TaxPayers' Alliance

Sustainability of the tax base

A submission to the Treasury Select Committee

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Commenting on the call for written evidence, Rt Hon. Andrew Tyrie MP, Chairman of the Treasury Committee, said:

"In his Autumn Statement, the Chancellor said that the government would consider how it could ensure that the taxation of earnings from 'different ways of working' is fair. He is right to be concerned about the sustainability of the tax base. A clear distinction is also needed between acceptable and unacceptable tax planning and avoidance."

Call for written submissions

Q1. How big is the threat to the base for income tax and National Insurance from the changing patterns of working (for example increased levels of multi-jobbing and self-employment and different ways of working, to which the Chancellor referred in his Autumn Statement)?

1. We have not studied this quantitatively. Nonetheless, we believe that the scale of the problem ought not to be the primary concern, given that removing the tax distortions between different forms of income ought to be a priority anyway. The fundamental problem is the distortions created by the differential tax treatment that affects employment patterns. The fact that a consequence of this problem is that people respond to the incentives, reducing revenues for the exchequer relative to expectations is of secondary importance.

Q2. What are the consequences of the divergence of the rates of corporation tax, income tax and capital gains tax? Are the proposed reductions in corporation tax rates likely to encourage tax-motivated incorporations - as happened after the introduction of a nil rate of corporation tax for the first £10,000 of profits in 2000? Have the recent reductions in Capital Gains Tax encouraged the taking of income as capital gains?

2. Because the three taxes are conceptually distinct, it is an error to assume that rates must be equal for tax burdens to be equivalent. Most starkly, capital gains tax operate as an additional tax because most capital gains are already effectively post-tax. This applies when the capital gain arises on an asset where the expected

future cash flow would be taxable income (such as shares and rental property). By contrast, capital gains arising on assets with no expected future cash flow that would incur an income tax charge are not already effectively post-tax. Such assets include owner-occupied property, art, fine wines and gold. Therefore, neutrality between income received in the form of taxable income or capital gain is usually subject to an equivalent tax burden only when capital gains tax rates are set to zero.

3. An example of the problem is provided in the Single Income Tax (pp. 316-317):

Suppose there are two individuals. One of them has little cash but a business which was built from scratch. The second has £1,000,000 in spare cash but does not own a business. The business looks healthy and generates £50,000 profits, which are expected to grow at a modest rate. The cash is deposited in a savings account that yields £50,000 annually in interest. This payment is not expected to change, but the deposit is thought to be much safer than the value of business.

Over the next ten years, the amount of tax due from the profits of the business, if they remain unchanged at £50,000 per year and assuming a flat tax rate of 30 per cent, would be £15,000 per year or £150,000 in total.

However, assume the two individuals decide to swap their assets, the £1,000,000 cash in exchange for the business. They do this because the business owner now wants the safety of cash whereas the investor with cash wants to take a chance on the business growing in the future. The business would still generate £50,000 of profits for the new owner and therefore £15,000 of tax. But because the sale represented a 'capital gain' for the seller, a capital gains tax would mean 30 per cent would be payable on that, another £300,000. It's not clear why a total of £150,000 of tax should be payable from the business when the two individuals keep their original assets but a total of £450,000 of tax from the business should be payable if they swapped. This example does show, however, why Capital Gains Tax stops the ownership of businesses and other assets from being transferred to people who are more suited to own them instead of remaining in the hands of those who simply owned them in the past.

This creates a number of practical problems. Chari et al. argue that locked in capital leads to entrepreneurs holding on to start-up companies longer than they necessarily should. They developed a quantitative model looking at entrepreneurial private businesses. Efficiency dictates that, as a company grows, professional managers buy into start-ups. But when entrepreneurs hold on to *them for too long – to defer the payment of CGT – they are less efficiently run. Not only is capital locked in, inefficient management of growing businesses is, too.*

4. On assets where a capital gain arises on a taxable income from an expected cash flow, cutting the rate of capital gains tax relative to income tax does not therefore *encourage* people to take income in the form of capital gains. Instead, it merely *reduces the discouragement* that the tax system creates to doing so. Abolishing capital gains tax on such gains would eliminate the discouragement entirely, leaving the tax system neutral between the two forms.

