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Section 165 holdover relief

Speed read

CGT holdover relief under TCGA 1992 s 165 is a valuable relief for gifts of business assets and certain other assets. The relief aims to prevent tax from being a hurdle to the succession of acceptable assets by ensuring that a dry tax charge does not arise on a gift. There are various conditions regarding the nature of the asset, the donor and the donee. Relief may be restricted or denied where conditions are not met. For the donor, an election results in the chargeable gain being reduced by the held over again; for the donee, the base cost is reduced by the quantum of the gain held over. A joint election by the donor and donee is required, except for settlements into trust where only the settlor need sign.

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The purpose of gift reliefs

Relief under TCGA 1992 s 165 is one of a small number of 'holdover reliefs' (or 'gift reliefs') available when certain chargeable assets are gifted wholly or partly to another person. Gift relief generally seeks to prevent tax from being a hurdle to the succession of acceptable assets by preventing a dry CGT charge arising on the gift.

Gift relief has been largely unchanged for more than 30 years and is available for:

- business assets, including shares and securities in certain trading companies (under s 165);
- qualifying furnished holiday lettings properties (under s 165, as extended by ss 241 and 241A);
- agricultural property that is not used in a business (under s 165(5)); and
- gifts immediately chargeable to IHT (under TCGA 1992 s 260).

This article specifically considered business asset holdover relief under s 165 ('s 165 holdover').

In practice, we mainly see s 165 holdover used:

- where a sole trade, an interest in a trading or professional partnership, or shares in a trading company are gifted to other family members or to certain family trusts; or
- on incorporation of a sole trade or partnership as an alternative to incorporation relief, i.e. a gift or sale at undervalue to a company that the donor owns, so they personally lose no value.

Where conditions for both s 260 and s 165 have been met, s 260 has priority. Hence, most gifts involving trusts are not within s 165, unless the trust is a qualifying interest in possession trust.

We often receive queries involving purported gifts where there is apparently no family connection. As tax professionals, we should be sceptical about such cases and seek to understand the true reason behind a person giving away an asset. Invariably, we find that a gift is made as a 'thank you' for something, which usually means that it is actually a disposal for consideration by the donor, and invariably income for the recipient (for example, a gift to a 'friend' who happens also to be a consultant who has helped with something).

Consequently, one of the few instances where we see s 165 applying outside of family gifts and incorporation scenarios is where a major shareholder might choose, for wholly commercial reasons, to gift a small number of shares to an employee as an incentive. In such cases, the employee is still likely to be taxed on receipt of the gift as an employment-related security, but a joint s 165 claim is still required to hold over gains, as the disposal will be deemed to have taken place at market value.

How s 165 holdover relief works

Ordinarily, the gift of a chargeable asset will be treated as a disposal and acquisition for consideration equal to the market value of the asset under either TCGA 1992 s 18 (transactions between connected persons) or TCGA 1992 s 17(1)(a) (bargains not at arm's length). However, if a joint election under s 165 is made, the effect would be that the donor's resulting gain is held over against the cost of the asset in the hands of the donee. For the avoidance of doubt, where an asset is deliberately sold at undervalue, the gain that can be held over is the gratuitous part, and CGT will remain due in respect of the actual proceeds received. For the purposes of this article the word 'gift' includes the bounteous element of a sale at undervalue.

The effect of a holdover relief election is:

- For the donor: the chargeable gain is reduced by the held over gain; depending on the circumstances, this could be to nil.
- For the donee: where the base cost would have been the market value of the asset received, this is reduced by the quantum of the gain held over. Where the whole gain is held over, mathematically the donee's base cost will be equal to the base cost for the donor, regardless of what the market value may be.

Conditions for relief

Section 165 specifically applies for gifts or undervalue sales of business assets, being:

- an interest in an asset used in a trade carried on by:
  - the transferor (either as a sole trade or partnership);
  - their personal company; or
  - a member of a trading group, the holding company of which is their personal company; or
- shares or securities in a trading company or holding company of a trading group, where:
  - the shares or securities are unlisted; and
  - the trading company or holding company is their personal company.

Definitions for this purpose

A 'personal company' is a company in which the transferor holds at least 5% of the votes.

A 'group' is a company which has one or more 51% subsidiaries, together with those subsidiaries.

A 'holding company' is a company with at least one 51% subsidiary.

'Trade', 'profession' and 'vocation' have the same meaning as in the Income Tax Acts.

