

Capital Gains Tax and the Defined Returns Plan

Background

Tax rates

For individuals, Capital Gains Tax (CGT) is payable on total gains made in a tax year to the extent that they exceed the annual exemption. The excess gains are treated as the very top slice of income – above even dividend payments – and are subject to the same rates of tax as savings income, i.e. 10%, 20% and 40%. There is no tax exemption for any excess gains where an investor has unused personal income tax allowances. In practice very few people pay CGT. Her Majesty's Revenue and Customs' (HMRC) estimate for 2006/07 is that there will be only 260,000 CGT payers, compared with 29.5m income tax payers.

Timing of payment

Under self assessment, Capital Gains Tax is payable on 31 January in the tax year following that in which the gain arose. For example, any tax on the final gain arising under a five-year Defined Returns Plan at maturity on 14 February 2012 would not be payable until 31 January 2013. There are no payments on account for CGT. If you remain under the allowance there is no need to report any gain to HMRC.

The annual exemption

Every individual, regardless of age, has an annual CGT exemption, which for 2006/07 is set at £8,800. Unless parliament decides otherwise, the annual exemption is increased each April in line with inflation to the previous September, with the resultant figure rounded up to the higher £100. Thus if the September annual inflation rate is 3.6% the annual exemption should rise to £9,200 from 6 April 2007 (£8,800 x 1.036 = £9,116.80, rounded up to £9,200).

Taper relief

Taper relief was introduced in April 1998 to replace indexation relief. For personal investment assets, taper relief generally reduces the amount of taxable gain according to the following table:

No of Complete Years	Less than 3	3	4	5	}	10 or more
Investment Owned*						
Taper Relief (%)	0	5	10	15		40

*An extra year is added to the holding period for an investment owned before 17 March 1998.

Taper relief is applied after deducting any losses, but before the annual exemption. It is often said that taper relief reduces the maximum effective CGT rate for an investment held 10 years or more to 24% (i.e. 40% x 60%), but this is a misleading simplification. It is probably better in the first instance to say taper relief increases the annual exemption to as much as £14,667 (i.e. £8,800/0.6) because taper relief reduces the gain before the annual exemption.

Investments for minors

The Finance Act 2006 introduced a new rule for settlements created by parents for their minor unmarried children. Any such settlement is now regarded as 'settlor-interested' and, gains realised by the trustees are taxable on the settlor until the child either reaches age 18 or marries.

This rule only applies to settlements. HMRC confirmed in Tax Bulletin 84 that the rule does not apply to designated accounts or similar bare trust structures. If a Defined Returns Plan is set up by a parent for a minor child using a designated account, any gains are offset against the child's annual exemption.

Interaction with the Defined Returns Plan

Annual exemption

Based on a £10,000 investment, the structure of the Defined Returns Plan means that if the FTSE® 100 Index has not fallen from the Initial Index Level at the maturity date, the gains that arise are:

Investment Term years	Gain £	Taper Relief %	Gain adjusted for taper relief £
3	1,800	5	1,710
5	3,500	15	2,975

If the annual exemption remains at £8,800, then an investor in the five-year plan with no other gains in the maturity tax year (2011/12) can invest £29,579 in a Defined Returns Plan with no tax liability, ie ($£10,000 \times £8,800 / £2,975 = £29,579$). The corresponding figure for a three-year term is £51,461.

A couple (married, civil partners or otherwise) could double this figure for a joint investment. However, if one of the couple dies within the Plan's term, the survivor could face a tax charge at maturity if their annual exemption is exceeded.

If inflation averages 2.5%, then under the current indexation rules the annual exemption when the three-year plan matures in 2009/10 should be £9,800 and, in 2011/12 when the five-year plan matures, £10,400. These figures equate to maximum individual investments to cover the full annual exemption of £57,309 for the three-year plan and £34,957 for the five-year plan.

If the annual exemption is exceeded...

Tax is only payable on the excess gains over the annual exemption. It is not a question that if total gains exceed the annual exemption, all gains are taxed.

Planning

From a tax planning viewpoint it makes sense to minimise the realisation of other gains in the year the Plan's maturity date is reached. If this cannot be done, then it may be possible to realise losses to set against the gain or use carried forward losses from earlier years.

Where CGT may be an issue, it is also worth considering splitting the investment between three and five-year terms, so that gains arise in 2009/10 and 2011/12. The three year/five year division of investment should be 63.5%/36.5% if the aim is to equal gains in each period.

Key dates

Offer period:	20 November 2006 to 31 January 2007	
Initial Index Level determined on:	14 February 2007	
Maturity dates:	Three-year Plan:	15 February 2010
	Five-year Plan:	14 February 2012
Any CGT reported by:	30 September 2010/2012	
Any CGT paid by:	31 January 2011/2013	

THIS IS FOR THE INFORMATION AND USE OF PROFESSIONAL ADVISERS ONLY. IT IS NOT APPROVED AS A FINANCIAL PROMOTION BY WOOLWICH PLAN MANAGERS LIMITED FOR DISTRIBUTION TO ANY OTHER PERSONS.

Remember, the information in this factsheet does not constitute tax, legal or investment advice and Woolwich Plan Managers Limited has given no advice.