<u>Capital Gains Tax review – Submission</u>

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Executive Summary

1. In aggregate, capital gains are large, highly concentrated, and growing rapidly. Growth has tended to come from privately-owned businesses, which has in turn been incentivised by changes in tax policy. The taxation system does not redistribute remuneration from gains nearly as effectively as it does remuneration from income.
2. In principle, capital gains should be taxed both in order to tax returns on rising asset values, and in order to capture income which is 'repackaged' as capital gains. Empirically these are difficult to distinguish; We present evidence suggesting that they tend to more closely resemble the latter: a large share of taxable gains is made up of gains which represent repackaged income, either through the legal recharacterization of income as gains, or through distortion of the choice whether to receive remuneration annually (as income) or in a deferred lump sum (as gains).
3. As a result, many of the highest-earning individuals are able to structure their taxes so that their average tax rates are very low, creating both horizontal and vertical inequities amongst taxpayers: in 2015-16 around one in ten people earning a combined total of income and capital gains over £100,000 paid an average tax rate of 10%.
4. A static estimate implies up to an additional £12 billion could be raised if all taxable gains were taxed at the same rate paid on income, even if the same reliefs which currently apply to income could be claimed. This estimate is a simplistic one and ignores likely behavioural responses; even so it is indicative of the scale of the revenue which is at stake.
5. There is a very strong case for moving towards the equalization of tax rates on income and gains. This reform could result in significant simplification of the tax system because it would remove the need to use complex rules to police the boundary between income and gains, since the characterization of remuneration in one or other form would not materially affect their tax treatment.
6. There are however good arguments for stopping someway short of direct equalization of tax rates on income and gains, mainly to avoid taxing inflationary gains. We argue for a return to the equalization subject to an Indexation Allowance that operated between 1988-1998. Equalization with a "normal rate of return" allowance, as proposed in the Mirrlees Review, would be an appropriate alternative.
7. Taxing assets of different types and different holding lengths creates sharp distortions, and should be avoided.
8. The Annual Exempt Amount is much higher than justifiable purely as a de minimis amount to reduce administrative costs, having grown substantially through indexation to the CPI and generous rounding. Taxpayers who can diversify their income sources across labour & capital income and capital gains benefit from this, as they can access a much higher tax-free allowance than individuals who only have either income or gains.
9. A number of reliefs to taxable gains, including uplift at death, Business Asset Disposal Relief (previously Entrepreneurs' Relief), and Investors' Relief, which do not seem to support the purpose of taxation of gains, or worse, actively distort behaviour.

About us

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Our research

We are collaborating on a series of academic research projects relevant to this review. Most of our work has taken place in HMRC's Datalab facility, giving us access to anonymised data from the personal tax records of every UK resident in recent years. Having done a significant amount of exploration of these data, we are in a unique position to submit evidence on these issues.

A key focus of our work has been capital gains, including the characteristics of those who earn the highest gains, the tax rates they typically pay, and the impact of capital gains on inequality. Our work documenting empirical evidence on the sources and distribution of taxable capital gains has been made public in four papers, to which our submission below refers.

Capital Gains: Overview

Empirical Evidence

1. Capital gains are large, highly concentrated, and growing rapidly. Our policy brief *Capital Gains and UK Inequality*[1] summarises the impact of capital gains[2] on inequality:
    a. Aggregate gains measured nearly £55bn in 2018, having grown by an average of 20% each year over the previous 5 years. Over half (54%) of all gains go to just 5,000 people.[3]
    b. For some, capital gains are regular part of their remuneration, rather than a rare or once-in-a-lifetime event: a third of those with gains over £20,000 in 2017 also averaged gains over £20,000 in the previous four years.
    c. Income-only measures of inequality have masked a rise in inequality: the top 1% share rises to 17% when including gains, while it has remained around 14% since 1997 based on income only. The largest growth has taken place towards the very top of the distribution.

[1] https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/bn19.2020.pdf
[2] Note that when we refer to our own work, our measure is always *taxable* capital gains as reported to HMRC.
[3] For comparison, the top 5,000 people ranked by income receive just 2% of all income.

