

10. Capital gains tax

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Summary

- The government's proposal in the Pre-Budget Report to abolish taper relief and the distinction between business and non-business assets was a welcome step in the direction of making capital gains tax (CGT) simpler and less distortionary.
- It would, however, probably be a good idea to sacrifice some of the gains in simplicity to make CGT even less distortionary, by applying reduced rates to corporate equity to reflect corporation tax already paid, and perhaps by re-introducing relief for inflation.
- There is a strong case for aligning CGT rates with the tax rates on earnings and dividend income. Higher CGT rates might discourage saving, investment and entrepreneurship, but these could be encouraged in better-targeted ways.
- Owners of business assets are understandably upset to see the withdrawal of a tax break from which they had expected to benefit, but it is not clear in many cases that the proposed regime is less favourable than when they bought the asset in the first place. The government could have offered transitional relief, but this would have re-complicated the system and created problems of its own.
- Announcing a reform without consultation, creating additional uncertainty by agreeing to rethink it in the face of intense lobbying, and then delaying the results of the rethink, are not the hallmarks of competent tax reform. It is hard to believe that whatever changes to CGT finally emerge this year will be the last.
- The announcement of a £200 million 'entrepreneurs' relief' to be introduced in April 2008 will be a welcome reprieve for many owner-managers of small businesses, but reintroduces complexities and inefficient distortions similar to those inherent in taper relief.

10.1 Introduction

Capital gains tax (CGT) in the UK has been much criticised and much reformed. It was partly dissatisfaction with the way in which CGT was first designed and enacted in 1965 that led to the creation of the Institute for Fiscal Studies. Proposals for the reform of CGT in last year's Pre-Budget Report have maintained this tradition for controversy and prompted such a backlash among business lobby groups and other critics that the government has promised a rethink.

¹ Thanks to Steve Bond, Claire Crawford, Malcolm Gammie, Rachel Griffith and Helen Miller for helpful comments.

Section 10.2 sets out the policy background and explains the proposals. Section 10.3 evaluates both the existing system and the proposed replacement against criteria for good design of the tax, while Section 10.4 addresses the question of whether and how to protect individuals who stand to suffer windfall losses from the reform. The process by which CGT policy has been made is evaluated in Section 10.5. Section 10.6 concludes.

The introduction of an ‘entrepreneurs’ relief’ was announced on 24 January 2008, too late to be integrated into this chapter before going to print. Entrepreneurs’ relief is discussed separately in Section 10.7.

10.2 Background

This section describes the evolution of CGT in the UK, the current system and the reforms announced in the October 2007 Pre-Budget Report.

Capital gains tax in the UK

CGT is a tax on the increase in the value of an asset between its acquisition and its disposal. Broadly speaking, this means its sale price minus its purchase price, though assets that are acquired or disposed of in other ways (e.g. gifts) are assigned a market value. Transfers to a spouse or civil partner do not trigger a CGT liability: roughly speaking, the recipient is treated as if he or she were the original purchaser of the asset, at the original acquisition date and price.² CGT is ‘forgiven’ completely at death: the deceased’s estate is not liable for tax on any increase in the value of assets prior to death, and those inheriting the assets are deemed to acquire them at their market value at the date of death.

CGT only applies to assets sold by individuals and trustees; gains made by companies are included in profits and subject to corporation tax. The rest of this chapter focuses exclusively on capital gains made by individuals.

As with income tax, there is an annual threshold below which CGT does not have to be paid. In 2007–08, this ‘exempt amount’ is £9,200. This is subtracted from total annual capital gains to give taxable capital gains. Taxable capital gains – after applying indexation allowances and taper relief, described below – are in effect subject to income tax as if they were taxable savings income: treated as the top slice of income, capital gains are taxed at 10% below the starting-rate limit, 20% between the starting- and basic-rate limits, and 40% above the basic-rate limit. Unused income tax allowances cannot be set against capital gains, and vice versa.

When CGT was introduced in the UK in 1965, it was levied at a flat rate of 30%. But the structure and rates of the tax have since undergone several major reforms. Relief for inflation was introduced in 1982 and substantially modified in 1985 and 1988: ‘indexation allowances’ adjusted the purchase price of an asset used to calculate the capital gain in line with the retail price index, so that only gains in excess of inflation were subject to tax. In 1988, the tax changed from being a flat 30% rate to being charged at the taxpayer’s marginal income tax rate.

² This is a characterisation of the effect of the current system. The precise rules for transfers between spouses and civil partners are slightly different from this, with one important implication discussed in footnote 31.

The next major reform occurred in 1998, when indexation allowances were abolished for periods of ownership after April 1998. Instead, a system of ‘taper relief’ was introduced, which reduced the taxable gain according to the number of years of ownership after April 1998.³ Taper relief was more generous for ‘business assets’ – the definition of which has changed several times since – than for other assets, and the taper for business assets was made still more generous in 2000 and 2002.

Table 10.1. The capital gains tax taper, 2007–08

Number of complete years after 5 April 1998 for which asset held	Non-business assets		Business assets	
	Percentage of gain chargeable	Equivalent tax rate for higher-rate taxpayer	Percentage of gain chargeable	Equivalent tax rate for higher-rate taxpayer
0	100	40	100	40
1	100	40	50	20
2	100	40	25	10
3	95	38	25	10
4	90	36	25	10
5	85	34	25	10
6	80	32	25	10
7	75	30	25	10
8	70	28	25	10
9	65	26	25	10
10 or more	60	24	25	10

Source: *Tolley's Capital Gains Tax 2007–08*.

Table 10.1 illustrates the taper relief system currently in place and shows the effective CGT rate payable by someone subject to the higher (40%) rate of income tax. For taper relief purposes, business assets are assets used wholly or partly for trading purposes, and shares and securities in a company if (a) the company is not listed on a stock exchange or (b) the shareholder is an employee of the company or has at least 5% of the voting rights in the company.^{4,5} Non-business assets therefore include most shares in listed companies, second homes and other physical assets such as jewellery, antiques and works of art. Figure 10.1 shows the contribution to total chargeable capital gains (before applying taper relief) of different asset types; Figure 10.2 shows the contribution of business and non-business assets of different holding periods. In 2004–05 (the latest year for which figures are available), business assets accounted for 61% of chargeable gains before taper relief was applied, but only 38% of tapered gains.⁶ In total, the government estimates that taper relief reduces

³ An additional ‘bonus’ year was added to the post-April-1998 ownership period for assets acquired before March 1998. Indexation and taper relief are applied before deducting the exempt amount.

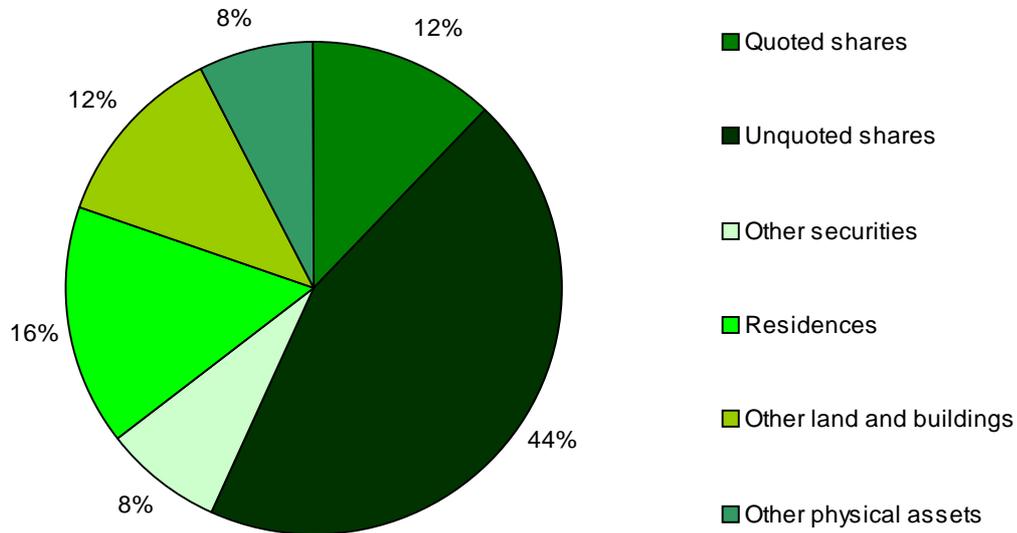
⁴ This roughly corresponds to owning 5% of the company, but the correspondence is not exact.

⁵ The conditions stated apply to a trading company or holding company of a trading group. Shares and securities in non-trading companies qualify as business assets if the shareholder is an employee of the company (or a connected company) and does not have a material (more than 10%) interest in the company.

