Policy Brief

The productivity cost of low Capital Gains Tax rates

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Arguments around Capital Gains Tax (CGT) focus on the trade-off between raising revenue and discouraging investment. As Adam, Advani, Miller and Summers (2024) describe, this concern is misguided. A higher CGT rate alongside sensible reform to the tax base, to tax only returns in excess of the cost of borrowing, reduces the tax rate for marginal investors while raising money from those with high returns.

Raising the tax rate to align with Income Tax also has a direct growth benefit, by removing the problems of 'misallocation'. Currently capital gains are taxed at much lower rates than income.[1] This encourages individuals to work in a form that allows them to be paid in capital gains, for example setting up a personal service company through which they get paid, and later extracting the income as capital gains by liquidating the company.

While many small companies are highly productive, these personal service companies are typically not designed to ever grow. A negative side effect of low CGT rates is the proliferation of these businesses, which not only reduce the overall tax take, but hamper productivity by having people working in ways that are less efficient but are individually optimal because of the tax saving. This contributes to the regularly diagnosed 'long tail' of unproductive firms in the UK (Olivera-Cunha, et al., 2021; De Loecker, Obermeier and Van Reenan, 2022; Resolution Foundation, 2022).

In this briefing, we present new quantitative evidence that a large share of capital gains in the UK are, in fact, the returns to labour rather than capital. We present two complementary pieces of evidence. First, using a reform which aimed to make it harder to regularly pay out income as capital gains, we show at the individual level a large spike in company liquidations. Since the CGT rate itself was unchanged, this behaviour can only be explained by 'forestalling', as individuals attempted to benefit from CGT treatment one final time before the new rules were in place.

Second, using de-identified administrative microdata from HMRC, we show at a macro level that over half of gains come from private business assets with annualised returns over 100%. While very occasionally individuals may make genuine capital gains in which they double their money year after year, the volume of such cases is again suggestive that for many this money is not actually the return to capital, but to labour.

Taxing labour income at the preferential rates currently offered to gains results in inefficiency, unfairness, and lost revenue. Equalising CGT with Income Tax rates, as we call for in a new report on CGT reform (Advani, Lonsdale, and Summers, 2024), would eliminate the incentive for owner-managers to repackage their income as a capital gain, improving productivity through a more efficient allocation of labour. Any changes to CGT that retain the preferential tax treatment of capital gains (i.e. rate hikes that fall short of full equalisation) will continue to distort owner-managers' decisions on how to take remuneration, which is a drag on productivity and growth

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[1] The top tax rate on labour income in the UK is 47%, including income tax and employee National Insurance Contributions (NICs), while for dividends it is 39.35%. Capital Gains Tax (CGT) is levied at far lower rates, ranging from 10% to 28% depending on the type of asset.

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Firms as tax shelters: Evidence from an anti-avoidance reform

Repackaging income as a capital gain has clear tax advantages yet can present logistical challenges, as owner-managers must either sell or liquidate their company to extract these earnings from their firm. Previously, owners of solvent UK companies who entered the process of 'Members' Voluntary Liquidation' (MVL) to close their businesses could immediately set up a new company that performed the same business activities as the preceding one, commonly known as a 'phoenix' company (so called because the new company effectively rose from the ashes of the old). This loophole allowed owners to access cash retained within their firm at preferential CGT rates before continuing with the same business affairs through the phoenix company, rather than paying themselves in dividends and facing a larger tax bill.

In 2016, the UK government introduced anti-avoidance legislation that denied CGT treatment to the proceeds of an MVL if the owner subsequently set up a phoenix company.[2] For these purposes, a phoenix was defined as carrying on 'a trade or activity which is the same as, or similar to, that carried on by the [old] company' within two years.[3] This new policy was announced roughly ten months before it became effective on 6th April 2016, so owner-managers who wished to leave open the option to 'phoenix' in the future were still able to do so by completing the MVL (and distribution) prior to this cut-off date.

We analyse the dates on which UK companies entered MVL and find substantial excess liquidations immediately before the reform took effect. Any irregular "bunching" of liquidations in the ten months prior to the reform is consistent with companies reacting to the announcement by bringing their future liquidations forward in time, allowing owner-managers to extract earnings from the business at CGT rates whilst still preserving the opportunity to phoenix. Importantly, the *only* reason for an owner to liquidate immediately pre-reform (if they had not originally planned to do so) was to take advantage of the expiring window to access retained profits at preferential tax rates whilst in substance continuing to run the same business.

Figure 1 shows a time-series plot of the number of firms entering MVL from 2015 to 2019, using data on 'resolution' dates obtained through Companies House.[4] The graph is broken down into companies owned by individuals (top), which benefit from preferential tax CGT treatment on distributions in MVL, and companies owned by other companies (bottom), which pay Corporation Tax and have no tax incentive to repackage retained profits as capital gains.

