Taxing Income from Capital

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Taxing Income from Capital

- Broad theme (as in Meade Report) is to tax consumption rather than income
- Not primarily because this is more efficient
  - there are arguments both ways
- But because there is little chance of taxing capital income coherently in practice
  - realized capital gains
  - inflation
- While taxing consumption coherently should be achievable

Taxing Consumption

- Indirect taxes not well suited to addressing equity concerns
- Progressivity of the system as a whole achieved through the direct tax system
- Indeed we propose substantial broadening of the UK VAT base, with compensation to poorer households through direct taxes and benefits

Taxing Consumption

- Three approaches to direct taxation of consumption
- Pure expenditure tax (EET)
  - Meade; cf. pensions
- Exempt all income from savings (TEE)
  - cf. ISAs; owner-occupied housing
- Exempt normal return on savings (TtE)
  - cf. ACE in corporate tax context

Taxing Consumption

- 3 approaches are broadly equivalent in the absence of super-normal returns (rents)
- Expenditure tax and allowance for normal rate of return on savings both raise revenue by taxing rents
- Rate of return allowance can be viewed as an expenditure tax with deferred rather than immediate tax relief for saving

Example 1

- Save £100 of this year's income in an account that pays 10%
- Next year have interest income of £10 plus principal of £100, a total of £110
- Standard income tax at 20% gives tax on interest income of £2, after-tax interest income of £8, and a return of only 8%
- Disincentive to save, particularly important for poorer households
- Exempting all interest income avoids this

Example 1 (cont)

- Expenditure tax at 20% gives tax relief of £20 on saving of £100 in first year
- Then taxes withdrawal of £110 in second year, giving tax payment of £22
- After tax, the saver gives up £80 this year and gets £88 next year, a return of 10%
- No distortion to intertemporal allocation of consumption

Example 1 (cont)

- Now suppose that instead of giving tax relief of £20 this year, we carry this forward, marked-up at the interest rate of 10%, and give tax relief (against the expenditure tax) of £22 next year
- The saver then gives up £100 this year and gets £110 next year, just as in the no-tax case, a return of 10%
- These two approaches are equivalent provided the individual is indifferent between tax relief of £20 in year 1 or £22 in year 2

Example 1 (cont)

- We can achieve this here, and more generally, by:
- Providing a Rate of Return Allowance (RRA), calculated as the risk-free (nominal) interest rate times the stock of savings (at historic cost) at the end of the previous year
  - 10% of £100 = £10 in the example
- Taxing (nominal) income from savings plus any realized (nominal) capital gains, net of this Rate of Return Allowance

Taxing Capital Income

- With many assets, offering different mixes of cash income (interest, dividends) and capital gains, taxing the normal return component of capital income in a uniform way becomes extremely challenging

- Inflation → taxation of nominal returns
  - full indexation is theoretically possible
  - but never implemented in practice

Taxing Capital Income

- Taxing capital gains on realization rather than on accrual favours assets with returns in the form of capital gains rather than cash income (even if realized gains are taxed at full marginal rates)
- Advantage increases with holding period
  - lock-in effect
- Incentives to convert income into capital gains
  - complex anti-avoidance provisions

Taxing Capital Income

- In theory we know how to tax capital gains on an accrual-equivalent basis
  - but never implemented in practice
- Expenditure tax and RRA approaches both achieve uniform treatment of capital gains and cash income, and do not require indexation for inflation
- Hence avoid distortions to form and timing of savings, which are inherent to taxing capital income, and have no obvious merit

Example 2

- Save £100 for 2 years
- Risk-free interest rate again 10%
- Choice of 2 assets
- Asset I pays interest
  - interest of £10 in first year is re-invested
  - gives holding of £110
  - interest of £11 in second year
  - plus principal of £110 gives total of £121

Example 2 (cont)

- Asset G appreciates in value
  - value £110 after one year
  - value £121 after two years
- With no uncertainty and no transaction costs, expect individuals to be indifferent between these 2 assets in the absence of tax
- Would like taxation to leave individuals indifferent between these 2 assets

