

# Does UK Capital Gains Tax Achieve Its Policy Objectives?

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## ABSTRACT

*This submission critically examines the UK capital gains tax (CGT) system, analysing its policy justifications, legal framework, and lasting impact. It explores the rationale behind CGT and evaluates whether it aligns with the observed outcomes. The piece investigates domestic and international case studies, along with administrative tax data, to assess the effectiveness of CGT. The research begins by analysing the policy justifications for CGT, including fairness, economic efficiency, and revenue generation. It then examines the legal framework supporting CGT implementation. Through empirical evidence, including case studies and tax data analysis, the study concludes that the effect of CGT does not match the policy justifications given for it. This article contributes to the debate surrounding the effectiveness and efficiency of CGT, providing valuable insights for policymakers, tax professionals, and scholars. The findings highlight discrepancies between intended outcomes and actual impact, shedding light on the implications for the economy, taxpayers, and revenue generation.*

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## INTRODUCTION

Over the last decade, capital gains in the United Kingdom (UK) have risen by an extraordinary amount. Indeed, between the tax years of 2012-2013 to 2020-2021, they have more than tripled — rising from £24 to £79.5 billion.<sup>1</sup> It should be clear, therefore, that both capital gains and Capital Gains Tax (CGT) occupy increasingly central roles in the UK taxation regime. Despite its prominence, CGT has been a divisive political issue ever since its introduction in 1965. For one camp of thinkers, CGT disproportionately, and unfairly, benefits wealthy individuals who receive much of their remuneration from capital gains. This stands in contrast to most individuals whose earnings derive from income and, as a result, pay proportionally higher rates of income tax. For the other camp, the current form of CGT encourages an efficient allocation of capital and provides the necessary incentives for investment.

The importance and contentious nature of CGT raise two questions. First, what are the policy justifications for the implementation and maintenance of CGT in the UK? Secondly, does UK CGT, in practice, live up to these justifications? These two questions form the basis of this article. As to the first, this piece will demonstrate how equity, fairness, tax base protection, entrepreneurship incentivisation, and greater economic efficiency constitute the fundamental policy objectives behind the CGT. In doing so, it will analyse the history behind its implementation. This will be done through an assessment of parliamentary debates, governmental Budget statements, and comparisons with

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<sup>1</sup> HMRC 'Capital Gains Tax Statistics' (*GOV.UK*, 31 October 2013) (CGT Statistics) <<https://www.gov.uk/government/statistics/capital-gains-tax-statistics>> accessed 24 July 2023.

other jurisdictions. The article will integrate the literature regarding the policy justifications for CGT into a condensed and more intelligible source. In addressing the latter question, this essay will draw on contemporary data. It will provide an up-to-date picture of the operation of CGT. Hence, this article will show how CGT operates not only in theory and in law, but also in practice.

The central argument of this article will be that in its current form, UK CGT fails to a significant extent to meet these policy objectives. It is further submitted that the theoretical basis for differing tax treatment between capital gains and income is weak. On this basis, it will be argued that reform to CGT is necessary if it is to live up to the justifications given for its existence. On this point, the author will propose the alignment of CGT rates with those of income tax.

This essay will be structured as follows. Section I will begin with a brief outline of what CGT is, as well as the history of its implementation. This will give background to the discussion, touching on the initial considerations for its adoption. Section II will give a more complete explanation of the justifications which form the basis of CGT. Section III will analyse the extent to which UK CGT fulfils the policy objectives discussed. This section will bring to light the shortcomings of CGT in relation to its stated purposes. Here, the article will underline how the discrepancy in the treatment between CGT and income tax drives these limitations. Finally, Section IV will recommend reform to CGT. This section will illustrate the benefits of aligning CGT and income tax rates in terms of enhancing equity and minimising tax avoidance. In doing so, it will also address concerns that may be raised to this proposal.

## SECTION I – BACKGRUOND

### A. What Is Capital Gains Tax?

CGT is a tax on the disposal (usually by sale or gift) of assets that have appreciated in value.<sup>2</sup> In the UK, CGT is charged on capital gains realised or deemed to be realised. It is a gain which is ‘not regarded as of an income nature’.<sup>3</sup>

The starting point in analysing the UK’s approach to CGT is the Taxation of Chargeable Gains Act 1992 (TCGA). Pursuant to section 1, CGT is charged over a tax year on chargeable gains accruing in the year to a person on the disposal of assets.<sup>4</sup> ‘Assets’ for these purposes apply to all forms of property, including: (a) options, debts, and incorporeal property; (b) any currency other than sterling, and; (c) any form of property created by the person disposing of it, or otherwise coming to be owned without being acquired.<sup>5</sup> Section 1A provides that CGT applies to gains made on the disposal of assets by a UK-resident individual. For companies, chargeable gains constitute income and are subject to corporation tax.<sup>6</sup> For the purposes of this article, the author will only focus on gains made by individuals.

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<sup>2</sup> Office of Tax Simplification, *Capital Gains Tax Review – first report: Simplifying by design* (2020) 21.

<sup>3</sup> George SA Wheatcroft, *Capital Gains Tax* (Sweet & Maxwell, London 1965) 9.

<sup>4</sup> Taxation of Chargeable Gains Act 1992, s 1(1) (TCGA).

<sup>5</sup> TCGA, s 21(1).

<sup>6</sup> TCGA, s 2(1).

For individuals, the CGT rate is 10% for basic rate income taxpayers<sup>7</sup> and 20% for higher and additional rate<sup>8</sup> income taxpayers.<sup>9</sup> The rates for gains deriving from residential property and carried interest are 18% or 28%.<sup>10</sup> An annual exemption of £6,000 applies in place of the income tax personal allowance.<sup>11</sup>

## B. A Brief History

Historically, capital gains were largely treated distinctly from income and, generally speaking, were not subject to taxation.<sup>12</sup> This changed, however, following a 1955 report by the Royal Commission on the Taxation of Profits and Income.<sup>13</sup> The majority of the Commission concluded against introducing CGT through treating capital gains as income.<sup>14</sup> Despite this, a 'Memorandum of Dissent' argued in favour of widening income that would encompass capital gains. This Memorandum provided the then Prime Minister, Harold Macmillan, with the requisite conceptual justifications to move towards the implementation of a CGT.<sup>15</sup>

The fundamental justifications provided were the two linked notions of fairness and equity. In particular, the Memorandum argued that people should

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<sup>7</sup> Those whose income is set at a basic rate of 20%.

<sup>8</sup> Those whose income tax is set at 40% or 45%.

<sup>9</sup> TCGA, s 1H(3).

<sup>10</sup> TCGA, s 1H(2).

<sup>11</sup> TCGA, s 1K(2).

<sup>12</sup> Philip Baker QC and Mark Bowler-Smith, 'The United Kingdom' in M Littlewood and C Elliffe (eds), *Capital Gains Taxation, A Comparative Analysis of Key Issues* (Edward Elgar Publishing 2017) 336.

<sup>13</sup> *ibid.*

<sup>14</sup> U.K. Parliament, *Royal Commission on the Taxation of Profits and Income: Final Report* (Cmd 9474, 1955) para 81.

<sup>15</sup> Bruce Sutherland and others, *A Discredited Tax: The Capital Gains Tax Problem and its Solution* (Institute of Economic Affairs 1992) 2.

pay tax in accordance with their capacity to pay. It emphasised that the accrual of capital gains increases one's ability to pay tax. A regime which does not tax such capital, therefore, provides an advantage to those individuals. It noted, moreover, that capital gains were not evenly enjoyed between taxpayers. This is especially true when one considers that individuals with greater income generally benefit more from capital gains. Hence, the lack of CGT disproportionately advantaged a certain bracket of wealthy taxpayers.<sup>16</sup>

In 1962, a few years after the report, the income tax code was widened to incorporate speculative short-term gains deriving from all forms of property (including land, stocks, and shares)<sup>17</sup> except tangible movable property.<sup>18</sup> These gains were subject to income tax. This approach was not helpful, however, considering the possibility for taxpayers to simply wait a day longer than the stipulated period for what constituted 'short-term gains' to dispose of their assets and, thus, avoid being subject to tax.

As such, the Inland Revenue Commission advised the introduction of a new tax code whereby short-term gains<sup>19</sup> would be taxed as income, while long-term gains<sup>20</sup> would be subject to a flat rate of 30%.<sup>21</sup> This was the approach adopted when CGT was first fully introduced in 1965 under the Finance Act. Since 1971, however, there has only been a single rate applied to capital gains.<sup>22</sup>

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<sup>16</sup> George Woodcock, Heather Bullock, and Nicholas Kaldor, 'Memorandum of Dissent' in *Royal Commission on the Taxation of Profits and Income: Final Report* (n 14) para 35.

<sup>17</sup> Baker and Bowler-Smith (n 12) 337.

<sup>18</sup> Finance Act 1962, s 11(1).

<sup>19</sup> Assets acquired and disposed of within twelve months.

<sup>20</sup> Assets held for longer than one year.

<sup>21</sup> Antony Seely, 'Capital Gains Tax: Background History' (2 June 2010) House of Commons Library SN860 6  
<<https://researchbriefings.files.parliament.uk/documents/SN00860/SN00860.pdf>>  
accessed 18 July 2022.

<sup>22</sup> Finance Act 1965, Part III.

## SECTION II – WHAT ARE THE POLICY JUSTIFICATIONS FOR CAPITAL GAINS TAX?

### A. Equity, Fairness, And Protecting The Tax Base

As is clear, the initial aim of CGT in the UK was to achieve greater fairness among different classes of taxpayers. In theory, CGT would work towards achieving greater horizontal and vertical equity in the tax system. Horizontal equity involves ‘taxpayers in like economic circumstances being taxed the same’, whilst vertical equity occurs where ‘higher income earners pay more tax in comparison to low-income earners because higher income earners have greater capacity to pay more’.<sup>23</sup> CGT, theoretically, would improve vertical equity insofar as it would apply to those with a greater ability to pay.<sup>24</sup> It would also achieve horizontal equity as the tax regime would no longer discriminate in favour of those who largely accrue revenue in the form of capital gains as opposed to income.<sup>25</sup> Indeed, James Callaghan expressed exactly this policy justification when introducing CGT in his 1965 Budget Statement:

There is little dispute nowadays that capital gains confer much the same kind of benefit on the recipient as taxed earnings more hardly won. Yet earnings pay tax in full while capital gains go free. This is unfair to the wage and salary

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<sup>23</sup> John Harrison, ‘Assessing the Taxation of Superannuation in Terms of Horizontal and Vertical Equity’ (2018) 13 *Journal of the Australasian Tax Teachers Association* 114, 116.

