

# CAPITAL TAXES

## RELEVANT TO ACCA QUALIFICATION PAPER P6 (UK)

This article is relevant to candidates sitting Paper P6 at the December 2008 session, and is based on tax legislation as it applies to the tax year 2007–08 (Finance Act 2007).

Capital gains tax (CGT) and inheritance tax (IHT) are tricky taxes, each with their own exemptions and reliefs, different forms of taper relief, and different methods of calculating the tax due. As a result, having understood the rules of each, it can seem a step too far to deal with both of them in respect of the same transaction. However, once students appreciate that the taxes should be addressed one at a time (and not simultaneously), it becomes clear that a firm knowledge of the rules, together with an orderly approach to the situation, is all that is required to answer an exam question.

This is not an introductory article; it is relevant to students coming to the end of their studies and finalising their preparations to sit the exam. It examines the position where both taxes are relevant to a transaction, and illustrates some of the matters that need to be considered when giving advice in the context of the Paper P6 exam. It does not include comprehensive explanations of the two taxes, but assumes a reasonable knowledge of the rules. It is intended to be read proactively, ie statements made should be confirmed as true by reference to the reader's understanding of the two taxes or to a relevant study text. This will enable future situations to be analysed from first principles, rather than by reference to a rigid set of memorised planning points.

### RELEVANT TRANSACTIONS

It is tempting to think that IHT is only relevant where a transaction includes an element of gift, so that there is a fall in the value of the donor's estate, and that CGT only arises in respect of lifetime gifts and can, therefore, be ignored on death. However, it is always worth considering both taxes where disposals of capital assets are being contemplated. Two examples of the importance of this are as follows:

- The principal relevant tax on the sale of an asset is CGT. However, a sale can also have an effect on the vendor's future IHT position. An example would be where assets qualifying for business property relief are sold and the proceeds retained in the form of cash, or are used to acquire assets that do not qualify for business property relief. This will bring about an increase in the IHT due on the death of the vendor, in respect of the vendor's estate, due to the lack of business property relief on that part of the individual's wealth.
- The principal consideration on the transfer of an asset on death is IHT. However, it is important not to ignore CGT. CGT is still relevant when advising on such a transfer due to the lack of a CGT liability as compared with the situation of a lifetime gift. There is also the fact that the legatee's base cost in the inherited asset is its probate value.

This article is confined to transactions between individuals. For situations where trusts are involved, see my article 'Trusts and tax'. For further detail regarding the relevance of residency, ordinary residence and domicile, see my article 'International aspects of personal taxation'. Both articles can be viewed on the ACCA website.

### EXAM APPROACH

The main problem demonstrated by candidates is a lack of precise knowledge of the rules governing the two taxes. This is particularly evident regarding the availability of exemptions and reliefs. Accordingly, the first task is to acquire an orderly knowledge of the rules so that the two taxes are not confused in the exam.

The two taxes should always be addressed separately under appropriate subheadings; never try to address both taxes at the same time. It does not matter which of the taxes is addressed first.

**Table 1** provides an overview of the elements of the two taxes. Read the table carefully and think about the issues raised. If you do not have sufficient knowledge to think through the implications of a particular point then research that area in your study text.

### COMPARISON OF ALTERNATIVE GIFTS

The following scenario is a combination of two commonly examined situations; comparing

**TABLE 1: CGT AND IHT OVERVIEW**

	<b>CGT</b>	<b>IHT</b>
Arises on:	<input type="checkbox"/> Sales <input type="checkbox"/> Gifts or sales at an undervalue <input type="checkbox"/> Lifetime transactions only	<input type="checkbox"/> Gifts or sales at an undervalue <input type="checkbox"/> On death or within seven years of death
Relevant value:	Market value of the gift	Fall in value of the donor's estate
Relevance of residence, ordinary residence and domicile:	Liability to CGT: <input type="checkbox"/> Only if resident or ordinarily resident If non-UK domiciled: <input type="checkbox"/> Gains on overseas assets taxed on a remittance basis	If non-UK domiciled: <input type="checkbox"/> Overseas assets are not subject to UK IHT Residency is relevant when considering deemed UK domicile
Transfer to spouse or civil partner:	Takes place at no gain, no loss	Exempt <sup>1</sup>
The importance of timing:	Need to consider: <input type="checkbox"/> The availability of taper relief <input type="checkbox"/> The tax year of disposal which will determine: – utilisation of losses – availability of the annual exemption – rate of tax payable by the vendor/donor	Need to consider: <input type="checkbox"/> The availability of the annual exemption <input type="checkbox"/> The use of the nil rate band in the previous seven years <input type="checkbox"/> The availability of taper relief <input type="checkbox"/> No IHT if donor survives gift for seven years
Exemptions:	Various assets are exempt, including: <input type="checkbox"/> Wasting chattels (see <b>Example 1</b> for definition) <input type="checkbox"/> Low value non-wasting chattels <input type="checkbox"/> Main residence There is also the annual exemption	All assets are subject to IHT with one important exception: <input type="checkbox"/> Overseas assets owned by an overseas domiciled individual Certain gifts are exempt including: <input type="checkbox"/> Small gifts <input type="checkbox"/> Marriage gifts <input type="checkbox"/> Gifts out of income There is also the annual exemption Business property relief
Reliefs available in respect of business assets:	Rollover relief <input type="checkbox"/> Requires proceeds to be invested in replacement business assets Gift relief	
Other reliefs:	Gift relief for agricultural property Enterprise Investment Scheme: <input type="checkbox"/> Requires proceeds to be invested in unquoted trading company shares	Agricultural property relief
Other matters to consider:	<input type="checkbox"/> The availability of double tax relief <input type="checkbox"/> Due dates	<input type="checkbox"/> The availability of quick succession relief <input type="checkbox"/> The availability of double tax relief <input type="checkbox"/> Due dates <input type="checkbox"/> Who is responsible for paying any tax due

