Institution **CIOT - CTA**
Course **APS IHT Trusts and Estates**

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Report for Jean Macfarlane to advise on her estate, living arrangements and options for mitigating tax liabilities to her beneficiaries

This report has been prepared for Jean Macfarlane. It should not be relied upon by any other person or entity without prior written consent.

The purpose of this report is to provide recommendations on:

1. Any tax issues that may arise as a result of living with either Emma or James as well as considering a gift of cash to James for renovation work.

2. Tax implications of gifting 3A Turney Road to James, Will planning, and the options for setting up a Trust for your grandchildren.

This report has been prepared based on this information held on record and the current tax legislation inforce at the date of this report. If there is a delay in implimenting our recommendation, a signficant fiscal event or a change in circumanstances then contact should be made with us to confirm that the details of this report are still accurate and relevant.

1. Executive Summary

Based on the current valuation of your assets (assuming they dont change), if you passed away on 29 April 2028 (2-years from the date of your email as per your recommendation) your esate would be exposed to an Inheritance Tax (IHT) liability of £330,400 (Appendix A). When providing recommendations of the two points listed above we will also look at the effect these planning options have on the IHT liability for your esate.

Tax issues with future living arrangements

a. If you live with Emma pre-owned asset tax (POAT) rules will apply to the £500,000 gift made in August 2020 for the purchase of her house. As a result an annual income tax charge will apply to you or 33.3% of a'deemed' market rent would need to paid to Emma which she would need to pay income tax on. Emma could claim 'rent a room' relief to reduce the income tax on this rent. Alternatively, an election to be within the GWROB rules could be made removing the rent charge but results in additional IHT exposure for your estate totalling £200,000.

b. If you live with James and make a £30,000 gift for him to renovate the parts of the house you would be living in similar to Emma both POAT and GWROB rules could apply. However, due to the size of the gift it is very safe to assume that any 'deemed' market rent would fall within the deminimus limit and therefore no income tax charges would apply under the POAT rules. The £30,000 gift does remaing within your estate as a PET for 7 years and therefore an IHT liability of £12,000 would arise on this gift if you pass away within 3 years.

c. Recommendation: There is an argument to be made than living with Emma would be better as whilst the 'deemed' rent money paid to her would be taxed at the same rate as IHT of 40% she is able to claim the 'rent a room' allowance reducing her Income Tax liability below the 40% rate. As this money isn't treated as a PET is avoid the 40% IHT and is only subject ot Income Tax as rental income. However, as your children have insisted on not receiving rental money it would be better to live with James from a tax perspective. I would recommend discussing again with your children the idea of receiving rental income with the full facts at your disposal before making your choice.

Gifting of 3A Turney Road

a. If you gift 3A Turney Road now a CGT liability of £102,000 arises as detailed below and the value of the property property will likely fully remain within your estate for IHT for an expsure totalling £220,000.

b. By changing your Will to allocate the property to James upon your death your IHT exposure of £220,000 does not change. However, no CGT liability of £102,000 arises and James inherits the property at probate value meaning no CGT liability will arise of he chooses to sell the property straight away following your death.

c. It is clear that the best option for transfering 3A Turney Road to James is through your Will in order to save £102,000 in CGT and therefore you should not go ahead with your plans to transfer the property in the next few weeks. As you have indicated there is no urgency in transfering the property and James likely wont sell it after you pass and therefore I can't see any reason not to transfer the property through your Will instead.

How your Will sets up a Trust for your Grandchildren

Your Will currently sets up a discretionary 18-25 related property Trust for your grandchildren as the beneficiaies made up of your excess estate after your chattels have been equally split between Emma and James who will be the trustees of the Trust. This 18-25 Trust is setup so that the beneficiaries don't become absolutely entitled to the capital until the turn 25 years old however the trustees can distributed income generated by the trust assets to the beneficiaries on a discretionary basis.

As it is a related property trust it will be subjected to 10-year princple charges and exit charges. However, as shown in more details below the size of the exit charge is not excesive and it likely the benefit of the protection acheived by the grandchildren not

being intitled to the money before 25 as you requested outweighs the nagative of the money being subjected to this charge.

There are some issues that arise following the Crowe vs Appleby case regarding the tax around absolutely entitling beneficiaries to the capital assets and the disconnect between IHT and CGT as discussed further below. However, this can be mitigated if the trustees convert certain assets into cash or other non-property assets prior to the first beneficiary turning 25.

