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Capital taxes: a beginner's guide

Pulling up stumps to pass your business on to the next generation earlier than anticipated? Relocating to work remotely with a view of the sea?

If, like many people, the pandemic has prompted you to reappraise your long term goals, the next step to turning aspirations into reality is to assess the financial consequences of your decision. We look here at the two capital taxes that might influence your thinking: capital gains tax (CGT) and inheritance tax (IHT).

Capital gains tax: an overview

CGT is all about taxing the gains on disposal of investments and other significant assets: assets usually held for the long term, either as part of your business, or personally. Indeed, your business itself can be a taxable asset if you sell it. Companies pay corporation tax on chargeable gains arising from the sale or disposal of an asset, rather than CGT.

Exemptions and reliefs from CGT include:

- CGT annual exemption, an amount of gain you can make before paying any tax. This is currently frozen at £12,300 until 5 April 2026
- principal private residence relief (PPR), applying to the sale of your main home
- reliefs for particular groups of assets, such as Business Asset Disposal Relief, formerly known as Entrepreneurs' Relief
- chattels relief, exempting most small personal items from charge, where proceeds are £6,000 or less. It covers things like items of household furniture, paintings and antiques.

Note: there's usually no CGT to pay on gifts to a husband, wife, civil partner or charity. The term spouse includes married couples and registered civil partners hereafter in this briefing.

CGT: how is it worked out?

Capital gains can arise when certain capital (or 'chargeable') assets are sold at a profit, or given away at less than market value. The gain is the sale

proceeds (after selling costs), minus the purchase price (including incidental costs of acquisition).

The rate of CGT you pay depends on your total income and gains. You pay at 10% (and 18% on residential property that doesn't qualify for PRR) if all your income and gains are within the income tax basic rate band. If the total takes you into the income tax higher rate band, you pay CGT at different rates: at 10% on the first part and at 20% on the part that falls into the higher rate band (and 28% on residential property that doesn't qualify for PRR).

CGT: what about my business?

Business Asset Disposal Relief (BADR) may be available for certain business disposals. It has the effect of charging the first £1 million of gains qualifying for the relief at an effective rate of 10%. Strict conditions apply if you are to qualify for BADR and it is essential to plan with these in mind. Please do talk to us for advice for your specific circumstances.

In overview, the relief is available to individuals on the disposal of:

- the whole, or part, of a trading business you carry on, whether alone, or in partnership
- shares in your 'personal company'
- assets used by a business or a company which has ceased within the last three years.

Where you make a qualifying business disposal, relief may also be available on what is called an 'associated' disposal. An associated disposal is a disposal of an asset:

- used in a qualifying company or group of companies belonging to you or
- used in a partnership, where you are a partner.

There can be restrictions on obtaining the relief on an associated disposal in some situations. This can happen, for example, where a property is in personal ownership, but used in an unquoted company or partnership trade, in return for a rent.

Key conditions

Period of ownership. Ownership conditions apply throughout the period, up to the date of disposal. For disposals on or after 6 April 2019, the necessary qualifying period of ownership is two years.

5% rule for company shareholders. Here, the company must be your 'personal company' and you must be a company employee or office holder: holding at least 5% of the company's ordinary share capital and able to exercise at least 5% of the voting rights. For disposals on or after 29 October 2018, you must also satisfy one of the following tests:

- a distribution test: this means being entitled to at least 5% of the company's profit available for distribution to equity holders and 5% of the assets available for distribution to equity holders in a winding up: or
- a proceeds test: this means being entitled to at least 5% of the proceeds in the event of a disposal of the whole of the ordinary share capital of the company.

There are also provisions for the scenario where your shareholding in the company is reduced below the normal 5% qualifying level, where this has arisen through the issue of new shares to raise funds for commercial purposes. Please contact us for more detail here.

CGT: what about the family home?

Principal private residence relief (PPR) exempts gains made on the sale of your home, whatever the level of gain. That's the broad overview, but there are important conditions to bear in mind to obtain relief.

Firstly, only a property that you have actually occupied as your residence can qualify. This rules out an investment property in which you've never lived. Secondly, 'occupation' requires a degree of permanence. Substantial renovation of a property,

followed by immediate sale, for example, can open the window to HMRC maintaining that the quality of permanence is lacking and is an issue that has caused problems for some taxpayers. If this is an area of concern to you, we would recommend a discussion as early in the process as possible.

