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TUC Tax Briefing 2

Capital Gains Tax

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Section one

What is Capital Gains Tax?

Capital Gains Tax (CGT) is an important tax, but it does not raise a great deal of money.

Capital Gains Tax was introduced in 1965. It is a tax charged on the sale or gift of assets owned by individuals or trusts, but not companies, which have their own separate arrangements under corporation tax rules.

In principle CGT is a simple tax. The assets most commonly subject to the tax are investments such as shares; land and buildings held for commercial purposes, the sale of privately owned businesses and some non-financial assets such as works of art. If an asset of this sort is sold or gifted then the sale proceeds, or market value if gifted, are compared to the cost of the asset when acquired and if there is a gain then tax is due.

In practice CGT is much more complicated than that. There are numerous allowances, reliefs and exemptions that mean that in many cases no tax is payable. For example, all gifts between spouses and civil partners are exempt. This provides enormous opportunities for tax planning. Domestic homes are exempt from the tax. Pension schemes do not pay the tax. Assets in ISAs are exempt. Each and every person enjoys an annual exempt amount of gains they can enjoy each year without paying tax. This currently stands at a surprisingly large £10,100, which compares incredibly favourably to the annual personal allowance for income tax of just £6,475. The sale of any asset for less than £6,000 can also be ignored, unlike income tax where every penny of income has to be brought into account.

Business owners have always enjoyed very favourable treatment under CGT rules. At present the first £1 million of gain arising from sale of a business is subject to a 10% tax rate whereas the standard rate of CGT is currently 18%.

This rate of tax is, in itself, remarkably low. Until 1987/88 the rate of tax was 30% irrespective of a person's income tax rate. This was harsh on those with lower income tax rates and generous to those who had income tax rates of up to 60% in the period in question. The incentive to transfer income into gains was high as a result.

From 1988/89 tax year until 2007/08 the value of capital gains a person made, after offset of their annual CGT allowance, was added to their income and taxed at the same rate that would then have applied to that sum as if it had been income. This meant rates as low as 10% were charged from 2000/01 to 2007/08, and in practice this rate was commonplace for entrepreneurs because

of special reliefs granted to them on the sale of business assets. In other words, there was no apparent significant incentive to avoid tax in this period since the capital gain would, but for tax avoidance noted below, have been taxed at the same or higher rates as income.

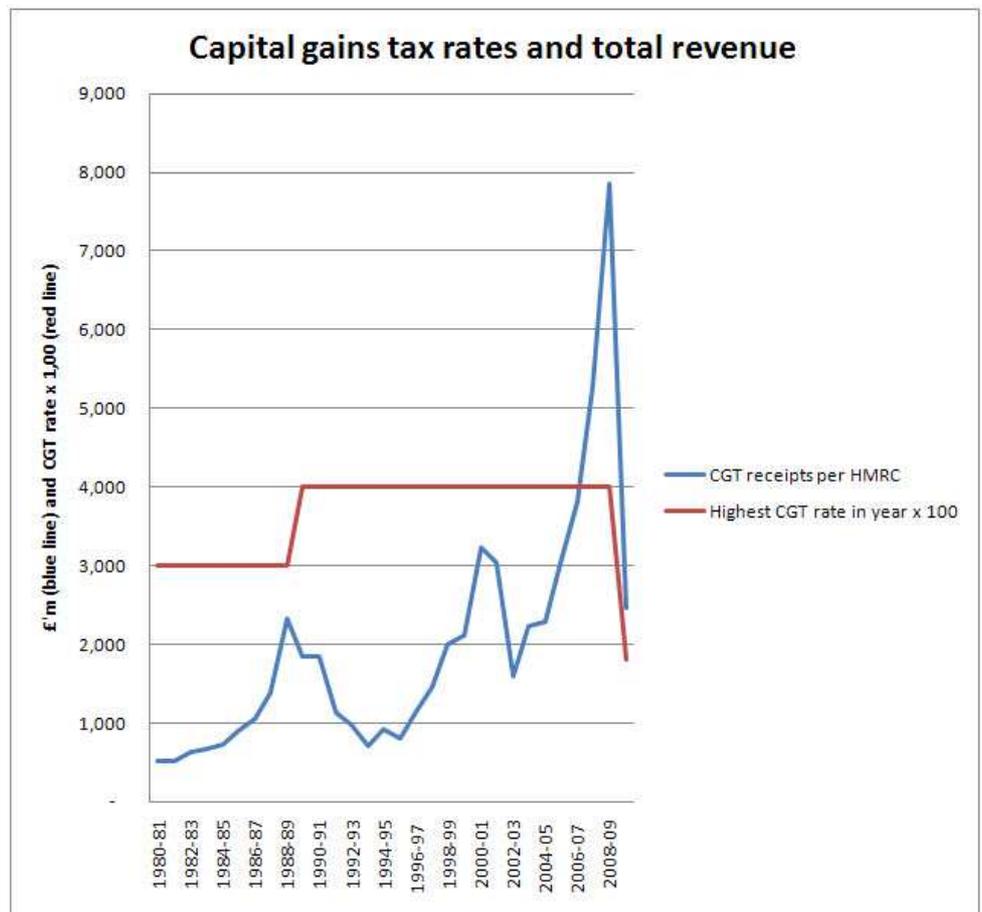
This relatively efficient situation was changed in 2008/09 when a tax rate of 18% (again subject to special reliefs for entrepreneurs) was introduced across the board, again creating significant incentives for those wishing to avoid higher rates of income tax by changing, if they could, income into gains.