2. Tax issues with future living arrangements

a. Living with Emma

From an IHT perspective there are some possible problems with living with Emma as a result of the pre-owned asset tax (POAT) rules. This rule comes into force when an asset, in your case chash, is gifted to someone who then uses that money to purchase an asset which you subsequently benefit from. In this case you gave Emma £750,000 on 8 April 2017 and an additional £500,000 on 3 August 2020 for the purchase of her houses. However, as these are potentially exempt transfers (PETs) they fall outside of your estate after 7 years. Therefore we only need to consider the £500,000 gift on 3 August 2020. This would fall outside of your estate on 3 August 2027 which is after July 2026 when your lease runs out. There are two options, you can either stay within the POAT rules or elect for the gift to be a 'gift with reservation of benefit(GWROB)'.

i. Remain within POAT

If no GWROB election is made by the 31 January following the end of the tax year you

move into Emma's house (in this case likely 31 January 2028) then you will remaing within the POAT rules.

Income tax effects:
Remaining within the POAT rules results in a tax charge on your personal tax return of a deemed market rent for the proportion of the property which your gift contributed towards. As you gifted £500,000 towards a property which was purchased for £1.5 million, your tax charge would be based on 33.3% of the deemed market rent of the property.

Alternatively you could instead pay a deemed market rent to Emma which should have to delclare on her Tax Return and pay tax on to avoid a charge on your Tax Return. Depsite both being higher rate tax payers there are a few benefits to this option:

+ Emma can claim rent a room relief of £7,500 instead of claiming expenditure. This will result in the first £7,500 of deemed rent being effectively free of income tax.

+ The deemed market rents paid to Emma are not treated as gifts and therefore are not PETs and are removed from your estate for IHT. Whilst Emma is paying 40% tax on the income as a higher rate taxpayer which is the same rate as IHT she is able to claim rent a room relief or expenditure signficantly reducing the tax liabilty on this income.

IHT effects:
Remaining with the POAT rules means that the cash gift of £500,000 stays outside of your estate for IHT as a PET. This means it will fully be outside of your estate by 3 August 2027 (7 years) which is within your expected life span.

ii. Elect into the GWROB rules

If you you make an election to be within the GWROB rules by 31 January 2028 as discussed above then no deemd rent income tax charges will apply as they do with POAT. However, the £500,000 will instead remain within your estate for IHT resulting in additional IHT exposure for your estate totalling £200,000. This exposure doesn't disappear on 3 August 2027 following 7 years from the initial gift due to the GWROB. It would be deemed a new PET of £500,000 occuring on the date you move out of Emma's house and therefore the GWROB rules do not apply.

b. Living with James and making cash gift of £30,000 for renovations

Similar to Emma you also made a cash gift of £750,000 for the purchase of his home on 8 April 2017 which is outside the 7 year window. However, unlike Emma no subsequent gift was made. Therefore as it currently stands POAT and GRWOB rules do not apply. However, if you gift £30,000 to James for renovating the living space you would be staying in then this rules would apply.

These rules would be applied the same way as discussed above and therefore if you remain within POAT a 'deemed rent' would apply. However, if this 'deemed rent' is less than £5,000 per year then it within the deminimus limit and no charge applies. COnsidering the home is the same size and Emma's and therefore likely a similar value your proportion of the 'deemed rent' chargeable is only 2%. And therefore a 'deemed rent' for the property would need to be £250,000 per year for a POAT charge to apply. It is very safe to assume this is not the case.

IHT:
Whilst the £500,000 stays outside of your estate for IHT the £30,000 gift to James is a PET and remaings within your estate for 7 years with tapering relief starting to apply

after 3 years. Assuming you die within 3 years that is an IHT liability of £12,000.

c. Recommendation

Due to the POAT and GWROB rules, if you live with Emma either a POAT charge on your own income tax position or rental income and income tax for Emma would apply. Living with James avoids this income tax charge if you stay within the POAT rules due to the diminimus limit. However, the £30,000 gift to renovate the property stays within your estate for an IHT exposure of £12,000. An argument could be made to say living with Emma is better under the POAT rules in order to transfer money to her in the form of rent where it will be taxed at a lower rate than IHT due to her benefiting from rent a room relief. However, as your children have insisted that they do not receive rent money for your stay this may not viable and therfore staying with James would be the better option. However I would recommend discussing this with Emma and James again with these new facts before making your choise as they may be more willing to recieve rental income from you now knowing the full picture.

