
The case for inflation-indexed CGT

In the recent June 2010 Budget, the coalition government increased the headline rate of capital gains tax (CGT) to 28%, and decided not to reintroduce any differentiation between different types of assets. But CGT, in its current form, also makes no allowance for inflation – increases in the general price level of the economy. This means investors and asset owners will effectively be taxed on inflation. This short note sets out the current mechanism, and proposes a simple way that CGT could be adjusted to take inflation into account.

Capital gains tax: a beginners' guide

Capital gains tax, as the name suggests, is a tax on the gain made on the sale of an asset that was originally bought at a lower price. This means that a fine painting bought for £2mn, and then sold for £4mn two years later, would be liable for CGT on the difference of the £2mn in price.

Apart from an annual exemption for the first £10,100 of gains made, there are certain other exemptions to CGT. Homeowners do not pay it on their primary residence, but second homes are captured, and ISAs and gilts are also exempt. The government also allows entrepreneurs to claim entrepreneurs' relief, which reduces the effective rate of CGT to 10% for the first £5mn of lifetime gains made by an entrepreneur - although the definition of entrepreneurs is narrow and typically excludes those who invest in others' innovations at an early stage.

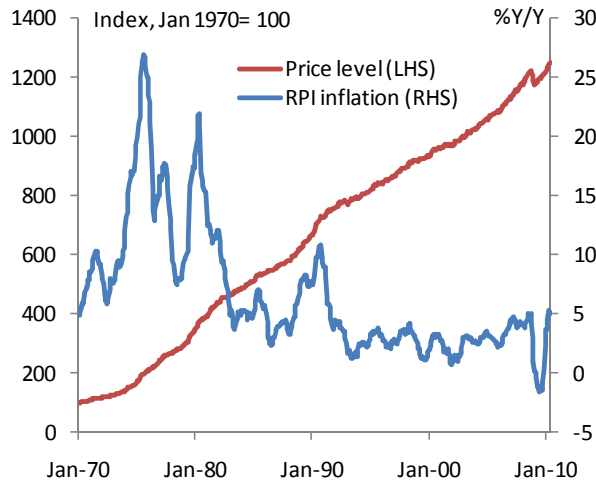
Inflation and why it matters

However, CGT makes no allowance whatsoever for inflation – the increase in the general price of goods and services across the economy as a whole. Inflation literally measure the decrease in the value of money – given an inflation rate of 5%, £100 buys you 5% fewer goods and services than it did the year before. This is why economists focus on inflation-adjusted data, such as real GDP growth, in order to abstract from changes in prices.

An indexation allowance, which took into account inflation, was available for CGT until 1998, when it was replaced with taper relief. This was abolished in the changes announced in the 2007 Pre-Budget Report and was not reinstated with the most recent Budget changes.

In the UK, the task of controlling inflation falls to the Monetary Policy Committee (MPC), which has to hit an annual inflation target of 2%, as measured by the Consumer Prices Index (CPI). The current rate of CPI inflation, at 3.4%Y/Y in May, is above the MPC's target, and is likely to remain above target in the near term, given the government's recent decision to increase VAT to 20% from 1 January 2011, before falling back over the medium term.

Chart 1: UK RPI and inflation



Source: ONS and BVCA

Over the lifetime of the MPC, CPI inflation has generally been close to the 2% target (and RPIX inflation, the old target measure, was close to its target of 2.5%). But in previous decades, UK inflation was higher and more volatile (Chart 1), reflecting amongst other things the lack of a credible monetary regime and other policy errors. To put this in context, at the start of 2010 the average level of prices in the economy was over 12 times higher than at the start of 1970, as measured by the Retail Prices Index (RPI). The lack of any indexation for CGT means that anyone holding an asset between 1970 and 2010, which had just increased in line with inflation, would have to pay CGT on over 90% of its sale price at the start of this year – despite the owner experiencing no real increase in the value of the asset.

The issue of indexation is a particular concern for private equity investors, who invest in companies for the long term, typically over three to seven years. Even if the MPC meets its inflation target of 2%, that still implies that over seven years inflation alone would increase the value of assets by 15%, making the investor liable for CGT even if the underlying real value of the asset was unchanged.

Recommendation

While CGT does not currently recognise the role that inflation plays in eroding value, it would be relatively simple to adjust the taxation system to take this into account. The government already issues inflation-adjusted bonds, which guaranteed a return indexed to the RPI, and various benefits are also linked to this measure of inflation. Simply by adjusting the increase in the nominal value of assets sold by the change in RPI or CPI over the same period, before CGT is applied, the government could avoid taxing people for inflation. Given that ONS already publish RPI and CPI figures on a monthly basis, and the price and timing of asset purchases and sales are already recorded for the purposes of CGT, this would be very simple to implement. Importantly, it would avoid individuals facing tax bills on assets that had experienced nominal price increases, but losses in real terms.

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