

CAPITAL GAINS TAX

As you will be aware, the Chancellor surprised everyone in his Pre Budget Report on the 9 October 2007 with major changes to the CGT regime.

What are the main changes?

Firstly, legislation will be introduced next year to create a new single flat rate of CGT at 18% for 2008/09.

Secondly, a number of changes will be made for disposals made on or after 6 April 2008 to simplify the CGT regime, including:

- the withdrawal of taper relief;
- the withdrawal of indexation allowance; and
- simplification of the share identification rules.

What will these changes mean for you?

The most significant change for owners of business assets is the withdrawal of taper relief. Currently, gains are treated as the top slice of income which often means a 40% tax charge. However if business assets are sold the gain may be reduced by up to 75% due to taper relief. That works out at an effective CGT rate of 10% for a higher rate taxpayer.

For example consider the situation of a higher rate taxpayer who is planning to sell a business asset which will make a gain of £1,000,000. Business asset taper relief is available at 75%, so, in simple terms, only £250,000 is chargeable at 40%, a bill of £100,000.

Under the new rules, the whole of the £1,000,000 will be chargeable at 18%, a bill of £180,000. So clearly this individual would want to sell this particular asset before 6 April 2008 if at all possible.

Of course, everyone's circumstances are different, so there will also be some winners. We enclose a fact sheet with this letter which sets out the changes in more detail and provides some examples of the differences in tax bills if assets are sold before or after 6 April 2008.

If you are in any doubt about an appropriate course of action please contact us before selling any assets so that we can advise you of the best way forward.

You should also be aware that many business groups are calling on the government to delay or amend the decision to increase the effective tax charge on business assets, so you may wish to take this into account in making a decision to sell. We will, of course, keep you posted on any significant changes to the government's proposals.

CAPITAL GAINS TAX FAX SHEET

CGT rates of tax

Individuals making capital gains currently treat those gains as the top slice of income. This means that, currently, tapered gains are charged at 10% where gains plus taxable income do not exceed £2,230; 20% between £2,231 and £34,600; and 40% on any balance. For trustees the rate of CGT is 40%.

For 2008/09 there will be a single rate of CGT set at 18%, which will apply to individuals, trustees and personal representatives.

Every tax year individuals are allowed to make gains of up to the annual exemption without paying any CGT. This year's annual exemption is £9,200. Although it has been confirmed that the annual exemption will be retained for 2008/09 the amount of the exemption has yet to be announced. We have included an estimated amount of £9,500 in the following examples for illustration purposes.

The withdrawal of taper relief

Taper relief was introduced for disposals on or after 6 April 1998 and can reduce the amount of the gain chargeable to CGT. The amount of relief available depends on whether the asset is classed as a business or non-business asset and, also, on the length of time an asset has been held since 1998. The reduction for business asset taper can be as high as 75% of the gain, with a 40% maximum available for non-business assets.

For any gains arising on or after 6 April 2008 and any held over gains coming into charge on or after that date, taper relief will no longer be available. The chargeable gain will be liable to tax at 18%, after deducting allowable losses, any other relief's and the annual exemption.

What does this change mean for me?

If you are entitled to the maximum business asset taper relief, you are likely to have an effective tax rate of 10% rather than 18% for disposals in the 2007/08 tax year.

If you are entitled to the maximum non-business asset taper relief, you are likely to have an effective tax rate of 24% (60% x 40%) for disposals in the 2007/08 tax year, rather than 18% proposed in 2008/09. You may be better off selling after 5 April 2008 but you need to consider the effect of the withdrawal of indexation allowance (see below).

The withdrawal of indexation allowance

Indexation allowance was, for individuals and trustees, the precursor to taper relief and gave relief for the effect of inflation on the costs incurred on acquiring and improving assets. Indexation was frozen as at 5 April 1998. Currently, where an asset was held at 6 April 1998 and is disposed of after that date, any gain on the disposal may be eligible for both indexation and taper relief.

For disposals on or after 6 April 2008 indexation allowance will no longer be available.

What does this change mean for me?

If you acquired investment assets before 1998 you need to consider the effect of the loss of indexation allowance. For example, an asset purchased in September 1988 would qualify for a 50% uplift in cost if sold before April 2008. This may reduce your effective tax rate to below 18%.

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| Example | Sale in 2007/08 £ | Sale in 2008/09 £ |
|----------------------------------|-------------------------|-------------------------|
| Current market value of asset | 600,000 | 600,000 |
| Less: Cost of asset in Sept 1988 | (300,000) | (300,000) |
| Less: Indexation allowance (0.5) | (150,000) | – |
| Gain before taper relief | 150,000 | 300,000 |
| Less: taper relief (40%) | (60,000) | – |
| Gain after taper relief | 90,000 | 300,000 |
| Less: annual exemption | (9,200) | (9,500) |
| Taxable gain | 80,800 | 290,500 |
| CGT at 40% / 18% | £32,320 | £52,290 |

The indexation allowance applies to the original cost of the asset, so if this was low the loss of indexation allowance may not be so important, even if the asset has been held for longer. An asset purchased in April 1982 would qualify for indexation allowance of over 100% if it is sold before 6 April 2008 but the base cost in 1982 may be low compared to today's market value.

| Example | Sale in 2007/08 £ | Sale in 2008/09 £ |
|------------------------------------|-------------------------|-------------------------|
| Current market value of asset | 600,000 | 600,000 |
| Less: Cost of asset in April 1982 | (100,000) | (100,000) |
| Less: Indexation allowance (1.006) | (100,600) | – |
| Gain before taper relief | 399,400 | 500,000 |
| Less: taper relief (40%) | (159,760) | – |
| Gain after taper relief | 239,640 | 500,000 |
| Less annual exemption | (9,200) | (9,500) |
| Taxable gain | 230,440 | 490,500 |
| CGT at 40% / 18% | £92,176 | £88,290 |

Simplification of the share identification rules

The current rules for the identification of shares and securities for CGT purposes require a complex order of identification, which is dependent upon the dates when the assets were acquired. Shares of the same company and same class are treated as if the last shares acquired since 5 April 1998 are disposed of first unless the shares are disposed on the acquisition date or within 30 days of that date.

Due to the changes to taper relief and indexation allowance, all shares of the same class in the same company will be treated as forming a single asset from 6 April 2008, regardless of when they were originally acquired. However, 'same day' and '30 day' anti-avoidance rules will remain.

What does this change mean for me?

In general you will be better off under the new system (if your shares are non-business assets) by selling in 2008/09.

Normal planning rules continue to apply regarding the utilisation of your annual exemption each year.

Other more complex areas

Capital gains can arise in many other situations. Some of these, such as gains on Enterprise Investment Scheme and Venture Capital Trust shares, and rolled over gains on share for share or share for loan note exchanges, can be complex. Please talk to us before making any decisions.

Things that will not change

And finally, many existing reliefs will continue to be available, such as:

- private residence relief;
- business asset roll-over relief, which enables the gain on a business asset to be deferred until a point in the future;
- business asset gift relief, which allows the gain on business assets that are given away to be held over until the assets are disposed of by the donee; and
- any unused allowable losses from previous years, which can be brought forward in order to reduce any gains.

“The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.”