The Chartered Tax Adviser Examination

November 2019

Application and Professional Skills

Taxation of Individuals

Suggested solution

REPORT TO GEORGE AND RACHEL HOSKING

INTRODUCTION

This report addresses:

1) The Capital Gains Tax (CGT) and Inheritance Tax (IHT) implications of the proposed gift to Amy of either of the following assets owned by Rachel:

i. The commercial premises formerly used by GRH Engineering ("the property"); or

ii. The 3,000 shares in John Ford (Engineering) Ltd ("the shares")

2) Personal pension contributions by George, and Income Tax relief thereon; and

3) Your combined Income Tax position from 6 April 2020.

Topics (2) and (3) are related and hence are concluded together.

EXECUTIVE SUMMARY

<u>Gift of property compared to a gift of shares</u>

Either gift will be a disposal for CGT purposes.

Entrepreneurs' Relief would apply to a gift of the property reducing the CGT payable by Rachel to £22,830. Entrepreneurs' Relief would not be available on a gift of the shares and so there would be CGT payable by Rachel of £33,660. CGT on the shares could be reduced to £nil by making a joint Gift Relief election with Amy.

Given the availability of a Gift Relief election (to reduce the tax payable to £nil), a gift of the shares may be preferred from an immediate CGT perspective.

From an IHT perspective, no immediate liability would arise on either gift. Provided Rachel survives the gift by seven years, no IHT would be payable on Rachel's death in respect of the gift.

Should Rachel die within seven years of the gift, no IHT would be payable on the gift of shares, provided that Amy still holds them, due to Business Property Relief (BPR). There would however be an IHT charge on the gift of the property, decreasing annually by £47,600 after three years, from an initial £238,000.

The shares are unlikely to attract IHT on Amy's death (if not gifted) as they would be subject to BPR.

The property (if not gifted) would be fully chargeable to IHT at 40% on Amy's death.

The reduction in total IHT exposure on a gift of the property after three years (£47,600) exceeds the CGT payable on the gift (£22,830). This gift would reduce the size of Rachel's estate subject to IHT on death.

The potential IHT saving (in comparison to CGT cost) arising from a gift of the property as time passes is significant, and hence a gift of the property is recommended.

<u>Future Income Tax position</u>

George's maximum tax relievable pension contribution is currently restricted to £3,600 per year as he has no relevant earnings.

From 6 April 2020, the equal allocation of furnished holiday letting profits will result in Rachel being subject to higher rate Income Tax with George having a largely unused basic rate band.

Qualifying furnished holiday letting profits represent relevant earnings for pension contribution purposes and as such it is recommended that the profits of that business are allocated primarily or wholly to George to facilitate his making of tax relieved pension contributions while minimising your combined Income Tax liability as Rachel's income would remain within her basic rate band.

CAPITAL GAINS TAX - GIFT

For tax purposes Rachel will be considered to be 'connected' with Amy. The impact of this is that despite the transfer being a gift, Amy would be deemed to have received an amount equal to the asset's market value at the time of gift. Therefore, Rachel would be taxed on any gain arising based on the gifted asset's market value.

Any gain will be reduced by Rachel's annual exemption (£11,700 for 2018/19) with the remaining gain subject to CGT at 10% to the extent that it falls in Rachel's basic rate band (£34,500 for 2018/19) after income. The excess gain would be taxed at 20%.

This is, of course, subject to any reliefs which may be available which are explored further below.

As Rachel intends to make the gift prior to 6 April 2020, (i.e. in the 2019/20 tax year), any CGT which arises would fall due for payment on 31 January 2021.

Commercial Property

The property is currently standing at a gain of £240,000, being its current market value of £920,000 less its market value of £680,000 at the date it was gifted to Rachel.

You have advised that the property was wholly used in the GRH Engineering partnership business between acquisition on 6 April 2009 and 30 September 2017, when the business was sold.

As such, the disposal of the property prior to 1 October 2020 (i.e. within three years of the partnership ceasing to trade and Rachel disposing of her partnership interest) would attract Entrepreneurs' Relief ("ER") as it was in use for the purpose of the partnership business at the time it ceased to be carried on, and for at least the 12 months prior to that cessation.

