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Answer-to-Question-_1_

**REPORT**

**From**: Chartered Tax Advisors LLP
**To**: Mr Robert Hodgson
**Date**: 9 November 2020
**Subject**: The taxation implications and planning options available in respect of The Hodgson Discretionary Trust, it's winding up, and the desires of the trust's beneficiaries.

The Report is based on the information provided by you in your letter to Karen Palmer dated 30 October 2020 and from the records we hold in respect of the Hodgson Discretionary Trust.

This report considers the following:

SECTION A: Whether there is sufficient cash in the trust to settle the principal charge on 22 December 2020 and distribute to Oliver in January 2021.

SECTION B: Whether the trust should be wound up prior to the principal charge and any planning opportunities.

SECTION C: An analysis of Oliver's position and the most efficient strategy to adopt.

SECTION D: Additional information and next steps

The following abbreviations are used in this Report:

The Hodgson Discretionary Trust "The Trust"

Inheritance Tax "IHT"

Capital Gains Tax "CGT"

Income Tax "IT"

Traditional Banking plc "TB"

Digital Bank plc "DB"

International Bank plc "IB"

Business Property Relief "BPR"

**EXECUTIVE SUMMARY**

- Incurring the principal charge on 22 December 2020 will result in a tax liablity of £43,076.64, which, would require the sale of assets within the trust due to insufficient cash reserves to pay the liability. In conjunction with this there would be a large Capital Gains Tax liability of £207,257.

-An IHT saving of £30,852.64 can be obtained by appointing the Traditional Banking plc and International Bank plc assets prior to the principal charge on 22 December 2020. We therefore recommend this is undertaken.

-During the appointment, the trust will also save Capital Gains Tax of £207,257 through the holdover relief claim that should be jointly made with the beneficiaries no later than 5 April 2021; a separate claim will be required for each asset. We recommend that the holdover relief claim is made.

-The exit of Traditional Banking plc and International Bank plc shares prior to December 2020 will provide Oliver with enough assets to sell in Q1 to facilitate the required cash difference of £450,000 to fund the purchase of the house in Bath. As Susan's desires are passive and there is no imperative need for immediate cash, we have proceeded on the basis assets should be distributed equally at all stages.

-The Digital Bank plc shares will qualify for BPR relief by virtue of their AIM listing. They should therefore remain in the trust as it also gives us additional time to consider the optimal income distributions and the lowering of the holdover relief claim as the wind up will fall in a new trust tax year in 2020/21, so the trust annual exemption of £6,000 will be available to the trustees on the disposal to the beneficiaries.

- Robert will provide income details for the beneficiaries (Oliver and Susan) as the next step at the earliest convenience to ascertain the optimal income distributions to the beneficiaries in light of their higher rate tax position.

**SECTION A: PRINCIPAL CHARGE ON 22 DECEMBER 2020 AND DISTRIBUTION TO OLIVER**

We will explore the tax implications of the principal charge in December 2020 and whether there are sufficient cash reserves in the trust currently to pay the principal charge that will occur on the 30th anniversary of the trust on 22 December 2020.

We will also consider the implications of the proposed distribution of assets to Oliver in January 2021.

<u>1.1 The prinipal charge on 22 December 2020 if no planning is undertaken</u>

If the trust continues and is not wound up, or any planning is undertaken to reduce the value of the trust prior to 22 December 2020, the trust will incur a principal charge to the sum of £43,076.64, as detailed in Appendix 1.

The principal charge is based on the value of the trust at 22 December 2020, net of any available Business Property Relief where available.

BPR is available on shares in unlisted trading companies and caries a relief rate if qualifying at 100% of their value. It is avilable where shareholdings, and therefore the business property, in excess of 2 years.

As the shares in DB are listed on the Alternative Investment Market (AIM), the shares will qualify for BPR at 100% as if they were unlisted. This is due to the shares also meeting the ownership crieteria of 2 years, having been purchased on 7 June 2017.

This value is therefore omitted in arriving at the value of the trust at the principal charge and furthermore, the value of this holding is not subject to the charge due to the afforementioned BPR releif.

