Chartered Institute of Taxation
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The Chartered Tax Adviser Examination

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Application and Professional Skills

Inheritance Tax, Trusts & Estates

Suggested Solution

REPORT TO THE TRUSTEES OF THE HODGSON DISCRETIONARY TRUST

INTRODUCTION

As requested in the letter from Mr Robert Hodgson on 30 October 2020, this report will consider:

1) The taxation implications arising from the winding up of the trust;

2) Tax efficient measures that can be taken to mitigate the arising tax charges

This report will explain the implications and tax charges that will arise should no action be taken prior to the end date of the trust. Explanations will also be provided for different routes that could be taken to achieve maximum tax efficiency.

This report is based upon the information provided by Robert Hodgson, specifically the trustees' desire for the trust assets to pass to Susan Hodgson and Oliver Hodgson equally. This report assumes that the most recent valuations remain constant going forward.

EXECUTIVE SUMMARY

The Hodgson Discretionary Trust is in the final stages of its lifecycle. The trust will end on 3 May 2021, although the trustees do have the power to distribute the assets to the trust beneficiaries prior to this date, at their discretion.

If the trustees choose to take no proactive action then the assets will pass to the two ultimate beneficiaries of the trust, Susan Hodgson ("Susan") and Oliver Hodgson ("Oliver") on 3 May 2021.

This has both Inheritance Tax and Capital Gains Tax implications. From an Inheritance Tax perspective, firstly the ten-year charge will arise on 22 December 2020 and this tax charge will amount to £44,697. Secondly, a small exit charge will arise upon the cessation of the trust in May 2021 amounting to £1,068. No immediate Capital Gains Tax liability will arise on the distribution of the assets to the beneficiaries due to the availability of full and unrestricted hold over relief should the trustees and beneficiaries make a joint election.

The trustees do have the opportunity to significantly reduce the tax burden of not only the trust but also the beneficiaries personally given their respective plans for the funds they are shortly to receive.

Susan is planning on retaining the assets in the long term. If the trustees were to distribute Susan's 'share' using their discretionary powers prior to the ten-year charge anniversary in December 2020, there will be a £16,676 Inheritance Tax saving as the exit charge (£6,206) will be less than the combined ten year charge and subsequent exit charge (50% share of £44,697 + £1,068). The trustees should also make a joint election with Susan to hold over the capital gain given that she wishes to retain the assets in the long term. This will ensure no tax is immediately payable meaning none of the assets will need to be sold to settle the tax liability.

Oliver does not intend to retain the assets and is planning to purchase a property so he will ultimately want cash from his trust assets. He has suggested that assets are transferred to him in January 2021 so that he can arrange for their sale prior to the expected purchase of a new residence. The trustees should not distribute the assets to Oliver (or Susan) between 23 December 2020 and 22 March 2021 as distributions in this period will not qualify for Capital Gains Tax hold over relief. Oliver has prior year capital losses brought forward that could be utilised against the crystallised gains and it is therefore of critical importance that Oliver, not the trustees, trigger the gains.

It is also possible for Oliver to save an additional £40,000 in Capital Gains Tax should he delay the sale of the trust assets until after 5 April 2021. This will mean that he has to finance his house purchase using the bank offered finance, but the tax savings far outweigh the cost of this.

The trustees should consider appointing the assets to Oliver before the ten year anniversary, in the same way as Susan's distribution, even though we recommend that Oliver does not sell them until after 5 April 2021 as once again this will save another £16,676 in Inheritance Tax.

The trustees should also consider making a full distribution of the Trust income to Susan and Oliver to ensure maximum tax efficiency.

OVERVIEW OF TRUST

The Hodgson Discretionary Trust is a discretionary trust and this has taxation implications for Inheritance Tax ("IHT"), Capital Gains Tax ("CGT") and Income Tax ("IT").

For IHT purposes the trust is classified as a relevant property trust. This means that the trust assets are subject to IHT charges every ten years (counting from the date of trust creation) and also when assets leave the trust (exit charge). The trust assets are not aggregated with any individual beneficiary's estate upon death.

For CGT purposes the trustees, as a body, are chargeable to CGT. The CGT rates within a trust are always at the higher rates, being 20% for non-residential property and 28% for residential property. The trustees benefit from a small annual exemption each year being half that of the annual exemption for an individual, so £6,000 for 2020/21.

