Capital gains tax : background history

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Capital gains tax (CGT) was first introduced in 1965 on gains made on the disposal of assets by individuals, personal representatives and trustees. This note provides a short history of the tax up to 2007.

Prior to April 2008, capital gains were treated as the top slice of income, and the tax was charged at the same rates of tax as savings income (10%, 20% and 40%). In the Pre-Budget Report on 9 October 2007 the then Chancellor Alistair Darling announced a major reform of CGT: the withdrawal of taper relief and indexation relief, and the introduction of a single rate of tax set at 18%, to take effect from 6 April 2008.[1] These reforms were confirmed in the Labour Government's Budget in March 2008, along with the replacement of taper relief and indexation allowance for CGT with a new tax relief – entrepreneurs relief.[2] These developments are discussed in a separate note.[3]

Guidance for taxpayers on the operation of CGT is collated on HM Revenue & Customs' internet site.[4]

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1 HC Deb 9 October 2007 cc169-70; HM Revenue & Customs Pre Budget Report Note PBRN17, *Capital gains tax reform*, 9 October 2007
2 HC 388 March 2008 paras 4.41-2
3 *Capital gains tax : the 2008 reforms*, Library standard note SN/BT/4652, 2 June 2010
4 http://www.hmrc.gov.uk/cgt/index.htm

A. Introduction

Capital gains tax (CGT) is charged on gains realised on the disposal of assets. For this purpose the disposal of an asset includes any occasion when the beneficial ownership of part or all of an asset is transferred from one person to another (although most transfers between husband and wife, or between registered civil partners, are treated as giving rise to neither gain nor loss). Types of disposal include sales, gifts, exchanges or generally when the owner of an asset derives a capital sum from it, but the death of an individual is not treated as a disposal of his or her assets.

The capital gain is broadly the difference between the disposal proceeds and the cost of acquiring the asset. In some circumstances, the market value of the asset at the time of acquisition/disposal is used. Expenditure which has increased the asset's value may be deducted, as may the incidental costs of acquisition/disposal. There are various reliefs and exemptions which may reduce the amount of CGT to be paid. For example, there is normally no CGT liability on the disposal of a person's main or only home.

Capital losses may be deducted from gains chargeable in the tax year in which the losses are incurred or, if these gains are insufficient, the unused losses may be carried forward to be deducted from gains in later tax years. Capital losses may be carried back to earlier tax years in only very limited circumstances.

The current capital gains tax system generally only taxes gains which have arisen since March 1982. *Prior to April 2008*, chargeable gains were tapered according to the length of time an asset had been held. The taper was more generous for business assets than non-business assets. Taper relief was introduced in the March 1998 Budget, as part of a wider reform which saw the withdrawal of indexation allowance (which provided relief for the effects of inflation on asset values), and the phasing out of retirement relief over a five year period. Chargeable gains, after reliefs, were taxed at rates equivalent to the individual's marginal income tax rate as if they were an additional amount of taxable income (taxable savings income from 1999-2000).

Corporation tax is charged on the capital gains of companies. Gains are calculated in the same way as for CGT except that companies that companies have no exempt amount and company gains are not affected by the reforms made in 1998 to CGT. Before 1987 gains charged to corporation tax were reduced by a specified fraction to produce the equivalent of the tax rate on gains by individuals.

Receipts from CGT were £7.9 billion in 2008-09; by comparison receipts from income tax were £148 billion in this year.[5] In the same year, it is estimated that 130,000 individuals paid CGT, whereas 31.3 million people paid income tax.[6]

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5 HM Revenue & Customs, *National Statistics : Table 1.2*, March 2010. The figure for CGT receipts excludes tax on capital gains made by companies.

6 HM Revenue & Customs, *National Statistics : Table T1.4*, April 2010

A summary of the main changes made in the structure of the tax over the last twenty years is given below:[7]

- in 1982 an indexation allowance was introduced. This allowance is the difference between the cost incurred and the same costs indexed by the Retail Prices Index;

- in 1988, the cost of assets held at 31 March 1982 was 'rebased' to their market value at that date to ensure that gains accruing before then were not charged to tax. In that year, the rate of capital gains tax was aligned with the rates for income tax. Capital gains were thereafter, in broad terms and after deducting any allowances and reliefs available, taxed as if they were the top slice of an individual's income;

- since November 1993, it has not been possible to use indexation allowance to create or increase a capital loss.

- in 1998 indexation was withdrawn for periods of ownership after April 1998. Instead chargeable gains are now tapered according to the length of time that the asset has been held after 5 April 1998. The taper is more generous for business assets than for non-business assets … Assets acquired before 17 March 1998 qualified for an addition of 1 "bonus" year to the period for which they are treated as held after 5 April 1998. The taper is applied to net gains that are chargeable after the deduction of any allowable losses. Losses are set against gains in the order that produces the lowest tax charge. Also, the rate applicable to trusts was extended to include interest in possession trusts and personal representatives, previously chargeable at basic rate;

- in 1999, capital gains tax rates were partially aligned with the income tax rates on savings income, giving rates of 20 per cent and 40 per cent for individuals;

- in 2000, business asset taper rates were modified so that the taper matures after 4 years instead of 10 and the definition of business assets was widened. Business assets acquired before 17 March 1998 no longer qualify for the bonus year in calculating the appropriate taper relief fraction to apply to gains. Also capital gains tax rates were fully aligned with the income tax rates on savings income to include the starting rate of 10 per cent;

- in 2001, the definition of business assets was further extended, with effect from April 2000, to employees disposing of shares in non-trading companies where they work so long as they do not have a material interest of more than 10% in the company;

- in 2002, the business asset taper rates were modified so that the taper matures after 2 years rather than 4. In both 2002 and 2003 there were a number of simplification measures … in 2004 the definition of business assets was again extended to cover all assets used wholly or partly for the purposes of an individual's trade irrespective of whether the owner is involved in carrying on the trade concerned. Also, the rate applicable to trusts was increased to 40 per cent.

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[7] Adapted from, HM Revenue & Customs, *National Statistics - Capital gains tax: introduction*

B. Should capital gains be taxed separately?

CGT is charged on gains in excess of the annual exempt amount, which for 2010-11 was set at £10,100. This compares with the personal tax allowance – which all taxpayers may set against income tax – which was £6,475 for the same tax year.

There are some obvious advantages to having an annual exemption amount for CGT. First, in practical terms, it removes many small gains out of tax, reducing the Revenue's administrative costs at relatively little revenue loss. Certainly withdrawing the annual exemption without increasing the personal allowance would increase the numbers of taxpayers paying tax on their capital gains, given that most taxpayers with capital gains will have incomes in excess of their personal allowance. Second, it is arguable that some acknowledgement should be made of the fact that the costs of assessing annual capital gains for tax purposes are likely to be much greater than those of assessing one's annual income.[8] Notably in their 2008 Green Budget, the Institute for Fiscal Studies suggested that the two allowances could be merged:

> A final issue to address is the continued separation of the CGT allowance from the income tax allowance, so that the CGT allowance cannot be set against income and the income tax allowance cannot be set against capital gains. This separation rewards people who in a given year have some income and some capital gain, rather than exclusively one or the other. There seems to be little rationale for having large separate allowances. Beyond a *de minimis* allowance specifically for capital gains (much lower than the current one) to avoid the burden of CGT compliance for those realising trivial gains, it would make much more sense to have a single allowance to set against both income and capital gains.[9]

In turn, this raises the much wider question of why gains should be taxed separately, rather than simply being treated as a component of income – as happens in some other countries. One concern that might be raised over such a move is that it would ignore some basic differences between income and gains. This question is taken up in a standard work on the UK tax system, as part of its analysis of how 'income' may be defined for tax purposes – an extract is reproduced below (*emphasis added*):

> It may seem trite to observe that to operate an income tax it is necessary to have a clear definition of what constitutes 'income', but the sad truth is that no single definition of income commands universal assent. Those who either doubt, or are surprised by, this statement are referred to the voluminous literature on the subject (some of which has been brought together in the volume edited by Parker and Harcourt (1969)[10]). One of the most popular definitions of income remains that of Hicks (1939)[11] who suggested that 'income is the maximum value which a man can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning' (p. 172). Unfortunately, it is not an operational definition, either for an accountant or a tax inspector. The difficulty lies in the word 'expect'. How can

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8 A point made in Bill Robinson, "Reforming the taxation of capital gains, gifts and inheritances", *Fiscal Studies* vol.10 no.1 February 1989 p 35 – though the author was critical of the *size* of the difference between the ordinary personal allowance and the annual exempt amount.

9 *The IFS Green Budget 2008*, January 2008 p224

10 RH Parker & GC Harcourt (eds), *Readings in the concept and measurement of income*, 1969

11 JR Hicks, *Value and capital: an inquiry into some fundamental principles of economic theory*, 1939

other people possibly determine what I expect? And what are they to do if my expectations are unreasonable? Accountants and revenue officers must work with verifiable facts, and hence they must look, not at what I could have expected to consume during a week or a tax year, but rather at what I could in fact have consumed while still remaining as well off at the end as at the beginning.

> Unfortunately, these two concepts are not the same. If things always materialized as I expected, then there would be no divergence between them; but of course things never do. Consequently, if events go well for me in some particular year—I win the pools, my shares prosper, and my forgotten rich Australian uncle dies—my receipts in that year will be greater than I could have expected them to be, or can expect them to be next year. My 'income', defined in terms of what I could have consumed in that year, will be greater than my income in the Hicksian sense of what I could have expected to consume and greater than my long-run spending capacity. Conversely, if I have an unexpectedly bad year, in which my shares collapse, I lose my job, and my wallet is stolen, my receipts fall below my permanent income; anyone who looks at my accounts will see a gloomy picture, but an unduly gloomy one, because these unexpected adversities are unlikely to happen again. An omniscient auditor or tax inspector would seek to remove from the published figures the influence of such events.

> Of course, there is no practicable method of doing this; but in raising the problem *we can see why the taxation of capital gains, and capital receipts generally, has posed such difficulties for the income and corporation taxes of this and other countries. The problem is that capital gains may arise for a variety of reasons and we would wish to differentiate between the components of capital gains, some of which are equivalent to other components of income and others of which are not.* This is clearly impossible and in practice we can only adopt some rather crude categorization which is based on things we can actually measure. The distinction between the expected and the unexpected can never be observed, and after a careful consideration of the problems involved Hicks came to the following conclusion about concepts of income, including his own: 'They are bad tools, which break in our hands' (1939, p. 177). [12]

In an analysis of capital gains taxes across countries, one study of tax policy in OECD countries noted a number of problems with taxing gains in the same way as income:

> Whether a country opts for a separate capital gains tax or to tax capital gains through the income tax is perhaps primarily a matter of administrative convenience, but the relative tax treatment of income and capital gains raises more substantial issues …. In addition to the fact that inflation may erode the value of capital gains more seriously than income, another argument in favour of preferential treatment of capital gains is the bunching problem … [that] capital gains may be very heavy in one year, but there may be no gains or even losses on the sales of similar assets in another year.[13]

It went on to note certain advantages to doing so:

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[12] JA Kay & MA King, *The British tax system (5th edition)*, 1997 pp 96-98

[13] K Messere, *Tax policy in OECD countries: choices and conflicts*, 1993 p 316, 312. [One issue the author does not touch on here is that in assimilating capital gains to income, the treatment of capital losses – and the extent to which taxpayers would be allowed to offset them against income tax – would pose a problem.]

