UK Capital Gains Tax: Where after18%?

A reaction to the 2007 Pre-Budget Report

Richard Murphy FCA[i]

Background

The Chancellor announced in the Pre-Budget Report (PBR) on 9 October 2007:

> *a major reform of capital gains tax, introducing a single rate of 18 per cent from April 2008, ensuring a more sustainable system that is straightforward for taxpayers and internationally competitive.*[1]

This replaced the existing system where the amount chargeable to Capital Gains Tax (CGT) is added onto the top of income liable to income tax for individuals and is charged to CGT if the resulting figure is:

- below the starting rate limit, at 10%,
- between the starting rate and basic rate limits, at 20%,
- and above the basic rate limit, at 40%.

A capital gain under the new scheme announced in the PBR is calculated as the difference between the proceeds of sale less the cost of acquiring the asset. At present this is the start point for calculating the sum liable to tax. Also capable of offset are:

1. **Indexation allowance** if the asset was acquired before 8 April 1998. Indexation allowance is a deduction to allow for the impact of inflation on asset values and is calculated by multiplying the cost of the asset or its value in March 1982 if acquired before then by the increase in the retail price index between the date of acquisition and April 1998. The resulting figure is treated as an additional cost of acquiring the asset.

2. **Taper relief.** This was introduced in 1998 by Gordon Brown to replace indexation allowance from that date onwards. Taper relief reduces a

[1] http://www.hm-treasury.gov.uk/media/B/9/pbr_csr07_chapter5_244.pdf Accessed 15-10-07.

chargeable gain on disposal of an asset dependent upon how long that asset had been owned for before being disposed of. The amount of the reduction also depends on whether the asset was a business asset or a non-business asset.

For disposals of assets after 6 April 2002, the amount of the chargeable gain on the asset remaining chargeable to tax after taper relief is as shown in the following table:

Business asset		Non-business asset	
Number of whole years in the qualifying holding period	**Gain remaining chargeable (%)**	**Number of whole years in the qualifying holding period**	**Gain remaining chargeable (%)**
Less than 1	100	Less than 1	100
1	50	1	100
2 or more	25	2	100
		3	95
		4	90
		5	85
		6	80
		7	75
		8	70
		9	65
		10 or more	60

So, and for example, if a business was sold for £110,000 in May 2007 and had cost £10,000 to acquire in January 2000 then the capital gain would be £110,000 less £10,000 reduced to 25% for charging purposes, giving rise to a capital gain of £25,000 probably subject to tax at a 40% income tax rate resulting in a £10,000 CGT bill, creating the popular notion that this tax was charged at 10% although technically that was not the case.

If the same transaction had been for a non-business asset the gain would still have been £100,000 but the gain would have been reduced to 75% of its value as it would have been held for seven whole years before sale and the tax would therefore have been 40% on £75,000 or £30,000, an effective rate of 30%.

Following the PBR both taper relief and indexation allowance are abolished. An 18% flat tax is charged instead. In the above case both gains would be charged at the same rate on the same sum, with a liability arising of £18,000 in both cases.

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Issues arising

As I commented on my blog immediately after the PBR announcement:

> *the Chancellor is now going to penalise [private equity partners] with an 18% tax rate on all capital gains. This will, incidentally be far too low when applied to non-business assets - leading to all sorts of abuse including the provision of massive incentive for any income to be recategorised as gains - something accountants were immensely good at many years ago before the income tax and capital gains tax rates were aligned for non business assets held in the short term. This will discourage small business and massively encourage financial speculation, which adds no benefit to this country at all. And it will leave private equity partners still paying tax at less than half the rate they should be paying under income tax rules.*[2]

A mass of commentators have now confirmed the validity of that opinion. A strong reaction has already emerged from the small business lobby. As the Guardian has reported[3]:

> *The British Chambers of Commerce, CBI, Institute of Directors and the Federation of Small Businesses have joined forces to put pressure on him in the hope of reversing his decision.*
>
> *Many small businesses were dismayed by the changes to the capital gains tax regime, which scrapped the system of taper relief that reduced the tax on a sliding scale from 40% to 10%, and replaced it with a flat 18% rate.*
>
> *In an open letter to the chancellor, the four organisations described the changes as a "bolt out of the blue" and said the reaction of their memberships "has been so universally strong that we have felt it necessary to write collectively to make clear the depth of our shared concerns".*
>
> *It continues: "The net effect will be to set back the growth of the economy over coming years, by discouraging longer term investment and risk-taking."*
>
> *The letter calls on the chancellor to "pause, suspend your decision and enter into urgent and detailed discussions with the key business organisations to resolve this situation".*

It is important to note that some unions have also criticised the change because:

