The Taxing Wealth Report 2024

Every politician's guide to "How to pay for it"[1]

Capital gains tax reform:

Aligning capital gains tax and income tax rates

Brief summary

This note suggests that:

- The tax owing on capital gains should in the future be taxed as if they represent the top part of the income of the person making those gains in the year that they arise.
- This proposal is made to end the current situation where capital gains are charged at rates that are very often half those applied to earned income.
- This change to the tax system would be easy to implement since the tax rate at which a gain is charged does at present require that the income of the taxpayer in the year in which the gain arises already be taken into account.
- The change in taxation that this proposal creates would be fair from the perspective of horizontal and vertical tax equity[2].
- This change would also eliminate a major tax spillover effect in the UK economy, as a result of which the credibility of the UK's income tax system is undermined by the existence of capital gains tax rates that are usually about half those due on equivalent income.

[1] This note forms a part of 'The Taxing Wealth Report 2024' published by Finance for the Future LLP, which is UK LLP number OC329502, registered at 33 Kingsley Walk, Ely, Cambridgeshire, CB6 3BZ. See https://www.financeforthefuture.com/taxing-wealth/. This note was written by Richard Murphy FAcSS FCA FAIA (Hon), Professor of Accounting Practice, Sheffield University Management School, who is a director of Finance for the Future LLP.

[2] These terms and the nature of tax spillovers are explained here. https://www.taxresearch.org.uk/Blog/2023/09/07/the-taxing-wealth-report-2024-methodology/

• There would be a significant reduction in the amount of time wasted on tax avoidance activity in the UK as a result of this change to the overall advantage of society at large as this activity makes no useful contribution to the wellbeing of society as a whole. • The proposed change is fair because the increase in the wellbeing of a person as a result of an additional pound of wealth is the same whether derived from income or capital gains, meaning that it is appropriate that they be taxed at the same rate. • The calculated estimated additional sum owing as a result of this change is in excess of £16 billion per annum. In case of potential behavioural changes it is assumed that a lower sum of £12 billion might be raised for the sake of prudence.

The proposal	To align the rates of tax charged on income and capital gains by assuming that the chargeable capital gains of a UK resident taxpayer form the top part of their income for taxation purposes in a year.
Reason for the proposal	1. To improve the horizontal equity of taxation, which is currently undermined by the reduced rates of tax payable on capital gains in the UK. 2. To increase the prospect of vertical equity of taxation in the UK which is heavily dependent upon the creation of improved horizontal tax equity. 3. To reduce the tax spillover effect that existing rates of capital gains tax create when compared to those charged under income tax rules. 4. To reduce the rate of tax avoidance in the UK. 5. To consequently improve the rate of tax compliance in the UK. 6. To raise additional tax revenues.
Estimated tax that might be raised as a result of the recommendation made	The behavioural response to this recommendation cannot be known, although it is likely to be small as most capital gains arise as a consequence of transactions undertaken in the normal course of economic activity and the number

	actually planned for tax reasons on which a tax liability might arise might be quite small. Assuming this to be the case then a sum of between £12 billion and £16 billion a year might be raised as a result of this proposal. The lower sum is used as the estimate for the additional revenue to be raised from this proposal to allow for possible behavioural changes.
Ease of implementation	Simple.
Likely difficulties that might result from implementation	Few.
Likely time required to implement the change	Months in the year preceding the year of actual change.
Consultation period required.	As short as possible to prevent abuse in advance of the change.

Background

Capital gains tax was introduced in the UK in 1965. As was made clear by the Rt Hon James Callaghan MP, the Chancellor of the Exchequer at the time, the aim was to ensure that income could not be recategorised as capital gains and so escape from either the income tax system or fall out of taxation altogether. The tax was as a consequence always as much an anti-avoidance measure as it was a revenue-raising tax.

This is good news since the tax raises relatively little revenue, suggesting that overall it has achieved at last some of its design objectives.

