

## The interaction of CGT and IHT (Lecture P1267 – 31.38 minutes)

The Office of Tax Simplification (OTS) have been asked in recent years to undertake wide-ranging reviews of both:

- CGT; and
- IHT.

### *The IHT document*

The IHT report, which is entitled 'Simplifying the design of IHT', came first. It was published in July 2019. The scope of this review included looking at the way in which the two taxes link together and the conclusion of the OTS was that the interaction between CGT and IHT is indeed complex and can certainly distort decision-making. It should be borne in mind that there is normally no CGT charge on death. For CGT purposes, the person inheriting is treated as having acquired the asset at its market value on the date of death rather than at the amount originally paid for it. This situation is referred to as the 'tax-free uplift on death' and it means that a chargeable asset can be sold shortly after the owner's death without any CGT falling due. Where an asset is exempted or relieved from IHT (e.g. because it passes to a spouse or represents relevant business property attracting a 100% relief), it can be sold shortly after death without either CGT or IHT being payable. With reference to this latter point, the OTS made the following comment in their report:

'This can put people off passing on assets to the next generation during their lifetime. It distorts and can complicate the decision-making process around passing on assets to the next generation. The OTS have concluded that this distortion would be best addressed by amending the CGT rules rather than changing IHT.'

### *Illustration 1*

Susan is a successful lawyer who retired with cash resources of £200,000. This would of course be subject to IHT on her death. Susan therefore decides to invest the entire £200,000 in a portfolio of AIM-listed shares selected by her financial adviser on the basis that they will qualify as relevant business property once Susan has held them for two years.

The AIM shares increase in value and, on Susan's death several years later, they are worth £450,000. These shares are left to Susan's daughter who sells them for £460,000 shortly after her mother's death.

The tax consequences of these arrangements are:

- The AIM shares qualify for business relief at 100% so that there is no IHT to pay on the daughter's legacy;
- There is no CGT on Susan's death on account of the tax-free uplift. The gain of £450,000 – £200,000 = £250,000 is eradicated. The daughter's subsequent gain of £460,000 – £450,000 = £10,000 will be covered by her annual CGT exemption (assumed still to be £12,300).

The zero tax situation illustrated in (c) above can be contrasted with double taxation where, for example, quoted shares are given to a child and the donor parent then dies within seven years of the gift. In this scenario, there is no CGT holdover relief at the time of the gift so that a CGT liability (usually at 20%) will arise on any gain, but the failed potentially exempt transfer (PET) will attract IHT at a rate of up to 40% with no relief for the CGT previously paid. The only exception to this double taxation regime is that, if, unusually, the CGT on the lifetime gift is satisfied by the donee rather than the donor, S165 IHTA 1984 allows the CGT borne by the donee to be taken into account in determining the quantum of the failed PET for IHT purposes.

### *Illustration 2*

Many years ago, Alastair set up an unincorporated business which has proved to be a great success.

Over the last three decades, Alastair has invested £180,000 in the business, but it is now valued at £780,000. He has reached retirement age and so he decides to hand over the business to his son.

A joint claim for CGT holdover relief under S165 TCGA 1992 means that the son takes over Alastair's business at a base cost of £180,000. There is no CGT uplift because Alastair is still alive at the time when he gives the business to his son.

Under the son's control, the business goes from strength to strength and it is sold two and a half years later for £1,100,000. The son realises a gain of  $£1,100,000 - £180,000 = £920,000$ , on which a 10% tax charge of £92,000 is due (this assumes that the son can make a claim for business asset disposal relief). The son invests the net sale proceeds in a holiday home in the south of France.

Unfortunately, Alastair dies a few months later so that the gift to the son turns out to have been made during the seven years prior to Alastair's death. This has the following tax effects:

There is no business relief for the failed PET, given that the son does not own the asset gifted (or a qualifying replacement) at the time of his father's death. This means that there is an IHT charge of up to 40% on the value of the business at the time of the gift (£780,000).

