COULD ONE BANK INDEXATION ON SHARES AND SECURITIES?

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Introduction

In my article 'The Preservation and Extension of the Indexation Allowance following the Finance Act 2008' (*Personal Tax Planning Review*, Volume 12, Issue 2), I demonstrated how the abolition of the indexation allowance with effect from 6th April 2008 – which had been frozen in any event since 6 April 1998 – has led to the inadvertent revival of indexed losses, provided that there was a transfer before 6th April 2008 between spouses or civil partners. In such a situation, any indexation allowance that had accrued up to the date of the transfer would have been successfully incorporated into the transferee spouse's (or civil partner's) base cost. If the transferee were now to dispose of the asset for less than the base cost (as enhanced by that indexation allowance), the previous rules restricting the availability of the allowance in such cases no longer apply so that it is once again possible to increase or create a loss by virtue of the indexation allowance.

It has been suggested, however, that a more fundamental obstacle arises in respect of shares and securities[2]. This obstacle takes the shape of the former section 110A of the Taxation of Chargeable Gains Act 1992 (as introduced by section 125 of the Finance Act 1998 with effect in relation to disposals on or after 6th April 1998 and abolished by Sch. 2, para. 92 to last year's Finance Act).

In the Explanatory Notes to the Finance Bill, the position in respect of the simplification of the pooling rules was stated thus:

> Where there is an existing section 104 holding at 5th April 2008, the record of the holding should distinguish between the original cost and indexed cost. It is the original cost (not the indexed cost) of an existing section 104

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2 and other (often called 'fungible') assets subject to the special pooling requirements in TCGA 1992, section 104 *et seq*.

> holding that is taken into account in computing the allowable expenditure in a "new" section 104 holding from 6 April 2008 onwards. Where there were any additions to a section 104 holding between 30th November 1993 and 5th April 2008 under transactions (such as transfers between husband and wife) that are treated for capital gains tax purposes as giving rise to neither a gain nor a loss to the person making the disposal, the amount of the original cost will not include any element of indexation allowance. (In such cases the indexation element was added to the indexed cost of the holding separately from the original cost.)

The inference from the Explanatory Notes is that the specific legislation applicable to shares and securities precluded the banking of the indexation allowance in respect of such assets.[3]

This article considers whether or not indexation allowance could be banked as previously thought in relation to shares and other 'fungible' assets. If so, it would follow that many gains could be significantly eroded upon a disposal post-6 April 2008 and (where applicable) losses might still be created or increased by reference to the historical indexation allowance.

Section 110A

It is first appropriate to look at what section 110A does (or, at least, what it did).

Its introduction was a consequence of the introduction of taper relief for capital gains tax purposes (but not for the purposes of corporation tax on companies' chargeable gains). Until the advent of taper relief, section 110 had the purpose of determining the amount of indexation allowance that would relate to (what became known as) a section 104 holding – that is the notional single asset made up of a number of shares from which disposals of some of the shares would constitute a partial disposal. Section 110A was carved out of section 110 because, unlike the position for companies, taxpayers subject to capital gains tax were not able to pool shares and securities acquired on or after 6th April 1998 to ensure that the last-in first-out ("LIFO") rules could be applied for taper relief purposes.[4] Thus section 110A was relevant only to those shares that were held by the taxpayer before 6 April 1998 and not later acquisitions (even if they were (say) identical shares in the same

3 For completeness, it should be mentioned that such an interpretation would contradict the clear assurances given to taxpayers in the form of a "Frequently Asked Question" prominently displayed by HM Revenue and Customs in the lead up to and in the wake of the changes to the capital gains tax system.

4 I would refer interested readers to my article 'The Interaction of the Share Identification Rules with Taper Relief' (*Personal Tax Planning Review*, Volume 10, Issue 2) on whether or not this was wholly effective.

company held by the taxpayer in the same capacity, except where any subsequent acquisitions were treated as part of the original holding).

Where section 110A applied, it (as did section 110 before 6th April 1998) replaced section 54, which contained the basic rule for the calculation of indexation allowance.[5]

Subsection (2) invoked the provisions of section 110(2) and (3) (that otherwise applied only for the purposes of corporation tax) and ensured that where there was a disposal of or from a section 104 holding, the indexation allowance applicable to that disposal would be the appropriate proportion of the indexation allowance attached to the pool. This made good sense and ensured that the disposal of half of the shares (say) in the pool would release half of the indexation allowance attributed to the shares.

Section 110A(3)–(5) was then concerned with the determination of the amount of indexation at any time. However, analysis of those subsections will show that those provisions were just that – they identified how much indexation allowance was accruing in the pool so that, upon a subsequent disposal, the taxpayer's entitlement (or otherwise) to indexation allowance could be determined in accordance with the provisions of section 110(2), (3), by virtue of section 110A. In short, section 110A(3)–(5) piggy-backed section 110, with some modifications to reflect the fact that, for capital gains tax purposes, section 104 holdings could not be added to (whereas they continued and continue to exist for corporation tax purposes).

The implication of the paragraph in the Explanatory Notes cited above is that, upon a transfer between spouses and/or civil partners, the transferee was required to keep separate the actual (or deemed) expenditure of the transferor from the indexation allowance. In the period before 6th April 2008, section 110A would have had this effect because section 110(6A) (added by the Finance Act 1994) required the base cost and any indexation allowance attributable to the transferor to remain separate and so that these two separate components would be inherited (as separate components) by the transferee.

The subsequent abolition of section 110A

The key question, however, is whether those two separate components were fused together on 6th April 2008 when the indexation allowance was finally scrapped.