3. Gifting of 3A Turney Road

a. Tax implications of gifting 3A Turney Road

Gifting 3A Turney Road to James at a value of £550,000 would result in the gift positions between Emma and James being close to equal with James having received £50,000 more than Emma. However, with Emma having received the money 6 years earlier it is likely inflation has removed any difference in the amounts recieved.

i. CGT implications

There will be Capital Gains Tax (CGT) to pay on the gift of the property to James. This is because the gift is treated as a disposal for CGT and there are no holdover claims that can be made in relation to the transaction. Based on a current value of £550,000 and a base cost of £125,000 a capital gain of £425,000 arises resulting in CGT totalling £102,000 reportable and due for payment within 60 days of completing the transfer of the property to James. Please note this CGT figure does not take into account any costs of sale or Stamp Duty Land Tax liabilities.

ii. IHT implications

This gift of the property would be a PET for IHT and therfore remain within your estate for 7 years. As per your email this means the property will likly fully remain within your esate at the date of your death. This exposes your estate to a 40% IHT liability of £220,000 on top of the £102,000 of CGT already paid on the transfer.

b. Changing Will to allocate 3A Turney Road on death or Dead of Variation

i. Changing the Will

Currently, your Will does not have any provisions for 3A Turney Road. Your Will provides your personal chattells to Emma and James in equal shares whilst the remainder of your estate goes into a Trust for your grandchildren. If a new Will is written it can be changed so that 3A Turney Road is given to James before the remaining excess of the estate is transfered into the Trust.

ii. IHT implications

As the property will remain within your estate for IHT upon your death, your estate will

still be liable to a 40% IHT liability of £220,000 on the property.

iii. CGT implications

Upon death when the property is transfered to the beneficiary, in this case James, there is no CGT to pay. Furthermore, the CGT base cost is uplifted to the probate value therefore avoiding completing the £102,000 of CGT is James chooses to sell the property after your death.

iv. Deed of Variation

Altneratively, if you do not wish to update your will and trust your children to obey your wishes, upon your death your children could complete a Deed of Variation (DOV) which effectively changes the details of your Will if they are both in agreement. This would need to be made effective for IHT under s.142 IHT 1984. However, whilst this would have the same result it is not recommended as you can never guarentee that your children will agree and therefore there is a risk that the property would be transfered into trust for your grandchildren instead.

c. Recommendation

My recommendation would be to update your Will to transfer to give the property to James on your death. This would avoid £102,000 of CGT whilst likely being exposed to the same IHT liability unless your life expectancy by more than a year. However, unless you exceed it by a significant amount of time alteral your Will is financially the much better option compared to gifting the property now.

4. How your Will sets up a Trust for your Grandchildren

Your current Will sets up an 18-25 year old discretionary Trust cotaining the remainder of your estate following the transfer of your personal chattels to James and Emma in equal shars. The beneficiaries of the trust will be your grandchildren with James and Emma as the trustees.

James and Emma, as trustees, will have the discretion to make payments out of trust income to the grandchildren and accumulate the surplus income until their 25th birthday which is when the grandchildren become absolutely entitled to the money.

This trust is a related property trust and is subject to 10-year principle charges and exit charges. However, all grandchildren will turn 25 prior to the 10-year anniversary and therefore only exit charges are likely to apply unless they keep their share within the trust after they turn 25.

If we use Cordelia as an example as she will become beneficialy intitled at 25. Lets assume all income generated by the trust has been distributed and she exits her quarter share on 9 March 2033. Assuming no change in value in the assets she would recieve assets valued at £255,727.45 net following an exit charge of £4,422.55.

Whilst no exit charge would be applied if these assets were gifted directly from the Will to your grandchildren you would lose all the benefits the trusts grants:

a. Grandchildren only become absolutely entitled to the money when they turn 25 but still have access to the income generated by the trust on a discretionary basis from their parents as Trustees. The key point that they wont be able to access the capital before they turn 25.

b. All income generated within the trust is taxed at the higher rate of tax before being distributed often resulting in a tax rebate for the grandchildren.

c. Income can be distributed on a discretionary basis allowing for tax efficiency by only distributing in years where the grandchildren have their personal allowances available. This could result in the tax saved being greater than the exit charge however this will require your grandchildren to likely be basic rate tax payers on an 'on and off' basis over the period of a few years.

