CHAPTER 16

CGT AND UK TRUSTS – FURTHER ASPECTS

In this chapter you will cover further aspects of capital gains tax and UK trusts including:

– CGT implications of appointments of assets to beneficiaries;
– deferral relief on capital appointments;
– treatment of losses on capital appointments;
– the “Crowe v Appleby” principle;
– CGT implications of the death of a life tenant;
– the disposal of an interest in possession.

16.1 Appointments to Beneficiaries

Trustees will distribute assets to beneficiaries on 3 occasions:

1. When Trustees exercise their discretionary powers to appoint an asset to a beneficiary;

2. In the event that the beneficiary becomes entitled to a share of the trust fund (for example on reaching a specified age); and

3. On the winding up of the Trust.

The appointment of an asset by the Trustees to a beneficiary on any of these occasions is a disposal by the Trustees for CGT purposes. Even though Trustees and beneficiaries are not “connected persons” for CGT purposes, the disposal takes place at market value by virtue of s.71 TCGA 1992. TCGA 1992, s.71(1)

Assuming that the assets passing out of the trust are chargeable to CGT (e.g. land & buildings, shares, chattels etc), a gain or loss will arise to the Trustees.

16.2 Deferring Gains

Gains arising on the appointment of assets to beneficiaries can be deferred on 3 occasions;

1. Where the distribution is a chargeable transfer for IHT purposes (for example, an appointment from a relevant property trust or from an “Age 18-to-25” trust after age 18); TCGA 1992, s.260

2. Where the asset being transferred is a “business asset” for CGT purposes (for example, shares in an unlisted trading company); or TCGA 1992, s.165

3. On an appointment of assets from a bereaved minor’s trust. TCGA 1992, s.260(2)(da)

The deferred gain will be rolled over and will reduce the base cost of the asset in the hands of the beneficiary.

Note that where assets are appointed from a relevant property trust either within 3 months of creation or within 3 months of a 10-year anniversary, as there is no occasion of charge for IHT purposes, there is no gift relief available under s.260
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16.3 Treatment of Losses on Capital Appointments

A capital loss will arise to the Trustees on the appointment of an asset to a beneficiary if the Trustees’ base cost of the asset exceeds its market value at the date of the distribution.

The loss must be used as follows:

1. First the loss must be set against any gains arising to the Trustees between 6 April and the date of the appointment. Gains arising in this period are called “pre-entitlement” gains; then

2. Any losses which have not been set against pre-entitlement gains will be treated as losses made by the beneficiary. However the beneficiary is only allowed to use these losses against gains made on the disposal of that same asset. TCGA 1992, s.71(2)

Illustration 1

A trust had the following disposals in 2015/16:

- On 1 May 2015 the Trustees sold some quoted shares making a gain of £20,000.
- On 1 September 2015 the Trustees transferred an investment property to a beneficiary. The property was worth £200,000 at the date of the appointment and had a base cost of £225,000.
- On 1 March 2016 the Trustees sold a painting making a gain of £50,000.

Comment on the CGT position for 2015/16.

- There is a capital loss of £(25,000) on the appointment of the investment property;
- Pre-entitlement gains of the trust are £20,000.
- The capital loss on the appointment must be set against those pre-entitlement gains. This reduces the gains to nil.
- The excess loss of £(5,000) cannot reduce the Trustees gain on the painting as this gain was made after the appointment to the beneficiary. The gain of £50,000 is therefore chargeable.
- The excess loss of £(5,000) is treated as a loss of the beneficiary.

TCGA 1992. In this instance the gains will only be eligible for deferral relief if the assets are business assets under s.165.

Gift relief claims under either s.260 or s.165 require the consent of the beneficiary.

Where Trustees are making a discretionary appointment of an asset, it is common in practice to make the beneficiary’s consent to a gift relief claim a condition of the distribution (this avoids the Trustees being left with a CGT liability).

Gift relief claims should be made no later than 4 years from the end of the tax year of the appointment (e.g. by 5 April 2020 for appointments in 2015/16).
• The beneficiary can only set this loss against any gains which may arise on the eventual disposal of the investment property. Otherwise the loss will be wasted.

16.4 The “Crowe v Appleby” Principle

The case of Crowe v Appleby (1975) involved beneficiaries of an A&M trust becoming absolutely entitled to a share of the trust assets on attaining the specified age. The trust fund included land and buildings.