5. Similarly, fundamental conceptual differences between corporation tax and income tax also weaken the validity of comparisons of the respective rates, although concerns regarding the distortions created do have a stronger logical basis. Corporation tax effectively seeks to tax investment (in addition to a tax on income distributed and taxed as income). Throughout the lifecycle of a company, taxing only distributed income would tax the income as it was distributed from the company into the hands of its beneficial owners. Corporation tax, by contrast, exists to tax the investment of retained earnings before they are reinvested (and which may subsequently prove to be unsuccessful).

6. Fundamentally, the question is whether we want the tax system to tax (and therefore discourage) investment instead of consumption.

Q3. What is the incentive effect of the tax on all dividends above £5,000? Given that the dividend tax is not restricted to dividends from "close companies", is it harmful to businesses which rely on attracting personal investments in shares?
Q4. What are the implications for the exchequer of the changing pattern of home ownership, in particular the reduction in owner occupation?

7. Owner-occupancy is a tax-advantaged tenure compared to renting and is becoming more so with recent changes to income tax and stamp duty. Therefore, falling owner-occupancy is harmful to taxpayers and beneficial to the exchequer. Rents to landlords are subject to income tax (or corporation tax, if owned through a company) and the sale of property is subject to capital gains tax. Neither of these are payable on owner-occupied property, due to the abolition of schedule A income tax on imputed rent and principle private residence relief from capital gains tax. These differences in tax treatment are being widened by the additional homes surcharge on stamp duty land tax and the removal of deductability of finance costs from rental income computation. (Further analysis can be found in our research note on the impact of tax changes on residential tenants, available at https://d3n8a8pro7vhmx.cloudfront.net/taxpayersalliance/pages/6572/attach

ments/original/1469027643/Taxing_tenants_how_taxes_on_landlords_end_up_hitting_tenants.pdf?1469027643)

Q5. How effective and economically efficient are Capital Gains Tax and Inheritance Tax as a means of taxing capital in the UK? Are their bases under threat as people live longer or as wealth is reduced, or spread more thinly, from one generation to the next?

8. Capital gains tax is highly inefficient for the misallocation reason given in answer to question 2 and because it discourages investment in favour of consumption, reducing capital formation, both of which both in turn reduce productivity growth. If anything, a departure from neutrality of treatment between immediate consumption and deferred consumption (ie, investment), should favour investment. Favouring immediate consumption is the opposite of what the system ought to do.

9. The effects of inheritance tax are unlikely to be as stark, however. But its incentive effects of discouraging investment relative to consumption nonetheless is likely to have harmful effects on capital formation and, consequently, productivity growth. Lifetime gifts and the nil rate band will reduce this effect somewhat, however.

Q6. How effective is the way that the UK taxes land? Is it economically efficient?

10. Land taxation is arguable the most inefficient aspect of the UK's tax system and is becoming slightly more so due to the additional homes surcharge for stamp duty land tax, and the removal of finance costs from landlords' taxable rental income calculations.

11. There are other concerns beyond economic efficiency, but an economically efficient tax system on land would seek to tax the locational value of land where possible (because this ought not have a substantial impact on incentives to improve it or build structures). It would then seek to tax income from property and the consumption of property equally (by value), regardless of tenure or use class. There would be no other taxes on it. The UK tax system differs dramatically from such a system.

12. Instead, it taxes income from rental property but not owner-occupied, distorting patterns of tenure. It will soon also ignore finance costs. This will distort asset ownership patterns and cause investors with a greater appetite for debt to switch

their asset holdings from property to other assets, with cash buyers and owner occupiers responding to the resulting change.

13. It taxes residential property consumption based on bands of 1992 notional property values, not current values, in council tax. This system means that residential property tax is highly regressive. It taxes business property usage through business rates, despite commercial property use only being an intermediate input into production. This distorts land markets away from commercial use in favour of residential use, reducing productivity. Similarly, exemptions for charitable use distorts usage patterns in favour of charitable use, explaining the prevalence of charity retail outlets in marginal high street locations.

14. Capital gains tax distorts ownership patterns further still, nudging people into owning a single larger property instead of multiple smaller ones, either for personal use or investment to let.

15. Stamp duty land tax discourages people from moving, once they have bought a home, reducing mobility of labour and discouraging property development, further weakening the UK property market's already poor ability to respond to demand. It also weakens the price signals to property owners to reallocate property efficiently, most notably older couples with larger homes that are too large once their children have left.

Q7. Attitudes to "avoidance" have changed significantly over the last decade. In what ways have the actions of the Government and HMRC contributed to this? Is there a clear distinction between what is acceptable and what is not? Can one be formed?

Q8. What other threats to the UK tax base should the Committee consider?