It is now widely believed that Capital Gains Tax rates will be increased in the June 2010 budget. This briefing considers some of the issues that such a change might give rise to.

Section two

How much revenue does CGT raise?

The total CGT collected in recent years and the top GGT rate that applied in the year in question has been as follows:



As a proportion of government revenues – totalling over £540bn in 2009-10 – these sums are very small but CGT is important not because it raises a lot of revenue, but primarily because it stops a significant amount of tax avoidance in the income tax system. It is a “back stop” measure that prevents lost revenue elsewhere.

If there was no CGT then tax avoiders, and their accountants, would work hard to make income look like gains and so fall out of tax altogether. The mere existence of CGT stops that happening, at least in part.

The disincentive works best, of course, when the differential between the income tax and capital gains tax rates are as low as possible.

CGT does also have significant symbolic and social justice significance. It would be quite unjust if unearned gains were not taxed when earned income was.

In this context it is important to note just what sales and gifts of assets Capital Gains Tax is charged on. This data, like all that in this paper derived from HM Revenue & Customs published statistics, is for the tax year 2006/07, which is the latest of the type available, and shows the composition of gains arising in that year:

Capital gains tax

Estimated number of taxpayer disposals, disposal amounts and chargeable gains net of in-year losses, by type of asset, disposed of in 2006-07

Numbers: thousands; Amounts: £ millions

Type of asset (at time of disposal)	Number of disposals		Disposal value		Chargeable gains ¹		Chargeable gains as % of disposal value
	Number	% of total	Amount	% of total	Amount	% of total	
Financial assets:							
UK & foreign ordinary shares listed on the LSE	801	64	14,902	20	6,248	15	42
UK & foreign shares not listed on the LSE	209	17	26,797	36	21,473	51	80
Other financial assets ²	27	2	3,035	4	1,006	2	33
All financial assets ³	1,037	83	44,734	60	28,727	68	64
Non-financial assets:							
Agricultural land and buildings	13	1	2,756	4	1,338	3	49
Commercial/industrial land and buildings	25	2	5,769	8	2,754	6	48
Residential land and buildings	143	11	16,212	22	6,148	15	38
Other non-financial ⁴ assets	35	3	4,359	6	3,411	8	78
All non-financial assets ³	216	17	29,096	40	13,651	32	47
All assets ³	1,253	100	73,830	100	42,378	100	57

LSE = London stock Exchange

¹ Net of in-year losses but before deducting taper relief

² Other financial assets includes assets such as UK & Foreign listed and unlisted securities, unit trusts, loan notes, etc.

³ Totals may not sum due to rounding.

⁴ Other non-financial assets includes intangible assets such as goodwill and tangible assets such as fine works of art, etc.

Three transaction types dominate total capital gains. The most important, it seems by far, is the disposal of shares not quoted on the London Stock Exchange. The majority of such disposals will be of privately held companies. A long way behind this activity come gains from share dealing on the London Stock Exchange and gains from the sale of residential property. The latter, of course, do not relate to people's homes which are exempt from Capital Gains Tax. They do instead relate to property dealing which was a major feature of

VAT - A regressive tax

the buy-to-let property boom and which helped fuel the increase in UK house prices over the last decade.