A 'trading company' is a company carrying on trading activities that do not include substantial non-trading activities. This is the same test to which both the business asset disposal relief and substantial shareholdings exemption legislation cross-refer. HMRC's view (at CG64090) was that 'substantial' in this context meant 'more than 20%'. However, in *Allam v HMRC* [2021] UKUT 291 (TCC), the Upper Tribunal found that it was 'not appropriate to apply any sort of numerical threshold as suggested by HMRC's guidance'. HMRC since replaced the former reference to the 20% threshold with the following statement: 'This requires identification of the trading and non-trading activities and then considering how best to measure the non-trading activities to see whether they are substantial in the context of the company's activities as a whole.' HMRC lists the following indicators which should be taken into account: income from non-trading activities; the asset base of the company; expenses incurred, or time spent, by officers and employees of the company in undertaking its activities; and the company's history. HMRC says that where neither the level of non-trading income nor the asset base of the company suggest that the non-trading element exceeds 20%, the case is unlikely to warrant any more detailed review.

A 'trading group' is a group of companies the business of whose members, taken together, consists wholly or mainly of the carrying on of a trade or trades.

Other conditions

Donor requirements: Section 165 is only available for individuals and trustees, not gifts by companies (which makes sense, as generally companies are legally unable to divest themselves of assets, except as distributions).

In common with other CGT reliefs, there is no restriction to s 165 relief because the donor is non-resident. That said, in practice the fact that non-residents are generally outside the scope of CGT means that we usually only see s 165 being claimed by non-residents in respect of assets used in a trade carried on in the UK.

Donee requirements: The overriding principal for the donee is that they would be subject to CGT on a subsequent disposal of the asset – in other words, that the asset does not pass outside the scope of UK tax as a result of the gift. In this respect, the donee cannot be tax-resident outside the UK, either under the statutory residence test or by treaty, unless the asset is of a type that would remain subject to non-resident CGT (NRCGT) in their hands (for example, UK land).

If the donee is a company, relief will additionally be denied if it is controlled by a non-resident person (or persons) who are themselves connected to the donor. As a person usually only gives assets to a corporate that is owned by themselves, their family, or family trusts, that connection usually exists, and we would therefore expect to have to consider the resident status of the shareholders.

Additionally for trusts, relief is usually unavailable where the trust is settlor-interested or it could become so, although there are some exceptions for trusts for the benefit of a disabled person and heritage maintenance funds.

Clawback provisions exist which would assess the donee on the gain if, within six years, they become non-resident or, in the case of a trust, become settlor-interested.

Qualifying assets: Although the general scope of assets falling within s 165 is set out above, additional provisions apply in respect of specific assets:

- No relief is available on a gift of shares or securities to a corporate done. In practice, it may instead be possible to transfer shares to a company tax-free through a share-for-share exchange.
- No relief is available in respect of a gain coming back into charge under TCGA 1992 s 116(10)(b) on the gift of a qualifying corporate bond (QCB).
- Woodland managed on a commercial basis is specifically included within the definition of 'trade' for the purpose of s 165.
- Agricultural land (within the meaning of IHTA 1984 Part V Chapter II) that is not otherwise used in a trade, is brought within the scope of s 165. Consequently, s 165 applies to all agricultural land (as defined), regardless of its use in the donor's trade.
- As noted above, UK trading premises held by non-residents has been brought within the scope of s 165 following the expansion of NRCGT in 2019.

Restrictions to the relief

For an outright gift, the starting position is that the whole gain is available for holding over. For assets sold at undervalue, the maximum gain that can be relieved is an amount equal to the discount. This basic position is subject to potential restrictions in certain circumstances:

Asset not used exclusively in the trade during its ownership: The gain is apportioned on a just and reasonable basis between trading and non-trading use, and relief is restricted to the gain attributable to the use in the trade.

Divorce or separation: Although the transfer of assets on divorce might appear to be a gift, it is likely to be made in return for the other party giving up rights to other matrimonial assets. As such, consideration may have been received which will restrict the s 165 relief available, possibly to nil.

Shares in companies with non-trading chargeable assets: Although for shares in a company to qualify, the company can have non-trading activities that are not substantial, availability of s 165 holdover will be restricted where the company/group owns non-trading chargeable assets. This is an oft-overlooked restriction that can have some extreme consequences.

Under the restriction, the gain available to be held over is subject to the fraction:

$$\frac{\text{Chargeable trading assets}}{\text{Total chargeable assets}}$$

Example

Dad proposes to gift a 100% shareholding in a trading company (worth £10m) to Son. The trading company was a people-based consultancy business, and its assets were:

- Goodwill (post-2002): £8,000,000
- Investment share portfolio: £100,000
- Cash: £1,900,000.

No holdover relief would have been available, due to a 100% restriction under TCGA 1992 Sch 7 para 7. Cash and goodwill are not chargeable assets for CGT purposes, so are ignored here. As the investment share portfolio is not used for the purposes of a trade, and is the only chargeable asset, a 100% restriction would have applied, despite the portfolio only representing 1% of the company's worth.

In this case, the director was able to instruct the broker to cash in all the investments immediately prior to the gift, as in the absence of any chargeable assets, holdover relief was not restricted.

