

Taxing calculations: Capital Gains Tax

Calculating gains and losses on all funds

Although calculating gains or losses on unit trusts and OEICs can seem a straightforward process, it is actually rather complicated. This article looks at the methodology for UK resident individuals, trustees, and personal representatives for UK-authorized unit trusts and OEICs.

The ways in which our industry has changed over the past few years now creates many more Capital Gains Tax (CGT) disposals and CGT transactions than seen previously and has increased the complexity yet further. First, the adoption of model portfolios and rebalancing creates a plethora of CGT events. Technology makes the portfolio rebalance process straightforward, but beneath that overtly simple rejig lies many individual sale and purchase transactions, each with CGT consequences. Secondly, the move to facilitated adviser fees and explicit platform charges means that small amounts of investment are often now constantly being cashed-in to meet fees. With that unfolds many CGT transactions not seen previously in the days of commission. Finally, we must consider situations where an investor switches between types of units of the same underlying fund. For example: between income and accumulation units and vice versa, or between differing AMC share classes.

1. Calculating the gain (or loss) on disposal or calculating the current unrealised gain (or loss)



To calculate a gain (or loss), you deduct acquisition cost from disposal proceeds. For the most part, **disposal proceeds** are uncomplicated. Usually, it is the amount received from the sale or current market value, if considering an unrealised gain. Remember, switches are combinations of sale and purchase orders, so are no different from any other sale or purchase. You must also establish the correct date of disposal, as this will determine the correct period of assessment and the tax rules which apply. It may affect the rate of tax, relief for losses, annual allowances and so on. In general, it is the date of sale (and not, if different, the time when proceeds are actually received by the client). It is the other side of the calculation, establishing '**acquisition cost**' (often called 'base cost') where things become more complex. In particular, you need to consider the type of units purchased and whether the investor has made multiple purchases of the same fund at differing times.

2. Calculating CGT 'acquisition cost'

2(i). Adjusting the acquisition cost of each unit within the fund holding

To establish the acquisition cost of each unit, you begin with the purchase price paid for that unit, but then adjustments are made. This is an ongoing process which means costs often fluctuate over time and differ from the price paid at outset. Units often make an equalisation payment with the investors first income distribution, however if your income is reinvesting this will happen on every distribution as you are purchasing new units at each reinvestment. For CGT purposes, this is treated as a return of capital and is deducted from the price paid.

Assume an investor paid 100p for a unit and then receives a distribution of 7p, of which 4p is taxable income and 3p is equalisation. The base cost of the unit is now adjusted to 97p. This only happens on the first and not subsequent distributions. However, it happens each and every time an investor purchases a new unit. So, if income is being reinvested to purchase new units, those new units may then have an equalisation payment with their first distribution. Similarly, if further units are purchased either as a result of portfolio rebalancing or generally, they too may then have an equalisation payment with their first distribution. All in all, this often means there are many equalisation payments within an overall holding of a fund.

Accumulation units

Accumulation units do not make income distributions. Instead, the net income amount that would have been distributed with an income unit is automatically reinvested in the fund. No new units are issued, but the value of the existing unit is increased. It is however, a requirement that the investor is subject to income tax on this income, on an annual basis. Thus, the investor is advised of this income amount, called a **'notional distribution'**, which is subject to income tax at the rate relevant to the investor, according to the income type. For CGT purposes, notional distributions are treated as allowable expenditure and are added to the acquisition cost.

For example, assume an investor pays 100p for an accumulation unit and at the end of year one the unit price is at 110p. Let's also assume that the net notional income distribution (which is subject to income tax) was 4p. We can see that the overall increase of 10p represents both the reinvested income of 4p and capital growth of 6p. It would arguably be 'unfair' to tax the whole 10p increase to CGT and by adding the amount that has been subject to income tax (the notional distribution) to the acquisition cost, this prevents this 'double taxation'. So, in this example, as the net notional distribution was 4p, the acquisition cost is adjusted to 104p.

The adjustment for notional distributions must be made each and every time there is a notional distribution. Where funds provide good annual yields, the total sum of all the notional distributions on accumulation units can amount to considerable sums over the years. Not adding these is one of the most common mistakes seen and can lead to considerably overstating a gain.

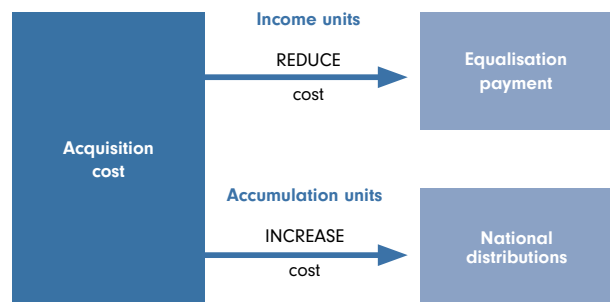
Income units - reinvested income

If income is being reinvested, this is treated as a new purchase of new units at that time and the reinvestment from the distribution does not affect the acquisition cost of the original units from where the distribution arose (save, of course, any adjustment needed to be made to the original holding, to account for any equalisation where it is the first distribution from that original holding).

