The Chartered Institute of Taxation

Application and Professional Skills

Inheritance Tax, Trusts & Estates

May 2023

Suggested solution

<u>Report to the trustees of the Avani Chandra Will Trust and the Chandra Discretionary Trust</u>

This report is prepared for the trustees of the above trusts and is issued in accordance with our engagement letter dated 1 May 2023. It may not be relied upon by any other person or entity without our prior written consent.

The report considers the tax implications of the sale of shares in Coastal Retreats Ltd held by the Avani Chandra Will Trust and a transfer of shares in Traditional Storage Ltd to Sunil. It is based on the information provided by the trustees in their email of 8 May 2023 and information held in our files and is based on legislation in force on today's date. If there is a delay in implementing our recommendations, a significant fiscal event (such as a Budget), or a change in circumstances, confirmation should be obtained to confirm whether the recommendations in this report have changed.

1. Executive Summary

We recommend that the trustees of the Avani Chandra Will Trust sell their holding of shares in Coastal Retreats Ltd and appoint the net cash proceeds out to Priya and Ravi equally. Total tax charges of £35,768 will arise by taking this option (comprising £23,770 capital gains tax ("CGT) and £11,998 inheritance tax ("IHT")) leaving net funds of £699,232 for Priya and Ravi. This compares to a minimum tax charge of £41,258 and net proceeds of £693,742 if the shares are appointed out of the trust to Priya and Ravi and they then sell them personally.

We suggest waiting until April 2024 and then appoint five shares in Traditional Storage Ltd to Sunil from the Chandra Discretionary Trust instead of Priya gifting shares to him. The transfer out of the trust will result in £6,770 CGT for the trust compared to £47,611 CGT for Priya. A gift of shares from Priya would also result in her losing a controlling ownership of the company and 50% IHT Business Property Relief ("BPR") would not be available on the new commercial property.

We also recommend that Priya considers transferring her shareholding in Traditional Storage Ltd into joint names with Richard to enable him to qualify for 50% BPR on his half share of the new commercial property when the property is purchased.

2. Avani Chandra Will Trust

<u>Trust Background</u>

The trust is an "interest in possession" ("IIP") settlement and originally provided Jayesh with a right to receive the trust income during his lifetime. It was created under the terms of Avani's Will, so Jayesh acquired an immediate post-death interest and as this was a qualifying interest in possession ("QIIP") for IHT purposes the value of the trust assets would have been aggregated with his estate on his death.

Priya and Ravi became successive life tenants after their father's death and it is at this point that the trust changed from being a QIIP to a relevant property trust ("RPT"). Under the RPT regime, the trust will be liable to IHT periodic charges on each ten year anniversary of its original creation and IHT exit charges will arise if the trustees advance capital out of the trust.

It should be noted that as Jayesh was the last holder of a QIIP in the trust, for IHT purposes he is treated as the settlor of the new RPT which commenced on 20 April 2020. Therefore, it is his gifting history in the seven years prior to 20 April 2020 which should be taken into account when any IHT charges are calculated, rather than Avani's.

The Chandra Discretionary Trust was also created on 20 April 2020 under the terms of Jayesh's Will, so this trust is a related settlement and the value of the 20 shares in Traditional Storage Ltd must also be included in the IHT calculations.

a. Sale of shares in Coastal Retreats Ltd

The trust holds 100 shares in Coastal Retreats Ltd and the trustees have been offered £7,350 per share to acquire the shareholding.

The trustees would like to wind up the trust, which can be done by exercising a power to advance the trust assets to Priya and Ravi equally. The power could be exercised after the trustees sell the shares, so the net cash proceeds are appointed to Priya and Ravi, or the shares could be advanced to them now and they would then sell them on personally. The tax implications of each option are covered below.

i) Option 1 – Wind up the trust after share sale

CGT

If trustees sell the shares, a capital gain of £125,000 will arise, which is the difference between the sale proceeds of £735,000 and the probate value of £610,000 on 20 April 2020. When Jayesh's life interest ended the trustees' base cost will have been uplifted to the value on 20 April 2020, however, as the shares would have qualified for 100% BPR for IHT purposes their value will be need to be agreed with HMRC for CGT purposes.

The gains on trust shareholdings are taxed at 20% after deducting the trust annual exemption of £6,150. Business Asset Disposal Relief ("BADR") may be claimed on a trust gain if a beneficiary holds an IIP and there is a disposal of shares in a qualifying company, allowing a 10% CGT rate to apply instead.

To qualify the shares must be held in an unquoted trading company, the beneficiary must be an employee or officer of the company and must also personally hold 5% of shares for a period of two years ending within three years up to the date of disposal.

