

R03 Capital Gains Tax 2020/2021

This will cover the whole subject in eight parts

- Basic principles
- Calculating the tax
- Dealing with losses
- Principle Private Residence Relief
- Share Pools and Matching Rules
- Chattels
- Inter spousal Transfers
- Entrepreneur's and other business reliefs

1: Basic principles

CGT taxes the gain made when an asset is sold or given away. If the gain arises from regular trading, e.g. an antique dealer buying and selling furniture, it would be treated as profit and taxed as income. A similar gain made by a collector would be taxed as CGT.

Individuals, Trusts and Companies can be liable for CGT but this part will be restricted to how the tax affects individuals.

Not all property is subject to CGT. The study text gives a complete list but for the moment note that the following assets are exempt:

- Principle Private Residence
- Life Insurance Policies in the hands of the original owner
- ISAs
- Gilts and Corporate Bonds (but not Unit Trusts or OEICS investing in these)
- Assets with an expected lifespan of less than 50 years. These are known as wasting assets.

In addition, some **disposals are exempt** even if the asset is subject to CGT. These are:

- Transfers between spouses or civil partners.
- Transfers to a charity
- Transfers made on death through a will or intestacy

Sam has an extensive art collection. He sells this whilst he is alive and realises a gain of £500,000. This would be subject to CGT

But it is left to his children on death all the gain is wiped out and there is no liability for CGT

2: Calculating the tax payable

There are two stages in calculating a CGT liability:

- Calculate the taxable gain
- Apply the correct rate.

Calculating the gain

The **basic gain** is the difference between the disposal and acquisition value.

Jane bought shares in Acme Widgets for £20,000 in June 2005. She sells them in September 2020 for £43,000. The gain is £23,000 but this is not necessarily the amount on which she will pay tax

Buying and selling an asset usually involves costs and these can reduce the gain.

A collector buys a painting for £10,000 at auction. If the auctioneer charges a 5% fee to the buyer the acquisition cost will be £10,500.

Some years later it is sold for £20,000 and the auctioneer charges a 10% commission, he only receives £18,000 so the basic gain is £7,500

The key is to ask yourself what was the total cost paid by individual and how much they received when it was sold?

An owner of a physical asset may spend money **enhancing** it. For example, the value of a painting may be increased by having it cleaned. This cost can be deducted when calculating the basic gain. HMRC will not allow any routine or maintenance costs, such as the cost of insurance, to be deducted. The test HMRC will apply is whether the expenditure enhances the value.

There is also the possibility of **rebasing** which applies if the asset was purchased prior to April 6th 1982. Inflation was above 10% for a large part of the 70's and early 80's. This meant that "real" gains, i.e. over and above inflation were small and sometimes non-existent. To compensate for this the 1982 budget allowed investors to ignore all "gains" made prior to April 6th 1982.

Ian bought shares in a company for £1 a share in 1977 and these were worth £2 a share in April 1982. The purchase price when these are sold will be £2 a share

The final stage is to deduct the annual exemption which for 2020/2021 is £12,300. This is on a "use it or lose it" basis. If it is not used in one tax year it cannot be carried forward to the following one.

Karem sold some unit trusts in 20/21 and made a gain of £8,000. This is below the annual exemption so no tax is payable.

Liam sold a number of assets in 20/21 making a total gain of £20,300. After deduction of the annual exemption the taxable gain is £8,000

Like income tax, CGT works on a tax year basis.

In March 2020 (tax year 19/20) Sue sold some shares and made a gain of £11,000. This was her only gain and as it was below the annual exemption, no tax was payable.

In May 2020 (tax year 20/21) she sold further shares making a gain of £12,000. Provided this is her only gain in 20/21 she will have no CGT liability.

This illustrates the importance of using the annual exemption. If Sue sold all the shares in May 2020 the total gain would be £23,000 and after deducting the annual exemption tax would be due on £11,700

Part Disposals

Problems can arise where there is disposal of part of an asset. For example someone may buy a set of figures and then decides to sell part of them. The disposal price will be known but at what price was this part acquired? When the remaining pieces are sold what will their acquisition price be?

The solution is to apply this formula

$$\frac{A}{A + B} \times \text{original cost}$$

Where A is the proceeds of the part disposed and B is the market value of the retained part

Sid buys an asset for £10,000 and sells part of it for £20,000, with the remainder being worth £60,000

The gain on the part disposal is £20,000 less £2,500 = £17,500

The deemed cost of future disposal of the remainder will be £7,500

Applying the correct rate

The rate is determined by adding the taxable gain to the individual's income.

