The Chartered Institute of Taxation

Application and Professional Skills

Inheritance Tax, Trusts & Estates

November 2022

Suggested solution

REPORT TO JULIA UPTON

INTRODUCTION

Further to your email of 25 October 2022, this report will consider:

1) A review of your situation and an assessment of whether you require a Will to achieve your aims,

2) A suggestion for an appropriate Will structure,

3) A review of your property plans and the impact on your tax situation,

4) Other steps that may be taken to mitigate your tax exposure.

This report is based upon the information and valuations provided by you. This report assumes that the most recent valuations remain constant going forward.

EXECUTIVE SUMMARY

A review of your estate indicates that your assets total just under £2 million. Your husband also has assets of £1 million. Your respective pension funds are not exposed to Inheritance Tax (IHT). After provision for the available tax reliefs, your IHT exposure amounts to £116,000.

You want your assets to go to your husband on your death and then be split equally between your four children. You do not currently have a Will and our review has concluded that you do need one to achieve your aims.

A Will would be required to ensure all assets go to Jonathan on your death and then to ensure appropriate protection is in place for Jacob and Emma's inheritances.

You wish to install protection for Jacob and Emma and also ensure that your Will works as a standalone document in case Jonathan does not make a Will. In view of this we have recommended the use of three different types of trusts to ensure all of these aims are achieved in a tax efficient way.

The trust installed for Jonathan's inheritance allows him to benefit from the assets for his lifetime. Your Will maintains control of the eventual destination of the assets.

The trust for Jacob offers your trustees discretion over how and when assets and income are distributed to him. This would allow them to benefit him as appropriate throughout his lifetime.

The trust for Emma's inheritance protects the assets until she attains 25. The trustees would be able to distribute the funds earlier than this if in their opinion Emma was financially responsible.

Your plan to downsize from your current property does give rise to Capital Gains Tax (CGT) as you have not occupied the property as your main residence throughout your ownership period. This CGT amounts to £40,893.

The plan does not however impact your IHT exposure as you would not lose any Residence Nil Rate Band (RNRB) relief by moving to a lower value property. Downsizing would also mean that cash gifts may be made from the excess cash in due course which could reduce your IHT exposure further.

Our review of your estate has highlighted that we could restructure your loan due from Lakeside Home Furnishings Ltd (LHF) to mitigate IHT exposure. The loan could be exchanged for additional shares in the company. After two years, these shares would qualify for Business Property Relief (BPR) which offers 100% relief from IHT.

OVERVIEW OF SITUATION

A review of your estate shows that your assets are valued at £1,990,000 (including your pension fund). Your husband, Jonathan, also has assets of £1 million (including his pension fund).

Your assets (excluding the pension fund) would give rise to a £116,000 IHT charge (see Appendix 1).

A key asset of value within your estate is a 100% shareholding in LHF. However, this shareholding would qualify for Business Property Relief (BPR).

BPR at 100% applies to the value of unquoted shares if certain conditions are met. The conditions are that the shares must have been owned for at least two years, they must not be listed on a recognised stock exchange, the company itself must be a wholly or mainly trading company, the company must not hold significant "excepted assets" (that is, assets which have not been used in the business for the previous two years or assets no longer required for the business) and there must not be a binding contract in place for the sale of the shares at the relevant date.

In relation to LHF, the shares have been held over two years, the company is both trading and unlisted and there is no indication of an offer in place for the sale of the shares, so these four conditions are met. The financial information provided shows there are no excepted assets held and there is no indication of investment activities being undertaken. BPR would therefore be available at a rate of 100%.

The loan due to you from the company does not qualify for BPR as relief is only available on shares.

You do not have a valid Will in place and this report will review whether one in necessary to achieve your aims.

Your estate will benefit from your Nil Rate Band (NRB) of £325,000. Your husband will also have £325,000 available. In addition, your estate will qualify for the RNRB and again your husband will also benefit from this relief. There is the potential for any unused NRB or RNRB to be transferred to the surviving spouse providing the relevant conditions are met.