> Against preferential tax treatment for capital gains is the vertical equity argument that beneficiaries of capital gains are likely to be in the highest income groups, and the tax avoidance point that significant preferential treatment for capital gains over income is likely to induce artificial conversion of higher taxed income into lower capital gains. Another equity argument … is that the asset-holder has already benefited from the postponement of payment of the tax from when it accrued to when it is realised.[14]

Of course, as with any tax, it is the historical development of CGT – rather than academic considerations – that has been critical in shaping its structure, and the remainder of this note focuses on this.

C. Reforms to CGT in the 1980s

The first moves toward a tax on capital gains were made in 1962, when Selwyn Lloyd introduced a short term gains tax, aimed exclusively at speculative gains. Gains made on shares and securities held for less than three months - and those made on land held for less than three years - were taxed as income. Capital gains tax as it was introduced by James Callaghan in 1965 was far more comprehensive. It comprised both a short term gains tax - by which taxable assets acquired and realised within twelve months were assessed to income tax - and, a long term tax on assets held over one year, which were charged at 30 per cent. The tax applied to the total net gains realised in the tax year on all assets, save those specifically exempted. Since 1971, there has been only one comprehensive tax on capital gains.

In its original form CGT made no allowance for inflation, and as a result, those who held assets over the long term found that they were being taxed on nominal gains only. This was a particular problem during the 1970s, as the UK's average rate of inflation was far above what had previously been experienced since 1945. The then Chancellor, Sir Geoffrey Howe acknowledged this problem, in his Budget statement, following the Conservatives General Election victory in 1979: "The objection to CGT in its present form is that most of the yield comes from paper gains arising from inflation. The tax is, therefore, a capricious and sometimes savage levy on the capital itself."[15] However, the problem of indexation was only addressed in a series of measures introduced from 1982 to 1988.

Initially a scheme of indexation was introduced to cover gains enjoyed after April 6 1982.[16] It indexed by reference to original acquisition costs (along with any expenditure made to enhance the value of the assets), though it only allowed for inflation occurring after March 1982. When calculating how much someone had gained from the sale of an asset, the price at which they had bought it - plus any allowable expenditure on it - would be increased by the proportion to which prices had generally increased since March 1982 (with the result that taxable gain would be cut). In addition, the annual exemption was raised from £3,000 to £5,000 and provision was made for it to rise automatically in line with inflation each year.[17] However, the allowance did not apply to assets which had fallen in nominal terms, and it could not be employed to turn a

[14] *Tax policy in OECD countries*, 1993 p 316
[15] HC Deb 12 June 1979 c 255
[16] under ss 86-87 of the *Finance Act 1982*
[17] under s 80 of the *Finance Act 1982*

gain into a loss for tax purposes (ie, if a nominal gain had been more than outstripped by inflation). No relief was given in respect for the first year of ownership.

Indexation worked in the following way: if someone bought an asset for £2,000 in 1982 then sold it six years later for £2,500, without indexation they would have been charged CGT on a gain of £500. If prices had, in this period, risen by 10%, then under the new scheme, their taxable gain would be only £300.[18] The scheme penalised those who had bought assets before 1982. If someone had purchased the same asset, but in 1970 for only £500, their realised taxable gain in 1988 would be £1,950 (since, for tax purposes, the indexed selling price would be £550); that is, an indexation allowance worth only £50 rather than £200.

In 1985 Nigel Lawson, who was then Chancellor, commented in his Budget speech on the fact that CGT still had a number of defects, "notably its combination of unfairness and complexity." He proposed to "build on the important change made by my predecessor three years ago when he introduced the 1982 indexation relief," by introducing three amendments. This was necessary because "that relief, valuable though it is, and increasingly valuable as it will become, suffers from three serious limitations."[19]

First, the twelve month rule - that meant indexation relief was not given for disposals made within a year of purchase - was abolished. Second, in the case where assets had been bought before 1982, the indexation allowance would be calculated by reference to the market value on 31 March 1982 (where this was greater than the original purchase price - plus enhancing expenditure).[20] Third, indexation was extended to losses. If someone had bought shares for £2,000 in 1982, and these had fallen in value to £1,000 by 1988, then their loss - allowable against tax - would be £1,200 (assuming that, as in the example above, prices had gone up by 10% in these six years). If someone had made a nominal gain of only £100 - only 5% growth for the period - then they could claim a loss of £100 against CGT.[21]

Finally in 1988, the matter of inflationary gain predating March 1982 was tackled: CGT was fully rebased by reference to market value on March 31 1982. For all disposals on or after 6 April 1988, that part of any capital gain which arose before April 1982 was made exempt from tax. In announcing this measure, the then Chancellor Nigel Lawson concluded "this Budget thus ends once and for all the injustice of taxing purely inflationary gains. This will benefit the economy by unlocking assets which have been virtually sterilised because of the penal tax that would have arisen on any sale. And it will help many small business men and farmers in particular." The annual exemption limit, which had by then risen to £6,600, was cut back to £5,000, though its value remained pegged to the retail price index; as Mr Lawson went on to explain in his Budget speech, "the relatively high level of this threshold stems from the substantial increase my

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[18] ie, the realised gain is now the selling price minus the indexed purchase price, where the indexed purchase price is £2,200 [£2,000 X 1.1].

[19] HC Deb 19 March 1985 c 795

[20] In the example given above - an asset bought for £500 in 1970, and sold for £2,500 in 1986 - the indexation allowance was now £200 (the same allowance as if the asset was bought in 1982 at £2,000), reducing the taxable gain from £1,950 to £1,800. Assuming CGT charged at a rate of 30 per cent, this would represent a cut in tax, from £585 to £540.

[21] These changes were implemented under s 68 & schedule 19 of the *Finance Act 1985*, and came into effect from 6 April 1985 (1 April, in the case of companies). The then Chancellor Kenneth Clarke announced the withdrawal of indexation for losses from April 1994 in his November 1993 Budget (HC Deb 30 November 1993 c 932). Legislation to this effect was made under s 93 of the *Finance Act 1994*.

predecessor made in 1982 explicitly as a rough and ready partial compensation for the continued taxation of pre-1982 paper gains."[22]

The solution of the problem of taxing only real gains suggested that - for the purposes of taxation - income and capital should be treated in the same fashion. At that time, capital gains were taxed at 30 per cent for all taxpayers, while income would either be taxed at the basic rate of 25 per cent, or the higher rate of 40 per cent. Mr Lawson argued that there was no longer a case to preserve this different, and that proposed that from 6 April 1988, income and capital gains would be charged to tax at the same rates:

> Rebasing the tax so as to produce a fully indexed system makes it possible to bring the taxation of gains closer to that of income. In principle, there is little economic difference between income and capital gains ... and in so far as there is a difference, it is by no means clear why one should be taxed more heavily than the other … I therefore propose a fundamental reform. Subject to the new base date, capital gains will continue to be worked out as now, with the present exemptions and reliefs. But the indexed gain will be taxed at the income tax rate that would apply if it were the taxpayer's marginal slice of income. In other words, I propose in future to apply the same rate of tax to income and capital gains alike …
>
> The changes I have announced represent a thoroughgoing reform of capital gains tax which will benefit the economy and eradicate a major injustice. They will sharply reduce the damaging effects of the tax, while ensuring that capital gains remain properly taxed and the yield of income tax adequately protected.[23]

D. The case for 'tapering'

During the early 1990s several commentators argued that the structure of CGT made no allowance for the length of time taxpayers held onto assets, and that 'tapering' the rate of CGT, so that assets held for a given number of years would be charged a lower rate of tax, would have a beneficial influence on investment. It was suggested that without tapering, CGT discouraged investment over consumption, short term holdings over long term investment, and the purchase of assets in long-established 'blue chip' companies rather than in new small businesses.

There were two aspects to this argument: the need to properly reward the risks of the individual entrepreneur and investor in new ventures; and, the need to tackle perceived 'short termism' of shareholders. To some extent the debate conflated the two, though the difficulties facing businesses to successfully attract investment will differ quite significantly given their size, age and share structure. One reason for this was that some of those supporting a move to tapering regarded the abolition of CGT as a desirable long term goal, and that gains from investment should not attract tax on principle.

Though it might appear that tapering CGT met both concerns – investors' rewards and shareholder short termism – two points are worth making. First, even before the changes in CGT introduced in April 1998, investors benefited from a number of existing reliefs by investing

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[22] HC Deb 15 March 1988 c 1005

[23] HC Deb 15 March 1988 cc 1005-1006. Provision was made under ss 96-103 of the *Finance Act 1988*.

a chargeable gain in an unquoted trading company (under the provisions for reinvestment relief), or by using one of two tax-privileged schemes for investment in the unquoted sector (the Enterprise Investment Scheme and Venture Capital Trusts).[24] Second, in considering the impact the tax structure might have on the pattern of investment, it is important to recall the context in which taxable capital gains are being made. In the quoted company sector, well over half the equity in stock-market listed companies has been held by financial institutions. Any short termism on the part of pension funds and insurance companies could not be attributed to CGT, as these institutions are exempt from the tax.[25]

Nonetheless the Institute of Directors, for one, suggested the main cause of the UK suffering from a lack of efficiently invested risk capital was “that the present tax system does not recognise the major differences between short-term and long-term gains.” The IoD made this case in a 1994 paper on capital gains, arguing “there may be a case for taxing short-term gains which are, in essence, of the nature of trading rather than investment ... there is no economic or other merit in taxing long-term gains.”[26]

The Institute made a number of arguments to support this claim, perhaps the most important of which was that the design of the tax was based on the assumption that the gains and losses from all types of investment are both regular and predictable. In general terms the most productive type of investments are long term ones where the risk of realising a loss is relatively high. If a loss is made, the investor is unlikely to have realised sufficient gains from other assets at that time to fully offset that loss against tax. If a gain is made, the investor will see a substantial part of this - usually 40%, once their annual allowance is accounted for - taxed immediately. The IOD argued that investors would be encouraged to invest in assets they can realise easily - such as publicly quoted shares - to turn over the assets in their portfolio relatively regularly, and to consume disposable funds they have rather than invest them. As a result investment in unquoted shares, family companies, venture capital enterprises, property and works of art was discouraged, clogging the market, restraining growth and eroding the amount of capital individuals have to invest.

