CHARGEABLE GAINS, PART 2

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The second of a two-part article focuses on shares, reliefs, and the way in which gains made by limited companies are taxed

This two-part article is relevant to candidates sitting Paper F6 (UK) in either the June or December 2013 sittings, and is based on tax legislation as it applies to the tax year 2012–13 (Finance Act 2012). Read part 1 here

Question 3 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 (CONTINUED)

Shares

The disposal of shares can create a particular problem. This is because the shares disposed of might have been purchased at different times, and it is then difficult to identify exactly which shares have been sold. Disposals of shares are matched with purchases in the following order:

- Shares purchased on the same day as the disposal.
- Shares purchased within the following 30 days.
- Shares in share pool.

The share pool aggregates all purchases made up to the day of the disposal.

Example 1

Ivy has had the following transactions in the shares of Jing plc:
1 June 2005 – Purchased 4,000 shares for £6,200.
30 April 2010 – Purchased 2,000 shares for £8,800
15 July 2012 – Purchased 500 shares for £2,500
15 July 2012 – Sold 4,500 shares for £27,000

Ivy's chargeable gain for 2012–13 is as follows:

	£
Purchase 15 July 2012	
Disposal proceeds (27,000 x 500/4,500)	3,000
Cost	2,500

	£	
	______	
		500
Share pool		
Disposal proceeds (27,000 x 4,000/4,500)	24,000	
Cost	(10,000)	
	________	
		14,000
		_______
		14,500
		_______

Share pool

	Number	
Purchase 1 June 2005	4,000	6,200
Purchase 30 April 2010	2,000	8,800
	________	________
	6,000	15,000
Disposal 15 July 2012 (15,000 x 4,000/6,000)	(4,000)	(10,000)
	________	________

	Number	
Balance carried forward	2,000	5,000
	_______	_______

- The disposal is first matched with the same day purchase and then against the share pool.

The reason that disposals are matched with shares purchased within the following 30 days is to prevent a practice known as bed and breakfasting. A person might sell shares at the close of business one day and then buy them back at the opening of business the next day. Previously, a chargeable gain or a capital loss could thus be established without a genuine disposal being made. The 30-day matching rule makes bed and breakfasting much more difficult, since the subsequent purchase cannot take place within 30 days.

Example 2

Keith purchased 1,000 shares in Long plc on 5 July 2012 for £10,000. The shares have fallen in value, so he would like to establish a capital loss. Therefore the shares were sold on 2 December 2012 for £2,000, and purchased back on 10 December 2012 for £1,900.

Keith's transactions are caught by the 30-day matching rule. The disposal on 2 December 2012 will be matched with the purchase on 10 December 2012, and so for 2012–13 he will have a chargeable gain of £100 (2,000 – 1,900).

With individuals it might be necessary to establish a market value figure where the shares are disposed of by way of a gift rather than being sold.

Example 3

Maude made a gift of her entire shareholding of 10,000 £1 ordinary shares in Night plc to her daughter. On the date of the gift the shares were quoted at £5.10 – £5.18, with recorded bargains of £5.00, £5.15 and £5.22.

- The shares in Night plc are valued at the lower of the quarter up price (£5.10 + ¼(£5.18 – £5.10) = £5.12) and the average of the days highest and lowest bargains ((£5.00 + £5.22)/2 = £5.11).
- The deemed proceeds figure is therefore £51,100 (10,000 x 5.11).

With a bonus issue there is no additional cost involved. The only thing that changes is the number of shares held.

Example 4

On 22 January 2013 Oliver sold 30,000 £1 ordinary shares in Pink plc for £140,000. Oliver had purchased 40,000 shares in Pink plc on 9 February 2011 for £96,000. On 3 April 2012 Pink plc made a 1 for 2 bonus issue.

Oliver’s chargeable gain for 2012–13 is as follows:

Disposal proceeds	140,000
Cost	(48,000)
	_______
	92,000
	_______

- Oliver was issued with 20,000 (40,000 x 1/2) new ordinary shares as a result of the bonus issue.
- The cost of the shares sold is therefore £48,000 (96,000 x 30,000/(40,000 + 20,000)).

