

RELEVANT TO ACCA QUALIFICATION PAPER F6 (UK) AND PERFORMANCE OBJECTIVES 19 AND 20

Chargeable gains, part 1

This two-part article is relevant to candidates sitting the Paper F6 (UK) exam in 2012, and is based on tax legislation as it applies to the tax year 2011–12 (Finance Act 2011).

Question three of Paper F6 (UK) focuses on chargeable gains in either a personal or a corporate context, and is worth 15 marks. A small element of chargeable gains may also be included in any of the other questions.

PERSONAL CHARGEABLE 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.
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Basic computation

For individuals the basic CGT computation is quite straightforward.

EXAMPLE 2

Andy sold a factory on 15 February 2012 for £320,000. The factory was purchased on 24 January 1993 for £164,000, and was extended at a cost of £37,000 during March 2003. During May 2005 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 2011–12 is as follows:

	£	£
Disposal proceeds		320,000
Cost	164,000	
Enhancement expenditure	37,000	
Incidental costs (3,600 + 5,800)	<u>9,400</u>	
		<u>(210,400)</u>
Chargeable gain		109,600
Annual exempt amount		<u>(10,600)</u>
Taxable gain		<u>99,000</u>

- 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 gain before deducting the annual exempt amount, while the term 'taxable gain' refers to the gain after deducting the annual exempt amount.

Capital losses

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

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EXAMPLE 3

For the tax year 2011–12 Nim has chargeable gains of £17,600. He has unused capital losses of £16,700 brought forward from the tax year 2010–11.

Nim's taxable gains for 2011–12 are as follows:

	£
Chargeable gains	17,600
Capital losses brought forward	<u>(7,000)</u>
Chargeable gains	10,600
Annual exempt amount	<u>(10,600)</u>
Taxable gain	<u>Nil</u>

- The set off of the brought forward capital losses is restricted to £7,000 (17,600 – 10,600) so that chargeable gains are reduced to the amount of the annual exempt amount.
- 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 £35,000, 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 2011–12 will be payable on 31 January 2013. Payments on account are not required in respect of CGT.

EXAMPLE 4

For the tax year 2011–12 Adam has a salary of £39,475, and during the year he made net personal pension contributions of £4,400. On 15 August 2011 Adam sold an antique table and this resulted in a chargeable gain of £17,400.

For the tax year 2011–12 Bee has a trading profit of £57,475. On 20 August 2011 she sold an antique vase and this resulted in a chargeable gain of £18,600.

For the tax year 2011–12 Chester has a salary of £35,475. On 25 August 2011 he sold an antique clock and this resulted in a chargeable gain of £23,800.

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Adam

Adam's taxable income is £32,000 (39,475 less the personal allowance of 7,475). His basic rate tax band is extended to £40,500 (35,000 + 5,500 (4,400 x 100/80)), of which £8,500 (40,500 – 32,000) is unused.

Adam's taxable gain of £6,800 (17,400 less the annual exempt amount of 10,600) is fully within the unused basic rate tax band, so his CGT liability for 2011–12 is therefore £1,224 (6,800 at 18%).

Bee

Bee's taxable income is £50,000 (57,475 – 7,475), so all of her basic rate tax band has been used. The CGT liability for 2011–12 on her taxable gain of £8,000 (18,600 – 10,600) is therefore £2,240 (8,000 at 28%).

Chester

Chester's taxable income is £28,000 (35,475 – 7,475), so £7,000 (35,000 – 28,000) of his basic rate tax band is unused. The CGT liability for 2011–12 on Chester's taxable gain of £13,200 (23,800 – 10,600) is therefore calculated as follows:

	£
7,000 at 18%	1,260
6,200 at 28%	<u>1,736</u>
	<u>2,996</u>

In each case, the CGT liability will be due on 31 January 2013.

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.

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The relief covers the first £10 million of qualifying gains that a person makes during their lifetime. Gains in excess of the £10 million 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 2012 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 2005, 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 2011–12.

