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

Answer-to-Question-_1_

REPORT TO THE TRUSTEES OF THE HARTLEY SETTLEMENT

Introduction and Scope:

As discussed in the meeting of 2 May 2022 between Caroline Robinson and the trustees of the Hartley Settlement (the Settlement), this report will consider:

1. The sale of the land, property and farm shop business at West Fields; and

2. The cessation of Peter's interest in possession in the Settlement.

This report will explain the implications and tax charges of the above and explanations will be provided for the different routes that could be taken to achieve maximum tax efficiency.

This report is for the trustees of the Hartley Settlement and is based on details held in our premanent records and information provided in the meeting held on 2 May 2022. This report assumes the most recent valuations remain constant going forward.

Executive Summary:

1. West Field Site is due to be sold with a substantial increase in value. If the trust sold the West Fields site this would result in the sum of £436,270 being due in respect of Capital Gains Tax (CGT). As trustees wish Peter to receive the sale proceeds, I recommend the appointment of West Field site absolutely to Peter before the sale and then for Peter to transfer a share of the West Fields site to his wife Saskia. This would allow the saving of £19,980 in CGT.

2. Peter wishes his interest in the trust to end and the trustees have stated they would like Luke to have either a right to the income now with the trust assets passing to Luke's blood children on his death or to end the trust now and pass the assets to Luke and request that he disposes of them as per their wishes on his death.

3. The implications of ending Peter's life interest and allowing the trust to continue on its current terms would meet their objective, this would result in a chargeable lifetime transfer (CLT) for inheritance tax but due to the availability of both Agricultural Property Relief (APR) and Business Property Relief (BPR) there is currently no inheritance tax (IHT) payable but there is a future risk of APR / BPR being withdrawn in the future which would result in IHT being due. CGT holdover relief could be claimed which would prevent the immediate payment of CGT but which would result in Luke having a lower base cost and therefore

higher gain when he later sold. Enquiries should be made with Luke about his future plans.

4. The alternative to end the trust now and distribute trust assets to Luke absolutely would result in a potentially exempt transfer (PET) for IHT with no way to ensure the ultimate destination of the trust assets on Luke's death. This is not ideal because if APR / BPR was withdrawn,as the transaction is a PET, this would affect Peter's cumulative total which may have a negative impact on Peter's death estate and the reduce his available nil rate band (NRB) should he die within 7 years.

5. It is recommended Peter ends his life interest by allowing the trust terms to continue as this would fulfil his request that the ultimate destination of the trust assets is controlled and would reduce his estate's exposure to IHT should he die and APR / BPR being withdrawn.

6. Peter should check with Luke to see whether he adopted his step-children and further advice sought if he has.

Report:

The sale of West Fields Site

Option 1 - Sale of West Fields site by Trust

Currently West Field contains a farmshop, car park, five derelict barns and unused land. The sale of this land will result in a CGT liability for the trust. This would result in a capital gain of £436,270 (Appendix 1).

Whilst business asset disposal relief (BADR) is available if a life tenant is running the business. The other conditions are not met as whilst Peter does carry on the trade, Peter does not personally own 5% in the company and in any event Peter has already used his lifetime limit of £1 million and therefore the full gain would be chargeable at normal rates rather than the reduced BADR rate of 10%.

If the trust sells the asset, this is not a chargeable event for IHT as for IHT purposes the trust assets are already treated as forming part of Peter's estate and therefore this is not an occasion to charge.

Option 2 - Absolute appointment of West Field Site to Peter before sale.

As stated above, the IHT positon of the sale wouldn't change if the West Field Site was first appointed to Peter before selling as it is already treated as being in Peter's estate.

The CGT position however could change, s165 TCGA 1992 holdover relief could be claimed as the appointment would be a transfer of business assets which would qualify for BPR. There are, however, some excepted assets which would not qualify and these would limit the value of the claim. This would result in £378,648.05 payable by the trust now and a further capital gain to be paid by Peter when he sells (Appendix 2).

To enable Saskia to utlise her losses and to also reduce the claim further by her annual exempt amount, I recommend transferring a share of West Field site to her before the sale takes place. For CGT purposes, this would be a transfer at a 'no gain no loss' as she is Peter's spouse.

This would reduce the capital gains tax to £416,290 (Appendix 2) a saving of £19,980 in CGT.

Unfortunately the gain by Peter and Saskia could not benefit from BADR as they are over their lifetime limit.

The Cessation of Peter's Interest in the Remaining Trust Assets:

Peter (life tenant) has said he would like his interest in possession in the trust to cease and for Luke to be given a life interest in the trust, then on Luke's death, Peter and Saskia (the trustees) would wish for the remaining trust assets to pass to Luke's children absolutely. They have said they would not want Luke's step-children to benefit.