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[2] http://www.taxresearch.org.uk/Blog/2007/10/09/domicile-private-equity-and-capital-gains-tax/ accessed 15-10-07
[3] http://politics.guardian.co.uk/economics/story/0,,2191341,00.html accessed 15-10-07

1. It has not tackled the issues that needed to be addressed as a result of private equity abuse of CGT;

2. It has reduced the tax rate on speculation, which is a straightforward tax cut for the well off.

Finally, even the investment community is objecting, as noted in the Telegraph:

> *Furious insurers are demanding urgent talks with the Government after it emerged that they will lose billions of pounds in lost revenue should the Pre-Budget proposals for a flat rate of capital gains tax at 18 per cent come into force.*
>
> *The Association of British Insurers fears sales of investment bonds – worth more than £20bn in 2006 – will grind to halt. Returns on life insurance-based products will continue to be classed as income and so higher-rate taxpayers will pay tax at 40 per cent. On the other hand, returns on products such as unit trusts will be treated as capital gains and taxed at 18 per cent. One senior insurance insider called it "a cock-up" and added: "This could be a disaster – we're buggered."*
>
> *Insurers are incensed that they have not been consulted and fear profits could be severely hit. It could render insurance bonds obsolete as an investment bondholder pays twice as much tax as a unit trust investor. A £50,000 investment in an investment bond that grows by 50 per cent would be worth £70,000 after the profits have been taxed at 20 per cent. However, the same investment in a unit trust would have a taxable charge of just £15,800 once the CGT allowance of £9,200 has been taken into account. An investor would pay just £2,844 tax at 18 per cent, compared with £5,000 with an investment bond.*
>
> *Danny Cox of Hargreaves Lansdown, the financial adviser, said: "As a private investor, especially a higher-rate taxpayer, why would you invest in a bond now? The Pre-Budget Report has thrown financial planning into chaos."*

It seems that even this community, from whom a warm welcome should have been expected to support this move have little enthusiasm for it.

The Treasury says that the measures it has announced will raise £350 million in 2008/09, and then £750 million and £900 million in subsequent years. Many doubt this because of the scope for tax planning that the changes create[4].

[4] http://www.hm-treasury.gov.uk/media/F/9/pbr_csr07_annexb_305.pdf accessed 15-1-0-07

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Where now?

The Treasury has said:

> *Certainly we will talk to people [with concerns] but there should be no sense we are softening on this. We have set out what we are going to do and it will happen. We feel we have introduced a major simplification of the tax system and 18% still offers a very significant tax advantage to entrepreneurs compared to ordinary income tax.*

Despite this the pressure on Alastair Darling to reform his proposal will be significant over the coming months and the political pressure from Left and Right on this issue will be immense. The above statement is dogmatic, but not pragmatic. It is apparent that a mistake has taken place. More work on this tax is needed to create a reform to the announcement now made that meets a range of objectives.

The objectives might be summarised as:

1. Simplifying this tax, which is a worthwhile objective, the current structure being overly complicated;
2. Keeping a rate of 18% - now announced;
3. Dealing with the abuse of this tax by private equity;
4. Ensuring that speculation is not favourably treated by the tax system;
5. Promoting enterprise;
6. Preventing the promotion of tax avoidance
7. Ensure employee share saving schemes are not harmed.

This is no small task.

Recommendations

I make the following recommendations:

1. Private equity.

Private equity has exploited two tax rules to create the unacceptable scenario where partners in private equity concerns have been paying tax at lower rates than their cleaners. The first is the domicile rule. It is not practical to return to this

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issue again at this moment. The second has been their success in having income attributed to the 'carried interests' they own taxed as capital gains.

This is the bigger issue. If income from carried interests were taxed as income and not capital gains it would be deemed to arise in the UK in any event and the impact of the domicile rule would be mitigated.

This issue of income attributable to carried interests being taxed as capital gains was not effectively addressed in the PBR. Raising the tax on that sum to 18% from 10% still left the income taxed at a rate less than half of that due under income tax rules.

I have suggested that[5]:

> *[The low rate of taxation of private equity] has arisen as a result of a non-statutory agreement between HM Revenue & Customs and the British Venture Capital Association as a result of which income arising from what is called the carried interest of senior employees in this sector is taxed as a capital gain and not as income. This was intended to reflect the risk these employees took when promoting smaller companies that were often start-up ventures.*
>
> *Over the last few years the nature of the British venture capital industry has changed considerably. It now focuses on buying existing businesses and turning them around by the application of management expertise. The risks inherent in this process are quite different from that associated with business start ups. The skills required are often quite different as well.*
>
> *[As a result the] BVCA agreement [should] apply only to what [should] be termed 'start up funds'. These will be funds that invest 80% or more of their capital in new, start up or mezzanine finance facilities not exceeding £5 million to any one company. The BVCA agreement [should] not apply to funds specialising in what is effectively mergers and acquisition activity.*
>
> *[As a result] the favourable provisions of this arrangement [would] only be available to those for whom it was intended.*

I believe that this move would be immensely popular and is politically feasible. It is a viable platform for requesting change at this time as it incorporates the basic belief that promoting business is of value, but promoting speculation is not.