The result of ER applying to the disposal is that the entire taxable gain is taxed at 10% despite it falling outside Rachel's basic rate band after income.

The CGT arising on the gift can therefore be estimated as follows:

	£
Market value	920,000
Cost	(680,000)
Gain	240,000
Annual exemption	(11,700)
Taxable	£228,300
CGT at 10% =	22,830

There is a lifetime limit to the value of gains which may be subject to ER of £10 million. It is assumed that Rachel has not previously reached this limit and will not as a result of this disposal.

Shares in John Ford (Engineering) Ltd

ER will not apply to this disposal as for the relief to apply a minimum shareholding of 5% is required.

Therefore a CGT liability would arise on the gift as follows:

	£
Market value	780,000
Cost	(600,000)
Gain	180,000
Annual exemption	(11,700)
Taxable	£168,300
CGT at 20% =	33,660

Depending on the level of Rachel's dividend income prior to the gift, she may be a higher rate taxpayer. If she is not a higher rate taxpayer part of the gain which falls within her basic rate tax band will be charged at 10%. Otherwise, the entire gain will be taxed at 20%.

Shares in unquoted trading companies are 'business assets' and as such it would be possible for Rachel and Amy, within four years of the end of the tax year of disposal, to make a joint election for 'Gift Relief' to apply. This effectively defers the gain into Amy's hands.

In the absence of a Gift Relief election the base cost of the shares to Amy would be £780,000 - the amount on which Rachel is taxed. Where a Gift Relief election is made, the gain arising of £180,000 is deferred by holding it over against the base cost of the shares in Amy's hands such that her reduced base cost is £600,000 – the same as Rachel's before the transfer.

Ultimately, if a joint Gift Relief election is made, no CGT would arise on the initial gift to Amy. However Amy's CGT base cost would be lower as a result of the election meaning that she may suffer a higher tax liability if she were to dispose of the shares in future.

The deferred gain is clawed back and chargeable on Amy should she become non-UK resident for tax purposes in any of the six tax years following the gift.

Transfers between spouses occur on a no-gain/no-loss basis. A small advantage may therefore be gained (in the absence of a Gift Relief claim) by transferring a suitable number of shares to George, prior to him gifting them to Amy. This could utilise his annual exemption and basic rate band (which is not utilised by income, as this is below his combined personal allowance and personal savings allowance).

A maximum reduction in the overall CGT liability of £5,790 could be achieved ((£11,700 x 20%) + (£34,500 x (20% - 10%))) by this route.

INHERITANCE TAX – GIFT

Lifetime giving is an effective way to reduce the value of the donor's estate on death, in order to reduce exposure to Inheritance Tax ("IHT").Transfers of value to an individual during the donor's lifetime represent 'potentially exempt transfers' ("PETs") for IHT purposes. The PET removes exposure to IHT by removing the asset from the estate, however there is a potential charge on the gift. Providing the donor survives the transfer by seven years, no IHT liability will arise thereon.

Should the donor die within seven years of a PET, IHT will be payable by the donee where the value of the PET exceeds the nil rate band ("NRB") at death (currently £325,000) less the value of any chargeable transfers in the seven years prior to the PET.

Where more than three years have passed between the date of the PET and the date of death of the donor, taper relief is given to reduce the tax payable by a given percentage derived from the time period between the PET and death.

Lifetime transfers may be reduced in value for IHT purposes by the annual exemption of £3,000 per tax year. Unused annual exemptions may be carried forward for one tax year. Owing to its relatively low value, this exemption is ignored hereafter.

Transfers on death (i.e. an individual's death estate), other than transfers to spouses (which are exempt), are broadly subject to IHT at 40% (or 36% in cases where 10% or more of the net estate is left to charity) following the deduction of the unused NRB after it has been applied to lifetime transfers.

While the current NRB available to individuals is £325,000, this can be proportionally increased, by way of claim, where the individual has been pre-deceased by a spouse or civil partner who, on their death, had some or all of their NRB unused.

It is assumed that any gift made to Amy will be outright and you would not continue to receive any benefit from the asset given away.

