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Capital gains tax reform

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What is capital gains tax (CGT)?

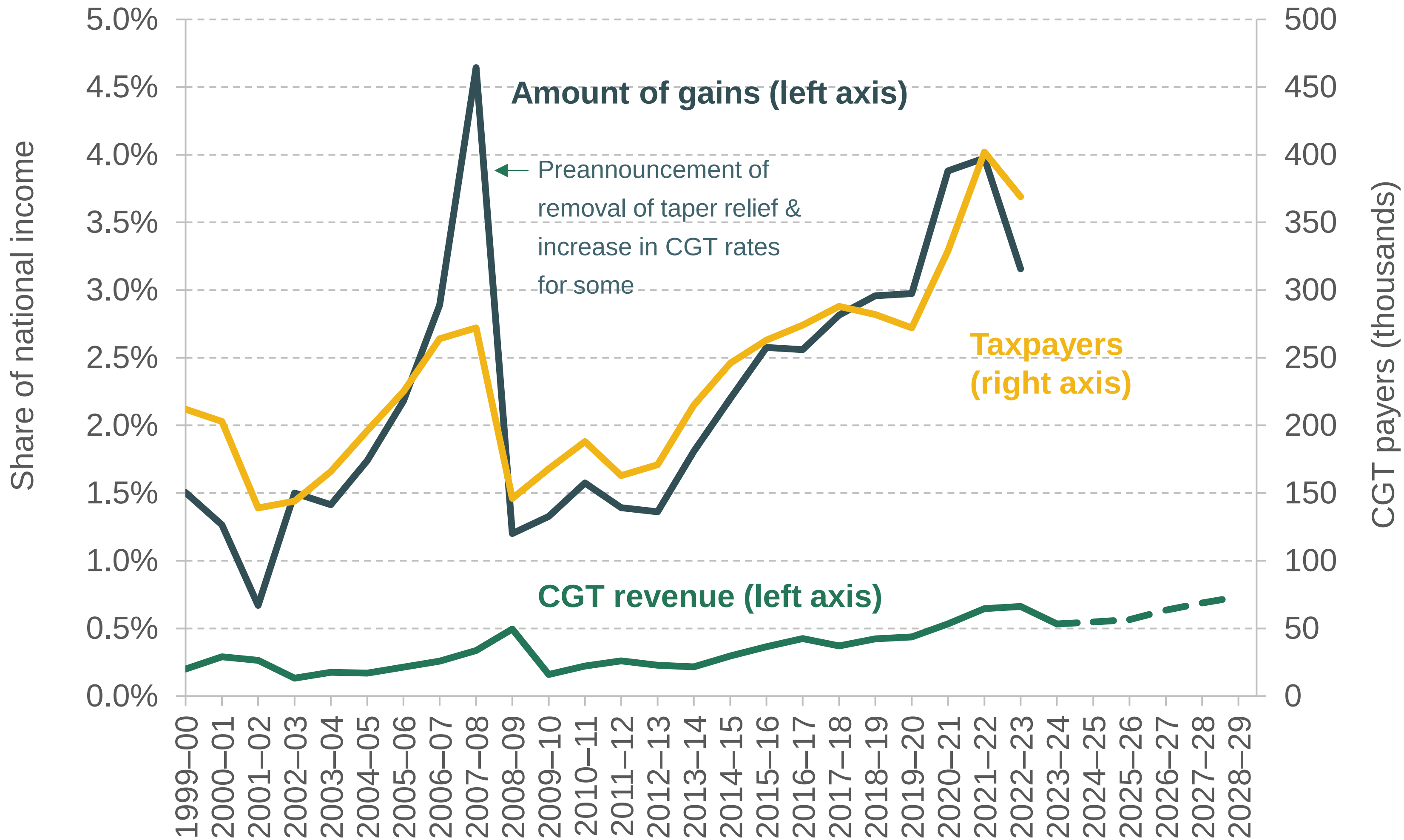
- CGT is a **tax on the increase in the value of an asset** between its acquisition and its disposal. (Broadly: sale price - purchase price)
- Not all assets subject to CGT (notably, **no CGT on main homes**)
- **Uplift at death**
  - deceased’s estate not liable for CGT on unrealised gains + those inheriting deemed to acquire assets at market value = CGT is ‘forgiven’ at death
- First £3,000 of gains (the ‘annual exempt amount’) not taxed
- 5 CGT rate schedules depending on the source of the capital gain

