CHAPTER 5

CLOSE COMPANIES

5.1 Close companies

A close company is a UK company **controlled by either** CTA 2010, s.439

- **5 or fewer participators**; or
- any number of participators (however many there are) who are directors.

A "participator" is defined as anyone who **possesses or is entitled to acquire share capital or voting rights** in the company.

For IHT purposes, the definition of a close company is extended to include non-UK companies. IHTA 1984, s.102(1)

5.2 Transfers of value by close companies

Close companies can make transfers of value for IHT. A transfer of value will arise where a close company makes a disposition such that there is a **loss to the company as a result of that disposition.** For example, if a close company transfers a house to a director for no consideration (or for a consideration at less than market value), this will give rise to a transfer of value.

However, while companies can make transfers of value, **only individuals (and trusts) can make chargeable transfers**. Therefore, when a close company makes a transfer of value, **that transfer is apportioned to each participator in the company in accordance with his / her rights and interests** immediately prior to the transfer. In essence, as companies cannot make chargeable transfers for IHT, **any transfer made by a close company is allocated to the shareholders** of the company for the purpose of charging IHT. IHTA 1984, s.94(2)

Lifetime transfers which do not qualify as PETs are immediately chargeable to IHT. A transfer of value by a close company is specifically prevented from being a PET. Therefore **where a close company transfer is apportioned to the shareholders, the value transferred is immediately chargeable to IHT**.

The transfer is based upon the net amount apportioned to each participator after taking account of any compensating increase in their estate resulting from the transfer. **The transfer can be reduced by any available annual exemptions**.
The spouse /civil partner exemption is also available. For example, assume a close company makes a transfer of value which is apportioned (or partly apportioned) to Mr Smith, a director. If that transfer results in an increase in the estate of Mr Smith's spouse / civil partner, all or part of the transfer is exempt.

Illustration 1

Starling Ltd is a UK company, owned by Guy Potter (75%) and Craig Turner (25%). In January 2011, Starling Ltd sold some land to Peter Garvey (a friend of Guy and Craig's) for £1 million. The value of the land at the date of the transfer was £1.2 million.

Starling Ltd is a close company as it is controlled by 5 or fewer shareholders. It has made a transfer of value of £(1,200,000 – 1,000,000) = £200,000. This is apportioned back to the shareholders as follows:

		£
Guy Potter	£200,000 x 75%	150,000
Craig Turner	£200,000 x 25%	50,000

Both Guy and Craig have therefore made chargeable lifetime transfers for IHT. The transfers can be reduced by annual exemptions. Transfers above exemptions are then charged to tax in the usual way (i.e. by deducting available nil bands etc).

Illustration 2

Assume that, in the above example, Guy Potter had created a discretionary trust for his family in June 2006 with £250,000 in cash. This had been his only previous transfer. Craig had made no previous gifts.

Tax payable by Guy Potter:

	£	£
Transfer apportioned under s.94 IHTA 1984		150,000
Less: annual exemptions		(6,000)
CLT		144,000
Nil band 2010/11	325,000	
Less: CLTs in previous 7 years £(250,000 – 6,000)	(244,000)	
		(81,000)
Taxable		63,000
IHT payable @ 20/80		£15,750
Gross chargeable transfer £(144,000 + 15,750)		£159,750

Tax payable by Craig Turner:

	£	£
Transfer apportioned under s.94 IHTA 1984		50,000
Less: annual exemptions		(6,000)
CLT		44,000
Nil band 2010/11	325,000	
Less: CLTs in previous 7 years	(NIL)	
		(325,000)
Taxable		NIL

HMRC's practice is to use the grossed-up lifetime rate of 20/80 as it is the transferor who will bear the tax.

5.3 The charge on the participator

The amount attributed to the participator is:

	£
Transfer of value by close company x % interest	X
Less: increase in participator's estate as a result of the transfer	(X)
Charge on the participator	X

IHTA 1984, s.94(1)

Illustration 3

Mirrorball Ltd is a UK company, owned in equal shares by Mark Jupp, Richard Black and Peter White. In March 2011, Mirrorball Ltd sold a property in Spain to Richard Black for £90,000. The value of the property at the date of the transfer was £150,000.

Mirrorball Ltd has therefore made a transfer of value of £(150,000 – 90,000) = £60,000. This is apportioned back to the shareholders as follows:

			Transfer of value
		£	£
Mark Jupp	£60,000 x 1/3		20,000
Peter White	£60,000 x 1/3		20,000
Richard Black	£60,000 x 1/3	20,000	
Less: increase in Richard's estate		(60,000)	
			NIL

5.4 Liability for the tax

As the transfer of value was made by the company, **it is the company who is primarily liable for payment of the inheritance tax**. Therefore, in Illustration 2 above, Starling Ltd will be liable to pay the tax of £15,750. IHTA 1984, s.202(1)

However, for cumulation purposes, the **gross transfers are normally added to the IHT "clock" of the participator**.