Commercial Property

As noted above, a lifetime gift of the property would represent a PET on which no immediate IHT charge would arise.

Providing Rachel survives the gift by seven years, no IHT liability would arise in respect of the gift at the time of her death.

Over the seven year period following the gift, the IHT liability to which Amy would be exposed should Rachel die is as follows:

Years	Calculation	IHT (£)
0-3	(£920,000 - £325,000) x 40% x 100% =	238,000
3-4	(£920,000 - £325,000) x 40% x 80% =	190,400
4-5	(£920,000 - £325,000) x 40% x 60% =	142,800
5-6	(£920,000 - £325,000) x 40% x 40% =	95,200
6-7	(£920,000 - £325,000) x 40% x 20% =	47,600
>7	N/A	Nil

Given the size of Rachel's estate, if the property were not gifted (i.e. it were to remain in her taxable estate on death) its market value at death would be subject to IHT. It would generally

be anticipated that this value (and therefore resultant IHT) would be greater than at present owing to inflationary increases in the property market.

Shares in John Ford (Engineering) Ltd

Again, a lifetime gift of the shares would represent a PET on which no immediate IHT charge would arise.

Similarly, providing Rachel survives the gift by seven years, no IHT liability would arise in respect of the gift at the time of her death.

Should Rachel die within seven years of the gift, an extremely valuable relief, Business Property Relief ("BPR") may apply. BPR applies to transfers of value where that transfer is of 'relevant business property'.

'Relevant business property' includes shares in unlisted trading companies, such as John Ford (Engineering) Ltd, where there is no binding contact for sale. There is no minimum holding requirement in respect of the percentage of shares held unlike ER.

Shares in unlisted trading companies qualify for 100% BPR, and there is no restriction to the quantum of relief unless the company in question holds 'excepted assets' such as large cash deposits which are not required for current or future use in the business.

In order for the shares to qualify for BPR, it is necessary for the donor to have owned them for two years, which Rachel has as of 1 October 2019.

Providing that at the date of Rachel's death (should that be within seven years of the gift) Amy has either:

a) retained the shares until that date (and they remain unquoted and not subject to a binding contract for sale); or

b) sold the shares and replaced them within three years with other qualifying business property,

then the value of the failed PET will attract 100% BPR such that no IHT is payable in respect of the gift in the event of Rachel's death within seven years.

CONCLUSION OF GIFT - PROPERTY VS SHARES

A gift of the property would give rise to CGT payable by Rachel of £22,830. This takes advantage of Entrepreneurs' Relief, which is 'time limited' and would only apply to a disposal prior to 1 October 2020.

A gift of the shares would give rise to CGT payable by Rachel of £33,660, however this tax burden may, effectively, be passed to Amy by way of a joint 'Gift Relief' election, resulting in no immediate CGT liability on the gift.

As such, the 'cheaper' option to minimize immediate exposure to CGT would be a gift of shares, providing Amy is in agreement to making the joint Gift Relief election.

From an IHT perspective, neither gift would give rise to an immediate IHT liability and providing the gift is survived by Rachel by seven years, no IHT liability would arise in respect of either gift on Rachel's death.

For the period between the date of gift and seven years subsequent, it is likely that the shares would attract 100% BPR such that they do not give rise to an IHT liability should Rachel die within that period.

While CGT of around £5,790 may be saved (in the absence of a Gift Relief claim) by transferring a number of shares to George (to utilise his annual exemption and basic rate band for CGT purposes) prior to the gift to Amy, this would not necessarily be advisable from an IHT perspective as George would not meet the two year ownership requirement for BPR purposes.

The impact of this would be that should George die within seven years of his gift to Amy, a lower NRB would be available to apply to his death estate as it would be utilised first by the lifetime transfer which would not qualify for BPR.

If the property were gifted, it would give rise to an IHT charge on Amy of between £238,000 and £47,600 should Rachel die within seven years.

The advantage of a lifetime gift of the property to Amy is that its potential exposure to IHT decreases as time passes. If it were not gifted and were to remain in Rachel's estate (i.e. the shares were gifted to Amy) the property would be fully liable to IHT on Rachel's death based on its market value at that time. Once seven years have passed, not only is no IHT payable on the property, but the nil rate band of £325,000 is fully restored and available to set off against either further lifetime gifts, or the estate left on Rachel's death.

