Should capital gains be tax privileged?

Madrid Public Economics Workshop 2024

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with Helen Hughson (CenTax, Warwick), Andrew Lonsdale (CenTax, LSE) and Andy Summers (CenTax, LSE)

HMRC Disclaimer

Introduction

Motivation

- Top incomes are responsive to tax incentives, e.g. lower tax rates on capital income leads to 'repackaging' of labour income (Smith Yagan Zidar Zwick, 2019; Miller Smith Pope, 2019)

- Even larger tax incentives to switch between income and capital gains in most OECD countries, calls for equalising rates (Slemrod, 1995; Mirrlees et al, 2010; Blundell, 2012)

- But, perhaps higher rates may discourage investment (Auten and Cordes, 1991; Cunningham and Schenk, 1992)

This paper: Research Question

- What are the effects of taxing capital gains differently from income?
  1. Equity implications?
  2. Efficiency cost of tax wedge with labour income?
  3. Do reduced rates promote (re)investment?

This paper: Results

1. Gains are highly concentrated, larger for repeat gainers, and come largely from business assets, often with low ‘base cost’.
2. Evidence that low rates encourage repackaging income as gains, shown in the context of an anti-avoidance reform
   - Consistent with most business disposals having low base cost.
3. No evidence that reduced rates on gains stimulate re-investment among successful entrepreneurs.
   - Benefits largely accrue to people exiting the labour force.

Data

Data (1) – administrative

- **Admin data from UK tax returns, 1996-97 to 2019-20:**
  - Universe of taxpayers receiving taxable capital gains, link to annual income data broken down by type (employment, dividend, property, etc.) to construct individual-level panel
  - Information on age, gender, industry, company director status, etc.

- **Asset-level survey (ALS), 2019-20**
  - Representative sample of UK tax returns reporting information on capital gains
  - Detailed information at the asset level (asset type, acquisition and disposal dates, base cost and disposal value)

Data (2) - companies

- **The Gazette, 2014-2019:**
  - All 'Resolution for Winding-up' notices (company liquidations)
  - Company number, company name, date of resolution to wind up

- **Companies House, 2014-19**
  - Statement of capital: capital injections into the company

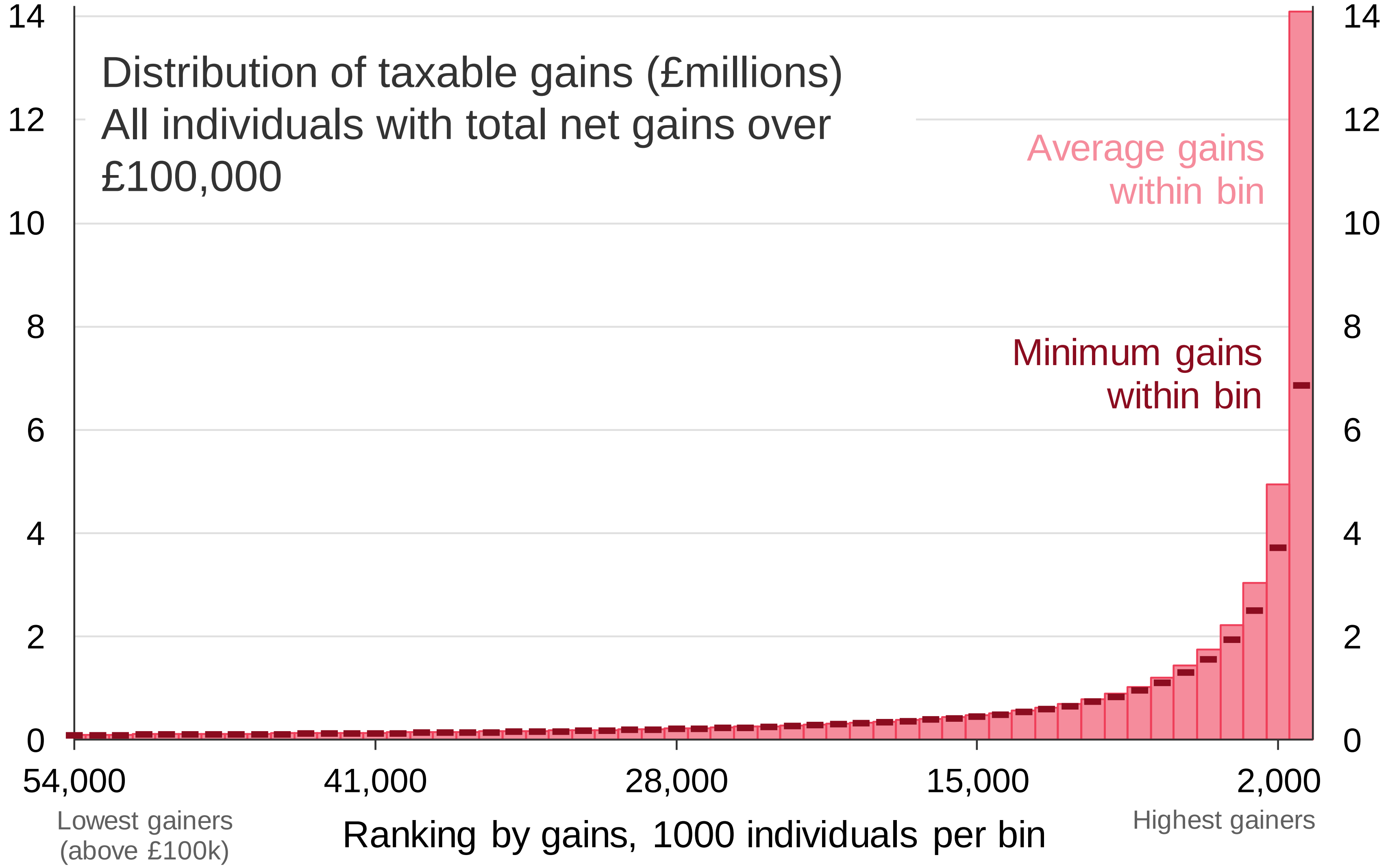
- **BvD Orbis, 2014-2019:**
  - Ownership (companies/individuals)
  - Company characteristics (age, size, industry)
  - Financials (balance sheet)

Five facts about capital gains

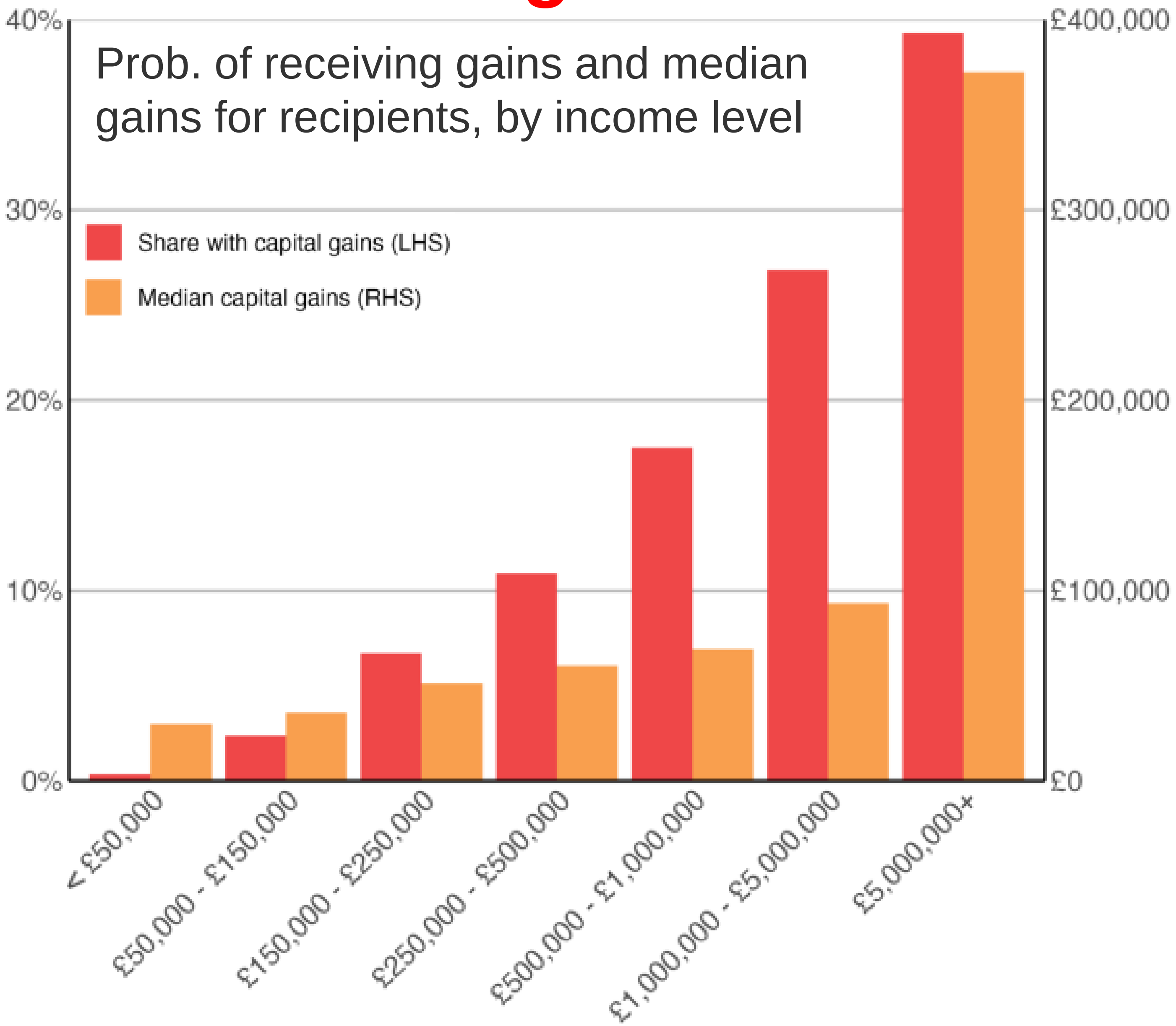
Five facts about capital gains

1. Gains are highly concentrated
2. …go to those with higher incomes
3. …are larger for repeat gainers
4. …come largely from business assets.
5. Returns are well in excess of normal rate of return

