Arun Advani Andrew Lonsdale Andy Summers October 23rd, 2024

# The UK's Capital Gains Tax system needs reforming – here's how

*The current system for Capital Gains Tax (CGT) is unfair and inefficient from an economic lens. Given this, **Arun Advani, Andrew Lonsdale** and **Andy Summers** (CenTax) set out a blueprint for CGT reform: one that would raise an estimated £14bn per year while leaving most CGT payers better off and incentivising growth-oriented entrepreneurship.*

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It is a near certainty that the first Budget of the Labour government will include revenue-raising reform to the Capital Gains Tax (CGT) system. Precisely what form this will take remains an open question. Prime Minister Keir Starmer has stated that the "heavier burden" of the upcoming budgetary measures should be borne by those with the "broadest shoulders", and the careful design of a new CGT system would be the most effective way to raise revenues from the country's richest individuals.

With that in mind, our new Centre for the Analysis of Taxation (CenTax) policy report provides a blueprint for CGT reform that would raise an estimated £14bn per year, while alleviating concerns over the impacts of CGT on entrepreneurship and leaving most CGT payers better off.

## What is Capital Gains Tax?

An individual pays CGT when they sell certain types of assets (such as shares purchased on the stock market, a private business, or a rental property) that have gone up in value since they were acquired. The tax is due on any difference between the sale price and the initial purchase price – the capital gain, or profit – that exceeds an annual tax-free allowance of £3,000. CGT rates currently range from 10% to 28%, whereas Income Tax has a top rate of 45%; in addition, unlike earnings, capital gains are not subject to national insurance contributions.

CGT was first introduced in 1965 to provide a "backstop" for Income Tax, preventing taxpayers from avoiding tax altogether by "disguising" their income as a capital gain. CGT rates were equalised with

Income Tax by Conservative Chancellor Nigel Lawson in 1988, which largely eliminated the incentive to disguise income in this way. Since 1998, however, a series of reforms to CGT – initiated by Chancellor Gordon Brown – have reinstated preferential tax treatment of capital gains.

## Issues with the current Capital Gains Tax system

The current CGT system is unfair. The vast majority of capital gains are highly concentrated amongst a small number of individuals: just 5,000 taxpayers received over half of *all* capital gains in the UK in 2020, an average of £6,815,000 each. Looked at geographically, the gains received in just one neighbourhood of London – Notting Hill – sum to more than those received in Liverpool, Manchester and Newcastle combined.

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This matters, because those making large capital gains benefit substantially from the discrepancy between CGT and Income Tax rates. Indeed, capital gains have played a key role in the rise of UK inequality over recent decades, and their privileged tax treatment means that the tax rates faced by affluent taxpayers actually decline, on average, as you move up the distribution.

Lower rates on capital gains also distort real economic decisions. Taxpayers in certain lines of work face strong incentives to set up companies purely for tax-saving purposes, allowing them to work through their firms (for example, as a "consultant", rather than being hired as an employee) and extract some of their profits under CGT rates by selling or liquidating the company. Offering low CGT rates is often framed as a tool to promote risky investment, but many of these companies operate with limited (if not zero) capital. In other words, CGT enables this group to benefit from lower rates on their earnings, directly reducing the tax take, but with no broader economic benefit. The British economy needs a CGT system that incentivises growth-oriented entrepreneurship and not the creation of businesses that solely exist to shelter their owners from Income Tax.

To some, the solution to these problems is simply to align rates of CGT with Income Tax. However, we think that it would be a serious mistake and missed opportunity if the government only changes tax rates in the upcoming Budget.

First, the current tax system disincentivises genuine capital investment by levying CGT on the entire nominal gain, even where some of the increase in price is merely due to inflation and the taxpayer is no better off from the sale. This can have the effect of disincentivising investments that are only marginally profitable in real terms. Another issue with the current regime is the ability to avoid CGT entirely through two main "leaks" in the tax base: emigration and death. Taxpayers selling a business that they have grown in the UK can move abroad before selling, allowing them to escape paying any UK CGT (and pay nothing at all in their new country if they move to a tax-free jurisdiction, as is often the case). CGT is also forgiven on assets held at death, encouraging taxpayers to hold assets indefinitely to transmit these tax-free to their descendants. Lastly, the current treatment of capital losses deters risk taking and entrepreneurship as successful investments are fully taxed while the government does not take an equal share of the downside when investments fail.

