

Capital gains tax

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Bill Dodwell considers the Office of Tax Simplification's first report on its capital gains tax review

The Office of Tax Simplification published its first report on its [capital gains tax review](#), 'Simplifying by design' on 11 November. The report arrived four months after the chancellor's request to 'identify opportunities relating to administrative and technical issues, as well as areas where the present rules can distort behaviour or do not meet their policy intent'. This report looks at policy design and principles and, in particular, at distortions in the system of taxing capital gains.

The review has attracted very strong engagement from advisers, businesses, academics and the general public, including over 1,100 responses to an online survey and 96 formal written responses to a call for evidence, supported by an extensive range of meetings with interested parties with a wide variety of perspectives.

Who pays capital gains tax - and on what sort of assets?

In the 2017/18 tax year, £8.3 billion of capital gains tax was paid, and £55.4 billion of net gains (after deduction of losses) were reported by a total of 265,000 individual UK taxpayers. Figures for 2017/18 are used throughout the report as that is the most recent year with full data. Unsurprisingly, 71% of taxpayers were aged between 45 and 74 and paid 78% of the total tax. Less than 3% of the total liability was paid by people who are under 35.

Over the 11 year period from 2007/08 to 2017/18, a total of 1.5 million different individual taxpayers reported taxable gains (after deductions for the annual exempt amount). 72% of those taxpayers (1.08 million) reported gains only once in the decade and 15% twice, with only 3,750 people (0.25%) doing so in ten or more years.

However, the bulk of gains relate to a relatively small number of taxpayers reporting very large gains. £20.1 billion in net gains (34% of the total) related to gains of over £5 million reported by just 2,000 taxpayers.

[Work by Warwick University and the LSE using HMRC data](#) showed there were 54,000 taxpayers with gains of £100,000 or more in 2015/16, accounting for 88% of total gains. Their analysis shows what types of asset gave rise to gains (using the analysis data on self-assessment tax returns).

Overall, over 20% of gains arose on residential property – a mixture of second homes, buy-to-let property and main residences not wholly exempt. About 15% of gains related to listed shares, which left 65% on unlisted shares (typically owner-managed businesses, together with some unlisted investments) and other assets (commercial and agricultural property, and carried interest, as well as valuable chattels). At the top of the distribution, a much greater percentage arose from unlisted shares, including those qualifying for entrepreneurs' relief and carried interest. Residential property and listed shares were much more significant for the

majority of taxpayers.

The review and its recommendations

It is worth starting with this initial comment from the report, as some have argued that the report strays too far into policy: 'It is for government to determine the principles and role of the tax when framing policy and determining tax rates. In doing this, the government should carefully consider the economic implications, the implications for people with different levels of income or gains, the tax yield and the compliance costs for taxpayers and HMRC.'

This is not a disclaimer, but it does set out the scope of the OTS's work, as well as the broader range of issues relevant to a government's policy choices.

The report looks at distortions in the tax system in relation to capital gains. Distortions – moving away from neutrality – risk incentivising inefficient economic activity, or as the Mirrlees report puts it, encouraging people into 'socially wasteful effort to reducing their tax payments by changing the form or substance of their activities'.

However, interventions – incentives in the tax system – can be justified if market failure could lead to economic damage or underperformance.

The OTS's consultation revealed a range of areas in which capital gains tax is counter-intuitive, creating odd incentives or opportunities for tax avoidance. It is an illustration of the broad range of responses that some respondents argued that capital gains tax is a barrier to economic growth, whilst others saw the current system as a barrier to a more equitable society. In particular, there was a range of opinion on whether there needs to be a tax incentive to encourage risk taking or entrepreneurship and whether such an incentive can be sufficiently targeted.

Rates of tax

The current rates of capital gains tax are lower than standard income tax rates. This disparity is one of the main sources of complexity.

Some argue that this is justified as rewarding risk taking and promoting enterprise, but when governments diverge from neutrality this should be done with a full understanding of the economic social and fiscal costs and benefits.

The rate disparity can distort business and family decision making and create an incentive for taxpayers to arrange their affairs in ways that effectively recharacterise income as capital gains. As already noted, most gains are concentrated among relatively few taxpayers, who also tend to have more flexibility about when they dispose of their assets. This can mean that they pay proportionately less tax on their overall income and gains than others.

A greater alignment of rates would reduce the need for complex rules to police the boundary between income and gains, as the way income is classified would not affect the tax position.