It is also important to note that the sale of businesses has also attracted significant tax reliefs. Until 2007/08 these gains were effectively taxed at 10%, which provided a massive tax avoidance opportunity for those who deferred taking income from their businesses and instead sold them with cash still in them, letting them enjoy the income arising in effect at a much lower tax rate. From 2008/09 this lower 10% tax rate has only been available for the first £1 million of gains. Because of these reliefs the amount of actual gain subject to tax arising from these sales may be a much lower proportion of the overall total than that indicated by the above table. Since total gains actually taxed in 2006/07 were only £16.6 bn as opposed to the £42.4 bn noted above this must, indeed, be the case, some £25.7 billion of gains having fallen out of account as a result of reliefs given in that year. £16 bn of these reliefs are likely to have been given on the sale of unquoted businesses.

These reliefs and exemptions help explain why the yield from this tax is so low.

Section three

Who pays Capital Gains Tax?

Capital Gains Tax is a minority interest. Over the period 2004/05 to 2007/08, which is the last year for which data is available, the total number of people paying Capital Gains Tax, differentiated by tax rate, was as follows:

Estimated numbers of individual taxpayers and gains by year of disposal, size of gain and income, 2004-08

Taxable Income (i.e. After offset of personal allowance)	Number of people making gains	Total gains reported £'m	Proportion of total declaring gains %	Proportion of total reported gains %
10% tax band	110,000	3,717	13%	7%
Basic rate income tax band	393,000	13,040	46%	23%
Higher rate band to £50,000	106,000	4,200	12%	8%
£50,000 to £99,999	119,000	6,895	14%	12%
£100,000 and above	131,000	27,752	15%	50%
	859,000	55,604	100%	100%

Data over a period has been used to eliminate annual trends.

In those years almost 60% of all reported gains and by value 30% of all gains declared are reported by people who pay little tax or paid income tax only at the basic rate.

This is surprising because according to HMRC data for 2005 (the last year available) the top 1% of the adult population of the UK owned 21% of all assets, the top 5% owned 40% of all assets, the top 10% owned 54% of all assets.

That leaves 46% owned by the rest of the population, but this does not take into consideration the considerable reliefs available for many assets such as family homes, pension funds and personal chattels which will form the vast majority of wealth for most people outside the top 10% of asset owners. Broadly speaking unless this group happen to own a second home (and this is unlikely) it would seem that most are unlikely to ever pay Capital Gains Tax.

VAT - A regressive tax

This is, in fact, the case: 128,000 lower or basic rate taxpayers paid CGT in 2007/08 – out of a total of 28.6 million lower and basic rate taxpayers in that year. Less than 0.4% of all ordinary rate taxpayers therefore paid CGT, a figure that rose to 3.1% amongst higher rate taxpayers.

But that still seems a surprisingly high number until a possible explanation is taken into account, and that is that a great many of those on very low rates of tax paying CGT were the spouses of tax payers on higher rates of tax who had the ownership of assets transferred to them by their higher tax paying partners prior to sale taking place. This transfer would have been tax free, but would have then meant an additional annual exempt sum for CGT would have been available for offset against the gain arising and lower rates of tax would have been available to offset up to £35,000 of chargeable gain, representing a potential total saving to a couple where the gain would otherwise have been charged on the higher rate spouse or civil partner of about £10,000.