CGT of £92,000 is paid by the son on the sale of the business. No part of this can be taken into account in the calculation of the failed PET. Because of the holdover relief claim, there was no CGT payable at the time of the gift. Therefore, S165 IHTA 1984 is irrelevant (and, even if there had been a CGT charge at that stage, the IHT relief would only have been available if the son – and not Alastair – had settled the CGT liability).

The single recommendation made by the OTS in this part of the IHT report is that, where a relief or exemption from IHT applies in connection with a death estate, the Government should abolish the tax-free uplift on death and instead provide that the recipient is treated as acquiring the asset at the deceased's historic base cost.

### *The CGT document*

The CGT report, which is entitled 'Simplifying by design', appeared in November 2020. It contains a fuller set of suggestions for dealing with the anomalies relating to the interaction of CGT and IHT. The review begins by contrasting the tax position where there has been:

- (i) a sale of a chargeable asset shortly before the owner's death; and
- (ii) a sale of the same asset, but this time by the legatee after the death.

### Illustration 3

Richard, a higher rate taxpayer, owns a buy-to-let property worth £370,000 which he acquired several years ago for £130,000. Given that Richard has already used up his annual CGT exemption for 2021/22 on a previous property transaction, his CGT position when he sells the asset is as follows:

	£
Sale proceeds	370,000
Less: Cost	<u>130,000</u>
CHARGEABLE GAIN	<u>£240,000</u>
CGT @ 28%	£67,200

This leaves Richard with cash of  $£370,000 - £67,200 = £302,800$ . Sadly, he dies later in the same year, leaving a sizeable estate. Richard's nil rate band is allocated against other assets so that the cash legacy triggers an IHT liability of  $40\% \times £302,800 = £121,120$ . His heir receives  $£302,800 - £121,120 = £181,680$ .

Alternatively, if Richard had not disposed of the buy-to-let during his lifetime, IHT of  $40\% \times £370,000 = £148,000$  would have been payable, but there would have been no CGT when the heir sold the property for £370,000 shortly after inheriting it. Richard's heir would therefore have received  $£370,000 - £148,000 = £222,000$ . Thus:

	£
Net receipt where heir sells buy-to-let	222,000
Less: Net receipt where Richard sells buy-to-let	<u>181,680</u>
INCREASE IN NET RECEIPT	<u>£40,320</u>

This increased receipt represents 60% of the CGT saved where the heir effects the sale. It makes clear how generous the tax-free uplift on death actually is.

As mentioned above, the OTS explored this area in their IHT report when they recommended moving to what might be called a 'no gain no loss' approach where an IHT relief or exemption applied. However, in the CGT review, the OTS seem to be taking a wider perspective whereby they suggest that the tax-free uplift concept should be abolished in toto (other than for main residences).

This would of course resolve the Government's dilemma as shown in Illustration 3, given that the position on a sale by Richard's heir under a no gain no loss rule would be:

	£
Sale proceeds	370,000
Less: Inherited base cost	<u>130,000</u>
CHARGEABLE GAIN	<u>£240,000</u>
CGT @ 28%	£67,200

On its own, the establishment of this revised approach would introduce what the OTS call ‘a new distortion in favour of lifetime transfers’ and so it would be necessary to take into account the asset’s unrealised gain which had accrued at the time of death. There are two possible options for dealing with this:

- (i) the value of the deceased’s estate for IHT purposes could be reduced by the CGT which would have been chargeable had the asset been sold on the date of death; or
- (ii) the full rate of IHT could be paid initially, with a tax credit being given on the eventual sale of the asset.

*Illustration 4*

Value of Richard’s estate reduced by potential CGT liability

Under the first scenario, the value of Richard’s asset on his death would be:

	£
Value of buy-to-let property	370,000
Less: Potential CGT liability	<u>67,200</u>
	<u>£302,800</u>
IHT @ 40%	£121,120

Richard’s heir would end up with:

	£
Buy-to-let property	370,000
Less: IHT payable	<u>121,120</u>
	248,880
Less: Subsequent CGT liability	<u>67,200</u>
NET RECEIPT	<u>£181,680</u>

In other words, Richard’s heir would receive the same level of legacy as he would have enjoyed had Richard sold the buy-to-let property shortly before his death – see Illustration 3.