⁶ Source: Table 14.9 of HMRC Statistics (http://www.hmrc.gov.uk/stats/capital_gains/table14-9.pdf). Mixed business/non-business assets are not included in business assets but are included in the total.

potential CGT receipts by £7.2 billion in 2007–08, £5.6 billion (77%) of which is from business assets.⁷

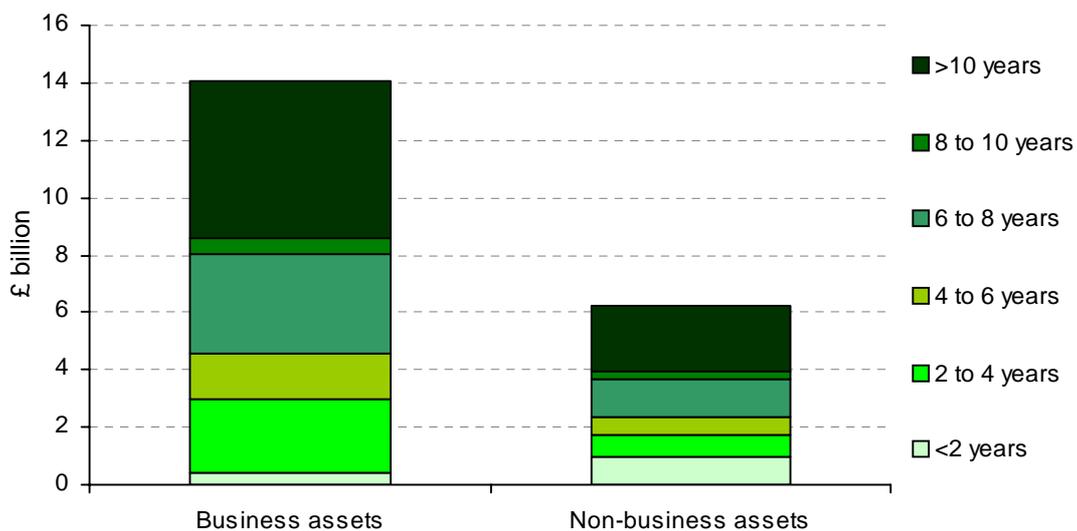
Figure 10.1. Chargeable gains by asset type, 2004–05



Notes: Chargeable gains measured before application of taper relief. 'Other securities' includes fixed interest investments, unit trusts, loan notes, etc. 'Other land and buildings' includes commercial, industrial and agricultural property. 'Other physical assets' includes jewellery, antiques, paintings, etc.

Source: Table 14.4 of HMRC Statistics (http://www.hmrc.gov.uk/stats/capital_gains/table14-4.pdf).

Figure 10.2. Chargeable gains by length of asset ownership, 2004–05



Note: Chargeable gains measured before application of taper relief. Mixed business/non-business assets excluded.

Source: Table 14.9 of HMRC Statistics (http://www.hmrc.gov.uk/stats/capital_gains/table14-9.pdf).

⁷ Overall cost from table 1.5 of HMRC Statistics (http://www.hmrc.gov.uk/stats/tax_expenditures/table1-5.pdf); breakdown into business and non-business assets from answers to Parliamentary questions, 29 October 2007, Hansard, columns 885W-886W (<http://www.publications.parliament.uk/pa/cm200607/cmhansrd/cm071029/text/71029w0062.htm#07103050000006>).

Crucially, increases in the value of owner-occupied homes (and private cars) are exempt altogether from CGT, as are any assets held within pension funds or Individual Savings Accounts (ISAs). Shares owned by company employees via a Share Incentive Plan for at least three years are exempt from CGT on any increase in value while they remain in the plan; when the shares are sold, the acquisition price for CGT purposes is the market value of the shares when they were withdrawn from the plan.

Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS) are investment vehicles that provide a CGT exemption for shares in small unquoted companies⁸ (as well as income tax relief on the purchase of the shares, with 20% relief on up to £400,000 invested through the EIS and 30% relief on up to £200,000 invested through a VCT) provided that the shares are held for at least three years (five years for VCTs). These schemes cannot be used by owner-managed companies to escape tax – EIS shareholders must not be employees of the company or hold more than 30% of the shares, and VCTs must be quoted companies with no more than 15% of their investments in any one company – but many other investments in small unquoted companies are channelled through these vehicles and attract no CGT. In 2007–08, VCTs are estimated to cost the exchequer £85 million, and the EIS £150 million, in CGT and income tax reliefs.⁹

In 2007–08, 260,000 individuals and trusts are forecast to pay CGT, raising a total of £4.8 billion for the exchequer, some 0.9% of total revenue.¹⁰ This compares with 1996–97, when CGT from 120,000 taxpayers provided 0.4% of total revenue – both figures that have more than doubled, although these numbers are highly cyclical.¹¹

The 2007 Pre-Budget Report proposals

In the October 2007 Pre-Budget Report, the Chancellor announced a radical reform of CGT: from April 2008, both taper relief and indexation allowances are set to be abolished completely, and CGT is to be charged at a flat rate of 18%. The Chancellor said in the PBR speech that his goal was ‘to make the system more straightforward and sustainable; to ensure it sets consistent incentives for investment and enterprise; and to ensure it remains internationally competitive’. The effect of the reform on the CGT rate structure is shown in Figure 10.3.

The graph shows that, if the proposal is implemented as announced, some disposals will be taxed more heavily than at present and others less heavily, according to a combination of whether the asset is a business or non-business asset, how long it has been held and whether the seller is a starting-, basic- or higher-rate taxpayer. The key changes are that:

⁸ At the time of the investment, companies must have fewer than 50 employees and no more than £7 million in gross assets (£8 million including the new investment). Companies are limited to raising no more than £2 million per year through the combination of VCT, EIS and the Corporate Venturing Scheme, a similar scheme available only to corporate investors and so ignored in this chapter.

⁹ Source: Table 1.5 of HMRC Statistics (http://www.hmrc.gov.uk/stats/tax_expenditures/table1-5.pdf).

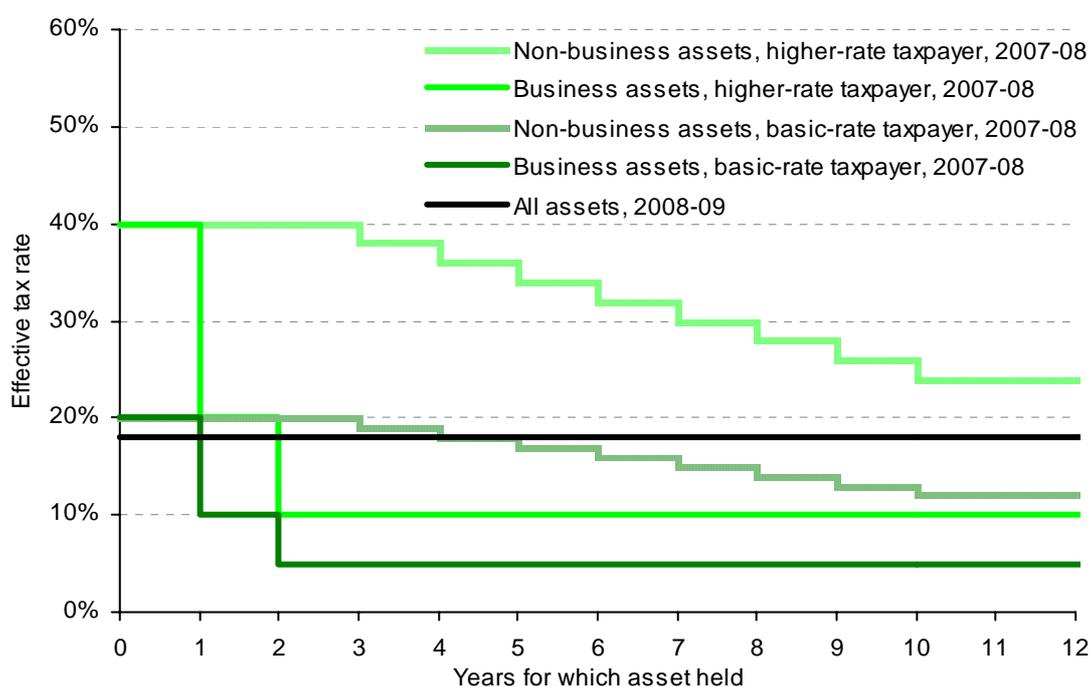
¹⁰ Numbers of taxpayers from table 1.4 of HMRC Statistics (http://www.hmrc.gov.uk/stats/tax_receipts/table1-4.pdf); revenue from table B8 of HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/media/F/9/pbr_csr07_annexb_305.pdf).

¹¹ Source: HM Treasury.

- capital gains on the non-business assets of higher-rate taxpayers will face a lower rate than at present;
- capital gains on business assets will be taxed more heavily than at present if the assets have been held for more than two years.

Overall, the increases will raise more for the exchequer than the reductions cost: the Treasury estimates that the net effect of the reform will be to increase the CGT yield in 2010–11 by an estimated £900 million, not a great deal in the context of overall tax revenue but quite substantial relative to the current £4.8 billion yield of CGT.

