Chargeable capital

In a tax basics article, Karen Bullen compares the taxation of capital gains for individuals and companies.

In general terms, a capital gain will arise when a person (individual, trust or company) disposes of a capital asset at a profit. The disposal (sale, gift, destruction) of a chargeable asset will give rise to a capital gain or a capital loss. Most property other than cash (sterling) is an asset for capital gains tax. An asset is a chargeable asset if it is not specifically exempt under the capital gains tax legislation. Examples of chargeable assets are land and buildings, shares and antiques.

> "The selling price will be reduced by incidental costs of sale such as auctioneers' fees, agents' fees, advertising and so on."

Examples of exempt assets are chattels costing less than £6,000 – tangible moveable assets such as a painting – if the disposal proceeds are also less than £6,000. If consideration exceeds that amount, the gain is limited to five-thirds of the excess. A wasting asset – one that has a predictable life of 50 years or less (TCGA 1992, s 45(1)) such as racehorses and machinery – is also exempt unless it was or could have been subject to a capital allowances claim.

At its most basic, to calculate a capital gain, we must ascertain two things: the cost of the asset and the sale proceeds – or if it is a gift, the market value.

Note the following points.

- The cost of the asset will include all incidental costs of purchase such as stamp duty on share purchases, stamp duty land tax on land and building purchases, legal fees, surveyors' fees and the like. If costs were incurred on improving the asset after purchase, such as building an extension to a house or draining land, these costs are also deductible and are called enhancement expenditure because the costs have enhanced (as opposed to maintained) the value of the asset.
- The selling price will be reduced by incidental costs of sale such as auctioneers' fees, estate agents' fees, advertising costs and so on.

Key points

- Examples of chargeable assets are land and buildings, shares and antiques.
- Exempt assets include cars and wasting chattels such as racehorses.
- The cost of an asset includes incidental costs of purchase
- Capital losses are set automatically against gains in the same tax year.
- The annual exempt amount can be offset in the most beneficial way.
- Companies may be eligible for an indexation allowance.

Individuals and trusts

Let's start with calculating gains for individuals (and trusts).

The basic computation is as follows:

	£
Sale proceeds	X
Less: cost	Y
Capital gain/loss	Z

The calculations are illustrated by the examples of ***Alexis***, ***Blake*** and ***Claudia***.

Alexis

In June 2003, Alexis bought a house as a rental property costing £120,000. Legal fees incurred to acquire the property were £5,000.

Alexis sold the house in May 2020 for £250,000, but in doing so incurred estate agents' fees of £4,000.

	£	£
Sale proceeds (May 2020)		250,000
Less: Incidental costs of sale – estate agents' fees		4,000
		246,000
Less:		
Cost (June 2003)	120,000	
Incidental costs of purchase (Legal fees)	5,000	
Total costs		125,000
Capital gain (May 2020)		121,000

Blake

Blake purchased a rental property, incurred expenditure and later sold the house. The relevant dates and amounts were as follows.

- In June 2003, Blake bought a house as a rental property costing £120,000. Legal fees to acquire the property were £5,000.
- In August 2010, he converted the attic of the house to make an additional bedroom with an en suite bathroom costing £25,000.
- Blake sold the house in May 2020 for £250,000 but in doing so incurred estate agents' fees of £4,000.

	£	£
Sale proceeds (May 2020)		250,000
Less: Incidental costs of sale – estate agents' fees		4,000
		246,000
Less:		
Cost (June 2003)	120,000	
Incidental costs of purchase (legal fees)	5,000	
Enhancement expenditure (August 2010)	25,000	
Total costs and enhancement expenditure		150,000
Capital gain (May 2020)		96,000

Claudia

Claudia purchased a rental property, incurred expenditure and later sold the house. The relevant dates and amounts were as follows.

- **In June 2003, Claudia bought a house as a rental property costing £120,000. Legal fees to acquire the property were £5,000.**
- **In August 2010, she converted the attic of the house to make an additional bedroom with an en suite bathroom costing £25,000.**
- **The house was sold in May 2020 for £150,000, but this incurred estate agents' fees of £4,000.**

	£	£
Sale proceeds (May 2020)		150,000
Less: Incidental costs of sale – estate agents' fees		4,000
Net sale proceeds		146,000
Less:		
Cost (June 2003)	120,000	
Incidental costs of purchase (legal fees)	5,000	
Enhancement expenditure (August 2010)	25,000	
Total costs/enhancement expenditure		150,000
Capital loss (May 2020)		4,000

Dexter

In June 2003, Dexter bought a house costing £120,000. Legal fees to acquire the property were £5,000.

Dexter sold the house in May 2020 for £250,000 but in doing so incurred estate agents' fees of £4,000.

Dexter has taxable income of £30,000 in 2020-21 and has no other disposals of assets in the year.