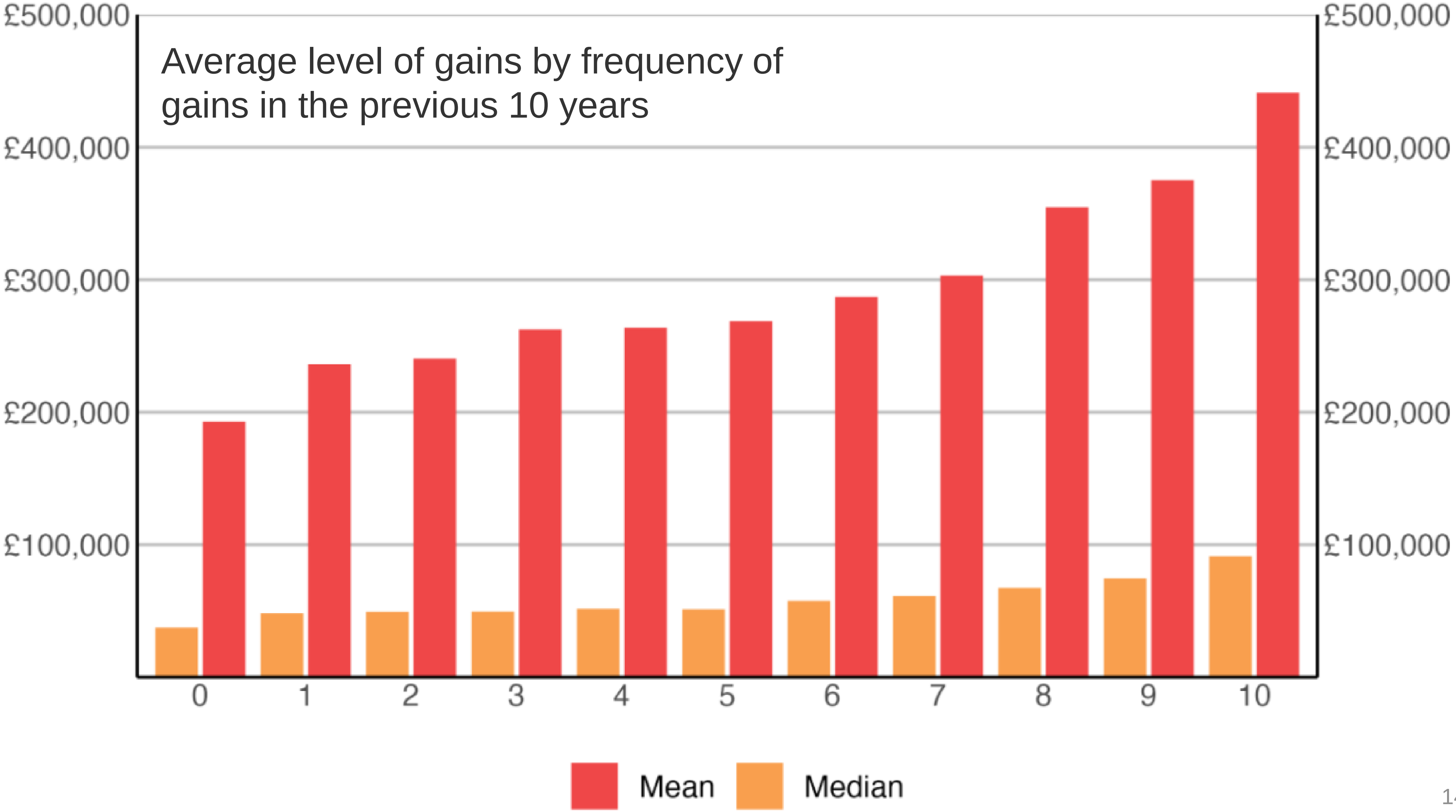
Gains are highly concentrated



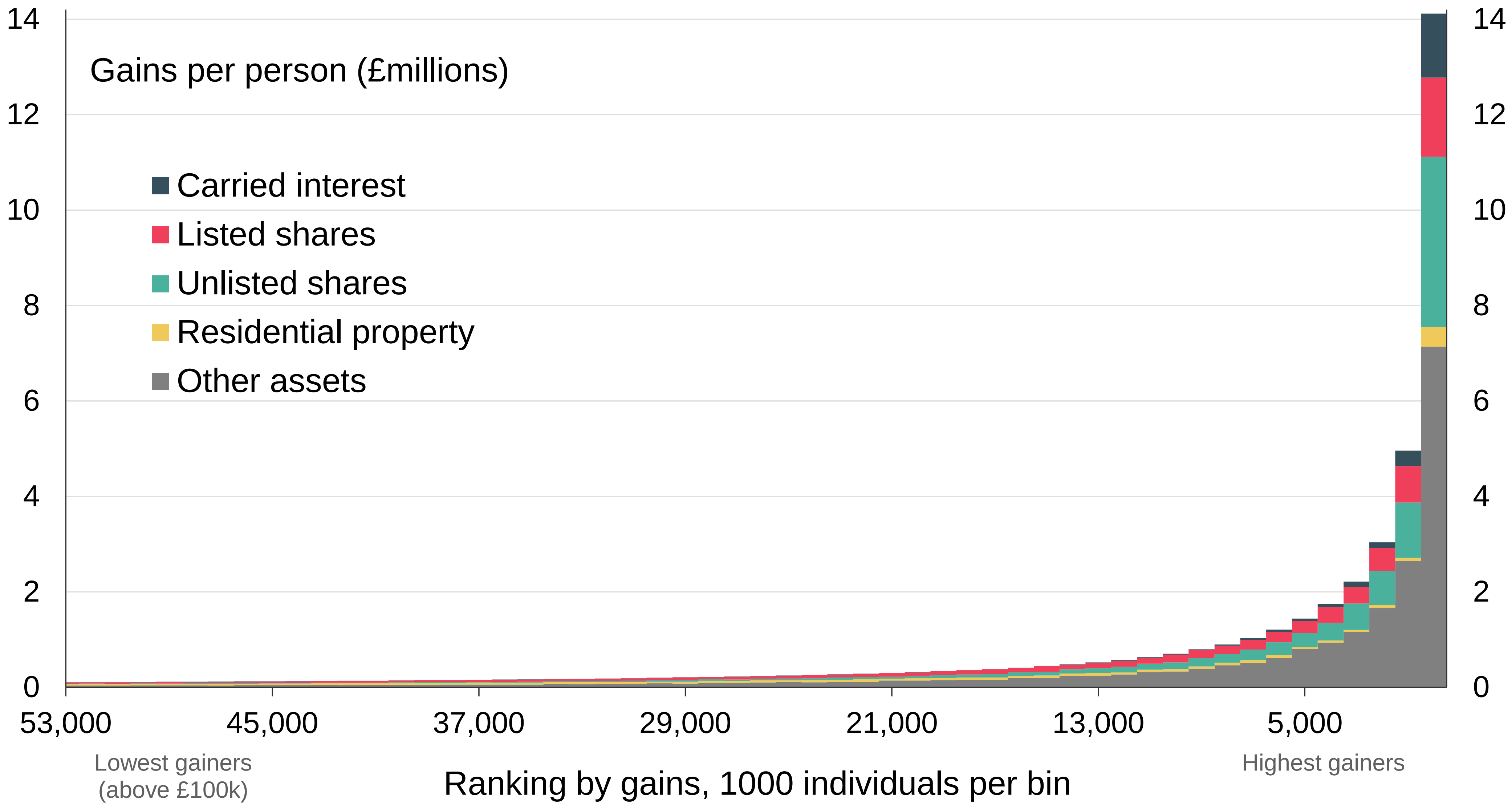
Gains go to those with higher incomes



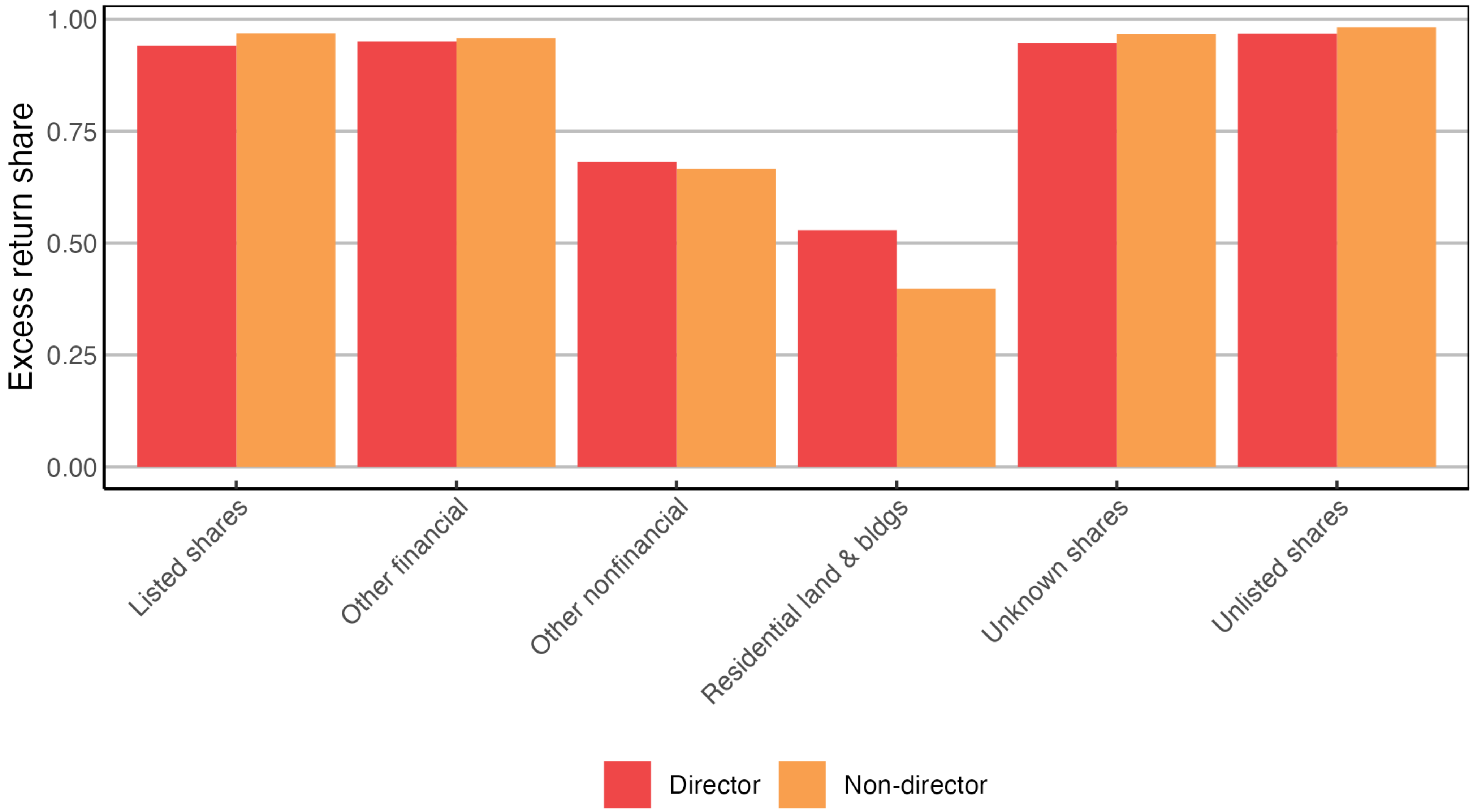
Gains are larger for repeat gainers



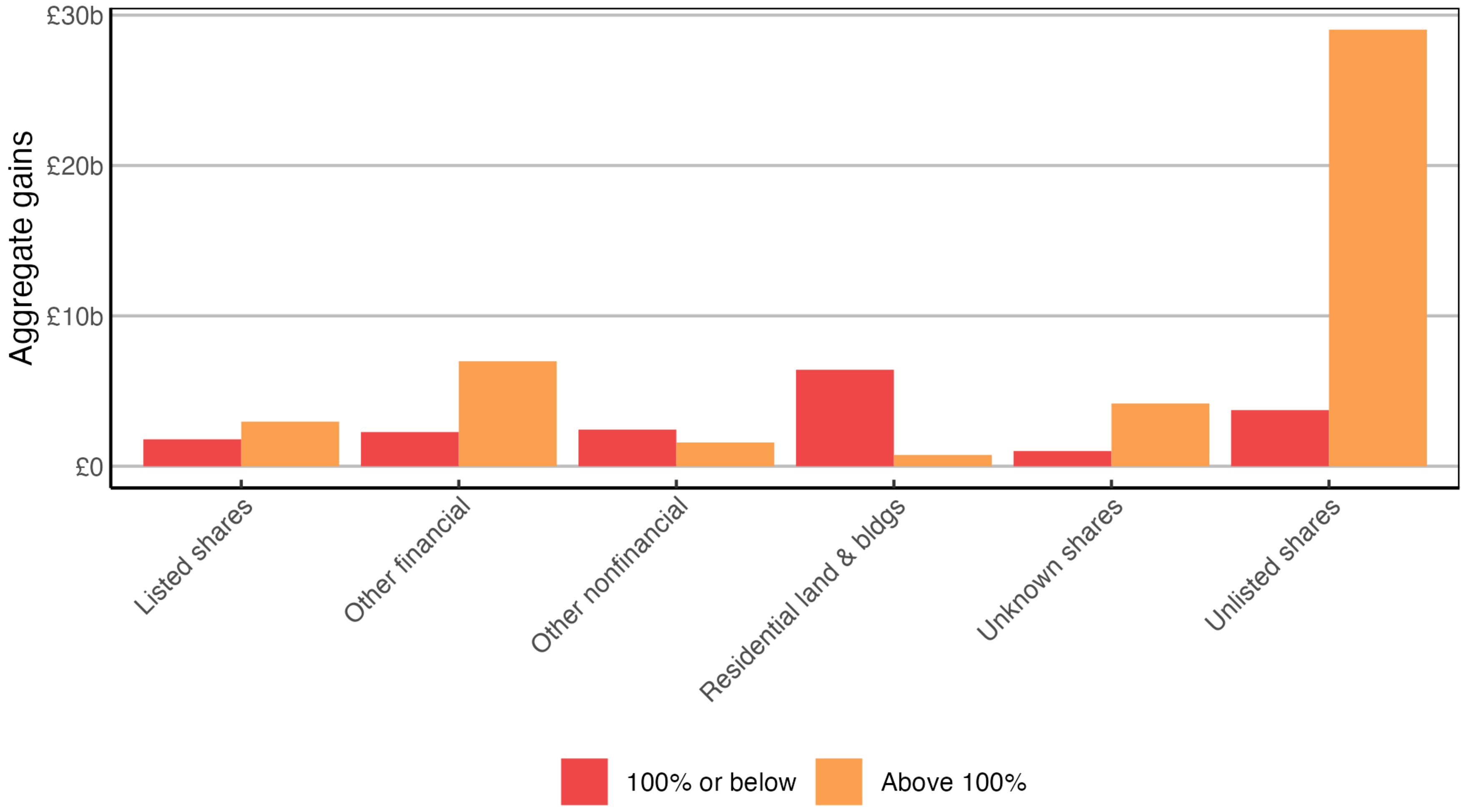
Gains largely come from business activities



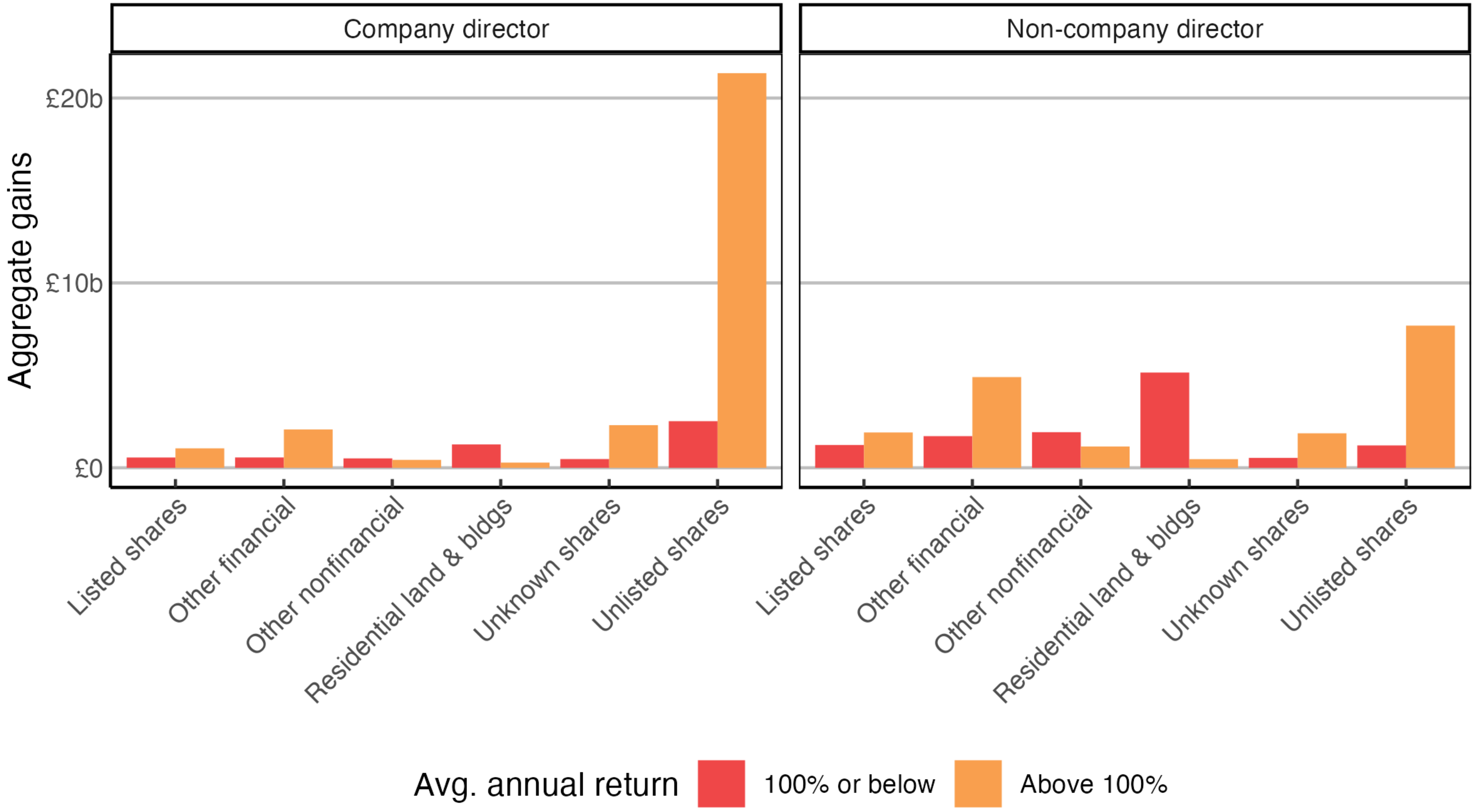
Returns are well in excess of the normal rate of return



Largest returns (> 100% per year on average) highly concentrated among business assets



These assets are typically held by company directors



Efficiency costs of a wedge between CGT and income tax

Income shifting?

- Tax wedge between CGT and income tax creates incentive to repackage income to appear to be gains.
  - Already substantial evidence of shifting between labour and capital income (Smith Yagan Zidar Zwick, 2019; Miller Smith Pope, 2019)
- Lower tax rates if shifting to gains, but higher hassle costs of extracting money.
  - Can’t just pay out dividends, need to sell or liquidate company.
- Do we see evidence of people doing this?

Evidence from an anti-avoidance reform

- Anti-phoenixing policy
  - Pre-reform: when wanted to take money out of company, could liquidate (‘MVL’), and then set up a replacement company (‘phoenix’)
  - Post-reform: no longer able to set up similar companies. Pre-announced.

