Close companies and IHT

Synopsis: Inheritance tax and close companies.

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A close company is one which is treated as such for corporation tax purposes or would be so treated if it were resident in the United Kingdom. That is, it is a United Kingdom resident company that is under the control of five or fewer participators, or of participators who are also its directors (Section 439 CTA 2010). A participator is, broadly, a person who has a share or interest in the capital or income of the company (Section 454 CTA 2010). Generally, this would be existing shareholders in the company.

Although for corporation tax purposes certain loan creditors (other than trade creditors and banks) would also be participators (section 453 CTA 2010), for inheritance tax (IHT) purposes a person who would only be a participator by reason of being a loan creditor is excluded (section 102 IHT Act 1984).

If a close company makes a transfer of value, the value transferred is apportioned among the participators (normally the shareholders) in the company broadly by reference to their rights and interests in the company immediately before the transfer. Any amount that is apportioned to another close company is further apportioned among its participators, and so on.

Tax is then charged as if each individual participator had made a transfer of the amount apportioned to them. If that amount is not more than 5% of the value transferred by the company it is not added to the cumulative total of the individual participator – Section 94 IHTA 1984. Where one or more of the participators is a trustee of a settlement, an amount apportioned is treated as either the coming to an end of an interest in possession or in the case of a non-interest in possession settlement as a disposition by the trustee which reduces the value of the settled property – Section 99(2) IHTA 1984.

The company is primarily liable for tax on amounts apportioned to the participator, but any person to whom more than 5% of the transfer of value has been apportioned is liable for their share of the tax if it is paid by the company. Any individual whose estate was increased in value by the company's transfer is also liable for a proportionate share of the tax if it is unpaid – Section 202 IHTA 1984.

However, if it is another participator who is the recipient of the transfer and their estate is increased by virtue of the transfer, that amount is deducted from the apportioned value. Hence a transfer of value to a participator with a 100% interest in the close company should not normally result in a chargeable amount.

The charge is also negated if the value is otherwise subject to income tax in the hands of the participator (e.g. if the transfer is treated as a distribution).

The amount apportioned to a participator for a transfer by a close company cannot qualify as a potentially exempt transfer (PET) – Section 3A(6) IHTA 1984. An

amount apportioned to a participator for a transfer by a close company to a participator's spouse or civil partner will qualify for the spouse/civil partner exemption. A participator can set their annual £3,000 exemption against any amount apportioned to them. The exemptions for gifts to charities and political parties and gifts for national purposes or public benefit are also available. The exemptions for small gifts and gifts in consideration of marriage do not however apply. If the transfer is not exempt it will be a chargeable lifetime transfer (CLT).

An alteration in the unquoted share or loan capital of a close company or in any rights attaching to its unquoted shares or debentures may also be treated as a disposition made by the participators – Section 98(1) IHTA 1984. An example of this would be if a new class of shares is created that are then issued to existing shareholders in different proportions to their existing shareholdings.

Another example of a disposition made by the participators would be a transfer at undervalue made by the company, for example a sale at undervalue.

Example

Company X is owned by shareholders A, B and C as follows...

- A – 40%
- B – 35%
- C – 25%

On 31 May 2023, X Ltd sells a property valued at £200,000 to a mutual friend of the shareholders for £100,000. This represents a transfer of value of £100,000 which is apportioned between A, B and C. Assuming that A, B and C have each made previous CLTs of more than £325,000 since June 2015, and have no available annual exemptions the tax position is...

	A	**B**	**C**
Value transferred	£40,000	£35,000	£25,000
Gross CLT	£50,000	£43,750	£31,250
Tax	£10,000	£8,750	£6,250

Had the sale been to the participators, or one of them, there would be no apportionment as this would be treated as a distribution liable to income tax.

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