CHAPTER 14

CAPITAL GAINS & UK TRUSTS

14.1 General principles

The way a settlor creates a UK trust, is by "settling" – i.e. transferring - assets into the trust. Assuming the assets transferred are not cash, the settlor is making a **disposal at market value** for capital gains tax purposes. Under general CGT principles, a gift between persons will take place at market value. Here the settlor and the trustees are "**connected persons**", so all transactions are deemed to take place at market value. In absence of any claims, the settlor will therefore be left with a chargeable gain.

TCGA 1992, s.17

TCGA 1992,s.286(3)

In certain instances, where a person makes a chargeable gain on a gift, **gift relief** may be claimed to defer all or part of the capital gain. You have already have looked at gift relief on your CGT course, and the rules here are no different. We will refresh ourselves about the basic principles of gift relief over the next few pages.

A transfer by a settlor to a trust will be a disposal at market value even if the settlor is a beneficiary of the trust that he or she sets up.

TCGA 1992, s.70

If the **trustees** consider it prudent to do so, they will **sell trust assets** and hope to make a profit. Therefore if they make a **capital gain** on settled property, the trustees, as a **chargeable person in their own right**, will be subject to CGT. Those gains will be reported on the trustees self-assessment return, and CGT will be paid in the normal way. Remember that trustees are treated as a single and continuing body of persons, distinct from the individual trustees themselves. A change in the composition of the trustees will have no effect for CGT purposes.

TCGA 1992, s.69

Finally, trustees can pay CGT on any deemed disposals they make. The most **common** example of this is when trustees **transfer an asset to a beneficiary**. If the trustees distribute an asset to a beneficiary, they are **deemed to have disposed of the asset at market value** and a capital gain could arise. We shall ook at this, and other special situations, in the next chapter.

14.2 Creation of a trust

Assume a settlor transfers shares to a UK trust. The shares have a market value of £200,000 at the date of the gift. A gift to a trust is a disposal by the settlor at market value, so we deduct cost to arrive at the capital gain in the normal way.

	£
Market value	200,000
Less: cost (say)	(120,000)
Gain	£80,000

As is the case for all gifts, the donee – i.e. the trustees – is deemed to have acquired the shares with a base cost equal to their market value at the date of the settlement. In certain instances, gift relief can be claimed by the settlor to defer this capital gain of £80,000.

Trustees' base cost:

	£
Market value at gift	200,000
Less: deferred gain	(80,000)
Base cost	£120,000

The way we calculate the capital gain and the gift relief is exactly the same as we did for individuals in the course on capital gains tax. We simply calculate the capital gain assuming a deemed disposal by the settlor at market value, and give gift relief where appropriate.

The capital gains tax rules for UK trusts are virtually identical to the CGT rules for UK individuals. Therefore, if in doubt, you should always go back to basic CGT rules when answering questions on capital gains tax and trusts.

14.3 Gift relief

Gift relief can be available to the settlor to defer the gain in certain circumstances. Gift relief is available either under Section 165 or Section 260 TCGA 1992.

TCGA 1992, s.165

TCGA 1992, s.260

An individual can make a claim under Section 165 if he makes a gift of "**business assets**". Business assets" include:

- assets used in a business;
- shares in a personal trading company (≥ 5%);
- shares in an unlisted trading company;
- land or buildings qualifying for APR.

TCGA 1992, s.165(2)(a)

TCGA 1992, s.165(2)(b)(ii)

TCGA 1992, s.165(2)(b)(i)

TCGA 1992, s.165(5)

TCGA 1992, Sch 7(3)

If an individual gives away shares in his or her personal company, and the company holds non-business assets on its balance sheet, the amount of the gift relief available is:

$$\text{Gain} \times \frac{\text{Chargeable business assets}}{\text{Chargeable assets}} \left[\frac{CBA}{CA}\right]$$

TCGA 1992, Sch 7 Para 7

Note that this restriction only applies when a **claim is made under Section 165** and the shares are in the donor's **personal company**. This means, for example, that if the donor only has 3% of the shares of an unquoted trading company, a gift relief claim can be made, but there is no restriction for non business assets.

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S.260 TCGA 1992 allows a capital gain to be deferred where the gift is a **chargeable transfer for inheritance tax purposes**. Therefore if the settlor transfers assets to a **discretionary trust**, this is a chargeable transfer, so any gain can be deferred under s. 260. Therefore capital gains arising on the gift of **any asset** to a discretionary trust will qualify for gift relief.

