Changes to capital gains tax

Shortly after taking office, the Coalition Government announced that it would seek ways of taxing non-business capital gains 'at rates similar or close to those applied to income'. The subsequent Emergency Budget saw the introduction of a new rate of capital gains tax (CGT) as well as changes to Entrepreneurs' Relief.

While the additional CGT rate of 28% may be lower than previously feared, the new rules will nevertheless affect millions of people including those with employee share schemes, owners of second homes and buy-to-let landlords.

This guide considers the implications of the recent changes and includes advice which may help to minimise your tax liability.

What are the new rules?

CGT is payable on the amount of profit or gain made when you sell or otherwise dispose of an asset, for example by giving it as a gift or transferring ownership to someone else.

As announced in the June Budget, there are now two rates of CGT for individuals – a standard rate of 18% and a higher rate of 28%. From 23 June 2010, the rate of CGT payable on gains realised on or after that date depends on the level of the individual's taxable income and post-22 June 2010 gains for the tax year.

The higher rate applies to gains realised after 22 June 2010 where an individual has total taxable income and gains for the tax year of more than the basic rate band for income tax. For 2010/11 this is set at £37,400. In deciding whether the higher rate applies, no account is taken of any gains realised before 23 June 2010. Where an individual's total taxable income and post-22 June gains are below £37,400 the standard rate of 18% applies.

All gains realised before 23 June 2010 are taxed at 18%. The figure for total taxable income and gains is calculated after taking into account all allowable deductions including losses, personal allowances and the CGT annual exempt amount.

All taxpayers will continue to benefit from the annual exempt amount, which remains unchanged at £10,100 for 2010/11.

Meanwhile, the rate of CGT for trusts and personal representatives of deceased persons has been increased to 28%, for gains arising on or after 23 June 2010, except where Entrepreneurs' Relief applies.

Entrepreneurs' Relief

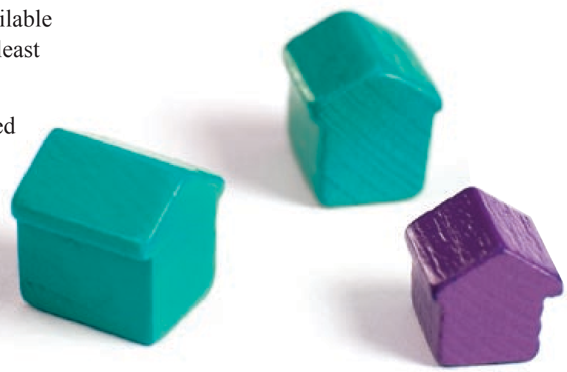
Entrepreneurs' Relief was introduced in April 2008 and enables qualifying gains to benefit from a reduced rate of CGT. For 2010/11 this rate effectively remains at 10%. Each taxpayer has a lifetime limit on gains which can qualify for Entrepreneurs' Relief, which was increased from £2 million to £5 million with effect from 23 June 2010.

Generally, Entrepreneurs' Relief is available to individuals on the disposal (after at least one complete qualifying year) of:

- all or part of a trading business carried on alone or in partnership
- the assets of a trading business after cessation
- shares in the individual's 'personal' trading company
- assets owned by the individual used by the individual's personal trading company or trading partnership.

Minimising your tax liability

An individual can normally choose to utilise losses and the annual exemption in a way that minimises his or her overall CGT liability. This offers a planning opportunity for 2010/11 in circumstances where pre-23 June 2010 gains are taxed at 18%, but gains arising after 22 June are taxed at 28%. Clearly it is better to save tax at 28% rather than at 18% and, where the higher rate applies, the annual exemption and any losses should be set against post-22 June 2010 gains first. This is illustrated in the case study overleaf.



Did you know...

Capital gains tax was first introduced in 1965 by Harold Wilson's Labour Government. It was intended to prevent individuals from avoiding income tax by realising capital gains, which at that time were mostly tax-free.

How will the new rate work?

Case Study

Karen realises gains and losses during 2010/11 as follows:

April 2010	Loss £5,000
May 2010	Gain £20,000
July 2010	Gain £40,000

Karen has other income, after deducting her personal allowance, of £30,000 for 2010/11. Her total income and post-22 June gains are £70,000, which will mean that the higher rate will have effect for part of the post-22 June 2010 gains.

