CHAPTER 5

RELIEF FOR CAPITAL LOSSES

5.1 Introduction

In this chapter, we shall look at how we deal with a situation when a taxpayer sells a chargeable asset, and makes a loss. The way we calculate a capital loss is very straightforward, a loss will only arise if proceeds are less than cost.

5.2 The offset of capital losses

A taxpayer will always **set capital losses against capital gains**. Capital losses reduce gains. They are never set against the taxpayer's income. TCGA 1992, s. 2(2)(a)

Capital losses must be **set off against capital gains in the same tax year**. This is **automatic**. This means, for example, that if a taxpayer makes a gain of, say, £5,000 on one asset, and a loss of £1,000 on another asset, these must be netted off, to give net gains in the year of £4,000. The taxpayer cannot ask HMRC to cover his gains by his annual exemption, and leave the losses to be used in another year.

Although capital losses must be set off against gains in the same year, the taxpayer can **deduct losses in the most beneficial way**, i.e. in order to **minimise the tax liability**. Where an individual has capital gains which are charged to tax at different rates, for example because one gain is eligible for entrepreneurs relief and taxed at 10% or because an individual has a gain arising before 23 June 2010 which is taxed at 18%, losses should be **offset against gains taxed at higher rates in priority**. TCGA 1992, s.4B

Illustration 1

Jess, who has an annual income in excess of £100,000, sells Asset A on 23 May 2010 and makes a gain of £10,000. She sells Asset B on 31 August 2010 and makes a gain of £18,000. The final disposal of 2010/11 gives rise to a loss of £2,000 on Asset C on 3 January 2011.

	Before 23.6.10	On or after 23.6.10
	£	£
Gain on Asset A	10,000	
Gain on Asset B		18,000
Loss on Asset C	______	(2,000)
Total chargeable gains	£10,000	£16,000

As Jess is a higher rate taxpayer, the gain on 31 August 2010 will be taxed at 28%. The loss is therefore set against this gain in priority to the gain on 23 May 2010 as this will be taxed at the lower rate of 18%. The annual exemption should also be allocated to the later gain, to save the most tax.

Where current year gains exceed current year losses, the excess gains are taxed. If, on the other hand, losses in the year exceed gains in the year, the taxpayer will be left with net gains of zero. The **excess losses will be carried forward and set against gains in future years.** It is therefore always important that you look back at the previous year, to see if the client had any capital losses which he is bringing forward. TCGA 1992, s. 2(2)(b)

5.3 Losses carried forward

If losses in the year exceed gains in the year, the excess loss is carried forward. The chargeable gains in the year will be nil and the annual exemption will be lost. Most taxpayers do not make use of their annual CGT exemption. If an **exemption is not used**, it **cannot be carried forward or transferred** to another person. The exemption is simply wasted.

Any excess losses for the year are carried forward and reduce capital gains in future years. **When a capital loss is carried forward**, it is **used in such a way as to bring gains down to the level of the annual exemption.** TCGA 1992, s. 3(5A) TCGA 1992, s. 3(5B)

Capital losses brought forward must be offset in this way. However, the taxpayer can again allocate the loss against gains in the most beneficial manner if there are gains charged to tax at different rates.

Illustration 2

Shirley's capital gains and losses in the tax year 2010/11 are as follows:

	Gain/(Loss)
	£
Asset A sold 1 July 2010 – eligible for entrepreneurs' relief	17,000
Asset B sold 10 September 2010	12,000
Asset C sold 9 November 2010	(10,000)

Shirley has capital losses brought forward from 2009/10 of £(4,000). Her taxable income is £47,000.

The first thing Shirley will do is utilise her current year loss – i.e. the loss on Asset C – which will be offset in full against her current year gains. She should set the loss against the gain on Asset B since this would be taxable at 28% rather than the gain on Asset A which is taxable at 10%.

Once we have dealt with current year losses, we turn our attention to the losses brought forward from 2009/10. Losses brought forward total £4,000. These losses must also be offset in full as they do not reduce chargeable gains to below the level of the annual exemption. The capital losses brought forward should first be set against the balance of the gain on Asset B and then against the gain on Asset A.