5 CGT rate schedules

Carried interest: share of profits from a private equity fund that is paid (in the form of capital gains) to private equity managers

***Business asset disposal relief** (previously entrepreneurs' relief): preferential 10% tax rate that applies to capital gains on owner-managers' shares in their companies, up to a limit of £1 million of lifetime gains

Rising gains and revenues



Source & notes: Figure 7.1. Adam et al 2024

Who gets gains

- 2022–23: 350,000 people - **0.65% of adults - realised taxable gains**
- Gains are very concentrated: **67% of CGT revenue from just 12,000 people (0.02% of adults)** who have average gains of £4 million.
- Gains flow disproportionately to people **already in the top 1% of the income distribution** (note: untaxed gains more equally distributed)
- Gains are **lumpy for most, but regular for some**.
  - 12% of those with taxable gains in 2019-20 received gains ≥5 times in preceding decade. Gains much higher for those realising regularly
- Half of gains related to unlisted shares – i.e. in **private businesses**

What capital gains represent

Normal return:

- return that just compensates savers/investors for delaying consumption – the return people need to be willing to part with more of their money

Excess returns:

- **Luck** in the outcome of risky investments
- **Economic rents** - return greater than required to make an investment worthwhile. E.g. monopoly power
- **Effort and skill** - returns to capital can directly reflect returns to effort
  - skill in choosing the best investments; effort renovating an asset; labour income 'disguised' as capital gain
  - around half of all taxable capital gains are closely linked to people's occupations

Problems with CGT design & how to fix them

CGT design – big picture

Aim: ‘neutrality’, at least as the benchmark

Current system distorts many choices; distortions vary across assets & over time (worse in high inflation periods). Creates:

- **Unfairness** – similar people get very different tax bills
- Economic inefficiency → for any level of revenue, get **lower economic growth and and wellbeing**
- Administrative burden & **complexity**

‘Big picture’ solution – big change for a big prize:

1. **Fix tax base** (definition of what is taxed) to address disincentives to invest & take risks and misallocation of capital (no tax on normal returns)
2. **Align overall marginal rates** (on excess returns) across all sources of income & gains

- Major trade-offs if only change some elements
    - E.g: base problems worse at higher rates

Risk-taking

- **Risk-taking is discouraged**
  - Relief for losses is less generous than taxation of gains/profits – government takes a bigger share of the upside than the downside of a risky project

- **Solution: improve loss relief**
  - there are genuine concerns about the use of artificial losses for tax evasion & avoidance
  - But loss relief could be made more generous

Investment

- **Tax on the normal return discourages saving and investment**
  - E.g. suppose I require 4.5% return to persuade me to invest. 20% tax reduces the return from 5% to 4%, so investment that would have been worthwhile is made unprofitable
- **‘Lock-in’ effect** - incentive to hold on to an asset, rather than reinvest in another taxed asset, even if the latter is more productive - **exacerbated by uplift at death**

- **Remove uplift at death** – should be a priority
  - Could choose whether to make tax payable at the point of death or only when an asset is sold
  - Note: CGT would sometimes be payable on top of inheritance tax. That is not a flaw – IHT is not a substitute for CGT

Full relief for investment costs

- **Give full deductions for amounts saved**; equivalent: remove normal return from tax (& tax only excess returns). 3 options:

1. **Up-front deductions (cash-flow tax)**

Deduct an asset's purchase cost from income at point of purchase; Tax the full proceeds of sale (akin to pensions)

