THE PRESERVATION AND EXTENSION OF THE INDEXATION ALLOWANCE FOLLOWING THE FINANCE ACT 2008

Keith Gordon[1]

Introduction

When he assumed office as Chancellor of the Exchequer, Alistair Darling was widely expected to represent a continuation of the previous ten years.[2] So it was somewhat of a surprise to learn on 9th October 2007 that his predecessor's key capital gains tax measure, taper relief, would be abolished with effect from 6 April 2008.

I would be the first to say that taper relief was a disaster. Whilst its underlying rationale should be welcomed, its implementation was inept (in particular the requirement for gains to remain in charge rather than for taper relief to extinguish the gains entirely) and it relied, partly, on taxpayers and HMRC turning a blind eye to the actual wording of the legislation in many cases. It is beyond the scope of this article to consider whether the replacement of taper relief by a single (generally reduced) flat rate of capital gains tax represents a good thing. However, I will acknowledge that it has represented the start of a simplification of the tax, and has permitted other complications to be removed.

This article will focus on one of those other complexities – indexation allowance – and will consider the extent to which its removal with effect from 6th April 2008 is merely illusory. The article will conclude by considering how the labyrinthine nature of the capital gains tax code has meant the reintroduction of a relief that was meant to have been abolished (subject to a temporary transitional measure) back in 1993.

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1 Keith Gordon MA (Oxon) FCA CTA(Fellow), is a barrister, chartered accountant and tax adviser. He practises from Atlas Chambers (020 7269 7980, www.atlaschambers.com) and can be contacted by e-mail: keith@keithmgordon.co.uk.

2 Cynics might comment that the chaos and confusion that has reigned at the Treasury and HM Revenue and Customs since June 2007 adequately fulfil that prophecy.

Indexation allowance – a potted history

Indexation allowance was a remnant of the high levels of inflation that inflicted the UK in the late 1970s. It was recognised at the time that capital gains tax was, broadly, a tax on paper gains.[3] With inflation touching 30% at times, it is not hard to imagine that tax was often exacted in cases where a gain was made on paper but where the asset had, in real terms, lost value.

The response to this came from Sir Geoffrey Howe's Chancellorship. He introduced a measure, that was modified in the years following its introduction, that provided a measure of relief to recognise the effects of inflation on the capital cost of acquiring (or enhancing the value of) an asset. By the late 1980s, indexation allowance was an additional amount that could be deducted alongside the actual costs of an asset when calculating the gain arising upon the asset's disposal.[4]

The allowance was calculated by comparing the retail prices index for the month in which the expenditure was incurred[5] with that for the month of disposal.[6]

For the purposes of capital gains tax, the indexation allowance was replaced by taper relief with effect from 6th April 1998. However, for assets owned prior to 1st April 1998 and disposed of after 5th April 1998, any indexation allowance earned continued to be deductible when calculating any untapered gain[7] (i.e. to the extent that the retail prices index for the month of expenditure[8] was less than the index for April 1998, the cost could be enhanced by indexation reflecting the rate of inflation between those months). For corporation tax, the indexation allowance rules continued to operate post April 1998 as they had done previously.

The 9th October 2007 announcement, however, heralded the ultimate demise of indexation allowance for the purposes of capital gains tax[9]. As part of the simplification process, capital gains tax would revert to being a tax on the difference

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3 With no disrespect intended to Lord Wilberforce, in the most straightforward of situations, capital gains tax *was* a tax upon arithmetical differences.

4 Since 1992, the rules have been contained in Pt II, Chap IV of the Taxation of Chargeable Gains Act 1992.

5 or, for March 1982, in cases where the expenditure was incurred before then

6 In cases where the retail prices index experienced a net fall between the date of expenditure and the date of disposal, the indexation allowance was nil (TCGA 1992, s 54(2)(b)).

7 section 54(1A)(b)(i)

8 or March 1982, if later

9 but, again, not for corporation tax

between the net proceeds upon the disposal of the asset and the total costs incurred on the asset.

The effect of the abolition of the indexation allowance

Clearly, the abolition of indexation allowance represents a step towards simplification of capital gains tax. However, as many taxpayers soon realised or, if they are particularly unlucky, will realise after it's too late, this change has led to an increase in the overall tax liability in many cases. And that is despite the reduction of the headline rate of tax. See the Example below.

