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Modernising the Taxation of Distributions from Companies: CenTax Response

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1 About CenTax

We are researchers at the Centre for the Analysis of Taxation (CenTax), a research centre co-hosted by LSE and University of Warwick. CenTax is dedicated to improving public understanding of tax policy and helping to design a better tax system, by generating evidence that is rigorous and relevant to policymakers and the public. Further information about CenTax is available via our website.

Our work focuses on tax policy design and the measurement of tax policy outcomes. We conduct cutting-edge research on the behavioural and economic impacts of tax policy changes and have contributed substantively to debates on tax policy in the UK over recent years. We use HMRC administrative data accessed through a secure research environment that allows us to compare academic research findings with official government costings, providing insight into how policy analyses are conducted.

We sent this in response to the government's consultation on modernising the taxation of distributions and repayments of capital from companies, which can be found here.

2 Introduction and summary

The rules governing the taxation of company distributions are complex, and much of that complexity exists due to the lower Capital Gains Tax (CGT) rates relative to Income Tax rates. The consultation identifies a number of areas where current rules produce inconsistent outcomes for economically similar payments, and we welcome the government's intention to address them.

We make five main points:

- The pressure on current rules in this area arises mainly because CGT rates are lower than Income Tax rates. Equalising the rates would mean that much of the existing complexity could be removed because the same or similar tax treatment would apply regardless of the characterisation.
- Capital treatment of distributions is currently too widely available, and the rules are piecemeal and complex. It would be better to start with a clear default that all distributions from companies, except for the return of initial capital invested – is charged to Income Tax. New Zealand offers a useful model of this approach.

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- Based on the principle of tax neutrality, we strongly support the proposals in Chapters 4 and 6 to align the treatment of distributions and loans from non-UK resident companies with that of UK resident companies and emphasise that motive should be irrelevant here.
- As a response to tax avoidance risks in the current system, we support the reform proposed in Chapter 2 (rules on 'capital on the shares' in the context of capital reductions) and in Chapter 5 (rules on the interaction of loans and distributions).
- Along with these substantive rules, we recommend that HMRC should introduce new reporting requirements to support the enforcement and evaluation of these rules.

3 General comments

3.1 The complexity resulting from different tax rates on income and gains

When assessing any part of the tax system, it is worth considering why the rules are needed at all. Many of the rules on the taxation of company distributions are required because CGT is charged at lower rates than Income Tax. If these rates were equalised, then policing the boundary – as current distributions rules attempt to do – would become less important, and taxpayers would have less incentive to distort the form of distribution to achieve capital treatment.

The gap between CGT and Income Tax rates creates a clear incentive to characterise company distributions as capital, even where their economic consequence is equivalent to a dividend. Previous research by CenTax provides clear evidence that taxpayers respond strongly to this incentive by seeking to make distributions in a tax-advantaged form.[1] Countering these behaviours requires complex rules to prevent distributions being characterised as capital.

We have argued that equalising CGT and Income Tax rates, alongside other structural reforms to the CGT base, would significantly improve the UK tax system.[2] The problems diagnosed in this consultation are a further illustration of the distortions that the gap between CGT and Income Tax rates currently creates. Equalising the rates would allow the Government to repeal or simplify many of the existing rules that seek to police the boundary between income and gains in the context of company distributions.

[1] Advani, et al. *The Productivity Cost of Low Capital Gains Tax Rates* (2024).
[2] Advani, et al. *Reforming Capital Gains Tax: Revenue and Distributional Effects* (2024).

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It is important to factor in this potential for simplification when weighing the merits of major CGT reform. Any major reform of the tax system results in some complexity in the short-term due to the need to make changes to existing administrative systems and handle transitional issues. However, this consultation illustrates that the status quo is a significant source of complexity, which in the long-term would be reduced by the reforms that we have proposed.

3.2 The New Zealand approach – A strong income default rule

For so long as different effective tax rates apply to income and gains, it will be necessary to police the boundary between distributions that are treated as income versus capital. New Zealand provides a model of how to handle this challenge as best as possible. Since New Zealand does not have a separate Capital Gains Tax, the boundary between income and gains has even more significance there than in the UK. Consequently, New Zealand has evolved a robust treatment of company distributions that starts from a strong default of Income Tax treatment, subject to limited exceptions.

Broadly, the approach adopted in New Zealand is that *any* distribution of value from a company is treated as a dividend chargeable to Income Tax, unless it is a repayment of the capital originally invested (narrowly defined).[3] This usefully strengthens the default Income Tax treatment, preserving capital treatment only where it is clearly justified. This approach avoids the need for a long list of specific provisions designating a distribution as chargeable to Income Tax.[4] In our view, this approach could offer a radical simplification of the UK's current tax treatment of distributions, whilst also protecting revenue and limiting avoidance.