For IT purposes the trustees have discretion to make income payments. These payments carry a 45% tax credit which can be utilised by the beneficiaries.

CURRENT SITUATION

The trust is nearing the end of its lifecycle and if no action is taken it will be wound up on 3 May 2021, being 21 years after the death of the settlor.

Prior to this, the final ten-year charge will also occur on 22 December 2020. This charge is based upon the value of the assets (net of reliefs) at the charging date, taking into account the settlor's historic gifting history and any capital distributions made since the last ten-year charge.

At this charging point it is likely that the shareholding in Digital Bank plc valued at £369,278 will qualify for IHT relief known as Business Property Relief (BPR).

BPR is available on unquoted shares which have been held for more than two years where the business is mainly trading and there is no binding contract for sale in place. Although the shares in Digital Bank plc are quoted on the Alternative Investment Market (AIM), share listings on this market are specifically treated as unquoted shares for BPR purposes. Subject to confirmation that Digital Bank plc is mainly trading and the trustees have no binding sale contract in place, it does appear that the shareholding qualifies for BPR. The rate of relief for unquoted shares (or AIM listed shares in this case) is 100% so the full market value of £369,278 will not be charged to IHT.

Based upon the current valuations of the assets held by the trust, the ten-year charge will amount to £44,697 (Appendix 1). This charge is a liability of the trust and must be settled no later than six months from the end of the month in which the anniversary fell and so by 30 June 2021. The trust currently holds insufficient cash to settle this liability.

An IHT exit charge will also arise when the trust assets are passed to Oliver and Susan upon termination of the trust. This charge will be minor in comparison to the ten-year charge as it is a proportional charge based upon the number of complete quarters that have passed since the ten year charge. As the trust will cease on 3 May 2021, only one complete quarter will have passed. If no changes are made to the trust assets between now and the point of winding up the trust this tax charge will amount to £1,068 (Appendix 2).

The chargeable assets leaving the trust upon its cessation will give rise to a chargeable event for CGT purposes. The gains on the share portfolio will crystallise and be taxable on the trustees at the trust rate of 20%. However, as the event gives rise to an immediate IHT charge (however small) it is possible for the trustees and beneficiaries to jointly elect to hold over the gains. This election means that the beneficiaries will acquire the assets with a CGT base cost equal to that of the trustees, ignoring a very slight uplift for the IHT paid, and no CGT becomes immediately payable as a result of the exit.

The asset distributions from the trust will not give rise to a Stamp Duty charge as no consideration is to be received by the trust. From an IT perspective any dividends received after the date the trust terminates will be reportable by Susan and Oliver separately. The two individuals will have the availability of the dividend allowance which currently allows £2,000 per year in dividends to be taxed at a rate of 0%. This allowance is not available to the trust.

OPTIONS FOR DISTRIBUTION TO SUSAN

Susan has indicated that, being financially secure, she is planning to retain the trust assets in the long term to provide income and in the hope of long-term capital growth.

As Susan is planning to retain the assets, to ensure tax efficiency, it is important that the trustees and Susan ensure the availability of CGT hold over relief as described above. This will enable Susan to acquire the assets pregnant with gains but this should result in an enhanced income return as no shares will need to be sold to settle any CGT liabilities.

An option is available to the trustees in respect of the distribution to Susan that will greatly reduce the IHT charge.

The trust is, as previously described, a discretionary trust and the trustees have the power to advance the capital to the beneficiaries at any time at their absolute discretion. This means that the trustees do not necessarily need to wait until 3 May 2021 to advance the funds to Susan.

It will be beneficial, from a taxation perspective, to transfer Susan's 'share' of the trust assets to her prior to the ten-year anniversary on 22 December 2020. This is because the exit charge that arises is a proportional charge based upon the number of complete quarters that have passed since the last ten-year anniversary that is now referenced back to 22 December 2010.

At the ten-year anniversary in 2010, the actual rate of tax was far lower because of the greatly reduced asset prices compared with the current valuation. The IHT charge arising as a result of the exit before the ten-year anniversary amounts to £6,206 (Appendix 3), this is £16,676 less than the charges that arise if no action is taken which amount to £22,882 (50% share of £44,697 + £1,068).

As the exit from the trust is a chargeable event for IHT purposes, CGT hold-over relief is still available in full.