Following Crowe v Appleby, where a beneficiary becomes entitled to an “undivided share” in land – i.e. a right to part of the sales proceeds once the land is sold – there is no disposal by the Trustees until such time as all of the beneficiaries become entitled to the land as against the Trustees.

Illustration 2

A trust has 2 beneficiaries, Amy & Ben. Under the terms of the trust, each beneficiary becomes entitled to a 50% share in the capital of the trust at age 25. The trust owns a residential investment property.

Amy is approaching her 25th birthday. Ben is 23.

On her 25th birthday, Amy will become entitled to 50% of the trust assets (in this case 50% of the investment property).

Following Crowe v Appleby, as Amy has an undivided share in the investment property (i.e. the property is still held on trust for Ben), the Trustees are not deemed to have disposed of a 50% share in the property for CGT purposes. No disposal of the property therefore takes place when Amy becomes 25.

When Ben becomes 25, there will be a deemed disposal of the whole of the property giving rise to a capital gain.

Note that Crowe v Appleby only applies for capital gains tax. For IHT purposes, when Amy becomes 25 and entitled to a 50% share in the trust, there is a transfer of value. If the trust is a relevant property trust, this transfer will give rise to an exit charge.

16.5 CGT Implications of the Death of a Life Tenant

When a life tenant of an interest in possession trust dies, either:

a. The trust assets will pass to the remainderman and the trust will come to an end; or

b. The trust will continue either with another life tenant taking a successive interest in possession or with the fund becoming discretionary with no rights to income.

The CGT position on the death of a life tenant depends on whether, at the point of death, the trust was a “qualifying IIP” or whether the trust was within the relevant property regime.
1) Where the trust was a “qualifying IIP”

Where the trust was a “qualifying IIP”, the death of the life tenant gives rise to a **deemed disposal by the Trustees of all assets in the trust** at that time. This is the case regardless of whether the trust continues or ends.

The **deemed disposal takes place at market value**. Capital gains (or losses) will arise to the Trustees at this point. **TCGA 1992, s.72**

Under general principles, death is not an occasion of charge for CGT purposes. Therefore any gains arising on the deemed disposals will not give rise to a CGT charge. **TCGA 1992, s.62**

However full exemption from CGT is not available if any capital gains were deferred when the asset(s) being disposed of were originally transferred into the trust.

**If any gains have been deferred**, then the gains arising on the deemed disposals by the Trustees will be **chargeable to CGT but the charge will be limited to the amount of those deferred gains. **TCGA 1992, s.74(2)**

**Illustration 3**

David transferred shares in an unlisted trading company to a trust in September 2005. The terms of the trust were that Eddie would have an interest in possession for life with capital reversion to Felix on Eddie’s death. The shares had a base cost of £120,000 and were worth £200,000 on settlement.

As Eddie’s right to income arose before March 2006, he has a qualifying IIP.

Gift relief is available under s.165 as the shares are business assets.

The CGT position on settlement is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value of shares at September 2005</td>
<td>£200,000</td>
</tr>
<tr>
<td>Less: Base cost</td>
<td>(£120,000)</td>
</tr>
<tr>
<td>Gain</td>
<td>£80,000</td>
</tr>
<tr>
<td>Less: Deferred under s.165</td>
<td>(£80,000)</td>
</tr>
<tr>
<td>Chargeable</td>
<td>Nil</td>
</tr>
<tr>
<td>Trustees’ base cost (£200,000 – 80,000)</td>
<td>£120,000</td>
</tr>
</tbody>
</table>

Eddie died on 15 March 2016. The shares were worth £350,000 at that point.

As Eddie had a qualifying IIP, **the death of the life tenant gives rise to a deemed disposal at market value by the Trustees** of all assets in the trust (being the unlisted shares).
However the chargeable gain is **limited to the amount of any gains deferred** on the settlement of the assets:

<table>
<thead>
<tr>
<th></th>
<th>£</th>
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</thead>
<tbody>
<tr>
<td>Market value at March 2016</td>
<td>350,000</td>
</tr>
<tr>
<td>Less: Base cost</td>
<td>(120,000)</td>
</tr>
<tr>
<td>Gain</td>
<td>230,000</td>
</tr>
<tr>
<td>Restricted to gains held-over on settlement</td>
<td>80,000</td>
</tr>
</tbody>
</table>

The CGT payable is therefore:

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<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Chargeable gain</td>
<td>80,000</td>
</tr>
<tr>
<td>Less: AE</td>
<td>(5,550)</td>
</tr>
<tr>
<td>Taxable gain</td>
<td>74,450</td>
</tr>
<tr>
<td>CGT @ 28%</td>
<td>20,846</td>
</tr>
</tbody>
</table>

On Eddie’s death, the trust asset pass to the remainderman (Felix) and the trust is wound up. Felix will take the shares with a base cost equal to their market value on Eddie’s death being £350,000.