[5] http://www.taxresearch.org.uk/Blog/2007/10/15/just-imagine-my-pre-budget-speech/ accessed 15-10-07

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2. Calculation of capital gains

This is the core of this issue. The reaction of the business community has created an opportunity to restore the differential between business and other assets. This difference does, however have to be simplified. The existing model is exceptionally complex, and widely criticised.

There is a way of making progress with both simplification and creating appropriate incentives here. First of all a business asset should be defined as any interest owned by an individual in a trading company, or any asset they own for use by them in a trading company they also own, unless in either case that company is quoted on a recognised stock exchange. The latter is a well understood taxation term, as is the definition of trading income.

If a company has non trading income then the gain arising on the sale of the interest should be restricted by the proportion that non trading income bears to total profits before tax as calculated for taxation purposes in the three trading years preceding sale unless the ownership stake is of less than 25% of the business in question when this ratio can be based upon that shown by the published accounts of the company instead. There are strong technical reasons for doing this. This calculation is much simpler than that now in use.

The gain on the sale of business assets should be charged at 18%, as announced in the PBR, but with the rate reducing by 1% for each complete year that the asset has been owned until a rate of 10% is reached.

Share held under SAYE and other share incentive schemes open to all employees of a company should be considered business assets for CGT purposes.

Indexation allowance should be abolished.

The gain on other assets should be charged at the highest of:

a. 18%, or
b. if the gain would, if added to the person's income subject to income taxation have given rise to some or all of that income being charged to tax at 40% then that part which did not give rise to a tax liability at 40% should be taxed at 18% and the remainder should be taxed at 40% less an allowance of 2% for each complete tax year for which the asset has been held until a rate of 18% is charged on the gain in its entirety.

3. Anti-avoidance measures

To protect revenue a new Targeted Anti-Avoidance Rule would be needed. This would ensure that schemes intended to convert income into capital gains for the

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sole or main purpose of saving tax would be declared null and void and the income in question would be subject to income tax in full.

Outcomes

These plans meet the stated objectives:

1. The rate of 18% is used;
2. The private equity problem is tackled;
3. All-employee share schemes keep tax favour;
4. Enterprise is encouraged;
5. Longevity of ownership is rewarded;
6. Speculation is discouraged both by the tax rates and by an anti-avoidance measure;
7. The definition of a business asset is massively simplified over that used now.

The complications are:

1. In the private equity area, but this is an industry that can manage complexity;
2. Tax rates might rise for some small businesses with the loss of indexation;
3. There remains a risk of avoidance behaviour;
4. The calculation of the tax due by an individual on speculative gains is not that straightforward. But nor is it that hard to count the number of years an asset has been held for, multiply it by 2 and deduct the result from 40 to come to the top rate of CGT to be used to calculate the tax due on some or all of the gain.

Political issues

It will take courage to back track from the existing proposal. But it is possible for the following reasons:

1. The private equity issues could be managed by stressing that the change limits the relief to those for whom it was originally intended;

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2. The recreation of the two tiers of gain is at the demand of business. It was assumed they would appreciate the proposed simplicity. As they do not complexity has been added to meet their demands. The claim that simplicity is good for business has been found to not be true;

3. Serious simplification of the existing system will have taken place despite this – making this a tax much easier for anyone to handle in the future. That will reduce the compliance burden on both individuals and businesses.

4. The special case of employee share schemes has been heard.

5. The stated intention of some in the accounting profession to exploit the new rules has been heard, and stifled before opportunity has arisen for them to abuse the generosity of the government, as has happened in the past. This has necessitated these changes.

Conclusions

Reform of the proposed new structure for Capital Gains Tax is possible.

But will the Chancellor have the courage to do it?

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[i] Richard Murphy is a chartered accountant and graduate economist. He trained with KPMG in London before setting up his own firm in 1985 in London. He and his partners sold the firm in 2000 when it had 800 clients. He is a serial entrepreneur, having directed more than 10 SMEs.

Since 2000 Richard has increasingly been involved in taxation policy, both as an adviser and campaigner. He is director Tax Research LLP and advises the Tax Justice Network, the Publish What You Pay campaign and many NGOs on tax and development.

He is a member of the ACCA's Research Committee and is a research fellow at the Centre for Global Political Economy at the University of Sussex and at the Tax Research Institute at the University of Nottingham.

A regular radio and TV commentator on tax and corporate accountability, he has also addressed UN, EU, HMRC and international diplomatic meetings on these issues. He writes a daily blog at www.taxresearch.org.uk/blog

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