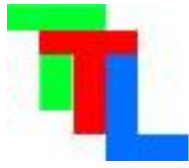

Capital gains tax

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Scope

Capital gains tax (CGT) is payable by individuals, personal representatives and trusts on gains made from disposing of an asset. CGT and income tax are mutually exclusive; if a gain falls to be taxed under CGT, it is not subject to income tax.

The exact difference between income and gain has often been litigated. There is much anti-avoidance legislation to stop income being classified as (usually lower taxed) gain.

Companies (with one exception) do not pay CGT. Instead they pay corporation tax on chargeable gains. Many of the rules are the same as for CGT. They are both legislated in Transfer of Capital Gains Act 1992. The exception is that a company can be liable to pay CGT on a disposal of a residential property from 6 April 2013.

CHT was introduced in 1965, before which many gains were not taxed. CGT is administered by HMRC. CGT is assessed according to tax years which run from 6 April to following 5 April. Gains are declared on the same tax return as income tax.

There are many exceptions whereby asset disposals are not taxed. For example, there are exemptions for plant and machinery, substantial shareholdings and for a person's main residence.

There are also schemes such as enterprise investment scheme and seed enterprise investment scheme that provide generous relief from CGT.

Non-residents are generally liable to pay CGT on gains from disposing of UK properties.

Basis of charge

The gain is basically disposal proceeds minus acquisition cost.

There is no tax on the gradual increase in value of an item. The liability to tax is only triggered when there is a crystallisation event, such as a disposal. The UK has no wealth tax.

A disposal arises whenever the owner ceases to own the asset. This includes sales, gifts, scrappage, theft and destruction. Some sales and gifts may have the CGT postponed by rollover relief or holdover relief. For shares and other securities, there is a procedure of deemed disposal when the value falls to a negligible value. CGT can rise on a part disposal.

The **acquisition cost** is the cost (or sometimes, value) of the asset plus related costs. These include legal fees, and any delivery or installation expenses. An item is not added to acquisition cost if it was allowed as an expense for income tax.

Similarly, **disposal proceeds** can mean subtracting expenses of disposal, such as advertising, legal fees, transport and similar.

If the acquisition cost is greater than disposal proceeds, there is a **capital loss**. This may be offset against capital gains in the same or subsequent tax year. It may not be offset against income.

The following are treated as disposals on a no gain/no loss basis:

- disposals between partners of a marriage or civil partnership
- disposals between 75% group companies
- transfers in a company reconstruction
- gifts to charities
- where rollover relief is claimed
- certain transfers in relation to trusts.

Where an **insured** asset is lost, the insurance proceeds are regarded as the disposal proceeds. There is no CGT if those proceeds are used to buy a replacement asset within one year of receiving the proceeds.

If an acquired item includes **VAT,** the acquisition cost is net of VAT where that may be claimed as input tax. It includes VAT if it cannot be so claimed.

If the disposal is made other than as an **arm's length bargain,** such as a disposal to a close relative, the market value may be substituted for disposal proceeds.

CGT is subject to many anti-avoidance rules.

Shares and other securities

Shares, debentures, unit trusts, options and other forms of securities and financial instrument are assets for the purposes of CGT. This means that gains on them are potentially subject to CGT. Note that gilts, National Savings products and qualifying corporate bonds are generally exempt from CGT.

One of the first issues for shares and other securities is **valuation.** For a share listed on a stock exchange, this process is simpler. The valuation method is set out in Market Value of Shares, Securities and Strips Regulations SI 2015 No 616 as follows:

- if quoted on the London Stock Exchange, the value is halfway between the highest and lowest closing prices of the day
- if quoted on a foreign exchange, the closing price of the day
- if the foreign exchange, quotes more than two closing prices, the lower or lowest figure plus half the difference
- if the relevant exchange is closed on the day, the equivalent figures for the previous day on which the exchange was open.

It should be noted that the CGT value is different from the inheritance tax value which uses the “quarter up” method. If a share close at 120p-124p, its value is 122p for CGT but 121p for inheritance tax.

For an **unquoted share,** the value is that the share or other security might reasonably be expected to fetch on a sale in the open market. It is assumed that a prospective buyer has all the information he or she would reasonably require when buying such shares at a fair price on an arm’s length basis.

The process of reaching a figure is, in practice, a matter of negotiation. HMRC has a special department known as the Shares and Assets Valuation Division. This is a specialist area.

It is worth remembering that different sizes of shareholding can create different share values. For example, a 75% holding could value shares at £100 each, whereas a 10% holding could value shares at £20 each.

The other main issue for shares is **identification.** When shares are bought and sold on different days at different prices, what acquisition costs and disposal proceeds are used? Special rules apply for shares acquired in a tax-advantaged scheme, such as enterprise investment scheme and seed enterprise investment scheme.

