RELEVANT TO ACCA QUALIFICATION PAPER F6 (UK)

Studying Paper F6

Performance objectives 19 and 20 are relevant to this exam

Capital gains: Part 1

This two-part article is relevant to those of you taking Paper F6 (UK) in either the June or December 2011 sittings, and is based on tax legislation as it applies to the tax year 2010–11 (Finance Acts (No 1) and (No 2) 2010).

Question 3 of Paper F6 (UK) focuses on capital gains in either a personal or a corporate context, and will be for 15 marks. A small element of capital gains might also be included in Questions 1 (focusing on income tax) or 2 (focusing on corporation tax).

Personal capital gains

Scope of capital gains tax (CGT)

CGT is charged when there is a chargeable disposal of a chargeable asset by a chargeable person.

A chargeable disposal includes part disposals and the gift of assets. However, the transfer of an asset upon death is an exempt disposal. A person who inherits an asset takes it over at its value at the time of death.

All forms of property are chargeable assets unless exempted. The most important exempt assets as far as Paper F6 (UK) is concerned are:

- Certain chattels (see later)
- Motor cars
- UK Government securities (Gilts).

In determining whether or not an individual is chargeable to CGT it is necessary to consider their residence status.

Example 1

Explain when a person will be treated as resident or ordinarily resident in the UK for a particular tax year and state how a person's residence status establishes whether or not they are liable to CGT.

- A person will be resident in the UK during a tax year if they are present in the UK for 183 days or more.
- A person will also be treated as resident if they make substantial visits to the UK, with visits averaging 91 days or more over four consecutive tax years.
- Ordinary residence is not precisely defined, but a person will normally be ordinarily resident in the UK if this is where they habitually reside.

- A person is liable to CGT on the disposal of assets during any tax year in which they are either resident or ordinarily resident in the UK.

Basic computation
For individuals the basic CGT computation is quite straightforward.

Example 2
Andy sold a factory on 15 February 2011 for £320,000. The factory was purchased on 24 January 1992 for £164,000, and was extended at a cost of £37,000 during March 2002. During May 2004 the roof of the factory was replaced at a cost of £24,000 following a fire.

Andy incurred legal fees of £3,600 in connection with the purchase of the factory, and legal fees of £5,800 in connection with the disposal.

Andy's taxable gain for 2010–11 is as follows:

	£	£
Disposal proceeds		320,000
Cost	164,000	
Enhancement expenditure	37,000	
Incidental costs (3,600 + 5,800)	9,400	
		(210,400)
Chargeable gain		109,600
Annual exemption		(10,100)
Taxable gain		99,500

- The factory extension is enhancement expenditure as it has added to the value of the factory.
- The replacement of the roof is not enhancement expenditure, being in the nature of a repair.
- Note that the standardised term 'chargeable gain' refers to the capital gain before deducting the annual exemption, whilst the term 'taxable gain' refers to the chargeable gain after deducting the annual exemption.

Capital losses
Capital losses are set off against any chargeable gains arising in the same tax year, even if this results in the annual exemption being wasted. Any unrelieved capital losses are carried forward, but in future years they are only set off to the extent that the annual exemption is not wasted.

Example 3
For the tax year 2010–11 Nim has chargeable gains of £17,100. He has unused capital losses of £16,700 brought forward from the tax year 2009–10.

Nim's taxable gains for 2010–11 are as follows:

		£
Chargeable gains		17,100
Capital losses brought forward	(7,000)	
Chargeable gains		10,100
Annual exemption		(10,100)
Taxable gains		Nil

- The set off of the brought forward capital losses is restricted to £7,000 (17,100 – 10,100) so that chargeable gains are reduced to the amount of the annual exemption.
- Nim, therefore, has capital losses carried forward of £9,700 (16,700 – 7,000).

Rates of capital gains tax
The rate of CGT is linked to the level of a person's taxable income. Taxable gains are taxed at a lower rate of 18% where they fall within the basic rate tax band of £37,400, and at a higher rate of 28% where they exceed this threshold. Remember that the basic rate band is extended if a person pays personal pension contributions or makes a gift aid donation.

CGT is collected as part of the self-assessment system, and is due in one amount on 31 January following the tax year. Therefore, a CGT liability for the tax year 2010–11 will be payable on 31 January 2012. Payments on account are not required in respect of CGT.

Example 4
For the tax year 2010–11 Adam has a salary of £39,475, and during the year he made net personal pension contributions of £4,400. On 15 August 2010 Adam sold an antique table and this resulted in a chargeable gain of £17,400.