REVIEW OF WHETHER A WILL IS REQUIRED

On your death, the distribution of your assets, except for your pension fund, are governed by a Will. However, as you do not currently have a valid Will in place the distribution will be made in accordance with the intestacy rules.

The distribution of your pension fund is determined by your pension trustees, usually with reference to nominations made by you during lifetime.

Your main residence is owned jointly as Tenants in Common. This means that your half share would not automatically pass to Jonathan on your death rather it would be distributed as part of your estate.

As you are married and in the absence of a Will, under the rules of intestacy your estate would be distributed as follows:

- Jonathan would be entitled to £270,000, and all your personal possessions; and
- Jonathan would also receive half of the remaining estate; and
- The other half would then be divided equally between your four children. However, as Emma is under 18, her share of the assets would be held upon a statutory trust by your personal representatives until she attained age 18.

The intestacy provisions do not achieve your wishes for three primary reasons:

1. Jonathan would not receive all of your assets initially.

2. Jacob would receive his share of assets in one lump sum. There would be no protection around his inheritance. The informal wishes to Jonathan and the older children would not be binding.

3. Emma would receive her inheritance at age 18. There would be no scope for your personal representatives / trustees to extend this this date even if they wanted to.

Based upon our review of your assets and your wishes we recommend that you make a Will as soon possible to ensure your wishes are achieved. We have suggested an appropriate structure in this report.

AN OPTION FROM AN APPROPRIATE WILL STRUCTURE

A common approach to achieving your wishes would be to have a "mirror Will". This would involve you and Jonathan both having similar Wills although the Wills would not be mutually binding. On first death, everything would pass to the surviving partner and then on second death the onward distributions to the children (with the relevant protections) would take place. As you are unsure of whether Jonathan would prepare a valid Will this is not a suitable option as it relies on both partners having valid Wills. The surviving spouse would also be free to amend their Will at any future point should they wish.

The mechanism chosen needs to ensure that Jonathan can benefit from the assets but while also ensuring your children ultimately benefit as you intend.

One way of achieving this (assuming you predecease Jonathan) would be to provide that your whole estate should pass into a life interest trust in favour of Jonathan. This would mean that Jonathan would have the right to enjoy the assets and enjoy the income generated therefrom.

The trust income generated would be taxable on Jonathan and reportable directly on his tax return if the income was mandated to him. The assets would however be trust assets and not Jonathan's absolutely. This means that upon his death, the terms of the trust would prescribe where the assets go rather than passing under Jonathan's Will or, in the event that he had not made a Will, under the intestacy rules.

The assets belong to the trust and if any chargeable assets are sold at a gain the burden of CGT would fall upon the trustees. The trust rates for CGT are 20% for all assets except for residential property which is 28%. Trustees also only benefit from an annual exemption equal to a maximum of half that of an individual.

This type of trust would be an Immediate Post Death Interest (IPDI) trust. As you and Jonathan are married the creation of this trust would be covered by spousal exemption with the result that no IHT would be due on first death. However, these assets would be aggregated with Jonathan's estate upon his later death and would attract IHT at this point. This type of trust is not a relevant property trust and so is not subject to IHT exit charges or 10 year anniversary charges.

If Jonathan should predecease you, the trust in favour of Jonathan would fail and the subsequent gifts provided for under your Will would take place instead.

We also need to consider the protection mechanisms you wish to put in place. Jacob has addiction issues and a significant inheritance in one go would not be helpful to him, whilst Emma is still young, and you are unsure of how financial responsible she will become in the future.

To achieve these protections your executors / trustees would need to have an element of discretion available to them.

In Jacob's case, one option would be to hold his inheritance upon discretionary trust terms. Jacob would be the primary beneficiary of the trust, but your trustees could have control over when they distributed income and/or capital to him.

You would leave a letter of wishes to your trustees explaining to them the circumstances in which and at what stages you would like Jacob to receive funds. This letter would not be legally binding but would be a useful guide to your trustees.

