Capital Gains Tax review – first report:
Simplifying by design

November 2020
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Simplifying by design

Presented to Parliament pursuant to section 186(4)(b) of Finance Act 2016

November 2020
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreword</td>
<td>2</td>
</tr>
<tr>
<td>Executive summary</td>
<td>3</td>
</tr>
<tr>
<td>Chapter 1 Introduction to Capital Gains Tax</td>
<td>20</td>
</tr>
<tr>
<td>Chapter 2 Capital Gains Tax rates</td>
<td>32</td>
</tr>
<tr>
<td>Chapter 3 Boundary issues</td>
<td>47</td>
</tr>
<tr>
<td>Chapter 4 Annual Exempt Amount</td>
<td>63</td>
</tr>
<tr>
<td>Chapter 5 Capital transfers</td>
<td>73</td>
</tr>
<tr>
<td>Chapter 6 Reliefs and losses</td>
<td>85</td>
</tr>
<tr>
<td>Annex A Scoping document</td>
<td>96</td>
</tr>
<tr>
<td>Annex B Consultative Committee</td>
<td>98</td>
</tr>
<tr>
<td>Annex C Organisations consulted</td>
<td>99</td>
</tr>
<tr>
<td>Annex D International comparisons</td>
<td>101</td>
</tr>
<tr>
<td>Annex E History of Capital Gains Tax</td>
<td>105</td>
</tr>
<tr>
<td>Annex F Data sources used in this report</td>
<td>109</td>
</tr>
</tbody>
</table>
Foreword

In July 2020, the Chancellor asked the Office of Tax Simplification (OTS) to carry out a review of Capital Gains Tax, to ‘identify opportunities relating to administrative and technical issues as well as areas where the present rules can distort behaviour or do not meet their policy intent’.

The review has attracted very strong engagement from advisers, businesses, academics and the general public, including over 1,000 responses to an online survey and 96 formal written responses to a call for evidence, supported by an extensive range of meetings with interested parties with a wide variety of perspectives.

Given the wide scope of the review, the OTS will produce two reports. This report is on the policy design and principles underpinning the tax; the second, which will follow early next year, will explore key technical and administrative issues.

The report highlights many features of Capital Gains Tax which can distort behaviour, including its boundary with Income Tax and interconnections with Inheritance Tax.

In that context, the recommendations are presented by reference to four areas where there are policy choices for governments to make: rates and boundaries, the Annual Exempt Amount, capital transfers and business reliefs. In each of these areas the report sets out interlinked changes which would need to be considered in the round.

The OTS would like to thank Mark Pickard, who led the review, supported by Charlotte Alderman, Sally Campbell, Sarah Glover, Suzanne Green (kindly seconded to the OTS by PwC), Julia Neate and Hannah Smith, guided by OTS Head of Office David Halsey. We are also very grateful to our HM Treasury and HM Revenue & Customs colleagues, our Consultative Committee members and all those who have willingly given time, ideas, challenge and support.

Kathryn Cearns – OTS Chair

Bill Dodwell – OTS Tax Director
Executive summary

Introduction

The Office of Tax Simplification (OTS) is the independent adviser to government on simplifying the tax system. The work of the OTS is rooted in improving the experience of all who interact with the tax system. The OTS aims to improve the administrative processes, which is what people actually encounter in practice, as well as simplifying the rules. These are often of equal importance to taxpayers and HM Revenue & Customs (HMRC).

In July 2020, the Chancellor asked the OTS to carry out a review of Capital Gains Tax (see Annex A), to ‘identify opportunities relating to administrative and technical issues as well as areas where the present rules can distort behaviour or do not meet their policy intent.’

In the wide-ranging consultation exercise which followed, the OTS received valuable contributions from representative bodies, professional advisers, businesses, academics and from the Consultative Committee (see Annex B), through 22 consultation meetings, 96 formal written responses to the call for evidence and over 1,000 members of the public contributing to an online survey. A list of organisations consulted, or which responded to the call for evidence, is in Annex C.

Given the wide scope of the review, the OTS will produce two reports. This report is on the policy design and principles underpinning the tax; the second which will follow early next year will explore key technical and administrative issues.

This report has been produced in a shorter than usual timeframe; while the OTS has confidence in its overall conclusions it recognises that there are wider policy trade-offs for government to make and that further, more detailed, work would be involved in taking forward specific recommendations. This report highlights ways in which different approaches may distort behaviour or make things complex in practice.

This review is focused on individuals’ liabilities and does not cover trusts or the attribution of offshore gains to UK resident individuals. Neither does it explore the Capital Gains Tax position relating to an individual’s arrival or departure from the UK.

Scope and principles of Capital Gains Tax

Capital Gains Tax is, very broadly, a tax on the difference between an asset’s value when acquired and its value at disposal, less any allowable expenses. The main exemption is a relief for a taxpayer’s main or only home. Assets can be acquired in
various ways including through purchase, inheritance or as a gift, and are generally disposed of either through selling or gifting.

Broadly, those paying Capital Gains Tax are business owners (for example, holding shares in an unquoted trading company), investors (for example, holding a buy-to-let property, a second home or a portfolio of listed shares outside a pension or ISA) and employees (for example, who participate in share schemes).

It is for government to determine the principles and role of the tax when framing policy and determining tax rates. In doing this, the government should carefully consider the economic implications, the implications for people with different levels of income or gains, the tax yield and the compliance costs for taxpayers and HMRC.

The stated principles and role of the tax have varied over the last 50 years as political priorities, economic conditions and the needs of the Exchequer have changed.

When the tax was introduced in 1965, Chancellor James Callaghan said that ‘…gains confer much the same kind of benefit on the recipient as taxed earnings… [and]… the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator.’

In 1988, Chancellor Nigel Lawson said, when aligning the rates with those for Income Tax, that there is ‘little economic difference between income and capital gains’ so income and gains should be treated along similar lines.

In 1998, Chancellor Gordon Brown said, when replacing indexation allowance with Taper Relief, that the ‘capital taxation system should better…reward risk taking and promote enterprise.’

These changes about the different ways in which Capital Gains Tax has been viewed were reflected in the wide range of perspectives the OTS has heard.

**Who pays Capital Gains?**

In the 2017-18 tax year £8.3 billion of Capital Gains Tax was paid and £55.4 billion of net gains (after deduction of losses) reported by a total of 265,000 individual UK

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1 James Callaghan, Budget 1965. https://api.parliament.uk/historic-hansard/commons/1965/apr/06/i-capital-gains-tax


4 Throughout this report 2017-18 data is used, as that this the latest year for which a full dataset (including all of the statistical tables referenced) is available. The Capital Gains Tax statistical tables can be found at https://www.gov.uk/government/statistics/capital-gains-tax-statistical-tables.
This compares with the £180 billion\(^7\) of Income Tax paid in 2017-18 by 31.2m individual taxpayers.\(^8\)

Most people do not need to pay Capital Gains Tax very often, but those who do often pay large amounts: Income Tax raises over 20 times as much overall, but the average (mean) amount of Capital Gains Tax paid by those who are liable to the tax is £32,000, which is more than five times the equivalent figure for Income Tax.

Diagram A, in which the size of the circles represents the amount of tax paid, illustrates these figures.

**Diagram A: Income Tax and Capital Gains Tax revenues (from individual taxpayers)** \(^9\)

Source: OTS

**Rates of Capital Gains Tax**

There are four different rates of Capital Gains Tax all of which are lower than the equivalent standard rates of Income Tax. The rates depend on the Income Tax status of the taxpayer and the type of asset disposed of, as shown in Table A.

**Table A: Table of rates**

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\(^6\) These figures exclude trustees. In 2017-18, trustees of 22,000 trusts reported £3.5 billion gains and paid £0.6 billion taxes. Companies are also taxable on their capital gains but these form part of their profits for Corporation Tax purposes and are not distinguished from income.


\(^8\) See footnote 7.

\(^9\) See footnotes 5, 6, 7 and 8.
Income tax status | Standard Income Tax rate | Standard Capital Gains Tax rate | Residential property & carried interest Capital Gains Tax rate | Business Asset Disposal Relief rate & Investors’ Relief
--- | --- | --- | --- | ---
Basic rate | 20% | 10% | 18% | 10%
Higher rates | 40/45% | 20% | 28% | 10%

**Distortions in the Capital Gains Tax system**

A starting point for an efficient tax system should be neutrality, to minimise distortions to taxpayers’ business and family choices. A non-neutral tax system risks incentivising inefficient economic activity, complex sub-optimal decision making, or encouraging people into ‘socially wasteful effort to reducing their tax payments by changing the form or substance of their activities.’\(^{10}\) However, intervention can justified if market failure could lead to economic damage or underperformance.

The OTS’s consultation revealed a range of areas in which Capital Gains Tax is counter-intuitive, creates odd incentives, or creates opportunities for tax avoidance. Some respondents also argued that Capital Gains Tax is either a barrier to economic growth or to a more equitable society.

In particular, significant issues were raised about
- the rates at which the tax is charged
- the boundaries between income and gains arising from employment, business and entrepreneurial activity in different contexts
- how Capital Gains Tax applies to transfers before and after a person’s death, and
- and the strong interconnections between Capital Gains Tax, Income Tax and Inheritance Tax, which all have to be considered when changes are made.

There was a range of opinion on whether there needs to be a tax incentive to encourage risk taking or entrepreneurship and whether such an incentive can be sufficiently targeted not to lead to unnecessary distortions.

The recommendations in this report are framed by reference to four interlinked areas in which the government has policy choices to make:
- rates and boundaries
- the Annual Exempt Amount
- capital transfers
- business reliefs

This report also considers a small number of significant administrative issues which bear directly on the recommendations. These will be covered in greater detail in the second report.

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The OTS is conscious of the inherent tensions in some parts of this report between smoothing out bigger picture distortions and improving administrative efficiency. The OTS has sought to be clear about these and to identify ways to mitigate them.

**Rates and boundaries (Chapters 2 and 3)**

Rates and boundaries are both integral to the strategic policy choices about how to simplify Capital Gains Tax.

The first choice for government, on which the number of Capital Gains Tax rates and the approach to boundary issues depend, is whether to more closely align the rates with Income Tax rates.

**Rates disparity or boundaries?**

The current rates of Capital Gains Tax are lower than standard Income Tax rates. This disparity is one of the main sources of complexity.

Some argue that this is justified as rewarding risk taking and promoting enterprise, but when governments diverge from neutrality this should be done with a full understanding of the economic, social and fiscal costs and benefits.

The rate disparity can distort business and family decision-making and it creates an incentive for taxpayers to arrange their affairs in ways that effectively re-characterise income as capital gains. Most gains are concentrated among relatively few taxpayers, who also tend to have more flexibility about when they dispose of their assets. This can mean that they pay proportionately less tax on their overall income and gains than others.

A greater alignment of rates would reduce the need for complex rules to police the boundary between income and gains, as the way income is classified would not affect the tax position.

Alternatively, the issues arising from the disparity in rates could be addressed at the boundary between income and gains. The two key areas where the OTS considers the boundary is under pressure are the use of share-based remuneration, and the accumulation of retained earnings in smaller owner-managed companies.

**More closely aligning rates**

More closely aligning Capital Gains Tax rates with Income Tax rates has the potential to raise a substantial amount of tax for the Exchequer.

However, there would be significant behavioural effects, which would materially reduce this, including an impact on people’s willingness to dispose of assets and trigger a tax charge, increasing the extent to which Capital Gains Tax has a ‘lock in’ effect.

In addition, an increase in rates would highlight other issues:

- the widely held view that it is inappropriate to tax the part of a gain that has arisen (perhaps over many years) merely because of inflation
• a rate increase would also increase incentive for taxpayers to hold assets through companies, as Corporation Tax is charged at a lower rate than the higher or additional rates of Income Tax

• there is also a case, if rates were increased, for considering a greater degree of flexibility in the use of capital losses in some situations

Multiple rates
The other main source of complexity, and the next major policy choice, is the number of different Capital Gains Tax rates and their interaction with Income Tax. This is particularly true for taxpayers straddling the basic and higher Income Tax rate boundary, as they cannot know their liability to Capital Gains Tax on a particular disposal until they know their total income for that tax year.

It would be administratively simpler for most taxpayers if there were two rates of Capital Gains Tax, rather than four, and if there were less or no interdependence with Income Tax rates. However careful thought would have to be given to the winners and losers across the income spectrum and the extent to which such changes could increase distortions.

Addressing boundary pressure points
Retaining a substantial difference in tax rates between Income Tax and Capital Gains Tax may put pressure on the boundaries between the two taxes. The two key areas considered in this report are the use of share-based remuneration, and the accumulation of retained earnings in smaller owner-managed companies.

Share-based remuneration is itself a complex area. Some arrangements benefit from tax advantages provided in legislation and others do not. These have a variety of stated purposes in relation to incentivising employees, owner-managers and entrepreneurs. The tax benefits can be significant as - to use a simple illustration - awards of employee shares are effectively taxed at much lower rates than equivalent cash bonuses.11

The boundary is hard to delineate. There will generally be greater opportunity for those with greater means to take greater advantage of the choices available, and shares are quite often made available on better terms to employees than to others. However, there are policy justifications for non-neutrality, particularly in the case of the tax advantaged all-employee share schemes.

In relation to the accumulation of retained earnings within smaller owner-managed companies, the issue is that business owners are taxed at lower rates if they retain profits arising from their personal labour in their business and realise the benefit on sale or on liquidation, than if they withdraw them as dividends.

One approach would be to tax some or all of the retained earnings remaining in the business on liquidation or sale at dividend rates (in effect shifting the boundary between Capital Gains Tax and Income Tax). This could make the treatment of cash taken out of the business during and at the end of its life more neutral.

11 The overall tax benefits relate not only to Capital Gains Tax and Income Tax, but also to the effects of Corporation Tax and National Insurance contributions.
Recommendation 1
If the government considers the simplification priority is to reduce distortions to behaviour, it should either:
• consider more closely aligning Capital Gains Tax rates with Income Tax rates, or
• consider addressing boundary issues as between Capital Gains Tax and Income Tax

Recommendation 2
If the government considers more closely aligning Capital Gains Tax and Income Tax rates it should also:
• consider reintroducing a form of relief for inflationary gains,
• consider the interactions with the tax position of companies, and
• consider allowing a more flexible use of capital losses

Recommendation 3
If there remains a disparity between Capital Gains Tax rates and Income Tax rates and the government wishes to make tax liabilities easier to understand and predict, it should consider reducing the number of Capital Gains Tax rates and the extent to which liabilities depend on the level of a taxpayer’s income.

Recommendation 4
If the government considers addressing Capital Gains Tax and Income Tax boundary issues, it should:
• consider whether employees and owner-managers’ rewards from personal labour (as distinct from capital investment) are treated consistently and, in particular
• consider taxing more of the share-based rewards arising from employment, and of the accumulated retained earnings in smaller companies, at Income Tax rates
Annual Exempt Amount and administration (Chapter 4)

The operation and level of the Annual Exempt Amount

The Annual Exempt Amount (of £12,300 in tax year 2020-21) is a threshold below which an individual’s overall gains chargeable to Capital Gains Tax in a given tax year are not taxed.

The Annual Exempt Amount could be considered to fulfil one or more purposes:

- an administrative de minimis, to reduce the number of people who need to submit Capital Gains Tax information
- a broader more substantive relief, comparable to the Income Tax personal allowance
- a rough and ready way to compensate for inflation

A significant number of respondents said the Annual Exempt Amount was too high to serve only as an administrative de minimis and that it is in effect more like a relief.

Although compensating for inflation was a stated policy objective when the level of the Annual Exempt Amount was increased in 1982, the OTS considers this is an ineffective way to achieve this objective, as it does not consider holding periods or asset values.

It is however clear that the relatively high level of the Annual Exempt Amount distorts investment decisions. In tax year 2017-18, around 50,000 people reported net gains close to the threshold and so ‘use up’ the allowance which is straightforward for holders of listed share portfolios.\(^\text{12}\) Chart A shows the frequency of different levels of net gains around the Annual Exempt Amount.

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\(^{12}\) 52,000 people reported gains within the range from £10,300 to £11,300 for 2017-18. See Chapter 4 and Annex F for more details.
One way to address this would be to revisit the level of the Annual Exempt Amount, with a view to reducing it so that it mainly operates as an administrative de minimis threshold.

The OTS is very mindful of the administrative implications of a lower Annual Exempt Amount and the consequences of bringing more people into the tax system.

If taxpayer behaviour did not change, the number of taxpayers required to pay Capital Gains Tax in 2021-22 would double if the Annual Exempt Amount were reduced to around £5,000, and would nearly triple at an Annual Exempt Amount level of around £1,000 (compared to the 265,000 individual taxpayers currently paying Capital Gains Tax in 2017-18).

Many of these taxpayers would already be making a Self Assessment tax return, but for those who would not otherwise be doing so this would involve additional administration. The lower the level of the Annual Exempt Amount, the higher proportion of newly liable taxpayers would also be new to self-assessment.14

It is also likely that taxpayers presently making gains just below the Annual Exempt Amount would be less likely to choose to realise similar levels of gain if the Annual Exempt Amount were reduced.

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13 The presentation of this chart is affected by the division of the gains into £100 intervals by value. Refer to Annex F for further information. Only gains reported under self-assessment are included in this chart.

14 See Chart B
Chart B: Estimates of new individual taxpayers and new taxpayers to self-assessment given reduced Annual Exemption Amount threshold – 2021-22 projection

Based on the data in Chart B, which shows how many extra people may be brought into Capital Gains Tax if the Annual Exempt Amount was reduced, a true de minimis level lies in the range between £2,000 and £4,000, below which the numbers of taxpayers new to self-assessment begins to increase more steeply. See Chapter 4 and Annex F for more information on the data in Chart B.

Any reduction in the Annual Exempt Amount would need to take into account the increased administrative costs and burden, for taxpayers and HMRC. The OTS considers it would be essential, at the same time, to improve the administrative arrangements for real time Capital Gains Tax reporting, simplify the rules about personal effects and review the threshold for reporting transactions if no gain arises.

**Recommendation 5**

If the government’s policy is that the Annual Exempt Amount is intended mainly to operate as an administrative de minimis, it should consider reducing its level.

**Recommendation 6**

If the government *does* reduce the Annual Exempt Amount, it should do so in conjunction with:

- considering reforming the current chattels exemption by introducing a broader exemption for personal effects, with only specific categories of assets being taxable,
- formalising the administrative arrangements for the real time capital gains service, and linking up these returns to the Personal Tax Account, and
- exploring requiring investment managers and others to report Capital Gains Tax information to taxpayers and HMRC, to make tax compliance easier for individuals.
Capital Transfers (Chapter 5)

Inheritance Tax and Capital Gains Tax operate differently and are underpinned by separate policy rationales, as noted in the OTS’s second Inheritance Tax report. There is however a high degree of practical overlap between the two as most assets are within the scope of both.

The OTS considers that at present the way the two taxes interact is incoherent and distortionary. Comparable transactions can lead to situations where either one, both or neither of the taxes arise (see Diagram D). This reflects the combined effects of Inheritance Tax exemptions and reliefs (for businesses, farming businesses, and assets passing to a surviving spouse) and the Capital Gains Tax exemption on death, coupled with the fact that those inheriting assets do so at their market value for the purposes of calculating any gain on a subsequent sale (known as the ‘death uplift’).
Diagram D: Illustration of how both or no taxes can arise with Capital Gains Tax and Inheritance Tax

Neither tax

<table>
<thead>
<tr>
<th>Assets owned</th>
<th>On death</th>
</tr>
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<tbody>
<tr>
<td>Estate assets that are exempt or pass to spouse</td>
<td>No IHT and no CGT</td>
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</table>

Both taxes

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<thead>
<tr>
<th>Assets gifted to children during life</th>
<th>Transferor dies within 7 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments including second homes</td>
<td>CGT on lifetime transfer</td>
</tr>
<tr>
<td></td>
<td>Possible IHT on death</td>
</tr>
</tbody>
</table>

Source: OTS

These features of the present rules incentivise decisions about the times assets are transferred which may not be best for the business, the individuals or families involved or the wider economy.

The OTS explored these issues in its Inheritance Tax report and continues to recommend that a taxpayer should not get both an Inheritance Tax exemption and a Capital Gains Tax death uplift.

A less distortive alternative to the death uplift could be a ‘no gain no loss’ approach, where (except in relation to a person’s main or only home) the recipient is treated as acquiring the assets at the historic base cost of the person who has died. This approach would make transfers in life and on death more neutral.

The OTS considers there is also a case for going further, as there would still be an incentive to hang onto some assets until death in a range of other situations, in particular in relation to gifts.
Most gifts attract Capital Gains Tax in the same way as sales. The OTS has heard that this can impede intergenerational transfers and is a barrier to the economic use of some assets.

While a no gain no loss approach on death would reduce a major distortion, it would increase the range of occasions on which there would be an administrative challenge in calculating historic base costs. The OTS has accordingly considered additional measures which could mitigate this.

One possibility would be to consider a general rebasing from 1982 to a later year for all assets. The OTS understands from professional valuers that valuations of land and property become much easier from the late 1990s onwards due to increasing registration with the land registry and widespread digitalisation. So perhaps the year 2000 would be a suitable one to consider.

If there were a move towards a no gain no loss approach on death the OTS considers that there is a good case for an expansion of Gift Holdover Relief to non-business assets, so that Capital Gains Tax is paid on a subsequent sale rather than at the time of the gift.

Taken as a package these proposals could potentially raise money for the Exchequer over the long term.

Recommendation 7
Where a relief or exemption from Inheritance Tax applies, the government should consider removing the capital gains uplift on death, and instead provide that the recipient is treated as acquiring the assets at the historic base cost of the person who has died.

Recommendation 8
In addition, the government should consider removing the capital gains uplift on death more widely, and instead provide that the person inheriting the asset is treated as acquiring the assets at the historic base cost of the person who has died.

Recommendation 9
If the government does remove the capital gains uplift on death more widely, it should:
• consider a rebasing of all assets, perhaps to the year 2000
• consider extending Gift Holdover Relief to a broader range of assets
Diagram E: Schematic representation of recommendations 7-9

Source: OTS

Business reliefs (Chapter 6)

Chapter 6 considers two of the main reliefs which are intended to encourage investment – Investors’ Relief and Business Asset Disposal Relief (formerly Entrepreneurs’ Relief).

Both reliefs reduce the Capital Gains Tax payable on the disposal of qualifying business assets, by applying a special tax rate of 10%. Business Asset Disposal Relief is targeted at owner managers and certain employee shareholders while Investors’ Relief is targeted at external investors.

Business Asset Disposal Relief

There is a policy judgement for government to make about the extent to which Capital Gains Tax reliefs should be used to seek to stimulate business investment and risk-taking.

However, the OTS considers that Business Asset Disposal Relief is mistargeted if this is its objective. Several respondents told the OTS that the rate of tax on an eventual disposal of an investment is an ineffective incentive, and that incentives for investment, if required, should apply at the time the investment decision is made.

Business Asset Disposal Relief and its predecessors have also long been understood as having another objective – as a specific relief when business owners retire. This was originally in recognition that a person’s business can be an alternative to a pension, representing many years of constant re-investment.

If this were the objective the government could, alongside having regard to the wider objectives of the pension system, consider:

- increasing the minimum shareholding to perhaps 25%, so that the relief goes to owner-managers rather than to a broader class of employees
- increasing the holding period to perhaps 10 years, to ensure the relief only goes to people who have built up their businesses over time
- reintroducing an age limit, perhaps linked to the age limits in pension freedoms, to reflect the intention that it mainly benefit those who are retiring.

Investors’ Relief

The OTS recognises that Investors’ Relief is a new relief, which investors have been able to claim only in relation to investments made from April 2016 and disposed of
from April 2019. As a result, evidence about the extent to which relief has been claimed against disposals is necessarily limited.

However, the OTS has received many responses which refer to Investors’ Relief, from a wide range of people including investor groups, accountants, lawyers and individuals. The message was almost unanimous – almost no-one has shown any interest in this relief or is using it.

Some respondents did feel that investors’ relief should be given more time. But the OTS considers that despite the newness of the relief, the emerging evidence is clear.

**Recommendation 10**

The government should consider replacing Business Asset Disposal Relief with a relief more focused on retirement.

**Recommendation 11**

The government should abolish Investors’ Relief.
Summary of recommendations

Rates and boundaries

1. If the government considers the simplification priority is to reduce distortions to behaviour, it should either:
   - consider more closely aligning Capital Gains Tax rates with Income Tax rates, or
   - consider addressing boundary issues as between Capital Gains Tax and Income Tax

2. If the government considers more closely aligning Capital Gains Tax and Income Tax rates it should also:
   - consider reintroducing a form of relief for inflationary gains,
   - consider the interactions with the tax position of companies, and
   - consider allowing a more flexible use of capital losses

3. If there remains a disparity between Capital Gains Tax and Income Tax rates and the government wishes the simplification priority is to make tax liabilities easier to understand and predict, it should consider reducing the number of Capital Gains Tax rates and the extent to which liabilities depend on the level of a taxpayer’s income.

4. If the government considers addressing Capital Gains Tax and Income Tax boundary issues, it should:
   - consider whether employees and owner-managers’ rewards from personal labour (as distinct from capital investment) are treated consistently and, in particular
   - consider taxing more of the share-based rewards arising from employment, and of the accumulated retained earnings in smaller companies, at Income Tax rates.

The Annual Exempt Amount

5. If the government’s policy is that the Annual Exempt Amount is intended mainly to operate as an administrative de minimis, it should consider reducing its level.

6. If the government does reduce the Annual Exempt Amount, it should do so in conjunction with:
   - considering reforming the current chattels exemption by introducing a broader exemption for personal effects, with only specific categories of assets being taxable,
   - formalising the administrative arrangements for the real time capital gains service, and linking up these returns to the Personal Tax Account, and
• exploring requiring investment managers and others to report Capital Gains Tax information to taxpayers and HMRC, to make tax compliance easier for individuals.

Capital transfers

7 Where a relief or exemption from Inheritance Tax applies, the government should consider removing the capital gains uplift on death, and instead provide that the recipient is treated as acquiring the assets at the historic base cost of the person who has died.

8 In addition, the government should consider removing the capital gains uplift on death more widely, and instead provide that the person inheriting the asset is treated as acquiring the assets at the historic base cost of the person who has died.

9 If the government does remove the capital gains uplift on death more widely, it should:
   • consider a rebasing of all assets, perhaps to the year 2000, and
   • consider extending Gift Holdover Relief to a broader range of assets.

Business reliefs

10 The government should consider replacing Business Asset Disposal Relief with a relief more focused on retirement.

11 The government should abolish Investors’ Relief.
Chapter 1
Introduction to Capital Gains Tax

How much tax does Capital Gains Tax raise?

