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Report on Pearson Legacy Trust and change of strategy by South West Bespoke Properties Ltd

Client: Trustees of the Pearson Legacy Trust

Prepared by: Chartered Tax Advisers

Date: 6 November 2019

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Introduction:

This report has been prepared following the call on 4th November 2019 and will address the issues raised. This report has relied on the information provided in that call and we assume that the permanent information held in our files has not changed.

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Executive Summary

From 30 June 2020, the shares in South West Bespoke Properties Ltd (SWBP) will no longer qualify for 100% business property relief (BPR) which reduces the inheritance tax (IHT) on distributions from the trust, as the company's change in strategy means that the company is no longer wholly or mainly trading.

We recommend that the trustees should also refrain from selling the shares and this would lose the BPR reduction for IHT on exit charges.

IHT of £37,034 is due by 31 March 2020 with an IHT return due by 31 October 2020 on the exit charge triggered as a result of Chloe turning 25 on 18 October 2019 and becoming entitled to her absolute share of the trust capital.

We recommend that the absolute entitlement for David is advanced before 30 June 2020 so that David can save IHT of £59,483 as there will be 100% BPR relief on his distribution.

IHT of £27,578 will be due by 30 May 2020 for David's distribution with an IHT return due by 31 November 2020 assuming the trustees distribute the capital by the end of November 2019.

We recommend that a joint claim for Gift Relief is made on the distribution of the estates and this will defer a capital gain of £2,675,000 and save the trustees CGT of £533,830. We recommend that the claim is made by 31 January 2021 so that the trustees do not have to pay the CGT with their 2019/20 tax return.

The trustees will need to inform the company to complete a stock transfer form on the shares to Chloe and David. Chloe should retain the shares as she does not require the cash but David needs the cash to purchase a home and so I would recommend that the trustees advise him that there is an option to sell the share by 30 April 2020. His base cost will be £562,500.

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Section 1: Tax Implications on Trust of change in strategy of South West Bespoke Properties Ltd

From the letter on 3 November 2019, South West Bespoke Properties Ltd (SWBP) are planning to cease trading as a property development company from 30 June 2020 and will instead undertake long-term lettings.

From an income tax perspective, the trust will pay tax on the dividends received regardless of the source of the income that generates the dividends and so there will be no impact for tax purposes.

A change in strategy could mean a further delay to dividends and so the trustees might be able to reduce the payments on account in their 2018/19 tax return if income is expected to be lower in 2019/20 than 2018/19.

From a capital gains tax purpose, the change in strategy will not have an effect as there is no beneficiary with an interest in possession so not possible for the trustees to benefit for entrepreneurs' relief.

However, this change in strategy has an effect on inheritance tax (IHT).

Current Status of the SWBP Shares and Business Property Relief

As SWBP is an unquoted trading company, the shares qualify for 100% business property relief (BPR). This is where the transfer of value of relevant business property is reduced for IHT purposes.

SWBP is considered trading as it has been assessed to be wholly or mainly trading which the courts indicate is an over 50% undertaking in trading activities.

HMRC can challenge the companies BPR status and can look further at key indicators such as turnover and time spent on each area but from the work by my firm's tax team, we are comfortable that the SWBP shares currently qualify for BPR.

A transfer of value for IHT is where these share are gifted or transferred below market value and was the case when Joanne transferred the shares to the Pearson Legacy Trust (The Trust) on 18 February 1998.

As the shares qualify for 100% BPR, it means that when there is a distribution by the trustees of the shares to Chloe or David, no IHT will be payable on the distribution of the shares.

Inheritance tax effect of the change in strategy by SWBP

However, from 30 June 2020, the shares in SWBP will no longer qualify for 100% BPR as the shares will be dealing in a disqualifying trade by renting out the properties.

From the letter on 3 November 2019 from SWBP, I am assuming that the rentals will be over 50% of the activities and so SWBP will therefore no longer be wholly or mainly trading.

This means that from 30 June 2020, the shares will no longer qualify for 100% BPR. Unlike other reliefs there is no reduced rate of BPR for unquoted shares and so no BPR is now available.