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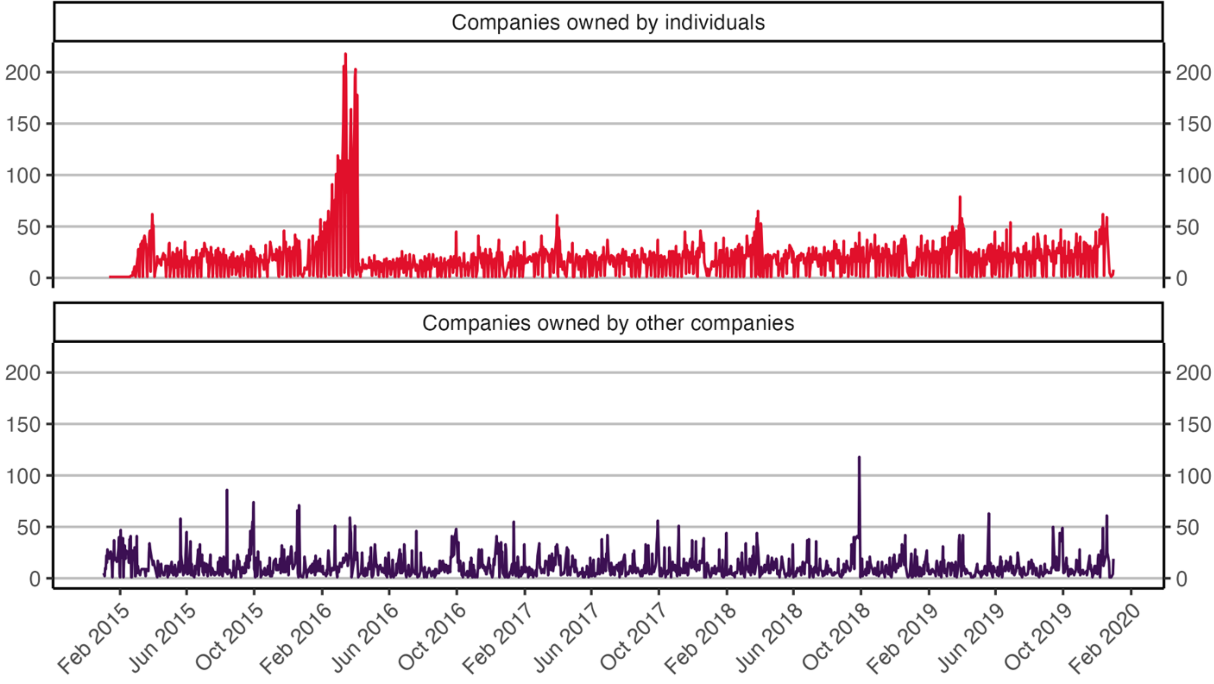
[2] Section 35(1) Finance Act 2016 (c24), inserting Section 396B Income Tax (Trading and Other Income) Act 2005. See further Appendix A.

[3] Section 396B(4).

[4] The resolution date is the earliest date at which a distribution eligible for CGT treatment could have been made.

Figure 1: Number of companies entering MVL over time



Notes: Daily counts of companies resolving to enter MVL.

Source: Authors' calculations based on data from Companies House.

We observe a stark bunching of liquidations by companies owned by individuals over the five-month period prior to reform taking effect (6th April 2016), which immediately followed the introduction of the draft legislation (9th December 2015). During this window, roughly 5500 companies resolved to enter MVL, which is over 3x greater than the amount observed in the same window exactly one year later (9 December 2016 - 6 April 2017). As expected, we find no response amongst companies owned by other companies, providing strong evidence that this bunching was motivated by the aim to take remuneration at CGT rates while preserving the option to carry on the same business via a phoenix.

Characteristics of bunching companies

Using historical company statistics from Bureau van Dijk's Orbis database, we identify patterns among firms liquidating in the pre-reform window ('bunchers') that are consistent with these firms largely deriving their value from labour rather than capital.

Table 1 displays the 10 most common types of bunching firms according to their industry classification. The bulk of these companies operate in industries where personal service companies are widespread—typically in consulting or other forms of professional support. In 7 of these industries the share of liquidating companies with 1-2 directors is above 70% (and reaches as high as 96% for computer consulting

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activities), which is in line with the small company sizes that we would expect from owner-managers using firms as tax shelters.

There are some exceptions to this trend. Three of the industries in Table 1 relate to real estate operations (development of building projects, buying and selling of own real estate, and letting and operating of own or leased real estate n.e.c.). These firms are far more likely to have more than two company directors and would reasonably require some invested capital to get started.[5] Their share of liquidations is also small in relation to the rest of industries in this list. Overall, the concentration of bunchers in small professional service firms lends strong support to our interpretation of the spike in liquidations ahead of the anti-phoenixing reform.