1.1 The total amount of Capital Gains Tax paid for the 2017-18\(^1\) tax year was £9.0 billion, on net gains (after deduction of losses) of £58.9 billion.\(^2\)

1.2 The total figures include £0.6 billion paid by trustees on £3.5 billion of trust gains. The remaining £8.3 billion\(^2\) of Capital Gains Tax was paid by 265,000 individual taxpayers, on net gains of £55.4 billion.\(^2\)

1.3 By comparison, £180 billion of Income Tax was paid in 2017-18 by 31.2m individual taxpayers.\(^4\) Diagram 1.A, in which the size of the circles represents the amount of tax paid, illustrates these figures.

Diagram 1.A: Income Tax and Capital Gains Tax revenues (from individual taxpayers)

\[\text{Capital Gains Tax} \]
\[\text{£8.3 billion a year} \]
\[\text{from 265,000 people} \]
\[\text{mean liability: £32,000} \]

\[\text{Income Tax} \]
\[\text{£180 billion a year} \]
\[\text{from 32 million people} \]
\[\text{mean liability: £5,800} \]

Source: OTS

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\(^1\) Throughout this report, unless specified otherwise, references are to 2017-18 data. This is the latest tax year for which a full, revised set of statistical data is available from HMRC. HMRC has published statistics for 2018-19 but these are provisional. The Capital Gains Tax statistical tables can be found at https://www.gov.uk/government/statistics/capital-gains-tax-statistical-tables.


\(^3\) Companies are also taxable on their capital gains but these form part of their profits for corporation tax purposes and are not distinguished from income.

1.4 About 60% of the adult population of the UK paid Income Tax in tax year 2017-18 compared with about 0.5% who paid Capital Gains Tax in that year.

1.5 While Income Tax raises over 20 times as much as Capital Gains Tax, the mean Capital Gains Tax liability of those who pay it (£32,000) was over five times the mean individual Income Tax liability (£5,800). This is because most people do not need to pay Capital Gains Tax very often, but those who do often pay it on large transactions.

Scope of Capital Gains Tax

1.6 Capital Gains Tax is a tax on the sale or gift of assets that have appreciated in value, as illustrated in Example 1.  

<table>
<thead>
<tr>
<th>Example 1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Value of asset</strong></td>
</tr>
<tr>
<td><strong>Cost of asset</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Annual Exempt Amount</strong></td>
</tr>
<tr>
<td><strong>Capital Gains Tax payable on</strong></td>
</tr>
</tbody>
</table>

1.7 The rate of tax is dependent on the type of asset sold and the level of the taxpayer’s income as compared with the level at which income starts to be taxed at the higher rate of Income Tax.

1.8 In practice, most gains made by UK taxpayers are not taxed because of the following key reliefs and exemptions:

- principal private residence relief applies to gains on a taxpayer’s main or only home
- personal possessions (or chattels) with a value under £6,000
- the Annual Exempt Amount, which sets a threshold of £12,300 below which an individual’s net gains in a tax year on chargeable assets are not taxable.

1.9 This leaves a relatively small number of taxpayers who report and pay Capital Gains Tax. These can be divided broadly into:

- business owners – for example, holding shares in an unquoted trading company

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5 As well as other, less common occurrences such as the exchange of one asset for another and the receipt of insurance proceeds in respect of assets normally within the scope of Capital Gains Tax.

6 2020-21. See https://www.gov.uk/capital-gains-tax/allowances
• investors – for example, holding a buy-to-let property, a second home or a portfolio of listed shares outside a pension or ISA
• employees – for example, who participate in share schemes.

Who reports and pays Capital Gains Tax?

Age profile of Capital Gains Tax payers

1.10 Taxpayers between the ages of 45 and 74 accounted for 78% of gains reported in 2017-18.7

1.11 As people tend to accumulate more assets over the course of their life,8 Capital Gains Tax is more often incurred by older people.

Chart 1.A: Individuals paying Capital Gains Tax by age (2017-18 tax year)9

Source: HMRC Capital Gains Tax statistical tables, Table 6

1.12 Of the 265,000 people paying Capital Gains Tax in tax year 2017-18, 71% were aged between 45 and 74 and paid 78% of the total tax (see Chart 1.A.). These taxpayers are also likely to benefit substantially from the exemption for their main or only home which have risen in value more quickly than general inflation over the last forty years. Less than 3% of the total liability was paid by people who are under 35.

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9 Please see Annex F for a description of this Chart and the underlying data.
Distribution of Capital Gains Tax payers

1.13 Total net gains reported to HMRC for the 2017-18 tax year were £58.9 billion, of which £55.4 billion by individuals. After allowing for the Annual Exempt Amount of £11,300 for that year, the average taxable gain for the 265,000 individual taxpayers was £200,000.

1.14 However, this does not reflect the position of most Capital Gains Tax payers because the bulk of gains relate to a relatively small number of taxpayers reporting very large gains. In tax year 2017-18, a total of £20.1 billion in net gains – 34% of the total – related to gains of over £5 million. Just 2,000 taxpayers accounted for these gains. For individuals, gains of over £1 million each made up 62% of the total, while the 200,000 taxpayers with the smallest gains accounted for only 12% of the total taxable net gains.

1.15 This is a trend that had been increasing over the years, as the total value of net gains reported has also been increasing, as shown in Chart 1.B:

Chart 1.B: Total net gains, by size of gain

Source: HMRC Capital Gains Tax statistical tables, Table 2

1.16 Over time, very large gains have become more prevalent and make up a larger proportion of total net gains. So, gains are becoming more concentrated among fewer taxpayers each year, although not necessarily the same taxpayers, as described below.

Repeat Capital Gains Tax payers

1.17 In all tax years from 2007-08 to 2017-18, a large proportion of net gains are reported by very few individuals. The identity of those reporting gains does

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11 Statistics in this paragraph are based on HMRC Capital Gains Tax statistical tables, Table 2. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/908649/Table_2.pdf

12 Please see Annex F for a description of this Chart and the underlying data.
change from year to year; however, those reporting gains more frequently pay more Capital Gains Tax than others.

1.18 Over an eleven-year period from 2007-08 to 2017-18, a total of 1.5 million different individual taxpayers reported taxable gains (after deductions for the Annual Exempt Amount). 72% of those taxpayers (1.08 million) reported gains only once in the decade and 15% twice, and so on, with only 0.25% doing so in ten or more years.

1.19 This is shown in Chart 1.C, which is based on HMRC data. This pattern is in contrast with Income Tax, which most UK residents pay annually.

**Chart 1.C: Frequency with which individuals paid Capital Gains Tax in the 11-year period 2007-08 to 2017-18**

![Chart 1.C](chart.png)

Source: HMRC

1.20 The mean tax paid increases with the frequency with which an individual taxpayer needs to report gains. Those reporting only once in the 11-year period pay an average of £18,000 in Capital Gains Tax, whereas those paying every year pay an average of £84,000 each year. Over the 11 years, those paying most frequently pay £922,000 in Capital Gains Tax on average, which is over 50 times as much as the average person who pays only once and 22 times the average amount paid by each of the 1.5 million people reporting gains in the period.

1.21 Overall, in any given tax year and over time, it can be seen that a great majority of gains and Capital Gains Tax revenues relate to a small number of individuals.

**On what types of asset is the most Capital Gains Tax paid?**

1.22 The CAGE research centre at the University of Warwick published a report in May 2020 on ‘Capital Gains and UK Inequality’ which included analysis of

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13 Please see Annex F for a description of this Chart and the underlying data.

gains of £100,000 or more reported for 2016-17 as well as the top 1,000 gains by value for that year.

1.23 Their report showed that a small number of successful business owners account for the vast majority of gains and Capital Gains Tax revenues.

1.24 Charts 1.D and 1.E below take the population of 54,000 taxpayers reporting gains of £100,000 or more for 2016-17 and divide them, in order of the size of their gains, into ‘bins’ of 1,000 individuals. Within each of those 1,000s, the average gain per taxpayer is quantified and analysed by reference to the type of asset concerned.

1.25 The first chart shows the breakdown by value of gain and by asset type. The second chart shows the breakdown by asset type only, as this is harder to see in the first chart.

Chart 1.D: Analysis of gains of £100,000 or more for tax year 2016-17, by value and by asset type – a) broken down by asset type and size

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15 Please see Annex F for a description of this Chart and the underlying data.

16 CAGE working paper no. 465, Capital Gains and UK Inequality, May 2020
https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/wp465.2020.pdf, Figure 2
Chart 1.E: Analysis of gains of £100,000 or more for tax year 2016-17, by value and by asset type – b) broken down by asset type only\textsuperscript{17}

\begin{center}
\includegraphics[width=\textwidth]{chart.png}
\end{center}

\textit{Source: The University of Warwick, CAGE Research Centre}\textsuperscript{18}

1.26 For definitions of the asset type and a further description of the graphs, please see Annex F.

1.27 Average gains rise sharply towards the top end of the distribution, most gains being reported by a very few individuals. The gains themselves more commonly arise from unlisted shares and other assets at the top end. Note that ‘other assets’ as a category is not further divisible for analysis purposes from the HMRC data available but is known to include significant amounts of gains on unlisted shares that qualified for Entrepreneurs’ Relief. So, the vast majority of gains by value relate to business assets.

1.28 This can also be seen in Chart 1.F, produced from HMRC data for the 2017-18 tax year, which breaks down the total of £58.9 billion of net gains reported for that tax year by asset type.

\textsuperscript{17} Please see Annex F for a description of this Chart and the underlying data.

\textsuperscript{18} CAGE working paper no. 465, Capital Gains and UK Inequality, May 2020
https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/wp465.2020.pdf, Figure A1
The category for unlisted shares makes up £27.8 billion of the £58.9 billion total (almost half). This includes most of the gains eligible for Entrepreneurs’ Relief of £24.5 billion for 2017-18, which commonly applies on the disposal of unlisted shares but can also apply to sales of unincorporated businesses and assets related to the business.

**What is an ‘ordinary’ Capital Gains Tax payer?**

**In tax year 2017-18, over three quarters of the 265,000 individual taxpayers reported a total of less than £100,000 of gains.**

**In tax year 2017-18, approximately 21% of all gains reported related to listed shares and 14% related to residential property not qualifying for relief (for example, a second home, a buy to let property, or a main residence not wholly exempt).**

**For taxpayers disposing of these types of assets, the considerations affecting the timing and calculation of the gain differ from those when disposing of businesses.**

**For example, in respect of timing, holders of listed share portfolios may be able to arrange for there to be some gains each year, to secure the most effective use of the Annual Exempt Amount.**

**Equally, owners of second homes and buy-to-let properties can usually make only infrequent, substantial, disposals, without any account being taken of inflation during the time between acquisition and disposal.**

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19 Please see Annex F for a description of this Chart and the underlying data.

20 HMRC Capital Gains Tax statistical tables, Table 4.
From an administrative perspective, for owners of second homes and buy-to-let properties held for long term investment, the task of calculating the base cost and any qualifying additions based on historic records can present difficulties. These taxpayers will also be affected by the 30-day filing and payment window rules introduced from 6 April 2020, which can increase administrative difficulties because of the shorter timeframe involved.

Owners of smaller businesses are also affected by Capital Gains Tax, to whom the same broad principles apply as for those making substantial gains. In contrast with the biggest gainers though, taxpayers disposing of smaller businesses may be more significantly impacted by administrative complexity and the timeframe within which the tax has to be paid.

International considerations

Capital Gains Tax is a charge that, until 6 April 2015, was charged only on taxpayers who were resident in the UK, or companies which had a permanent establishment in the UK. The concept of tax residence is complex but, in broad terms, an individual who lives in the UK is a resident and a company that is managed and controlled in the UK is a resident. Broadly, a non-UK company has a permanent establishment in the UK when a part of its operations is carried out in the UK.

Residents pay Capital Gains Tax on their worldwide assets whereas permanent establishments only pay it on assets forming part of the UK operation. Generally speaking, a person has to be in the UK to be charged to Capital Gains Tax.

An exception was introduced from 6 April 2015 which initially applied only to residential property. Since that date, non-UK resident individuals, companies, trusts and other types of entity that own, or have an interest in residential property in the UK, are charged to Capital Gains Tax on any gains from disposals (or to Corporation Tax in the case of non-UK resident companies). This applies only to the gains arising since 6 April 2015; any increase in value prior to that date is disregarded.

This rule was extended to all UK property or land disposals with effect from 6 April 2019 in relation to any increase in value since that date.

A person who moves to the UK and becomes resident will potentially be in the scope of Capital Gains Tax on all of their assets and a person who leaves the UK, and remains non-UK resident for 5 complete years, would not have to pay UK Capital Gains Tax on disposals of assets acquired or held while UK resident.

So, for example, a person who lived in Chile and moved to the UK last year with an asset worth £80,000 that was acquired for £40,000 and sold that asset this year might have to pay UK Capital Gains Tax on a gain part of which accrued while they were resident in Chile. However, if they had left the UK and sold the asset while resident in Chile they would have no UK tax liability.

21 The 30-day filing issues will be considered in the second report.
Capital Gains Tax to pay on the part of any gain which accrued while they were UK resident.

The role and history of Capital Gains Tax

1.43 Capital Gains Tax is an important source of revenue for the Exchequer, raising £9 billion in 2017-18. However, there is no universal consensus on the role of the tax.

1.44 One rationale is that there is ‘little economic difference between income and capital gains’ so income and gains should be treated along similar lines, as outlined by Chancellor Nigel Lawson in his 1988 Budget speech.22

1.45 The logical conclusion of this approach, which not all who favour this rationale would advocate, would be the full integration of Income Tax and Capital Gains Tax, as suggested in the Mirrlees review.23 However even those who take this view of capital gains often accept that there are practical issues around taxing them in exactly the same way as income.

1.46 More broadly, on this rationale, there are three ways in which the absence of a tax on capital gains would be felt:

- ‘a tax system without a [Capital Gains Tax] … distorts investment decisions by encouraging investment in assets with returns in the form of capital gains over other types of investment’ as argued by Evans, Minas and Lim.24 So, when governments diverge from neutrality this should be done with a full understanding of the costs and benefits.

- ‘a tax system without a [Capital Gains Tax] violates the principles of horizontal… equity’.25 Horizontal equity is the idea that two taxpayers with a similar ability to pay should not end up paying significantly different amounts of tax. However, it is not clear that all of those making gains do always have a similar ability to pay.26

- ‘a tax system without a [Capital Gains Tax] violates the principles of vertical… equity’27 or that ‘failure to tax such gains only perpetuates existing inequalities’ as noted by Professor Judith Freedman28. Vertical equity considers the tax treatment between individuals at different points

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24 Evans, Minas, Lim, Taxing personal capital gains in Australia: an alternative way forward. https://research-repository.griffith.edu.au/bitstream/handle/10072/173613/EvansPUB769.pdf?sequence= , part 2

25 See footnote 24.

26 Freedman, ‘Treatment of capital gains and losses’ in Peter Essers and Arie Rijkers (eds), The Notion of Income from Capital (IBFD 2005)

27 See footnote 24.

28 Freedman, ‘Treatment of capital gains and losses’ in Peter Essers and Arie Rijkers (eds), The Notion of Income from Capital (IBFD 2005)
in the income spectrum. In tax year 2017-18, 90% of Capital Gains Tax was paid by taxpayers with gains above £100,000.

1.47 Another rationale for Capital Gains Tax is that it also exists to protect Income Tax (this is also sometimes referred to as the backstop argument).  

1.48 For example, Chancellor James Callaghan said in 1965 that a lack of a Capital Gains Tax facilitated tax avoidance by giving ‘a powerful incentive to the skilful manipulator.’  

1.49 These overlapping and complementary arguments for a Capital Gains Tax are not unchallenged. A minority would challenge the principle of Capital Gains Tax on the basis that ‘Most capital gains represent double taxation… and so [taxing them] presents an obstacle to the efficient reallocation of capital assets within the economy.’

1.50 All of these principles and ideas, and wider political priorities, have played their part in shaping how the tax has developed over the last 50 years as economic conditions have changed, and have been well represented in the responses the OTS has received.

1.51 One area that has evolved over that time is the balance between neutrality and technical simplicity. This is demonstrated by changing approaches to the rate structure. Between 1965 and 1988, and again from 2008 to 2010, Capital Gains Tax was levied at a single flat rate. However, between 1988 and 2008 it was levied at the various Income Tax rates. And since 2010 it has been loosely connected to Income Tax bands but set at lower rates. Another example is the decision in 1982 and 1998 to introduce and then abolish indexation relief.

1.52 A second major development has been for governments to increasingly see capital gains as a barrier to economic growth and to look for ways to reduce its impact. This view became more prevalent from the 1980s onwards, with the introduction of share loss relief in 1980, the Business Start-Up Scheme in 1981 and the Enterprise Investment Scheme in 1994. And, in 1998, Chancellor Gordon Brown said that the ‘capital taxation system should …reward risk taking and promote enterprise’ when he introduced Taper Relief.

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29 Rose, ‘Treatment of capital gains and losses’ in Peter Essers and Arie Rijkers (eds), The Notion of Income from Capital (IBFD 2005)


31 Freedman, ‘Treatment of capital gains and losses’ in Peter Essers and Arie Rijkers (eds), The Notion of Income from Capital (IBFD 2005)


1.53 One area of relative continuity is for different types of asset to be treated differently. In particular, there has always been some sort of favourable treatment for business assets. Originally this took the form of a retirement relief but developed into reliefs aimed also at promoting economic growth. Alongside this, some assets have always been exempt: main homes on policy grounds, and cars and government securities because they can easily be used to generate losses. By contrast it is only quite recently that rates for other types of asset diverged, with the reduction in rates for all assets other than residential property and carried interest in 2016.

1.54 It is for the government to determine its view of the principles behind, and role of, Capital Gains Tax in framing its policy approach. This report highlights some of the ways in which different approaches may distort behaviour or make things more complex in practice.

1.55 The OTS has considered a range of approaches in other countries. Some of these are directly applicable, while others need to be considered in their individual context.

1.56 It is also important to recognise the need, as with any tax, for Capital Gains Tax to be practically administrable and enforceable. Forming recommendations by reference to economic principles is important, but they must always take account of what can be done in practice. Otherwise, there is a risk of widening the tax gap, by making compliance or enforcement more difficult.
Chapter 2
Capital Gains Tax rates

Background
2.1 The rate of Capital Gains Tax that applies to a gain depends on the level of the individual’s taxable income and the type of asset that has been sold or gifted.

2.2 Higher rate taxpayers will pay any Capital Gains Tax entirely at the higher Capital Gains Tax rates. Basic rate taxpayers benefit from the lower rates of Capital Gains Tax on gains that take the total of their taxable income and gains up to the maximum of the basic rate band, beyond which income is taxed the higher rates of Income Tax. If their gains take the total taxable income and gains above that level, then taxpayers will then pay some of their Capital Gains Tax at the basic Capital Gains Tax rates and the remainder at the higher rates.

Case Study 1
Sid earns £30,000 in the 2020-21 tax year. £12,500 of this is tax free due to his personal allowance and £17,500 is subject to Income Tax at the basic rate of 20%. His income would need to be £20,000 higher for it to reach the top of the basic rate band, above which the higher rates of Income Tax apply.

Sid makes a gain of £40,000 on non-residential property (after deduction of the Annual Exempt Amount). Half of this would fall into his basic rate band and be charged to Capital Gains Tax at 10%, and half would fall into the higher rate band and be charged at 20%. So, his total Capital Gains Tax liability would be £6,000 (£20,000 at 10% and £20,000 at 20%).

2.3 The asset being disposed of is also relevant. Gains on assets qualifying for Business Asset Disposal Relief (formerly Entrepreneurs’ Relief) are taxed at 10% up to a lifetime limit of £1 million, and the rates applicable to gains on residential property and carried interest\(^1\) are an additional 8% on the rates that would otherwise apply.

\(^1\) Carried interest being a share of profits from a private equity or hedge fund.

Table 2.A: Table of rates

<table>
<thead>
<tr>
<th>Income Tax status</th>
<th>Standard Income Tax rate</th>
<th>Standard Capital Gains Tax rate</th>
<th>Residential property &amp; carried interest Capital Gains Tax rate</th>
<th>Business Asset Disposal Relief rate &amp; Investors' Relief</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic rate</td>
<td>20%</td>
<td>10%</td>
<td>18%</td>
<td>10%</td>
</tr>
<tr>
<td>Higher rates</td>
<td>40/45%</td>
<td>20%</td>
<td>28%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Scottish taxpayers

2.4 The Income Tax rates and bands in Scotland are different to those paid by the remainder of the UK, but the Capital Gains Tax rates are the same UK wide.

2.5 Scottish taxpayers are required to use the UK Income Tax bands to decide whether or not they are a higher or basic rate taxpayer for the purposes of calculating the correct Capital Gains Tax rate. This complication is unique to Scottish taxpayers.

Observations – the differential in rates between Capital Gains Tax and Income Tax

2.6 There is both a theoretical and a practical case for greater convergence of tax rates on income and gains.

2.7 In many situations, such as those of owner managers, employee shareholders or privately-owned property investment businesses, the line between capital and income is blurred in practice.

2.8 For example, the owner of an investment property portfolio might consider the acquisition of an additional property to be just another investment. However, if the purpose of the acquisition is to renovate the property and then sell it on at a profit, this is a trading transaction, and the profit is
assessable to Income Tax. Not understanding the difference between investing and trading activities can clearly lead to non-compliance, if the taxpayer incorrectly declares a capital gain rather than a trading profit.

2.9 A greater alignment of rates would create a more neutral tax system, in which people were left free to make the right decisions for their business or family without the complexity of having to worry about unwittingly stumbling across the wrong side of a boundary.

2.10 A greater alignment of rates would also reduce the need for complex rules to police the boundary between income and gains (though not to eliminate it because of the continuing National Insurance contributions disparity). As Freedman has said, ‘The conversion of income into capital…in the UK as elsewhere, is a basic method of tax mitigation or avoidance’. ²

2.11 There are several anti-avoidance rules in place to deal with the boundary between income and gains, for example, Transactions in Securities, Transactions in UK Land, Transfers of Income Streams and the Accrued Income Scheme. For example, the Accrued Income Scheme works, on say a bond, to ensure that the income arising is accrued and taxed on the owner, on a day to day basis, distinguishing this from changes in its underlying capital value.

2.12 Although there are areas where government has specific reasons to encourage certain behaviour (such as saving for retirement), as a general rule an efficient tax system should aim to be as neutral as possible, to minimise distortions to people’s choices and behaviour.

2.13 As the table of rates above shows, taxpayers have a clear incentive to favour capital over income. This is compounded by the relatively high level of the Annual Exempt Amount which effectively brings down the average Capital Gains Tax rate. This may be justified by reference to a policy objective to reward risk taking and promote enterprise, but when governments diverge from neutrality this should be done with a full understanding of the costs and benefits.

2.14 Some particular areas where the boundary is under pressure are explored in Chapter 3. But, more widely, it is not always possible for people to shift income to gains, and those who cannot do so are treated less favourably by the tax system. Two people, one receiving gains and the other receiving a salary or investment income, can pay very different amounts of tax.

2.15 Where two taxpayers with a similar ability to pay incur significantly different amounts of tax, questions about whether they should be taxed along similar lines also arise. But as Professor Freedman explores, some types of gains may have different properties from regular income, ³ so it is not always clear that those with similar levels of gains do have similar abilities to pay.

² Freedman, ‘Treatment of capital gains and losses’ in Peter Essers and Arie Rijkers (eds), The Notion of Income from Capital (IBFD 2005)

³ Freedman, ‘Treatment of capital gains and losses’ in Peter Essers and Arie Rijkers (eds), The Notion of Income from Capital (IBFD 2005)
2.16 Another dimension is the difference between the tax paid by those with the highest and lowest incomes (vertical equity). While determining the appropriate approach is a political matter, the OTS notes recent research from the CAGE research centre at the University of Warwick and the LSE International Inequalities Institute in this area.

2.17 This research includes analysis of anonymised data collected from the personal tax returns of everyone who received over £100,000 as a combined total of taxable income and taxable capital gains in 2015-16. The analysis indicates that, for a taxpayer earning £100,000 or more in income alone, the average tax paid remains steady at around 40% even as their income increases; meanwhile, the average tax paid on income and gains combined of £100,000 or more is around 30% and reduces to 27% for taxpayers with total combined income and gains of £4m or more.

2.18 Several respondents argued that it was difficult from an economic point of view to see why the capital return on investment should generally bear a lower tax burden than an income return on investment. The OTS has also been told that it can incentivise companies to maximise short term profit and cut back on longer term investment in order to boost their immediate value in the run up to a sale. One respondent argued that ultimately this disparity reduces long term productive investment, erodes UK productivity, and has held back the UK equivalent of the mid-market German Mittelstand.

2.19 A rough static costing suggests that alignment of Capital Gains Tax rates with Income Tax rates could theoretically raise an additional £14 billion a year for the Exchequer. This reflects the fact that the vast majority of Capital Gains Tax by value comes from higher and additional rate taxpayers. However, it is clear that nothing like this amount would be raised in practice, due to behavioural effects (such as people delaying disposals) and other changes that might be made in parallel (such as allowing for inflation).

Challenges with a rate increase

2.20 If Capital Gains Tax rates were aligned more closely with Income Tax, some respondents argued that this would increase the disincentive effect of Capital Gains Tax on economic activity. The argument is that as capital gains often accrue on more risky assets, taxing them at higher rates deters risk-taking and innovation to the detriment of the economy. However lower rates

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4 Freedman, ‘Treatment of capital gains and losses’ in Peter Essers and Arie Rijkers (eds), The Notion of Income from Capital (IBFD 2005)
6 The University of Warwick, CAGE Research Centre; and London School of Economics, International Inequalities Institute - CAGE Policy Briefing no. 27, How much tax do the rich really pay? New evidence from tax microdata in the UK, June 2020. https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/bn27.2020.pdf, Figure 2a
7 HMRC analysis. 2018-19. Static costing: if all gains reported for 2018-19 had instead been taxed at the marginal Income Tax rate of the taxpayer. See Annex F for commentary.
do not necessarily encourage risk taking or stimulate additional investment (see Chapter 6).

2.21 If rates were increased this could lead to increased levels of avoidance through taxpayers changing their residency status in order to make disposals when no longer caught by the UK residency rules. Anti-avoidance rules, particularly around the residency regime and people coming to and leaving the UK, would need to be reviewed.

Lumpy nature of gains

2.22 Where a significant gain has accumulated over a period but been realised in one tax year, it may attract a higher rate of tax than an equivalent amount of gains would have done if received in stages over that period. This would have the greatest effect on basic rate taxpayers, who could find an occasional gain was taxed at higher rates.

2.23 Case Study 2 shows this can already lead to non-neutral outcomes between gains that can be spread out over several years and gains that must be taken in one go. Closer alignment with Income Tax rates would compound this as more people would be pushed into paying the 45% rate of tax on often very irregular gains. Although there are a few people who make gains every year, in an 11-year sample period 72% of taxpayers paid only once. 8 So if gains were taxed at Income Tax rates some taxpayers could face a substantial increase in their overall tax liability.

Case study 2

Sid earns £30,000 in the 2020-21 tax year. £12,500 of this is tax free due to his personal allowance and £17,500 is subject to Income Tax at the basic rate of 20%. His income would need to be £20,000 higher for it to reach the top of the basic rate band, above which the higher rates of Income Tax apply.