<sup>24</sup> Chris Evans, John Minas, and Youngdeok Lim, ‘Taxing personal capital gains in Australia: An alternative way forward’ (2015) 30 *Australian Tax Forum* 735, 743.

<sup>25</sup> Leonard Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed* (Brookings Institution Press 1999) 3.

earner [...] This new tax will provide a background of equity and fair play.<sup>26</sup>

Policymakers also recognised that CGT could act as a backstop for income tax. Between the introduction of the 1799 Income Tax Act and the introduction of CGT in 1965, many key tax disputes revolved around income tax avoidance.<sup>27</sup> This was because a world without CGT incentivised taxpayers to characterise their profits as tax-exempt capital gains. Allowing individuals to move profits to tax-exempt structures, however, was seen as unacceptable to the goals of fairness. CGT purported to mitigate this issue by plugging gaps in the UK tax system. This would ensure that those who escaped income tax would be charged on their revenue. Again, this was one of Callaghan's stated justifications:

[...] there is no doubt that the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator of which he has taken full advantage to avoid tax by various devices which turn what is really taxable income into tax-free capital gains. We shall only make headway against avoidance of this sort when capital gains are also taxed.<sup>28</sup>

When looking to other jurisdictions, the justifications of fairness, equity, and protection of the tax base are almost universal. Indeed, as the OECD identifies, horizontal and vertical equity are central to the adoption of the tax for

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<sup>26</sup> HC Deb 06 April 1965, vol 710, col 245.

<sup>27</sup> Baker and Bowler-Smith (n 12) 340.

<sup>28</sup> HC Deb (n 26).

many countries.<sup>29</sup> For example, its introduction in Canada<sup>30</sup> derives from tax reform proposals stating the need for fairness and efficiency.<sup>31</sup> Two further considerations have been cited. The first is the desire to balance the ‘unfair distribution of the tax burden’ which existed before CGT and weakened the ‘progressive nature’ of the income tax regime.<sup>32</sup> The second is the minimisation of income tax avoidance.<sup>33</sup> The same rationales of equity and efficiency have been cited in Australia in the Asprey Report, as well as in a Treasury Draft White Paper,<sup>34</sup> before CGT’s introduction in 1985.<sup>35</sup>

## **B. Justifying The Different Treatment Of Capital Gains And Income**

In the UK, capital gains attract different attention vis-à-vis ‘normal’ income. Fundamentally, CGT and income tax exist in distinct categories and a preferential tax rate applies to CGT. Indeed, since 6 April 2017, a 10% and 20% CGT rate has applied to individuals (excluding residential property and carried interest).<sup>36</sup> For income tax, however, the rates are 20% (basic rate), 40% (higher rate), and 45% (additional rate) for 2022–23.<sup>37</sup> Two questions must be asked here:

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<sup>29</sup> OECD Tax Policy Studies, *Taxation of Capital Gains of Individuals: Policy Considerations and Approaches* (2006) 63.

<sup>30</sup> Canada Income Tax Act 1972, s 1.

<sup>31</sup> Edgar Benson (Canadian Minister of Finance), ‘Proposals for Tax Reform’ (1969) 36, para 3.1-3.2.

<sup>32</sup> Benson (n 31) 37, para 3.7.

<sup>33</sup> Benson (n 31) para 3.10.

<sup>34</sup> Australian Taxation Review Committee, *Full Report* (Australian Government Publishing Service January 1975); Department of the Treasury, *Reform of the Australian Tax System: Draft White Paper* (Australian Government Publishing Service 1985) 78.

<sup>35</sup> Initially, as an amendment to the Income Tax Assessment Act 1936, Part IIIA, then later as a complete redrafting with the Income Tax Assessment Act 1997.

<sup>36</sup> HMRC, ‘Capital Gains Tax rates and allowances’ (GOV.UK, 4 June 2018) <<https://www.gov.uk/guidance/capital-gains-tax-rates-and-allowances#:~:text=6%20April%202017%20onwards,residential%20property%20and%20carried%20interest>> accessed 16 September 2023.

<sup>37</sup> Finance Act 2022, s 2.

(i) why are CGT and income tax placed into separate categories, and (ii) why are they subject to different rates?

### **(1) Reasons For The Categorical Distinction**

It is difficult to ascertain precisely why income and capital gains are treated separately. One suggestion is that they are different in nature.<sup>38</sup> On this view, capital gains, unlike income, are ‘irregular’ and perhaps may be incidental, unintended, or unpredictable.<sup>39</sup> This article submits, however, that this justification is conceptually weak. As some have pointed out, most capital gains are only considered by taxpayers at the moment of the asset’s acquisition and disposal;<sup>40</sup> this is particularly so in the case of shares. Moreover, in practice, those who pay CGT enjoy a great deal of consistency in their gains. Indeed, as shown by Advani and Summers, capital gains are ‘not a rare event, but a regular part of how [individuals paying CGT] receive remuneration’.<sup>41</sup>

Furthermore, as will be discussed later, the justification is unsupportable when considering how capital gains function for individuals in practice. To summarise the argument here, tax administrative data suggest that the wealthiest individuals treat capital gains in a functionally similar way to income: a significant proportion of their earnings is enjoyed through capital gains. Therefore, treating the two separately makes little sense when those who benefit the most from capital gains consider them very similarly to income. The categorical distinction is also weak when considering that, in reality, this discrepancy undermines the

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<sup>38</sup> Baker and Bowler-Smith (n 12) 346.

<sup>39</sup> *ibid.*

<sup>40</sup> Baker and Bowler-Smith (n 12) 346.

<sup>41</sup> Arun Advani and Andy Summers, ‘How much tax do the rich really pay? New evidence from tax microdata in the UK’ (2020) CAGE Warwick and LSE International Inequalities Institute 6.

other policy objectives of CGT. In particular, the distinction does little to achieve greater equity and minimise tax avoidance (again, this will be discussed in the following Section).

It is also unclear why capital gains must be treated differently from income tax. Indeed, other jurisdictions show that it is possible to incorporate them into income. For example, capital gains in New Zealand are treated fully as taxable income. The United States (US) likewise places capital gains in the same category as income but subjects them to a different tax rate. Having said this, the approach itself appears to make little practical difference. Even in systems where capital gains fall under income tax, the rules regarding their calculation are frequently distinct from those applicable to other forms of income tax. This is the case in the US, Australia, and Canada. Hence, the effect is similar insofar as capital gains are treated differently in practice from income: the question is one of form rather than of substance.<sup>42</sup>

## **(2) Reasons For Differing Tax Rates**

Many countries, like the UK, subject capital gains (accruing to individuals) to a lower tax rate than that of income.<sup>43</sup> This begs the question as to why the UK, like other jurisdictions, provides preferential CGT rates compared to income tax. There appear to be two main justifications for this disparity.

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<sup>42</sup> Michael Littlewood, 'Capital gains taxes — a comparative survey' in M Littlewood and C Elliffe (eds) *Capital Gains Taxation, A Comparative Analysis of Key Issues* (Edward Elgar Publishing 2017) 8.

<sup>43</sup> See for example US Internal Revenue Code, 26 U.S.C. § 1(h).

*(a) Economic Efficiency*

Advocates of preferential CGT rates have suggested that it promotes a more efficient allocation of capital.<sup>44</sup> This is because a lower tax rate encourages the sale of assets and the redirection of that capital to new and better investments.<sup>45</sup> It thereby minimises the disincentive to hold on to capital. This, in turn, alleviates the issue of lock-in. Lock-in refers to the fact that ‘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’.<sup>46</sup> Mitigating this issue, some argue, enhances the efficiency and fluidity of the capital market.<sup>47</sup>

*(b) Encouraging Entrepreneurship*

Another justification is the need to ‘subsidize risky new ventures’.<sup>48</sup> In theory, lower rates incentivise investors to provide capital for businesses which allows for more business activities.<sup>49</sup> This is seen, for example, in Business Asset Disposal Relief (BADR). This relief provides that gains made from the disposal of the whole or part of a business (including the selling off of shares in the business) are chargeable to CGT at a lower rate of 10% up to a lifetime limit of £1 million.<sup>50</sup> To benefit from this preferential rate, the taxpayer must be an

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<sup>44</sup> US Joint Committee on Taxation, *Tax treatment of capital gains and losses* (1997) 117.

<sup>45</sup> Patric Hendershott, Eric Toder, and Yunhi Won, ‘Effects of Capital Gains Taxes on Revenue and Economic Efficiency’ (1991) 44 *National Tax Journal* 21, 32.

<sup>46</sup> Institute for Fiscal Studies, *Tax by design: the Mirrlees review* (Oxford University Press 2011) 296.

<sup>47</sup> Claire Y Nash, ‘Capital Gains Tax Policy: The Effect on Investment Company Capital Gains Realizations’ (DPhil Thesis, University of Mississippi 1999) 21-22.

<sup>48</sup> James Poterba, ‘Capital Gains Tax Policy Toward Entrepreneurship’ (1989) 42 *National Tax Journal* 375.

<sup>49</sup> US Joint Committee on Taxation 1997 (n 44) 31.

