

Capital Gains Tax: Capital Distributions

Imagine you have an 'unwrapped' fund holding of 1,000 OEICs shares or 1,000 units in a unit trust in your general investment account (that is, outside an ISA or Pension). You don't sell or personally dispose of any units, but you receive a payment of capital from the OEIC or Unit Trust scheme. Where the capital payment doesn't extinguish the fund, the overall net asset value of the collective scheme will reduce, the price per unit will reduce but you still have 1,000 units of lesser market value and you've received a capital sum. How does Capital Gains Tax (CGT) law deal with such scenarios?

Our normal way of calculating gains and losses (see: "Taxing calculations: Capital Gains Tax - Calculating gains and losses on unit trusts and OEICs") does not function properly in this scenario. Instead we must turn to the CGT rules on "**Capital Distributions**".

In simple terms, a capital distribution is any distribution which is not treated as income for Income Tax purposes. Most distributions from collectives are ordinarily income payments (dividends or interest) which are subject to Income Tax and don't therefore fall within these CGT rules. However, an example of a capital distributions might be one being made in the course of a winding-up a fund. The following is a simplistic overview assuming a UK resident/domiciled individual investor with fund holdings acquired after April 2008.

Starting point

The receipt of a capital distribution is treated as a **disposal** in the underlying shares/unit UNLESS the distribution is deemed as SMALL (see below). To calculate the gain or loss arising from the capital payment we use the following formula:

Disposal proceeds (Capital payment received) MINUS attributed acquisition cost = gain or (loss)

Where the capital payment extinguishes the whole fund holding and nothing remains, the attributed acquisition costs will be the whole amount of the holding's acquisition costs as they were at the moment of the capital payment. This should be reasonably straightforward. However, if the holding still exists and has value after the capital payment, then it is treated as a **part disposal**. Because no shares/units are actually sold we cannot apportion the acquisition costs in the normal way, by reference to the number of shares/units sold. Instead we must turn to the **part-disposal formula**. Here the attributed acquisition costs are:

$$\frac{\text{capital payment received}}{\text{capital payment received} + \text{market value of remaining assets}} \times \text{overall acquisition cost of holding}$$

This then produces the gain or loss which applies to the relevant tax year in question, when the capital payment is received. The overall acquisition cost for the holding will then be reduced by the amount attributed to the part disposal with balance becoming the current acquisition cost for the holding thereafter.

Small capital distribution: what is a small distribution?

As mentioned previously, the receipt of a "small" capital distribution will not generally (subject to the below) be regarded as a disposal for CGT. What constitutes "small" is not defined in legislation. It has been examined in case law and HMRC have a published practice. In essence, the purpose of this regime is to avoid the need for assessments in trivial cases and to avoid the time and expense of a full part disposal computation where it would be out of proportion to the amount of the capital distribution. The Revenue's approach is that 'small' means a capital distribution, which amounts to 5% or less of the value of the shares/units at the date of the capital distribution or (if over 5%) where the amount distributed to the taxpayer is less than £3,000.

Small capital distributions: where the capital payment is less than the pre-distribution overall acquisition costs

A capital distribution is **not treated as a disposal** if the distribution is **small**. Instead, the amount received is deducted from the overall acquisition costs of the holding. In essence, this will roll things over until there is a disposal and then increase the final gain by the amount received. No account is taken of these distributions in respect of the taxpayer's annual exempt amount.

Small capital distributions: where the capital payment is more than pre-distribution current overall acquisition costs

It is possible that the value of the small capital distribution may be more than the pre-distribution current overall acquisition cost of the holding. Here the small distribution rule does not apply. However, the taxpayer can make an election to reduce the amount of the capital distribution by the current overall acquisition cost. In essence, this means the current overall acquisition costs of the holding (reduces to nil) and is then no longer available to set off against any later disposal of the shares/units. Any balancing amount over and above the current overall acquisition cost would be a disposal; simplistically part of the capital payment is rolled-over until later (with a corresponding reduction in the acquisition cost) and part is brought into account as a current tax-year disposal.

What if the taxpayer does not want the distribution treated as small?

