



Peter Horner of Brompton's Auctioneers, The Royal Institution, 21 Albemarle Street, Mayfair discusses the taxation of fine musical instruments with Stephen Parnham

PETER

You are a Chartered Tax Adviser of 30 years experience. I would be interested to hear your views on how is a fine musical instrument such as a violin, viola, cello or guitar is taxed when it is sold.

STEPHEN

The straightforward answer is that a musical instrument such as a violin is a chargeable asset for capital gains tax purposes. When it is sold or gifted it will potentially be liable to capital gains tax (CGT), subject to any available exemptions. The chargeable gain itself is calculated by taking the consideration and deducting the original cost of the instrument and the cost of subsequent enhancements as well as the incidental costs of acquisition and disposal. One then deducts any unused annual exemption, currently £10,600, and the excess is taxed at the vendors marginal rate of income and capital gains tax.

PETER

You mentioned the annual exemption of £10,600. Are there any others ?

STEPHEN

Absolutely ! A violin is a particular kind of asset. It represents tangible moveable property, a chattel, and chattels are subject to special rules when it comes to CGT. Unfortunately these rules bring complications with them but they are intended to make the lives of vendors easier where smaller transactions are involved. The rationale from HM Revenue & Customs perspective is that they do not want to be inundated with CGT calculations which would yield little or no tax and the special rules are designed to achieve this outcome.

There are two main exemptions to consider with respect to fine musical instruments.

Firstly, where the instrument has an expected life of less than 50 years it is regarded as a wasting asset. In that event any gain would be completely exempt from capital gains tax. If one were to purchase a relatively inexpensive violin for instance, its expected life would arguably be less than 50 years. However, fine musical instruments are much more likely to be regarded as antiques and consequently would be expected to last longer than 50 years.

This brings us to the second and more important exemption which is the general one for chattels. This is a simple exemption which exempts any transaction from CGT provided the amount or value of the consideration does not exceed £6,000. If I sell a fine English violin for £5,000 there will be no charge to capital gains tax.

Where the consideration exceeds £6,000, a marginal relief is available to restrict the chargeable gain to a maximum of five-thirds of the excess of the amount or value over £6,000. This is undoubtedly best demonstrated by way of example.

Suppose I were to sell a fine French violin from the late 19th century for £8,000. I purchased it a few years ago for £5,000 and my allowable disposal costs were £300. I would prepare two computations.

The first shows the actual gain which of £2,700 (i.e. £8,000 - £5,000 cost - £300 disposal costs).

The second establishes the excess of consideration over the chattel exemption threshold, in this case £2,000 (i.e. £8,000 - £6,000) multiplied by the fraction $\frac{5}{3}$ to give £3,333 (i.e. £2,000 x $\frac{5}{3}$).

One then takes the lower gain as the taxable gain, in this case £2,700. Consequently there is no marginal relief in my example.

Suppose however that I had acquired the instrument many years before for a mere £2,000.

My first calculation then shows a gain of £5,700 (i.e. £8,000 - £2000 - £300). The second calculation again shows £3,333 as before so the gain on the violin is taken as that lower amount i.e. £3,333. Marginal relief is available giving a welcome reduction of £2,367 in the chargeable gain.

PETER

So the marginal relief is only of practical use where the consideration is not greatly in excess of the £6,000 threshold rather than much higher ?

STEPHEN

Quite. The precise mechanics also depend on the actual gain which needs to be higher than the gain calculated under marginal relief but the general principle from these deliberations is that if your instrument is sold for £6,000 or less it will be exempt for the purposes of CGT.

If it is sold for more then you may be taxed on something less than the actual gain as a result of marginal relief. The important thing to realise is that you will never be taxed on anything more than the actual gain because marginal relief is precisely that, a relief. It is not a mechanism to increase tax. Two calculations are always recommended, one showing the actual gain and the other the chattel relief calculation. Even where you feel it is obvious that the actual gain will be the correct figure to use, marginal relief can sometimes yield surprising results.

PETER

That seems clear but would a professional musician be able to rely on the same principles ?

STEPHEN

Broadly yes. The disposal of an instrument would be subject to CGT. Although a professionals' instrument would certainly be a chattel and therefore two computations should be prepared as a matter of course, the reality is that the consideration is likely to be higher than lower and so the chattels exemption and marginal relief less likely to have relevance for a professional musician.

There is a further point. A professional musician may well have submitted a claim for capital allowances as part of their annual reporting to HM Revenue & Customs with respect to their instrument. This will have served to reduce the owners business income for taxation purposes over one or more years. When the instrument is sold the capital allowance regime has an interface with the capital gains regime and the point to watch for is where the sale proceeds exceed the unrelieved expenditure, sometimes referred to as 'tax written down value'. This will not be uncommon where fine instruments are concerned and any capital allowances given will be withdrawn or clawed back to the extent that the proceeds exceed the tax written down value of the asset but only up to the amount of the original cost. The excess over original cost is dealt with as a capital gain. This effectively means that while the capital gain is usually what one may anticipate (i.e. based on consideration less cost) there may nevertheless be an income tax charge, a so called balancing charge, on disposal.

