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The tax with an ever-changing face

News analysis

Governments have often changed CGT rules to suit their needs

By Tanya Powley

Capital gains tax (CGT) might be less than 50 years old but, during its short history, the rate charged has had a significant impact on second-home ownership – and has played a part in fuelling the recent buy-to-let property boom.

Since its introduction in the 1960s by James Callaghan, chancellor during Harold Wilson's government, CGT has been changed a number of times. David Kilshaw, head of private client advisory at KPMG, the accountancy firm, points out that, over the years, CGT has been: levied at the same rate as income tax; at a lower rate than income tax; with allowances for inflation, without allowances for inflation; with "taper" relief according to how long an asset is held; and with different rules for different assets.

The tax was originally introduced at 30 per cent on capital gains of more than £9,500 to stop people avoiding income tax by switching their income into capital. It wasn't until 1982, under Margaret Thatcher's government, that CGT was revisited and indexation was introduced in order to exempt gains that arose purely through the effects of inflation.

Liam Bailey, head of residential research at Knight Frank, the estate agency, believes this change was critical in encouraging the purchase of assets that could rise in price and generate capital gains. "High inflation in the 1970s had killed the rationale for capital gains, as you were simply taxed on inflation," he says.

However, the allowance was criticised for only exempting inflation post-1982, when the highest rates of inflation had occurred before 1982. In 1988, the government attempted to address this by making all gains pre-March 31 1982 exempt – rebasing the tax from its original imposition on April 6 1965 to March 31 1982. At the same time, dual CGT rates were introduced – mirroring changes to income tax rates – at 40 per cent for higher tax payers and 25 per cent for basic rate taxpayers, with a lower exemption of £5,000.

However, analysts say that it was the Labour government's decision to replace indexation with "taper relief" in 1998 that had the biggest impact on private investors. According to David Adams, head of residential at Chesterton Humberts, the estate agency, the move contributed to the buy-to-let property boom, which had been triggered by a drop in borrowing rates, and a shift of investment from the stock market into bricks and mortar.

Under the taper relief system, the longer an asset was held, the less CGT was paid on its disposal, based on a sliding scale from three to 10 years. Once you had owned an asset for 10 years, the rate fell from 40 per cent to 24 per cent.

> 'It will be the middle classes that have put their money into a property who will get clobbered again'

"There is no doubt in my mind that taper encouraged a longer-term mindset among some investors," says Mr Bailey. "Whereas indexation simply made the situation fairer – in that the investor was not taxed on inflation – suddenly with taper the investor was actively encouraged to hold an investment for a medium to long-term hold to reduce his tax rate."

Research by Savills, the estate agency, has found that buy-to-let mortgage lending increased by 688 per cent in the first half of the noughties, compared with just 112 per cent growth in the second half.

But while the tapering of CGT rates, the availability of higher loan-to-value mortgages, and lower interest rates fuelled the buy-to-let boom, other factors also played a part, experts say.

"After the 1989 stock market crash, people lost faith in equities and turned their attentions towards property which saw a consistent and fairly rapid rise in capital values," says Dan Channer of Finders Keepers, a lettings agent. This coincided with declining faith in pensions following a series of mis-selling scandals.

