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November 2019

Application and Professional Skills

Inheritance Tax, Trusts & Estates

Suggested solution

REPORT TO THE TRUSTEES OF PEARSON LEGACY TRUST ON

1) **THE CHANGE OF STRATEGY BY SOUTH WEST BESPOKE PROPERTIES LTD**
2) **TAX EFFICIENT STRUCTURING OF REMAINING CAPITAL APPOINTMENTS**

INTRODUCTION

As requested in the telephone call from Andrea Loom on 4 November 2019, this report considers:

1) The tax implications for the Pearson Legacy Trust of the change in strategy by South West Bespoke Properties Ltd.

2) Tax efficient ways of structuring the remaining capital appointments from the trust.

This report is based upon the information provided by Andrea Loom, the trust deed and accompanying documentation that we hold. This report assumes that the most recent valuations remain constant going forward.

EXECUTIVE SUMMARY

The Pearson Legacy Trust currently holds a minority interest in South West Bespoke Properties Ltd ("SWBP"). SWBP has historically been a trading company although this will shortly change, and it will become an investment company. The directors of SWBP have made arrangements that will give minority shareholders, such as the trust, the option to sell their shares should they wish.

This strategy change has significant Inheritance Tax ("IHT") implications for the trust. The IHT charges on the remaining capital appointment will significantly increase. This increase is due to the loss of Business Property Relief (BPR) on the SWBP shares as the company becomes an investment company. If the trustees choose to accept the offer to sell their SWBP shares significant Capital Gains Tax ("CGT") charges will arise.

The strategy change also coincides with the trust entering the final stages of its lifecycle - Chloe reached age 25 on 18 October 2019 (but has not yet received her share of the fund) and the trust now has one remaining beneficiary, David, who has not yet become entitled to his share of the trust fund but will do so upon attaining 25 on 18 July 2021. The trustees, by virtue of the trust deed, have the power to appoint capital at their discretion meaning they do not need to wait until David attains 25.

The trustees should consider the appropriateness of advancing David's capital appointment as this will save in excess of £59,000 in IHT. The appointment could be advanced so that it occurs while the shares in SWBP still qualify for BPR meaning a significant portion of the assets appointed will be relieved fully from IHT charges.

The beneficiaries, Chloe and David have slightly different short term objectives for their respective shares of the trust fund.

David wants liquid cash from the trust to purchase a property and the appointment of the trust assets, in their current form with an accompanying joint holdover election, will enable him to sell the assets personally. This will be more beneficial from a CGT perspective than the trust selling the shares directly not only because David has a marginally higher annual exemption from CGT but also, he will receive CGT relief for the IHT payable on the capital appointment.

Chloe is not yet sure of her longer terms plans. It is therefore beneficial from a CGT perspective to transfer the assets to Chloe and claim CGT deferral relief in the form of gift relief. This will mean that no CGT charge arises as a result of the appointment to Chloe. Should she then choose to retain the assets no CGT liabilities will have been triggered unnecessarily.

OVERVIEW OF PEARSON LEGACY TRUST

When the trust was created, it was an accumulation and maintenance (“A&M”) trust and at that time was not subject to IHT exit or principal charges.

Changes made to the taxation of trusts with effect from 22 March 2006 mean that some but not all of this type of pre-existing A&M trust are subsequently classified as an 18-25 trust. However, the tax impact of the March 2006 changes on these newly classified trusts was only implemented from 6 April 2008. An 18-25 trust is not liable to the IHT principle charge on each ten year anniversary but is liable to limited IHT exit charges.

The Pearson Legacy Trust is classified as an 18-25 trust as it meets the two criteria, being:

- the class of potential beneficiaries is closed and no further beneficiaries were added post 21 March 2006; and
- the beneficiaries have entitlement to their respective share of capital upon attaining 25.

SOUTH WEST BESPOKE PROPERTIES LTD (SWBP)

There are significant IHT implications arising from the strategy change at SWBP. The majority of the trust’s value derives from its shares in SWBP. These shares have been held for more than two years and as an unquoted trading company, with no apparent investment assets or binding contracts for sale these shares appear to qualify for Business Property Relief (BPR).