There are a number of important points to consider should a government move to align tax rates on income and capital gains. Firstly, as almost all respondents pointed out, capital gains typically accrue over time and thus include inflationary gains. Indexation was abolished by Gordon Brown in 1998, when tapering was introduced. A further point is that common income tax and capital gains tax rates could lead to some wealthier people moving investment assets into companies, to benefit from the lower 19% corporation tax rates. We have already seen this with the reduction of interest relief on loans to acquire buy-to-let residential property; many investors have transferred their properties and related loans into companies, which are unaffected by the restrictions. Finally, unifying rates should prompt examination of current loss utilisation restrictions.

It is also worth mentioning the lock-in effect. This essentially means that higher tax rates may discourage investors from selling lower-performing assets to acquire higher-performing assets (or even at all).

Boundary issues

The issues arising from the disparity in rates could alternatively be addressed at the boundary between income and gains. The two key areas considered are the use of share-based remuneration, and the accumulation of retained earnings in smaller owner-managed companies.

The issue on share-based remuneration is that some employees can enjoy the benefits of acquiring shares in their employer company on terms more favourable than those offered to investors. Some shares can be designed with minimal value when acquired but with the hope value that future profits will accrue to those

shares. In other cases, the employee may contribute money to buy the shares, but still receive more favourable terms than investors. The challenge in considering this area is how to define value attributable to the employment, as opposed to the capital invested. Those defending lower capital gains tax rates on employee gains from shares point to the motivational benefit, perhaps leading to greater productivity. However, a relatively small part of the UK workforce has access to lower tax rates on gains from employment. There are perhaps policy reasons for all-employee schemes, or for the enterprise management incentive, which supports employees in start-ups; the policy reasons for wider benefits is not as clear.

In relation to the accumulation of retained earnings within smaller owner-managed companies, the issue is that business owners are taxed at lower rates if they retain profits arising from their personal labour in their business and realise the benefit on sale or on liquidation, than if they withdraw them as dividends.

One approach discussed in the report would be to tax some or all of the retained earnings remaining in the business on liquidation or sale at dividend rates (in effect shifting the boundary between capital gains tax and income tax). This could make the treatment of cash taken out of the business during and at the end of its life more neutral. The report acknowledges the design issue of specifying which types of company should be subject to this recharacterisation, suggesting that 'small' close companies are the most likely category.

The annual exempt amount

The question posed by the annual exempt amount is whether it is set at the current £12,300 level as an administrative easement, or whether there is a wider policy reason. Using HMRC data, the OTS suggests that the administrative de minimis level is in the £2,000 to £4,000 range. Cutting the amount to this level would bring in more capital gains taxpayers – although there are about 50,000 individuals who manage every year to realise gains within £1,000 of the threshold, which rather suggests they are using the exempt amount to rebase listed share portfolios. Should the government be minded to reduce the amount, the OTS recommends that it also considers introducing a stand-alone capital gains tax return (preferably as part of the personal tax account); re-examines the chattels exemption; and gives consideration to requiring wealth managers and others to provide information directly to HMRC for incorporation into the personal tax account, for pre-populating tax returns.

Transfers on death and gift relief

The OTS recommended in its inheritance tax report that the government should consider removing the market value step-up for capital gains, where assets pass on death and benefit from one of the three major inheritance tax exemptions (business property relief, agricultural property relief or the spouse exemption). This would not have led to additional tax where the beneficiary retained the asset, but would give rise to capital gains tax on a subsequent disposal.

In this report, the OTS recommends going further and removing entirely the market value step-up, apart from in relation to the main residence. At the same time, consideration should be given to reintroducing a broader lifetime gift relief. The aim of these linked changes would be to introduce neutrality between lifetime gifts and those on death. In this way, the behavioural distortion would be removed and assets could be given at the best time for the business or family.

The report acknowledges that a range of issues need to be examined as part of this policy change. Rebasing asset base costs to a more recent date – the report suggests 2000 – would help with administration and give some relief for inflation since 1982. Anti-fragmentation rules might also limit the use of multiple allowances and lower rate bands within a family.

Changing reliefs

Finally, the report proposed the abolition of investors' relief. Consultation with a wide range of stakeholders could not identify any significant use of the relief and it appears poorly targeted. The much disputed business asset disposal relief (formerly entrepreneurs' relief) remains complicated and an ineffective incentive for business start-ups. The OTS recommends that the government considers refocusing it as a retirement relief, taking account of broader pension policy.

The chancellor noted that the review was part of the continuing work of the OTS in examining the UK's major taxes and he would take time to consider the report. The work of the OTS now moves to a second report, due in Spring 2021, covering detailed aspects of the tax, but equally interesting and full of a wide range of ideas!