With a rights issue the new shares are paid for, and so the cost figure will have to be adjusted.

Example 5

On 22 January 2013 Quinn sold 30,000 £1 ordinary shares in Red plc for £140,000. Quinn had purchased 40,000 shares in Red plc on 9 February 2010 for £100,000. On 3 May 2012 Red plc made a 1 for 2 rights issue. Quinn took up her allocation under the rights issue in full, paying £3.00 for each new share issued.
Quinn’s chargeable gain for 2012–13 is as follows:

Disposal proceeds	140,000
Cost	(80,000)
	_______
	60,000
	_______

- Quinn was issued with 20,000 (40,000 x 1/2) new ordinary shares under the rights issue at a cost of £60,000 (20,000 x £3.00).

- The cost of the shares sold is therefore £80,000 (100,000 + 60,000 = 160,000 x 30,000/(40,000 + 20,000)).

A paper for paper takeover or reorganisation is not a chargeable disposal. The new shares simply take the place of the original shares, and are deemed to have been purchased at the same time and for the same cost. Where more than one class of new share is acquired as a result of the takeover/reorganisation, the original cost is apportioned according to the market values of the new shares immediately after the takeover/reorganisation.

Example 6

On 28 March 2013 Rita sold her entire holding of £1 ordinary shares in Sine plc for £55,000. Rita had originally purchased 10,000 shares in Sine plc on 5 May 2010 for £14,000. On 7 August 2011 Sine plc had a reorganisation whereby each £1 ordinary share was exchanged for two new £1 ordinary shares and one £1 preference share. Immediately after the reorganisation each £1 ordinary share in Sine plc was quoted at £2.50 and each £1 preference share was quoted at £1.25.
Rita’s chargeable gain for 2012–13 is as follows:

Disposal proceeds	55,000
Cost	(11,200)
	_______
	43,800
	_______

- On the reorganisation Rita received new ordinary shares valued at £50,000 (2 x 10,000 x £2.50) and preference shares valued at £12,500 (10,000 x £1.25).
- The cost attributable to the ordinary shares is £11,200 (14,000 x 50,000/(50,000 + 12,500).

Where cash is received on a takeover then the normal disposal rules will apply.

Example 7

Cherry purchased 12,000 £1 ordinary shares in Alphabet Ltd on 27 July 2005 for £23,900. On 15 July 2012 Alphabet Ltd was taken over by ABC plc, and Cherry received £6 for each of her shares in that company.
Cherry’s chargeable gain for 2012–13 is as follows:

Disposal proceeds (12,000 x £6)	72,000
Cost	(23,900)
	_______
	48,100
	_______

Where a takeover is partly for shares and partly for cash then the part disposal rules will apply.

Example 8

Richard purchased 10,000 £1 ordinary shares in Split plc on 21 July 2009 for £23,100. On 28 August 2012 Split plc was taken over by Combined plc. For each of his £1 ordinary shares in Split plc, Richard received two £1 ordinary shares in Combined plc plus £2.50 in cash. Immediately after the takeover Combined plc's £1 ordinary shares were quoted at £4.00.

Richard's chargeable gain for 2012–13 is as follows:

Disposal proceeds (10,000 x £2.50)	25,000
Cost	(5,500)
	_______
	19,500
	_______

- On the takeover Richard received new ordinary shares valued at £80,000 (2 x 10,000 x £4.00) and cash of £25,000.
- The cost attributable to the cash element is £5,500 (23,100 x 25,000/(25,000 + 80,000).

Rollover relief

Rollover relief allows a chargeable gain to be deferred (rolled over) where the

disposal proceeds of the old asset are reinvested in a new asset. The deferral is achieved by deducting the chargeable gain from the cost of the new asset.
To qualify for rollover relief both the old asset and the new asset must be qualifying assets. The most relevant types of qualifying asset as far as Paper F6 (UK) is concerned are:

- Land and buildings
- Fixed plant and machinery
- Goodwill

It is not necessary for the old asset and the new asset to be in the same category.

