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Property Capital Gains Tax

How to Pay the Absolute Minimum CGT on Rental Properties & Second Homes

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&

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Important Legal Notices:

Taxcafe®
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Introduction

In the 2010 ‘emergency Budget’ the new Chancellor of the Exchequer, George Osborne, announced some important changes to capital gains tax.

The current rules apply to all disposals that take place after 22nd June 2010. It doesn’t matter whether you bought your property before or after this date.

As a result of these changes, capital gains tax has become more costly and more complicated.

The flat 18% capital gains tax rate, which used to apply to everyone, was scrapped and replaced with two tax rates:

- 18% for basic-rate taxpayers
- 28% for higher-rate taxpayers

What this change means is the amount of capital gains tax you currently pay depends on how much *income* you have earned during the tax year.

The amount of tax you pay also depends upon the size of your capital gains. Your capital gains are added to your income, so even someone with no income but large capital gains could end up paying tax at 28% on some of their gains.

In Chapter 10 we will show you how to reduce your taxable income so that your capital gains are taxed at just 18%.

Inflation Protection

When the Chancellor of the Exchequer introduced the higher 28% tax rate he did not bring back indexation relief or taper relief to protect long-term investors from the ravages of inflation. So someone who has owned a property for one year will pay tax at the same rate as someone who has owned a property for 20 years.

This means that the current 28% tax rate is potentially higher than it was under even the old pre-2008 tax regime. Under those rules, capital gains were taxed at up to 40% but, thanks to taper relief, the effective rate for long-term investors who held on to assets for more than 10 years was just 24%.

The Annual CGT Exemption

Back in 2010 there was a rumour going around that the annual capital gains tax exemption would be drastically reduced.

But in the June 2010 emergency Budget the Chancellor of the Exchequer promised that this tax relief, instead of being reduced, "will continue to rise with inflation in future years". Unfortunately, this promise was broken. The annual CGT exemption was frozen at £10,600 for two tax years.

Fortunately, for the current 2013/14 tax year the CGT exemption has been increased to £10,900. It will increase to £11,000 in 2014/15 and £11,100 in 2015/16.

In Chapter 12 we will show you how to obtain extra tax savings by making better use of your annual CGT exemption.

Furnished Holiday Lets

You have to pass a number of tests to qualify for furnished holiday let tax treatment but, for those that do, it's the tax equivalent of winning the lottery.

Owners of furnished holiday lets enjoy a host of special income tax and capital gains tax concessions.

The previous Labour government tried to kill these off ahead of the last general election but ran out of time. To the delight of many owners of holiday cottages and apartments, the Conservatives won a last-minute stay of execution.

As a result, the favourable furnished holiday letting tax regime continues to exist and applies to properties both in the UK and elsewhere in the European Economic Area (EEA).

That's the good news. The bad news is the qualifying criteria have been tightened and some changes have been made to the tax concessions available.

In Chapters 20 and 21 we explain what these changes are and take a closer look at the capital gains tax concessions enjoyed by owners of furnished holiday lets.

Paying Tax at 10%

The coalition agreement between the Conservatives and Liberal Democrats promised to tax capital gains more heavily but with "generous exemptions for entrepreneurial business activities".

The "generous exemptions" came in the shape of a big increase in the lifetime limit for Entrepreneurs' Relief in the June 2010 Budget. The relief was then significantly increased once again in the March 2011 Budget.

Entrepreneurs' Relief currently lets you pay just 10% tax on up to £10 million of capital gains.

Entrepreneurs' Relief can be claimed when you sell or transfer a business. Unfortunately, most rental properties and second homes do not qualify for this relief.

There are, however, two important exceptions:

- Furnished holiday lets
- Your business trading premises

So, if you own furnished holiday lets, or if you have a trading business and own your own business premises, you may be able to pay capital gains tax at 10%.

Entrepreneurs' Relief is covered in greater detail in Chapter 20.

Other Capital Gains Tax Reliefs

So far, the new Coalition Government has not made any changes to any of the other CGT reliefs, some of which are extremely valuable, including:

- Principal private residence (PPR) relief
- Private letting relief
- Holdover relief
- Rollover relief

The value of these reliefs has been greatly enhanced by the increase in the CGT rate and any planning measures that use them will be even more worthwhile than before.