Whilst Coastal Retreats Ltd is an unquoted trading company and Priya and Ravi both hold an IIP in the trust, neither are employees or officers of the company and Ravi does not personally hold 5% of the shares, so BADR will not be available on the disposal. Therefore, the trust will be liable to CGT at the 20% rate, resulting in a liability of £23,770, payable to HMRC by 31 January 2025. See calculation at **Appendix 1**.

The net sum to advance out of the trust to the beneficiaries after CGT will be £711,230 (£355,615 each). There will be no CGT payable on the advancement of this sum to Priya and Ravi as it is a cash payment.

IHT

As Avani's trust is now an RPT, an IHT exit charge will arise when the cash funds are advanced to Priya and Ravi.

The exit is prior to the first ten year anniversary of the trust, so the tax rate applicable is calculated using the value of the trust assets when it became an RPT on 20 April 2020 together the value of the assets in the Chandra Discretionary Trust, as a related settlement, but before any reliefs, such as BPR, are applied. The exit charge only applies to the period during which the trust was an RPT, so in this case, it will only cover the period running from 20 April 2020 up to the date in on which the cash is advanced to the beneficiaries.

An IHT exit charge of £11,998 will become payable, see calculation at **Appendix 2**. The trustees will be required to complete form IHT100 to declare the exit of the assets from the trust and the IHT liability will become due for payment to HMRC by 31 March 2024, assuming the cash is advanced to Priya and Ravi during September 2023.

The total tax cost will be £35,768 (£23,770 CGT plus £11,998) which will leave a net cash sum of £699,232 (or £349,616 each to Priya and Ravi).

ii) Option 2 – Advancing the shares to beneficiaries prior the sale

CGT (without holdover relief)

If the shares are advanced to Priya and Ravi, for CGT purposes this will be a deemed disposal at market value by the trustees and as before a capital gain of £125,000 will arise on which £23,770 CGT will become payable (see previous calculation at **Appendix 1**).

The onward sale will be personal sales by Priya and Ravi and the cost of their shares from the trust will be pooled together with the shares they inherited directly from their mother. Neither Priya nor Ravi are able to claim BADR on a personal sale of the shares as they do not meet all the qualifying conditions.

With this option the personal CGT payable on the shares appointed out of the trust will amount to £16,909 for Priya and £10,333 for Ravi (see **Appendix 3** for calculations).

This means the total tax cost of this option will be £51,012 (£23,770 trust CGT, £16,909 CGT for Priya and £10,333 CGT for Ravi), which will leave a net cash sum of £683,988 (or £338,706 to Priya and £ 345,282 to Ravi).

CGT (with holdover relief)

There is another option in this scenario to reduce the tax payable. As the gain relates to the transfer of shares in an unquoted trading company, CGT holdover relief may be claimed. The effect of the claim is that the trustees will have no CGT to pay on the gains and Priya and Ravi will acquire the assets at the trustees' base cost instead of the market value. The claim must be made jointly between the trustees and the beneficiaries within four years from the end of the tax year of the appointment.

As before, Priya and Ravi will sell the shares in their own names after they are transferred out of the trust and the new base cost will be pooled together with their other personal shareholdings in Coastal Retreats Ltd.

The calculations at **Appendix 3** show that on the subsequent sale of the shares that came out of the trust £22,591 CGT will be payable by Priya and £18,667 CGT will be payable by Ravi. if a full holdover claim is made.

Therefore, the total tax cost of this option will be £41,258, leaving net cash of £693,742 (£344,909 to Priya and £348,833 to Ravi).

IHT

The trust is an RPT, so an IHT exit charge would usually arise when the shares are appointed out. However, so long as this occurs before contracts for the sale of the shares are signed, the exit will qualify for 100% BPR and no IHT will be due. It must be noted that once a binding contract for sale is in place, the shares will fail to qualify for BPR and an exit charge will arise, so timing is crucial with this option.

The shares qualify for BPR because the company is an unquoted trading company and its trade does not fall within the excluded activities of dealing in securities, stocks or shares, land or buildings or making or holding investments, the trust has owned the shares for two years and the company does not hold any excepted assets (that is, assets that are neither used for business purposes throughout the previous two years nor required for future use in the business).

Recommendation

We recommend that Avani's Trust sells its holding of shares in Coastal Retreats Ltd and then advances the net cash proceeds out to Priya and Ravi.

This option results in tax charges of £35,768, compared to £51,012 if the shares are appointed out to Priya and Ravi without claiming holdover relief or a liability of £41,258 if holdover relief is claimed.

