Application and Professional Skills

Chartered Institute of Taxation
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Taxation of Individuals

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Report

To: George and Rachel Hosking
From: Leanne Jones
Date: 6 November 2019
Subject: Gift to Amy and Income tax planning.

This report is in response to our meeting on 23 October 2019 and your follow up email on 31 October 2019. I have used 2018/19 tax rates throughout the report.

The report will cover the following topics

SECTION A: Proposed Gift to Amy

SECTION B: New Furnished Holiday Letting Business (FHL)

SECTION C: Other Income Tax and Inheritance Tax planning.

Executive Summary

Section A : Gifts to Amy

RH should gift the property to Amy over the Shares before September 2020.

With entrepreneur's relief available on the deemed disposal of the property, RH would save CGT of just under £11,000.

Although Amy would be better off by £1,000 each year with the dividend income, RH would be better off by just under £3,000 per year ~~with~~ by retaining the dividends. RH could then consider gifting less than £3,000 to Amy each year free of IHT to use RH's annual ~~gifting~~ allowances.

Section B - New FHL business

GH should own the FHL 100%. A transfer of 50% ownership from RH to GH would be at nil gain nil loss.

GH would then be taxed at 20% on rental profits compared to a likely 40% on RH

GH can then make larger pension contributions as FHL income is 'relevant earnings' ~~for~~ for pension contributions.

GH should be careful to meet the requirements of a FHL annually and ensure it is rented out at least 105 per year otherwise averaging may be available.

GH should maximise his pension contributions each year to obtain income tax relief and because pension funds are outside a person's estate for IHT purposes

<u>Section C - Other tax planning</u>

RH & GH's estates currently have large IHT exposure.

Consider making up to £3,000 cash gifts each year to use up annual exemptions.

RH and GH should keep an eye on investments as respective estates are close to £2 million threshold which would taper the RNRB.

SECTION A : Proposed gift to Amy.

George (GH) and Rachel (RH) wish to gift Amy an income generating asset in the form of either a commercial property or shares in John Ford.

A gift of either of the above assets made to Amy is a deemed disposal, by RH the "donor", of the asset. The deemed proceeds of the deemed disposal is the market value of the asset at the date of the gift.

The cost basis of the asset is deducted from the proceeds to calculate the capital gain which is subject to Capital gains tax on either the donor (RH) or the donee (Amy) if a gift relief claim can be made.

The gift will be a potentially exempt transfer (a PET) for inheritance tax (IHT) purposes by RH at the market value (mv) of the asset at the date of the gift

As long as RH survives the gift by 7 years there will be no IHT due on the gift by the donor. However, if RH were to pass away within 7 years, IHT of 20% would be due by Amy on the value of the asset less ~~x~~ £6,000 annual exemptions from 2018/19 and 2019/20 since RH has made no other lifetime gifts.

Tapering relief will reduce the amount subject to IHT by 20% for every year RH survives the gift after 3 years.

The proposed options for the gift are
Option 1: Commercial property used by GRH Engineering or
Option 2: Shares in John Ford Ltd

We will discuss each option separately.

Option 1 : The "property"

If ~~you~~ RH were to gift the property to Amy, RH will have deemed to have sold the property at mv on the date of the gift.

The base cost of the property is the mv at the date of the gift made by RH's father being £680,000. Since there was no hold-over claim RH would have had the step up in basis being £680,000.

The current mv of the property is £920,000, therefore RH would have a deemed gain of £240,000 as shown in Appendix 2.

Assuming RH makes no other disposals in the year, she will have an annual exemption of £11,700 which reduces the gain.

As the property was used in RH's unquoted trading company 'GRH Engineering partnership' and will be sold within 3 years of the sale of the business (i.e. before September 2020), the sale of the property will qualify for entrepreneur's relief. (ER)

As you may remember from the sale of your business, ER taxes the gain from a material disposal of a person's trading business at the reduced rate of 10%. This also includes the disposal of an asset used in the business as long as it was held by the business for at least one year prior to the sale of the business. The asset must be sold within 3 years of the sale of the business to qualify for ER.