	£	£
Sale proceeds (May 2020)		250,000
Less: Incidental costs of sale – estate agents' fees		4,000
		246,000
Less:		
Cost (June 2003)	120,000	
Incidental costs of purchase (legal fees)	5,000	
		(125,000)
Total capital gains 2020-21		121,000
Less: annual exempt amount		(12,300)
Taxable gains 2020-21		108,700
Capital gains tax		
£7,500 (£37,500 – £30,000) x 18%		1,350
£101,200 (£108,700 – £7,500) x 28%		28,336
Tax payable 31 January 2022		29,686

Fallon

Fallon has income of £100,000 in 2020-21. She sells a painting in May 2020 making a capital gain of £100,000 and sells a flat she had been renting out making a gain of £18,000 in August 2020. Her final disposal in 2020-21 was of shares in a company and this sale created a capital loss of £2,000 in January 2021.

	Gain on painting £	***Gain on residential property*** £
Painting (taxed at 20%)	100,000	
Flat (taxed at 28%)		18,000
Less:		
Capital loss *		2,000
Annual exempt amount *		12,300
	100,000	3,700
Capital gains tax at 20%	20,000	
Capital gains tax at 28%		1,036
Total capital gains tax: £21,036, payable 31 January 2022		

Note
*The capital loss and the annual exempt amount are offset against the gain that is taxed at the highest rate to minimise the capital gains tax for the taxpayer.

Garrett

Garrett has income of £10,000 in 2020-21. He sells a painting in May 2020 making a capital gain of £10,000 and sells a flat he had been renting out making a gain of £18,000 in August 2020. His final disposal in 2020-21 was of shares in a company and this sale created a capital loss of £2,000 in January 2021. There is also a brought forward capital loss of £11,000 from 2019-20.

	Gain on painting	Gain on residential property
	£	£
Painting (taxed at 20%)	10,000	
Flat (taxed at 28%)		18,000
Less:		
Capital loss *		2,000
Annual exempt amount *		12,300
	10,000	3,700
Less: Brought forward capital loss *	7,300	3,700
Taxable gain	2,700	Nil
Capital gains tax 20%	540	
Capital gains tax 28%		Nil
Total capital gains tax: £540, payable 31 January 2022		

Note
*The current and brought forward capital losses and the annual exempt amount are offset against the gain that is taxed at the highest rate to minimise the capital gains tax for the taxpayer.

Taxation of gains for individuals and trusts

Capital gains are taxed on disposals in a tax year (6 April to 5 April). Each individual has an annual exempt amount allowing an amount of gain each tax year to escape the charge to capital gains tax. In 2020-21 the annual exempt amount is £12,300 for each individual and £6,150 for a single trust (unless there are several trusts created by the same settlor).

> "Each individual has an annual exempt amount."

The rate of capital gains tax is 20% on most assets, but an increased rate of 28% applies to gains on the disposal of residential property. However, if the individual has any unused basic rate tax band (£37,500) from their income tax computation in the tax year, an amount of gain equal to the unused amount can be taxed at just 10% (or 18% if residential property).

See the example of ***Dexter***.

Capital losses

Capital losses are set against capital gains made in the same tax year automatically and, along with the annual exempt amount, those losses can be offset in the most beneficial way for the taxpayer (see ***Fallon*** and ***Garrett***).

Capital losses that cannot be offset against gains in the same tax year are carried forward to future tax years and offset against future gains. However, the annual exempt amount is deducted *before* relief is given for capital losses brought forward in those future years.

Dynasty Ltd

In June 2003, Dynasty Ltd bought a house costing £120,000. Legal fees to acquire the property were £5,000.

Dynasty Ltd sold the house in May 2020 for £250,000 but in doing so incurred estate agents' fees of £4,000.

	£	£
Sale proceeds (May 2020)		250,000
Less: Incidental costs of sale – estate agents' fees		4,000
		246,000
Less: Cost (June 2003)	120,000	
Incidental costs of purchase (legal fees)	5,000	
		(125,000)
Capital gain (May 2020)		121,000
Less: Indexation allowance		
Cost x $\frac{\text{RPI December 2017 – RPI June 2003}}{\text{RPI June 2003}}$		
£125,000 x $\frac{278.1 - 181.3}{181.3}$		
£125,000 x 0.534 (0.5339216 rounded to 0.534)		66, 750
Taxable gain		54,250

Taxation of capital gains for companies

The basic rules for calculating gains are the same for companies but with a few important differences. First, the gain is charged to corporation tax rather than capital gains tax. The gain is added into taxable total profits for the accounting period of the company in which the asset disposal takes place.

Second, companies do not have an annual exempt amount.

Third, companies have a deduction to iron out the impact of inflation, but this is frozen at December 2017. This indexation allowance (IA) is calculated using the following formula based on the retail prices index (RPI) at the date of purchase and the date of sale or December 2017 if earlier, as follows:

$$\frac{\text{RPI at date of sale or December 2017 if earlier – RPI at date of purchase}}{\text{RPI at date of purchase}}$$

This decimal is rounded to three places and is called the indexation factor. The indexation allowance is the cost multiplied by this indexation factor.

Note that the indexation allowance:

Denver Ltd

In June 2003, Denver Ltd bought a house costing £120,000. Legal fees to acquire the property were £5,000.