Example 2 (cont)

- Standard income tax does not achieve this
- Asset I
  - tax on interest income of £10 in first year
  - tax on interest income of £11 in second year
- Asset G
  - tax on realized gain of £21 in second year
  - tax on accrued gain of £10 in first year is deferred until the asset is sold
- Capital gains favoured over cash income
- Incentive to defer sale of assets that have risen in value

Example 2 (cont)

- Rate of Return Allowance
- Asset I
  - RRA 10% of £100 = £10 in first year
  - RRA 10% of £110 = £11 in second year
  - no tax paid (on normal return)
- Asset G
  - RRA 10% of £100 = £10 in first year
  - no taxable income → 'tax loss'
  - carry forward, marked up at risk free interest rate → allowance of £11 in second year

Example (cont)

- Asset G
  - RRA 10% of £100 = £10 in first year
  - no taxable income → 'tax loss'
  - carry forward, marked up at risk free interest rate → allowance of £11 in second year
  - RRA 10% of £100 = £10 in second year
  - plus allowance carried forward gives total allowance of £10 + £11 = £21 in second year
  - also no tax paid (on normal return)

Example 2 (cont)

- Exempting the normal return on income from capital thus makes it straightforward to achieve uniform treatment of cash income and capital gains
- It makes no difference to our example
  - whether the risk-free real interest rate is 10% and inflation is zero
  - or whether the risk-free real interest rate is 3% and inflation is (approximately) 7%
- Effective tax rates do not fluctuate in an arbitrary way with price inflation

Example 2 (cont)

- Easily checked that uniform treatment of cash income and capital gains extends to assets with above-normal returns
- Suppose the risk-free interest rate is 5%, but assets I and G return 10%, as above
- Asset I
  - tax base £10 - £5 = £5 in first year
  - tax base £11 - £5.50 = £5.50 in second year

Example 2 (cont)

- Asset G
  - tax base £21 - £5 - £5.25 = £10.75 in second year
- Present value of the tax base for asset I also

$$\frac{5}{1.05}+\frac{5.5}{1.05^2}=\frac{5\times 1.05}{1.05^2}+\frac{5.5}{1.05^2}=\frac{10.75}{1.05^2}$$

- Same present value of tax on the above-normal component of the return, whether this comes as capital gain or cash income

Rate of Return Allowance

- Approach extends easily to portfolios rather than individual assets, and to assets held for periods that don't coincide with tax years
- In addition to information on income and realized capital gains, used to implement standard income tax, this just requires the risk-free interest rate to be specified
  - approximated by nominal yield on govt debt

Rate of Return Allowance

- Some advantages of this RRA approach over expenditure tax approach
  - Govt not required to provide up-front tax relief in return for (promise of) future tax payments
  - Closer to structure and operation of familiar income taxes

Taxes on Capital Income

- Pragmatic shift towards taxing consumption can combine different approaches for different kinds of assets
- For ‘safe’ interest-bearing accounts, simply exempt interest income from taxation (TEE approach; little or no rents)
- For pragmatic reasons, retain this treatment for owner-occupied housing and limited holdings of other risky assets (ISAs)

Taxes on Capital Income

- For pension saving, retain current expenditure tax treatment (EET approach)
- For substantial holdings of risky assets (investment property, mutual funds, bonds, equities, unincorporated business assets), introduce Rate of Return Allowance
- For corporate profits, Allowance for Corporate Equity (ACE) exempts the normal return on corporate capital in the same way

Small Business Taxation

- This approach could substantially simplify small business taxation
  - ACE corporate tax
  - RRA treatment of dividend income and capital gains on company shares
  - RRA treatment of income from unincorporated businesses

Small Business Taxation

- Suitable alignment of personal and corporate tax rates can then:
  - equalize tax treatment of income from employment, self-employment and small companies
  - reduce incentives to convert labour income into dividend income/capital gains
- Scope for significant simplification of anti-avoidance legislation

The Mirrlees Review

- http://www.ifs.org.uk/mirrleesReview