To minimise her overall liability, Karen should set the loss of £5,000 and the annual exemption of £10,100 against the July gain of £40,000, reducing it to £24,900. It does not matter that the loss was realised before 23 June 2010 as it was still within the 2010/11 tax year.

Karen's other income is £30,000, leaving £7,400 of the gain to be taxed at 18%. The remaining £17,500 of the gain is taxed at 28%.

Her total CGT liability for 2010/11 is therefore £9,832, calculated as follows:

May gain £20,000 @ 18%	£3,600
July gain £7,400 @ 18%	£1,332
£17,500 @ 28%	£4,900
CGT liability for 2010/11	**£9,832**

Had the loss and the annual exemption been set against the May gain, this would reduce the May gain to £4,900, but increase the portion of the July gain liable to higher rate CGT to £32,600. This would increase her CGT liability for 2010/11 to £11,342.

By utilising the exemption and loss carefully the overall CGT liability is minimised.

The failure to align CGT and income tax rates means that capital is preferable to income where the option exists. This should be taken into account as part of your planning strategy.

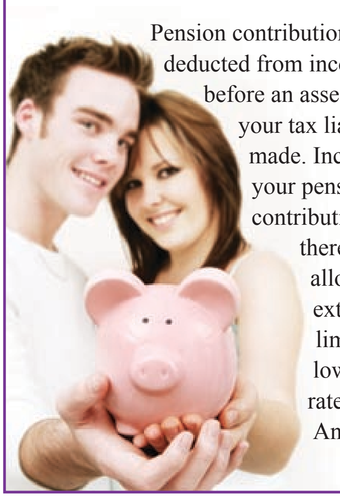
For information and advice tailored to your individual circumstances, please contact us.

Other strategies to consider

Transferring assets

It may be possible to transfer assets to a spouse or civil partner or hold them in joint names in order to minimise your CGT liabilities. Holding an asset in joint names means the annual exempt amount for each individual (£10,100) is deducted from the gain before tax is due. If appropriate, you might want to transfer full ownership to a spouse or civil partner where their income places them in the lower rate tax band, thereby making use of both income and capital gains allowances. However, this constitutes a legal transfer and you should always seek expert advice before taking action.

Pension contributions



Pension contributions are deducted from income before an assessment of your tax liability is made. Increasing your pension contributions could therefore allow you to extend the limits of the lower tax rate band. Any gains realised from other assets are taxed in accordance with this extended band after allowances have been taken into account.

Sell gradually

Individuals with a particularly large gain may want to realise it gradually to take full advantage of more than one tax year's allowance. This would then shelter the gain from a 28% CGT charge.

Assets exempt from CGT

There are a number of assets which can grow in value, free of CGT. For example, the tax is not levied on any asset held in an Individual Savings Account (ISA), so you may want to transfer assets into your ISA to ensure that they are CGT-free in the future.

Other exemptions include Premium Bonds, profits made from selling your main home or private car, betting and lottery winnings, personal injury awards and personal possessions worth no more than £6,000.

Investments in some 'wasting assets' such as wine, classic cars and race horses are also exempt from CGT.

Beneficiaries of inherited assets are not liable to pay CGT at the time of inheritance, although they may be liable to pay the tax on any profits or gains made when they dispose of the assets in the future.

Reporting a gain

If you have CGT to pay, you will need to complete the supplementary pages of the Self Assessment (or Trust and Estates) tax return. If you do not normally complete a return, or have not received a tax return or letter from HM Revenue & Customs, you will need to notify them of your liability to pay CGT, by the 5 October following the end of the tax year. You should also keep a record of any information that you use in order to help you work out your capital gain or loss, fill in your return, and make a claim for losses.

The Chancellor has signalled that CGT rates for 2011/12 may be reviewed in next year's Budget, which could pave the way for further increases in the future. Action should therefore be taken as soon as possible to ensure that you are making the most of the allowances and options available to you now. Please note that the proposed changes to CGT are subject to the Finance (No. 2) Act 2010 receiving Royal Assent.

This guide is intended as a brief summary of the changes and is not exhaustive. If you have any questions about the new rules or would like more information on how you may be able to reduce your CGT liability, please contact us.
We will be delighted to assist you.