

## Article for New Model Adviser

### Q and A Tax

#### Reducing Capital Gains

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#### 1,634 Words

Annie Best is 65 years old and has recently retired. She has decided to sell the flat she used in Birmingham as a pied à terre and realises that the sale will trigger a capital gains tax liability. After a conversation with her son, Mark, Annie had an initial meeting with Ben Dawson, Mark's IFA, a couple of weeks ago, to see whether there were any ways that the tax liability could be reduced.

Annie has now come back for a second meeting with Ben.

“Well Annie, I'm pleased to tell you that I think we may be able to reduce your tax bill”, starts Ben.

“Oh, Ben, I'm so glad Mark suggested I spoke to you. He was sure that you'd be able to help. He says he's known you for a long time and never managed to come up with anything yet that you haven't been able to help him with.”

“Well, I'm very pleased that his gardening business seems to be going so well now. He's had to work hard to make it successful, hasn't he? Now Annie, let's have a look at your situation. Since we last met, I've been through the information that you gave me and come up with some proposals that I'm sure you'll find interesting. There are quite a few figures involved in this, so I've written a short report for you to take away with you, but let's go over the main points together, shall we?”

Annie nods expectantly.

“So, to recap, you've decided to sell your flat in Birmingham, but are worried about the amount of tax that you think you'll need to pay.”

“Yes, Ben, that's right,” says Annie, “and since we last met, I've received an offer for the flat for the asking price, so I've accepted it.”

“That's great, Annie – it also makes my job easier as it means that the figures I've prepared won't need to be changed! So you're selling for £112,950 and, after estate agent's and legal fees, expect to end up with about £109,000?”

Annie nods.

“You bought the flat in November 1993 for £30,000, including legal costs, and haven’t made any major improvements to it apart from decorating it and minor maintenance every now and then. When do you expect your sale to complete?”

“Well, Ben, the man buying it is a cash buyer and has said, if possible, he’d like to get everything tied up by Christmas, but if not, certainly early in the new year.”

“Good. OK, Annie, I’ve done some calculations and estimated your potential capital gains tax liability – let’s have a look at this, and then we can discuss ways of reducing it. Now, I don’t know how much you know about capital gains tax, but it is not one of the easiest taxes to understand.”

“There has been quite a lot in the papers about it recently, hasn’t there?” says Annie, “hasn’t that new Chancellor done something that a lot of business people don’t like?”

“Yes”, laughs Ben, “he has come up with some proposals that don’t seem too popular. If your sale does complete before April, these won’t affect you, but we will have a look at what your tax liability would be if the sale takes longer than expected.”

“So, assuming that everything completes before 6 April, your capital gains tax liability will arise in the current tax year, although the tax won’t actually be payable until the end of January 2009. There are two reliefs that we can claim to reduce the amount of your gain, indexation allowance, which applied up until April 1998 and effectively gives an allowance for inflation, and taper relief that has applied since. Based on this calculation, I have calculated the taxable capital gain to be £35,536.”

“Really, that sounds better than I was expecting – I thought it would be closer to double that”, says Annie.

“Now, to calculate the CGT liability, we need to add the taxable gain onto your taxable income for the current tax year to see what tax rates will apply. Last time we met, you told me that you expected your income for the current tax year to be around £29,000, of which about £18,000 is salary received before you retired and £8,000 from your state and occupational pension schemes. You also have about £60,000 in a deposit account which you expect to produce about £3,000 gross interest. Are these figures still correct?”

“Yes, Ben, I think they’re about right.”

“OK, based on these, I have estimated your taxable income for the current year to be £23,775 giving an income tax liability of £4,902. The taxable capital gain is then added to your taxable income and taxed at 20% for any part that falls in the basic rate band, up to £34,600 in total, and 40% for any part above £34,600. This gives a capital gains tax liability of £12,049 and total tax payable of £16,951. Now, I know that sounds a lot, but there are a couple of things that we can do to reduce it.”

“As you may know, as you have attained the age of 65 during this tax year, you are entitled to what is known as age allowance for income tax purposes, which effectively means more of your income can escape the income tax net, but, unfortunately, as your taxable income exceeds the limit of, currently, £20,900, this age allowance is cut back, in your case, due to the level of your income to the standard rate of £5,225.”

“That doesn’t sound very fair, does it Ben?” says Annie.

“No, perhaps not”, replies Ben, “but, one of the things we can look at to reduce your CGT bill is to make a contribution to a personal pension. Based on your earnings for this year, you could pay a maximum of £18,000 gross into a pension and receive income tax relief. Paying this contribution would also reduce the tax rate on part of your taxable capital gain from 40% to 20% and give you back the benefit of age allowance. In addition, as a pension, it can provide you with some further income for the rest of your life.”

“Wow, Ben, that sounds good, but I am not sure that I can afford to put £18,000 into a pension at my age, especially as I have just retired.”

“Well, bear with me, Annie, and let me take you through the figures before you make your mind up. As I said before, you get income tax relief on a pension contribution, and the way this works means that you only have to pay the net amount and the tax relief is claimed on your behalf, so rather than paying £18,000 across, you would only need to pay £14,040 for £18,000 to be invested on your behalf. You could then decide to draw the pension immediately and take 25% or £4,500, as a tax-free cash sum, reducing the effective cost to £9,540. The remaining £13,500 in the pension fund could be used to purchase an annuity, which I would estimate to be in the region of £750 per year, if it increases in payment each year at 3% to counter the effects of inflation. So, counting the first year’s annuity payment, the net cost comes down to £8,790, or less than half what you were expecting to pay a couple of minutes ago!”

“Well, that certainly is starting to sound more interesting”, says Annie.

“And, it doesn’t stop there, Annie. Remember I said we could also save some CGT and give you back your age allowance? We could also reduce your tax bill slightly by restructuring your deposit account so that the balance of the interest payments that you would have received this year aren’t paid until after 5 April 2008, so they fall in the next tax year. Incidentally, the annuity payments from the pension would also be set up so you don’t receive the first payment until the next tax year. I have calculated your revised tax liability, so let’s have a look – you’ll see that your net income has reduced by just under £300, but you will be receiving the deposit interest we have moved to next year in April, and this will be subject to less tax than if it had been paid this year. More importantly, you will also see that your income tax liability for this year has reduced by £711 and the CGT liability by £4,265, so in total we have saved almost £5,000 in tax. This reduces the effective cost of the pension contribution to £3,814, but, to be fair, let’s add back the reduction in your net income, so the net cost

to you for providing the pension of £750 a year, increasing at 3% pa, becomes £4,103.”

“Ben, that sounds fantastic. I think I have even followed your calculations and it all makes sense to me. You did mention that there were some changes to capital gains tax from next April, would these save me even more?” asks Annie.

“What the Chancellor is proposing is a simplification, which means a flat rate of tax of 18% and the abolition of the indexation allowance and taper relief from which you have benefited. In effect, your capital gain next year, if we assume the same CGT annual exemption of £9,200, would be calculated as £109,000 - £30,000 - £9,200 = £69,800 and this would be taxed at 18%, giving a potential liability of £12,564, or £515 more than if you realised the gain this year.”

“So”, says Annie, “another example of tax simplification costing me money! It does make sense to do something this year, doesn’t it, and not only save tax, but increase my income. Do you have any other tricks up your sleeve?”

“Well.....”, replies Ben.

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