

Further Notes on CGT

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UK Shareholders Association
BM UKSA
London
WC1N 3XX

Phone: 0870-70-60-600
Email: uksa@uksa.org.uk
Web: www.uksa.org.uk

CGT proposals: UKSA demands that indexation be reintroduced, to prevent a “wealth tax” on inflation

It is the view of the UK Shareholders Association that unless changes are made to adjust for the impact of inflation on asset values, the Chancellor's plans for capital gains tax amount to a disgraceful retrospective wealth tax, aimed directly at long term investments.

We have waited for the Government to acknowledge this and to revise their plans, but they have not done so. The apparent “consultation” was with the private equity community, so perhaps there was little concern about the impact on ordinary savers.

We have to conclude either that the Chancellor has either failed to understand the impact of inflation on people's savings – or, worse, that this is a cynical tax-raising measure and the Chancellor knows full well that CGT now incorporates a wealth tax on long term holdings.

The argument that gains can be managed within the annual allowance carries little weight when cash-only takeovers of major companies are increasing, or when someone facing a major life crisis needs to liquidate their savings. One badly affected group will be the elderly holders of one or two defensive blue chips who have sat on shares for well over ten years and now need to fund re-housing or care.

The Government's “spin” on the CGT changes related to the way in which private equity managers have been able to treat what is arguably earned income as especially lightly taxed capital gains. But the surprise victims of the CGT changes will be those basic rate taxpayers who, following the removal of taper relief for long term holdings, and the removal of all past indexation relief, will now find themselves with a capital gains tax bill. The fact that there has not been greater outcry means that the “spin” has been successful and that most people are not aware of the impact.

The calculations needed to adjust for inflation are clearly within the capability of the Revenue to implement properly. Gross unfairness is too high a price to pay for simplicity.

We have asked to meet the Chancellor to discuss this, as the Government needs to replace these appalling proposals with something more sustainable. Better to get something sensible in place for 2009/10 than to try a quick fix.

For further information, please contact:

Roger Lawson, Communications Director
Telephone: 020-8467-2686
Email: roger.lawson@btclick.com

Notes for editors

Some further observations on capital gains tax, and numerical illustrations

The proposals for CGT give the strong impression that the Government does not know how to design a fairer system. We submit that a fairer system will have at least the following elements:

- An acceptance that it is wrong to tax capital gains without adjusting for the impact of inflation of the real cost of living.
- An overall structure which has cross-party support, which is not subject to radical changes. We are increasingly encouraged to save and to plan for our financial futures – without the confidence that the system is going to stay unchanged, how are individuals to do this? If investments are encouraged, for example in high risk or developing business on the understanding that a certain tax regime will apply, any changes in that regime should be prospective, not retrospective.

There appears to be a wide consensus on the desirability of encouraging long term investment, and we understood that taper relief was introduced to meet that objective and to compensate for the discontinuation of indexation. Now not only will taper relief be removed, but also all past indexation relief. We are urged to provide for ourselves as the proportion of aging dependants rises. What conclusions are we to draw from the latest announcements?

For people living on their savings income, their priority must be to maintain the value of their income and assets against the ravages of inflation. The ordinary saver, with investments in managed funds, does well even to stand still in real terms, after taking a small income from those investments.

To illustrate the problem with inflation, over the last 10 years, the retail price index, which is a reasonable reflection of the cost of living (unlike indices which ignore the cost of housing), has risen by about 30%. So for an investment of £100,000 in 1998 to keep pace with inflation, it needs to have risen to £130,000. Let's assume that it has done precisely this and see what the Chancellor's proposal means.

- True gain = current value – indexed cost = £130,000 – £100,000 = nil
- Nominal gain = current value – nominal original cost = £30,000
- Tax payable = 18% of 30,000 = 5,400, which is 4.1% of the current value.
- The investor has made zero real gain, but has suffered a tax of 4.1%. As a result, his / her future income will suffer a real fall by 4.1%, other things being equal

This amounts to a wealth tax, powered by inflation. We believe the long term inflationary threat is very serious. Inflation at 5% for 20 years¹ requires an initial sum of £100 to grow to £265 to stay level in real terms. At the end of that period, the current proposals would result in £165, which represents 62% of the fund, being subject to tax. At a rate of 18%, the effect of CGT would be a tax bill of about £30. This amounts to a wealth tax of over 11% ($30/265=11\%$). The impact is even more extreme if we consider higher rates of inflation or longer periods. And there can be no assurance that the tax rate will stay at 18%.

¹ We note that the RPI has more than doubled since January 1997, and since indexation was rebased in March 1982, the RPI has risen by 164.1%. Source: www.statistics.gov.uk.

For investors realising small gains, the annual CGT allowance will continue to reduce the tax bill. But for long term investors, the gains come through in lumps. With the removal of taper relief, many more investors will find themselves paying CGT from now on – which we believe is exactly what the Chancellor intends.

Particularly hard hit by the proposed changes will be basic rate taxpayers who have held assets for several years. For example, on a gain of £20,000 on an asset held for ten years, they stand to suffer almost a four fold tax hike – paying £1890 as opposed to £500 if the current regime were to continue (assuming taper relief to 60%, and next year's basic rate tax of 20%, and CGT allowance of £9500). And that assumes that the capital gain doesn't push them into a higher tax bracket. Higher rate taxpayers who have held an asset for 10 years will be surprised that they too will pay more, and will not reach the break even point between the taper relief system with 40% tax and the 18% flat rate until they have a gain of about £34,000. Below this figure they will be paying more under the new system. For example, with a gain of £20,000, they would pay £1890 under the 18% flat rate system compared with £1000 under the current regime.

Only short term holders, who do not qualify for taper relief, benefit from the new system paying only 18% rather than 20% or 40% on their taxable gains.

Investment in qualifying AIM shares will suffer substantially from the loss of the two year relief and some are saying it will no longer be worth the additional risk of investing in that market. It may hence have a very damaging effect on the provision of finance for smaller companies who have gained major benefits from the availability of listing on AIM.

We feel strongly that there is a place for private investors to play a long term ownership role in the UK. Hasty changes which have not been thought through do not help.

For an excellent summary and commentary of the impact of the proposed changes, see <http://www.icas.org.uk/site/cms/contentviewarticle.asp?article=5208> where the Institute of Chartered Accountants of Scotland express their view in uncharacteristically strong terms:

"..Chancellor's announcement concealed the true impact of the proposed scrapping of longstanding reliefs aimed at keeping inflationary gains out of tax" " hiding vast stealth increases in effective CGT rates" ... "astonished to find the Government favouring short term speculation".... "We would urge the Chancellor to think again"

About the UK Shareholders Association (UKSA)

UKSA is the leading independent organisation which represents the interests of private shareholders in the United Kingdom. We campaign to protect the rights of shareholders in public companies, and to promote improved standards of corporate governance. Our educational activities, regular regional meetings, company "analyst" meetings and the resources of our web site, help to inform the public on investment management. UKSA is a "not for profit" organisation which is financially supported primarily by its individual members.