The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Owner-Managed Businesses

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Suggested solution

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Proposed Gift of Shareholdings in Simpson Engineering Ltd to Simon Simpson and Ancillary Issues

Introduction
As agreed at our meeting on 22 April 2022 this report considers the transfer of your shareholdings in Simpson Engineering Ltd (`SEL') to Simon. Our analysis is based on the share values provided by ZYX Valuation Services Ltd and on the following assumptions:

- Your shareholdings will be entirely gifted to Simon (i.e. there are no sale proceeds at all)
- Anne`s life expectancy is a further three years.
- That your shareholdings will increase in value by a further 15% after 3 years and 40% after seven years
- Your only previous relevant significant gift was of your former house on 30 June 2019 and that this gift was valued at £675,000.
- Surplus cash within SEL is £75,000.

Executive Summary
Gifting your shareholdings in SEL to Simon now would give rise to CGT liabilities of £7,722 and maximum IHT liabilities of £12,150 for both of you if you do not survive the gifts by at least three years.

To achieve your objective of gifting your shareholdings as quickly as possible whilst avoiding these CGT and IHT liabilities:

SEL should sell both of its non-trading assets and remove the majority of the expected £285,000 surplus cash arising by making total pension contributions of £185,000 on your behalves.

Both of your shareholdings could then be transferred. Gift relief (`GR`) claims should be made, for which Simon`s consent will be required, to cover the chargeable gains arising.

The residual expected surplus cash of £100,000 should then be used to buy Robert`s warehouse for its market value (`MV`).

If these steps are taken no personal CGT or IHT liabilities should arise on the share disposals although SEL will become liable for corporation tax (`CT`) of £3,895 and Robert for CGT of £2,200.

The pension contributions are likely to create a trading loss for SEL enabling CT savings at the rate of 19% (if the loss is carried back) or 25% (if the loss is carried forward).

Capital Taxation of Gifts

Capital Gains Tax
Lifetime
A gift of your shareholdings during your lifetimes will be a chargeable disposal for CGT purposes. You will each be deemed to dispose of your shares at their MV when gifted. Where unquoted shares are

disposed of this MV will reflect the actual proportion of shares held, with shares forming part of a 50% holding currently valued at £725 per share.

If you make the gifts now you would each generate a chargeable gain, being the difference between £362,500 (725 x 500) and your base cost. Robert`s base cost will be £10,000 (£20,000 x 500/1000), based upon the probate value when his father died. Anne`s base cost will also be £10,000 as assets transferred between spouses are deemed transferred on a no gain/no loss basis. For both of you therefore a substantial chargeable gain of £352,500 (£362,500 - £10,000) would arise.

When considering lifetime gifts, it will be very important to consider the availability and effects of any potential mitigating reliefs available, particularly GR and/or business asset disposal relief (`BADR'). Both of these are considered in more detail below.

As the shares are increasing in value, delaying the gifts during your respective lifetimes would lead to higher chargeable gains arising, so the timing of any gifts also requires consideration.

Following the gifts Simon will have a base cost equal to the MV of the shareholdings at the date of the gifts.

Death
There is no CGT upon death so no CGT liability would arise if Anne's shareholding was transferred upon her death. Simon would again acquire the shareholdings at their MV at that time (which, it is noted, is likely to have increased from now, giving him a higher base cost to offset on any future disposal).

Inheritance Tax
Lifetime
IHT can arise upon lifetime gifts, as well as upon death (unlike CGT).

For somebody likely to survive seven years there can be some advantages in making lifetime gifts as soon as possible:

- IHT will not arise if the donor survives the gift by seven years, in which case a gift to another individual (referred to as a potentially exempt transfer (`PET') becomes exempt.
- Annual exemptions are available (£3,000 for the tax year of gift and £3,000 brought forward from the previous tax year if unused in that year)
- Even if death occurs within seven years (referred to as a 'failed PET'):
    - (i) Any IHT arising will be based upon the value of the asset when gifted (and not in the case of an appreciating asset the potentially higher value at death).
    - (ii) Tapering relief will be available after surviving at least 3 years (which reduces any IHT liability on the gift by 20% for each full year after three years that the donor survives).

Any IHT arising on a failed PET will be payable at the rate of 40% by the donee, subject to the tapering relief noted above.