At this time the CBI also made a case for tapering, although it tended to emphasise the need to encourage a long-term view among investors, rather than to adequately reward entrepreneurs:

> A change to the system of tapered CGT for corporate equity is … recommended, which proposes moving below [a tax rate of] 20% for some holdings. The higher rate should remain at 40% for short-term gains (up to one year) but be tapered for longer-term holdings to around 10%. That would encourage individuals to take a longer-term view. It would also remove the anomaly of paying a high rate of tax on a gain on an indivisible asset, which had been built up over a long period. This reform of CGT would be expected to cost very little in the first year, as it might lead to the realisation of profits presently ‘locked in’ because of the high 40% rate.[27]

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[24] Prior to April 1998 individuals also benefited from the provision of retirement relief, discussed below.

[25] A point made by the Institute for Fiscal Studies in its 1995 Green Budget (IFS, *Options for 1996: the Green Budget*, October 1995 p 57).

[26] IoD, *Tax on Capital Gains*, 1994 p 1, pp 4-5. The next year the Institute proposed that assets held for more than three years should be free of tax, and the CGT charge should be tapered for assets held for less time than this (*Budget ‘95 - A Budget for Business*, September 1995 p 17).

[27] CBI, *The Way to Balanced Growth*, September 1994 p 10. The CBI reiterated its concerns about the distortionary impact of CGT in its Budget submission the following year (*Keeping a Steady Course*, September 1995 p 10).

The *Times* saw a short correspondence on the merits of tapering in October 1995 following a piece by Kenneth Baker MP, arguing that tapering was a preferable alternative to abolishing CGT outright, given the cost of abolition.[28] One correspondent argued that if "CGT were to be tapered out ... all the old avoidance dodgers would be brought out and dusted off. It would be fascinating to observe the changes in the balance between salary and share options of, for example, directors of privatised utilities." A second noted the existing provision of reliefs: "Haven't we got retirement relief, roll-over relief, reinvestment relief, personal equity plans, annual exemption (of as much as £12,000 for those still married) and indexation? If people wish to spend the gain other than paying into a pension policy why on earth shouldn't they be taxed?"[29] In response to these points, David Shaw MP and Bernard Jenkin MP underlined what they saw as the principle of this reform:

> Capital formation is a more valuable activity for the economy than mere earning. It is also much more difficult to achieve. It is therefore wrong for taxation to regard income and capital gains similarly, as now ... The array of reliefs, exemptions and allowances [now given] ... are simply attempts to ameliorate the damage [CGT] causes to saving and enterprise. [30]

In its Green Budget in October 1995 the Institute for Fiscal Studies was strongly critical of the case made for tapering capital gains, arguing that the relatively small amounts of revenue raised by CGT should not blind commentators to the primary purpose of the tax:

> It should be noted that capital gains tax currently raises less than £1bn from individual investors, and is only paid by around 85,000 people. We continue to have capital gains tax primarily as an anti-avoidance measure. Many wealthy individuals, including company directors, could relatively easily convert part of their income into capital gains, and would have a strong incentive to do so if capital gains taxation were abolished or the rate lowered. The existence of capital gains tax prevents this incentive from being too great, and therefore protects the income tax base. The implications of abolishing capital gains tax, both for government tax revenues and for the distribution of post-tax incomes, are much greater than would appear to be the case from the small amount of revenue that this tax raises.

It went on to argue that the structure of the tax did not foster short termism in large companies, nor did it present a significant barrier to investment in either new or existing enterprises:

> Some evidence that 'short-termism' is a problem facing large UK companies comes from the unusually high dividend pay-out ratios[31] and levels of take-over activity (particularly hostile take-over activity) found in Britain … Action using the tax system to deal with these concerns would require either bold measures to correct the bias in favour of dividend income currently facing tax-exempt institutional investors … or to limit the ease with which hostile take-over bids can be made, rather than largely irrelevant changes to capital gains tax legislation …

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28 "The taxes that we should cut", *Times*, 17 October 1995

29 "Letters: Opportunities in the Budget", *Times*, 23 October 1995

30 "Letter: Capital growth and tax reform", *Times*, 27 October 1995

31 (The changes made to dividend taxation in the Labour Government's July 1997 Budget – specifically the abolition of reclaimable tax credits on dividends paid to pension funds and corporations – were justified by reference to this pattern in pay-out ratios. The issue is examined in *Advance corporation tax and pension funds*, Library standard note SN/BT/581, 9 July 2007.)

Small companies, rather than being largely owned by institutional investors, are often entirely owned by their original founders or close family members. The existence of capital gains tax raises two sets of issues for this type of company. The first is whether or not the existence of CGT discourages individuals from leaving full-time employment to set up in business by themselves. The second is whether or not CGT discourages individuals from realising the gain on past investment and using the funds in more lucrative areas …

In the past, there have been potentially large differences between the rate of tax on income and the rate of tax on capital gains. This provided a tax incentive for individuals to take the risk of setting up in business by themselves, given the existence of opportunities for taking cash out of a business in the form of a capital gain rather than as income. However, since 1988 this incentive has been significantly reduced, now that the marginal rate of tax on capital gains is set at the individual's marginal income tax rate. It has been argued that lowering the rate of CGT, i.e. restoring this differential between the treatment of income and capital gains, would provide a helpful incentive to entrepreneurs to establish new, riskier ventures. But even if we accept the case for trying to encourage people to take more risks, the alternative of providing specifically targeted schemes, such as the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs), seems a more sensible response to this problem.

The second issue relates to companies already in existence. It is argued that capital gains tax locks individuals into holding on to an investment that they would prefer to sell, because of the tax that would have to be paid. In the case of the sale of business assets, however, it is often possible to postpone the payment of tax (thus reducing the present value of the tax), if the gain from the sale is reinvested in another form of business asset. The principal reliefs from capital gains tax when the gains are reinvested include reinvestment relief, hold-over relief, roll-over relief and reliefs aimed at investments in particular types of companies. All have rules about the exact type of investment that qualifies for relief (usually in a qualified unquoted company), the amount of gain that can be postponed (up to £100,000 a year in some cases) and the length of time that the tax payment can be put off (often until the new asset is itself sold). Although there may be a case for some simplification in this area, these schemes are designed to reduce the problem of capital being `locked in' to less profitable investments, or to encourage investment in riskier ventures, which addresses the two main objections to CGT from small companies.

In addition to the above reliefs for capital gains tax, individuals selling their business on retirement can get full exemption from CGT, for capital gains of up to £250,000, and partial exemption for any capital gain in excess of that. This provides relief for investors in small businesses when they want to retire. The only certain way of avoiding capital gains tax is to die, which leads us to the question of inheritance tax and small companies. Reliefs from inheritance tax (IHT) for business property also exist, subject to some rules. … The result is that the smallest companies do not have to meet large tax bills on the death of the owner. There do not seem to be compelling reasons for the wholesale abolition of CGT and IHT arising from the small companies sector because the reliefs available already address the problems outlined. [32]

[32] IFS, *Options for 1996: the Green Budget*, October 1995, pp 57-59

The pros and cons of tapering were debated at some length during the proceedings of the Finance Bill in spring 1996, when a number of Conservative backbenchers - including David Shaw - tabled a new clause to taper CGT on assets held over a year (with complete exemption for assets held over seven years), and two Labour backbenchers - Denis MacShane and Ian Pearson - tabled amendments to this clause, to apply tapering solely to shares held in UK manufacturing industries.[33] In the event the clause was withdrawn in the face of the Conservative Government's opposition: the then Financial Secretary Michael Jack argued that a tapering system would prevent capital markets operating "freely and without distortion", and should not prejudice the Government's long term ambition to abolish the tax outright: "[tapering arrangements] would distort individual investment decisions because people would have one eye on the taper and one eye of the investment opportunity. That is not the best way to ensure that full and proper investment decisions are made."[34]

E. The introduction of taper relief and abolition of retirement relief (1998-99)

The then Chancellor, Gordon Brown, announced a major reform of CGT in the March 1998 Budget. This followed a consultation exercise on the tax announced in the Labour Government's first Budget in July 1997 after its General Election victory that year. From April 1998, a taper would be introduced, so that the amount of gain charged to tax would be reduced the longer an asset had been held at the time of its disposal. The taper would be more generous for business assets. Indexation allowance would be scrapped for periods after this date, and retirement relief would be withdrawn gradually over five years.

Mr Brown set out the rationale for this reform in his Budget speech:

> We must do more to increase the quantity and quality of long-term investment. The capital gains tax regime that we inherited rewards the short-term speculator as much as the committed long-term investor. It is time also for a fundamental reform of capital gains tax. In a low inflation environment a complex system of indexation is no longer necessary. Indexation will continue until April 1998 and will then be frozen. The annual exempt amount will rise in line with prices. Following extensive consultation, I have decided to phase out complex allowances, and instead I will introduce a new structure of capital gains tax which will explicitly reward long-term investment, and which is based on a downward taper and lower tax rates. The short-term rate of capital gains tax will remain at 40p. For investors holding non-business assets, who invest long-term for 10 years, the rate of capital gains tax will fall from 40p to 24p in the pound. For those who build businesses or stake their own hard-earned money in them, the long-term rate will be reduced even more from 40p to 10p in the pound - the lowest rate ever achieved.[35]

Reaction to Mr Brown's announcement was mixed, with many commentators arguing that the taper system would prove far more complex than the existing system. In a long piece on these changes, the *Financial Times* quoted two tax practitioners expressing on this concern: "'These proposals are an administrative nightmare,' says Maurice Parry-Wingfield, a tax

33 SC Deb (E) 12 March 1996 cc 791-832
34 SC Deb (E) 12 March 1996 cc 819-820
35 HC Deb 17 March 1998 c 1101

partner at Deloitte & Touche. But Simon Philip, a partner at Arthur Andersen, says accountants should have little difficulty since they use computers to make their calculations. 'It is the private investor using self-assessment I feel sorry for,' he says."[36] Nevertheless there was support for the Government's aims to encourage long-termism in investors and enterprise in aspiring entrepreneurs; for example, in an editorial in the *Financial Times*:

> There can be little doubt that the new tapered system will encourage long-termism for ordinary investors, though this is more a matter of stick than carrot. The Treasury says the tax bill for an investment with a real growth rate of 6 per cent and inflation of 2.5 per cent will be higher than under the present system for the first seven years. On the score of promoting enterprise, the government is on stronger ground. It could, of course, be argued that the existing retirement and roll-over reliefs are already generous. Yet in proposing an ultimate CGT rate of 10 per cent for entrepreneurial companies the budget offers a more transparent incentive for people to give up safe employment for enterprise. Stronger evidence It might be objected that before raising the returns in this way the government should produce stronger evidence that enterprise is lacking. But in a world where net job creation is increasingly confined to the small and medium-sized business sector, many will give ministers the benefit of the doubt, especially in the absence of a more lively, US-style entrepreneurial culture.[37]

One part of the reform package that proved particularly controversial was the withdrawal of retirement relief.[38] When someone retires from their trade or profession, they often sell off part or all of the business they own and the assets used in that business. At this time retirement relief was provided to diminish the impact of CGT on this disposal. Relief was given to individuals who were aged 50[39] or over (or who retire earlier on ill health grounds) against capital gains on the disposal of: the whole or part of a business; individual business assets (provided they are disposed of within a period of the business having ceased); and, shares in a personal trading company (ie, a trading company in which an individual who is a full-time employee holds more than 5 per cent of the voting rights).

