RATHBONES

LABOUR'S FIRST BUDGET

AND HOW IT COULD AFFECT YOUR FINANCES
SEPTEMBER 2024

Chancellor Rachel Reeves has set low expectations ahead of her first Budget on 30 October, talking about "incredibly tough choices" to address a supposed £22 billion black hole in the public finances. Meanwhile, Prime Minister Keir Starmer has suggested the burden should be borne by those with the "broadest shoulders". What might be in store?

In an article in our upcoming *Investment Insights* publication, we explain why we believe Mrs Reeves also has an opportunity to set out a clear agenda to revive investment – the weakness of which lies behind the UK economy's long funk. In our view, one of the key factors to grasping this opportunity is avoiding counterproductive tax changes – specifically those that might discourage private investment. Whether or not the Chancellor will grasp this opportunity remains to be seen.

Given Labour has pledged not to increase the four taxes that raise the most revenue, capital gains tax (CGT), pensions and inheritance tax (IHT) are in the spotlight. Here we'll spell out some of the tax changes that might be coming. But we don't know what will be in the Budget, and this shouldn't be taken as advice. You can find out more in another report at www.rathbones.com/knowledge-and-insight/how-could-labour-government-affect-my-finances

Capital gains tax rates

The easiest way for Labour to raise cash would be to increase CGT. Relatively few people pay CGT – usually less than 0.5% of the population in any one year. However, the percentage of people paying the tax has increased noticeably over the past decade, while the tax liability has jumped more than 300% in that time to £16.7 billion (as of the 2021/22 financial year).

Labour says it has "no plans" to raise CGT rates, and there's little wiggle room on allowances, as the tax-free allowance halved to £3,000 on 6 April 2024. If allowances fall any lower than that then voters could be filling out tax returns for the odds and ends they've sold. There are exemptions that could be trimmed as well, including antiques and jewellery below £6,000, second-hand cars and wine, gambling winnings and capital appreciation on government bonds. It would be a similarly tough sell to scrap these. Individual Savings Accounts (ISAs) could also be attacked but this would also be a tough call for the Chancellor.

There's also Business Asset Disposal Relief (formerly known as Entrepreneurs' Relief), which reduces the rate of CGT to just 10% for the sale of 'personal businesses' (where an owner/officer holds at least 5% of the company) to encourage business creation. Ending this subsidy could jar with Labour's business-friendly stance – besides, a £10 million lifetime cap was slashed to £1 million in 2020, so the Exchequer has already raided this tax relief somewhat.

If CGT rates were changed, Labour could equalise CGT with the marginal income tax rate, as Conservative Chancellor Nigel Lawson did in 1988. If so, that would double the CGT rate for higher rate taxpayers to 40% and by even more for additional rate payers to 45% (residential property gains currently attract a higher rate of 24%). Given most CGT taxpayers are wealthier, that would boost the government's coffers considerably.

On paper at least, it would also encourage people to avoid the increased levy through a mixture of financial planning, buying offshore bonds, swapping shares for collective investment funds that can trade within the fund structure without incurring CGT, investing in an Enterprise Investment Scheme or Venture Capital Trust and simply not selling. All of the above could reduce the take. Back in 1988 Lawson increased the CGT rate for the wealthy, yet decreased it for standard rate payers. CGT receipts dropped considerably over the following five years.

Something else Labour may review is the reset of capital gains on assets on the death of an owner. When assets are transferred at death, any capital gains made are wiped (although IHT may be payable if the beneficiary isn't a spouse); it is as if the assets have just been purchased at their current value. If the assets are jointly held, this CGT relief applies to the deceased's half share.

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This is extremely valuable, as it means assets can be disposed of without tax. When combined with Business Relief, this rule can be very powerful indeed. A portfolio can be sold and moved into Alternative Investment Market (AIM) stocks, and under current rules, after two years it would be completely free from IHT. Of course, investing comes with the risk that the value of your investment may fall, and you could get back less than your original investment.

If the CGT reset rules were changed, CGT would be levied on all uncrystallised gains over a person's life and then IHT would be levied where applicable. A way to prevent this could be using offshore bonds to roll up annual gains without paying CGT and income tax. Another way to indirectly tax wealth would be to increase dividend tax rates – perhaps equalising those with marginal income tax rates as well – or to reduce the current £500 tax-free allowance on dividends.

Breaking into the pensions piggy bank

Labour pledged to maintain the triple lock for state pensions (increased in line with inflation, wage growth or 2.5%, whichever is highest), and committed to a "review of the pensions landscape" to improve "pension outcomes" and increase investment in UK markets.

