Capital Gains Tax to Harm Business

How do you earn your money and how to do you pay tax? The answer to this question for most people is that they earn an income and pay tax through the payroll. Various income tax rates are levied in the UK, starting with a general rate of 22% and a higher income rate of 40%.

But what if you don’t earn an income and instead you invest in undervalued companies, improve their performance, sell them on and make a profit? What tax do you then pay? This is the issue faced, or enjoyed by the private equity industry. Private equity companies take the bulk of their gains, which are often in the millions of pounds, via capital appreciation, rather than through income. So a gain of a few millions should be taxed at an equivalent income level of 40%, right? Wrong, the effective capital gains tax is more likely to be around 10%! All seems very attractive, too attractive for some including the government.

The government recently announced that the effective capital gains rate would increase to 18%. Many in industry are not impressed. John Cridland, deputy director-general of the CBI, said: "Raising the minimum Capital Gains Tax rate to 18% will adversely affect the balance between risk and reward, both for entrepreneurs and for the UK's vital private equity industry. This is disappointing and may lead to a reduction in investment in start-up and growing businesses."

Paul Davies, UK head of tax for Ernst & Young, said, "The changes we saw today to taper relief are clearly motivated by the heightened focus on private equity. We are extremely disappointed with these proposals as they threaten to undermine the entrepreneur culture that has blossomed over the last decade.

"Complete abolition of the taper removes a large incentive for entrepreneurs and challenges the 'Dragon's Den' success of the UK. It also represents a fundamental retreat from his predecessor's key policy," said Mr Davies. The Chancellor said that possible reforms to be applied to the private equity sector would be published in a review by Sir David Walker next month, in order that private equity firms "pay a fairer share."

The Institute of Directors said that a single 18 per cent capital gains tax rate would simplify the system but would mean higher tax bills for some.

Richard Baron, head of tax at the IOD, said: "If there is no revival of indexation allowance then long-term investment will be penalized by the taxation of inflationary gains, giving an effective tax rate on real gains that will be significantly higher than 18 per cent."

Questions

1. Is it fairer to tax people who accumulate more money?

2. Is it fair for the tax system to subsidize risk takers?

3. Should the tax system determine whether an investment is profitable or not?