

Capital Gains Tax for Individuals

1 Principle and scope of capital gains tax

The charge to tax

A charge to capital gains tax (CGT) arises on the **chargeable disposal** of a **chargeable asset** by a **chargeable person**.

A **chargeable disposal** includes the **sale** or the **gift** of an **asset**.

The term **chargeable asset** includes all assets **except** exempt assets. (The only exempt asset in the syllabus is a **motor car**).

A **chargeable person** may be an individual, a company, or partners in a partnership business.

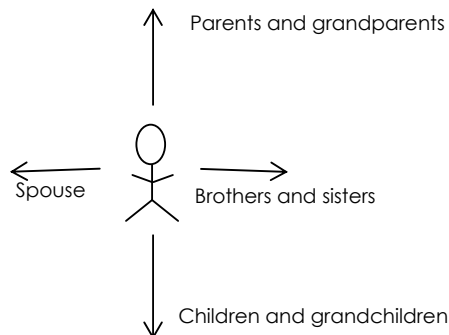
The basic calculation

The following proforma is used for individuals.

	£	£
Disposal value		X
Less Incidental costs of sale		(X)
Net sale proceeds		<u>NSP</u>
Less Allowable expenditure		
Acquisition cost	X	
Incidental costs of acquisition	X	
Enhancement expenditure	X	
	<u> </u>	(Cost)
Unindexed gain		<u>X</u>
Less Indexation allowance (to earlier of April 1998 and the month of sale) (= 0.XXX × Cost)		(IA)
		<u>Gain</u>
Less: Losses (current year/brought forward)		(X)
		<u>X</u>
Less: Taper relief @ ?%		(X)
		<u>X</u>
Gain before annual exemption		<u>X</u>

Connected persons

Sale to a connected person (Sale proceeds = market value)



The indexation allowance (IA)

The indexation allowance runs from the date of the acquisition expenditure to the date of disposal. For disposals by individuals you will not be expected to calculate the indexation factor (0.XXX) and you are likely to be supplied with the relevant indexation allowance.

For individuals only (i.e. not companies) the indexation allowance has been **frozen at 5 April 1998**. This means that for disposals **after 5 April 1998**, only the indexation allowance due at April 1998 is available.

An Example

Elise sells a chargeable asset on 31 March 2003 for £24,600 after deducting auctioneer's fees of £400. She has acquired it on 1 May 1986 for £10,000.

Required: What is the chargeable gain before taper relief?

The indexation allowance from May 1986 to April 1998 is £6,430 and from May 1986 to March 2003 is £9,120.

Solution

	£
Sales proceeds (March 2003) – (gross figure)	25,000
Less Incidental costs	(400)
Net sale proceeds (NSP)	24,600
Allowable cost (May 1986)	(10,000)
Unindexed gain	14,600
Indexation allowance	(6,430)
Indexed gain	8,170

Taper relief

For disposals **after 5 April 1998 only**, taper relief may **reduce chargeable gains**. This relief is intended to provide a progressive reduction in the amount of a gain, according to how long the asset has been owned, and replaces the indexation allowance from that date.

Taper relief operates as a percentage reduction on individual gains after indexation to 5 April 1998. The amount of the relief depends upon:

- ✚ whether the asset is business or non-business
- ✚ the number of complete years (after 5 April 1998) the asset has been owned.

Non-business assets acquired **before 17 March 1998** qualify for an **additional year (a bonus year)** of taper relief. The percentage amount of the gain chargeable (i.e. after giving the reduction) is as follows.

Complete years of ownership after 05 th April 1998	Gain on business asset chargeable	Gain on non-business asset chargeable
0	100	100
1	50	100
2	25	100
3	25	95
4	25	90
5	25	85
6	25	80
7	25	75
8	25	70
9	25	65
10	25	60

This table (or an extract) will be provided on the examination paper.

Definition of a business asset

Business assets are defined as follows.