This time Sid makes a £100,000 gain (after deduction of the Annual Exempt Amount) on unlisted shares he has owned for 10 years. As things stand, he would pay £18,000 in Capital Gains Tax (£20,000 at 10% and £80,000 at 20%).

It would be different if the gain was spread across the 10 years of his ownership (after one deduction for the Annual Exempt Amount). Sid would pay Capital Gains Tax of £10,000 as he would be paying all of the tax at the lower rate of 10% – if his income remained unchanged.

There would be more pronounced effects if Capital Gains Tax and Income Tax rates were more closely aligned. If the tax charge fell in a single tax year and rates were aligned with Income Tax rates he could pay as much as £36,000 of Capital Gains Tax (£20,000 at 20% and £80,000 at 40%).

2.24 One way of addressing this could be some form of averaging relief to address the lumpy nature of capital disposals and reduce the likelihood of

8 HMRC SA data 2018-19. See also paragraph 1.18 in Chapter 1, Chart 1.C and Annex F.
taxpayers finding themselves paying tax at higher rates. There is also precedent for this in how insurance bonds are taxed.

2.25 Further work would be required to assess its feasibility and understand the proportion of total gains involved, though as gains of over £1 million each accounted for 62% of total Capital Gains Tax paid the Exchequer implications are likely to be relatively modest. However, while this could smooth out a distortion, it would clearly create additional administrative complexity.

The lock in effect

2.26 Several respondents raised concerns that higher rates of Capital Gains Tax would increase the Capital Gains Tax ‘lock in’ effect – which Mirrlees explains as ‘once an asset has risen in value, there is an incentive to hold on to it, to shield the accrued gain from tax for a longer period.’ Several respondents argued that this would encourage inefficient assets to be held longer than was necessary and negatively affect Exchequer revenues.

2.27 The cause of the lock in effect is rooted in the structure of Capital Gains Tax which requires tax to be payable on realisation (on disposal of the asset) rather than on accrual (when the rise in value occurs). This means individuals have some choice about when they pay the tax. But structure aside, the rate is the main driver of behaviour.

2.28 In theory, one way to eliminate the lock in effect would be to tax gains as they accrue. However it is unrealistic in practice for the two reasons noted in the Mirrlees report: ‘first, all assets would need to be ‘marked-to-market’ or valued in periods when they are not traded; and second, individuals may be required to pay tax on accrued gains in periods when they lack the liquid financial resources to make these payments.’

2.29 The extent to which sellers have choices about when to dispose of assets is of course debateable and depends on their circumstances and the assets involved. Some respondents pointed to scenarios where sellers have almost no discretion (such as after a divorce) while others referred to situations where an individual has wide discretion (such as when selling listed shares – see Chapter 4). Other respondents argued that commercial factors – and the simple need for cash – are more significant drivers of behaviour than tax effects.

2.30 Generally, wealthier taxpayers may be better able to control when they realise gains as they are more likely to control the assets they are disposing of and less likely to have to rely on the proceeds of any gains to live on. It is also possible to realise value from property without selling it, for example by securing a mortgage. In any event those paying Capital Gains Tax will

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9 HMRC Capital Gains Tax statistical tables, Table 2 (2017-18). See also paragraph 1.14 in Chapter 1, above.


11 See footnote 10.
generally have more control over the time tax is paid than is usually the experience of those paying Income Tax.

2.31 The tax incentives to retain assets rather than sell them can be amplified by:

- the fact that there is no Capital Gains Tax on death, and that those inheriting assets are treated as acquiring them at their market value, which encourages taxpayers to pass on family assets in this way (see Chapter 5)
- higher rates of tax which make the barrier to selling and reinvesting higher (see below); and
- uncertainty about future government policy, for example if there an expectation that rates could reduce, or assets be rebased in the future

2.32 Where it operates, the lock in effect may well mean that people retain assets for longer than is most efficient from an economic point of view.

2.33 Auerbach said that ‘this effect leads investors to accept a lower rate of return before-tax than they would for new investments without such accrued gains, resulting in a distorted allocation of capital and inefficient portfolio selection.’ It could also lead to less effective company management if it discourages sales of shares to new owners or passing shares on to the next generation.

2.34 It is widely established in academic research that increases in Capital Gains Tax rates can result in large behavioural changes. The main behaviour observed is in terms of reduced realised gains. Much of this research is from the United States of America, where it is estimated that a 1% increase in rates would typically result in a reduction in realised gains of between 0.3% and 1%, which would remove some of the increase in yield.

2.35 An increase in rates would increase these lock in effects and, in a sense, increase the underlying distortion. So, if rates were increased it would make sense for the government to consider a return to some form of indexation, and to reduce other incentives to retain assets (such as those considered in Chapter 5).

Tax on gains arising due to inflation

2.36 If Capital Gains Tax rates were more closely aligned with Income Tax rates, the OTS considers that the government should also consider reintroducing a form of relief for inflationary gains.

2.37 The view that Capital Gains Tax should not apply to that part of any gains that has arisen purely due to inflation was widespread among respondents. Debates about how to account for inflation are not new – Chancellor Sir Geoffrey Howe in his March 1982 Budget argued that it ‘is intolerable for people to be permanently condemned to pay tax on gains that are apparent


but not real—gains that exist only on paper\textsuperscript{14} and Chancellor Nigel Lawson echoed this view in 1988 when he argued against the ‘injustice of taxing purely inflationary gains.’\textsuperscript{15}

2.38 Although inflation levels in the 1980s greatly exceeded current levels, the compounding effect can mean that assets held for decades have risen in value due to inflation. The rate differential and the Annual Exempt Amount have sometimes been presented as ways of addressing this, but their impact is crude as they provide the same benefit for those with short term gains. Allowing for inflation would create a less distortive system that was more neutral towards both long and short term holdings. If rates were increased, then the argument for some provision for inflation look stronger.

2.39 Prior to 1998, there was an indexation allowance for individuals which attempted to take account of inflation. There are several ways to account for inflation and evaluating the previous method, which broadly produced the right outcome in a way that minimised distortions, would be a good starting point for this debate. But consideration would also have to be given to how to deal with losses (particularly those that only occurred because of indexation). Previously indexation could not give rise to a loss.

2.40 Some respondents argued as Gordon Brown did in 1998 when he got rid of the indexation allowance, that it was ‘difficult to understand and complicated to administer’.\textsuperscript{16} For instance, costing and indexing improvements to land and property assets which have not been accurately recorded would not be simple. Others pointed to situations where taxpayers would struggle to understand the computation for holdings of quoted shares that changed over time. The OTS does not dismiss these challenges but considers that integrated software and modern technology could go a long way towards addressing them.

2.41 Mention is also made of Taper Relief as an alternative to indexation. Taper Relief was introduced in 1998 to ‘differentiate structurally between short-term speculative assets and longer-term holdings.’\textsuperscript{17}

2.42 From 1998 until 2008, when it was abolished, it reduced the percentage of the chargeable gain to 25% (for assets held for 10 years or more), which was equivalent to a reduction in the rate of tax from 40% to 10% for a higher rate taxpayer.

2.43 The OTS does not consider this to be an effective approach given that it creates an arbitrary holding period – as illustrated by the Charts below, which show the distortive impact of Taper Relief. Many respondents also said it is difficult to see why a longer holding period is necessarily a good thing.


\textsuperscript{17} See footnote 16.
2.44 Chart 2.A shows the change in holding periods that occurred when Taper Relief was removed. Chart 2.B shows the significant surge in disposals of assets qualifying for Taper Relief between the announcement of its abolition and the date it ceased to apply.

Chart 2.A: Share of gains across different holding periods 1997 - 2018

Source: The University of Warwick, CAGE Research Centre

CAGE working paper no. 465, Capital Gains and UK Inequality, May 2020
https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/wp465.2020.pdf, Figure B3. The data in respect of the 10+ years holding periods does not feature in the original presentation of the chart and was provided by the authors of the report. Please see Annex F for further details.
Both of the above charts are described and explored in more detail in Annex F, including an analysis of the taxpayer behaviours evidenced.

**Rate of return allowance**

Some respondents argued that instead of an indexation allowance government should introduce what is known as a rate of return allowance. This idea is to ‘exempt from taxation the component of... capital gains earned on savings that corresponds to a risk-free or ‘normal’ rate of return – for example, that paid on medium-term government bonds’.  

Under current economic conditions both the inflation rate and normal rate of return are relatively similar by historic standards, but a rate of return allowance is seeking to achieve a fundamentally different purpose – to provide a measure of neutrality in people’s decisions whether to consume now or to invest with a view to consuming later.

Without evaluating the economic effectiveness of this proposal, the OTS notes that it could be less intuitive than indexation as the consumer price index provided by the Office of National Statistics seems much less arbitrary – and far more easily understood and applied in practice by taxpayers – than

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19 CAGE Policy Briefing no. 19, Capital Gains and UK inequality: New evidence from tax microdata, May 2020
https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/bn19.2020.pdf, Figure 7. This is not an exact reproduction as the chart in its original form also adjusts for indexation allowance, see Annex F for further details.

20 Conclusions and Recommendations for Reform, Tax by Design, Mirrlees review (2011).
picking a less popularly understood medium-term bond as the Mirrlees review proposes.\textsuperscript{21}

The interactions with the tax position of companies

2.49 If Capital Gains Tax rates were more closely aligned with Income Tax rates, there would be an additional incentive for those who could afford it to hold assets in a company, rather than directly.

2.50 Those who have fewer resources are less likely to do this as the costs of an individual or family setting up and running a company are only worthwhile if a reasonably significant level of funds is involved. Additionally, the benefit is much more significant where monies in the company are continually reinvested rather than being distributed.

2.51 Such companies are often generically known as family investment companies and hold a collection of assets on behalf of a number of family members over the long term.

2.52 Such family investment companies can offer a range of tax advantages, including the following:

- non dividend income generated on an investment portfolio is taxed to Corporation Tax at 19%, which is a lower tax rate than Income Tax rates of up to 38.1% which would apply if the investments were held personally

- if adult children are shareholders of the family investment company, dividends can be paid to the children, who may not pay Income Tax at higher or additional rates

- the shares of a family investment company can be structured to allow any growth in value to be funnelled into the value of the shares held by the children

2.53 On the other hand, the Income Tax charges that arise when money is taken out of the company mean that the overall tax charge is often higher than if the investments were held personally. In addition, the company does not benefit from an Annual Exempt Amount.

2.54 More widely, the Capital Gains Tax rate for higher rate taxpayers is comparable to the current Corporation Tax rate so, in itself, this difference in rates is not at present usually an incentive to use a family investment company.

2.55 However, if Capital Gains Tax rates were more closely aligned with Income Tax rates, the rate would be much higher than the Corporation Tax rate. This would provide an additional incentive for individuals or families to use family investment companies.

2.56 There would still be high personal taxes to pay if the taxpayer wanted to withdraw funds from the company but those who choose to keep their

\textsuperscript{21}The OTS notes that there may be other rough approximations for the correct rate of return such as the Bank of England base rate but have not considered these in any detail.
funds invested for the long term would see the benefits of using family investment companies increase.

**Case study 3**

**Investments held personally**

Chris is an additional rate taxpayer. She owns a portfolio of investments. She pays 38.1% Income Tax on dividends she receives and 45% Income Tax on other investment income.

She purchased UK listed shares for £100,000. If she sells the shares for £200,000, she will pay £20,000 of Capital Gains Tax (assuming her Annual Exempt Amount is used elsewhere), leaving net proceeds of £180,000 available to be reinvested.

**Family investment company**

Chris sets up a family investment company and allocates some of the shares to her children. Chris owns the A shares, and the children own the B shares. The company uses cash funds to acquire an investment portfolio.

The family investment company purchased UK listed shares for £100,000. If the shares are sold for £200,000, Corporation Tax of £19,000 is paid, leaving £181,000 available to be reinvested.

**Case study 4 (Case study 3 revisited if Capital Gains Tax rates are aligned with Income Tax)**

**Investments held personally**

Chris continues to pay Income Tax on her investment income.

If she sells her shares for £200,000, she will pay £45,000 or 45% Capital Gains Tax, (assuming her Annual Exempt Amount, Personal Allowance, basic and higher rate bands are used elsewhere), leaving £155,000 available to be reinvested.

**Family investment company**

The family investment company continues to pay Corporation Tax at 19% on income and gains realised on the investment portfolio, leaving £181,000 available to be reinvested.

So, there would be an additional £26,000 to reinvest in the investment portfolio after the share sale as a result of the disparity between the tax paid by individuals and companies on the disposal of the same assets. This difference will be compounded over time. There would be additional Income Tax charges if Chris wanted to extract the profits from the company.

In this example, the company owns an investment portfolio. If the company held residential property, the tax position would be different.
2.57 If Capital Gains Tax rates were more closely aligned with Income Tax rates, the government would need to consider the potential for such a change in the tax incentives to use such companies to distort taxpayer behaviour and to consider any associated changes that might be desirable.

**Losses**

2.58 If Capital Gains Tax rates were more closely aligned with Income Tax rates, in effect taxing gains in the same way as income, the government should by the same token also consider increasing the flexibility with which capital losses can be used to offset income or capital gains. Currently, capital losses can only be used against income in certain very specific circumstances (see Chapter 6).

2.59 If rates were aligned and the existing treatment for losses was maintained, it could distort investment decisions against relatively more risky assets, and there would be greater pressure to find ways of re-characterising capital losses as income losses. The approaches identified in the Mirrlees review, was to ‘require that losses… be offset in some way… through outright tax refunds, setting losses on one asset against gains on another (or perhaps against labour earnings), or carrying losses forward or back to set against taxable income or gains in other years.’

2.60 The main challenge with relaxing the rules on utilising losses is that the timing of losses is often a matter of choice. So, for example, it would be inevitable that, as part of normal tax planning, a taxpayer would churn through the loss making shares in their share portfolio, while holding onto those standing at a gain, in order to bring down their income considerably, with significant Exchequer implications. Limiting the scope for this, if desired, could require additional complex provisions.

2.61 Care would accordingly be needed in taking any steps in this direction, but the OTS sees merit in the government considering some increased flexibility in the way that capital losses can be used, whether by way of carry back, or an extension of the range of situations in which capital losses can be offset against income.

**Observations – the different rates of Capital Gains Tax**

2.62 While some respondents were more concerned with the distortions to behaviour that the non-neutrality between income and gains created, other respondents were more concerned with making tax liabilities easier to understand and predict.

2.63 Several of these respondents told the OTS that the presence of four rates of Capital Gains Tax is itself a source of complexity. Typically, these respondents preferred the single flat rate that applied between 1965 and 1988, and again from 2008 to 2010. Some respondents noted that there are additional

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complexities in relation to Scottish taxpayers and for those with gains that straddled the boundary between basic and higher rate bands of Income Tax.

2.64 Other respondents said it was unsatisfactory that a taxpayer couldn’t know their final Capital Gains Tax liability until they knew their annual Income Tax liability, saying this was particularly problematic when completing a 30 day tax return for residential property.

2.65 Other respondents were more concerned about distortions flowing from the higher rate of tax levied on residential property compared to other types of asset.

2.66 While there is a simplification case for moving to two rates of Capital Gains Tax, rather than four, careful thought would have to be given to the implications for taxpayers with different levels of income. Moving to one rate would either involve basic rate taxpayers (more than half the total number paying Capital Gains Tax) facing an increased rate, or higher and additional rate taxpayers benefitting from a reduced rate.

2.67 Government would have to weigh up the simplification benefits against the risk of exacerbating existing distortions within Capital Gains Tax. It would be undesirable if, in moving to fewer rates of tax, the existing distortions outlined elsewhere in this Chapter were made starker.

2.68 A different simplification option could be to set multiple rates of Capital Gains Tax independently from the Income Tax status of the taxpayer; this report does not consider this option further.

Conclusions

2.69 The disparity between Capital Gains Tax rates and standard rates of Income Tax is a key source of complexity, as the non-neutrality it creates produces an incentive for taxpayers to favour activities and investments that generate capital gains rather than income.

2.70 A greater alignment of rates would reduce the need for complex rules to police the boundary between income and gains, since how the income was classified would not then materially affect the tax position.

2.71 If government did align rates it would be essential to consider other changes to the tax system such as reintroducing a form of relief for inflationary gains, addressing the interactions with the tax position of companies, and some extension of the scope to offset capital losses against income, as well as the proposals in Chapter 5 to reduce the present distortions which incentivise people to hang onto assets.

2.72 Chapter 3 will build on these themes, focusing on two specific areas where the OTS considers the boundary is under particular pressure: the use of share-based remuneration, and the accumulation of retained earnings in smaller owner-managed companies.

2.73 In contrast, the number of different Capital Gains Tax rates is another inherent source of complexity, particularly for taxpayers straddling the basic and higher Income Tax boundary. It would be an easier tax to understand and predict if there are two rates of Capital Gains Tax, rather than four.
2.74 It is for the government to determine its view of the principles behind, and role of, Capital Gains Tax in framing its policy approach. This report highlights some of the ways in which different approaches may distort behaviour or make things complex in practice.

2.75 Alongside any changes to rates careful consideration would need to be given to the economic implications, the relative balance of tax paid by lower rate and higher rate income taxpayers and those of similar means, its other policy objectives, and of course the yield.

Recommendation 1

If the government considers the simplification priority is to reduce distortions to behaviour, it should either:

• consider more closely aligning Capital Gains Tax rates with Income Tax rates, or
• consider addressing boundary issues as between Capital Gains Tax and Income Tax

Recommendation 2

If the government considers more closely aligning Capital Gains Tax and Income Tax rates it should also:

• consider reintroducing a form of relief for inflationary gains,
• consider the interactions with the tax position of companies, and
• consider allowing a more flexible use of capital losses

Recommendation 3

If there remains a disparity between Capital Gains Tax rates and Income Tax rates and the government wishes to make tax liabilities easier to understand and predict, it should consider reducing the number of Capital Gains Tax rates and the extent to which liabilities depend on the level of a taxpayer’s income.
Chapter 3

Boundary issues

Distinguishing income and capital

3.1 The substantial difference between the rates of Income Tax and Capital Gains Tax can create an incentive for taxpayers to favour activities and investments that generate capital gains rather than income, as discussed in Chapter 2. There is also an incentive for taxpayers to arrange their affairs in ways that effectively convert or re-characterise income into capital gains.

3.2 These incentives place considerable pressure on the boundary between income and capital, making it more difficult to ensure that income is identified and taxed as such.

3.3 The distinction between income (whether from employment or from running a business) and investment gains is often clear. This includes situations where assets are themselves being bought and sold or developed in the context of a trading activity (such as regular and frequent online dealings in antiques which amount to running a business, or property development).

3.4 However, ‘capital gains that are closely related to people’s own labour are of interest … because they challenge traditional conceptions of capital gains as being returns on arms-length investments’,¹ and this is particularly relevant to shares in trading companies.

3.5 The value of the shares in a trading company derives, at least in part, from work performed by its employees or by owner-managers. There are two key areas in which at least some of the reward for such labour is capable of being deferred and accumulated into the value of shares the gains on which, when sold, are subject to Capital Gains Tax rather than to Income Tax:

- employee share schemes used as a form of remuneration; and
- the accumulation of retained earnings within smaller, owner-managed companies

3.6 Both areas raise important questions about the disparity in tax rates on labour income, picking up issues raised by the OTS in its July 2020 ‘stock

There may also be greater opportunity for those with greater means to take greater advantage of the choices available. For example, wealthier individuals are generally more able to afford and to obtain tax advice, set up and administer corporate structures, access executive reward schemes or defer the time at which they need to turn assets into cash.

3.8 As explored in Chapter 2, the Capital Gains Tax system allows people to accumulate gains on assets over a period without having to pay tax until the eventual sale, whereas Income Tax is normally incurred on the income from their labour as it arises. Less wealthy people will more often need to spend what they earn on their outgoings and so are more likely to sell any shares from a share scheme as soon as they are able to.

### Share schemes

#### Overview

3.9 Most forms of employee remuneration (such as wages, bonuses or taxable benefits such as company cars) are taxed at Income Tax rates (typically with National Insurance contributions also being paid).

3.10 Share-based remuneration is a complex area, where some arrangements benefit from tax advantages provided in legislation and other employee share scheme arrangements do not.

3.11 While there is generally good data available in relation to tax advantaged share schemes, it is less easy to secure data relating to the effect of share arrangements on tax revenues more generally.

3.12 Share scheme arrangements have a variety of stated purposes in relation to incentivising employees, owner-managers and entrepreneurs.

3.13 The personal tax benefits can be significant as the tax paid in relation to awards of employee shares may be much lower than would be paid on an equivalent cash bonus, as share awards can be structured to be taxed at Capital Gains Tax rates, rather than to Income Tax and National Insurance contributions.

3.14 The employer may also be able to obtain Corporation Tax relief (depending on various qualifying conditions in relation to the shares, the employee and the type of company) on the value of share awards, where there is an Income Tax charge on the employee. Relief can also apply in some situations where there is no Income Tax charge on the employee, for example in relation to the Enterprise Management Incentive. No Corporation Tax relief is available if an employee pays full value for the shares.

3.15 Corlett, Advani & Summers observe that ‘these schemes clearly emphasise the porous boundary between labour-related earnings and capital gains, as well as the strong incentive to forgo salary in favour of other more lightly

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taxed forms of remuneration, for those with the financial flexibility to do so.

3.16 So, it is important to understand the extent to which employee shares reflect rewards for labour (which one might expect to be taxed at Income Tax rates) as distinct from capital investment (which one might expect to be taxed at Capital Gains Tax rates).

3.17 There may also be more opportunity for those with greater means to take advantage of the choices available as people with higher incomes often spend a smaller proportion of their income and so can be more flexible about how and when they receive remuneration. Equally, there are policy justifications for non-neutrality, particularly in the case of the tax advantaged all-employee share schemes such as Save as You Earn schemes.

3.18 The OTS took in detail at the processes and complexities of share schemes in 2012 and 2013, conscious of this background. Here, however, the underlying boundary issues are explored in the wider context of Capital Gains Tax as a whole.

General tax rules for share schemes

3.19 There are many different types of share schemes but broadly, the two main scenarios are an award of shares, or an award of options:

- where the award is of shares, there is an Income Tax charge on the employee based on the market value of the shares at the time of award. The award may also be subject to National Insurance contributions if the shares fall within the Readily Convertible Assets regime (broadly, if the shares are listed shares or otherwise readily convertible to cash, for example just prior to a third-party sale). If the shares carry restrictions (which is usual) there may be further Income Tax charges if those restrictions are later lifted, or on the disposal of those shares. However, this is subject to an election to tax the unrestricted value of the shares to Income Tax at the time of the award, in which cases there are then no further Income Tax charges when the restrictions are lifted, or the shares sold
- if the award is of options, the Income Tax charge arises when the options are exercised

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3.20 In either case, where the shares are subsequently sold, any increase in value is taxed as a capital gain (assuming, where shares are restricted, the election referred to above has been made).

3.21 However, shares acquired through the exercise of options are often sold just after the options are exercised (for example, on the sale of the company) in which case any capital gain is likely to be negligible and most of the growth in value will be taxable as income.

**Shares as a form of remuneration**

3.22 Share incentives can take many forms, which expose employees to various levels of personal investment risk.

3.23 At one end of the spectrum are low value shares acquired by employees on terms that would not be available to an external investor, such as growth shares.

3.24 At the other end there are shares acquired by employees who pay significant amounts for them and so have taken appreciable investment risk.

**Growth shares**

3.25 Growth shares typically work on the basis that a company will set up a new class of shares specifically for selected employees. These shares are used across a range of industries and unlisted companies of all sizes and they are often used where the Enterprise Management Incentive scheme is not available.

3.26 Such shares are designed to benefit only from increases in the company’s value from the date on which they are created (or potentially from a future date).

3.27 If the shares have little value when employees acquire them, there will be little or no Income Tax or National Insurance contributions to pay at that time – or the employee may choose to pay the (typically, low) market value for the shares, in which case there is no tax charge.

3.28 When the shares are sold, there will be a capital gain based on the difference between the sale proceeds and amount paid for the shares. So, the initial award of shares to the employee, made when the shares had a low value, attracts minimal Income Tax or National Insurance contributions, while all the growth in the shares will be subject to Capital Gains Tax, which is likely to be at a much lower rate.

3.29 However, it could be argued that growth shares are similar to share options, as they involve what is likely to be a low tax charge on award with little risk to the employee.

3.30 The OTS has been told that valuing growth shares at the time of award can be challenging, as factoring in future growth potential is highly subjective.
3.31 Case studies 5 to 7 demonstrate the different tax outcomes arising from three different approaches to employee remuneration.

**Case study 5: Growth Shares**

Janice is awarded 100 Growth Shares. The rights in these shares are designed so that they participate only in future growth of the value of the company. In consequence of this restriction the value of these shares is £500 when they are awarded.

Janice pays the company £500 for the shares so there are no Income Tax or National Insurance contributions charges on the initial award.

The company is sold a few years later and as part of that process Janice receives £100,000 for her shares.

The gain on disposal is subject to Capital Gains Tax. The Capital Gains Tax due could be about £17,500, if Janice were a higher rate taxpayer with no other capital gains. It is possible, in some circumstances, that the shares could qualify for Business Asset Disposal Relief in which case the Capital Gains Tax would be about £8,750.

In either case, there is no Corporation Tax relief as Janice originally paid full value for the shares.

**Case study 6: Non tax advantaged share options**

Instead of a share award, Jasmine is granted options over 100 shares at an option price of £5 per share, which is the market value of the shares at that time. There are no Income Tax or National Insurance contributions charges on the grant of the option.

The company is sold a few years later and as part of that process Jasmine exercises her options, paying £500 and subsequently receives £100,000 for the shares one day later.

The gain on exercise of £99,500 is subject to Income Tax and National Insurance contributions. The Income Tax and employee National Insurance contributions due could be around £47,000 if Jasmine is a higher rate taxpayer (or more if the additional rate applies). The company would also have an employers’ National Insurance contributions charge of around £13,800 but it could save Corporation Tax of around £21,500 if it meets the conditions for Corporation Tax relief.

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6 The examples use 2019-20 rates and thresholds throughout.
Case study 7: Cash Bonus

Jacob instead receives a performance related cash bonus as part of the exit deal, which is subject to Income Tax and National Insurance contributions.

If the bonus was £100,000 the Income Tax and employee National Insurance contributions due would be at least £47,000 (and again would be greater to the extent the additional rate applies), assuming Jacob was a higher rate taxpayer. The company would also have an employers’ National Insurance contributions charge of around £13,800 but it could save Corporation Tax of around £21,600.

The position here is therefore broadly the same as in the case study above relating to non tax advantaged share options, assuming those options qualify for Corporation Tax relief.

Tax advantaged share schemes overview

3.32 There are several tax advantaged (commonly referred to as ‘approved’) share schemes which in specific situations offer tax benefits. These include Enterprise Management Incentives, Company Share Option Plans, Share Incentive Plans and Save as You Earn schemes.

