The cost of COVID

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A summary of our findings

The 2020 COVID-19 lockdown has seen many aspects of life in the UK change. The way many of us work has changed. Will communities continue to rally together to support each other and celebrate key workers, or will we return to the old normal? How will furloughed workers find the return to work and indeed how long will those jobs last?

As we move out of lockdown it's important to review the impact on your financial planning. You may have an emergency fund to replenish, a portfolio that needs to recover value, or indeed have decided to reshape your work/life balance. No doubt the government will be doing a similar exercise to balance the nation's finances.

Just like our own budgets, their options are simple. Spend less. Get more money in. Or borrow money.[1]

Government spending has risen and with further job losses we think the breadth of support will need to continue. Indeed, the messages from the government are very much 'spend, spend, spend'.

Tax revenue is already significantly down on last year. With a weakened economy, the money coming in to the government is likely to be lower than anticipated in the Budget earlier this year.

Taking on more national debt has been a temporary solution to the widening deficit, but with debt levels tantalisingly close to 100% of GDP it is not a safe long-term solution. Just like our own borrowings – it must be repaid.

So what might the solution be? Our view is that taxes will rise but there is a need to do this strategically. A false move here could cause the economic recovery to stumble and falter. On balance the most likely target is Capital Gains Tax ('CGT') which is taxed at a very different rate to Income. We anticipate a closing of this gap. As a result, clients with significant unrealised gains may wish to consider paying some CGT now at the current rates.

In this paper we will look at this in detail, highlighting the consequences and opportunities this may present for you. Paradigm Norton's financial planning and tax teams are well placed to help you work out what to do.

How has COVID-19 impacted government spending ...

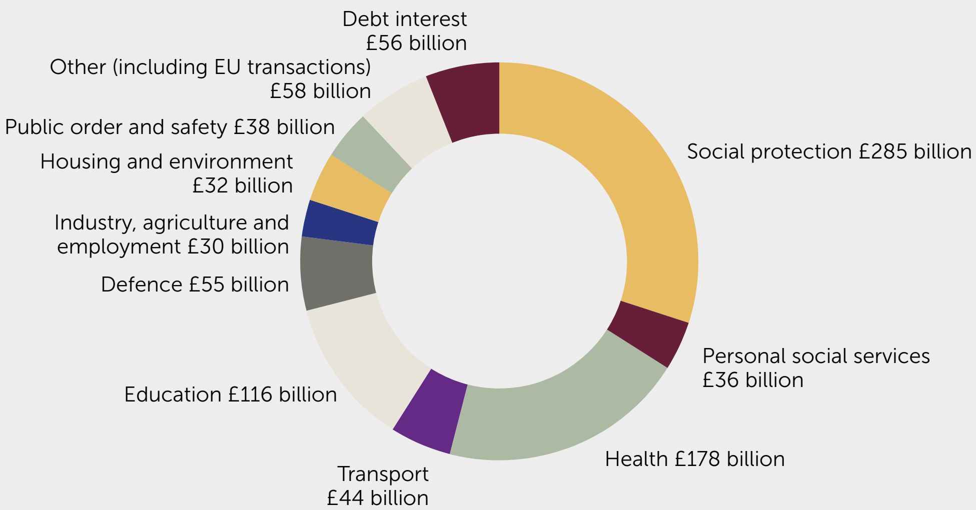
The chart below from the 2020 Budget in March shows expected spending of around £928 billion. This was just under two weeks before the UK entered lockdown and whilst COVID-19 relief was included, it was limited.[2]

During lockdown the State supported 9.4 million jobs (£27.4 billion to 5 July) through the Coronavirus Job Retention Scheme (CJRS 'furlough' support) with further support extended to c2.7 million self-employed people (£7.7 billion to 5 July). Adding in the expected cost of the policies announced on 8 July, around £230 billion has been added to government spending this year.[3]

We expect this to increase as the challenges faced by sectors of the economy, such as aviation and hospitality, bite. A number of large employers have already announced redundancies and as the furlough support reduces, there may be more to come. Some commentators anticipate unemployment rising to around 10%.[4] The State may need to support these individuals for a time through Universal Credit.

The State Pension increases in April each year by the highest of earnings growth, inflation, and 2.5%. The earnings element is based on average weekly 'total pay' (including bonuses) measured in the previous May/July. Initial data suggests that this could be down 2-3% this year due to the CJRS impact and reduced hours.