- ✚ Those used for the purposes of a trade carried on by a sole trader or partner.
- ✚ Those used for the purposes of a trade carried on by a qualifying company of the individual concerned.
- ✚ Those held for the purposes of an office or employment
- ✚ Shares in a qualifying company.

A qualifying company is one that is a trading company which is either:

- ✚ Unquoted; or
- ✚ Quoted and the individual
 - is an employee (full or part-time), or
 - has at least 5% of the shares.

To ensure that taper relief (where available) is **maximised** **capital losses** can be allocated against chargeable gains on the **most beneficial basis** to the taxpayer.

This normally means **allocating losses to non-business assets before** any **business assets** which qualify for taper relief.

Annual exemption

Each individual has an annual exemption, which is applied to total gains still chargeable **after capital losses** and **taper relief** have been applied. **This is £8,500 for 2005/06 (Finance Act 2005).**

The annual exemption and brought forward losses

Brought forward capital losses are **not** allocated against gains where this would lead to **a wastage** of the annual exemption. This rule does **not** apply to **current tax year capital losses**, which **must** be set off against gains and can therefore result in a wastage of annual exemption.

In both situations taper relief may be wasted where the combined availability of **losses** and **annual exemption exceeds** any **chargeable gains**.

Calculating the tax payable

The capital gains tax payable on any gains remaining after the annual exemption has been applied depends upon the level of taxable income of the individual.

An individual's tax liability is computed first on income then on gains. The gains are taxed as if they were on top of taxable income (**an extra slice on top of the band where income ended**).

Gains are taxed using the savings income rates. This means that gains falling within the basic rate band are taxable at 20% (10% if they fall within the starting rate band of £2,090). Gains in **excess** of the basic rate threshold of £32,400 are taxed at 40%. **Note that gains are never taxed at 22%.**

Even if the Personal Allowance (PA) is **unused** or only **partly used** against income any balance **cannot** be set against gains.

Enhancement expenditure

Any **additional capital expenditure** on the asset is an **allowable deduction**. Indexation can only be calculated from the actual date of expenditure; therefore where there is cost plus later enhancement expenditure two indexation calculations will be required.

This approach does not apply for taper relief. The taper relief is always based on the period of ownership of the original asset.

2 Shares and securities

The matching rules

What distinguishes a share disposal from other asset disposals is the need for identification rules. We have come across this problem before where the shareholder is a company. **Unfortunately the matching rules for individual shareholders differ from those for company shareholders.**

The main reasons why they are different rules for individuals are because of:

- ✚ the **introduction of taper relief for individuals** and the need to identify periods of **qualifying ownership for that relief to apply**, and;
- ✚ the **cessation of indexation** at 5 April 1998.

Neither of these changes apply to companies.

In relation to individuals, we therefore match shares disposed of in the following order:

- ✚ **first**, with shares acquired on the **same day** as the disposal
- ✚ **second**, with shares acquired **within the following 30 days**
- ✚ **third**, with shares **acquired after 5 April 1998** (using the most recent acquisition first on a **LIFO basis**)
- ✚ **fourth**, with the **1985 FA Pool**.

Acquisitions after 5 April 1998

The calculation of the gain on disposal (before taper relief) is straightforward as there is **no indexation** allowance.

	£
Sale proceeds or market value	X
Less Allowable costs	(X)
Gain	<u>X</u>

Most quoted company share disposals are likely to be non-business assets and therefore taper relief will due if the shares have been held for **3 complete years**.

The operation of a 1985 pool

The 1985 pool operates just as it does for companies but with two differences:

- (1) Indexed rises only apply **up to April 1998**.
- (2) Additions are only added into the pool after 5 April 1998 if they result from **bonus or rights issues** arising out of the shares **already in the pool**.

Note that as the shares in the 1985 pool were held at 17 March 1998, if they are non-business assets they qualify for a **'bonus'** year of taper relief. Therefore, for disposals in 2005/06, there will be six (6) qualifying years of ownership. The gain on a non-business 1985 pool disposal will therefore be tapered to 75%.

The calculation of the indexation allowance for individuals is not examinable.