3.33 Broadly, Share Incentive Plans and Save as You Earn schemes are intended to ‘develop… employees’ understanding of, and commitment to, business and industry [or] spread a wider understanding of the role for risk-taking and initiative in the economic system.’ The Enterprise Management Incentives and Company Share Option Plans are intended to ‘recruit and retain the high calibre people [small businesses] need to grow and succeed.’

3.34 Employees received an estimated £540 million of relief from Income Tax and £330 million from National Insurance contributions in 2018-19 from tax-advantaged employee share schemes. However, it is not possible to identify how much Capital Gains Tax comes from shares that were part of an employee share scheme, as the shares involved cannot be linked to the gains reported on returns.

3.35 Where employees are given the option (or right) to acquire shares in the companies they work for, the general rule is that the grant (or award) of the option is usually ignored for tax purposes and no Income Tax charge arises at that time. Instead, the Income Tax and National Insurance contributions charge arises at the time the options are exercised, as noted above.

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3.36 For certain tax advantaged schemes, such as the Enterprise Management Incentive scheme and Company Share Option Plans, any Income Tax charge at the time the option is exercised and the shares acquired by the employee is based on the value of shares at the time the option was granted, rather than on the (often much higher) value of the shares when the option is exercised.

3.37 However, provided the employee pays at least the option price for the shares, no Income Tax or National Insurance contributions arises when the option is exercised (assuming the option price is at least equal to the share value at date of grant). When the employee sells the shares, the difference between the sale price and their value when the option was granted is then charged to Capital Gains Tax rather than Income Tax and National Insurance contributions.

3.38 If Jasmine, in the case study above, had been awarded those options under an Enterprise Management Incentive scheme the position would have been:

- no Income Tax or National Insurance contributions when the options were awarded or exercised
- Jasmine’s Capital Gains Tax liability could be around £8,750 assuming she is eligible for Business Asset Disposal Relief
- the employer may be eligible for Corporation Tax relief of around £18,900

Observations – share schemes generally

3.39 One of the policy objectives of Capital Gains Tax is to ‘reward risk taking and promote enterprise.’\(^{10}\)

3.40 Many respondents were generally positive about the role of certain types of share schemes in incentivising senior management, and in start-up or technology businesses. Some also argued that smaller companies were unable to attract and retain the right talent without government support through measures such as the Enterprise Management Incentive scheme.

3.41 Other respondents argued that it was important to maintain the existing treatment to preserve neutrality between employee and non-employee investors.

3.42 The OTS has been told that some employee shareholders take material risk, so it would be unreasonable to tax them less favourably than external investors. For these employees, especially if any shares are acquired on similar terms to those available to investors generally, options, shares, and cash bonuses may well not be commercially comparable so it is to be expected that the tax treatment would diverge.

3.43 However, not all employees who benefit from employee share schemes are taking the same level of risk with their invested capital, or acquire them on the same terms, that an external investor would.

\(^{10}\) Gordon Brown, Budget 1998.  
3.44 For instance, if they had acquired growth shares at a very low value, they may not be risking significant amounts of their own capital if they walked away. So at least in some cases the returns look more like rewards from labour than from capital investment.

3.45 One respondent told the OTS that if tax rates were harmonised then mechanisms such as growth shares would not be used at all, and another senior tax practitioner said the boundary leads to a lot of fancy footwork and machinations, which suggests that the tax position is key here.

3.46 If share ownership has the positive effect envisaged, one might expect businesses to continue to support it even if the income or gains arising were taxed in the same way as other forms of remuneration. After all, while the OTS recognises that share schemes can be an important part of a balanced employee reward package, so are salaries and bonuses – which are taxed at the normal Income Tax and National Insurance rates.

3.47 The OTS recognises though that seeking to ensure that all returns which appear mainly to be derived from labour are taxed as such, and to preserve broad neutrality between employee and non-employee investors, would involve creating a new boundary between different types of arrangements, which would bring its own complexities.

3.48 Some respondents noted the risks involved if employees invest too heavily in their own employer: if their employer went bankrupt, they could face not only losing their jobs but also their savings.

Observations – Tax advantaged share schemes

3.49 Tax advantaged share schemes clearly reflect policy choices – broadly Share Incentive Plans and the Save as You Earn scheme have social policy objectives and the Enterprise Management Incentives and Company Share Option Plans have economic ones.

3.50 However, the OTS notes that the evidence of the effectiveness of tax advantaged share schemes in promoting economic growth is mixed. A 2019 Ipsos study for HMRC found that many employers and employees felt that tax advantaged share schemes ‘were important tools for recruiting and retaining talented and key staff and employers felt [they] enabled companies to remain competitive and improved staff retention.’

3.51 In a study by Loughborough University in 2018 on employee attitudes and behaviours in participation in Employee Share Ownership (ESO) it was noted that ‘employees tended to feel that ESO had not increased their motivation, commitment or performance because they were already exhibiting these at a high level, as any good employee should’.

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Observations – Tax advantaged all-employee schemes

3.52 A separate case can be made for the all-employee schemes, as those who benefit from them include many individuals with relatively low incomes and the policy justification is as much social as economic.

3.53 However, the OTS questions whether tax advantaged share schemes are the most cost effective approach to helping people save or encouraging long term share ownership, recognising that many millions of lower paid employees (including those in the public sector, or professional partnerships, or private equity backed companies) cannot have access to them.

3.54 While the policy rationale for Save as You Earn arrangements is about promoting savings as well as encouraging share ownership, 38% of Save as You Earn users sold some or all of their shares as soon as they were able to.\(^\text{13}\)

Retained earnings in close companies

Labour income and the taxation of retained earnings

3.55 The OTS has explored previously how small businesses can structure themselves and pay taxes in different ways, at different times, and at several rates.\(^\text{14}\) This section explores the implications of an individual storing up retained earnings in their company until it is either wound up or sold, and this then being chargeable to Capital Gains Tax as opposed to Income Tax.

3.56 If an individual sets up a company through which to trade, the net profit after Corporation Tax has been paid can either be distributed as dividends or accumulated as retained earnings. Dividends are subject to Income Tax which can be as high as 38.1% for additional rate taxpayers. Earnings which are retained in the company are not subject to Income Tax on the owner – or shareholders – unless they are paid out by way of a distribution prior to the winding up or sale of the company.

3.57 The value of any retained earnings remaining within the company at the time of a winding up or a sale of the company will form part of the value of the final distribution or sale proceeds, which will be charged to Capital Gains Tax. The rate at which it is charged may be as low as 10% where Business Asset Disposal Relief applies.

3.58 Illustrative Case Studies 8 and 9 contrast the tax position of two individuals in business, only one of whom has incorporated her business, neither of whom is to be treated as an employee.

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\(^{13}\) ProShare SAYE & SIP Report 2018, page 15.

Case study 8

Rose sets up a company, R Ltd, through which to conduct her consultancy business. R Ltd has an annual turnover of £150,000 and no overheads apart from a salary of £8,500 payable to Rose.

The salary is deductible from R Ltd’s income in calculating its profits for Corporation Tax purposes and is below the threshold above which National Insurance contributions would be paid in relation to Rose’s earnings.

Rose also receives an annual dividend of £41,500 from R Ltd, so her total income from the company is £50,000, all of which is taxed at the basic rate of Income Tax. Rose’s total Income Tax liability is £2,662 and R Ltd pays £26,885 in Corporation Tax, giving a total of £29,547.

After five years, R Ltd has accumulated reserves of £365,575. Rose decides to liquidate the company and claims for Business Asset Disposal Relief on the disposal. After deducting her Annual Exempt Amount, Rose pays Capital Gains Tax at 10% on the proceeds of the final distribution of £35,358.

Over the life of the business, Rose and R Ltd have paid a total of £183,093 in taxes and Rose has earned £566,907 after tax – an effective rate of 24%.

3.59 By contrast, income from self-employment is subject to up to 47% Income Tax and National Insurance contributions.

Case study 9

Like Rose, Geoff is also a consultant, but Geoff conducts his business as a self-employed individual. Geoff earns £150,000 and has no overheads.

Each year, Geoff pays a total of £58,382 annually in Income Tax and National Insurance contributions. After five years, this adds up to £291,910, leaving Geoff with £458,090.

Over the five years, Geoff has earned 20% less than Rose and contributed 60% more in taxes even though their businesses are essentially identical. The only difference is that Geoff has not operated through a company.

Observations

3.60 It is clear, from these examples and interaction with a wide range of respondents, that the tax system produces outcomes which distort

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15 The examples use 2019-20 rates and thresholds throughout.

16 For the purposes of this example, it is assumed that the disposal either does qualify for Business Asset Disposal Relief and that the anti-avoidance rules described below do not apply, or that Rose is not aware of the anti-avoidance rules if they do apply and her claim has not been challenged (an example of how complexity can worsen the tax gap).
behaviour, pushing taxpayers towards incorporation, where they might otherwise have preferred to remain self-employed. Although 2017 research for HMRC found tax wasn’t the main driver to incorporate, ‘most respondents thought that it generally was very or fairly common (63%) for UK businesses to incorporate in order to reduce tax liabilities.’

3.61 The OTS considered these issues in a ‘stock take’ paper published in July 2020, which included detailed consideration of the Income Tax position of individuals working through Personal Service Companies, like Rose, which compares favourably with the position of self-employed individuals, like Geoff, and even more with that of employees, even if all profits are distributed.

The importance of control

3.62 In the example of R Ltd, it is significant that Rose has complete control over the company. She occupies three positions:

- **Employee**: Rose personally performs the work of the company
- **Director**: Rose oversees the strategic decisions of the company, including what activities it undertakes, and what dividends to declare and when
- **Shareholder**: Rose owns the company and is the recipient of any dividends and of any proceeds from a winding up or sale

3.63 Apart from the tax differences, it makes no difference to Rose which of these things are done, as in all cases the money goes to her. So, on one level, this means that her ‘capital gain is effectively interchangeable with labour-related earnings.’ At the very least Rose has some ability to choose which tax she pays and when.

3.64 The position is clearly very different for large companies, with many thousands of employees, and where in general no individual investor has a controlling stake. However, it is less easy to draw that line in relation to smaller companies.

Defining control

3.65 Most companies are close companies. As the IFS research shows ‘the majority (70%) of UK companies have strictly fewer than three directors and three shareholders; in 90% of these companies, at least one director is also a shareholder.’

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3.66 The UK tax code contains a definition of a ‘close company’,\(^{21}\) which broadly is one that can be controlled by its owners or – in particular if it has either five or fewer participators or where all the participators are also involved with the company as directors. So, R Ltd would clearly qualify while large listed companies clearly would not.

**The effect of control on distortive behaviours**

3.67 Where those who own and those who run a company are the same or closely related there is scope for the owners’ interests to influence and indeed determine the company’s decision-making. For example, R Ltd need not pay Rose a market-rate salary for her work if she is content to benefit instead from the accumulation of retained earnings within the company. It is still clear in this case that its profits are, in effect, Rose’s earnings in respect of her work.

3.68 The ability of those conducting their business through Personal Service Companies to roll up retained earnings into what becomes a capital gain produces an additional tax benefit for those with the means and the desire to secure it: there is an incentive to ensure that ‘Taxable income is shifted across time to smooth income that fluctuates around tax kinks and to access preferential capital gains tax rates.’\(^{22}\)

3.69 The spikes in Chart 3.A demonstrate the prevalence and relative ease with which this can be done. It shows that Rose, in taking a salary below the National Insurance contributions threshold and ensuring her total income is taxed only at the basic rate of Income Tax, represents a relatively typical case. Rose may of course have other reasons for only taking £50,000 from her company but tax is clearly a significant driver for many people in particular those who, like Rose, are consultants with few if any staff and low overheads.

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Overall, the IFS research suggests that such behaviours are both distortive and significant in extent in respect of companies that are owned and run by a small number of people. See Annex F for more details of the IFS research and an analysis of Chart 3.A.

The OTS recognises that not all close companies are likely to operate in this way. In particular some large companies are held privately by a small number of shareholders who, while being directors, deal with the company on an arm’s length basis.

In the UK, there are specific company accounting and Companies House filing requirements for micro-entities which meet two of the following three conditions: turnover of £632,000 or less, balance sheet of £316,000 or less and no more than 10 employees, and for small companies.

A company is ‘small’ if it has any two of the following:

- a turnover of £10.2 million or less
- £5.1 million or less on its balance sheet
- 50 employees or less

Companies that are not classed as small are quite substantial and very likely to have responsibilities to many more parties beyond the shareholders. So, the OTS considers that any consideration of the tax treatment of retained earnings should be focused on smaller close companies.

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23 [https://www.gov.uk/annual-accounts/microentities-small-and-dormantcompanies#:~:text=Micro%2Dentities%20are%20very%20small,10%20employees%20or%20less](https://www.gov.uk/annual-accounts/microentities-small-and-dormantcompanies#:~:text=Micro%2Dentities%20are%20very%20small,10%20employees%20or%20less)
Anti-avoidance

3.75 There are already some anti-avoidance rules which partly address these issues. They counter specific activities known as phoenixing and money-boxing in some situations.

3.76 The anti-phoenixing rules address situations where shareholders liquidate a company, extracting funds as capital, and subsequently set up another company undertaking similar activities. The rules operate by imposing an Income Tax charge on the retained earnings that would otherwise be subject to Capital Gains Tax.

3.77 The anti-money-boxing rules apply to prevent cash-rich companies from qualifying for Business Asset Disposal Relief.

3.78 In both cases the rules require the exercise of judgment by the taxpayer in self assessing their position and depend on HMRC challenging the arrangements. As a result, this can be complex and brings an inherent risk of inconsistency.

A solution: taxing retained earnings at Income Tax rates

3.79 One solution would be to tax some or all of the retained earnings remaining in the business on liquidation or sale at dividend rates – in effect shifting the boundary between Capital Gains Tax and Income Tax in these situations. This could create make the treatment of cash taken out of the business during and at the end of its life more neutral.

Case study 10

Continuing from Case Study 8, if Rose’s accumulated retained earnings on cessation had been taxed at dividend rates, then over the life of the business, Rose and R Ltd would have paid a combined total in taxes of £269,094 and Rose has earned £480,906 net of tax.

Targeting the solution

3.80 The issues around money-boxing and phoenixing mainly relate to Personal Service Companies like Rose’s. However, the tax position for the generality of trading companies can be similar, as it is possible – where the shareholders have sufficient control – for relatively low levels of remuneration and dividends to be paid during the company’s lifetime, with the potential for accumulated retained earnings to be taxed at Capital Gains Tax rates as part of the proceeds for shares on eventual sale.

3.81 Typically, in that situation, there would not be a liquidation, but shares would be sold at a value that represents both retained earnings and assets of the company such as goodwill. From an economic perspective, this additional goodwill value should continue to be taxed as a capital gain as it represents an increase in value over and above a normal labour reward.
3.82 In the case of a large listed company, all employees and directors will in general have been remunerated at a market rate and they have little or no direct interest in the accumulated profits.

3.83 Careful thought and further consultation would be required to fully assess which companies should be within the scope of any measures taken in this area. The scope should go wider than Personal Service Companies but well short of large publicly listed companies with thousands of shareholders. As above, a starting point for exploring the definition might be close companies that are small, or those falling within the micro-entity definition.

Challenges

3.84 The OTS recognises however that there can be good reasons, unrelated to tax, to store up cash in a company, and that the tax system should not discourage this in a way which distorts such decision-making. However, taxing retained earnings at Income Tax rates is the default position for many smaller businesses (see Case Study 9). The Institute for Fiscal Studies present evidence that suggests retained earnings are not associated with increased investment in business capital and that tax plays a significant role in distorting decision-making for this group.24

3.85 The OTS is also aware that this area is technical and complex. Wherever the line is drawn to distinguish a company that ought to be subject to Income Tax on accumulated retained earnings and one that ought not, care should be taken to avoid creating another distortive boundary or an arbitrary cliff edge between different types of company.

Alternatives

3.86 One suggested alternative would be to tax retained earnings within the company, rather than on the shareholder. To ensure the overall tax position is comparable with taxing the retained earnings as income, this would need to be at an enhanced Corporation Tax rate.

3.87 Another possibility would be to tax retained earnings on an annual basis, similar to the $250,000 retained earnings cap for C Corporations in the US. Corporations are able to negotiate with the Internal Revenue Service if there is a specific reason to retain earnings over that level. This is perhaps comparable to the UK’s (complex) ‘close company apportionment’ rules, abolished in 1989.

3.88 The OTS has not explored these possibilities in any detail as part of this review, as they are not directly related to Capital Gains Tax but mentions them to inform wider debate.

Conclusion

3.89 Retaining a substantial difference in tax rates between Income Tax and Capital Gains Tax may put pressure on the boundaries between the two taxes.

3.90 Share-based remuneration is a complex area, where some arrangements benefit from tax advantages provided in legislation and other employee share scheme arrangements do not. These have a variety of stated purposes in relation to incentivising employees, owner-managers and entrepreneurs. The tax benefits can be significant as – to use a simple illustration – awards of employee shares may be effectively taxed at much lower rates than equivalent cash bonuses.

3.91 The boundary is hard to delineate. There are policy justifications for non-neutrality, particularly in the case of the tax advantaged all-employee share schemes. Equally, the OTS has also been made aware of some anomalous situations relating to shares made available to some employees on better terms than to other investors, such as the growth shares described above, which demonstrate particular pressure on the boundary.

3.92 Turning to the accumulation of retained earnings within smaller owner-managed companies, business owners may be taxed at lower rates if they realise the value of these accumulated earnings on sale or on liquidation, than if they withdraw them as dividends. One solution would be to tax some or all of the accumulated retained earnings on liquidation or sale at dividend rates (in effect shifting the boundary between Capital Gains Tax and Income Tax). This could make the treatment of cash taken out of the business during and at the end of its life more neutral.

3.93 If the government chooses to take this forward, it should undertake a thorough analysis of the types of businesses and taxpayers potentially affected, and engage with relevant industry bodies to minimise the extent to which any changes would be likely to distort the choice of how a business is operated or set up in other ways.

3.94 It is for the government to determine its view of the principles behind, and role of, Capital Gains Tax and the wider concept of employee ownership in framing its policy approach. This report highlights some of the ways in which different approaches may distort behaviour or make things complex in practice.

3.95 Alongside this, any changes to employee share schemes or accumulated retained earnings in close companies would require careful consideration to be given to the economic implications, the relative balance of tax paid by lower and higher income people and those of similar means, its other policy objectives, and of course the yield.

Recommendation 4
If the government considers addressing Capital Gains Tax and Income Tax boundary issues, it should:

- consider whether employees’ and owner-managers’ rewards from personal labour (as distinct from capital investment) are treated consistently and, in particular
- consider taxing more of the share-based rewards arising from employment, and of the accumulated retained earnings in smaller companies, at Income Tax rates
Chapter 4
Annual Exempt Amount

Background
4.1 The Annual Exempt Amount is a threshold below which gains chargeable to Capital Gains Tax are not taxed. Its key features are that:

- it is deducted from the total net chargeable gains made by an individual taxpayer in a given tax year – after current year losses have been offset against gains but before losses from prior years are taken into account
- where gains are chargeable to Capital Gains Tax at different rates, taxpayers can choose which gains to set their annual exemption against (to minimise their liability)
- if it is not all needed in a given tax year, the surplus cannot be carried forward or carried back to set against gains in other tax years; and
- it is not transferable between taxpayers

4.2 While taxpayers will generally use their Income Tax personal allowance every year, the Annual Exempt Amount is much less likely to be used as consistently. This is because it is generally the taxpayer’s decision to realise gains and this often happens at longer intervals or as a ‘one-off’.

4.3 A threshold for taxing gains has been around in some form since 1977, when the government exempted annual gains below £1,000. This exemption was renamed the Annual Exempt Amount in 1980 and increased to £3,000; and in 1982 it was increased again to £5,000. The law now provides that the Annual Exempt Amount is adjusted annually in line with the Consumer Prices Index, rounded up to the nearest multiple of £100 (which means that the allowance has increased by more than inflation over the years). For the 2020-21 tax year the Annual Exempt Amount is £12,300.

4.4 The Annual Exempt Amount could be considered to fulfil one or more purposes:

- a substantive relief, comparable to the Income Tax personal allowance
- an administrative de minimis, to reduce the number of people who need to report Capital Gains Tax information; and
- a means to compensate for inflation
4.5 The OTS has examined taxpayer data and responses to its Call for Evidence to explore the extent to which the Annual Exempt Amount appears to operate in these different ways.

The Annual Exempt Amount as a relief

4.6 A significant number of respondents described the Annual Exempt Amount as being too high to serve only as an administrative de minimis and that is in effect more like a relief.

4.7 Respondents cited, in particular, the behaviour of holders of listed share portfolios and their portfolio managers in actively realising gains annually up to the threshold for the tax year in order to ‘use up’ the Annual Exempt Allowance as if it were an allowance.

4.8 HMRC data shows there is a significant and consistent ‘spike’ in the number of gains reported annually at a level just under the Annual Exempt Amount for the given tax year. This was true for the ten tax years ending with 2017-18. The majority of net gains below the Annual Exempt Amount in all years (two thirds to three quarters) related to listed share disposals.

4.9 Chart 4.A shows the spike in gains reported close to the Annual Exempt Amount for the tax year 2017-18. Data for the preceding nine years reflects a comparable pattern. See Annex F for more information.

Chart 4.A: Frequency of reported net gains up to £15,000 for tax year 2017-18

4.10 This offers some support for the proposition that holders of listed share portfolios ‘use up’ the Annual Exempt Amount as if it were an allowance. Two thirds of taxpayers reporting gains close to but below the Annual Exempt Amount did not report capital gains more than once in an 11-year period and, of those that did report more than once, the number of taxpayers reduced as the frequency of reporting increased.
4.11 (These charts do not include data from those taxpayers whose gains fell below the Annual Exempt Amount and did not need to be reported to HMRC. These gains mainly relate to disposals for which the proceeds are less than four times the level of the Annual Exempt Amount for the tax year).¹

The Annual Exempt Amount as a de minimis

4.12 As things stand, the Annual Exempt Amount is comparable with the personal allowance for Income Tax (£12,300 compared with £12,500 in the 2020–21 tax year) and represents a significant amount of money for most people in the UK (median household income in 2019 was £29,600).²

4.13 One way to address this potential distortion in behaviour would be to reduce the level of the Annual Exempt Amount, so that it mainly operates as an administrative de minimis threshold.

Administrative impact of reducing the Annual Exempt Amount

4.14 The OTS is of course very aware of the administrative implications of a lower Annual Exempt Amount and the consequences of bringing more people into the tax system.

4.15 HMRC estimates³ show the administrative and revenue impacts for tax year 2021–22 of reducing the Annual Exempt Amount to a lower threshold, and indicate that:

- a reduction to £6,000 would result in 235,000 more individuals needing to report a capital gain and could generate £480 million in additional revenues in the first year. (About 96,000 of the affected taxpayers would already routinely file Self Assessment tax returns.)

- a reduction to £2,500 would result in 360,000 more individuals having a requirement to report a capital gain and could generate £835 million in additional revenues in the first year. (About 120,000 of the affected taxpayers would already routinely file Self Assessment tax returns.)

4.16 The numbers of taxpayers affected, and revenue raised are likely to be overestimates. This is because the analysis does not take account of behavioural impacts; for example, it does not adjust for taxpayers who might alter the extent to which they actively realise gains on listed shares, as described in the section above. This is especially likely to be true of the 118,000 individuals estimated to make gains of £10,000 or more in tax year 2021–22.

4.17 Chart 4.B shows how the number of taxpayers that would newly be required to pay Capital Gains Tax and to complete a Self Assessment tax return, would increase as the threshold is reduced. These figures are an estimate for

¹ HMRC.
³ HMRC data. 2021-22 projection
the 2021-22 tax year so the starting point for the Annual Exempt Amount is £12,500.⁴


Source: HMRC⁵

4.18 Not all those who would be brought into paying Capital Gains Tax would be newly brought into self-assessment, as many of them would be completing a Self Assessment tax return anyway. That said, the more the Annual Exempt Amount is reduced, the higher the proportion of newly liable taxpayers who would also be new to self-assessment.

4.19 Ignoring changes in behaviour, a reduction from £12,500⁶ to £12,000 alone is estimated to affect 50,000 taxpayers because of the increased prevalence of gains just below the threshold as described above.

4.20 After this, the gradient of the curve from right to left reduces and settles as taxpayers are steadily brought into Capital Gains Tax as the threshold is reduced, as far as £4,000. Once the threshold is below £2,000, the gradient increases more steeply to £1,000 and more sharply still to £0. This indicates that, from some point between £2,000 and £4,000, further decreases in the Annual Exempt Amount are estimated to produce a proportionately greater administrative burden.

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⁴ This is the anticipated threshold for 2021-22, as the current policy is to increase the threshold annually by inflation and round up to the nearest £100.

⁵ Please see Annex F for further information. As with all graphs presented in this report this graph presents static estimates. Taxpayers would plan their affairs differently if the Annual Exempt Amount were lower.

⁶ The threshold in 2021-22 is expected to be £12,500 and this estimate is based on future projections.
4.21 One of the reasons why there are proportionally fewer taxpayers newer to self-assessment the nearer their gains are to the existing Annual Exempt Amount is that there is a reporting requirement for any taxpayer whose total proceeds from capital disposals exceed four times the value of the Annual Exempt Amount.

4.22 Unless this rule were revisited, a much reduced Annual Exempt Amount would result in a sharp increase in reporting requirements for people with no Capital Gains Tax to pay. So it would make sense to revisit this requirement if significant reduction in the threshold were made.

Comparisons with smaller de minimis thresholds

4.23 Comparatively small de minimis thresholds exist both within the UK Income Tax system and in some foreign Capital Gains Tax systems.

4.24 In the UK Income Tax system, the trading income, property income and personal savings allowances are each set at £1,000 and the dividend allowance is £2,000, for most taxpayers, each year.

4.25 De minimis thresholds are intended to balance the cost of administering taxes with yield. Capital Gains Tax is a relatively expensive tax to administer both for the tax authority and the taxpayer, as it requires the calculation of a base cost of an asset that may have been acquired some time ago and invested in over the years in the form of additions and enhancements.

4.26 However, there are examples of considerably lower Capital Gains Tax de minimis thresholds internationally:

- Germany\(^7\)
  - Shares: There is a €801 (£721) allowance against savings and dividend income and gains on shares.
  - Other assets: A €600 (£540) de minimis exemption applies when total gains on other assets in a given tax year fall below this threshold.
  - Many assets are exempted entirely provided they are held for a given time period. Generally, this is one year but ten years for real property.

- Australia\(^8\)
  - Shares: There is no de minimis or allowance for shares, units and similar investments. (These gains form part of income and are covered by the Income Tax personal allowance to the extent that it hasn’t been exhausted against income.)
  - Other assets: There is an exemption for personal use assets (boats, furniture, electrical goods, household items) with an acquisition cost of below AUD 10,000 (£5,500) and ‘collectables’ (artworks, jewellery, antiques, rare stamps, etc.) with an acquisition cost or value at acquisition below AUD 500 (£275).