<u>Option 1: Wind up the trust and appoint to Luke absolutely.</u>

At present the trust assets form part of Peter's estate as his interest is a qualifying interest in possession (QIIP) for IHT.

Where a QIIP ceases and assets pass to Luke absolutely, this is a lifetime disposal of Peter's interest (other than for consideration) and is therefore a potentially exempt transfer (PET) for IHT purposes as the assets pass from Peter's estate to Luke's by virtue of s52 IHTA 1984.

Peter currently uses his annual exemption each year and therefore I understand this would not be available to reduce the value of the PET. Should Peter die within 7 years of the QIIP ceasing, this would be a failed PET and any IHT payable as a result of the death of the life tenant would be payable by the trustees under s201 IHTA 1984.

Whilst the trustees are strictly liable to pay any IHT under s201, they should ensure it is the donnee who will suffer the tax as they have the asset if they do not retain sufficient funds.

Whilst Peter has confirmed he will settle any tax charges arising as a result of his interest ending, as the IHT would be a PET, there is no way of knowing whether this charge will arise. Peter should therefore either retain sufficient funds to cover this future liability or take out life insurance to cover such a scenario. If the policy is taken out by Peter, it should be written into trust and the premiums should be covered by the normal expenditure out of income provisions.

The maximum IHT charge would be subject to taper relief should Peter survive for at least three years from giving up his QIIP and the trust will be able to claim BPR and APR.

Whilst the agricultural value of North Fields, South Fields and East Fields all meet the criteria of agricultural property.

The development value of the land i.e. the difference between the market value and the agricultural value is covered by BPR @ either 100% or 50%.

As the land is currently being farmed in hand by the trust, BPR will be available at a rate of 100% of the development value of North Fields and South Fields. BPR on the development value of East Fields will not be available as the land is currently being let and and not used by the trust of the life tenant on a business carried out by them. APR at 100% will however still be available.

The trustees should also consider the implications of APR / BPR being withdrawn at the time of Peter's death. This would likely occur if Luke left the country within 6 years or the land ceased to qualify.

Appendix 4 shows value of PET which amounts to £6,295.

On Luke's death, the assets would form part of Luke's estate and would be subject to inheritance tax - potentially at the rate of 40%.

The transfer of assets to Luke absolutely will be a disposal for CGT purposes as the beneficiaries of the trust would be absolutely entitled to trust assets as against the trustees. The CGT arising on the appointment would be payable by the trustees. I understand Peter has agreed to cover this.

Holdover relief under s165 TCGA 1992 would be available to the assets being used in business or which qualify for APR (you should note that assets being let are still qualifying agricultural property and benefit from APR).

Holdover relief can be jointly claimed by the trustees and donee within 4 years, so Luke would need to agree to the claim.

The claim would apply to the full market value of the land and buildings provided there are no further non-business assets.

North Fields whilst it has arable land being farmed is surrounded by 30 acres of Woodland. The woodland area still meets the definition of agricultural land as its purpose is to shelter the crop against the harsh weather. The storage barns also qualify as they are being used to store farm equipment. There will therefore be no restriction.

South fields holds no restricted assets as all is being farmed and whilst East Fields is not currently being farmed by the trust it still qualifies as it is being let on a post-1995 Farm tenancy and therefore meets the defintion of agricultural land.

Having considered the above, I believe holdover relief would be available in full and Luke would take the trust assets with a base costs as follows:

North fields - hold over relief was claimed when placed in the trust so Luke would take the land subject to both holdover relief claims with a base cost equal to those on 6 October 1983.

South fields - hold over relief was claimed when placed in the trust so Luke would take the land subject to both holdover relief claims with a base cost equal to those on 6 October 1983.

East Fields - no hold over relief was claimed when placed in the trust so Luke would take the land at the 8 May 1995 valuation.

The main downside of this option is there is no way to ensure Luke disposes of the assets as you suggest as you are unable to contract with Luke about the contents of his will and it would be a moral obligation that he dispose of the trust assets after they have been appointed to him absolutely in the manner you suggest.

On Luke's death, the assets would benefit from a free capital gains uplift to date of death value; however, there would still be a chargeable gain as Luke's estate would be liable for the deferred gain of £2,720,500.

BADR is not available on death and therefore there would be no 10% rate available and the gain would be charged at Luke's rates pre-death. Luke may want to realise some of this gain in his lifetime to benefit from the £1m lifetime limit and further advice should be sought by Luke about this.

See appendix 5.

<u>Option 2: End Peter's life interest and allow the trust to continue as per the terms of the trust.</u>

Another option would be to end Peter's life interest and to allow the trust to continue as per it's original terms. This would mean that Luke would have a life interest in possession and then on his death his share would pass to his children.