As appendix 2 shows, RH would have a CGT liability of £22,830.

It is not possible, nor would it be desireable, to hold-over this gain against the base cost of the property as Amy would not qualify for ER on the future disposal of the property.

If RH were to gift the property to Amy, and Amy rented out the property. Amy would be taxed on the rental income.

As Amy does not have any other income, she has a full personal allowance of £11,850 to reduce the income. The taxable income is below the basic rate band (BRB) of £34,500 and is therefore taxed at 20%.

Appendix 2 shows that Amy's net income after tax would be approx £28,770.

Option 2 - Gift the JFord shares to Amy

The 'deemed' sale of the JFord shares to Amy would generate a capital gain of £180,000 as shown in Appendix 3.

~~As y~~ The base cost of the shares are the mv at the date they were issued to RH on the sale of GRH engineering being £600,000.

The sale of JFord shares by RH would be a sale of 3% of the company. Since this is below 5%, the sale would not qualify for ER. The capital gain after RHs annual exemption would be taxable at 20% as RH has other income using up her nil rate band. The CGT as shown in Appendix 3 would be £33,660.

Any number of shares in an unquoted trading company can qualify for gift relief.

Gift relief (GR) defers the capital gains tax charge by reducing the cost basis of the shares in the hands of the donee (Amy)

Without the GR, RH would pay CGT of £33,660 and Amy's basis of the shares would be £780,000 in a future sale.

With GR, RH would not pay CGT on the deemed disposal to Amy and Amy's base cost would be £600,000 (same as RHs)
Amy would then be liable to a bigger CGT charge on a future sale.

From my understanding of RH and Amy's financial position, it is unlikely that RH would want to make a GR claim.

If a claim were to be made, it is a joint claim between RH & Amy.

If Amy held the JFord shares, she would be taxed on the dividends received (approx £31,000 per year)

As Appendix 3 shows, after a full personal allowance and dividend allowance of £2,000 (tax-free dividend allowance), Amy's tax liability would be £1,286 and net income after tax would be approx. £29,714.

From a purely net income after tax basis, Amy would be better off by approximately £1,000 per year if she held the dividends rather than the property.

However, from a capital gains tax perspective, assuming a Gift Relief claim is not desireable, RH would save approx £10,830 in capital gains tax if RH gifted the property (pre Sep 2020) instead of the JFord shares.

From an income tax perspective on RH, in 2020/21 it is understood that RH will retire from J Ford Ltd and receive pension income of £13,000 per year.

Appendix 1 shows RHs approximate net income after tax if she were to keep the property and receive rental income of £33,000 per year compared with receiving dividend income from J Ford Ltd.

Using 2018/19 tax rates, RH would be 'better off' by approx. £2,700 per year if she were to keep the dividends and gift the property to Amy

In summary, the below table compares the net income after tax from the proposed gifts on Amy & RH and the CGT due on RH

	Amy	RH	RH CGT
Option 1 (gift property)	28,770	42,795	22,830
Option 2 (gift shares)	29,714	40,090	33,660.

Although Amy is slightly better off each year with the shares, RH would be far better off gifting the property to Amy from an income tax and capital gains tax perspective

I would recommend in any event that RH sell the property ahead of September 2020 to make use of ER ~~and~~ at a tax saving of £22,830 than if she were to keep hold of the property and sell at a later date with CGT at 20%.

The income tax that RH will also save each year more than doubles the additional tax due on Amy, RH should therefore consider making annual gifts of less than £3,000 to

Amy to use her IHT annual exemptions. Such small gifts would not be taxable if RH were to die in 7 years, and would reduce RHs estate for IHT purposes.

I recommend that RH gift the property to Amy over the shares and consider gifting up to £3,000 of cash to Amy each year free of any IHT charges.

Section B - New furnished Holiday letting Business

RH and GH currently hold a residential property as joint tenants. Any income generated by the property would currently be taxed 50% by GH and 50% RH.

As Appendix 1 shows, in 2020/21, if RH were to retain her JFord shares as previously recommended, adding additional rental income to the tax calculation would likely push RH's dividend income into the 32.5% income tax bracket.