There may be situations where the taxpayer wants a small capital distribution to be treated as a disposal (rather than effectively 'rolled-over' to a later date). For example, any gain would be covered with their annual exempt amount or any loss could be used to offset other gains. Technically, the legislation imposes the treatment where the payment is "small" as a matter of fact. However, HMRC's practice prior to self-assessment was to allow a taxpayer to have the small capital distribution treated as a disposal if they would prefer. If relevant, it is suggested that enquiry be made of HMRC to ascertain whether it is possible under an individual's self-assessment and how it should be approached.

Examples

Let's assume client has a holding of 10,000 units in Fund W. On 30 January 2020, the fund in the course of ultimately intending to wind up makes a capital payment of 58.6631p/unit. After the capital distribution the client still has 10,000 units, albeit the unit price had dropped.

Current pooled acquisition cost of total holding immediately before capital distribution:	£9,000.00	[90.0000p per unit]
Capital distribution:	£5,866.31	[58.6631p per unit]
Market value after distribution on 30/01/20	£2,083.00	[20.8300p per unit]

Disposal calculation:	Disposal proceeds:	£5,866.31
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Attributed acquisition cost	(5,866.31)	X 9,000 =	£6,641.68
	(5,866.31 + 2,083.00)		
	CGT LOSS on 30/01/2020		(£775.37)
Remaining current acquisition cost of pooled holding (1,000 units)	(£9,000-£6,641.68) =		£2,358.32

Let's assume the holding was only 1,000 units and the capital distribution event constitutes and is treated as a small payment.

Current pooled acquisition cost of total holding immediately before capital distribution:	£900.00	[90.0000p per unit]
Capital distribution:	£586.63	[58.6631p per unit]
Market value after distribution on 30/01/20	£208.30	[20.8300p per unit]

No CGT disposal (loss or gain) occurs on 30/01/2020; instead:

Current pooled acquisition cost of total holding immediately before capital distribution:	£900.00	[90.0000p per unit]
DEDUCT CAPITAL PAYMENT	£586.63	
Remaining current acquisition cost of pooled holding (1,000 units)	(£900.00-£586.63) =	£313.37

This method reduces the pooled acquisition cost of the holding and effectively rolls-over the capital payment so that it will increase subsequent chargeable gains (or cause lower losses) on future disposals. Let's say the holding is then disposed on 01/05/2020 with no further movements in unit price or any other adjustments to CGT base cost.

Actual disposal proceeds:	£208.30
CGT acquisition costs:	£313.37
CGT Loss:	(£105.07)

Under the non-small procedure; the loss would have been £77.54 on 30/01/2020. On 01/05/2020 the disposal proceeds are still £208.30. However, they would be offset against 'reformulated' acquisition costs of £235.83. This would produce a loss of £27.53. In total the loss is £105.07. It's the same ultimate loss either way but a fundamentally different approach (and in this example the small payment method falls solely in tax year 2020/21, whereas the non-small method falls partly in 2019/20 and 2020/21).

Conclusions

Where a capital payment effectively extinguishes the fund and the investor's rights therein in one capital payment, the CGT situation should be reasonably straightforward. Where part disposals take place, it is certainly more complex. As can be seen, there are differing CGT treatments depending on whether the payment is "small". Since, the working approach to "small" includes payments of less than £3,000 per person it is apparent those investors who receive payments below this figure will potentially have differing CGT treatment from those receiving amounts above that figure, albeit they are all in the same fund receiving the same capital payment per share/unit held.

Finally, please note that this document contains an overview of general CGT rules and it is not intended to imply that any particular fund situation either falls within or not within these generic rules. Recourse should always be taken to the operator of any particular fund to ascertain the CGT position of that particular fund in any given set of circumstances.

The logo for FundsNetwork, featuring a vertical red bar on the left and the text "FundsNetwork" in blue to its right.

Important note: This document contains a simplistic generic overview of relevant capital gains legislation. It is for investment professionals only and is not intended for and should not be read by private investors. Relevant underlying tax legislation must always be consulted and appropriate advice should always be sought from a relevant professional tax adviser or HMRC. Nothing herein should be construed as providing an opinion or advice and no party should act or refrain from acting on anything contained in this document. No statements or representations made in this material, document or at the presentation are legally binding on Fidelity or the recipient and no liability is accepted in connection with this material or any matter discussed at the events. FundsNetwork cannot give advice regarding tax. Issued by Financial Administration Services Limited, authorised and regulated by the Financial Conduct Authority. Fidelity, Fidelity International, FundsNetwork™, their logos and F symbol are trademarks of FIL Limited.

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