The good news is that if you are selling your instrument to trade up as it were, then for technical reasons the balancing charge will probably be cancelled out by the new acquisition, although there would in effect be a restriction on the future allowances you can claim as a consequence. The balancing allowance is likely to be much more visible on the cessation of your business as there can be no replacement instrument.

PETER

Interesting

STEVE

Well, it does get a little more convoluted still.

I omitted to mention earlier that if one could successfully maintain that an asset is machinery then there is no chargeable gain at all. HMRC is of the opinion that, say, an antique clock constitutes machinery even though it may not function and even though it was created in the 17th century. In other words the machinery exemption takes precedence over anything else. It is effectively a third exemption. I think that while one may be able to argue with some eloquence that an instrument constitutes machinery, I am far from convinced. A piano may stand a better chance than a stringed instrument but I suspect that HM Revenue & Customs would still be sceptical. .

In any event, I cannot see that this exemption would not be available to professional musicians. One always has to remember that if, say a violin or viola had been used in a professional capacity then the exemption is lost as a matter of course.

PETER

So two taxes could be involved for professional musicians ?

STEPHEN

Potentially, yes, depending on the circumstances. If there are any doubts on the whether capital allowances have been claimed, a review of the last three years accounts and self assessment tax returns should serve to clarify matters. For the continuing professional musician this is more about correct reporting to HM Revenue & Customs. For a musician facing their final curtain call as it were, there can be a more immediate financial consequence.

PETER

You mentioned earlier that capital gains are taxed at a vendors marginal rate of income and capital gains tax. What does that mean exactly ?

STEPHEN

A good question.

Assuming that a capital gain becomes chargeable after any exemptions, it can be taxed at any one of three tax rates. This is because the rate of tax is dependant on both the quantum of the gain and on your marginal income tax rate. In short the capital gain will stand on the shoulders of your taxable income. Where your income after personal allowances and gains are £35,000 or less the gain will be taxed at 18%. To the extent that all or part of the gain exceeds this threshold it is taxed at 28%. If the gain straddles the threshold it will be a blended rate. That is, some of the gain would be taxed at 18% and some at 28%.

However where the gain arises on a business asset one may be looking to secure a rate of 10% through accessing CGT Entrepreneurs' Relief. You would be interested in doing this to be taxed at the third and most beneficial rate of tax, 10%. There are strict conditions to comply with and so it is worth properly reviewing and consolidating the position rather than making assumptions.

It is crucial to remember that there is no 10% rate at all for simply disposing of business assets alone. What one must do is couple that disposal with withdrawing from the business, in this case that of a professional musician. Then you have a good chance of qualifying for this relief. A 10% CGT tax rate and the Entrepreneurs' Relief which justifies it is most likely to be pertinent when retiring as a professional and the timing of disposals can be crucial in obtaining the lower tax rate.

PETER

Fascinating ! Is there anything else vendors should be on the look out for ?

STEPHEN

Always look for any expenditure to increase the allowable cost of your instrument since this will reduce your tax on a sale . I am thinking of areas such as restoration costs and really anything which has not found its way into reducing income tax over the years. Brompton's fees at auction would usually constitute allowable expenditure as a cost of sale, for instance.

There are also capital gains tax consequences when insurance monies are received to put right damages. The calculations can be tortuous even for tax advisers.

We have been talking about things from the vendors perspective but buyers may be selling their instrument to fund the new acquisition and, even if this is not the case, they are likely to be vendors at some point in the future. Everything we have touched on will be pertinent to them also. Tax efficiency is often about taking a prudent medium term stance in relation to planning.

Of course, if you die while owning your instrument it is within your estate and potentially liable to inheritance tax at 40% where the value of your estate exceeds your nil rate band (currently £325,000) or transferable nil rate band. If you are a professional musician your instrument may attract a 100% exemption in the right circumstances.

Finally, if you have built up any historical capital losses over the years these can be set against a gain on future disposals. One would be advised to keep good records of these and identify them every year through your annual self assessment tax return.

PETER

It appears from what you say that while there are identifiable tax principles here it is individual circumstances, both of the instrument itself and of the owner, which determine the ultimate amount of tax which is paid on a disposal.

STEPHEN

Absolutely correct.

A relatively inexpensive instrument may escape tax entirely either because it has a short lifespan or because the proceeds are covered by the chattels exemption. A violoncello by Giovanni Battista Guadagnini or a violin by Giorgio Seraphin is a very different prospect. One also needs to carefully consider the individuals overall and unique tax position. There is not really a substitute for thoroughly understanding an individuals tax position and circumstances before advising on specific cases.

PETER

Could I ask you to sum up in a couple of points?

STEPHEN

Could I make it three ?

Firstly, if you are selling an instrument always think capital gains tax and ways of mitigating it. Our discussion has merely touched on how tax affects fine musical instruments. There are other more general planning tactics which could be employed to mitigate capital gains tax.

Secondly, accurately calculate the gain and ask yourself if any exemptions apply.

Thirdly, constantly ask yourself whether the relevant rate of tax is 18%, 28% or a blended rate and seriously reflect on whether your circumstances could qualify you for the 10% rate, or whether they can be engineered to do so, as you approach retirement.