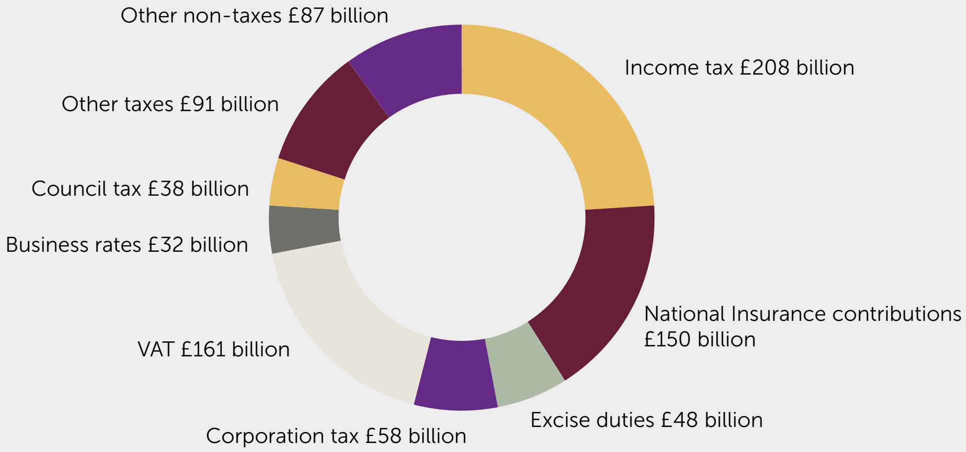
The Resolution Foundation estimates that over the next two years the State Pension could rise by 7.6% against a backdrop of earnings rising by just 1.5%, and inflation around 2.5%.[5]



Figures may not sum due to rounding.
Illustrative allocations to functions are based on HMT analysis including capital consumption figures from the Office for National Statistics

Source: Office for Budget Responsibility and HM Treasury calculations.

... and revenue



Figures may not sum due to rounding.
Other taxes includes capital taxes, stamp duties, vehicle excise duties and other smaller tax receipts. Other non-taxes includes interest and dividends, gross operating surplus and other smaller non-tax receipts.
Source: Office for Budget Responsibility and HM Treasury calculations.

On the income side, 90% of the money central government receives comes via HM Revenue and Customs (HMRC) in the form of taxes and duties. This revenue is down 35% on last year.[6]

Businesses who took up the VAT deferral option will have to pay this back next year. However, with reductions in VAT being used to stimulate certain sectors, and some businesses failing, revenue from VAT is likely to be less than expected. Loss of jobs in these situations is likely to impact both Income Tax and National Insurance revenue.

The economy shrank by 2.2% in the first quarter of 2020, with the hospitality sector hit much harder. During the depth of the crisis (April) Gross Domestic Product (GDP) was 25% lower than in February[7]; there has been some recovery since.[8] This will also have an impact on Corporation Tax liabilities for many businesses.

In the 2020 Budget Chancellor Rishi Sunak expected to receive c£873 billion of tax.[9] If nothing changes, the deficit is likely to be far greater than the planned for c£55 billion.

How has this spending impacted borrowing?

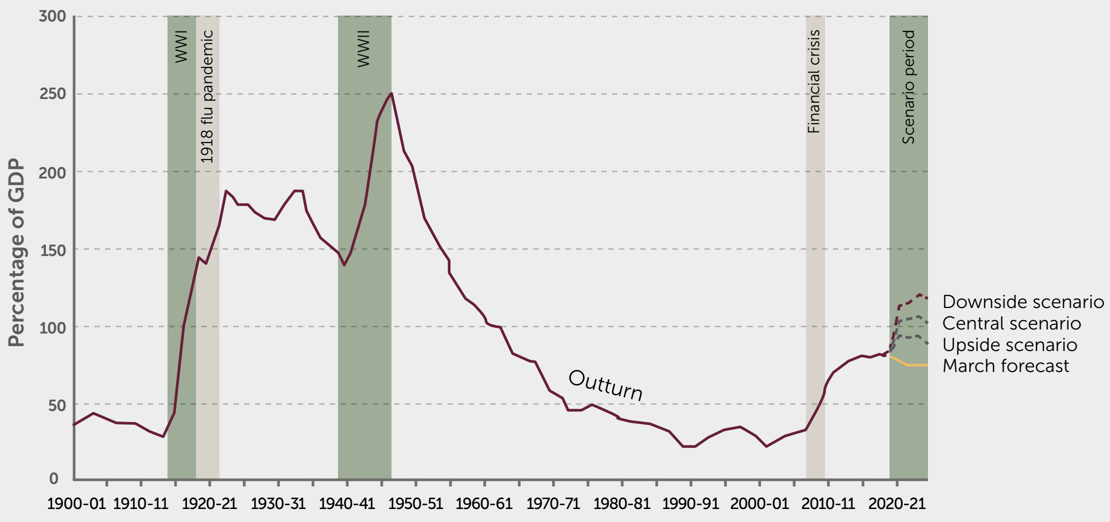
With spending up and tax revenue down, the deficit, covered by borrowing, has increased. Between April and June the government borrowed £128 billion. This is more than double the expectation for the whole year. The Office of Budget Responsibility suggests that this could exceed £300 billion by the end of the financial year.[10]