As Eddie had a qualifying IIP, the shares will form part of his death estate. **The transfer of the shares to Felix will therefore be a chargeable event for IHT.**

Where a disposal for CGT gives rise to a chargeable event for IHT, **deferral relief is available under s.260.** Therefore, assuming a gift relief claim is made, the trust gain of £80,000 can be rolled against the base cost of the shares in the hands of the remainderman. Felix’s base cost would therefore become £(350,000 – 80,000) = £270,000.

A s.260 claim would require the consent of the beneficiary (which is not guaranteed here). If Felix did not give consent to the deferral claim, the Trustees would have to pay the CGT due and distribute the balance of the fund to Felix. If there was no cash in the trust to meet the CGT, the Trustees would sell the shares and appoint the trust fund as cash.

2) **Where the trust was NOT a “qualifying IIP”**

Where the life tenant did NOT have a “qualifying IIP”, the above rules do not apply.

Instead the CGT position on the death of the life tenant **depends on whether the trust assets are actually appointed** out of the trust.

If the terms of the trust are such that on the death of the life tenant the assets pass to the remainderman, there is an **actual disposal by the Trustees at this point.** The disposal takes place at market value. A gain (or loss) will arise on the transfer of any chargeable assets.

If the trust is not a “qualifying IIP”, it will be a relevant property trust. Where assets are appointed out of a relevant property trust, an exit charge usually arises. As the disposal gives rise to a chargeable event for IHT, **deferral relief is available under s.260.** Therefore, assuming a claim is made, the trust gains can be rolled against the base cost of the assets in the hands of the remainderman.

A s.260 claim would again require the consent of the remainderman (otherwise the Trustees would pay the CGT due and distribute the balance).
Sometimes, on the death of a life tenant, the trust will continue (either with another life tenant taking a successive interest or as a discretionary trust). In this case, as no assets will leave the trust there is no disposal and no CGT issues to consider.

16.6 Transfers between settlements

Providing they have the legal power to do so, the Trustees of one Trust (“Trust 1”) may transfer assets to another (“Trust 2”). If this happens we need to consider:

1. The IHT implications – i.e. does this give rise to an exit charge?; and
2. The CGT implications – i.e. is there a disposal for CGT purposes by the trustees of Trust 1?

Inheritance Tax

The IHT treatment of assets moving between trusts is dealt with by s.81 IHTA 1984.

S.81 says that when property is transferred from one trust to another, it is treated as remaining in the first trust for inheritance tax purposes. \(\text{IHTA 1984, s.81}\)

This means that:

- The transfer of property from one relevant property trust to another does not incur an exit charge; &
- Principal charges arise on the ten year anniversary of the commencement of the original settlement.

Capital Gains Tax

The CGT rules are more complex.

The trustees of Trust 1 will make a deemed disposal under s.71(1) TCGA 1992 where assets pass from the original settlement to a different settlement. The question to address therefore is whether Trust 2 is a “different settlement”.

This is dealt with by HMRC Statement of Practice 7/84.

SP 7/84 says that each case must be considered on its own facts and should include an objective examination of the powers exercised by the trustees.

SP 7/84 makes 2 main points:

1. Where the appointment is revocable or there is a possibility of the property transferred to Trust 2 reverting back to Trust 1 at some future point, there is no deemed disposal under s.71 and no gains will arise in Trust 1.

For instance, the temporary creation by discretionary trustees of a revocable interest in possession would not create a “different settlement” and would not therefore be a disposal for CGT.

The creation of a revocable IIP for a beneficiary is a useful planning tool in accessing entitlement to entrepreneurs’ relief on a trust gain. ER is only available if a beneficiary with an interest in possession has 5% of the share capital and works for the company in which the trust is selling shares. Therefore discretionary trustees could create a revocable IIP in favour of a beneficiary in
this position (if one can be found!). The share sale would then take place while
the IIP exists in order to access ER. The IIP would then be revoked after the sale
of the shares.