<sup>50</sup> TCGA, s 169H(1), s 169N(3) and (4A).

individual carrying on a business as a sole trader or as a partner,<sup>51</sup> a trustee disposing of assets used in a business,<sup>52</sup> or hold 5% of the company's ordinary share capital.<sup>53</sup> In any event, the taxpayer must also have owned the business (or owned shares in it) for two years.<sup>54</sup> Note that, given how recently BADR was introduced, this article will refer to its former equivalent of Entrepreneurs' Relief (ER) in its place insofar as it provided the same relief under law and possesses the same desire to encourage 'entrepreneurship';<sup>55</sup> additionally, more data dedicated to analysing its impact exists.

The preferential tax rate provided by ER is understood as a means of enhancing 'entrepreneurship' by encouraging risk-taking<sup>56</sup> and of stimulating economic growth by business owners through the incentivisation of business investment.<sup>57</sup> Proponents here argue that such an incentive is necessary to counteract the tendency of individuals towards risk-aversion. Additionally, deficiencies in the market mean that market rewards do not sufficiently outweigh the risks of entrepreneurial endeavours.<sup>58</sup>

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<sup>51</sup> TCGA, s 169L(3)(a).

<sup>52</sup> TCGA, s 169J.

<sup>53</sup> TCGA, s 169S(3).

<sup>54</sup> TCGA, s 169I(3), 169J(4), and 169K(4).

<sup>55</sup> HM Treasury, *Budget 2020: Delivering on Our Promises to the British People* (2020, HC 121) 57.

<sup>56</sup> Joseph Stiglitz, 'The Effects of Income, Wealth, and Capital Gains Taxation on Risk-Taking' (1969) 83 *The Quarterly Journal of Economics* 263, 274.

<sup>57</sup> Helen Miller, Thomas Pope, and Kate Smith, 'Intertemporal income shifting and the taxation of business owner-managers' (2021) *Institute for Fiscal Studies Working Paper 21/49* 1 <<https://ifs.org.uk/publications/15885>> accessed 15 July 2022.

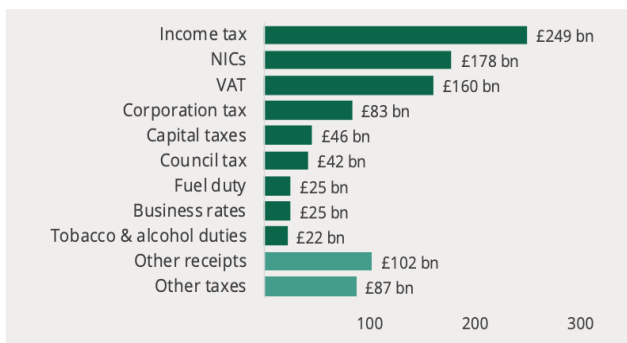
<sup>58</sup> Agnar Sandmo, 'The Effects of Taxation on Savings and Risk Taking' in AJ Auerbach and M Feldstein (eds), *Handbook of Public Economics: Vol I* (Elsevier Science Publishers 1985) 265, 306.

### C. Raising Revenue

It should be noted that ‘raising revenue’ was not offered as a policy motivation for CGT.<sup>59</sup> This seems to explain why CGT represents a seemingly insignificant proportion of total received revenue. Indeed, estimates for the tax year of 2023–24 suggest that CGT will represent a mere 1.7% of all tax receipts.<sup>60</sup> This is compared to income tax and NICs, which are predicted to represent 45.9% of total revenue.<sup>61</sup>

The total revenue yield from the tax year of 2022–23 is shown below:<sup>62</sup>

**Figure 1: Public sector current receipts 2022/23: £1,017 billion**



Source: ONS. Public sector current receipts: Appendix D.<sup>63</sup>

<sup>59</sup> We can distinguish ‘raising revenue’ from protecting the tax base (acting as a backstop to income tax). For our purposes, we can characterise the latter as a desire to mitigate income tax avoidance, while ‘raising revenues’ can be seen as motivated by the goal of increasing revenue receipts.

<sup>60</sup> Office for Budget Responsibility, *Economic and Fiscal Outlook* (CP 804, March 2023), 92.

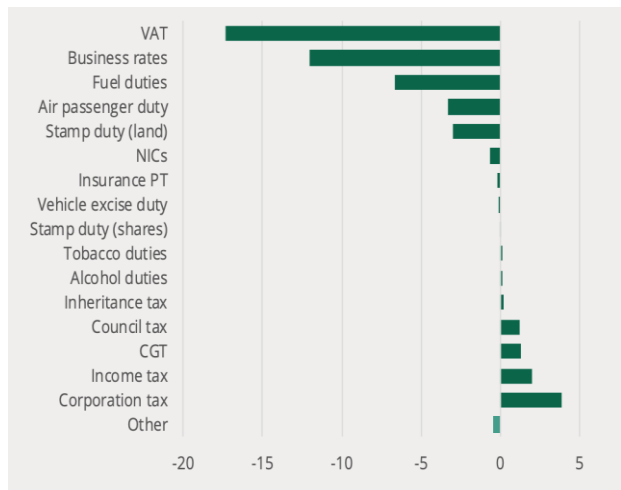
<sup>61</sup> Office for Budget Responsibility (n 61) 83.

<sup>62</sup> Matthew Keep, ‘Tax statistics: an overview’ (House of Commons Library Research Briefing Paper 8513, 5 June 2023) 6  
<<https://researchbriefings.files.parliament.uk/documents/CBP-8513/CBP-8513.pdf>> accessed 24 July 2023.

<sup>63</sup> Public Sector current receipts: Appendix D (*Office for National Statistics*, 21 July 2023) (Public Sector current receipts)

In 2021–22, capital taxes (which include taxes beyond CGT, such as inheritance tax) represented 4.48% of total yield. This is a stark increase in CGT relative to total revenue. However, this is likely a result of governmental action during the pandemic, which resulted in major reductions in revenue from other sources. This, for example, was reflected in the Government’s temporary reduction of VAT for the hospitality and tourism industry from 20% to 5%,<sup>64</sup> and the announcement of discounts on business rates.<sup>65</sup> The effect of such temporary changes and reliefs is shown below:

**Figure 2: Change in receipts 2019/20–2020/21, £ billion**



Source: ONS. Public sector current receipts: Appendix D.<sup>66</sup>

<<https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/datasets/appendixdpublicsectorcurrentreceipts>> accessed 24 July 2023.

<sup>64</sup> HMRC, ‘VAT: reduced rate for hospitality, holiday and accommodation and attractions’ (GOV.UK, 9 July 2020) 6 <<https://www.gov.uk/guidance/vat-reduced-rate-for-hospitality-holiday-accommodation-and-attractions#:~:text=The%20government%20made%20an%20announcement,hospitality>> accessed 25 June 2022. This was extended by the ‘Winter Economy Plan’ in September 2020: HM Treasury, *Winter Economy Plan* (September 2020) CP 297.

<sup>65</sup> HM Treasury, *Budget 2020* (n 55) 90.

<sup>66</sup> ‘Public Sector current receipts’ (n 63).

### SECTION III – DOES UK CAPITAL GAINS TAX ACHIEVE ITS OBJECTIVES?

Having explained the policy justifications behind the existence and maintenance of CGT in the UK, it is now necessary to analyse the extent to which CGT achieves the stated objectives in practice: whether the actual outcome of CGT matches the intended outcome.

Despite the policy motivations underpinning the UK CGT regime, this article will argue that CGT in its current form fails considerably to achieve these aims. The reason for this is the lack of neutrality in the tax system.<sup>67</sup> Neutrality can be found where a tax system treats like activities alike. The UK fails to do this by treating income tax and CGT differently. Such discrepancy gives rise to economic distortions as individuals engage in more complex and economically inefficient activities to achieve tax advantages.<sup>68</sup> This creates further complexity, incentivises tax avoidance, lends itself to inequality, and unduly adds costs for taxpayers and tax administrators alike. As such, almost none of the policy aims stated in the preceding section are adequately achieved.

#### A. Tax Avoidance

James Callaghan stated that introducing CGT would help minimise tax avoidance. In practice, however, avoidance remains rampant. Tax avoidance, in this context, should be taken to mean the arranging of one's tax affairs, often in

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<sup>67</sup> Institute for Fiscal Studies, *Mirrlees Review* (n 46) 40-41.

<sup>68</sup> Office of Tax Simplification, CGT Review (n 2) 6.

an artificial way, to gain a tax advantage not intended by Parliament. It means operating within the letter of the law, but not its spirit.<sup>69</sup>

As for CGT, avoidance manifests in two ways. First, income can be characterised as capital gains. In doing this, taxpayers benefit from the lower CGT rate, as opposed to the comparatively higher income tax rate. Secondly, there is avoidance caused by the insufficiency and/or complexity of CGT legislation. In practice, this sees taxpayers construct extremely challenging fact patterns to avoid CGT liability entirely. This section will illustrate this by highlighting the issue of residence.

### **(1) Characterising ‘Income’ as Capital Gains**

It is perhaps obvious that favourable CGT rates would encourage the characterisation of income as capital gains. This is especially the case in a world where the capital market is as sophisticated as it is.<sup>70</sup> As such, it provides greater opportunity to wealthier taxpayers to organise their activities in a manner in which gains constitute capital rather than income. This applies even when such gains look like, and possess much of the same functional elements as, income. Of course, the incentive to characterise income as capital gains is weaker than the pre-1965 period when CGT did not exist. Nevertheless, the incentive created by the disparate tax rates remains considerable.

One simple way in which individuals can recharacterise income as capital gains is by establishing businesses in which they are owner-managers. These are

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<sup>69</sup> HMRC, ‘Introduction to tax avoidance’ (2016) <<https://www.gov.uk/guidance/tax-avoidance-an-introduction>> accessed 14 July 2022.

<sup>70</sup> Baker and Bowler-Smith (n 12) 346.

often framed as personal service companies whereby the individual provides their labour through the business form as opposed to directly with the client (for example, contractors or locum doctors).<sup>71</sup> If an owner-manager liquidates the company shares, or otherwise sells the company, the remuneration from this is charged under CGT to the individual owner-manager. The said individual can then, in turn, build a considerable amount of wealth in the business and dispose of it. This would thereby allow them to subject themselves to a preferential CGT rate on what would otherwise constitute income and be charged as income tax if paid to the individual as a salary.