2. Preferential rates on taxable gains incentivise changes in behaviour. Our report *Who Gains? The importance of accounting for capital gains*,[4] written in collaboration with the Resolution Foundation, includes novel analysis of the key factors driving changes in reported gains since early 2000s:

    a. Gains tend to come from privately-owned businesses: 72% of capital gains growth over the 4 years to 2017 came from unlisted shares.

    b. Entrepreneurs' Relief has helped to drive a rise in the realisation of very large gains: gains of £1m or more have made up the vast majority of gains on which Entrepreneurs' Relief was claimed since the cap was increased in 2010 and 2011.

    c. This change has also seen a larger number of people becoming directors of their own limited business: the number of sole directors roughly doubled between 2012 and 2017. [5]

    d. Combining carried interest with those gains that are eligible for entrepreneurs' relief, a conservative estimate is that around half of taxable capital gains are now closely linked to people's occupations.

3. These preferential tax rates create both horizontal and vertical inequities amongst taxpayers. Our policy brief *How Much Tax do the Rich Really Pay?*[6] documents enormous variation in average tax rates paid, even amongst those who earn a similar amount in total income + taxable gains.

    a. In the 2015-16 tax year,[7] effective average tax rates (EATRs) tended to fall across the income distribution, such that around one in four of those with total remuneration between £5 million and £10 million pay an EATR of just over 10%.

    b. The average person with total remuneration (which we define as the sum of taxable income and taxable gains) of £10 million paid an EATR of just 21% in 2015-16. This is far less than the statutory average tax rate on taxable income of 47%; in fact it is less than the rate that would be paid by someone on median earnings of £30,000.

4. Access to these low tax rates reduces the ability of the tax system to effectively redistribute remuneration. Our working paper Capital Gains and UK Inequality[8] shows that the effect of the tax system was to reduce the top 1% share of total income from 13.3% to 9.3% in 2017. However, including taxable gains, taxes only reduced the top 1% share of total remuneration from 16.1% to 12.3% of the aggregate – a higher level and a smaller reduction. This pattern is even more pronounced higher up the distribution.

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[4] https://www.resolutionfoundation.org/app/uploads/2020/05/Who-gains.pdf

[5] Miller, Pope, and Smith (2019) show how owner-managed companies can and do systematically retain income or shift it across tax periods in response to changes in personal taxes.

[6] https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/bn27.2020.pdf

[7] The subsequent rise in dividend rates from 2016, and decrease in the lifetime cap on Entrepreneurs' Relief in 2020, will have improved equity outcomes. However, there is still substantial scope for some individuals to pay tax rates which are low compared to both headline tax rates and to rates a middle-income earner would expect to pay. Tax discounts on capital gains play a significant role in this.

[8] https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/wp465.2020.pdf

Principles of Capital Gains Tax

5. The Call for Evidence reports the following quote by then Chancellor James Callaghan, given around the introduction of capital gains tax in 1965:

   > *"… capital gains confer much the same kind of benefit on the recipient as taxed earnings… yet earnings pay tax in full while capital gains go free. This is unfair to the wage and salary earner… Moreover… the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator… to… turn what is really taxable income into tax-free capital gains."*

   This is striking because it still rings true today: while capital gains are no longer entirely tax free, they are still taxed at a markedly lower rate than wage or salary income. We discuss this in more detail with reference to our own work on the topic below.

6. We can conceptualise Capital Gains Tax as serving two main functions:

   I. Taxing returns from rising asset values (referred to below as 'type I gains')

   II. An anti-avoidance measure to prevent 'leakage' from income tax ('type II gains')

   It is these type II gains to which the above quote refers.

7. One can argue about what the right rate of tax on rising asset values should be in order to serve the first function, and whether to tax someone who makes money from buying and selling assets differently to someone who makes money in regular employment. We note that the Haig-Simons 'comprehensive' definition of income, equal to the sum of consumption and the change in net worth, would include even type I gains as a component of income.

8. To serve the second function, though, it makes sense to tax income that is either directly repackaged as gains or is forgone in exchange for gains in the same way that income is taxed.

