HM Revenue & Customs

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# CAPITAL GAINS TAX REFORM

## Who is likely to be affected?

1. Individuals, trustees and personal representatives with a gain which is chargeable to capital gains tax (CGT). Companies that are liable to corporation tax in respect of their chargeable gains are not affected by any of these changes.

## General description of the measure

2. Legislation will be introduced in Finance Bill 2008 to give effect to a new single rate of charge to CGT at 18 per cent. A number of changes to simplify the capital gains tax regime will be made, including:
   - The withdrawal of taper relief;
   - The withdrawal of indexation allowance;
   - The abolition of the ‘kink test’ for assets held at 31 March 1982;
   - Abolition of halving relief; and
   - Simplification of the share identification rules.

3. The Annual Exempt Amount (AEA) will remain. The current level for 2007-08 is £9,200 for individuals and £4,600 for some trustees. The AEA for 2008-09 will be announced at Budget 2008. Other CGT reliefs, as explained below, continue to have effect.

## Operative date

4. The measure will have effect for disposals made on or after 6 April 2008. The current CGT rules continue to apply for disposals made up to 5 April 2008.

## Current law and proposed revisions

5. Section 4 of Taxation of Chargeable Gains Act 1992 (TCGA) provides that an individual is currently chargeable to CGT at the rates for income tax on savings income (10 per cent, 20 per cent or 40 per cent in the tax year 2007-08), treating his or her net chargeable gains (after deduction of allowable losses, taper relief, any other relevant reliefs, and the AEA) as

the top slice of his or her income. Most trustees and personal representatives are chargeable at the rate applicable to trusts (40 per cent for 2007-08).

6. For the tax year 2008-09 there will be a single rate of capital gains tax set at 18 per cent. The rate will apply to individuals, trustees and personal representatives. The 18 per cent rate of CGT does not affect the income tax rates.

7. The main **taper relief** provisions are in section 2A of and Schedule A1 to TCGA. Taper relief came into effect for disposals on or after 6 April 1998. The relief may reduce the amount of the gain chargeable to capital gains tax (and hence reduce the effective rate of tax payable on the gain). The amount of relief available depends on the length of time an asset has been held since that date, and whether the asset is classified as a business or non-business asset for taper relief purposes. Currently maximum business assets taper relief is available if the business asset has been held for 2 years, and the maximum non-business asset taper relief is available if the non-business asset is held for 10 years.

8. For disposals on or after 6 April 2008 and held over gains coming into charge on or after 6 April 2008 taper relief will no longer be available (even if assets were held before this date) and the chargeable gain will be liable to tax at the new rate of 18 per cent (subject to the deduction of allowable losses, any other reliefs and the AEA).

9. The **indexation allowance** rules are in sections 53 to 57 of TCGA. Indexation was introduced as a mandatory relief with effect from 31 March 1982. It was frozen for CGT purposes at 6 April 1998 for assets held at that time. Currently where an asset was held at 6 April 1998 and is disposed of after that date the gain on the disposal may be eligible for indexation and taper relief. For disposals on or after 6 April 2008 indexation allowance will no longer be available in computing the gain arising. This change will only affect assets that were acquired before 6 April 1998.

10. The '**kink test**' rules are in section 35 of TCGA and only affect assets that were held on 31 March 1982. This has the effect that the gain (or loss) on the disposal of an asset held on 31 March 1982 is the lower of two amounts: the gain (or loss) calculated by reference to the original acquisition cost of the asset (and any other allowable expenditure on it), and the gain (or loss) based on treating the value of the asset on 31 March 1982 as the total allowable expenditure up to that date. It is possible to elect for the actual 31 March 1982 market value to be used without considering the kink test. The abolition of the kink test will mean all assets held on 31 March 1982 will be deemed to have had a cost equivalent to their market value on that date.

11. **Halving relief** will also be abolished. This relief, the rules for which are in Schedule 4 to TCGA, reduces the amount of a chargeable gain which, because of the previous operation of certain reliefs, effectively includes a deferred gain that relates to a period before 31 March 1982. The abolition

of taper relief, indexation allowance, the kink test and halving relief will apply to disposals on or after 6 April 2008.