For IHT purposes the basis of valuing your shareholdings will be different to CGT. The value transferred will be determined as the difference between the value of your estate before and after the gift (under the loss to the donor principle). Further, under the related property rules, your respective spouse's shareholdings will also need to be taken into account. This means that the values before and after must be valued as a proportion of the value of the whole of the related party (and not just on the individual's personal holding).

If the gifts are made in the very near future the maximum transfer value for each of you is likely to be £485,000 (Appendix I). If certain IHT anti-avoidance provisions (referred to as associated operations) are found not to apply and the gifts are made on separate days the second gift (when there will no longer be any related property) may have a reduced transfer value of £362,500 (500 x £725). These are also substantial amounts, which will increase as the underlying share values increase over time. Again, it will therefore be very important to consider the availability of any mitigating reliefs, notably business property relief (`BPR') considered further below, as well as the timing of any gifts.

Death
Your shareholdings, again valued using the related property rules, would form part of your estate. The delay will therefore result in IHT being based on a higher value. Additionally, no annual exemptions are available upon death.

Any IHT arising will be payable at the rate of 40% by the executors of the estate.

Stamp Duty
No stamp duty is payable when shares are gifted as lifetime gifts (providing there is no consideration) or upon death. Stamp duty does not therefore need to be considered further.

Overall
The chargeable gains and transfer values for IHT purposes mentioned above are substantial. CGT will only arise on lifetime gifts whilst IHT could arise for both lifetime gifts and those on death. Taking account of any available reliefs there will therefore be a need to balance any CGT and IHT liabilities on making lifetime gifts in the near future (which will be based on lower values) compared to any future IHT (only) liabilities arising on death (which will be based on higher future values).

Availability of Reliefs

CGT

Business Asset Disposal Relief
This relief operates by reducing the rate of CGT on eligible disposals from 20% to 10%. Disposals of shareholdings can qualify providing, throughout a period of two years ending with the disposal, (i) the company is the individual's personal company (holds at least 5% of the ordinary shares (and any attached rights)); (ii) the company is a trading company, and; (iii) the individual is an officer (directors are officers) or employee of the company.

A trading company is one whose activities do not include more than 20% non-trading activities. This is measured using such factors as company income, how staff time is spent, and the value of non-trading assets in the company`s balance sheet (as a proportion of total company assets).

SEL owns relatively significant non-trading assets with a current MV of £210,000 (comprising £50,000 for the shares in WR Woodturning Ltd (`WRWL`) and £160,000 for an investment property). HMRC may also regard the surplus cash of £75,000 as being a non-trading asset. Non-trading assets as a percentage of total company assets could therefore be as high as 28.5% (£285,000/£1,000,000 (£970,000 plus £30,000 liabilities), exceeding the 20% limit. However, the above factors have to be considered `in the round`. SEL does not have very much investment income and little management

time will be involved in managing its investments. On balance it is therefore considered that BADR should be available, meaning that a CGT rate of 10% is likely to apply.

Gift Relief

This relief operates by reducing the donor's qualifying chargeable gain to zero whilst simultaneously reducing the donee's base cost for future disposal purposes by the relieved gain. It therefore acts as a deferral, rather than a permanent, relief.

Shares in unquoted trading companies are qualifying assets but the same 20%-test detailed above to determine trading status also applies. This relief should also therefore be available.

However, two other points are worthy of mention:

(i) GR requires a *joint* election (in writing within 4 years of 5 April following the relevant tax year), such that Simon would need to give his consent.

(ii) GR is restricted where chargeable (to CGT) non-trading assets are held by a company at the time of the gift (see Appendix II).

It is worth noting that surplus cash is not a chargeable non-trading asset.

IHT

The most significant mitigating relief is BPR.

Providing the required conditions are satisfied BPR provides 100% relief from IHT for shareholdings in unquoted companies, for both lifetime gifts and transfers upon death. It is therefore a very valuable relief.

The main conditions are (i) that shareholdings have been held for at least two years prior to the transfer; (ii) the company's business is `wholly or mainly' trading in nature, and; (iii) for lifetime gifts, the donee needs to have retained the shares until the donor's death (or replaced them with other qualifying assets) and they remain qualifying in nature.

You will both meet the first condition.

Wholly or mainly simply means more than 50% and is determined by reference to the main activities undertaken by a company, its assets and sources of income over a reasonable time period (usually twelve months). This is therefore much less onerous than the 20% test used for CGT reliefs. Your shareholdings in SEL should therefore meet the second condition.