9. If we think that type I gains should be taxed in the same way as type II gains, it is natural to suggest that all taxable realised capital gains should be taxed at a rate equal to income tax rates. If there is some reason for treating type I gains differently, then we must trade off the benefit of maintaining this differential with the 'deadweight loss' that comes from encouraging more type II gains.

10. Although it is very difficult to distinguish type I and II gains empirically using available data, our analysis indicates that type II gains are quantitatively large, as are the losses in tax revenue sustained in treating these gains differently to income (see paragraph 23). This also raises issues of horizontal unfairness, as the benefits accrue only to those among rich who can most easily earn as gains.

Inflation

11. A key difference between income and capital gains is that income reflects value added for the relevant time period, while capital gains can accrue over many years. As a result, gains partly reflect inflation, which, clearly, we should not tax. But having a different tax rate for capital gains is not a good way to solve this.

12. A better solution would be to implement a form of Indexation Allowance (IA) which effectively exempts from tax the part of the rise in the asset's value which is just due to inflation. This was the approach introduced by Nigel Lawson as Conservative Chancellor in 1988, and maintained until 1998 when Gordon Brown replaced IA with Taper Relief (TR). We believe that returning to a Lawson-style-IA system would be a substantial improvement on current approach.

13. Our research has not uncovered any clear reasons for the shift from IA to TR; however, TR has itself since been abolished. Importantly, the move away from IA must not have been motivated by IA being hard to calculate: with the rate applied varying by length of holding period, the TR system was much more complex.

14. In fact, implementation would be much easier now than in the days when tax filers needed to rely on look up tables. It would be straightforward to provide an online calculator to calculate taxable gain given acquisition year(s) and value(s), and sale value.

Normal rate of return

15. We would also support the notion of an allowance to cover the "normal rate of return" (NRR), as suggested in Mirrlees (2010). The aim of such an allowance is to reduce the distortion between consuming today, and saving to consume in the future, which would be introduced in applying the same marginal tax rate on income to taxable gains. An example benchmark rate would be the Bank of England's base rate.

16. Conceptually, IA and the NRR allowance address quite different issues. However in practice, under current economic conditions, the effect of introducing one or the other alongside alignment of headline rates would be quite similar: that is, they would amount to a relatively small deduction from the tax base. There are many details which would need to be decided in the choice between IA or NRR allowance, but either would be vast improvement on current system.

17. If there is a desire to tax capital at risk separately, the value of spending on assets could also be assessed, and used as the basis for a deduction of some allowable return. This specifically removes from the tax base returns to purchased capital, but doesn't create any relief in the case of repackaged labour income.

Administration

18. One further issue of timing that comes from equalising rates is that gains come from multiple years. There would need to be an administrative method to "share" out the gains over past years when calculating the applicable tax rates. We note that, for types of trading income which are often volatile (in particular, incomes of creators of literary or artistic work) multi-year averaging is allowable, so a framework for addressing a problem of this type already exists.

The boundary between gains and income

19. It is empirically very difficult to cleanly distinguish asset-price gains from 'repackaged income', but our analysis suggests that the latter accounts for a large share of taxable gains. We discuss repackaging not just in the legal context of the characterization of certain types of gains (such as the extraction of retained profits), but also the distortions to behaviour which is incentivised (such as an owner-manager waiting for gains on exit instead of taking an annual salary from their business).

20. Capital gains that are closely related to people's own labour are of interest both because they challenge traditional conceptions of capital gains as being returns on arms-length investments; and because they have been an important part of the large capital gains increase over the last decade – driven especially by tax policy. There are three particular groups of capital gain that can be seen as close substitutes for labour-related earnings:

a. employee share schemes: employees may be able to acquire shares in their employer's company. Under most such schemes, the profit made from selling the shares for more than their initial value (or the value of the option) is taxed as a capital gain.

b. carried interest (see paragraph 25)

c. disposal of closely-held or other private companies: we note above the rise in the number of small, 'closely-held' companies: particularly sole-director and dual-director companies. As a company owner-manager, someone can choose how much salary to take; how much to take in dividends, and when; and also open up opportunities to take income in the form of a capital gain.