The UK Government is seen as extremely credit worthy and a safe haven. As a result the cost of servicing debt is relatively low. However, UK Public Sector net debt now stands at £1,983.8 billion.[11]

Combined with a bruised and shrunken economy, this now stands at just under 100% of Gross Domestic Product (GDP) – a level not seen since 1963.[12] Summer spending on holidays and tourism is likely to be lower than previous years. Combined with the spending announced on 8 July[13] this ratio will inevitably increase beyond 100%.

The chart below from the Office of Budget Responsibility puts this in context.[14] The increase in borrowing level is unprecedented in peacetime.

Chart 1 : Public sector net debt: coronavirus scenarios versus March forecast



Source: Bank of England, ONS, OBR

So how might the nation balance the books?

The government has broadly the same options as we do.

Spending less is unlikely to be an option. In previous years much of the 'fat' in departmental budgets has already been trimmed. As we have seen, spending has, and is likely to continue to, increase.

Borrowing more is already forming part of the solution. However carrying high levels of debt over the long term may impact the UK's credit rating. This money does need to be paid back or refinanced in the future.

Earning more which, in this context, means increasing tax revenues. This looks like the most viable and effective solution. Whilst some organisations, such as the Institute for Fiscal Studies, would like to see major tax reform[15] we think that tinkering with the existing structures is more likely, at least in the short term.

Two extreme options that are highly unlikely but worth knowing

Encourage inflation to reduce debt

Rising inflation indicates that the price of goods and services are rising. The pound in your pocket will be able to buy less 'stuff'.

Imagine that your weekly shop cost £100. If inflation was 2.5% p.a. for the next 10 years the cost would have risen to £128. We describe this future cost of £128 as being £100 in real terms.

If our income increases at the same rate, then we can still buy the same amount of 'stuff'. However, if it does not, then we would only be able to buy 'stuff' worth £78 in real terms.

Generally, for governments, revenue increases and debt does not. So having high inflation means that the debt, when it needs to be paid off, becomes lower in real terms. It should therefore be easier to pay off.

This is unlikely to be a serious option for several reasons. The triple lock would lead to increased spending on State Pension. Pensioners with fixed incomes would also be at increased risk of poverty. Indeed, inflation is not really something you can directly control (like a tax rate) and is more of a consequence of wider economics and policy decisions.

Defaulting on the debt

In the past some countries have defaulted on their debt – effectively becoming bankrupt. They were unable to service their debt or make the required repayments, and were unable to come to an agreement with creditors. This has severely impacted their ability to borrow money. It is highly unlikely that the UK would consider this extreme measure.

What taxes could be used to reduce the deficit?

If we set VAT and various forms of Duty (e.g. fuel, alcohol, tobacco) to one side, we broadly have two main types of tax. Taxes on working (e.g. Income Tax and National Insurance) and taxes on wealth (e.g. CGT, Inheritance Tax, Stamp Duties). It's not a perfect split as depending on how portfolios are structured, investors will pay some Income Tax.

Taxes on work

Income Tax represents the largest slice of tax revenue. HMRC's pre-COVID models suggests that changing the basic rate of Income Tax (or indeed National Insurance contribution rates) would provide significant tax revenue.[16] However, we feel that this is unlikely to be used to address the deficit whilst unemployment is rising and the government is seeking to encourage consumer spending. It would be counter intuitive and deeply unpopular.

Likewise, with Corporation Tax. Rates are now very low, but with COVID-19 taking its toll on profits, this revenue stream is likely to be smaller in the short term. Increasing the rate of this tax would potentially damage the recovery.