Since GH is not currently using all of his basic rate band and is considering making pension contributions (which I will discuss later), I recommend that the property is held ~~EA~~ by GH: 100% ~~alone~~ ~~only~~.

The transfer of RHs 50% ownership to GH will be done so at Nil gain nil loss since spouses can transfer assets free of CGT exposure.

GH would then be subject to Income tax on 100% of the rental profits.

The property qualifies as a Furnished Holiday Let (FHL) as it will meet the following requirements.

1) Situated in the UK
2) Furnished
3) available to rent out for 210 days in the year of which it is actually occupied for 105 days per year

As you ~~wrote~~ mentioned in your meeting, the property satisfies the above conditions.

Since rental profits will be below £150,000 per year, GH will account for the profits and expenses on a cash basis (receipts basis).

A benefit for holding a FHL is that the cost of furnishing the property to make it suitable for renting will be an allowable expense.

Another benefit is that FHL's qualify for rollover relief. If you were to sell the property and buy another FHL within 12 months before and 36 months after the sale, then the gain can be deferred until a future sale of the new FHL.

FHL's also qualify for ER. ~~Any~~ Any gain realised on the future sale of your FHL will be subject to 10% CGT compared to 18%/28% residential property CGT rates.

It is therefore important that you maintain the level of periods of renting out the property to ensure it meets the FHL conditions above.

The most important benefit of having a FHL in GHs case is that profits are 'relevant earnings' for pension contributions.

GH is considering making pension contributions and he is correct that there is a maximum contribution of £40,000 per year before there is a tax charge. However, the amount an individual can contribute is a maximum of 100% relevant earnings.

Without relevant earnings, anyone can contribute up to £3,600 per year.

Therefore, the more relevant earnings (rental income) GH has, the more pension contributions he can make. This is again why I would recommend the FHL being owned 100% by GH.

GH can contributed a gross amount equal to his relevant earnings each year.

~~from your email meeting, it~~

GH has said that he approximates profits of £26,000 - 30,000 per year. For the report, I will assume on average GH receives £28,000 rental income from the FHL per year.

George can therefore make gross contribution of £28,000, this is below the £40,000 threshold so no tax charge applies.

GH will physically contribute 80% of £28,000 = £22,400 and HMRC will 'top up' the additional 20% of £5,600.

GH will therefore obtain tax relief of £5,600 by making pension contributions.

The pension fund will grow tax-free.

Since GH is over 55, he can make a distribution from the pension at any time with the first 25% of distribution tax-free. We can discuss this at a future time. ~~or you~~

GH can make contributions into his pension scheme up to the age of 75.

A pension fund is also outside a person's estate for IHT purposes, I would therefore recommend contributing the maximum amount per year based on your rental income profits up to £40,000 to gain income tax relief and to reduce your exposure to IHT on your estate.

As mentioned above, you can draw down from your pension at any time if you needed to.

Section C - Other tax planning.

Inheritance tax

Since you provided me with current mvs of your estates I thought I would update it based on the recommendations made in this report.

Appendix 4 shows how your estates would sit after making a gift of the business property to Amy (from RH) and paying the CGT on the deemed disposal. It also shows the increase in GH's estate after transferring the rental property to GH 100% at NGNL.

For IHT purposes RH and GH will have a NRB of £325,000 each. Although your wills specify that Amy will receive your respective estates in the case ~~od~~ of death, this is not the case for jointly owned assets. i.e. your main residence. The main residence will be held by the surviving spouse.

When you leave your main residence to a dependant (Amy) you also have a Residence Nil rate band (RNRB) which exempts £175,000 of the value of the property from IHT. This is reduced by £1 for every £2 your estate is above £2 million. Combined, you will have £350,000 RNRB available.

Since your respective estates are borderline the £2 million threshold, I would recommend you keeping an eye on your investments and so that we can discuss any IHT planning at a later time.

You should each make full use of your £3,000 annual exemption amounts. Any unused annual exemptions are carried over into the next tax year. This will reduce your cash accounts gradually each year.