Example

James bought an asset for £100,000 on 31st March 1982. He sold it for £300,000 (net proceeds) in April 2008. Due to a complexity in the contract it is not immediately clear whether or not the sale became unconditional on 5th or 6th April and thus it is not certain in which tax year the asset was disposed of.

Supposing a sale on 5th April 2008

For simplicity, treat the increase in the retail prices index between March 1982 and April 1998 as 104%.

James may therefore deduct from his net proceeds, the cost of £100,000 and the indexation allowance of 104% × £100,000 (i.e. £104,000).

Thus James's untapered gain was £96,000. Assuming that the anti-avoidance rules did not apply, taper relief would have reduced the gain to something ranging from £24,000 (assuming that the asset qualified as a business asset for the taper relief rules throughout the period from 6 April 1998) to £57,600.

Assuming James was a higher rate taxpayer and that the annual exemption was otherwise used, the disposal of the asset would have given rise to a capital gains tax bill of between £9,600 and £23,040.

Supposing a sale on 6 April 2008

Under the new rules, the gain is calculated simply as £300,000 minus £100,000 (i.e. £200,000), on which tax is charged at 18% (£36,000).

Preserving the indexation allowance

It can be seen, therefore, that the indexation allowance, whilst being an additional complexity, was of considerable value to many taxpayers. Given nearly six months' warning, taxpayers have therefore attempted to devise ways to preserve the effects of the indexation allowance prior to its abolition on 6th April 2008.

The simplest, for taxpayers in a position to take advantage of the method, was for assets to be transferred to spouses or civil partners under the provisions of section 58.

Section 58 transfers

I considered section 58 in some depth in my article, 'Separation and capital gains tax – has the Civil Partnership Act 2004 led to an unexpected change in relation to couples who separate?'[10] and, therefore, will not discuss it in any detail here. However, as is well known, section 58 provides for the tax-free transfer of chargeable assets amongst married couples and civil partners provided that they are living together at some time in the year of the transfer.

Section 58 does not, as it could have done, deem the transferee's acquisition to have arisen when the transferor originally acquired the asset. Instead, it recognises the transfer as an effective disposal by the transferor and as an effective acquisition by the transferee, those events occurring at the time of the transfer itself.[11] From a computational perspective, however, section 58 ensures that such transfers are deemed to be for such consideration that would give rise to neither a gain nor a loss to the transferor.[12]

Thus, in the simplest case, assume that Sarah acquires an asset in 2007 when it was worth £200 and she gives it to her husband, Gordon, in 2008. Irrespective of the value of the asset in 2008, Sarah is treated as disposing of it for £200 (so giving rise to neither a gain nor a loss) and Gordon's base cost is deemed to be the same amount.

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10 *P.T.P.R.* [2007] 11(3) pp43-50

11 Consequently, such transfers can be used to circumvent the share identification rules (or, equally, can cause taxpayers to fall foul of those rules).

12 section 58(1)

Section 58 transfers and indexation allowance

Upon the introduction of indexation allowance, what is now section 58 would arguably have had the same effect. However, what became section 56(2) provided explicitly that the notional disposal value should take into account any indexation allowance that had accrued since the date of acquisition until the date of the transfer (or April 1998, if earlier).

Thus, suppose Norma had acquired an asset in 1990 for £1,000 which she transferred to her husband, John in 2000. Suppose further that the increase in the RPI between the month of acquisition and April 1998 was 25%. In that case, Norma and John would, respectively, be treated as having disposed of and acquired the asset for £1,250.

During the months before the publication of this year's Finance Bill, it became clear that the abolition of indexation allowance would not unwind any allowance that had already been earned. Thus, to refer to the example of Norma and John, John's base cost would remain £1,250 even if he retained the asset beyond 5th April 2008.

Furthermore, it was acknowledged by HMRC that that would be the case even if transfers were made between spouses and civil partners at any time until 5 April 2008; in other words, couples, aware of the proposed legislative changes, could take action prior to the coming into effect of the new rules to 'bank' any accrued entitlement to taper relief.

The draft legislation published during the winter gave rise to two restrictions on this rule: one, in my view, was unsurprising; the other simply highlighted the complexities within the 1992 Act.