Figure 10.3. The PBR 2007 capital gains tax reform



Note: Effective rates for starting-rate taxpayers have been omitted for ease of viewing. Effective rates for them in 2007–08 fall from 10% to 2.5% on business assets and from 10% to 6% on non-business assets.

Sources: *Tolley's Capital Gains Tax 2007–08*; HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/pbr_csr07_index.cfm).

The reform announced in the Pre-Budget Report returns the CGT regime to roughly where it was before 1982: a single flat rate – unrelated to the taxpayer's marginal income tax rate and much lower than the higher rate(s) of income tax – with no allowance for indexation and no taper.

The rise in CGT rates on long-held business assets from 10% to 18% (or from 5% to 18% for basic-rate taxpayers) provoked angry reactions from many in the business community. The UK's four main business groups – the British Chambers of Commerce, the Confederation of British Industry, the Federation of Small Businesses and the Institute of Directors – jointly wrote an open letter to the Chancellor to object to the reform, stating: 'The reaction of our memberships has been so universally strong that we have felt it necessary to write collectively

to make clear the depth of our shared concerns'.¹² The *Daily Telegraph* ran a 'CGT: no thanks Darling' campaign; a petition on the 10 Downing Street website to keep taper relief has attracted over 18,000 signatories.¹³

In response to these objections, the government signalled that it would hold discussions with business groups and adjust the details of the reform. Chancellor Alistair Darling told the Confederation of British Industry's annual conference on 27 November 2007, 'we are working with the CBI and other business organisations to listen to what you have to say. I expect to publish final proposals in the next three weeks'.¹⁴ These proposals have since been delayed again: Mr Darling told the House of Commons on 13 December that 'it is not now going to be possible to conclude that process until the New Year'. At the time of writing, no new proposals have been announced.

10.3 CGT design and the proposed reform

This section examines how both the current system and the replacement proposed in the Pre-Budget Report measure up against some of the features we might look for in a tax on capital gains. We look first at neutrality: our starting point is that taxes should not, without a very strong rationale, distort commercial decisions about who holds assets for how long, which assets are chosen and whether remuneration is taken as earnings, dividends or capital gains. We consider each of these in turn. As well as being economically inefficient, arbitrarily favouring one action over another is unfair in penalising otherwise equivalent people who behave in the non-tax-favoured way.

We then consider the extent to which CGT discourages saving and investment that would take place in the absence of the tax; its possible role in actively encouraging entrepreneurship; and finally at the simplicity of the tax.

Allocation of assets and the period of ownership

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.

¹² Available at [http://www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/bfb7fe8cd5119c258025737200534ce2/\\$FILE/Chancellor%20letter%20-%20BCC%20CBI%20FSB%20IOD%20-%2015.10.07.pdf](http://www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/bfb7fe8cd5119c258025737200534ce2/$FILE/Chancellor%20letter%20-%20BCC%20CBI%20FSB%20IOD%20-%2015.10.07.pdf).

¹³ <http://petitions.pm.gov.uk/SaveCGTrelief/>.

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<http://www.cbi.org.uk/ndbs/Press.nsf/0363c1f07c6ca12a8025671c00381cc7/f254e58732292458802573a000431cca?OpenDocument>.

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.¹⁵ 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.¹⁶ 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 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.

This argument suggests only that the tax rate should not fall with the holding period. It does not shed any light on whether the tax rate should be ‘levelled out’ at 10% or 40%, the government’s chosen level of 18%, the taxpayer’s marginal rate or something else.

Taper relief is not the only feature of CGT that encourages people to hold assets for longer than they otherwise would:

- The fact that CGT is ‘forgiven’ at death encourages people to hold on to assets that have risen in value and bequeath them, even if it would be more profitable to sell them and use the proceeds in some other way before death (at which point other assets, including the proceeds from the sale of the original assets, could be passed on instead) and even if it would be preferable to pass on the assets (or the proceeds from selling them) immediately.
- Taxing capital gains when they are realised (i.e. on disposal of the asset) rather than when they accrue (i.e. when the rise in value occurs) means that the latent tax liability is deferred until disposal. This creates a ‘lock-in’ effect: once an asset has risen in value, holding on to it shields the gain from tax, in effect providing an interest-free loan of the tax liability from the point of accrual to the point of realisation.

There is a strong case for ending the forgiveness of CGT on death (which costs the exchequer £560 million in 2007–08), though this might need to be considered in conjunction with reform

¹⁵ 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.

¹⁶ 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>).

of inheritance tax.¹⁷ Ending the lock-in effect of realisation-based taxation is more difficult, since taxing on accrual is impractical for assets that cannot easily be valued without an actual transaction, and the only realisation-based scheme that does not distort holding periods is complicated and creates different problems.¹⁸ But abolishing taper relief is certainly a move in the right direction.

The *Daily Telegraph* and the *Financial Times* reported that, as a concession to opposition to its proposal, the government was planning to introduce a scheme similar to ‘retirement relief’, which was gradually reduced in value under the current Labour government before finally being abolished in April 2003.¹⁹ Retirement relief reduced the CGT payable on business assets if the seller was aged 50 or over (or had retired early on ill-health grounds), with a greater reduction the longer the asset had been held.²⁰ Hence it made relevant assets both more valuable to older individuals and more valuable the longer they had been held – once again, encouraging people to hold on to assets beyond the point where commercial considerations would lead them to dispose of them. It would seem bizarre to abolish taper relief but to introduce an alternative with similar flaws.

Choice of assets

The government should not distort the form in which savings are held and invested without a very good rationale: whether someone puts their money into a bank account, housing, shares in a quoted company, or his or her own business should generally be left to the individual’s judgement of which offers the best return (i.e. is the most productive investment) given their different risk profiles and other characteristics.

Taper relief violates this principle: by favouring business assets over non-business assets, it encourages individuals to put their money into their own business or shares in the company they work for rather than into shares in other companies or a second home. Removing this distortion is therefore an advantage of the proposed reform.

There is, however, a justification for taxing gains on corporate equity more lightly. The tax system as a whole should be neutral across different forms of saving and investment, but CGT is only part of that system. Company profits that give rise to capital gains are already taxed once under the corporation tax. There is therefore a clear case for taxing capital gains on corporate equity at a lower rate than capital gains on other assets in order to place investments in incorporated firms on a level playing field with investments in other assets. Indeed, this is

¹⁷ The cost of CGT forgiveness on death is taken from table 1.5 of HMRC Statistics (http://www.hmrc.gov.uk/stats/tax_expenditures/table1-5.pdf). The Tax Reform Commission, established by the Conservative Party and chaired by Lord Forsyth, recommended ending forgiveness on death with a reformed CGT (which tapered to zero after 10 years in any case) and abolishing inheritance tax altogether: see Tax Reform Commission, *Tax Matters: Reforming the Tax System*, October 2006 (<http://www.conservatives.com/pdf/taxreformcommissionreport.pdf>).

¹⁸ A realisation-based scheme with holding-period neutrality is presented in A. J. Auerbach, ‘Retrospective capital gains taxation’, *American Economic Review*, 1991, 81(1): 167–78, and developed in A. J. Auerbach and D. F. Bradford, ‘Generalized cash-flow taxation’, *Journal of Public Economics*, 2004, 88(5): 957–80.

¹⁹ ‘Gordon Brown concedes over capital gains tax’, *Daily Telegraph*, 1 November 2007 (<http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/10/31/cncgt231.xml>); ‘Business attacks CGT climbdown’, *Financial Times*, 31 October 2007 (<http://search.ft.com/ftArticle?sortBy=gadatearticle&queryText=jean+eaglesham&y=0&aje=true&x=0&id=071031000683&ct=0&page=21>).

²⁰ The definition of business assets for retirement relief purposes was different from that for taper relief purposes.

precisely what is already done for income tax in respect of dividends: once the dividend tax credit is taken into account, the effective income tax rates on dividend income are zero (at the starting and basic rates) and 25% (at the higher rate), reflecting the corporation tax paid on profits before they are distributed as dividends. Similar CGT rates could be adopted for capital gains on shares.

But the distinction between corporate and non-corporate assets does not correspond to the business/non-business assets distinction in taper relief, which applies preferential rates to unincorporated and unquoted businesses and does not apply them to shares in quoted companies unless the share owner is an employee of the company or has at least 5% of the voting rights in the company. The distinction made for taper relief introduces differentials between the treatment of quoted and unquoted companies, employee and non-employee shareholders, and shareholders with more or less than a 5% stake in the company. These differentials seem inequitable, as well as distorting a variety of decisions: not only how an individual invests his or her money, but also how to structure the ownership of a company, whether or not a company lists on a stock exchange, whether an employee holds shares in the company he or she works for or in other companies, and whether or not an employee leaves his or her job. None of these are decisions we would obviously want to be affected by their implications for liability to CGT.