BPR is a valuable tax relief for certain types of assets which operates to reduce the value of assets charged to IHT. The rate of BPR on unquoted shares in a trading company is currently 100%, meaning that subject to the ownership rules, the appointment of this asset to a beneficiary will not currently give rise to an IHT exit charge.

BPR legislation requires a company to be mainly trading, this means that more than 50% of its activities must be trading. Other activities can still qualify for BPR if they are within the overall business of the company. However, in the case of SWBP, the directors have stated in their letter that the company will cease its development activities completely at the end of June 2020 and will thereafter focus solely on rental returns. This will mean there will be no trading activity undertaken from that point and the company will become an investment company so BPR will not be available.

This loss of BPR will greatly increase the IHT exit charges on capital appointments made post 30 June 2020. Chloe became entitled to her capital share (to include 50% of the SWBP shareholding) when she reached age 25 on 18 October 2019 and thus her exit charge of £37,034 (as already notified to you) will be unaffected. However, when David reaches age 25 on 18 July 2021 his capital entitlement (which includes the remaining SWBP shareholding) will not benefit from BPR and the IHT exit charge (based on current values) increases to £87,060 (Appendix 1).

Accordingly, the direct impact of the change in SWBP strategy will increase the IHT otherwise due on David’s absolute entitlement of his share of the trust fund.

STRUCTURING OF CAPITAL APPOINTMENTS – IHT

As already noted if the trust is left to run its course there is likely to be a significant difference in the IHT charges payable by Chloe and David.

The trust deed does expressly provide the trustees with the appropriate discretionary power to appoint the respective beneficiary’s shares to them before they attain 25. Even if the trust deed had not provided for this power, the trustees are able to advance up to 50% of the beneficiary’s potential share under the Trustees Act 1925 which covers English trusts. [Scottish trusts – In the absence of specific powers in the trust deed this is not possible under Scottish law as the Trustees Act 1925 is not applicable to Scottish trusts]

The letter of wishes accompanying the trust also stated that the settlor never intended to control the assets beyond what was deemed to be necessary.

An option available to the trustees is to advance capital to David before he attains 25. We have set out below the tax consequences of advancing this distribution although, as ever, there are significant non-tax considerations to review before committing to this course of action. The trustees should consider their position on this matter in detail.

The Pearson Legacy Trust is an 18-25 trust and is subject to special rules on the calculation of IHT exit charges which occur on or after 6 April 2008.

Until a beneficiary attains the age of 18 no IHT exit charges will apply to capital appointments made by the trust.

If the terms of the trust are such that it continues after the beneficiaries have attained age18 but provides for capital entitlement on or before age 25 then IHT charges apply when either:

- The beneficiary becomes absolutely entitled to the trust assets:
- The death of a beneficiary aged 18 or over:
- The assets of the trust are applied for the benefit of a beneficiary aged 18 or over.

The exit charges are dependent upon the overall effective rate of the trust, which is multiplied by 30%, and the number of complete quarters (three month period) elapsed from the date the relevant beneficiary attained 18 (or the 6 April 2008 if later) and the date of the chargeable event. The maximum number of quarters cannot therefore exceed 28 (7 x 4) being seven years from a beneficiary attaining 18 until they attain 25.

The effective rate is calculated based upon the initial value of the trust, the nil rate band at the event date and the settlor's gifting history in the seven years prior to creation of the trust. The settlor's gifting history is only affected by chargeable lifetime gifts. In this case both gifts made in the seven years prior to 18 February 1998 were potentially exempt transfers as they were cash gifts to individuals and these gifts, which have since become fully exempt, are not taken into account in the calculation. The effective rate of trust has previously been calculated to be 14.222%.

As already stated, David will not attain 25 until 18 July 2021 by which time, assuming that the strategy is implemented, the shares in SWBP will no longer qualify for BPR. It is this loss of BPR that causes David's significant IHT exit charge projection.

If the appointment of David's share of assets is to be brought forward to reduce this tax liability, the greatest tax saving is achieved if that appointment takes place before BPR is lost in relation to the shares in SWBP i.e. by 30 June 2020. A later advancement made after BPR is no longer available will still save tax as the number of complete quarters will be reduced but the effect is small in comparison with the BPR savings.

If for illustrative purposes, David's appointment is advanced to 1 January 2020, the IHT charge will be significantly reduced as at this point BPR will still be available on the value of the shares held in SWBP. David's IHT exit charge will fall to £27,776 (see calculation in Appendix 1), this is a tax saving of £59,284.