2. **A stream of annual deductions (rate of return allowance)**

New annual allowance = normal return on the purchase cost of asset (use the nominal interest rate on medium-term government bonds)

3. **Deductions at the point of sale (indexation for interest rate)**

Tax on *sale price - purchase price indexed* (or stepped up) with the (normal) interest rate over the period the asset was held

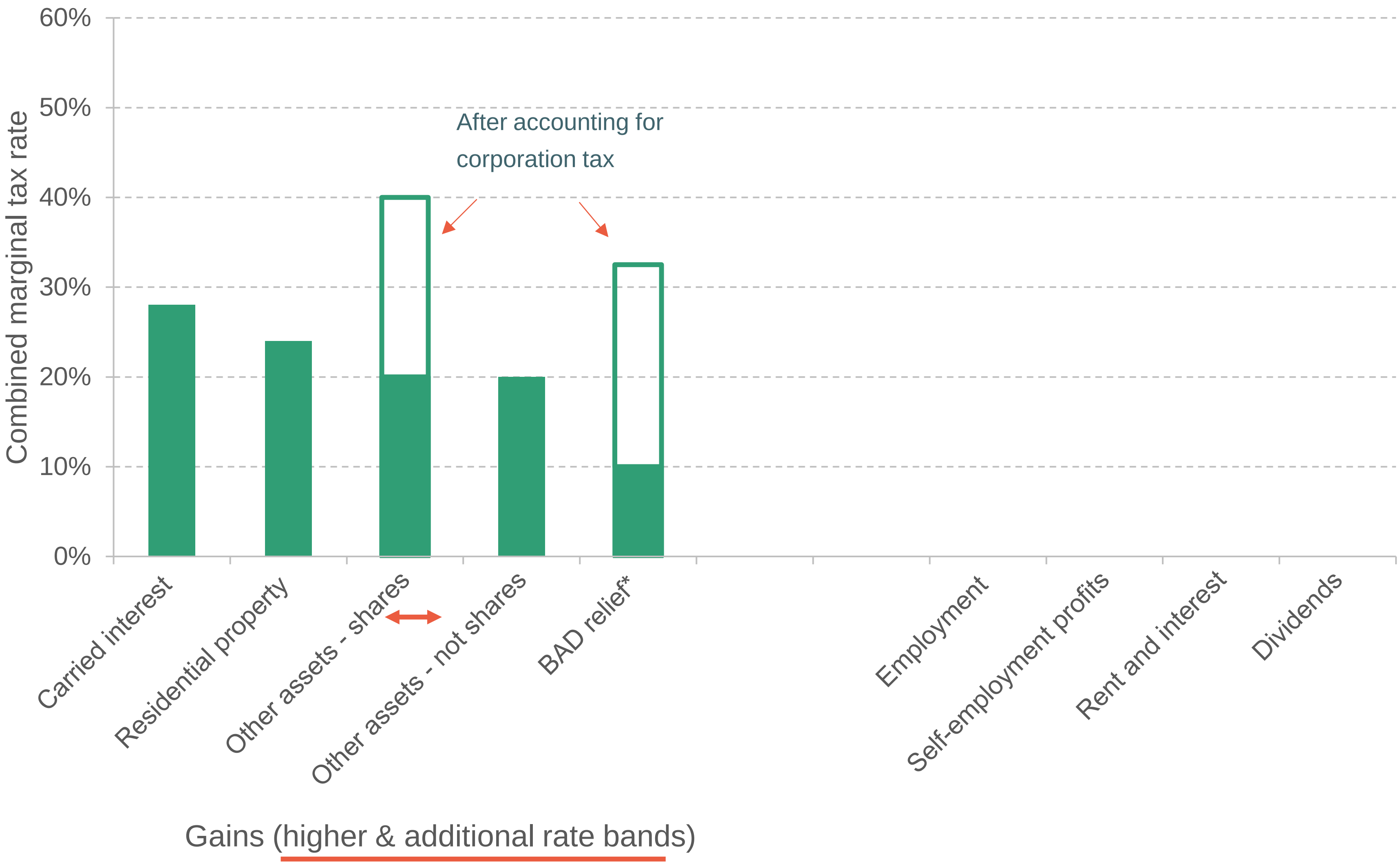
- We have options! And could do different things for different assets

