LABOUR'S FIRST BUDGET
INVESTORS IN ITS SIGHTS?

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OCTOBER 2024

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Summary

- Budgets are always important for investors.

- The imminent Budget, at the end of October, will be doubly so, because it is the first from the new Labour government, and it has already signalled the need to fill an alleged £22bn black hole, while ruling out changes to more than half the tax base. That implies a lot of the pain will be felt by investors.

- This paper considers the impact of increases in rates for those taxes that affect investors, and the withdrawal of tax concessions and reliefs.

- We apply four "critical" tests to each measure to judge whether:

    - it will raise more tax immediately;
    - it will help grow the economy;
    - only the rich will suffer; and
    - it will be complex to effect.

- Of course, increased taxes and reduced relief are never likely to encourage growth; meanwhile, one of the aims of the new chancellor is to get Britain growing again. However, some measures will have greater impact than others.

- Many of the measures that it would appear are being contemplated would raise little additional revenue.

- Some of the measures will negatively affect liquidity in company shares as well and make funds more attractive than company shares. Altogether, this will make it more difficult for growth companies to raise cash on the equity market.

Introduction

A critical moment approaches for investors – the new Labour government will deliver its first Budget, scheduled for Wednesday, 30 October.

Budgets are always important to investors, this one more so than most

A Budget is always a balancing act of meeting competing demands on spending, taxes and borrowing. There is also a balance in another dimension, between politics and economics. This will be the first Budget of a new government and the best time to get some bad news out. The new Prime Minister and Chancellor are certainly preparing us for a "tough" event.

Markets will pass judgment on the likely macroeconomic effects of the Budget. That judgment will consider both the impacts and the credibility of the numbers and measures.

This paper will touch only briefly on the macro impact, and instead mainly focuses on possible changes to taxes and tax concessions that will affect investors.

Investors may well have every reason to be worried by promises made during the election campaign.

Budget background

The new Labour government has been working hard, in the short period of time since winning the July election, to build up a bank of reasons to explain spending cuts and tax increases on the horizon. Inevitably, this strategy principally consists of "blame the Tories" for everything. Rachel Reeves has already warned us, in shocked tones, that she has uncovered a "black hole" of £22bn in the spending budgets.

Actually, it should not be a total shock, because the respected Institute for Fiscal Studies warned both parties during the election campaign that they were being unrealistic about their promises. Nevertheless, the £22bn figure is a useful cloak for Labour ministers to trot out in media interviews.

This magic figure of £22bn has already been deployed to justify uncomfortable decisions, such as withdrawing the "Winter Fuel Allowance" from most pensioners.

To the man in the street, £22bn sounds like a huge sum; and, of course, it is, However, let's put that into context. The Government's Office for Budget Responsibility forecasts public spending in 2024/25 of £1,226bn. Therefore, £22bn is just 1.7%, almost a rounding error.

Having ruled out increases in the "big" taxes, investors look likely to bear a disproportionate burden

Investors are particularly concerned because Labour ruled out tax rises on "working people" during the election campaign. Pushed even further, it promised no increases in VAT, National Insurance or Income Tax.

Of course, it may renege on these promises. However, as ministers seem to be on the back foot already on a number of issues, breaking this promise on tax would be catastrophic. Labour could also play around with allowances without changing the rates to generate revenue.

The table, below, uses actual government receipts for 2023/24,

Public sector current receipts 2023/24

	£bn	%
Taxes ruled out		
Income Tax	277	25
National Insurance	180	16
VAT	170	15
Total	**627**	**57**
Other taxes		
Corporation Tax	103	9
Council Tax	45	4
Capital Taxes	39	4
Business Rates	27	2
Fuel Duty	25	2
Tobacco & Alcohol Duties	21	2
Other receipts	115	10
Other taxes	95	9
Total	**470**	**43**
Overall total	**1,097**	**100**

Source: House of Commons Library "Tax statistics: an overview", Hardman & Co Research

This table shows that VAT, National Insurance and Income Tax accounted for more than half of total receipts. Of the other taxes, Rachel Reeves seems to be ruling out changes to Corporation Tax and, we suspect, Council Tax and Business Rates will be untouched. That means that, if the £22bn "hole" is to be closed by tax hikes, it will come from an historical base of £295bn; i.e., an increase of 7.5% in those taxes.

It may be that Reeves will close the "gap" partly with tax increases, partly by making spending cuts and partly through increased borrowing. However, Labour governments are not generally inclined to cut spending, and markets are already concerned about the ratio of UK Government debt to GDP.

Investors are right to fear, therefore, that they are likely to be in the Chancellor's sights.