The first was that it would not be possible for any pre-1998 indexation allowance to be 'banked' by effecting an inter-spouse transfer or a transfer between civil partners after 5th April 2008. This is because section 58 has remained unamended but for the indexation allowance rules in Chapter IV to be limited to corporation tax only in respect of any disposals on or after 6th April 2008.[13] Consequently, any transfer after 5th April 2008 would not attract any indexation allowance and, therefore, section 58 operates on the basis of the transferor's actual base cost (plus any allowable enhancement expenditure).[14]

The second restriction was tackled by the Parliamentary drafters between the publication of the draft legislation and the first introduction of the Finance Bill.

13 section 52A (as to be inserted by (per the Finance Bill as introduced) FA 2008, Schedule 2, paras 78 and 83)

14 Of course, if the transferor's base cost included banked indexation allowance from a previous section 58 transfer, then that amount would be included in the base cost.

Because of the special legislative rules applying to assets held by a person on 31st March 1982, it would not have been so easy for couples to bank indexation allowance in respect of assets that were acquired by the couple before April 1982, even if there had been a transfer between them after 31st March 1982.

This was because TCGA 1992, Schedule 3, paragraph 1 provided that the transferee's acquisition date would have been backdated to 31st March 1982 and section 55(6) overrode the application of section 56(2) in such cases. Until the abolition of indexation allowance, this separate régime was of little consequence because this would simply have permitted the transferee to claim indexation allowance from March 1982, irrespective of that person's actual date of acquisition. However, most importantly, it did not bank any entitlement to indexation allowance at the time and, therefore, upon the abolition of the allowance, subsequent gains would be calculated simply by comparing the net disposal proceeds with the March 1982 value.

Fortunately, the Government has responded to concerns and introduced a provision to deal with such cases. It has introduced a new section 35A which confirms that section 56(2) is to be treated as having applied on any intermediate transfer between spouses or civil partners.

Thus, with the slight complication caused by the insertion of new section 35A, the post-FA 2008 rules provide that if:

1. an asset is disposed of by an individual on or after 6th April 2008,

2. that asset had been acquired by the individual from a spouse or civil partner before 6th April 2008,

3. that acquisition was governed by the provisions of section 58 (or a statutory predecessor of that section); and

4. there had been no transfer outside the scope of section 58 since 31st March 1998

then the disponer's base cost shall include any accrued indexation allowance up to April 1998 irrespective of when the last transfer outside the scope of section 58 took place.

An oversight by HM Government

Due to the underlying complexities in the legislation and the doubts raised concerning the effect of section 56 in many cases, the other provisions of section 56 have attracted more attention than might otherwise have been the case. In particular, section 56(3) and (4).

Those subsections were inserted by the Finance Act 1994, section 93(5)(b) in relation to disposals made on or after 30th November 1993 and were part of the measure that was designed to prevent indexation allowance either creating or augmenting a capital loss.[15]

Suppose, now, that an individual had acquired an asset before April 1998 on which there was a subsequent transfer to the individual's spouse or civil partner (before 6 April 2008).

Initially, suppose the original acquisition had taken place after March 1982. Thus, section 58 would have operated in conjunction with section 56(2) with the effect that the transferee spouse or civil partner would have acquired the benefit of any indexation allowance as part of that individual's base cost.

When Finance Act 1994 introduced the rule that prevented indexation allowance from creating or increasing an allowable loss with effect from 30th November 1993, the effect of section 56(2) could have been applied so as to circumvent the new rules.

For example, suppose Margaret had acquired an asset from Denis. Suppose further that:

(1) Denis had originally bought the asset for £1,000;

(2) section 56(2) deemed Margaret's base cost to have been £1,200 and

(3) when Margaret eventually sold the asset:

  a. indexation allowance was worth a further 10% (increasing Margaret's allowable cost to £1,320) and

  b. the asset was worth only £1,100.

Prior to 30th November 1993, Margaret would have been able to claim an allowable loss of £220, representing the difference between the real cost of the asset (£1,000 + 20% inflation + a further 10% inflation (compounded)) and the eventual disposal value.

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15 For example, if an asset cost £100 and the indexation allowance thereon would have been £20, for disposals on or after 30th November 1993 (ignoring the transitional rules), the allowable deductions will be (a) £120 if the net proceeds equal or exceed that amount, (b) £100 if the net proceeds are equal to or less than that amount or (c) the actual net proceeds in all other cases.