- Look at bunching before reform date
  - How many companies are liquidating immediately pre-reform? Suggestive of income shifting, as incentive to do this only if were expecting to phoenix at some point (CGT was unchanged)

Anti-phoenixing reform leads to anticipatory liquidations

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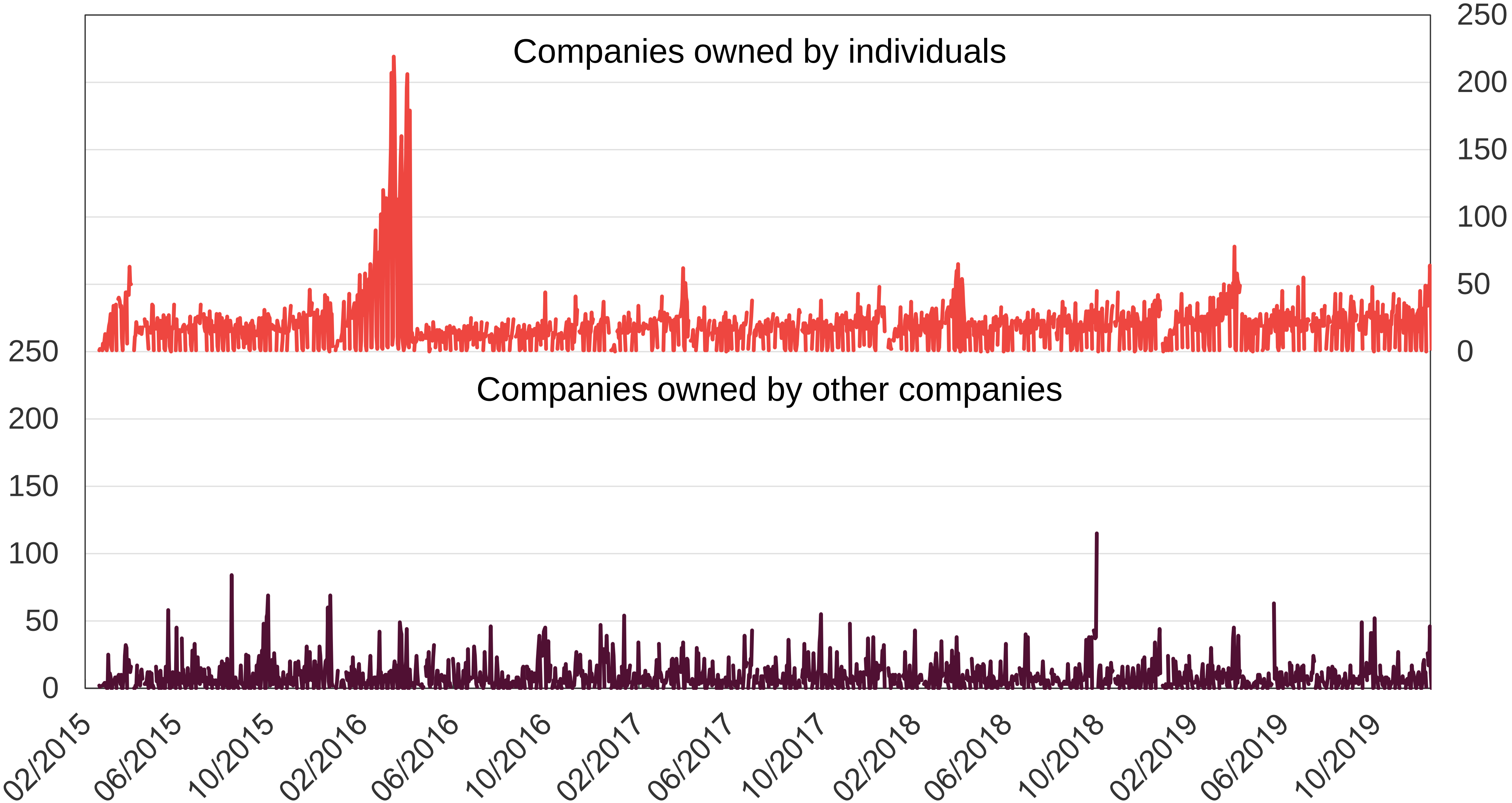
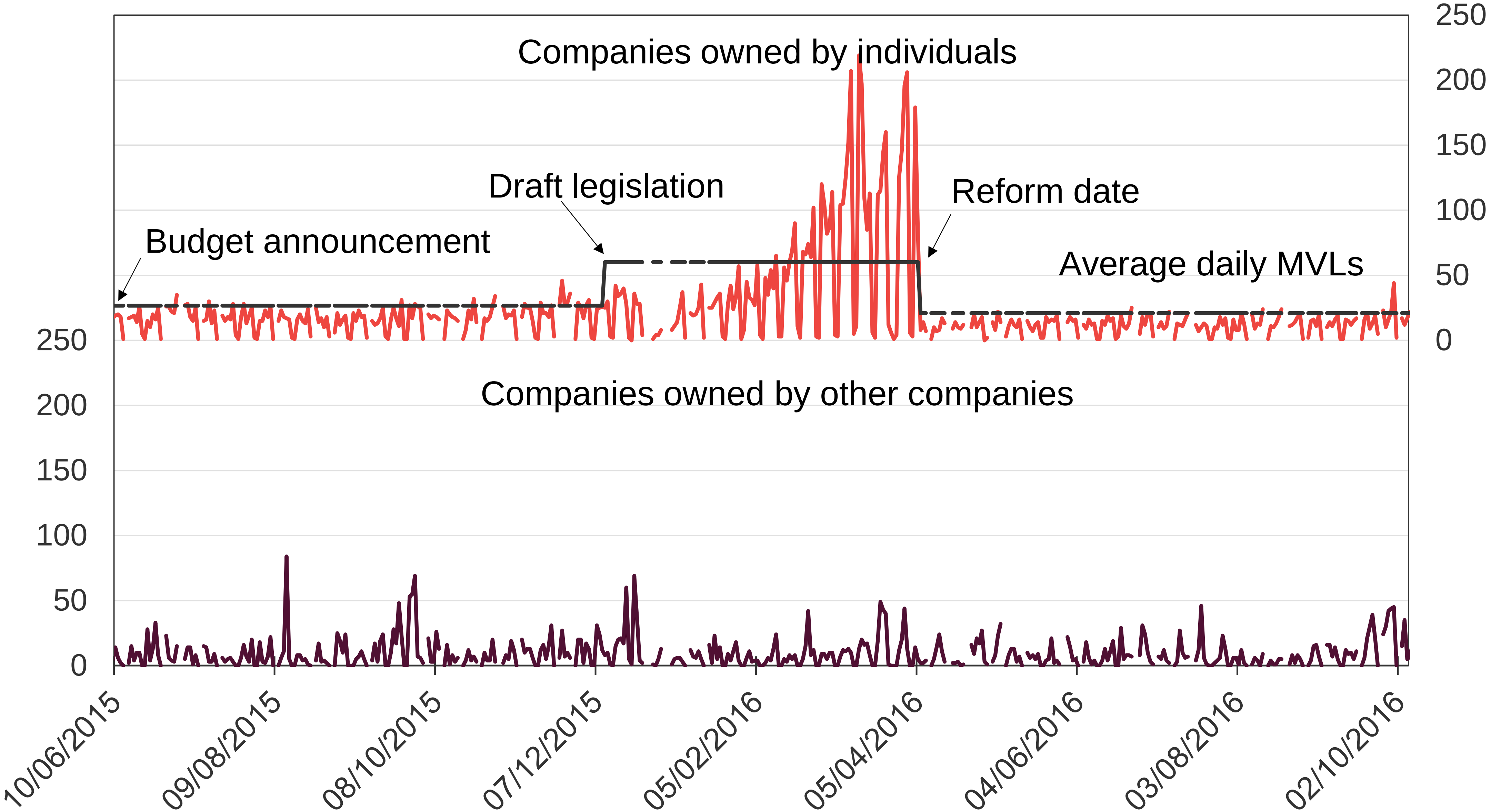


More liquidations around the reform



Liquidations around the reform

- In the six months up to the reform, there were more than 6.5k liquidations
- This is >7.5x the expected number of liquidations
  - Based on pre-reform data, there were 870 liquidations in the same period a year earlier

Liquidating companies are younger, more profitable, and have less invested capital and fewer employees

	Bunchers: MVL 9 Dec 2015 – 5 Apr 2016	**Non-bunchers:** 6 months before and after	p-value
Share with 0-2 employees	99.0%	98.1%	0.0002
Share making profit	72.1%	63.2%	0.03
Age	9.6	11.8	< 2.2e-16
Capital	£16,308	£154,046	0.23
Total Assets	£725,333	£3,501,959	0.25
Number of companies resolving to MVL	5541	4623	

What happens if we tax gains more like income?

Why not equalise income tax and CGT rates?

- Common concern is impact on investment.

- Have evidence on the effects of equalisation on *entry* into investment (Smith and Miller, 2023).
  - Equalising rates and providing tax deductions for investment is more efficient and raises revenue.

- But maybe low rates allow successful business owners to invest again?

Research Design

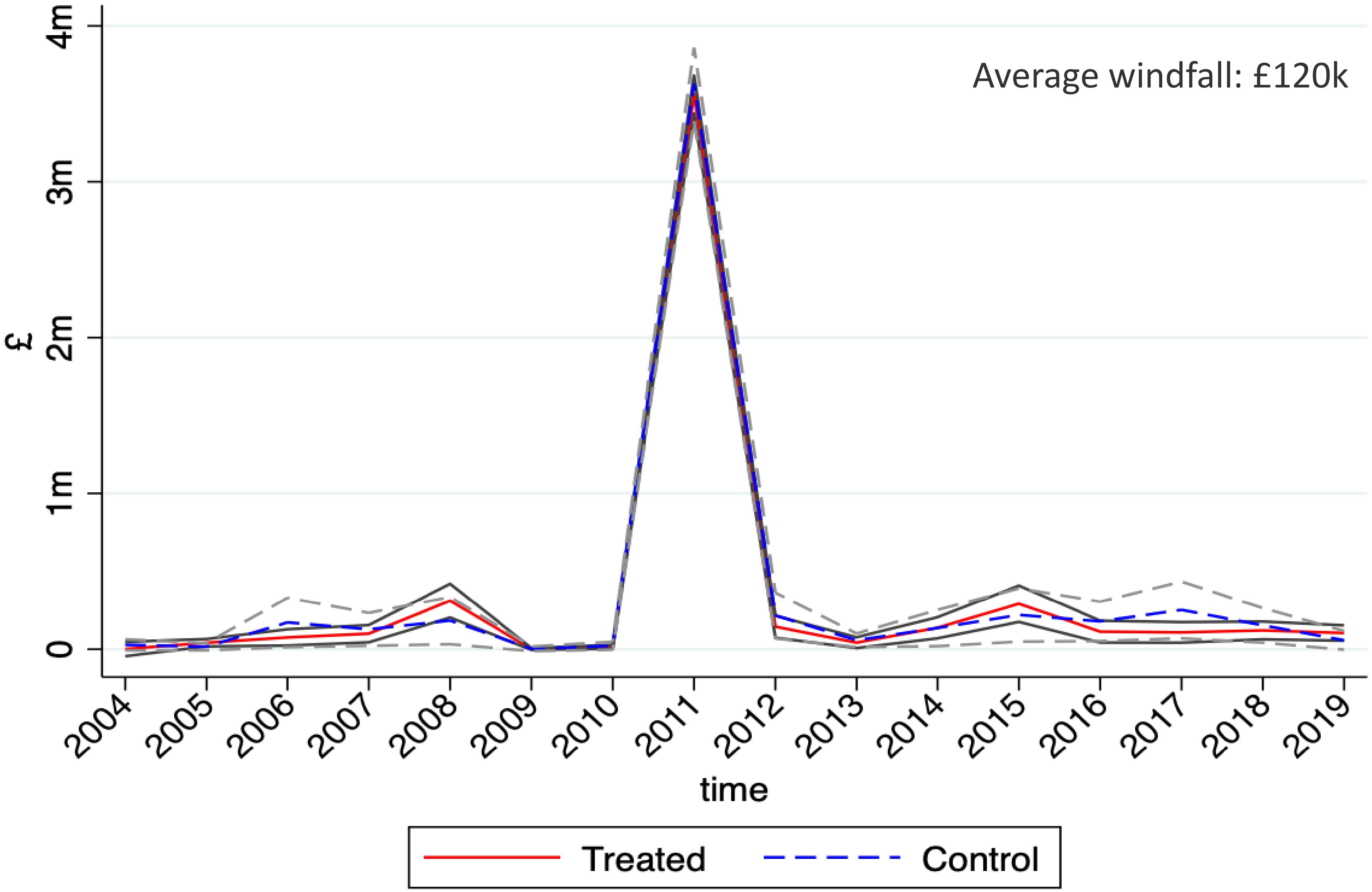
- Pre-reform policy: 18% headline CGT rate, but up to £2m at 10% if gains come from owner-managed business (‘Entrepreneurs’ Relief’).

- Reform: £2m cap raised to £5m partway through the 2011 tax year, not pre-announced. CGT rate on non-ER gains increased to 28%.
  - Effect is an increase in net gains for a given level of gross gains if receiving business gains of between £2m-8m.

- Design: look at effect of higher net gains, conditional on gross gains, on economic behaviour over the following decade

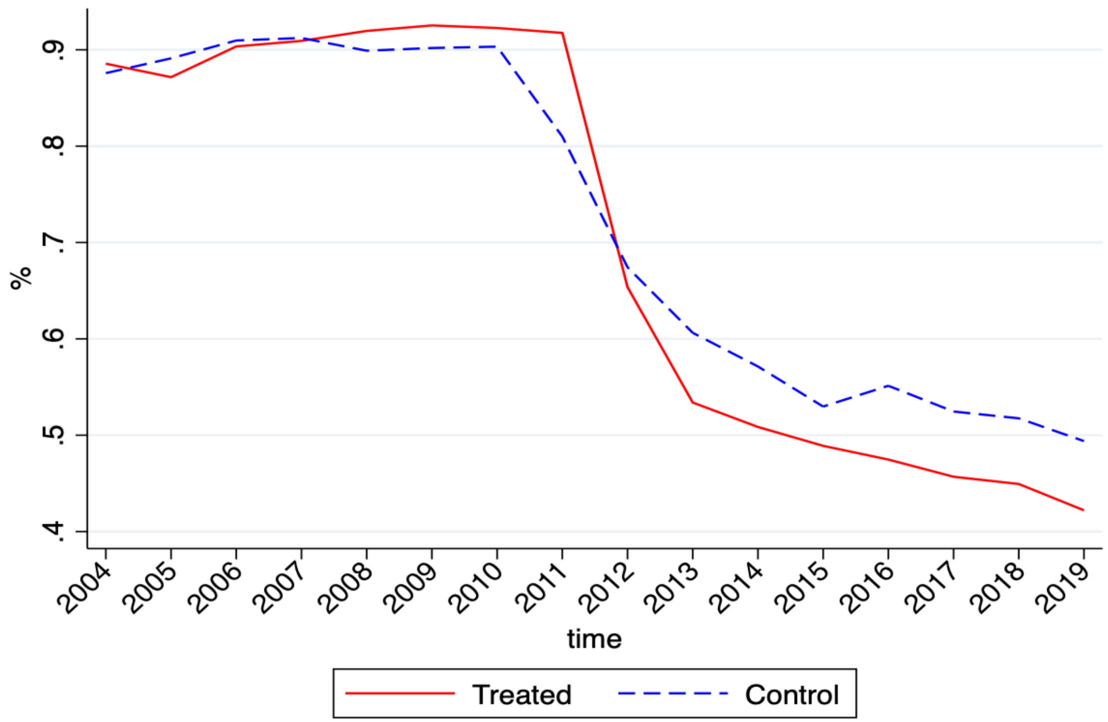
- Outcomes: investment, employment, earnings, directorship

No difference in average total gains for ER recipients

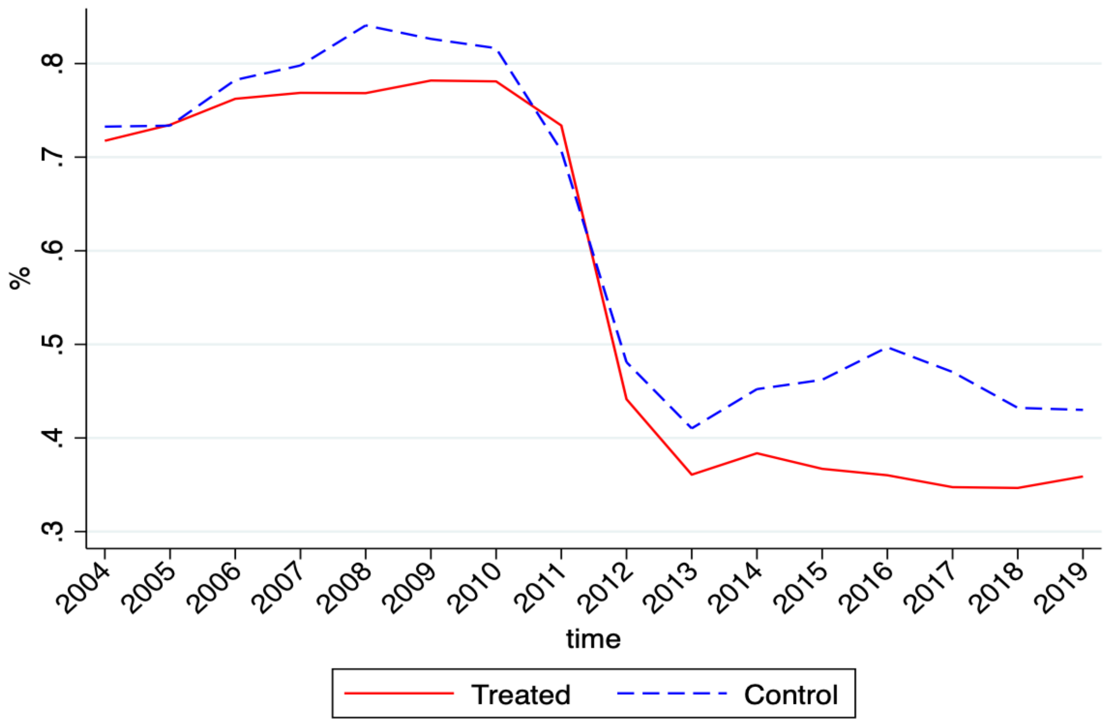


What did gainers do after receiving ER?

