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Capital Gains Tax: Annual Exempt Amount

Capital Gains Tax and the Annual Exempt Amount (AEA)

In the UK Chancellor's Autumn Statement on 17th November 2022, it was announced that the Capital Gains Tax (CGT) Annual Exempt Amount (AEA) was being reduced.

The statement announced that the AEA was being reduced from £12,300 in 2022/23 to £6,000 in tax year 2023/24 then to £3,000 in 2024/25.

As a result, the impact of the AEA reduction will require financial advisers to assess the possible additional CGT liabilities for their clients with investments held within collective investments. If left unchecked, the reduction could lead to a poor client outcome and fall counter to one of the 3 cross-cutting rules of Consumer Duty – *'Firm must avoid causing foreseeable harm to retail customers.'*

HMRC estimates that the reduction of the AEA will bring an additional 260,000 individuals and trusts into the scope of CGT for the first time, many of which will be clients of financial advisers.

It is therefore essential that the new AEA level are considered in relation to the ongoing individual suitability of client investment and financial planning circumstances.

Category:
Investment and Tax

Annual Exempt Amount (AEA) reduced from:

- **£12,300 in 2022/23 to**
- **£6,000 in tax year 2023/24**
- **£3,000 in 2024/25**

What is Capital Gains Tax (CGT)?

CGT may be payable by individuals/trusts on gains (investment profits) made from the full or partial disposal of chargeable assets, such as shares or investment funds. Gains can occur if there is an increase in value between the original acquisition cost and the disposal proceeds. CGT does not apply to assets held in a Stocks and Shares ISA, Junior ISA, Lifetime ISA, or a pension.

If the realised gain is greater than the CGT AEA of £3,000 in tax year 2024/25 there may be tax due.

What is classed as a disposal under CGT?

A disposal for CGT purposes typically occurs when ownership of an asset comes to an end – often when the asset is sold, in full or in part.

What rates of tax apply to CGT now?

The total taxable gains realised by the client over the £3,000 AEA are added on top of all other income in that tax year to determine the rate of tax which will apply. Any unused CGT AEA cannot be carried forward to future tax years.

It is worth noting that. CGT rates are not aligned to those of UK income tax, The rates applicable for chargeable assets are 10% and 20%, for Basic Rate and Higher Rate taxpayers respectively. Any chargeable gains on residential property are subject to a higher rate of 18% and 24%.

Asset being sold	CGT rate applied UP to Higher Rate Tax threshold	CGT Rate applied ABOVE Higher Rate Tax threshold
Unit Trusts/OEICs	10%	20%
Shares	10%	20%
Residential property	18%	24%
Business Assets Disposal Relief (BADR) *	10%	10%
Trusts **	20%	20%

*This applies to the first £1million of gains from the sale of self-employed businesses, partnerships and trading companies where an employee holds more than 5% of the shares in the company.

**The annual CGT exemption for trustees is £1,500 in tax year 2024/25, half of the personal AEA. This amount is shared between any other trusts created by the same settlor during lifetime, up to a maximum of 5 trusts.

The taxation implication to an investor of the reduction of the AEA

In direct comparison to tax year 2022/23 (when the AEA was £12,300), the reduction in the AEA equates £9,300 in tax year 2024/25. This will result in both basic and higher rate taxpayers being potentially subject to more CGT.

For clients with income over the higher rate tax threshold and gains above the new AEA of £3,000, they could be liable to an extra £1,860 (£9,300 @ 20%) in tax year 2024/25.

For basic rate taxpayers, these amounts could be up £930 in tax year 2024/25.

The reduction in the AEA has led to the increased potential CGT liability for all clients invested in a collective investment vehicle. Therefore, the impact that this may cause and the potential increase in CGT chargeable will need to be considered by the financial adviser and discussed and understood by the client.

Impact of the reduction in the AEA on investment and financial planning advice

The reduced AEA will require consideration of the CGT liability on those clients who are disposing of all or part of an asset – with a significant impact on those who use the AEA to manage their investment portfolios on an ongoing basis throughout the year.

With only a £3,000 AEA available from April 2024, common tasks in investment management and financial planning will more frequently result in CGT becoming payable.

Investment management and financial planning scenarios that will be directly impacted by the reduced CGT AEA include:

- Rebalancing of portfolios
- Extracting capital to fund ISA subscriptions
- Completion of individual self-assessment

The previous £12,300 CGT AEA ensured that many clients did not need to be concerned about a CGT liability on the ongoing management of their investment, including the rebalancing of a portfolio or annual Bed and ISA advice. However, as a consequence of the AEA reduction, this may no longer be the case.

As a result, the 'structure' of the investment solution recommended to the client will now need to be carefully considered to ensure the optimal outcome for the individual client circumstances; there are different CGT structures for unitised and non-unitised collectives' investment solutions.

Impact of reduction in the AEA on the choice of investment solution

Question – Will the reduction in the CGT AEA have a bearing on the investment solution recommended?

Through the financial planning fact-finding process, each client's suitability is assessed on an individual basis and the recommendation is based on the client's identified requirements. However, there are ranges of investment solutions that are widely utilised by the financial advice marketplace in the UK. These solutions are both unitised and non-unitised structures. As both structures have a different taxation environment for CGT, the AEA reduction should prompt careful consideration within the context of client suitability.