Michael's CGT liability for 2011–12 is as follows:

	£
Chargeable gain	800,000
Annual exempt amount	<u>(10,600)</u>
	<u>789,400</u>
Capital gains tax: 789,400 at 10%	<u>78,940</u>

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 exempt amount 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.

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EXAMPLE 6

On 30 September 2011 Mika sold a business that she had run as a sole trader since 1 January 2005. The disposal resulted in the following chargeable gains:

	£
Goodwill	260,000
Freehold office building	370,000
Freehold warehouse	<u>170,000</u>
	<u>800,000</u>

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 2011–12. She has unused capital losses of £28,000 brought forward from the tax year 2010–11.

Mika's CGT liability for 2011–12 is as follows:

Gains qualifying for entrepreneurs' relief

	£
Goodwill	260,000
Freehold office building	<u>370,000</u>
	<u>630,000</u>

Other gains

Freehold warehouse	170,000
Capital losses brought forward	<u>(28,000)</u>

	142,000
Annual exempt amount	<u>(10,600)</u>

131,400

Capital gains tax: 630,000 at 10%	63,000
131,400 at 28%	<u>36,792</u>

Tax liability	<u>99,792</u>
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- The capital losses and the annual exempt amount are set against the chargeable gain on the sale of the freehold warehouse as this does not qualify for entrepreneurs' relief.
- £31,000 (35,000 – 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.

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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 2011–12:

- On 10 July 2011 Bill and Cathy sold a house for £380,000. The house had been purchased on 1 December 2008 for £290,000, and has never been occupied as their main residence.
- On 5 August 2011 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 2009 for £48,000.
- On 7 October 2011 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 2011–12.

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 2011–12

	£
House	45,000
Annual exempt amount	<u>(10,600)</u>
	<u>34,400</u>
Capital gains tax: 34,400 at 28%	<u>9,632</u>

- 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.

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Cathy Dew – CGT liability 2011–12

	£	£
House		45,000
Ordinary shares in Elf plc		
Disposal proceeds	70,000	
Cost	<u>(48,000)</u>	
		<u>22,000</u>
		<u>67,000</u>
Annual exempt amount		<u>(10,600)</u>
		<u>56,400</u>
Capital gains tax: 56,400 at 28%		<u>15,792</u>

- Bill's original cost is used in calculating the chargeable 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 2012 Joan sold three acres of land for £285,000. She had originally purchased four acres of land on 17 July 2010 for £220,000. The market value of the unsold acre of land as at 16 February 2012 was £90,000.

- The cost relating to the three acres of land sold is £167,200 ($220,000 \times \frac{285,000}{285,000 + 90,000}$).
- 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 ($220,000 - 167,200$).

With part disposals, care must be taken with enhancement expenditure and incidental costs as these may relate to the whole asset or just to the part being disposed of.

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EXAMPLE 9

On 20 February 2012 Furgus sold an acre of land for £130,000. He had originally purchased four acres of land on 13 April 2000 for £210,000. During January 2012 Furgus spent £22,800 clearing and levelling all four acres of land. The market value of the unsold three acres of land as at 20 February 2012 was £350,000. Furgus incurred legal fees of £3,200 in connection with the disposal.

Furgus' chargeable gain for 2011–12 is as follows:

	£	£
Disposal proceeds		130,000
Cost	56,875	
Enhancement expenditure	6,175	
Incidental costs	<u>3,200</u>	
		<u>(66,250)</u>
		<u>63,750</u>

- The cost relating to the acre of land sold is £56,875 ($210,000 \times 130,000 / 480,000$ ($130,000 + 350,000$)).
- The cost of clearing and levelling the land is enhancement expenditure. The cost relating to the acre of land sold is £6,175 ($22,800 \times 130,000 / 480,000$).
- The incidental costs relate entirely to the acre of land sold, and so they are not apportioned.