TCGA 1992, s.260

S.260 gives relief where the transfer is "chargeable" to inheritance tax. There is no requirement for inheritance tax to actually have been paid for a gift relief claim to be made. Therefore, for example, if a settlor makes a gift to a discretionary trust and the transfer is covered either by the settlor's nil band or business property relief etc, even though no IHT is payable, a gift relief claim can still be made for CGT purposes.

TCGA 1992, s.260(2)(a)

If both s.165 and s.260 relief are potentially available, s.260 has priority.

TCGA 1992, s.165(3)(d)

In most instances, a gift relief is a joint claim to be made by the donor and the donee. This is not the case when the donee is a trust. Therefore if the settlor transfers assets to a trust and wishes to defer the gain either under s. 165 or s.260, the **claim will be made by the settlor only**, and the **consent of the trustees is not required**.

TCGA 1992, s.165(1)(b)

TCGA 1992, s.260(1)(c)

A gift relief claim must be made within **4 years** after the end of the tax year in which the assets were transferred.

Therefore, for gifts in 2010/11, a gift relief claim must be made no later than 5 April 2015.

TMA 1970, s.43

Remember that a gift relief claim is not automatic, so if the settlor's gains are either covered by losses or his annual exemption, no claim will be made and the trustee's base cost will not be reduced.

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14.4 Availability of gift relief

(i) Gift to an interest in possession trust

For trusts created before 22 March 2006, a gift to an **interest in possession trust** was not a chargeable transfer for inheritance tax purposes. Therefore **gift relief was only available** if the assets transferred were **business assets under s.165**.

If the asset was a non-business asset – such as a private residence or an investment property – or the asset is shares in a quoted company in which the donor held less than 5% of the votes, no gift relief was available and the settlor had a chargeable gain.

For trusts created on or **after 22 March 2006**, gift relief will be available under s.260 as there will be a **chargeable lifetime transfer** on the creation of the trust.

(ii) Gift to an A&M trust

A transfer to an A&M trust before 22 March 2006 was a potentially exempt transfer for IHT purposes, so gift relief under s.260 was not available. Therefore on the creation of an A&M trust, gift relief was only available to the settlor if the assets transferred were **business assets under s.165.**

No new A&M trusts can be created after March 2006. Trusts which would have been A&M trusts under the old rules, will now be treated as discretionary trusts. Therefore any gain arising on the transfer into the trust can be deferred under Section 260.

(iii) Gift to a discretionary trust

As a gift to a discretionary trust is a chargeable lifetime transfer, **gift relief is always available regardless of type of asset** transferred. There is no requirement for IHT to actually be paid for a claim to be made under s.260.

If business assets are transferred to a discretionary trust or to an interest in possession trust after 22 March 2006, gift relief will be claimed under **s.260 in priority to s.165**.

Most of the time it makes no difference under which section the settlor makes a claim. However, if a settlor transfers shares in a personal company to the trust and claims relief **under s.260, there is no "CBA/CA" restriction** as this restriction only applies for claims under **s.165**.

14.5 SP 8/92

SP 8/92

Under SP 8/92, there is **no requirement for the asset transferred to be formally valued** if a gift relief claim is to be made which will wipe out the capital gain.

In practice it can be difficult obtaining values for assets such as land and unquoted shares. Therefore where no chargeable gain will arise, HMRC will simply require details of the assets transferred, the **date of the gift and the base cost of the assets**, as this information is sufficient to enable them to calculate the trustees' base cost.

A valuation will be necessary if the gift is a chargeable transfer to a trust so that an IHT charge arises.

14.6 Restrictions relating to gift relief claims

There are a **couple of additional rules** relating to gift relief and trusts that you need to be aware of. **Both were introduced by Finance Act 2004, taking effect from 10 December 2003.**

The first rule **restricts gift relief under both section 165 and section 260.** Under this rule, it is **not possible to make a gift relief claim** on a gift into a trust **if the settlor of the trust has an interest in the trust.**

TCGA 1992, s.169B

An interest in the trust means that **trust property can be paid or applied for the benefit of the settlor or his spouse/civil partner or minor child.**

TCGA 1992, s.169C

Additionally, there is **a possible clawback of gift relief.** This will happen if the trust is not a settlor interested trust when the gift is made and gift relief is claimed, but **the trust becomes a settlor interested trust within six tax years.**

The second rules relates to **principal private residence** relief. The general rule is that principal private residence relief is available to trustees if a **beneficiary** occupies a trust property as his only or main residence.