Summary: how to fix the tax base

- Make loss offsets more generous
- Remove uplift at death
- Give full deductions for amounts saved. 3 options:
  1. **Up-front deductions (cash-flow tax)**
  2. **A stream of annual deductions (rate of return allowance):**
  3. **Deductions at the point of sale (indexation)**

- Fixing the tax base is best way to address investment disincentives
  - Problems are worse at higher rates but **not fixed by low rates**!

Problem: rate differentials



*Business asset disposal relief; here assumed that underlying business is a company. Employment bar includes income tax and employee & employer NICs. Self-employment bar includes income tax and self-employed NICs. Dividends bar includes income tax and corporation tax. Corporation tax included at 25%

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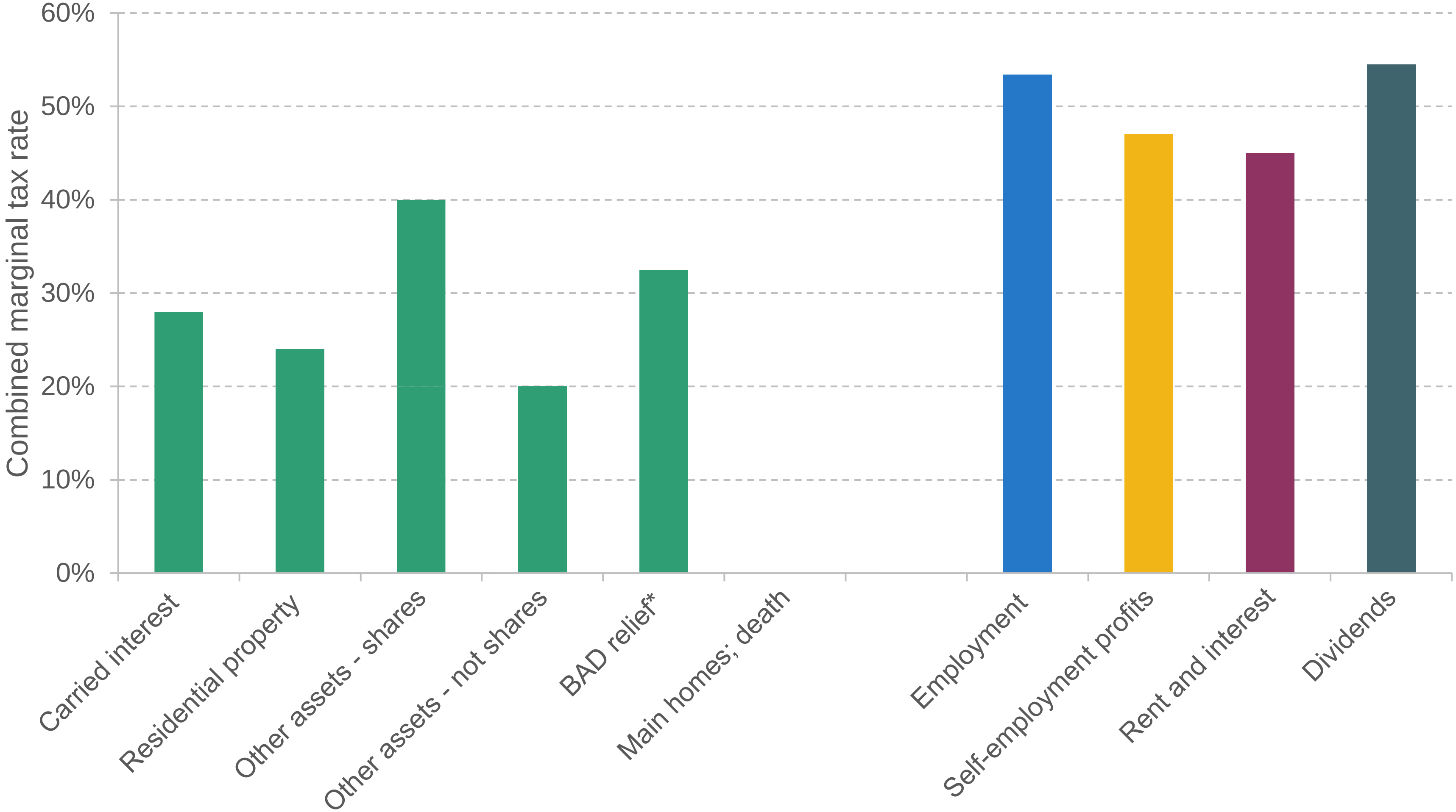

