

Quick guide to capital gains tax

Introduction

Capital gains tax is a tax on the disposal of assets by an individual or trust.

The tax has many detailed and complicated provision, so this guide is no more than an overview of its main and more common provisions.

Capital gains tax is charged on the gain you make by selling shares, land, works of art or other types of asset for more than you paid for them. It also includes intangible assets.

This does not apply if you sell such assets as part of a trade. In that case, you will probably pay income tax on the profit earned. If you sell a work of art that you no longer wish to keep, you will probably pay capital gains tax. If you keep buying and selling works of art, you will become regarded as an art dealer and will pay income tax on your profits.

Only individuals pay capital gains tax. This includes trusts and partnerships. Companies and other collective bodies instead pay corporation tax on their gains, though many rules are similar.

The rates of capital gains tax are less than the equivalent rates for income tax:

Rate of tax	Income tax	Capital gains tax
Basic rate	20%	18%
Higher rates	40% or 50%	28%

The 28% rate only applies to disposals from 23 June 2010.

If you sell your business, you may qualify for **entrepreneurs' relief** which reduces the tax rate to 10%.

Because capital gains tax rates have usually been less than income tax rates, many ingenious schemes have been devised to turn income into capital gain. You should be careful that such tax avoidance is effective, as artificial schemes are routinely attacked by HMRC, often successfully.

Note that you can no longer generally claim indexation to compensate for inflation during the period of ownership. Nor can you now claim taper relief.

There is a separate **annual allowance** for capital gains tax. For the year from 6 April 2011, this is £10,600. If your gains in a year do not exceed the annual allowance, you pay no capital gains tax. This allowance cannot be carried forward or back; if you do not use it for a year, it is lost.

A **trust** is entitled to an annual allowance of half the figure (ie £5,300) except that certain trusts for the disabled qualify for the full £10,600.

Each person in a **marriage** or civil partnership is entitled to the full annual allowance.

There are also many types of asset whose gains are **not taxed** however much they are. These include:

- your main residence (see below),
- shares held in an ISA (individual savings account),
- many types of government security,
- wasting assets, such as animals, machines and vehicles,
- leases of up to 50 years,
- insurance policies,
- winnings from gambling,
- foreign currency acquired for private use, and
- awards given to you for valour.

For **chattels** (personal moveable property), there is a separate allowance of £6,000 a year.

Capital gains tax is not charged on any gain that arose before 1 April 1982.

Some people are **exempt** from capital gains tax completely. These are:

- charities,
- pension funds,
- diplomats and visiting forces,
- local authorities and some other public bodies.

Disposals are exempt from capital gains tax if made to:

- a charity,
- a housing association,
- a museum, gallery, heritage body or similar organisation on a list,
- a trust for the benefit of employees.

There is also no capital gains tax on the disposal of a gift agreed as part of an inheritance tax settlement.

Disposal

Liability for capital gains tax only arises when there is a disposal of an asset. This includes a part-disposal.

If you own shares, land and works of art, these may increase in value each year, but you pay no tax on that increase in wealth. The gain is only crystallised when you make a disposal.

A disposal can be:

- the sale of the asset,
- giving away the asset,

- the destruction of the asset.

A disposal does not include:

- the increase in value on an asset which you keep,
- a transfer of an asset arising from the owner's death,
- a transfer of an asset between husband and wife, or between civil partners.

If an asset is disposed of and the proceeds are used to buy another asset, you may be able to claim **rollover relief**. So if you buy a building for £300,000, two years later sell it for £400,000 and use this money to buy another building, and three years later sell that for £500,000. The two buildings are treated as if they were one asset. You will pay capital gains tax on the gain of £200,000 over the five-year period.

If you give away an asset, such as to your son or daughter, you and they may be able to claim **holdover relief**. This means that both periods of ownership are treated as one. So no capital gains tax is paid when you give away the asset; it is paid when the person you gave it to disposes of the asset. They pay capital gains tax on the gain for both periods of ownership.

Calculation

Capital gains tax is charged on the gain. This is calculated as:

$$\text{disposal proceeds} - \text{acquisition cost} = \text{capital gain.}$$

Disposal proceeds is usually how much you sold the asset for. If the asset was destroyed, this figure will be zero, except to the extent that you were compensated. This will often mean that the capital gain is actually a capital loss.

Disposal proceeds is reduced by costs of disposal, such as legal fees, advertising, transport costs and similar.

If a disposal is a sale not at arm's length, such as letting your daughter buy your second home for a reduced price, the market value is substituted for disposal proceeds.

Acquisition cost is usually how much you paid for the asset. This includes related charges, such as the cost of delivery, site preparation, installation, stamp duty, related legal fees and similar. If you created the asset, the acquisition cost is your costs of creation. If you spent money enhancing an asset after acquiring it, those enhancement costs are added.