For CGT (not corporation tax), the position has been simplified from 6 April 2008. All shares of the same company and same class are treated as being in a single pool. The acquisition costs are allocated to disposal proceeds in this order:

- shares acquired on the same day as disposal
- shares acquired within 30 days of the disposal, taking earlier acquisitions first
- all other shares (sometimes known as s104 pool).

The second of these, the 30-day rule, was introduced in 1998 to stop “bed and breakfasting”. This is when shares are sold at the end of a tax year to crystallise a gain to utilise the annual exemption, and then buy them back again.

There are many other provisions for shares and securities.

Carried interest

When an investment manager invests in a company, that manager is often given a share of profits greater than the amount that the manager has contributed to the investment fund (usually a partnership).

When the fund disposes of the investment, the gain is considered a capital gain of the partnership. This is taxed in the hands of the individual partners. The sum that is in excess of the manager’s investment is known as carried interest.

From 6 April 2016, carried interest is taxed as:

- income if the average holding period is less than 36 months

- capital if the average holding period is more than 40 months
- income for an average holding period of between 36 and 40 months, but where each month above 36 reduces the income by 20%.

Carried interest is taxed at the rates of 18% and 28%, not 10% and 20%.

Rates

From 6 April 2016, the main rates of CGT are 10% for a basic rate taxpayer and 20% for a higher rate taxpayer. A higher rate taxpayer is one whose income plus capital gains exceeds the higher rate threshold for income tax.

The rates are 18% and 28% respectively for capital gains on property.

For periods between 6 April 1982 and 5 April 1998, indexation removed the element of gain that related to inflation. From 6 April 1998 to 5 April 2008, indexation was dropped but taper relief introduced to reduce rates for longer periods of ownership. From 6 April 2008, taper relief was abolished, but the rates were reduced to 18%. In 2010, the higher rate of 28% was introduced and entrepreneurs' relief reduced the rate to 10% when selling a business. (Indexation may be claimed by companies for periods between April 1982 and December 2017.)

Only the gain from 6 April 1982 is taxed. If an asset was acquired before that date, its cost is replaced by its value on that date. (A company has the choice to use the acquisition cost for pre-1982 assets, but cannot go further back than 6 April 1965.)

Exemptions

The following are excluded from the scope of assets for CGT purposes:

- a person's main residence (explained later)
- sterling, but other currency may be an asset
- wasting assets (see below)
- works of art, historic buildings, under certain circumstances
- winnings from betting, gaming, lotteries etc
- woodlands
- gilts, as listed by the Treasury
- savings certificates and some other government securities
- qualifying corporate bonds
- renewables obligation certificates
- decorations for valour or gallantry, from original holder
- foreign currency for personal expenditure
- compensation for any injury or wrong.

Wasting assets are assets with an expected life of less than 50 years. This includes all plant and machinery, vehicles and animals, even if they are already more than 50 years old. An extreme example was the case *HMRC v The Executors of* Lord Howard *of Henderskelfe [2014] EWCA 278,* where a painting that had hung in a tourist attraction was held to be a wasting asset even though it was then 225 years old.

Assets disposed of on **death** are not subject to CGT. They may be subject to inheritance tax.

There are some exceptions relevant to **trusts,** such as the disposal of an interest in settled property by an original beneficiary.

The following tax-advantaged schemes provide a measure of CGT relief:

- enterprise investment scheme
- seed enterprise investment scheme
- Individual Savings Accounts
- Junior ISAs
- venture capital trusts
- SAYE savings schemes
- gains by a pension fund
- social investment
- shares acquired as employee shareholder status before 1 December 2016.

The **substantial shareholding exemption** (SSE) broadly exempts a holding of at least 10% of a company's shares, provided they have been held for at least 12 months.

Some **persons** are exempt from CGT. These include charities, community amateur sports clubs, and nominee and bare trustees.

Allowances

There is an annual allowance, called the **annual exemption,** which is available to taxpayers. This exemption is indexed to consumer prices index, which means it increases in most tax years for disposals from 6 April. The exemption for 2018/19 is £11,700.

Most trusts are entitled to an exemption of half this figure. For 2018/19, this is £5,850.

The annual exemption cannot be carried forward or back to another tax year. If it is not fully utilised in a tax year, the unutilised part is lost.

Where there is a **capital loss**, that must be offset against capital gains in the same tax period, even if this means reducing the net gains to less than the annual exemption. It is not possible to restrict a capital loss to maximise the annual exemption.

There is a separate and additional **chattels exemption** of £6,000 (unchanged since 1989). Chattels are moveable personal assets.

Main residence relief

A taxpayer is entitled to **main residential relief (MRR)** on the sale of their main residence. This is also known as private residence relief.