There is an **exception for persons to whom not more than 5% of the value has been attributed** (i.e. to individuals having 5% or less of the share capital or voting rights). In this case a tax charge can still arise, but the **gross transfer is not then added to that individual's cumulative total**. IHTA 1984, s.202(2)

If the company has not paid the IHT by the normal due date, **HMRC can seek recovery of the tax either from the participators** to whom the transfer of value was attributed, **or from any person benefitting from the transfer** of value. No tax can be recovered from participators with no more than 5% of the shares.

The due date for payment of the tax is the **usual due date for payment of IHT** on lifetime transfers being the later of: IHTA 1984, s.226(1)

- 6 months from the end of the month of the transfer of value; or
- 30 April in the following tax year.

5.5 Exceptions

Certain transfers of value by close companies are **disregarded for IHT purposes**. These include: IHTA 1984, s.94(2)

1) the value attributable to a **payment to any person who is chargeable to income tax or corporation tax on that payment**. This provision exempts payments such as those to employees or suppliers in the ordinary course of business and any distributions to shareholders as dividends;

2) transfers apportioned to **individuals not domiciled in the UK** where the **transfer is attributable to property situated outside the UK**. For example, if a close company makes a transfer of value of a foreign asset (eg, a non-UK investment property), no apportionment is made to a non-UK domiciled participator. This is consistent with the general rule for excluded property in that, if the non-domiciled individual had owned the foreign assets directly rather than via a company, the transfer would be outside the scope of IHT;

3) dispositions by close companies for the benefit of employees. The transfer is **disregarded if the company makes a contribution to a qualifying employee benefit trust**. IHTA 1984, s.13

5.6 Alterations of share capital

IHTA 1984, s.98

Under S.98 IHTA 1984, where there is an alteration to either:

a) the unlisted share capital of a close company; or
b) the rights attaching to unlisted shares or debentures of a close company;

the **alteration is treated as a disposition made by the participators** of the company.

The disposition will give rise to a **chargeable lifetime transfer** (not a PET). IHTA 1984, s.98(3)

Illustration 4

The share capital of Sundance Investments Ltd, an unlisted investment company, is held as follows:

	Shares
Paul Redford	6,000
Bob Newman	4,000
Issued shares (ordinary £1)	10,000

Paul's shares are worth £100 per share (being part of a majority holding) while Bob's shares are worth £40 per share.

Sundance Investments Ltd allows Bob Newman to subscribe for 20,000 new £1 shares at par. The revised shareholdings are now as follows:

	Shares
Paul Redford	6,000
Bob Newman	24,000
Issued shares (ordinary £1)	30,000

Paul's shares are now worth £15 per share while Bob's shares are worth £28.75 per share (now being part of a majority holding).

Neither Paul nor Bob has previously made any transfers.

Paul's transfer of value for IHT purposes is:

	£
Value of holding before the alteration £(6,000 x 100)	600,000
Value of holding after the alteration £(6,000 x 15)	(90,000)
Transfer of value	510,000
Less: 2 x AEs	(6,000)
CLT	504,000
Less: nil band (fully available)	(325,000)
Taxable	179,000
IHT @ 20/80 (payable by Paul)	£44,750

A different answer would arise if Sundance Investments Ltd had offered the shares to Paul and Bob under a rights issue, and Paul had decided not to take up his rights.

> Under S.3(3) IHTA, **an omission to exercise a right as a result of which the value of another person's estate is increased, is a transfer of value for IHT**. Therefore Paul's failure to take up his rights shares would give rise to a transfer of value of £510,000 (before exemptions) as calculated above. IHTA 1984, s.3(3)

However, **an omission to exercise a right gives rise to a PET** such that tax would only be chargeable in the event of Paul's death within 7 years.

Example 1

Henry Gondorf and John Hooker are shareholders of Sting Investments Ltd, an unlisted investment company. Henry owns 60% of the shares and John owns 40%.

Both shareholders are wealthy and have made substantial gifts to family trusts in recent years to use all available nil rate bands and annual exemptions.

In 1995 the company bought a matching pair of Samurai swords at an auction as a speculative investment. The swords are now worth £500,000 collectively and £180,000 individually. However, Henry and John have had difficulty in locating a suitable buyer so Sting Investments Ltd gave one sword to Henry and one to John.

Calculate the IHT payable by the company as a result of the transfers.

Answer 1

Sting Investments Ltd has made a transfer of value of £500,000.

This is apportioned to the shareholders as follows:

		£	£
Henry Gondorf	£500,000 x 60%	300,000	
Less: increase in Henry's estate		(180,000)	
			120,000
John Hooker	£500,000 x 40%	200,000	
Less: increase in John's estate		(180,000)	
			20,000
			140,000
IHT @ 20/80			£35,000