Adviser Edge

Capital Gains Tax:
Rebalancing an investment solution

In the UK Chancellor's Autumn Statement on 30th of October 2024, significant changes were introduced to the Capital Gains Tax (CGT) regime. Announcements were made on the individuals Annual Exempt Amount (AEA) and taxation rates applied to chargeable disposals.

The statement confirmed that the AEA of £3,000 was to be retained for both tax years 2024/25 and 2025/26.

In addition, the CGT rates applicable to most chargeable disposals were increased with immediate effect. For Basic Rate Taxpayers, the CGT rate rose from 10% to 18%, while Higher and Additional Rate Taxpayers saw an increase from 20% to 24%. Notably, these changes did not affect chargeable gains from Residential Property, which continue to be taxed at the pre-statement rates of 18% and 24%.

The importance of re-balancing an investment portfolio

The amount of AEA available should not however detract from the fundamental reason for re-balancing a clients investment solution. The need to have a well diversified portfolio, aligned to the client's risk profile, maintaining the investments ongoing suitability.

Annual Exempt Amount (AEA):

- £3,000 in 2024/25 & 2025/26

In the past, when the AEA was significantly higher, this enabled many clients to rebalance their portfolio every year, with very few realising a liability to CGT. However, with the AEA now at £3,000, then this may have an impact on the potential CGT management of the portfolio for some clients that did not have an issue previously. As a direct consequence, the 'structure' of the investment solution recommended to the client will now need to be even more carefully considered to ensure the optimal outcome for the individual client circumstances.

The reason being is that there are different CGT structures for unitised and non-unitised collectives' investment solutions.

- The **Advisory/Discretionary portfolio** is a non-unitised portfolio, a basket of direct holdings, held in the client's name, therefore the act of re-balancing for either asset management or risk profile considerations, could incur a charge to CGT. The ongoing management of each holding would need to be considered in isolation to determine its tax position.
- The **Model Portfolio Service (MPS)** is also a non-unitised portfolio, however, it is a standardised portfolio across many clients. Therefore, individual client circumstances are not considered in the management of the portfolio and the client's individual tax position is not considered. As a result, the client/adviser has no influence on the investment decision making of the MPS and realised gains could lead to the client facing a CGT liability.
- The unitised portfolio, such as **Multi Asset and Fund of Funds** portfolios, are held in a collective structure. Therefore any rebalancing of the underlying portfolio is not subject to CGT. The potential CGT liability occurs when the client sells units of the collective investment.

Therefore, if the client is faced with the prospect of a significant CGT liability, due to the lowering of the AEA, then they may be reluctant to realise a gain and may consider not rebalancing. The risk to the client and the adviser is that the underlying portfolio loses diversification and could move out of the client's calculated risk profile.

Example: Rebalancing advisory portfolio – calculation of the gain and Capital Gains Tax on equity

John, as part of his investment and tax strategy, wishes to re-balance his advisory portfolio to retain the right investment and risk profile. John's original investment was £200,000, with a 60% weighting (£120,000) of the monies invested in global equities.

Fund	Acquisition Cost (£)	Current Value (£)	Rebalanced Value (£)	Gains (£)
Global Equity (60%)	120,000	153,000	141,000	2,588
Fixed Interest (20%)	40,000	35,000	47,000	Nil
Property (15%)	30,000	36,000	35,250	126
Cash (5%)	10,000	11,000	11,750	Nil
Total	**200,000**	**235,000**	**235,000**	**2,714**

The portfolio has performed well, and the global equity element has increased in value to £153,000, an increase of £33,000.

To bring John's portfolio back into line with his risk profile asset allocation (60% global equity weighting) the portfolio needs to be rebalanced. This means that £12,000 (current value less rebalanced value) of the global equity holding needs to be sold and the assets invested in other parts of the portfolio.

Therefore, to calculate the tax due on this rebalancing (a part disposal), a calculation is required to establish how much of the rebalanced value is return of capital and how much is taxable to CGT.

The return of capital value amount can be calculated using the following formula:

$$PP \times \frac{A}{A + B}$$

PP = Original investment
A = Value disposed
B = Value retained

The gain on partial disposal is calculated as follows:

***Return of capital = £120,000 x (12,000 / (12,000 + 141,00)) = £9,412**

Disposal required to rebalance global equity	£12,000
Less the return of capital*	(£9,412)
Capital gain	**£2,588**

The total gain in this example (including Property) is £2,714, therefore within the £3,000 2024/25 AEA. As a result, John would still have a small balance of unused AEA (£286) for future disposals.

However, if John were to also move monies to an ISA wrapper in the same tax year from his portfolio or have a larger portfolio then this could very easily create a CGT liability.

Contact us

0207 464 5855

clientsupport@columbiathreadneedle.com

columbiathreadneedle.co.uk/adviser-edge

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