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\(^7\) [https://taxsummaries.pwc.com/germany/individual/income-determination](https://taxsummaries.pwc.com/germany/individual/income-determination)

4.27 Note that these jurisdictions also build in broad exemptions for personal effects, which are considered under ‘Chattels’, later in this chapter. See Annex D.

Implications for anti-avoidance legislation

4.28 If the Annual Exempt Amount were reduced to be closer to a de minimis level there would then be less incentive for tax avoidance, in relation to which there are currently complex rules, potentially enabling these to be abolished.

Application of the Annual Exempt Amount to those with large gains

4.29 Some respondents have questioned why the Annual Exempt Amount is available to taxpayers who realise the most substantial gains. By contrast, the Income Tax personal allowance is reduced for taxpayers whose income is above £100,000 and withdrawn completely for those whose income is above £125,000.

4.30 Gradually withdrawing the Annual Exempt Amount in a comparable way would not materially affect the work involved for those paying the largest amounts of Capital Gains Tax, as they are already required to report gains. It would however introduce an additional complex calculation for taxpayers in the tapering zone. It may also encourage these same taxpayers to split up their gains among different family members – although there are already anti fragmentation rules in place to tackle this.

4.31 Such a change, if it extended to taxpayers with gains in excess of £100,000, could raise revenues of £150 million annually, assuming 60,000 taxpayers paid tax on an additional £12,300 at 20%. The resulting increase in the effective tax rate would be no more than 2% for these taxpayers.

4.32 The yield would be greater if the reduction in the Annual Exempt Amount began at a lower threshold than that for income, for example tapering to nil in respect of gains in the range £20,000 to £30,000. This would have a proportionately greater impact on the effective rate for taxpayers with smaller excesses of gains over the threshold; however, it would still not materially affect the administrative work involved.

4.33 The OTS considers that this is essentially a policy question; it would increase complexity for some taxpayers but could result in a less distortive regime overall, if the Annual Exempt Amount was a little higher than it would otherwise be for taxpayers with low levels of gains.

Summary

4.34 The OTS considers that there is a case for considering a reduction in the Annual Exempt Amount, if its main purpose is to function as an administrative de minimis. Based on the data presented in this report, a true de minimis level could lie in the range between £2,000 and £4,000, below which the extra administrative burden begins to increase more steeply.

4.35 Any change would need to take into account the increased administrative costs, for taxpayers and HMRC, and these may point to setting a higher
threshold than this. Importantly, any change should also be accompanied by measures to improve administrative processes (see below).

The Annual Exempt Amount as a means to compensate for inflation

4.36 On the introduction of indexation allowance in 1982, Chancellor Sir Geoffrey Howe also increased the Annual Exempt Amount from £3,000 to £5,000, stating:

‘Because we have not found it possible to extend the new [indexing] scheme to cover past gains, I propose also that the exempt slice should be increased to £5,000.’

4.37 Subsequently, in 1988, Capital Gains Tax assets were rebased to their 1982 market value. At that time the Annual Exempt Amount, which by 1987/88 had been increased by inflation to £6,600, was reset to £5,000 where it remained for three consecutive tax years. Chancellor Nigel Lawson stated:

‘At present, the first £6,600 a year of capital gain is tax free. The relatively high level of this threshold stems from the substantial increase my predecessor made in 1982 explicitly as rough and ready partial compensation for the continued taxation of pre-1982 paper gains. Now that I have taken pre-1982 gains out of tax altogether, I propose to reduce the capital gains tax threshold to £5,000.’

4.38 Since then, there is no obvious reason why the Annual Exempt Amount might be considered to have been a form of compensation for inflation.

4.39 As discussed in Chapter 2, indexation allowance has been abolished in favour of Taper Relief, which in turn was abolished alongside the introduction of a lower rate of Capital Gains Tax. So now, in combination with the lower rate, the seemingly generous Annual Exempt Amount could be seen as an acknowledgment for the typically longer holding period of investment assets subject to Capital Gains Tax (as compared with traded assets).

4.40 The view that the Annual Exempt Amount was a poor means to compensate for inflation was also expressed by respondents representing taxpayers and businesses who invest in or require the use of land. Land, particularly farming land, as an asset is typically held for long periods and ultimately sold all at once, or in high value transactions. The Annual Exempt Amount clearly does not materially compensate for, say, 30 years’ worth of inflation on an asset costing £100,000 (roughly £150,000).

4.41 Independently of the arguments for and against indexation, the OTS considers that the Annual Exempt Amount is not an appropriate means to compensate for inflation.

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9 https://hansard.parliament.uk/ Commons/1982-03-09/ debates/ecc60a19-cf61-4097-b2df-04e38579974c/CapitalTaxes

Administrative easements alongside reducing the Annual Exempt Amount

4.42 If there were a reduction of the Annual Exempt Amount, the OTS considers it would be essential to consider a number of administrative changes, which are explored briefly here.

4.43 These potential measures would have merit in their own right, whatever the level of the Annual Exempt Amount, so the OTS may develop this thinking in the second report.

Personal effects: Chattels

4.44 A consideration put forward by respondents in relation to the Annual Exempt Amount’s function as a de minimis, was the possibility of revisiting the chattels exemption.

4.45 A chattel is a tangible, moveable asset such as an item of furniture or jewellery or a work of art. The chattels rules apply to such items when they have a predictable life of more than 50 years.

4.46 Chattels that are expected to have become useless or worthless within 50 years are within a different category called wasting assets. Wasting assets will, more often than not, generate a loss on disposal and are exempt from Capital Gains Tax altogether. However, some wasting assets, such as antique clocks and vintage cars, generally appreciate in value.

4.47 The chattels exemption exempts disposals where the proceeds are less than £6,000 from Capital Gains Tax and restricts the charge on disposals for proceeds of up to £15,000. (There is also an anti-avoidance provision preventing the break-up and staggered sale of a set of items that is worth more than the sum of its parts, such as chess pieces which together form a set.)

4.48 These rules are designed to reduce administration by exempting a large volume of smaller transactions while protecting revenues by ensuring that higher value transactions are still caught.

4.49 The chattels exemption is less likely to be relied on if there is a relatively high Annual Exempt Amount which will often cover any disposals of chattels. The OTS survey results indicated that disposals of chattels resulting in chargeable gains are relatively rare, or at least rarely reported (recognising that respondents are among the minority of taxpayers who have actually paid Capital Gains Tax).\(^\text{11}\)

4.50 Chattels are included in HMRC data within other non-financial assets, which collectively account for £4 billion or 6% of all gains by value.\(^\text{12}\) This figure also includes gains on goodwill, relating to the value of the brand or other intangible property of a business. So, although it cannot be quantified more

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\(^{11}\) Only 3.5% of respondents to the OTS survey question on assets disposed of said they had disposed of chattels. OTS survey as of 12.120.2020

precisely, the contribution of chattels to Capital Gains Tax revenues appears relatively small.

Observation
4.51 A lower Annual Exempt Amount would mean that the chattels rules would be applied in relation to more transactions. As it stands, a person disposing of a chattel for up to £15,000 of proceeds does not have often have to think about the chattels rules if their Annual Exempt Amount has not been used up on other disposals and covers the gain.

4.52 However, if the Annual Exempt Amount were reduced, more transactions would entail calculations and possibly valuations for gifts and the complexity of having to determine the base cost of an asset which may have been acquired as a gift or acquired some years ago.

Stand-alone Capital Gains Tax returns
4.53 There are currently several different ways a gain can be reported to HMRC, as outlined in the Call for Evidence. While it is helpful that people can choose to report capital gains information early in real time, outside of a Self Assessment tax return, the OTS considers that the process is imperfect as it stands.

4.54 In particular, the current ‘real time service’ is not formalised as a return and there is debate on whether it has a sufficiently robust legislative framework to govern filing and enquiry deadlines.

4.55 The OTS is also aware that it is not possible to access the service through the Personal Tax Account.

4.56 The OTS considers there would be benefit in formalising the administrative arrangements for the real time capital gains service and linking up these returns to the Personal Tax Account. This would ease the administrative burden for some taxpayers, and help those who struggle to pay, by making it easier to be aware of what tax may have to be paid. It would also give taxpayers more certainty.

Information from investment managers
4.57 When calculating gains on listed shares, taxpayers may need to understand and cross reference reports from several investment managers or others. This can be challenging as investment managers can report in very different ways.

4.58 This could be addressed through greater standardisation in how such information is reported to taxpayers (as is the case, for example, with employers), and the potential for investment managers to report such information directly to HMRC. This would simplify the system by making tax compliance easier for individuals.

Conclusion
4.59 The government should consider whether the role of the Annual Exempt Amount is to be as relief or allowance like the personal allowance, an administrative de minimis like the savings allowance, or a means to compensate for inflation.
4.60 Although it was a stated policy objective when increased in 1982, the OTS considers the Annual Exempt Amount is an ineffective way to compensate for inflation, as it does not consider holding periods or asset values.

4.61 It is clear however that the relatively high level of the Annual Exempt Amount distorts investment decisions. Around 50,000 people report gains annually close to the threshold (see Annex F) and so ‘use up’ the Annual Exempt Amount as if it were an allowance – which is particularly easy for holders of listed share portfolios.

4.62 A true de minimis level could be considered to lie in the range £2,000 to £4,000, below which the extra administrative burden begins to increase more steeply.

4.63 Any such change would however need to take into account the increased administrative costs, for taxpayers and HMRC, which is why in the view of the OTS it would be essential, at the same time, to take forward measures to improve administration and taxpayer experience.

Recommendation 5
If the government’s policy is that the Annual Exempt Amount is intended mainly to operate as an administrative de minimis, it should consider reducing its level.

Recommendation 6
If the government does reduce the Annual Exempt Amount, it should do so in conjunction with:

- considering reforming the current chattels exemption by introducing a broader exemption for personal effects, with only specific categories of assets being taxable,

- formalising the administrative arrangements for the real time capital gains service, and linking up these returns to the Personal Tax Account, and

- exploring requiring investment managers and others to report Capital Gains Tax information to taxpayers and HMRC, to make tax compliance easier for individuals
Chapter 5
Capital transfers

5.1 This chapter outlines the current tax implications of capital transfers and considers potential improvements to reduce distortions to family and business decision-making, including by moving more widely to a 'no gain no loss' approach, and a broader form of Gift Holdover Relief.

How capital transfers work
Interaction between Inheritance Tax and Capital Gains Tax

5.2 Inheritance Tax and Capital Gains Tax operate differently and are underpinned by separate policy rationales, as noted in the OTS’s second Inheritance Tax report.¹

5.3 Capital Gains Tax is charged on the increase in the value of an asset since its acquisition, whereas Inheritance Tax is generally levied by reference to the total value of assets transferred. Several respondents to the OTS Call for Evidence also took this view, arguing that liability for one should have no bearing on liability to the other.

5.4 Despite these differences, there is a naturally high degree of practical overlap between Capital Gains Tax and Inheritance Tax, as most of the assets on which Capital Gains Tax is levied can also attract Inheritance Tax. Many respondents emphasised this, arguing that there was a relationship between the two taxes, and that liability to one should be considered in the context of liability to the other.

5.5 An outline of how the taxes fit together can be found in the OTS’s Inheritance Tax report. Whatever philosophical view of how the taxes should fit together is taken, the OTS does not consider that they fit together coherently at present. As Diagram 5.A shows, similar transactions can lead to situations where one, both, or neither of the taxes arise. This reflects the high tax free Inheritance Tax threshold (or nil rate band), the Inheritance Tax exemptions and reliefs (namely those available for farms and businesses or for assets passing to a surviving spouse), and the Capital Gains Tax exemption on death.

5.6 The Inheritance Tax report covered some instances where the taxes interacted relatively elegantly, where one tax covered the ground vacated by the other. For instance, investments such as listed shares are included in the value of the estate on death for Inheritance Tax purposes but are not subject

to Capital Gains Tax on death. Principal private residence relief means taxpayers do not have to pay Capital Gains Tax when they dispose of their main or only residence. However, such residences are included in the value of the estate for Inheritance Tax purposes. Subject to the nil rate band and the residence nil rate band, their value is taxed on death.

Diagram 5.A: Illustration of how both or no taxes can arise with Capital Gains Tax and Inheritance Tax

Neither tax

<table>
<thead>
<tr>
<th>Assets owned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate assets that are exempt or pass to spouse</td>
</tr>
</tbody>
</table>

On death

No IHT and no CGT

Both taxes

<table>
<thead>
<tr>
<th>Assets gifted to children during life</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments including second homes</td>
</tr>
</tbody>
</table>

Transferor dies within 7 years

CGT on lifetime transfer

Possible IHT on death

Source: OTS

**Capital Gains position on death**

5.7 When someone dies, there is no Capital Gains Tax to pay on any unrealised gains that have arisen since they acquired their assets.

5.8 When someone inherits those assets, the value (or base cost) of the assets at which the inheritor is treated as acquiring them for capital gains purposes is the market value of those assets on the date of death. Any previous increase in value is wiped out. This is often known as the ‘capital gains uplift’ on death. (It is possible this rule could wipe out an accrued loss, but this is rare in practice.)
5.9 This is illustrated in Diagram 5.B which shows a gain that would be charged to Capital Gains Tax on a lifetime disposal, but not on death. The capital gains uplift applies to all capital assets, including business property, farms, residential property, shares and other investments held at death.

Diagram 5.B: Disposals in life and on death and the Capital Gains uplift

Case study 11: A sale before a death
Rushab owns a buy to let house worth £200,000 which he acquired for £100,000. He has already made several high value disposals this year so no Annual Exempt Amount is available.

He sells the house at market value giving him a tax liability of £28,000 and free cash of £172,000. Unfortunately, he dies the following year. His estate is very large and his Inheritance Tax free allowance (or nil rate band) is allocated against other assets. This triggers an Inheritance Tax liability of £68,800. His heirs consequently receive £103,200.

Case study 12: A sale after death
If instead Rushab had not disposed of the buy to let in his lifetime, but hung onto it for a little longer, Inheritance Tax of £80,000 would have been due but there would have been no Capital Gains Tax if his heirs sold it the day after they had inherited it. His heirs would then have received a net £120,000 when they disposed of it.
Diagram 5.C shows more clearly how the sequencing of transactions can have a material effect on the tax due, again assuming all thresholds have been used up by other gains or assets.

**Diagram 5.C: Effects of the time at which disposals are made**

Source: OTS

**Observations**

**The death uplift**

5.11 The OTS has heard from numerous advisers that although there are a range of factors in succession planning, it is unhelpful that Capital Gains Tax pushes many people towards waiting until death to transfer assets.

5.12 This is one aspect of the lock in effect, explored in Chapter 2. Where an individual holds an asset that has risen in value, and is considering transferring it during life, they are often advised to retain it until death rather than giving it away during their lifetime, because of the Capital Gains Tax benefits. So the absence of Capital Gains Tax on or after a death is another factor in the lock in effect. It is perhaps one reason why 66% of respondents to the OTS survey said that Capital Gains Tax was a barrier to passing on assets.²

5.13 The OTS has explored this issue previously in relation to assets which are exempt from Inheritance Tax but as Case Studies 11 and 12 show it is also relevant for assets liable to Inheritance Tax.³

5.14 Although some business assets already benefit from relatively favourable treatment through Business Asset Disposal Relief or Gift Holdover Relief, the death uplift is still more generous than both. Some advisers suggested that it would simplify decision-making around succession if there were no capital gains uplift. Individuals would be able to focus on when the time is right to pass on their assets without being influenced by this.

5.15 The different treatment of capital gains as between disposals of assets on death and in life runs counter to the principle of neutrality. In other words, it is not clear what the policy reason is for the situation in Case Study 11 to be treated less favourably than Case Study 12.

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² OTS survey. As of 12.10.2020

5.16 The OTS has heard, during several of its reviews, of businesses (including farming businesses) being adversely affected because these tax issues have prompted owners to remain in charge longer than would otherwise be desirable. Of course, tax may not be the primary driver, but it is unhelpful that the tax system has the capacity to distort decision-making in this way.

No gain no loss

5.17 Freedman has argued that a ‘complete uplift of the base cost on death resulting in exemption, as is given in the UK, is unnecessary.’

5.18 An alternative, to seek to reduce these distortions, would be a ‘no gain no loss’ approach, where the recipient is treated as acquiring the assets at the historic base cost of the person who has died. Such an approach is adopted in Australia and Germany (although it should be noted that, in Australia there is no Inheritance Tax and that certain long held small businesses are exempt from Capital Gains Tax).

5.19 To minimise the administrative burdens the OTS would envisage that the executors calculate notional capital gains on death as part of or alongside their Inheritance Tax calculations. They could record this on ‘executor certificates’ of gains which the beneficiary could then refer to if they later made a sale.

5.20 An example of how this sort of approach could operate is shown in Diagram 5.D.

Diagram 5.D: Illustration of no gain no loss approach

*Assumes an adjustment for future tax liabilities
Source: OTS

5.21 The OTS explored this area in its Inheritance Tax report, when recommending moving to a no gain no loss approach where a relief or exemption from Inheritance Tax applied.

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4 Freedman, ‘Treatment of capital gains and losses' in Peter Essers and Arie Rijkers (eds), The Notion of Income from Capital (IBFD 2005)
5.22 The OTS recognises that this proposal was unpopular with some tax advisors and accepts that there would be some administrative challenges with this approach.

5.23 An alternative to removing the Capital Gains Tax uplift where there is an Inheritance Tax exemption would be to make it conditional on the beneficiary holding on to the asset. The OTS considers that this brings its own challenges, as it could alter the way Inheritance Tax is effectively borne as between beneficiaries and any retention time limit itself creates a distortion. It could also entrench poor quality management if it meant that beneficiaries only held onto a business to benefit from the tax relief.

5.24 The OTS considers that there is a good case for exploring whether such a no gain no loss approach should be extended more widely, as this would reduce the extent to which the timing of disposals cut across commercial incentives or personal preferences.

5.25 About 90% of wealth transfers happen on death in the UK\(^7\) so this change would bring the gains on these wealth transfers within the scope of Capital Gains Tax. In the short term the static Exchequer yield from Capital Gains Tax could on average raise between £470 million and £900 million extra each year, depending on the rate at which people dispose of assets after inheriting them.

5.26 Over a period of more than 20 years, as more people receive and dispose of assets on a no gain no loss basis, the Exchequer yield could potentially rise to around £1.6 billion at today’s asset values (with the actual value being higher with asset growth). However, this would be reduced by any changes to the way that Capital Gains Tax interacts with Inheritance Tax and due to changes in taxpayer behaviour.

5.27 If Capital Gains Tax rates were raised generally, this would be likely to increase the existing lock in effect. So if such a change were considered, government might wish to consider extending the no gain no loss principle at same time to mitigate this. While it would reduce the lock in effect in many situations, in other situations, such as for people with newly inherited assets it would have the opposite effect.

5.28 If the government were minded to consider no gain no loss on death then it would strengthen the case for a reintroduction of indexation relief, discussed in Chapter 2. Otherwise the no gain no loss approach could mean an increasing number of intergenerational family businesses, which are likely to have been owned for many years, would face paying tax on purely inflationary gains, on those occasions when they are sold.

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No gain no loss and main residence relief

5.29 The OTS envisages that if a no gain no loss approach were adopted the gains arising before death on a main or only home would continue to be exempt. This could, for example, be achieved by ensuring that the Capital Gains Tax free status of the period of occupation is preserved, where the sale is made by the personal representatives (executors of a will or administrators of an intestacy) or beneficiaries.

No gain no loss and interactions with Inheritance Tax

5.30 If government introduced a no gain no loss approach, further thought would have to be given to the extent to which to seek to maintain neutrality in situations where Inheritance Tax was also due.

5.31 If the objective were to make succession decisions more neutral and avoid a new distortion in favour of lifetime transfers, there would be a need to consider how to take account of the capital gain that has been accrued (but not realised) on death.

5.32 Two potential ways of doing this are:

- the value of the estate for Inheritance Tax purposes could be reduced by the amount of the capital gains that would be chargeable if the asset had been sold at the time of death (so that in this case the estate is treated as reduced by £28,000 before the Inheritance Tax is calculated)

- or, reversing this, the full rate of Inheritance Tax could be paid upfront (in this case £80,000), with a credit then being applied against the eventual sale of the asset (so in this case £11,200 of the Inheritance Tax could be set against the £28,000 Capital Gains Tax bill)

5.33 These options would not be simple to apply in every case but there are precedents to draw on as there are already some specific circumstances where Inheritance Tax can be offset against Capital Gains Tax. Improvements to the Personal Tax Account could also help calculate and keep track of the information needed.

5.34 If the government was less concerned to preserve neutrality between disposals made just before and just after death, an administratively simpler solution would be to charge Inheritance Tax and Capital Gains Tax on death quite separately. In the case above this would change the Inheritance tax liability to £80,000, leave the Capital Gains Tax liability of £28,000 unchanged, and so only leave the beneficiary with £92,000 after tax – as opposed to £103,200 if the disposal had happened just before death.

5.35 Careful thought would be needed to assess the extent to which it was desirable to main neutrality and how this should be addressed. The government would need to balance ease of understanding, exchequer impacts, and burdens on both HMRC and taxpayers, and consider how the rules would operate in relation to trusts, those relocating offshore, or will variations.

5.36 However, the OTS considers these challenges are well worth exploring.
Valuations and rebasing

5.37 A no gain no loss approach would add to the existing challenge of drawing upon historic valuations. Such a process would require personal representatives (executors of a will or administrators of an intestacy) to establish historic base costs. If the deceased had not kept these, this could be difficult.

5.38 The OTS heard different views on this, with some respondents noting that records of land transactions were commonly retained easily (albeit that enhancement expenditure may be harder to identify). The OTS heard that record keeping standards vary widely, and in some cases, it would be impossible to find either the date of acquisition or the base cost of an asset.

5.39 Although the OTS has not been able to quantify it, the OTS recognise this challenge and offer two potential options to mitigate the problem:

- a rebasing of all assets to a set date (in place of the existing date of 1982)
- a new allowance for executors of small estates

5.40 Any new rebasing date would need to apply equally in lifetime and on death to prevent the measure distorting taxpayer behaviour.

5.41 The OTS has been told by professional valuers that valuations of land and property become much easier from the late 1990s onwards due to increasing registration with the land registry and widespread digitalisation. However, the OTS has heard that it would still be difficult for many taxpayers to find accurate base costs unless the rebasing date was much closer to the present day.

5.42 Further work would be required to ascertain exactly what date would be the most appropriate as the government would have to balance Exchequer considerations against the administrative challenges for taxpayers. However, the OTS offers the year 2000 as a starting point for this debate.

5.43 It is estimated that a new rebasing date of 2000 would cost the Exchequer between £200 million and £500 million per year in the first few years although this will decline over time.\(^8\)

5.44 This measure would benefit those with assets which rose in value before the rebasing date and would not equally benefit all taxpayers. The OTS consider that the merits of this should be looked at in the round. It could be a reasonable way to help facilitate a step towards a more neutral system.

5.45 The current rebasing date is 31 March 1982 and due to the number of years that have passed since this date, most assets that are sold can use their actual base cost rather than requiring a valuation.

5.46 A move to a more recent rebasing date for all assets would cause a large increase in the number of taxpayers who acquired assets prior to the new rebasing date. These taxpayers would need to obtain a valuation, rather than using their historic base cost. Some of these taxpayers would face additional

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\(^8\) HMRC analysis, please see Annex F for explanation.
complexity and cost as a result, even where they kept detailed records. It would also lead to more taxpayers engaging with HMRC to agree valuations. So it would not be a simplification in every case.

5.47 Detailed work would be required to work through how rebasing would apply on transition and in a range of specific situations, including where assets are transferred into trust.

5.48 An alternative way to ease the challenge of historic valuations could be to consider whether a specific allowance could be provided for personal representatives (executors of a will or administrators of an intestacy). This could protect some smaller estates from being brought into tax on disposals immediately following a death.

5.49 This allowance could take the form of an increased Annual Exempt Amount. Notwithstanding the broader issues in relation to the level of Annual Exempt Amount considered in Chapter 4, there could be a case for a higher amount in this context.

5.50 Alternatively, the proceeds of lower value assets sold in the administration period could be exempted, entirely freeing personal representatives from ascertaining base costs of low value items.

5.51 The OTS has considered alternative methods to reduce the burden on taxpayers, including a method of ‘reverse indexation’, working backwards in time from a present-day market value.

5.52 This would not be a valuation (as it would rely on future information) but could provide an alternative basis for arriving at a figure to use. While this could offer certainty more easily, it could also give very different outcomes (whether higher or lower), which could lead to pressure to be allowed to use a true valuation if preferred, which is likely to lead to greater complexity overall.

5.53 While there are credible indices for some types of asset, such as residential or commercial property, for other types of asset, a suitable index does not exist. In these cases, a figure arrived at using reverse indexation is likely to be far removed from the true valuation - such as in the example of a painting which only became valuable after the death of the painter or for unlisted shares which can grow in value in an unpredictable way over time.

5.54 Accordingly, a system of reverse indexation would not generally feel as if it was a simplification and would require further consideration about its desirability, detailed policy design, and Exchequer implications.

Capital gains on death

5.55 Some respondents advocated reintroducing Capital Gains Tax on death as an alternative to Inheritance Tax, in line with comments the OTS received during its work on the Inheritance Tax report.

5.56 As that report explained, 30,500 more people would be brought into the scope of such a charge on death than are currently subject to Inheritance Tax and overall about £3.8 billion less tax would be raised (assuming primary
residence relief was unaffected). So this approach has not been considered further as part of this review.

**Lifetime gifts**

5.57 The OTS has been told that one of the main barriers to people passing on assets at the most appropriate time for them is the lock in effect created by the death uplift. In addition, several respondents to both the Call for Evidence and Survey emphasised that paying tax in situations where they have no cash to pay it, such as when one makes a gift, also presents a significant barrier.

**Gift Holdover Relief**

5.58 Usually gifts attract Capital Gains Tax in the same way as sales. But there is one important relief from Capital Gains Tax that can apply to some lifetime gifts, known as Gift Holdover Relief.

5.59 Where a trading business is given away during a person’s life, the rules allow that a claim to Gift Holdover Relief may be made, so there is no immediate charge to Capital Gains Tax. Instead, the recipient is treated as acquiring the asset at the donor’s historic acquisition cost and no gains arise until there is a subsequent disposal.

5.60 The original reason for the relief was ‘to avoid a form of double taxation’ between Capital Gains Tax and Capital Transfer Tax which would have applied until Capital Transfer Tax became Inheritance Tax in 1984.\(^9\)

5.61 Gift Holdover Relief used to apply to a broader range of assets but was restricted to trading assets in 1989 because government believed it ‘is increasingly used as a simple form of tax avoidance’.\(^11\) One reason for this is that it allowed a taxpayer to make transfers to relatives and for each of them to benefit from the Annual Exempt Amount on subsequent sales. Anti-avoidance legislation was maintained for gifts to non-UK residents, trusts and companies to prevent any continuing abuse of this relief. If the Annual Exempt Amount were substantially reduced as explored in Chapter 4, then this sort of avoidance is unlikely to reoccur.

