CAPITAL GAINS TAX TO INCREASE ... WHAT'S YOUR NEW STRATEGY?

The new coalition Government has indicated that there are likely to be major changes to the Capital Gains Tax (CGT) regime, which will affect landlords and property investors across the board. Although we won't know precisely what these changes are, and when they will kick in, until the emergency Budget is announced on 22 June, YPN asked specialist property accountant Stephen Fay ACA, to give us the low-down.

Stephen Fay ACA is a Chartered Accountant specialising in all aspects of property taxation, and has been a property investor since 1999. Stephen combines expert technical tax knowledge with real-life property investment experience to offer property investor clients a unique service.

Here, Stephen considers some options that property investors may consider to combat the new CGT regime...

How does the current CGT regime work?

Property investors pay CGT on the capital appreciation on their properties when they 'dispose' of a property ('dispose' generally means 'sell', but can also mean 'transfer' to another party). The tax is payable at a flat rate of 18% on the gain, after deducting an Annual Allowance of £10k. Acquisition and selling costs, as well as any 'capital improvement' spend, are deducted when calculating gains. Note that how the property is financed is not relevant for CGT purposes.

There are two types of 'asset': business assets, and non-business assets. Residential property is specifically a non-business asset, and so does not benefit from the lower CGT rates, and various tax breaks, that 'business assets' do. But, given that many modern investors effectively operate a 'business', this seems unfair. Such is life for landlords!

Currently, the top rate of income tax is 50% whereas for CGT it is only 18%. This encourages investors (of all kinds, not just property) to sell assets, rather than increase their income, and to structure their business affairs to pay CGT rather than income tax. Nick Clegg, in particular, is keen to remove this temptation!

What changes are possible in the June Budget?

Higher CGT Rate...

It's virtually certain that the CGT rate itself will increase, and the media has mentioned a figure of 40%. However, it would be very unfair for a flat rate of 40% to apply also to Basic Rate (20%) taxpayers, as well as Higher Rate (40%) taxpayers.

It's likely that capital gains will simply be added to the taxable income of a taxpayer so that, effectively, gains are taxed as income (similar to the approach before the current flat-rate was introduced by Alistair Darling).

'Inflation relief' ...

I would hope that there will be some sort of indexation relief applied to capital gains, to strip out the 'inflation element' (CGT is intended to be a tax on 'capital' gains only).

'Long-term hold' tax incentives ...

Given that modern investors have a vital role in providing long-term housing, I would also hope that some sort of taper relief will be announced (as used to be in place). Taper relief reduces the tax rate paid, the longer the asset is owned. Previously, taper relief kicked in after 3 years non-business asset ownership, and steadily reduced the effective tax rate from 40% to 24% for Higher Rate taxpayers. Personally, as a Higher Rate (40%) income tax-payer, I am pretty happy with a 24% CGT rate.

Lower Annual Allowance ...

Another potential CGT change is a reduction in the Annual Allowance, from £10k to possibly £2k. The Allowance was really only ever intended to reduce HMRC admin in dealing with small gains, rather than be a 'true' tax allowance.

Such a reduction means a higher tax bill of up to £3k per tax year.

What can we do to reduce our CGT bills?

Don't sell (or transfer) ...

The easiest way to avoid CGT is not to sell, or transfer, your properties. When you die, your CGT liabilities die with you, and Inheritance Tax kicks in, instead. It is generally easier to mitigate Inheritance Tax liabilities.

... or do sell!

Assuming the Budget changes kick in from the next tax year, 6th April 2011, now could be a good time to sell off any properties that have large capital gains, to benefit from the current low CGT rate. Ensure you have good records to get tax relief for all acquisition and selling costs, capital improvements (doe the easy stuff right!).

Claim relevant reliefs ...

If you have ever lived in a property, Private Residence Relief can be claimed, according to the proportion the property was lived in / rented, and Private Lettings Relief of up to £40k can also be claimed. These two reliefs, combined, are very powerful in minimising CGT, so if investors do get the opportunity to live in an investment property, this can be very worthwhile on sale. Husband and wives (and Civil Partners) should also ensure that properties are put into joint ownership, well before exchange of contracts, to ensure both Annual Allowances are used.

Use a company ...

Property investment companies are likely to now make more sense for investors, since corporation tax is payable at (usually) 21%, which is clearly a big saving compared to CGT and income tax for individuals at 40% or 50%. Although there remains the challenge of extracting the company profits, for many husband and wife companies, up to around £80k actual cash per tax year can be extracted with no further tax payable. For many investors this makes for a reasonable income level!

Or, be more adventurous ...

More exotic CGT options include emigrating for five complete tax years, to eliminate all CGT on gains made in the years after non-residency. This needs careful planning (contrary to popular belief, it is NOT only, or mainly, to do with how many days out of the UK you spend!). Or, investing capital gains into an Enterprise Investment Scheme company (EIS) allows capital gains to be rolled over into the shares invested (this defers, rather than wipes out, the CGT due). Finally, using a discretionary trust can also allow gains to be rolled over without CGT becoming immediately payable, allowing assets to be passed onto beneficiaries without triggering a CGT bill.

What about BTS and developers?

Don't forget that CGT only applies to investors, not to those who trade or develop property (who pay income tax and National Insurance). The equalising of CGT and income tax rates also means that there will be little incentive for investors to try to treat income as capital gains.

Finally ...

The tax regime is constantly changing, and will continue to change. Hopefully, the new Government will get the balance right between raising tax revenue, and being fair to investors. Property investors need to ensure that THEIR tax strategy is tailored to THEIR circumstances, and is re-assessed regularly.

To receive a summary of how the Budget changes will affect property investors (sent out the day after the Budget!), register for our FREE Newsletter via our website (www.fyldetaxaccountants.co.uk)

Don't forget ... if YOU don't have a plan for your property profits, the taxman does!