For this purpose, 'chargeable assets' means only assets that are within the capital gains regime, so it excludes post-2002 intangible assets that are treated as corporate intangibles under CTA 2009 Part 8. This distinction can result in very substantial restrictions for companies that are not asset-rich (for example, employee service companies) and that have a low value non-trading chargeable asset. (See the example above.)

Note that making a transfer through a trust would not encounter this particular restriction, as it does not apply to claims made under s 260.

Partnership incorporations

It is not always possible to meet the strict conditions for incorporation relief (IR) to apply, and as such, s 165 is quite commonly used for an incorporation of a partnership or LLP. It can equally be used where the underlying assets are gifted/sold at undervalue to a company, or the partnership interest is gifted/sold at undervalue (which is deemed to be a gift of the underlying assets, due to the transparent treatment of partnerships for CGT purposes).

For the company: The main consequential difference to IR is that under s 165 the CGT base cost of the assets received is reduced by the held over gain, usually to an amount equal to the partners' base cost, whereas under IR its base cost would be market value. Where tangible assets, including property, are transferred, this may be seen as an issue for a future buyer of the company due to the larger unrealised gain attaching to its assets, and they may seek to negotiate a discount. However, this is not usually seen as an issue for professional service firms whose greatest asset is goodwill, and a future asset sale is unlikely.

For the partners: The CGT position is very similar to that for IR. The gain itself is rolled into another asset, so no gain arises, and the base cost in the company's shares is usually nominal, being the actual subscription price for the shares on its incorporation.

Strictly, s 165 relief is available only for assets used in a trade or profession 'carried on by the transferor.' Although no specific guidance is available on the point, it is nevertheless expected to remain available to any partners who are not actively involved in the business, as under the Taxes Acts, all partners are considered to be carrying on the trade together, regardless of their personal day to day involvement.

Although an individual partner could choose not to make the gift relief election, in practice that is extremely unlikely, because without the election the partner would crystalise a 'dry tax charge' on a capital gain that would never otherwise accrue to them. There would also be no corresponding increase in the base cost of their shares, so CGT subsequently arising on their sale would be unaffected.

Intangible fixed assets (IFAs)

Importantly, the definition of business assets includes any chargeable assets used in the trade, profession or vocation of a partnership. As IFAs are subject to CGT in the hands of individuals, they are chargeable assets for this purpose, and consequently the relief will be available on the transfer of goodwill and other IFAs on an incorporation.

Donee liability

Although it does not often arise in practice, it should be remembered that in the absence of a s 165 claim, HMRC can recover unpaid CGT on a gift from the donee (TCGA 1992 s 282). If a donor (or their personal representatives) does not pay tax due on a gift within 12 months of the due date, HMRC can raise an assessment on the donee (in the name of the donor) for the tax within two years of the due date. Note that:

- the assessment on the donee is for the tax year in which it is raised by HMRC (as established in *Z Hamar v HMRC* [2011] UKFTT 687 (TC));
- the rate at which the donee is liable to CGT is irrelevant, and they are not allowed to use any capital losses in respect of this assessment;
- the donor has no right of appeal against an assessment made on the donee;
- if there is more than one donee, the assessable amount is apportioned between them; and
- the donee has a right to recover the tax amount from the donor.

Making the claim

Because the donee is essentially taking on the gain arising on the gift from the donor, the claim requires a joint election to be made (except for settlements into trust where only the settlor need sign). As this requires two signatures, a claim cannot in practice be made on the tax return itself. Instead, a joint claim must be made to HMRC.

Following changes to its policy during the Covid lockdown, HMRC now accepts a PDF version of the claim attached to the tax returns when filed electronically.

HMRC, by concession (and use of its standard form), does not require the donor to determine the market value of the asset and calculate the capital gain to be rolled over. However, reliance on that concession is conditional on the election then being irrevocable for the parties. Although no formal valuation will be needed, on a business transfer an exercise to quantify the base cost of goodwill and other assets may be required before completing the forms.

The time limit for making gift relief claims is four years from the end of the tax year of disposal. Therefore, if the gift falls during 2022/23, a claim will need to be made on or before 5 April 2027.

However, in practice it may be preferred to sign forms before or soon after completion (even if not immediately filed with HMRC) whilst the transfer remains in mind, and, for an incorporation, before personnel changes. We usually see submission of the forms made with the tax return on which the gain is disclosed.

In respect of completing the form, note that:

- Strictly, a gift may consist of the disposal of multiple chargeable assets, especially with an incorporation. Submission of a single claim form is usually acceptable, although it should be accompanied with a schedule of individual assets and their base cost.
- On an incorporation of a partnership, each partner is required to make a separate claim jointly with the company.
- The standard form does include a box for a valuation, but this can be estimated if concessional treatment is taken.

Conclusion

Section 165 holdover is a valuable, long-standing relief for transferring businesses either on incorporations or for succession. However, it can have its complexities, especially around shares, and careful consideration of the facts is always recommended before a gift is made. ■