CHAPTER 12

CONNECTED PERSONS AND SERIES OF TRANSACTIONS

12.1 Definition of "connected persons"

There are a number of anti-avoidance provisions to prevent taxpayers from obtaining tax advantages, by entering into transactions with "connected persons".

Section 286 TCGA 1992 identifies persons with whom we are "connected" for CGT purposes. A taxpayer is connected with his or her **spouse.** Remember that the term spouse includes a civil partner. A taxpayer is also connected with his **"relatives".** "Relatives" include **ancestors** such as one's parents or grandparents. Relatives also include **lineal descendants** such as children or grandchildren, and one's brothers or sisters. TCGA 1992, s. 286

A taxpayer is also connected with any **relatives of his spouse**. These will include one's brothers-in-law or sisters-in-law, they being the brothers or sisters of one's spouse. Relatives of one's spouse will also include one's mother-in-law or father-in-law, so these people are also treated as connected persons.

Finally a taxpayer is connected with **spouses of his relatives**. For example, these include one's son-in-law or daughter-in-law being spouses of one's children, or a step-father, him being the spouse of one's mother. A taxpayer is not connected with his uncles, cousins, nieces or nephews, as they are not relatives or lineal ancestors for CGT purposes.

Section 286 extends the definition of connected persons to cover certain other situations.

An individual is connected with a **company that he or she controls**. An individual will have control of a company, if he or she has power to exercise **more than 50% of the voting rights**.

A settlor of a trust is connected with the trustees of that settlement. Finally, a partner is connected with his **fellow business partners and their relatives** – i.e. their spouses, ancestors and descendants etc.

12.2 Transactions with connected persons

The significance of individuals being "connected persons", is that **all transactions between them take place at market value** for capital gains tax purposes. The only **exception** to this is transactions between **spouses** which we know take place at "no gain no loss". TCGA 1992, s. 17 & s.18 TCGA 1992, s. 58

Illustration 1

A taxpayer transfers an asset to his daughter. The asset is worth £100,000 at the date of the transfer, but the daughter only pays her father £60,000 for the asset. This is therefore a **"sale at undervalue"** – i.e. Dad is selling the house to his daughter for less than its present market value.

This is a disposal by Dad for CGT purposes. As he is connected with his daughter for CGT purposes, the **deemed proceeds in the CGT computation are the market value** of the asset at the date of the transfer – in this case £100,000. From this we will deduct Dad's cost, to give him a gain.

You will note that when preparing the donor's CGT computation, we ignore the actual amount of cash changing hands. This is because all transactions between connected persons take place at market value, irrespective of the actual consideration paid.

The **deemed proceeds of £100,000 now becomes the daughter's base cost** for CGT purposes. The computation would have been exactly the same if the transfer had been an outright gift – i.e. if no cash had changed hands between the two parties. An outright gift is a disposal for capital gains tax purposes, with deemed proceeds being equal to the market value of the asset at the date of the gift.

12.3 Losses on disposals to connected persons

There is a special rule to deal with transactions between connected persons which give rise to a capital loss.

Under normal circumstances, a loss must be set against any gains in the year, or carried forward against future gains. This is not the case when the loss arises on a transaction between connected persons. **Where a disposal to a connected person gives rise to a loss, that loss may only be used against gains on future disposals to the same connected person.** The future disposal could be in the same tax year or in a later tax year. This rule is to prevent a taxpayer from deliberately generating artificial losses in order to reduce his CGT liability. TCGA 1992, s. 18(3)

Illustration 2

Dad transfers an asset to his daughter when it is worth £100,000. The daughter pays Dad £60,000 for the asset. If Dad had originally paid £120,000 for the asset, the computation gives rise to a capital loss of £20,000.

The only way that Dad can utilise this loss of £20,000, is to make a future transfer of an asset to his daughter on which a capital gain will be generated. Otherwise the loss will be wasted.