In removing the distinction between business and non-business assets, the abolition of taper relief is therefore again moving in the right direction. The continued exemption of main homes remains a peculiarity, though this is a far larger issue (the exemption is estimated to cost the exchequer £17.3 billion in 2007–08,²¹ more than three times the total CGT yield) and any reform must be considered in the context of the overall tax treatment of housing, which is idiosyncratic in many respects. There is a strong case for introducing a preferential rate for shares, to reflect corporation tax already paid. Such a preferential rate would be removing rather than introducing a distortion in the system, and would be relatively simple to implement, since equity in companies liable for corporation tax is readily identifiable. But the abolition of the present distinction between business and non-business assets is welcome.

Form of economic activity and remuneration

Taxing different forms of remuneration in different ways creates an avoidance problem if remuneration can be shifted from one form to another, and encourages people to move into occupations where taking less heavily taxed remuneration is possible. While governments sometimes devise rules to try to restrict the form in which remuneration can be taken in particular circumstances (recent examples include the IR35 and Managed Service Company rules), such attempts are usually unsuccessful and never fully satisfactory: their main effect is to generate complexity and arbitrary distinctions and to occupy the minds of tax advisers in finding ingenious ways around the rules. Ultimately, the only solution is to align the tax rates on different forms of remuneration. In this context, the taxation of capital gains is out of line with the taxation of two other forms of remuneration that can be substituted for capital gains – dividends and earnings. We now look at each of these in turn.

²¹ Table 1.5 of HMRC Statistics (http://www.hmrc.gov.uk/stats/tax_expenditures/table1-5.pdf).

Taxation of dividends and capital gains

A company's profits can be returned to shareholders in at least two ways. The company can pay dividends, or it can hold on to the profits, increasing the value of its shares and creating a capital gain. There is no obvious reason for the tax system to treat one of these more favourably than the other, and owners of small businesses can to a large extent choose in which form to take the return on their investment. This would suggest aligning CGT rates on corporate equity with the income tax rates on dividends.

For starting- and basic-rate income taxpayers, dividend income is in effect untaxed at the personal level. A flat 18% CGT rate therefore represents a move away from alignment, since the current rate (for owner-managed firms, whose shares are business assets) is 5% for basic-rate taxpayers as long as the shares have been held for at least two years. However, since owner-managers who are basic-rate taxpayers would prefer untaxed dividends to capital gains in any case, this further differential is likely to make little difference. For basic-rate income taxpayers who have small shareholdings in quoted companies (non-business assets), the change is smaller – 18% replaces something between 12% and 20%, depending on the holding period – and substitution between dividends and capital gains is less of an issue, although differential treatment is still difficult to justify.

More important is the effect on owner-managers who are higher-rate taxpayers. For them, a rise in the CGT rate from 10% to 18% would move the headline rate closer to the 25% effective tax rate on dividend income, although the lack of relief for inflation (discussed in the next subsection) means that headline rates do not tell the whole story: the extent of the distortion in favour of capital gains (if any) also depends on how long after the dividends would be taken the capital gains would be realised, inflation rates in the intervening period, and the tax treatment of any asset the dividends were put into in the interim.

However, these comparisons serve mainly to highlight how strange it is for any difference to exist at all. The obvious way forward would be alignment of CGT rates on shares and income tax rates on dividends for both basic- and higher-rate taxpayers.

Taxation of earnings and capital gains

It is sometimes difficult to distinguish capital gains from earnings. The recent controversy over the treatment of 'carried interest' received by private equity fund managers provides a high-profile illustration of this, and it featured heavily in a recent Treasury Select Committee inquiry into the industry.²² But a more prosaic example is ordinary small companies: owner-managers might choose to forgo some or all of their salary to increase the value of the business and then sell it on (or pay themselves dividends, as discussed above). Indeed, as well as distorting the form in which remuneration is taken, preferential treatment of capital gains can distort the underlying economic activity, providing an incentive for people to move into occupations in which rewards can be taken as capital gains rather than earnings. Again, this points towards aligning the tax rates on capital gains and earnings, in order to minimise the need to make difficult distinctions, minimise the scope for tax avoidance and ensure equal treatment of people whose effort is rewarded with capital gains rather than salary.

²² The Treasury Select Committee's report can be viewed at <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/567/56702.htm>.

Under the existing system, CGT is charged at almost the same rates as income tax on earnings if the gains are realised within a year: 20% basic rate and 40% higher rate.²³ However, taper relief reduces the CGT rates dramatically to 5% basic rate and 10% higher rate if the capital gains are realised after more than two years.²⁴ This might seem to suggest that alignment is currently well achieved for short holding periods but not long ones, and that a flat 18% CGT rate creates close alignment with income tax for basic-rate taxpayers regardless of the holding period, while for people facing the higher (40%) rate of income tax, a flat 18% CGT rate is closer to alignment for long-held business assets (currently subject to 10% CGT) but further from alignment for business assets sold within a year (currently subject to 40% CGT).

However, this simple analysis again neglects the effect of the rest of the tax system. In particular, when considering the potential for converting salary into capital gains, the central case of interest is an owner-managed incorporated firm, and corporation tax cannot be ignored. Salaries are deductible for corporation tax, but profits retained to generate capital gains (or paid out as dividends) are not. If the company faces the 22% small companies' corporation tax rate that will be in place from April 2009 (see Chapter 11 for a discussion), then the current 10% and 40% CGT rates faced by higher-rate taxpayers at either end of the business assets taper imply overall tax rates of 29.8% and 53.2%; for basic-rate taxpayers, the corresponding figures are 25.9% and 37.6%.²⁵ A flat CGT rate of 18% implies an overall tax rate of 36.0%.

These might seemingly be compared with income tax rates of 20% and 40% for basic- and higher-rate taxpayers respectively, suggesting that the proposed CGT reform is primarily a move away from alignment for basic-rate taxpayers who hold on to their assets for two years or more, and a move towards alignment for higher-rate taxpayers at both ends of the business asset taper. But income tax is not the only tax on earnings. National Insurance contributions are a major tax on earnings that is escaped altogether by people taking remuneration as capital gains or dividends. Taking employee and employer contributions into account, the effective marginal tax rate on earnings is 38.8% for basic-rate taxpayers and 47.7% for higher-rate taxpayers.²⁶ For the purist, it is with these overall tax rates on earnings that combined corporation tax and CGT rates should be aligned. Yet even this analysis is not complete: as with the discussion of dividends above, the lack of indexation for inflation makes comparing effective tax rates on salary received now and capital gains realised in the future more difficult.

Despite all these complications, two lessons are clear. The first is that the case for having lower CGT rates on corporate equity than on other assets remains compelling: alignment of

²³ The main exception to this is that basic-rate taxpayers face a 22% marginal tax rate on earnings but only 20% – the savings rate – on capital gains. This small difference would disappear naturally in April 2008 as the basic rate of income tax falls from 22% to 20%. However, at the same time, the 10% starting rate of income tax is being abolished for earnings, but kept for savings income, and therefore would presumably be kept for capital gains in the absence of the proposed reform, introducing another small disparity. A further difference is in the different tax-free allowances for the two taxes, discussed further below.

²⁴ This assumes the assets are business assets, as they typically would be. For non-business assets, the rates fall much more slowly, to 12% basic rate and 24% higher rate after 10 years.

²⁵ For comparison, the overall tax rates on dividends in this case are 22.0% at the basic rate and 41.5% at the higher rate.

²⁶ These figures assume that the Income Tax and National Insurance reforms announced in Budget 2007 are implemented, and that the individual is contracted into the State Second Pension. They ignore the effect of earnings (or capital gains) on means-tested benefits and tax credits.

the effective rates at which gains on different asset types are taxed must be a prerequisite for successful alignment of these rates with those on other forms of remuneration. The second lesson is that a capital gains tax with basic and higher rates would inevitably line up more closely with taxes on income than a flat-rate tax does. When all other forms of income are taxed at rising marginal rates, a flat rate on capital gains seems hard to justify on either equity or efficiency grounds. A return to taxation of capital gains at the taxpayer's marginal income tax rate, as happened from 1988 to 1998, but with preferential rates on shares, would be a move in the right direction

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.

Encouraging saving and investment

Most criticism of the reform has focused not on the elimination of the differentials between short- and long-held assets and between business and non-business assets, but on the rise from 10% to 18% in the CGT rate on long-held business assets that is set to face higher-rate taxpayers. It is argued that this discourages investment and entrepreneurship. This subsection focuses on saving and investment; the next considers wider concepts of entrepreneurship.

High rates of CGT (and indeed other capital taxes such as corporation tax and income tax on savings, dividends and self-employment profits) certainly discourage saving and investment. This is usually undesirable: too little investment will be undertaken if otherwise profitable investments are made unprofitable by tax. And if an individual would rather save his or her money than spend it now, it is difficult to see why taxes should be used to discourage this.