As explained further on in the report, from 30 June 2020 this will increase the Exit Charges on the Trust as the shares would be taxable for IHT purposes.

Trust's option to sell shares by 30 April 2020

In the letter of 3 November 2019, the minority shareholders are given an option to dispose of their shares in light of the change on business strategy with a deadline by 30 April 2020.

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Unquoted company shares do not have a market for sale and so if the trustees wanted to sell then the offer remains until 30 April 2020 and so the trustees could sell anytime before then and pay the same CGT. If the trustees split the sale before and after the 6 April 2020, then they could take advantage of two trust CGT annual exemptions.

By selling the shares, the trustees would receive proceeds of £3,350,000 and there would be a taxable gain of £2,225,000. This would be charged at 20% after the trust CGT annual exemption of £5,850 resulting in CGT due of £443,830.

However, even though the option to sell shares is rarer, the trustees should not take up this option as selling the BPR qualifying shares would replace the shares with cash which does not qualify for BPR.

This means that IHT on the cash would be payable on exit charges on distributions from the trust unlike the BPR qualifying shares. This is the same charge as the shares becoming non-BPR eligible and this is explore below.

We therefore recommend that the trustees do not take up the offer to sell the shares so that the BPR status reduces the IHT on the exit charges.

Section 2: Chloe's Entitlement and exits from the trust

Trust Status

When the trust was settled by Joanne, as an Accumulation and Maintenance (A&M) trust, this was a potentially exempt transfer (PET) for Joanne and so IHT was not due as she survived 7 years from the date of the settlement.

As noted in the trust deed, this A&M trust was set up to look after assets for Joanne's grandchildren until they each turn 25 when they can have their share absolutely and this was given to the older grandchildren.

Any income received by the trust would be subject to the rate applicable to trust (RAT) and beneficiaries would receive income net of a 45% tax credit.

However, following rules introduced on 22 March 2006, the status of the trust changed to either become relevant property trust or conform to the Age 18-25 rules for IHT purposes.

As the Trust already gave an absolute share of the trust fund when the beneficiary turned 25, it automatically qualified to be treated as an Age 18-25 trust and so no action was required by the trustees following the changes to the rules of A&M trusts.

Under the age 18-25 trust rules, there are no principle charges (which are for relevant property rules) but they do have exit charges.

This is an IHT charge on the capital distribution of property from the trust and would have been charged on Laura and James when they each turned 25 and were given their absolute share.

IHT Exit Charge on Chloe's Entitlement

As noted, Chloe turned 25 on 18 October 2019 and so became entitled to her absolute share of the trust capital.

This triggered an 18-25 trust exit charge and there is IHT to pay of £37,034 by 31 April 2020 with an IHT return due by 31 October 2020.

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As shown in Appendix 1, the 18-25 exit charge is based on the initial value of the trust being the market valuation of the SWBP shares at the date of settlement.

We then deduct the current nil rate band (NRB) which in turn is reduced by any chargeable lifetime transfers made by Joanne (as the settlor) in the 7 years before settling the trust.

As Joanne had only made PETs in the previous 7 years (which are not chargeable until death), the full NRB is allowed.

We then take a notional tax rate multiplied by 30% and then a fraction of 40.

For an 18-25 trust, the settlement fraction is the number of quarters since the later of:

- When Chloe turned 18 which was on the 18 October 2012.
- When the trust because age 18-25 which was on the 6 April 2008.

This is therefore when Chloe turned 18 and there have been 28 quarters since.

The final step is to multiply this actual rate by the chargeable IHT share of the property that is leaving the trust.

As Chloe is entitled to half the trust property this is a total of £2,915,000 less the SWBP shares which currently qualify for 100% BPR and so the chargeable property is the half of the quoted share portfolio and half the cash. As shown, this produced a tax charge of £37,034.

Section 3: David's Entitlement and winding up the trust

As David has not yet turned 25, the trust will continue with David as the sole beneficiary.

On David turning 25 on 18 July 2021, there would be an IHT exit charge (using the same calculation as for Chloe) of £87,061.

