

CAPITAL TAXES

RELEVANT TO ACCA QUALIFICATION PAPER P6 (UK)

THIS ARTICLE IS BASED ON TAX LEGISLATION AS IT APPLIES TO THE TAX YEAR 2008-09 (FINANCE ACT 2008), AND IS RELEVANT FOR CANDIDATES SITTING PAPER P6 (UK) EXAM IN JUNE OR DECEMBER 2009.

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Capital gains tax (CGT) and inheritance tax (IHT) are tricky taxes, each with its own exemptions and reliefs, and different methods of calculating the tax due. As a result, having got to grips with the rules of each of them, it can seem like a step too far to deal with both of them in respect of the same transaction. However, once it is appreciated that the taxes should be addressed one at a time (and not simultaneously), it becomes clear that all that is necessary is a clear knowledge of the rules, together with an orderly approach to the situation in the 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 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 approach 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 can be tempting to think that IHT is only relevant where a transaction includes an element of gift, such that there is a fall in value of the donor's estate, and that CGT only arises in respect of lifetime gifts and can 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 given below.

1. 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 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.

2. 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 on 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 P6 (UK)'; for detail on the relevance of residency, ordinary residence and domicile, see my article 'International aspects of personal taxation for P6 (UK)'. Both these are available at http://www.accaglobal.com/students/study_exams/qualifications/acca_choose/acca_professional/atx/technical_articles/

Exam approach

The main problem demonstrated by candidates in the exam is a lack of precise knowledge of the rules governing the two taxes. This is particularly evident in connection with the availability of exemptions and reliefs. Accordingly, your first task is to acquire an orderly knowledge of the rules such that you do not confuse the two taxes 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.

CAPITAL GAINS TAX (CGT) AND INHERITANCE TAX (IHT) ARE TRICKY TAXES, EACH WITH ITS OWN EXEMPTIONS AND RELIEFS, AND DIFFERENT METHODS OF CALCULATING THE TAX DUE. AS A RESULT, HAVING GOT TO GRIPS WITH THE RULES OF EACH, IT CAN SEEM LIKE A STEP TOO FAR TO DEAL WITH BOTH OF THEM IN RESPECT OF THE SAME TRANSACTION.

Table 1 on **page 68** 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, you should research that area in your study text.

Comparison of alternative gifts

The following scenario is a combination of two commonly examined situations; the comparison of alternative gifts and the comparison of gifting an asset now with leaving it to the intended recipient via a will.

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 2009. Anne will sell the gift received from Edward immediately, to enable her to purchase a second home overseas. Both Edward and Anne are resident, ordinarily resident and domiciled in the UK.

There are two possible gifts:

1. 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.

2. A yacht

The yacht is worth £650,000. It cost Edward £400,000 in May 2002; a further £150,000 was spent in May 2003 to install 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

(a) 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).

Edward owns more than 5% of Adventure Ltd and has owned the shares for more than 12 months. In addition, Adventure Ltd is a trading company. However, entrepreneurs' relief will only be available if Edward is an employee of Adventure Ltd.

Gifts holdover 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).

If Edward is an employee of Adventure Ltd, such that entrepreneurs' relief is available, gifts holdover relief should not be claimed (unless Anne has significant capital losses). Edward's gain of £100,000 would be reduced by 4/9 and any available annual exemption; the maximum capital gains tax would be £10,000 (£100,000 x 5/9 x 18%). 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.

If Edward is not an employee of Adventure Ltd, he and Anne should claim gifts holdover relief in order for each of them to benefit from an annual exemption. Edward would make a gain of £10,000 (£100,000 x 10%), due to the non-business chargeable assets, which would then be reduced by any available annual exemption. The maximum CGT liability would be £1,800 (£10,000 x 18%).

The remainder of the gain of £90,000 would be held over and 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. The maximum CGT liability would be £16,200 (£90,000 x 18%). The total CGT due would be a maximum of £18,000 (£1,800 + £16,200).

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.

(b) 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

(a) 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 capital gains tax.