Had the then Government simply prevented indexation allowance from creating or increasing a loss, it might have been possible to argue that Margaret's base cost was £1,200 and her disposal value was £1,100 – giving Margaret an allowable loss of £100. However, FA 1994, section 93 went further and introduced section 56(3) and (4). They provide that, where:

1. a loss arises on a disposal

2. that loss includes an amount arising from the application of section 56(2) on a nil-gain nil-loss transfer

3. that nil-gain nil-loss transfer was made on or after 30th November 1993,

then section 56(2) is treated as not having applied to the extent that it creates or increases a loss on the eventual disposal.

Therefore, once one accepts that indexation allowance is going to be curtailed as envisaged from 30th November 1993, it made perfect sense for the obvious method of circumventing the rules to be blocked.

For the reasons explained earlier in this article, sections 56(3) and (4) had no application if the asset had been originally acquired before 1st April 1982 because the transferee did not take over the indexed base cost from the transferor. Instead, the transferee (upon making the eventual disposal) was treated as having owned the asset on 31st March 1982, even if the transfer between the spouses or civil partners actually occurred some time later.

The position after 5th April 2008

The natural assumption is that the abolition of indexation allowance would have meant that taxpayers would not be better off after 5th April 2008 than they were on or before that date, with the exception of those cases where new section 35A explicitly provides parity for couples with pre-April 1982 assets with those whose assets were acquired on or after 1st April 1982.

However, that assumption relies upon a straightforwardness of the capital gains tax legislation that does not (yet) exist.

The key is the difference between section 56(2) and section 56(3). So far as capital gains tax is concerned, the former operated at the time of the transfer between spouses or civil partners. Thus, it had the effect of banking indexation allowance in those cases where:

- the asset was originally acquired on or after 1st April 1982 and

- (because new section 52A provides that, since 6th April 2008, Chapter IV has effect only for corporation tax) the transfer between the spouses or civil partners took place before 6th April 2008.

Section 56(3), on the other hand, was relevant only at the time that the transferee disposes of the asset to a third party (and only in cases where a loss arises). Therefore, if the couple still owned the asset on 6th April 2008, section 56(3) would not have been in point. More importantly, since section 56(3) is no longer of any application so far as capital gains tax is concerned[16], section 56(3) cannot be invoked by HMRC in relation to any disposal by the transferee spouse or civil partner after 5th April 2008.

Therefore, to use the example of Denis and Margaret above, Margaret is once again able to claim a loss. That loss is not as much as she would have been able to claim before 30th November 1993 (because Margaret is not entitled to any indexation allowance in respect of her period of ownership[17]. However, Margaret does not forgo the indexation allowance applicable to Denis's period of ownership[18]. In other words, any indexation allowance that was banked by virtue of a pre-6th April 2008 transfer between spouses or civil partners is fully available for relief, even if it means that an overall loss is created or increased.

Had Denis acquired the asset before (but transferred it to Margaret after) 1st April 1982, the analysis is only slightly different.

The pre-2008 code operated by invoking section 56(2) (as with all section 58 and other nil-gain nil loss transfers) on the transfer to Margaret[19]. Under the present code, it is still the case that Margaret's acquisition cost includes Denis's indexation allowance.

However, section 55(6) is no longer of any relevance and therefore there is nothing to upset this conclusion when Margaret ultimately disposes of the asset. More importantly, new section 35A makes it clear that section 56(2) is not to be disapplied in any event. Therefore, the Margaret's base cost is undeniably equal to that of Denis *plus* any indexation allowance that would have been available when Denis disposed of the asset. Consequently, any disposal value that is less than Margaret's base cost will mean that Margaret becomes entitled to loss relief, even if the disposal value is actually in excess of Denis's original cost.

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16 because of the effect of section 52A

17 10% in the example

18 adding £200 to the allowable deductions

19 although this would then have been disapplied by section 55(6)(b) upon a subsequent disposal to a third party

The conclusion is therefore that this year's Finance Bill has reintroduced the possibility of couples claiming an indexation allowance that creates or increases a loss.

Caveat

For completeness, it should be remembered that section 16A purports to impose restrictions on losses accruing to a person arising from arrangements that are intended to secure a tax advantage (as defined). The scope of section 16A is, it is regretted, unclear but I cannot imagine even HMRC suggesting that obtaining indexation losses as set out above will, in most cases, trigger the section 16A rules.