Example 9

What are the conditions that must be met in order that rollover relief can be claimed?

- The reinvestment must take place between one year before and three years after the date of disposal.
- The old and new assets must both be qualifying assets and be used for business purposes.
- The new asset must be brought into business use at the time that it is acquired.

Where the disposal proceeds of the old asset are not fully reinvested in the new asset, the amount not reinvested reduces the amount of chargeable gain that can be rolled over. Therefore if the amount not reinvested is greater than the chargeable gain no rollover relief is available.

Where the new asset is a depreciating asset, then the gain does not reduce the cost of the new asset but is instead held over. A depreciating asset is an asset with a predictable life of less than 60 years. The only types of depreciating asset that you need to be aware of are fixed plant and machinery and short leaseholds.

Example 10

Violet sold a factory on 15 August 2012 for £320,000, and this resulted in a chargeable gain of £85,000. She is considering the following alternative ways of reinvesting the proceeds from the sale of her factory:

- A freehold warehouse can be purchased for £340,000.
- A freehold office building can be purchased for £275,000.
- A leasehold factory on a 40-year lease can be acquired for a premium of £350,000.
- A freehold factory can be purchased for £230,000.

The reinvestment will take place during November 2012.

Freehold warehouse

- The sale proceeds are fully reinvested, and so the whole of the chargeable gain can be rolled over.
- The base cost of the warehouse will be £255,000 (340,000 – 85,000).

Freehold office building

- The sale proceeds are not fully reinvested, and so £45,000 (320,000 – 275,000) of the chargeable gain cannot be rolled over.
- The base cost of the office building will be £235,000 (275,000 – (85,000 – 45,000)).

Leasehold factory

- The sale proceeds are fully reinvested, and so the whole of the chargeable gain can be held over.
- The factory is a depreciating asset, and so the base cost of the factory is not adjusted.
- The chargeable gain is held over until the earlier of November 2022 (10 years from the date of acquisition), the date that the factory is sold, or the date that it ceases to be used in the business.

Freehold factory

- No rollover relief is available as the amount not reinvested of £90,000 (320,000 – 230,000) exceeds the chargeable gain.
- The base cost of the factory will remain at £230,000.

When the asset disposed of was not used entirely for business purposes then the proportion of the chargeable gain relating to the non-business use does not qualify for rollover relief.

Example 11

Willow sold a freehold factory on 8 November 2012 for £146,000, and this resulted in a chargeable gain of £74,000. The factory was purchased on 15 January 2010. 75% of the factory had been used for business purposes by Willow as a sole trader, but the other 25% was never used for business purposes. Willow purchased a new freehold factory on 10 November 2012 for £156,000.
Willow's chargeable gain for 2012–13 is as follows:

Gain	74,000
Rollover relief (74,000 – 18,500)	(55,500)
	———
	18,500
	———

- The proportion of the chargeable gain relating to non-business use is £18,500 (74,000 x 25%), and this amount does not qualify for rollover relief.
- The sale proceeds are fully reinvested, and so the balance of the gain can be rolled over.
- The base cost of the new factory is £100,500 (156,000 – 55,500).

Holdover relief

Holdover relief allows a chargeable gain to be deferred (held over) when a gift is made of a qualifying business asset. The deferral is achieved by deducting the chargeable gain of the donor who has made the gift from the base cost of the donee who has received the gift.
Holdover relief is also available when a sale is made at less than market value. In this case there will be an immediate charge to capital gains tax (CGT) where the sale proceeds exceed the original cost of the asset.

For Paper F6 (UK) the most relevant types of qualifying business asset are as follows:

- Assets used for trade purposes by a sole trader.
- Shares in a personal company (where the individual has at least a 5% shareholding).
- Shares in unquoted trading companies.

Remember that the market value of an asset is used rather than the actual proceeds when a gift is made between family members since they will be connected persons.