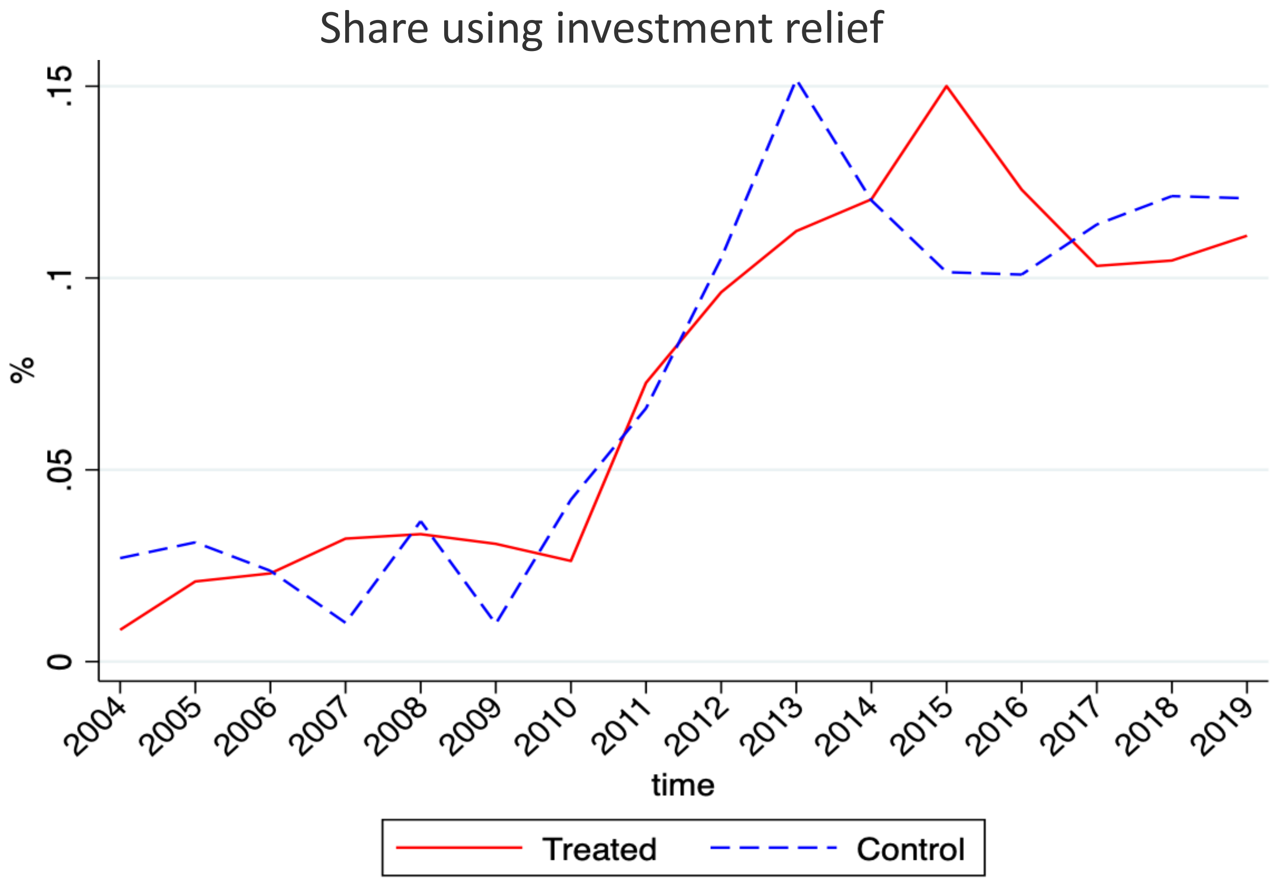
Share receiving employment income



Share of company directors

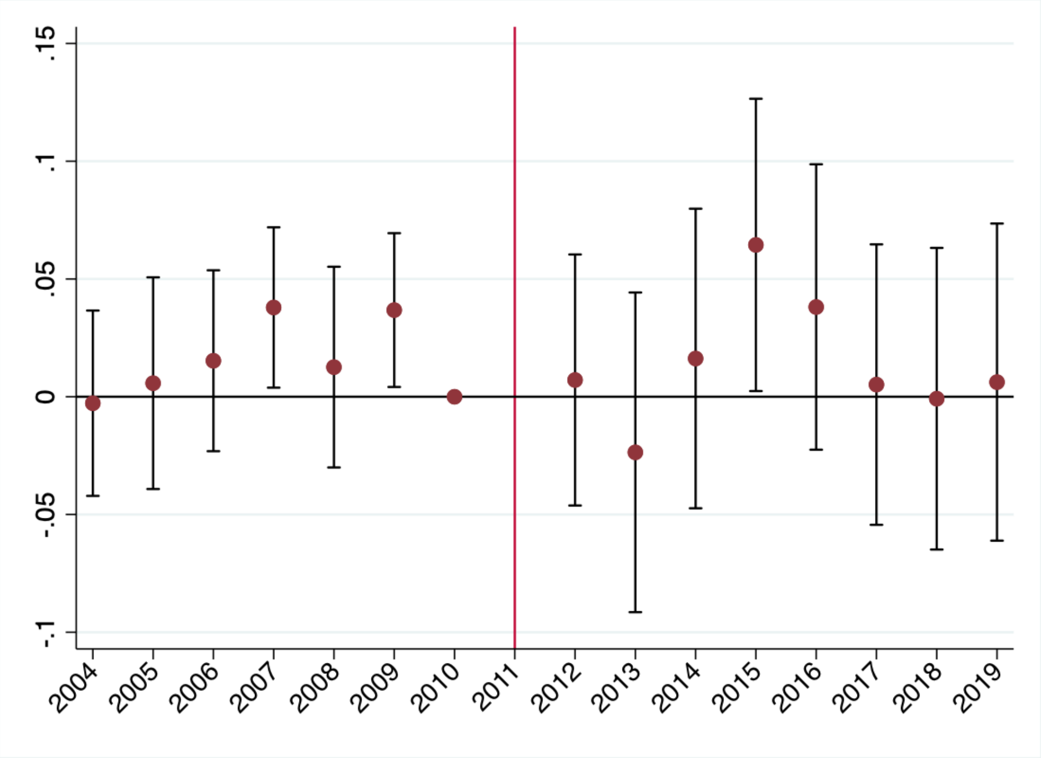


What did gainers do after receiving ER?