For all assets other than residential property (buy to let)

- If it is all in the basic rate band it is charged at 10%
- If it is all in the higher or additional rate band the whole gain is charged at 20%
- If the gain straddles the higher rate threshold, then part is taxed at 10% and part at 20%

For residential property the rates are 18% for gains in the basic rate band and 28% in the higher rate.

Jane has a total income of £32,500 and has a taxable gain (after deduction of the annual exemption) of £10,000. After deduction of her personal allowance she has a taxable income of £20,000. The £10,000 gain doesn't take her above the higher rate threshold so the entire gain is taxed at 10% giving a tax charge of £1,000

If Jane had an income of £60,000 she would already be a higher rate tax payer so 20% would be charged giving a tax bill of £2,000

If Jane's income was £45,000 she would have £5,000 of her basic rate band left so £5,000 would be taxed at 10% and £5,000 at 20%

A non-taxpayer would still have to pay CGT at 10% of any gain in excess of the annual exemption. The gain cannot be reduced by the income tax personal allowance.

If the basic rate threshold has been increased by Personal Pension contributions or Gift Aid contributions, then the amended threshold will be used in calculating what rate of CGT is payable.

Jenny has an income of £50,000. This is the point at which the next £ of income would be taxed at 40% so if she makes a chargeable gain it will be taxed at 20%

If though she makes a PP contribution of £4,000, this will be grossed up to £5,000 and her basic rate band extended to £42,500. Now the first £5,000 of any chargeable gain will be charged at 10%

3: Treatment of Losses

Since CGT taxes gains or profits on the disposal of an asset it follows that any losses can be offset against gains. As with gains, losses can only be offset when the loss is realised. How losses are treated in the calculation will depend on whether the loss was made in the current tax year or is a loss carried forward from a previous year.

If a loss and a gain are made in the **same tax year**, the rule is that the **total** loss must be deducted against any gain made in the same tax year **before** you apply the annual exemption.

Sandra has made a loss of £10,000. If she made a gain of £23,000 the loss reduces this to £13,000. The annual exemption can then be deducted.

If the gain was only £15,000 the loss would reduce this to £5,000. This is below the annual exemption of £12,300 so no tax is payable. Ideally she should only offset £2,700 of the £10,000 loss as this would have taken the gain down to the annual exemption. She could then carry forward £7,300 to a later year. Unfortunately, HMRC do not allow this.

When a loss is carried forward the rule is that the annual exemption is offset against a gain **before** the annual exemption. The individual is free to offset part of the loss against any future gains

Charles has made a gain of £12,000 but in the same tax year made a loss of £20,000. The loss wipes out the gain but leaves a further £8,000. This can be carried forward to another year.

Similarly if only losses are made (i.e. there are no gains) the whole of the loss can be carried forward to subsequent years.

David has a gain of £18,000 in 2020/2021 and has losses from previous years amounting to £10,000.

As it is a carried forward loss the annual exemption is deducted first to bring the gain down to £5,700. If there was no loss to carry forward this would result in tax being charged at 10% or 20%

He then offsets £5,700 of the carried forward loss to bring this down to zero so no tax is payable. He can carry forward the remaining £4,300 to a future tax year

Losses can be carried forward indefinitely but HMRC should be notified of a loss within 4 years of the loss occurring even though it is not claimed at that time.

If you there is a loss and a gain in the same tax year and losses to carry forward the process is as follows:

- The whole of the current year's loss must first be offset against that year's gain

- The annual exemption of £12,300 would be deducted.
- If there is still a taxable gain all or part of the carried forward loss can offset to further reduce the gain

Kate made a gain of £20,000 and a loss of £6,000 in 20/21. She also has a carried forward loss of £13,000.

Gain	£20,000
Loss (current year)	<u>6,000</u>
Taxable gain	14,000
Less Annual Exemption	<u>12,300</u>
Chargeable gain	1,700
Less c/f loss	<u>1,700</u>
	0
Previous loss	£13,000
Less	<u>1,700</u>
Loss to be carried forward	11,300

In general an asset must be sold or given away to create a loss but there is an exemption for shares of negligible value. These are shares in companies that have either gone into liquidation or have ceased trading and there is no market to trade them. HMRC publish an official list of them and it's possible to make a claim for loss without selling the shares

4: Principle Private Residence Relief

The most valuable asset individuals possess is their own house and this is normally exempt from CGT. To qualify for this exemption, the house must be the individual's **principle private residence** (PPR). In addition:

- Part of it hasn't been let out (apart from taking in a lodger)
- The grounds including all buildings are less than 5,000 square metres.