21. Our working paper *Capital Gains and UK Inequality*[9] suggests that the boundary between gains and income is, at best, blurred – but this tends to benefit individuals doing certain types of work:

    a. Gains are concentrated amongst people in certain types of work: the majority of gains go to business managers rather than arms-length investors.

    b. There is often little distinction between 'gains'-type income and 'labour'-type income: for example, a full 5% of gains are from fund managers' 'carried interest', payments which depend on their investment performance (human capital) rather than equity stake.

    c. Gains are concentrated amongst people who also have high incomes: across the income distribution, very few people have capital gains, but this rises substantially at the top. Even among those with gains, those who also have high incomes receive much larger gains on average: the mean (median) gains for gain recipients with incomes below the 90th percentile of income was £46,400 (£12,200); for those in the top 1% by income it was £306,800 (£13,600). The much more muted impact on medians highlights that even among gainers, gains are very concentrated.

22. *How Much Tax do the Rich Really Pay?*[10] shows that many of the highest-earning individuals are able to structure their remuneration so that their average tax rates are very low. The analysis below is from the 2015-16 tax year.[11]

    a. There is substantial variation in EATRs across individuals with total remuneration above £100,000: around a quarter paid the headline average rate for earnings, while around one in ten people paid an EATR of 10%, a lower rate than someone earning just £15,000.

    b. The highest earners, and investors and business owners in particular, overwhelmingly take their total remuneration in a form taxed at a lower rate than earned income: among investors and owner-managers in the top 1%, only 10% of remuneration comes from earnings, while capital gains make up 40-50% of all remuneration (and 20% is from the most lightly taxed form of gains).[12]

23. There is a lot of tax revenue at stake: a simple estimate implies up to an additional £12 billion could be raised if all taxable gains were taxed at the same rate paid on income. This is roughly

[9] https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/wp465.2020.pdf

[10] https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/bn27.2020.pdf

[11] As noted earlier, the subsequent rise in dividend rates from 2016, and decrease in the lifetime cap on Entrepreneurs' Relief in 2020, will have since improved equity outcomes.

[12] By contrast, top-earning employees and self-employed workers earn around 80% of their total remuneration in earned income, taxed at an effective rate of 47%.

the same as a 2p increase in VAT rates, a 2.5p increase in the basic rate of Income Tax, or a 7p increase in both the higher and additional rates of Income Tax. Equalising rates also makes avoidance more difficult.

24. It is important to note that this is likely to be a generous estimate, since it does not include or attempt to predict behavioural responses. If taxpayers were pre-warned of the reform, they might bring forward realisations; or if they did not believe that the reform would be permanent, they might defer them. There would be an increased incentive to defer realisations until death, unless forgiveness on death was also removed. The impact on investment and other real behaviours is more difficult to predict. The calculation also assumes that all deductions and reliefs against capital gains tax would be removed, but the retention of some reliefs may be desirable. Even so, this estimate does indicate the scale of the cost to the Exchequer of the differential marginal tax rates between income and capital gains.

Carried Interest

25. Private equity managers receive a management fee based on the initial value of their fund, plus a performance fee known as 'carried interest' if the fund performs well. Both fees are in substance a reward for the fund manager's personal services, effectively equivalent to a basic salary plus a bonus, respectively. But whereas the management fee is taxed as income, most carried interest is taxed as a capital gain at a rate of 28%, even though there is typically no capital at risk in its earning. The tax treatment of carried interest has long been controversial (Seely, 2010) and has recently been the subject of several complex reforms.

