

# **The Chartered Institute of Taxation**

## **Application and Professional Skills**

### **Inheritance Tax, Trusts & Estates**

**May 2024**

**Suggested answer**

## **Report to the trustees of the Lucy Reed Will Trust**

This report is prepared for the trustees of the Lucy Reed Will Trust and is issued in accordance with our engagement letter dated 31 March 2024. It may not be relied upon by any other person or entity without our prior written consent.

It considers the tax issues arising on the sale of shares in Honey Group plc (“HG plc”), the sale of Lavender Cottage (“Lavender”), the distribution of funds to Jessica and the transfer of 250 shares in Floral Scents Ltd (“the Company”) to Charlotte.

The report is based on information provided by the trustees and the legislation in force at today’s date. If there is a delay in implementing our recommendations, or a significant fiscal event (such as a Budget), or a change in circumstances, confirmation should be obtained to check whether the recommendations have changed.

### **1. Executive Summary**

We recommend that the executors of Lucy’s estate should make a claim for inheritance tax (“IHT”) loss relief in relation to the sale of the shares in HG plc as these have fallen in value by £27,000 since 15 June 2022. This claim will result in an IHT refund of £10,800.

We also recommend that the trustees transfer Lavender to Jessica before 15 June 2024 and she should then sell the property to the third-party purchaser personally. This should be followed by a distribution of £16,200 to Jessica in October to provide her with the £90,000 required to settle her university fees.

No capital gains tax (“CGT”) will be payable on the transfer of Lavender to Jessica as the gain will be fully covered by principal private residence relief and this option will result in an IHT exit charge of £203 for the trustees compared to an IHT exit charge of £1,127 if they sell Lavender themselves followed by a £90,000 cash distribution to Jessica.

In relation to the appointment of 250 shares in the Company to Charlotte, we recommend the trustees delay the appointment until after 15 June 2024 as this will allow a claim for capital gains holdover relief to be made as a corresponding IHT exit charge will arise on the same event. The holdover claim will allow a gain of £148,750 to be deferred, saving the trustees £29,150 CGT.

### **2. Lucy Reed Will Trust**

The Lucy Reed Will Trust was created on Lucy’s death on 15 June 2022 under the terms of her Will. The assets are held on discretionary trust for the benefit of Lucy’s children and future grandchildren.

The trust is a relevant property trust (“RPT”), so is liable to IHT principal charges based on the value of the assets on each ten-year anniversary of its creation on Lucy’s death. In addition, a capital distribution from the RPT will give rise to an IHT exit charge.

#### **a. HG plc, Lavender and capital distribution to Jessica**

The trustees want to help Jessica pay her university fees by making a one off £90,000 lump-sum payment to the University in October 2024. The shares in HG plc were sold by the executors in 2023/24 but there are various bills to pay on Avenue House, which means there will be insufficient cash funds to fund the lump sum payment.

The trustees have proposed to raise the additional funds by selling Lavender. One option is for the trustees to sell the property and make a capital distribution of £90,000 to Jessica in October. Alternatively, they can transfer Lavender to Jessica to sell personally and then distribute a balancing payment of cash to her in October so she can pay the fees.

## **i. Sale of shares in HG plc**

### CGT

There was a compulsory acquisition of the estate's shareholding in HG plc in May 2023 for £43,200 and as the executors' base cost is the probate value of £70,200 plus the allowance permitted under Statement of practice 2/2004 (SP2/04), a capital loss of £27,143 arose on this disposal.

This was a sale by Emma and Alex in their capacity as executors of the Lucy's estate. The administration period ended on 31 August 2023 and no further disposals were made, so no CGT relief will be available for the £27,143 loss, leaving it unutilised.

The loss cannot be carried forward against and offset against the capital gain arising on the sale of Lavender referred to below or against any gains arising on the disposal of other trust assets in the future as it is an estate loss, not a loss belonging to the Will Trust.

### IHT Loss Relief

Instead of claiming an unrelievable capital loss on the disposal of the HG plc shares, the executors have the option to claim IHT loss relief. This is available when quoted shares, authorised unit trusts or shares in open ended investment companies are sold at a value lower than their probate value within 12 months years of the deceased's death. It will allow the lower sale value to be substituted for the probate value, which will reduce the taxable value of Lucy's estate and provide an IHT refund.