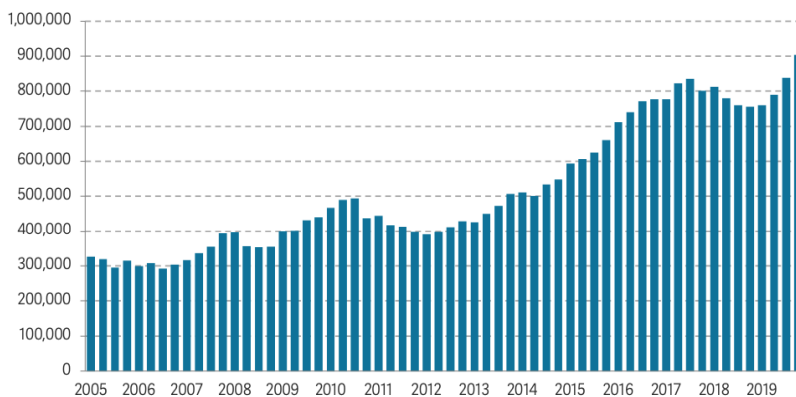
The benefit provided to owner-managers is augmented by mechanisms such as ER, which allow individuals to enjoy a CGT rate of just 10% when they sell all or part of the business. Tools like ER have been simple avenues for tax avoidance. Indeed, in 2017–18, 43% of all taxable gains were eligible for ER.<sup>72</sup> It is, then, no wonder why the number of sole directors has increased so significantly. This is shown in the graph below:

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<sup>71</sup> Antony Seely, 'Personal service companies & IR35' (10 March 2021) House of Commons Library Briefing Paper 5976, 3  
<<https://researchbriefings.files.parliament.uk/documents/SN05976/SN05976.pdf>> accessed 25 June 2022.

<sup>72</sup> Adam Corlett, Arun Advani, and Andy Summers, 'Who gains? The importance of accounting for capital gains' (Resolution Foundation, May 2020) 16  
<<https://www.resolutionfoundation.org/app/uploads/2020/05/Who-gains.pdf>> accessed 11 September 2023.

**Figure 3: Number of people receiving payment as sole directors of their own limited business**



Source: Corlett, Advani and Summers, 'Who gains? The importance of accounting for capital gains' (2020).<sup>73</sup>

This rapid increase in sole directorship and the potential use of ER also explains why the government sought to control their enjoyment by limiting eligible gains in March 2020 from the previous £10 million to £1 million.<sup>74</sup> A similar sort of benefit is provided for by Investors' Relief,<sup>75</sup> which grants a 10% CGT rate for the disposal of unlisted shares.<sup>76</sup> Mechanisms like ER and Investors' Relief might reveal why unlisted shares from private businesses constitute such a large proportion of capital gains (63% of total gains in the UK in 2018–19).<sup>77</sup> It is clear here that individuals enjoy remuneration in a manner very similar to

<sup>73</sup> Corlett, Advani, and Summer (n 72) 31.

<sup>74</sup> Corlett, Advani, and Summer (n 72) 6.

<sup>75</sup> Investors' Relief was only introduced in 2016 and so data on its impact as a tax avoidance mechanism is limited: OTS, CGT Review (n 2) 89.

<sup>76</sup> TCGA, s 169VB-169VC.

<sup>77</sup> HMRC, CGT Statistics (n 1).

income, insofar as it is closely connected to their labour, yet enjoy significant tax advantages.

Another opportunity for recharacterisation exists for private equity fund managers, who can receive their remuneration in the form of ‘carried interest’. ‘Carried interest’ is a reward for a fund performing well in the form of a share of the fund’s profits. This reward, however, is treated as a capital gain.<sup>78</sup> It is hard to identify exactly why carried interest is taxed preferentially to income, especially when the two are largely indiscernible in practice. Unfortunately, since income tax statistics do not include capital gains, the author cannot precisely ascertain the importance of carried interest as a proportion of fund managers’ remuneration. Nonetheless, what is important is that an opportunity exists for wealthy individuals to decrease their tax liability by taking income in the form of capital. This thereby allows them to take advantage of the preferable CGT rate.

In effect, capital gains frequently play a role functionally akin to that of income, all while permitting individuals to enjoy considerable tax advantages. As a result, the dividing line between capital gains and income becomes increasingly unclear and difficult to justify. The same is true of the rationale for the distinction between them.

## **(2) Complexities Facilitating Capital Gains Tax Avoidance**

Complexities in the CGT regime also give rise to opportunities for avoidance. The issue of residence provides a potent illustration of this. The inconsistent application of CGT to residents and non-residents, coupled with the

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<sup>78</sup> TCGA, s 103KA-103KH.

existence of double taxation treaties, introduces complexity into UK CGT which allows for avoidance to occur.

Pursuant to Schedule 1 of the Finance Act 2019, UK-resident individuals and trusts are subject to CGT on worldwide assets regardless of where they are disposed of.<sup>79</sup> By contrast, CGT is only chargeable to non-resident individuals where the disposal of the asset is done for the purposes of a trade, profession, or vocation carried out through a UK branch or agency.<sup>80</sup>

This approach has traditionally created problems. The case of *Smallwood v IRC* serves as a clear example (although the taxpayer was ultimately unsuccessful).<sup>81</sup> The discussion in *Smallwood* revolved around the absence of a CGT charge on non-residents, which meant that individuals could establish themselves temporarily as non-residents, dispose of their assets, and claim to avoid CGT. This ‘round-the-world’ scheme likewise saw taxpayers utilise non-resident trustees to dispose of UK shares before the appointment of UK-resident trustees following the disposal. Taxpayers would argue that because the shares were disposed of by non-resident trustees, they were not subject to UK CGT. However, this scheme was ended in *Smallwood* when the Court held that the question of residence was determined for the year of assessment and not at the point of the shares’ disposal.<sup>82</sup> As a result, the claim failed. The trustees were considered resident in the UK and were, therefore, subject to CGT.

Cases like *Smallwood* give satisfaction to British citizens who wish to limit tax avoidance by UK residents through such round-the-world schemes.

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<sup>79</sup> Finance Act 2019, sch 1, pt 1, s 1A(1).

<sup>80</sup> TCGA, s 10(1) (as originally enacted).

<sup>81</sup> *Smallwood v Revenue and Customs Commissioners* [2010] EWCA Civ 778; [2010] STC 2045.

<sup>82</sup> *Smallwood* (n 81) [46].

Furthermore, abuse of the temporary non-resident rules has been mitigated by subsequent legislation. For example, since 2019,<sup>83</sup> section 1M(1) TCGA has provided that gains made when an individual is temporarily non-resident (defined as non-resident for less than five years) are subject to CGT as if made by the individual in the year of his return to the UK. Moreover, the UK has extended CGT to non-residents for the disposal of UK residential property interests in 2015<sup>84</sup> and for non-residential property in 2019.<sup>85</sup> As such, it appears that UK CGT has been moving in the right direction in attempting to minimise tax avoidance through the ‘non-resident loophole’.

Nonetheless, the statute does not eliminate issues concerning investments by non-residents in a jurisdiction with which the UK has a tax treaty. The UK-Hong Kong Double Taxation Agreement (DTA) illustrates this problem. According to the DTA, Hong Kong-resident companies, defined as companies that derive most of their asset value from immovable property in which they carry on their business, can only be subject to CGT in Hong Kong.<sup>86</sup> This means that disposals effected through a Hong Kong-resident company can escape UK CGT. Hong Kong, however, lacks a CGT.<sup>87</sup> Therefore, an individual can in effect utilise a Hong Kong-resident company to dispose of assets in the UK and avoid CGT altogether.

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<sup>83</sup> Following the Finance Act 2019, sch 1, para 2.

<sup>84</sup> Finance Act 2015, sch 7; Details can be found at: HMRC, ‘Tell HMRC about Capital Gains Tax on UK property or land if you’re non-resident’ (2015) <<https://www.gov.uk/guidance/capital-gains-tax-for-non-residents-uk-residential-property>> accessed 28 June 2022.

<sup>85</sup> Finance Act 2019, sch 1, s 1C.

<sup>86</sup> UK/Hong Kong Double Taxation Agreement and Protocol (adopted 20 December 2010) Hong Kong Treaty Series, art 13(4)(c). This is unless the company is closely held by a UK resident: TCGA, s 3.

<sup>87</sup> See: Michael Littlewood, ‘Tax Treaty Disputes in Hong Kong’ in Eduardo Baistrocchi (ed), *A Global Analysis of Tax Treaty Disputes* (Cambridge University Press 2017) 9, 44.

This is only possible due to the asymmetric treatment of residents and non-residents and the existence of double taxation treaties which conflict with UK legislation. The combination of these factors means that the legislative mechanisms that exist to mitigate issues of non-residency are ineffective. As such, there is an asymmetry between the purported desire to close the ‘non-resident loophole’ through legislative provisions like section 1M and the practical result caused by the provision’s co-existence with the DTA. On the one hand, UK policy-makers have changed the domestic CGT regime to ensure that liability is placed on temporary and general non-residents (and thereby, to some degree, win over voters). Nonetheless, they simultaneously rely on the international taxation regime to maintain (or potentially enhance) the tax attractiveness of the UK for non-resident taxpayers who see an opportunity to minimise their tax base. As a result, DTAs practically undermine the attempts by domestic legislation to solve the problem of avoidance. UK voters perceive a change. Nevertheless, non-residents continue to enjoy the tax advantage previously complained of. In effect, tax avoidance persists.

Ultimately, UK CGT fails to achieve one of its key purported objectives: dealing with tax avoidance. Although CGT does protect the tax base to some degree, it does so suboptimally and the incentive to avoid income tax persists. Preferential CGT rates certainly facilitate this by encouraging the recharacterisation of income as gains. Moreover, complexities in the regime have given room to opportunities for avoidance. The intricacies involved with residency and DTAs are but one example of this. This highlights how individuals can accrue significant gains from assets located within the UK without incurring liability to pay tax.