12.4 Series of transactions

Where a taxpayer makes a "series" of disposals, either to one connected person or to several persons connected with him, the anti-avoidance rules in Sections 19 and 20 TCGA 1992 must be considered. Section 19 tells us, that where a taxpayer enters into two or more transactions which are "linked", we will need to apply some special rules to calculate the resulting capital gains. **Transactions are "linked"** for the purpose of Section 19, if they **occur within 6 years of one another**. TCGA 1992, s. 19

Capital gains are calculated by using an **appropriate proportion of the "aggregated market value".** The effect of the rules, is to require the taxpayer to go back and recalculate earlier capital gains, with the aim of preventing the artificial reduction of gains by using a series of transactions to one or more connected persons.

Illustration 3

Bev owns 6,000 shares in a company called Bev Co Limited. Bev bought the shares for £120,000 in May 2000. Bev has a 60% holding, and as this is more than 50%, Bev will have control of the company.

It is now August 2010 and Bev wants to give the shares to her son Jason. The 6,000 shares are currently valued at £420,000.

If Bev goes ahead with this transfer, she will generate a capital gain of £300,000, being the market value of the shares, less their original base cost. Bev wonders whether it is possible to reduce this capital gain, by **giving the shares to Jason in two tranches** at two different times.

She decides to give Jason 2,000 shares – i.e. a 20% holding - immediately. A 20% holding in the company is worth £80,000. A few weeks later, Bev will give Jason her remaining 40% - i.e. the other 4,000 shares. A 40% holding in the company is worth £180,000. These share valuations are based on the principle that shares out of a 40% holding are worth considerably less than shares out of a 60% holding, because a 40% holding does not give the shareholder control of the company.

August 2010: 2,000 shares to Jason

	£
MV in August 2010	80,000
Less: cost	
$120{,}000 \times \frac{20}{60}$	(40,000)
Gain	£40,000

September 2010: 4,000 shares to Jason

	£
MV in September 2010	180,000
Less: cost	
$120{,}000 \times \frac{40}{60}$	(80,000)
Gain	£100,000
Total gains £(40,000 + 100,000)	£140,000

Bev's total gain on the gift of the two tranches of shares to Jason, is £140,000. This is considerably lower than the gain of £300,000 which would have arisen had Bev given away all the shares at the same time.

As this is a very simple – and indeed a very artificial – way of avoiding capital gains tax, there is an **anti-avoidance provision** which prevents this from working.

On the first disposal in August 2010 of 2,000 shares, Bev's gain will be as we originally calculated – i.e. £40,000. However, if Bev subsequently **disposes of more shares to either the same person** - i.e. Jason – **or to another person connected with Bev** - **within 6 years**, then the anti-avoidance provisions will take effect.

Bev gave some more shares to Jason in September 2010. The anti-avoidance rules in Section 19 will therefore be applied and revised computations of the gains which arose in August 2010 and September 2010 must be prepared.

In August 2010 the sales proceeds for the 2,000 shares given to Jason will be an "appropriate proportion" of the market value at that date of all of the assets disposed of. The assets given away in the two transactions looked at together, are 6,000 shares in Bev Co Limited. These 6,000 shares have a total value of £420,000.

Therefore in August 2010:

$$\text{Deemed proceeds} = \frac{2000}{6000} \times 420{,}000 = £140{,}000$$

A similar calculation is done in respect of the gift to Jason in September 2010. The revised gains will be as follows:

August 2010	£	September 2010	£
Proceeds	140,000	Proceeds	280,000
Less: cost		Less: cost	
$\frac{20}{60} \times 120{,}000$	(40,000)	$\frac{40}{60} \times 120{,}000$	(80,000)
Revised gain	£100,000	Gain	£200,000

If we add these together, the total gains chargeable on Bev in 2010/11 will be £300,000. You will see that these aggregated gains are exactly the same as would have been the case, had Bev simply transferred all the 6,000 shares at the same time. The only way that Bev could have avoided falling foul of Section 19, was to leave a period of more than 6 years between the two transfers to Jason.

