TAX BRIEFING NOTE
CAPITAL GAINS TAX

DECEMBER 2017

What is it?

Capital gains tax (CGT) is a tax on the gain in value of most assets between purchase and sale.

A personal allowance is deducted from 'chargeable gains', and the rest is then taxed. From 1988 to 2008, the rate was the same as the taxpayer's income tax rate. In 2008 it was simplified into a single 18 per cent rate until 2010, when a higher 28 per cent rate was added. The higher rate was paid on gains over the income tax higher rate threshold when taxable income and chargeable gains are combined. So those paying higher rate income tax would pay the higher rate of CGT on all their gains above the CGT personal allowance. In 2016, the rates were cut to 10 and 20 per cent except for residential property, which remain at 18 and 28 per cent.

Rate payable above allowance (£11,300 in 2017-18)	Basic rate taxpayers (%)	Higher rate taxpayers (%)
Residential property	18	28
Assets other than residential property	10	20

What's the problem with it?

It's a double tax that causes two significant economic problems. First, it weakens the financial incentives to reallocate economic assets when the current owners are no longer the best people to own them. This means, for example, that control of start-ups is retained by founders for too long. Entrepreneurs don't start as many new companies and more mature companies are controlled by people better suited to managing companies in their earliest stages. Secondly, it discourages investment by reducing post-tax returns.

It's tempting to think that setting CGT at the same rate as income tax would make the tax system neutral between income and capital gains, discouraging avoidance. But this is fundamentally and conceptually flawed. Most capital gains are *already* effectively post-tax. To understand why, imagine you own a company which you founded with no capital. This company now has no prospects of any future activities and has ended trading, but during your ownership its bank balance grew to £100,000. You have two options. One is to wind the company down and the £100,000 surplus would be treated as income. Or you could sell the company to someone else who would have the same options. But no buyer would pay £100,000 because of the tax payable on extracting the cash.

To keep things simple, let's assume there is only one income tax rate of 40 per cent, one CGT rate of 20 per cent, and no allowances. If you took the income, you'd receive £60,000 after tax. If you sold the company, the buyer would only pay at most £60,000 to avoid a loss. Your supposedly 'pre-tax' capital gain would be £60,000 which would then be subject to the 20 per cent capital gains tax. So capital gains are usually already effectively 'post tax'. A further CGT liability of 20 per cent (£12,000) wouldn't equalise the treatment. They're already the same with no CGT.

What should be done?

1. Abolish capital gains tax entirely when possible.

2. In the meantime, scrap the higher 20 per cent rate, and the 18 and 28 per cent rates on residential property to simplify the system. This would eliminate the need for entrepreneur’s relief by extending its 10 per cent rate to all investors and assets.