If Simon retains the shareholdings until you die (and SEL has not materially changed in character) the third condition will be met.

Whilst SEL should satisfy the 50% test, BPR will still be restricted for any excepted assets the company owns. Excepted assets are those which were neither used wholly or mainly for business purposes during the previous two years nor are required for future use in the business. The key word here is `business' - providing the overall wholly or mainly test has been satisfied whilst SEL's activities include an investment `business', this is still nevertheless part of its overall business so the underlying investment assets will not be regarded as excepted assets.

It is, however, likely that the £75,000 surplus cash will be regarded as an excepted asset. BPR would therefore be restricted (as outlined in Appendix I).

Whilst £75,000 is a relatively small part of the total asset value of SEL this would mean that some IHT will remain payable upon transferring your shareholdings to Simon, either as lifetime gifts or upon death.

Preliminary Conclusions

Without further action being undertaken (see below) it would not be possible to gift your shareholdings without a tax cost. The position would be as follows:

Anne

After taking account of the £75,000 excepted asset, a gift of Anne`s shareholding now (assuming she dies within three years) triggers a maximum IHT liability of £12,150 (Appendix I). For each full year she survives after three years taper relief would be available to reduce this liability (at 20% per year).

Assuming GR and BADR are available, a gift now would also trigger a CGT liability of £7,722 (Appendix II) payable by 31 January 2024. It should be noted that as there are no funds generated by the transfer this liability would need to be met from other available resources.

A total liability of £19,872 (£12,150 + £7,722) would therefore arise.

If the shareholding is instead transferred to Simon upon Anne's death (again assumed to be within three years) an IHT liability of £16,732 would arise (£485,000 x 1.15 = £557,750 x 7.5% (100% - 92.5% BPR) = £41,831 x 40%). This assumes that the surplus cash, an excepted asset, increases by the same proportion. There would be no CGT upon Anne`s death so Simon would receive a significant tax-free uplift in the base cost of the shares.

Without further action, from a tax perspective, it would therefore be preferrable for Anne to transfer her shareholding upon her death.

Robert

If Robert gifts his shareholding now, again assuming GR and BADR will apply, a CGT liability of £7,722 would also become payable by 31 January 2024. If he survives a further seven years no IHT will, however, become payable (and if he does not the IHT payable will be based on current values and will be a maximum of £12,150 (Appendix I), with tapering after surviving three years).

Without any further action the position for Robert is less clear-cut and would ultimately turn upon his view regarding surviving a gift of shares now by seven years (or at least three years to access taper relief). As he is in good health, a gift to Simon now, whilst triggering a CGT liability, may be preferred, as this would maximise his chances of surviving seven years, thus avoiding any IHT liability. Alternatively, Robert could transfer his shares to Anne (using available inter-spouse exemptions to avoid any immediate CGT or IHT liabilities) with Anne then transferring all of the shares to Simon upon her death.

GR/BADR not available

In the unlikely event that a non-trading status is determined for SEL such that BADR and GR are not available it is important to note that, as also shown in Appendix II, the resulting CGT liability for Robert (assuming Anne transfers her shares CGT-free upon her death) would, at £68,040, be considerably greater. For reasons of prudence alone therefore it would be recommended that any possible mitigating action detailed below is carefully considered.

Further Action

The principal problem identified with gift of your shares to Simon now is the existence of chargeable non-trading assets within SEL which are likely, at the very least, to cause a restriction of GR. The surplus cash, being an excepted asset, is also a problem for IHT purposes.

The disposal of these assets by SEL is therefore likely to be beneficial. It will, however, be necessary to consider (i) any CT implications that may arise and (ii) the fact that the disposals in themselves could create additional surplus cash, which will therefore need to be extracted from the company in some way.

Corporation Tax

Companies pay CT on the disposal of chargeable assets at the rate of 19%. A disposal of your shares in WRWL, however, being at least a 10% holding held for at least twelve months, will be exempt from charge.

Assuming that the MV does not materially change, a disposal of the industrial unit would, however, result in a chargeable gain of £45,000 (£160,000 - £115,000). The capital loss brought forward of £24,500 could be offset producing a net gain of £20,500 and a CT liability of £3,895 payable by 1 July 2023 (if sold in the year ending 30 September 2022).

The total CT liability of £3,895 would therefore be much less than your personal liabilities detailed above.