Land for 'occupation and enjoyment with the residence as its garden or grounds up to the permitted area' is included in the exemption. The permitted area is half a hectare, including the site of the property itself. There can be a case to include a larger area of garden and grounds, if appropriate to the size and character of the property and required for its reasonable enjoyment: this is sometimes of particular relevance where equestrian interests are involved. Again, we would be pleased to provide further guidance on this or other issues.

Inheritance tax: an overview

As a Report by the Office of Tax Simplification puts it, 'Although only a small number of people pay IHT each year, a far greater number worry about it.'

IHT is levied on the estate on death, on certain gifts made to individuals within seven years of death and some other lifetime gifts. Lifetime gifts and gifts on death between UK-domiciled spouses are exempt from IHT and in fact, fewer than 5% of deaths create a liability to IHT.

IHT: rates and thresholds

On death, IHT is charged at 40% and at 20% on lifetime transfers, where chargeable. Until 5 April 2026, the IHT threshold (known as the nil rate band) is frozen at £325,000.

You and your spouse can transfer any nil rate band unused on the first death to the survivor. It can then be used on the second death, when the estate has both the nil rate band of the second deceased and the transferred unused portion of the first spouse. Such a transfer can be utilised where the second death takes place on or after 9 October 2007, regardless of the date of the first death.

IHT: what about residential property?

For deaths on or after 6 April 2017, there has been an additional nil rate band, known as the residence nil rate band (RNRB), applying when you pass an interest in what is known as a qualifying residence to direct descendants. This is currently £175,000 and like the nil rate band, is frozen until 5 April 2026.

For many married couples, the relief is effectively doubled: each individual has a main nil rate band and each potentially benefits from the RNRB. Where the deceased spouse did not use, or was not entitled to use, their full RNRB, the survivor may be entitled to an increase in the RNRB. The calculation can be complex, but the increase often means a doubled RNRB for the surviving spouse. Please do talk to us for further information.

The RNRB can only be used in respect of one residential property. It does not have to be the main family home, but it must at some point have been a residence of the deceased. There are restrictions where an estate (before reliefs) is worth more than £2 million. The RNRB may also be available if you downsize, or cease to own a home on or after 8 July 2015 and assets of an equivalent value, (up to the value of the RNRB), are passed, on death, to your direct descendants.

IHT: what can I give away?

Much estate planning hinges on making lifetime transfers in order to use exemptions and reliefs and to take advantage of the lower rate of tax on lifetime transfers. Key planning points include use of the IHT annual exemption of £3,000; use of IHT gifting provisions, such as those for 'small gifts' (not exceeding £250 in total per tax year, per recipient); gifts for weddings/civil partnerships; gifts for family maintenance; and gifts that qualify as being normal expenditure out of income.

Particularly significant are the provisions on making lifetime gifts to individuals (potentially exempt transfers). Where the donor survives for seven years, no IHT is due. Taper relief, reducing the rate of IHT, may be available for gifts made three to seven years before death.

Chargeable transfers, such as lifetime gifts to trusts, covered by the nil rate band can be made without an IHT liability. Once seven years have elapsed between chargeable transfers, the clock is reset: the earlier transfer is no longer taken into account in determining IHT on later transfers. In other words, a full nil rate band is available every seven years for lifetime chargeable transfers.

IHT: what about my business?

Business property relief (BPR) and agricultural property relief (APR) are important IHT reliefs, enabling businesses and farms to pass down the generations without being sold or broken up on the death of the owner. BPR provides either 50% or 100% relief on the value of what is called 'relevant business property'. Not every business or interest in a business is eligible and relief is generally only available if the deceased owned the business or asset for at least two years before death. The business must not consist wholly or mainly of holding investments: this is not defined in the legislation, but is thought of as a greater than 50% test. This is only a broad overview, however, and we should be delighted to advise further.

Working with you

Whatever your aspirations for the future, planning for capital taxes can help pave the way. It's an area where advice specific to your circumstances is essential and where advance planning will always improve the outcome. Please don't hesitate to contact us to start a discussion.