For the majority of individuals there are no issues. They only own one house in which they live permanently. There is a general exemption for individuals who by reason of their work live in job related accommodation but own a house with the intention that they will live there say after retirement. This will probably apply to a member of the Armed forces. The house they own will still qualify for PPR even though they don't occupy it.

Clearly you can only have one PPR at any one time. If an individual owns more than one house they must tell HMRC which one is their PPR within two years of commencing ownership of the second house.

If they don't HMRC will do it for them and this will be based on

- Which address they use for correspondence
- Where they spend their time
- Where they are registered to vote
- Where they are employed
- How each residence is furnished.

There is a relaxation of the one property rule if someone temporarily owns two houses because of a house move. The period from purchase to moving in will be deemed residence provided it doesn't last more than a year and is immediately followed by actual residence.

A property bought purely for investment purposes will never qualify for PPR relief. Sometimes only part of the ownership will get PPR relief.

Calculating the amount of PPR relief

Graham has his own home but then marries Barbara and moves into her house. Her house now becomes his PPR. He decides to let his old house so when he eventually decides to sell it part of the period of ownership will be deemed to be his PPR and therefore qualifies for PPR relief but the period of ownership when it wasn't his PPR won't get the relief.

This is the likely scenario you can expect in a question and the first step is to calculate the gain for the whole period of ownership.

Graham bought his property for £100,000 and paid £20,000 in additional costs. He sold it for £210,000 incurring £10,000 costs. The gain is £100,000

Next the number of **months** that qualify for PPR relief is calculated and applied to the gain.

This calculation should be done **in months** using the formula

$$\text{Total Gain} \times \frac{\text{Number of months that qualified for PPR relief}}{\text{Total number of months of ownership}}$$

This figure is the amount of PPR relief which is then deducted from the total gain.

Graham owned the property for 120 months (10 years) but if for 24 months it hadn't been his PPR then the available relief is $\text{£}100,000 \times 96/120 = \text{£}80,000$.

This would give a chargeable gain of $\text{£}20,000$ and if the annual exemption is available, a taxable gain of $\text{£}8,000$ which is taxed at 18% or 28% as it is residential property

PPR relief is always given if the owner is living in the house but they can be absent and still get PPR relief.

- The period prior to April 1st 1982 is ignored so if a property was purchased before then the acquisition price would be the value on April 1 1982 and the period of ownership starts on that date.
- The last 9 months of ownership are always treated as exempt if at some time the house had been the resident's PPR. This is increased to 36 months if the owner has moved into a residential care home.
- **EXAM TIP. The best way to deal with a question on PPR is to draw a time line.**

Tom bought his house on 1 September 2000 and lived there until 1 September 2015. He then moved in permanently with his daughter in her house as his health had deteriorated. He sold the property on 1 September 2020

- The house was owned for 20 years (240 months)
- 1 September 2000 to 1 September 2015 (180 months) gets PPR as he was living there
- The last 9 months (1 December 2019 to 1 September 2020) are exempt as it had been his PPR
- Therefore 189 months will qualify for PPR relief
- If the gain on the whole period of ownership was $\text{£}200,000$ then the amount of PPR would be $189/240 \times \text{£}200,000 = \text{£}157,500$

- The taxable gain would be:

	£200,000
Less PPR	<u>£157,500</u>
	£42,500
Annual Exemption	<u>£12,300</u>
Taxable gain	£30,200

This would be charged at either 18% or 28%

Other periods of absence will also qualify for PPR relief provided:

- you have no other exempt residence at the same time
- immediately before and after the period of absence it was the owner's PPR.
- the periods of absence didn't exceed set limits.

These limits are:

- periods of absence for up to three years for any reason
- periods when the owner was required by reason of employment to live abroad.
- periods of up to four years when the owner was required to live elsewhere in the UK due to his work

Jack wins the lottery and decides to go on a round the world tour. He is away for two years and in that time lets out his property. He then returns and continues to live in the property

The two year absence would qualify for PPR relief

This example would be exempt under the "three years any reason rule". However, the three years represents the **maximum period** over the whole time of ownership. For example, if in the above example Jack were to have another two year trip in the future and then return home, only three years would qualify for PPR relief. Similarly, if he has a single absence lasting 4 years, only three years would get PPR relief.