For the tax year 2010–11 Bee has a trading profit of £56,475. On 20 August 2010 she sold an antique vase and this resulted in a chargeable gain of £18,100.

For the tax year 2010–11 Chester has a salary of £36,475. On 25 August 2010 he sold an antique clock and this resulted in a chargeable gain of £23,800.

Adam
Adam's taxable income is £33,000 (39,475 less the personal allowance of 6,475). His basic rate tax band is extended to £42,900 (37,400 + 5,500 (4,400 x 100/80)), of which £9,900 (42,900 – 33,000) is unused.

Adam's taxable gain of £7,300 (17,400 less the annual exemption of 10,100) is fully within the unused basic rate tax band, so his CGT liability for 2010–11 is therefore £1,314 (7,300 at 18%).

Bee
Bee's taxable income is £50,000 (56,475 – 6,475), so all of her basic rate tax band has been used. The CGT liability for 2010–11 on her taxable gain of £8,000 (18,100 – 10,100) is therefore £2,240 (8,000 at 28%).

Chester
Chester's taxable income is £30,000 (36,475 – 6,475), so £7,400 (37,400 – 30,000) of his basic rate tax band is unused. The CGT liability for 2010-11 on Chester's taxable gain of £13,700 (23,800 – 10,100) is therefore calculated as follows:

	£
7,400 at 18%	1,332
6,300 at 28%	1,764
	3,096

In each case, the CGT liability will be due on 31 January 2012.

Entrepreneurs' relief
A reduced CGT rate of 10% applies if a disposal qualifies for entrepreneurs' relief. This rate applies regardless of the level of a person's taxable income. Entrepreneurs' relief can be claimed when an individual disposes of a business or a part of a business as follows:

- A disposal of the whole or part of a business run as a sole trader. Relief is only available in respect of chargeable gains arising from the disposal of assets in use for the purpose of the business. This will exclude chargeable gains arising from investments.
- The disposal of shares in a trading company where an individual has at least a 5% shareholding in the company and is also an employee

or director of the company. Provided the limited company is a trading company, there is no restriction to the amount of relief if it holds non-trading assets such as investments.

The relief covers the first £5m of qualifying gains that a person makes during their lifetime. Gains in excess of the £5m limit are taxed as normal at the 18% or 28% rates.

There is no age requirement in order to claim entrepreneurs' relief, but assets must have been owned for one year prior to the date of disposal in order to qualify.

Example 5
On 25 January 2011 Michael sold a 30% shareholding in Green Ltd, an unquoted trading company. The disposal resulted in a chargeable gain of £800,000. Michael had owned the shares since 1 March 2004, and was an employee of the company from that date until the date of disposal.

He has taxable income of £8,000 for the tax year 2010–11.

Michael's CGT liability for 2010–11 is as follows:

	£
Chargeable gain	800,000
Annual exemption	(10,100)
	789,900
Capital gains tax: 789,900 at 10%	78,990

Although chargeable gains that qualify for entrepreneurs' relief are always taxed at a rate of 10%, they must be taken into account when establishing which rate applies to other chargeable gains. Chargeable gains qualifying for entrepreneurs' relief therefore reduce the amount of any unused basic rate tax band.

The annual exemption and any capital losses should be initially deducted from those chargeable gains that do not qualify for entrepreneurs' relief. This approach will save CGT at either 18% or 28%, compared to just 10% if used against chargeable gains that do qualify for relief.

There are several ways of presenting computations involving such a mix of gains, but the simplest approach is to keep gains qualifying for entrepreneurs' relief and other gains separate.

Example 6
On 30 September 2010 Mika sold a business that she had run as a sole trader since 1 January 2004. The disposal resulted in the following chargeable gains:

	£
Goodwill	260,000
Freehold office building	370,000
Freehold warehouse	170,000
	800,000

The assets were all owned for more than one year prior to the date of disposal. The warehouse had never been used by Mika for business purposes.

Mika has taxable income of £4,000 for the tax year 2010–11. She has unused capital losses of £28,000 brought forward from the tax year 2009–10.