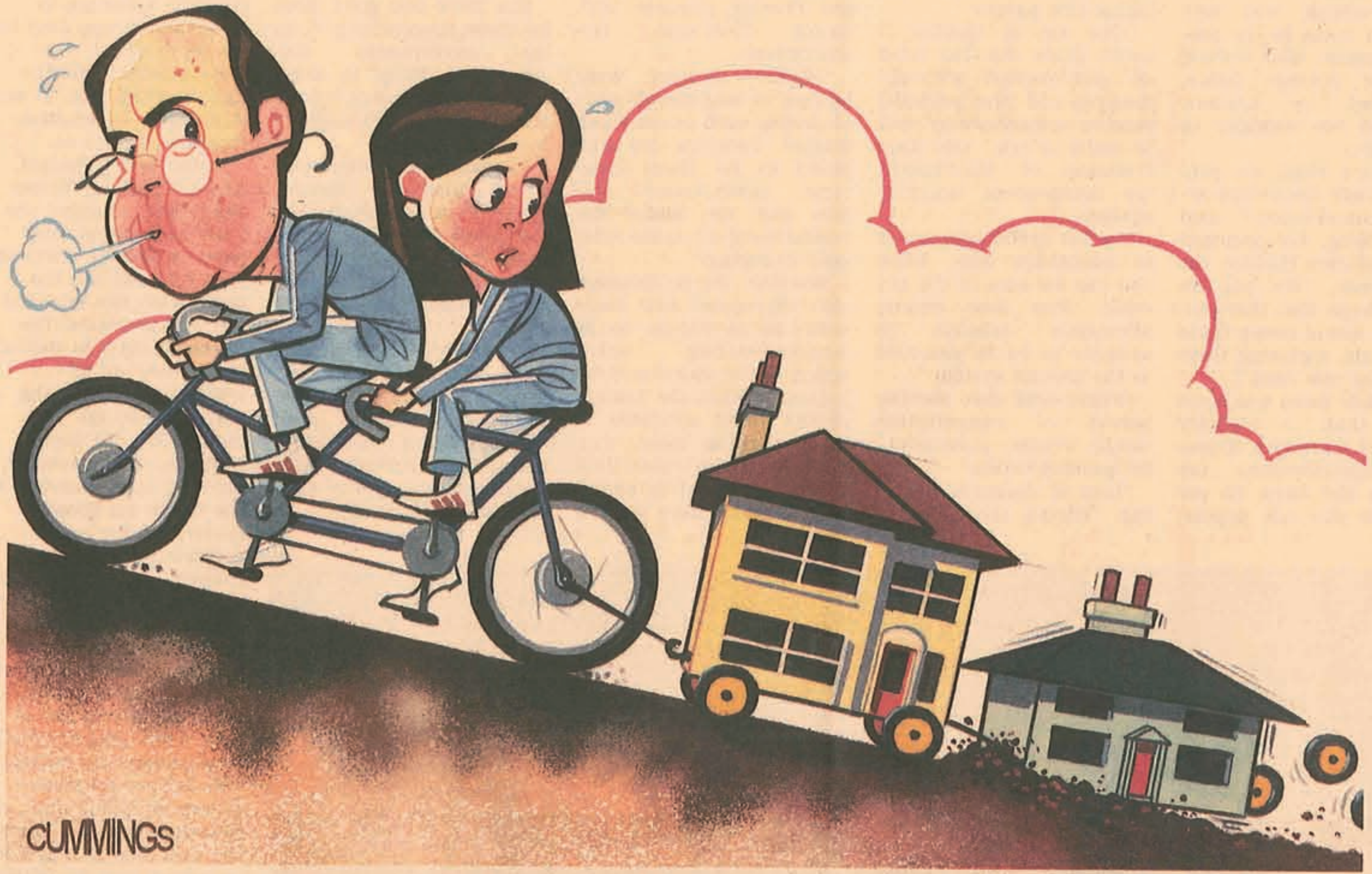
According to Mr Channer, in 1985, 10 per cent of the company's clients were investors. By 2008, this had risen to 65 per cent.

That was the year in which Alistair Darling changed the rules again: scrapping taper relief and dual rates, and replacing them with a single flat rate of 18 per cent. This encouraged further property speculation, removing the tax incentive to hold investments for a long period.

Second-home ownership and property investment became the middle-class hobby du jour. But property experts warn that it will be these investors who are hit hardest by George Osborne's CGT increase to 28 per cent. "It will actually be the middle classes that have put their money into a property, where they've seen their pensions get bashed, who will be the ones to get clobbered again," says Robert Bailey, a property buying agent.

Estate agents had reported that investors were rushing to sell ahead of the announcement in yesterday's emergency Budget. Instructions taken on by Chesterton Humberts last month were more than 150 per cent above the levels last May. Mr Adams says the company has seen an "enormous uplift" in the number of properties being put up for sale by landlords and second-home owners as a result of the expected rise in CGT.

However, many believe that the CGT rise will have little impact. Mr Bailey argues that with interest rates so low, rental yields have become a more important driver of demand for buy-to-let investors, rather than short-term capital price growth.



Capital gains tax: a short history

● 1965 – Wilson government
Rate: 30 per cent
Tax details: Introduction of capital gains tax. Aim was to stop people switching their income into capital to avoid taxation. Threshold of £9,500 was set.
Comment: Created a more level playing field between those taking income and those living on capital receipts.

● 1982 – Thatcher government
Rate: 30 per cent
Tax details: Indexation introduced to exempt gains that arose purely through the effects of inflation post 1982.
Comment: Critical in encouraging the purchase of assets for the purpose of realising future capital gains. High inflation in the 1970s had killed the rationale for capital gains as you were simply taxed on inflation.

● 1988 – Thatcher government
Rate: 40 per cent for higher-rate taxpayers; 25 per cent for basic rate taxpayers.
Tax details: Re-basing: dual CGT rates introduced, mirrored changes to income tax rates. Aim was to resolve the problems of the 1982 indexation. Made all pre-March 31 1982 gains exempt, hence CGT was "rebased" from April 6 1965 to March 31 1982. Threshold lowered to £5,000 – this crept up to £6,500 by the time the Conservatives left power in 1997.
Comment: No significant impact

● 1998 – Blair government
Rate: 40 per cent for higher-rate taxpayers; 25 per cent for basic rate taxpayers.
Tax details: Taper relief replaced indexation. Two types: Business Asset Taper Relief and Non-Business Asset Taper Relief. The longer you held the asset, the lower the rate of tax you paid on it. Initially, if you had owned an asset for 10 years, the rate fell from 40 per cent to 24 per cent. Threshold crept up to £7,700 by 2002.
Comment: Whereas indexation simply made the situation fairer – in that the investor was not taxed on inflation – with taper the investor is actively encouraged to hold an investment for a medium to long-term hold to reduce his tax rate.

● 2008 – Brown government
Rate: 18 per cent
Tax details: Alistair Darling scraps taper relief and dual rates. Replaced by a single rate of 18 per cent. By 2009, threshold had reached £10,100.
Comment: With taper removed there is now no incentive to hold investments for a long time period.

Source: Knight Frank