Table 1: Ten most common industries among bunching firms

Industry (5-digit SIC code)	Share of liquidations in the bunching window	Share of bunching firms in industry with 1-2 directors
Management consultancy activities (70229)	16.2%	88.2%
Computer consultancy activities (62020)	11.3%	95.7%
Other business support service activities n.e.c. (82990)	10.7%	77.7%
Development of building projects (41100)	4.4%	47.3%
Other professional, scientific and technical activities n.e.c. (74909)	3.9%	86.3%
Buying and selling of own real estate (68100)	2.5%	45.2%
Other information technology and computer service activities (62090)	2.4%	89.1%
Other personal service activities n.e.c. (96090)	2.4%	72.2%
Specialist medical practice activities (86220)	2.4%	76.8%
Letting and operating of own or leased real estate n.e.c. (68209)	1.8%	38.1%

Notes: Firms without industry information accounted for < 3% of all liquidations and were omitted from the analysis. 'n.e.c.' stands for not elsewhere classified, and is part of the official Standard Industrial Classification (SIC) code definitions.

Source: Authors' calculations based on data from Companies House.

[5] It is nevertheless easy to imagine how some capital-intensive firms in the real estate industry still have a large share of the return actually coming from labour, e.g. businesses where the owner improves properties and resells them for a profit. Low CGT rates relative to Income Tax rates tax advantages this activity relative to working for someone else to improve their property.

Beyond phoenixes: Income taxed as gains more generally

While our MVL analysis identifies a striking case study of income-shifting by private business owners, it only covers one mechanism for repeatedly accessing preferential CGT treatment on earnings.[6] There are many other ways in which income from work can be taxed as a capital gain. For example, owner-managers can still use an MVL to access CGT treatment on their retained earnings provided that they do not resume the same business: e.g. if they are planning to retire or retrain. They can also access CGT treatment on retained earnings in their company via a sale. Taxpayers therefore still face strong incentives to create private firms in order to reduce tax, even when this is not the most economically efficient way for them to work. We next draw on administrative tax data from HMRC to get a better sense of how widespread shifted or substituted income might be as a share of aggregate capital gains.

Although in principle CGT is thought of as a tax on the increase in value of an existing asset, right from its introduction in the UK it has had an important role as a backstop to the income tax (Advani, 2021). At the individual level, one way to infer whether gains are really the return to capital is to look at the rate of return individuals are making. While a small number of individuals might by chance consistently make large returns to capital they have invested, systematically high returns will usually come from skill or work by the individual receiving them i.e. they are returns to labour (Adam and Miller, 2021).[7]

Advani, Hughson, Lonsdale and Summers (2024) draw on a representative survey of taxpayers that filed an SA108 return in the 2019-20 tax year, providing detailed information on their asset disposals (such as asset types, base costs/disposal values, and acquisition/disposal dates). From these data, they break down aggregate realised capital gains according to a) asset category, b) average annual return, and c) whether the taxpayer is a company director. Returns greater than the market average are indicative of either luck or work. As a clear indicator of returns above anything that can reasonably be expected on invested capital, Advani, Hughson, Lonsdale and Summers look at gains where the average annual return is above 100%.

[6] In principle this specific behaviour is no longer possible, although it is not clear how well-enforced the anti-phoenixing legislation is. Anecdotally we are aware of recent examples where phoenixing has taken place. We are not aware of any mechanism currently by which HMRC, Companies House and the Insolvency Service coordinate to ensure automatic 'risking' and review of cases.

[7] Where high returns are down to luck, rather than skill, this does not obviously imply a lower tax rate. Since luck is both unmerited, and out of one's control, there is a good case for a higher tax rate on this (Adam and Miller, 2021).