	Asset A	Asset B
	£	£
Asset A	17,000	
Asset B		12,000
Asset C (CY loss)	______	(10,000)
	17,000	2,000
Less: b/f	(2,000)	(2,000)
Gains	15,000	-
Less: AE	(10,100)	
Taxable	£4,900	
CGT £4,900 @ 10%	£490	

Capital losses c/f (4,000 – 4,000) = Nil

Illustration 3

Laura made a capital gain on 1 August 2010 of £20,000. She made a capital loss of £6,000 on a disposal on 1 October 2010. She has capital losses brought forward at 6 April 2010 of £15,000.

Laura must offset her current year loss against her current year gain in full. She must then offset as much of her brought forward loss as is needed to reduce her remaining gain down to the level of the annual exemption. This means she will offset £3,900 of her brought forward loss. The balance of the gain of £10,100 will be covered by the annual exemption, leaving taxable gains of nil.

	£
Gain	20,000
Less: CY loss	(6,000)
	14,000
Less: losses b/f	(3,900)
	10,100
Less: Annual Exemption	(10,100)
Taxable gain	Nil
	______
Losses c/fwd (£15,000 - £3,900)	£11,100

5.4 Losses carried back on death

There is **one instance** when capital losses may be **carried back**. Capital losses made by a taxpayer in the **year of death** may be carried back. These losses may be carried back for a maximum of **three tax years,** on a **"last in first out" basis**, i.e. capital losses are set against gains of later years, before earlier years. TCGA 1992, s. 62(2)

The losses carried back must be used in such a way so as to **bring gains down to the level of the annual exemption**. The effect of carrying back a capital loss, is to reduce chargeable gains of previous years. As tax would already have been paid for these years, the carry back of losses will **generate a repayment of CGT**.

Again, losses should be offset in a particular tax year in the most beneficial manner.

Illustration 4

Wilf died in December 2010, and his gains and losses in the year of death and the previous three years, were:

	2007/08	*2008/09*	*2009/10*	*2010/11*
Gains	20,000	15,400	10,500	
Chargeable loss				(12,000)

As Wilf made a capital loss in the year of death this loss will be used against gains of the three previous years.

We carry back the losses on a "last in first out" basis. This means that the loss of 2010/11 will first go against gains of 2009/10, then against gains of 2008/09, then finally against gains of 2007/08. If there are any losses unused at this point, the losses will be wasted because it is not possible to carry back for more than three years.

	2007/08	*2008/09*	*2009/10*	*2010/11*
Gains	20,000	15,400	10,500	(12,000)
Losses carried back	(5,800)	(5,800)	(400)	
	£14,200	£9,600	£10,100	

First we carry back part of the loss from 2010/11 to 2009/10. We must use enough of the loss to bring the gains down to the annual exemption for 2009/10 of £10,100. This means that we must use £400 of the capital loss.

As we still have some losses remaining, we carry these back to 2008/09. Again we must use losses so as to bring gains down to the annual exemption for 2008/09 of £9,600. In this instance we must use £5,800 of the capital losses.

Of the loss of £12,000, we have used £400 in 2009/10 and £5,800 in 2008/09. This leaves a loss of £5,800 which we set against gains in 2007/08. This reduces chargeable gains in this year down to £14,200.

5.5 Restrictions on allowable losses

As a result of the increase in capital gains tax avoidance schemes, a general anti-avoidance rule (GAAR) has been introduced. This applies to individuals and companies. TCGA 1992, s. 16A

The legislation states that an allowable loss for capital gains tax purposes "**does not include a loss which arises as a result of arrangements made for the main purpose of securing a tax advantage"**.

"Arrangements" include any agreement, understanding, scheme, transaction or series of transactions.

"Tax advantage" is also widely defined and means relief (or increased relief) from tax, repayment (or increased repayment) of tax or avoidance or reduction of a charge to tax.

HMRC have provided guidance on when they consider this legislation would apply by way of two illustrations which follow.

Before we look at these illustrations, remember that transfers of assets between spouses or civil partners take place at no gain, no loss and are therefore effectively CGT exempt.

Illustration 5

Mr H has shares in S plc which are standing at a loss. Mrs H has shares in a separate company, T plc, standing at a gain.