Likewise, the "four years work in the UK" exemption is the maximum exempt period over the whole length of ownership.

Phil is offered a job in Australia on a five year contract. If he lets out his property and then returns and resumes occupation, the whole period qualifies for PPR relief.

Paying CGT on property gains

Since the start of the 2002/2021 tax year CGT on gains from the disposal of residential property must be paid within 30 days of completion. This is a payment on account and a final payment taking into account other gains and losses must be made on the following 31 January.

5A: Share Pools

A gain is the difference between the disposal and acquisition value of an asset. This is normally straightforward but consider this situation:

Jack bought shares in Acme Widgets as follows:

June 2005	5,000 shares @ 100p
November 2008	10,000 shares @ 80p
October 2010	15,000 shares @ 70p

In September 2020 he decides to sell 8,000 shares. Individual shares aren't identified by a serial number so it's not possible to identify which specific shares are sold so what was the acquisition price?

What happens is that his entire holding is "pooled". He owns 30,000 shares and has spent £23,500 so the average or pool cost is 78.3p a share

This is known as a **Section 104 holding**.

If the shares are sold there will be 22,000 shares in the pool and the average price will remain at 78.3p

If he then decides to buy a further 10,000 shares at 120p the average price will increase

Pool shares	22,000 @ 78.3p = £17,226
New shares	<u>10,000 @ 120p = £12,000</u>
	32,000 £29,226

The new acquisition price for all future transactions will be $£29,226 / 32,000 = 91.3p$

Therefore the rule is:

- Taking shares out of the pool: the acquisition price doesn't change
- Adding shares to the pool: The acquisition price will change

The same rules apply to investments in the same fund in unit trusts or OEICS that were bought at different dates.

5B: The 30 day rule

Since the annual exemption of £12,000 is on a "use it or lose it" basis, it makes sense to make sufficient gains each tax year to use it up. This is good financial planning but there is a complication if the same company's shares are repurchased.

Ken sells a holding of shares for £23,000 having acquired them for £12,000. The gain is £11,000 and assuming this is his only gain in the tax year, no tax is payable

Ken believes there are good growth prospects for the shares so a few days later buys the same number of shares for £22,900 which he believes would become the new acquisition price for any future disposal. This technique is known as “bed and breakfasting” but is no longer possible due to the share matching rules.

If the same shares (or unit trusts/OEICS) are repurchased within 30 days of the sale, the gain or loss is the acquisition cost of the shares bought within 30 days less the sale price of the shares. In this case his gain is not £11,000 but in fact a loss of £100. (£22,900 less £23,000).

This might seem advantageous but the acquisition price for future purchases is not £22,900 but the original one of £12,000.

To avoid this Ken would have to wait 30 days before buying back the shares and that would reset the acquisition price. The risk is that being out of the market for 30 days, the price may rise and he misses out on the potential gain.

There are two ways to get round this. These are:

- “Bed and ISA”
- “Bed and spouse”

With bed and ISA the investments are sold and then repurchased but within an ISA wrapper. The same exercise can be done with a SIPP.

With bed and spouse the investments are sold, the proceeds passed to the seller’s spouse who buys the same investments in his or her own name.

A further alternative is to buy investments with a similar profile. This can be useful with unit trusts or OEICS.

Greg has a substantial holding in a FTSE tracker fund with ABC managers. He sells sufficient to use up his annual exemption and next day uses the proceeds to buy a similar fund with XYZ managers

6: Chattels

Chattels may sound a little Dickensian but it has a specific legal meaning. A chattel is tangible moveable property. Tangible means it must physically exist. A house or painting exist, a share does not since it merely confers the possibility that the investor will receive a dividend. Moveable means exactly that, the property can be moved from place to place. A house can never be a chattel but a painting is likely to be one. Note that if moveable property is permanently fixed to a building it ceases to be a chattel.

The first rule to note about chattels and CGT is that they are exempt if they are sold for less than £6,000. This is the sale price, not the gain. This limit applies to each separate sale so if someone sells four paintings, two antique sofas and a piece of sculpture with each having a price of less than £6,000 no CGT is payable. Where the Revenue considers an item is part of a set, e.g. a collection of matching chairs is sold separately, they would take the price for the set as a whole in determining whether CGT was payable.