The difference arises because despite the trustees having to pay both CGT on the share disposal and IHT on the appointment of the cash with this option, if the shares are appointed out to Priya and Ravi for a personal sale, the CGT share pooling rules prevent them from getting the full benefit of the uplift in the base cost to market value on the trust holding because the cost is diluted by being pooled together with the lower value shares inherited in 2016.

b) Transfer of shares in Traditional Storage Ltd to Sunil

i) Appointment from Chandra Discretionary Trust

The trust capital may be transferred to any of the beneficiaries under the terms of the Chandra Discretionary Trust at any time, but Jayesh left a Letter of Wishes requesting that the trustees should only consider transferring 10% of the trust capital (that is, two shares) to any beneficiary before they are 25 years old.

Whilst the trustees do not have to follow this request, it is understood that you want to act in accordance with your father's wishes, in which case the transfer five of shares to Sunil from the trust should be delayed until his 25th birthday on 18 April 2024.

The appointment will have the following tax consequences:

CGT

For CGT purposes, an appointment will be a deemed disposal at market value by the trustees, so will result in a chargeable event.

Therefore, assuming the share value is the same in April 2024, the deemed proceeds for five shares will be £490,000. The trustees' base cost is the probate value of those shares on 20 April 2020, which was £450,000, so the capital gain will be £40,000. It is suggested that an up to date share valuation is obtained in April 2024 as this is over a year away.

The trust's 2024/25 CGT annual exemption of £6,150 will be deducted, leaving a taxable gain of £33,850. This will be taxed at 20%, resulting in a CGT liability of £6,770 for the trustees payable to HMRC by 31 January 2026.

CGT holdover relief may usually be claimed on an appointment of shares in an unquoted trading company out of a trust because the shares qualify as business assets. However, in this case because Sunil is not UK resident, a claim for holdover relief will not be available.

IHT

The Chandra Discretionary Trust is a RPT so an IHT exit charge will arise when the shares are appointed out. However, the shares in Traditional Storage Ltd will qualify for 100% BPR, so no IHT will be payable on this event assuming there have been no changes in the company's business operations by April 2024.

The shares should qualify at this date on the basis that Traditional Storage Ltd remains an unquoted trading company and the shares have been owned by the trust for two years. There must also be no indication that a binding contract for the sale of the shares is in place and the company must continue to not hold any excepted assets at this date.

Even though IHT should not become payable due to the availability of 100% BPR, the trustees must still complete form IHT100 to declare the exit of the shares from the trust to HMRC by 31 October 2024 if the shares are appointed to Sunil in April 2024.

ii) Direct gift from Priya

CGT

If Priya gifts five shares out of her personal holding to Sunil, for CGT purpose this will be a disposal by her made at market value as she and Sunil are connected parties.

The base cost of her 54 shares is £150,030 (comprising £150,000 for the 24 shares gifted by Jayesh in 1998 and only £30 for the 30 shares gifted by Avani in 2012 due to the holdover relief claim made), which is £2,778 per share. Therefore, her gain on a gift of five shares to Sunil will be £476,108 (£490,000 - £13,892).

Priya's shares will qualify for the 10% BADR CGT rate as the company is an unquoted trading company, she holds a 5% interest in the company and is an officer of the company and has met these conditions for two years.

She already utilises her CGT annual exemption each year on quoted share disposals, so the CGT on the transfer to Sunil will be £47,611, due for payment to HMRC by 31 January following the end of the tax year of the transfer. Again, CGT holdover relief will not be available as Sunil is not UK resident and he will acquire the shares at the current market value for future disposals.

IHT

The gift to Sunil will be a potentially exempt transfer ("PET") by Priya for IHT purposes and the value is calculated using the loss to donor principle, meaning the value of Priya's shareholding before and after the gift, are compared to calculate the loss to her estate. The value of the PET will account for any discounts applied for minority shareholdings, so Priya's PET to Sunil will be considerable as her shareholding will reduce from a controlling holding (of 54 shares) before the gift to Sunil down to a non-controlling holding (49 shares) after the gift.

The value of the PET can also be reduced by Priya's IHT annual exemption of £3,000 in the tax year of the gift and £3,000 from the previous tax year if she has not made any gifts in that year.

If Priya survives seven years from making the gift it will fall outside the charge to IHT. If she does not survive seven years, the PET will become chargeable and will utilise her IHT nil rate band on death in priority to the remainder of her estate.

The value charged to IHT can be reduced by 100% BPR, provided the assets qualify at the date of the PET to Sunil and on Priya's death within seven years. The shares currently qualify for 100% BPR, so if Sunil retains them and the company continues to qualify or if he sells them and replaces them with other BPR qualifying assets, then the relief will be available if Priya does not survive seven years from making the PET.