Crowe vs Appleby issue

Crowe vs Appleby was a historical case which now effects how we tax 18-25 trusts. When the first beneficiary becomes absolutely entiteld to their trust assets an exit charge occurs for IHT purposes. However that beneficiary doesn't necessarily become entitled to those assets for CGT purposes, for example 1B Meadow Hill Road, unless the assets are sold or the remaining beneficiaries reach 25 and become absolutely entitled. This was determined by Crowe vs Appleby. However, an issue with this arises if the property isnt sold and the beneficiary therefore doesn't become absolutely entitled to the property. When the final beneficiary becomes absolutely entitled to the property hold over relief is available for that beneficiary on the CGT as there is a respective IHT charge. However the other beneficiaries who have already had the IHT charge are unable to holdover the CGT on the exit of the property from the trust and therefore have to pay the CGT charge.

These issues can be avoided if certain trust assets like 1B Meadow Hill Road which are not distributable due to the complexity of ownership are sold for easility distributable assets like cash or stocks and shares portfolio. This means all assets when beneficiaries turn 25 are absolutely entitled for both IHT and CGT allowing for holdover relief to be claimed for CGT by all beneficiaries. This requirement could be laid out within the Will

or as you trust your children to be the trustees you warn them in advance of this issue that will arise so that they know they will likely want to change investments around for tax purposes.

Overall your current Will setups a trust that works for your needs and complies with your request for your grandchildren not to became able to access the majority of the funds before they turn 25. I can't think of a different type of a trust that would work better for your scenario.

5. Conclusion

Overall I would recommend the following:

1) Update your Will to transfer 3A Turney Road to James upon your death instead of gifting it to him now in order to save £102,000 of CGT.

2) Live with James instead of Emma to avoid 'deemed' rent income tax charges unless Emma changes her mind and is willing to receive rental income.

If you have any questions regarding the contents of this report or wish to discuss any points in more detail please give me a call and I will happily talk you through the options.

Apendix A - Current IHT liability if died on 29 April 2028

Value of estate:

3A Turney Road	550,000
1B Meadow Hill Road	250,000

Bank account balance (23,000 + 178,000)		201,000
Castle Galleries Ltd shares		420,000
Stocks and shares portfolio		430,000
Stocks and shares ISA		70,000
Total estate value		1,921,000
Less BPR 100% (Note 1)		(420,000)
Less NRB	325,000	
CLTs in last 7 years	0	
	(325,000)	
RNRB (Note 2)		(350,000)
Chargeable estate		826,000
IHT @ 40%		£330,400

Note 1: Jean owns 60% of Castle Galleries Ltd which is an unquoted company. As she owns 60% and there are only 3 shareholders is a 'close company'. Furthermore, the company does not have any investment assets/avtivities or any excepted assets. Exhibit B says that Jean's neice and nephew run the business day to day therefore it is safe to assume this is a trading company as it has no investments and eligable for 100% Business Property Relief (BPR).

Note 2: Jeans husband, Colin, died in 2014 and was UK resident and domiciled. When he passed his total estate was less than £2 million. Furthermore, his nil rate band (NRB) was used up before transfering all his other assets including his share in their family home to Jean valued at £250,000 for his share. Therefore he transfered 100% of his residence nil rate band (RNRB) to her. The RNRB is only available when transfering your main residence to your direct disendent. However, Jean does not have a main residence as she

rents following selling her main residence. This suggest Jean would not be able to utilise either her own or her husbands RNRB, however, she can make a downsizing claim. This allows for individuals who owned a main residence and subsequently downsized even to a value of nil to still make use of their RNRB up to the value of the original property. As a 50% share of the property was worth £250,000 in 2014 it is safe to assume the property sold for at least £500,000 and therefore the full 200% RNRB is available. £175,000 * 200% = £350,000.

Apendix B - Possible exit charge from trust

Total value of Trust assets		
1B Meadow Hill Road	250,000	
Bank account balance (23,000 + 178,000)	201,000	
Castle Galleries Ltd shares	420,000	
Stocks and shares portfolio	430,000	
Stocks and shares ISA	70,000	
Less: IHT paid on death (Appendix A)	(330,400)	
Total value in trust	1,040,600	
Less BPR	(420,000)	
Chargeable	620,600	
1/4 of assets exiting the trust	260,150	
Notiontal tax @20%	124,120	
Effective rate	124,120 / 1,040,600 * 100	11.928%
Actual rate	11.928% * 30% * 19/40 (Note 1)	1.700%

Exit charge 260,150 * 1.7%	£4,422.55
Net received 260,150 - 4,422.55	£255,727.45

Note 1: There are 19 complete quarters between 29/4/2028 (assume date of death) and 9/3/2033 when Cordelia turns 25