This type of trust would incur IHT charges every 10 years counting from the date of your death. This tax charge would be based on the value of the chargeable assets at the anniversary date in excess of the available trust Nil Rate Band at that time but set at a maximum of 6%. If assets are distributed in between 10 year charges then a proportionate exit charge applies based on the number of complete quarters since the last charging point.

Trustees of this type of trust are considered to be one chargeable person for CGT and are liable to CGT if they sell assets or transfer them to beneficiaries. For disposals which are liable to CGT the trustees always pay tax at a rate of 20% (28% for residential property) of the taxable gain. The annual exemption available to the trustees would be shared between all trusts created by you and in existence during the tax year of disposal (subject to a de minimis of five).

For Income Tax purposes, the trustees would be treated as a single person and would be liable for Income Tax on the trust income charged at the trust rates. These trust rates are 38.1% for dividend income and 45% for non-dividend income. The first £1,000 of income would be taxed at the basic rates of tax, being 7.5% for dividend income and 20% for non-dividend income.

Trustees are required to register online within 90 days counting from the date on which a settlement is created. The income and gains would be reported via the Self-Assessment system. Trustees must file a tax return no later than 31 January following the end of the tax year if filing online.

Any income distributions made to Jacob as a discretionary beneficiary would carry a 45% tax credit which could be repayable depending on his personal circumstances. For example, if the trustees distributed income of £5,500 to Jacob it would carry a tax credit of £4,500. Jacob would be taxed on the gross amount £10,000. If this was Jacob's only income (noting that currently he is a non-taxpayer) the whole £4,500 tax credit would be repayable to him.

However, care must be taken by the trustees to ensure that they have paid Income Tax equal to or in excess of the total amount of tax credits attached to the income distributions. If this is not the case the trustees would incur extra income tax charges.

In Emma's case you could choose to replicate the discretionary trust structure used for Jacob and leave instructions to your trustees. You could even use one trust for both beneficiaries. An alternative option would be to specify that Emma could receive her inheritance absolutely when she attained 25. This would mean that her assets would be held upon a separate trust from Jacob's assets. This type of trust is an 18-25 trust. The Income Tax and CGT implications are the same as the discretionary trust used for Jacob, but the IHT implications would be slightly different.

An 18-25 trust is not a relevant property trust and there are no IHT charges while the beneficiary is under 18. There is no 10 year charge but an IHT exit charge would apply as and when assets are distributed to Emma between the age 18 and 25 with the scale of charge dependent on the time elapsed between Emma's 18th birthday and date of distribution. The trust assets would become Emma's absolutely when she attains 25 but could not be extended beyond this date.

If you are comfortable that by age 25 Emma could receive her inheritance without restriction this would be an appropriate solution. In addition, if your trustees considered that Emma was financially responsible earlier than 25, they would be able to exercise their powers and allow her to inherit the assets absolutely early.

Based upon your wish to ensure your assets firstly benefit your husband and then your children together with your desire to install certain protection mechanisms we would recommend the following as an appropriate Will structure:

- All of your assets to be left upon a Life Interest Trust for the benefit of your husband.

- When your husband's life interest ceases (or in the event that he predeceases you) the assets would be split in four equal parts.

- One part will be for Edward absolutely, one part for Lucy absolutely, one part for Emma once she attains 25 and one part held upon a discretionary trust with Jacob noted as the primary beneficiary.

The above ensures your wishes are met without any reliance on Jonathan to create a Will.

TAXATION IMPLICATIONS OF DOWNSIZING

The potential sale of Lakeside Lodge in August 2023 has taxation implications. This is since you have not occupied the property as your main residence throughout its ownership and as a result, CGT would be due on the sale.

You inherited the property in 1990 when it had a value of £85,000. This becomes your cost figure for CGT purposes.

You transferred ownership into joint names with your husband in 1993. This transaction would have been a Nil Gain/Nil Loss transaction and would not have triggered any CGT.

You have occupied the property as your main residence since August 1998. This would mean that the gain would be time apportioned over your entire ownership period. You would be exempt on the time apportioned gain arising in the period from 1998 until 2023.