Taxes and concessions

It seems probable that the Labour government will take this opportunity not only to raise the tax take but also to rethink tax concessions, reliefs. In its eyes, it could equalise the treatment of tax payers by levelling down for wealthy investors. There are many actions that could be taken and there is simply not enough room to cover them all in this paper, without sending our readers to sleep!

What might those changes be and what impact could they have on investment?

In considering each of these possible measures, we think four critical tests should be set:

Critical tests

1. Will it raise more tax immediately?
2. Will it help grow the economy?
3. Will only the rich suffer?
4. Will it be complex to effect?

Pensions

Before the General Election, the Labour Party made noises about reintroducing a lifetime allowance for an individual's pension pot, albeit with exceptions for doctors. Luckily, it seems that the folly of such a move was recognised and the idea was dropped.

Tax relief on pension contributions may be restricted to the Basic Rate of Income Tax…

Nevertheless, pensions remain a tempting target from which to raise tax. Two measures are probably being considered. The first is to restrict the relief on pension contributions to the Basic Rate of Income Tax. Individuals contributing to their pension can offset those payments against Income Tax; the relief could be as much as 45% vs. the Basic Rate of 20%. It will be easy to question why richer taxpayers currently get much more support. Restricting the relief has the additional benefit of immediately creating extra revenue.

…and the maximum tax-free lump sum might be cut

The second measure might be to reduce the tax-free cash lump sum that can be taken. Currently, an individual can take up to 25% of their lifetime allowance out in cash after the age of 55; that could amount to hundreds of thousands of pounds. It would be tempting to cap this figure at, say, £100,000. Again, it could be argued that the burden will fall on the wealthy. The difficulty is that many people's financial planning assumes they will have access to that cash; a common example might be to use the lump sum to pay off a mortgage. Governments, generally, want to encourage citizens to plan ahead; it would be ironic, therefore, if the Government's own actions were to undermine long-term plans. Thus, it is likely that transitional arrangements might be necessary, reducing the revenue-raising impact of any measure.

These measures would make other types of tax-advantaged investment more attractive

To summarise, pensions are a likely juicy target. Any reduction in the favourable tax treatment of pensions will make saving for pensions less attractive and, for those that want to provide for their future, other investments more appealing.

Critical tests

1. Will it raise more tax immediately? Yes
2. Will it help grow the economy? No
3. Will only the rich suffer? Arguably, yes
4. Will it be complex to effect? With the need for transitional arrangements for lump sums, yes

Capital Gains Tax (CGT)

Investors are already suffering from a lower tax-free allowance

Investors are already coping with a substantial reduction in the tax-free allowance, which was cut by the previous Conservative government from £12,300 in 2022/23 to just £3,000 in 2024/25. This measure will not only increase the bill that those already paying CGT will pay in the future but also drag in taxpayers who were previously outside the net.

Likely that income Tax and CGT rates will be aligned

However, it looks likely that the new Chancellor will go further and listen to voices calling for CGT rates to be raised to match those for Income Tax. Supporters of this measure argue that there is no reason for treating capital gain differently to income; they also argue that this creates an incentive to turn income into capital gain, where possible.

The table, below, provides a simplified overview of the current situation. The CGT rate you pay broadly depends on whether or not you just pay Basic Rate Income Tax. Of course, the real picture is rather more complicated; for example, if you are a Basic Rate payer, but, if your gain is such that, were it treated as income, you would become a higher rate tax payer, you will pay the higher bands of CGT.

Comparing CGT to Income Tax rates

	Income Tax rate	CGT rate	Asset
Basic Rate Income Tax Payer	20%	18%	Residential
		18%	Carried interest
		10%	Other
Higher Rate Income Tax payer	40%	24%	Residential
		28%	Carried interest
		20%	Other

Source: HMRC, Hardman & Co Research

Even so, gains are clearly taxed at a lower rate than income. The rate depends on the type of asset the taxpayer sold. Readers will note the term "carried interest" in the table; this was designed to cover the way many private equity managers are rewarded.

If the Chancellor does "level up" CGT rates, there are several implications:

1. It reduces the rewards for taking risks and investing. Gains are taxed, but losses are not necessarily relieved. An investor might only make losses, which will only be relieved if they can make a gain! It might seem, therefore, that an asymmetric risk for investors is created.
2. This is hardly the incentive to help support growth in the economy that Reeves claims she wants so much.
3. Higher CGT rates will mean that some investors will postpone sales that they would otherwise make; perhaps to hold for a change in government and the hope that lower rates might come back, or simply because a sale would now have more implications. Slower sales would have a particular impact on stock markets. Portfolios would be more fossilised, reducing market liquidity, which has already been a growing issue in stock markets.
4. Slowing sales of assets will reduce the extra tax revenue that the government might hope to raise; perhaps, there would be no additional revenue.
5. Another effect will be that some investors might prefer to hold funds rather than individual shares. That way, they would only pay CGT on the sale of the fund and have more control over when they pay tax. This would shift market liquidity from individual companies to funds. Might this make it more difficult for such companies to fund their growth? Such a scenario would be likely to concentrate decision-making in fewer hands, increasingly that of fund managers.
6. One particular risk about investing in individual companies is that there might be times when investors would have no choice about the timing of a disposal and paying tax. The London market has seen a lot of cash-only takeovers in recent years where there is no way of postponing the crystallisation of a gain; the CGT rules say that if your shares are swapped for those of an acquirer or a loan note, then there has not been a crystallisation and thus no tax is payable – the base cost of the original investment becomes that of the new holding.
7. Investors will complain that, to some extent, CGT is simply a tax on inflation rather than real gain. After a period of very high inflation, this was recognised in the past by the introduction of "Taper Relief" (long since gone).
8. An administrative nightmare. Finding the base cost for a holding can be problematic, particularly in respect of long-standing holdings that have had capital changes over many years or for the more amateur investors, who have not kept records. There is anecdotal evidence that companies

and registrars are not as helpful as they might be. One partial solution could be a repeat of Nigel Lawson's measure; a rule was introduced whereby investors were able to rebase the holding cost to 31 March 1982 for holdings bought before that date.

9. Assets that fall outside the scope of CGT will become more attractive relative to shares than is the case now. That includes gilts (UK Government issued bonds), personal possessions (within limits), cars, business assets (if subject to BR relief) and gambling. Many investors in crypto assets think they are out of scope as well, or have never heard of CGT – that is simply not true.[1] One outcome of raising CGT rates, therefore, will be that it will encourage individuals to switch from investing in shares to gambling (which includes spread betting on shares!). It is hard to see how is that going to help growth companies and economic progress.

Critical tests

1. Will it raise more tax immediately? Probably, no
2. Will it help grow the economy? No
3. Will only the rich suffer? Arguably, yes
4. Will it be complex to effect? Partly

Tax-advantaged schemes

There are many sorts of relief, but, for this article, we will focus on the Venture Capital Trusts (VCTs), Enterprise Investment Scheme (EIS) and Seed Investment Schemes (SEIS). Investors in new shares of some AIM companies can benefit from EIS and there is a raft of quoted VCTs.

A quick recap of the tax relief and differences between VCTs, EIS and SEIS:

Tax treatment

	VCT	EIS	SEIS
Min. holding period	5 years	3 years	3 years
Max. investment p.a.	£200,000	£1,000,000	£100,000
Income Tax relief	30%	30%	50%
CGT on gains	None	None	None
CGT rollover relief	No	Yes	Yes
IHT relief	No	Yes	Yes

Source: HMRC, Hardman & Co Research

To qualify for the tax reliefs in these assets, there is a maximum investment amount and a minimum holding period. However, the Income Tax relief is given immediately (although it could be clawed back if the asset is not held for the minimum period); thus, if you invest £100,000 in an EIS fund or company in a tax year, your Income Tax bill is reduced by £30,000.

Tax-advantaged schemes have several attractions

If the Budget increases CGT rates, then these tax-advantaged schemes will become more attractive to investors. EIS and SEIS will be particularly appealing because you can use the scheme to defer CGT payable on assets that do not qualify for relief; for example, if you make a chargeable gain on listed shares and invest an amount equal to the chargeable gain in EIS, then the tax on the gain is deferred until the EIS asset is sold.

[1] https://www.gov.uk/guidance/check-if-you-need-to-pay-tax-when-you-sell-cryptoassets

The EIS incentive has been very successful. HMRC statistics published in May this year showed that, for the 2022/23 tax year, £1.9bn was raised by 4,205 companies. SEIS raised £157m for 1,815 companies.[2]

Labour seems to support these schemes, so is unlikely to touch them

EIS and SEIS are recognised as, probably, the best schemes in the world for helping start-ups, creating an eco-system and generating investment. We can be reasonably confident that EIS, SEIS and VCT tax reliefs will be largely untouched by the Budget. Why? Well, there are two reasons. First, in November 2023, HMRC extended the "sunset clause" from 2025 to 2035 (that is the year when the scheme will end). Secondly, in a Labour Party paper published in 2022,[3] the then Shadow Chancellor, Reeves, wrote that the paper answered questions about "building on our pre-existing system of tax reliefs for entrepreneurs and investors – Seed Enterprise Investment Scheme, the Enterprise Investment Scheme and R&D tax credits – to widen access and ensure those tax reliefs work to the greatest effect, spurring innovation and entrepreneurship. The ideas contained in this document will inform the development of our next manifesto."