Example 12

On 15 August 2012 Xia sold 10,000 £1 ordinary shares in Yukon Ltd, an unquoted trading company, to her daughter for £75,000. The market value of the shares on that date was £110,000. The shareholding was purchased on 10 July 2011 for £38,000. Xia and her daughter have elected to hold over the gain as a gift of a business asset. Xia’s chargeable gain for 2102–13 is as follows:

Deemed proceeds	110,000
Cost	38,000
	_______
	72,000
Holdover relief (72,000 – 37,000)	35,000
	_______

	37,000

- Xia and her daughter are connected persons, and therefore the market value of the shares sold is used.
- The consideration paid for the shares exceeds the allowable cost by £37,000 (75,000 – 38,000). This amount is immediately chargeable to CGT.
- The daughter’s base cost will be £75,000 (110,000 – 35,000).

If a gift is going to result in an immediate chargeable gain, it might be possible to restrict the gain to the amount of the annual exempt amount or any available capital losses.

Example 13

Bertie has a holding of 5,000 £1 ordinary shares in Gift Ltd, an unquoted trading company, which he had originally purchased for £2.35 per share. The current market value of the shares is £7.50, but Bertie is going to sell some of the holding to his son at £5.00 per share during 2012-13. Bertie and his son will elect to hold over any gain as a gift of a business asset.
The consideration paid for each share will exceed the allowable cost by £2.65 (5.00 – 2.35), and this amount will be immediately chargeable to CGT.

The annual exempt amount for 2012–13 is £10,600, so Bertie can sell 4,000 shares (10,600/2.65) to his son without this resulting in any CGT liability.

Where entrepreneurs’ relief is available, it may not be beneficial to claim holdover relief.

Example 14

On 10 April 2012 Pia made a gift of her entire holding of 60,000 £1 ordinary shares (a 60% shareholding) in Zuper Ltd, an unquoted trading company, to her daughter, Rita. Pia had purchased the shares on 1 June 2002 for £60,000, and was an employee of the company from that date until 10 April 2012. The market value of the shares on 10 April 2012 was £260,000.
Rita sold the 60,000 £1 ordinary shares in Zuper Ltd on 28 March 2013 for £270,000. She has never been an employee or a director of the company.

Both Pia and Rita are higher rate taxpayers, and neither of them made any other chargeable gains during the tax year 2012–13.

No election for holdover relief

Pia’s CGT liability for 2012–13 is as follows:

Deemed proceeds	260,000
Cost	(60,000)
	200,000
Annual exempt amount	(10,600)
	189,400
Capital gains tax: 189,400 at 10%	18,940

Rita will not have a CGT liability for 2012–13 as her chargeable gain of £10,000 (270,000 – 260,000) is less than the annual exempt amount.

Election for holdover relief

Rita's CGT liability for 2012–13 is as follows:

	£	
Disposal proceeds		270,000
Cost	260,000	
Held over again	(200,000)	
		(60,000)
		210,000
Annual exempt amount		(10,600)

	£
	______
	199,400
	______
Capital gains tax: 199,400 at 28%	55,832
	______

Rita's disposal does not qualify for entrepreneurs' relief as she is not an officer or an employee of Zuper Ltd, and she has not met the qualifying conditions for one year prior to the date of disposal.

A claim for holdover relief will result in an overall CGT liability of £55,832 compared to £18,940 if no claim is made. A claim is not therefore beneficial.

Where the disposal consists of shares in a personal company, holdover relief will be restricted if the company has chargeable non-business assets.

Example 15

On 5 October 2012 Zia made a gift of her entire holding of 20,000 £1 ordinary shares in Apple Ltd, a personal company, to her daughter. The market value of the shares on that date was £200,000. The shares had been purchased on 1 January 2012 for £140,000. On 5 October 2012 the market value of Apple Ltd's chargeable assets was £150,000, of which £120,000 was in respect of chargeable business assets. Zia and her daughter have elected to hold over the gain as a gift of a business asset.
Zia's chargeable gain for 2012–13 is as follows:

Deemed proceeds	200,000
Cost	(140,000)
	______
	60,000
Holdover relief	(48,000)
	______

	12,000
	________

- Holdover relief is restricted to £48,000 (60,000 x 120,000/150,000), being the proportion of chargeable assets to chargeable business assets.