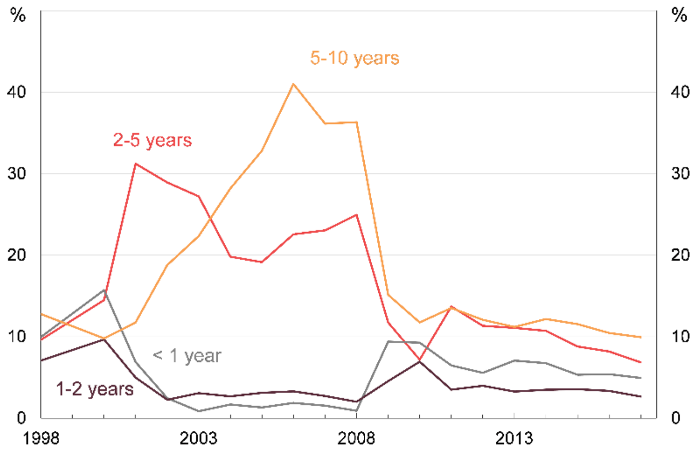
26. As noted above, carried interest made up a full 5% of taxable gains in 2017. The total of £2.3 billion paid out in carried interest went to just 2000 individuals, equivalent to over £1 million each.[13] Over half (58%) of this went to individuals who received at least £7 million each in total taxable gains (placing them in the top 1000 ranked by gains); this is on top of management fees and any income-based carry, which are taxed as income. If all carried interest were taxed as income instead of capital gains it would increase tax rates on these receipts by 19 percentage points (including 2% NICs), raising up to £440 million in additional revenue on a static basis.

Short-term vs Long-term Gains

27. The tax system should not draw distinctions between short- and long-term gains by length of holding, because these are easily manipulated at threshold. The chart below, from our working paper[14], shows the distortions introduced in asset holding lengths by the 2008 reforms. While there may be a temptation to address this problem by adopting a graduated schedule to avoid cliff-edges, this would essentially result in a return to taper relief, which led to all of the problems that led to a return to a flat rate in 2008.

[13] This includes only carried interest taxed as a capital gain (at 28%), so excludes any income-based carry or sums caught by the Disguised Investment Management Fee rules.
[14] https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/wp465.2020.pdf

Share of realised gains (by value) held for different holding lengths, 1997-2018



Constructed using data on reported holding lengths for capital gains realised by individuals. Each line shows the share of all gains realised in that year (by value) that were held for a particular length of time.
Source: Authors' calculations based on HMRC holding length survey.

Gains on different asset types

28. While in general we do not support different rates on different asset types, we acknowledge that, if there is a case for maintaining a distinction based on asset type, this is at least harder to manipulate than holding length. However, this calls for taxation of assets that are most likely to reflect asset-price gains, such as housing, at lower rate than that of assets which represent repackaged income – the reverse of the current situation.

Allowances

Annual Exempt Amount

29. The Annual Exempt Amount (AEA) could be justified as being either a de minimis amount to reduce administrative costs, or a structural relief designed to allow individuals access to some money without tax, such as the Income Tax personal allowance or the Inheritance Tax nil rate band.

30. Currently the AEA looks much more like the latter, being roughly the same size as the Income Tax personal allowance. This violates horizontal equity: it favours those who can diversify income sources, even though they have same ability to pay as those who have all their income from earnings. By spreading income across labour, capital income and (short-term) capital gains, an individual can now obtain a total tax-free allowance of over £28,000 per year (Summers, 2019)[15], compared with an individual who only has either income or gains. We cannot see a clear rationale for this.

31. As a de minimis threshold, the current AEA level vastly exceeds anything that could be justified purely on grounds of administrative convenience. A relevant comparison point is the trading profits allowance of £1000.

[15] In 2019: Personal allowance (£12,500), personal savings allowance (£500), dividend allowance (£2,000), property allowance (£1,000), trading allowance (£1,000), capital gains tax annual exempt amount (£12,000).

32. The AEA is one of the very few thresholds in tax system where the threshold is automatically linked to inflation: Section 1L of the Taxation of Chargeable Gains Act 1992 provides that the AEA is increased annually in line with increases in the Consumer Prices Index, applying a generous rounding up to the next £100.[16] As such, the AEA has been rising faster than inflation each year without any active parliamentary scrutiny.