TCGA 1992, s.226A

It is now **not possible** for trustees to claim this relief if a gift subject to a **section 260** gift relief claim has been made previously.

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14.7 Sales by trustees

Trustees are a chargeable person in their own right with a distinct legal personality, and they will pay CGT in the same way as an individual.

TCGA 1992, s.69

Trustees will dispose of assets if they consider it to be in the interest of the beneficiaries to do so. If trustees dispose of trust assets at a profit and make a capital gain, normal CGT rules will apply.

When a trustee acquires an asset from the settlor, the base cost of the asset is equal to the market value at the date of the gift, reduced by gift relief if a claim is made under either s.165 or s.260.

To calculate CGT payable by trustees, we use the rules which apply for individuals, with one minor exception.

Trustees receive an annual exemption which is equal to **half of an individual's exemption**. Therefore for 2010/11, the trustee's annual exemption is £5,050.

TCGA 1992, Sch 1 Para2 (2)

There is an anti avoidance rule to prevent a settlor setting up a number of trusts and claiming an annual exemption for each of those trusts. The annual exemption of £5,050 is **divided by the number of trusts settled by the same settlor after 6 June 1978.**

TCGA 1992, Sch 1 Para2 (3)

Therefore if a settlor created 2 trusts, each trust will receive an annual exemption of £2,525. Where the anti avoidance rule applies, the **minimum** annual exemption given to each trust is £1,010. This is equal to **one-tenth of an individual's annual exemption.**

The rate of capital gains tax applying to gains made by Trustees is;

- 18% for disposals on or before 22 June 2010; &
- 28% for gains arising after 22 June 2010.

Trustees will **set their annual exemption against gains arising after 22 June 2010** in priority to those arising before 22 June 2010 as this maximises tax relief.

If Trustees sell assets and make a loss, normal loss rules apply. The Trustees must first set losses against gains of the same tax year. **Losses can be set against post-22 June 2010 gains before pre-22 June 2010 gains** as this maximises relief for the losses. This will be the case even if the loss arose before 22 June 2010.

Excess losses are carried forward against future capital gains. Trustees cannot carry back a capital loss.

Illustration 1

The Ashley Family Trust sold the following assets in 2010/11;

- A painting on 30 April 2010 giving rise to a gain of £20,000;
- Some shares in BP plc on 1 June 2010 giving rise to a loss of £(15,000); &
- An investment property on 31 October 2010 giving rise to a gain of £50,000.

The CGT payable by the Trustees for 2010/11 is as follows;.

	On or before 22 June 2010	After 22 June 2010
	£	£
Painting	20,000	
Investment property		50,000
Less; loss on shares	_____	(15,000)
Chargeable gains	20,000	35,000
Less: AE	_____	(5,050)
Taxable gains	20,000	29,950
CGT @ 18% / 28%	3,600	8,386
Total CGT liability	£11,986	

14.8 Entrepreneurs' relief

Entrepreneurs' relief is available where a disposal is made by a qualifying trust. The rules apply in a similar way as they do to a disposal by an individual.

In order for an entrepreneurs' relief claim to be made in respect of trust gains, **the beneficiary must have an interest in possession in the trust**. Fully discretionary trusts therefore will never be able to claim entrepreneurs' relief.

TCGA 1992, s.169J(3)

The disposal must either be of:

1) a business owned by the trustees but run by the beneficiary (either alone or in partnership); or (more likely)

2) shares in a qualifying company. The qualifying company must be the beneficiary's personal trading company (ie 5%+) and the beneficiary must be an employee or officer of the company. Note, it is the **beneficiary who must own at least 5%** of the shares. The trustees have no minimum shareholding.

The trustees and the beneficiary must make the claim for relief jointly, since it is the beneficiary's relief which is being utilised. This is important as it means that **the beneficiary's lifetime gains "ceiling" of £5 million is reduced by any gains for which entrepreneurs' relief is given to the trustees**.

TCGA 1992, s.169N

This is to prevent an individual "doubling up" his entrepreneurs' relief by transferring assets to an IIP trust for his own benefit.