The gross proceeds of all shareholdings sold up to 15 June 2023 (12 months years from Lucy's date of death) must be considered together, but in this case the compulsory purchase of HG plc shares was the only disposal made.

Any costs of sale and the SP2/04 allowance are ignored when calculating the IHT loss, therefore, the loss relief claim will produce an IHT refund of £10,800 (£27,000 x 40%). Emma and Alex, as executors of Lucy's estate, must submit a claim to HMRC by 15 June 2027 (five years from Lucy's date of death) to obtain the refund.

Once the claim is made, the original capital loss of £27,143 on the sale of HG plc shares can no longer be claimed, as the probate value of the shares will be reduced to £43,200.

### Recommendation

We recommend that the executors make this claim and obtain the £10,800 IHT refund as the £27,143 capital loss cannot be utilised in any way.

## **ii. Sale of Lavender by the trustees and cash distribution to Jessica**

### CGT

A capital gain will of £13,800 arise on the sale of Lavender by the trustees in August 2024. This is based on the difference between the £75,000 sale proceeds and the £60,000 probate value and after accounting for the £1,200 costs of sale.

Trustees are able to claim principal private residence ("PPR") relief to exempt gains from CGT where they have allowed a beneficiary to live in a trust property as their main residence. In the case of Lavender, as Charlotte lived in the property as her main residence after Lucy's date of death until the end of January 2024, the trustees may claim PPR relief for this period. PPR relief may also be claimed for the remaining period of ownership from February 2024 to August 2024 because this falls within the final nine months of ownership, so will be treated as a period of deemed occupation for the purpose of the relief. Therefore, the trustees gain will be fully covered by PPR relief and no CGT will be payable.

The trustees will not be required to complete a CGT return as no tax is payable on the sale of Lavender, but they will be not automatically entitled to PPR relief in the same way as individuals. Instead, the trustees must submit a claim for PPR relief to HMRC within four years from the end of the 2024/25 tax year and the easiest way to do this will be to include the claim on the trust's 2024/25 self-assessment tax return.

The trustees will be left with a balance of £73,800 from the sale proceeds after accounting for the costs of sale. Therefore, £16,200 will need to be withdrawn from the cash accounts to fund the balance of the required £90,000 distribution to Jessica in October.

#### IHT Exit Charge

An IHT exit charge will arise when the capital distribution of £90,000 is made to Jessica in October. The distribution will fall within the first ten years of the trust, so the IHT rate applicable will be calculated based on the value of the assets on creation but before any reliefs, such as IHT business property relief ("BPR"), are applied, and the number of quarters that have elapsed since creation.

We calculate an IHT exit charge of £1,127 will arise on the distribution to Jessica (see Appendix 1). The trustees will be required to complete form IHT100 to disclose the distribution to HMRC and the liability will become payable by 30 April 2025.

### **iii. Appointment of Lavender to Jessica to sell and balancing distribution**

#### CGT

The appointment of Lavender to Jessica will be made after the estate administration period has ceased, so there will be a deemed disposal by the trustees for CGT purposes calculated in the normal way based on the difference between the market value at the date of the appointment and the probate value of the property. However, as referred to above, no CGT will become payable as the trustees will be able to claim PPR relief to fully cover the gain.

Jessica will acquire Lavender from the trustees at the market value of £75,000, so the onward disposal of the property by her will itself result in a capital loss of £1,200, relating to the costs of sale she will incur. Jessica can offset this loss against any other personal capital gains arising in 2024/25 and then carry it forward against any personal gains in the future.

#### IHT Exit Charges

An IHT exit charge normally arises when capital distributions are made from a RPT. However, when distributions are made from a discretionary trust created under the terms of a Will within two years of the date of death, the distribution is deemed to have been made by the deceased in their Will, so this means an exit charge will not arise.

Therefore, if the trustees appoint Lavender to Jessica before 15 June 2024, no IHT exit charge will arise. Jessica will receive £73,800 net proceeds from the property sale after the costs of sale are paid and the trustees will then need to distribute a further £16,200 to her in October so she can pay her fees. The £16,200 distribution will result in an IHT exit charge of £203 (see Appendix 1).

This distribution will need to be reported to HMRC on a IHT100 form and the exit charge will become due for payment by 30 April 2025.