Mika's CGT liability for 2010–11 is as follows:

	£
Gains qualifying for entrepreneurs' relief	
Goodwill	260,000
Freehold office building	370,000
	630,000
Other gains	
Freehold warehouse	170,000
Capital losses brought forward	(28,000)
	142,000
Annual exemption	(10,100)
	131,900
Capital gains tax: 630,000 at 10%	63,000
131,900 at 28%	36,932
Tax liability	99,932

- The capital losses and the annual exemption are set against the chargeable gain on the sale of the freehold warehouse as this does not qualify for entrepreneurs' relief.
- £33,400 (37,400 – 4,000) of Mika's basic rate tax band is unused, but this is set against the gains qualifying for entrepreneurs' relief of £630,000 even though this has no effect on the 10% tax rate.

Married couples
Transfers between spouses do not give rise to any chargeable gain or capital loss. The same treatment applies to transfers between same-sex partners in a registered civil partnership.

Example 7
Bill and Cathy Dew are a married couple. They disposed of the following assets during the tax year 2010–11:
- On 10 July 2010 Bill and Cathy sold a house for £380,000. The house had been purchased on 1 December 2007 for £290,000, and has never been occupied as their main residence.
- On 5 August 2010 Bill transferred his entire shareholding of 20,000 £1 ordinary shares in Elf plc to Cathy. On that date the shares were valued at £64,000. Bill's shareholding had been purchased on 21 September 2008 for £48,000.
- On 7 October 2010 Cathy sold the 20,000 £1 ordinary shares in Elf plc that had been transferred to her from Bill. The sale proceeds were £70,000.

Bill and Cathy each have taxable income of £50,000 for the tax year 2010–11.

Jointly-owned property
- The chargeable gain on the house is £90,000 (380,000 – 290,000).
- Bill and Cathy will each be assessed on £45,000 (90,000 x 50%) of the chargeable gain.

Bill Dew – CGT liability 2010–11

	£
House	45,000
Annual exemption	(10,100)
	34,900
Capital gains tax: 34,900 at 28%	9,772

- The transfer of the 20,000 £1 ordinary shares in Elf plc to Cathy does not give rise to any chargeable gain or capital loss, because it is a transfer between spouses.

Cathy Dew – CGT liability 2010–11

	£	£
House		45,000
Ordinary shares in Elf plc		
Disposal proceeds	70,000	
Cost	(48,000)	
		22,000
		67,000
Annual exemption		(10,100)
		56,900
Capital gains tax: 56,900 at 28%		15,932

- Bill's original cost is used in calculating the capital gain on the disposal of the shares in Elf plc.

Part disposals
When just part of an asset is disposed of then the cost must be apportioned between the part disposed of and the part retained.

Example 8
On 16 February 2011 Furgus sold three acres of land for £285,000. He had originally purchased four acres of land on 17 July 2009 for £220,000. The market value of the unsold acre of land as at 16 February 2011 was £90,000.

- The cost relating to the three acres of land sold is £167,200 (220,000 x 285,000/375,000 (285,000 + 90,000)).
- The chargeable gain on the land is therefore £117,800 (285,000 – 167,200).
- The base cost of the remaining acre of land is £52,800 (220,000 – 167,200).

Chattels
Special rules apply to chattels. A chattel is tangible moveable property.

Example 9
On 18 August 2010 Gloria sold an antique table for £5,600 and an antique clock for £7,200. The antique table had been purchased on 27 May 2009 for £3,200, and the antique clock had been purchased on 14 June 2009 for £3,700.

- The antique table is exempt from CGT because the gross sale proceeds were less than £6,000.
- The chargeable gain on the antique clock is restricted to £2,000 (7,200 – 6,000 = 1,200 x 5/3) as this is less than the normal gain of £3,500 (7,200 – 3,700).

Wasting assets
A wasting asset is one which has a remaining useful life of 50 years or less. The cost of such an asset must be adjusted for the expected depreciation over the life of the asset.

Example 10
On 31 March 2011 Mung sold a copyright for £9,600. The copyright had been purchased on 1 April 2006 for £10,000 when it had an unexpired life of 20 years.

The chargeable gain on the copyright is as follows:

	£
Disposal proceeds	9,600
Cost (10,000 x 15/20)	(7,500)
	2,100

- The cost of £10,000 is depreciated based on an unexpired life of 20 years at the date of acquisition and an unexpired life of 15 years at the date of disposal.

Insurance proceeds
If an asset is lost or destroyed then the receipt of insurance proceeds is treated as a normal disposal. However, rollover relief is available if the insurance monies are used to purchase a replacement asset within a period of 12 months.