This suggests a tension between keeping capital tax rates as low as possible so as not to discourage investment, and raising them towards income tax rates so as to minimise tax avoidance problems and avoid distorting choices over how to use effort, as discussed above. Indeed, the attempt to manage this trade-off has arguably been at the heart of CGT reform for decades: Nigel Lawson aligned CGT and income tax rates; Gordon Brown introduced taper relief, with a 10% CGT rate on long-held business assets to encourage investment; and finally, following a furore over the low tax rates faced by private equity executives, Alistair Darling increased the 10% rate to 18%. It seems unlikely that this reform will prove to be the final word on the matter.

However, this trade-off is not as straightforward and inescapable as it might seem, because it is not just headline rates that matter; the definition of the tax base is also important. In particular, capital allowances, which explicitly give deductions for the purchase cost and depreciation of assets, are crucial. Indeed, increasing capital allowances is a better way to encourage investment than reducing rates, because they focus specifically on reducing the

effective tax rate on investment rather than on effort, luck or other factors that generate capital gains.

In the 2007 Budget, the government announced the introduction in April 2008 of an Annual Investment Allowance (AIA), which allows investors to deduct the first £50,000 per year of investment in plant and machinery from their taxable profits. This will reduce the effective tax rate on small firms' investment in such assets by more than the CGT reform will increase it.

To see this, note that a rise in the CGT rate from 10% to 18%, though widely described as 'an 80% increase in the tax rate', is best thought of as meaning that the amount an investor gets to keep of any capital gain is 82/90 of what it was before the reform, an 8.9% fall in the post-tax rate of return. Equivalently, only investments that yield at least 90/82 of (just under 10% more than) what was required to break even before the reform will still be worth undertaking after the reform. And this assumes that all return is taken in the form of capital gains – if some (or all) of the investment return is taken as dividends, the net investment return falls by less (or not at all).

Compare this with the introduction of the AIA. If the investor faces the 22% small companies' corporation tax rate that will be in place from April 2009, this means that money that could previously buy £78-worth of equipment can now buy £100-worth of equipment. So each pound invested will yield 100/78 of what it did before the reform, a 28.2% rise in the rate of return. Equivalently, the rate of return required for an investment to be worthwhile will now be 78/100 of (22% lower than) what it was before the reform.²⁷

We would question the decision to restrict the AIA to investment in plant and machinery (rather than in industrial or commercial buildings, for example). But for companies whose investment is mainly in plant and machinery and is below the £50,000 limit, the combination of the introduction of the AIA and the increase in the CGT rate is likely to increase rather than reduce incentives to invest. And the AIA also encourages investment by other groups whose investment incentives are largely unaffected by the CGT reform: unincorporated businesses, which cannot easily convert profits into capital gains, and basic-rate taxpayers, for whom dividends are tax-favoured relative to capital gains in any case. All of this illustrates that preferential rates of CGT are a relatively ineffective way of using the tax system to stimulate investment.

In any case, small unquoted companies can still seek new external finance through the Enterprise Investment Scheme or Venture Capital Trusts, which are exempt from CGT and also receive upfront relief from income tax.

The most troubling aspect of the proposed reform is the continuing absence (indeed, the abolition for periods up to 1998) of indexation for inflation. Both the existing system and its proposed replacement fail to distinguish between real capital gains, which represent an increase in purchasing power when assets are sold, and nominal capital gains, which may simply reflect asset prices rising in line with inflation. Even at low rates of inflation, a tax on nominal capital gains corresponds to a much higher tax rate on real gains: for example, if

²⁷ This assumes that the pre-existing schedule of capital allowances corresponds exactly to true economic depreciation of plant and machinery. The reduction in effective tax rates will be smaller (larger) for forms of plant and machinery that depreciate less (more) rapidly than the schedule of capital allowances.

inflation is 2%, an 18% tax rate on a 5% nominal return corresponds to a 30% tax rate on the real return. And it can generate a hefty tax bill on holdings of assets even where no real gain at all has been made. This is both distortionary and inequitable. There is no obvious reason to tax purely inflationary gains, and no obvious reason to discourage saving and investment more when inflation is expected to be higher. Indexation operated successfully up to 1998, at some cost in complexity but far less than that associated with taper relief. In a world with online tax-return software widely available, it might now be possible for HMRC to administer a system in which the purchase price of assets is automatically updated in line with specified inflation rates over the period they are held. Failing that, in a world with low and stable inflation around the government's target, a close approximation to indexation could be achieved just by allowing for a constant, target inflation rate throughout the holding period.

There are two reasonable arguments against indexation. One is the complexity that it re-introduces into the system, albeit less than that associated with taper relief. It is hard to believe that this complexity alone would be enough to justify forgoing the benefits of indexation, but a judgement on that question rests partly on what path inflation might take in future and how great the benefits of indexation are therefore likely to be. The second argument against indexing capital gains is that it is not done for capital income: ordinary savings accounts, for example, are taxed according to the nominal interest they pay, not only interest above the current rate of inflation. That being the case, taxing only above-inflation capital gains would be inequitable, would distort the savings market in favour of assets that yield capital gains and would lead to conversion between income and gains. Of course, the ideal solution to that would be to provide inflation indexation of capital income as well as gains. But failing that, there is a judgement to be made as to whether some indexation is better than none at all.

Encouraging entrepreneurial risk-taking

So far, this section has considered as a goal not distorting decisions that would be made in the absence of tax. But should CGT be used actively to encourage certain activities?

Low rates of CGT are often defended as essential to reward difficult and risky entrepreneurial activity. But it is important to recognise that the difficulty and risk associated with entrepreneurship do not themselves justify favourable tax treatment. If the market rewards for particularly difficult or risky activities are not sufficiently high to compensate for the additional difficulty and risk involved, it suggests that the activities are not worth undertaking: there is no reason for the government to give them special tax breaks. A justification for government intervention arises only if markets fail to provide the appropriate incentives for entrepreneurship.

Market failure might arise if certain activities generate positive spillovers to society at large that neither the entrepreneur nor the investors in such activity can appropriate and that the individual does not take into account when choosing an occupation. The government might then wish to intervene to encourage this behaviour. For example, research and development – which brings benefits that cannot be fully appropriated by the researcher because intellectual property rights to the resulting innovations are limited – is encouraged by the R&D tax credit and through state funding of universities.

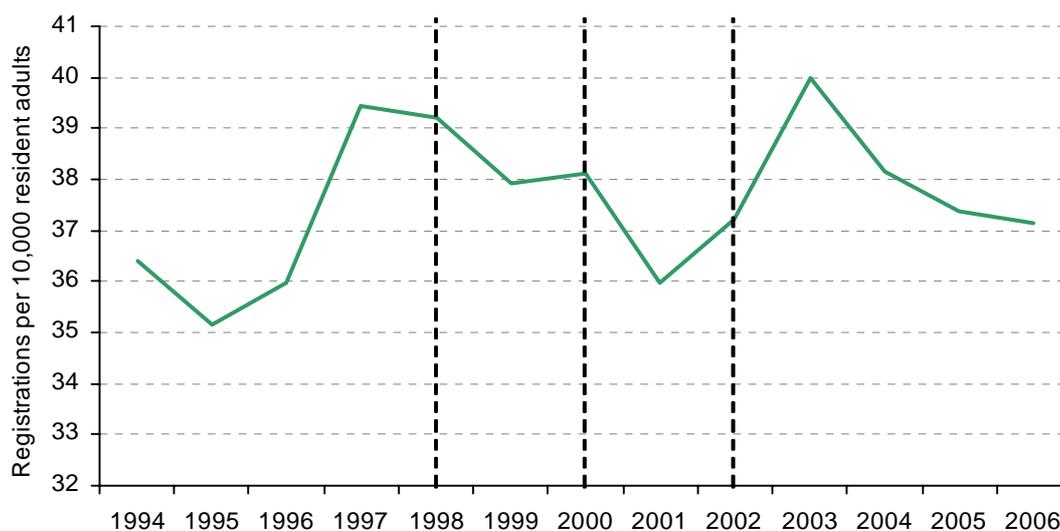
It is highly plausible that entrepreneurial activity in some sense does bring benefits to wider society. Ideally, the government would identify precisely what it is that generates these spillovers, and address it directly. But the spillovers from entrepreneurship may be difficult to pin down to specific activities in this way: for example, if the benefits to wider society come from individuals' trying out new ideas, from which others can learn whether or not they are successful, it is difficult to see how this could be addressed in as direct a way as the R&D tax credit. It may therefore be that tax incentives are not good tools for eliciting the elusive behaviour that we would like to encourage. Yet even if the nearest proxy we could find were starting a business (as opposed to being employed), that would at most point towards reducing tax rates on company and self-employment profits – though such a blunt instrument would scatter benefits much more widely than just on the additional entrepreneurs created and would create additional problems such as encouraging people to convert earnings into profits. It is even harder to see why low CGT rates, which help only firms that retain profits (thus excluding unincorporated businesses and companies that need to pay out dividends or salaries to cover the entrepreneur's living costs), would be an appropriate response.

