The Taxing Wealth Report 2024

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

Income tax reform:

Creating an investment income surcharge on unearned income

Brief summary

This note suggests that:

- It is inequitable that those with unearned income in the UK do not make a contribution equivalent to national insurance at present.
- Such a contribution could be made by recreating the investment income surcharge that was included in the income tax system and which was applied to unearned income at a rate of 15% until 1984.
- This charge could also be extended to capital gains.
- This charge would be collected via a person's self-assessment tax return for each year.
- This charge would only be applied to investment income and gains (excluding pensions) exceeding £5,000 in a year. This sum takes into account the fact that almost all those paying would have already had the benefit of a national insurance allowance in the year. A higher ceiling could be set for pensioners.
- This charge would raise approximately £7.1 billion in tax each year if capital gains were not taken into consideration. This sum would increase to approximately £18 billion per annum if capital gains were taken into account.

[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.

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The proposal	To charge those in receipt of unearned income (i.e. income from savings such as interest or dividends, or from other sources such as rents and from capital gains and trusts, but not pensions) above an agreed level to an investment income surcharge on that excess unearned income. That investment income surcharge would be at the rate of 15%. It is suggested that it would only be applied to investment income of above £5,000 per annum. This liability would be collected as part of the income tax liability of those due to pay it, usually though their self-assessment tax return. This sum would be due because unearned income is not at present subject to a national insurance charge when income earned from work and self-employment is.
Reason for the proposal	1. To improve the horizontal equity of taxation, which is currently seriously undermined by the differential between the tax rates due on earned and unearned income due to the absence of a national charge, or a charge equivalent to it, on unearned income. 2. To increase the prospect of vertical equity of taxation in the UK which the absence of this charge seriously undermines. 3. To reduce the tax spillover effect that the existing charge structures of national insurance create when compared to those charged under income tax rules. This has most especially been seen in tax planning designed to transform earned income into unearned income via the medium of limited liability companies and dividend payments to working shareholder / directors.

	4. To help close the UK tax gap. 5. To reduce the rate of tax avoidance in the UK. 6. To consequently improve the rate of tax compliance in the UK. 7. To raise additional tax revenues.
Estimated tax that might be raised as a result of the recommendation made	The behavioural response to this change is hard to predict, but since significant attempts have already been made by HM Revenue & Customs to reduce the rate of tax abuse via the use of limited liability companies it is likely to be smaller now than it might have been in the past. The inclusion of capital gains in the charge is vital if abuse via that tax is to be prevented. Some dividend and other payments to connected parties might be deferred as a result of this charge being introduced but the likelihood of this could be counter-acted via the use of close company apportionment rules (see separate recommendation). It is possible that such a charge might also defer the recognition of some capital gains. Overall, however, the impact on revenue is likely to be small and short term. The reality is that companies will still need to distribute dividends; that interest will still be paid on deposits and capital gains will be realised as a result of commercial transactions. Significant deferral of these in order to avoid a charge to this proposed investment income surcharge will, in that case, ultimately be hard to achieve. On investment income alone the yield from this charge would yield approximately £7.1 billion a year. If extended to capital gains that sum could exceed £18 billion per annum.

Ease of implementation	In essence this proposal is simple since such legislation has existed before. It was abolished in 1984. The principles are, therefore, known and could be revived. The equity of such a charge is obvious, making its passage easier. What is harder to predict is the scale of hostility any such proposal might create.
Likely difficulties that might result from implementation	Few.
Likely time required to implement the change	Up to two years planning might be required for a change such as this, even though it previously existed in UK law.
Consultation period required.	A significant consultation exercise would be required with regard to this change to win acceptability for it.

Background

National Insurance is a complex tax. It was originally introduced by a Liberal government in 1911 as part of a range of measures that also saw the introduction of the first state old age pension in this country. It was, however, considerably expanded after the Second World War by the Labour government of that period that was seeking to provide a social safety net for the people of the UK as part of the new social contract that they were seeking to create between the working people of the UK and its government.

National insurance was created, as its name implies, as a state supplied insurance mechanism that guaranteed that in exchange for contributions made an employee or self-employed person might, depending upon their precise circumstances and contributions made, claim for unemployment benefits, some sickness and disability benefits and a state old age pension. It was also suggested that national insurance contributions should contribute to the cost of the National Health Service.

The pretence that national insurance contributions now make direct payment for any pension, benefit or health care provided by the UK state has effectively been abandoned, although the entitlement to some such benefits is still dependent upon having made such contributions during the course of a working career. For all practical purposes, national insurance is now just one of many taxes within the UK. In the tax year 2023/24 it is likely that national insurance will raise total contributions of £172 billion[2]. This sum will represent approximately 18.1% of all anticipated tax revenues during the course of that year.

National insurance charges are complicated and differ for those who are employed and self-employed. There is also an option for a person to make voluntary national insurance contributions.

Importantly for the purposes of this recommendation, national insurance is not charged on a person's unearned income arising in a year, including:

- Interest on savings.
- Dividends on shares.
- Rental profits.
- Payments from trusts.
- Capital gains.

This creates considerable inequity in the UK tax system as a result since these sources of income are taxed at considerably lower rates than are those that are earned from work or self-employment.

Recommendation

It is recommended that an investment income surcharge be introduced that would be payable on the total unearned income of a person, including capital gains, arising in a year.

It is suggested that this be paid at 15 per cent, which was the rate last used when such a charge was included in the UK tax system before its abolition in 1984. The rate exceeds the national insurance charge but is much less than it when the national insurance contribution due by employers (13.2 per cent) is also taken into account.

It is suggested that an annual tax-free allowance equivalent be given for the purposes of this charge, largely to reduce the cost of administration of small cases. £5,000 would be sufficient for this purpose. In the event that a person did not have income subject to national insurance this could be increased to the lower national insurance threshold via the self-assessment tax return. A higher limit for pensioners could be considered.

Based on HM Revenue & Customs data[3] on taxable income arising from property, dividend, interest and other income for 2020/21 (the most recent year available), an investment

[2] https://obr.uk/economic-and-fiscal-outlooks/
[3] https://www.gov.uk/government/statistics/income-tax-liabilities-of-starting-savers-basic-and-higher-rate-taxpayers-by-largest-source-of-income-2010-to-2011 table 3.5, other income.

income surcharge charged at 15% on income of this sort exceeding £5,000 per annum would yield approximately £7.1 billion per annum.

Extending the charge to capital gains would, based on HMRC data[4] increase the yield by more than £11 billion a year on top of other proposed increases in the capital gains tax rate noted in these proposals.

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