Full relief was given if the necessary conditions have been satisfied throughout a period of 10 years. If the qualifying period is between one and ten years, the maximum relief was reduced pro rata. Since 1991-92 relief had been given for chargeable gains up to £600,000; no CGT was charged on the first £150,000 of gain, and half relief was given on any excess up to £450,000. These limits were increased – to £250,000 and £1,000,000 – following the November 1993 Budget. At this time it was estimated that there were about 10,000 people with retirement relief each year.[40]

As noted above, Mr Brown had announced a consultation exercise on the operation of CGT in his July 1997 Budget,[41] and details of the responses received were published at the time of the spring 1998 Budget. Some respondents had been critical of retirement relief, and it

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36 "Ever more complex", *Financial Times*, 21 March 1998

37 "Capital tax trade-offs", *Financial Times*, 19 March 1998

38 An EDM laid at this time which argued that the withdrawal of retirement relief imposed an unfair burden on small businesses attracted 150 signatures (EDM 1394 of 1997-98, 8 June 1998). The issue was also raised by Desmond Swayne MP, in an adjournment debate (HC Deb 8 May 1998 cc 1004-1008).

39 The age limit for retirement relief was cut from 55 to 50 under s 176 of the *Finance Act 1996*.

40 HC Deb 2 June 1998 c 195W

41 HC Deb 2 July 1997 c 306

was the Government's view that these concerns had been taken into consideration with the introduction of taper relief (*emphasis added*):

> The reform of CGT follows consultation on the taxation of capital gains, as announced in the July 1997 Budget. A total of 171 replies were received in response to the Inland Revenue's press release of 29 July 1997 (87/97), of which 75 were from representative bodies and companies and 96 from individuals. The responses covered many issues and contained a wide range of views … There was … a strong view that the present system should be simplified. In particular, many respondents were concerned about the extra complexity and costs caused by indexation allowance. Some thought that this was not necessary in a low inflation environment and so should be abolished, while others suggested replacing it with something else. The most frequently mentioned replacements were to rebase acquisition costs or to introduce a taper on the amount of the chargeable gain.
>
> It was commonly suggested that having a taper in place of indexation would favour long-term investment. Most who commented on the point thought that this would be a good thing, although there was also a view that it would not be desirable to use the tax system to influence behaviour in this way. Various forms of taper were suggested to reduce the taxable gain over time, with many wanting it to operate over a short period and to reduce the gain to zero. These suggestions did not, however, consider the effects that such a taper would have on the yield from capital gains tax.
>
> The Government's proposals respond to these views by abolishing indexation for non-corporate taxpayers for periods after April 1998 and by replacing it with a taper. The taper should both reward long-term investment and be simpler to operate than indexation. It will not entail the significant compliance costs that would be caused by regularly rebasing the tax to meet the same objective. The proposal for the taper also reflects a general desire that the system of capital gains taxation should encourage enterprise. This is achieved by having a more generous taper for business assets. This taper will reduce the percentage of the gain that is chargeable to 25 per cent (for assets held for 10 years or more), which is equivalent to a reduction in the rate of tax from 40 per cent to 10 per cent for a higher rate taxpayer.
>
> *The business assets taper also responds to many of the representations on retirement relief, which was criticised for being too narrowly targeted and dependent on the taxpayer's age. At the same time, some respondents suggested that it should be abolished as part of the simplification of capital gains tax. The taper relief will meet these criticisms by being available to everybody who invests in a business, and by depending only on the length of time that a business asset is held.* Phasing out retirement relief will ensure that, while a generous relief continues to be available on retirement, some tax is paid even on long-term business gains.[42]

The Government proposed that retirement relief should be withdrawn over a five year period, ending in April 2003:

> For the year 1998-99 the thresholds for retirement relief will remain unchanged. From the year 1999-2000 onwards the exemption and half-exemption limits will be reduced annually as taper relief becomes more valuable. The maximum retirement relief for each year in the transitional period will be as follows -

[42] Inland Revenue press notice, *Capital gains tax reform*, 17 March 1998

Year	100 per cent relief on gains up to:	50 per cent relief on gains between:
1998-99	£250,000	£250,001 - £1,000,000
1999-00	£200,000	£200,001 - £800,000
2000-01	£150,000	£150,001 - £600,000
2001-02	£100,000	£100,001 - £400,000
2002-03	£50,000	£50,001 - £200,000

> The rules for computing retirement relief will remain unchanged throughout the period of phasing out. The relief will continue to be given against qualifying chargeable gains computed after indexation allowance (available in respect of periods up to April 1998) but before any taper relief. Taper relief will be available on any gains which remain chargeable after retirement relief has been allowed. Where qualifying gains are not wholly covered by retirement relief, retirement relief will be applied so as to provide the maximum possible benefit from taper relief in respect of those gains that remain chargeable.[43]

So, for someone retiring in 2001-02 with gains of £300,000, the reduction in retirement relief would be equivalent to their tax bill rising from £10,000 to £40,000 (100% relief on the first £100,000 of their gains; 50% relief on the remainder). Of course, to some extent this would be mitigated by the operation of taper relief.[44] The annual yield from abolishing this relief was estimated to be about £200 million.[45]

The withdrawal of retirement relief was debated at some length during the Committee stage of the Finance Bill.[46] Speaking for the Liberal Democrats, Edward Davey MP argued that "small businesses will be severely hit by the measure" and moved an amendment to allow someone to "elect retirement relief or the Government's proposals."[47] Nonetheless, the amendment was negatived, as were two other amendments tabled by Conservative Members, and this provision was adopted.[48] On this occasion, the then Financial Secretary to the Treasury, Dawn Primarolo, set out the Government's position in some detail; the following comments are taken from her contribution to the debate:

> At the outset of the debate, it is important to put it in context. First, as Opposition Members have said, the application of CGT in retirement relief is complex, narrow and capricious and does little to encourage long-term investment and business growth. The taper relief, in contrast, is much simpler; it will apply to everyone, be more wide ranging and certain in its application and, most important, will encourage all those who run businesses to invest for the long term and expand their businesses.

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43 Inland Revenue press notice, *CGT: phasing out of retirement relief*, 17 March 1998

44 Clearly an exact comparison between the pre and post Budget situation would require an estimate of how indexation relief would have affected someone's taxable gain - had it not been replaced with taper relief - which itself would depend on the rates of asset growth and inflation.

45 "If the present retirement relief thresholds of £250,000 and £1 million applied in 2003-04 and assuming unchanged taxpayer behaviour it is estimated that the cost of retirement relief would be about £200 million" (HC Deb 8 April 1998 c 254W).

46 SC Deb (E) 16 June 1998 cc 809-842

47 *op.cit.* c 836

48 under section 140 of the *Finance Act 1998*. The provisions introducing taper relief, and freezing indexation allowance, were set out in ss 121-122 and schedules 20-21 of the Act.

> That will benefit everyone. To assist the Committee, I shall contrast retirement relief with the taper relief. Retirement relief is available only to the over-50s and those who retire on grounds of ill-health … The taper relief does not depend on age and there is no lifetime limit. Many people missed out on retirement relief because that had to sell while their business continued. The definition of a business asset is wider for taper relief than for retirement relief. A shareholder with a substantial interest in the company will receive relief without having to be a full-time employee in the company. More people will have access to the new system than to the old system …
>
> We have to move to the new system in as reasonable a period of time as we can to ensure that we get the maximum benefit from it. In doing that, it would have been harsher to have taken away retirement relief for people who are very close to retirement and had planned on the basis that most, if not all, of their gains would be tax-free. We have decided to withdraw it gradually by reducing the exemption and half-exemption limit in equal annual stages until the relief ceases entirely in 2003. We are trying to behave as fairly and reasonably as we possibly can in respect of the transition period from one system to the next: we are giving people time to plan. Beyond the phasing out period, we acknowledge that the rates will rise a little in 2003-04, before steadily coming down in later years as the taper builds up. The effective rate on the gains of people over 50 who sell their businesses in 2003-04 who would have paid no tax at all on their gains had they sold this year cannot exceed 22 per cent …
>
> I want to respond to the argument that was used by all the Conservative Members who spoke that the Government are imposing a heavy tax burden on those who made their retirement plans on the basis that they would pay no tax. I shall focus on the effective rates so there is no misunderstanding about the tax that people will be asked to pay. Let us take someone in business on Budget day who has £250,000 the largest gain that is exempt under the current rules. Let us not forget that to achieve a gain of that order, with indexation relief up to April this year, we are looking at gross proceeds from the sale of a business possibly approaching £500,000. If that person sold the business in the year 1999-2000, he would pay an effective tax rate of under 3 per cent. If he sold in 2000-2001, the effective rate would be under 6 per cent. In 2001-2002 it would be under 8 per cent., and in 2002-2003 it would be under 12 per cent. Those are the maximum rates in the phasing-out period. After that, in 2003-04, the effective rate rises, as hon. Gentlemen have made clear, to a maximum of 22 per cent. before dropping progressively over the years. Those rates cannot be said to be unreasonable given the size of the gains involved. For the reasons that I have set out, the objectives of CGT reform and the placing of retirement relief within it are a fair package, which will ensure that people have the benefit of the gains that they have made and make their contribution in the tax system at a reasonable level.[49]

In answer to a PQ in January 2001 the Minister stated that, "the Government remain committed to the system of taper relief within capital gains taxation so no detailed analyses of the behavioural effects of abolishing taper relief while reintroducing indexation and retirement relief have been made."[50]

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[49] SC Deb (E) 16 June 1998 cc 827-833

[50] HC Deb 23 January 2001 c 570W. The full year yield, including the effect of likely taxpayer reaction, from simultaneously abolishing taper relief and reintroducing retirement relief was estimated to be £200 million in 2002-03 and £400 million in 2003-04 (HC Deb 30 January 2003 cc 995-6W).