If the proceeds of the sale exceed £6,000 the profit becomes liable to CGT but this can be limited to $\frac{5}{3} \times (\text{Gross proceeds less } £6,000)$

Carol buys a painting for £2,000 and sells it for £9,000. The gain is £7,000 but if she uses the chattels rule the gain would be $\frac{5}{3} \times (£9,000 \text{ less } £6,000) = £5,000$

If though the painting had been sold for £24,000, the chattels rule would have been of no value.

The gain would have been £22,000 whereas using the chattels rule the gain would be $\frac{5}{3} \times £18,000 = £30,000$. She would therefore not use the special chattels calculation.

Whilst there is no legal limit to the number of items that can be sold for less than £6,000, if this is done regularly with items being sold on shortly after purchase, HMRC will consider the individual is trading and tax the profits as income.

7: Inter Spousal transfers

This also applies to civil partners and is a very valuable CGT planning tool. Inter spousal transfers are exempt and the benefits of this can be seen in the following examples.

Sandra and John aren't married but live together. Sandra holds some shares on which she calculates the potential tax gain is £20,000. If she were to transfer half of these to John she would be liable to CGT. John would be deemed to have acquired them at their market price at date of transfer.

Carol and Tom are married. She holds some shares on which she calculates the potential CGT liability is £20,000. If she were to transfer half of these to John she would not have to pay CGT. John would be deemed to have acquired them at the price that Carol originally paid for them.

To qualify you must be married/civil partner and have lived together at some point in the tax year of the disposal.

8: Miscellaneous reliefs

Business Asset Disposal Relief (formerly called Entrepreneur's relief)

Strictly speaking this is not a relief but rather a lower rate of 10% that is charged on the disposal of certain business assets. The most common example is when a sole trader sells their business.

To get the lower rate:

- It must be a trading business. Property or investment businesses aren't eligible.
- The seller must be a sole trader or business partner
- The individual owned the business for at least two years before it was sold.

If it is a business rather than a sole trader, the conditions are:

- The seller must be a sole trader or business partner
- The individual owned the business for at least two years.

If shares are being sold the conditions are:

- The seller must have at least 5% of the shares and voting rights.
- The seller is an employee or an office holder of the company.

If the business is being closed all assets must be disposed of within three years of the business being sold.

There is a lifetime limit of £1 million

From 2019/20 it is possible to get the same reduced rate even if you are an outside investor and neither employed in the business or an office holder.

The conditions are:

- It is a trading business
- You must have invested in **new shares** that were issued after March 17 2016
- They must have been held for three years
- There is a lifetime limit of £1 million

Business Holdover Relief

CGT is applied if the owner disposes of the asset. This means that the donor could face a tax bill even though no money has been received. To get round this problem holdover relief may be claimed on the transfer of **business** assets. This could include shares in a private company. It could not be claimed if someone passed shares in a public company to their son. Both the donor and recipient must claim this relief. The donor does not need to pay CGT as in effect the

recipient takes on this liability. The result is that CGT is deferred until the recipient disposes of the asset. The acquisition price is the price that the donor paid.

Alan has shares in a private company that was valued in 1998 at £10,000. In 2011 they were worth £30,000 and he gifted them to his son Simon. If both agree to claim holdover relief, there would be no CGT at the time of the gift. Simon would be liable to pay CGT when he disposes of the share and the acquisition price will be £10,000

Holdover relief can also be claimed if assets are transferred into a Relevant Property Trust. This will be looked at in more detail in the IHT chapters.

Business Asset Rollover relief

When an asset is sold CGT becomes payable even if all the proceeds are reinvested.

However if a business sells assets and reinvests them into **trade or business** assets it is possible to defer the CGT until the new assets are sold.

A small family firm owns its own business premises. It wants to move to a bigger unit and will then sell its original premises.

The sale would normally trigger a CGT liability but by claiming rollover relief the charge can be deferred until the new premises are sold. The acquisition price will be that of the original rather than the new premises

Rollover relief can only be claimed if the new assets are purchased in the period one year before and three years after the sale of the original asset.

A business bought new premises on June 1 2017. It then sold another building in May 2018. Rollover relief can be claimed

If the original building was sold in August 2018, rollover relief could not be claimed.

If the old premises were sold in August 2018, rollover relief can be claimed if the proceeds are reinvested into business assets by the end of July 2021

Incorporation relief

If a self-employed person incorporates the business and receives shares, technically it is a disposal. Claiming incorporation relief defers CGT until the new company is sold.