Unsure of where '***in comparison with tax year 2022/23.***' goes?

Popular non-unitised investment solutions include bespoke portfolios, such as Advisory Model Portfolios, Discretionary Fund Manager (DFM) services or the standardised Model Portfolio Services (MPS).

Popular and well supported unitised structures include Multi Asset Funds and Fund of Funds Open Ended Investment Companies (OEICs).

Research indicates that the type of investment solution recommended to the client is influenced by a range of factors. These include fund costs, trading charges, platform availability, client reporting and tax efficiency.

One of the principal reasons often quoted by advisers when recommending an advisory/discretionary (DFM/MPS) has historically been tax efficiency – the rationale being the ability to utilise the CGT AEA when selling assets within the portfolio. Doing so allowed gains, less than the AEA, from the portfolio to be removed without a tax liability. However, the reduction in the AEA will mean that considerably lower gains will be able to be realised from the investment solution without triggering a CGT liability.

Research indicates that an important factor in determining the type of investment solution recommended is the amount being invested. Typically, the unitised solutions, such as Multi-Asset and Fund of Funds being recommended to clients with smaller sized investments, whereas advisory/discretionary non-unitised portfolios, such as DFM/MPS being recommended for larger sized investments.

Also, importantly, in relation to the size of the investment is the percentage growth required within a portfolio to fully utilise the client's AEA. Due to the new AEA limits the investment growth required to fully utilise the AEA has been reduced by 75% in 2024/25. Clients with larger investment portfolios will utilise their AEA with significantly less fund performance than previously required, potentially triggering a liability to CGT. Therefore, the size of the portfolio and the impact of the reduction in the AEA will also need to be considered.

There is no right or wrong answer as to whether one 'structure' is more beneficial than another. Financial advisers have a wide choice of investment solutions and the decision on which to use is based on individual client requirements and suitability. However, each structure has a different underlying CGT regime and therefore will have different implications for the potential management of CGT for the client.

Non-unitised investment solutions

Discretionary and advisory portfolios – bespoke to the individual

A non-unitised portfolio, such as a discretionary portfolio, is a segregated portfolio containing a basket of individual holdings (such as funds or shares), which are all directly held by the client.

If a holding is sold, in full or in part, within the portfolio then the gain realised contributes towards the client's current tax year's AEA. If the gains exceed the AEA (net of losses), a CGT liability may be created.

The investment manager has control on the timings of the gains and losses through the management of the portfolio, in relation to the client's individual circumstances. This should mean that the CGT position is known to both the adviser and client.

Model Portfolio Service (MPS) – standardised portfolio

MPS are segregated portfolios of individual holdings that are directly held by the client. This type of solution is managed to a mandate set by the investment manager. Therefore, the MPS are standardised across a large number of clients.

As a result, individual investment preferences or tax circumstances are not taken into consideration when the manager makes investment decisions. This standard mandate means that the flexibility to utilise gains and losses within the portfolio to manage individual tax positions is very limited.

The reduction in the AEA and the standardised nature of the MPS portfolio management may create gains or losses on the portfolio that, if not reviewed regularly, could lead to unforeseen CGT liabilities for the client.

Unitised investment solution

Multi-Asset/Fund of Funds OEIC – collective structure

Unitised portfolios are held within a collective structure – an OEIC or Unit Trust fund. The collective structure is treated as one investment that is directly held by the client. Like the MPS, the portfolio is therefore standardised across all clients.

The significant difference to the non-unitised investment solution is that any changes made by the investment manager to the underlying portfolio, due to the asset being held within the collective structure, are not subject to CGT. The potential CGT liability only occurs when the investor sells units of the collective investment.

The reduction in the CGT AEA has no direct impact on the taxation of an Investment Bond, both Onshore and Offshore, as gains are subject to Income Tax. However, as with all investment solutions the taxation depends on the individual circumstances of the client. Therefore, the merits of either an Onshore or Offshore Investment Bond to the client may need to be considered in relation to the reduction in the AEA.

Tax considerations of rebalancing

The reduction in the AEA has no impact on the fundamental reasons for rebalancing a client's investment solution. The need to have a well-diversified portfolio, aligned to the client's risk profile, continues to be a critical element of an investment solution's ongoing suitability. However, the reduction of the AEA will have an impact on the potential CGT management of the portfolio, with a potential impact on the structure of the solution recommended.

As the Advisory/Discretionary portfolios and MPS solutions are baskets of direct holdings, held in the client's name, the act of re-balancing for either asset management or risk profile considerations, could, therefore, incur a charge to CGT.

The act of rebalancing an Advisory/Discretionary Investment solution is bespoke to the individual. The ongoing management of each holding would need to be considered in isolation in order to determine its tax position. If the client is faced with a significant CGT liability, due to the reduction in the AEA, then they may be reluctant to realise a gain and consider not rebalancing. The risk to the client is that the underlying portfolio loses diversification and could move out of their risk profile.