alternative gifts, and comparing the immediate gifting of an asset with leaving it to the intended recipient via a will.

**EXAMPLE 1**

Edward Teach, a 74-year-old widower, has one child, Anne Bonney. Edward intends to leave the whole of his estate to Anne on his death, but

wishes to make a lifetime gift to her on 1 June 2008. Anne will sell the gift received from Edward immediately and will purchase a second home abroad. Both Edward and Anne are resident, ordinarily resident, and domiciled in the UK. There are two possible gifts:

- 6,000 shares in Adventure Ltd  
Adventure Ltd is an unquoted trading company. Edward owns 20,000 shares in the company representing an 80% holding. The 6,000 shares have an estimated market value of £650,000 and cost Edward £550,000 four years ago. The company owns land held as an investment which represents 8% of the value of its total assets and 10% of the value of its chargeable assets.
- A yacht  
The yacht is worth £650,000. It cost Edward £400,000 in May 2001, and a further £150,000 was spent in May 2002 installing new engines and navigation equipment.

The tax implications of the two gifts are considered below. Commercial matters would also have to be considered, particularly in relation to the introduction of a new shareholder in Adventure Ltd, a company controlled by Edward.

**GIFT OF SHARES**  
**CGT implications**

**Lifetime gift**  
Edward would make a capital gain by reference to the deemed sales proceeds equal to the market value of the shares, ie a gain of £100,000 (£650,000 - £550,000).

Gift relief would be available as the shares are unquoted and Adventure Ltd is a trading company. However, the relief would be restricted because the company owns non-business chargeable assets (the investment land). The shares are business assets as Adventure Ltd is an unquoted trading company (as the non-trading activities relating to the investment land are unlikely to be substantial,

they do not prevent the company from being regarded as a trading company). Accordingly, business asset taper relief would be available such that only 25% of the gain would be chargeable.

In view of the availability of business asset taper relief to Edward, but not to Anne, gift relief should not be claimed (unless Anne has significant capital losses). Edward's gain would be £25,000 (£100,000 x 25%) as reduced by any available annual exemption; the maximum capital gains tax would be £10,000 (£25,000 x 40%).

If Edward and Anne were to claim gift relief, Edward would make a gain of £10,000 (£100,000 x 10%) due to the non-business chargeable assets. After business assets taper relief, this would be reduced to £2,500. The remainder of the gain of £90,000 would be held over and would reduce Anne's base cost to £560,000 (£650,000 - £90,000). Accordingly, Anne's gain would be £90,000 (£650,000 - £560,000) as reduced by any available annual exemption. CGT would then be due at 10%, 20%, or 40% as appropriate. This would result in a liability in excess of £10,000.

On the assumption that gift relief is not claimed, Anne's base cost in the shares would be their market value at the time of the gift. Accordingly, there would be no gain on the immediate sale of the shares by Anne following the gift, as her sales proceeds would equal her base cost.

**Gift via Edward's will**

Gifts on death are exempt from CGT. Anne's base cost would be the market value of the shares at the time of death, so an immediate sale by Anne would be at nil gain.

**IHT implications**

**Lifetime gift**

The gift would be a potentially exempt transfer that would only be subject to IHT if Edward were to die within seven years. If the gift became chargeable, business property relief would not be available as Anne would not own the shares at the time of Edward's death.

Edward intends to retain some of his shares in Adventure Ltd. Accordingly, the value of the transfer would be the fall in value of Edward's estate at the time of the gift. This is likely to differ from the market value of the shares gifted as Edward's holding would be reduced from 80% to 56%, such that he would no longer be in a position to prevent special resolutions being passed.