Chattels

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

EXAMPLE 10

On 18 August 2011 Gloria sold an antique table for £5,600 and an antique clock for £7,200. The antique table had been purchased on 27 May 2010 for £3,200, and the antique clock had been purchased on 14 June 2010 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 ($7,200 - 6,000 = 1,200 \times 5/3$) as this is less than the normal gain of £3,500 ($7,200 - 3,700$).

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Where a chattel is sold at a loss and the sale proceeds are less than £6,000, then the amount of allowable capital loss will be restricted. If capital allowances have been claimed then no capital loss will be available at all.

EXAMPLE 11

Giles sold the following assets during the tax year 2011–12:

On 3 February 2012 he sold an antique table for £4,700. The table had been purchased on 2 May 2001 for £10,200.

On 12 March 2012 he sold machinery for £22,600. The machinery had been purchased on 1 June 2008 for £34,000. Giles claimed capital allowances totalling £11,400 in respect of this machinery.

Table

- The table has been sold for less than £6,000, so the proceeds are deemed to be £6,000 (rather than £4,700).
- The allowable capital loss is therefore £4,200 (6,000 – 10,200).

Machinery

- The cost of £34,000 is reduced by the capital allowances claimed of £11,400, giving an allowable cost of £22,600.
- Since the proceeds are also £22,600, the disposal is on a no gain, no loss basis.

Wasting assets

A wasting asset is one that 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 12

On 31 March 2012 Mung sold a copyright for £9,600. The copyright had been purchased on 1 April 2007 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)	<u>(7,500)</u>
	<u>2,100</u>

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- 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.
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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 13

On 20 October 2011 an antique table owned by Claude was destroyed in a fire. The table had been purchased on 23 November 2009 for £50,000. Claude received insurance proceeds of £74,000 on 6 December 2011 and on 18 December 2011 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 is £51,400 ($75,400 - 24,000$).
-

If the insurance proceeds are not entirely reinvested then there will be an immediate chargeable gain.

EXAMPLE 14

Continuing with Example 13, assume that the replacement table only cost £71,500.

- The insurance proceeds not reinvested of £2,500 ($74,000 - 71,500$) are taxed as a chargeable gain in 2011–12.
 - The balance of the gain of £21,500 ($24,000 - 2,500$) is set against the cost of the replacement table, so its base cost is £50,000 ($71,500 - 21,500$).
-

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.

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EXAMPLE 15

On 1 October 2011 an antique carpet owned by Juliet was damaged by a flood. The carpet had been purchased on 17 November 2007 for £69,000. Juliet received insurance proceeds of £12,000 on 12 December 2011, and she spent a total of £13,400 during December 2011 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 16

On 30 September 2011 Hue sold a house for £381,900. The house had been purchased on 1 October 1991 for £141,900.

Hue occupied the house as her main residence from the date of purchase until 31 March 1995. The house was then unoccupied between 1 April 1995 and 31 December 1998 due to Hue being required by her employer to work elsewhere in the UK.

From 1 January 1999 until 31 December 2005 Hue again occupied the house as her main residence. The house was then unoccupied until it was sold on 30 September 2011.

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The chargeable gain on the house is as follows:

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

- 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 1991 to 31 March 1995 (occupied)	42	
1 April 1995 to 31 December 1998 (working in UK)	45	
1 January 1999 to 31 December 2005 (occupied)	84	
1 January 2006 to 30 September 2008 (unoccupied)		33
1 October 2008 to 30 September 2011 (final 36 months)	36	
	207	33

- The unoccupied period from 1 January 2006 to 30 September 2008 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 17

Continuing with Example 16, 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	<u>(141,900)</u>
	240,000

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Principal private residence exemption	(207,000)
Letting relief exemption	<u>(33,000)</u>
	<u>Nil</u>

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 18

On 30 September 2011 Mae sold a house for £186,000. The house had been purchased on 1 October 2001 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	<u>(122,000)</u>
	64,000
Principal private residence exemption	<u>(56,000)</u>
	<u>8,000</u>

- 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 gains made by limited companies are taxed. It also contains some guidance for when you are answering a chargeable gains question in the exam.

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