12.5 "Sets" of assets

There is an interaction between the "series of transactions" rules and the "chattels" rules. These rules apply when a taxpayer has a **"set" of assets** – for example a set of antique dining chairs – which would have a **higher value if sold as a collection**, as opposed to being sold individually.

There is anti-avoidance legislation to prevent a taxpayer from reducing his capital gains by selling each individual asset in the set separately to obtain an artificial advantage. The legislation **treats a series of disposals either to the same person or to a number of connected persons, as being one transaction** for capital gains tax purposes. Having treated the series of disposals as one transaction, if the **"5/3rds rule"** is appropriate, it will be applied to **total gross sale proceeds.** TCGA 1992, s.242(4)

Illustration 4

Toby bought a set of two antique dining chairs in May 1988 for £1,000. The two chairs form part of a matching set. Together they are valued at £9,000 in January 2011.

Toby is considering giving both of the chairs to his grandson. Toby will then be left with a chargeable gain. One way to reduce the chargeable gain, would be to give away the chairs in two separate disposals of one chair each. The chairs would be valued at £3,000 each if they were to be sold separately.

In January 2011, Toby gives one chair to his grandson. This will not give rise to a capital gain, as it will be covered by the chattels exemption. You will recall, that if a chattel costs less than £6,000, and disposal proceeds are also less than £6,000, any gain is exempt from CGT.

Six months later (July 2011) Toby gives the second chair to his grandson. Again, the gain will be exempt from CGT under the chattels rules. This seems like a very simple way to avoid a capital gain. However there are anti-avoidance rules to prevent a taxpayer from abusing the chattels rules in this way.

Where a taxpayer disposes of a "set" of assets by a number of different transactions to the same connected person or to a number of connected persons, the gifts are treated as one transaction for CGT purposes. Toby is therefore treated as having disposed of a "set" of assets for the total market value of the set, which here is £9,000.

	£
Deemed proceeds	9,000
Less: cost	(1,000)
Gain	£8,000

Then the 5/3rds formula, is applied to the total gross disposal proceeds:

$$(9{,}000 - 6{,}000) \times \frac{5}{3} = \underline{£5{,}000}$$

Toby's capital gain is therefore restricted to £5,000. This must now be divided between the two disposals, one in January 2011 and one in July 2011. As the chairs each had the same market value at the date of transfer, we split the gain equally. Toby is therefore treated as having made a capital gain of £2,500 in 2010/11, and a gain of £2,500 in 2011/12.

Example 1

James makes the following gifts to members of his family in 2010/11:

Asset	*Given to*	*Date*	*Gain/(loss)*
Shares	Grandson	1.7.2010	£6,000
Cottage	Daughter	1.8.2010	£(5,000)
Picture	Son	1.9.2010	£(4,000)
Land	Son	1.10.2010	£3,500

Calculate James's gains in 2010/11.

Example 2

Charlotte invites the following people to her 40th birthday party:

a) Husband Henry
b) Uncle George
c) Henry's sister Henrietta
d) Financial adviser Percy
e) Mother in law Isabel
f) Best friend Tamsin

Which of the people are connected with Charlotte for CGT purposes?

Answer 1

	£	£
Gain on shares given to grandson (July 2010)		6,000
Loss on cottage given to daughter	(5,000)	
C/f against future gains on gifts to daughter		
Loss on picture given to son (Sept 2010)	(4,000)	
Gain on land given to son (Oct 2010)	3,500	Nil
Net loss remaining	(500)	
C/f against future gains on gifts to son		
Gains		**£6,000**

Answer 2

		Connected	
		Yes	*No*
a)	Husband Henry	√	
b)	Uncle George		X
c)	Sister-in-law Henrietta	√	
d)	Financial adviser		X
e)	Mother-in-law Isabel	√	
f)	Best friend Tamsin		X