If the shares were to remain in Rachel's estate (i.e. the property were gifted), it would be expected that those shares would qualify for BPR on Rachel's death (providing the company retains its trading status and does not hold excepted assets), such that no IHT liability arises directly on the shares in her estate.

Therefore, it would be recommended to gift the property, rather than shares, to Amy. Providing Rachel survives the gift of the property by three years, the IHT which would arise as a result of her death will have decreased by £47,600 - clearly this outweighs the 'up front' CGT cost of the disposal of £22,830. As each further year after three years following the gift passes, the IHT which would arise as a result of Rachel's death decreases by another £47,600. After seven years, the IHT saving is £368,000 as the nil rate band of £325,000 is reinstated.

A lifetime gift of the shares would not reduce exposure to IHT in this way as they are expected to remain fully relieved by BPR and thus would not attract IHT.

No Stamp Duty will arise on the gift of the shares, nor will any Stamp Duty Land Tax arise on the gift of the property as in both cases there is no consideration.

Rachel should ensure that following either gift she will retain sufficient capital and income producing assets to maintain her desired standard of living going forward.

The value of the property is £140,000 greater than the shares – clearly a gift of the former would decrease Rachel's capital wealth by a larger amount.

PENSION CONTRIBUTIONS - TAX RELIEF

Making pension contributions may be tax efficient for George because, up to the age of 75, tax relief is given on income used to make contributions, and any growth of funds within the pension pot is completely tax-free.

When funds are accessed, 25% can be withdrawn tax free. As George is over 55, he can access his pension at any time, however this may restrict his ability to make future contributions by reducing the amount of contributions on which tax relief is given (the Annual Allowance) to £4,000 per year.

Provided pension funds have not previously been accessed, there are two primary restrictions to the amount of pension contributions that George can obtain tax relief on.

1. Relevant earnings

An individual's tax relieved pension contributions in a given tax year are capped at an amount equal to their 'relevant earnings' in that year.

'Relevant earnings' includes employment income (including benefits), trading income, patent income in respect of inventions by that individual and income from qualifying furnished holiday letting businesses.

George's current income consists of interest and dividends neither of which are relevant earnings.

In the absence of any relevant earnings, it is possible to contribute up to £3,600 per annum into a pension scheme and still obtain tax relief, so that a net contribution of only £2,880 is needed, the difference being 20% tax relief added by HMRC.

2. Annual allowance

Where an individual has sufficient relevant earnings, the maximum tax relievable pension input in a tax year they can make is limited to the annual allowance ("AA") of £40,000.

This restriction is achieved by way of a tax charge levied on the contributions in excess of the AA.

The £40,000 current year AA can be increased by any unused AA of the previous three years, however it is necessary to have been a member of a registered pension scheme in those earlier years for the carry forward to be available.

Therefore, the primary restriction applying to George in making tax relieved pension contributions at present is his lack of relevant earnings. In the absence of any relevant earnings, George can contribute £3,600 gross to a pension scheme.

However, this position can be improved (see below).

INCOME TAX AFFAIRS FROM 6 APRIL 2020

Following Rachel's retirement, excluding the furnished holiday letting ("FHL") profits, and following the gift to Amy (assumed to be the property based on the above analysis) your respective income levels from 6 April 2020 are expected to be as follows:

	George (£)	Rachel (£)
Pension	-	13,000
Interest	2,300	1,200
Dividends - share portfolio	9,800	-
Dividends - John Ford (Engineering) Ltd	-	31,000
	£12,100	£45,200

It is clear from the above that any share of FHL profits attributable to Rachel post 6 April 2020 which exceed £1,150 will result in her paying Income Tax at the higher rate whereas George has £34,250 of unused basic rate band before the allocation of FHL profits.

Usually, where income is derived from assets held jointly by married couples, that income is split equally for Income Tax purposes unless the couple have made an election that the income should be split according to the underlying beneficial ownership.

