A tale of two taxes

Chris Siddle takes a practical look at the inheritance tax and capital gains tax implications of gifts of assets at undervalue.

When an individual makes the gift of an asset or a sale at undervalue, both of the capital taxes – inheritance and capital gains – come into consideration. As well as the different approaches to determine how much is chargeable to tax, each has its own array of exemptions and reliefs.

All of this can be tricky for a student to deal with in an examination. A good understanding and clear thinking is needed, as is reflected in this case study.

Share transfer

Manette, who is a higher rate taxpayer, owns 60,000 shares of the 100,000 share capital in Defarge Ltd, an unquoted trading company. The shares cost £1 each when he subscribed for them many years ago. He wishes to transfer 20,000 shares to his daughter Lucie who will pay him £2.50 a share. However, the shares are valued as follows:

20% holding	£3 share
40% holding	£9 share
60% holding	£15 share

Inheritance tax

Let's start with inheritance tax. For this, the amount subject to tax is determined using the 'diminution in value' approach – that is the loss to the donor estate (in this case Manette) as a consequence of the transfer. This may be totally different from the value received by the donee (Lucie). The transfer of value is calculated as follows:

Before:	60,000 shares @ £15 each	£900,000
After:	40,000 shares @ £9 each	£360,000
		£540,000

Key points

- Shares in an unquoted trading company may be eligible for business property relief and gift relief.
- Entrepreneurs' relief may be available for the donor of a gift of shares.
- Rules for transfers of shares from an investment company are less generous.
- Chargeable lifetime transfers to a trust are subject to the lifetime rate of 20%.

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But, because Manette received £50,000 (20,000 x £2.50) from his daughter, this reduces the amount of the loss to his estate:

Share value	£540,000
Receipt from daughter	(£50,000)
Transfer of value	£490,000

The shares are in an unquoted trading company so they should be eligible for business property relief (BPR) as long as Manette has owned them for more than two years, which is the case here:

BPR @ 100%	(£490,000)
Chargeable to IHT	nil

Capital gains tax

Now let's turn to the capital gains aspects. This is a disposal of shares between connected persons – father and daughter – so the proceeds are taken to be the market value of the asset disposed of:

Proceeds/MV (20,000 @ £3 each)	£60,000
Cost (20,000 @ £1)	£20,000
Gain	£40,000

Since the shares are in an unquoted trading company they should be eligible for gift relief under TCGA 1992, s 165. But, as Manette has received consideration that exceeds the original cost of the shares, this 'real profit' of £30,000 (£50,000 – £20,000) cannot be held over by gift relief.

So the calculation is:

Gain	£40,000
Gift relief	(£10,000)
Chargeable gain	£30,000

This is because the amount received by Manette from his daughter (£50,000) is greater than the original cost of the shares (£20,000), so the excess is immediately taxable and cannot be held over by gift relief. The element of the gain deferred by gift relief is held over against the value of the shares received by Lucie (see below). Manette and Lucie must claim gift relief jointly within four years of the end of the tax year in which the gift takes place.

We now need to turn our attention to the rate of capital gains tax that Manette will pay. This will depend on his taxable income. He is a higher rate taxpayer so the rate of capital gains tax would be 20% unless he can claim entrepreneurs' relief to reduce the rate to 10%. To be eligible, as well as the shares being in a trading company, Manette must have held at least 5% of the shares and worked for the company throughout the 12 months before the disposal. Note that neither the 5% rule nor the working rule is required to claim business property relief or gift relief.

Before calculating the capital gains tax, Manette would be able to deduct any capital losses with the annual exemption if they have not yet been used.

Finally, for Lucie, her base cost for future capital gains tax purposes is:

Value of shares received	£60,000
less: gain deferred	(£10,000)
Base cost	£50,000

Flies in the ointment

The above situation is typical for many businesses but an examiner can change the circumstances, which will have a knock-on effect to the amounts taxable.

Suppose Defarge Ltd was an investment company. For inheritance tax purposes business property relief would no longer be available so the full £490,000 would be chargeable to inheritance tax. However, Manette may have the current and previous year's annual exemptions available, which would reduce this by £6,000 to £484,000. But, because this was an outright gift from Manette to his daughter, it would be considered a potentially exempt transfer so no inheritance tax would be payable immediately. It would become due only if Manette were to die within seven years of making the transfer.

For capital gains tax, the fact that Defarge Ltd was an investment company would block the availability of gift relief. The full gain of £40,000 becomes chargeable, subject to the availability of losses and the annual exemption. In addition, entrepreneurs' relief would not be available, so any remaining gain would be taxed at 20% given that Manette's income indicates he is a higher rate taxpayer.

Or suppose the shares in Defarge Ltd – which is still assumed to be an investment company – were put into a trust for Lucie rather than given to her outright. For inheritance tax this would make the gift a chargeable lifetime transfer and inheritance tax would be payable at the lifetime rate of 20% on the £484,000. This would be reduced if Manette has any of his nil rate band available. The fact that the gift is immediately chargeable to inheritance tax means that, for capital gains tax, it is eligible for gift relief under TCGA 1992, s 260 so £10,000 of the gain could be deferred again by making an election.

Despite the complexities that arise when inheritance tax and capital gains tax apply to the gift, it is possible to deal with the two taxes separately. As long as students have a clear understanding of the way to compute the chargeable amounts and which relief applies to which tax (for which the legislation can be helpful) it is an exam question that can be answered well. ●

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