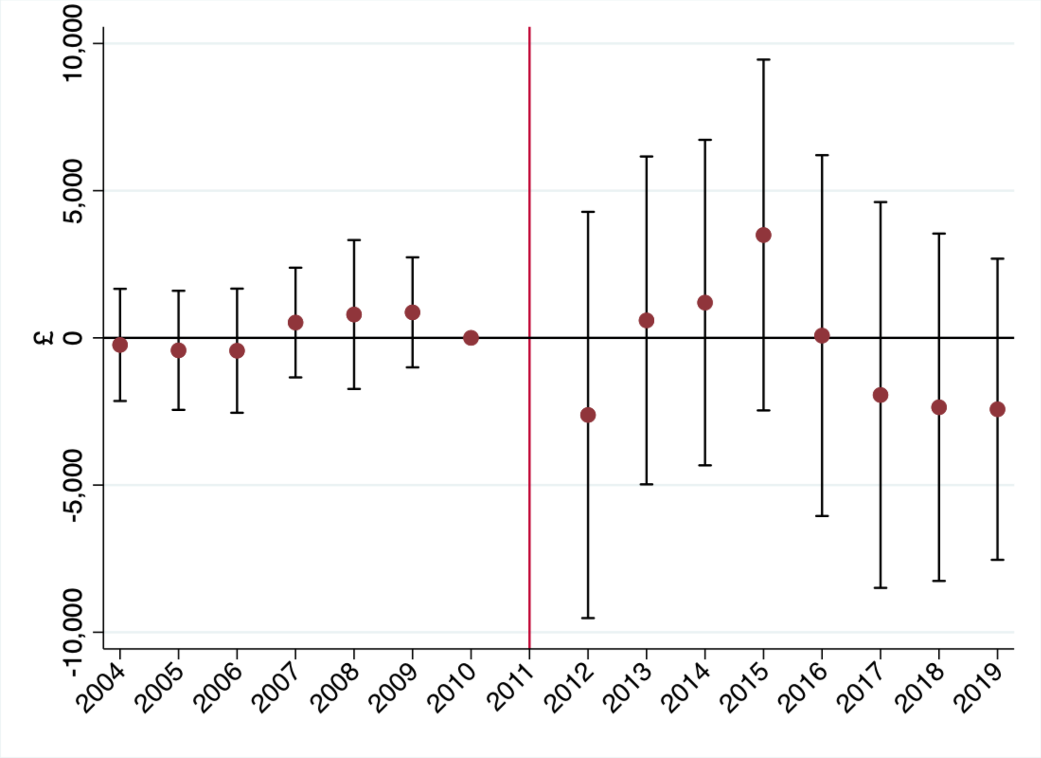


Treatment effect estimates of 2011 windfall: Investment relief

Probability of using investment relief

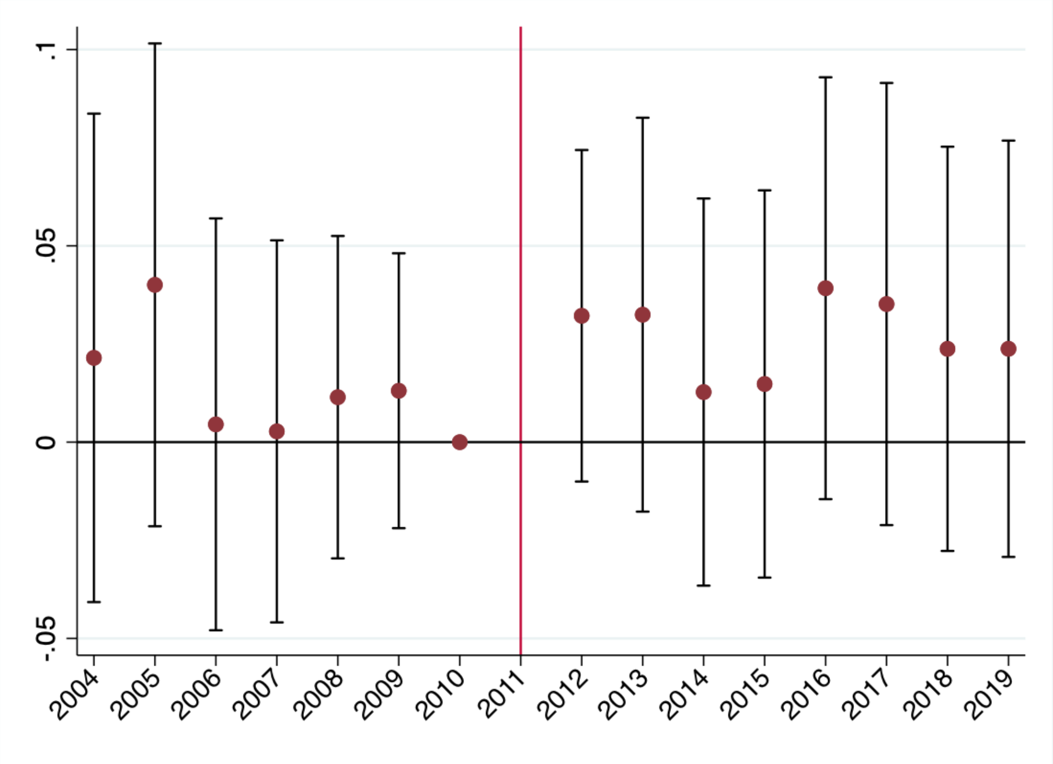


Amount of investment relief used

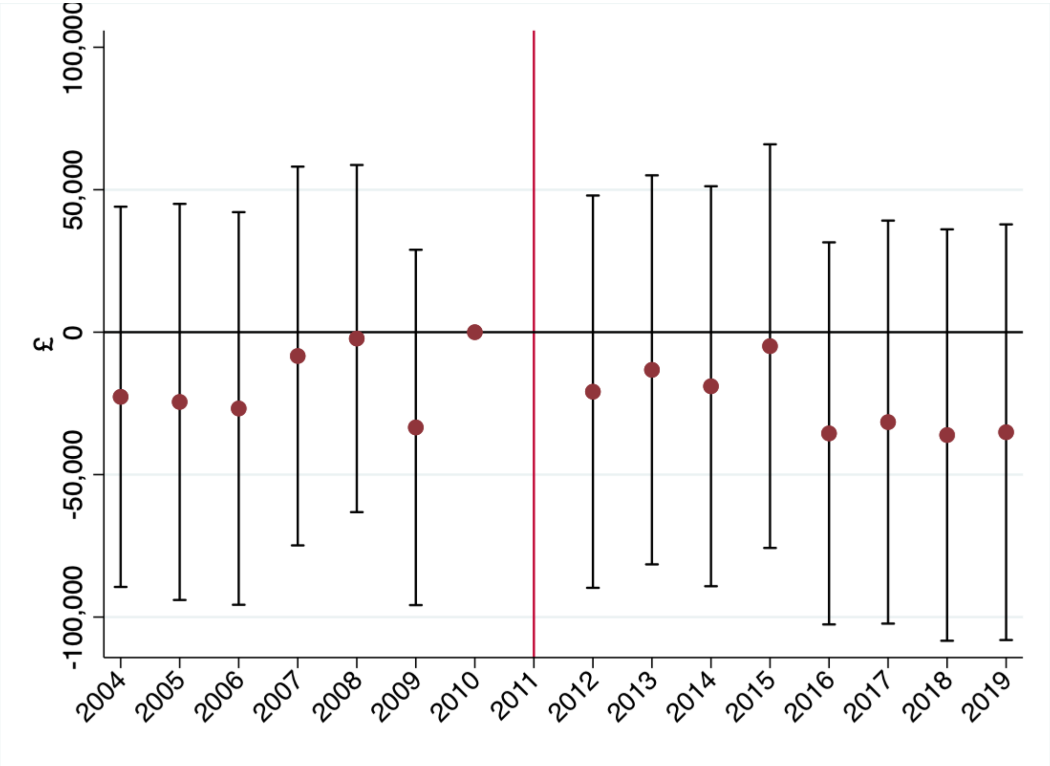


Treatment effect estimates of 2011 windfall: All investment income

Probability of receiving investment income

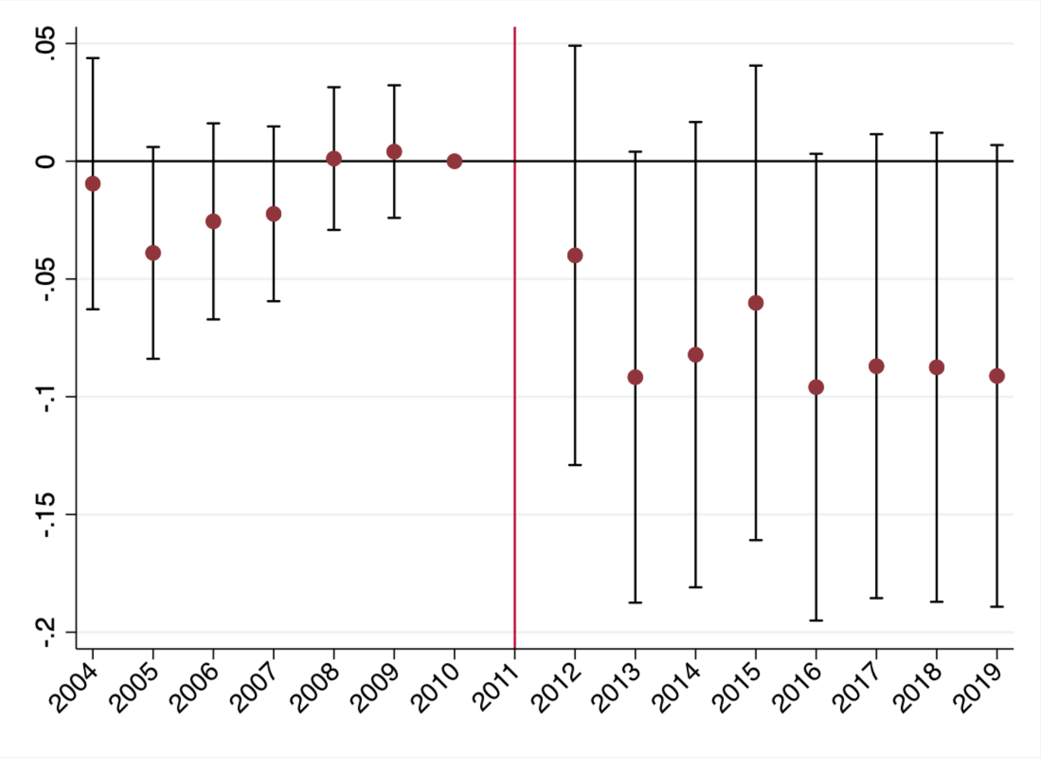


Amount of investment income received

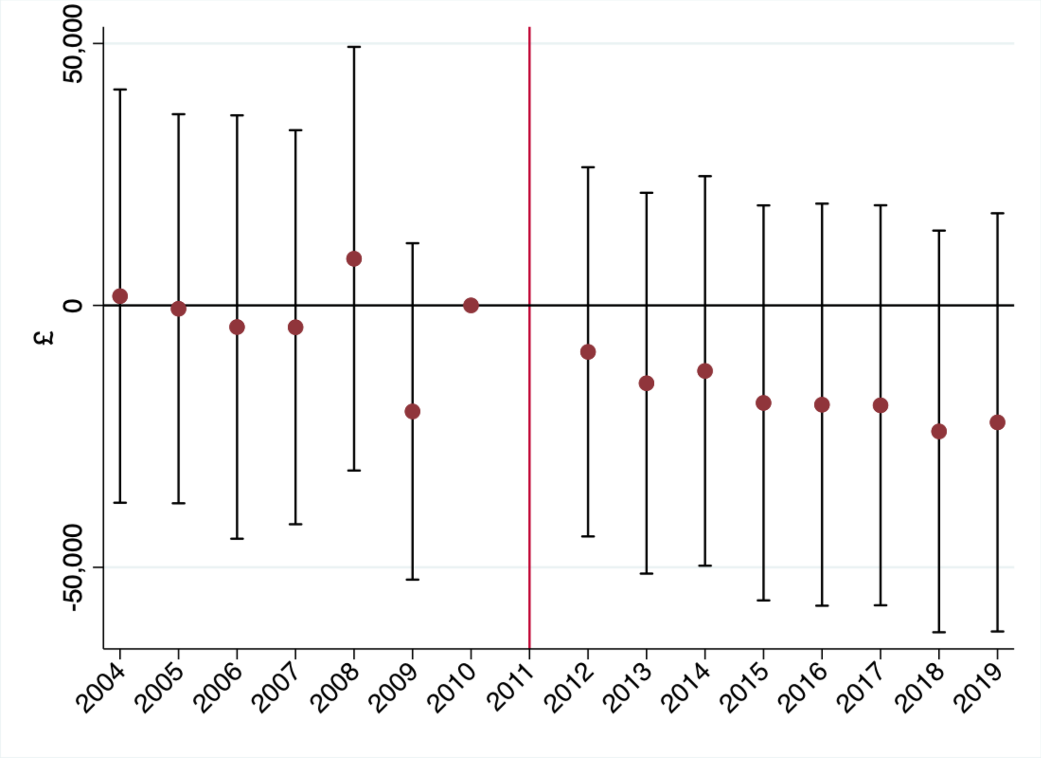


Treatment effect estimates of 2011 windfall: Employment income

Probability of receiving employment income

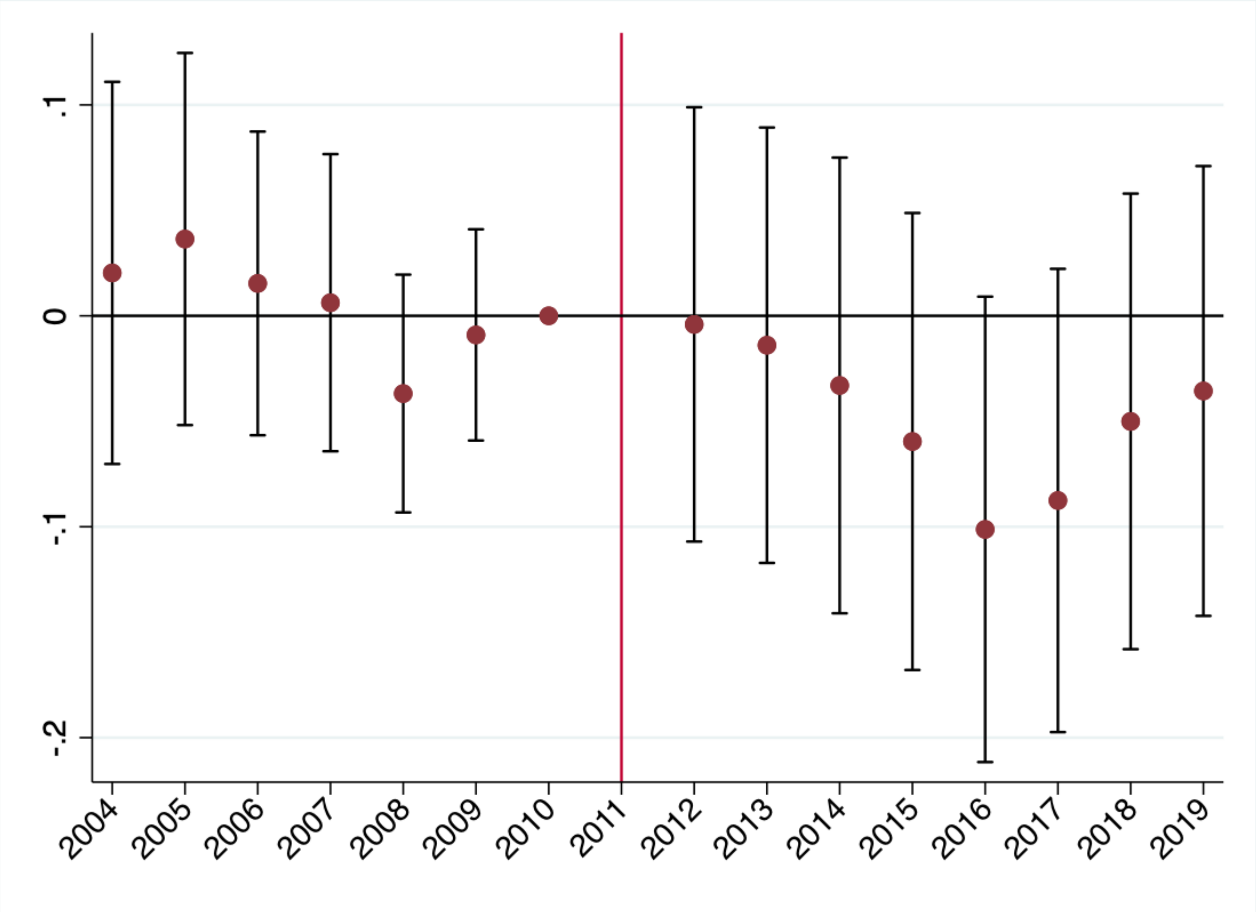


Amount of employment income received



Treatment effect estimates of 2011 windfall: Company director status

Probability of being a company director



Conclusions

Conclusions

- Most gains come from business returns → and those typically do not stem from an individual's capital at risk
- Offering tax break for gains on exit has little effect on re-investment
  - Seems to encourage retirement
- Suggests gains should be taxed more like income

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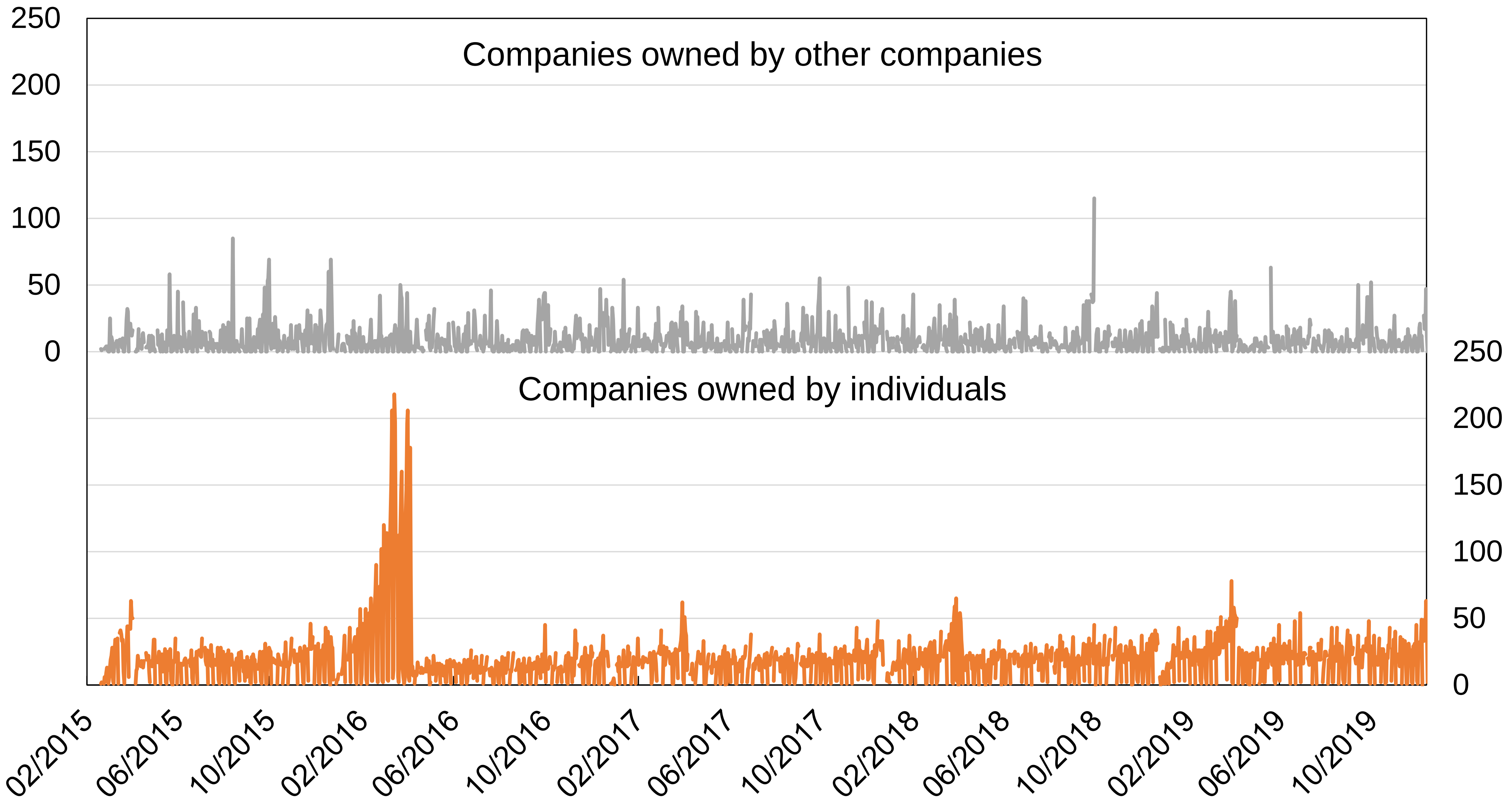
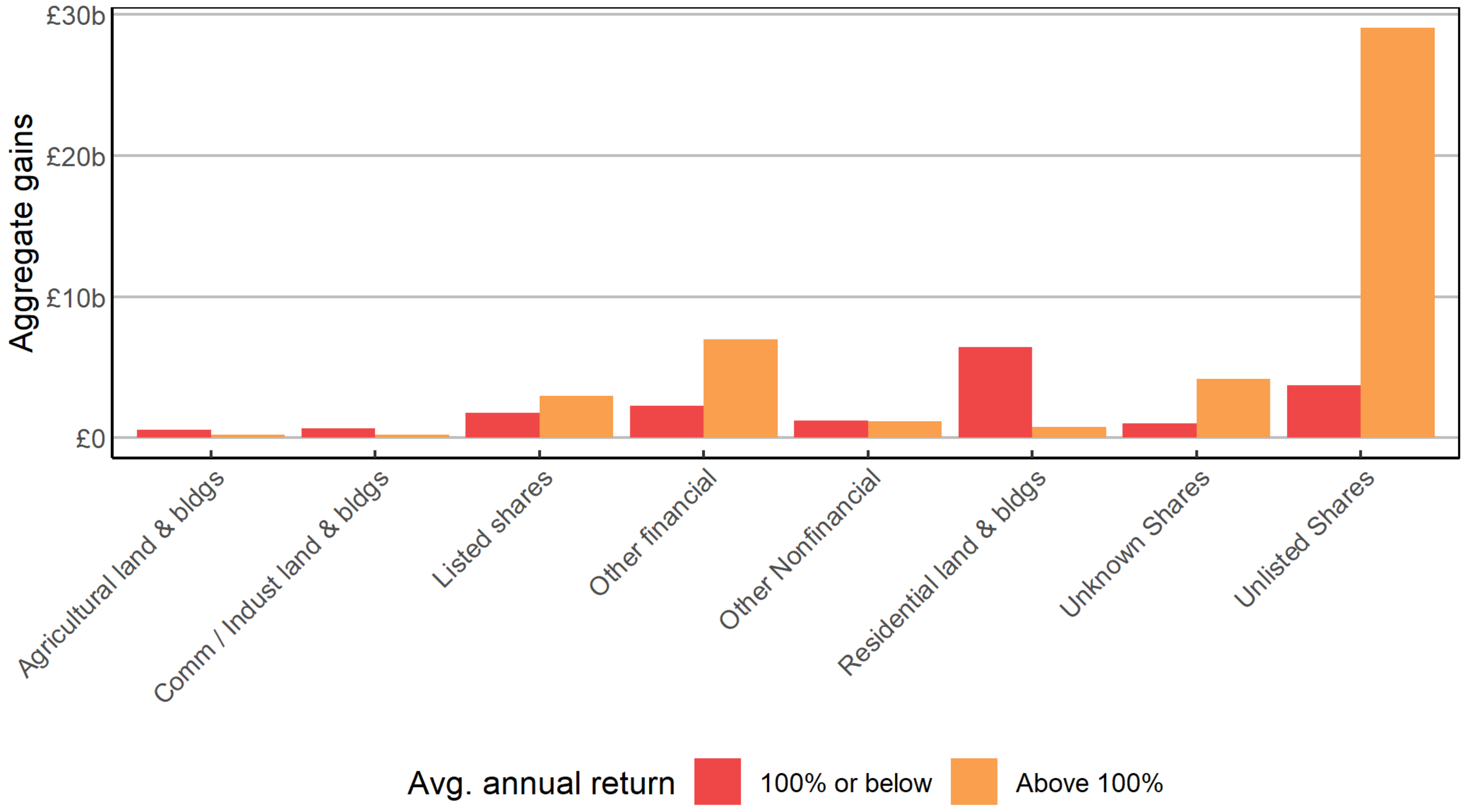
Liquidations over a longer span