## **B. Inequality: Who Actually Enjoys The Benefits Of Capital Gains Tax?**

There is somewhat of a paradox regarding whether CGT goes towards reducing the unfairness complained of before its introduction. On the one hand, its existence means that the small proportion of the population that would have escaped tax liability altogether are now subject to taxation. From this perspective, CGT offers greater parity by subjecting those wealthy few to tax. On the other hand, by possessing a preferential rate to income tax, those same wealthy individuals can benefit from significant tax advantages on their revenue compared to the remaining population of taxpayers who are largely subject to higher income tax rates. Viewed through this lens, a significant inequality remains. Because of this, CGT is far from achieving the policy objectives of greater equity and fairness.

First, the accrual and enjoyment of capital gains and associated tax advantages is remarkably limited to the wealthiest individuals. Indeed, between 2020 and 2021, CGT liability applied to just 323,000 individuals in the UK.<sup>88</sup> This constitutes roughly 0.5% of adults in the UK — 92% of whom are in the top 1% of income earners.<sup>89</sup> More striking, however, is that 45% of CGT paid came from less than 1% of those 323,000. These individuals, in turn, made more than £5 million in gains.<sup>90</sup> Hence, even among the individuals who accrue capital gains, the distribution of those gains is incredibly unequal.

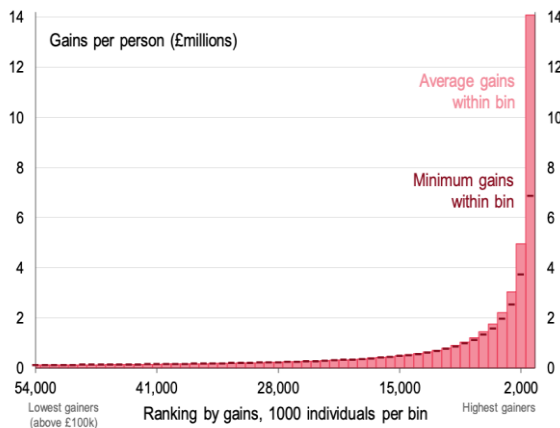
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<sup>88</sup> HMRC, ‘CGT Statistics’ (n 1).

<sup>89</sup> Corlett, Advani, and Summers (n 72) 7.

<sup>90</sup> HMRC, ‘CGT Statistics’ (n 1).

**Figure 4. Distribution of capital gains among those receiving more than £100k in gains, 2017**



**Notes:** Constructed using data on all reported taxable capital gains going to individuals in 2017. Individuals are ranked by reported capital gains and grouped into bins of 1000. Only individuals with gains over £100,000 shown here. Bars show minimum and mean gains within each bin.

Source: Advani and Summers, ‘Capital Gains and UK Inequality’ (2020).<sup>91</sup>

Moreover, for those at the very top of the distribution, capital gains represent most of their total remuneration. Indeed, in 2017, 90% of total remuneration for 57% of individuals in the top 0.01% of earners came as capital gains.<sup>92</sup> This is important insofar as capital gains are not included in statistics

<sup>91</sup> Arun Advani and Andy Summers, ‘Capital Gains and UK Inequality: New Evidence from Tax Microdata’ (2020) CAGE Warwick and LSE International Inequalities Institute 4.

<sup>92</sup> Advani and Summers, ‘How much tax do the rich really pay?’ (n 41) 9. This has led to some calling CGT a ‘wonderland for the wealthy’: ‘Wonderland for the wealthy: Gordon Brown’s reforms of capital gains tax have created a convoluted system that is of most benefit to the rich’ (*Financial Times*, 27 April 2000). This is probably not a fair characterisation, however, since lower top 1% earners (total remuneration of around £128,000) benefit little from preferential CGT rates given that the vast majority of their earnings come from income. A better framing, therefore, might be a ‘wonderland for the uber wealthy’.

relating to earnings. The fact that a significant minority receive most of their remuneration from capital gains yet have low incomes plays an important role as well. In fact, when gains are considered, 10% of the original top 1% of income earners are displaced by these low income-earners but high capital-gainers.<sup>93</sup>

The inclusion of capital gains in inequality statistics also helps to reveal that wealth inequality between the top 1% and the remaining population has grown in the last 20 years. This is exacerbated for those among the top 0.1% and 0.01%.<sup>94</sup> This is not shown by traditional ‘income-focused’ data, which suggests that the top 1% share of income has remained relatively stable for the preceding decade.<sup>95</sup> This can be seen from the following graph:

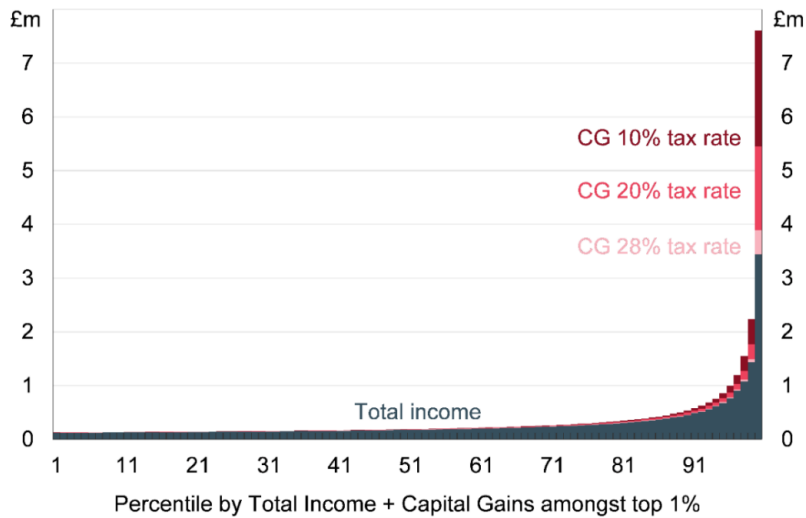
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<sup>93</sup> Advani and Summers, ‘Capital Gains and UK Inequality’ (n 91) 7.

<sup>94</sup> Advani and Summers, ‘Capital Gains and UK Inequality’ (n 91) 14.

<sup>95</sup> *ibid.*

**Figure 5. Distribution of income and gains attracting different tax rates by percentile of the top 1%, scaled by total remuneration within bin, 2017**



Source: Advani and Summers, ‘How much tax do the rich really pay?’ (2020).<sup>96</sup>

Again, the disparity between CGT and income tax rates is almost certainly a key contributor to this inequality. This discrepancy means that the effective average tax rate (EATR)<sup>97</sup> of wealthy individuals can be significantly lower than the headline rate for earnings. Indeed, an individual’s EATR only corresponds with the headline tax rates provided that the income is in the form of earnings subject to income tax (and in the absence of deductions or reliefs).<sup>98</sup>

<sup>96</sup> Advani and Summers, ‘How much tax do the rich really pay?’ (n 41) 10.  
<sup>97</sup> Effective tax rate is the rate of tax one pays for the entirety of their remuneration.  
<sup>98</sup> Advani and Summers, ‘How much tax do the rich really pay?’ (n 41) 5.

With lower rates of CGT, however, individuals can massively lower their EATR — to the point where the tax system is regressive past £250,000.<sup>99</sup>

This becomes even greater for those with the highest total remuneration. In fact, the average individual whose total earnings exceed £10 million is subject to an EATR of just 21%. This is below the rate charged to an individual on median earnings of £30,000.<sup>100</sup> Moreover, 10% of those earning more than £1 million had an EATR below individuals earning £15,000. Additionally, 25% of those with total remuneration below £2 million had EATRs equivalent to individuals that earned £60,000.<sup>101</sup>

The vast majority of these low EATRs apply to investors and business owners, since these are the sources of income that can be most easily ‘repackaged’ as capital gains. In particular, as noted above, this is because they can benefit from CGT and ER upon disposal of the business and because private equity managers can enjoy CGT on ‘carried interest’. Having said this, even abolishing reliefs like ER is unlikely to result in tangible change. Indeed, the main rate of CGT is so low (20%) that the EATRs of this group would still match individuals earning just £26,000.<sup>102</sup>

This reaffirms the point made earlier that, for many, capital gains are intimately linked to one’s profession or trade. As opposed to arms-length investors, whose passive and modest accumulation of wealth might reflect a more traditional understanding of capital gains, most gains today are enjoyed by business managers or investors who receive remuneration in the form of capital

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<sup>99</sup> Advani and Summers, ‘How much tax do the rich really pay?’ (n 41) 6.

<sup>100</sup> *ibid.*

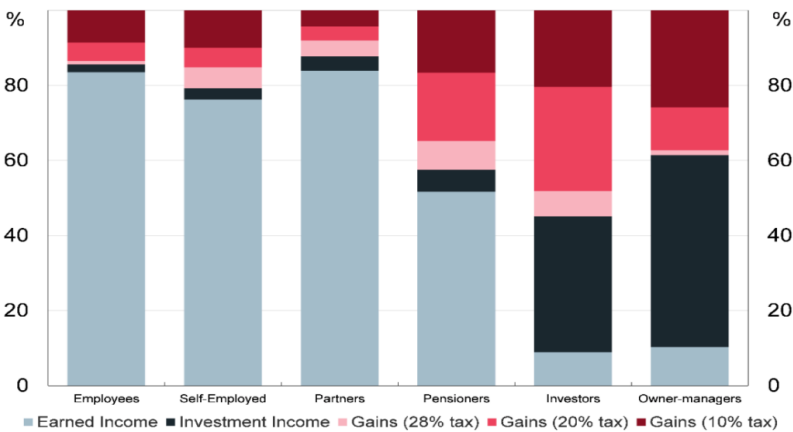
<sup>101</sup> Advani and Summers, ‘How much tax do the rich really pay?’ (n 41) 9.

<sup>102</sup> *ibid.*

gains despite being closely connected to their labour.<sup>103</sup> It highlights, again, that the justification underpinning the differing treatment between CGT and income tax is weak in practice.