The trust currently has insufficient cash resrves, totalling £35,000 to meet this principal charge. To meet the principal charge, the trust would be required to sell some of it's assets, and therefore the shareholdings will need to be considered to be sold.

This is unsatisfactory as an objective, as from your letter it appears that the preferable course of action will be to retain the assets in the hands of the grandchildren of the settlor. To obtain sufficient cash to pay the principal charge, it would also generate a capital gains tax liability for the trust.

By exhausting some of the tax pool and income at this juncture to pay the principal charge, it would also lose any benefit of income distributions to the beneficiaries, as, these distributions are not subject to an exit charge and would form income at the hands of the beneficiaries, who, in conjunciton with our notes are both higher rate taxpayers. An income distribution is deemed to carry a 45% tax credit, and would therefore generate a repayment of tax for the beneficiaries; we will explore this planning opportunity at a later stage.

Once the principal charge occurs, the assets will still remain in the trust and will then need to be distributed to Oliver and/or Susan in January 2021 to fulfil Oliver's house purchase desire.

<u>1.2 Exit from the trust in January 2021</u>

On the basis that the principal charge is paid and the assets remain in the trust following 22 December 2020, there will need to be an exit event in January 2021 to ensure that Oliver can sell his share of the assets to obtain the cash he desires to fund the purchase of his desired property in bath.

If there is an exit in January 2021, we calculate that the trust will incur a Capital Gains Tax liability of £207,257, as shown in Appendix 2.

Upon the exit of the assets from the trust, the trustees are deemed to sell the assets at their Market Value at the date of the exit. We have assumed for the purposes of this report that the valuations will remain the same in January 2021 as those provided on 2 Novemeber 2020.

As with the principal charge, there are insufficient cash reserves to meet this liability, so assets will need to be sold within the trust to generate the cash available for the trustees to meet this liability with HMRC.

If this approach occurs and the exit is in January 2021, the value of the assets eventually passing to Oliver and Susan will significantly reduce due to the high CGT payable.

There is no way to mitiage this liability if there is no exit prior to December 2020. The reason for the inability to mitigate this CGT liability is due to the unavailablility of s260 holdover relief.

Holdover relief allows the the capital gains tax liability to be 'held over' and effectively rolled over into the base cost of the asset moving forward. The beneficiaries will still inherit the asset at it's market value, however, they will effectively inherit the trustees base cost also, however, no CGT will be payable by the trust.

For s260 holdover relief to be available, however, there is a requirement for there to have been a chargeable event for IHT purposes. As an exit within the first quarter following a principal charge, and therefore, before 22 March 2021, will not attract an IHT exit charge, there is no holdover relief available and the full CGT will be payable by the trustees.

As mentioned in respect of the principal charge, this is not a satisfactory outlook.

**Reccomendation**

The total liabilities if no planning is undertaken and the trust assets are distributed in January 2021, sit at £250,333.

We reccomend that planning is implemented to ensure that the trustees do not have the liability detailed above and the trust does not undergo the principal charge in it's entirety.

## SECTION B: TRUST WIND UP AND PLANNING OPPORTUNITIES

As running the trust's course and adhering to the current plan creates a large tax liability for the trustees, we will now examine the planning opportunities available to significantly reduce the tax implications of the situation.

1.1: Exit prior to 22 December 2020

An exit charge is a chargeable IHT event and will involve distributing some of the assets of the trust, or the cash, during a window between two principal charges.

To avoid the principal charge, it would be highly beneficial to distribute some of the trust assets to both Oliver and Susan prior to 22 December 2020.

As Susan has no salient desire to sell the assets and meet any personal objectives, we have considered that it would be sensible to distribute 50% of the assets to each of the beneficiaries. If her objectives change, please do let us know and we can recalculate our outlook.

Following on from a previous point, we believe it would be advantageous to distribute the shares in TB and IB to both Oliver and Susan, with the trustees settling the tax due on the exit charge. I will address the reasons for leaving the DB shares in the trust at this juncture in the subsequent section.

We have calculated that a distribution of the TB and IB shares, prior to 22 Decemeber 2020, will result in an exit charge of £12,224, as shown in Appendix 3, which, is significantly lower that the principal charge if no planning is undertaken of £43,076.64, resulting in an IHT saving of £30,852.64.

The exit charge is based on the value of the assets leaving the trust prior to 22 December, being £993,007, and therefore, the full shareholding of TB and IB.

The exit charge, however, unlike the principal charge, looks at the value of the trust at the previous 10 year anniversary and the applicable effective rate at this date. As the value of the trust, per the information we hold on file, is significantly lower than the valuation at 22 December 2020, this provides a much lower percentage for the exit to be charged to.

The relevant percentage, as detailed in Appendix 3, sits at 4.161%, per the prinicpal charge at December 2020. As there has been no income capitalised prior to this date we do not need to look back and add this to the principal charge in 2010 and adjust the rate.

The rate is then multiplied by 30% and then by the number of complete quarters that have run since the last principal charge, over a total of 40. As we are proposing to distribute the assets in the final quarter, the relevant quarters will therefore sit at 39 and the exit charge therefore at 39/40.

By exiting before the principal charge, these assets will then not be sat in the trust at 22 December 2020, and therefore there will be no IHT due on their value at this date.

We also propose grossing up the rate of tax for the trustees to pay, as there is sufficient cash within the trust to meet the exit charge. No assets therefore need to be sold, and we believe this is a much more favourable position for both the trust and the beneficiaries.

This will leave cash in the account of £22,776.

1.2 Base Cost Uplift and s260 relief availability

Whilst significantly reducing the IHT exposure of the trust we can also reduce the capital gains tax exposure of the trust, and uplift the base cost for the beneficiaries of the trust assets.

On the exit, the trust will be deemed to have disposed of the assets at their market value at the date of exit, as shown in Appendix 4.

As mentioned previously, if the assets are distributed in January 2021, there is no IHT event so there is no holdover relief available. With an exit in the final quarter prior to the principal charge, however, this will be an IHT event, so we can holdover the gains the trust will make, against the base cost for the beneficiaries under s260.

It should be noted that this election will need to be joint and with the consent of both Susan and Oliver, and this will need to be made within 4 years of the end of the relevant 2020/21 Tax year, and therefore, by 5 April 2021. The holdover relief claim is also on an asset by asset basis, so there will need to be a joint claim for each of the trusts assets.

The beneficiaries will therefore inherit the trust assets at the trustees base costs, which, will also be uplifted by the IHT paid on the exit charge, as shown in Appendix 4.

This is advantageous, as it means the assets can pass in their entirety to the beneficiaries, without some of the assets needing to be sold to generate enough cash for the CGT payable. It also enables Oliver to utilise his brought-forward capital losses of £50,000 and for the beneficiaries to utilise their annual exempt amount of £12,000 for each tax year, which, means they could stagger their sales to ensure they are selling the assets to utilise all of their available exemptions.

The holdover gain has been reduced by the trusts AEA of £6,000.

1.3 Leaving the Digital Bank plc shares within the trust past 22 December 2020

It would make sense, at this stage, to keep the trust running and leave the DB shares within the trust.

As previously mentioned, the DB shares are AIM listed so meet the relevant criteria to be considered as business property for BPR relief.
There will therefore be no principal charge on 22 December 2020 and there will be no subsequent exit charge on the winding up of the trust on the date of May 2021, as the exit is based on the value of the trust at the principal charge, which, will be nil.

As we explore in the next section in respect of Oliver specifically, we do not need to plan to exit with all of the assets and wind the trust up prior to 22 December 2020. This is threefold:

1) Sufficient cash can be generated from the exit of just TB and IB for Oliver's sale to generate the amount required for his house purchase.

2) By leaving the AIM shares in the trust until the 21 May 2021 for the sale we can utilise the trust's annual exemption for 2020/21 of £6,000.

3) We can request further information from the individuals as to their precise income for the year to utilise the available tax credits for distribution and to ensure that the distibution can be made so that they do not exceed £100,000 of income and therefore suffer a personal allowance abatement.

In accordance with point 2 above, by distributing the DB shares in May 2021, we can utilise the Trust's annual exemption for 2021/22 of £6,000 which, will increae the beneficiaries base costs as less of the gain will need to be held over.

**Reccomendation**

Exit charge planning should be undertaken as soon as possible to exit and distribute the TB and IB shareholding to Oliver and Susan. This will result in a significant IHT and CGT saving.

As it is not imperative for the beneficiary objectives to receive all the assets by Q1 of 2021, there is no IHT or CGT benefit to distributing the AIM shares and winding up the trust. We therefore recommend leaving this asset in the trust as it gives us additional time to ascertain the income tax position of the individuals and decide the prefrable time to distribute the income in the trust to them, the timing of this, or whether this should be capitalised as this will fall within the nil rate band at the eventual exit in any case if accumulated to capital.

## SECTION C: OLIVER'S POSITION AND STRATEGIES AVAILABLE

Oliver requires sufficient cash to purchase his desired property in Bath in the first quarter of 2021.

The required cash is £450,000, being the difference between the value of the property at £550,000 and the savings he has of £100,000.

Oliver will sell an existing property, however, due to delays he does not expect this to be until the second quarter of 2021, and therefore, not in time for the purchase.

The planning on the exits above, has been undertaken to ensure that Oliver is in receipt of sufficient assets to sell and generate enough cash in his bank account to fund the difference in the purchase of his Bath property.

1.1

Oliver's asset sale

Provided the planning approach is undertaken as outlined in Section B of the report, the following scenario will be applicable.

Following the receipt of the shares in TB and IB from the exit from the trust and the holdover relief claim, Oliver will, as afforementioned, have inherited the shares as the base cost of the trustees with the uplift due to the IHT paid on exit, as shown in Appendix 4.

If the valuations are to remain the same in TB and IB, Oliver will be able to sell the assets for the following proceeds:

| | |
|---|---|
| TB 734,360 x 50% | 367,280 |
| IB 258,647 x 50% | 129,323 |
| Proceeds | 496,603 |
| Less cost TB | (181,030) |
| Less cost IB | (101,194) |
| Less AE £12,000 | (12,000) |
| Less losses b/f | (50,000) |
| Chargeable gain | 152,379 |
| Tax at 20% | 30,475.80 |
| **Cash to Oliver =** | **466,127** |

The cash generated from the sale of the assets is sufficient to meet the difference required to fund the purchase of the Bath property.

The net cash due from the proceeds to Oliver has benefitted from the deductibility of his brought-forward capital losses.

1.2 Loss on property in Q2

If Oliver's property sale goes through on his existing property in the second Quarter of 2021, he will generate a capital loss of £200,000, being the proceeds of £500,000 less the base cost of the property of £700,000.

This loss will be available to carry forward and offset against any future capital gains made in the 2020/21 Tax Year. On the same of the AIM shares Oliver will receive, this loss will be available to offset and reduce the capital gains tax payable.

**Reccomendation**

Upon receipt of the assets from the distribution from the trust, Oliver should sell these assets and offset his brought forward Capital Loss.

This planning will enable Oliver to obtain sufficient cash to fund the purchase of the property in Bath, whilst also enabling him to offset his capital loss that will likely be generated from his future property sale in Q2, from the value of his AIM shares upon receipt on the winding up of the trust.

## SECTION D: ADDITIONAL INFORMATION AND NEXT STEPS

There are some additional planning points that should be considered in respect of the beneficiaries income tax position.

This is a salient reason to keep the trust going until the winding up in May as it enables us to collate the information required in time to ascertain the appropriate distributions to the beneficiaries.

1.1 Income pool in the trust

There is currently an income pool within the trust of £18,983. We have assumed for these purposes that it has remained at this figure for this point.

An income distribution to the beneficiaries will not result in an IHT charge, however, as both Oliver and Susan are higher rate taxpayers we thought it would be pertinent to delay this distribution until we have the full details of their income for the year.

Once their income exceeds £100,000, they will be subject to a personal allowance abatement of £1 for every £2 in excess of this threshold. Ideally the income distibution will not push them over this boundary.

We therefore would be grateful if you would provide us with details of the income of the individuals before 5 April 2021, being the end of the tax year. We could also look to split the distributions over two tax years if their income was close to the £100,000 level.