The CGT, based on an August 2023 sale, has been computed in Appendix 2 and is £40,893. This amount would be split equally between you and Jonathan.

The CGT would need to be reported and paid to HMRC within 30 days of completion.

I understand that you are concerned about the IHT implications of downsizing. Your estates currently qualify for the RNRB which in total amounts to £350,000 of relief sheltering IHT at 40%.

If you were to sell your current property and purchase a property for £250,000 you would not lose any IHT relief. Provisions exist to cover downsizing situations and your combined RNRB would remain at £350,000. There is no need to take any other action to maintain this relief.

We therefore recommend that should you wish to downsize, you continue with this plan. Continuing with your current plan also offers options for further IHT mitigation in future should you choose to make gifts of excess cash in years in the future.

Any gift of excess cash would be a Potentially Exempt Transfer (PET). For this gift to be fully exempt and therefore outside the scope of IHT you would need to survive seven years from the date of gift. Depending on the size of the gift you may make IHT savings after three years due to the availability of tapered rates of IHT applied to gifts made in excess of the NRB.

OPTION FOR IHT MITIGATION

As already noted, the shareholding in LHF should qualify for 100% relief from IHT in the form of BPR. However, BPR cannot apply to the loan due to you from the company and this would be fully exposed to IHT. As the loan is £200,000, the IHT exposure is £80,000.

One option with this asset would be to convert the loan into additional shares in LHF.

A share issue could take place whereby £200,000 of new shares are issued to you in the company. Your loan would be used to satisfy the share consideration.

Once you have held these additional shares for two years they would also qualify for BPR at the rate of 100% therefore eliminating the £80,000 IHT exposure. The company would have an enhanced value as it would no longer have a creditor of £200,000.

The downside of this planning is that you would no longer have the ability to draw down on your directors' loan which is tax free. However, as you have been living comfortably without drawing on this loan, we suggest that the IHT savings outweighs this downside, but it should be noted.

We recommend that the director's loan account is converted into additional shares in LHF to mitigate £80,000 of IHT exposure if the newly acquired shares are held for two years.

Tax Advisers

5 November 2022

APPENDIX 1

Summary of Estate and Inheritance Tax charge (based upon suggested Wills)

	Julia	Jonathan	Total
	£	£	£
Land and Property			
Lakeside Lodge, Coniston Water, LA23	450,000	450,000	900,000
Bank account balances			
UK Current Account	10,000	10.000	20.000
UK Savings Account	40,000	40,000	80,000
	50,000	50,000	100,000
Investments			
Stock and Shares ISA	90,000	-	90,000
Business related assets			
Shares in LHF	700,000	-	700,000
Loan to LHF	200,000	-	200,000
	900,000	-	900,000
Total assets	1,490,000	500,000	1,990,000
Inheritance Tax Calculation			
Total assets	1,490,000	500,000	1,990,000
Available Reliefs			
Business Property Relief	(700,000)	-	(700,000)
2022/23 Nil Rate Band	(325,000)	(325,000)	(650,000)
Residence Nil Rate Band	(175,000)	(175,000)	(350,000)
	(1,200,000)	(500,000)	(1,700,000)
Taxable estate	290,000	-	290,000
Tax at 40%	116,000	-	116,000

APPENDIX 2

Capital Gains Tax Charge on sale of Lakeside Lodge

	£	£
Provisional sale date	August 2023	
Date property acquired	August 1990	
Occupation as main residence started	August 1998	
Total months property held	396	
Total months property held as residence	300	
Estimated sales proceeds		900,000
Cost		(85,000)
Gain		815,000
Principal Private Residence Relief		
£815,000 x 300 / 396		(617,424)
Chargeable Gain		197,576
Annual exemptions x 2		(24,600)
Taxable Gain		172,976
£75,400 taxable at 18% (2 x Basic Rate Limit as income equal to personal allowance)	13,572	
£97,576 taxable at 28% (balance)	27,321	
Tax		40,893