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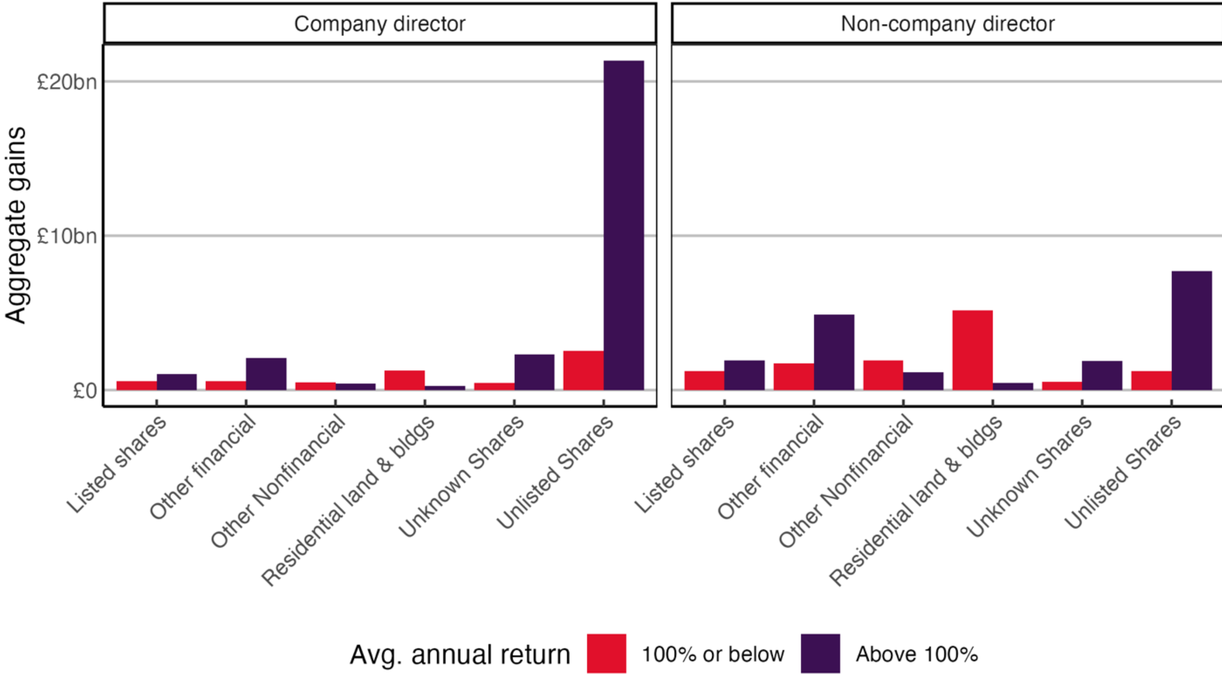
Figure 2: Breakdown of aggregate capital gains by asset type, average annual rate of return, and director status of recipient, 2019-20 tax year



Notes: Asset categories taken from the HMRC Asset Level Survey.

Source: Advani, Hughson, Lonsdale and Summers (2024).

Figure 2 paints a striking image of the composition of UK capital gains. Nearly half (£29 billion) of all gains in 2019-20 came from unlisted company shares where the average annual return exceeded 100%.[8] Over £20 billion of these gains went to company directors, consistent with sizeable income shifting among owner-managers in response to the preferential tax treatment of capital gains. Many of the non-director cases will likely come from splitting ownership, and hence capital gains, with spouses (Advani and Summers, 2020). Over 40% of unlisted share disposals correspond to returns above 100% annually, highlighting that despite the high concentration of gains, these results are not driven by just a handful of taxpayers with large capital gains.

Turning to large business gains (whether from investments in public or private companies), over 30% of all gains in excess of £5 million were made on assets acquired for less than £500, reinforcing the idea that a sizeable portion of capital gains come from income retained in personal service companies that function as de facto tax shelters. By working through and retaining earnings in the firm, income is taxed as a capital gain upon sale or liquidation.

[8] The 'unknown shares' and the two 'other' categories also contain private businesses. The breakdown available in the Asset Level Survey assigns 50% of gains to unlisted shares, while from tax returns we know this to be closer to 70% (Advani, Lonsdale and Summers, 2024).

Conclusion

This briefing provides new evidence of a large and unintended consequence of taxing capital gains at much lower rates than income: it creates a large incentive for taxpayers to use companies to repackage income as a capital gain. Drawing on a 2016 anti-avoidance reform that made income-shifting harder, we document a substantial increase in pre-reform liquidations by companies extracting cash from their firms ahead of the policy's implementation. These companies tended to operate in industries where income-shifting to have labour income taxed as capital is most feasible e.g. personal services such as consulting. Administrative tax data from HMRC show that over £20 billion of capital gains realised in 2019-20 were received by company directors disposing of private business shares with limited (if not zero) acquisition costs. The existence of such high annual returns is suggestive evidence of widespread income from work that is being taxed as a capital gain.

Our findings have important implications for the design of CGT policy. Specifically, we show that the existence of a tax wedge between capital gains and income distorts how owner-managers' decide to take remuneration. The obvious conclusion is that there is a substantial revenue cost from this behaviour. However, there is a wider cost: preferential tax rates on capital gains result in economic distortions in how people do their work, which is a drag on productivity and ultimately growth.

A key takeaway from our analysis is that incremental rates hike to CGT would preserve the incentives for individuals to use companies as tax shelters. It is only under the equalisation of CGT and Income Tax rates, with an appropriate deduction for the costs of capital investment, that we can tackle these economic distortions, improving productivity while preventing revenue loss from income-shifting.

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