Taxes on wealth

Some countries, such as France, have had annual wealth taxes for many years. Whilst this was promised by the 1974 Labour Government, it was never implemented.[17] No doubt there will be calls to revisit this, but the lessons from the past suggest that it would be unpopular, complex to administer and there may be a time lag on tax revenue receipts. There is also a risk that those with significant wealth would take action to mitigate it perhaps by leaving the country.

We think that making changes to existing taxes is more likely than the introduction of a new tax on wealth.

In the last few years there has been a major review of Inheritance Tax but no action taken to date. By far the majority of Inheritance Tax is paid on death but for 2018-19 (the latest data we have) this tax only raised c£5 billion.[18] Changes would be complex to introduce and have limited short term impact on the deficit.

Stamp Duty Land Tax has temporarily been relaxed by the government to stimulate the property market. There is a variant of Stamp Duty which applies to share transactions that could be a potential target. However, announcing changes here is likely to cause the public unwanted confusion.

The area that we feel is most likely to be impacted is CGT. This tax is paid on profits when you sell assets such as investments.

What is it about Capital Gains Tax that makes it a target?

On 14 July 2020 the Chancellor of the Exchequer, Rishi Sunak, asked the Office of Tax Simplification (OTS) to review this tax. In his letter[19] he highlights three broad areas to review which we will address here.

• Allowances, exemptions and reliefs

The current regime provides an annual exemption for all UK residents (£12,300 in 2020/21) which we feel broadly meets its objective. Most CGT is paid by high earners.[20]

Reliefs such as Entrepreneurs' Relief (now called Business Asset Disposal Relief[21]) have been tightened in recent years, reducing the lifetime limit from £10m to £1m. As this is designed to encourage people to be entrepreneurial, starting and running their own businesses, we feel it is unlikely to be revised further.

At the moment, CGT is not paid when you sell your primary residential property. Given historic increases in property values, removal of this exemption would raise a significant sum. Thinktank 'Society Market Foundation' suggested replacing the exemption with a 10% tax could raise £421 billion over the next 25 years.[22] However, this unlikely move could create a short-term imbalance between supply and demand at a time the government is trying to revive the property market.

At present gains are not taxed on death and the base cost is 'reset' to the probate value. This is a valuable relief and there has been much talk of reform, including the All-Party Parliamentary Group report in January 2020 which went as far as to suggest that this exemption should be abolished.[23]

Any tax revenue raised would be reliant on the death of investors and may be more politically palatable. We think that the removal of the base cost 'reset' on death presents a real risk to those who are relying on this exemption in their financial planning.

• Treatment of losses

At present, investors can offset capital losses against capital gains. They must be claimed within 4 years of the tax year in which the loss occurs and may then be carried forward indefinitely until they are exhausted. However, if they are not used during lifetime, they are lost.

We think that it is unlikely this facility will be removed, especially in the aftermath of COVID-19. Business failures are inevitable, and removal of this relief could discourage people from investing in businesses.

The economy needs investment to provide jobs, so on balance we think that this is unlikely to be removed. A possibility would be to limit how long losses can be carried forward but this would greatly increase complexity.

Selling holdings at a loss to mitigate potential changes (use it or lose it) might feel attractive. If CGT rates increased, the losses (assuming still relieved) would become more valuable. There's an overused but true saying 'don't let the tax dog wag the investment tail'. Investment decisions need to consider your goals, attitude to risk, and wider financial planning – not just a tax.

• Taxation of gains compared to other types of income

At the moment, capital gains in excess of the Annual Exemption (£12,300 for 2020/21) are taxed at lower rates than Income. The table below illustrates this for taxpayers in England, Wales and Northern Ireland. The situation is similar in Scotland.

