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Fundsmith Investors' Topics

Issue 2 | August 2021

Capital Gains Tax and the Fundsmith Equity Fund

We've written previously about the Office of Tax Simplification (OTS) second report on Capital Gains Tax (CGT) focussing on whether the report (and data) supported any major and/or imminent changes to CGT. Our view was that no easy conclusion could be drawn over whether changes are likely anytime soon, noting challenges faced by the government with implementing the OTS recommendations. We felt it would be a good opportunity to remind investors how CGT and taxation in general applies to their holdings in the Fundsmith Equity Fund.

Capital Gains Tax at the fund level

The Fundsmith Equity Fund is structured as an Open Ended Investment Company (OEIC). This structure means that when Terry and the team make a decision to sell a company in the fund and buy another, any gain (profit) made on that sale is not taxed, i.e. no CGT or corporation tax is payable by the fund.

Is the Fundsmith Equity Fund subject to any other taxes at the fund level?

Any dividend income received in the fund is not chargeable to UK corporation tax. However, as the majority of the holdings are companies based outside the UK, dividends received by the fund may be subject to a withholding tax in the country where the underlying company was located. The UK has tax treaties with most countries in which the fund is likely to invest and the Fundsmith team will submit claims for lower treaty rates or refunds whenever possible. This tax is applicable to all overseas investors (although the rates may differ) and so, if you were to invest directly, you would also suffer withholding tax. As private investors are often unaware of this tax and/or struggle to reclaim it, the fund may be more tax efficient than holding the same underlying positions directly.

How is the fund holder taxed on capital gains?

If you are subject to UK CGT, you are in control with regards to the timing of when you realise gains and will only be liable to CGT if you sell. (Jurisdictions outside the UK may be different so please verify your personal position). If you hold the fund for 40 years, you may see numerous changes to CGT over that period which don't affect you because you choose to never realise a gain above the tax-free exempt amount. This 'timing' benefit is why we suggested only holding investments that you are happy to hold long term – if you are not a seller, there are no gains to tax.

When you sell a share, some of the sale proceeds will be a return of the original investment capital – this element is not taxable. It is common for investors to mentally account for a sale as a realisation of the gain only. For example, where a £500,000 initial investment has risen by 10% to £550,000, an investor sometimes thinks "I will sell £50,000 and realise my profit". However, if they simply sold £50,000 of value, only 10% of that amount is gain, i.e. £5,000. The other £45,000 is return of capital.

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Using Fundsmith Equity Fund T class income shares as an example, someone who invested on day one of the fund would have bought shares at 100 pence. As at 30th June 2021, these shares were worth 567.83 pence (i.e. a circa 468% increase). If an investor sold one share, £1 of the sale proceeds they receive would be return of capital and circa £4.68 would be capital gain.

The majority of fundholders in the Fundsmith Equity Fund actually hold accumulation shares. Although a dividend has been 'paid' every six months since launch, holders of accumulation shares do not receive a payment; instead

the amount is retained in the fund and invested (hence the price of the accumulation shares is higher than those of the income shares, which pay out any dividends received). However, the dividend amount still needs declaring annually for income tax (where not held through an ISA or pension). An investor should keep a record of the cumulative value of these declarations to deduct from any capital gains amount when shares are sold (because they have already been charged to income tax). The dividend history is available on the Fundsmith website and can be found here in the fund factsheet section. Investors often forget to deduct this figure and end up declaring larger capital gains on their accumulation shares as a result.

How to avoid or reduce any potential CGT liability

To shelter investments from potential CGT, where possible, consider utilising your annual ISA allowance. Doing this as early as possible in a tax year, not later, ensures that (in general) more of a gain benefits from ISA protection.

Remember also, when appropriate, you can use your annual CGT exempt amount (£12,300 in 2021/22 tax year) and your spouse's/civil partner's as well if you have one.

Importance of compounding

Through late 2020 and early 2021, many investors, fearful of changes to CGT, were considering selling positions, then re-investing in those same positions to 'lock in' realised gains at a lower CGT rate. The mindset was that it was better to pay 20% tax on gains now, then 40/45% on future gains rather than have the entire amount taxed at 40/45%. How great a benefit might such a course of action produce? If we make some assumptions about the future, we can perform a basic analysis to try and answer that question.