The fall in value in Edward's estate would be reduced by any available annual exemptions. IHT would then be due on the excess of this amount over the nil rate band at the date of death, as reduced by any chargeable transfers in the seven years prior to the gift of the shares. Taper relief would be available if Edward were to survive the gift by at least three years. The maximum IHT liability would be 40% of the fall in value.

**Gift via Edward's will**

Business property relief of 100% would be available on the non-excepted assets. Accordingly, only 8% of the value of the shares as at the time of death would be subject to IHT (this is on the assumption that the proportion of the company's assets held in the form of investments has not changed).

The shares would be included in Edward's death estate. The excess of the death estate over the available nil rate band (as reduced by

any chargeable transfers in the seven years prior to death) will be subject to IHT at 40%. The maximum liability would be 3.2% (8% x 40%) of the value of the shares.

**GIFT OF YACHT**

**CGT implications**

**Lifetime gift or via will**

The yacht is a wasting chattel (tangible, moveable property with a useful life of no more than 50 years) and as such is an exempt asset for the purposes of CGT.

**IHT implications**

**Lifetime gift**

The gift would be a potentially exempt transfer and would only be subject to IHT if Edward were to die within seven years. IHT would be due on the excess of the value of the yacht at the time of the gift (as reduced by any available annual exemptions) over the available nil rate band (as reduced by any chargeable transfers in the seven years prior to the gift). Taper relief would be available if Edward were to survive the gift by at least three years.

**Gift via Edward's will**

The yacht would be included in Edward's death estate at its value on death. The excess of the death estate over the available nil rate band (as reduced by any chargeable transfers in the seven years prior to death) would be subject to IHT at 40%.

It is clear from **Table 2** that, purely from a tax point of view, Edward should give Anne the yacht rather than the shares.

**TABLE 2: SUMMARY OF POSITION AND ADVICE**

	<b>CGT liability at time of gift</b>	<b>IHT liability on death</b>
<b>Shares:</b>		
Lifetime	Maximum liability of £10,000	Possibly significant if death within seven years Falls as time period between the gift and death increases
Death	Nil – exempt	Small
<b>Yacht:</b>		
Lifetime	Nil – exempt	Possibly significant if death within seven years Falls as time period between the gift and death increases
Death	Nil – exempt	Significant

There will be no tax at the time of the gift. In addition, there will be no tax at the time of death provided Edward survives the gift by seven years. Even if Edward were to die within seven years of the gift, the amount of IHT due on death is likely to be less than the amount due if the yacht were held by Edward until death, due to the availability of taper relief. Before concluding on this, it would be necessary to consider the chargeable transfers made by Edward during the seven years prior to the proposed gift and the likelihood of the yacht increasing or falling in value.

The situation regarding a gift of the shares is not so straightforward. A lifetime gift will result in a CGT liability of up to £10,000. There is also the possibility of an IHT liability of 40% of the fall in value of Edward's estate if Edward were to die within three years of the gift. However, there would be no IHT liability if he were to survive the gift by at least seven years.

Retaining the shares until death would avoid the CGT liability, and would guarantee an IHT liability up to a maximum of 3.2% of the value of the shares.

Accordingly, a lifetime gift of the shares would be a gamble by Edward. If he were to survive the

gift by seven years, the total tax due would be CGT of £10,000; if he were to die within three years, the total tax due is likely to be considerable. His alternative is to hold on to the shares and then a relatively small amount of IHT would be paid out of the death estate.

### **CONCLUSIONS**

The following general conclusions can be drawn from this article:

- 1 With reference to IHT, assets which are subject to IHT but not CGT (ie those which are exempt from CGT) can be planned for by reference to IHT only. From an IHT point of view it is, of course, advantageous to give away assets as soon as possible as this opens up the possibility of surviving the gift by seven years or, failing that, the possibility of taper relief. It is particularly important to gift assets that are expected to increase in value as the value on which IHT is calculated is fixed at the time of the gift.
- 2 Also with reference to IHT, care must be taken when advising on assets that qualify for business property relief or agricultural property relief due to the need for the recipient to hold the assets until the death of the donor in order

for the relief to be available on the donor's death. If it is clear from the facts that the recipient intends to sell the assets gifted, there is likely to be a significant difference between the IHT due on death within seven years of the lifetime gift and that due on the asset when comprised within the death estate.

- 3 With reference to CGT, it is not always advantageous to claim gift relief. Also, gift relief is not always available; in particular, unless the gift is to a trust, the assets must qualify for the relief.

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<sup>1</sup> (maximum exempt transfers of £55,000 from domiciled individual to non-domiciled individual)

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