#### Recommendation

If the trustees sell Lavender followed by a capital distribution of £90,000 to Jessica in October, an IHT exit charge of £1,127 will become payable. In comparison, if Lavender is transferred to Jessica before 15 June 2024 to sell personally, followed by a £16,200 distribution in October, there will be an IHT exit charge of only £203. Jessica will also have a personal capital loss of £1,200 to offset against her capital gains in the future.

Therefore, we recommend that the trustees transfer Lavender to Jessica before 15 June 2024 and she should then sell the property to the buyer herself. A distribution of £16,200 cash should then be made to Jessica in October, as this provides the best tax outcome.

Jessica will not be required to complete a CGT Return when she sells the property to the third party purchaser as there is no CGT payable, but she should enter details of the sale on her 2024/25 personal tax return to claim the £1,200 capital loss that will arise.

## **b. Appointment of shares in the Company to Charlotte**

### IHT

Lucy had planned to gift 250 shares in the Company to Charlotte during her lifetime and the trustees would like to vary her Will to carry out her intentions. Unfortunately, it is not possible to do this by entering into a Deed of Variation without obtaining court approval because some of the potential beneficiaries of the estate cannot provide their consent, including Lucy's daughters Chloe and Grace, who are still under the age of 18.

However, it is possible to achieve the trustees' objective by appointing the shares out of the trust to Charlotte prior to 15 June 2024. As referred to above, if the capital distribution occurs within two years of Lucy's date of death there will be no IHT exit charge as the distribution will be deemed to have been made by Lucy in her Will.

If the appointment of shares to Charlotte is delayed until after the cosmetic company meetings in September 2024, more than two years will have passed since Lucy's death and an IHT exit charge will arise, although BPR may be available on this event, so no IHT becomes payable.

BPR is available on qualifying business property and 100% relief applies to unquoted shares if certain conditions apply. The first condition is that the company must be mainly trading and not carrying out dominant investment activities. Trading activities are not defined in the IHT legislation and so take its ordinary meaning, but BPR will not apply if a company is wholly or mainly dealing in securities, stocks or shares, land or buildings or making or holding investments.

The Company carries out investment activities by renting out flats as well as its trading activity of manufacturing and selling candles and perfumes, so it is necessary to consider whether it is still mainly trading for BPR purposes.

Many tax cases have considered the meaning of "wholly or mainly holding investments" and the leading case on this area set out five factors which must be considered when looking at BPR claims. The factors are how the capital of the business is employed, the split of the turnover between trading and investment, the profits generated by each side of the business, the time spent by employees and directors and the overall context of the business. This must then be considered "in the round" and if it is considered that more than 50% of the company's activities relate to investment activities, BPR will be denied.

Looking at the Company financial information, the turnover from trading activities exceeds investment income with 76% relating to trading activities in the two most recent accounting periods. In addition, the trading side represents around 70% of the profits during the same period. The value of the investment property is however higher than the property and plant and machinery relating to the trading side, representing 60% of the value of the Company's fixed assets. However, clearly no staff or director time is spent on the investment side as this is entirely outsourced to a letting agency.

Looking at the overall context of the business, even though the value of the investment property is higher than the trading assets, the other factors still point to the company carrying out mainly trading activities, so this BPR condition should be met.

The other BPR conditions are that the shares must have been owned for at least two years, must not be listed on a recognised stock exchange and must not be subject to a binding contract for the sale of the shares at the relevant date. Finally, 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 future use of the business.

The trust's shareholding will have been owned for over two years after 15 June 2024, the Company is unlisted and so long as the shares are transferred to Charlotte before any contracts for sale are signed, the next three BPR conditions are met.

The financial information shows there are no excepted assets, although HMRC can restrict BPR where there are cash balances held which are surplus to a company's business needs. The balance sheet at 31 March 2024 shows the Company has £162,000 cash, but as this is quite a small proportion of the turnover this is likely to be needed for working capital, so BPR should not be restricted. The residential flats will not be treated as excepted assets as although they are not used in the trade, they do form part of the overall business.

### CGT

The appointment of shares to Charlotte will be a deemed disposal at market value for CGT purposes resulting in a taxable gain of £145,750 for the trustees. As the trust is discretionary, CGT business asset disposal relief will not be available to the trustees, so the gain will be taxed at 20%, resulting in a CGT liability of £29,150 due for payment by 31 January 2026 (Appendix 2).