Offshore funds

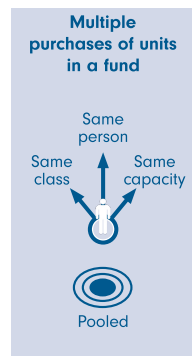
Income received by a reporting fund but not distributed to the investor is called Excess Reportable Income (ERI). Investors are liable to income tax on ERI accrued. Furthermore, any gain arising from the disposal of an investment is subject to capital gains tax. The excess reportable income amounts that have been subject to income tax have been added to the base cost of the investment, thereby reducing the gain subject to capital gains tax.

Our third-party vendor has assured us that periodic checks are completed against the HMRC register ensuring all offshore reportable funds are included within our CGT reporting. Where the fund manager has not reported ERI or where our third-party vendor has not been able to secure ERI information, this will not appear within our reporting.



2(ii). Pooling the fund holding - the pooling rules

These rules establish the 'acquisition cost' for each individual unit. However, units within a fund holding are often not all purchased at the same time, for the same price or all disposed in one sale. Assume an investor has continually purchased 1,000 units in a fund on 1 January each year for the past 10 years, so now has a total of 10,000 units. Each tranche will have likely been purchased at different prices and each of the units will have been adjusted in the way described above for any equalisation payments or notional distributions. Let's assume the investor now wishes to sell 3,000 units of the overall 10,000 units. The CGT framework now has to cope with how we establish the acquisition cost of the 3,000 units being sold, from an overall holding of 10,000 units. A number of differing approaches have been used over the years, but I shall concentrate only on the current system.



What the investor cannot do is stipulate which of the 10,000 units they are selling. They cannot, for example, say they want the 1,000 units purchased on 1 January 2022, the 1,000 units purchased on 1 January 2023 and the 1,000 units purchased on 1 January 2024 as treated as having been sold. Instead, an averaging

mechanism is used, whereby the total acquisition cost for all units (having been duly adjusted, as described in 2(i) above) is divided by the total number of units to give the average acquisition cost for each unit. This is what's known as the **'Section 104 pool' (s.104)**. This average cost is used as the acquisition cost of units sold to calculate the gain or loss. The table below illustrates a simple s.104 pool calculation for a holding of accumulation units in a fund. Units of a different class of the same fund are pooled separately.

s.104 Pool (example of accumulation units)

Date	Units bought	Unit price paid	Acquisition cost <small>*(duly adjusted for net notional income distributions)</small>	Running total units	Running total costs
10 March 2018	2,000	1.00	2,000 + 250* = 2,250	2,000	2,250
15 June 2019	1,800	1.20	2,160 + 180* = 2,340	3,800	4,590
6 August 2020	2,500	0.75	1,875 + 100* = 1,975	6,300	6,565
13 May 2023	4,000	1.15	4,600 + 200* = 4,800	10,300	11,365
			Cost per unit 1.1034		
			Sales proceeds 6,000		
			Acquisition costs (3,000 units at 1.1034)		
			3,310.20		
SELL			Realised Gain		
14 Dec 2023		Sale Price of units			
3,000 units	(3,000)	2.00	2,689.80	(3,000)	(3,310.20)
Continuing pool after sale				7,300	8,054.80
			Cost per unit remains at 1.1034		

3. The disposal matching rules

Where a fund holding or part of the holding is sold, the matching rules dictate the method of calculating the gain (or loss). In essence, this dictates from where the acquisition cost must be obtained and it is perfectly possible for a single tranche disposal to need to be matched in one, two or more ways. Provided that the so called 'bed & breakfast' rules are not triggered, gains (or losses) will be calculated by reference to acquisition costs derived from the s.104 pool previously described. However, note that a sale may initially be matched against the 'pool' but readjusted if the 'bed & breakfast' rules are subsequently triggered.

The simplistic rules for matching sells and buys are:

- first, matched against any acquisitions (purchases) on the same day;
- then, matched against any acquisitions (repurchases) in the 30-day period following disposal;
- then, matched against the s.104 pool.

3(i). The same-day rule

In simple terms, if a person in the same capacity sells and buys the same class of units in the same fund, on the same day, the disposals are first matched against the purchases on the same day. This means the acquisition cost is not derived from the s.104 pool, but is the purchase cost of the same-day buys. So, in the example above if the investor sold 3,000 units on 14 December 2023 and also purchased 3,000 units on the same day, the disposal proceeds are 6,000 (3,000 x 2.00) and the acquisition costs are (3,000 x unit purchase cost). If the buys and sells are at the same price, they effectively cancel each other out. Crucially, any same-day purchased units do not enter the existing s.104 pool. In the example, the pool would continue as it was with 10,300 units and 11,365 costs, and the average cost is not affected by the same-day buys and sells. If 3,000 units had been sold and only 1,000 purchased on the same-day, then 1,000 are matched under the same-day rule and then the remaining 2,000 units are matched under the other rules as follows.