**An expansion of Gift Holdover Relief**

5.62 If there were a move towards a no gain no loss approach on death the OTS considers that there would be a good case for an expansion of Gift Holdover Relief to include non-business assets, making any subsequent sale rather than the gift the time Capital Gains Tax is paid.

5.63 This would contribute to making succession decisions more neutral, facilitate the early transfer of assets and fit well with the OTS’s recommendation in its Inheritance Tax report to reduce the Inheritance Tax gifting period to 5 years.


5.64 Some respondents have argued such an approach could lead to some assets never being taxed as they would be able to simply pass down through successive generations or to people who moved abroad. However, the way Inheritance Tax and Capital Gains Tax interact already facilitates holding onto assets across generations through the zero-tax outcomes outlined in Chart 5.B.

5.65 Other respondents argued that the Capital Gains Tax system should maintain its relatively more generous treatment for business assets. The OTS accepts that Gift Holdover Relief is important for business assets but maintaining a situation in which tax must be paid on gifts of non-business assets, where no cash has been realised, is also undesirable.

5.66 To minimise the avoidance of fragmentation of the asset between family members reforms to the Annual Exempt Amount might be desirable (see Chapter 4). The existing anti-avoidance rules would need to be reviewed in particular with regard to individuals leaving the UK.

5.67 The OTS recognises that the expansion of Gift Holdover Relief to more assets would have a significant Exchequer cost – for example, expanding it to residential property would cost in the region of £310 million a year, against an existing Exchequer cost of £320 million a year in relation to business assets.\(^\text{12}\)

Conclusion

5.68 The OTS considers that at present, the way Inheritance Tax and Capital Gains Tax interact is incoherent and distortionary. Comparable transactions can lead to situations where either one, both, or neither of the taxes arise.

5.69 There is a significant ‘lock in effect’, discouraging people from disposing of assets before they die, because no Capital Gains Tax is charged on death, and anyone inheriting the asset does so at its then market value for the purposes of calculating gains on a subsequent sale (the so-called death uplift).

5.70 The OTS previously explored these issues in its Inheritance Tax report, recommending that one taxpayer should not both get an Inheritance Tax exemption and a Capital Gains Tax death uplift. The OTS considers there is also a case for going further, as there would still be an incentive to hang onto some assets until death in a range of other situations, in particular in relation to gifts.

5.71 Usually gifts attract Capital Gains Tax in the same way as sales. The OTS has heard that this can impede intergenerational transfers and is a barrier to the economic use of some assets. So if the government removed the capital gains uplift on death, the OTS consider it should also consider extending Gift Holdover Relief to a broader range of assets.

5.72 While a no gain no loss approach on death would reduce a major distortion, it would increase the range of occasions on which there would be an administrative challenge in calculating historic base costs. So if government

\(^{12}\) HMRC data 2017-18. Please see Annex F for explanation.
removed the capital gains uplift on death, the OTS considers the government should look at a rebasing of all assets, perhaps to the year 2000.

5.73 Taken as a package, these proposals could potentially raise money for the Exchequer over the longer term. Though the effect of any one of them on overall tax yield would be affected by the others, the initial estimates of each of them are calculated individually.

5.74 It is for the government to determine, and communicate, its view of the principles behind, and role of, the tax in framing its policy. Alongside any move to no gain no loss, careful consideration would need to be given to the economic implications, the relative balance of tax paid by lower and higher income people and those of similar means, its other policy objectives, and of course the yield.

5.75 The OTS recognises there will be trade-offs to consider but seeks to highlight some of the ways in which the present position distorts behaviour or makes things complex in practice. In particular, the OTS notes that if government introduced no gain no loss it would reduce a major distortion but could increase administrative burdens for some individuals (such as those dealing with an estate) even after the proposed mitigations.

Recommendation 7
Where a relief or exemption from Inheritance Tax applies, the government should consider removing the capital gains uplift on death, and instead provide that the recipient is treated as acquiring the assets at the historic base cost of the person who has died.

Recommendation 8
In addition, the government should consider removing the capital gains uplift on death more widely, and instead provide that the person inheriting the asset is treated as acquiring the assets at the historic base cost of the person who has died.

Recommendation 9
If government does remove the capital gains uplift on death more widely, it should:
• consider a rebasing of all assets, perhaps to the year 2000
• consider extending Gift Holdover Relief to a broader range of assets
Chapter 6
Reliefs and losses

Overview
6.1 There are many different Capital Gains Tax reliefs, which have evolved over many years.
6.2 Generally, these reliefs fall into three categories:
   • reliefs to encourage investment
   • reliefs to prevent tax charges arising where there are no proceeds with which to pay the tax; and
   • reliefs for specific assets such as for medals or in relation to heritage
6.3 This chapter focuses on Business Asset Disposal Relief (which replaced Entrepreneurs’ Relief), Investors’ Relief and relief for losses.
6.4 These reliefs generated the most comment from respondents and have not already been covered elsewhere. Chattels Relief is considered in Chapter 4 and Gift Holdover Relief in Chapter 5.

Business Asset Disposal Relief
Overview of the relief
6.5 Capital Gains Tax has always given specific relief for the disposal of certain business assets, ever since its introduction in 1965.
6.6 Initially this took the form of Retirement Relief, later overtaken by Taper Relief, Entrepreneurs’ Relief and Business Asset Disposal Relief.¹
6.7 Business Asset Disposal Relief reduces the Capital Gains Tax payable on the disposal of qualifying business assets, by charging the gains at a special rate of 10%.
6.8 In conjunction with Entrepreneurs’ Relief giving way to Business Asset Disposal Relief in March 2020, the lifetime limit for claiming the relief was significantly reduced from £10 million to £1million. This followed a report published in July 2019 by the Office for Budget Responsibility, which showed that the cost of the relief to the Exchequer had increased significantly.

¹ Please see Annex E.
6.9 In his Budget speech in March 2020, Chancellor Rishi Sunak described Entrepreneurs’ Relief as: ‘Ineffective – with less than 1 in 10 claimants saying the relief has been an incentive to set up a business.’

6.10 According to HMRC’s published statistics for 2018-19: In 2018-19, Entrepreneurs’ Relief (ER) was claimed on £27.7 billion of gains. […] The number of taxpayers claiming Entrepreneurs’ Relief increased by 7% to 46,000 between 2017-18 and 2018-19. The number of ER claimants has fluctuated between 40,000 and 51,000 between the last six years for which data is available.

The rationale for the relief

6.11 The earliest form of the relief was Retirement Relief, which, broadly, was given to individuals who were aged 60 or over (later 50 or over) against capital gains on the disposal of their business where the necessary conditions were satisfied throughout a period of 10 years. This relief was seen by many as a recognition that their business can operate as an alternative to a pension and represent many years of continuing re-investment.

6.12 Retirement Relief was phased out in 2003 on the grounds (questioned by some respondents to the OTS Call for Evidence) that it was too complex and too narrowly targeted, and replaced by Taper Relief which was intended would, as Chancellor Gordon Brown said in 1998 ‘better…reward risk taking and promote enterprise’.

6.13 Taper Relief was itself abolished in April 2008 as part of another ‘simplification’ package (following a period of further discussion and representations from small businesses) and was replaced by Entrepreneurs’ Relief. Chancellor Alistair Darling justified this on the grounds that the new relief would ‘encourage entrepreneurship’ and ‘benefit the owners of small businesses when they choose to sell their businesses, as well as business angels and other business investors who take a 5 per cent or greater stake in the company concerned’.

Does Business Asset Disposal Relief encourage entrepreneurship?

6.14 The OTS recognises that there is a policy judgement about the extent to which Capital Gains Tax reliefs should be used to seek to stimulate business investment and risk-taking.

6.15 The OTS has been told that Business Asset Disposal Relief is especially important in encouraging founders of businesses to grow and scale up their business. One respondent said that without a lower rate of tax on his eventual sale he would not have worked nearly so hard to grow the business.

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5 https://hansard.parliament.uk/Commons/2008-01-24/debates/08012472000004/CapitalGainsTax
6.16 However, the idea that Business Asset Disposal Relief is an effective means to stimulate risk-taking investment has been questioned by many, including several respondents to the OTS Call for Evidence.

6.17 A venture that appears very likely to be successful will attract investment much more than one that appears very likely to fail, irrespective of the tax rate. It is the riskier or marginal cases that might require incentivisation and a promised tax advantage that may never materialise on an anticipated gain that equally may never materialise is unlikely to be compelling.

6.18 Respondents said that risk-taking would be better encouraged by smaller upfront cash relief, than by an eventual reduction in a tax liability on disposal. This is because, at the point of investment, investors are interested in the overall return and not the tax position.

6.19 An example is the Enterprise Investment Scheme, which provides upfront Income Tax relief for external investors. Many respondents said that the Enterprise Investment Scheme also encourages repeated investment, which some described as ‘entrepreneurial activity’, especially through the Capital Gains Tax deferral relief it provides for those who have made a gain and want to re-invest.

6.20 The OTS does not consider that the rate of tax on an eventual disposal of an investment is an effective means to incentivise the investment in the first place and that incentives for investment, if required, should apply at the time the investment decision is made.

6.21 Accordingly, the OTS considers that Business Asset Disposal Relief is mistargeted if its objective is to stimulate investment and risk-taking by business owners.

**Does Business Asset Disposal Relief create more technical complexity or distort behaviour?**

6.22 Respondents expressed concerns about the Business Asset Disposal Relief requirement for a 5% qualifying shareholding, highlighting cases where a company board is keen for a founder member to move on, but the member insists on keeping a 5% shareholding in order to keep his eligibility to the relief, which can distort behaviour.

6.23 Having a separate tax rate for Business Asset Disposal Relief adds its own complexity to a capital gains system that already has multiple rates, as noted in Chapter 2.

6.24 Despite the March 2020 reduction in the Business Asset Disposal Relief lifetime limit, the significant differential between Income Tax and Capital Gains Tax rates may still make it attractive for some to seek to re-characterise income into gains in order to use the relief.

6.25 Respondents also pointed to specific avoidance behaviour around voluntary liquidations, asking if the government could simply remove Business Asset Disposal Relief in such situations, as discussed in Chapter 3.
Would Business Asset Disposal Relief be better targeted on retirement?

6.26 Business Asset Disposal Relief and its predecessors have also long been understood as having another objective – as a specific relief when business owners retire. This was originally seen by many as a recognition that their business can operate as an alternative to a pension and represent many years of continuing re-investment.

6.27 The following case study is based on a response to the OTS Call for Evidence and illustrates the importance that can be placed on Business Asset Disposal Relief by small business owners.

Case study 13
Rhena is a small business owner. Ever since she started her company in 2001, she had understood she would have some level of exemption from Capital Gains Tax through Entrepreneurs’ Relief.

She accordingly planned to use this when getting a capital gain from her business activities and to use this both to start new ventures and to set aside a sum for retirement.

Rhena knew she could have opted for a personal pension scheme or to take more money out of the business but chose this route and reinjected as much profit as possible to grow the business.

Having created dozens of jobs in one company alone, she would like to use the capital gains from her current business to go on and fund new businesses but because of the changing tax rules may not feel able to do this.

6.28 Some respondents suggested that a better relief for business owners could be provided by mirroring features or the eligibility criteria of the pension system. The government would have to weigh up the practicalities of how business owners operate with the wider objectives of the pension system. It would also have to carefully set out its rationale for any changes in order to manage the legal risks associated with restricting tax reliefs to certain age groups. In any event, the OTS sees merit in considering the future of Business Asset Disposal Relief in the wider context of provision for retirement.

Conclusions

6.29 The OTS considers that there is still a strong case for the existence of a Capital Gains Tax relief in relation to retiring business owners, particularly those who founded or scaled up their company. However, Business Asset Disposal Relief is currently broader than this, and so would require reform were it to specifically address this objective.

6.30 If this were the objective the OTS suggests that the government start by considering:
• increasing the minimum shareholding to perhaps 25%, so that the relief goes to owner-managers rather than more passive investors
• increasing the holding period to perhaps 10 years, to ensure the relief only goes to people who have built up their businesses over time
• reintroducing an age limit, perhaps linked to the age limits in pension freedoms, to reflect the intention that it should mainly benefit those who are retiring (noting however that introducing an age limit would compound the lock in effect for those approaching retirement.)

6.31 In making any changes in this area government should also be mindful of those who would lose out, in particular younger people making disposals of smaller shareholdings.

Recommendation 10
The government should consider replacing Business Asset Disposal Relief with a relief more focused on retirement.

Investors’ Relief
Overview of the relief
6.32 Investors’ Relief was announced at Budget 2016 as an ‘extension of Entrepreneurs’ Relief’ to external investors in unlisted trading companies, with the relief intended to be a support to unlisted companies in accessing capital.  

6.33 The relief operates by applying a 10% rate of Capital Gains Tax on the disposal of qualifying shares after a minimum holding period of three years, starting from 6 April 2016. A person’s qualifying gains for Investors’ Relief are subject to a lifetime cap of £10 million. Shares must be newly issued and held by an individual who is not an employee of the unlisted trading company.

6.34 When the relief was launched the government stated that: “The government wants to create a strong enterprise and investment culture and ensure that companies can access the capital they need to expand and create jobs. Extending ER to external investors is intended to provide a financial incentive for individuals to invest in unlisted trading companies over the long term.”

Effectiveness of the relief
6.35 The OTS recognises that Investors’ Relief is a new relief, which investors have been able to claim only in relation to investments made from April 2016 onwards and disposed of from April 2019 onwards.

6.36 Evidence relating to the extent to which relief has been claimed to date is therefore necessarily limited.

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7 https://www.gov.uk/government/publications/capital-gains-tax-entrepreneurs-relief-extension-to-long-term-investors/capital-gains-tax-entrepreneurs-relief-extension-to-long-term-investors#:~:text=This%20new%20investors%20relief%20will,held%20for%20a%20period%20of
6.37 However, the OTS has received many responses which refer to Investors’ Relief, the overwhelming message of which was that Investors’ Relief is simply not being used. These responses came from a wide range of people including investor groups, accountants, lawyers and individuals and their message was virtually unanimous – almost no-one has shown any interest in this relief or is using it. This evidence is further supported by the results of the OTS’s online survey, with only 5% of those responding indicating that they would envisage using this relief.

6.38 Some respondents did feel that Investors’ Relief should be given more time, and wondered for example whether investments in the future might be made by directors’ spouses, given the disparity that now exists between the lifetime limits of Investors’ Relief (£10 million) and Business Asset Disposal Relief (£1 million). But there is no evidence that this is likely to be the case, and the OTS considers that despite the newness of the relief, the lack of evidence about its effectiveness is striking.

Reasons for the limited effectiveness of the relief

6.39 If the relief is not being used, then the relief is not having its stated policy effect (to enable unlisted trading companies to secure additional investment).

6.40 One explanation for this from respondents to the call for evidence was that people who invest in multiple small companies not listed on the stock exchange tend to do so through a company rather than in their own names.

6.41 In addition, as with Business Asset Disposal Relief, a tax relief that applies on an eventual disposal does not influence decisions at the point of making the investment (see above).

Recommendation 11
The government should abolish Investors’ Relief.

6.42 If the government believe there is a remaining need to encourage investment in unquoted trading companies the OTS considers that it should explore other ways to do this.

Loss Relief
Background

6.43 When taxpayers realise a capital loss on the disposal of a chargeable asset, tax relief is available for the loss. Capital losses may be set against gains (and, in restricted circumstances, income).

6.44 Capital losses are first offset against gains realised in the same tax year, before deducting the Annual Exempt Amount. Remaining losses in a tax year are carried forward to offset against the net amount of gains and losses of future tax years, this time after the deduction of the Annual Exempt Amount.

6.45 Capital losses can be carried forward indefinitely. There are also a limited number of specific situations in which they can be carried back to offset against gains in earlier years.
However, to be carried forward a loss has to be calculated and notified to HMRC within four years of the end of the tax year in which it was incurred.

**Who uses losses?**

Chart 6.A illustrates the gains and losses realised by taxpayers with different level of taxable income in the 2017-18 tax year. The total losses reported for the 2017-18 tax year were £5.0 billion and in the ten tax years from 2008-09 to 2017-18 the average total of losses reported was £5.2 billion.\(^8\)

**Chart 6.A: Gains and losses reported for tax year 2017-18 by income bracket**

![Chart 6.A: Gains and losses reported for tax year 2017-18 by income bracket](image)

*Source: HMRC*

Taxpayers with incomes over £45,000 make the most losses and gains: over 70% of both, with 45% of losses reported by taxpayers with incomes over £150,000.

The ratio of losses to gains in each income category (except ‘Unknown’) is between 7% and 9%, with an overall ratio of 9%.

A significant proportion of losses, by total amount and by frequency, relate to the disposal of listed shares as illustrated in Chart 6.B.

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\(^8\) HMRC
6.51 Losses on listed shares were reported by 114,000 taxpayers and the average was £17,000. (See Annex F for further information.)

6.52 This reflects both the volatile nature of listed shares and the relative ease with which they can be sold. This may assist taxpayers in planning to maximise the loss relief available, subject to commercial considerations and the anti-avoidance rules about what is often referred to as the “bed and breakfasting” of shares.

**Losses and the Annual Exempt Amount**

6.53 Some respondents to the Call for Evidence argued that the order in which losses and the Annual Exempt Amount are taken into account is anomalous.

6.54 The present approach to offsetting losses has been the same for many years and is well understood.

6.55 There would be two possible ways to ensure that there is consistency:

- apply current year losses after the deduction of the Annual Exempt Amount; or
- apply brought forward losses before the Annual Exempt Amount.

6.56 The first option would mean that a taxpayer would have more losses to carry forward to offset against future gains. However, it is not clear this would be a simplification.

6.57 This is because currently, a taxpayer often has only to consider their gains and losses in a given tax year: if their net gains are below the Annual Exempt Amount, they do not need to consider their brought forward loss position or make a claim – their need to calculate losses and gains stops there.

6.58 However, if the Annual Exempt Amount was deducted against current year gains first, then a taxpayer would still have to consider their capital losses in...
that year. Otherwise in a future year when a taxpayer needs to use those losses, they would not have the information to hand or, most importantly, would not have notified HMRC within the required time limit.

6.59 It is not clear that the second option of deducting brought forward losses before the Annual Exempt Amount would be a simplification either.

6.60 To change the position for brought forward losses in order to achieve a notional consistency would be a real cost to the taxpayer who may consider that they are not receiving the full benefit for their brought forward losses. This would reduce the amount of losses that are available to be carried forward by £200 million per year.\(^9\)

**Carrying back losses**

6.61 Other respondents argued that the use of losses is very restrictive, and it has been suggested that there should be an ability to carry back a capital loss one year so that it aligns with trading losses, as well as flexibility on the use of losses between connected parties.

6.62 Currently loss carry back is restricted to losses made by a taxpayer in the year of death which can be carried back for a maximum of 3 years, as well some specific rules in relation to the sale of shares in a private company.

6.63 However, the downside of extending carry back loss relief is that a taxpayer would have to revisit their previous year’s tax return and HMRC would need to process the tax repayment producing an additional administrative burden. If rates were the same in later years, a taxpayer would simply have accelerated the tax relief on these losses, which would otherwise just be carried forward.

**Carrying forward losses**

6.64 The OTS also considered whether there should be limit on the number of years that taxpayers can carry forward a loss as is the case in some other countries, with time limits varying from five (Indonesia) to eight years (India).\(^10\)

6.65 Such an approach could help to reduce the burden of record keeping in some cases. The OTS were told that many taxpayers don’t know they need to report losses and even when they do, they struggle to maintain adequate records over a period of years.

6.66 However, the OTS do not consider that this would be a simplification as it would be necessary for a taxpayer to keep a detailed record of when each loss arose rather than just have one brought forward amount as is currently the case. As Chart 6.C below demonstrates any restriction to limiting the number of years that a taxpayer could carry forward a loss would significantly add to the gains brought into charge, as the stock of available losses withers away. This would result in taxpayers never being compensated for their losses despite continuing to make investments and gains.

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\(^9\) 2018/2019 HMRC SA data.

Chart 6.C: Estimated total gains for tax year 2017-18 if the period for carrying forward losses is restricted

<table>
<thead>
<tr>
<th>Restricted loss carry forward period (years)</th>
<th>Actual</th>
<th>Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>55,000</td>
<td>56,000</td>
</tr>
<tr>
<td>1</td>
<td>56,000</td>
<td>57,000</td>
</tr>
<tr>
<td>2</td>
<td>57,000</td>
<td>58,000</td>
</tr>
<tr>
<td>3</td>
<td>58,000</td>
<td>59,000</td>
</tr>
<tr>
<td>4</td>
<td>59,000</td>
<td>60,000</td>
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<tr>
<td>5</td>
<td>60,000</td>
<td>61,000</td>
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<tr>
<td>6</td>
<td>61,000</td>
<td>62,000</td>
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<tr>
<td>7</td>
<td>62,000</td>
<td>63,000</td>
</tr>
<tr>
<td>8</td>
<td>63,000</td>
<td>64,000</td>
</tr>
<tr>
<td>9</td>
<td>64,000</td>
<td>65,000</td>
</tr>
<tr>
<td>Total net gains (£ millions)</td>
<td>55,000</td>
<td>56,000</td>
</tr>
</tbody>
</table>

Source: HMRC

6.67 If the carrying forward of losses were restricted then the amount of net gains would increase, becoming greater the shorter the restricted period. This is because taxpayers would lose the benefit of claiming losses that had been timed out. (See Annex F for more details on this estimate.)

6.68 There is also an inconsistency in the benefit of capital losses to taxpayers as a result of there being four different rates of Capital Gains Tax. For example, a taxpayer could have brought forward losses which are offset against a gain taxable at 10%, whereas another taxpayer offsets a loss against a gain taxable at, say, 28%. This would be partly addressed if the number of different rates were reduced. This inconsistency also arises when there is a change in the rates of Capital Gains Tax.

Setting losses against taxable income

6.69 A minority of respondents suggested that taxpayers should be able to offset capital losses against income to a greater extent.

6.70 There are a few specific situations where this is already possible – such as for example capital losses arising on the disposal of shares in an Enterprise Investment Scheme qualifying company. It is considered that there is specific justification for this relief as it encourages the taxpayer to invest in smaller companies which by their nature are normally a more higher risk investment.

6.71 The great majority of countries only allow capital losses to be offset to be against capital gains, Indonesia being one exception.

6.72 As Income Tax rates are higher than Capital Gains Tax rates, allowing capital losses to be offset against income would give some taxpayers a greater economic benefit. As illustrated in Chart 6.A above, there are £2.3 billion of losses in the 2017-18 tax year for taxpayers in the Income Tax bracket above £150,000. If these capital losses could be offset against income, then the tax relief would be given at 45%. The OTS consider that there may be a case for
losses to be set against income to a greater extent if the rates of Income Tax and Capital Gains Tax were more closely aligned.

**Conclusion**

6.73 The OTS considers the regime for losses to be generally fit for purpose. The OTS does not recommend changes to how losses interact with the Annual Exempt Amount, how losses can be carried back, how losses can be carried forward, or how capital and income losses intersect.

6.74 However, as considered in Chapter 2, if the rates of Income Tax and Capital Gains Tax were more closely aligned, the OTS sees a case for considering a more flexible use of capital losses.
Annex A
Scoping document

A.1 This scoping document was published on 14 July 2020.

Capital Gains Tax Simplification Review

Capital Gains Tax is charged on the chargeable gains of individuals and trusts. Chargeable gains made by companies are charged to corporation tax. Both taxes were introduced in 1965 and have a common core of rules, while having changed and diverged from each other somewhat since then.

The Chancellor of the Exchequer has requested that the Office of Tax Simplification (OTS) carry out a review of Capital Gains Tax and aspects of the taxation of chargeable gains. The review will identify, and offer advice to the Chancellor about, simplification opportunities relating to administrative and technical issues affecting individuals, partnerships, and unincorporated or single entity owner-managed companies, as well as areas where the present rules can distort behaviour or do not meet their policy intent.

The OTS has touched on aspects of Capital Gains Tax and the taxation of chargeable gains in some previous reports, but this is the first time the OTS will have looked more widely at this area.

The OTS will publish a call for evidence and may publish more than one report on its findings.

Scope of Review

The review will consider Capital Gains Tax and the taxation of chargeable gains in relation to individuals and smaller businesses and develop recommendations for simplification including reducing distortions from both an administrative and technical standpoint.

This will include consideration of general areas such as:

• the overall scope of the tax and the various rates which can apply
• the reliefs, exemptions and allowances which can apply, and the treatment of losses
• the Annual Exempt Amount and its interactions with other reliefs
• the position of individuals, partnerships and estates in administration
• the position of unincorporated businesses and stand-alone owner-managed trading or investment companies, including the setting up, selling or winding up of such businesses or companies
• any distortions to taxpayers’ personal or business investment decisions

• interactions with other parts of the tax system such as income tax, Capital Allowances, Stamp Taxes and Inheritance Tax, including potentially different definitions for similar transactions/events.

It will also look at more specific areas such as administrative or technical issues relating to

• clearance and claims procedures

• chargeable gains on shares and securities, including holdings of listed shares

• the acquisition and disposal of property

• the practical operation of principal private residence relief

• consideration of the issues arising from the boundary between income tax and capital gains tax in relation to employees

• valuations, record-keeping, calculating any tax payable and making returns, including claiming losses

• the information HMRC have and can use to help them reduce administrative burdens, improve customer experience and ensure compliance.

In keeping with the focus on smaller businesses and individuals, this review will, in particular, not extend to issues specific to corporate groups, such as substantial shareholding exemption, company reorganisations or demergers.

**Further guidance for the review**

In carrying out its review, the OTS will

• research widely among all stakeholders

• have regard to the effect of the tax and its reliefs on investment and the productive use of assets

• consider the likely implications of recommendations on the Exchequer, the tax gap and compliance

• take account of relevant international experience

• establish a Consultative Committee to provide support and challenge

• liaise with HMRC’s Administrative Burdens Advisory Board

• consider the implications of devolution of tax powers and different legal systems within the UK

• be consistent with the principles for a good tax system, including fairness and efficiency

• be mindful of the effect of taxpayer trust in the operation of the tax system
Annex B

Consultative Committee

B.1 The OTS normally establishes a Consultative Committee, chaired by the Tax Director, for reviews requested by the Chancellor under section 186 of FA 2016. Two meetings of the Committee were held during the work on this report.

B.2 The purpose of the Committee is to facilitate confidential consultation to provide input and challenge during the course of the review. Committee members serve in a personal capacity, rather than on behalf of any organisation to which they may belong.

B.3 We are very grateful for the time and support of our Consultative Committee members.

B.4 The report’s content and recommendations remain the responsibility of the OTS.