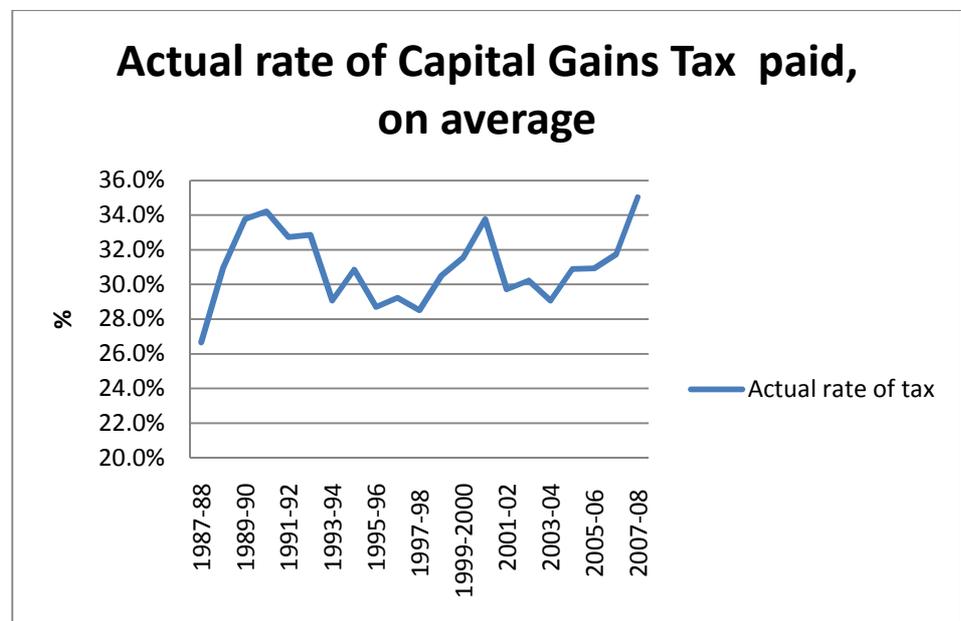
This type of tax planning was commonplace in the accountancy profession at the time and could both explain the unusual data on large numbers of seemingly low income people having high gains and the relatively low yield of the tax.

Section four

Do Capital Gains Tax revenues change when tax rates change?

It is frequently argued that if Capital Gains Tax rates were lower then the amount of tax due to the Exchequer would increase. There is clear, if limited evidence, that this is not true.

The effective rates of Capital Gains Tax paid (having matched revenues received with the gains of the year to which they relate – a necessary process because Capital Gains Tax tends to be paid at least a year after the actual gain to which it relates arises) from 1987/88 to 2007/08 (the only years for which this data is available) are as follows, but note that the gains against which this sum is calculated are after the generous tax reliefs noted in the previous section:



There was an unambiguous rise in the effective tax rate with regard to Capital Gains Tax when the tax rate rose from 20% in 1987/88 to be set at income tax rates throughout the rest of this period. In other words, the tax rate increase resulted in extra revenues. The so called “Laffer” effect, where it is claimed that increased tax rates result in reduced revenues did not happen.

Why have VAT revenues declined as a proportion of overall tax revenues?

Initial evidence from the fall in the Capital Gains Tax rate in 2008/09 also suggests that the Laffer effect has not been seen. If that effect were to hold true the fall in rate should result in an increase in revenue. However, total revenues in 2008/09 – the year when the Capital Gains Tax due on gains arising in 2007/08 would be paid – this being the last year when CGT could be charged at rates as high as 40% - were £7.85 billion. In 2009/10, the first year when tax was due to be paid at the reduced rate of 18% the total anticipated revenues amounted to £2.45bn. Of course some of the fall might be because of the recession resulting in a lower volume of gains being realised. But that is unambiguously clear is that the cut in rates did not increase revenue.

The conclusion is unambiguous: the amount of Capital Gains Tax paid in a year is directly related to the tax rate, and there is no apparent inverse reaction where cuts stimulate the reporting of more gains with more taxes paid and vice versa.

Section five

Capital Gains Tax and tax avoidance and evasion

As noted in section 1 of this report, one of the reasons for having Capital Gains Tax is to prevent avoidance of income tax.

As also noted in section 3 of this report, tax avoidance with regard to Capital Gains Tax is rife, especially when there are significant tax differentials that can be exploited with ease.

Since Capital Gains Tax has been set at a rate of 18% whilst top rates of income tax have been increased to 50% the incentive to seek to switch income into capital gains has been very high.

That this switching of income into gains occurs is readily apparent from HMRC data: in 2006/07 (the last year for which data is available) 33% of all capital gains reported on shares and financial assets arose on assets owned for less than a year. 10% were owned for less than two months. 48% were owned for less than two years. It is hard to see this as anything but trading which gives rise to income rather than investment resulting in gains, but the treatment as gains, with the favourable consequences in terms of additional allowances, reliefs and potentially lower rates of tax are allowed none the less.