In 2020/21, the last year for which detailed statistics for capital gains tax data is available, capital gains tax raised £11.1 billion in tax revenue[3], which was just 1.9% of total tax income of HM Revenue & Customs. However, in the next two years revenues rose significantly to £15.3 billion in 2021/22 (2.1% of total revenues raised in that year) and £16.9 billion in

[3] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1171979/NS_Table.xlsx

2022/23 (2.15% of total revenues in that year)[4]. It is clear that the returns to wealth are growing.

Total gains and the number of taxpayers making them in 2020/21 were as follows[5]:

Range of gain (Lower limit £)	Number of individuals	Amounts of gains for individuals	Amounts of tax for individuals
0	2	2	9
10,000	96	1,680	85
25,000	73	2,621	304
50,000	53	3,708	582
100,000	40	6,234	1,076
250,000	16	5,575	938
500,000	10	6,782	1,085
1,000,000	5	7,437	1,252
2,000,000	3	10,737	2,011
5,000,000	2	30,706	6,161
All	301	75,481	13,503

Note that since an additional £811 million of capital gains tax was also paid by trusts in this year according to this data it does not reconcile by some way with the more recent data from HM Revenue & Customs for overall capital gains tax paid in the year as noted above. These differences cannot be explained and add to the difficulty of working with HMRC data on tax yields.

The tax rate in operation from April 2020 to April 2024 have been as follows:

	From 6 April 2023	From 6 April 2020 to 5 April 2023
Standard rate (basic income tax rate taxpayers)	10% / 18%	10% / 18%
Higher rate (higher and additional rate income taxpayers)	20% / 28%	20% / 28%
Business asset disposal relief (Entrepreneur's relief) effective rate	10%	10%

[4] Based on HMRC data for total tax revenues raised and not just capital gains tax https://www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk

[5] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1094358/Table_2_Size_of_gain.ods

Annual exemption:		
Individual	£6,000	£12,300
Trusts	£3,000	£6,150

Where two rates of tax are shown the lower one is the rate charged on the disposal of all assets except properties and the higher one is that due on property.

Now that the annual exemptions for this tax were reduced from 6 April 2023.

Note too that the rate of tax a person pays is determined by their income in a year, and not (at least in the first instance) by the total of their capital gains in the year.

To determine whether a person is a standard or higher rate taxpayer for the purposes of this tax their income tax liability has to be computed on the basis of the following allowances, rates and reliefs:

Personal allowances	**2023-24**	**2022-23**
Personal allowance (PA)	£12,570	£12,570
Income Tax bands and rates	**2023-24**	**2022-23**
Basic rate band:	**£37,700**	**£37,700**
Savings rate	20%	20%
Non-savings rate	20%	20%
Dividend rate	8.75%	8.75%
Higher rate band:	**£37,701-£125,140**	**£37,701-£150,000**
Savings rate	40%	40%
Non-savings rate	40%	40%
Dividend rate	33.75%	33.75%
Additional rate band:	**£125,140 or more**	**£150,000 or more**
Savings rate	45%	45%
Non-savings rate	45%	45%
Dividends rate	39.35%	39.35%

If the capital gain less the capital gains tax allowance for the year is a positive sum i.e. there is a chargeable gain on which tax is potentially due, then if that net gain when added to income subject to income tax in the year is less than £50,270 (£12,570 personal allowance plus the basic rate income tax band) then the tax due is charged at the lower capital gains tax rates. If it exceeds that sum, then to the extent that it does the higher rates of capital gains tax apply.

It will be noted that in effect the capital gains tax annual allowance did effectively almost exactly double the available tax-free sum that a person might enjoy until 5 April 2023. This has now been reduced. This has increased the number of people to whom the higher rates of capital gains tax might now apply.

In the last year for which data is available (2020/21) 301,000 people paid tax on gains that they had made. Of these at least 129,000 had gains that in themselves guaranteed that they were higher rate taxpayers for capital gains tax purposes. If, as it would be reasonable to assume, all of these capital gains taxpayers had income of at least £25,000 subject to income tax in that year then the number likely to be paying tax at higher rates would increase to 202,000.

Reform recommendation

If a government is to address the apparent under taxation of wealth then it is apparent that the rates of tax due on income and capital gains must be equalised.