F. Changes to taper relief (1999-2002)

In the November 1999 *Pre-Budget Report* the Government proposed shortening the business asset taper from ten to five years to "to bring the timing of CGT incentives more into line with entrepreneurial investment patterns" and reducing the percentage thresholds for qualifying business asset shareholdings, "widening the scope of CGT incentives towards entrepreneurial investment."[51]

Following consultation the Government cut the taper to four years in the March 2000 Budget; details were given in a press notice issued at the time:

> For disposals on or after 6 April 2000, the new 4 year taper for business assets will apply for holding periods from 6 April 1998. The gains charged to tax will be reduced as set out in the table:

Period asset held (years)	Percentage of gain chargeable (%)	Equivalent rate for higher rate CGT payer (%)
0-1	100	40
1-2	87.5	35
2-3	75	30
3-4	50	20
>4	25	10

> For business assets, the additional year for assets held at 17 March 1998 will be consolidated into the new 4 year taper so that it will not be added for disposals on or after 6 April 2000. All CGT payers holding business assets will benefit from the enhanced taper relief. For non-business assets, the existing 10 year taper, together with the additional year for assets held at 17 March 1998, will continue to apply.
>
> The present thresholds for shareholdings in unquoted and quoted trading companies of 5% for full-time employees and 25% for others will be reduced so that the following shareholdings will qualify as business assets: all shareholdings held by employees and others in unquoted trading companies; all shareholdings held by employees in quoted trading companies; shareholdings in a quoted trading company where the holder is not an employee but can exercise at least 5% of the voting rights.
>
> All employees, including part-time employees, of the company in which they hold shares (or any group company etc.) will qualify. Officers of a company are presently treated in the same way as employees and this will continue. The threshold reductions will apply from 6 April 2000. Where shares qualify as a business asset only from that date, an apportionment of the eventual gain will be necessary so that part qualifies for business taper and the balance for non-business taper. The apportionment will be carried out under existing rules. Unquoted companies will be defined as those which have no shares or securities listed on a recognised stock exchange. Shares traded on the Alternative Investment Market of the London Stock Exchange will be treated as unquoted.[52]

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51 Cm 4479 November 1999 pp 36-37

52 Inland Revenue Budget press notice REV4, 21 March 2000 Legislation to this effect was made under ss 66-67 of the *Finance Act 2000*. These provisions were debated on 8 & 13 June 2000: SC Deb (H) cc 590-639.

Despite these reforms there was continued criticism that the tax was complex in its structure and contradictory in its effects.[53] At the CBI conference in November 2000 the Chancellor indicated that the Government were minded to make further changes to simplify the tax,[54] although the March 2001 Budget contained only one change to the structure of CGT, in an extension of the business assets taper to employees of non-trading companies.[55]

One complaint commentators made concerned the ability of employees to claim business assets relief on company shares sold *after* they had retired or left the company concerned over the *entire* period of their shareholding. During the Committee stage of the Finance Bill in June 2000, Howard Flight MP submitted an amendment to extend taper relief to disposals of company shares made by retired employees, by taking qualification from the day the shares were acquired (when the retired individual would clearly still be working), rather than the day on which they were sold.[56] Melanie Johnson, the then Economic Secretary, set out the Government's case for opposing this change as follows:

> [These amendments] would defeat the whole purpose of the change that we propose. The purpose of extending business asset taper relief to encompass all employee shareholdings in trading companies is to promote productivity by aligning the interests of employees with those of the trading company for which they work.
>
> As with the new all-employee share plan that we discussed earlier, the extension of business asset taper relief to employees of trading companies gives them the opportunity to build a community of interest between themselves and the company owners, to make the company successful and help it to grow. Those benefits cannot arise in the case of people who no longer work for the company. Leaving a company on retirement or for any other reason does not alter the fact that the assets were business assets for the time that the person was an employee. The business asset taper will be available for that period. If the company is unlisted, the shares will remain business assets in any event. That is right in those circumstances, because the investment is more risky.
>
> Allowing people to keep business asset treatment on employees' shares in listed companies for ever would be unfair to those who had never qualified for business asset taper relief on their shares. Why should a person who works for a company for three months receive generous business asset taper relief for holding shares for another four years, while the person who never worked for the company, but holds the shares for a much longer period, receives much less relief? The reward should relate only to the time that the individual actually works for the company. It would be wholly unfair for those who had assets that changed their status from business to non-business for other reasons to be allowed to retain the more generous relief. I am not sure whether Opposition Members are aware that the amendment would deny business asset taper to those who acquired shares in listed companies before they became employees. That would not be right.[57]

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53 "Wonderland for the wealthy", Financial Times, 27 April 2000. This is reproduced at the end of this note.

54 "Brown signals capital gains tax reform", *Financial Times*, 7 November 2000

55 Inland Revenue Budget Note BN4, 7 March 2001. Provision was made under section 78 of the *Finance Act 2001* of the Finance Bill 2001.

56 For an explanation of the current rules see *CGT1*, August 2002 pp 54-55

57 SC Deb (H) 13 June 2000 cc 626-7 This issue was raised again at the Report stage, when the Government opposed a similarly worded amendment (HC Deb 19 July 2001 cc 426-434).

Mr Flight raised the issue in Standing Committee the following year, when the provision to extend the business assets taper to employees of non-trading companies was scrutinised. In her response the then Paymaster General, Dawn Primarolo, summarised the Government's approach to the business assets taper as follows:

> The purpose of the business asset taper relief on employee shareholdings is to promote productivity by aligning the interests of employees with those of the company for which they work. The benefit therefore cannot arise in the case of people who are no longer working for the company, whether that is because they have retired or because they have moved on to another job. Business asset taper relief for non-employee investors is designed to encourage investments in productivity and to enhance trading companies by compensating for risk. If the companies cease to trade and become companies that exist only to hold the director's personal assets, or if the risk falls away, the special relief is no longer justified. That is the central case of the changes that the Government have made to date.[58]

In June 2001 the Labour Government published a policy document on productivity, within which it proposed a further reduction in the business asset taper, a review of treatment of non-business assets, and consultation on ways to simplify the tax:

> The UK's CGT regime for business assets is now one of the most competitive in the world. However the Government believes it is now time to go further and ensure that our regime is among the most favourable to enterprise in the developed world. For disposals from next April, the Government will improve the CGT business assets taper so that the effective rate of tax for a higher rate taxpayer is reduced to 20 per cent after one year and 10 per cent after only two years. In addition, the Government will consider whether, during the lifetime of this Parliament, it is necessary to improve the CGT treatment of those assets that do not qualify for the business taper in order to promote access to finance for other businesses and improve incentives to invest. The Government will also consult on ways to simplify CGT.[59]

The Institute for Fiscal Studies commented on these proposals, and the changes made in CGT over the previous four years, in their 'Green Budget' in January 2002, arguing there was little reason for the taper system to discriminate against non-business assets, and that the Government should consider introducing a single flat rate of tax on all assets.[60]

The case for a much simpler structure of tax was also made by Edward Troup writing in the *Financial Times* at this time. Echoing the IFS, Mr Troup suggested the business assets taper had little impact on the pattern of investment, given that "the overwhelming bulk of risk capital is raised from corporate, pension fund and institutional investors" and that the differential tax rates created by the taper system had simply created new opportunities for tax avoidance.[61]

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58 SC Deb (A) 3 May 2001 c 141

59 HM Treasury, *Productivity in the UK*, June 2001 pp 12-13

60 Institute for Fiscal Studies, *The IFS Green Budget: commentary 87*, January 2002 pp 97-102

61 "A messy and inequitable tax", *Financial Times*, 22 January 2002. Mr Troup is now head of Budget, Tax & Welfare at HM Treasury. This article, and an extract from the IFS' commentary on CGT, are reproduced in an appendix to this note.

In the April 2002 Budget the Government confirmed that the minimum holding period for business assets to attract the maximum 75% taper would be two years, not four;[62] a number of measures to simplify the tax were also introduced.[63] During scrutiny of these proposals at the Committee stage of the Finance Bill, the then Economic Secretary Ruth Kelly, commented on the shorter two year taper:

> The change that we are making this year will specifically build on the success of earlier reforms and, in particular, encourage investment in start-up and growing companies. For such companies, equity investments are a vital source of finance. However, venture capitalists and other early-stage investors frequently invest with a view to realising their capital in less than two years, so we have designed the taper specifically to take into account the natural mode of operation and interests of venture capitalists, and their investments in start-up businesses.[64]

At this time it was estimated that the cost of taper relief was around £575 million in 2001-02, rising to £625 million in 2002-03.[65]

The consultation exercise on simplifying CGT launched in June 2001 brought forward a number of proposals for wider change, in particular: abolishing of the tax; introducing a single flat rate of charge; exempting gains if the total value of shareholdings was less than £100,000; and, allowing business asset treatment to be retained when the status of an asset changed (the point debated in Standing Committee in both 2000 and 2001). In a summary of responses, the Government noted that it "was not attracted by any of these proposals", though it confirmed that it was "continuing to consider the case for changes to the CGT regime for non-business assets to encourage investment, in line with the productivity agenda."[66]

G. Assessment of the impact of taper relief

In answer to a PQ in September 2003 the then Paymaster General, Dawn Primarolo, noted that the Government intended "to review taper relief once the system has had time for its effects to become measurable."[67] In December 2006 HM Revenue & Customs published an evaluation of the CGT reforms since 1998 carried out by Ipsos MORI. As the authors explain, "this research explored the *perceptions* of CGT payers and agents, at the time that they were surveyed. It is based on payers' and agents' recollections, both of their investment behaviour and of any effects that changes to the CGT system had upon these."

On the possible impact of CGT on investment decisions, the report found that "neither CGT nor tax generally was spontaneously mentioned as influencing investment decisions, with

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62 Inland Revenue Budget Notice BN8, 17 April 2002.

63 Inland Revenue Budget Notice BN7, 17 April 2002. Legislation to this end is contained in ss 45-52 of the *Finance Act 2002*. These provisions were debated at the Committee stage of the Finance Bill on 21 May 2002: SC Deb (F) cc 163-194.

64 SC Deb (F) 21 May 2002 c 170

65 "Table 7", HM Treasury, *Tax ready reckoner and tax reliefs*, November 2002

66 Inland Revenue, *Summary of replies to CGT simplification consultation*, April 2002 p 7, p 4. The *Pre-Budget Report* in November 2002 did not add to this (Cm 5664 p 45).

67 HC Deb 16 September 2003 c656W

financial (such as rate of return, selling at a market peak) and personal considerations (such as wanting to work for yourself) more important”:

> When prompted, 3 in 10 CGT payers (34 per cent) said that CGT affected their decisions to acquire assets, and half (48 per cent) said it affected their decisions to sell assets. The main influence CGT rules had on CGT payers was for them to ensure that their gains stayed within the annual exempt amount. However, there were also a variety of other CGT-related influences. Almost half of CGT payers (44 per cent for business assets and 43 per cent for non-business assets) said that their past disposals of assets would not have happened if CGT had been higher, while around a third (34 per cent for business assets and 37 per cent for non-business assets) said their past disposals would not have happened if the holding period required to maximise taper relief had been longer.[68]

One practitioner writing on the AccountingWeb site commented on the report’s findings:

> What the report appears to say is that the prospect of paying CGT has virtually no impact on people’s decisions about the acquisition of assets, but that it has some limited impact of their decisions about selling. That appears in my experience to be borne out by the gadarene rush into the purchase of buy to let property and the complicated problems later presented to this and other websites when it seems like a good idea to sell. Furthermore, the rate of tax often seems to have little effect on people ...
>
> So what it comes down to is asking whether the changes – designed to make us a nation of serial entrepreneurs – have actually had any impact at all on taxpayer behaviour. The answer seems to be that they have not. People who have money acquire assets. People buy business assets because they want to be in business. People buy properties to let because they think the walls are papered with gold and they think that the equity in their houses is like real money. So it goes.[69]

As noted at the start of this note, in his Pre Budget statement in October 2007 the then Chancellor Alistair Darling announced the abolition of taper relief from April 2008. The impact of the relief on taxpayer behaviour was discussed when Treasury officials appeared before the Treasury Committee after the PBR. Andrew Love MP asked if there was not a credibility problem, given that “some years ago we started out with a scheme not dissimilar to what you propose”:

> **Mr Mark Neale** [Managing Director, Budget, Tax and Welfare]: We are now putting capital gains tax on a long-term sustainable basis and one that will be credible.
>
> **Mr Nicholas Macpherson** [Permanent Secretary] : The tax system evolves. If one looks at capital gains tax, there have been big changes since it was introduced in 1965, for example by Nigel Lawson in 1988 and Gordon Brown in 1997. This is a further evolution.
>
> **Q222 Mr Love:** It seems to me that if you adopt simplification only because that is what people have asked for, as you seem to suggest, that is only half the equation. I

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68 HM Revenue & Customs, *Evaluation of the changes to Capital Gains Tax since 1998 : Research report 26*, December 2006 p4. The report may be downloaded from: http://www.hmrc.gov.uk/research/index.htm

69 “What did CGT ever do for you?”, *AccountingWeb.co.uk*, 19 January 2007

asked the academics on Monday whether any research had been done into whether or not taper relief had ever sponsored long-term investment. Of course, they said that it was incredibly difficult to disaggregate it and find out. Have you done any research into it?