Use of Funds

Assuming both investment assets are sold, surplus cash will rise to £285,000. It is recommended that £100,000 of this should be retained to buy Robert`s warehouse (see below). This will be an asset used in SEL's trade so whilst this is the case will not create future GR problems. Additionally, because these otherwise surplus funds are now allocated for future use in the business, they will no longer be regarded as excepted assets for IHT purposes. It would be prudent to record the fact that these funds are being retained to buy the warehouse in a director's minute.

The remaining £185,000 would then need to be extracted. Extracting this as additional equal remuneration would result in additional income, mostly subject to a 40% income tax but some, particularly for Anne, also liable at 45%, and additional class 1 national insurance contributions (`C1NIC`) (employee's 2% and employer's 12%) and the loss of your personal allowances. Whilst such payments would be CT deductible, they will therefore be very tax-expensive and not recommended. Additional dividends would be better as, whilst these are not CT-deductible, income tax rates applying will be lower at 32.5% and 38.1% respectively and they would not be subject to any C1NIC. This would also, however, be tax-expensive and therefore not recommended.

The most tax-efficient option would be for the company to make additional contributions to your pension schemes. Such contributions would need to be wholly and exclusively for the purposes of

SEL's trade, but we do not believe that this would be a problem. SEL would therefore obtain a CT deduction when paid whilst there would be no personal tax implications for yourselves. This would therefore be the recommended course of action.

Additional contributions totalling £185,000 paid in the year ended 30 September 2022 will almost certainly create a trading loss for that year. This could be offset against any chargeable profits for that year (including the residual gain on a sale of the industrial unit), with any excess carried back to obtain a CT refund for the year ended 30 September 2021. This would achieve savings at the current CT rate of 19%. Alternatively the loss could be carried forward for use against any future profits which, as CT rates will rise from 1 April 2023 to 25%, would achieve savings at a higher rate.

Sale of Warehouse

Robert would incur a chargeable gain of £22,000 (£100,000 - £78,000) if he sells his warehouse to SEL. Because the warehouse has been used by SEL in its trade for more than two years and has been owned by Robert for more than three years an `associated disposal' will occur if (i) the disposal of Robert's shareholding qualifies for BADR (ie SEL has met the 20% test for at least two years), and; (ii) the warehouse is disposed of within three years of the share disposal. In these circumstances the CGT rate applying will reduce to 10%.

With BADR Robert's CGT liability would therefore be £2,200 (22,000 x 10%).

It is also worth noting that currently BPR at the rate of 50% is available for the warehouse. When this transfers to SEL its value will be within the value of SEL's shares thus attracting BPR at the increased rate of 100%.

Other Issues

Share Transfers

To transfer your shareholdings stock transfer forms will need to be completed followed by amending entries in the company`s share register. Any pre-emption rights contained in the Articles will need to be formally waived.

Wills

Your wills are currently reciprocal in nature, passing your estates to the surviving spouse and then onto Simon. It may be prudent for you to arrange for these to be altered to make it clear that, if retained, your shareholdings in SEL will pass to your son on your deaths.

Appendix I
Potential IHT Liability

Valuation of first gift of shares using related party rules

			£
Value Before gift		50% x £970,000 (1000 x £970)	485,000
Value after gift		0% of 50% holding	0
			________
			485,000
Less:	BPR	(£1,000,000-£75,000)/£1,000,000 (92.5%)	(448,625)
			________
			36,375
Less:	Annual exemptions	– tax year of transfer	(3,000)
		- previous tax year brought forward	(3,000)
			________
			30,375
			========
IHT x 40%			12,150
			========

Notes:
The nil rate band of £325,000 is allocated to the gift occurring on 30 June 2019 (which being within seven years of death also becomes chargeable)
No taper relief is available as death is assumed to be within three years of the gift.

Appendix II
Potential CGT Liability

With Restricted GR and BADR

			£	
Chargeable gain			352,500	
Less:	GR (working)	470,000/630,000 x 352,500	(262,976)	
Remaining chargeable			89,524	
Less:	Annual Exempt Amount			(12,300)
			77,224	
CGT x 10%			7,722	

Working
£220,000 (freehold) + £250,000 (goodwill) = £470,000 + £160,000 (industrial unit) = £630,000.
Goodwill is included as created before 1 April 2002. The WRWL shares are excluded as they are not chargeable.

Without GR and BADR

		£	
Chargeable gain		352,500	
Less:	Annual Exempt Amount		(12,300)
		340,200	
CGT x 20%		68,040	