Arun Advani  University of Warwick
Paul Aplin  Freelance tax writer and consultant
John Barnett  Burges Salmon LLP
Isobel d’Inverno  Brodies LLP
Andrew Jackson  Fiander Tovell
Emma McGuire  HM Revenue & Customs
Pete Miller  The Miller Partnership
Michael Parker  The National Farmers Union
Andy Richens  Freelance tax training consultant
Lisa Spearman  Mercer & Hole
Donald Stark  HM Treasury
Andy Summers  London School of Economics
Gemma Tetlow  The Institute for Government
Helen Thornley  The Association of Taxation Technicians
Annex C

Organisations consulted

C.1 The OTS has listed below the wide range of organisations who gave their time to provide evidence to this review. The OTS is grateful to these organisations and to the large number of individuals who gave their time to provide evidence either in writing or through the online survey. Individual names have not been published here.

38 Degrees
A J Bell
Agricultural Law Society
Alvarez & Marsal Tax and UK, LLP
Association of British Insurers
Association of Taxation Technicians
Bates Weston
BDO
British Venture Capital Association
Central Association of Agricultural Valuers
Centre for Policy Studies
Church Action for Tax Justice
Chartered Institute of Taxation
Country Land and Business Association
David Allen Chartered Accountants
Deloitte
Employee Ownership Association
Ernst & Young
Fieldfisher
Harrison Legal
Herbert Smith Freehills

KPMG
Law Society
LCM Family
Mazars
McKie & Co
National Farmers' Union
Oxfam
Penningtons Manches Cooper
Proshare
PwC
Quoted Companies Alliance
Resolution Foundation
Roliscon Ltd
RSM
Saffrey Champness
Scotland for Employee Ownership
Scottish Government
Scottish Land & Estates
Share Plan Lawyers
Society of Trusts and Estate Practitioners
Tapestry Compliance
<table>
<thead>
<tr>
<th>Organization</th>
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<tbody>
<tr>
<td>Historic Houses</td>
<td>Tax Justice UK</td>
</tr>
<tr>
<td>HM Revenue &amp; Customs</td>
<td>Tax Research LLP</td>
</tr>
<tr>
<td>HM Treasury</td>
<td>UK 200 Group</td>
</tr>
<tr>
<td>Institute of Chartered Accountants in England and Wales</td>
<td>UK Women’s Budget Group</td>
</tr>
<tr>
<td>Institute of Chartered Accountants of Scotland</td>
<td>Wales Co-operative Centre</td>
</tr>
<tr>
<td>Institute for Fiscal Studies</td>
<td>Warwick Business School</td>
</tr>
<tr>
<td>Institute for Family Business</td>
<td>Wedlake Bell</td>
</tr>
<tr>
<td>Institute for Public Policy Research</td>
<td>Write Tax</td>
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<tr>
<td>Intergenerational Foundation</td>
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</tbody>
</table>
Annex D

International comparisons

Table of Capital Gains International Comparisons

<table>
<thead>
<tr>
<th>Country</th>
<th>Current CGT rates for individuals</th>
<th>Standalone tax or part of Income Tax</th>
<th>Tax free Inheritance Tax?</th>
<th>CGT charged on death?</th>
<th>CGT uplift given on death?</th>
<th>CGT on main residence</th>
<th>Treatment of Main CGT reliefs</th>
<th>CGT on capital losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>UKa</td>
<td>10%/18%/20%/28% (20% most assets, 28% residential property and carried interest) (2020-21)</td>
<td>Separate tax</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Offset against current year gains and indefinite carry forward with some exceptions for set off against income</td>
<td>BADR (ER), Investors’ Relief and chattels exemption</td>
</tr>
<tr>
<td>Australiab</td>
<td>Income Tax rates (19%-45%); for assets held &gt;1-year gain reduced by 50% or can apply indexation</td>
<td>Part of Income Tax</td>
<td>No unless to a tax advantaged entity for example a charitable post 20/09/85; Donee takes on historical base cost</td>
<td></td>
<td></td>
<td>No</td>
<td>Offset against current year gains and indefinite carry forward against gains</td>
<td>Personal use assets (acquired &lt; AUD 10,000, collectible &lt; AUD 500), long held businesses and business assets</td>
</tr>
<tr>
<td>Country</td>
<td>CGT of up to 20% (but most pay at 15%) for long term assets (held &gt;12 months); otherwise taxed as income max rate 37%) (2020)</td>
<td>Yes, but depends on length of ownership</td>
<td>USD 40,000 on long term gains (2020)</td>
<td>Federal, estate and gift taxes apply</td>
<td>No</td>
<td>Yes</td>
<td>No (but only up to first USD 250,000 or USD 500,000 if married of gain)</td>
<td>Generally offset against current year capital gains plus USD 3,000 and indefinite carry forward with some exceptions</td>
</tr>
<tr>
<td>---</td>
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</tr>
<tr>
<td>Germany</td>
<td>Income Tax rates (14% to 42%) except shares where 25% flat rate if holding &lt;1% and if holding &gt;1% in last 5 years then taxable gain reduced by 40% (can opt for Income Tax rates)</td>
<td>Part of Income Tax</td>
<td>Income Tax free threshold: €9,408 and Investor’s Allowance of €801</td>
<td>Yes</td>
<td>No – Donee takes on historical acquisition date and cost (so exemptions for long held assets applies)</td>
<td>No</td>
<td>Offset against current year first, then carry back to the previous year up to €1 million or carry forward. Limitation if loss carry forward exceeds 1 million EUR</td>
<td>No CGT on non-business real estate owned for &gt;10 years and other private assets held &gt; 1 year</td>
</tr>
<tr>
<td>Canada</td>
<td>Half of a capital gain is taxable and included as income; Income Tax rates of 15-33%</td>
<td>Part of Income Tax</td>
<td>Personal tax credits system in place</td>
<td>No – deemed disposal of capital property before death</td>
<td>N/A as deemed disposal</td>
<td>No</td>
<td>Offset against current year gains first, then carry back to reduce taxable capital gains in preceding 3 years or carry forward indefinitely</td>
<td>Lifetime exemption for some share disposals (up to CAD 883,384) and for farms/fishing properties (up to CAD 1 million)</td>
</tr>
<tr>
<td>Country</td>
<td>CGT on property: rates vary widely dependent on length of ownership. Net gains (after deductions for length of ownership) are taxed at 36.2% with additional taxes due dependent on the circumstances. CGT on shares and bonds is a flat 30%. Lifetime gift tax of up to 60% but the rate is much lower for gifts to children or other relatives.</td>
<td>Separate tax rates: Taxpayers with low income may opt to tax the capital gains at the progressive Income Tax rates</td>
<td>Exemptions available for different types of assets</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No (principal residence is exempt)</td>
<td>None</td>
</tr>
<tr>
<td>---</td>
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<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Spain</td>
<td>19%/21%/23% for Spanish residents 19% for non-residents. Part of Income Tax (gains are treated as part of savings income)</td>
<td>No specific CGT allowance</td>
<td>Yes but limited</td>
<td>No</td>
<td>Yes</td>
<td>No (main home exemption if proceeds are reinvested into another main home or the seller is over 65)</td>
<td>Losses can only be offset against capital gains and carried forward for a maximum of 4 years</td>
<td>Main home exemption, age related exemption for over 65s.</td>
</tr>
<tr>
<td>Ireland&lt;sup&gt;h&lt;/sup&gt;</td>
<td>Specific types of assets with different rates: 33% for most gains 40% for foreign life assurance policies 15% for venture capital funds for individuals 12.5% for venture capital funds for companies</td>
<td>Separate tax</td>
<td>Personal exemption for gains for individuals of €1,270</td>
<td>Yes (called Capital Acquisition Tax)</td>
<td>No</td>
<td>Yes No (principal private residence relief)</td>
<td>Losses can be offset against current year gains or carried forward indefinitely. They can also be transferred to a spouse or civil partner. Entrepreneurs’ relief, inflation relief/indexation relief, farm restructuring relief, retirement relief, land transfer relief, Entrepreneur’s relief, transferring land to a child</td>
<td>Principal private residence, inheritance tax, capital gains tax</td>
</tr>
</tbody>
</table>

---

a [https://www.gov.uk/capital-gains-tax/rates](https://www.gov.uk/capital-gains-tax/rates)
f [https://taxsummaries.pwc.com/france/individual/other-taxes](https://taxsummaries.pwc.com/france/individual/other-taxes)
g [https://taxsummaries.pwc.com/spain/individual/income-determination](https://taxsummaries.pwc.com/spain/individual/income-determination)
Annex E

History of Capital Gains Tax

E.1 Historically, the relationship between Capital Gains Tax and Income Tax has been subject to considerable change. The following table highlights the key rates and allowances of both taxes from when CGT was introduced in 1965 to the present day.

E.2 Data is sourced from:
https://webarchive.nationalarchives.gov.uk/20060214112018/http://www.hmrc.gov.uk/stats/tax_structure/00ap_a2a_2.htm

Table E.1: Comparison of Capital Gains Tax and Income Tax main rates and reliefs 1965-2021

<table>
<thead>
<tr>
<th>Financial year</th>
<th>Rate of CGT</th>
<th>Annual exempt amount</th>
<th>IT lower rate</th>
<th>IT basic rate</th>
<th>IT higher rate/additional rate</th>
<th>IT personal allowance</th>
<th>Retirement relief¹</th>
<th>Indexation allowance²</th>
<th>Rebasing to March 1982³</th>
<th>Taper relief⁴</th>
<th>Entrepreneurs relief⁵</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>£</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>£</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1965-66</td>
<td>30</td>
<td>20/30</td>
<td>41.25</td>
<td>220</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1966-67</td>
<td>30</td>
<td>20/30</td>
<td>41.25</td>
<td>220</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

¹ Retirement relief: provided an effective exemption for a certain amount of gains on disposals of all or part of a qualifying business, including certain share disposals
² Indexation Allowance: gave relief by adjusting the allowable expenditure for increases in the retail prices index from month of expenditure to month of disposal
³ Rebasing: any asset held at 31 March 1982 was deemed to have been sold and immediately reacquired at its market value on that date
⁴ Taper Relief: reduced the gains which were taxable by a percentage which was determined by how long the asset had been held
⁵ Entrepreneurs’ Relief: gains up to the lifetime allowance are taxed at a reduced rate of 10% (Renamed Business Asset Disposal Relief from 2020)
<table>
<thead>
<tr>
<th>Year</th>
<th>30</th>
<th>20/30</th>
<th>41.25</th>
<th>220</th>
<th>✓</th>
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<tr>
<td>1967-68</td>
<td>30</td>
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<tr>
<td>1968-69</td>
<td>30</td>
<td>20/30</td>
<td>41.25</td>
<td>255</td>
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<tr>
<td>1969-70</td>
<td>30</td>
<td>30</td>
<td>41.25</td>
<td>325</td>
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</tr>
<tr>
<td>1970-71</td>
<td>30</td>
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<td>325</td>
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<tr>
<td>1971-72</td>
<td>30</td>
<td>38.75</td>
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<tr>
<td>1972-73</td>
<td>30</td>
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<tr>
<td>1973-74</td>
<td>30</td>
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<td>40</td>
<td>75</td>
<td>595</td>
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<tr>
<td>1974-75</td>
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<td>33</td>
<td>38</td>
<td>83</td>
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<td>1975-76</td>
<td>30</td>
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<td>40</td>
<td>83</td>
<td>675</td>
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<tr>
<td>1976-77</td>
<td>30</td>
<td>35</td>
<td>40</td>
<td>83</td>
<td>735</td>
</tr>
<tr>
<td>1977-78</td>
<td>30</td>
<td>34</td>
<td>40</td>
<td>83</td>
<td>945</td>
</tr>
<tr>
<td>1978-79</td>
<td>30</td>
<td>25</td>
<td>33</td>
<td>40</td>
<td>83</td>
</tr>
<tr>
<td>1979-80</td>
<td>30</td>
<td>25</td>
<td>30</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>1980-81</td>
<td>30</td>
<td>3,000</td>
<td>30</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>1981-82</td>
<td>30</td>
<td>3,000</td>
<td>30</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>1982-83</td>
<td>30</td>
<td>5,000</td>
<td>30</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>1983-84</td>
<td>30</td>
<td>5,300</td>
<td>30</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>1984-85</td>
<td>30</td>
<td>5,600</td>
<td>30</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>1985-86</td>
<td>30</td>
<td>5,900</td>
<td>30</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>1986-87</td>
<td>30</td>
<td>6,300</td>
<td>29</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>1987-88</td>
<td>30</td>
<td>6,600</td>
<td>27</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>1988-89</td>
<td>Income tax rates</td>
<td>5,000</td>
<td>25</td>
<td>40</td>
<td>2,605</td>
</tr>
<tr>
<td>Year</td>
<td>Income tax rates</td>
<td>25</td>
<td>40</td>
<td>2,785</td>
<td>✓</td>
</tr>
<tr>
<td>--------</td>
<td>------------------</td>
<td>-----</td>
<td>-----</td>
<td>-------</td>
<td>---</td>
</tr>
<tr>
<td>1989-90</td>
<td>Income tax rates</td>
<td>5,000</td>
<td>25</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td>1990-91</td>
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<td>5,000</td>
<td>25</td>
<td>40</td>
<td>3,005</td>
</tr>
<tr>
<td>1991-92</td>
<td>Income tax rates</td>
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<td>25</td>
<td>40</td>
<td>3,295</td>
</tr>
<tr>
<td>1992-93</td>
<td>Income tax rates</td>
<td>5,800</td>
<td>20</td>
<td>25</td>
<td>3,445</td>
</tr>
<tr>
<td>1993-94</td>
<td>Income tax rates</td>
<td>5,800</td>
<td>20</td>
<td>25</td>
<td>3,445</td>
</tr>
<tr>
<td>1994-95</td>
<td>Income tax rates</td>
<td>5,800</td>
<td>20</td>
<td>25</td>
<td>3,445</td>
</tr>
<tr>
<td>1995-96</td>
<td>Income tax rates</td>
<td>6,000</td>
<td>20</td>
<td>25</td>
<td>3,525</td>
</tr>
<tr>
<td>1996-97</td>
<td>Income tax rates</td>
<td>6,300</td>
<td>20</td>
<td>24</td>
<td>3,765</td>
</tr>
<tr>
<td>1997-98</td>
<td>Income tax rates</td>
<td>6,500</td>
<td>20</td>
<td>23</td>
<td>4,045</td>
</tr>
<tr>
<td>1998-99</td>
<td>Income tax rates</td>
<td>6,800</td>
<td>20</td>
<td>23</td>
<td>4,195</td>
</tr>
<tr>
<td>1999-20</td>
<td>Income tax rates</td>
<td>7,100</td>
<td>10</td>
<td>23</td>
<td>4,335</td>
</tr>
<tr>
<td>2000-01</td>
<td>Income tax rates</td>
<td>7,200</td>
<td>10</td>
<td>22</td>
<td>4,385</td>
</tr>
<tr>
<td>2001-02</td>
<td>Income tax rates</td>
<td>7,500</td>
<td>10</td>
<td>22</td>
<td>4,535</td>
</tr>
<tr>
<td>2002-03</td>
<td>Income tax rates</td>
<td>7,700</td>
<td>10</td>
<td>22</td>
<td>4,615</td>
</tr>
<tr>
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<td>Income tax rates</td>
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<td>10</td>
<td>22</td>
<td>4,615</td>
</tr>
<tr>
<td>2004-05</td>
<td>Income tax rates</td>
<td>8,200</td>
<td>10</td>
<td>22</td>
<td>4,745</td>
</tr>
<tr>
<td>2005-06</td>
<td>Income tax rates</td>
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<td>10</td>
<td>22</td>
<td>4,895</td>
</tr>
<tr>
<td>2006-07</td>
<td>Income tax rates</td>
<td>8,800</td>
<td>10</td>
<td>22</td>
<td>5,035</td>
</tr>
<tr>
<td>2007-08</td>
<td>Income tax rates</td>
<td>9,200</td>
<td>10</td>
<td>22</td>
<td>5,225</td>
</tr>
<tr>
<td>2008-09</td>
<td>Income tax rates</td>
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<td>20</td>
<td>40</td>
<td>6,035</td>
</tr>
<tr>
<td>2009-10</td>
<td>Income tax rates</td>
<td>10,100</td>
<td>20</td>
<td>40</td>
<td>6,475</td>
</tr>
<tr>
<td>Year</td>
<td>Period</td>
<td>Rate</td>
<td>Deductible</td>
<td>PAL</td>
<td>PA</td>
</tr>
<tr>
<td>------</td>
<td>--------</td>
<td>------</td>
<td>------------</td>
<td>-----</td>
<td>----</td>
</tr>
<tr>
<td>2010-11</td>
<td>10 or 18/28</td>
<td>10,100</td>
<td>20</td>
<td>40</td>
<td>6,475&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>2011-12</td>
<td>10 or 18/28</td>
<td>10,600</td>
<td>20</td>
<td>40</td>
<td>7,475&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>2012-13</td>
<td>10 or 18/28</td>
<td>10,600</td>
<td>20</td>
<td>40</td>
<td>8,105&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>2013-14</td>
<td>10 or 18/28</td>
<td>10,900</td>
<td>20</td>
<td>40</td>
<td>9,440&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>2014-15</td>
<td>10 or 18/28</td>
<td>11,000</td>
<td>20</td>
<td>40</td>
<td>10,000&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>2015-16</td>
<td>10 or 18/28</td>
<td>11,100</td>
<td>20</td>
<td>40</td>
<td>10,600&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>2016-17</td>
<td>10 or 10/20 or 18/28</td>
<td>11,100</td>
<td>20</td>
<td>40</td>
<td>11,000&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>2017-18</td>
<td>10 or 10/20 or 18/28</td>
<td>11,300</td>
<td>20</td>
<td>40</td>
<td>11,500&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>2018-19</td>
<td>10 or 10/20 or 18/28</td>
<td>11,700</td>
<td>20</td>
<td>40</td>
<td>11,850&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>2019-20</td>
<td>10 or 10/28 or 18/28</td>
<td>12,000</td>
<td>20</td>
<td>40</td>
<td>12,500&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>2020-21</td>
<td>10 or 10/20 or 18/20</td>
<td>12,300</td>
<td>20</td>
<td>40</td>
<td>12,500&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

<sup>6</sup> The PA reduces where an individual’s income is above £100,000 – by £1 for every £2 of income above the £100,000 limit.

Source: All figures are taken from https://webarchive.nationalarchives.gov.uk
Annex F

Data sources used in this report

F.1 This Annex contains the HMRC data and projections that are referred to, or published for the first time, in this report.

F.2 Unless specified, these are rooted in the self-assessment data underpinning the published National Statistics for the 2017-18 tax year.¹

F.3 Where relevant, both here and in the body of the report, there are references to the specific tables from which data has been used.

F.4 The Exchequer impact projections set out in this report are estimates produced using the Office for Budget Responsibility’s (OBR) March 2020 economic forecast. They have not been certified by the OBR and are therefore indicative and subject to change. Estimates are on an accruals basis unless otherwise stated. This means they relate to the period the Capital Gains Tax liability arises rather than when HMRC receives it.

F.5 In addition, the projections are on a static basis only. This means they do not take into account the potential impact of any changes to people’s behaviour as a result of the considered policy change.

F.6 This means that the impact projections of making some of these changes may overestimate or underestimate any potential Exchequer yield.

F.7 Where the report refers to an ‘average’, this refers to an arithmetic mean unless otherwise specified.

Chapter 1: Introduction to Capital Gains Tax

Chart 1.A: Individuals paying Capital Gains Tax by age (2017-18 tax year)

F.8 Chart 1.A gives information about who pays Capital Gains Tax and how much, by reference to their age. It is based on Table 6 of HMRC’s Capital Gains Tax statistical tables.²

F.9 The 265,000 individual taxpayers who paid Capital Gains Tax in the 2017-18 tax year are split between age categories shown in the blue columns. The amount paid by the taxpayers in each category is shown by the orange dots. The total is £8.3 billion.

F.10 The underlying data is in the table below, the figures coming from Table 6.

<table>
<thead>
<tr>
<th>Age range</th>
<th>No. of taxpayers (thousands)</th>
<th>Amount of tax (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>15 and under</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>16 to 24</td>
<td>2</td>
<td>22</td>
</tr>
<tr>
<td>25 to 34</td>
<td>10</td>
<td>197</td>
</tr>
<tr>
<td>35 to 44</td>
<td>29</td>
<td>977</td>
</tr>
<tr>
<td>45 to 54</td>
<td>55</td>
<td>2414</td>
</tr>
<tr>
<td>55 to 64</td>
<td>70</td>
<td>2493</td>
</tr>
<tr>
<td>65 to 74</td>
<td>63</td>
<td>1565</td>
</tr>
<tr>
<td>75 to 84</td>
<td>26</td>
<td>540</td>
</tr>
<tr>
<td>85 and over</td>
<td>8</td>
<td>133</td>
</tr>
<tr>
<td>Total²</td>
<td>265</td>
<td>8343</td>
</tr>
</tbody>
</table>

³ The totals do not sum due to rounding.
Chart 1.B: Total net gains, by size of gain

F.11 Chart 1.B was produced from data included in Table 2 of the Capital Gains Tax statistical tables produced by HMRC. For each of the years featured, it shows a breakdown of the total net gains (after deduction for losses) by reference to the size of the gains made.

Chart 1.C: Frequency with which individuals paid Capital Gains Tax in the 11-year period 2007-08 to 2017-18

F.12 Chart 1.C shows the frequency with which individual taxpayers reported a gain subject to Capital Gains Tax over the eleven-year period from 2007-08 to 2017-18.

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4 The formatting of the data in this way is based on the presentation of the equivalent data for tax years 2008-09 to 2017-18 at: https://www.resolutionfoundation.org/app/uploads/2020/05/Who-gains.pdf
F.13 This chart is drawn from HMRC data for tax years 2007-08 to 2017-18. The result was obtained by comparing Unique Taxpayer Reference numbers.

F.14 Every individual taxpayer who reported once during the period is counted here in the chart, shown in the blue columns. Each is attributed a number which reflects the total number of years for which they reported a gain subject to Capital Gains Tax in the period. There is no requirement for years to be consecutive: someone paying Capital Gains Tax in tax years 2008-09, 2014-15 and 2017-18 would be counted as having a frequency of “3”.

F.15 The orange line shows how much tax was paid by each category of taxpayer over the whole period.

F.16 This table shows the data that is reflected in the chart.

<table>
<thead>
<tr>
<th>Frequency</th>
<th>No. of taxpayers</th>
<th>No. of returns*</th>
<th>Tax paid (£ millions)</th>
<th>Ave. tax/Return (£)*</th>
<th>Ave. tax/taxpayer (£)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1,077,900</td>
<td>1,077,900</td>
<td>18,869</td>
<td>17,500</td>
<td>17,500</td>
</tr>
<tr>
<td>2</td>
<td>234,200</td>
<td>468,300</td>
<td>10,927</td>
<td>23,300</td>
<td>46,700</td>
</tr>
<tr>
<td>3</td>
<td>87,100</td>
<td>261,200</td>
<td>8,141</td>
<td>31,200</td>
<td>93,500</td>
</tr>
<tr>
<td>4</td>
<td>42,200</td>
<td>168,900</td>
<td>5,606</td>
<td>33,200</td>
<td>132,800</td>
</tr>
<tr>
<td>5</td>
<td>24,200</td>
<td>120,900</td>
<td>4,484</td>
<td>37,100</td>
<td>185,400</td>
</tr>
<tr>
<td>6</td>
<td>15,100</td>
<td>90,300</td>
<td>3,928</td>
<td>43,500</td>
<td>260,900</td>
</tr>
<tr>
<td>7</td>
<td>9,800</td>
<td>68,600</td>
<td>3,206</td>
<td>46,700</td>
<td>327,100</td>
</tr>
<tr>
<td>8</td>
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<td>51,400</td>
<td>2,655</td>
<td>51,700</td>
<td>413,600</td>
</tr>
<tr>
<td>9</td>
<td>4,300</td>
<td>39,000</td>
<td>2,403</td>
<td>61,700</td>
<td>555,300</td>
</tr>
<tr>
<td>10</td>
<td>2,500</td>
<td>25,300</td>
<td>1,901</td>
<td>75,200</td>
<td>751,700</td>
</tr>
<tr>
<td>11</td>
<td>1,400</td>
<td>14,900</td>
<td>1,250</td>
<td>83,800</td>
<td>921,500</td>
</tr>
<tr>
<td>Total</td>
<td>1,505,000</td>
<td>2,386,600</td>
<td>63,369</td>
<td>26,600</td>
<td>42,100</td>
</tr>
</tbody>
</table>

*Rounded to nearest 100. Columns may not sum to total due to rounding errors.

F.17 Charts 1.D and 1.E were reproduced from data provided by Dr Arun Advani of the University of Warwick and Dr Andrew Summers of the London School of Economics. Versions were produced in a working paper by the University of Warwick’s CAGE Research Centre entitled ‘Capital Gains and UK Inequality’ published in May 2020.6

F.18 Chart 1.D shows a breakdown of gains of over £100,000 for tax year 2016-17 by value and by asset type, such that the considerable size of the very biggest gains in the category is highlighted. The height of the columns in Chart 1.D represents the mean liability of individuals within each bin (so the top 1,000 had an average of £14 million in gains each, and a total of £14

5 https://warwick.ac.uk/fac/soc/economics/research/centres/cage/
billion between them, while the bottom 1,000 had an average of £100,000 and a total of £100 million). Chart 1.E shows the breakdown by asset type as a proportion of the totals in the first chart, to make it easier to see the shift in the asset mix.

Chart 1.D: Analysis of gains of £100,000 or more for tax year 2016-17, by value and by asset type – a) broken down by asset type and size

Chart 1.E: Analysis of gains of £100,000 or more for tax year 2016-17, by value and by asset type – b) broken down by asset type only
Definitions

**Residential property:** houses, flats and other dwellings including freehold and long-term leasehold.

**Carried interest:** profits made by a financial fund that are considered to be capital gains.

**Listed shares:** company shares listed for trading on a major stock exchange such as the London Stock Exchange.

**Unlisted shares:** company shares that are privately held or traded on the Alternative Investment Market.

**Other assets:** this category includes some unlisted shares (those that qualified for Entrepreneurs’ Relief on disposal), land and property other than residential property, tangible assets like paintings, intangible assets like the goodwill of an unincorporated business and financial investments other than shares.

F.19 The CAGE report contains an analysis of the gains of £100,000 or more reported for tax year 2016-17. It takes the 54,000 taxpayers who had reported such gains and divides them into groups (called ‘bins’) of 1,000 according to the size of the gain. So those 1,000 with the very largest gains are in one bin and then the next 1,000 and so on.

F.20 Analysis was carried out of the asset type mix which shows that, the larger the gains, the greater proportion of them is likely to relate to unlisted shares and ‘other assets’. It is important to note that in this data set the category of ‘other assets’ included all unlisted shares which were eligible for Entrepreneurs’ Relief.

F.21 For more information on the research and methodology behind Charts 1.D and 1.E, please refer to the CAGE Research Centre’s publications as referenced above.