General holdover relief is available to defer the payment of CGT when assets are appointed out of a RPT, so long as there is a corresponding IHT charge on the same event. However, if the shares are appointed to Charlotte before 15 June 2024, there will not be an IHT exit charge as the distribution falls within two years of Lucy's death, so holdover relief will be denied.

Business asset holdover relief is also available to the trustees if business assets, including shares in unquoted trading companies, are transferred out of the trust. For CGT purposes, a trading company is defined as “a company carrying on trading activities whose activities do not include, to a substantial extent, activities other than trading activities”. The key word in the definition is “substantial” and HMRC consider this to mean more than 20%.

In a similar manner to the IHT test, the 20% CGT test will be applied to the Company's turnover and profits, its asset base, expenses incurred or time spent by employees and directors on investment versus trading activities.

The analysis of the Company's financial information for BPR purposes above showed that 24% of its turnover and 30% of the profits relate to investment activities. In addition, 60% of the Company's asset base relates to investments, although the Company's expenses and time spent by the employees and directors on the investment side clearly fall below the 20% level.

On the basis that three of the CGT tests indicate that the Company's investment activities are substantial, it seems unlikely that trading status will be achieved for CGT purposes and a claim for holdover relief on the basis that the shares are business assets may be denied.

In comparison, if the trustees wait until after the meetings in September 2024 to appoint the shares to Charlotte, CGT holdover relief will become available as an IHT exit charge will arise on the same event, albeit no IHT will become payable as 100% BPR may be claimed.

The effect of the holdover claim is that the trustees will defer payment of the CGT liability on the appointment and Charlotte will be treated as acquiring the shares at their value on Lucy's death for the purpose of any future disposals.

## Recommendation

The trustees do not need to wait until after the meetings in September to appoint the shares to Charlotte, but we recommend that this is delayed until after 15 June 2024 at the earliest.

Delaying the appointment until two years have passed since Lucy's date of death will trigger an IHT exit charge, but 100% BPR may be claimed so no IHT will be payable, and this will allow a claim for holdover relief to be made to defer the payment of £29,150 CGT. It is important to ensure that the appointment of the shares to Charlotte takes place before the contract for the sale of the company's shares is signed to preserve access to BPR.

The trustees must still submit a form IHT100 to HMRC to report the appointment to Charlotte within six months from the end of the month in which the appointment takes place. A joint claim for holdover relief must also be signed by the trustees and Charlotte and submitted to HMRC by 5 April 2029 (four years from the end of the tax year of the transfer).

## **Appendices**

### **Appendix 1 – IHT Exit Charge on appointment to Jessica**

	£	£
Initial value of assets on 15 June 2022:		
480 ordinary £1 shares in Floral Scents Ltd		3,072,000
Avenue House		650,000
Lavender Cottage		60,000
13,500 shares in HG plc – revised IHT base cost used		43,200
Cash in bank and building society accounts		79,435
		<hr/>
		3,904,635
Less: Liabilities		(16,190)
		<hr/>
		3,888,445
Less: Available nil rate band		
Nil rate band at exit (2024/25)	325,000	
Reduced by Lucy's chargeable transfers in the seven years prior to 15 June 2022	(0)	
		<hr/>
		(325,000)
		3,563,445
Notional tax @ 20%	712,689	
Effective rate	$\frac{£712,689}{£3,888,445} \times 100 =$	18.328%
Quarters between 15 June 2022 and 1 October 2024 (approx.)	9 quarters	
Actual rate	$\frac{9}{40} \times 30\% \times 18.328\% =$	1.237%
Grossed up rate as IHT payable by trustees	$\frac{1.237}{(100 - 1.237)} =$	1.252%
Appointment to Jessica	£90,000 x 1.252%	<hr/>
Or		£1,127
Appointment to Jessica (if she sells the property herself)	£16,200 x 1.252%	<hr/>
		£203
		} Due 30 April 2025

**Appendix 2 - CGT on appointment of shares in the Company to Charlotte**  
£

MV of 250 shares (£6,995 per share)	1,748,750
Less: Probate value 15 June 2022	<u>(1,600,000)</u>
Gain / (Loss)	148,750
Less: 2024/25 Trust Annual Exemption	<u>(3,000)</u>
Taxable Gain	<u><u>145,750</u></u>
CGT @ 20%	<u><u>£29,150</u></u>