The transfer of a business to a limited company

Rollover relief is available when an unincorporated business is incorporated. For relief to be available all the assets of the unincorporated business must be transferred to the new limited company in exchange for a consideration that must be wholly or partly in the form of shares.

The deferral is achieved by deducting the chargeable gains arising on the disposal of the assets of the unincorporated business from the value of the shares received from the new limited company.

Where some of the consideration is in the form of cash or a loan, then that proportion of the chargeable gains cannot be rolled over.

Example 16

On 8 August 2012 Bua incorporated a business that she had run as a sole trader since 1 March 2008. The market value of the business on 8 August 2012 was £250,000. All of the business assets were transferred to a new limited company, with the consideration consisting of 200,000 £1 ordinary shares valued at £200,000 and £50,000 in cash. The only chargeable asset of the business was goodwill, and this was valued at £100,000 on 8 August 2012. The goodwill had a nil cost.

Bua’s chargeable gain for 2012–13 is as follows:

Deemed proceeds	100,000
Cost	(Nil)
	________
	100,000
Rollover relief (100,000 – 20,000)	(80,000)
	________

	20,000

- The proportion of the chargeable gain relating to the cash consideration cannot be rolled over, so £20,000 (100,000 x 50,000/250,000) of the gain is immediately chargeable to CGT.
- The base cost of the shares in the new limited company will be £120,000 (200,000 – 80,000).
- If the consideration had consisted of just shares then the whole gain of £100,000 would have been rolled over.
- However, it will be beneficial to take some of the consideration in the form of cash or a loan if the resulting chargeable gain means that the annual exempt amount and capital losses can be utilised.

Rollover relief on incorporation is given automatically, but it is possible to elect for the relief not to apply. This might be done in order to claim entrepreneur’s relief instead.

In the exam

- A question may ask you to just calculate a person’s chargeable gains or taxable gains rather than their CGT liability. If this is the case then do not waste time calculating the liability, as there will be no marks for doing so.
- Make sure you identify any exempt disposals so that you do not waste time performing unnecessary calculations.
- A question may tell you that a certain relief is not available for a particular disposal. Make a careful note of such guidance or you will waste time and might also lose marks as well.
- An unincorporated business is not treated as a separate entity for CGT purposes. Therefore, when a business is disposed of you should deal with each asset separately.
- Do not forget to deduct the annual exempt amount.
- When dealing with shares it is important to look carefully at the dates to see if same day or 30-day matching is applicable.
- It is important to establish how much of a person’s basic rate tax band is available. Remember that a taxable income figure is **after** the personal allowance has been deducted.

Example 17

On 13 July 2012 Dear sold 1,000 of her 3,000 £1 ordinary shares in XYZ plc for £6,600. She died on 5 April 2013, and the remaining 2,000 shares were inherited by her daughter. On that date these shares were valued at £15,600. The holding of 3,000 shares had been purchased on 20 June 2005 for £4,800.

- There is no CGT liability on the sale of the XYZ plc shares as the gain of £5,000 (6,600 – (4,800 x 1,000/3,000)) is less than the annual exempt amount *(note that it should be obvious that where sales proceeds are just £6,600 then there is no CGT liability).*
- The transfer of the XYZ plc shares on Dear's death is an exempt disposal.

Corporate chargeable gains

Overview

You have seen how individuals are subject to CGT. Although there are a lot of similarities in the way in which the chargeable gains of a limited company are taxed, there are also some very important differences:

- A limited company's chargeable gains form part of the taxable total profits. They are not taxed separately.
- The annual exempt amount is not available.
- Indexation allowance is given when calculating chargeable gains for a limited company.
- Limited companies can only benefit from rollover relief, and this is applied after taking account of any indexation allowance. They cannot benefit from entrepreneurs' relief, holdover relief for the gift of business assets or for rollover relief upon incorporation.

Basic computation

The basic computation for a limited company is virtually the same as for an individual. However, you may also be expected to calculate the indexation allowance:

- The indexation allowance is given from the month of acquisition up to the month of disposal.
- The indexation factor is normally rounded to three decimal places.
- The indexation allowance cannot be used to create or increase a capital loss.
- Because the indexation allowance is not available in respect of the incidental costs of disposal, it is necessary to show these separately in the computation.