Note that expenses that relate to disposals and acquisitions are not deductible for income tax.

Where you have owned an asset from before 1 April 1982, you substitute the asset's value on that date for the acquisition cost. (For disposals before 6 April 2008, you could use the original acquisition cost if that was lower. That option has now been removed.)

Entrepreneurs' relief

This relief is available for disposals of a business or business assets from 6 April 2008.

The relief has the effect of reducing the rate of capital gains tax to 10%, instead of the 18% or 28% that would otherwise be payable.

It is a cumulative limit that applies for the lifetime of the taxpayer. The limits are:

From	Amount
6 April 2008	£1 million
6 April 2010	£2 million
23 June 2010	£5 million
6 April 2011	£10 million

Suppose a taxpayer has two businesses. He sells:

- the first for a gain of £3 million on 1 March 2009,
- the second for a gain of £6 million on 1 March 2011.

For the first gain of £3 million, the limit was £1 million. So he pays tax at:

- 10% on £1 million, and
- 18% on the other £2 million. (There was no 28% rate then.)

For the second gain of £6 million, the limit was £5 million. He has used £1 million on the first sale, and so has £4 million left. The result is that he pays tax at:

- 10% on £4 million, and
- 28% on the other £2 million.

Private residence

Your main private residence is exempt from capital gains tax. So you pay no tax if you sell your home for a profit.

This only applies to one property per person or per couple. So if you own two or more properties, you must decide which one qualifies. Although you do have some choice, it must be a property that you lived in. There have been several cases where this relief was refused because the evidence suggested that the taxpayer had not lived there.

The private residence includes gardens and grounds of up to half a hectare (about 1.2 acres). A larger area may qualify if it is in keeping with the size of the property.

Private residence includes outbuildings within the curtilage of the property. It also includes land that relates to the property even if it does not adjoin the property, such as a garden across a road.

Shares

Shares and most other forms of security are subject to capital gains tax. However their nature means that they have some special provisions.

Someone may at different times buy 100 shares, 200 shares and 300 shares in the same company but at different prices. He then sells 250 shares, but which ones are they and at what acquisition cost? The answer is determined by rules that identify what shares relate to a disposal.

The **identification rules** broadly are now that:

- you first take any shares bought on the same day,
- next you include any shares bought in the last 30 days,
- then you take other shares in a pool at an average cost.

These provisions apply from 6 April 2008. Different rules apply for earlier disposals.

The 30-day rule above was introduced to prevent **bed and breakfast** transactions where shares were sold and then promptly bought again to crystallise a capital gain to offset against an otherwise unused allowance.

A similar result can still be achieved by means as simple as your spouse buying shares instead of you. Alternatively, the finance industry has devised many alternative products, such as contracts for difference and derivatives. These can allow an investor to participate in a company's fortunes without actually owning any shares.

Sometimes shares lose most of their value. For quoted companies, HMRC periodically publishes lists of shares and other securities that are considered to be of **negligible value**. A taxpayer may treat such shares as if they had been disposed of and immediately re-acquired on that date. This allows the loss to be crystallised.

Sometimes, shares may have a low value even though they are not considered to be of negligible value. The value may have fallen to a low figure, perhaps £10 or so. This is not enough to pay the dealing costs of selling them. A neat solution is to give them to **Sharegift**, a charity which does not pay dealing costs. Choosing the date can determine when you trigger a capital loss.

For some **unquoted shares**, the shareholder may claim *income tax* relief instead of treating the loss as a capital loss.

Bonus issues are added to the original shares in the pool. Shares acquired in a **rights issue** are regarded as having been acquired at the time the original shares.

Shares in **employee schemes** are subject to special provisions. Some are free of CGT.

A **qualifying corporate bond (QCB)** generally is not subject to capital gains tax. A QCB is a security, other than a share, which meets certain conditions. This includes most forms of loan stock issued from 13 March 1984, provided the bond cannot be converted to ordinary shares. A **debenture** issued after 15 March 1993 is usually a QCB.

Land

Someone who **trades** in land will pay income tax or corporation tax on profits, and not pay capital gains tax. A single purchase of land for commercial gain can itself create a new trade.

A **part-disposal** of land is subject to capital gains tax on the appropriate portion of the acquisition cost.

There is a special rule that if a part-disposal is both:

- less than one fifth of the land, and
- is sold for no more than £20,000.

In such a case, the disposal is not subject to tax at all. Instead it is treated as a reduction in acquisition cost. This option must be specifically claimed by 31 January following the end of the tax year of the part-disposal.

The **grant of a new lease** is treated as a part disposal of land. This is calculated by the reduction in value of the land to the land-owner.