Example - You invested £100,000 in Fundsmith Equity Fund income shares, worth £500,000 after 10 years. You used your annual CGT exemption elsewhere (and will continue to do so) and you are a top rate income taxpayer. Gains are currently taxed at 20% but will be taxed at 45% in future (i.e. alignment with top income tax rates). Future gains will average 10% per annum after charges for next 10 years.

To shelter investments from potential CGT, consider utilising your annual ISA allowance.

Scenario 1	Scenario 2
Sell now and re-invest	No sales now, all gain taxed in future
(£500,000 - £100,000) x 20% = £80,000 CGT	
£420,000 @ 10% over 10 years = £1,089,372	£500,000 @ 10% over 10 years = £1,296,871
Tax position if all sold after 10 years	
(£1,089,372 - £420,000) x 45% = £301,217 CGT	(£1,296,871 - £100,000) x 45% = £538,592 CGT
Net investment after tax	
£788,155	**£758,279**

Observations

All else being equal, there would have been a small benefit of realising gains early in Scenario 1 vs Scenario 2 – holding throughout the period and realising gains later at a higher CGT rate. But perhaps not by as much as the different tax rate suggests or the investor may have thought. In scenario 2, the investor has paid £157,375 more in CGT. However, they did not end up with £157,375 less because they benefited from compounding on a fund which was £80,000 more due to not paying tax on earlier realised gains. Their end position is 'only' lower by £29,876.

It's not as simple as that though...

This simplistic analysis also doesn't address some key issues. When a UK investor does some tax planning involving selling to use an allowance or lower tax rate then buys back the same position through the same account type, they have to wait 30 days to do the re-purchase due to HMRC rules (doing this sell and buy back trade is often referred to as bed and breakfasting). The same shares can be bought back within 30 days but HMRC would 'look through' the sale (i.e. treat it as if it did not happen).

Whilst you wait for 30 days to ensure you comply with the rules, you run the risk of missing out on share gains in that period. For example, the Fundsmith Equity Fund rose 6.6% in June 2021. If you had sold on 30th May, waited 30 days and bought back in on July 1st, that missed gain could nullify any potential tax benefit. So if the 30 day rule applies to you, don't automatically assume selling and repurchasing will always be beneficial.

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Should I be taking any action?

We are unable to give advice on specific scenarios, but we would make these observations:

- Even if tax rates were to rise, that is generally only a problem if you plan to realise all of your gains during that period of higher rates (which most investors don't)
- Future tax rates may be lowered again, especially if increases did not raise much additional revenue or worse, reduced revenue
- Avoiding CGT now means more in your account to grow, i.e. the compounding effect applies to a higher value
- You can sell any Fundsmith investment fund and buy it back through an ISA ***without*** the 30 day rule applying ('bed and ISA')
- By realising some gains tax efficiently using the CGT exemption and then sheltering future growth from CGT (thanks to the ISA), it's possible that any future gain amount subject to CGT is lower than expected, even if rates are increased. Like investing, think longer term when considering your tax position.
- The return of capital effect from each sale means CGT applies to an element of the share price, not all of it. So even if periodic taxable gains were realised over time, the amount subject to tax may be lower than expected.

Over the long term, the benefit of compounding on pre-tax gains in the fund is likely greater and more important to your wealth than short-term taxation legislation

We always stress the '**do nothing**' part of our investment strategy. With tax, a 'do little' position may be beneficial (as opposed to worrying about every tax wrinkle) for long term investors. ***Appropriate*** selling to make use of tax exemptions and ISA allowances makes sense in most cases but don't forget risks of missed gains when out of the market during any selling and buying process. Over the long term, the benefit of compounding on pre-tax gains in the fund is likely to be greater and more important to your wealth than short-term taxation legislation, especially when potential for lost gains due to being out of market are factored in.

Avoiding CGT now means **more in your account to grow**, i.e. the compounding effect applies to a higher value

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