Large returns (> 100% per year on average) highly concentrated among business assets



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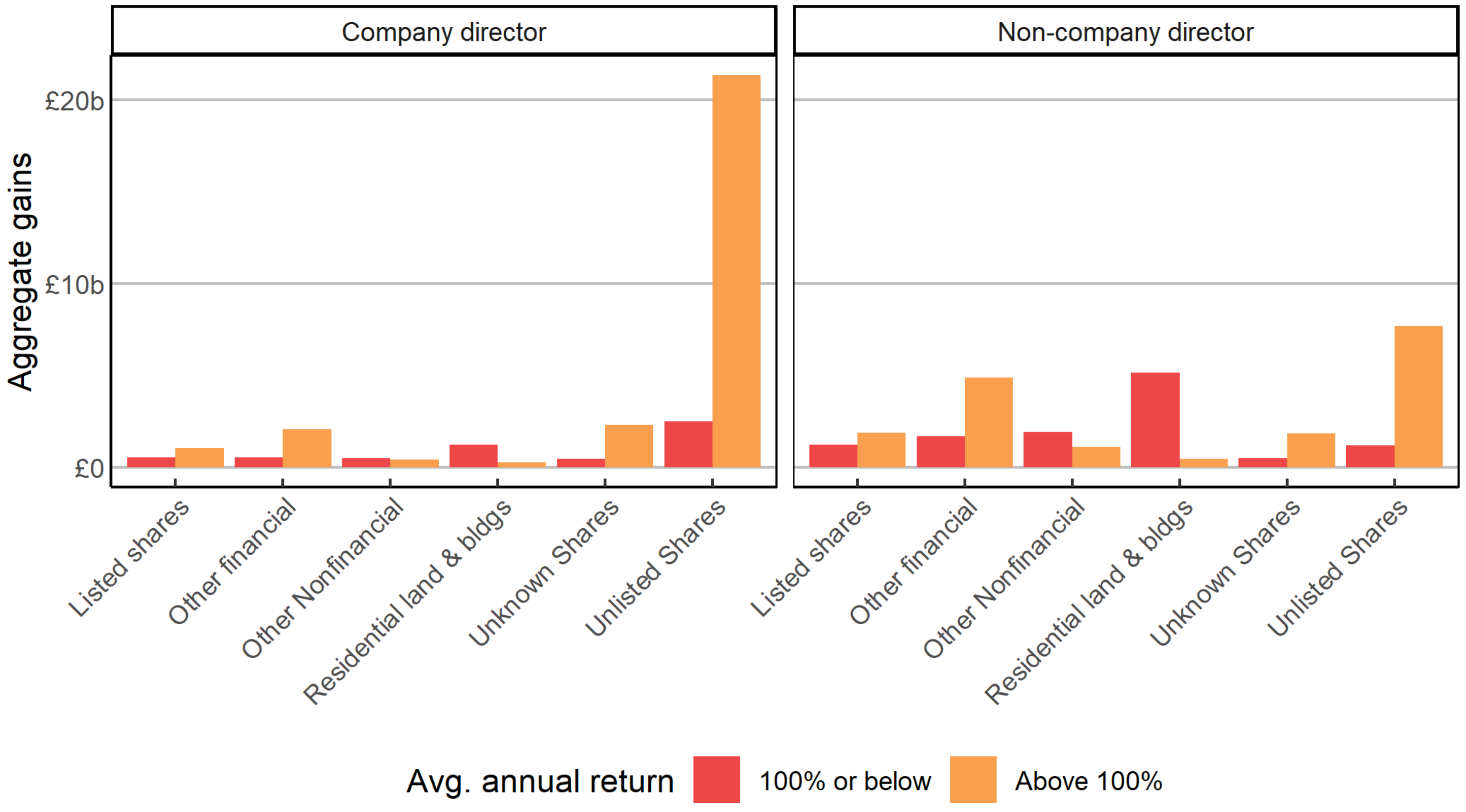
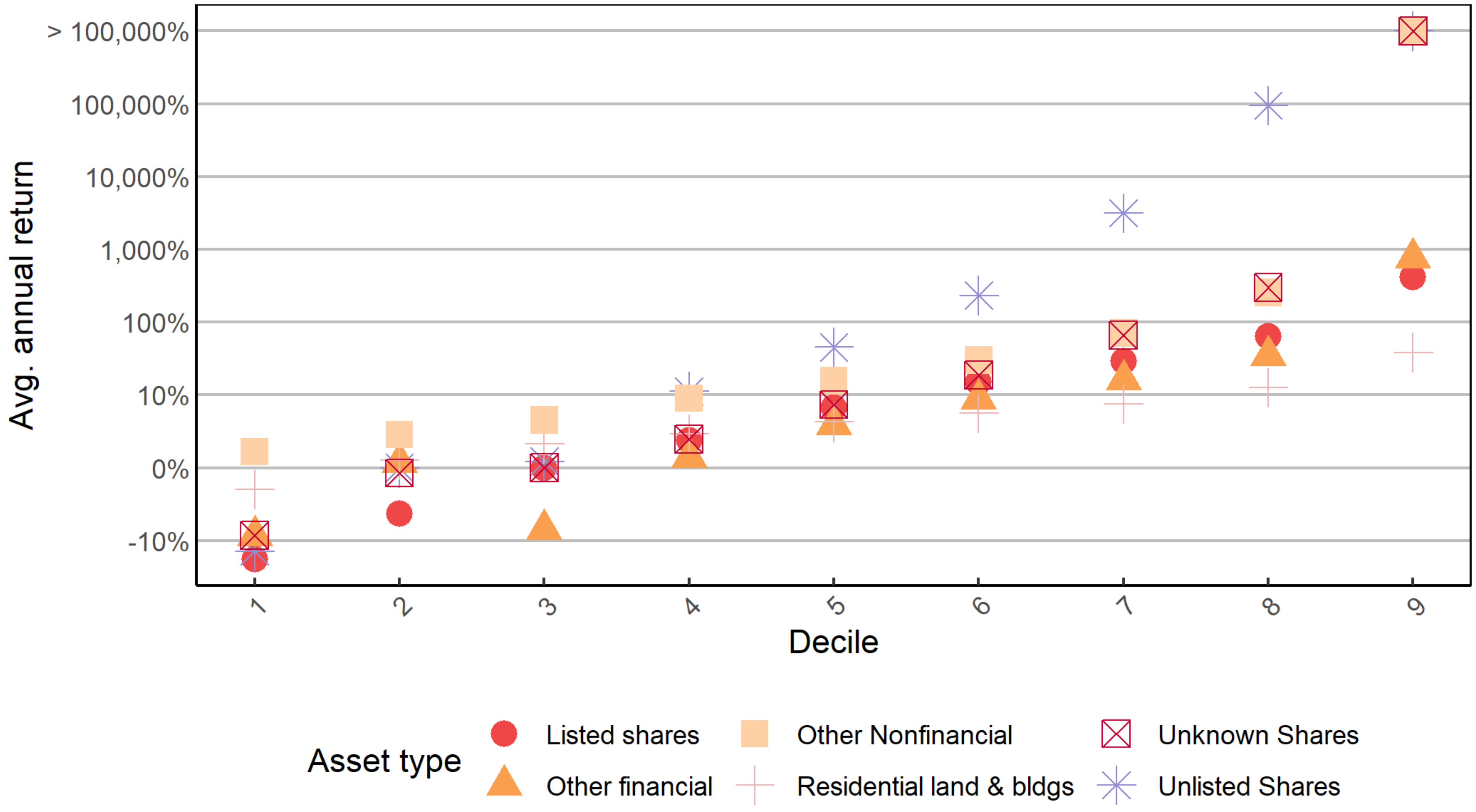


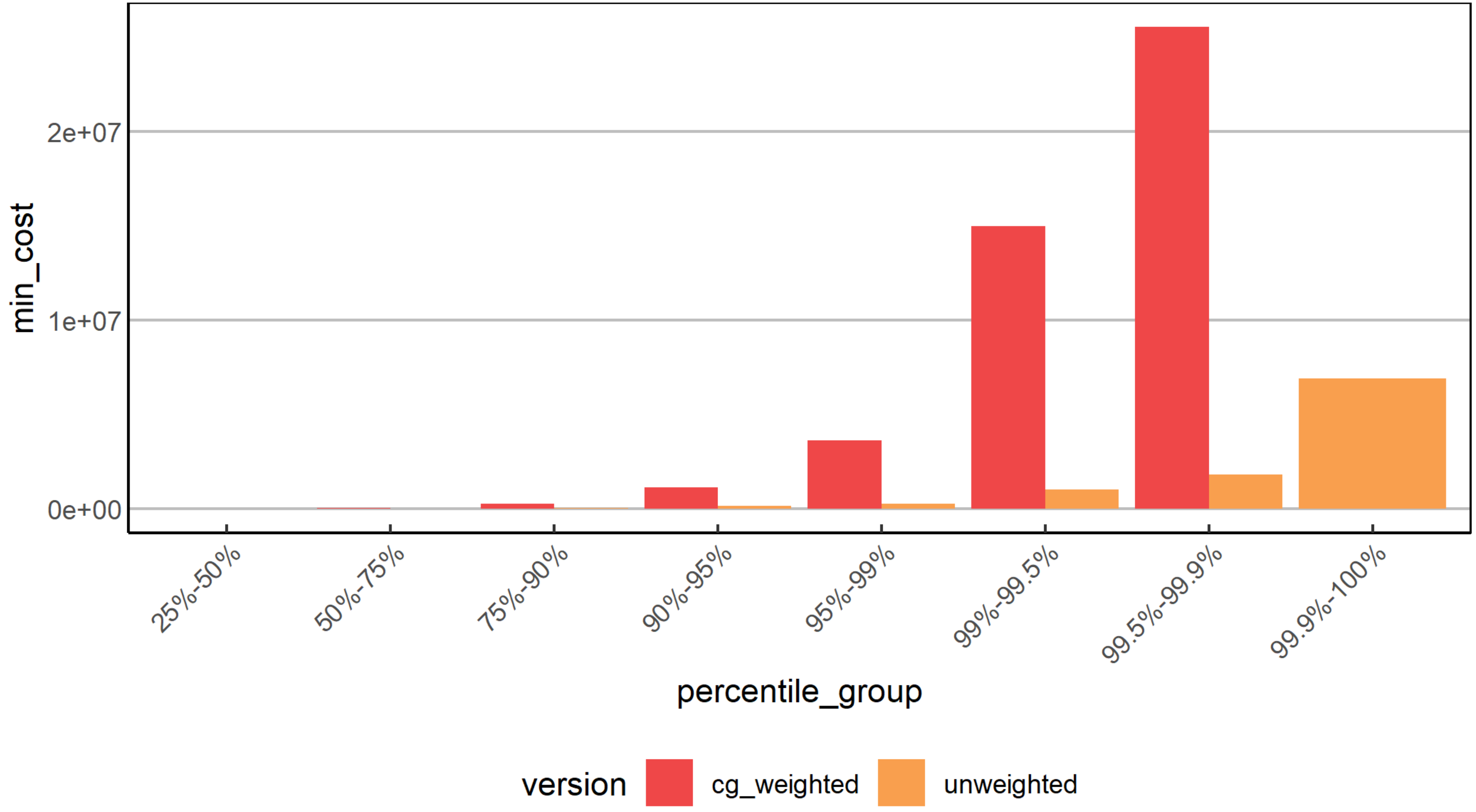
The distribution of returns by asset type is highly skewed for financial assets



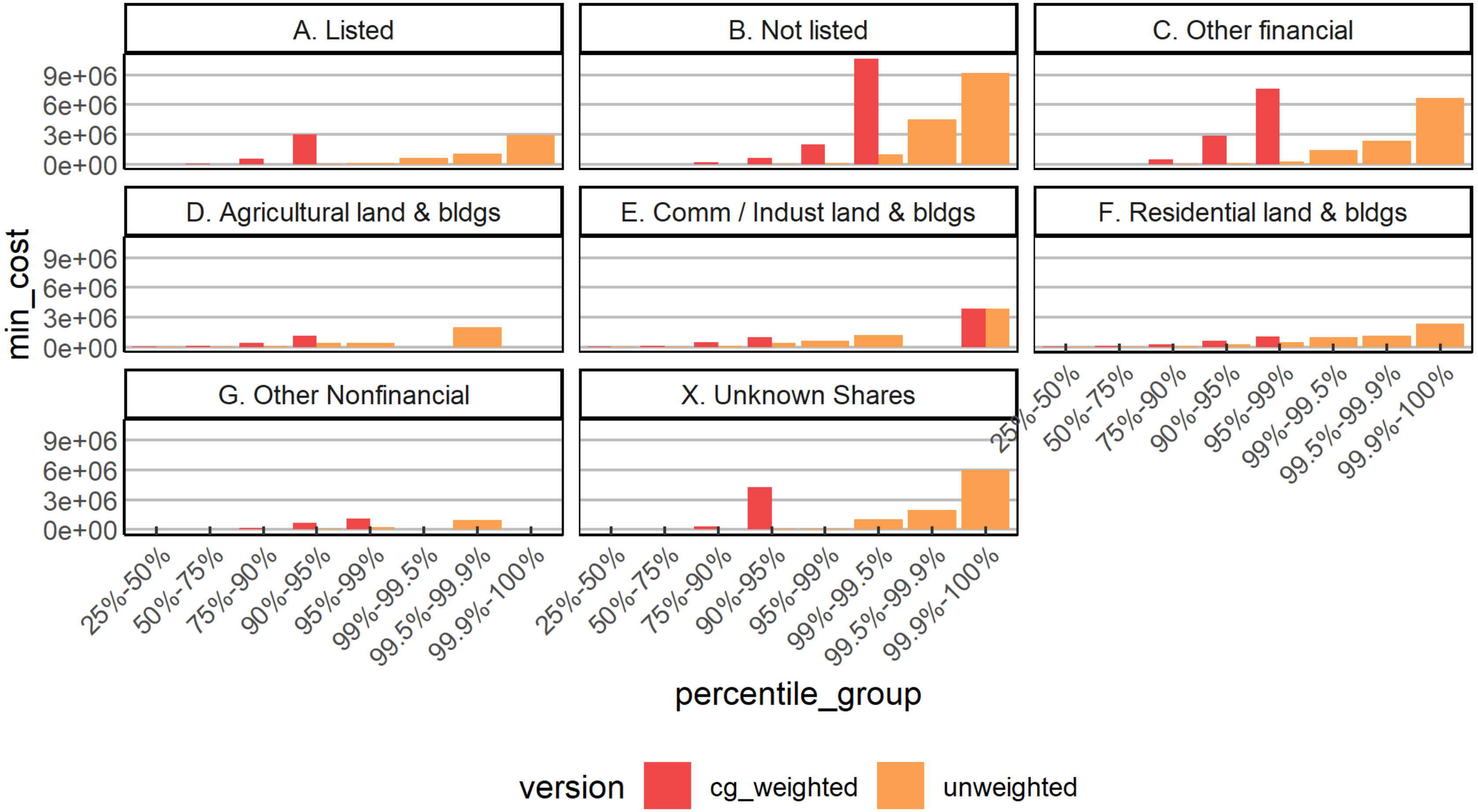
Other points of note:

- Among shares (private or public) with gains over £5m, 30% were acquired for less than £500
- High-return gains on shares are concentrated among people working in professional service industries (e.g. management consulting, IT), typically company directors
  - Exceptions: Non-directors in finance (private equity partners), people without any reported employment income (but a large share still company directors)

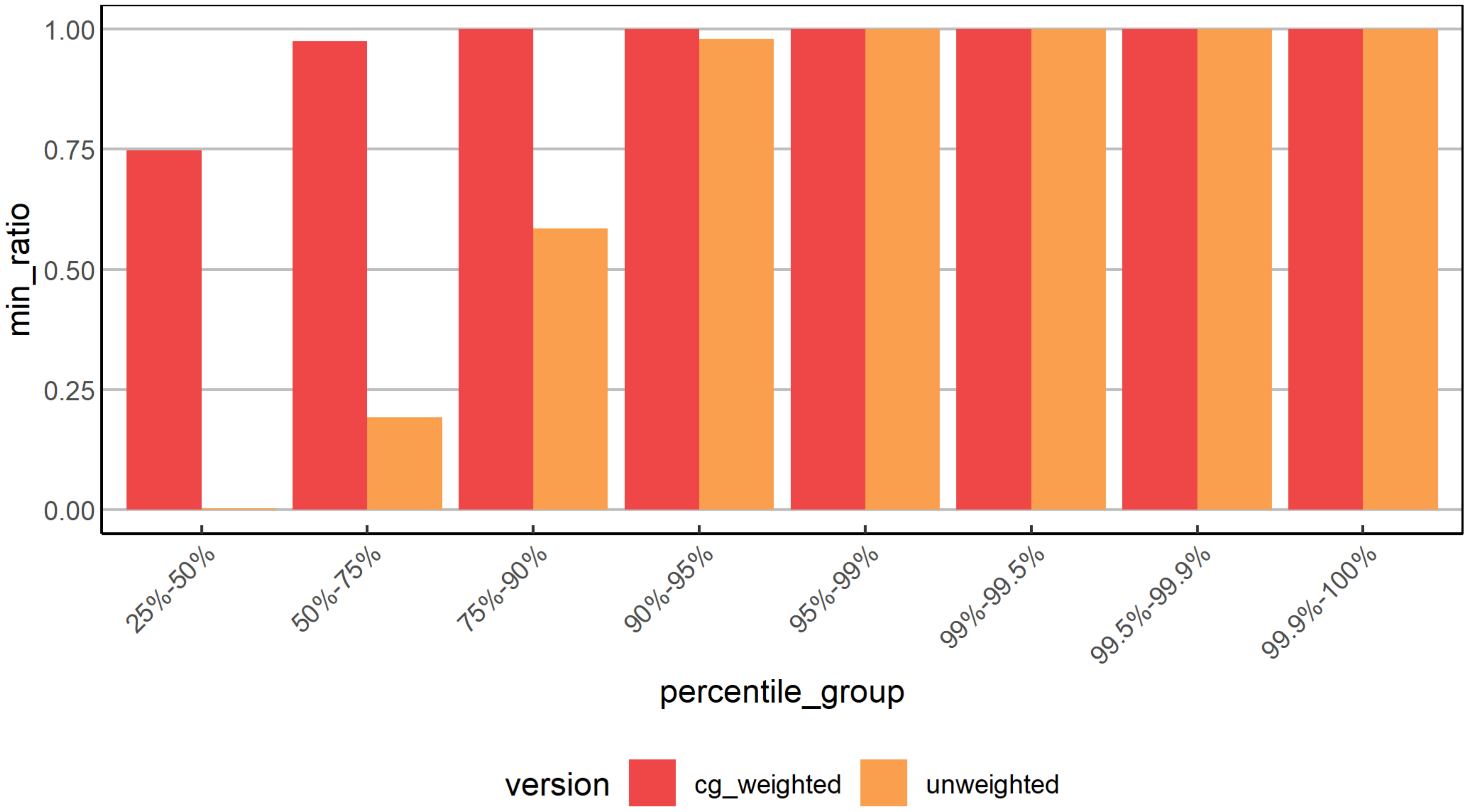
Base cost distribution: Minimum base cost of assets in each quantile group, weighted (by cg) and unweighted



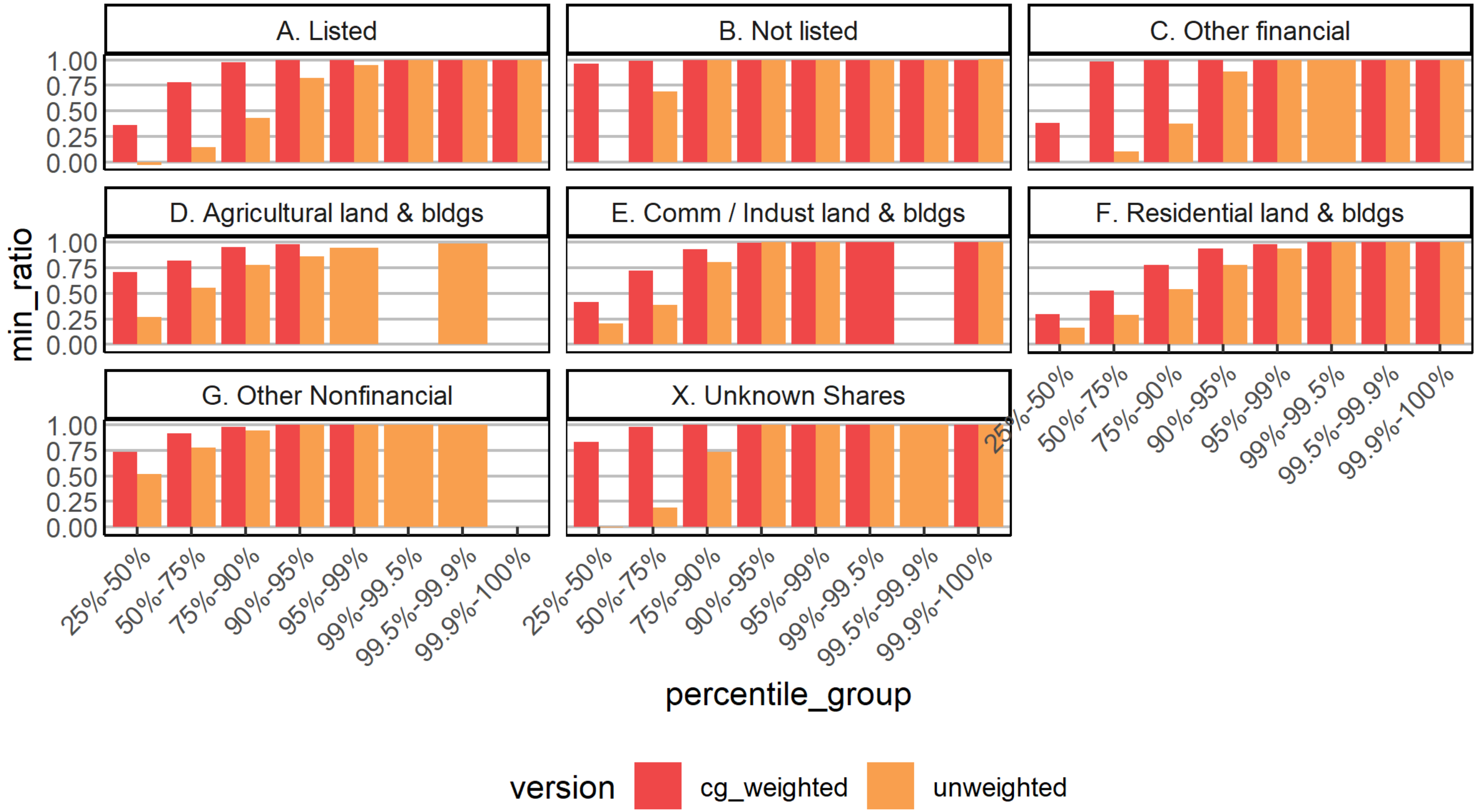
Base cost distribution: Minimum base cost of assets in each quantile group by asset category, weighted (by cg) and unweighted



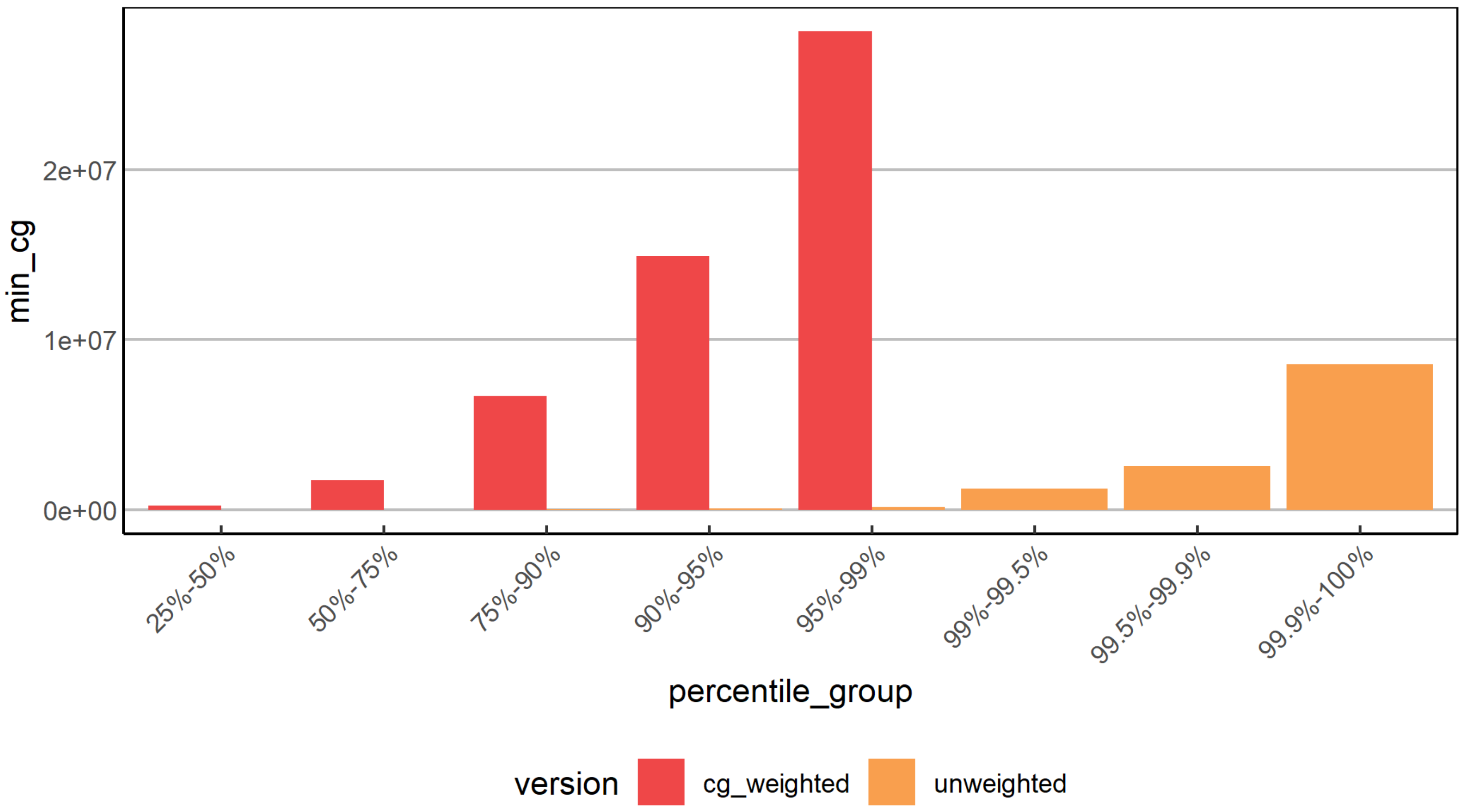
Gain ratio distribution: Minimum gain ratio (cg/disposal) of assets in each quantile group, weighted (by cg) and unweighted



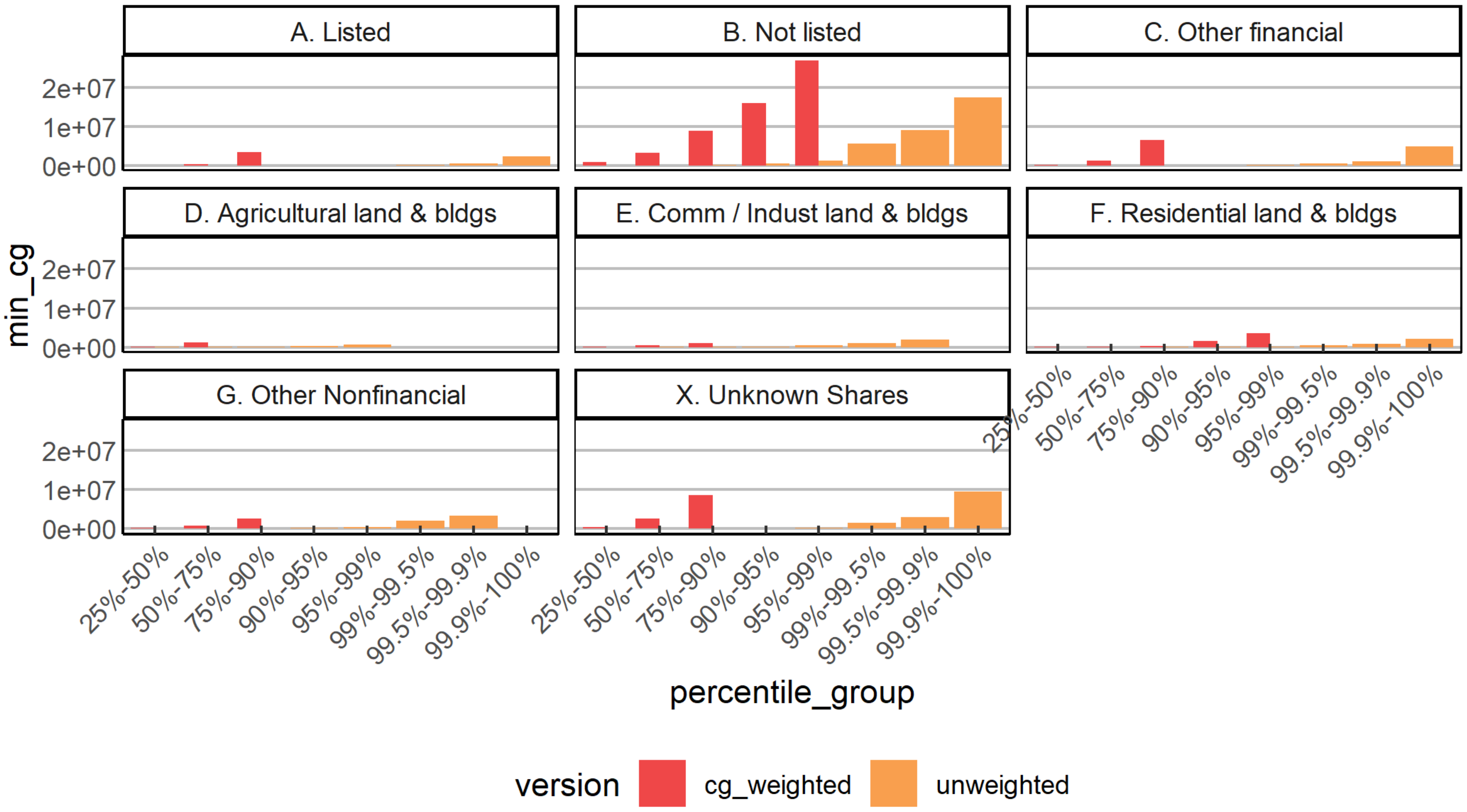
Gain ratio distribution: Minimum gain ratio of assets in each quantile group by asset category, weighted (by cg) and unweighted