2. In addition, a deemed disposal is unlikely to arise if duties in regard to the
appointed assets still fall to the trustees of the original settlement.

This was established in Bond v Pickford (1983) where a discretionary trust
executed two deeds of appointment under which property thereafter
became held on two allocated funds. The funds continued to be administered
by the original trustees under the powers given to them by the original
settlement. In this case the Courts held that there had been no deemed
disposal for CGT as no new settlement had been created.

In the event that a new settlement IS created, the trustees of Trust 1 will be
deemed to dispose of any chargeable assets transferred to Trust 2. The disposal will
take place at market value.

Consideration would then need to be given as to whether any gains arising in Trust
1 could be held over under s.165 TCGA (on a transfer of business assets) or under
s.260 TCGA (in the event that the transfer is immediately chargeable to IHT).

As discussed above, transfers between trusts do not give rise to an exit charge, so
s.260 relief would not be available. Therefore unless the assets transferred are
business assets (e.g. shares in an unlisted trading company), the creation of a new
settlement will leave a CGT liability in the hands of the Trust 1. The trustees of Trust 2
would then acquire the new assets with a base cost equal to market value.

16.7 Disposal of an Interest in Possession

An interest in possession is a right to income. This right to income is an asset in itself
and could have significant value. The person with the right to income (the life
tenant) may therefore want to sell his interest in possession and effectively
exchange an income stream for a capital sum. If he does so, the purchaser
thereafter becomes entitled to the trust income.

For CGT purposes, any gain arising on the disposal of an interest in possession is
not chargeable to tax.

However this exemption does not apply if the interest in possession was acquired
for “money or money’s worth”. Therefore a disposal will be exempt in the hands of
the beneficiary who originally acquired the interest under the trust deed, but a
subsequent disposal by the new life tenant will be chargeable to
CGT. TCGA 1992, s.76

The exemption for disposals of life interests does not apply if the trust is (or ever has
been) non-UK resident. TCGA 1992, Sch 4A

Some settlements (called “Protective Trusts”) are created in such a way that the
life tenant is prohibited from selling the right to income. Under a Protective Trust
arrangement, if the life tenant attempts to sell his interest in possession, the IIP
ceases and the trust becomes fully discretionary.
EXAMPLES

Example 1

Robert set up an interest in possession trust for his son James in March 2001 with shares in XYZ Ltd worth £220,000. A gain of £160,000 was held over on creation. James died in November 2015. The XYZ Ltd shares were worth £200,000 and passed to James' son Michael as remainderman.

Assuming all appropriate claims are made, calculate the base cost of the XYZ Ltd shares for Michael.

Example 2

Indicate whether gift relief is available in respect of the following disposals.

Assume none of the trusts is a settlor-interested trust.

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Gift of quoted shares by a discretionary trust to a beneficiary</td>
<td></td>
</tr>
<tr>
<td>2. Gift of farmland to an interest in possession trust created in 2004</td>
<td></td>
</tr>
<tr>
<td>3. Transfer of quoted shares by a bereaved minors' trust to a beneficiary</td>
<td></td>
</tr>
<tr>
<td>4. Death of a life tenant of a trust created in 2000 with trust assets passing to his son as remainderman</td>
<td></td>
</tr>
<tr>
<td>5. Gift of unquoted trading company shares to an overseas trust</td>
<td></td>
</tr>
</tbody>
</table>
ANSWERS

✓ Answer 1

Lower of:
Market value at death 200,000
Less: Cost (220,000 – 160,000) (60,000)
Gain 140,000

or
Gain held over on creation 160,000

i.e. 140,000

Base cost for Michael:
Market value @ James' death 200,000
Less: Gain deferred (s.260) (140,000)
Michael's base cost 60,000

✓ Answer 2

Gift relief

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<table>
<thead>
<tr>
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</tr>
<tr>
<td>2.</td>
<td>Transfer of quoted shares by a bereaved minors' trust to a beneficiary</td>
<td>Yes (s.260(2)(da))</td>
</tr>
<tr>
<td>3.</td>
<td>Death of a life tenant of a trust created in 2000 with trust assets passing to his son as remainderman</td>
<td>Yes (s.260)</td>
</tr>
<tr>
<td>4.</td>
<td>Gift of unquoted trading company shares to an overseas trust</td>
<td>No (Non resident donee)</td>
</tr>
<tr>
<td>5.</td>
<td></td>
<td></td>
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</tbody>
</table>