3(ii). Re-purchases within 30 days after disposal

In simple terms, if a person in the same capacity purchases the same class of units, in the same fund, within 30 days after the disposal, the acquisition cost for the disposed units is the price paid for the newly acquired units. In essence, the newly acquired units (notwithstanding they were purchased after the sale) are deemed to have been sold at that previous sale date. As with the same-day rule, any purchases matched under the rule do not enter the s.104 pool.

This can be a tad tricky to understand and we often hear people say that a 'buy back' during the 30-day period is like the original sale never took place. That is incorrect. There is still a disposal on the date of the original sale, it is just that now, any gain or loss will be calculated by reference to an acquisition cost, of the amount that was paid to 'buy back' the relevant units within the 30-day period. If the unit price was higher when the 're-purchase' took place, the transaction shows a loss, or if the price was lower, the transaction will show a gain. Generally, these gains or losses will be relatively small, provided the unit price has not moved to any great extent.

In the example, the investor sold 3,000 units on 14 December 2023 at a price of 2.00 to produce proceeds of 6,000. Let's assume 3,000 units of the same class of the same fund are then repurchased in the same capacity on 2 January 2024. If they are repurchased at a price of 2.10, the disposal proceeds remain at 6,000 but the acquisition cost is 6,300, so the transaction will show a 300 loss. If they are repurchased at a price of 1.95, the disposal proceeds remain at 6,000 but the acquisition cost is 5,850, so the transaction will show a 150 gain.

If 3,000 units had been sold on 14 December 2023 and only 1,000 purchased on 2 January 2024, then 1,000 are matched under the 30-day rule and the remaining 2,000 units are matched against the s.104 pool.

In reality, the sale will always initially be calculated against the s.104 pool average cost. If and when a repurchase happens within the 30-day rule, then the calculation will be 're-adjusted' at that time. The units that were originally deducted from the s.104 pool before the repurchase took place, are effectively now added back, because they are no longer deemed as sold, because it was the units bought after the sale that are now deemed to be sold under the bed & breakfast rule.

3(iii). Matched against the s.104 pool

As described in section 2.

Finally, it is surprising how many times the bed & breakfast rules can be triggered, often inadvertently and without too much knowledge. Nowadays, outside of overt investor-instructed withdrawals, small disposals can also take place to fund adviser fees, to fund platform fees, or as part of automated portfolio rebalancing exercises. If within 30 days there is a purchase, the rules are triggered. Outside of overt investor-instructed purchases, small purchases often take place as re-investment of distribution income or again, as part of automated portfolio rebalancing exercises.

4. Moving between different classes of the same fund

This could involve moving between income and accumulation units or between differing AMC classes or combinations. CGT legislation stipulates, where an investor 'exchanges' units in a fund for other units in that fund, it is not a disposal and base cost of the original holding is rolled over to the new holding. It doesn't matter whether the investor has switched or converted units – HMRC will regard either as an 'exchange', provided the investor perceives the exchange as effectively, a single combined instruction/transaction. This is subject to the fund property and the investor's right to capital and income from the fund being the same before and after the event (save any changes to fund management charges). This will generally be the case unless the 'exchange' is between hedged and unhedged classes (or vice versa), or between some other manifestly different types of share class, in which case the switch will constitute a disposal.

In conclusion, as you can see, there can be many separate calculations at play in arriving at the client's overall capital gains and losses... and that's before these figures are applied to the investor's own unique tax circumstances. Whether manually calculating figures or sense-checking reported figures, having a handle on the methodology can only but assist you in staying on top of the client's CGT position.

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- any investments that a client may also hold outside of a Fidelity account;
- any interaction of investments that a client may hold across more than one account with Fidelity;
- any recent changes of the relevant UK legislation after the start of the current tax year;

- any non-UK legislation relevant to any non-UK assets held in a client's Fidelity account;
- any investments that have been moved between accounts either at Fidelity or from external providers to Fidelity;
- investments that have undergone a complex transaction such as a corporate action. In many cases we will stop calculating Capital Gains as our report is unable to consider the effect of the corporate action without looking at your clients' personal circumstances.

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Offshore funds are included within the capital gains reports. We obtain excess reportable Income from a third-party provider. Income received by a reporting fund but not distributed to the investor is called Excess Reportable Income (ERI). Investors are liable to income tax on ERI accrued. Furthermore, any gain arising from the disposal of an investment is subject to capital gains tax. The excess reportable income amounts that have been subject to income tax have been added to the base cost of the investment thereby reducing the gain subject to capital gains tax.

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