The reforms that the Government has proposed in this consultation would effectively move the UK's tax treatment of distributions some way closer to New Zealand's. This is welcome, but significant complexity would remain. Instead, we recommend a strong and clearly defined default in favour of Income Tax treatment, with a narrower and exhaustive list of circumstances where CGT treatment is granted. This would achieve similar goals to the Government's proposal, but via a simpler and more robust overall framework.

4 Supporting the proposed reforms: avoidance and neutrality

[3] The New Zealand Income Tax Act defines a dividend as any "transfer of value to a person if…the cause of the transfer is a shareholding in the company" (NZ Income Tax Act 2007, s CD 4).
[4] E.g. CTA 2010, s.1000.

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Subject to our preceding comments, we support the direction of reform proposed in the consultation as an improvement on the status quo. Two key considerations help justify these reforms - we set these out below because they provide an important counterweight to arguments for preserving the existing treatment of distributions covered by the consultation.

4.1 Tax neutrality

It is a fundamental principle of tax design that economically equivalent transactions should face the same tax treatment regardless of their formal characteristics and other economically irrelevant factors. Put another way, differences in the legal structure or location of economically equivalent transactions should not lead to different tax outcomes. This is essential *both* for reasons of economic efficiency (i.e. limiting tax-motivated behaviours) *and* because, even where a transaction is not tax-motivated, fairness requires that like cases be treated alike.

We therefore welcome the proposals in Chapter 4 (Income Tax treatment of distributions from non-UK resident companies) and Chapter 6 (loans from non-UK resident companies), which align the treatment of transactions that are currently taxed differently according to whether the company involved is UK resident. Moreover, we wish to emphasise (in anticipation of objections) that it is irrelevant whether the transaction was tax-motivated: taxes are routinely levied on purely commercial transactions – see e.g. VAT, and Income Tax on trading profits – and it is no answer to say that these transactions did not have a tax avoidance motive.

Our support for the proposed reforms in Chapters 4 and 6 also rest on an additional reason. The current rules encourage UK individuals to use offshore corporate structures to organise their economic affairs, which is undesirable from a tax enforcement perspective. The distortion therefore pushes taxpayers in the opposite direction to the one we would want. The proposals in Chapters 4 and 6 therefore improve both the neutrality of the tax system and the compliance environment in which UK taxpayers operate.

4.2 Tackling tax avoidance

The differential between Income Tax and CGT creates opportunities for avoidance. It is therefore appropriate for the Government to update the legislation in this area as new forms of avoidance are identified. That is particularly so in two respects:

- Chapter 2 (capital on the shares). The consultation identifies an avoidance arrangement in use, and the proposed amendment appears to be an appropriate response.

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- Chapter 5 (interaction between debt, loans and the distributions legislation). The consultation correctly identifies weaknesses in the Income Tax Self Assessment framework and proposes three options to address these. Of these, we favour Option 1 (establishing a priority rule), as the simplest and the least open to abuse. We do not think Option 2 (legislating the current discretionary practice) is advisable, as it would require ascertaining the taxpayer's intention and whether 'reasonable efforts' were made to value the transaction, both of which are subjective tests that are hard to enforce.

5 Improving the information available to apply these rules

The information currently available to HMRC is not well suited to enforcing the tax rules applicable to company distributions, either under the status quo or under the proposed reforms. HMRC can request information to establish whether the rules apply in a particular case. But it has no bulk data useful to proactively identify cases in which they may apply. This lack of information severely limits HMRC's capacity to undertake more sophisticated risk assessment across the relevant population of taxpayers.

We recommend that HMRC should introduce new reporting requirements as follows:

- disclosing dividends from close companies separately on SA100, including each company's company registration number (CRN), so that HMRC can systematically link shareholders to close companies. We are strongly of the view that the recently implemented requirement for directors to report close company dividends on SA102 is insufficient, because it does not cover passive shareholders i.e. shareholders who are not also directors;
- disclosing gains on shares in close companies separately on SA108 (in a separate box from gains on other unlisted shares and from gains qualifying for Business Asset Disposal Relief) again including the CRN; and
- requiring exempt distributions to be disclosed, together with the statutory provision relied on for the exemption.

These reporting requirements would support HMRC to detect non-compliance with the applicable rules more effectively, quantify the revenue effects of these rules, and allocate compliance resources to where the risk of non-compliance is greatest.

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