The impact of capital gains tax on investment decisions

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Editor's note: although Amin is a member of UKSA's Policy Team, he is writing in a personal capacity.

Like many people, I hold apparently inconsistent views. On the one hand, I agree with Supreme Court Justice Oliver Wendell Holmes Jr who said in 1927: "Taxes are what we pay for civilized society." On the other hand, while paying all the taxes that the law requires, I hate paying taxes, and consider the tax implications of every decision. (An occupational hazard of being a tax adviser!)

Accordingly, I am acutely conscious of how tax law affects my investment decisions. In the late 1990s, most of my own and my wife's individual shares were held outside tax-favoured wrappers (ISAs and SIPPs). I still have painful memories of owning shares that had soared during the dot-com boom which I didn't sell because I didn't want to pay the capital gains tax ("CGT"), and which then plummeted in value.

Since then, with gradually increasing consistency, I have changed the shape of our portfolio. The goal is, wherever possible, to have individual shares held in tax-favoured wrappers while our non-tax-favoured holdings consist of collective investment schemes ("CISs") such as OEICs, investment trusts and exchange traded funds, rather than individual shares. We are almost there, and should achieve this goal in the next five years.

The rationale is that paying CGT currently is a drain on your portfolio. You decide for investment reasons to sell share A. If share A stands at a gain, part of your sales proceeds disappear in a CGT payment, thereby reducing the amount that you can reinvest in share B.

Conversely, a CIS suffers no such drain. When the scheme sells a share, as no CGT is payable, the full sale proceeds can be reinvested. Instead, CGT is only payable at the very end when you sell your holding in the CIS.

Indeed, it is perfectly possible that CGT will never be paid. You might die while you still own that CIS holding. If so, your heirs will inherit it at market value for tax purposes and can sell it without suffering any CGT. I have a former client who has never let me forget a comment I made to him in the 1980s: "Dying is a great form of tax planning!"

There are several differences between investing in a CIS and investing in directly held shares outside a tax-favoured wrapper:

1. As explained above, the scheme can change its portfolio holdings without any CGT cost. Unless all your gains are below the CGT annual allowance, you cannot.
2. The scheme inevitably involves an additional cost. This may be tiny for very low-cost exchange traded funds (as low as 0.08% per year for one in the USA which I recently recommended to my younger son) to as high as say 2%, or more, if you pick something expensive.
3. The scheme may make better or worse investment decisions than you would personally.

I decided to do some modelling to look at the effects of (1) and (2). Many years as a tax professional taught me two key things about models:

A. The purpose of the model is not to predict the future. It is to help you to think about a problem as part of your decision-making.

B. Many problems are so complicated that "first principles" thinking in your head is insufficient to grapple with the complexities. Creating a model forces you to clarify your thinking. Very often quantifying the effects of a particular factor (such as paying CGT now or later) can be very illuminating.

Accordingly, I built a model looking at the effects of equity investment over a 30-year period. I kept the assumptions relatively simple to avoid over-engineering the model:

Assumptions	
£ 100,000	Initial investment
8.0%	Total return per year
2.0%	Dividend yield, retained and spent
6.0%	Capital growth = difference
20.0%	CGT rate

Obviously, in real life we hold individual shares for differing periods. I made the simple assumption that all of the capital return is subject to CGT, with the tax paid in the following year, except in final period, when, for simplicity, I assumed the tax to be paid in the same year.

I am currently running a quantitative portfolio of individual shares (held in my SIPPs) where the average holding period is around one year. Accordingly, the assumption of having all of the capital return subject to CGT (if it was not in my SIPP) is realistic, particularly since my annual CGT exemption is already otherwise utilised.

I compared the 30-year outcome with the 30-year outcome of investing in a CIS where CGT is paid only at the end. In my modelling, I assume that the scheme earns the same underlying returns that you can achieve as a direct investor.

I ran the model three times for different levels of CIS annual cost:

1. With the CIS annual cost set at zero. This brings out the impact of paying CGT annually compared with paying it only once at the end. The difference of £64,991 is very marked (16% more in your hands than direct investment) because paying CGT at the end means that money that would otherwise have been paid to HMRC is invested to earn returns for you. This model version is not unrealistic. Essentially it is what happens if you invest in a very low-cost ETF. For example, putting in an annual cost of 0.08% p.a. to match the ETF my son will invest in shows a 30-year benefit of £63,951. See PDF1 here.

2. With the annual CIS cost set at 1% per year. In this case, the costs of the scheme outweigh the benefit of the tax deferral. You are £48,732 worse off. Accordingly, direct investment is better. See PDF2 here.

3. I wanted to know the "break-even" annual CIS cost. Excel makes that very easy to calculate using the "goal seek" function. It works out as an annual cost of about 0.54% per year. If the scheme costs you less than this, then the benefit of the tax deferral

outweighs the scheme charges. See PDF3 here.

Even more important than CGT, my main reason for investing in CISs is to provide an insurance policy against my own potential incompetence as an investor. Accordingly, a few years ago I set a policy of holding not less than 40% of our portfolio in CISs, but also not more than 55%, with the rest of the portfolio being in individual shares chosen by me.

For the CGT reasons explained above, eventually everything my wife and I own outside tax favoured wrappers will be a CIS holding with the intention of that holding never being sold, except for small sales to utilise the annual CGT exemption.

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