However, this doesn't rule out changes to the way pensions are taxed, such as subjecting state pension income to tax, changing/reducing pensions tax relief, or tax-free lump sums that can be withdrawn, or removing exemptions from IHT for pension savings. (The Conservatives promised to shield the state pension from income tax.) While Mrs Reeves had previously said she would reintroduce the lifetime allowance, media reports suggest Labour has backed away from this, and although not ruled out, it wasn't mentioned in the manifesto.

Over past decades, the UK built up a range of generous tax incentives for savings, from pensions to ISAs. In recent years the generosity has cooled somewhat. Labour may continue to turn the dial, especially as part of the vague "pension reform" mentioned in its manifesto.

Changing to a flat rate of tax relief on pensions has been discussed in the past. Because tax relief on pensions accrues at your marginal income tax rate, the wealthiest receive the largest savings. This may spur Labour to reform pensions toward a single, flat tax rate on pensions (say 20%, 25% or 30%) regardless of income band. A flat rate of tax would be much harder for employers and savers to administer and would lead to double-taxation for higher-paid workers.

This is because at a flat rate of, say 30%, higher-rate taxpayers would pay 10% on income deposited in their pensions (because their marginal rate is 40%) and then another 20% (if they are basic rate taxpayers at retirement) when they withdraw them years down the line. This is complicated and would take time to roll out, so it's not something we would expect early in a Labour term. But it's something to watch out for.

Up to £60,000 a year can be deposited before tax into pensions, whether auto-enrolment schemes at work or self-invested personal pensions (SIPPs). However, that is much lower than the £255,000 limit in place before the global financial crisis. Changes since 2016/17 have eroded the generosity further for the very wealthy. Today, the annual limit for tax-free payments into a pension is tapered by £1 for every £2 earned over £260,000. The standard annual allowance could be cut even after only being recently increased by the Conservatives, bringing more cash into HMRC's net.

Labour has allegedly ditched its plan to reinstate the recently scrapped £1,073,000 standard lifetime allowance for pension pots, above which extra tax was levied, particularly on higher earners. This is good news; however, it's important to remember that there are still limits on what lump sums can be taken tax-free from your pension. And they look pretty similar.

There is a new 'lump sum allowance' of £268,275. This figure is 25% of the old lifetime allowance, and limits your total tax-free pensions payouts at death to £1,073,100. The maximum amount you can transfer overseas without penalty is capped at, you guessed it, £1,073,100. Although it's unlikely that the old system would be reintroduced, there remains a cohort of savers where larger lump sums are available and reducing the cap on lump sums could raise additional revenue from those with "broader shoulders".

The ISA is another savings device that has grown increasingly generous in recent years. It was introduced by New Labour in 1999, replacing an earlier savings scheme with a more flexible alternative. However, one report by the Resolution Foundation, a thinktank that seeks to improve the living standards of low- to middle-income families, has argued that HMRC could save £1 billion each year by capping ISA savings at £100,000. Everything over that would be taxed as normal.

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Yet the number of people it would affect would be very small – there are just 1.5 million people living in families with more than £100,000 of ISA savings per adult. If this were to come into force, it would make sense for people to reassess what to keep in their ISA and determine whether it made sense to move it to another tax wrapper.

In this year's Spring Budget, Conservative Chancellor Jeremy Hunt promised an extra £5,000 of ISA allowance strictly for investment in UK assets (the 'British ISA'), albeit without an implementation date. This hasn't appeared in either main party's manifesto, so its future is uncertain. The "pension reforms" promised in Labour's manifesto may include keeping this idea alive as a way to boost investment in the UK. It may even ratchet up even further this quid pro quo of tax savings for investing in UK assets, perhaps by reducing the general ISA annual allowance and adding to the allowance for British ISAs.

That would greatly reduce the choice available to investors and could introduce a large bias to sterling investments in portfolios, which could reduce returns relative to the risk taken on. This bias would create additional risks and require investors to make difficult assessments about whether tax efficiency offsets a balanced portfolio comprising the whole global market. Or Labour could leave the plan by the wayside.

Tax-incentivised investments such as Venture Capital Trusts, the Enterprise Investment Scheme and Business Relief investments are due to come under the microscope in 2025. They offer a range of generous relief from Income Tax, CGT and IHT, yet Mrs Reeves broadly favours these investment vehicles for the effect they have on UK business growth and entrepreneurship. We will have to wait and see what the Budget brings on this front.