Peter and Saskia are concerned about the truste assets being inherited by Luke's step children. A trust can specifiy precisely what references to children mean, but if there is no defintion, the general law applies. A step-child is not, as a matter of general law a step-parent's child unless the step parent has adopted the child. We are told the children are adult children but we are not told whether they were adopted. I recommend obtaining clarification from Luke on this point. Provided they were not adopted, the trust can continue as it is. If they were adopted, then the trustees have power in the trust to appoint assets absolutely or create new trusts. If a new trust was created, it could stipulate which beneficiaries were to inherit by name on Luke's death.

If Peter accelerates his life interest so that it comes to an end and Luke's commences earlier, this is a lifetime disposal of Peter's interest (other than for consideration) and is therefore a chargeable lifetime transfer (CLT) for IHT purposes as the QIIP ends and the assets pass from Peter's estate into a non-qualifying ineterest in possession trust (NQIIP).

The value of the CLT will be the value of the trust assets on the date of the gift net any APR, BPR and available annual exemptions. For the reasons given above, I believe APR would be available on the agricultural value of the farmland. The development value of the land i.e. the difference between the market value and the agricultural value is covered by BPR @ either 100% or 50%.

As the land is currently being farmed in hand by the trust, BPR will be available at a rate of 100% of the development value of North Fields and South Fields. BPR on the development value of East Fields will not be available as the land is currently being let and and not used by the trust of the life tenant on a business carried out by them. APR at 100% will however still be available.

The value of the CLT is shown in appendix 6 and is currently nil as it is within Peter's nil rate band. Peter has however utilised £6,295 of his nil rate band.

Should Peter die within 7 years of the QIIP ceasing, there could be a further charge to IHT and the trustees would be liable for any IHT payable. For the reasons given above, Peter should either retain a reserve fund to cover this liability or take out a life insurance policy.

Whilst the disposal benefits from APR and BPR now, Peter should consider the implications of a withdrawal of APR / BPR in the event that the land no longer qualifies / is sold by Luke without Luke purchasing replacement property and in that respect a CLT may be preferable over a PET as if further tax is due on death by Peter's estate as a result of the failed PET / CLT. If APR / BPR is withdrawn in calculating the value of the transfer for both a PET and CLT, the CLT is more beneficial as Peter's cumulative total which is taken into consideration to calculate the additional tax due on death is unaffected by the withdrawal of the APR / BPR whereas the PET does not have this benefit. The benefit of the CLT would therefore be there would be more NRB available on Peter's death.

The trust will then continue as a NQIIP trust which will be subject to the relevant property regime and will incur exit charges any time a distrubtion of capital is made and principal charges every 10 years. Income received by the trust would be taxed at the applicable rates of trusts i.e. 45% and 48.1%. Luke could claim tax credits for any tax paid and if he is not an additional rate tax payer, he will receive a refund in tax.

Whilst Peter is treated as the settlor for the purpose of the CLT, Geoffrey remains the settlor of the trust and the first principle charge will be on 8 May 2025. The trust will also continue to use Geoffrey cumulative clock for both exit and principal charge purposes and not Peter's and therefore none of the lifetime gifts Peter makes will affect the trusts cumulative total going forward.

On Luke's death, as he does not have a QIIP, the underlying assets are not part of his estate for inheritance tax purposes and the cessation of his life interest would not be a transfer of value by Luke for IHT purposes and instead the trust assets would remain relevant property.

As the trust assets would then be appointed to Luke's children absolutely, because assets would leave the trust at this time an exit charge would arise.

The capital gains tax position of the gift from Peter will give rise to a deemed disposal at market value by the trustees of all the assets in the trust at that time. This is regardless of whether the trust continues or ends. Capital gains will arise to the trustees at this point under s72 TCGA 1992. Alternatively gains can be deferred under s260 TCGA 1992 as it is a chargeable transfer of IHT and s260 has priority over s165 TCAG 1992.

On Luke's death, under the terms of the trust, the trustees will be distributing the assets absolutely to Luke's children, there would be an actual disposal by the trustees at market value and a gain (or loss) will arise on the transfer of chargeable assets.

In this case, deferral relief will normally be available under s260 so the appointment will usually only give rise to an IHT exit charge.

A s260 claim would however require the consent of Luke's children to roll over the gain and this would result in a higher capital gain for the beneficaries when they later sold the assets.

There is also a potential problem as Luke's children are currently minors one being aged three and the other five and therefore if Luke died when one was a minor and the other was an adult, property would leave the trust at different times. Under the rule in Crowe v Appleby this may restrict the use of holdover relief when the assets are appointed to the second child. This is because holdover relief is only possible when there is a charge to inheritance tax and if a land is part disposed, whilst there is a disposal for IHT when the first beneficary receives their share there is no disposal for CGT. The disposal for CGT only takes place when the second beneficiary receives there share. At this point, only the second beneficiaries share is subject to the exit charge and therefore only a part claim for holdover relief can apply at that time.