This is substantially higher than the charge on Chloe of £37,034 as by 18 July 2021, the SWBP shares would no longer qualify for 100% BPR and so the exit charge is on total exit value of £2,915,000.

However, from the letter of wishes, Joanne requested that the trustees were mindful of the best for beneficiaries and the trust deed also allows for the advancement of capital and the absolute entitlement.

If the distribution by the trustees was instead before 30 June 2020 then David can benefit from the 100% BPR relief and the IHT charge will only be on £1,240,000 and will reduce the IHT to £27,578 being a saving of £59,483.

Advancing the capital will also reduce David's settlement fraction from 28/40 to 21/40 (if distributed before January 2020) and so less IHT is due. Every additional 3 months will increase the IHT due by a 40^{th}. However, as this is a smaller percentage, the distribution before 30 June 2020 is up to the trustees.

Recommendation

We therefore recommend that the distribution to David is advanced to before 30 June 2020 so that David can benefit from the 100% BPR relief and the IHT charge will only be on £1,240,000. This will reduce the IHT to £27,578 being a saving of £59,483.

Assuming the trustees distribute the capital by the end of November 2019, the IHT will be due by 30 May 2020 with an IHT return due by 31 November 2020.

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Capital gains tax on Exit Charges

A distribution of capital by the trustees to the beneficiaries (as a connected party) is a disposal by the trustees for capital gains tax (CGT) purposes.

As cash does not incur CGT, CGT is chargeable on the gain in the SWBP shares and the Quoted share portfolio.

Therefore if the trustees distribute the entire trust, there will be CGT due of £533,830 and the full calculation is shown in Appendix 3.

The CGT will need to be paid and reported on the trustees' tax return for 2019/20 with both due by 31 January 2021. This has assumed that the distribution takes place on or before 5 April 2020.

As shown, the trustees will be able to use the reduce trustees' CGT annual exemption of £5,850 with tax then due at 20%.

Please note that the increased CGT rate for residential property (28%) is not applied to shares of companies with properties.

As explained in Section 1 of the report, no entrepreneurs' relief (ER) is available as there is no beneficiary who qualifies for ER and has an interest in possession.

Gift relief

However, as the distributions are immediately chargeable to IHT, the trustees can make a claim for gift relief.

Gift relief acts to hold over the capital gain so that no CGT is due. Instead, the base cost of the beneficiaries is reduced to the base cost of the trustees.

Gift relief is claimed jointly by the beneficiary and the trustees as it will be the beneficiary that incurs the higher CGT when they eventually sell the asset. The claim needs to be made within 4 years of the disposal and so therefore by 30 November 2023.

Recommendation

We recommend that a joint claim for Gift Relief is made on the distribution of the estates and this will defer a capital gain of £2,675,000 and save the trustees CGT of £533,830. We recommend that the claim is made by 31 January 2021 so that the trustees do not have to pay the CGT with their 2019/20 tax return.

Section 5: Winding up the trust and administration issues

As the trust will be wound up following the distribution to David, the trustees will lose any remaining tax pool which has collected the credit on the trust tax paid.

Therefore before the winding up, the trustees should distribute any un-accumulated income to reduce the tax pool and allow the beneficiaries to benefit from the tax credit.

One this has been completed, any remaining un-accumulated income should be accumulated as then the IHT charged on the exit of this property will be minimal as it has only been treated as capital for a short time.

The trustees will also be required to report any income tax until the cessation of the trust and the CGT already mentioned on a trust return for 2019/20 due by 31 January 2021. As the trust is ceasing, the trustees should reduce the payments on account (POA) for 2020/21 to nil.

Distribution of Trust Assets

On the transfer of the shares, the trustees will need to inform the SWBP to complete a stock transfer form as the shares will be passing to Chloe and David.

There will be no stamp duty land tax (SDLT) as no consideration was exchanged for the shares.

It is not necessary for a complete split of the trust assets however.

Both Chloe and David will require cash for the IHT charge on the exit but beyond that, they both have slightly different needs.

As Chloe has no immediate need for the cash, I would advise that the trustees recommend that Chloe holds onto the shares and this will defer the CGT due.

