

Freezing operations – an update (Lecture P1244 – 21.09 minutes)

At times during the 12-year period since 2008, there have been significant falls in the value of UK land and buildings. This has led clients who are owners of property investment companies to consider the possibility of 'freezing' part of their estates for IHT purposes.

Shares in property investment companies do not qualify for 100% business relief. Individuals holding such assets therefore need to seek other alternatives in an effort to minimise their IHT liabilities. Typically, these involve the client pegging the current value of their property investment company shares and passing on any potential capital growth to the next generation. This can be achieved by an outright gift or by a transfer into a trust.

Let us imagine the shareholders of a property investment company. It does not matter whether this company is involved in commercial properties or residential properties or both.

The shareholders will normally hold ordinary shares which have the following attributes:

- voting rights;
- dividend rights; and
- an entitlement to share in any capital appreciation.

The shareholder's first tax planning step is to create a new class of 'growth' share, usually by way of a bonus issue. These new shares will only be eligible for voting, dividends and any winding up or sale proceeds once the present value of the company has been distributed to the holders of the original ordinary shares. The rights attaching to these original shares can be altered by amending the company's Articles of Association to restrict their right to receive future dividend and winding up (or sale) proceeds to a sum equal to the present market value of the company. This amendment will have the immediate effect of freezing the value of the original shares at this amount.

The new bonus shares will initially be worth very little. Indeed, they may well have a nil value, given that they should have no voting rights, no dividend rights and no capital value other than their nominal value of, say, £1 each. However, they will grow significantly in value over the next few years as the property market continues to flourish. It is these new shares which are then given to the donor's children or, alternatively, put into trust (particularly if the capital growth may be substantial).

Illustration 1

Charles, who is aged 72, holds 100% of a company which owns a number of let commercial properties. The value of Charles' property company is currently £4,800,000.

In recent years, Charles has been drawing annual dividends of £240,000 from his company.

New 'B' shares are issued to Charles by way of a bonus issue, with his original ordinary shares being redesignated as 'A' shares. The company's Articles of Association are changed so that the 'B' shares are only entitled to votes, dividends and capital on a winding up (or sale) in the event that the 'A' shares have already received a total of £4,800,000 since this planning stratagem was implemented.

At this stage, the 'B' shares are worth virtually nothing. After all, unless there is a liquidation or sale, it will take 20 years before a 'B' shareholder qualifies for votes or dividends. Charles therefore makes an immediate gift of these shares to a discretionary trust for the benefit of his adult son, Henry, and Henry's issue.

Five and a half years later, Charles dies at a time when his property company is worth £8,400,000. In the meantime, the 'A' shares have paid Charles dividends totalling £1,500,000 since the share reorganisation.

As a result, the 'A' shares in Charles' estate are valued at £4,800,000 – £1,500,000 = £3,300,000 and the 'B' shares held by the discretionary trust are worth £5,100,000, i.e. the balance of the company's value. The 'B' shares have captured the property company's subsequent capital growth of £5,100,000 (£8,400,000 – £4,800,000 + £1,500,000) and the 'A' shares have been frozen at their original value of £4,800,000 less the dividends received by Charles over the last five and a half years. Note that the value of the 'B' shares falls completely outside Charles' estate on death.

The IHT saving for Charles' estate, compared with what the position would have been if he had not undertaken this form of planning, is $40\% \times £5,100,000 = £2,040,000$.

In Illustration 1, the bonus issue of the new shares and the reorganisation of the original share capital fall within the provisions of S127 TCGA 1992, as a result of which there is no disposal for CGT purposes at that time. The subsequent gift of the 'B' shares to the discretionary trust will be a market value transaction, but any gain should be nominal in view of the fact that the deemed proceeds will be very small. If necessary, holdover relief under S260 TCGA 1992 is available as long as the settlor, the settlor's spouse and their minor children are excluded from benefit.

From an IHT perspective, the share reorganisation is a non-event, but the gift of the shares to the discretionary trust constitutes an immediately chargeable transfer. However, on the assumption that the settlor has all or most of his IHT nil rate band available, it is unlikely that detailed negotiations will need to be entered into with HMRC's Shares and Assets Valuation team about the IHT value of this transfer.

It will be sensible for the client to involve a share valuation specialist from the outset, both to value the company at the time of the initial planning and at the time of the shareholder's death and, in particular, to confirm the low initial worth of the 'B' shares following the amendment of the Articles of Association.

An alternative strategy is to ensure that the 'B' shares have no voting or dividend rights (and so remain virtually worthless) until such time as the company is wound up or sold or until the 'A' shares are transferred to the 'B' shareholder. This latter event would normally occur on the death of the 'A' shareholder. As a result, there is little to any value in the 'B' shares for creditors or divorcing spouses while the 'A' shareholder remains alive and in full control of the company.

It is generally considered that using this type of structure can turn out to be sound IHT planning. It may not be cheap to implement (perhaps £10,000 + VAT upwards), but, when one considers that every £1,000,000 of capital growth will eventually equate to a tax saving of £400,000, it begins to sound like reasonable value for money.

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