This unequal distribution of the benefits of lower EATR for total remuneration is illustrated by the graph below. This shows that owner-managers and investors receive a larger proportion of their earnings through investment and preferential CGT rates compared to the general population of the employed and self-employed:

**Figure 6. Share of remuneration taxed at different rates, by main income source, among those in the top 1% by total remuneration, 2017**



Source: Advani and Summers, ‘How much tax do the rich really pay?’ (2020).<sup>104</sup>

<sup>103</sup>Advani and Summers, ‘Capital Gains and UK Inequality’ (n 91) 2.

<sup>104</sup> Advani and Summers, ‘How much tax do the rich really pay?’ (n 41) 11.

In summary, an incongruence is observed between what UK governments purport to achieve with CGT with respect to its underlying policy — reflected in the legislation — and what CGT delivers in practice. Despite aiming to combat inequity, the lack of neutrality in the tax system means that inequity remains. There is also a lack of both horizontal and vertical fairness. This is because two individuals earning the same amount can have different tax rates depending on the source of remuneration; additionally, those on highest earnings can enjoy tax rates lower than base rate taxpayers.<sup>105</sup> This leads to the wealthiest individuals enjoying a significantly lower EATR despite having a greater ability to pay. As such, the benefits provided by CGT are overwhelmingly enjoyed by the wealthiest. As a result, the UK CGT regime falls short of achieving the two main policy objectives set out for its implementation in 1965 — fairness and equity.

### C. Efficiency

It is debatable whether lower rates of CGT do in fact improve efficiency. Some may argue, for example, that tax neutrality delivers efficiency as it does not distort how individuals behave. As has already been shown, the preferential rates applicable to CGT and reliefs such as ER create economic distortions. These do so insofar as the tax and reliefs are not neutral as to the type of investment. For instance, ER incentivises investing in one's own business over investing into a bank account or into shares in a listed company. As such, they distort not only the form of remuneration, but also the underlying economic activity engaged in by an individual.<sup>106</sup>

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<sup>105</sup> Shreya Nanda and Henry Parkes, 'Just Tax: Reforming the Taxation of Income from Wealth and Work' (*Institute for Public Policy Research*, September 2019) 7  
<<https://www.ippr.org/files/2019-09/just-tax-sept19.pdf>> accessed 12 July 2022.

<sup>106</sup> Institute for Fiscal Studies, 'Green Budget' (2008) 222  
<<https://ifs.org.uk/budgets/gb2008/index.php>> accessed 28 June 2022.

There is also the issue of lock-in to which CGT contributes. The central factor that creates lock-in is that capital gains are taxed upon realisation as opposed to upon accrual. Another key element of the CGT regime that contributes to this is the exemption of the tax upon death.<sup>107</sup> This means that unrealised gains that have arisen before death avoid CGT. When inherited, the assets are treated as being acquired at market value — representing a new base cost — and previous gains on the assets are wiped out.<sup>108</sup> This incentivises individuals to hold on to assets until death before transferring them to family members. This is the case even if disposing of the assets beforehand could have been more profitable.<sup>109</sup> The problem here is that individuals retain assets in an inefficient manner.

In sum, what this suggests is that it is dubious that preferential CGT rates facilitate efficient allocations of capital insofar as they do in fact create economic distortions.<sup>110</sup> Moreover, other elements of the regime — particularly the exemption of CGT upon death — mean that lock-in persists. It is questionable, therefore, whether the economic efficiency justification for having a favourable CGT is in fact valid.

#### **D. Does Entrepreneurs' Relief Actually Help Entrepreneurship?**

Today, ER continues to represent a significant part of CGT, with 28% of CGT deriving from disposals benefitting from the relief.<sup>111</sup> Its importance in CGT revenue begs the question: who are the individuals that actually benefit from

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<sup>107</sup> TCGA, s274.

<sup>108</sup> TCGA, s 62(1).

<sup>109</sup> Institute for Fiscal Studies (n 106) 219.

<sup>110</sup> For a more detailed discussion on whether preferential rates improve allocation efficiency, see: Congressional Budget Office, *Capital Gains Taxes in the Short Run* (1991).

<sup>111</sup> HRMC, CGT Statistics (n 1).

such relief? One often conceives of entrepreneurship as individuals crafting businesses from their shed. One would likely want to know, then, if those benefiting from ER are those its name suggests. In essence, does ER genuinely help ‘entrepreneurship’?

### **(1) Theoretical Issues**

This begs another question: what does ‘entrepreneurship’ mean? Asking this question, however, highlights that the UK’s application of the relief — despite its policy motivations — is conceptually flawed. This is because it is not clear that the UK legislation has a coherent understanding of the type of entrepreneurship that is being encouraged.

Business owners are not homogeneous. While some may engage in risky business activities or investments (activities that might be labelled ‘entrepreneurial’), many merely use the business form as a means of marketing their labour services (as in personal service companies). Activities of the latter sort do not involve substantial investments — let alone risky ones.<sup>112</sup> Other business activities also include venture capitalists who, despite taking risks, are not engaged in a creative endeavour. This means that they are not ‘entrepreneurs’ in the sense of driving innovation. Entrepreneurial endeavours can, therefore, be differentiated from other business activities along the following lines. First, the former is riskier; second, entrepreneurial activities tend to require more focus on the initial investment; and third, entrepreneurship often revolves around engaging in a new business activity.<sup>113</sup>

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<sup>112</sup> Miller, Pope, and Smith (n 57) 9.

<sup>113</sup> Roger Gordon and Sarada Gordon, ‘How should taxes be designed to encourage entrepreneurship?’ (2018) 166 *Journal of Public Economics* 1, 2.

The problem with ER in the UK is that no such distinction is made between what constitutes an ‘entrepreneurial’ activity in the legislation.<sup>114</sup> Instead, one rate of tax applies to all: (just) 10%. Despite this, simply having a uniform preferential CGT rate means that no particular class of investor, nor any specific type of investment, is encouraged or targeted.<sup>115</sup> As such, the relief is potentially open to being overused by individuals for whom it was not designed. For instance, ER might extend to so-called ‘habitual entrepreneurs’<sup>116</sup> (for example, entrepreneurs who own multiple businesses or who are experienced in creating businesses which are later sold),<sup>117</sup> rather than the ‘risky new ventures’ that ER was designed to support.<sup>118</sup>

Conceptually, therefore, there is a disconnect between the name ‘Entrepreneurs’ Relief’ — with the implication that it is to assist entrepreneurs — and those who could benefit from the relief according to the wording of the legislation.

## **(2) Practical Issues: A Weak Incentive**

Yet, even if it were supposed that ER is utilised by the people for whom it is purportedly intended, to the extent that ER does influence business activities,

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<sup>114</sup> Natalie Lee and Rupert Seal, ‘Capital gains tax relief on the disposal of business assets: a clear strategy for encouraging entrepreneurs?’ (2013) 7 *Journal of Business Law* 723, 727.

<sup>115</sup> We should be charitable, however, and recognise the theoretical and practical difficulties of implementing a relief that specifically targets ‘risky’ business activity.

<sup>116</sup> Lee and Seal (n 114) 727.

<sup>117</sup> See for example Mike Wright, Paul Westhead, and Jeff Sohl, ‘Editor’s Introduction: Habitual entrepreneurs and angel investors’ (1998) 22 *Entrepreneurship Theory and Practice* 5.

<sup>118</sup> Poterba (n 48).

the data manifestly shows that such influence at the stages of (i) investment and (ii) disposal of the business, is incredibly limited.

At the point of initial investment, only 16% of those who paid ER were conscious of its existence, with only 8% stating that this awareness influenced their choice to make the investment.<sup>119</sup> This highlights that the relief, even for those who ultimately benefit from it, has very little impact on ‘entrepreneurs’ in their decision to make the initial investment. Further, it seems to have little effect on encouraging ‘risky’ business activities. Indeed, only 7% of the 16% said ER influenced their investment decision because it ‘made taking action less risky’.<sup>120</sup> The relief also does not seem to have any notable impact on decisions to dispose of business assets. Just 16% of ER payers stated that they were influenced by the existence of ER, with only 1% stating that ER influenced them in making the disposal less risky.<sup>121</sup>

As such, it is difficult to argue that ER (and therefore BADR) has any substantial impact on encouraging ‘entrepreneurship’. First, an extremely small section of those who utilise its preferential rate are aware of its existence at the time of investment. Indeed, without the assistance of an agent, there is very little awareness of the relief among those who enjoy ER. For those who claimed ER, only 12% claimed it of their own accord (without any advice), 65% had an agent deal with the entire process of claiming it, and 20% received advice or had an agent deal with some part of the process.<sup>122</sup> This demonstrates that the vast

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<sup>119</sup> HMRC, ‘Capital Gains Tax Entrepreneurs’ Relief: Behaviours and Motivations’ (2017) Research Report 456, 24

<[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/663877/HMRC\\_Report\\_456\\_CGT\\_ER.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/663877/HMRC_Report_456_CGT_ER.pdf)> accessed 22 July 2022.

<sup>120</sup> HMRC, ‘Capital Gains Tax Entrepreneurs’ Relief’ (n 119) 25.

<sup>121</sup> HMRC, ‘Capital Gains Tax Entrepreneurs’ Relief’ (n 119) 33.

<sup>122</sup> HMRC, ‘Capital Gains Tax Entrepreneurs’ Relief’ (n 119) 13.

majority are not aware of it by themselves. Rather, they only become conscious of it after receiving some advice. Hence why less than half of ER claimants have ‘a lot/some knowledge’ of the relief.<sup>123</sup> Secondly, an even smaller proportion of those aware are influenced by it to start an entrepreneurial endeavour or to engage in riskier business ventures.