Another potential market failure is financing constraints arising from asymmetric information. The supply of funds may be important if new ventures require a certain amount of equity finance in order to be viable. If potential investors know less about a venture's prospects than the entrepreneur involved, financial markets might fail to supply enough capital for a viable venture to go ahead. To the extent that the potential investors are liable to CGT, a low rate could allow viable start-ups to go ahead. However, the major sources of venture capital that are not subject to CGT, such as bank loans, pension funds, EIS and VCTs, at least partly alleviate this bottleneck,²⁸ and there is little hard evidence that any remaining problem is significant: it may be that entrepreneurs who fail to find finance just don't have viable business propositions. And again, CGT seems badly targeted to address whatever market failure there might be: in so far as it encourages investors to back viable ventures when they lack the information to perceive viability, it will also encourage them to back ventures that would not be viable at all but for the tax break.

There is scant evidence that CGT reform has an important effect on whether or not individuals start new ventures. Figure 10.4 plots the rate of UK VAT registrations in the UK, highlighting the dates of the introduction of, and two major changes to, the taper relief regime. 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.

²⁸ A US study in 1989 found that more than three-quarters of the funds that are invested in start-up firms are provided by investors who are not subject to the individual capital gains tax: see J. Poterba, 'Capital gains tax policy toward entrepreneurship', *National Tax Journal*, 1989, 42(3): 375–89. Recent survey evidence for the UK (<http://www.gemconsortium.org/document.aspx?id=579>) similarly suggests only a small role for CGT-payers in financing start-ups.

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/>).

Low rates of CGT do not, then, look like a well-targeted measure to encourage otherwise under-incentivised entrepreneurship. They do not directly focus on activities that the market might fail to reward adequately, and do not have a clear impact in increasing start-up activity, while they provide favourable treatment to many others without good reason, as discussed earlier in this section.

Simplicity

The government's principal justification for the CGT reform has been simplification of the tax system. One glance at Figure 10.3 reveals that the new system is considerably simpler than the one it is replacing. This is most obvious in the removal of the need to calculate taper relief and to make different calculations for business and non-business assets. In practice, much of the simplification arises from the less obvious implications of these features.

Taper relief requires rules to determine, if an individual buys shares in a company at more than one date and then sells some of them, which is the purchase date and price for the shares being sold. Distinguishing between business and non-business assets not only requires a complicated set of rules in itself; it also requires a set of rules for dealing with assets that were business assets for part of the holding period and non-business assets for the remainder: for example, in the case of an employee shareholder who sells his shares some time after leaving his job, a shareholder in a company that lists or de-lists on a stock exchange, or a shareholder whose share of voting rights in the company moves above or below 5% (perhaps repeatedly). Many such rules will become unnecessary under a flat-rate tax, and others will become less troublesome to police because the benefits of circumventing them will be reduced. A simple, across-the-board 18% rate also removes the need to keep separate sets of rules for assets acquired before 1998 and 1982. CGT is a notoriously complicated tax, and the value of such a major simplification should not be underestimated.

Perhaps the one area in which the proposed reforms would create potential for additional complexity is in the de-linking of the CGT rates for short-held assets from income tax rates. As discussed above, the true incentive to convert income into capital gains is rather more complicated than this would suggest, once the effects of inflation and other taxes are taken into account. Nevertheless, there is a risk that significant new opportunities will open up to avoid tax by converting income into immediately realised gains. It remains to be seen whether people who were not willing to wait two years for taper relief will be persuaded to take capital gains instead of income if the tax advantage can be obtained immediately. And perhaps tax advisers will be able to devise forms of remuneration that can be dressed up as instantly realised gains but that were not available if an asset had to be held for an extended period before disposal, though legal developments over the years have reduced the scope for such schemes. But if conversion of income into instantly realised gains becomes widespread, taxpayers and the government face the prospect of yet more rounds of avoidance schemes, anti-avoidance rules and court cases.

10.4 Managing transition

The previous section considered the current CGT regime and its proposed replacement in abstract terms: how one would design CGT if starting from scratch. This is a good way to think about how to tax people who buy assets in future. But a large part of the complaint about the PBR proposals has been about the perceived unfairness of retrospectively imposing a higher-than-expected tax on gains that people have already made.

Almost any capital tax reform creates windfall gains and losses for existing asset holders. This reform creates windfall gains for higher-rate taxpayers who own non-business assets²⁹ and windfall losses for people who have owned business assets for more than two years, both of which seem undeserved.

We should be clear about who the losers from the reform are and who they are not.

For example, owner-managers of companies still have the option of paying themselves dividends instead of maximising capital gains – and for basic-rate taxpayers that is a tax-advantaged option both before and after the reform, so they may be little affected.

Concern has been expressed about millions of members of employee share schemes being vulnerable to a tax hike. But the majority of such individuals are members of Share Incentive Plans (SIPs), which are CGT-exempt. A substantial minority (an estimated 1.7 million people) participate in Save As You Earn schemes, which are not CGT-exempt; but they can avoid CGT by transferring their shares to an ISA.³⁰ The vast majority of those who remain will not realise capital gains on these shares exceeding £9,200 in a single year, and those who do can hardly be described as the most vulnerable members of society.

²⁹ Owners of non-business assets who acquired them before 1998 are still set to lose from the abolition of indexation allowances, however, and in some cases this might outweigh the gains from reduced statutory rates.

³⁰ The 1.7 million estimate, and the fact that the majority of employee share scheme members participate in a SIP, come from ifs ProShare; see http://www.ifsproshare.org/lobbying/pdf/cgt_briefing_note_nov_07.pdf.

More generally, no-one whose savings are held in their main home, a pension, ISA, EIS, VCT or SIP loses; nor does anyone who holds on to their assets until death, or who realises gains of no more than £9,200 in any given year. And there are options available to mitigate the effect of the CGT increase. Part of the asset can be transferred to a spouse or civil partner before disposal to make use of both partners' annual exempt amounts. Individuals can defer their CGT bill by investing the proceeds of a sale through the EIS: not only are investment returns within the EIS CGT-exempt, but the CGT due on the original disposal is deferred without interest until disposal of the EIS shares. And, of course, many people investing in non-business assets, such as most quoted shares or second homes, will gain from the reform.

Nevertheless, there are some holders of business assets with a legitimate grievance about a retrospective tax increase. We can think of these as two groups. Those who started businesses (or acquired business assets more generally) before 1998 were not doing so in expectation of a 10% tax rate. They may have been led to expect one since – and perhaps reduced their other retirement saving as a result, for example – but the abolition of taper relief does not reduce their investment return below what they were expecting when making the investment. Indeed, 18% is a lower rate than they would have expected at the time – much lower, for higher-rate taxpayers – although this is offset by the abolition of indexation allowances, which were then in place. The CGT bill for people who acquired business assets before 1998, then, will be higher than they would have expected before the Pre-Budget Report, but it is not clear whether it will be higher than they would have expected when buying the asset. The effect of the reform for these people is in large part to take back the windfall they were given when taper relief was introduced.

For people who acquired assets from 1998 onwards, however, the argument is more clear-cut. Not only are they being made worse off now, but they invested on the basis that the tax rate on long-held business assets would be 10%. They may not even have benefited from taper relief if the low expected tax rate on long-held assets was reflected in a higher purchase price of the assets.

The government's approach to this issue has been unconvincing. It has made no explicit provision for transitional protection to avoid a windfall tax on already-accrued gains. But it has deliberately given a few months' notice of the reform to allow asset owners to 'arrange their affairs'. This is highly distortionary: it gives owners of business assets a huge incentive to dispose of their assets before the new regime comes in (and owners of non-business assets an incentive to hold on to their assets until then), regardless of the commercial desirability of doing so.³¹ This has been exacerbated by the subsequent uncertainty over possible

³¹ Owners of assets acquired before 1998 can avoid losing from the abolition of indexation allowances – though not from the abolition of taper relief – without having to sell their assets to anonymous third parties, by transferring the assets to a spouse or civil partner before 6 April 2008. The 'no gain / no loss' basis for treating transfers between spouses and civil partners means that the transfer is deemed to happen at the original purchase price plus indexation allowances given for periods up to 1998; but the holding period for taper relief purposes is the couple's combined length of ownership. Under the existing system, that is equivalent to treating the asset as acquired by the recipient at the original purchase price and date: the indexation allowance is simply built into the recipient's deemed acquisition cost instead of being calculated on final disposal. But from April 2008, no indexation allowance will be provided on final disposal; the deemed acquisition date will be irrelevant and only the deemed acquisition cost will matter. If no transfer takes place before April, the acquisition cost used for CGT purposes on eventual disposal will be the original acquisition cost; but if the asset is transferred to a spouse, the acquisition cost used on eventual disposal will include indexation allowance for periods up to 1998. Thus if an asset acquired before 1998 is transferred to a spouse or civil partner before 6 April, the indexation allowance for periods up to 1998 is crystallised into the deemed acquisition cost even though indexation is then retrospectively abolished. This possibility neutralises a significant part of the windfall losses facing some long-term asset holders, but far from all, and at the cost of discriminating against those without a

adjustments to the reform, which leaves existing holders of business assets still uncertain (at the time of writing) as to whether they will in the end face a much higher tax bill if they dispose of their assets after 5 April 2008 even as the window of opportunity before that date shrinks. As well as the economic distortions this approach causes, it seems grossly unfair to give much more generous treatment to those who dispose of their assets before 6 April than to those who are unwilling or unable to do so.