There has also been speculation around a few other potential tax changes, which we list below. As with the areas already mentioned, this is only speculation and we don't know what will actually be announced at the Budget.

Inheritance tax

After the 2024 Budget, Labour indicated it supported proposals from the Conservatives to reform domicile status, including the move to a 10-year residence based test for IHT from April 2025. Although IHT is unpopular, Labour has pointed out in the past that a small proportion of the population actually pay it – less than 5% of deaths during the 2020/21 tax year resulted in IHT charges. With an IHT-free band of £325,000 available to all, and another £175,000 for some who leave a residence to their children, there is scope to reduce allowances, exemptions or even increase the overall rate (currently 40% for most).

Non-domicile status

Labour's manifesto pledged to abolish non-dom status and replace it with a system for people in the country for a short period of time. Labour have stated that new rules will be introduced from 6th April 2025. No further details were given, other than pledging to go further than the changes announced in Budget 2024. Currently non-UK domiciled individuals are broadly able to live in the UK for 15 years before their worldwide income and assets fall into the scope of UK tax, however this will be significantly reduced to just four years for capital gains and income tax. For IHT this will be reduced to 10 years. But with only 55,500 non-doms who were UK resident in 2022 it's unlikely to be a big earner for Labour.

Taxation of carried interest

Labour's manifesto pledged to reform taxation of carried interest (income paid to partners of private investment funds), but without further details. In a June interview with the *Financial Times*, Mrs Reeves signalled a Labour government would continue the UK's favourable treatment in instances where fund managers put their own capital at risk, and would hold consultations before making any changes.

Stamp duty land tax

Labour's manifesto pledged to increase the stamp duty surcharge paid by non-UK residents by one percentage point.

Agricultural property relief

Through agricultural property relief, farmers are protected from paying inheritance tax when passing on their farm. There was no mention of removing this relief in Labour's manifesto, but neither has it been specifically ruled out by Labour.

Planning can help

While not triggering the concerns that a more left-wing Jeremy Corbyn-led Labour Government would have raised, Starmer's administration needs to raise money to fulfil its plans to improve a range of public services. To do that, it may make changes to long-standing taxes, allowances, investment schemes and rules that could hit the unwary. Sensible long-term financial planning will help you maximise the opportunities available now and avoid some of the pitfalls the future may bring.

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WHAT CAN I DO ABOUT IT?

If pensions tax relief changes to a standard flat 30%
This would greatly reduce the benefit of surrendering your income to a pension to avoid higher rates of tax. For higher earners, it would also mean paying tax twice — once when it's put in a pension and then again when it's withdrawn as income. Financial advice can help determine whether it makes sense to add to a pension and then how to arrange your affairs to keep taxes to a minimum in retirement.

If dividend tax rates and allowances change
It could make sense to adjust your investment portfolio to reduce exposure to dividend-paying shares in favour of those companies that reinvest in themselves or buy back shares. We suggest talking to an adviser first.

If ISAs are made UK-only investment vehicles
This would be a radical move that would greatly reduce the diversification and potential returns of all UK taxpayers. If it were to be introduced, portfolios would need to be reappraised to determine whether the tax-sheltering benefits of the ISA were outweighed by the lack of diversification and limited opportunities that the wrapper would then offer.

If CGT rates increase or allowances fall
You can crystalise losses before the change, maximising your allowance. Also, you can use losses from previous years to reduce your liability. You have up to four tax years to report a loss to HMRC, but the losses can be brought forward indefinitely. These losses become more useful as CGT rises because it shields a greater portion of gains from tax. You can also defer CGT by investing in the Enterprise Investment Scheme. Although we do not know if CGT rates will increase, there is the potential to realise gains before the budget and hope that any increase in rates will be not backdated to the beginning of this tax year.

If business property relief is removed for certain assets/schemes, or abolished outright
This would bring potentially large portfolios back into an estate for IHT purposes, making them liable for 40% tax. These assets might also be subject to CGT if their value had increased since they had been purchased. Without the generous tax incentives, these riskier assets might no longer be suitable for some investors. These portfolios would need to be carefully reinvested to minimise tax and improve their risk-reward profile. There are also life assurance policies that can be taken out to ensure the money is there to pay any IHT bill on your death.

If CGT relief on death is removed
This would make it more beneficial to make use of allowances and offset losses where possible. Astute tax planning could help reduce tax liabilities and ensure more of your money is passed on to your loved ones.

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