It is telling that 61% of ER claimants stated that reforms at the time of the report would have no effect on their decisions to invest or dispose of assets.<sup>124</sup> Yet, such findings are not that surprising. After all, it is unlikely that entrepreneurs preoccupy themselves with CGT when formulating business proposals. It is reasonable to assume that the proposal itself will constitute most of the focus. From this perspective, then, it makes sense why some state that ‘tax cuts do not produce more Einsteins’.<sup>125</sup>

Ultimately, these findings reveal just how limited the preferential rate is in influencing the decision to engage in entrepreneurship or start-ups. At most, ER appears to be a mechanism for facilitating exit from a business or as a relief for those retiring. In practice, ‘Entrepreneurs’ Relief’ seems to have very little to do with entrepreneurship at all.

### **(3) A Historical Analysis Of The Relief**

Looking at how ER came into existence and what reliefs followed may explain why it is so ineffective at promoting entrepreneurship and why ‘Entrepreneurs’ Relief’ constitutes little more than a title. Indeed, a historical

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<sup>123</sup> HMRC, ‘Capital Gains Tax Entrepreneurs’ Relief’ (n 119) 13-14.

<sup>124</sup> HMRC, ‘Capital Gains Tax Entrepreneurs’ Relief’ (n 119) 39.

<sup>125</sup> Natasha Sarin and others, ‘Rethinking How We Score Capital Gains Tax Reform’ (2021) 36 National Bureau of Economic Research 19.

analysis reveals ER to be nothing more than a survivor of Taper Relief (abolished in 2008) and the preceding Retirement Relief (abolished in 1998), both of which carried similar justifications to ER.

Taper Relief provided a reduced rate of tax for longer-held assets.<sup>126</sup> It was suggested that this would reduce speculative activity in the short-term and simultaneously incentivise long-term investment.<sup>127</sup> It effectively had the same purported justification as ER. Indeed, in his 1998 Budget, Gordon Brown stated that CGT should ‘reward risk taking and promote enterprise’ and that it would do this through the introduction of Taper Relief.<sup>128</sup> When the relief was abolished, it was quickly replaced by ER. This was because the desire to impose a flat rate of 18% CGT without the existence of Taper Relief angered many business owners who, but for the changes, would have enjoyed a 10% rate.<sup>129</sup> Therefore, it might be said that political compromise, rather than any thoroughly-developed underlying principle, drove the preferential rates provided by ER in practice.

Realising that Taper Relief also derives from Retirement Relief further helps to clarify the rationale for its existence: that is, as a relief aimed at supporting those who made long-term investments in businesses to be relied upon on retirement. Indeed, Retirement Relief was essentially the same as ER in that it applied to the disposal of part or all of the business and could even be relied upon by those not retiring.<sup>130</sup>

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<sup>126</sup> HM Treasury, *Financial Statement and Budget Report* (18 March 1998) HC 620, para 4.28.

<sup>127</sup> HM Treasury, *Financial Statement and Budget Report* (n 126) para 4.25.

<sup>128</sup> HM Treasury, *Financial Statement and Budget Report* (n 126), para 4.24-4.29.

<sup>129</sup> Glen Loutzenhiser and John Tiley, *Tiley's Revenue Law* (9<sup>th</sup> edn, Hart 2019) 42.5.

<sup>130</sup> TCGA, sch 6, para 13 (as amended in 1994).

Appreciating this historical perspective helps one to understand what ER is truly meant to be doing. Instead of being distracted by the title, it can be seen that ER is merely a remnant of the old regime. This is a regime that was likely not truly intended to support entrepreneurs but was simply a relief upon disposal. As such, this is a regime that persists for pragmatic, rather than principled, reasons.

Viewing ER in the context of the broader CGT relief system also elucidates its purpose. Indeed, other mechanisms in the regime might be said to exist to truly support entrepreneurship. This includes the existence of the Enterprise Investment Scheme (EIS), which provides ‘upfront income tax relief for external investors’.<sup>131</sup> Therefore, it might properly be said to constitute the sort of scheme designed for increasing entrepreneurship. This is in contrast to ER, which is focused on relief for disposal of a business, not for its creation.

All of this would help to explain why the relief seems to have such an insignificant effect on encouraging entrepreneurship in its conventional, everyday understanding. Fundamentally, ER was not designed for this purpose. Indeed, ER was never meant to be anything more than what is effectively Retirement Relief and Taper Relief incarnate: intended to provide small business owners with tax relief for long-term business investments. At its heart, the ‘Entrepreneurs’ Relief’ is nothing but a title. This explains why ER was renamed ‘Business Asset Disposal Relief’ — a title more suited to its role. Indeed, Rishi Sunak highlighted the fact that ER has ‘done little’ to generate entrepreneurial activity as a key reason for BADR’s introduction.<sup>132</sup> At the very least, this demonstrates that ER is ineffective

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<sup>131</sup> Office of Tax Simplification, CGT Review (n 2) 87.

<sup>132</sup> HM Treasury, *Budget 2020* (n 55).

at achieving its stated policy objective: the improvement of entrepreneurship and the facilitation of risky business ventures.

#### **SECTION IV – Proposed Reform**

Perhaps the underlying issue with CGT is that its policy objectives are inconsistent in some cases. For example, the desire to minimise inequality through the promotion of equity and fairness cannot be easily squared with the desire to incentivise business investment with preferential tax rates which benefit a limited category of taxpayers. Moreover, the aim of reducing avoidance does not seem balanced with the desire to treat CGT and income tax differently. Attempting to balance these policy objectives inevitably leads to the suboptimal attainment of them all. With this in mind, it is suggested that if CGT is to meet its purported objectives, a reconsideration of the justifications underpinning its existence, alongside reform to the tax, are necessary.

As to the former, the justifications for the separate categorisation and treatment of CGT and income tax, namely that capital gains and income are different in nature, and that preferential rates promote an efficient allocation of capital and encourage ‘risky’ investments, should be given significantly less consideration. As it has been shown, these explanations do not hold up either conceptually or in light of the data both on how capital gains function for wealthy individuals as well as on how it impacts the decision-making of owner-managers. As such, they fail to accurately reflect how CGT and taxpayers operate in practice. For this reason, greater focus should be placed on the other justifications for CGT, that being, improving fairness and preventing tax avoidance. This takes this article onto the question of reform. Here, it is proposed that aligning CGT rates

with those of income tax will best achieve the policy objectives of greater equity and curtailing tax avoidance. This is for two reasons: minimising tax avoidance and minimising inequality.

### **A. Minimising Tax Avoidance**

First, aligning CGT rates with income tax would limit the possibility of tax avoidance by mitigating economic distortions. As Section III of this article has revealed, the separate treatment of CGT from income tax is what creates economic distortions and the opportunity for avoidance in the first place. Indeed, preferential CGT rates incentivise taxpayers to characterise what would otherwise be income as capital gains. One simple way taxpayers do this is by providing their labour through personal service companies in which they are owner-managers. Such arrangements allow these individuals to receive payment in the form of capital gains when they liquidate their business assets. In doing so, they can charge these gains to CGT and even benefit from Business Asset Disposal Relief. As such, they avoid paying income tax on their remuneration. Private equity fund managers can also receive their remuneration as ‘carried interest’, which is treated as a capital gain instead of as income. The proposed reform of aligning the tax rates would significantly mitigate such economic distortions. This is because there would be no tax benefit from recharacterising one’s income as capital gains. Since taxpayers would thereby be disincentivised from doing so, alignment would reduce such avenues for tax avoidance.

Of course, it would be impossible to eliminate distortions and entirely prevent avoidance through the suggested reform. Indeed, it is unclear how

responsive taxpayers (especially the wealthiest) are to such reforms to tax rates<sup>133</sup> and certain individuals will always inevitably look for more elaborate ways to reduce their tax burden. Moreover, it is not evident that the opportunities for avoidance presented by the international taxation regime and tax treaties can easily be overcome through such reform. For instance, as has been highlighted, the asymmetry in treatment between residents and non-residents under section 10 TCGA coupled with DTAs, has provided an opening for tax avoidance. For instance, under the UK-Hong Kong DTA, UK gains made by Hong Kong-resident companies are only subject to Hong Kong CGT. However, Hong Kong lacks a CGT. As such, taxpayers can use Hong Kong-resident companies to generate gains in the UK all while avoiding UK CGT. In such instances, the renegotiation of DTAs would likely be necessary to address these gaps.<sup>134</sup>

Ultimately, the author recognises that aligning CGT with income tax rates is not a catch-all solution. Nevertheless, by aligning tax rates, it is submitted that taxpayers would be less likely to artificially alter their economic behaviour as the opportunity to do so would be less easily accessible. As such, alignment would go a long way to control tax avoidance and operate as a significant mechanism through which to restrain the ‘skilful manipulator’ that James Callaghan referred to in his 1965 Budget.<sup>135</sup>

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<sup>133</sup> Isaac Delestre, Wojciech Kopczuk, Helen Miller, and Kate Smith, ‘Top income inequality and tax policy’ (IFS Denton Review of Inequalities 7 April 2022) 3 <<https://ifs.org.uk/books/top-income-inequality-and-tax-policy>> accessed 1 August 2023.

<sup>134</sup> There is also the potential exacerbation of the lock-in effect by raising CGT rates. Admittedly, the question of lock-in is an inevitable trade-off that policymakers will have to accept if the issues of equity and tax avoidance are to be addressed adequately.

<sup>135</sup> HC Deb 06 April 1965, vol 710, col 245.

## B. Minimising Inequality

Secondly, the proposed reform would ensure greater equity between different classes of taxpayers. This is because capital gains, which, in effect, operate as income, would be taxed similarly to income. It would therefore mean that individuals who exploit preferential rates provided by CGT and reliefs such as ER would no longer receive disproportionate tax benefits for what is effectively their income.

As this article has highlighted, there is very little justification for the separate treatment of capital gains and income, given how taxpayers benefit from capital gains in practice. As mentioned earlier, capital gains are intimately connected with one's profession or trade and thus remuneration often takes the form of capital gains despite being closely connected to one's labour. The previous section of this article outlined how capital gains represent the majority of one's total remuneration among the wealthiest in the UK. For instance, capital gains represented 90% of total remuneration for the majority of top 0.01% of earners.<sup>136</sup> The effect of disparate rates between CGT and income tax has also meant that the wealthiest individuals benefit from a lower effective average tax rate (EATR). This has resulted in those with earnings over £10 million being subject to an EATR of just 21%: a rate lower than individuals on median earnings.<sup>137</sup>

Given that the wealthiest individuals enjoy a significant proportion of their remuneration through capital gains, and insofar as they benefit from lower EATRs than the average taxpayer, it begs the question why capital gains are not

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<sup>136</sup> Advani and Summers, 'How much tax do the rich really pay?' (n 40) 9.