The obvious answer is that they did not because the indexation allowance was intended to become irrelevant on 6th April 2008 and, so, it would not be surprising to learn that there was no provision that sought to merge the two components.

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5 Section 110A(1)

Consequently, it appears that the plan (effectively confirmed by HMRC) to allow spouses and civil partners to bank indexation allowance was not available in respect of shares and securities.

However, this is subject to some major exceptions.

Pre-April 1982 shareholdings

The first relates to shareholdings that were acquired before 1st April 1982. The fact that this exception exists contains some irony because the exception is partly as a result of section 35A, which was introduced in last year's Finance Act specifically to extend the banking of indexation allowance to pre-April 1982 assets.

Section 35A applies to assets acquired by transferee spouses and civil partners between 1st April 1982 and 5 April 2008 (inclusive) where the asset had been acquired by the transferor (or the transferor on a previous nil-gain nil-loss transfer) before 1st April 1982.[6]

Where section 35A applies, section 35A(2) specifically provides that, contrary to the position before 6th April 2008, the transferee's acquisition cost:

(a) is based upon the 31st March 1982 value;[7] and

(b) is enhanced by any indexation allowance that would have accrued to the transferor on such a disposal.

Pre-30th November 1993 transfers

The second exception relates to cases where there was an inter-spouse transfer that took place before 30th November 1993. That was the date on which the indexation allowance was restricted so as to prevent taxpayers from increasing or creating a capital loss using the allowance. That restriction was reflected in section 110 by the insertion of section 110(6A), referred to above.

The separate identification of the actual base cost and any indexation allowance is contrary to the normal rule, set out in section 56(2) of the 1992 Act. However, the disapplication of section 56(2) arises because of section 110(6A), which applies only

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6 Section 35A(1)

7 Section 35A(2)(a)

in the case of inter-spouse transfers (and transfers between civil partners) on or after 30th November 1993.[8]

Therefore, where an inter-spouse transfer took place between 1st April 1982 and 29 November 1993 (inclusive), the normal rule in section 56(2) would have applied, so as to ensure that the transferee's base cost included any indexation allowance that accrued between the transferor spouse's acquisition date and the date of the transfer.

Assets acquired after 31st March but before 6th April 1982

The next category of exception is very limited – and, indeed, not beyond doubt. It relates to shares and securities that were first acquired (i.e. by the transferring spouse or civil partner) during the first five days of April 1982. Such acquisitions could not be protected by section 35A, because that covers only assets acquired before 1st April 1982. On the other hand, shares and securities acquired before 6th April 1982 cannot form part of (what is now) a section 104 holding because of the express provision in former section 104(2)(a). Arguably, by being excluded from a section 104 holding, the rules of sections 110 and 110A could not apply to them. Therefore, assuming the shares to be transferred to the original owner's spouse or civil partner before 6th April 2008, section 110(6A) cannot have the effect of disapplying section 56(2).

The contrary view is that (assuming the inter-spouse transfer occurred between 30th November 1993 and 5th April 1998 (inclusive)) the wording of section 110(6A) (which refers to the acquisition of, or addition to, a section 104 holding) operates in a stand-alone fashion, notwithstanding the fact that the corresponding disposal was from (or of) a 1982 holding. Had the provisions of section 110(6A) been in a stand-alone section, it would have been my view that they would have had that effect. However, by placing those words in a section that focuses on the disposal of section 104 holdings (and, in fact, the whole thrust of the 1992 Act is to consider only disposals) together with the fact that (until 6th April 2008) there would have been no purpose or effect of having a stand-alone rule (because the effect was already provided for by section 56(3), (4)), it is my view that this does not represent the better view of the legislation.

Post-5th April 1998 transfers

The final exception relates to cases where couples can simply side-step the provisions of sections 110 and 110A altogether. If the inter-spouse transfer (or transfer between civil partners) took place on or after 6th April 1998 and the transferor acquired the shares (or other fungible assets) on or after 5th April 1982,

8 Finance Act 1994, section 93(6), (11)

section 110A will still apply, because subsection (1) provides that there is a disposal of a section 104 holding. However, as previously noted, section 110A effectively leans on the provisions of, and applies the assumptions in, section 110, including the problematic section 110(6A).

However, section 110(6A) (which disapplies section 56(2)) does not bite in such cases, because the scope of that subsection is limited to those cases where a person (the transferee spouse or civil partner) is acquiring or adding to a section 104 holding. However, that cannot apply to acquisitions on or after 6th April 1998.[9] Therefore, section 56(2) will have the effect of amalgamating the transferor's base cost and accrued indexation allowance (up to April 1998) into the transferee's base cost.

Conclusion

Thus, it appears that indexation allowance could be successfully banked but only in respect of:

(a) all assets not subject to the identification rules for shares and securities; and

(b) assets subject to the identification rules for shares and securities provided that:

  (i) the assets were acquired before 6th April 1982 (and therefore excluded from the section 104 holding); or

  (ii) the assets were acquired on or after 6th April 1982 and on or before 5th April 1998[10] (and therefore forming part of the section 104 holding) if the inter-spouse transfer (or, where relevant, the transfer between civil partners) took place either:

    (1) on or before 29th November 1993; or

    (2) on or after 6th April 1998 and on or before 5th April 2008.

Where the indexation allowance has been successfully banked then all the consequences follow, including the fact that a loss can be created or increased if the eventual disposal proceeds fall short of the indexed cost.

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9 section 104(2)(aa)

10 Technically, there will be no entitlement to indexation allowance in respect of acquisition on 1, 2, 3, 4 or 5 April 1998.

It is hoped that the anomaly (i.e. relating to inter-spouse transfers between 30th November 1993 and 5th April 1998) will be retrospectively removed in the forthcoming Finance Bill.