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ActionAid International Briefing

Capital gains tax

Progressive Taxation Briefing

What is capital gains tax?

Capital Gains Tax (CGT) is a tax on the increase in value of an asset when it is sold. Such an asset could consist of land, buildings, stocks and shares, or valuable items such as paintings or boats. For the purposes of calculating the tax, all that matters is how much the asset has appreciated in value (minus some deductible expenses). So, an item that has appreciated in value from US$100 to US$200 would be subject to more tax than an item that has appreciated from US$5,000 to US$5,001.

CGT is a relatively new tax in many parts of the world. It was first introduced in the USA in 1913,[1] and in the UK in 1965.[2] Previously it either did not exist at all or was considered an integral part of a person or company's ordinary income (which is still the case in many parts of the world). While CGT has a relatively limited role in total revenue collection in richer countries, it has significant importance and potential in many developing countries, especially those with large (or potentially large) extractives sectors. For example, a single capital gains tax payment in Mozambique in 2012 of US$170 million constituted 43% of state revenue from the extractive sector.[3] Between 2012 and 2014, Mozambique is estimated to have collected around US$1.3 billion in capital gains taxes from five companies in the extractive industry alone.[4]

How can capital gains tax be made more progressive?

Wealth taxes, such as capital gains tax, are inherently progressive as wealth inequality is on average twice as large as income inequality.[5] Ensuring that people pay tax on their wealth, including their capital gains, will therefore be a more

progressive measure than making sure they pay tax on their income. CGT rates should be identical or similar to income tax rates (personal and corporate) to avoid taxpayers trying to convert their gains to income or vice versa.

When designing a capital gains tax, it is key for countries to ensure that non-residents are covered by the CGT requirement. This should be written into law, but it should also be ensured by not giving away any capital gains taxing rights in tax treaties with other countries.

In 2013, ActionAid exposed how tax treaties can be exploited to avoid paying capital gains tax when it published a document from the global accountancy firm Deloitte in which the firm advised clients that they could avoid paying capital gains tax in Mozambique by investing through Mauritius, based on the tax treaty between Mauritius and Mozambique.[6] Mauritius was also a part of the Heritage Oil and Gas Limited Company's strategy to avoid paying capital gains tax in Uganda. The company was originally domiciled in Bahamas but changed its domicile to Mauritius as Mauritius had a tax treaty with Uganda which would stop Uganda from being able to charge them US$404 million in capital gains tax.[7] Following a lengthy legal process, Uganda was finally able to collect the tax, but the company's behaviour illustrated how companies often see tax treaties as a way of avoiding capital gains liabilities.

Further research published by ActionAid in 2016 showed that 49% of the tax treaties in force left lower-income countries exposed to relatively simple tax planning techniques used to avoid capital gains tax on land, buildings and infrastructure. In addition, more than 70% of tax treaties with lower-income countries prohibited those countries from taxing gains made by foreign corporations when selling shares in local corporations.[8]

Governments should ensure that individuals and companies cannot avoid capital gains tax through the way they own their assets, such as through a trust or company, or registered in a foreign country.

Taxing capital gains as part of a person or company's ordinary income is usually progressive. In effect, it would guarantee that capital gains are taxed at least at the same levels as income, while if a person or company has very large capital gains, that income might push their overall income into a higher tax band, meaning that the capital gains would be taxed at a higher rate than their other income.

Introducing a threshold or annual allowance under which taxpayers are not liable for capital gains tax can make a tax system more progressive. While taxing capital appreciation is generally progressive, exempting smaller gains from capital gains tax can encourage poorer segments of society to save and invest. The threshold or annual allowance should be low enough to ensure that it doesn't significantly lower the capital gain liabilities of wealthier taxpayers.

Examples of good and bad uses of capital gains tax

In **Brazil**, a 15% CGT is applied to assets such as shares and derivatives held for longer than one day.[9] For very large capital gains, the rate gets progressively higher with 22.5% being the top rate. There are some exemptions though. CGT does not apply to dividends, and individuals are exempt if they sell assets worth less than 20,000 Brazilian reais (c. US$4,000-5,000 using mid-2018 exchange rates) in any individual month. The threshold for paying CGT can be seen as progressive, as the tax then targets wealthier segments of society more.

In **India**, CGT is 10% on long-term capital gains and 15% on short-term gains. It is not charged on inheritance, but it is applicable if and when the person who has inherited an asset sells it.[10] Meanwhile, **Zimbabwe** charges a healthy 20% CGT with limited exceptions,[11] and **Sierra Leone** 30%.[12]

In other places such as **Ecuador**,[13] **Senegal**[14] and **Uganda**[15], capital gains are considered part of the ordinary personal income and taxed accordingly. The advantage of this is that capital gains is effectively added 'on top' of a person's ordinary income and is therefore taxed at the same rate as the ordinary income of that person (or at a higher

rate). As wealth inequality is greater than income inequality, taxing capital gains in the same way as ordinary income can be considered progressive.

In many developing and emerging economies there is however no or low CGT. In **Malaysia**, there is no CGT on non-property assets.[16] In **Kenya**, CGT was not charged between the mid-1980s and 2015, when a 5% CGT was introduced.[17] It applies to land and buildings as well as securities.[18] Other countries have significant exemptions, such as Nigeria where there is a general 10% CGT, but stocks and shares are exempt in an attempt to encourage trading on the Nigerian stock exchange.[19] Maintaining no or low CGT rates, or providing extensive exemptions, constitutes a missed opportunity to tax the appreciation of wealth, and such tax regimes are by their very nature **regressive**.

Recommendations

Governments should:

- *Ensure that capital gains are taxed at a meaningful rate, as the tax is progressive by nature.*
- *Review their tax treaty networks to ensure that none of the treaties limit their ability to charge capital gains on non-residents who have realized those gains in their country.*
- *Ensure that any exemptions to capital gains taxes have a clear social objective, are progressive in nature and have limited impacts on overall revenue collection.*
- *Introduce a threshold for when capital gains should be paid, or introduce limited annual allowances, to encourage saving and investments in poorer segments of society.*
- *CGT rates should ideally be similar to income tax rates, but another option is to treat capital gains as part of a person or company's ordinary income to ensure that it is taxed at the same or a higher rate as earned income.*

This is one of a series of briefings on Progressive Taxation published by ActionAid International in October 2018. You can find them at www.actionaid.org/taxpower

Endnotes

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2. https://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN00860
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