An **assignment** of an existing lease is treated as a disposal, not a part-disposal. A **lease** with less than 50 years to run is usually a wasting asset, and not subject to capital gains tax on assignment. If the tenant has the right to extend the lease, the lease term is regarded as to the latest date that the lease could be extended. If a landlord has the right to terminate a lease, the lease term is to the earliest date of termination.

A **lease premium** is generally regarded as a capital payment whereas rent is not. Care may sometimes be needed to distinguish them. A **reverse premium** (where the land-owner pays the tenant) is usually taxed as revenue and not capital.

There are many other provisions relating to land. Professional advice should usually be sought.

Capital losses

If the disposal proceeds are less than the acquisition cost, you have made a capital loss.

Any capital loss made in a tax year may be offset against any capital gains in the same tax year, so that only the net gains are taxable.

If there are insufficient gains, any unrelieved loss may be carried forward indefinitely for offset against future capital gains.

When a taxpayer **dies**, any unrelieved capital losses in the tax year of death may be carried back and offset against capital gains in the three previous tax years. This will often mean that the capital gains tax already paid is refunded to the estate.

A loss sustained on an **earn-out right** may be carried back for offset against gains in the year of the original disposal. Apart from these two exceptions, a capital loss cannot be carried back. Nor may it be offset against profits subject to income tax.

From 6 December 2006, there are some anti-avoidance rules to stop individuals getting loss relief from artificial schemes.

Use of allowances

From 23 June 2010 there are three rates of capital gains tax: 10%, 18% and 28%.

Tax law allows the taxpayer to use the various allowances and reliefs in the most effective way.

For example suppose a taxpayer has £10,000 worth of capital losses for one year. The following year, he makes capital gains of £15,000.

He could carry forward the whole £10,000 loss giving a net capital gain of £5,000 which is covered by the annual exemption. However he would be better advised to carry forward only £4,400 of capital losses. This would reduce his capital gains to £10,600 which is covered by the annual allowance. That leaves £5,600 worth of capital losses to relieve future gains.

Subject to the above exception, a capital loss must be netted off against a capital gain in the first year possible. An unused loss that arose after 5 April 1996 must be relieved before any losses still unrelieved from before then.

If a taxpayer has some gains taxed at 10% and others at 28%, he will obviously use the annual allowance to relieve the gains taxable at 28% first.

For chattels, the separate allowance should be used before the annual allowance.

You may also have scope for deciding when to make a capital gain or loss. If you have used your annual allowance, you may be able to delay making a further capital gain until the next tax year when you have a new allowance.

Administration

Capital gains are disclosed on the same tax return used to declare income tax. There is usually a separate sheet to include details. It should be noted that it is not possible to declare a capital gain on its own; it must always be declared with income.

Capital gains have the same filing date as income tax, generally by 31 January after the end of the tax year (5 April) in which the gain arose.

The tax is subject to the usual rules about due dates, and the inevitable interest and penalties for any non-compliance. Disputes may be taken to the tax tribunal.

History

Capital gains tax has changed several times since it was introduced in 1965. Because assets can be owned for decades before being sold, it is useful to know a little history of the tax.

Before 6 April 1965 most capital gains were not taxed at all.

From its introduction on 6 April 1965 until 5 April 1977, the whole gain was taxed at 30%, with some relief for gains up to £5,000. There was no annual exemption and no indexation. During this period inflation was very high, and so the tax could become a tax on inflation rather than on gains.

From 6 April 1977 to 5 April 1980, there was still no annual exemption or indexation, but relief was extended for small gains up to £9,500.

The annual allowance was introduced from 6 April 1980 at £3,000, and has increased in most years since then apart from 1988, when it reduced from £6,600 to £5,000 when the system of taxation was changed.

From 6 April 1982 to 5 April 1998, it was possible to claim **indexation relief**. This uplifted the acquisition cost by the increase in retail prices index between acquisition and disposal. This method is still used for gains made by companies. All gains that had accrued before 1 March 1982 were no longer taxed. Some other changes were made.

From 6 April 1988 to 5 April 2008, the 30% rate was abolished. Instead capital gains were taxed at the same rates as the person's highest rate of income tax.

During this period, indexation was replaced by taper relief from 6 April 1998 to 5 April 2008. This reduced the percentage of capital gain subject to tax according to how long the asset had been owned. A business asset could be taxed on as little as 25% of the gain, and a non-business asset on 60%.

Taxing a business asset at a marginal rate of 40% on 25% of its value meant that the effective rate of tax was 10%.

Until 5 April 2003, it was also possible to claim retirement relief when someone sold a business on retirement.

From 6 April 2008, taper relief was abolished and a single rate of 18% was introduced. In the wake of protests, entrepreneurs' relief was introduced so that business assets could still be taxed at 10%.

The higher rate of 28% was introduced from 23 June 2010.