<u>Examples</u>

12. As a result of these changes individuals disposing of assets on or after 6 April 2008 will work out the tax due as follows (please note that these examples use the 2007-08 AEA for illustrative purposes; the AEA for 2008-09 will be announced at Budget 2008):
    - In 1995 Mr E purchased a holiday home in Devon for £100,000. He sells it in July 2008 for £250,000. The CGT due is calculated by deducting the purchase cost of £100,000 from the sale proceeds of £250,000 to give a gain of £150,000. Assuming he has no other capital gains in the tax year 2008-09 he can deduct from this the full AEA of £9,200 giving a chargeable gain of £140,800. That gain is taxed at 18 per cent giving tax payable of £25,344.
    - In 1960 Miss S purchased some shares costing £500. In March 1982 they were worth £450. In August 2008 she sells the shares for £25,000. To calculate her CGT liability Miss S will need to deduct from the disposal proceeds of £25,000 the March 1982 valuation of £450 giving £24,550. (She cannot deduct the cost of the shares of £500 as abolition of the kink test means she has to use the March 1982 valuation.) Assuming she has the full AEA for 2008-09 available she then deducts the £9,200 giving a chargeable gain of £15,350. That gain is taxed at 18 per cent giving tax payable of £2,763.
    - In 2006 Mr D had a loss of £30,000 on disposal of an asset. He had no other gains against which he could set off the loss. In June 2008 he sold his holiday home at a gain of £80,000. To calculate his liability to CGT Mr D can still bring forward his loss of £30,000 and set it off to reduce the gain to £50,000. Assuming the full AEA for 2008-09 is available he then deducts £9,200 giving a chargeable gain of £40,800. That gain is taxed at 18 per cent giving tax payable of £7,344.
    - In November 2007 Miss E enters into an unconditional contract to sell assets to Mr Y in May 2008. Because the contract is unconditional the disposal takes place for CGT purposes in November 2007 and the existing rules for indexation (if appropriate), taper and rates of tax will apply. The gain is chargeable for 2007-08, and the tax is payable in January 2009 under the normal Self-Assessment rules.
    - Also in November 2007 Ms F enters into a conditional contract to sell assets to Mr Q in May 2008. Because the contract is conditional the disposal date is when the conditions are satisfied. If the conditions are satisfied in May 2008 then the new rules will apply, the gain will be chargeable in the year 2008-09 at the new rate of 18 per cent, and the tax will be payable in January 2010.
    - Mr G owns a fish and chip shop in Brighton. On 1 June 2008 he sells the shop and reinvests the gain into buying a larger shop on the seafront. Mr G claims business asset roll-over relief so there is no tax payable when he disposes of the shop. CGT liability will be deferred until a point in the future (this may be on the disposal of the replacement shop if it is not replaced with another qualifying business asset).

13. These changes to the CGT rules will allow certain provisions to be simplified. For example the current rules for the identification for CGT purposes of shares and securities (and other assets which cannot be distinguished from one another) can be found at sections 104 to 106A and 109 of TCGA. These prescribe a complex order of identification, dependent upon the dates when the assets were acquired. Currently shares disposed of on any given day are identified with shares acquired on that day (the "same day rules") and within the next 30 days (the "bed and breakfasting rules"), then with shares acquired from April 1998 (on a LIFO – "last in first out" – basis), and then with shares in up to three separate pools. As a result of the changes described above, it will be possible to replace the LIFO rules with a simpler system under which from 6 April 2008 all shares of the same class in the same company will be treated as forming a single asset (a "share pool"), regardless of when they were originally acquired. The same day rules and bed and breakfasting rules remain unchanged, and shares will be identified under those rules before they are identified with shares in the share pool.

14. Other CGT reliefs will continue to be available. For example:
    - Private Residence Relief will continue to be available for principal private residences.
    - Business asset roll-over relief continues to be available. Roll-over relief enables the CGT payable on the gain on a chargeable asset to be deferred until a point in the future. Taper relief is not given on the rolled-over gain under the current rules.
    - The Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCT) attract a number of CGT reliefs. These include CGT exemption where Income Tax relief has been claimed; loss relief on unquoted shares; deferral relief; and extended taper relief (all subject to certain conditions). For disposals on or after 6 April 2008 there will be no taper relief available. All other CGT EIS and VCT reliefs continue to apply.
    - Business asset gift hold-over relief also continues to apply. This relief allows CGT on business assets that are given away to be held over until the assets are disposed of by the donee.
    - As in the example above, any unused allowable losses from past years will continue to be allowed to be brought forward in order to reduce any gains.

15. Detail of any consequential changes and draft legislation will be published later this year. In the interim HMRC will be discussing the detail of these proposals with interested parties.

**Further advice**

16. If you have any questions about these changes or if you would like to take part in discussions, please contact Rachel Salisbury on 020 7147 2743 (email: Rachel.Salisbury@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk