

Capital Gains Tax and Trusts

Introduction

This technical note explores the rules around Capital Gains Tax ('CGT') and how these interact with the settlement of assets into trusts.

The trustees of a trust are treated as a separate and single taxable entity to the settlor of it and therefore, if trustees dispose of assets, then they may be liable to pay any CGT triggered by such a disposal.

However, in addition to these 'actual disposals' of assets, there are occasions when trustees are 'deemed' to have made a disposal and capital gains tax is charged accordingly.

Key Learning Points

- When CGT may be triggered
- Types of assets that may trigger a liability to CGT
- Calculation of the gain
- The principles of the base cost
- The principles of the Trustees CGT allowance
- The rates of CGT that apply to trustees
- Reliefs available to trustees

Types of assets and calculation of gain

CGT is charged in respect of chargeable gains accruing on the disposal of most types of assets including assets such as;

- Stocks and shares excluding Investment Bonds (unless traded)
- Commercial/residential property and land

Calculation of the gain

The gain arising on a disposal is calculated in the same way as it would be for an individual. The tax is applied to the difference between the disposal value and the acquisition value (base cost), subject to reliefs and exemptions.

Base cost (starting point for CGT calculations) of trust assets

Where assets are acquired by the trustees of a trust, the trustees' base cost of the asset is the purchase price, the date of death value (for probate purposes) or the market value at the time of the transfer by the settlor as applicable.

The base cost will differ from the market value when assets are acquired under a hold-over claim. In the case of a holdover claim the base cost will be that at which the settlor acquired the asset.

CGT and Chargeable Lifetime Transfers (CLT) a quick note

If hold-over relief was claimed when the settlor transferred property to the trust and the transfer triggered a CLT charge, the amount of Inheritance Tax on the CLT paid on the CLT is available as a deduction in the calculation of the capital gain arising to the Trustees on a later disposal of that property.

The deduction can reduce the trustees' gain to zero, but cannot create a loss.

Annual exemption

The annual exemption is the amount of capital gains that can arise in the financial year free from CGT. The trustees of a trust are entitled to an annual capital gains tax exemption equal to half of that of an individual, but this exemption is divided by the number of all of the trusts settled by the settlor which are in existence during any particular tax year (or any part thereof).

Special provisions apply to trusts that are primarily for the benefit of a disabled person and meet certain criteria. Such trusts are entitled to a full annual exemption; however, if the same settlor has made more than one such settlement, then the annual exemption is reduced in a similar manner as that described above subject to a minimum exemption equal to 10% of that of an individual.

Annual exemption - note

Pilot/lifetime Trusts

As part of an estate planning strategy, a person may have established one or more 'pilot' trusts. Even though each settlement may only hold £10, it will reduce the annual exemption available to any other settlements made by the same settlor.

Rates of CGT

Trustees must pay capital gains tax at the higher rates of 20% and 28%. The rate was of 20% applies for the disposal of all assets except residential property. This is subject to the possible availability of business asset disposal relief (formerly entrepreneurs' relief), which, if available, will reduce the rate of tax to 10%. The rate of 28% applies on the disposal of residential property.

Reliefs

Trustees are potentially entitled to a number of reliefs against capital gains tax.

Hold-over relief

'Hold-over' relief allows for the deferral of a gain that would otherwise arise in relation to a disposal and in this respect, hold-over is to avoid having to pay a CGT charge now when you will not be realising any cash from the sale, i.e. we are talking about a transfer of the asset with no moneys passing the other way.

No capital gains tax (CGT) is due in respect of the disposal, but the base cost of the asset for the transferee for the purpose of a future disposal is reduced by an amount equal to the gain that would otherwise have arisen.

Hold-over relief can be of two types:

- 'Business' hold-over relief on disposals of certain types of business assets (s165 TCGa 1992)
- General' hold-over relief on certain disposals that give rise to an IHT charge (plus some other disposals by trustees) (s260 TCGa 1992)

The relief is optional and has to be claimed.

If both types of hold-over relief are available in relation to a disposal, then general hold-over relief must be claimed instead of business hold-over relief.

Hold-over relief is available to trustees but not to personal representatives/executors.

When personal representatives/executors transfer the assets of the estate to the persons entitled to them, no gain will arise in any event, and the beneficiaries will generally receive the asset with a base cost equal to that at death. (S62 TCGa 1992)

Business asset disposal relief (entrepreneurs' relief)

Entrepreneurs' relief (now called 'business asset disposal relief') is a relief that reduces the rate of capital gains tax payable by business-owners on a disposal of their business. Trustees are able to claim the relief on the disposal of business assets held by them in the same manner that individuals can. (s169 TCGa 1992)

Gains that qualify for business asset disposal relief are subject to capital gains tax at the rate of 10% whereas other trust gains are subject to tax at the higher capital gains rates of 20% or 28%. Please note that there is no provision for personal representatives to qualify for business asset disposal relief. The conditions for claiming the relief are broadly very similar to those applicable to an individual.

Disposals of shares

In order for the shares to qualify for business asset disposal relief, all of the following conditions must be met:

- The shares must be shares or securities of a company that is either a trading company, or the holding company of a trading group.
- At the time of the disposal, a 'qualifying beneficiary' must have an interest in possession (ie a present right to present enjoyment).
- The qualifying beneficiary must be an officer or employee of the company. The qualifying beneficiary must have a personal holding of at least 5% of the ordinary share capital of the company and be beneficially entitled to 5% of voting rights. In addition, he must be personally entitled to 5% of the profits available for distribution or 5% of proceeds on the disposal of all the ordinary share capital of the company. (s169 TCGa 1992)

Claiming business asset disposal relief

Unlike individuals, the trustees are not entitled to their own individual business asset disposal relief allowance. Instead, the trustees must use the qualifying beneficiary's allowance and therefore must make a joint claim with the beneficiary in order to do so. Each individual has a lifetime limit of £1m, which is the total amount of gains that can be subject to the relief.

Private residence relief

The gain on the sale of a residential property held in trust will be wholly or partly exempt if, during the period of ownership by the trustees:

- the property has been occupied by a beneficiary of the trust as his or her only or main residence, and
- the beneficiary in question is entitled to occupy the property under the terms of the trust (s225 TCGa 1992)

A similar relief is available on the disposal of a property by the personal representatives/executors of a deceased person.

The relief is only available to trustees if a claim is made. It does not apply automatically as with individuals. A claim must be made within four years of the tax year in which the disposal occurred.

This final period is now nine months thus allowing a further nine month period of relief to factor in to any calculation. However, a period of 36 months continues to apply where the beneficiary who has occupied the property under the terms of the trust is a disabled person or a resident in a care home at the date of disposal provided that no other residential property is owned by that person.

The fact that a person does not have an interest in possession does not preclude him or her from being entitled to occupy the property if he is among the class of potential beneficiaries and the trustees allow him into occupation.

This can happen when property is owned by the trustees of a discretionary trust. If the trustees have exercised their powers to allow a beneficiary to use the property as a residence, then this will be sufficient entitlement for the purpose of obtaining the relief.

Letting relief

Letting relief is available only if there is a degree of shared occupancy (i.e the beneficiary and the tenant both live in the residence). Just the period during which both the beneficiary and tenant occupy the residence qualifies for letting relief.

The relief is limited to the lesser of the following:

- the gain attributable to the period during which the property was let
- the gain qualifying for PPR
- £40,000