

Capital Gains Tax (Part 2)

This Fact Sheet outlines tax-planning ideas for reducing your potential liability for Capital Gains Tax. It should be read in conjunction with Part 1, which deals with what Capital Gains Tax is, whether it will affect you and the way that it is calculated. All references in this Fact Sheet to 'married couples' and 'spouses' will refer equally to civil partners.

Tax Awareness is an Essential Part of Good Investment Advice

When giving investment advice to our clients we need to be aware of the **tax position of the investor** and the **tax treatment of the various investments recommended** in all their aspects. The aim, of course, is to avoid giving unsuitable advice and involving the investor in paying unnecessary tax.

CGT can be avoided in most cases with proper planning, except where clients make very large gains, for example from the sale of a second property. Furthermore, unlike income tax, CGT may be reduced by taper relief (or possibly also by indexation).

Keep Accurate Records

You should keep **accurate records of every purchase and sale of assets** that are likely to involve you in CGT.

If you sell a portfolio of shares, for example, and do not have proper records to hand you could find that the professional fees for calculating your liability to CGT are more than the gain that you have made!

If you inherit assets you should keep **a record of their valuation at the date of the donor's death**, which you should obtain from the solicitor or executor handling the deceased person's estate.

Be aware of the Annual Exemption

If you decide to dispose of an asset **you should be aware of the annual exemption** and whether you have already used up some or all of the exemption in the current financial year.

So, for example, if you wish to sell a second property that you own, and on which you will have to pay CGT, **you might wish to delay the sale until the next tax year** if you have already used up your CGT exemption (ie £8,500 in 2005/06) in the current tax year by selling shares at a profit.

Such a delay **could save you up to £3,400** of tax (ie 40% of £8,500).

The same might apply if you wish to dispose of a large shareholding. It could make sense to **sell half of the shares now and the other half at the beginning of the next tax year** so that you use the annual exemption twice.

Of course, tax is only one consideration and you will have to take account of the fact that the price of your shares might fall while you delay, or indeed, you might be in a hurry to realise the capital.

As the **CGT annual exemption is not cumulative**, that is, it is lost if not used, you should be aware of **the usefulness of 'crystallising gains or losses' in a tax year**. Such gains or losses can also be transferred to your spouse to be used by them.

In this respect it is important to review your investments at least once a year. If you find that an investment has made a loss and there is no reason to believe that the under-performing investment will now move to out-performance then **you should consider selling the investment to materialise the loss** to offset your capital gains.

By taking positive action before the tax year end **you may be able to save 40% on your CGT bill** and recoup part of the loss you have suffered on a disappointing investment.

Use Tax Efficient Investments

If you are going to invest over the longer term you should consider using one or more tax efficient investments that will avoid your need to pay CGT.

For example, **there is no CGT to pay** on ISAs (or PEPS that you already hold), National Savings Certificates, Gilt-edged securities and qualifying corporate bonds or VCTs (venture capital trusts).

There is also **no CGT for you to pay on profits made on investments in life assurance bonds**. These are often described to reflect the underlying investment funds such as With Profit Bonds, Distribution Bonds, Property Bonds or Capital Investment Bonds.

In this case, however, **you are not escaping the payment of CGT**, it is just that the provider of the bond, usually a life assurance company, has already paid corporation tax on the profits made by the underlying funds so you do not have to pay it again.

In fact, rather confusingly, profits from such products are charged to income tax (although not at the basic rate).

If either you or your spouse are not income tax payers **you could consider investing in an offshore life assurance bond**. In this way you not only avoid CGT on the gains on your investment but there will also be no CGT charged on the underlying fund.

Use Unit Trusts Rather than Shares

Collective investment schemes such as unit trusts, investment trusts and OEICs (Open Ended Investment Companies) have a major tax planning advantage for you over direct shareholdings.

This is because, under CGT, the gains are effectively reduced in stages over 10 years through taper relief and this **is applied from the date of your investment** and not to each sale and investment of shares within the collective investment.

Under taper relief, for example, **a chargeable gain on an asset held for 7 years is reduced by 25%**. Whilst you may not personally hold many individual shareholdings for 7 years it is much more likely that you would hold a unit trust for this period of time, thus attracting the 25% reduction in the chargeable gain.

Use Spouse Transfers

Where you have investments that have large capital gains you should **consider the transfer of these to your spouse**, or putting them in the joint names of yourself and your spouse, before they are encashed. In this way the amount of CGT liability can be reduced or perhaps removed altogether.

Such inter-spouse transfers **only apply to couples who are actually married**. Second homes are often to be found in the ownership of one spouse which is not good from a tax planning point of view.

It is **not possible for you to transfer** any unused CGT exemption to your spouse.

It is **particularly important for higher-rate taxpayers** to make maximum use of their annual CGT exemption to avoid the build up of very large capital gains.

The availability of such a large amount of capital gains free of tax each year (ie £17,000 for a couple in 2005/06) provides scope for **using growth investments to produce a tax free 'income'**. Portfolios of unit trusts are particularly useful for this.

Transferring Assets on Marriage

If you transfer assets **to your intended spouse before your marriage**, you will be deemed to have made a disposal at market value and a capital gain may therefore arise.