Example 11
On 20 October 2010 an antique table owned by Claude was destroyed in a fire. The table had been purchased on 23 November 2008 for £50,000. Claude received insurance proceeds of £74,000 on 6

December 2010 and on 18 December 2010 he paid £75,400 for a replacement table.

- The insurance proceeds of £74,000 received by Claude have been fully reinvested in a replacement table.
- There is therefore no disposal on the receipt of the insurance proceeds.
- The gain of £24,000 (insurance proceeds of £74,000 less original cost of £50,000) is set against the cost of the replacement table, so its base cost becomes £51,400 (75,400 – 24,000).

If an asset is damaged then the receipt of insurance proceeds is treated as a part disposal. However, if all the proceeds are used to restore the asset then a claim can be made to ignore the part disposal rules.

Example 12
On 1 October 2010 an antique carpet owned by Juliet was damaged by a flood. The carpet had been purchased on 17 November 2006 for £69,000. Juliet received insurance proceeds of £12,000 on 12 December 2010, and she spent a total of £13,400 during December 2010 restoring the carpet. Juliet has made a claim to ignore the part disposal rules.

- The insurance proceeds of £12,000 received by Juliet have been fully applied in restoring the carpet.
- There is therefore no disposal on the receipt of the insurance proceeds.
- The revised base cost of the carpet is £70,400 (69,000 – 12,000 + 13,400).

Principal private residences
A gain on the disposal of a principal private residence is exempt where the owner has occupied the house throughout the whole period of ownership. The final 36 months of ownership are always treated as a period of ownership. The following periods of absence are also deemed to be periods of occupation:
- Periods up to a total of three years for any reason.
- Any periods where the owner is required to live abroad due to their employment.
- Periods up to four years where the owner is required to live elsewhere in the UK due to their work.

These deemed periods of occupation must normally be preceded and followed by actual periods of occupation.

Example 13
On 30 September 2010 Hue sold a house for £381,900. The house had been purchased on 1 October 1990 for £141,900.

Hue occupied the house as her main residence from the date of purchase until 31 March 1994. The house was then unoccupied between 1 April 1994 and 31 December 1997 due to Hue being required by her employer to work elsewhere in the UK.

From 1 January 1998 until 31 December 2004 Hue again occupied the house as her main residence. The house was then unoccupied until it was sold on 30 September 2010.

The chargeable gain on the house is as follows:

	£
Disposal proceeds	381,900
Cost	(141,900)
	240,000
Principal private residence exemption	(207,000)
	33,000

- The total period of ownership of the house is 240 months (207 + 33), of which 207 months qualify for exemption as follows:

	Exempt months	Chargeable months
1 October 1990 to 31 March 1994 (occupied)	42	
1 April 1994 to 31 December 1997 (working in UK)	45	
1 January 1998 to 31 December 2004 (occupied)	84	
1 January 2005 to 30 September 2007 (unoccupied)		33
1 October 2007 to 30 September 2010 (final 36 months)	36	
	207	33

- The unoccupied period from 1 January 2005 to 30 September 2007 is not a period of deemed occupation as it was not followed by a period of actual occupation.
- The exemption is therefore £207,000 (240,000 x 207/240).

Letting relief will extend the principal private residence exemption where a property is let out during a period that does not otherwise qualify for exemption.

Example 14
Continuing with Example 13, assume that Hue let her house out during the periods that she did not occupy it.

The chargeable gain on the house will now be as follows:

	£
Disposal proceeds	381,900
Cost	(141,900)
	240,000
Principal private residence exemption	(207,000)
Letting relief exemption	(33,000)
	Nil

The letting relief exemption is the lower of:
- £40,000
- £207,000 (the amount of the gain exempt under the principal private residence rules)
- £33,000 (the amount of the non-exempt gain attributable to the period of letting (240,000 x 33/240))

Where part of a house is used exclusively for business use then the principal private residence exemption will be restricted.

Example 15
On 30 September 2010 Mae sold a house for £186,000. The house had been purchased on 1 October 2000 for £122,000. Throughout the period of ownership the house was occupied by Mae as her main residence, but one of the house's eight rooms was always used exclusively for business purposes by Mae.

The chargeable gain on the house is as follows:

	£
Disposal proceeds	186,000
Cost	(122,000)
	64,000
Principal private residence exemption	(56,000)
	8,000

- The principal private residence exemption is restricted to £56,000 (64,000 x 7/8).

The second part of the article will cover shares, reliefs, and the way in which the chargeable gains of limited companies are taxed. It also contains some guidance for when you are answering a capital gains question in the exam.

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