In the circumstance that 100% BPR is not available, the value after tax reliefs exceeding the NRB on death will become liable to IHT at 40% and the IHT will be payable by Sunil as donee. If Priya survives more than three years, a tapering relief will be available to reduce the IHT rate applicable.

As referred to above, a transfer of five shares from Priya to Sunil will push her own holding down to 49 shares, so she will no longer control Traditional Storage Ltd. This is of relevance because the new commercial property that she intends to purchase with Richard for the company to use will qualify for 50% BPR in respect of her half share, but only if control of the company is retained.

Recommendation

We recommend that five shares in Traditional Storage Ltd are transferred to Sunil from the Chandra Discretionary Trust on or after 18 April 2024. This option results in a much lower CGT liability of £6,770 for the trustees which can be met out of the trust's cash account compared to a CGT liability of £47,611 for Priya if she gifts shares to Sunil. It also avoids the loss of BPR on the new commercial property and prevents Priya from using up a large proportion of her CGT BADR lifetime limit. The transfer will also follow the request made by Jayesh in his Letter of Wishes.

The appointment of the shares out of the trust will not result in an IHT exit charge because 100% BPR should be available. In comparison, if Priya loses control of the company by gifting five shares to Sunil, she will lose her entitlement to 50% BPR on her share of the commercial property that is due to be purchased shortly, which will leave the full value of the property subject to IHT on her death.

It is also recommended that Priya considers transferring her shares into joint names with Richard as his half of the commercial property will not qualify for any IHT relief on death. Joint ownership of the controlling shareholding will allow both parties to qualify for 50% BPR on their respective half shares of the property. The transfer into joint names will not result in a CGT liability as the transfer between spouses will be at a nil gain/loss and Richard will acquire his interest in the shares at Priya's base cost and the transfer will be covered by the spouse exemption for IHT purposes.

Appendices

Appendix 1

CGT on sale of shares in Coastal Retreats by the Avani Chandra Will Trust

	£
Proceeds (100 shares @ £7,350)	735,000
Less: Cost (probate value 20 April 2020)	(610,000)
Gain	125,000
Less: 2023/24 Trust Annual Exemption	(6,150)
Taxable Gain	118,850
CGT @ 20%	**23,770**

Appendix 2

IHT exit charge on the advancement of cash out of the Avani Chandra Will Trust

	£	£
Initial value of relevant property (15 January 2016)		0
Value of property converted to RPT (20 April 2020)		610,000
Value of property in related settlement (Chandra Discretionary Trust) on 20 April 2020		1,800,000
		2,410,000
Less: Available nil rate band		
Nil rate band at exit (2023/24)	325,000	
Reduced by Jayesh's chargeable transfers in the 7 years prior to 20 April 2020	(0)	
	)	
		(325,000)
	)	2,085,0000
Tax @ 20%		417,000

Effective rate is $\frac{417{,}000}{2{,}410{,}000}$ X 100 = 17,303%

Exit charge applies between 20 April 2020 and 30 September 2023 — 13 quarters

Actual rate is $\frac{13}{40}$ x 30% x 17.303% = 1.687%

Value leaving the trust	711,230	
IHT payable by beneficiaries £711,230 x 1.687%		**£11,998**

Appendix 3

Calculation of CGT payable by Priya & Ravi on the sale of their shares in Coastal Retreats Ltd

Priya's Share Pool

Date	Event	No	No holdover relief Cost (£)	Holdover relief Cost (£)
15 Jan 2016	Inheritance (£4,250 per share)	60	255,000	255,000
June 2023	Appointment out of trust	50	367,500	305,000
Pool c/fwd		110	622,500	560,000

Ravi's Share Pool

Date	Event	No	No holdover relief Cost (£)	Holdover relief Cost (£)
15 Jan 2016	Inheritance (£4,250 per share)	25	106,250	106,250
June 2023	Appointment out of trust	50	367,500	305,000
Pool c/fwd		75	473,750	411,250

CGT on sale of shares appointed out of the trust

NO HOLDOVER RELIEF	**Priya** £	**Ravi** £
Proceeds (50 shares @ £7,350)	367,500	367,500
Less: Cost		
Priya 50/110 x 622,500	(282,955)	
Ravi 50/75 x 473,750		(315,833)
Taxable Gain (annual exemptions utilised already)	84,545.	51,667
CGT @ 20%	**£16,909**	**£10,333**

WITH HOLDOVER RELIEF	**Priya** £	**Ravi** £
Proceeds (50 shares @ £7,350)	367,500	367,500
Less: Cost		
Priya 50/110 x 560,000	(254,545)	
Ravi 50/75 x 411,250		(274,167)
Taxable Gain (annual exemptions utilised already)	112,955	93,333
CGT @ 20%	**22,591**	**18,667**