Exemptions and reliefs

Specific Reliefs

33. We question the retention of a £1m lifetime cap on Business Asset Disposal Relief (BAD, previously known as Entrepreneurs' Relief, ER). The government's rationale for keeping BAD on taxable gains below £1m was to support more 'entrepreneurial' or 'risk-taking' individuals, but if anything the individuals who make gains over £1m are probably a closer fit for the popular image of an 'entrepreneur'. The current cap still does not preclude the distortions we cover in paragraph 19.
34. Like BAD/ER, Investors' Relief provides a 10% rate on taxable gains from sales of private company shares. The eligibility requirements seem to complement BAD/ER: the relief can only be claimed if the individual was *not* a manager of the company. Unlike BAD, however, the lifetime cap remains at £10m. We note the possibility that Investors' Relief could become a similarly expensive relief to BAD, with no strong rationale to justify it.
35. Capital gains uplift at death has already been identified as having a distorting influence on decisions, causing people to delay sales of assets (OTS 2019, pg 9). No clear economic rationale exists for it.
36. Objections may be raised about the administrative burden of removing this relief: some may claim that acquisition values are harder to obtain at death. If it were felt necessary, an alternative formula approach based on acquisition year and asset type could be used in this case. However, to reduce scope for avoidance that would be caused by this, the formula would want to add a penalty on top of the average gains: this would discourage people from deliberately using this where they happen to have experienced faster asset price growth than average. There is a real trade-off here, since there is still a risk of it being used in cases where initial valuations *can* be come by. Hence one would also want clear evidence that valuation can't be achieved any other way.

Evaluation of reliefs

37. Tax policy evaluation is critical, and the lack of consistent evaluation of tax exemptions and reliefs has drawn criticisms from key bodies and observers, including:
    a. Office for Budget Responsibility (2019): The 2019 Fiscal Risks Report highlights that the government does not know the overall cost of tax reliefs & expenditures, but that the cost of identified expenditures is almost 8% of GDP. "It is not clear that the Government gives tax reliefs and expenditures adequate scrutiny to control their cost"
    b. National Audit Office (2020): A report on management of tax expenditures noted that the impact of such measures is 'not guaranteed' and recommended that both HMRC

[16] We note there also does not appear to be a provision to decrease the AEA in a deflationary environment.

and Treasury should "formally establish their accountabilities for tax expenditures and enable greater transparency."

c. Public Accounts Committee (2020): an inquiry launched into the issues raised in the NAO report will question officials on "management of tax reliefs, the number of reliefs and the Government's understanding of whether they represent value for money."

38. It is important that HMRC is properly resourced to scrutinise effectiveness of reliefs. HMRC's Datalab facility, where most of our own research has taken place, is perfectly positioned to play a key role in extending the facility for such evaluation. Use of the Datalab benefits both the research community and HMRC itself: any research carried out in the Datalab must also serve one of HMRC's functions. Researchers conducting analysis within the Datalab have deep technical expertise, can use cutting-edge analytical techniques, and can pursue research projects that are bigger-picture or longer-term than the scope available to internal HMRC staff.

Key Recommendations

The typical case for low taxes on capital gains is to avoid distorting investment decisions. However, this comes at a price. First, it creates strong incentives to repackage income as gains. Second, to the extent that gains are received unequally, it is less able to redistribute out of gains. We see both that income repackaging is occurring, and that the tax system is ineffective in redistributing these resources. There are therefore both efficiency and equity reasons for taxing gains more similarly to income. We refer to specific recommendations below.

39. *Align the tax rate for <u>all forms</u> of taxable capital gain with taxpayer's marginal Income Tax rate, subject to a deduction from the chargeable gain to account for inflation*: We essentially advocate a return to the Lawson 1988-1998 approach, including indexation allowance based on CPI, and removing specific allowances for taxable gains based on asset type or holding length.

40. *Align the CGT AEA with the trading allowance for Income Tax, currently set at £1000*: The AEA should serve the purpose of an administrative de minimis, not of a structural relief. In absence of clear evidence that filing costs are greater for capital gains than trading income, these thresholds should be set equal.

41. *Abolish CGT uplift on death*: it may be desirable to allow inheritors to inherit the deceased's base cost instead of treating death as a disposal event charged on the estate.

42. *Reject calls for rebasing:* Rebasing would result in unjustified windfall to long-held assets. If long-held assets raise administrative challenges for establishing base cost, an alternative to rebasing would be to move to a formulary approach for estimating base cost.

43. *Abolish BAD Relief entirely*: The current £1m does nothing to prevent the distortions incentivised under the original ER policy.

44. *Abolish Investors' Relief,* before it becomes exploited in the same way BAD/ER can be exploited.

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