(b) 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%.

Table 2 on **page 69** shows a summary of position and advice.

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

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 £18,000. 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, but 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 either £10,000 or £18,000, depending on whether or not he is an employee of Adventure Ltd. If he were to die within three years of the gift, the total tax due is likely to be considerable due to the IHT payable. His alternative is to hold on to the shares and pay a relatively small amount of IHT out of his death estate.

Finally, Edward should be advised that an insurance policy could be taken out on his life in order to satisfy any future IHT liability arising in respect of a lifetime gift.

WITH CGT, IT IS NOT ALWAYS ADVANTAGEOUS TO CLAIM GIFTS HOLDOVER RELIEF. ALSO, THE RELIEF IS NOT ALWAYS AVAILABLE; IN PARTICULAR, UNLESS THE GIFT IS TO A TRUST, THE ASSETS MUST QUALIFY FOR THE RELIEF.

Conclusions

The following general conclusions can be drawn from the above.

1. IHT – Assets which are subject to IHT but not CGT (i.e. 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. 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. CGT – It is not always advantageous to claim gifts holdover relief. Also, the 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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TABLE 1: OVERVIEW OF CGT AND IHT

	CGT	IHT
Arises on	<ul style="list-style-type: none"> ▣ Sales ▣ Gifts or sales at an undervalue ▣ Lifetime transactions only 	<ul style="list-style-type: none"> ▣ Gifts or sales at an undervalue ▣ 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: <ul style="list-style-type: none"> ▣ Only if resident or ordinarily resident If non-UK domiciled: <ul style="list-style-type: none"> ▣ Gains on overseas assets taxed on remittance basis (may require payment of £30,000 fee) 	If non-UK-domiciled: <ul style="list-style-type: none"> ▣ 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
The importance of timing	Need to consider the tax year of disposal which will determine: <ul style="list-style-type: none"> ▣ Utilisation of losses ▣ Availability of the annual exemption ▣ Rate of tax payable by the vendor/donor 	Need to consider: <ul style="list-style-type: none"> ▣ The availability of the annual exemption ▣ The use of the nil rate band in the previous seven years ▣ The availability of taper relief ▣ No IHT if survive gift for seven years
Exemptions	Various assets are exempt, including: <ul style="list-style-type: none"> ▣ Wasting chattels ▣ Low value non-wasting chattels ▣ Main residence There is also the annual exemption	All assets are subject to IHT with one important exception: <ul style="list-style-type: none"> ▣ Overseas assets owned by an overseas domiciled individual Certain gifts are exempt including: <ul style="list-style-type: none"> ▣ Small gifts, marriage gifts ▣ Gifts out of income There is also the annual exemption
Reliefs available in respect of business assets	Rollover relief <ul style="list-style-type: none"> ▣ Requires proceeds to be invested in replacement business assets Gifts holdover relief Entrepreneurs' relief	Business property relief

TABLE 1 CONTINUED: OVERVIEW OF CGT AND IHT

Other reliefs	Gifts holdover relief for agricultural property Enterprise investment scheme: <ul style="list-style-type: none"> ▣ Requires proceeds to be invested in unquoted trading company shares 	Agricultural property relief
Other matters to consider	<ul style="list-style-type: none"> ▣ The availability of double tax relief ▣ Due dates 	<ul style="list-style-type: none"> ▣ The availability of quick succession relief ▣ The availability of double tax relief ▣ Due dates ▣ Who is responsible for paying any tax due

TABLE 2: SUMMARY OF POSITION

	CGT liability at time of gift	IHT liability on death
Shares: <i>Lifetime</i>	Edward is an employee: Maximum liability of £10,000 Edward is not an employee: Maximum liability of £18,000	Possibly significant if death within seven years. Falls as time period between the gift and death increases.
<i>Death</i>	Nil - Exempt	Small
Yacht: <i>Lifetime</i>	Nil - Exempt	Possibly significant if death within seven years. Falls as time period between the gift and death increases.
<i>Death</i>	Nil - Exempt	Significant