When Capital Gains Tax rates were set at income tax levels but the partners in a marriage or civil partnership had the opportunity to switch the ownership of assets between them was high, savings of up to £10,000 a year in tax could be achieved in many cases with relative ease as noted in section three.

There are numerous other tax avoidance opportunities using gains. For example, despite anti-avoidance measures seeking to prevent it occurring there is considerable avoidance of income tax taking place on the extraction of income from private limited companies which are sold when cash or asset rich so that the value disposed of which might have been subject to income tax is instead received as a capital gain.

Other VAT issues

One of the greatest abuses of Capital Gains Tax of all has been in the private equity and hedge fund sectors where the so-called ‘carried interest’ of partners in such funds are considered to be business assets for CGT purposes, even though they result from the work activities of those engaged in these trades. This, notoriously gave rise to the situation where hedge fund and private equity partners were paying tax at lower rates than their office cleaners. This abuse of the definition of business assets has created considerable wealth disparity and misplaced economic activity in the UK economy.

Finally with regard to avoidance (although this list is far from exhaustive) the categorisation of second homes as ‘furnished holiday lettings’ allows them to be considered business assets. Business assets, as noted above, have always been subject to favourable Capital Gains Tax treatment. The result is that the low rate of tax on these properties has encouraged further house price inflation in rural communities as well as denying properties to local buyers. Both are unfortunate side effects of a Capital Gains Tax relief.

The issue of Capital Gains Tax evasion is hard to assess but it is likely to be rampant. In 2004, data from the London Stock Exchange showed that the total value of equity shares traded on the London Stock Exchange was £2,316 billion and there were 54 million “bargains”¹. The last breakdown of share trading volumes was however published by the London Stock Exchange at the end of 2000. This showed that 91% of trades were on behalf of UK clients. Private clients created 65% of trades by number, but only 8% by value. In July 2007, UK private individuals owned shares worth £239 billion, or 12.8% of the market. The average trade size for UK institutions in 2000 was over £200,000 but only £7,800 for private clients (and the latter was falling although the numbers were increasing, presumably because of lower cost trading facilities and the influence of internet trading). This might imply that the total value of UK private client sales in 2004 of shares quoted on the London Stock exchange might be in the range £168 billion to £273 billion. This is entirely plausible: the average period of ownership of a share on the London Stock Exchange is now about seven months.

Data on the composition of declared capital gains is not available for 2004, but is for 2006/07, when, admittedly, the value of the market had risen and the number of trades had increased. In that year the recorded value of disposals by HM Revenue & Customs of shares quoted on the London Stock Exchange was £14.8 billion, a sum less than ten per cent of the lowest estimate of the value of shares disposed of in 2004, with the likelihood that that the sum was higher in 2006/07.

¹ Data from London Stock Exchange via http://www.uksa.org.uk/UK_stock_market.htm

Of course it is entirely plausible that a large number of those trading shares did not make either disposals or gains of sufficient amount to require their declaration for tax purposes.

It is equally plausible that many of those who did make such disposals failed to declare the resulting gains.

There is as a consequence a real risk that Capital Gains Tax is a “honesty box” tax, paid only by those who chose to declare with a significant number of those with liabilities either being unaware of that fact or choosing not to declare, safe in the knowledge that this little known tax, which raises limited revenue and attracts little attention seems to attract the attention of few tax inspectors, and so gives rise to limited risk of being caught. This may be the greatest problem of all with Capital Gains Tax.

Section six

Increasing CGT - The TUC View

It is widely believed that the rates of Capital Gains Tax will be increased in the June 2010 budget despite widespread opposition in the popular press to such a move. This increase, and a reduction in the annual allowance for the tax to a sum as low as £2,000 per annum, were both features of the Liberal Democrat election manifesto subsequently adopted by the coalition government.

The TUC would welcome both moves, for a number of reasons, and suggests further measures that are in its opinion necessary to ensure that the increased rates of tax are effective in operation, the latter being the subject of the next section of this report.

The first reason for supporting an increase in the rate of Capital Gains Tax is that this is a measure likely to be targeted almost entirely at those with the capacity to pay the additional tax. In the case of the significant number of basic rate taxpayers who do pay Capital Gains Tax, as noted above, the use of their income tax rate for assessment of Capital Gains Tax will have little impact on their overall tax bill, the rate change being from 18% to 20% is likely to have any significant impact on tax owed. On the other hand an increase in the rate from 18% to maybe 50%, which might happen, is significant and is an appropriate move to collect tax from those best able to make settlement of it at this time, especially as such sums will arise from unearned income and only for those in receipt of substantial income subject to tax already. There is, therefore, economic justice in such a change.