This is something the trustees should consider and plan for should Luke die when his children are still minor's.

If Luke's children also farmed the land, they could claim BADR and the rate of CGT would be 10%. I note Luke's intention to bring South Fields back into full agricultural use and therefore BADR should be available on the whole value.

Recommendation: As destination of the assets is important and there is a risk of APR / BPR being withdrawn in the future I recommend that Peter ends his life interest and the trust continues on its current terms with Luke having a successive life interest and then on his death the trust funds passing to his (blood) children absolutely. Peter and Saskia should establish whether Luke has adopted his step-children before proceeding with this. I also recommend that further valuations are obtained at the time the trust ends to prevent any difficulties which may arise retrospectively if HM Revenue and Customs wish to apply hindsight to the valuations.

Appendix 1: Sale of West Field by Trust

Sale Proceeds			2,320,000
Less: enhancement expenditure			(75,000)
Less base cost	n1		(57,500)
Gain			2,187,500
Less: AEA for trusts			(6,150)
CGT @ 20%			£436,270

n 1 Base cost: No holdover relief claimed on creation
35 acres land @ £1,250 = £43,750
5 barns @ £2,750 = £13,750

Appendix 2: Appointment by Trust

gain			2,187,500
s165 Relief	n1		(288,109.75)
Less AEA			(6,150)
CGT @ 20%			£378,648.05

n1 Gain eligible for gift relief:

Chargeable business assets = Farm Shop = 120,000, developed barn and carpark £150,000 = £270,000

Company's chargeable assets = 35 acre site and four barns £1,850,000 plus £200,000 = £2,050,000

Gain eligible for gift relief = 270,000 / 2,050,000 = 13.2%

13.2% x 2,187,500 = £288,109.75

Appendix 3: Sale by Peter and Saskia

Sale proceeds			2,320,000.00
Less base cost	n1		(2,031,890.25)
Gain			288,109.75
Less: AEA x 2	n1		(24,600)
Less Saskia brought forward losses			(75,300)
Chargeable gain			188,209.75

CGT @ 20%			£37,641.95

n1 Base cost of West Field: £2,320,000 less s165 holdover claim £288,109.75 = £2,031,890.25

n2 Peter and Saskia have an annual exempt amount of £12,300 each

Total CGT for after appointment and sale by Peter and Saskia £416,290.

<u>Appendix 4: PET</u>

Gift:	n1		£
North Fields	n2	1,992,000	
Less APR / BPR		(1,992,000)	
			nil
Southfields	n3	625,000	
Less APR / BPR		(625,000)	
			nil
Eastfields	n4	585,000	
Less APR / BPR		(585,000)	
			nil
Cash			6,925
Transfer of Value			6,295
Less: AE	n5		nil
Value of PET			6,295

n1 the value of the gift is on the loss to trust principle.

n2: Northfields:

APR @ 100% available on 120 acres of land @ £9,750 = £1,170,000
APR @ 100% available on 30 acres of shelter belt @ £4,400 = £132,000

APR @ 100% available for barns used for agriculture 6 barns @ £10,000 = £60,000

BPR @ 100% for development value of 120 acres of land @ £5250 = £630,000

Nil chargeable.

n3 Southfields:

APR @ 100% 50 acres @ £8,000 per acre = £400,000
BPR @ 100% 50 acres for development value = £225,000

Nil chargeable

n4 Eastfields:

Let on a post-1995 farm tenancy qualfies for APR @ 100%. It is irelevant that it was unused from 8 May 1995 until June 2017 as it meets the qualifying criteria as it was used for agriculture at the time of the transfer. 90 Acres @ £6,500 = £585,000

n5 Peter uses his annual exemptions each year so I have assumed these to be nil.

Appendix 5: Holdover Relief:

	Base cost £	current value n4 £	held over gain £
Northfields n1	256,500	1,992,000	1,735,500
Southfields n2	67,500	625,000	557,500
Eastfields n3	£157,500	585,000	427,500
Total	£481,500	£3,202,000	£2,720,500

n1 Northfields: base cost equal to 6 October 1983

120 acres @ £2,000 = £240,000
30 acres @ £350 = £10,500
6 barns @ £1,000 = £6,000

n2 Southfields: base cost equal to 6 October 1983

50 acres at £1,350 = £67,500

n3 Eastfields: base cost equal to 8 May 1995

90 acres at £1,750 = £157,500

n4 - current values as per appendix 4

<u>Appendix 6 CLT</u>

Transfer of value	n1		6,295
Less: AE	n2		nil
CLT			6,295
Peter's NRB		325,0000	
Less: CLT in 7 years before trust restricted to value of CLT		nil	
			(6,295)
Taxable			nil
Peter's cumulative total			£6,295

n1 - the same transfer of value is as per Appendix 3.

n2 - Peter utilises his annual exempt amounts each year.