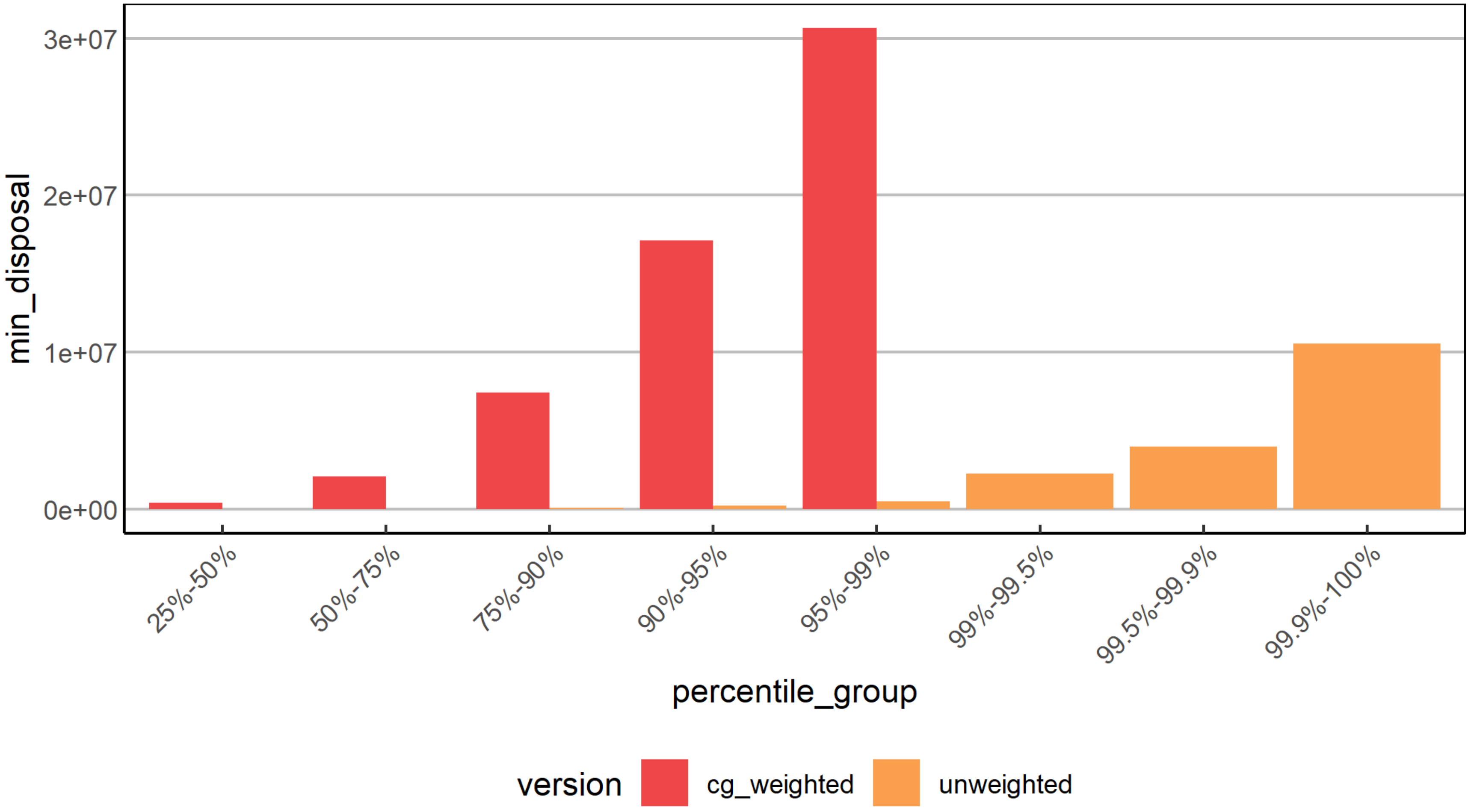
Cg distribution: Minimum cg of assets in each quantile group, weighted (by cg) and unweighted



Cg distribution: Minimum cg of assets in each quantile group by asset category, weighted (by cg) and unweighted

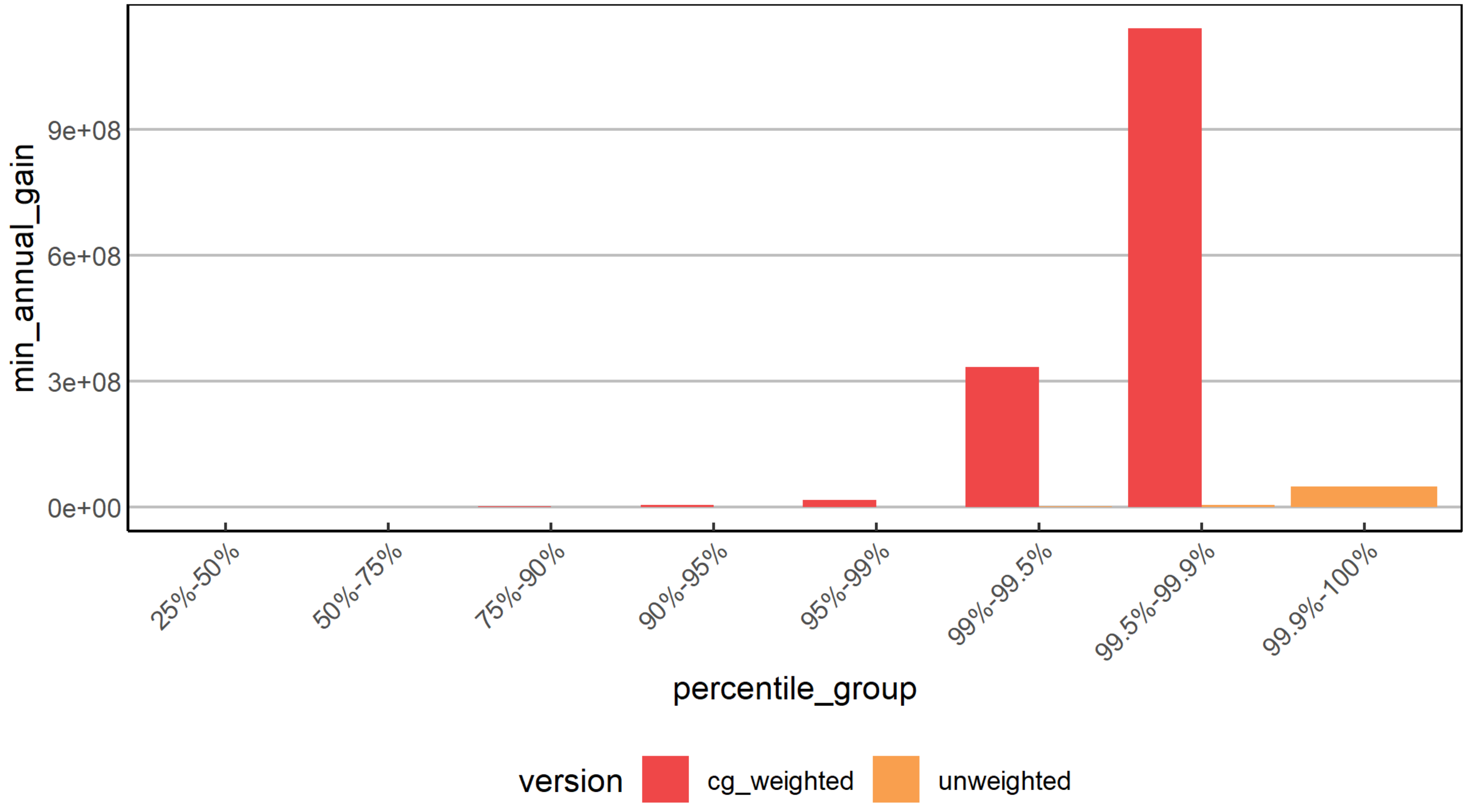


Disposal value distribution: Minimum disposal value of assets in each quantile group, weighted (by cg) and unweighted

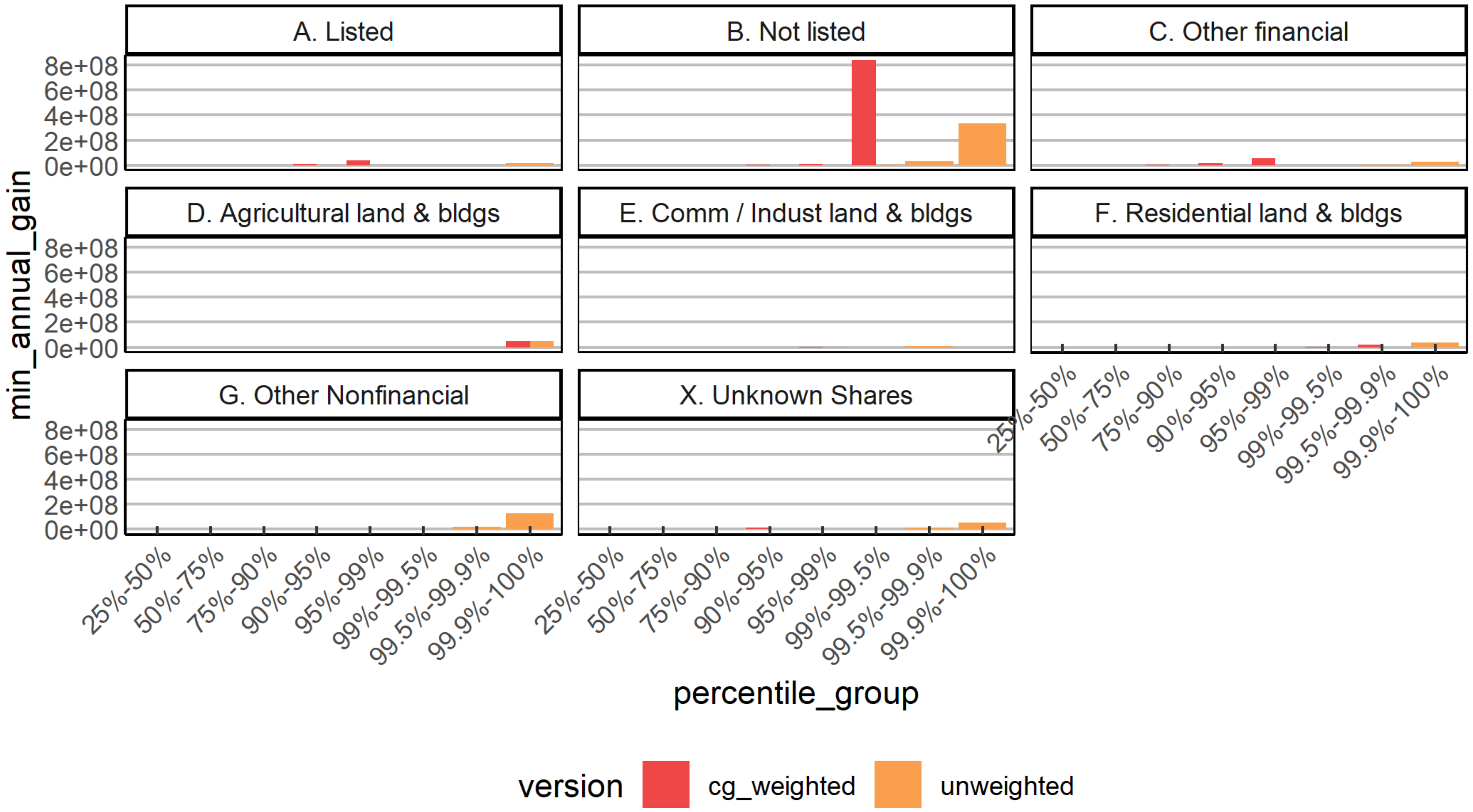


Disposal value distribution: Minimum disposal value of assets in each quantile group by asset category, weighted (by cg) and unweighted

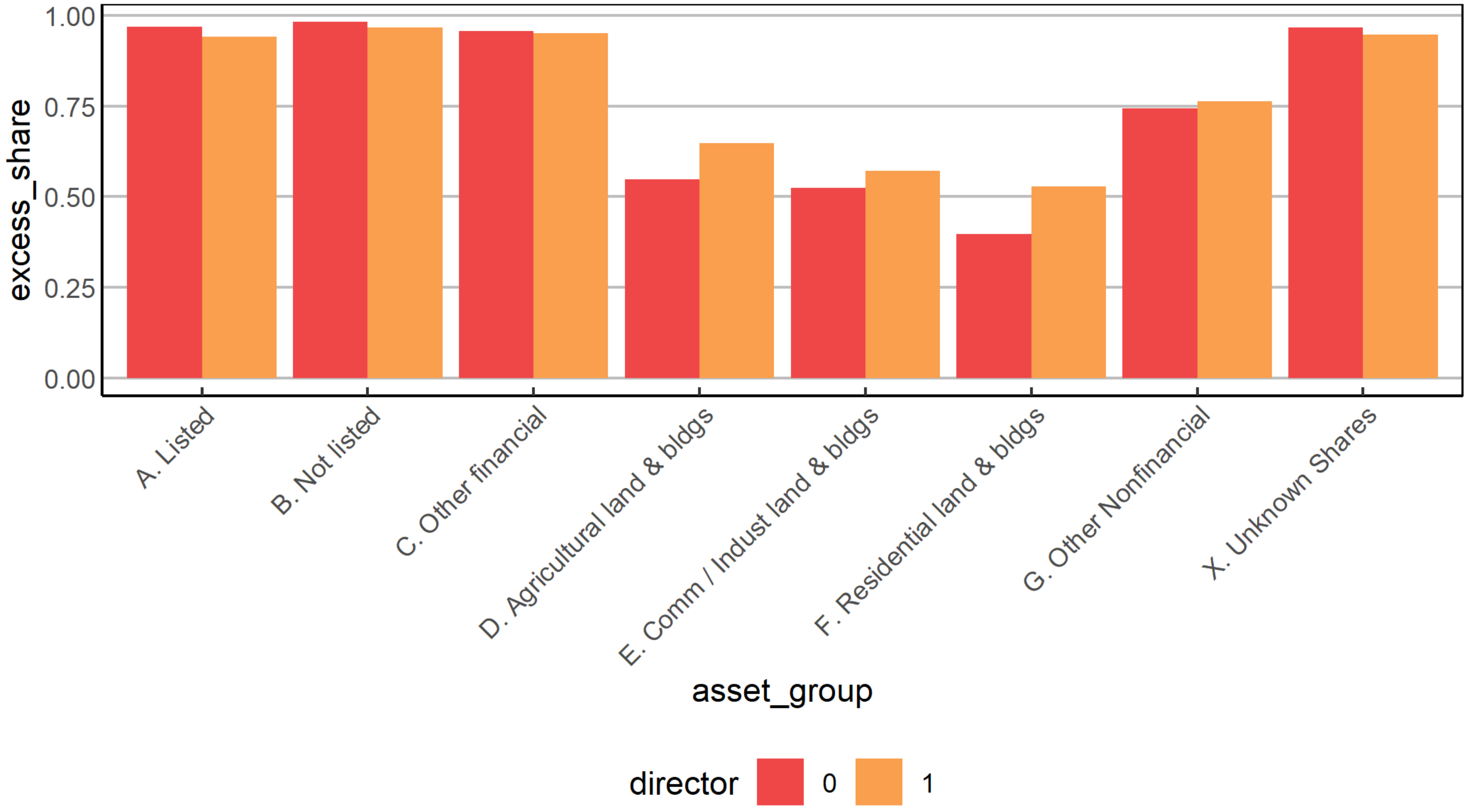
Mean annual gain distribution: Minimum mean annual gain of assets in each quantile group, weighted (by cg) and unweighted



Mean annual gain distribution: Minimum mean annual gain of assets in each quantile group by asset category, weighted (by cg) and unweighted



Share of excess gains (gains made beyond the normal rate of return), by asset type and whether the taxpayer is a company director



Share of inflationary gains (gains made in excess of CPI), by asset type and whether the taxpayer is a company director