We could also discuss the possibility of setting up a trust for Amy and your grandchild as trusts have some IHT tax planning benefits.

We can discuss this if you are interested at a later time.

Appendix 1

Rachels Income 2020/21 (approx. using 18/19 rates)

	NS.	S.	D.
Pension	13,000		
Interest		1,200	
(Rental)	[33,000]		
or (Dividends)			[31,000]
P.A	(11,850)		

Keep property			Keep dividends		
34,150	@ 20%	6,830	1,150	@ 20%	230
500	@ 0%	0	1,200	@ 0%	0
700	@ 40%	280	2,000	@ 0%	0
Tax		7,110	29,000	@ 7.5%	2,175
			Tax		2,405

Net cash after tax
= 47,200 - 7,110 = 40,090

Net cash after tax
= 45,200 - 2,405 = 42,795

Appendix 2.

If Rachel Gifts the property to Amy. (pre April 20)

Rachel's CGT liability

Deemed Proceeds.	920,000
Base cost	(680,000)
Gain	240,000
Less A.E	(11,700)
	228,300
CGT @ 10%.	22,830

Income to Amy.

Rental Income	33,000
P.A	(11,850)
	21,150
Tax @ 20%.	4,230

Net Income after tax = 28,770

Appendix 3

If Rachel gifts J Ford shares to Amy

Rachel's CGT liability

Deemed Proceeds	780,000
less cost	(600,000)
Gain	180,000
less A.E	(11,700)
	168,300
CGT @ 20%	33,660.

could defer.

Income to Amy.

Dividend Income	31,000
P.A	(11,850)
	19,150

Tax	2,000	@ 0%	0
	17,150	@ 7.5%	1,286
		Tax.	1,286

Net Income after tax = 29,714

Appendix ~~5~~4.

Estate after proposed gift and transfer of rental property to George

	George	Rachel
Cash (after CGT)	205,000	92,170
Shares	195,000	
John Ford shares		780,000
Main Res.	600,000	600,000
FHL	980,000	
Chattels	15,000	5,000
	1,995,000	1,477,170

[redacted]

Plan

Gift Section 1

1. Property. Amy gets 28,770 per year.
(1,000 less than shares)

* CGT @ 10%. Rachels liability is £22,830
compared to £45,660 if retained

Rachel's income from dividends: 42,795
v. 40,090 from property.

2. Dividends Amy 29,714 per year.
(1,000 more)

Rachels CGT = 33,660.

Rachels Income from property = 40,090.

Section 2 FHL. - Should owne by George 100%.

NGNL. Qualifies for FHL - ER @ 10%.

Capital expenditure on furniture etc.

Taxed on George @ 20%. v. 40% Rachel.

Relevant property for pension contr.

~~Rachel should transfer~~

[redacted]

[redacted]

PLAN

Section A - Gift → PET pre 5 April 2020.

OPTION 1. Property

Deemed sale.	Proceeds.	920,000
	base cost	(680,000)
	Gain	240,000.
	less A.E	(11,~~85~~700).
	ER @ 10%.	~~£24,000~~ *
		228,300
	Rachel CGT.	£22,830 *

Income to Amy

	Amy
Rental	33,000
P.A	(11,850)
	21,150
@ 20%.	4,230.

Net Income Amy = 28,770

If kept by Rachel.

~~Net Income = 33,000 @ 40% = 13,200~~

~~Net = £19,800~~

Net annual income after tax = 40,090

Future CGT on property @ 20%. = ~~91,320~~ 45,660

Option 2 PLAN

Shares

Deemed sale

Proceeds	780,000
base cost	(600,000)
Gain	180,000
	(11,700)
AE	168,300
CGT @ 20%	33,660

<5% no ER.

Income to Amy. D.

Dividends	31,000
P.A	(11,850)
	19,150

Div Allowance 2,000 @ 0% = 0

17,150 @ 7.5% = 1,286

Net Income = 31,000 − 1,286 = 29,714

If kept by Rachel

Net Inc after tax = 42,795

Plan

Section 3. Estate Planning.