

# Capital Gains Tax and the Defined Returns Plan

## Background

### Tax rates

For UK resident and/or ordinarily resident individuals, Capital Gains Tax (CGT) is payable on net realised 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 by 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 19 April 2012 would not be payable until 31 January 2014. There are no payments on account for CGT.

### The annual exemption

Broadly 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. Given that the September annual inflation rate was 3.6% the annual exemption should rise to £9,200 from 6 April 2007 ( $£8,800 \times 1.036 = £9,116.80$ , rounded up to £9,200).

### Taper relief

Taper relief was introduced in April 1998 to replace indexation relief for individuals. For non-business assets, taper relief generally reduces the amount of taxable gain according to the following table:

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

\*An extra year is added to the holding period for an investment on 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.  $40\% \times 60\%$ ), 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.

## 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                     | 3,750  | 15             | 3,187.50                         |

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 (2012/13) can invest £27,607 in a Defined Returns Plan with no tax liability, ie ( $£10,000 \times £8,800 / £3,187.50 = £27,607$ ). 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 rules the annual exemption when the three-year plan matures in 2010/11 should be £10,000 and, in 2012/13 when the five-year plan matures, £10,600. These figures equate to maximum individual investments to cover the full annual exemption of £58,479 for the three-year plan and £33,255 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, investors may wish 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 so as to reduce gains to the level of the annual exemption, before taper relief.

Where CGT may be an issue, investors may wish to consider splitting the investment between three and five-year terms, so that gains arise in 2010/11 and 2012/13. The three year/five year division of investment should be 68%/32% if the aim is to equal gains in each period.

### Key dates

|                                    |   |
|------------------------------------|---|
| Offer period:                      | 12 February 2007 to 5 April 2007                                |
| Initial Index Level determined on: | 19 April 2007   |
| Maturity dates:                    | Three-year Plan: 19 April 2010<br>Five-year Plan: 19 April 2012 |
| Any CGT reported by:               | 30 September 2011/2013*   |
| Any CGT paid by:                   | 31 January 2012/2014  |

\* If the investor wishes HM Revenue & Customs to calculate the liability.

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