In the examination you will be given the cost and the indexed cost of the FA 1985 pool as at 6 April 1998.

3 Holdover relief for the gift of business assets

Gift relief works by **'deferring' the gain** (often described as **'holding over'** the gain) against the **'deemed'** base cost to the **donee**.

	Donor £		Donee £
Market value of gift	50,000	Deemed cost	50,000
Cost	(10,000)		
	<u>40,000</u>		
IA (say)	(5,000)		(35,000)
	<u>35,000</u>		
Gain			<u>15,000</u>

Revised CGT cost

Note that any taper relief that would have been available on the gain held over is wasted.

Partial consideration

Where a disposal is **part gift/part sale** then a **portion of the gain** may be charged on the donor **now!**

Conditions for relief

Assets which qualify for the relief include the following

- ✚ Assets used in a trade by the donor or by his personal trading company (i.e. one in which donor holds at least 5% of voting rights)
- ✚ Shares and securities in either the donor's personal trading company (quoted or unquoted) or in any unquoted trading company).

Conditions affecting the donee:

The donee can be an individual or trust or company, but **must** be UK resident or ordinarily resident at the time of the gift.

Administration of the election:

Gift relief requires a **joint election** by donor and donee **within five years of 31st January** following the end of the year of assessment in which the gift takes place.

Interaction of gift relief and taper relief

A claim for gift relief is an **option**. Where gift relief is claimed, there may be no gain still in charge, eligible to be reduced by taper relief.

Where gift relief is **not** claimed or part of a business gain is not covered by gift relief (i.e. partial consideration) taper relief applies as normal to the gain remaining chargeable.

The donee will be entitled to taper relief on gains subsequently charged when he disposes of the gifted asset. This will be done by reference to the donee's period of ownership only.

4 Relief when a business is transferred to a company

The transfer of an unincorporated business by a sole trader to a company, wholly or partly in exchange for shares, **is a disposal** of the assets of that business by the sole trader.

A relief ('incorporation relief') is available to defer the net gains arising on the business assets.

The conditions:

- ✚ the transfer must be to a company.
- ✚ it must be a transfer of a business as a going concern.
- ✚ all assets of the business must be transferred, with the possible exception of cash.
- ✚ the consideration received must be wholly or mainly shares in the company.

When the above conditions are satisfied the relief is **mandatory**. The gains are calculated in the usual way on each asset and the net gains are deducted from the market value of the shares acquired.

The operation of the relief depends on whether the purchase consideration consists wholly or only partly of shares.

Wholly shares

📌 Whole gain on individual assets deducted from MV of shares acquired.

📌 Taper relief up to incorporation is wasted.

Partly shares

📌 Loan or cash element is taxable now, less any taper relief due.

📌 Rest of gain deducted from the MV of shares acquired.

The sole trader can elect for incorporation relief **not to apply**. This may be important to avoid wasting accumulated taper relief.

5 Rollover relief for business assets

Introduction

Rollover relief for replacing business assets was covered in another chapter in the textbook in the context of incorporated businesses. We looked at various aspects of the rules, all of which also apply for unincorporated businesses with one slight difference – goodwill is always a chargeable asset for an unincorporated business and is therefore always a qualifying asset for rollover purposes.

There is, however, **one additional aspect** relevant for unincorporated businesses – the interaction with taper relief.

Taper relief entitlement on gains rolled over is wasted as it only applies to gains that remain chargeable. Taper relief for the replacement asset runs from the date the replacement asset is acquired. No recognition is given of the ownership period of the original asset whose gain is rolled over.

Therefore if the replacement asset is likely to be held only briefly, a rollover claim may defer gains but at the expense of generating more gains overall due to the wastage of taper relief.

If the replacement asset is a depreciating asset, the gain on the original asset is merely 'put into suspense' until a chargeable event, i.e. the earliest of the sale of the depreciating asset, ceasing to use it in the trade, and the 10th anniversary of its acquisition.

When it comes out of suspense the original taper relief entitlement is still 'clinging to it'.