Regarding the income held by the trust, the trustees can choose to distribute this income to Susan. As Susan is a higher rate taxpayer, she will be able to reclaim an element of the tax credit associated with the trust income. There will be no adverse tax effect on the trust as the tax pool brought forward will fully cover the tax credit associated to the income distribution.

We therefore recommend that, given Susan's plans for the future, the trustees should consider advancing Susan's 'share' of the trust to her prior to the ten-year anniversary on 22 December 2020. We also recommend that a joint CGT hold over election is entered into by the trustees and Susan to allow the assets to pass to Susan without triggering a CGT payment. Finally, we recommend that a discretionary income distribution amounted to half of the income account £4,000 also takes place before the trust reaches its termination date.

OPTIONS FOR DISTRIBUTION TO OLIVER

Oliver's situation is more complicated. He is hoping to purchase a property in January or February 2021 and it would be ideal if he could use the funds from the trust to fund that purchase. He was planning on utilising the funds realised from the sale of another property but the sale of this property is not likely to take place until the second quarter of 2021 and so this is not an option.

The timing of the distribution to Oliver is key from a tax perspective. The current plan is for the assets to be transferred to Oliver and for him to sell them in January 2021. This is not tax efficient not only due to the IHT cost noted with Susan but also due to CGT implications. Also, if as recommended, Susan's share is distributed before the ten-year anniversary the tax charge on 22 December (which will then be solely attributable to and met from Oliver's share) will be greater and therefore the intention to treat both equally will not be met.

CGT hold over relief is only available when an immediate charge to IHT arises as a result of the transfer of assets. Although the transfer of assets to Oliver in January 2021 will be a capital distribution from the trust it will not give rise to a charge to IHT as a complete quarter will not have passed since the previous ten-year charging point in December 2020. In these circumstances hold over relief will not be available and the trustees will remain assessable on the gain. The significance of this is that the trust gain cannot benefit from for Oliver's capital losses brought forward of £50,000 and further, the trust annual exemption is only half the amount available to Oliver, albeit the tax differential in this respect is small.

Holdover relief will only be in point if the capital distribution is made before 22 December 2020 or after 22 March 2021. However, given that Oliver will sell the assets to fund his new house purchase the distribution needs to be made prior to the ten-year anniversary on 22 December 2020. The taxation implications of this will be identical to those of Susan's described in Appendix 3 with an IHT charge arising of £6,206.

If Oliver does receive the assets before the ten-year anniversary and sells them to fund his new property purchase, CGT of £90,620 (Appendix 4) will be generated. After all tax charges Oliver will be left with funds of £597,817 of the trust assets which will be more than sufficient to finance the new property purchase.

However, the additional aspect of the distribution to Oliver is the expected £200,000 loss that will be generated on the sale of the London property but this will not be realised until the 2021/22 tax year. That potential £200,000 loss may not be carried back to an earlier tax year and therefore Oliver will need to delay the sale of the shares until 2021/22 to allow the London property loss to also be utilised against these disposals.

Oliver will not need to delay the share sale until the London property is actually sold but he will need to wait until the start of the 2021/22 tax year on 6 April 2021. As long as contracts are exchanged for the sale of the London property at some point in the 2021/22 tax year (so before 6 April 2022) the loss on the London property will be relievable against the in-year gains generated by the sale of the trust assets. Delaying the sale of the shares will therefore save £40,000 of additional tax (£200,000 at 20%) and also ensure that the losses generated on the London property are utilised immediately and are not wasted. This delay also means that the CGT itself will not be payable for another year with a payment date now being no later than 31 January 2023.

Of course the downside of this is that Oliver will not be able to generate the funds required to purchase the Bath property without the expensive bridging loan being offered by the bank. However, the cost of the bridging loan is £2,000 per month so a delay of three months, while the trust assets are sold in April 2021, will cost £6,000 compared with the £40,000 CGT tax savings. The cost of the bridging loan could be funded in part by the income distribution from the trust.

The benefits of the delayed share disposal is based solely upon tax considerations and assumed static asset values. Professional advice should be sought as to the likelihood any delay may have on eventual sales prices for the trust assets given the prices can be volatile dependent on market conditions.

It is also beneficial to Oliver to receive a discretionary income payment for the same reasons described regarding Susan.