Mr Neale: Yes. We have looked at this very carefully. Our conclusion is that the introduction of taper relief did have a positive impact in signalling a new hospitality to entrepreneurship. This very often happens when one introduces an incentive into the tax system. It has a positive impact at the outset and one finds that it comes under pressure as others seek to take advantage of it and structure deals or their affairs to be within it rather than without it. That is why we are now taking this step both to simplify the tax and to put it on a long-term basis.[70]

In this context it is worth noting that estimates of the Exchequer cost of taper relief have grown strongly over the last five years. The Budget report in April 2003 estimated the relief would cost £600 million in 2002-03; *Budget 2008* estimates its cost to be £6.3 billion in 2006-07, rising to £7.2 billion in 2007-08.[71]

Finally, in their 2008 Green Budget the IFS argued that taper relief represented an unnecessary distortion in the tax system:

The tax system should not, without very good reason, distort the allocation of assets: they should be held by the people who value them most, and voluntary agreements to buy and sell assets (in which both purchaser and seller presumably expect to gain from the transaction) should not be discouraged by tax considerations. This, however, is the defining feature of taper relief, which cuts the CGT rate the longer an asset is held. Taper relief encourages people to hold on to business assets for at least two years, and non-business assets for at least 10 years, regardless of the underlying commercial desirability of doing so. Removing this distortion would be eminently sensible.

The introduction of taper relief was partly justified by the government because of a supposed culture of excessive short-termist speculation damaging the economy. The theoretical argument for why mutually beneficial transactions may be harmful rests on the idea that investors who trade on the basis of tip-offs or other information that is not related to fundamental value may reduce market efficiency and increase price volatility and risk.[72] However, by reducing market liquidity, a tax that discourages transactions might increase volatility rather than necessarily reducing it, and indeed there is some evidence that this is what happens.[73] In any case, it seems highly unlikely that any benefits of reducing volatility would outweigh the cost to the individuals concerned of losing out on a mutually beneficial trade or the cost to the wider market of reduced liquidity.

A second justification given at the time was that taper relief would encourage long-term investment. But providing a tax incentive for people to hold assets for longer

[70] *The 2007 Pre-Budget Report*, 26 November 2006 HC54-II 2007-08 Ev33-4

[71] HC 500 April 2003 p208; HC 388 March 2008 p136. According to the 2007 edition of HM Treasury's *Tax Ready Reckoner*, these figures are "particularly tentative and subject to a wide margin of error" (p15).

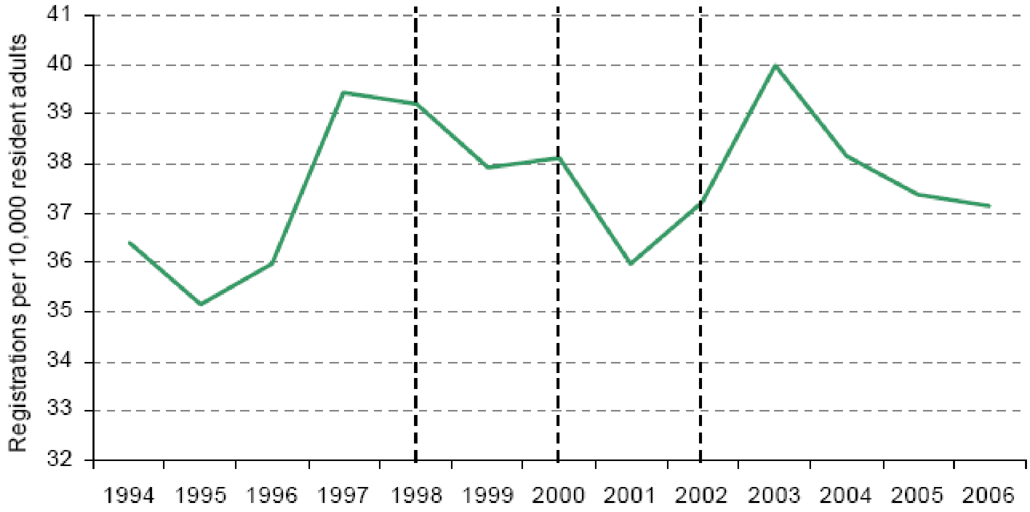
[72] This argument for taxing transactions is developed in, for example, J. Tobin, 'On the efficiency of the financial system', *Lloyds Bank Review*, 1984, 153: 1–15.

[73] See annex A of M. Hawkins and J. McCrae, *Stamp Duty on Share Transactions: Is There a Case for Change?*, IFS Commentary 89, June 2002 (http://www.ifs.org.uk/comms/comm89.pdf).

than they would otherwise wish to do is not the same thing as encouraging long-term investment. Whether a company undertakes a major investment, with large upfront costs and returns that may arise years later, will depend in part on the expected rate of CGT (as well as corporation tax and allowances for investment costs, as discussed below). Tapering – a tax rate that is higher for short holding periods than for long ones – merely influences whether the shares in that company are held by one person for a longer period or by several people for shorter periods, which is not something where there is a clear rationale for government intervention.[74]

The authors also presented some evidence on the impact of CGT reform on entrepreneurship, plotting the rate of UK VAT registrations in the UK since 1994 – and highlighting the dates of the introduction of, and two major changes to, the taper relief regime.

Figure 10.4. UK VAT registration rates and capital gains tax reforms



Notes: VAT registration rates are by calendar year. Vertical lines represent the years in which taper relief was introduced and the rates made more generous; in each case, the reform took effect in April of the relevant year.
Source: Table 1e of Department for Business, Enterprise and Regulatory Reform, VAT Statistics (http://stats.berr.gov.uk/ed/vat/).

As they comment, there appears to have been no impact at all:

VAT registrations can be seen as a crude gauge of the number of new ventures. Although each reform introduced a more favourable tax treatment for entrepreneurs, there is no clear relationship with the number of new VAT registrations. One would expect that if CGT had a large effect, it would be at least partly seen in this graph. In fact, the effect of the business cycle is much more important.[75]

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74 *The IFS Green Budget 2008*, January 2008 pp218-9
75 *op.cit.* pp227-8

H. Debate about CGT in relation to the Euro (2003)

Following the Labour Government's assessment over joining the Euro in mid-2003, there was considerable speculation that it was intending to abolish the exemption from capital gains tax (CGT) of the gains made from the sale of one's own home.[76] The cost of this exemption was estimated to be £15.8 billion in 2006-07, although as a written answer has noted, "these costs are not the same as the yield from abolition of the relief, as consequential effects on the housing market would substantially reduce the yield. Reliable estimates of the yield from imposing capital gains tax at present rates on the disposal by individuals of their only or main residences are available only at disproportionate cost."[77]

On 9 June 2003 the then Chancellor, Gordon Brown, made a statement on economic and monetary union and published an assessment of the Government's five economic tests to joining the single currency.[78] At this time the Treasury published a series of discussion papers on related issues, one of which focused on the role of fiscal policy to foster economic stability, in the event of the UK joining the Euro and losing a UK-specific monetary policy.[79] This paper looked at the operation of 'automatic stabilizers' – the elements of the tax and spending regime which 'automatically' tend to stabilise the economy over the business cycle[80] – and the use of fiscal instruments in a discretionary manner for stabilisation purposes. In considering the most effective fiscal instruments for stabilisation purposes, the paper made the following conclusions (*emphasis added*):

> Key criteria for such instruments are to maximise the impact on activity for a given change in the deficit, minimise lags and to minimise any adverse impacts on wider government objectives such as equity and efficiency. Frequent changes in government expenditure would conflict with the current multi-year spending review structure and could impact on other public policy objectives such as delivering public services. Hence the focus is on tax instruments, such as:
>
> - direct taxes: however, varying income taxes or national insurance contributions is likely to generate significant practical problems and may have only a relatively limited stabilisation impact. They are thus unlikely to be suitable instruments for stabilisation purposes;
> - consumer credit tax: such a tax could impact on household spending decisions through the effect on borrowing to finance consumption. However, the paper concludes that such a tax would not be feasible, all the more so in an integrated EU financial market;
> - investment instruments: temporary tax credits could, for example, be used to stimulate investment in a recession. However, the effectiveness of such a measure might be limited, and frequent use of temporary tax incentives could increase uncertainty, damaging long-run investment in the economy;

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76 For example, "Home thoughts from abroad", *Guardian*, 11 June 2003; "Brown ponders plans to tax all house sales", *Daily Telegraph*, 19 October 2003; "Brown likely to raise stamp duty as deficit grows", *Financial Times*, 21 October 2003

77 HC 388 March 2008 p135. HC Deb 14 October 2004 c347W

78 HC Deb 9 June 2003 cc 407-436; *UK membership of the single currency: an assessment of the five economic tests* Cm 5776, June 2003

79 HM Treasury, *Fiscal stabilisation and EMU: a discussion paper*, June 2003. The study's conclusions are summarised in the Government's Euro assessment (Cm 5776 pp 129-134).