From this point of view, **it may be better to delay matters until after you are married** as no capital gain arises on transfers between spouses who are living together.

Of course, if you are thinking of transferring an asset on which a capital loss would arise, **it may be best to crystallise this loss by making the transfer before you get married**.

Something else to bear in mind is the position if both of you already own your own home. You will have **three years grace to resolve the position**, but at the end of that time only one property can qualify as your main residence and be exempt from CGT.

The property concerned may be a new home or **one of you may move into the other's existing home**.

Reinvestment Relief

Even where you have become liable for a capital gain **it is still possible to use certain types of investment to delay paying the tax** and possibly to remove it altogether.

For example, **the chargeable gain is deferred where the gain is re-invested in** an Enterprise Investment Scheme (EIS).

This can have great tax planning opportunities because **the chargeable gain is reduced by the effects of inflation and by a further annual exemption in the year that the EIS is encashed**.

Furthermore, if you were to die with the chargeable gain outstanding **it is not payable by your estate**. EIS schemes, however, are very high risk investments and you will need to balance your desire to defer your chargeable gain with the potential loss to your capital if the investment goes badly.

The Usefulness of Pension Payments

The rate of CGT is determined by adding the gain to your other taxable income as a 'top slice'. Therefore, **if you can reduce your other taxable income** you may be able to reduce the rate of tax on a capital gain or even remove the gain from tax altogether.

If **you were able to make additional pension contributions in the same tax year** as the gain you could reduce the resultant CGT tax charge.

This will be **very much easier to do under the new pensions regime** from 6 April 2006. This is because the more restrictive pension contribution limits in any year are being replaced with a single limit which will **allow you to contribute up to 100% of your income** into a pension scheme in any tax year.

An Example:

Mr Jones has taxable income (after personal allowances) in 2005/06 of £28,000. He also has capital gains of £17,600. After deducting his CGT allowance of £8,500 he needs to add £9,100 to his income making his total taxable income for CGT purposes £37,100. The CGT payable is calculated as follows:

Tax at 20%

£32,400 (the limit for basic rate tax) - £28,000
= £4,400 at 20% = **£880**

Tax at 40%

£37,100 (his total taxable income) - £32,400
= £4,700 at 40% = **£1,880**

Total CGT payable = £2,760

However, **if Mr Jones makes a pension contribution of £4,700** in 2005/06 his taxable income reduces to £23,300 so that his total taxable income for CGT purposes reduces to £32,400 and the situation is as follows:

Tax at 20%

£32,400 (the limit for basic rate tax) - £23,300
= £9,100 at 20% = **£1,820**

Tax at 40%

£32,400 (his total taxable income) - £32,400
= £Nil at 40% = **£Nil**

Total CGT payable = £1,820

The gross pension contribution of £4,700 has **received income tax relief of £1,034** (ie at 22%) and **saved a further £940 of CGT** so that the net cost of the pension contribution is just £2,726, **a total tax saving of 42% for a basic rate tax payer!**

Bed and

Let us assume that you have shares, which have increased in value by an amount just within your annual exemption after available reliefs.

You could previously have sold the shares, creating a gain, which escaped CGT. If you immediately bought the shares back, the 'new' shares would have had a new higher base cost, reducing your gain at a subsequent disposal. You could in fact have continued to do this over a long period, creating several gains and never actually becoming liable for any CGT.

Because shares were often sold last thing one day and bought first thing the next, **the practice became known as 'bed and breakfast'**.

The introduction of new rules in 1998 together with an enforced delay of 30 days between the sale and repurchase of shares in the same company spelled the death of 'bed and breakfast'.

However, **there are possible alternatives to bed and breakfasting.**

Bed and spousing - We have seen that if you transfer assets such as shares to your spouse, their gain on a subsequent disposal would be based on your acquisition cost and date. Instead, **suppose you sell the shares, and your spouse buys identical shares.** The eventual gain made by your spouse on disposal will be based purely on their own period of ownership. **The gain has been crystallised without a CGT liability arising**, and without the investment risk of a 30 day delay. It is important to note, however, that **taper relief would then be based on your spouse's sole period of ownership**, and not your combined ownership period.

Bed and ISAing - In the same way you could realise a gain and then repurchase the shares or units within an ISA.

Risk Factors

These notes are intended as a guide only. The information given in this Fact Sheet is based on our understanding of current legislation and practice.

Whilst we believe our interpretation of current law and practice to be correct, we cannot be responsible for the effects of any future legislation or any change in interpretation or treatment.

In particular you are warned that levels of tax and tax reliefs are subject to alteration and, in any case, the value of such reliefs and benefits may depend on an individual's circumstances.

You should not take action based on these notes without talking through your personal situation with an independent financial adviser or your accountant.

For Further Info

If you have a particular query concerning capital gains tax please ask your usual Arch adviser or contact us via one of the following:

Tel: **01483 204600**

Email: **enquiries@arch-fp.co.uk**

Online: **www.arch-fp.co.uk**

Please note, however, that we are not accountants and cannot get involved in complicated capital gains tax calculations that are more properly the domain of a qualified accountant

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