The excess not distributed, if they are both close to this threshold can be accumulated as capital and exit the trust in this manner. As the AIM shares will attract BPR and there will have been no exits in since the principal charge, this distribution will fall well within the nil rate band of £325,000 of the trust so no IHT will be payable.

As the beneficiaries, however, are higher rate taxpayers, it would be advantageous to precisely ascertain the amount of income that can be distributed as it is deemed to carry a 45% tax credit, which, will generate a repayment of tax for a 40% higher rate taxpayer, as both Oliver and Susan are.

The income currently available for distribution sits at.

B/F Tax pool of £18,983

We then frank this 55/45 to achieve distributable income of 23,201.

There is therefore £42,184 of income available to distribute, so £21,092 per beneficiary.

As mentioned, this may push them over the £100,000 theshold.

**Recommendation**

Robert to provide us with details of Oliver and Susan's income for the year ended 5 April 2021 so we can ascertain the optimal income distribution for both the tax year ended 5 April 2021, and if required the year ended 5 April 2022.

**APPENDECIES**

Note:

For the purpose of this report we have assumed that two annual exemptions totalling £6,000 were deducted from the transfer to the trust on 1/12/1990, and therefore the gross transfer to the trust was £56,000 prior to deductions. This is in line with our File note, however, if the gross transfer was £50,000, please let us know and we will re-calculate our calculations, however, the difference in figures will be negligible.

**APPENDIX 1**

Tax posiiton if no planning is undertaken and trust incurs principal charge on 22 December 2020

We have assumed for these purposes that the figures at 2 November 2020 and the valuations at this date will remain the same at 22 December 2020.

| | | | |
|---|---|---|---|
| TB | | 734,360 | |
| DB | 369,278 | Nil | |
| Less BPR | (369,278) | | |
| IB | | 258,647 | |
| Value of trust at 22/12/20 | | | 993,007 |
| Less NRB at 22/12/20 | | 325,000 | |
| Less settlor's chargeable transfers in seven years prior | | (50,000) | |

to creation

Less distributions in 10 years
prior to December 2020 Nil (275,000)

718,007

Notional Tax at 20% 143,601

Effective Rate 143,601/993,007 = 14.46%

Actual Rate= 14.46 x 30% = 4.338%

Principal charge = 993,007 x 4.338% = 43,076.64

**APPENDIX 2**

Tax position if assets distributed in January 2021 as suggested

No exit charge as within 3 months of the principal charge, but no holdover relief available so trustees will incur a CGT liability on the exit.

| | | |
|---|---|---|
| Proceeds | TB | 734,360 |
| | DB | 369,278 |
| | IB | 258,647 |
| | | 1,362,285 |
| Less cost | | (320,000) |
| Gain | | 1,042,285 |

Less AE (6,000)

1,036,285

Tax at 20% 207,257

**APPENDIX 3**

Exit charge before 22 December 2020 if planning is undertaken and following principal charge

Effective rate at 22 December 2010: 4.161%

Assets leaving the trust:

TB 734,360

IB 258,647

DB Nil - BPR available on exit

Total 993,007

Actual rate x 4.161 x 30% x 39/40 = 1.217%

If trustees pay tax it is grossed up = 1.217 x 100/100-1.217 = 1.231

Exit charge = 993,007 x 1.231% = £12,224

Principal Charge on 22 December 2020

DB 369,278

Less BPR relief (369,278)

Asset value in trust Nil

Principal charge is nil.

Exit on this figure is also nil.

The income all arose more than 5 years ago so will not be added as relevant property to the trust.

**APPENDIX 4**

Capital Gains Tax Due if assets distributed at exit prior to 22 December 2020

Proceeds

TB 734,360

IB 258,647

993,007

Less cost (270,000)

Gain 723,007

Less holdover relief (723,007)

No CGT due.

Beneficiaries base costs =

TB 172,000

IB 98,000

These will be uplifted by the IHT paid on exit:

12,224 x 734,360/994,007 = 9,030

12,224 x 258,647/994,007 = 3,194

TB 172,000 + 9,030 = 181,030

IB 98,000 + 3,194 = 101,194