Combined marginal tax rates – gains (higher & additional rate bands)

Combined marginal tax rates – income (additional rate band)

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Solution: align rates (on excess returns)

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International issues

- Broadly (and with some simplification):
  - UK CGT paid by UK residents on their worldwide gains
  - UK CGT can affect *movement of people* (into or out of UK residence)
  - investment in UK assets is affected only insofar as that is linked to whether people live in the UK

- **People have an incentive to move to a lower taxed country before realising gains to avoid UK CGT** – bigger incentive at higher UK tax rates
  - One option: ‘deemed disposal on departure’ for CGT purposes, matched by ‘rebasing on arrival’ for new arrivals
  - i.e. tax people emigrating from the UK on their accrued but unrealised gains; exempt new arrivals from UK CGT on gains they made whilst living abroad
  - There are challenges, but this approach is operated by some other countries

Steps in the right direction

Why BAD relief is bad

- Government may want to support entrepreneurship

- But BAD relief is poorly targeted & leads to range of undesirable distortions
  - Applies very widely (anyone operating a business); does little to change investment incentives (it targets high returns)
  - Evidence shows: get more money in owner-managed companies; not more investment in those companies

- Just scrapping BAD relief would have trade-offs. For example:

  ✓ reduced incentive to take returns in the form of capital gains

  ✗ weakened investment & work incentives; exacerbated bias against risk-taking and the lock-in effect

From BAD relief to a good relief

Example reform: scrap BAD relief + new up-front relief for investment

- New **'Personal Shareholding Account'** (PSA) – cash flow tax
  - upfront income tax relief on any money put in;
  - use to invest in own company;
  - taxed when money taken out
- A reorienting away from tax relief on large gains to tax relief on investment

- Miller and Smith (2023) simulate the impact on business owners
  - Tax cut for investment costs = more investment;
  - Raise a modest amount of revenue – from taxing large gains; very progressive.
- Pattern of winners and losers would be similar for broader reforms

Revenue

Revenue

- HMRC Ready Reckoner: 10 percentage point increase in CGT rates *costs* around £2 billion in 2027–28
  - Our view: not a good guide revenue effect over a longer time horizon; rate increases (up to a point) would raise money
- Exact reform is critical
- Transition choices affect revenue in the short run
- More generous treatment of purchase costs would cost money
  - also mean that rate increases had less of a disincentive effect
  - evidence suggests gains are large relative to purchase costs
- Expectations matter – need a policy that is credibly lasting!

- My view: significant reform could bring in significant revenue; there’s uncertainty

Summary

- **Current system causes many problems – bad for growth and wellbeing**
  - Distorts choices over assets, legal form, type & timing of income/gain
  - Disincentivises investment, capital reallocation & risk-taking
  - Adds lots of complex boundaries (to determine what's a capital gain)
- Many **problems stem from tax base design**
  - Higher rates would worsen some problems
  - But lower rates can't fix the problems – and create other problems
- Need **proper reform of CGT** – not just tinkering with tax rates
  - A CGT that is fairer & less damaging to economic growth should be a priority
  - Especially if government wants to raise more revenue

We know how to design CGT – government should pick a good reform and seek to make it credibly lasting