	Income Tax (earnings and interest)	Income Tax (dividends)	Capital Gains Tax*
Basic rate	20%	7.5%	10% / 18%
Higher rate	40%	32.5%	20% / 28%
Additional rate	45%	38.1%	20% / 28%

* the lower figure applies to most investments

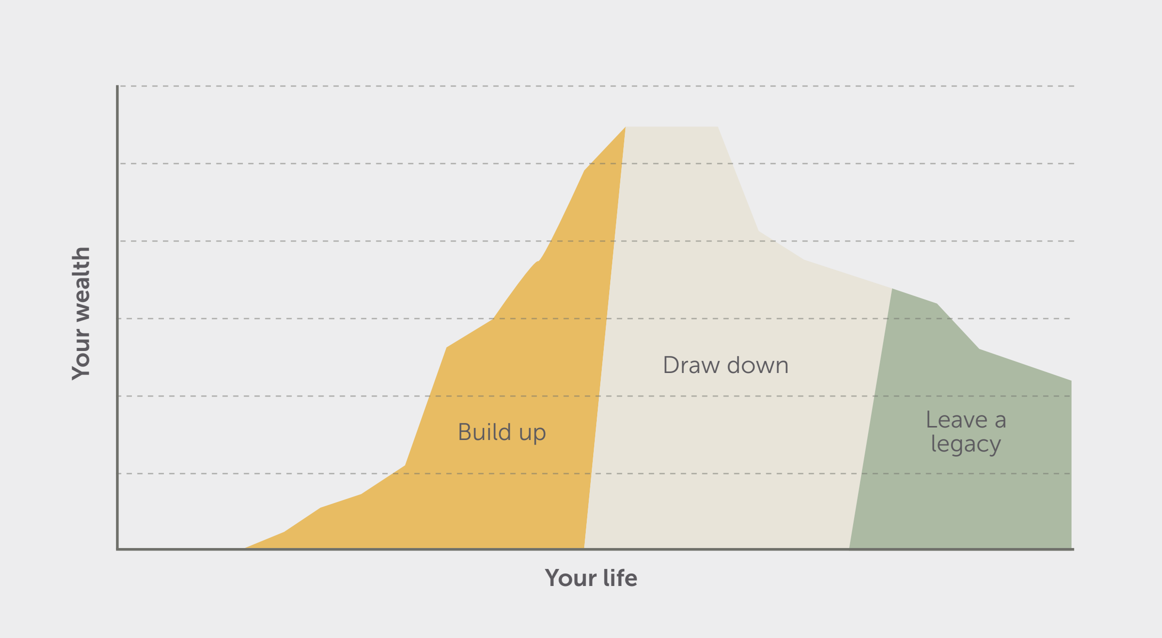
The most recent data[24] shows that most CGT is paid on the largest gains, with 62% of CGT paid in respect of gains over £1 million (3% of CGT-liable individuals). 40% of gains which were subject to CGT came from additional rate taxpayers, who represented 12% of all CGT liable individuals. The tax brings in c£58 billion (including Trusts) and increased by 13% from 2016-17 to 2017-2018.

The current legislation sets out two rates of CGT[25], with the rate determined by the type of asset which is sold (investments are subject to CGT at 10%/20% vs residential property and certain other assets at 18%/28%). The higher rate applies if the taxpayer pays Income Tax at the higher rate (or runs out of their basic rate band).

One possibility would be to create an additional rate for CGT, as there is for Income Tax. Looking at the pattern above, 25% and 30% might be logical. This would be in harmony with the current progressive taxation. However, our tax system is already complex and in need of simplification, with the Office of Tax Simplification established for this remit alone. We feel that such a change is unlikely to be proposed on this basis but is a risk to bear in mind. There would also be a concern about people becoming 'accidental' additional rate taxpayers.

We feel that the Chancellor may take the opportunity to bring CGT rates closer to Income Tax rates. There have certainly been calls for this. Between 1988 and 2008 this is the way gains were taxed.[26] The Chancellor may well find support for this from the other side of the house due to the potential for redistribution of wealth.

What action should you consider?



There are three broad stages in our financial lives. We build up wealth to fund our future lifestyle, then we draw down on it (some might call this retirement). What's left is our financial legacy. Our experience of each stage (and some of us may experience these multiple times) will be unique to us, but there are broad principles that we can all apply.

So, what might we want to think about doing if CGT is potentially reformed in the ways we think it might?

In a 'build up' stage

In balance with your current lifestyle spending you will be focusing on putting money aside for the future. Taking advantage of tax allowances to fund pensions and ISAs is important. Parts of your portfolio which are invested outside of these products may be building up unrealised gains, or losses, (you only pay CGT when you sell the holdings, and realise the gain or loss).

Start by checking what your current position is to understand your exposure to this risk. Consider switching funds to pay CGT at the current rates, rather than the risk of higher rates in the future.

In a 'draw down' stage

Taking money out of your portfolio, to fund your lifestyle, needs to be done carefully. The impact of tax can be managed, to an extent, by drawing on the different pots you have built up. Part of your 'income' might come from parts of the portfolio that attract CGT.