In some instances therefore it may be in the beneficiary's interest not to consent to the trust's entrepreneurs' relief claim.

Where an IIP trust has more then one beneficiary with an entitlement to income, the **gains eligible for entrepreneur's relief are apportioned**. The apportionment is by reference to the qualifying beneficiary's proportional entitlement to the trust income.

14.9 Private residence relief

If the Trustees own a property and under the terms of the settlement they **permit one or more beneficiaries to occupy the property as their only or main residence,** then **private residence relief is available** on a disposal of the property.

TCGA 1992, s.225

Therefore where a trust property is occupied by a beneficiary, the following periods of ownership will be **exempt periods for the purposes of PPR relief**;

1) the period during which the **property was occupied by the beneficiary**;

2) the **last 36 months of ownership**; &

3) the "**deemed occupation" periods** in S.223(3); ie

TCGA 1992, s.223

   a) periods of absence **up to 3 years**;

   b) periods of absence during which the beneficiary was **abroad by reason of his or her employment**;

   c) periods of absence up to **4 years where the taxpayer was required to work elsewhere**.

Note that the deemed occupation periods in S.223(3) can only apply to trust gains where **the same beneficiary occupied the trust property both before and after** the period of absence.

Where PPR relief is given on a trust gain, **lettings relief will also be available** in respect of periods during which the property was let to a third party tenant.

TCGA 1992, s.223 (4)

Illustration 2

The Miller Family Discretionary trust bought an investment property in London for £100,000 in May 1989. The property was immediately let to an unconnected family on a 3 year lease.

Between May 1992 and May 1993 the property was renovated at a cost of £50,000. The property was unoccupied in this period.

In May 1993, the trustees permitted Zoe, a beneficiary, to live in the property while she was at Drama School in London. Zoe moved out in May 1995 to take up a 2 year employment contract with a TV company in the north of England. The contract ended in May 1997 and Zoe returned to London to live in the trust property. The property had remained empty during this period.

Zoe lived in the trust property for a further 3 years until she married and moved out in May 2000.

The property was empty until May 2001 at which point it was let on a 12-month lease to an unconnected tenant. The tenant moved out in May 2002 after which property remained empty until May 2003.

In May 2003, another beneficiary, Claire, was permitted to occupy the property. Claire bought her own house in May 2006 and moved out. The property was then let again from May 2006 to a third party tenant on a rolling lease until it was sold in May 2011 for £810,000 (after expenses of disposal).

Solution

The gain made by the Trustees will qualify for PPR relief as the property had been occupied by a beneficiary as a private residence under the terms of the settlement.

We therefore need to determine periods of occupation and periods of absence;

	Occupation by beneficiary	*Absence*	*Let*
May 1989 – May 1992		3	3
May 1992 – May 1993		1	
May 1993 – May 1995	2		
May 1995 – May 1997 (N1)	2		
May 1997 – May 2000	3		
May 2000 – May 2001		1	
May 2001 – May 2002		1	1
May 2002 – May 2003		1	
May 2003 – May 2006 (N2)	3		
May 2006 – May 2008		2	2
May 2008 – May 2011 (N3)	3	_	_
Totals	13	9	6

Notes:

N1: Zoe occupied the property both before and after this 2 year period of absence. This 2 year period will therefore qualify as "deemed occupation" under S.223(3), either under the "3 year rule" (s.223(3)(a)) or because Zoe was required to work elsewhere (s.223(3)(c)).

N2: Claire occupied the property between May 2003 and May 2006. The period between May 2000 and May 2003 will not qualify under the 3 year deemed occupation rule as a different beneficiary occupied the property.

N3: as the property has been a PPR of a beneficiary, the last 36 months of ownership will qualify as deemed occupation (s.223(2)(a)).

The chargeable gain is therefore;

	£	£
Proceeds		810,000
Less: base cost		
Original cost	100,000	
Enhancement expenditure	50,000	
		(150,000)
Gain		660,000
Less: PPR relief (£660,000 x 13/22)		(390,000)
		270,000
Less; lettings relief:		
a) PPR relief	390,000	
b) Gain in let period £(660,000 x 6/22)	180,000	
c) Statutory maximum	40,000	
		(40,000)
Chargeable gain		£230,000

As mentioned in section 14.6 above, it is not possible for the Trustees to claim PPR relief, if a gift of the property into the Trust had been subject to a S.260 gift relief claim.