Several reasons why the SEIS and EIS world might actually benefit from tax changes elsewhere

Since we believe that no changes will be made, there is no purpose in looking at our critical tests. It is possible that these schemes will benefit from measures taken elsewhere. Those wishing to manage a CGT tax bill would invest to benefit from rollover relief and some money would switch from investment in pensions and other assets to tax-advantaged schemes.

Inheritance Tax (IHT)

It is curious how much concern there is about IHT, when so few people pay it. Many who will probably not pay it still worry about it. Perhaps, this is because people would like to leave something to their children. They also wonder why their estates should pay tax on monies which have already suffered tax on their accumulation.

Among the changes being mooted, we look at two:

1. **The levying of CGT at death:** Regardless of the accumulated gain on investments, CGT is, currently, not charged at death. If shares are passed on *in specie*, the inheritor uses the value at the date of death for their base cost. If CGT were to be levied, there could be some serious difficulties for executors; it is their duty to complete the IHT return, but, often, records are incomplete or missing.

   Levying CGT might cause individuals approaching death to change their investment policy; for example, away from listed shares.

2. **AIM relief:** Investments in most AIM (Alternative Investment Market) shares fall outside the scope of IHT if held for two years or more.

[2] https://www.gov.uk/government/statistics/enterprise-investment-scheme-seed-enterprise-investment-scheme-and-social-investment-tax-relief-may-2024/enterprise-investment-scheme-seed-enterprise-investment-scheme-and-social-investment-tax-relief-statistics-2024#main-points-and-summary

[3] Labour Party "Start-up, scale-up: Making Britain the best place to start and grow a business"; https://labour.org.uk/wp-content/uploads/2022/12/WEB-17247_22-Start-up-review-v12-ALT-2.pdf

Ending AIM IHT relief might make it more difficult for growth companies to raise money, undermining the Government's "dash for growth"

This relief has encouraged investors to buy shares in companies that have made a real difference to the UK. For example, AB Dynamics, a company making highly technical equipment for the car industry. This is a world-leading company generating well-paid jobs in the South West as well as substantial exports. The company was nearly bought by an overseas buyer many years ago. Fortunately, it decided to stay in the UK and raise money on AIM. Today, it is valued at almost £500m.

Axing this relief would make it more difficult for these companies to raise the cash they need to grow in the UK. It might also persuade some to leave these shores.

Critical tests

1. Will it raise more tax immediately? Yes
2. Will it help grow the economy? No
3. Will only the rich suffer? Arguably, yes
4. Will it be complex to effect? No

Individual Savings Accounts (ISAs)

There are suggestions that a new maximum cap will be set for fund sizes. Ever since the scheme was introduced in 1999, there has been a cap on individual contributions within a tax year, but not on the total accumulated funds. Currently, an individual can invest a maximum of £20,000 each tax year in ISAs in total. Some individuals have created funds worth millions of pounds through contributions and good investment choices.

There are, inevitably, practical difficulties when introducing a cap on the total value of an individual's ISA holdings:

1. Does it apply to each ISA or the total of an individual's ISA plans (an individual may have different types of ISAs; e.g. Cash or Stocks & Shares, or different providers of the same type)?
2. If a cap is set at, let's say £250,000, would that mean that further contributions cannot be made, unless the total falls below that level…
3. …or will any surplus above the limit not qualify for the ISA tax reliefs (no Income Tax or CGT)?
4. When is the test of value conducted? Is it continuous or conducted once a year (for example, on 6 April for the tax year ahead)?
5. What happens if the value hovers either side of the cap?

6. **This could create more difficulties in fund raising and liquidity**

Let us assume that these difficulties can be overcome. Such a measure may appeal to a Labour Government, because they will argue that only those with the broadest shoulders would suffer. However, it cannot be denied that the incentive to invest in ISAs would be dented, making it more difficult for companies to raise money to fund growth and reducing stock market liquidity. The latest estimate from HMRC is that £750bn is held in ISAs, of which £456bn is invested in Stocks & Shares ISAs. A cap might have a meaningful negative impact.

Critical tests

1. Will it raise more tax immediately? Yes
2. Will it help grow the economy? No
3. Will only the rich suffer? Arguably, yes
4. Will it be complex to effect? Undoubtedly

About the author

Keith Hiscock is the Chief Executive of Hardman & Co Keith has published a number of papers on the issues facing companies and markets in today’s climate. His career in stockbroking started 43 years ago at James Capel, at the time, the top-ranked research house in London. He was a founding member of Schroder Securities and of Agency Partners, a leading research boutique, and was a member of the five-man securities board at Evolution. Keith has also advised companies, large and small, on their relationships with the capital markets

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