Second, the TUC believes it inappropriate at a time when everyone is being asked to tighten their belts that very generous annual tax allowances, far in excess of those given to those who work for a living, should be given to those who make unearned capital gains. It would appear to be timely and appropriate to lower these allowances at this time, and to also review the generous allowances that mean that the sale of all assets for sums of less than £6,000 need not be declared for Capital Gains Tax purposes so that the tax base for this tax is widened considerably to ensure that those trading in chattels and capital items make a fair contribution to the economy at this time.

Third, the TUC believes it vital that rates be aligned for income tax and Capital Gains Tax be aligned so that the motivation for seeking to turn income into gains is reduced.

Fourth, whilst the TUC accepts the need for favourable treatment of the sale of business assets, usually occurring on the sale of a trade after many years work in creating its value, it is aware that this relief is widely abused, examples from hedge fund, private equity and holiday furnished lettings being noted in this report. Considerably tighter definitions of business assets and business itself have to be adopted if continued lower rates for genuine entrepreneurs are to be made available or the relief as a whole should be withdrawn in the interest of overall economic equity at this time.

Finally, the TUC believes it important that Capital Gains Tax be increased to reduce wealth disparities in the UK. There is ample evidence that too little action has been taken to reduce wealth disparities in the UK. The TUC believes that redistribution of wealth is a fundamental reason for taxing. Capital Gains Tax has a role to play in this process that has not been properly appreciated or valued to date and the role of CGT in redistribution has to be recognised at this time if the impact of cuts and tax increases for the poorest in the UK are to be mitigated as far as is possible.

Importantly, the TUC believes all those changes in tax will be effective and will raise revenue. The claim that Capital Gains Tax revenues will reduce if rates rise is, as the evidence in this report shows, wrong. Increasing CGT rates results in increased tax revenues, and that is what is needed from this tax at this time.

Section seven

Preventing avoidance and evasion of Capital Gains Tax

The TUC believes Capital Gains Tax rates should be increased and that CGT allowances should be reduced. But it also believes that if these changes are to be effective enhanced anti-avoidance procedures are needed to ensure that as much of the Capital Gains Tax owing to HM Revenue & Customs is actually declared and collected.

There are a number of important changes to legislation and tax practice needed to ensure that this happens:

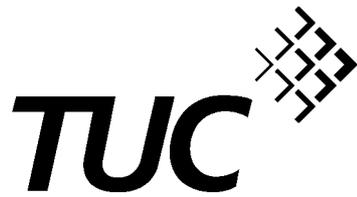
- The automatic notification of transactions that might give rise to a Capital Gains Tax liability should be made to HM Revenue & Customs. There is substantial evidence available from academic studies that if a taxpayer knows that transactions they undertake are automatically reported to their tax authority the chance that they will be declared on their tax return can increase from around 50% to maybe 90% or more. As a consequence:
 - All purchases and sales of land should be reported to a person's tax office
 - The sale of all shares and other investments by a person should be automatically reported to their tax office, at least annually
 - Auction house sales above an agreed value should be automatically reported to the vendor's tax office.

These measures will not stop tax evasion, but they will help limit it.

- More and better trained HM Revenue & Customs staff should be allocated to the investigation of Capital Gains Tax cases. Such staff always recover a yield many times in excess of their salary and employment costs even without taking into account the deterrent effect they create.
- All sales of assets held for a period of less than two years should be taxed as if trades under income tax rules. This will prevent abuse of the second annual allowance. It will also ensure that disposals of all such assets have to be declared in full on a person's tax return as trading income, with only

the income tax allowance available for offset against them if not used elsewhere, so substantially increasing the tax yield from this trading activity.

- The rate of tax relief for chattels should be reduced so that the opportunity to abuse this rule is reduced.
- Assets transferred from one partner to a marriage or civil partnership to the other should be considered the property of the original owner for two years after the gift is made to limit the shifting of asset sales into the name of the partner with a lower tax rate and to limit abuse of a second annual allowance for Capital Gains Tax purposes.



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