January 2021

BVCA comment on OTS report on Capital Gains Tax

The Office of Tax Simplification published its first report on CGT (OTS Capital Gains Tax Review: Simplifying by design) in November 2020. In this short paper, the BVCA sets out its high level policy response stressing the need to tax capital gains and income differently and the validity of the current dividing line between the two.

The BVCA represents entrepreneurs and investors in businesses. We advocate for a tax system that encourages the activities of both. In our view a tax system which distinguishes between capital gains and income is critical to achieving that aim. This distinction alone is, of course, not enough, but it plays a vital role alongside a stable legal system, a clear regulatory regime and a tax system that is internationally competitive.

We agree with Gordon Brown who as Chancellor in 1998 said, that the 'capital taxation system should better…reward risk taking and promote enterprise'. To the BVCA and its members the case for capital gains tax is clear and compelling and we would urge the Chancellor to maintain a separate capital gains tax system for the taxation of gains derived from investment and entrepreneurial activities.

The case for a competitive capital gains tax regime

The case for a tax regime that incentivises investment and entrepreneurship, driving innovation and wealth creation in the UK economy could not be clearer. A stable and internationally competitive capital gains tax forms a key part of such a regime, incentivising investors to deploy their capital in UK businesses.

Any systematic overhauling of the UK taxation of capital gains would risk undermining the case for investment at precisely the moment the economy needs its investors and entrepreneurs the most. Such a change would also run counter to the government's broader efforts to make the UK a more competitive jurisdiction for investment, in particular the welcome ongoing consultation into the UK's tax regime for asset holding companies.

The Office of Tax Simplification (OTS) report notes that the total amount of capital gains tax paid for the 2017-18 tax year was £9bn, as compared to £180bn in income tax receipts. The maximum amount raised by even the most radical reform (alignment of rates with income tax) is estimated at £14bn, although the report notes that the actual increase in capital gains tax receipts would be 'nothing like this' in practice as a result of behavioural changes. The risk of distortive behavioural change is particularly acute in relation to capital gains tax given that, as the OTS report itself notes, the bulk of capital gains are realised by a relatively small number of taxpayers on an infrequent basis (the report notes that in 2017/18, gains over £5m made up 34% of the total but were accounted by only 2,000 taxpayers).

The risk to the wider UK economy of disincentivising investment and entrepreneurial activity which is highly internationally mobile does not merit the limited revenue raising opportunity of aligning income tax and capital gains tax rates. The UK already underperforms internationally in relation to the so-called 'equity gap' (the difference between the investment UK companies need and are able to attract), with a recent report from the ScaleUp Institute, Innovate Finance and Deloitte identifying a £15bn funding gap for growth capital and noting the 'inadequacy of UK growth capital flows compared to other countries'. Any reforms to the tax system which discourage investment risk exacerbating this equity gap, starving UK businesses of much needed capital. There are other areas within the UK tax system where more revenue may be raised without disincentivising wealth generating behaviour such as seeking to close the c.£31bn (2018/19) tax gap.

Tax neutrality

Beyond policy considerations, the OTS report focuses on several key areas where they consider that the existing capital gains tax regime has distortive effects and undermines the neutrality of the tax system. Of particular importance to the BVCA's membership are the discussions and recommendations on rate alignment, share-based renumeration, owner-managed companies and reliefs targeted at business assets. Each are considered in turn below.

Rate alignment

The OTS consider that the different rates of capital gains tax and income tax distorts behaviour by artificially pushing taxpayers towards activities which generate capital gains rather than income. Yet even ignoring the clear policy case for taxing capital gains at a lower rate (discussed above), there are reasons to be sceptical that rate alignment would be the panacea many of its proponents suggest.

First, as the OTS report itself acknowledges, rate alignment would simply replace one set of distortive effects with another, with taxpayers seeking to use companies (which are taxed on gains at the corporation tax rate of 19%) to hold capital assets, as well as causing a 'lock-in' effect, with taxpayers incentivised to retain assets rather than sell them. Complex anti-avoidance rules would be required to address these concerns, cutting across the supposed simplicity created by rate alignment.

The OTS report also notes several ways in which rate alignment would create outcomes likely to be perceived as unfair, such as the inflexibility in the ability to offset capital losses against income and taxing purely inflationary gains at a higher rate (as an example, if an asset is sold after ten years in which inflation ran at 2%, over 21% of the capital gain realised on the sale of the asset would be attributable solely to inflation). Reliefs introduced to mitigate these issues would inevitably be both complex and risk creating unintended distortions.

Rate alignment in the name of simplicity is a false hope, as is rate alignment in the name of significant revenue raising. This is point underlined by the fact that rate alignment would leave the UK out of step with the vast majority of its international competitors (including France, Germany and the US, all of which tax income and gains at differential rates). Given the potentially negative effect on investment and entrepreneurial activity it is difficult to understand the benefit rate alignment would bring to the UK economy.

