Funding the Future

The case for capital gains tax reform: a submission to ...

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As was widely noted a few weeks ago, the Office for Tax Simplification is undertaking a review of capital gains tax, and appears to be acting in great haste when doing so as if the Treasury is keen to hear its suggestions as soon as possible.

I have long been concerned about capital gains tax because I feel that it has not been fulfilling its basic task of supporting the effectiveness of income tax. This became very clear when Prof Andrew Baker of the University of Sheffield and I undertook research on tax spillovers. We have as a result made a joint submission to that review, which includes our spillover review on the weaknesses of that tax. This is available here.

This work forms part of the Tax After Coronavirus (TACs) project.

We summarise our concerns by suggesting that the spillover assessment we have conducted identified the following major weaknesses within UK CGT:

1. That the UK CGT system potentially undermines other parts of the UK tax base because it provides considerable incentive for income to be re-categorised as capital gains, largely because of the disparity in rates between the income tax and capital gains tax systems.

2. That the provision of generous allowances for offset against CGT, including the equivalent of an additional annual personal allowance (that is effectively transferable between spouses) to that provided for income tax, means that awareness of CGT amongst many taxpayers is quite low and the risk of non-disclosure, even if inadvertent, is high, and this undermines the credibility of the tax as well as its yield while permitting CGT to seriously undermine the income tax system.

3. The CGT base is undermined because many asset sales are not subject to automatic information exchange from those who manage them on behalf of vendors, resulting in potential widespread under declaration.

4. The exemptions and reliefs within the CGT system distort behaviour. So, for example, there is little doubt that corporate behaviour has been distorted by a bias *towards generating gains for shareholders rather than dividend returns while UK housing is over-valued as a result of primary residences not being subject to CGT and the management of mergers and acquisitions is significantly distorted by CGT allowances and reliefs.*

5. The UK CGT system is undermined by generous capital gains allowances within UK corporation tax that mean most merger and acquisition activity within such companies is exempt from a UK capital gains charge.

6. The CGT system is also undermined by the ease of incorporation in the UK and the laxness of both company law regulation and the corporation tax system, where there is evidence of substantial non-submission of corporation tax returns each year[1]. This makes it relatively easy to evade a capital gains tax liability by having it recorded in the name of a corporate entity that is then struck from the Register if Companies without disclosure taking place of tax being paid.

7. The use of tax havens remains a threat to capital gains tax. Research into tax haven activity by accountants shows how insubstantial are the activities of many accounting firms in those places. They frequently act only as 'booking locations'[2]. Due to the low number of staff employed in such places[3] it is likely that most of tax planning relating to their use takes place onshore, which is from where automatic information exchange from those engaged in that process is required as a result.

We added:

This means that if the UK capital gains tax system is to resume its defensive role within the UK tax system and deliver the back up to the income tax system that it was intended to, creating equity in taxation between income derived from work and investment activity, and preventing artificial tax avoidance within the income tax system, the following reforms are required:

* *Tax rates should be aligned between the income tax and capital gains tax systems even if a modest indexation allowance is provided to allow for this;*

* *The annual allowance for CGT should be reduced significantly to prevent leakage from the tax system by those able to engineer persistent gains as a source of income;*

* *The ability to effectively transfer CGT allowances between spouses by making tax free transfers of the ownership of assets prior to sale should be restricted to prevent tax avoidance;*

* *Capital gains within closely held limited companies should by subject to close company rules, requiring that they be subject to tax as if earned by the shareholders in those entities, the only exception being in the case of reinvestment in the trade of the entity making the gain;*

* *All limited companies should, without exception, be required to file a corporation tax*

return each year, with personal liability for any taxes owing falling upon those persons with responsibility for making such returns and who fail to make them;

* *Automatic information exchange from banks and other agents within the financial services sector should be required each year requiring disclosure by those agents with regard to those persons (natural or legal) whom they are aware have:*

* *Been in receipt of capital sums resulting from the sale of assets that might be subject to a capital gains charge, with basic information on the transaction to be supplied;*

* *Managed, directed, controlled or had a stake of more than 10% in a limited company or similar entity;*

* *Been a settlor, trustee or beneficiary of a trust;*

* *Had an interest in a financial arrangement outside the UK to which a capital gain might have accrued;*

7. The special favour provided to capital gains arising within companies in the UK should be reviewed and eliminated to the greatest possible degree.

We believe that these reforms would recreate the purpose of capital gains tax as a tool to beat tax avoidance and to create a level playing field in UK taxation, which is what it was always intended to be.

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[1] http://www.taxresearch.org.uk/Documents/Intheshade.pdf

[2] See ‘Tax havens: How globalization really works’ R Palan, R Murphy, C Chavagneux. 2010. Cornell University Press.

[3] See ‘A Tax Map of Global Professional Service Firms: Where Expert Services are Located and Why’ R Murphy, L Seabrooke, SN Stausholm. Copenhagen Business School 2019