80 By way of an example, the paper notes that, "during an upswing, incomes will rise and tax receipts will increase tending to dampen the cycle. Similarly, in a downturn, unemployment benefit payments will rise tending to moderate the slowdown." *Fiscal stabilisation and EMU*, June 2003 p 4

- *housing taxes: fiscal instruments impacting on the housing market could help reduce volatility in this sector of the economy, through automatic stabiliser properties, as well as potentially providing an additional discretionary stabilisation tool. The paper looks at stamp duty and at the wide variety of property taxes levied in other countries;* and
- expenditure taxes: temporary changes to a combination of expenditure taxes, for example through the regulator power, could prove useful instruments with limited undesirable impacts on incentives, the supply side or the overall equity of the tax system.[81]

The paper concluded that "specific fiscal instruments" were *one* of the "credible policy options" to "make discretionary fiscal policy more effective for stabilisation purposes and strengthen the automatic stabilisers." It went on to note that "the Treasury will conduct further analysis into these issues to ensure the policy proposals would deliver effective counter-cyclical stabilisation of the economy were the UK to join EMU."[82]

Some commentators took the discussion of housing taxes in this paper as an indication that the Government might scrap tax relief for the sale of one's own home, though neither this particular paper nor the Government's Euro assessment contained this proposal. The issue was raised during the Commons debate on economic and monetary union on 11 July 2003, in particular by Mark Prisk, summing up the debate for the Conservatives.[83] In response the then Chief Secretary to the Treasury, Paul Boateng, made the following comments:

> The hon. Member for Hertford and Stortford (Mr. Prisk) suggested that we had a hidden agenda on taxing property. That is nonsense … there are no proposals for new taxes in the fiscal stabilisation paper … Important issues relating to the housing market must be addressed. Our agenda is not to attain market structures identical to those of other countries. Every country's market will have unique features, but history shows that the combination of house price inflation and volatility has been a problem for stability. We all know that, and we are determined to do more to entrench stability and to reduce the risk of inflation, irrespective of the decision on the euro.[84]

Speculation about this issue continued, and the Government reiterated it had no such plans, both in answer to PQs, and at Prime Minister's Questions, in October that year.[85] In the 2005 Budget report it was noted that, "gains arising on disposal of a principal private residence will continue to be exempt from capital gains tax", and since then, the issue does not appear to have resurfaced.[86]

81 *op.cit.* pp 5-6. The use of housing taxes as a stabilisation tool in other countries is discussed in chapter 6 of the paper (pp 85-87).
82 *op.cit.* p 6
83 HC Deb 10 July 2003 c 1477
84 HC Deb 10 July 2003 cc 1479-80
85 HC Deb 23 October 2003 c 647W; HC Deb 22 October 2003 c 636
86 HC 375 March 2005 para 5.114

I. Appendix : Rates of CGT 1977-2007

1977-78 to 1979-80

	Total net gains for year of assessment	Tax chargeable
Individuals:	Not exceeding £1,000	Nil
	£1,001 - £5,000	Excess gains over £1,000 at 15%
	£5,001 - £9,499	£600 plus excess gains over £5,000 at 50%
	£9,500 or more	All gains at 30%
Trusts:	Not exceeding £500	Nil
	£501 - £1,249	Excess gains over £500 at 50%
	£1,250 or more	All gains at 30%

1980-81 to 2006-07

	Annual exempt amount		Rate of tax[1] chargeable on excess of gains over annual exempt amount		
	Individuals	Trusts	Individuals	Discretionary & accumulation trusts	Interest in possession trusts & personal representatives
1980-81	3,000	1,500			
1981-82	3,000	1,500	30%	30%	30%
1982-83	5,000	2,500	30%	30%	30%
1983-84	5,300	2,650	30%	30%	30%
1984-85	5,600	2,800	30%	30%	30%
1985-86	5,900	2,950	30%	30%	30%
1986-87	6,300	3,150	30%	30%	30%
1987-88	6,600	3,300	30%	30%	30%
1988-89	5,000	2,500	Income tax rates	Trust rate	Basic rate of income tax
1989-90	5,000	2,500	Income tax rates	Trust rate	Basic rate of income tax
1990-91	5,000	2,500	Income tax rates	Trust rate	Basic rate of income tax
1991-92	5,500	2,750	Income tax rates	Trust rate	Basic rate of income tax
1992-93	5,800	2,900	Income tax rates	Trust rate	Basic rate of income tax
1993-94	5,800	2,900	Income tax rates	Trust rate	Basic rate of income tax
1994-95	5,800	2,900	Income tax rates	Trust rate	Basic rate of income tax
1995-96	6,000	3,000	Income tax rates	Trust rate	Basic rate of income tax
1996-97	6,300	3,150	Income tax rates	Trust rate	Basic rate of income tax
1997-98	6,500	3,250	Income tax rates	Trust rate	Basic rate of income tax
1998-99[2]	6,800	3,400	Income tax rates	Trust rate	Trust rate
1999-00[2]	7,100	3,550	Income tax rates[3]	Trust rate	Trust rate
2000-01[2]	7,200	3,600	Income tax rates[4]	Trust rate	Trust rate
2001-02[2]	7,500	3,750	Income tax rates[4]	Trust rate	Trust rate
2002-03[2]	7,700	3,850	Income tax rates[4]	Trust rate	Trust rate
2003-04[2]	7,900	3,950	Income tax rates[4]	Trust rate	Trust rate
2004-05[2]	8,200	4,100	Income tax rates[4]	Trust rate	Trust rate
2005-06[2]	8,500	4,250	Income tax rates[4]	Trust rate	Trust rate
2006-07[2]	8,800	4,400	Income tax rates[4]	Trust rate	Trust rate

[1] Income and trust tax rates are contained in the Table TA.2.
[2] For 1998-99 onwards, taper relief may reduce the proportion of gains chargeable as described in the following table.
[3] Treated as savings income, except that capital gains in the starting rate band are taxed at 20%.
[4] Treated as savings income.

Taper relief (for gains on disposals after 5.4.1998)

		Proportion of gain chargeable (%) Number of complete years after 5.4.1998 for which asset held										
Year of disposal	Type of asset	0	1	2	3	4	5	6	7	8	9	10 or more
1998-99	Business[1, 2]	100	92.5	85	77.5	70	62.5	55	47.5	40	32.5	25
	Non-business[1]	100	100	100	95	90	85	80	75	70	65	60
1999-2000	Business[1, 2]	100	92.5	85	77.5	70	62.5	55	47.5	40	32.5	25
	Non-business[1]	100	100	100	95	90	85	80	75	70	65	60
2000-01	Business[2]	100	87.5	75	50	25	25	25	25	25	25	25
	Non-business[1]	100	100	100	95	90	85	80	75	70	65	60
2001-02	Business[2]	100	87.5	75	50	25	25	25	25	25	25	25
	Non-business[1]	100	100	100	95	90	85	80	75	70	65	60
2002-03	Business[2]	100	50	25	25	25	25	25	25	25	25	25
	Non-business[1]	100	100	100	95	90	85	80	75	70	65	60
2003-04	Business[2]	100	50	25	25	25	25	25	25	25	25	25
	Non-business[1]	100	100	100	95	90	85	80	75	70	65	60
2004-05	Business[2]	100	50	25	25	25	25	25	25	25	25	25
	Non-business[1]	100	100	100	95	90	85	80	75	70	65	60
2005-06	Business[2]	100	50	25	25	25	25	25	25	25	25	25
	Non-business[1]	100	100	100	95	90	85	80	75	70	65	60
2006-07	Business[2]	100	50	25	25	25	25	25	25	25	25	25
	Non-business[1]	100	100	100	95	90	85	80	75	70	65	60

[1] Assets acquired before 17.3.1998 qualify for an addition of 1 year to the period for which they are treated as held after 5.4.1998.

[2] Business assets are defined broadly as: an asset used for the purposes of a trade carried on by the individual or by a qualifying company[3,4]; or an asset held for the purposes of a qualifying office or employment (for periods before 6 April 2000 the employment had to be substantially full time); or shares in a qualifying company[3,4] held by the individual. Since 6 April 2004 business assets include those assets used for the purposes of a trade irrespective of whether the individual is involved in carrying on the trade concerned.

[3] For the period 6 April 1998 to 5 April 2000, a company was a qualifying company for an individual if it was a trading company or the holding company of a trading group and the individual could exercise either -
(a) at least 25% of the voting rights in that company or;
(b) at least 5% of the voting rights in that company, provided the individual was a full-time working officer or employee of that company.
There are similar provisions in respect of trusts.

[4] For periods from 6 April 2000, a company is a qualifying company for an individual if it is either
(1) a trading company or the holding company of a trading group and is
(a) unlisted or
(b) the individual is an employee or officer of the company, or
(c) the company is listed and the individual has not less than 5% of the voting rights, or
(2) a non-trading company where an individual is an employee or officer and does not have a material interest of more than 10% in the company.
There are similar provisions in respect of trusts.

Adapted from, HM Revenue & Customs, *National Statistics: Table A.7*

J. Appendix 2: Selected reading on CGT reform

1. "Wonderland for the wealthy", *Financial Times*, 27 April 2000
2. "Capital Gains Tax" in Institute for Fiscal Studies, *The IFS Green Budget: commentary 87*, January 2002
3. "A messy and inequitable tax", *Financial Times*, 22 January 2002

*

"Wonderland for the wealthy: Gordon Brown's reforms of capital gains tax have created a convoluted system that is of most benefit to the rich", *Financial Times*, 27 April 2000

The investor entering the capital gains tax system must sometimes feel like Alice venturing through Wonderland. Tax experts say last month's Budget has left the rules pitted with peculiarities as confusing as events in Lewis Carroll's world of the bizarre. This state of affairs raises doubts about the government's strategy and philosophy. A series of targeted measures has left an already complex system looking Byzantine. Manipulations ostensibly aimed at ordinary employees seem to bring most benefit to a wealthy few. "It is probably not much use for the majority of people," says one government official. "It's when you have gains in the tens of thousands and hundreds of thousands that it makes a difference."

It is the latest in a series of political tacks and gybes over CGT, which was a creation of Harold Wilson's 1964 Labour government. It is essentially a tax on the well-off, applied to gains related to the disposal of assets by individuals, personal representatives and trustees. The charge, made on the difference between the sale price and the cost of the acquisition, yielded the Treasury £3.2bn last year, or 3.6 per cent of the take from income tax.

The Budget measures piled more detail on to an already convoluted system. Gordon Brown, the chancellor, announced a series of tax breaks on shareholdings. Budget press releases said these were aimed at encouraging employee share ownership and investments by entrepreneurs. Employee shareholdings in quoted trading companies, and non-employee stakes of more than 5 per cent, are now treated as business assets instead of non-business assets. The same applies to all shareholdings in unquoted trading companies. Instead of waiting 10 years for the CGT rate to taper down from 40 per cent to 24 per cent, a higher-rate taxpayer reaches a floor of 10 per cent after just four years.

This has created a paradox. While an employee buying shares on April 6 2000 would reach the 10 per cent level by 2004, a worker who bought shares in February 1998 would have to wait until 2010. The reason is that employees who bought shares two years ago are caught by the less favourable regime that applied previously. This apparent unfairness is the product in part of pragmatism. It seems the government felt it would be over-generous to allow existing shareholders to enjoy the full benefit of the rule change. The Treasury called time on a policy shift already forecast to cost £225m next year and £600m by 2004-05. The chancellor's position is underpinned by qualitative reasons, too. Offering the full effect of the more generous relief to employees who already hold shares would have no incentivising effect. The Treasury would have been giving away something for nothing. The problem is that these narrow arguments obscure the broader picture. In this, the rules for employees are an afterthought.

