% of the businesses surveyed admitted they did not have a formal exit strategy in place and only 31% have implemented a management structure to support an external sale, which supports HMRC's research that capital gains tax is not a major preoccupation of small businesses. Robert James find that 'selling up is generally the single biggest reason behind an entrepreneur creating a company in the first place, especially given the favourable selling conditions available due to taper relief'. Furthermore, in practice, poor planning, lack of awareness of the value of the business and failure to master the basics of selling a company may all lead to a less than successful transaction. Generally, say Robert James, 'small business owners are not aware of the need to seek tax advice prior to beginning any contractual negotiations'.

Lesley Stalker, tax partner, says that she 'recently worked with a client who had unfortunately agreed the form of his business sale and signed contracts before seeking tax advice. The contracts did not allow for "deferred consideration" which would effectively stagger the purchase payments and make him eligible for full business asset taper relief at 10%. We were powerless to change his contracts and the higher 20% rate had to be applied'.

The survey also highlighted high levels of confusion and perceived complexity surrounding how to minimise tax liability during a business sale, with 62% admitting they found the whole area very confusing.



compared with the average of 9%; while 11% of represented capital gains taxpayers with larger gains were more likely to have used 'marketed' schemes.

With regard to the better known ways of mitigating large gains, e.g. offshore trusts or moving overseas, in the survey only 3% of capital gains taxpayers had used the former and only 1% had moved overseas. MORI explains these relatively low percentages as being, in part, explained by the fact that it would have been unlikely to contact taxpayers living abroad for interview.

Most who had used such schemes said they had only used them once or twice. The survey suggests that more research may be required to understand whether this relatively low use of schemes was a result of these taxpayers tending not to use avoidance schemes when they paid capital gains tax, or whether they did not pay the tax frequently but used a scheme each time they did. Capital gains taxpayers making larger gains were no more likely to use avoidance schemes than those with smaller gains.

Tax impact on decisions

Contrary to the apparent belief of some in HMRC who inhabit a cocooned little tax world, taxpayers' investment actions tend not to be governed solely by tax considerations. The research bore this out. For instance, it seems that most agents, viz. 68%, believe that the 1998 changes did little to encourage riskier investing or more entrepreneurial business. As one agent representing over 100 clients put it: 'You don't actually ever do anything, expecting to lose money... very, very few people would actually say "yes, I'll do that" ... people do not actually invest in what they consider to be riskier investments'. In similar vein, another agent said 'people are either investing for risk or not, and I don't think the rate of capital gains tax changes their outlook'. He did not believe that the changes to the regime had had a 'major effect on the attitude of investors to risk'.

On the other hand, 21% of agents thought the changes had had an effect, with 70% attributing this to the generous taper relief rules.

Looking in greater detail at the reasons why taxpayers acquire business assets, the main reason was to set up in business (32%), followed by to make money (18%). Only

1% cited tax reasons. The most popular reason for acquiring a non-business asset was as an investment (29%) and then to make money (17%). Again, tax reasons were not prominent, with only 1% mentioning capital gains tax as a reason to buy an asset. These findings were backed up in more specific replies from taxpayers, with one saying that the important factor was 'whether it's a sound investment: a) that it won't make a loss and b) hopefully it will make a profit'. Another taxpayer was not even sure what reliefs might be available on the investment, but bought because he 'fancied it'.

As to the disposal of assets, the most common reasons were that:

- it was a good time to sell;
- there was a change of circumstances;
- a good opportunity arose;
- funds had to be released;
- the taxpayer wanted to reinvest in property.

Tax reasons were cited by only 4% of taxpayers. Among those holding assets, 46% had no plans to sell their main asset, and many intended to keep them as a long-term investment. The research reflects that this means that there is little evidence of taxpayers planning a quick sale of assets to take advantage of the capital gains tax taper relief regime on the ground that it was too good to last.

The trusts survey

HMRC's other recently published research report concerned the setting up and running of trusts. The objectives of the research was to understand why trusts are set up and the impact of the trust regime on those decisions. A 'central aim' was to 'understand the motivations of individuals from different socio-economic backgrounds holding assets in trust'.

Unfortunately, the responses are described as 'rather low' and the researchers admit that this may result in some 'deficiencies in terms of being representative of the total trust population'.

Crucially, however, the research found that tax was only a secondary consideration when creating a trust. They are mainly set up to control assets. Given the Treasury's sudden Budget 2006 changes to inheritance tax and trusts, one would have assumed that this finding comes as a surprise to officials, even if not to those involved in working in trusts. In fact, the Government must have been aware of results of the research before the Budget since the survey took place between July and October 2004, yet it is not unreasonable to assume from the Budget changes that the only motivation for setting up a trust was to gain a tax advantage.

Importance of tax

According to the research, the main motivation for setting up a trust is related to control of assets, for instance to prevent children from gaining access to money before they are mature enough to handle it. Tax planning is usually of secondary importance, although was considered an important factor for trusts with high income, where 60% said it was important compared with 29% who said it was

not. Those who mentioned tax as an important factor, referred to the ability to reduce inheritance tax.

Of the 1,000 trustees questioned, only 26% were professional. The survey found that there was a 'gulf of awareness' of responsibilities and tax obligations between lay and professional trustees, with lay trustees relying on professional co-trustees or tax advisers. For example, the survey of trustees found that trustees were often unsure which type of trust they held, and in the in-depth interviews, they acknowledged that they would not have known which type of trust they had without checking. One respondent said that he 'would rely on the accountant if there were any changes on the HMRC requirements'. A few use HMRC as a source of information, overall finding them easy to deal with. For instance, one trustee said that he had found 'HMRC to be very helpful on more than one occasion'.

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Trustees agreed that tax simplification was a good idea, with professional trustees being more likely to suggest that tax law be improved. Most were unable to make any specific suggestions as to how the regime could be improved.

Damn lies

Neither survey suggests that tax is an overwhelming consideration when arranging one's financial affairs. With capital gains, it seems, and this really is not rocket science, people are in it for the money: they want to build and maintain a comfortable lifestyle. Tax is a factor, but way down the list in terms of importance. When it comes to trusts, the survey reflects the general public's lack of understanding of trusts, and the extent to which non-professionals are involved in trusts, which may come as a surprise given the complexities involved. Again, tax is not the most important factor in creating trusts, but it becomes more so when professionals are involved.

It is perhaps a matter of concern that HMRC commission this research and then apparently pick and choose the bits they like. Certainly it is curious. For example, they seemed to ignore the fact that often, although not always, trusts are set up effectively to protect people or to protect them from themselves. Was the research perhaps swept under the carpet because so few respondents were questioned?

While it could conceivably be justified as having little relevance to trusts in the main, because of the small number of respondents, it could perhaps have been used as a jumping board for further research and understanding before the Government took the plunge with its changes, particularly given that the changes were so ill-thought through and required considerable amendment to bring them to a workable state. ■