If the government did not want to provide transitional protection to existing holders of business assets, it should have implemented the reforms with immediate effect (i.e. presumably made the announcement in the forthcoming Budget for the 2008–09 tax year). If it viewed transitional protection as desirable, it should have been introduced explicitly.

Possible transitional arrangements

The purest form of transitional arrangement would apply the new regime in future but not retrospectively. This would involve rebasing asset values to a particular date (hereafter ‘the rebasing date’), applying the new regime to gains accruing thereafter, and continuing to apply the old regime – or some alternative – to gains accruing before that date. Arrangements broadly along these lines already exist for assets held before 1965 and for assets held before 1982.

The rebasing date could not be announced in advance, as that would leave open the possibility of manipulation of asset values around the relevant date. Since the government’s announcement of the CGT reform came as a surprise, we suggest that the rebasing date should be the date of the Pre-Budget Report, 9 October 2007, or earlier. The Institute of Chartered Accountants in England and Wales has suggested rebasing to 31 March 2002 as a possibility worth considering.³²

In effect, individuals would be treated as if they had sold their assets and bought them again (‘deemed realisation’) at market value on the relevant date. To achieve precise transitional protection, the government could continue to apply taper relief to gains accruing up to that date (according to the number of years between 1998 and the rebasing date for which the asset had been held) and to apply the existing transitional arrangements such as indexation for periods before 1998. To prevent cash-flow problems, tax due on increases in value prior to the rebasing date would become payable only upon eventual disposal of the assets, ideally with a market rate of interest accruing in the intervening period.

A less precise but simpler approach would be to apply a single system for all gains accruing before the rebasing date. For example, in 1988 all assets acquired before 1982 were rebased to their 1982 market values; for disposals since then, gains that accrued prior to 1982 are taxed under the regime in place at the time of disposal, but with a 50% reduction. Of course, the more generous the treatment of gains accruing before the rebasing date, and the more recent the rebasing date chosen, the greater the cost to the exchequer.

spouse or civil partner and perhaps introducing strife into marital relations where an individual is reluctant to give large assets to his or her spouse.

³² <http://www.icaew.com/index.cfm?route=152112>.

Maintaining a separate system – or more than one, if precise transitional protection were pursued – for gains accruing before a particular date would add considerably to the complexity of the overall CGT regime. Over time, as assets held before the rebasing date were disposed of, these complexities would become gradually less important (as the rules for assets held before 1965, 1982 and 1998 successively have), but simplification would become a painfully slow process.

The biggest disadvantage of the rebasing approach, however, is administrative: it would require all assets acquired before the rebasing date to be assigned a market value as at the rebasing date when they came to be sold. For quoted shares, this might be reasonably straightforward; for other assets, it seems a daunting task. It was done (and is still done) for the 1982 rebasing, and the burden can be significantly reduced by choosing a rebasing date some time ago, before the acquisition date of many assets now held. Nevertheless, rebasing is a burden the government may be reluctant to take on.

A number of practical compromises are possible which do not require valuation of all assets, though none is very satisfactory:

- Time apportionment: gains could be assumed to accrue smoothly, so that when an asset is sold, a proportion of the gain could be treated as arising under the new regime, equal to the proportion of the holding period that is after a particular date. This is theoretically inferior to the approach described above – if an asset holder expects future gains to accrue more quickly than past gains, he or she has an incentive to hold on to the asset so that the large gains are taxed as if partly arising under the old, more generous regime, and vice versa – but it would avoid the need for a complete rebasing of asset values. On the rare occasions when rules are still needed, assets acquired before 1965 are broadly subject to rebasing if they are quoted shares (the market values of which are more easily assessed) and time apportionment otherwise. A similar approach could be adopted now.
- The government could allow assets acquired before the reform to continue to be taxed under the current regime, either indefinitely or for a limited period. This would be deeply unsatisfactory. It would unfairly give much better treatment to people making gains on assets bought before that date than people making gains on newly acquired assets; it would provide a strong incentive for individuals to hold on to existing assets for as long as possible (or until their preferential treatment ended); and, if the preferential treatment were for a limited period only, it would penalise people who for commercial reasons would want to hold on to their assets beyond the limited period and push them to dispose of their assets earlier than they otherwise would.
- The least radical option would be to extend the government's approach by announcing now that the new regime would come into effect, not in a few months, but in (say) two years' time. The longer implementation is delayed, the longer people would have to 'arrange their affairs', and so fewer people would be unfairly penalised because disposing of their assets before the implementation date is an unattractive or unfeasible option. But there would still be a large distortionary incentive for people to dispose of assets shortly before the implementation date, and this distortion would become relevant for the many people who bought assets between now and the implementation date. Delaying implementation would also increase the distortion of non-business asset holders hanging on to their assets until implementation, and give people an incentive to try to compress

capital gain into the period before implementation (e.g. owner-managers forgoing salary until implementation and then taking a large salary afterwards).

In some cases, a decision would have to be made regarding whether to make the transitional scheme optional or compulsory; whether to apply it to people who gain from the proposed reforms as well as to people who lose. In all of the cases described above, applying the transitional arrangements to people who gain from the reform would remove some of the windfall gains. The gains of non-business asset holders seem just as undeserved as the losses of business asset holders, so applying the transitional arrangements to both groups would seem fair, as well as costing the Exchequer less. But, having announced reforms that benefit these groups, the government would be risking another backlash if it then withdrew part of these benefits.

This discussion has illustrated that all transitional schemes have significant disadvantages in terms of equity, economic efficiency and/or practicality. All would also significantly reduce or delay the simplification of the tax system that the Pre-Budget Report proposal represents. And all would be costly to the exchequer.

All tax and benefit reforms create winners and losers, and anyone making an investment takes the risk that the government will increase the tax rate on the investment return by the time it arises. A tax rate of 18% is still not very high, whether the comparison is with historical CGT rates, other countries' CGT rates, or tax rates on other economic activities. Individuals who invested on the basis of a 10% CGT rate understandably feel aggrieved, but given the disadvantages of transitional arrangements, whether protecting these (relatively few and relatively wealthy) people is the best use of exchequer funds seems uncertain at best.

10.5 The policy-making process

The problem of transition discussed in the previous section arises because the government is trying to withdraw a generous tax break that it had earlier given out. Like the introduction and then abolition of the 0% rate of corporation tax discussed in Chapter 11, the introduction and then (almost) abolition of the 10% starting rate of income tax, the introduction and then abolition of the stamp duty land tax exemption for non-residential properties in disadvantaged areas, and the almost annual reforms to first-year capital allowances for small firms' investment in plant and machinery, the introduction and then abolition of taper relief also adds to the instability of the tax system and creates a perception of uncertainty around not only the particular feature of the tax system being reformed but the rest of the tax system too. This makes it difficult for taxpayers to plan. The lesson is obvious: avoid making bad policy that will later need reform.

The desirability of stability does not mean that reform should never happen. Taper relief was overly complicated, overly generous and economically distortionary, and it is better to remove it than to leave it in place. But it would have been better still if the entirely foreseeable problems had been foreseen by the government, and taper relief never introduced in the first place. After a decade of reform, we are set to be left with a system that is arguably less sensible than the one Labour inherited. But in the mean time, the introduction of a tax break has created a vocal constituency for its retention, making it politically difficult to remove and

arguably unfair on those who had been led to believe it would remain – with the losers from its abolition not always the same people as the gainers from its introduction. The complaints of these losers may yet lead to even more unsatisfactory (and perhaps soon-to-be-reversed) measures to appease them.

In evidence to the Treasury Select Committee's inquiry into the Pre-Budget Report, Chancellor Darling claimed that taper relief had been a good idea when it was introduced, but that it was no longer needed. He argued that in the 1990s, there had been a climate of excessive short-term speculation that needed to be countered by incentives for long-term asset holding, but that this climate of short-termism had now changed.³³ This is unconvincing. It is doubtful that 'excessive' speculation was ever adequate justification for introducing taper relief; it is more doubtful that this aspect of the economic climate has changed much over the past 10 years; and it is still more doubtful that any of this justifies the problems associated with introducing a tax break and then removing it again.