<sup>137</sup> Advani and Summers, 'How much tax do the rich really pay?' (n 40) 6.

subject to a rate equivalent to that of income tax. There seems to be very little justification for why wealthy individuals, who stand to benefit the most from preferential CGT rates, should not be subject to the same income tax rates when their gains largely possess the same quality as income. Indeed, if capital gains and income are similar in practice, they ought to be treated similarly. Aligning CGT with income tax would address this issue directly. It would also thereby promote the horizontal and vertical equity which justified the very introduction of CGT in 1965.

### C. Criticisms of this Reform

There are two potential criticisms for removing the preferential CGT and ER rates. First, it could be argued that even if preferential rates are exploited by a range of businesses potentially ‘undeserving’ of them, such rates remain necessary for encouraging ‘genuine’ entrepreneurial endeavours. After all, the overwhelming majority of businesses (99.2%) in the UK are small businesses with very few (if any) salaried employees.<sup>138</sup> Some might argue that preferential CGT rates are essential to ensuring such businesses continue to be incentivised. Some in other jurisdictions have even highlighted that preferential rates significantly increase investment.<sup>139</sup> Secondly, it could be said that aligning CGT and income tax is unfair. In particular, it is unfair to owner-managers who entered into their

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<sup>138</sup> Department for Business, Energy & Industrial Strategy, ‘Business population estimates for the UK and regions 2022: statistical release’ (6 October 2022) <[https://www.gov.uk/government/statistics/business-population-estimates-2022/business-population-estimates-for-the-uk-and-regions-2022-statistical-release.html#:~:text=SMEs%20\(small%20and%20medium%2Dsize,99.9%25%20of%20the%20business%20population](https://www.gov.uk/government/statistics/business-population-estimates-2022/business-population-estimates-for-the-uk-and-regions-2022-statistical-release.html#:~:text=SMEs%20(small%20and%20medium%2Dsize,99.9%25%20of%20the%20business%20population)> accessed 31 August 2023.

<sup>139</sup> Terry Moon, ‘Capital Gains Taxes and Real Corporate Investment: Evidence from Korea (2022) 89 *American Economic Association* 2669, 2698.

business arrangements with the expectation of benefiting from these preferential rates.

As to the first criticism, it is contended that aligning CGT and income tax will not have the negative implications suggested. This article has shown that the preferential rates offered by ER have had little impact on the decision-making of taxpayers. Only 16% of those who paid ER knew of its existence at the point of initial investment,<sup>140</sup> and only 16% were influenced by ER when either commencing, or choosing to dispose of, their business.<sup>141</sup> What is clear from this is that taxpayers have little knowledge of these preferential rates and only a small proportion of them either commence their businesses, or choose to dispose of them, so as to enjoy these rates. This indicates that alignment of CGT with income tax will have a minimal bearing on the decision of entrepreneurs to further engage in ‘risky’ business activities.

Furthermore, if policymakers wish to support entrepreneurial activities, policies directly targeted at encouraging upfront investment are more appropriate for achieving this end than simply offering lower tax rates. Indeed, such mechanisms already exist (for example, EIS). Moreover, other jurisdictions provide examples of schemes which are effective at incentivising investment. For instance, the USA has offered several iterations of investment tax credits which allow businesses to offset investment spending directly against taxable income. This was seen most recently under the Inflation Reduction Act 2022, where tax credits have been offered for certain renewable and clean energy projects.<sup>142</sup> Such tax credits directly reduce investment costs by lowering a business’s tax base.

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<sup>140</sup> HMRC, ‘Capital Gains Tax Entrepreneurs’ Relief’ (n 118) 24.

<sup>141</sup> HMRC, ‘Capital Gains Tax Entrepreneurs’ Relief’ (n 118) 33.

<sup>142</sup> US Inflation Reduction Act 2022.

With this in mind, the argument for supporting ‘genuine’ entrepreneurs through preferential tax treatment fails to stand up to scrutiny. Policies aimed at directly encouraging investment are more suitable for achieving the ends supposedly justifying ER. If preferential rates for ‘genuine’ entrepreneurs are found to be necessary, however, then the author welcomes the Government’s reduction of the relief to £1 million from the previous £10 million.<sup>143</sup> This change allows smaller businesses to continue to benefit whilst ensuring that the wealthiest cannot abuse the relief for avoidance purposes. It, therefore, guarantees a more equitable system.

As to the second criticism, a limited qualification to the proposed reform will alleviate any concern. Here, a simple solution would be to allow the current preferential ER rates to apply to gains accrued before the date on which CGT and income tax rates are aligned (or on an earlier date if policymakers so choose) and to subject gains made after this date to the higher CGT rate implemented. This simple ‘rebasings’<sup>144</sup> would allow individuals who engaged in their businesses for the specific purpose of benefiting from preferential CGT rates to have their reasonable expectations met. This is because the gains which individuals reasonably assumed would be subject to the preferential rates would indeed be subject to these rates. It would also mean that future gains would be subject to the new aligned rates. As such, rebasing would not only keep owner-managers happy, but it would also simultaneously facilitate the author’s proposal to treat future gains proportionately to income. In doing so, this simple mechanism would mitigate taxpayer concerns whilst guaranteeing greater fairness and minimising tax

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<sup>143</sup> TCGA (n 49).

<sup>144</sup> That is, ‘wiping out all gains before some date’: Arun Advani, ‘The taxation of capital gains: principles, practice, and directions for reform’ (2021) Warwick Economics Research Papers no.589, 14.

avoidance going forward. Rebasing is also not uncommon in tax reform<sup>145</sup> and so does not pose any logical or logistical difficulties to implementing the proposed tax alignment.

In summary, alignment of CGT with income tax rates would resolve many of the problems raised by this article with CGT. Not only would alignment minimise tax avoidance by limiting the scope for income recharacterisation (and hence minimise economic distortions), but it would also enhance equity within the system by ensuring that wealthy individuals who most benefit from capital gains are taxed on those gains in a more proportionate manner. Alignment would thereby have a significant impact on delivering the policy objectives which justify the existence of CGT in the UK taxation regime.<sup>146</sup>

## CONCLUSION

The goal of this article was to assess whether the current UK CGT framework fulfils its declared aims. The central policy motivations given to justify its existence include the desire to improve equity and fairness, to protect the tax base/minimise avoidance, to facilitate economic efficiency, and to promote entrepreneurship. However, while the existence of CGT *prima facie* moves the UK

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<sup>145</sup> For instance, see Office of Tax Simplification, CGT Review (n 2).

<sup>146</sup> As a side note, it is estimated that aligning CGT such that headline average rates of earnings would apply to all those earning (in total) above £100,000, could raise £12 billion for the Treasury. This is assuming that ‘all taxable income faces the same effective rate as earnings [...] and that Capital Gains Tax rates are aligned with the taxpayer’s marginal Income Tax rate plus 2% National Insurance Contributions’, and ‘estimates are on a static basis’: Advani and Summers, ‘How much tax do the rich really pay?’ (n 40) 13. This highlights the potential opportunity available to policymakers if they decide to reform CGT in the manner proposed by this article.

towards meeting these goals, this article has demonstrated that these policy objectives are far from being met.

Central to this is the lack of neutrality in the UK tax regime. The favourable rate of CGT in relation to income tax has provided individuals with a simple mechanism through which to avoid income tax. As such, CGT has failed to adequately protect the tax base against those who can recharacterize what is otherwise income in the form of tax advantaged gains. This ability to enjoy favourable tax rates on what is essentially income has also led the author to conclude that the categorical distinction between CGT and income tax is unsupportable. Undue complexities in the legislation, highlighted by the intricacies involved in the application of CGT and Double Taxation Agreements to non-residents, have also been shown to permit the avoidance of CGT altogether.

Given that wealthy individuals stand to gain the most from such avoidance mechanisms, insofar as they tend to be freer to choose their form of remuneration, a tiny proportion of the wealthiest individuals disproportionately experience the benefits of CGT. As a result, UK CGT is fraught with the inequity and unfairness which it purports to mitigate.

This piece aims to highlight the insufficiency of CGT for enhancing economic efficiency as disparity between CGT and income tax in itself creates economic distortions. As for entrepreneurship, the regime falls short from two perspectives. Technically speaking, the legislation regarding Entrepreneurs' Relief lacks clear purpose. The fact that it fails to offer a distinct and coherent conception of 'entrepreneurship' means it fails to target specific 'desirable' investments. It thus becomes a catch-all for any individual establishing any

business for any reason. Practically speaking, it also provides very little incentive for an individual to initially invest in an entrepreneurial endeavour. Looking at its introduction, seen as a political compromise to maintain the old regime rather than a principled decision, suggests that it likely did not intend to encourage entrepreneurship. Fundamentally, therefore, ER considerably fails to achieve its objectives.

Ultimately, Capital Gains Tax in theory and Capital Gains Tax in practice paint different pictures. As such, if the reality of the tax is to match its intended outcomes, then reform is necessary. This article has proposed the alignment of CGT rates with those of income tax. Not only would this diminish tax avoidance by limiting the scope for income recharacterisation, but it would also promote equity and fairness in the tax system as individuals will be taxed on the basis of their ability to pay, not on the basis of their source of remuneration. While such reform cannot resolve every issue identified by this article, in particular the problem of asymmetry created by the international taxation regime, the proposed reform would move UK CGT significantly more towards achieving the policy objectives set out in Section I of this article. It would therefore provide a simple yet effective mechanism for realising the horizontal and vertical equity which justified the very existence of CGT at its conception.