The breakdown of net gains

F.22 Chart 1.F was produced from data included in Table 7 of the Capital Gains Tax statistical tables produced by HMRC for tax year 2017-18. It shows the breakdown of the total of £58.9 billion net gains (after deduction of losses) reported for that year by asset type.

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7 The formatting of the data in this way is based on the presentation of the equivalent data for 2016-17 at: https://www.resolutionfoundation.org/app/uploads/2020/05/Who-gains.pdf
Notes: Unlisted UK and foreign shares include shares listed on the Alternative Investment Market. Listed shares are those listed on the London Stock Exchange and equivalent foreign exchanges. Non-residential in the context of land and buildings (the yellow category) means for commercial, industrial or agricultural use.

Chapter 2: Capital Gains Tax rates

F.23 Citation from paragraph 2.19: ‘A rough static costing suggests that alignment of Capital Gains Tax rates with Income Tax rates could theoretically raise an additional £14 billion a year for the Exchequer.’

F.24 This figure was calculated by HMRC analysts by taking the total gains reported for the 2018-19 tax year and finding the difference between the Capital Gains Tax that was actually paid and the Capital Gains Tax if the rates aligned with income tax rates.

F.25 The calculation assumes the Annual Exempt Amount is still allowed to reduce the taxable gain. For example, a person who had a gain of £20,000 was treated as having £8,300 additional income (after allowing for the Annual Exempt Amount of £11,700 for the 2018-19 tax year). So a higher rate taxpayer earning £60,000 would be deemed to pay 40% tax on the £8,300 instead of the 20% or 28% that was actually paid.

F.26 If the calculation is performed and the Annual Exempt Amount is not allowed (so subjecting the total £20,000 to a marginal income tax rate) then the total additional revenues calculated for 2018-19 are £16 billion.

F.27 The calculation also adjusts the figures for the 2018-19 tax year to take account of the withdrawal of Entrepreneurs’ Relief and its replacement with Business Asset Disposal Relief, with a lower lifetime limit on gains, with effect from tax year 2020-21, so as not to overestimate the impact of taxing large gains on business disposals at considerably lower rates than income tax (see Chapter 6 for more details).
It is important to note that this is a static costing, meaning that it only recalculates the actual position for the 2018-19 tax year and does not factor in any differences in taxpayer behaviours that taxing gains at income tax rates would cause. In reality, the additional yield from increasing Capital Gains Tax to income tax rates would be a reduced amount because of the extent to which taxpayers can (and would) control the realisation of gains.

Share of gains across different holding periods

Chart 2.A was reproduced from data provided by Dr Arun Advani of the University of Warwick and Dr Andrew Summers of the London School of Economics. A version was produced in a working paper by the University of Warwick’s CAGE Research Centre entitled ‘Capital Gains and UK Inequality’ published in May 2020.

Chart 2.A: Share of gains across different holding periods 1997-2018

<table>
<thead>
<tr>
<th>Percentage of total gains</th>
<th>Percentage of total gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 1 year</td>
<td>1-2 years</td>
</tr>
</tbody>
</table>

Key to holding periods

- **Green**: less than one year (<1 year)
- **Light blue**: one year or more but less than two years (1-2 years)
- **Yellow**: two years or more but less than five years (2-5 years)
- **Orange**: five years or more but less than ten years (5-10 years)
- **Dark blue**: ten years or more (10+ years)

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8 https://warwick.ac.uk/fac/soc/economics/research/centres/cage/
9 CAGE working paper no.465, Capital Gains and UK Inequality, May 2020
The chart is based on total net gains, before Taper Relief but after deduction of losses, reported to HMRC for each tax year from 1997-98 to 2016-17. The gains (and losses) have been aggregated according to the holding period of the asset that was sold and are shown on the chart as a proportion of the total gains for the year.

There is an apparent sharp shift in behaviours in respect of holding periods immediately following the abolition of Taper Relief from tax year 2008-09. This is attributed by Dr Advani and Dr Summers to the effect of Taper Relief on the decision when to realise (cash in) an investment: as opposed to actively incentivising the making of longer term investments, Taper Relief encourages the prolonged holding of assets that may otherwise have been better off sold. This is evidenced by the significant shift in behaviours after 2008 followed by a more settled pattern.

Notes to the data

It is evident from the chart that the totals of all of the lines in later years do not add up to 100%. The difference is accounted for by gains for which the holding period is unknown. They appear in the underlying data but not in the chart.

The reason for this is that, before the abolition of Taper Relief, Capital Gains Tax returns included a specific, formatted box for entering the acquisition date. This information was required to calculate Taper Relief. Following the abolition of Taper Relief, the acquisition date was no longer included in its own box but in a free text section of the form. This meant the data was not captured in HMRC’s digital systems in a way which made it accessible for analytical purposes.

The OTS also considered whether the coincidence with the financial crash of 2008 could impact behaviours. Losses for the 2008-09 tax year make up a much more significant proportion of total net gains than in the 2007-08 tax year, and it is plausible that the reduction in gains on assets held for between two and ten years may be in some part attributable to losses on disposal of bad investments held for that time. However, the OTS notes the continuation of the trend in later years and the further evidence of the effect of Taper Relief on taxpayer behaviour in Chart 2.B, below.
Chart 2.B: Comparison of HMRC statistics with gains before Taper Relief

This chart was also reproduced from information provided by Dr Advani and Dr Summers and is composed from datasets used in the CAGE Research Centre’s publication of May 2020 entitled ‘Capital gains and UK inequality: New evidence from tax microdata’. This chart shows a comparison of HMRC’s published statistics for total taxable capital gains with a revised calculation of total gains after removing the effects of Taper Relief. Until tax year 2007-08, the gains in HMRC’s statistics are calculated after allowing for Taper Relief, which reduces the net gains. From tax year 2008-09 onwards Taper Relief no longer applied, which is why the lines coincide after this point. The chart shows that there is a significant increase in untapered gains and a wide disparity between tapered and untapered gains during the time between the announcement (9 October 2007) and the coming into force of the abolition of Taper Relief from 6 April 2008. For more information on the research and methodology behind Charts 2.A and 2.B, please refer to the CAGE Research Centre’s publications as referenced above.

10 CAGE Policy Briefing no. 19, Capital Gains and UK inequality: New evidence from tax microdata, May 2020
Chapter 3: Boundary issues

F.40 Chart 3.A was reproduced from tables provided by the Institute for Fiscal Studies (IFS).\(^\text{12}\) The chart originally appeared in the IFS’s working paper entitled ‘Intertemporal income shifting and the taxation of owner-managed businesses’ published in September 2019.\(^\text{13}\)

Chart 3.A: Distribution of taxable income for owners of owner managed companies (2014-15 tax year)

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F.41 *In their paper, the IFS explain how they identified owner-managed companies and cross-referenced company records to those of the individual taxpayers who own those companies using HMRC’s data and company accounts data from Financial Accounting Made Easy (FAME) provided by Bureau van Dijk. The IFS then studied the behaviours of a population of owner managed companies, which is distributed on the chart with reference to the taxable income of the owner up to £90,000. (Those whose income was over £90,000 were looked at separately.)

F.42 The IFS prepared the above analysis of the income distributed to owners by owner managed businesses in relation to tax year 2014-15. For that tax year the annual National Insurance Lower Profits Limit was £7,956 and the Income Tax Personal Allowance was £10,000. There are modest spikes in the incidence of taxable income at these levels, indicative of planning around them.

F.43 The large spike indicates the threshold of £42,010 which was the top of the basic rate band for tax year 2014-15 (the equivalent of the £50,000 threshold in the case study of Rose). The IFS performed this analysis for all tax years from 2008-09 to 2014-15\(^\text{14}\) and in each year recorded a

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\(^{12}\) https://www.ifs.org.uk/


\(^{14}\) See figure A.2 on page 13 of the above-referenced report.
comparable spike in the incidence of taxable incomes at the equivalent threshold.

F.44 For more information on the study, please refer to the Institute for Fiscal Studies’ Working Paper W19/25 Intertemporal income shifting and the taxation of owner-managed businesses, by Helen Miller, Thomas Pope and Kate Smith.

Chapter 4: Annual Exempt Amount

F.45 Chart 4.A has been prepared based on HMRC data for tax year 2017-18, when the Annual Exempt Amount was £11,300.

Chart 4.A: Frequency of reported net gains up to £15,000 for tax year 2017-18

Source: HMRC

F.46 The blue line tracks the frequency of gains reported to HMRC. The underlying data is divided into £100 intervals so, to explain the visible ‘spikes’:

- 6,300 taxpayers reported gains between £0 and £100; and
- 26,600 taxpayers reported gains between £11,200 and £11,300

F.47 The frequency rises towards a significant spike at the level of the Annual Exempt Amount for the tax year, which was £11,300. A total of 52,000 taxpayers reported gains in the £1,000 range between £10,300 and £11,300 out of the 212,000 taxpayers whose data is shown in the chart. The pattern is repeated in other years, as shown in the following table:
<table>
<thead>
<tr>
<th>Tax year</th>
<th>Annual Exempt Amount</th>
<th>Total</th>
<th>Frequency in range AEA - £1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007-08</td>
<td>£9,200</td>
<td>172,800</td>
<td>32,000</td>
</tr>
<tr>
<td>2008-09</td>
<td>£9,600</td>
<td>113,100</td>
<td>19,600</td>
</tr>
<tr>
<td>2009-10</td>
<td>£10,100</td>
<td>147,000</td>
<td>34,400</td>
</tr>
<tr>
<td>2010-11&lt;sup&gt;15&lt;/sup&gt;</td>
<td>£10,100</td>
<td>missing</td>
<td>missing</td>
</tr>
<tr>
<td>2011-12</td>
<td>£10,600</td>
<td>166,900</td>
<td>39,800</td>
</tr>
<tr>
<td>2012-13</td>
<td>£10,600</td>
<td>189,700</td>
<td>48,500</td>
</tr>
<tr>
<td>2013-14</td>
<td>£10,900</td>
<td>209,000</td>
<td>54,500</td>
</tr>
<tr>
<td>2014-15</td>
<td>£11,000</td>
<td>218,800</td>
<td>56,100</td>
</tr>
<tr>
<td>2015-16</td>
<td>£11,100</td>
<td>214,700</td>
<td>50,200</td>
</tr>
<tr>
<td>2016-17</td>
<td>£11,100</td>
<td>224,700</td>
<td>58,400</td>
</tr>
<tr>
<td>2017-18</td>
<td>£11,300</td>
<td>212,000</td>
<td>52,000</td>
</tr>
</tbody>
</table>

Source: HMRC

F.48 The data represents only those net gains which were reported to HMRC. One reason a taxpayer might report a gain to HMRC that is below the Annual Exempt Amount (and therefore not taxable) is that the proceeds from the sale exceed four times the value of the Annual Exempt Amount (when it is then required to report the gains). So, sales of assets for over £45,200 would have been reportable to HMRC for tax year 2017-18, even if the gain was less than £11,300.

F.49 The picture is necessarily incomplete because gains that do not have to be reported to HMRC, because they fall below the Annual Exempt Amount and the proceeds are less than four times this amount, are not included within HMRC data.

F.50 Citation from paragraph 4.15:

‘HMRC estimates show the administrative and revenue impacts for tax year 2021-22 of reducing the Annual Exempt Amount to a lower threshold, and indicate that:

- a reduction to £6,000 would result in 235,000 more individuals needing to report a capital gain and could generate £480 million in additional revenues in the first year. (About 96,000 of the affected taxpayers would already routinely file Self Assessment tax returns.)

- a reduction to £2,500 would result in 360,000 more individuals having a requirement to report a capital gain and could generate £835 million in additional revenues in the first year. (About 120,000 of the affected taxpayers would already routinely file Self Assessment tax returns.)’

<sup>15</sup>The 09/10 data is omitted as it is not possible to undertake analysis on the same basis due to differences in data in that year.
The figures about how many new taxpayers would have to report and file correspond with Chart 4.B and the method of calculation is described below that Chart. The additional revenue figures represent estimated additional Capital Gains Tax revenues from all taxpayers. They are calculated on a static basis and therefore do not take into account changes in taxpayer behaviour that would likely reduce the additional revenues.

**Chart 4.B: Estimates of new individual taxpayers and new taxpayers to self-assessment given reduced Annual Exempt Amount threshold – 2021-22 projection**

F.52 Chart 4.B was produced based on estimated figures provided by HMRC analysts at the request of the OTS. It shows the total number of additional taxpayers estimated to have a liability to Capital Gains Tax for tax year 2021-22 were the Annual Exempt Amount to be reduced to various possible values as compared to £12,500\(^{16}\) and how many of those taxpayers would newly have a requirement to complete a Self Assessment tax return as a result.

F.53 The blue line shows all individuals who are estimated not to have a Capital Gains Tax liability for tax year 2021-22, based on an assumed Annual Exempt Amount of £12,500, but who would have a liability if the threshold were reduced. So, if the threshold were reduced to nil, it is estimated an additional 677,000 taxpayers would have to pay Capital Gains Tax, on top of those who would already have a liability for tax year 2021-22.

F.54 The orange line shows how many of those taxpayers represented by the blue line would not be expected to complete a Self Assessment tax return for tax year 2021-22, but who would have a requirement to do so if the Annual Exempt Amount were reduced. This is an important indicator of how much

\(^{16}\) This is the assumed Annual Exempt Amount for 2021/22 if there are no policy changes.
extra work would have to be done, by both the taxpayer and HMRC, if the threshold were reduced.

F.55 The space between the two lines represents taxpayers who would ordinarily have to complete a Self Assessment tax return, even without having a liability to Capital Gains Tax for tax year 2021-22. It is less effort administratively, for both the taxpayer and HMRC, for these individuals to have to pay Capital Gains Tax as they were going to have to complete a tax return anyway. Less administration means less additional cost (aside from the tax itself) for both parties.

F.56 The data is set out in the table below.

<table>
<thead>
<tr>
<th>New threshold (£)</th>
<th>Total new taxpayers (thousands)</th>
<th>New to self-assessment (thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>-</td>
<td>677</td>
<td>508</td>
</tr>
<tr>
<td>1,000</td>
<td>478</td>
<td>347</td>
</tr>
<tr>
<td>2,000</td>
<td>392</td>
<td>268</td>
</tr>
<tr>
<td>3,000</td>
<td>334</td>
<td>217</td>
</tr>
<tr>
<td>4,000</td>
<td>293</td>
<td>183</td>
</tr>
<tr>
<td>5,000</td>
<td>262</td>
<td>159</td>
</tr>
<tr>
<td>6,000</td>
<td>234</td>
<td>138</td>
</tr>
<tr>
<td>7,000</td>
<td>205</td>
<td>116</td>
</tr>
<tr>
<td>8,000</td>
<td>177</td>
<td>96</td>
</tr>
<tr>
<td>9,000</td>
<td>148</td>
<td>75</td>
</tr>
<tr>
<td>10,000</td>
<td>118</td>
<td>54</td>
</tr>
<tr>
<td>11,000</td>
<td>85</td>
<td>32</td>
</tr>
<tr>
<td>12,000</td>
<td>47</td>
<td>11</td>
</tr>
<tr>
<td>12,500</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Notes to the data

F.57 Given the limited information about these taxpayers (especially those taxpayers not currently completing a Self Assessment tax return), the figures are necessarily estimates (based on the Office of National Statistics’ Wealth and Assets Survey) and are uncertain.

F.58 In particular, the estimates have been prepared on a ‘static’ basis. This means the figures have not been adjusted for any behavioural changes that might be anticipated if the Annual Exempt Amount were reduced. For example, if there are taxpayers with listed share portfolios who would ordinarily realise gains just under the threshold then they will feature in the figures, whereas in reality they would be unlikely to continue the same pattern of realising gains if the Annual Exempt Amount were lower.
Chapter 5: Capital transfers

F.59 Citation from paragraph 5.25:

‘In the short term, the static Exchequer yield from Capital Gains Tax could on average raise between £470 million and £900 million extra each year, depending on the rate at which people dispose of assets after inheriting them. Over a period of more than 20 years, as more people receive and dispose of assets on a no gain no loss basis, the Exchequer yield could potentially rise to around £1.6 billion at today’s asset values (with the actual value being higher with asset growth). However, this would be reduced by any changes to the way that Capital Gains Tax interacts with Inheritance Tax and due to changes in taxpayer behaviour.’

F.60 These figures are from an HMRC analysts’ estimated costing of a proposed rule that gifts made on death are made on a no gain no loss basis. The rule would mean that inherited assets would retain the base cost they had when the deceased was still alive, as opposed to this being rebased to the market value on death as is the case now.

F.61 As most assets passed on in death estates have increased in value since acquisition, the rule is anticipated to have a positive impact on tax revenues.

F.62 Initially, an estimated costing was prepared based on a different assumption: that gifts on death would be chargeable to Capital Gains Tax immediately. This was a static costing (one that did not take into account any changes in taxpayer behaviour that might result from the change in the rules) that estimated the additional annual revenues would be £1.6 billion.

F.63 This is the basis for the costing of the no gain no loss rule. In this case, however, the full revenue impact is not immediate because it is not until the inheritor of the assets disposes of them that the tax is payable. This is why the forecast is now that it may take over 20 years for the revenues to increase by a similar amount. As the costing is at today’s values and asset values typically increase over time, it is anticipated that over 20 years from now the equivalent amount will be higher than the £1.6 billion estimate.

F.64 The £470 million and £900 million figures refer to the mean additional annual revenues forecast over a five year period immediately following the introduction of the rule. The costings are highly sensitive to what assumption is made about the disposal of inherited assets.

F.65 The £900 million figure relies on the assumption that a total of 34% by value of assets are sold in the first year (it is set high to reflect that many of those who inherit assets will want to cash them immediately, as well as executors needing to liquidate assets in order to divide up an estate). The £470 million figure relies on more conservative assumptions, reducing the figure after 20 years from £1.6 billion to £1.3 billion and the proportion of first year disposals by value from 34% to 20%.

F.66 The costing is based on Capital Gains Tax only. It does not take into account any impact on Inheritance Tax in the event of introducing some allowance for inherited Capital Gains Tax liabilities in the Inheritance Tax calculation or the other way round.
F.67 Citation from paragraph 5.43:

'It is estimated that a new rebasing date of 2000 would cost the Exchequer between £200 million and £500 million per year in the first few years although this will decline over time.'

F.68 These are from an HMRC analysts’ estimated costing of a proposal to introduce a rule that allows assets acquired before 6 April 2000 to have their base cost reset to the market value at that date. Ordinarily, assets standing at a gain at the rebasing date would have their base cost adjusted and assets standing at a loss would not (so decreasing the value of gains but not losses). This means that the new rule would have an adverse impact on tax revenues.

F.69 HMRC analysts used taxpayer data in relation to assets held for longer than 20 years to estimate the value of gains and Capital Gains Tax that would be eliminated on a rebasing, making the following key assumptions:

- a constant annual growth rate in the value of assets (so, for example, an asset that had accrued a gain of £25 by year 25 of ownership would have accrued a gain of £26 by year 26)
- estimates based on the tax year 2018-19 data, with an assumed ‘20 years ago’ rebasing date of 6 April 1998, is representative of the impact the proposed measure would have if and when introduced

F.70 The upper range estimate of £500 million relies on the following further assumptions:

- the holding period profile of assets for which the holding period is unknown is the same as for assets for which it is known (see the commentary on Chart 2.A which deals with unknown holding periods). This means assets for which the holding period is unknown have been taken into account on an apportioned basis
- older assets are more likely to be those charged at higher rates of Capital Gains Tax (such as residential property, to which a 28% rate applies)

F.71 The lower range estimate of £200 million relies on the following, alternative assumptions:

- assets for which the holding period is unknown have not been held for longer than 20 years
- the average rate of Capital Gains Tax across all disposals for tax year 2018-19 of c15% is representative of the average tax rate that would have been imposed on the gains eliminated on rebasing

F.72 In both cases, the figure represents an annual amount, meaning this is the amount of tax revenue that it is estimated would be lost in the first tax year following the implementation of the rebasing rule. Over time, this effect would lessen as more assets held since 2000 changed ownership.

F.73 Citation from paragraph 5.67:
'The OTS recognises that the expansion of Gift Holdover Relief to more assets would have a significant Exchequer cost – for example, expanding it to residential property would cost in the region of £310 million a year, against an existing Exchequer cost of £320 million a year in relation to business assets.'

F.74 Currently, Gift Holdover Relief is only available on disposals of business assets. Its effect is to defer the Capital Gains Tax due on a gift of such assets until such a time as the recipient makes a sale. As a result, the tax is collected later (or may never be collected, for example if the recipient dies or leaves the UK) and this reduces tax revenues.

F.75 HMRC analysts estimate that the annual cost of Gift Holdover Relief on business assets as at tax year 2017-18 was £320 million. This is based on reported claims for Gift Holdover Relief, calculating the tax on the gain held over as if it had been taxable in the year. Random sampling was used to approximate the equivalent value where multiple claims were submitted by the same taxpayer (and hence Gift Holdover Relief claims could not be isolated easily). The tax collected from gains held over in previous years was estimated and offset against the cost to arrive at the figure of £320 million.

F.76 The figure of £310 million is from an HMRC analysts’ estimated costing for the extension of Gift Holdover Relief for gifts of residential property that would otherwise fall within the charge to Capital Gains Tax. Again, this represents a reduction in tax revenues as the gains are deferred and possibly never taxed.

F.77 This is an indicative figure calculated with reference to the value of gains held over on unlisted shares (the most common business assets) as a proportion of the total gains on those assets. It has been assumed that the proportion would be the same for residential property, but the average tax rate has been increased to reflect the higher tax rate on residential property.

F.78 To complete the picture, costings would be required for of other asset types not currently qualifying for Gift Holdover Relief, the largest category of which is listed shares.

F.79 Finally, the costing does not take into account the potential adverse impact on Inheritance Tax revenues that could arise if there were less of a disincentive to gift residential property in lifetime, because Capital Gains Tax would not immediately be payable. A consequent change in taxpayer behaviour could mean that that a lower value of residential property would be held until death.

Chapter 6: Reliefs and losses

F.80 Chart 6.A was produced based on data provided by HMRC in respect of the 2017-18 tax year.
The blue columns represent the total losses of £4.9 billion\textsuperscript{17} for tax year 2017-18, categorised according to the income level of the individual reporting them. The orange dots show the gains reported by individuals in each income category for the same year.

The ratio of losses to gains in each income category (except ‘Unknown’) is between 7% and 9%, with an overall ratio of 8.3%.

The data is set out in the table below.

<table>
<thead>
<tr>
<th>Income bracket</th>
<th>Losses (£ billions)</th>
<th>Gains (£ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>£0 - £45,000</td>
<td>1394</td>
<td>16,337</td>
</tr>
<tr>
<td>£45,000 - £150,000</td>
<td>1284</td>
<td>17,687</td>
</tr>
<tr>
<td>£150,000+</td>
<td>2255</td>
<td>25,829</td>
</tr>
<tr>
<td>Unknown</td>
<td>66</td>
<td>373</td>
</tr>
</tbody>
</table>

Chart 6.B was produced based on data provided by HMRC in respect of the 2017-18 tax year.

\textsuperscript{17} This figure differs from the £5.0 billion stated elsewhere in the report as the analysis does not include losses made on residential property by non-residents or income losses that were set against capital gains in the year.
Chart 6.B: Losses reported for tax year 2017-18 by asset type

The blue columns represent the total losses of £4.9 billion for tax year 2017-18, categorised according to asset type. The definitions of the different asset types are the same as for Charts 1.D and 1.E, above. Note that residential property and carried interest have not been separated and losses on both combined are £0.5 billion.

The orange dots show the number of individuals who reported the total losses. It can be seen that losses on listed shares are more frequent but smaller than those on unlisted shares.

The figures in the chart are also set out in the following table. The table also shows the mean loss in each category, which is an average calculated by dividing the total losses by the total number of individuals in each category.

<table>
<thead>
<tr>
<th></th>
<th>Total losses in 2017-18 (£ millions)</th>
<th>Number of individuals (thousands)</th>
<th>Mean loss (£ thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listed shares</td>
<td>1,964</td>
<td>114</td>
<td>17</td>
</tr>
<tr>
<td>Unlisted shares</td>
<td>1,165</td>
<td>21</td>
<td>57</td>
</tr>
<tr>
<td>Residential property</td>
<td>519</td>
<td>21</td>
<td>25</td>
</tr>
<tr>
<td>and carried interest</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>1,265</td>
<td>28</td>
<td>47</td>
</tr>
<tr>
<td>Total</td>
<td>4,913</td>
<td>182</td>
<td></td>
</tr>
</tbody>
</table>

Note that there are no totals for number of individuals and mean loss because some individuals have been counted more than once in instances where they report losses against more than one type of asset. The number of individuals column adds up to 182,000 when in fact 172,000 individuals reported losses in 2017-18 (meaning up to 10,000 taxpayers reported a loss on more than one type of asset).
Chart 6.C was prepared based on data provided by HMRC. The data gives an estimate of how the value of net gains reported for tax year 2017-18 would increase if a restriction were placed on the period for which an individual may carry forward losses to offset against gains in future years.

**Chart 6.C: Estimated total gains for tax year 2017-18 if the period for carry forward losses is restricted**

The blue line shows the actual gains that were reported for tax year 2017-18 for comparison, and hence stays the same. The orange line shows the estimated additional gains that would have been reported had the period for the carrying forward of losses been restricted.

So, if the period were restricted to five years, it is estimated that an additional £720 million of net gains would have been reported due to the restriction, taking the total to £59,635. These estimates are static and therefore do not account for individuals changing their behaviour to offset losses before the cut off and so likely overstate the additional gains. The data is also set out in the following table:

<table>
<thead>
<tr>
<th>Unrestricted</th>
<th>Actual net gains for 2017-18 (£ millions)</th>
<th>Estimated additional net gains for 2017-18 (£ millions)</th>
<th>Total (£ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>No restriction</td>
<td>58,915</td>
<td>0</td>
<td>58,915</td>
</tr>
<tr>
<td>9</td>
<td>58,915</td>
<td>316</td>
<td>59,231</td>
</tr>
<tr>
<td>8</td>
<td>58,915</td>
<td>410</td>
<td>59,325</td>
</tr>
<tr>
<td>7</td>
<td>58,915</td>
<td>543</td>
<td>59,458</td>
</tr>
<tr>
<td>6</td>
<td>58,915</td>
<td>621</td>
<td>59,536</td>
</tr>
<tr>
<td>5</td>
<td>58,915</td>
<td>720</td>
<td>59,635</td>
</tr>
<tr>
<td>4</td>
<td>58,915</td>
<td>822</td>
<td>59,737</td>
</tr>
<tr>
<td>3</td>
<td>58,915</td>
<td>934</td>
<td>59,849</td>
</tr>
</tbody>
</table>

*Source: HMRC*
<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>58,915</td>
<td>1,119</td>
<td>60,034</td>
</tr>
<tr>
<td>1</td>
<td>58,915</td>
<td>1,364</td>
<td>60,279</td>
</tr>
<tr>
<td>0</td>
<td>58,915</td>
<td>1,678</td>
<td>60,593</td>
</tr>
</tbody>
</table>