This helps explain why they look odd. In this world, the policy shift is not targeted at ordinary workers but at entrepreneurs holding much larger stakes. These are what the Treasury styles "business angels": wealthy individuals who provide risk capital to entrepreneurial companies. As the government official says: "The fact that (the change) goes on to employees is important but somewhat secondary." This helps explain why the changes appear to contradict the government's aims for employee share ownership. Improving breaks on CGT sits uneasily with rhetoric about encouraging employees to invest long-term. People are unlikely to tie their fortunes to those of their companies if they can get in and out at minimal cost within four years. The argument that employees are a second-order consideration also makes sense in the context of the history of CGT.

Paying it has always been a minority sport, restricted to the few who make more than their annual tax-free allowance. In 1997-98 only 144,000 people posted gains higher than the threshold, which now stands at £7,200. This transforms the way in which the latest action is to be understood. The changes begin to look like appeals to the wealthy, be they big private investors or company directors with large holdings of shares and share options.

Whatever the arguments about encouraging investment in young companies, one effect of the changes will be to boost executive pay. The decision to go for a 10 per cent bottom rate seems a sop to investors who might otherwise place funds offshore. Better to collect a little tax, the government reasons, than to see it all disappear to the Channel Islands or the Caribbean. If the rate is low enough, it will no longer be cost-effective to indulge in complex avoidance schemes. In this context, protests about the system look less like a cry from the public than moans from a privileged few. Concessions are on the agenda, and the beneficiaries want more.

The result is a complex, contradictory system. It raises much the same feelings of puzzlement as Alice's wanderings induce in children. It is, says Maurice Parry-Wingfield, tax director at Deloitte & Touche, "absolutely full of anomalies and inconsistencies". It is a muddle that clouds deeper questions about the purpose and application of the tax. Labour has done little to convince people that the manipulations bring benefits for more than just a wealthy minority. Like Alice's adventures, they risk looking like meanderings without a moral purpose.

*

"Capital Gains Tax" in Institute for Fiscal Studies, *The IFS Green Budget: commentary 87*, January 2002 pp 99-102

Changes to CGT are often seen as ways to encourage risk-taking behaviour. It is likely that for certain types of investment project, such as those funded by new firms, the rate of CGT affects the investment decision more than for other types of investment, such as those carried out by larger incorporated businesses. The lower rate of CGT on business assets may induce more investment in this class of assets, potentially both through an increased supply of funds and through demand for those funds from individuals – for example, those starting their own businesses.[87] However, reductions in the CGT rate on business assets are unlikely to have a large effect on overall UK investment levels. Changes to CGT affect a small proportion of individuals. Fewer than 200,000 individuals pay CGT,[88] and those investing in certain smaller businesses can also receive relief from CGT via the Enterprise Investment Scheme.

Encouraging long-term investment

Since Budget 2000, a tax-induced bias towards long-term holding remains only for non-business assets. The structure of the CGT system would not be expected to affect financial institutions often cited in the debate on 'short termism'. The non-business assets affected by the CGT taper are individuals' shares in quoted companies. Individual shareholders hold a small proportion of the total equity in UK quoted companies. Most equity is held by financial institutions, such as pension funds and insurance companies, that do not pay CGT or by foreign shareholders.[89] Furthermore, there is no clear evidence that the length of time that shares are held affects firms' investment decisions. It is equally difficult to make a case for having a tax-induced bias for long term holding of business assets. So the fact that most of the bias introduced in 1998 for business assets has been removed, by the changes to the business assets taper in 2000 and by those to be implemented in 2002, is to be welcomed.

But the removal of this bias, by shortening the business assets taper, has increased another potential distortion … business assets held for at least two years will now be subject to a 10% rate, compared with 40% for non-business assets at this point. There is no clear economic distinction between business and non-business assets.

For instance,

- shares quoted on the Alternative Investment Market could count as business assets, shares on the FTSE SmallCap do not;
- virtually all employee shareholdings count as business assets, but when an employee leaves the company their shareholdings usually revert to being non-business assets.

Yet the government has made the tax distinction between these two categories of assets wider. In the absence of any clear rationale or evidence supporting a 30 percentage point difference in the tax rates on the two types of assets after a two-year holding period, some concern must exist over whether the differential creates a distortion

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87 See, for example, J. M. Poterba, *Venture Capital and Capital Gains Taxation*, NBER Working Paper no. W2832, July 1989.

88 Table 14.1 *IR Statistics*

89 For UK quoted firms at the end of 2000, the Office for National Statistics estimates that 38.7% of total equity was owned by pension funds and insurance companies, 32.4% was owned by foreign shareholders and only 16% was owned by individuals. See Office for National Statistics, *Share Ownership: A Report on the Ownership of Shares at 31 December 2000*, London, 2001

that induces inefficient investment decisions. However, given that we have argued that the impact of CGT cuts on overall UK investment is likely to be small, this may not be a significant problem.

Complexity and other distortions

One of the government's aims in 1998 was to simplify the CGT system. By June 2001, the system contained considerable complexity, leading the government to consult on simplification of CGT.[90] While this initiative is certainly welcome, it is likely to be confined to rather technical issues. Much of the complexity in CGT is now structural. There are the straightforward compliance costs, such as the problems of calculating the tax liabilities on capital gains and the likely need for anti-avoidance rules to prevent the avoidance of income tax and National Insurance contributions. Some of the complexity in the system is transitional, with the same gain being potentially taxed under more than one system.[91]

But much of the complexity will remain in the long run – for example, in situations where shares change classification from business to non-business assets, such as when a firm floats on the stock market or when an individual changes employer. Such circumstances can also produce rather perverse incentives, with the average tax rate on any unrealised gains increasing due to the non-business assets taper being less generous than the business assets taper. So, in addition to the complexity, we may also be worried about distortions to behaviour, such as how the CGT system affects a firm's decision to float on the stock market.

Further reform?

In addition to consulting on issues of complexity, the government is considering whether further changes to the CGT system might be made.[92] As a starting point, consideration could be given to a number of features of the CGT system that might merit removal:

- the bias towards longer holding periods for non-business assets;
- the large differential between the tax rates on business and non-business assets;
- the general complexity and potential distortions in the system, which in part are due to a series of reforms being applied in a remarkably short period of time.

Many of these issues could be addressed either by changing the non-business assets taper to a flat rate after two years or by moving quoted shares into the business assets regime. But any significant move is likely to be costly. A compromise would be a single flat CGT rate for all assets, in part funded by increasing the rate on business assets. But in light of the government's announcement last June of further changes to the business assets taper, that option now looks unlikely. The absence of discussion in the Pre-Budget Report of options for further reform probably means that none of these potential solutions will be taken forward in the Budget. While the issues outlined here will not go away and action will be needed at some point, another quickly implemented reform might only complicate the position further. One sensible option for the government would be a commitment not to change the capital gains tax regime again without some form of consultation.

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"A messy and inequitable tax: Gordon Brown should simplify capital gains by introducing a 20 per cent flat rate, argues Edward Troup", *Financial Times*, 22 January 2002

No significant tax costs more to collect or is paid by fewer people than capital gains tax, yet no other tax seems to hold the same fascination for governments of every hue. Like too many of his predecessors, Gordon Brown has been lured by economic theory and political lobbying into tinkering with a tax where the best policy approach is rough, tough pragmatism. But unlike many of his other micro-measures, this tinkering carries real cost to the ex-chequer. The yield from capital gains tax will be cut by more than Pounds 1bn. That may be no bad thing, given the high rates of tax he inherited, but Mr Brown has done it in a way that has created further distortions and directionless complexity.

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90 HM Treasury, *Enterprise and the Productivity Challenge*, London, June 2001 p 13

91 For example, if a proportion of the gain qualifies for indexation relief and the remainder is subject to the CGT taper.

92 The government has stated that it will 'consider whether, during the lifetime of this Parliament, it is necessary to improve the CGT treatment of those assets that do not qualify for the business assets taper' (*Enterprise and the Productivity Challenge*, June 2001 p 12)

Britain is not alone in lacking any clear consensus on the taxation of capital gains. Worldwide, rates of tax and the tax base vary wildly. In at least two developed countries - New Zealand and the Netherlands - CGT has not yet been introduced. There is no international consensus because there is no right answer. The alternatives are equally unpalatable: leaving gains untaxed, or significantly undertaxed, creates opportunities for avoidance of income tax, while any tax on capital gains distorts investment decisions. The best approach is to accept that taxing capital gains is the art of the possible, not of high policy. It will never be more than a sticking plaster at the end of the tax system to prevent excessive leakage. This untidy truth was recognised in 1965 when CGT was introduced across the board at a single rate of 30 per cent. It was a practical policy but, being based on pragmatism rather than on identifiable principle, it was also more difficult to defend from the gnawing of the special interest groups and meddling politicians.

In just such a vein, Nigel Lawson, the former Conservative chancellor, aligned the tax with income tax at 40 per cent in 1988, leaving Britain with one of the highest rates of capital gains tax in the world. Successive chancellors tweaked and tinkered but left the rates unchanged. As a result, the system Labour inherited was both messy and inequitable. Many of those who lobbied for lower rates were indeed the entrepreneurs of whom governments are so fond. But they had already made their pile. Claims that high rates of tax deter entrepreneurship were merely convenient arguments, a polite way of asking for a tax cut.

For the would-be self-made man or woman the obsession is with making that first million, not worrying about the tax that he or she may have to pay if that unlikely dream comes true. Fear of tax rates, at whatever level, rarely deters the developer of a good idea until it is too late to do anything about it. Yet even if evidence of stifled entrepreneurship was hard to find, it was right to cut the tax - to deter the emigration of those few talented individuals who had indeed made good and whose tax advisers recommended a spell in warmer climes to achieve non-residence and avoid the tax entirely. The surprise was that a Labour chancellor should devote any attention at all to such a minority sport. The tax is paid by only 150,000 individuals in any year. Fewer than 5,000 of these account for half the yield - well over £1bn a year.

Arguments that cutting a tax paid only by individuals would encourage investment look thin, given that the overwhelming bulk of risk capital is raised from corporate, pension fund and institutional investors. The case that the tax system should favour long-term holdings looks even thinner. The real entrepreneur should be encouraged to divest his successful investment and move on to new opportunities, not to retain his holding to achieve a lower tax rate. But Mr Brown has been over-generous and has ill-targeted the benefits. The tax has been all but cut in half. And not in a simple way: a new long-term rate of 10 per cent is introduced - but not for all investments; for other assets the rate has been cut - but not immediately. With these cuts come new distortions. The tax avoidance industry thrives on the incentives offered by differential tax rates. New opportunities have been created: rebadging investments into business assets cuts the rate from 40 per cent to 10 per cent; converting annual bonuses into employee shares achieves an equal saving; and the lower tax rate for longer holding periods distorts behaviour.

The opportunities to avoid that led to the introduction of the tax in 1965 are coming back, compounded by unnecessary complexity. Pragmatism has been replaced by opportunism masquerading as principle. The clock should be rolled back. A single rate of, say, 20 per cent applied across the board would stop the worst excesses of avoidance without creating undue distortion. The chancellor should shun the siren voices of economists and interest groups and accept that where no right answer is to hand, the least worst option is the simplest one.

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