TCGA 1992, s.226A

For example, assume a settlor gave a house to a discretionary trust and a S.260 claim was made to roll-over the gain on the property against the Trustees base cost. The Trustees then permit a beneficiary to occupy the house as their main residence.

On a disposal of the house by the Trustees, PPR relief would not be available.

14.10 Interaction with IHT paid

TCGA 1992, s.260(7)

There is an interaction between capital gains tax and inheritance tax, when a disposal for CGT purposes results in IHT being paid.

This will be the case when either:

- a settlor gives assets to a discretionary trust (or an interest in possession trust after 22 March 2006); or
- when assets leave a trust and pass to a beneficiary such that an exit charge arises.

Under s.260(7) TCGA 1992, the **inheritance tax paid** on the transfer is an **allowable deduction for the donee for capital gains tax purposes**.

Illustration 3

An individual transferred an asset to an A&M trust in 2005, making a potentially exempt transfer. The asset is a business asset so the capital gain is deferred under s.165. The transferor dies within 7 years of making the gift. Any IHT on the "failed PET" will be paid by the trustees. Under s.165(10), the **IHT payable by the trustees is an allowable deduction for capital gains tax purposes**, and thereby **increases** the trustees' CGT base cost.

TCGA 1992, s.165(10)

Illustration 4

A settlor transfers quoted shares to a discretionary trust in 2010/11. The gain is as below:

	£
Market value at gift	500,000
Less: cost of shares (say)	(280,000)
Gain	220,000
Deferred under s.260 TCGA 1992	(220,000)
Chargeable	Nil

As the gift to the discretionary trust is a chargeable lifetime transfer, we must consider any IHT payable.

IHT paid:	£
Gift	500,000
Less: AEs (2010/11 and 2009/10)	(6,000)
CLT	494,000
Less: Nil band	(325,000)
Taxable	£169,000
IHT @ 20% (paid by trustees)	£33,800

Under s.260(7), the IHT paid on the transfer is allowed as a deduction for CGT purposes and can be treated as an additional cost incurred by the trustees in acquiring the shares. The trustees' base cost in the event of a future disposal is therefore as follows:

Trustees base cost:	£
Market value at gift	500,000
Less: deferred under s.260	(220,000)
	280,000
Add: additional relief given under S.260(7)	33,800
Revised base cost	£313,800

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Example 1

David gave a 1% holding in ABC plc (an AIM listed company) to an A&M Trust in January 1996. The shares cost £20,000 in 1987 and were worth £100,000 at the date of the gift. An election was made to hold over the gain of £70,000.

David created a discretionary trust in 1999.

The A&M trustees sold the ABC plc shares for £250,000 in December 2010. This was their only disposal.

Calculate the CGT payable by the trustees in 2010/11.

Example 2

The Peterson Family Trust sold a house in Manchester in March 2011 for £240,000. This was their only disposal in 2010/11.

The house had been bought in March 1999 for £150,000. For the first 4 years it was let to a third party tenant. Between March 2005 and March 2007 it was occupied by a beneficiary. For the rest of the period of ownership, the house was unoccupied.

Calculate the CGT payable by the Trustees for 2010/11.

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Answer 1

	£	£
Proceeds		250,000
Less: base cost		
MV @ January 1996	100,000	
Less: deferred gain	(70,000)	
		(30,000)
		220,000
Less annual exemption: £5,050/2		(2,525)
Taxable gain		217,475
CGT @ 28%		£60,893

Answer 2

	Occupation by beneficiary	*Absence*	*Let*
March 1999 – March 2003		4	4
March 2003 – March 2005		2	
March 2005 – March 2007	2		
March 2007 – March 2008		1	
March 2008 – March 2011 (N)	3	_	_
Totals	5	7	4

Note: last 36 months will qualify as occupation.

The CGT liability is therefore;

	£	£
Proceeds		240,000
Less: cost		(150,000)
Gain		90,000
Less: PPR relief £(90,000 x 5/12)		(37,500)
		52,500
Less; lettings relief:		
a) PPR relief	37,500	
b) Gain in let period (£90,000 x 4/12)	30,000	
c) Statutory maximum	40,000	
		(30,000)
Chargeable gain		22,500
Less; AE		(5,050)
Taxable gain		17,450
CGT @ 28%		£4,886