In August 2010, the company converted the attic of the house to make an additional bedroom with an en suite bathroom costing £25,000.

Denver Ltd sold the house in May 2020 for £250,000 but in doing so incurred estate agents' fees of £4,000.

	£	£
Sale proceeds (May 2020)		250,000
Less: Incidental costs of sale – estate agents' fees		4,000
		246,000
Less:		
Cost (June 2003)	120,000	
Incidental costs of purchase (legal fees)	5,000	
Enhancement expenditure (August 2010)	25,000	
		150,000
Unindexed gain		96,000
Less:		
Indexation allowance on cost		
Cost x $\frac{\text{RPI December 2017 – RPI June 2003}}{\text{RPI June 2003}}$		
£125,000 x $\frac{278.1 - 181.3}{181.3}$		
£125,000 x 0.534 (0.5339216 rounded to 0.534)	66,750	
Indexation allowance on enhancement cost		
Enhancement cost x $\frac{\text{RPI December 2017 – RPI August 2010}}{\text{RPI August 2010}}$		
£25,000 x $\frac{278.1 - 224.5}{224.5}$		
£25,000 x 0.239 (0.2387527 rounded to 0.239)	5,975	
Total indexation allowance		72,725
Taxable gain		23,275

- is calculated on the cost and enhancement expenditure separately because, most probably, the enhancement expenditure would have been incurred on a later date;
- cannot create or increase a capital loss; and
- is not available in respect of expenditure incurred after 31 December 2017. For expenditure incurred on or before that date and falling to be deducted on a disposal after that date, indexation allowance is computed up to and including December 2017 only (TCGA 1992, s 54(1)(1B)).

See the examples, ***Dynasty Ltd***, ***Denver Ltd*** and ***Deveraux Ltd***.

Deveraux Ltd

In June 2003, Deveraux Ltd bought a house costing £120,000. Legal fees to acquire the property were £5,000.

The company sold the house in May 2020 for £200,000 but in doing so incurred estate agents' fees of £4,000.

In August 2010, Deveraux Ltd converted the attic of the house to make an additional bedroom with an en suite bathroom costing £25,000.

	£	£
Sale proceeds (May 2020)		200,000
Less: Incidental costs of sale (estate agents' fees)		4,000
		196,000
Less:		
Cost (June 2003)	120,000	
Incidental costs of purchase (legal fees)	5,000	
Enhancement expenditure (August 2010)	25,000	
		150,000
Unindexed gain		46,000
Less:		
Indexation allowance on cost		
Cost x $\frac{\text{RPI December 2017 – RPI June 2003}}{\text{RPI June 2003}}$		
£125,000 x $\frac{278.1 - 181.3}{181.3}$		
£125,000 x 0.534 (0.5339216 rounded to 0.534)	66,750	
Indexation allowance on enhancement cost		
Enhancement cost x $\frac{\text{RPI December 2017 – RPI August 2010}}{\text{RPI August 2010}}$		
£25,000 x $\frac{278.1 - 224.5}{224.5}$		
£25,000 x 0.239 (0.2387527 rounded to 0.239)	5,975	
Total indexation allowance 72,725 restricted to *		46,000
Taxable gain		Nil

Note *

Indexation allowance deduction is restricted to £46,000 so that it reduces the gain to nil and does not create a capital loss. Unused indexation allowance is wasted.

Conclusion

In its simplest form, a capital gain is the cash profit made on the disposal of an asset. The way a gain (or capital loss) is calculated compares the sale proceeds (or market value if the asset was acquired by way of a gift) and the cost of the asset.

We can note the following key points.

- If property is owned jointly between two (or more) persons, each person can set their annual exempt amount against their share of the gain. Consider whether each joint owner has the full annual exempt amount available in the tax year of disposal, or whether a delay in the disposal date may be beneficial.
- Transfers between spouses or civil partners are free from capital gains tax and it may be tax efficient to consider a transfer before disposal. However, ensure that this will not prejudice entitlement to reliefs such as entrepreneurs' relief (now business asset disposal relief) and check that both parties will still qualify.
- Trustees are, in general, entitled to one half of the annual exempt amount. However, this amount is then divided by the number of trusts created by the same settlor, but with a minimum annual exemption of £1,230.
- Consider the timing of the disposal and whether it might be possible to spread the disposal across two tax years as part disposals. Two part disposals on either side of the tax year end will each be eligible for a full year's annual exempt amount (assuming that it is fully available), which may give a beneficial result in terms of tax payable.
- Remember to offset all deductible items against acquisition costs and costs of disposal, including accountancy fees for the transaction itself such as determining market value.
- If the disposal is a gift, the market value is substituted for the sale proceeds.

Companies may also be able to claim an indexation allowance to allow for inflation, while individuals (and trusts) have a tax-free amount each tax year called the annual exempt amount.

Individuals and trusts pay capital gains tax on the taxable gains arising in a tax year whereas companies pay corporation tax on the capital gains arising in an accounting period.

Planning point

Companies used to have an indexation allowance to reduce the taxable gain. This was abolished from December 2017, but can still be taken into account on costs and expenditure incurred before then.

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