Based upon Oliver's circumstances we recommend that the trust assets are distributed to him before the December 2020 ten-year anniversary in the same way as for Susan so as to reduce the IHT charge. We also recommend that Oliver and the trustees make a joint CGT hold over election to enable Oliver to utilise his personal capital losses brought forward.

Finally, we recommend that Oliver delays the sale of the trust assets until at least 6 April 2021 to enable the expected loss on the sale of his London investment property to also be relieved in the CGT calculations on the trust assets.

CONCLUSION

The Hodgson Discretionary Trust is in the final stages of its lifecycle and it will cease on or before 3 May 2021.

It is possible for significant tax savings to be made both in relation to IHT and CGT should the trustees and beneficiaries time their actions precisely and bring forward the trust termination.

The IHT savings can be made by advancing the capital assets of the trust to the beneficiaries before the upcoming ten-year anniversary in December 2020. The resulting exit charge is £16,676 per beneficiary less than the ten-year charge and subsequent exit charge due to the mechanisms of the tax charges.

Susan and the trustees will be able to jointly elect to holdover the gain arising from the distribution of assets from the trust which will mean that there is no immediate CGT charge enabling Susan to retain all of the assets to generate the maximum income return as she desires.

Oliver should also receive his distribution before the ten-year charge not in January 2021 as he has requested. He should also delay the sale of the trust assets until the 2021/22 tax year which should enable a total of £250,000 (£200,000 + £50,000) of capital losses to be utilised against the trust gains saving £50,000 in CGT.

Ensuring the timing of the distributions and subsequent sales is structured in this manner ensured the highest proportion of the trust fund passes to the beneficiaries after all relevant taxes have been paid.

Novus Chartered Tax Advisers

3 November 2020

APPENDIX 1

Inheritance Tax ten-year charge 22 December 2020

	£	£
Asset values as at 22 December 2020		
Traditional Banking plc	734,360	
Digital Bank plc	369,278	
International Bank plc	258,647	
UK bank account	22,000	
US bank account	5,000	
Less: Business property relief on Digital Bank plc	(369,278)	
	1,020,007	1,020,007
Effective rate		14.606%
Actual rate (14.606% x 30%)		4.382%
Tax charge (4.382% x £1,020,007)		44,697

APPENDIX 2

Inheritance Tax exit charge 3 May 2021

	£	£
Total trust assets as at 2 November 2020	1,397,285	
Less: Income account balance	(8,000)	
Less: IHT liability – Ten-year charge	(44,697)	
Expected trust assets at winding up	1,344,588	1,344,588
Less: Business property relief on Digital Bank plc		(369,278)
Value of trust assets subject to tax		975,310
Effective rate		14.606%
Actual rate (14.606% x 30%)		4.382%
Tax charge (4.382% x 1/40 x £975,310)		1,068

APPENDIX 3

Inheritance Tax exit charge on Susan's share of assets before 22 December 2020

	£
Total trust assets as at 2 November 2020 (excluding income account)	1,389,285
Less: Business property relief on Digital Bank plc	(369,278)
Value of trust assets potentially subject to tax	1,020,007
Less: 50% reduction for Oliver's effective share	(510,003)
Value of trust assets subject to tax	510,004
Tax charge (1.248% x 39/40 x £510,004)	6,206

APPENDIX 4

Capital Gains Tax Calculation – Oliver's 'share'

	£	£
Total value of chargeable assets as at 2 November 2020		
Traditional Banking plc	734,360	
Digital Bank plc	369,278	
International Bank plc	258,647	
	1,362,285	1,362,285
Less: CGT base cost		
Traditional Banking plc	172,000	
Digital Bank plc	50,000	
International Bank plc	98,000	
	320,000	320,000
Gain		1,042,285
Less: 50% share attributable to Susan		(521,142)
Less: IHT paid on exit charge (excluding cash element)		(6,042)
Chargeable gain		515,101
Less: Annual exemption		(12,000)
Less: Capital losses brought forward		(50,000)
Taxable gain		453,101
Tax at 20%		90,620
Memo: Net assets received after tax		
Total trust assets at 2 November 2020 (excluding income account)	1,389,285	
Less: 50% reduction for Susan's share	(694,642)	
Less: IHT payable (exit charge)	(6,206)	
Less: CGT payable	(90,620)	
Net assets received by Oliver after tax	597,817	597,817