David, on the other hand needs the cash to purchase a home and so I would recommend that the trustees advise him that there is an option to sell the share by 30 April 2020. His base cost will be £562,500.

As a higher rate taxpayer, the CGT will be due at 20% but he will have his annual exemption of £11,700. I would then advise that he sell some now on or before 5 April 2020 and sell some on or after 6 April 2020 to utilise two lots of annual exemption.

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Appendix 1:

Exit Charge options for Chloe		
Initial Value		1,125,000
NRB	(325,000)	
Less CT of the Settlor in previous 7 years	nil	(325,000)
		800,000
Notional IHT at 20%	160,000	
ER	160,000/1,125,000 x 100	0.14222
Actual Rate	0.14222 x 0.3 x 28/40	0.02986
Exit		
Before 30 June 2020	1,240,000 x 0.02986	37,034
After 30 June 2020	2,915,000 x 0.02986	87,061
	Difference	50,027

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Appendix 2

<u>Exit Charge options for David</u>		
Initial Value		1,125,000
NRB	(325,000)	
Less CT of the Settlor in previous 7 years	nil	(325,000)
		800,000
Notional IHT at 20%	160,000	
ER	160,000/1,125,000 x 100	0.14222
Actual Rate	0.14222 x 0.3 x 21/40	0.02239965
Exit		
Before January 2020	1,240,000 x 0.02224	27,578
When David Turns 25 on 18/07/2021	2,915,000 x 0.02986	87,061
	Difference	59,483

Appendix 3

Trust CGT on winding up the Trust		
Shares in SWBP	OMV	3,350,000
	Base cost	(1,125,000)
	Gain	2,225,000
Quoted Share portfolio	Proceeds	2,050,000
	Base cost	(1,600,000)
	Gain	450,000
Total Gain on distributions to Chloe and David		2,675,000
Trust CGT annual exemption	11,700/2	(5,850)
	Chargeable Gain	2,669,150
	CGT at 20%	533,830

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Plan

Section 1: Tax Implications on Trust of change in strategy of South West Bespoke Properties Ltd (SWBP)

Implications of trust of change of strategy

Income tax: less income

CGT: no impact as shares

IHT:

Currently qualifies for BPR on shares in SWBP

BPR Specific explanation

Could be challenged by HMRC as

"Shares in...a company are not relevant business property if the business carried on by the company consists wholly or mainly of...dealing in...land or buildings or making or holding investments".

As it would be dealing in land. An example of this is FHL where the rental part does not qualify

Not qualify from 30 June 2020

Impact Exit Charges on Chloe

Impact Exit Charge on David

No effect for Income and CGT

RAT

Income from shares could change

Section 2: Option to sell shares by 30 April 2020

Trust take option to sell shares before 30 April 2020

CGT on Shares 445,000, stay same

Recommend to hold share to benefit from BPR on Exit charge

Section 3: Chloe's Entitlement and exits from the trust

IHT Exit Charge

18-25 trust

Capital gains tax on Exit Charges

Annual exemption + CGT rate

No ER

Gift relief as chargeable to IHT

Recommend Claim for Gift Relief

Joint election

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Section 4: David's Entitlement and winding up the trust

Letter of wishes, best for beneficiaries

Distribute any accumulated income to reduce the tax pool

David's exit charge now

David's exit charge when turn 25

If wait then increase IHT by 1/40 but beyond 30 June 2020 then increase to age 25

Winding up trust

Income tax return for 2019/20 due by 31 January 2021, reduce POA to nil.

In return for 18/19, advise to reduce POA

Distribution of Trust Assets

Need to inform the company to complete a stock transfer form

No SDLT as no consideration for the shares

Not necessary for a complete split

Both require cash for the IHT charge on the exit

Chloe Entitlement

No immediate need for the capital funds so Chloe can hold onto the shares

David Entitlement

Needs cash

Recommend:

SWBP shares to David and trustees advise him that there is an option to sell. His base cost will be

As a higher rate taxpayer will be 20% but annual exemption so sell some now on or before 5 April 2020 and sell some on or after 6 April 2020.