Share-based renumeration

Another area of focus in the OTS report is so-called 'share-based renumeration'. The OTS consider that shares awarded to employees in connection with their employment place particular pressure on the boundary between income tax and capital gains tax, making the distinction between rewards for labour and returns on investment hard to delineate. The OTS report highlights a particular boundary concern relating to growth shares, described by the OTS as 'low value shares acquired by employees on terms that would not be available to an external investor'.

We disagree with the proposition that the boundary is hard to draw. Concerns as to the boundary between employment income and capital gains are not new. But in this particular case the BVCA's view is that the boundary is well defined and well-drawn. The UK tax regime has evolved to produce detailed and well understood rules (most notably the employment related securities regime) which police the line between gratuitous value given to an employee as a reward for their employment, and value generated by a capital investment made by an employee.

Where an employee makes an investment in shares in their employer's group, provided that they pay market value for those shares at the time of award, there is no principled reason for the employee to be treated differently to an external investor: both are taking genuine, often material, investment risk with no guarantee of success. The tax rules in most developed economies follow a similar approach too.

Many of the specific concerns in relation to growth shares are misplaced. Like any share, the holders of growth shares participate in both the upside and downside of a company's investment cycle. This contrasts with a share option, which is a one way bet and does not deliver the alignment between employees and shareholders which drives business growth.

Rather than focusing on whether an investment carries sufficient risk (which is inherently hard to measure objectively), a principled capital gains tax regime should ensure that any investment where capital is at risk is capable of delivering a capital return. It is, of course, clearly correct that shares which bear more risk will typically have a lower value when they are acquired. Perhaps the perceived boundary issue arises from the fact that successful investments (that is those whose high-risk investments return value) are more 'visible' than the many cases where such investment does not deliver any return and the investment is lost.

The UK tax rules in this area are clear, well defined and draw the distinction between employment return and capital gains in a logical way. We see no reason to disrupt an area of tax law that is working well and as parliament intended. As with rate alignment, we would be concerned that any attempt to introduce new rules that overruled the employment-related securities rules in certain cases would lead to unwarranted complexity and simply create new boundaries that might be the subject of debate for those that wish to exploit them.

Owner managed businesses

The OTS report focuses on small owner managed businesses as another 'boundary area'. In particular, there are concerns relating to companies with retained profits being liquidated or sold, thus generating a capital gain (as opposed to extracting those profits as a dividend, which would be subject to income tax).

Again, these concerns are not new: the UK tax system has long been concerned with preventing distortions through the use of closely-held companies, and has developed targeted anti-avoidance measures (including the transaction in securities regime, the 'phoenixism' rules and, from April 2021, the extension of the off payroll working rules) addressing these concerns.

These anti-avoidance rules are well understood and appropriately targeted. By contrast, the suggestion in the OTS report that retained earnings are taxed as dividends on a sale or liquidation of certain companies would be complex to implement and create serious distortions of its own on the boundary between companies which are considered to be sufficiently closely held to be subject to the rules, and those which are not. We cannot see why it would be appropriate to change the tax system so that it effectively assumed that any company that is sold should be stripped of all of its retained earnings before sale.

The decision to incorporate is much less driven by tax than it is driven by the desirability of limited liability. To incorporate means incurring two layers of tax: corporation tax on the underlying economic activity of the company and tax on the shareholder on the extraction of value. That value can be extracted as salary (taxed as employment income) or as dividends (taxed at dividend rates). If it is not extracted and is left in the company to provide working capital or for other commercial purposes, it will be subject to UK corporate law on the maintenance of capital and protection of creditors. In such a case, we cannot see a principled reason for it to be taxed otherwise than as capital on a liquidation or sale. Or, to put it another way, for egregious behaviour that seeks to exploit corporate structures there is existing anti-avoidance legislation which we refer to above that should defeat tax avoidance. If it does not, then the answer should be to focus on targeted areas of perceived abuse rather than making a simple assumption that individuals should be taxed on all retained earnings of their businesses as if they had distributed them.

Business asset disposal relief

Following substantial reform in recent years, the availability of business asset disposal relief (formerly entrepreneur's relief) has already been significantly limited. It is now available only on an investor's first £1m of capital gains, with the investor required to hold at least 5% of the economic rights in the company. The OTS report recommends taking this reform further, radically overhauling the relief such that it becomes, in effect, a limited relief available only on retirement.

An effective and targeted relief for business investments, which recognises their particular economic value, is an appropriate part of an internationally competitive capital gains tax regime. The effective abolition of business asset disposal relief and replacement by a new retirement relief risks reducing the UK's international competitiveness, whilst creating its own distortions, with business founders disincentivised from disposing of their shares until they meet the conditions for relief on 'retirement', restricting the availability of the third party investment needed for their businesses to grow and locking up capital which might otherwise be deployed in the wider economy.