You may want to consider taking steps to reduce your unrealised gains by switching funds within the portfolio or bringing forward withdrawals. This way you will pay CGT at current rates rather than the risk of higher rates in the future.

In the 'leave a legacy' stage

Some of us will be fortunate and find that we have sufficient wealth to not only support ourselves but leave a financial legacy or inheritance. Whilst some people choose to make gifts and legacies during their lifetimes, many use their Will to do this (or a combination of the two).

Under current rules, unrealised capital gains are wiped out on death. Your Estate may have to pay Inheritance Tax but no CGT. If you have investments with very large unrealised gains, it currently makes tax sense to leave them alone until death. It's worth considering whether these investments are still suitable for you based on your attitude to risk and capacity for loss.

If this rule was changed and CGT did become payable on death, this decision would need to be reviewed.

If you are in this situation, you should review your CGT position. It may be worth considering paying CGT on some or all of those gains now reducing the impact of any CGT rate increase. You may also wish to consider bringing forward gifts from your Will and instead make them during your life.

We can help you plan for this risk

These are complex decisions to make and we are not suggesting taking action purely on what we expect may happen. However, changes in tax rates are a risk to consider in your financial plan.

We can help identify how exposed you are to this risk and how it affects your ability to achieve your goals. With a clear view of where you stand we can guide you to make the right decisions.

Paradigm Norton clients benefit from direct access to highly qualified and experienced financial planners and tax professionals. Working in partnership, our teams are well placed to help you align your financial life with your goals.

How we think about tax

We've started to approach all aspects of our business through the three Ps of our B-Corp lens – People, Planet, and Profit. We have a responsibility to consider all three together. We think it's a helpful framework as we think about our footprint in the world (both corporate and personal).

Money matters, but life matters more. If how we handle money means that we can also improve the lives of others that can only be a good thing. So, whilst it is prudent to managing the impact of tax, let's not forget we are part of a bigger whole.

So let's look at how we apply our three P thinking to form a view on tax.

People

Government spending and the way in which it is funded are by no means perfect. There are certainly areas that could be more efficient or are open to abuse. However, the principle of having a State that looks out for those in need is a good thing.

The response to the pandemic kept the roof over the heads of many people. Some 14,500+ rough sleepers[27] were provided with emergency accommodation.[28] And the NHS was given a blank cheque book to get the job done.[29] This type of response for the benefit of the people is not possible without funding – primarily from tax.

Planet

Providing tax breaks (such as for electric vehicles) or targeting tax (such as those on polluting industries) can lead to a better outcome for the environment. Taxes are a way of driving behaviour change.

Like many things, a bit of 'carrot and stick' thinking is needed. Government money has been used to encourage people to have more efficient homes, scrap their old polluting cars, and fund cutting edge research into greening our electricity supply.

Profit

As a business we apply some of our profits to benefit other communities at home and abroad through the Paradigm Norton Trust. Like you may be doing, many of our team support a diverse range of charities (not just through giving). It is possible to have a great impact by giving.

However, there are areas that we cannot easily effect change in, directly, such as protecting homes from floods and refurbishing schools.[30] The taxes we pay on the profits we make, and the salaries we pay, enable government to take on these projects.

Personal financial planning

An adviser from the US, Tim Maurer, put it well when he said 'personal finance is more personal than it is finance'.[31] When we take you through the financial planning process, we explore what's important to you about life. Understanding your goals and priorities is key. We then seek to align your money with your life.

It can be similar with tax. Your personal view of tax is probably somewhere on the spectrum between 'avoid at all costs' and 'sign me up for extra'. Aligning this aspect of your financial life with your views on the 3 Ps is achievable.

Unlike many firms, our clients have access to specialists in both financial planning and tax. Taking an integrated approach ensures that your strategies for life, three P success, and taxes are implemented successfully. Whether you've been a client for 20 years, or we're just starting to get to know you, let's have a conversation about how this approach might benefit you.

Notes and resources

1. Since 1997 responsibility for monetary policy (and the ability to ‘print money’) was passed to the Bank of England, the government does not have the same level of control as other countries.

2. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/878995/Covid-19_fact_sheet.pdf

3. The Office of Budget Responsibility (OBR) have been tracking and projecting the impact of each wave of COVID-19 support measures. https://obr.uk/docs/July-2020-PSF-Commentary.pdf https://obr.uk/download/coronavirus-policy-monitoring-database-14-july-2020/

4. https://www.niesr.ac.uk/publications/prospects-uk-economy-37

5. https://www.resolutionfoundation.org/publications/locked-in/

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10. https://cdn.obr.uk/OBR_FSR_July_2020.pdf

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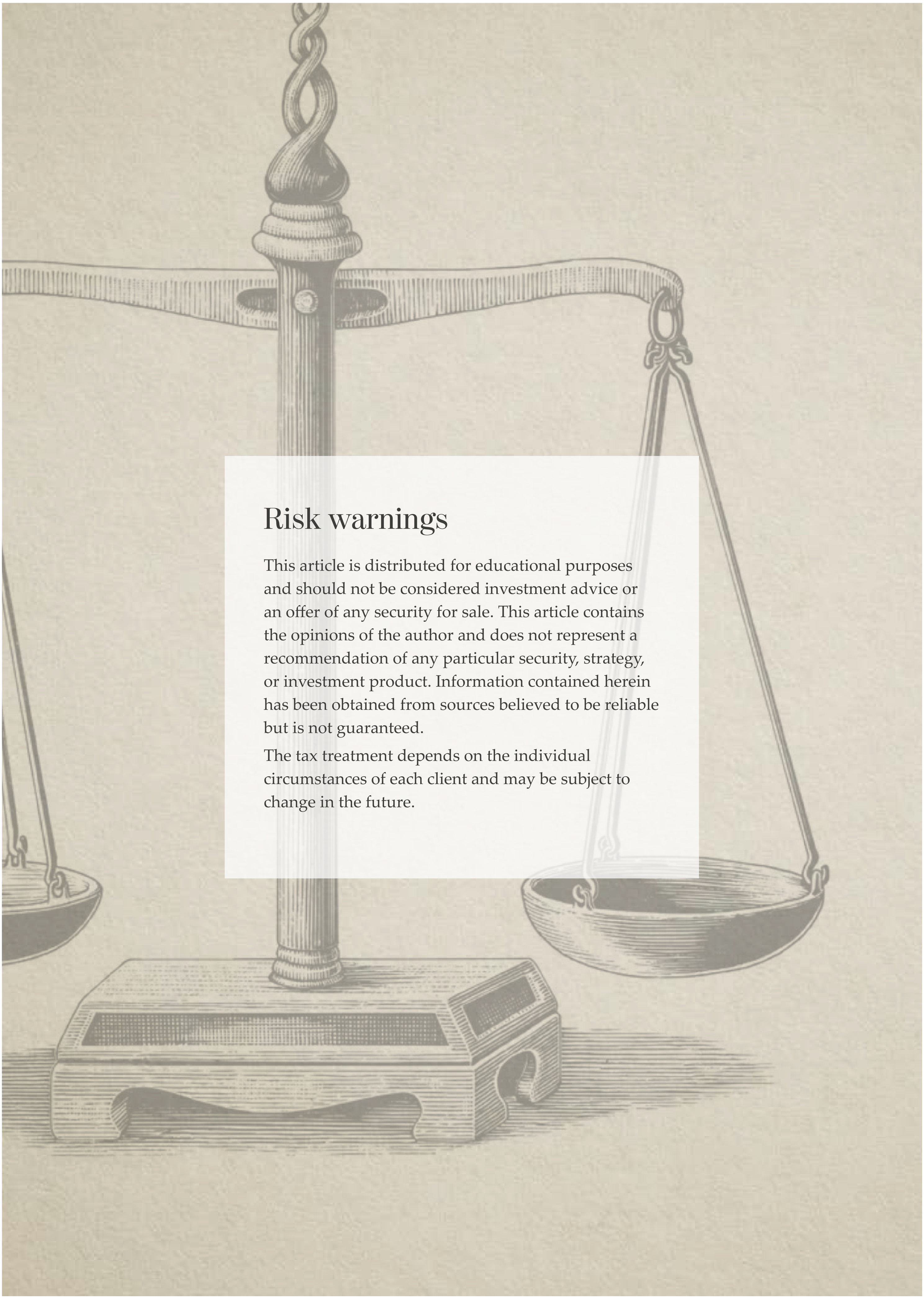
31. https://timmaurer.com/about-tim-maurer/



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The tax treatment depends on the individual circumstances of each client and may be subject to change in the future.

The cost of COVID

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