There are a number of reasons for suggesting this. First of all, it should be noted that unless the rates of capital gains tax and income tax are equalised then capital gains tax fails to stop tax avoidance, which is its purpose. Instead, it actually encourages tax avoidance[6] by the creation of a deliberate spillover[7] effect. As a result, it reduces tax compliance[8]. These perverse situations must be brought to an end.

Secondly, by offering a lower rate of tax on a return from wealth the significant disparity in the overall tax contribution made by those with wealth and higher incomes when compared to those with lower incomes noted in this report will continue.

Third, this disparity in rates will continue to encourage perverse behaviour in the economy, including the encouragement of the recognition of capital gains rather than dividends in the returns from companies.

[6] Tax avoidance involves an activity deliberately undertaken by a taxpayer in a way that they know might not be tax compliant.
[7] Tax spillovers are the consequences of the interactions between different tax systems or different parts of the same tax system that can often (sometimes unintentionally) reduce tax revenues and the size of a tax base.
[8] Tax compliance is seeking to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

Fourth, the effort expended on tax planning, which is wholly unproductive for the economy as a whole, will be reduced if these rates are equalised.

Fifth, in the short-term the churning of gains to minimise tax might end, to the advantage of investment management of portfolios where long-term views should be taken.

Finally, and most importantly of all, people will be seen to be equal within the economy. When, as a matter of fact, a pound received is indifferent in worth as to its source[9] it should be taxed at the same rate taking into consideration the situation of the recipient whatever that source might be, and unless it is the tax system is obviously discriminatory. This should cease to be the case.

The recommendation made is that capital gains should always be taxed as if they are the top part of a person's income with income tax rates applying to that gain.

This change would be easy to implement: it is already necessary to treat capital gains as if they are the top part of income to work out the tax capital gains tax payable at present.

Importantly, the declaration process for capital gains need not change at all.

Using the assumptions noted previously on the number of taxpayers likely to be liable to basic, higher and additional rates of tax noted above and presuming that none of the capital gains tax due related to property gains, then the increased tax yield in 2020/21 using the data noted previously for that year assuming no behavioural change in the recognition of capital gains took place might be[10]:

Range of gain (Lower limit £)	Number of individuals	Amounts of gains for individuals	Amounts of tax for individuals	Additional tax due at basic income tax rate	Additional tax due at higher rate of income tax	Additional tax due at additional rate of income tax	Total additional tax due
0	2	2	9	9			9
10,000	96	1,680	85	85			85
25,000	73	2,621	304		304		304
50,000	53	3,708	582		582		582
100,000	40	6,234	1,076			1,345	1,345
250,000	16	5,575	938			1,172	1,172
500,000	10	6,782	1,085			1,356	1,356

[9] For a discussion of this issue see https://www.taxresearch.org.uk/Blog/2023/09/07/the-taxing-wealth-report-2024-methodology/

[10] The additional sum owing is the original sum owing multiplied by the ratio of the new rate owing to the original rate owing e.g. assuming, as noted, that all gains are payable at 20%, the extra sum owing at the additional rate is the original sum owing multiplied by 45/20, less the original sum paid. In case this is an overestimate a lower range estimate of approximately 75% of the calculated additional sum owing is used as the estimate for likely additional revenues from this change.

1,000,000	5	7,437	1,252			1,565	1,565
2,000,000	3	10,737	2,011			2,514	2,514
5,000,000	2	30,706	6,161			7,701	7,701
All	301	75,481	13,503	94	886	15,653	16,633

It cannot, of course, be guaranteed that there will be no behavioural change on the part of taxpayers as a result of this alignment of tax rates. However, since most capital gains that were artificially created in the past were intended to use the higher rate of annual allowance available until April 2023, which allowance has now been reduced, and most actual chargeable gains will therefore now be the unavoidable consequence of transactions that really arise in the course of normal trading and investment, the scale of this change in behaviour might well be modest.

Prudently, to allow for uncertainty about this behavioural response and to allow for uncertainty referred to in footnote nine it is assumed that approximately seventy five per cent of this forecast additional tax might be collected, resulting in potential additional income of around £12 billion per annum whilst recognising that this sum might actually be higher in practice.