Qualifying FHLs are specifically excluded from this treatment by statute and HMRC's view is that the profits of FHL businesses may be split in any way that the parties agree.

You have indicated that the FHL business will realise profits of between £26,000 and £30,000 per annum.

It would, therefore, be recommended that agreement is reached between you to allocate the profits wholly or mainly to George as they would fall within his currently unused basic rate band thereby minimising the amount of Income Tax payable between you.

This would particularly appear justifiable on the basis that it is intended that the business will be run by George.

It is important that the business does qualify as a FHL for tax purposes. In order to qualify, it must be furnished, and, during the tax year:

i. the accommodation must be available for commercial letting as holiday accommodation to the public generally for at least 210 days;

ii. the accommodation must be commercially let as holiday accommodation to members of the public for at least 105 days (excluding periods of longer term occupation); and

iii. If occupied by the same person(s) for more than 31 days, have a total of no more than 155 days of such 'longer-term' occupation.

Based on your expectations, it appears these conditions will be met.

CONCLUSION - PENSION CONTRIBUTIONS AND INCOME TAX AFFAIRS

As Rachel's income (before the apportionment of FHL profits) is greater than George's it would be advisable to seek to equalise income to utilise George's basic rate band while preventing Rachel becoming liable to higher rate Income Tax.

Interest and dividend income (excluding John Ford (Engineering) Ltd dividends) is not hugely significant and as such the primary sources of income to consider transferring from Rachel to George are that from the John Ford (Engineering) Ltd shares or new FHL business.

George is seeking to make tax relieved pension contributions having no pension savings at present. However, as he has no 'relevant earnings' the maximum gross tax relieved contribution available to him is £3,600 per annum.

The logical conclusion is therefore to allocate the profits of the FHL business to George, as these represent relevant earnings. It is necessary for the business to meet the FHL qualifying conditions both for the profits to qualify as relevant earnings and to allocate the income in unequal shares; however this does not appear to be a point of concern.

The result of this allocation is that George can make annual tax relieved pension contributions of around £26,000 to £30,000 (based on the expected FHL profits) if desired. Additionally, Rachel's income remains within her basic rate band while utilising a greater proportion of George's previously unused basic rate band.

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ASSESSMENT NARRATIVE

Structure

A simple pass or fail will be awarded.

Identification and Application

The following are the relevant topics for assessment with their weightings:

1	15%	Explaining CGT and other tax implications (SDLT and IT) arising on gift of property. Identifying as appropriate and explaining entrepreneurs' relief.
2	15%	Explaining CGT and other tax implications (Stamp Duty and IT) arising on gift of shares Identifying as appropriate and explaining gift relief.
3	15%	Identifying when IHT may arise on lifetime transfer of property. Identifying advantage of IHT taper relief on property gift after three years.
4	15%	Identifying when IHT may arise on lifetime transfer of shares Identifying BPR as relevant to eliminate IHT liability.
5	20%	Identifying tax issues relating to pension contributions and restrictions to George's tax relieved pension contributions.
6	20%	Identifying tax issues relating to FHL including George's unused BRB and equal share of FHL profits would push Rachel into higher rate Income Tax.

A grade of 0,1,2,3, or 4 is awarded to each topic. The weighting is applied to that grade to produce a weighted average grade. Thus, supposing a candidate scores 3, 3, 4, 2, 2, and 2 respectively on the above topics, this will equate to weighted scores of 0.45, 0.45, 0.6, 0.3, 0.4, and 0.4. The total of these scores is 2.6. This is then converted to a final absolute grade by rounding up or down to the nearest grade. Thus, scores in the range 2.5 to 3.49 will be a grade 3. In this example, the candidate will score a grade 3 overall and secure a pass for this skill.

Relevant Advice and Substantiated Recommendations

The following are the topics for assessment with their weightings:

50%	Advice and recommendations on whether it is preferred to make a lifetime gift of the property or shares.
25%	Advice on the equalisation of income to minimise George & Rachel's overall Income Tax liability.
25%	Advice on the making of pension contributions and allocation of FHL income to maximise George's tax relieved pension contributions.

The final grade will be determined for this skill in the same way as for Identification and Application.