Mr H transfers his shares in S plc to Mrs H. This is a no-gain no-loss transfer, so no CGT is due. Mrs H effectively inherits Mr H's loss. Mrs H then sells both holdings of shares. The loss on the shares in S plc covers the gain arising from the shares in T plc, and so no CGT is payable by Mrs H.

Taking the spouses together, Mr and Mrs H each have shares which they want to sell. What happens in fact, is that they do sell their shares, and the economic consequence is that they realise a gain on one set of shares and a loss on the other set.

To decide whether or not the anti-avoidance legislation applies, it is necessary to **consider whether there have been "arrangements", and whether a "main purpose of those arrangements was the securing of a tax advantage"**.

In this case, it seems clear that there have been "arrangements", namely the transfer of the shares from Mr H to Mrs H. It is then necessary to look at what the main purpose of Mr and Mrs H was, in entering into these arrangements. This can be determined only by looking at all the circumstances surrounding the arrangements.

In this illustration, Mr and Mrs H wanted to dispose of their shareholdings and they did this in a straightforward way. They made use of the "no gain, no loss" rules in s.58 TCGA 1992, which provides the opportunity for spouses (or civil partners) to bring together gains and losses. The **straightforward use of a statutory relief in this way does not (of itself) bring arrangements within the anti-avoidance legislation.**

Moreover, the tax outcome of the transactions reflects the economic reality of Mr and Mrs H's situation. Given all the circumstances, this suggests that there was no main purpose of achieving a tax advantage, and so the GAAR should not apply.

Illustration 6

Mr H has shares in a company, X Ltd, which are standing at a loss. He decides to sell the shares in order to crystallise a loss which can then be set against his chargeable gains in the year.

Mr H makes arrangements for his wife (Mrs H) to purchase the same number and class of shares. Mrs H then transfers the shares back to Mr H on the following day as a "no-gain no-loss" transaction.

Mr H now has the same shares in X Ltd as he had a day or so ago, but he also now has a loss to reduce his CGT for the year.

To decide whether or not the anti-avoidance legislation applies, it is necessary to consider whether there have been "arrangements", and whether a "main purpose" of those arrangements was the securing of a tax advantage.

In this case it is clear that there have been "arrangements", as Mr H has arranged for his wife to purchase the same number and class of shares.

It is then necessary to look at what the main purpose of Mr and Mrs H was in entering into these arrangements. To do so it is necessary to consider the **overall economic objective of the arrangements**, and whether that objective is being fulfilled in a straightforward way, or whether additional, complex or costly steps have been inserted.

Clearly the **real economic ownership of the shares** has remained with Mr H, which suggests that the disposal of the shares was **incidental to some other main purpose** of the arrangements.

The only substantive change here, is that a tax loss has been obtained. Since Mr and Mrs H have the same effective holding of shares and no less cash at the end of the arrangements then they had at the beginning, they have not suffered any corresponding economic loss. This suggests that a main purpose of the arrangements was the securing of that tax advantage.

The anti-avoidance legislation will therefore apply and **the capital losses claimed by Mr H will not be allowable losses.**

Example 1

Anthony sold his 1% shareholding in Technik Ltd (an unlisted trading company) in November 2010 making a gain of £12,000. He has never worked for the company.

Anthony has capital losses brought forward of £5,000.

Calculate the capital losses available to carry forward to 2011/12.

Example 2

Jason earns a salary of £64,000 p.a. In 2010/11, Jason made the following disposals, none of which qualify for entrepreneur's relief:

	Date sold	*Gain/(Loss)*
		£
Painting	1.5.10	21,000
Factory	6.9.10	8,000
Shares	1.2.11	4,000
Cottage	1.2.11	(18,000)

Calculate Jason's CGT liability for 2010/11.

Answer 1

	£
Gain	12,000
Less: Losses b/f	(1,900)
	10,100

The gain remaining is covered by AE.

Capital losses remaining to c/f:
£5,000 - £1,900 **£3,100**

Answer 2

	Before 23.6.10	On or after 23.6.10
	£	£
Painting	21,000	
Factory		8,000
Shares	_____	4,000
	21,000	12,000
Less: CY loss	(6,000)	(12,000)
	15,000	-
Less: Annual Exemption	(10,100)	
	£4,900	

CGT
4,900 @ 18% £882