This is probably the most widely known relief from CGT and also the most contested.

To claim the relief, it is necessary to establish that the property was a residence, and that it was the main residence. Camping on a building site does not make a property a residence.

A dwelling includes outbuildings within the its curtilage, and up to half a hectare (about 1.2 acres) of garden. The garden size may be larger if in keeping with the building. The garden need not adjoin the property, so country gardens on the opposite side of a road may be included. A permanent caravan and permanently moored houseboat may be included.

If any part of the dwelling is used primarily for business, that part does not qualify for MRR.

There is no minimum period of occupation, as MRR depends on the quality of occupation, rather than its length. There is no single test, but each of the following will help a claim for MRR if the taxpayer:

- is registered to vote at that address
- receives utility bills for that address
- sends his children to the local school
- has his personal possessions there
- and family spend most of their time there
- has bank statements, driving licence etc at that address
- is registered with doctor and dentist at that address
- has his car registered at that address
- has council tax bills in the taxpayer's name
- has a television licence for that address
- has an Internet connection
- entertains guests there.

MRR may be denied when there is evidence that the occupation is temporary or that the property was bought to be sold for a quick profit.

There are generous **absence reliefs** when a taxpayer may claim a dwelling as the main residence while not living there. This includes terminal relief for the last 18 months of "occupation". This was 36 months before 6 April 2014.

If a taxpayer has two or more properties, he or she may elect which one is the main residence. There is a separate **lettings relief** that may be claimed. It is subject to rules and conditions, and is capped at £40,000.

A buy-to-let property does not qualify for MRR.

Entrepreneurs' relief

Entrepreneurs' relief may be claimed by an individual who disposes of a trading business. It reduces the CGT to 10%, up to a limit. It was introduced for disposals from 6 April 2008.

The relief is a cumulative lifetime limit, so it may be used by a serial entrepreneur for more than one business disposal. The limits, relative to the date of disposal, are:

From	entrepreneurs' relief
6 April 2008	£1 million
6 April 2010	£2 million
23 June 2010	£5 million

6 April 2011 £10 million.
To claim the relief, the taxpayer must generally own at least 5% of the company and be an officer or employee of the company (or be an employee of another group company).

Entrepreneurs' relief may be claimed for a business run as a sole trader or partnership.

Rollover relief

Where a property is sold and the proceeds are applied to acquiring a new property, rollover relief may be claimed. This relief is most relevant to property but can apply to some other assets.

This does not avoid a charge to CGT, but postpones it. So if a taxpayer sells property A and uses the proceeds to buy property B, no CGT is paid on the sale of property A. Instead CGT is charged on the gain for properties A and B combined, unless that gain is rolled over again. Proceeds may be rolled over without limit.

The new property must be acquired up to 12 months before the disposal of the old property, and up to three years after its acquisition. Thus, there is a four-year window for acquiring the new property.

Administration

CGT is reported on the annual tax return that is also used to report income tax and class 4 national insurance.

Since 6 April 1996, this is administered under **self-assessment.** This means that the taxpayer is wholly responsible for declaring the gain, stating the amount, calculating the tax and paying it. Penalties and interest may be charged for lateness or non-compliance.

HMRC may issue a notice to a taxpayer to deliver a return. Failure to comply is itself an offence. A taxpayer must not rely on receiving a notice.

HMRC provides much free guidance on its website. This includes helpsheets on a range of topics, toolkits to assist in completing returns, and the CGT manual giving technical details.

The returns must be submitted online by 31 January after the end of the tax year, or on paper by 31 October after the end of the tax year.

An individual does not have to provide details of gains on the tax return if any of the following apply:

• the gains do not exceed the annual exemption
• the gain is wholly covered by the exemption for main residence
• the aggregate amount or value of all chargeable gains does not exceed four times the annual exemption, and the gain is less than the annual exemption.

Where a **valuation** has been used, the return must state who carried out the valuation and on what basis. For land or buildings, a description of the property and how it is held must also be given.

A taxpayer must not delay submitting a return because a figure is not available. If necessary, a **provisional figure** should be used. A note to this effect should be indicated on the return, perhaps with additional details in the “white space”. The figure should be a best estimate. The taxpayer should indicate why the exact figure is not known, and when the taxpayer expects it to be known. Final figures must be submitted promptly when known.

Payment of tax

CGT is payable as a single lump sum by 31 January after the end of the tax year in which it arose. CGT is not payable in two instalments as income tax often is.

If the disposal proceeds are received in **instalments** over at least 18 months, the taxpayer may ask for the tax to be paid in instalments for a similar period to a maximum of eight years. The taxpayer does not have to demonstrate hardship to pay in instalments.

There are many other provisions for capital gains tax that have not been mentioned in this quick summary.

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