Before the March 2011 Budget there were fears that one of the most valuable PPR rules would be done away with: the one that allows you to elect to treat a second home as your tax-free main residence.

This tax break came under the media microscope when it was found that a number of MPs had used it to avoid paying CGT on properties that had been paid for by taxpayers.

Although very few of us have much sympathy for MPs and their tax bills, it is good news for all the other second home owners out there that this tax-saving strategy still works! (See Chapter 8 for more details.)

Converting Income into Capital Gains

The reason why capital gains tax rates were increased was to satisfy the Liberal Democrats' desire to tax capital gains "at the same rates as income so that all the money you make is taxed in the same way".

In particular, the Government wanted to crack down on people converting heavily taxed income into leniently taxed capital gains.

Many investors and business owners will be delighted to know that the changes failed miserably to achieve this result.

In Chapter 19 we take a detailed look at how you can convert income taxed at 40% or more into capital gains taxed at just 18% or 28%.

Worse to Come?

Property investments are mostly long-term investments, i.e. investors hold on to their properties for five or ten years and often much longer.

On the other hand, politicians can and do change tax laws at the drop of a hat.

This puts property investors in a difficult position. If you buy a property today you have absolutely no idea how much capital gains tax you will pay when you eventually sell it.

The effective rate of tax you pay could vary from 0% to 40% or more, depending on the political leanings of the Government of the day and the health of the nation's finances.

Always remember this crucial fact before you take the plunge and buy any property based on current tax rates and reliefs.

Scope of this Guide

The aim of this guide is to give you a thorough grounding in property capital gains tax.

It does not, of course, cover **every** eventuality. So please bear in mind the general nature of the information.

Furthermore, the guide does not cover the capital gains tax rules that applied to property sales before 23rd June 2010.

Individual circumstances vary so it's also always vital to obtain professional advice before you do anything that may have tax consequences.

After reading this guide, however, we are confident that you will have a firm grasp of how capital gains tax is calculated and what you can do to pay less of it when you sell your properties.

As for jargon, there isn't very much of it, you'll be pleased to hear.

We sometimes refer to capital gains tax as just CGT. You may also see us talk about the 'taxman' when referring to HM Revenue & Customs, also known as HMRC.

Tax is all about tax years and some of the examples have dates in them. The UK is one of the few remaining countries that insist on having a tax year that does not run from January to December. Our tax year runs from 6th April in one year to 5th April the next year.

Chapter 2

Just How Bad Is Capital Gains Tax?

The top capital gains tax rate was increased significantly in the 2010 Budget but the tax burden can be mitigated through the many exemptions and reliefs that are still available.

For starters, £10,900 of annual capital gains are tax free. Couples enjoy one capital gains tax exemption each so they can have £21,800 of tax-free capital gains.

Whatever's left over will be taxed at 18% (basic-rate taxpayers) or 28% (higher-rate taxpayers).

Sample Tax Rates

Let's say you and your spouse or partner are both higher-rate taxpayers and sell a jointly-owned property, making a £25,000 profit.

The first £21,800 will be covered by your two annual exemptions and the remaining £3,200 will be taxed at 28%, producing a tax bill of just £896.

What this means is that your actual effective tax rate is just 4%:

Profit	**Tax**	**Tax Rate**
£25,000	£896	4%

Clearly, earning £25,000 of capital gains is a lot better than earning an extra £25,000 of income, especially if you're paying 40% or more in income tax. 40% tax on £25,000 would produce a £10,000 tax bill!

Here are some more examples of effective capital gains tax rates for married couples and others who own property jointly.

These effective tax rates are calculated by deducting two annual exemptions and taxing the remaining profits at 28%:

Profit	**Tax**	**Tax Rate**
£50,000	£7,896	16%
£100,000	£21,896	22%
£250,000	£63,896	26%

Clearly, paying tax at 16%, 22% or 26% is quite attractive compared with the tax you would have to pay on an equivalent amount of income.

However, £21,896 or £63,896 is still a lot of tax, but the good news is there are lots of things you can do to reduce your capital gains tax bill… as we'll see shortly.