Any increase to CGT rates that does not also address these concerns in the current tax system is likely to be ineffective, as it would leave open channels for tax avoidance while further reducing investment incentives.

## Our proposal for reforming the UK's CGT regime

With these considerations in mind, our report recommends a comprehensive package of CGT reforms that combines changes to both the tax rate and the tax base. We use de-identified tax data accessed via His Majesty's Revenue and Customs (HMRC) to provide estimates of the revenue and distributional impacts of these measures.

We propose a package of five reforms:

**(1) Equalising CGT with Income Tax rates.** This is a crucial step towards ensuring that all forms of income are taxed in the same way, and reduces the incentive to set up companies solely in order to convert income into gains.

**(2) Introducing an investment allowance.** This could take the form of an allowance for inflation, although we prefer a more generous allowance for the risk-free rate of return. Crucially, this would *cut* the effective tax rate for 51% of CGT payers (and leave it unchanged for a further 7%) while improving investment incentives.

**(3) Removing the tax "uplift" at death.** This would address the distortion to investment incentives arising from the fact that, currently, assets held until death escape tax altogether.

**(4) Making sure that gains received by those living in the UK are taxed in the UK.** This can be done by a system of "rebasing on arrival" and "deemed disposal on departure", ensuring that individuals

always pay UK tax on the gains they make whilst living in the UK.

**(5) Treating losses more generously.** This would give more support for genuine risk-taking by ensuring that the government shares in the downside as well as the upside from risky investments.

The report sets out each of these reforms in more detail. Overall, we estimate that our package of reforms would together raise an additional £14bn in revenue per year, even after accounting for changes in taxpayer behaviour.

Our estimate differs substantially from figures previously published by HMRC, which conclude that a 10 percentage point increase in the top CGT rates would *reduce* government revenue by £2 billion per year after three years. A major reason for the discrepancy is that HMRC have modelled a rise in rates without further changes to the CGT base, leaving the door open for increased avoidance while worsening the investment incentives of the current system.

Unfortunately, there have been reports that the government has ruled out taxing capital gains on emigration and will leave the CGT rate on investment properties at 24%. If these reports are true then revenues raised from any upcoming reform will fall substantially below £14bn, reflecting a policy choice not to embark on the more fundamental reforms called for by our research team and supported by other prominent think tanks (eg, the IFS, the IPPR, and Tax Policy Associates).

From a distributional perspective, we find that our proposed reforms would actually result in more "winners" than "losers". Over half (51%) of CGT payers in 2020 would have been better off under the recommended package, and two in five (40%) CGT payers would have been taken out of having to pay CGT altogether. This is a consequence of the investment allowance, which exempts any returns below the "normal" risk-free rate without imposing a major impact on revenues, since capital gains are concentrated among taxpayers earning high returns. Most (68%) of the additional revenue from the proposed reforms comes from the top 0.1%, and the biggest losers would be those currently using the preferential CGT rate to reduce the tax on their income from work.

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But are our reforms just pie in the sky? Actually, we do not need to look far to see examples of these policies already working in practice. Equalising rates with a new allowance for investment would reinstate the system introduced in the UK by Chancellor Nigel Lawson in 1988, but with a more generous investment allowance. Several countries – such as Australia, Canada, Japan, Norway and the United States – already have "deemed disposal on departure" for CGT purposes, and many of our OECD counterparts do not offer CGT forgiveness at death.

Drawing on lessons from our own experiences as well as those of our international partners suggests that it is indeed possible to design a CGT system that will leave most taxpayers better off, and which would go a long way towards meeting the budgetary pressures faced by the current government.

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*You can read the full report, "Reforming Capital Gains Tax: Revenue and Distributional Effects", here.*

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