Business lobby groups, tax professionals and the Treasury Select Committee have all expressed concern about the lack of consultation before the announcement of the CGT reform in the Pre-Budget Report.³⁴ It is difficult to think of good reasons not to consult on major reforms to the structure of a perennially awkward tax. One reason might have been if the government had wanted to implement the reforms with no notice so as to avoid a rush to sell assets before the new regime came into effect, and feared that consultation would not remain confidential. But the government clearly did not want the reform to come as a surprise: rightly or wrongly (as discussed in the previous section), the government deliberately gave some months' advance warning to allow taxpayers to arrange their affairs, so there could have been little additional harm done even if the details of a consultation had leaked out.

A second justification for not consulting before announcing the reform might be if the government was so sure that its policy was the right one that no consultation was needed. Yet the government has proclaimed itself willing to reconsider the detail of the reform since announcing it. Having created uncertainty in this way, the government has exacerbated it by missing its self-imposed deadline for publishing its 'final proposals' (though there had been no indication at the time of the Pre-Budget Report that the proposals were anything other than final). And there is no guarantee that the 'final proposals' that do emerge will be sensible, given that the government is constrained to make some decision before the policy is due to take effect on 6 April and is being lobbied intensively by interested parties. Almost the worst option of all is to announce reforms without consultation and then to make hasty policy in the months between announcement and implementation to try to deal with the response.

To the fiscal purist, the lack of consultation prior to this announcement, the strong incentive to sell assets before the announced changes are supposed to be implemented in April 2008, and the subsequent period of uncertainty about how they will in fact be implemented fail every test for sensible tax reform.

³³ See <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/54/5402.htm>.

³⁴ For the views of business lobby groups, see [http://www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/bfb7fe8cd5119c258025737200534ce2/\\$FILE/Chancellor%20letter%20-%20BCC%20CBI%20FSB%20IOD%20-%2015.10.07.pdf](http://www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/bfb7fe8cd5119c258025737200534ce2/$FILE/Chancellor%20letter%20-%20BCC%20CBI%20FSB%20IOD%20-%2015.10.07.pdf); for those of professional organisations, see <http://www.tax.org.uk/showarticle.pl?id=6315> and <http://www.icaew.com/index.cfm?route=152112>;

10.6 Conclusion

The guiding principles of capital gains tax design should be neutrality and simplicity. More often than not, these coincide, but not always. On simplicity, the reform proposed in the 2007 Pre-Budget Report passes with flying colours: it is hard to envisage a simpler system than a single flat rate. On neutrality, the proposed reforms are a significant improvement on the existing system, removing the principal incentive to hold on to assets for longer than makes commercial sense, the unequal treatment of business and non-business assets, and some of the incentive to convert income into gains.

It would be worth sacrificing some of the simplicity of the proposed reforms in favour of greater neutrality. Reduced rates should be applied to corporate equity to reflect corporation tax already paid, and serious consideration should be given to re-introducing relief for inflation. And the choice of an 18% rate seems determined by the government's immediate revenue needs rather than by a coherent view of how CGT fits into the tax system as a whole. It would be better to aim for alignment of CGT rates with those on earned income and dividends, and it is hard to understand why marginal CGT rates alone of these should not rise with income. Higher tax rates do discourage saving, investment and entrepreneurship. But saving and investment can better be encouraged by other means; so could entrepreneurship, once it is identified precisely what activity deserves special treatment.

Nevertheless, the proposed reform is a move in the right direction. Owners of existing business assets are understandably angry about the removal of a tax break they had been led to expect; if it were deemed appropriate, transitional protection could be devised, though it would be far from simple and would lead to problems of its own. The main lesson should be to avoid that kind of problem by providing certainty, stability and predictability, and to introduce carefully thought-out policies that will not need to be reformed or reversed in future. Yet the process of this reform has run exactly contrary to this lesson: an announcement was made without advance consultation; adverse reaction has prompted the announcement of a partial rethink, leading to instability and uncertainty; and the rethink is now being conducted under intense time pressure and lobbying, not the best environment for producing sensible policy proposals. It is hard to believe that whatever reform to CGT the government finally settles on this year will be the last.

10.7 Postscript: entrepreneurs' relief

On 24 January 2008, Mr Darling announced a concession to opponents of his proposed CGT reform: the introduction of a £200 million 'entrepreneurs' relief' that the Chancellor estimated would be available to 80,000 people in 2008–09.³⁵

and for the Report of the Treasury Select Committee, see <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/54/5402.htm>.

³⁵ Source: Statement to Parliament by the Chancellor of the Exchequer, 24 January 2008, available at http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/statement/speech_statement_240108.cfm. More details of the policy can be found at http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2008/press_05_08.cfm and <http://www.hmrc.gov.uk/cgt/disposal.htm>.

Entrepreneurs' relief will reduce the rate of CGT from 18% to 10% on the first £1 million of otherwise taxable capital gains realised over an individual's lifetime on the sale after 6 April 2008 of certain eligible assets:

- shares in a trading company (or holding company of a trading group) of which the shareholder has been a full-time employee or director, owned at least 5% of the shares, and had at least 5% of the voting rights, all for at least a year;
- an unincorporated business (or share in a business) or business assets sold after the individual stops carrying on the business.

This definition of eligible assets is based on that used for retirement relief prior to its abolition in 2003, and is different from the definition of business assets for taper relief purposes. In particular, it excludes three kinds of disposal that are currently eligible for business asset taper relief:

- assets of an unincorporated business if the individual continues the business thereafter;
- employee shareholdings of less than 5% of a quoted company;
- substantial shareholdings held by people who are not full-time employees or directors of the company (such as many private equity partners).

The ability of married couples and civil partners who both work for the same business to transfer shares of the business between them tax-free means that they can take advantage of the additional relief on lifetime gains of up to £2 million.

Taking together the reform announced in the Pre-Budget Report and the entrepreneurs' relief later bolted on, the main gainers from the CGT reforms due to take effect on 6 April will be higher-rate taxpayers making capital gains on non-business assets (primarily second homes and most quoted shares). The losers will be:

- investors in assets that qualified as business assets for taper relief but are not eligible for entrepreneurs' relief, as summarised above;
- investors in business assets who realise capital gains of over £1 million over their lifetimes after 6 April 2008;
- basic-rate taxpayers for whom the 10% rate created by entrepreneurs' relief remains higher than the 5% rate created by taper relief for business assets held for at least two years, or for whom the 18% main rate remains higher than the rate created by taper relief for non-business assets held for at least five years;
- people who have held assets since before 1998 and lose more from the abolition of indexation allowances than they gain from the rest of the package (if anything).

Entrepreneurs' relief will help to encourage people to start a business and invest in it, although, as discussed in Section 10.3, this could have been done in better-targeted ways and there is little evidence that reduced rates of CGT significantly affect the rate of business start-ups.

However, the relief will seriously complicate the admirably simple system proposed in the PBR. In particular, it reintroduces a need to distinguish between qualifying and non-qualifying assets.

The lifetime limit also introduces a need to keep records of disposals on which relief is claimed over the whole lifetime of any individual disposing of an asset, although only disposals that take place from 6 April 2008 onwards will count towards the £1 million lifetime limit, so there will be no need for records of disposals prior to that date.

Unlike retirement relief, entrepreneurs' relief does not have a minimum age requirement or give a higher rate of relief for longer-held assets. This reform therefore avoids reintroducing an explicit incentive for people to hold on to assets for longer than they would on commercial grounds alone. However, the design of the relief in fact entails several similar distortions:

- It gives self-employed individuals and partnerships a large incentive not to sell any assets of the business until they are ready to stop doing business altogether, regardless of whether the assets could be more profitably used by others and whether the proceeds of a sale could be more profitably used in other ways.
- The need to meet the qualifying conditions for the relief for at least a year is also a distortion, but the owner-managed businesses that qualify for relief are not the kind of assets typically traded in relatively short time horizons, and a qualifying period (or some alternative measure) is probably necessary to counter tax avoidance. Even with the one-year qualifying period, the incentive to roll existing assets into a business environment in order to shelter previously accrued gains from tax will put pressure on any anti-avoidance rules designed to counter this.
- The fact that only disposals from 6 April onwards will count towards the £1 million lifetime limit means that people have a strong incentive to realise accrued gains (that are taxed at 10% under the current system) before 6 April if they would otherwise expect to reach the £1 million lifetime limit.

Finally, the reform encourages owner-managers of companies to retain profits in the company rather than take them out as dividends or salary, regardless of whether (in the absence of tax considerations) they would rather spend the money or could invest it more profitably elsewhere. The strong incentive to set up a company in which to retain profits will also keep pressure on the IR35 and Managed Service Company rules which attempt to define when companies are 'artificial' avoidance devices.

As well as the economic inefficiency caused, it also seems unfair to discriminate in this way against owner-managers who cannot afford to retain profits in their company and against self-employed people who choose (or need) to sell business assets before giving up the business altogether. More generally, the justification for applying lower tax rates to people who own their own business than to the rest of the population seems far from clear. These people will no doubt welcome entrepreneurs' relief, but this tax break appears to come at the cost of some complexity, inefficiency and unfairness.