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CAPITAL GAINS TAX (CGT) - POSSIBLE CHANGES IN 2010 BUDGET

With the government's coffers bare, there is strong pressure not just to reduce public spending but also to raise taxation. Changes to the capital gains tax rate were predicted to be announced in the Pre-Budget Report in December 2009 but the Chancellor resisted the temptation. With a gap as wide as 32%, it is considered only a matter of time before the Government (whichever political party wins the election this year) harmonises the rates. There are many ways the Government could reduce the differential including increasing the rate generally or by introducing a higher rate of CGT for assets held for 12 months or less.

Where assets qualify for Entrepreneurs Relief (resulting in a 10% CGT rate on gains up to £1 million over a lifetime), the differential is even greater. So what opportunities are there to 'bank' the Entrepreneurs Relief or even the current rate of 18%?

Consider the following example. Ben is 62, and with his health not as good as it used to be, he is considering selling his business in the next year or two when the economy has recovered a little. He hopes to receive £5m for his company which he set up in the 1970s. The company sells fashion clothes and has built a niche market. A sale of the shares in his company which he owns outright would under current rules result in CGT as follows:

First £1m of gain taxed at 10% = £100,000
Balance £4m of gain taxed at 18% = £720,000
Total CGT due = £820,000
Net proceeds retained = £4,180,000 (83.6%)

This ignores the small base cost of the shares and the annual exemption.

Now, if the Chancellor decided in the forthcoming Budget to increase the CGT rate to 25% from 6 April 2010 (which is still only half the 50% rate of income tax) and abolish Entrepreneurs Relief, the CGT payable becomes as follows:

CGT at 25% on £5m gain = £1,250,000
Net proceeds retained = £3,750,000 (75%)

The net proceeds drop off a cliff if the rate of CGT is harmonised with the income tax rate (which happened in 1988 and carried on until 1998 when taper relief was introduced). If CGT is charged at the marginal rate of income tax of 50% (from next April), the net proceeds are as follows:

CGT at 50% on £5m gain = £2,500,000
Net proceeds retained = £2,500,000

This scenario is probably unlikely but these are unusual financial circumstances for the Government and such a possibility cannot be discounted.

So what are the options? Potential planning measures to crystallise a gain at current rates include.

- Selling the business to a third party under the current tax rules and rates. This is ideal but may be difficult to do prior to Budget Day or next April, and may not achieve the best price.

- Gift to a family member (although this does not work if the gift is to a spouse or a civil partner).

- Setting up a trust and transferring the shares to the trust. Inheritance tax issues will need to be considered.
- Transferring the shares to a company. It is possible to structure the sale whereby the sale contract can be rescinded by mutual agreement. Where a contract is made and later rescinded by mutual agreement, there is no disposal for CGT purposes. One possibility could be to enter into a contract for sale in this tax year with completion in the next tax year.

Sole traders or partners should consider whether there is benefit in incorporating the business thereby rebasing the assets. This could be a sale of assets for cash or with consideration credited to a director’s loan account enabling tax efficient withdrawal of funds out of the profit made by the business.

The key point in any crystallisation of the gain is that a tax charge will be triggered. Bringing forward a disposal that results in a CGT liability will of course also advance the date of payment of CGT and this will be a factor to consider in deciding whether to make a transfer of an asset.

As always, specific advice will be needed in relation to each individual’s circumstances. In summary, the discrepancy in the CGT rate and the income tax rate makes it highly probable that in 2010, the CGT rate will be raised to bring it more into line with income tax rates. Some relief is likely to be provided where the asset has been owned for a certain period of time such as 12 months. However, entrepreneurs need to consider their CGT position NOW in conjunction with their tax advisors.

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