Full rate of IHT being payable followed by tax credit on sale

Under the second scenario, Richard’s property would be subject to a full IHT charge. Thus:

Buy-to-let property	<u>£370,000</u>
IHT @ 40%	<u>£148,000</u>

The CGT for Richard's heir on the sale of the property would be:

	£
Sale proceeds	370,000
Less: Inherited base cost	<u>130,000</u>
	<u>£240,000</u>

	£
CGT @ 28%	67,200
Less: Tax credit (40% x 67,200)	<u>26,880</u>
	<u>£40,320</u>

Note: The tax credit is the IHT attributable to the CGT charge.

Richard's heir would receive:

	£
Buy-to-let property	370,000
Less: Full IHT charge	<u>148,000</u>
	222,000
Less: Subsequent CGT liability	<u>40,320</u>
NET RECEIPT	<u>£181,680</u>

There are of course other permutations which might be worth exploring if the Government were not overly concerned about exact fiscal neutrality.

If the Government do decide to abolish the tax-free uplift on a more widespread basis, the OTS made two further recommendations which they feel should accompany such an outcome:

- a rebasing of all chargeable assets, perhaps to the year 2000 (although this would have significant cost implications for the Exchequer – certainly over the first few years); and
- an extension of the holdover relief rules to a broader range of assets such as the UK had prior to FA 1989.

#### *The impact of S165(10) TCGA 1992*

Another area where there is an interface between CGT and IHT can be found in S165(10) TCGA 1992. This scenario was not specifically addressed by the OTS in their CGT report. Because the relief is not widely understood, it is worth explaining briefly how the provision operates. Where there is a gift in respect of which holdover relief is claimed under S165 TCGA 1992 and the transaction attracts an IHT charge (e.g. because the donor has died within seven years of making the gift), there is an automatic deduction from a subsequent gain accruing to the donee equal to the lesser of:

- the IHT attributable to the value of the asset gifted; and
- the chargeable gain on the donee's disposal of the asset.

This rule is mandatory and no claim is required.

*Illustration 5*

Peter and Colin were partners in a trading enterprise. On 1 August 2015, Peter acquired a freehold office for use in their business costing £500,000. On 1 August 2020, Peter gave the property, which was now worth £800,000, to Colin. Holdover relief was claimed by Peter and Colin under S165 TCGA 1992. Peter had a cumulative total of chargeable transfers amounting to £340,000 as of that date. Peter died from COVID-19 on 27 December 2020. As a result, his PET on 1 August 2020 fails.

Because of the death of his partner, Colin decided to sell the premises and close down the business. The property was sold for £820,000 on 1 December 2021. Colin is a higher rate taxpayer for 2021/22.

On the assumptions that Peter had no exemptions available at the time of the gift and Colin agreed to pay any tax due, the IHT position is:

	£	Gross £
b/f		340,000
Office	800,000	
Less: Business relief (50%)	<u>400,000</u>	
		<u>400,000</u>
		<u>£740,000</u>

Because Peter's death was shortly after making the gift, the IHT payable by Colin is  $40\% \times £400,000 = £160,000$ . Note that business relief of 50% is available because the property gifted falls into S105(1)(d) IHTA 1984.

Colin's CGT computation shows:

	£	£
Sale proceeds		820,000
Less: Cost	500,000	
Less: Held over gain (800,000 – 500,000)	<u>300,000</u>	
		<u>200,000</u>
		620,000
Less: IHT credit (see above)		<u>160,000</u>
		<u>£460,000</u>
CGT @ 20%		£92,000

Note: There is no deduction for IHT if a holdover claim has not been made under S165 TCGA 1992. It may therefore be worthwhile submitting such a claim, even if the gain is modest, in order to secure IHT relief on a subsequent disposal by the donee.

### *Conclusion*

Will the Government be minded to grasp these particular nettles? With the damage done by COVID-19 ostensibly on the decline (as a greater and greater proportion of the population are vaccinated), it seems likely that there will be major reforms to the capital taxes code in due course. Given that the OTS proposals on CGT and IHT have the capacity to raise additional tax revenues, change may well happen sooner rather than later.

*Contributed by Robert Jamieson*