The MPS is a non-unitised portfolio and 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, are held in a collective structure therefore any rebalancing of the underlying portfolio is not subject to CGT. The potential CGT liability only occurs when the client sells units of the collective investment.

Taxation implications of the reduced AEA on partial disposals

Example: Funding a client's ISA from a GIA (General Investment Account)

It is common practice for advisers to fund a client's annual ISA subscription from a client's GIA. In the past the £12,300 AEA enabled many clients to do this, with very few clients realising a liability to CGT. However, the reduction in the AEA to £3,000 in tax year 2024/25 may cause some to be liable to CGT. This may impact on the client's willingness to move assets into an ISA.

Example

Paul invested £200,000 into an OEIC 10 years ago. Today it's valued at £300,000. Paul wishes to withdraw £20,000 to fund his ISA.

To calculate the potential CGT on the capital withdrawn from the GIA to fund the ISA, a calculation is required to establish how much of the withdrawn value is return of capital.

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

PP = Original investment

A = Value disposed

B = Value retained

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

The gain on partial disposal is calculated as follows:

***Return of capital = £200,000 x [£20,000 / (£20,000 + £280,000)] = £13,333**

Disposal required to fund ISA	**£20,000**
Less the return of capital*	**(£13,333)**
Capital gain	**£6,667**

Paul's gain in this example is in excess of the £3,000 2024/25 AEA. As a result, Paul would have a CGT liability on the part disposal to fund the ISA. Would this put Paul off from undertaking the advice knowing there could be a CGT liability?

For future calculations, the capital withdrawn element must now be reflected in the base acquisition cost. In this example the base acquisition cost is now **£186,667** (£200,000 – £13,333).

Example: rebalancing portfolio – calculation of the gain and CGT on equity

John, as part of his investment and tax strategy, wishes to re-balance his 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 in 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.

***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 gain in this example is £2,714, therefore within the £3,000 2024/25 AEA. As a result, the client would still have unused CGT AEA on the disposal. However, if John was to also move monies to an ISA wrapper in the same tax year from his portfolio, this could very easily create a CGT liability.

Similar to the ISA funding example, future calculations of the capital withdrawn must also be factored in the original acquisition cost. In this example the original investment is now **£190,588** (£200,000 – £9,412).

Capital losses and the reduced AEA

When a client sells an asset, it may create a capital loss. The reduction in the AEA will need to be considered in the timing of realising a loss and when it is used to offset against a gain, as losses and gains realised in the same tax year and losses carried forward are applied slightly differently to the CGT calculation.

Losses that are incurred in the same tax year as a gain, are offset against each other prior to the AEA being applied. This potentially means that gains may be reduced to zero prior to the AEA being applied, resulting in the AEA being unused. With a greatly reduced AEA then maximising the use will increase in importance.

However, if a loss is carried forward from a previous tax year, then it is applied after the AEA is applied against the gain, therefore maximising the potential to use the AEA.

Any excess loss in a tax year can be carried forward indefinitely.

Reporting and paying CGT

From 6th April 2024 individuals have been required to report capital gains where the gain is greater than the annual CGT exemption of £3,000 in tax year 2024/25, or if the total sale proceeds exceed £50,000 (this is regardless of whether there has been a taxable gain or not).

Gains are reported on the self-assessment tax return or online, with payment usually due by 31st January following the end of the tax year where the disposal occurred.

The exception to this is residential property. A UK resident selling a residential property must report and pay any capital gains tax to HMRC within 60 days of completion of the disposal.

Trustees must report capital gains where the sale proceeds exceed £50,000. The annual CGT exemption for trustees is £1,500, in tax year 2024/25, half of the individual AEA. This amount is shared between any other trusts created by the same settlor in his lifetime, up to a maximum of 5 trusts. They must also report and pay any capital gains tax to HMRC within 60 days of completion of the disposal.

The reduction in the AEA is likely to mean that many more individuals will need to submit a HMRC self-assessment for the first time.

Summary

The reduction to the CGT AEA is set to affect hundreds of thousands of clients across the UK from April 2023 onwards, having a direct impact when it comes to certain areas of financial and investment planning.

The changes have seen the CGT AEA being reduced from £12,300 in tax year 2022/23 to £3,000 in 2024/25.

As with all client advice, each recommendation is based on the suitability for the individual's own circumstances and not solely driven by one factor, such as the taxation environment. However, the reduction to the AEA will mean that – everything else being equal – both basic rate and higher rate taxpayers invested in collectives will potentially be liable to pay more CGT on realised gains than they would have prior to the changes.

Importantly, despite the reduction in the CGT AEA, the actual main rates of CGT have not been changed. CGT rates remain at 10% and 20% for Basic Rate and Higher Rate taxpayers respectively, therefore continuing to be lower than UK income tax rates.

The result of the reduction in the AEA will require financial advisers to carefully consider the implications of the appropriateness of the collective investment solutions that have been recommended to the client in the past. In addition, they will have to assess whether these same solutions are the most appropriate going forward. If left unchecked, the reduction in AEA could lead to a poor client outcome and fall counter to one of the 3 cross-cutting rules of Consumer Duty – 'Firm must avoid causing foreseeable harm to retail customers.'

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