Example 18

Delta Ltd sold a factory on 15 February 2013 for £360,000. The factory was purchased on 24 October 1995 for £164,000, and was extended at a cost of £37,000 during March 1997.

Delta Ltd incurred legal fees of £3,600 in connection with the purchase of the factory, and legal fees of £6,200 in connection with the disposal. Retail price indices (RPIs) are as follows:

October 1995	149.8
March 1997	155.4
February 2013	243.0

	£	
Disposal proceeds		360,000
Incidental costs of disposal		(6,200)
		353,800
Cost	164,000	
Incidental costs of acquisition	3,600	
	167,600	
Enhancement expenditure	37,000	(204,600)
		149,200
Indexation – Cost 167,600 x 0.622 – Enhancement 37,000 x 0.564	 104,247 20,868	
		(125,115)
		24,085

- The indexation factor for the cost is 0.622 (243.0 – 149.8)/149.8, and for the enhancement expenditure it is 0.564 (243.0 – 155.4)/155.4.

When a limited company has a capital loss, it is first set off against any chargeable gains arising in the same accounting period. Any remaining capital loss is then carried forward and set off against the first available chargeable gains of future accounting periods.

Although chargeable gains are included as part of a company's taxable total profits, capital losses are never set off against other income.

Example 19

Even Ltd has the following results:

	Year ended 31 March 2012 £	
Trading profit/(loss)	56,000	(17,000)
Property business profit	4,000	10,000
Chargeable gain/(capital loss)	(8,000)	85,000

The corporation tax liability of Even Ltd for the years ended 31 March 2012 and 2013 is as follows:

	Year ended 31 March 2012 £	
Trading profit	56,000	–
Property business profit	4,000	10,000
Chargeable gain	–	77,000
	________	________
	60,000	87,000
Loss relief	–	(17,000)
	________	________
Taxable total profits	60,000	70,000
	________	________
Corporation tax at 20%	12,000	14,000

	Year ended 31 March 2012 £	
	________	________

- The capital loss for the year ended 31 March 2012 is carried forward, and so the chargeable gain for the year ended 31 March 2013 is £77,000 (85,000 – 8,000).

Shares

For limited companies, disposals of shares are matched with purchases in the following order:

- Shares purchased on the same day as the disposal.
- Shares purchased during the nine days prior to the disposal.
- Shares in the 1985 pool.

When calculating indexation allowances for the 1985 pool, the indexation fraction is not rounded to three decimal places.

Example 20

On 15 June 2012 Fair Ltd sold 70,000 £1 ordinary shares in Gong plc for £350,000. Fair Ltd had originally purchased 40,000 shares in Gong plc on 10 June 1995 for £110,000, and purchased a further 60,000 shares on 20 August 1999 for £180,000. Retail price indices (RPIs) are as follows:

June 1995	149.8
August 1999	165.5
June 2012	241.8

Chargeable gain

Disposal proceeds	350,000
Cost	(203,000)
	________
	147,000

Indexation allowance (308,379 – 203,000)	(105,379)
	41,621

1985 Pool

	Number £	Cost £	
Purchase June 1995	40,000	110,000	110,000
Indexation to August 1999 110,000 x (165.5 – 149.8)/149.8			11,529
			121,529
Purchase August 1999	60,000	180,000	180,000
	100,000	290,000	301,529
Indexation to June 2012 301,529 x (241.8 – 165.5)/165.5			139,013
			440,542
Disposal June 2012 Cost x 70,000/100,000	(70,000)	(203,000)	(308,379)

	Number £	Cost £	
Balance carried forward	30,000	87,000	132,163

In the exam

- Remember that limited companies are not entitled to the annual exempt amount.
- Remember that chargeable gains are part of a limited company's total taxable profits. They are not taxed separately.
- When dealing with shares it is important to look carefully at the dates to see if same day or nine-day matching applies.

Written by a member of the Paper F6 examining team