STRUCTURING OF CAPITAL APPOINTMENTS – CAPITAL GAINS TAX

The trustees, as a body, are a chargeable person in their own right for CGT purposes. This means that if the trustees sell chargeable assets (realising either gains or losses) this will be a chargeable event for CGT purposes. In addition, if the trustees transfer assets to a beneficiary, they will be deemed to have disposed of the assets at their market value and even though technically the trustees and beneficiaries of the trust are not connected parties for CGT purposes, special rules exist to ensure that the market value is used in the tax calculations.

The quoted share portfolio and the shares held in SWBP are chargeable trust assets for CGT purposes and are exposed to a tax charge on disposal. Cash is not a chargeable asset for CGT purposes and therefore no CGT will arise if cash is transferred from the trust to the beneficiaries as part of an appointment.
In the absence of reliefs, the trust is liable to CGT at a rate of 20%. It will benefit from a small annual exemption of £5,850.

The trust is unable to benefit from Entrepreneurs' Relief which is a relief that can result in a portion of the gain being taxed at only 10%. This relief is available for business assets of which unquoted shares in a trading company, like SWBP, is a qualifying category. However, a trust can only benefit from this relief if it has consenting beneficiaries which qualify for the relief and the beneficiaries have an interest in possession in the trust. In this case neither of these conditions are met.

A key factor in deciding upon the CGT route for the trust regarding David's appointment is establishing what he is likely to do with the funds. He has indicated that he currently plans to realise cash from his trust interest. The trustees should therefore consider how this can best be achieved.

Working on the basis that the trustees will decide to advance David's appointment to 1 January 2020. If the trust sells all the assets and then distributes the resulting cash to David, the CGT liability will amount to £266,330 (see Appendix 2 for calculations).

The trust CGT liability of £266,330 will reduce the amount the trustees are able to appoint to David but the IHT payable as a result of the transfer will significantly increase. This is because the trustees will now only be appointing cash and no BPR relief will be due.

David's IHT exit charge will increase to £59,329 (see Appendix 2 for calculations). This is clearly not a satisfactory solution.

An alternative approach is that the assets are appointed out in their current form to David in the same way as they will be distributed to Chloe. Both beneficiaries then have the option to sell assets in one tranche or sell assets as they require cash funds.

In the absence of any relief this too will result in the above CGT liability arising on the trust. The trustees hold insufficient cash resources to pay the CGT liability, so they will need to sell a portion of the quoted share portfolio, instead of appointing it, to ensure they have sufficient funds. This will slightly reduce the IHT liability. The trustees should avoid realising the value in SWBP as this negatively impacts the IHT charges due to the current availability of BPR.

However, there is a deferral relief known as Gift Relief. Gift Relief avoids an immediate CGT charge upon appointment of chargeable assets to beneficiaries by deeming the proceeds to be equal to the market value of the assets in the usual way but allowing this amount to be reduced by the gain. This results in the beneficiaries, in effect, acquiring the chargeable assets at the trust's CGT base cost rather than the market value at the time of the appointment.

The relief is available as the capital appointment is also a chargeable event for IHT purposes. This relief applies to all CGT chargeable assets being appointed not just the business assets (SWBP shares).

A joint claim to gift relief, signed by the trustee and relevant donee, must be made within four years of the end of the tax year in which the deemed disposal occurs. The donee must also be UK resident at the time and must remain UK resident for six years after the end of the tax year or, if the asset has not been disposed of, clawback rules exist generating a chargeable gain.

If David were to immediately sell the assets upon receiving them he will incur a CGT liability of £260,568 (see Appendix 3). This is therefore a tax saving of £5,762, compared to the liability of the trust.

The clear majority of the tax saving is realised because David can increase his CGT base cost by the IHT exit charge which will be due as a result of the asset appointment. A very small proportion of the tax saving is caused by the availability of increased annual exemptions relating to individuals.

The tax savings could even be increased slightly as the beneficiaries will have the ability to sell the assets appointed to them as and when they required funds. This brings the added benefit that they may be able to utilise several years of annual exemptions by staggering disposals over several tax years.

CONCLUSION

The change in strategy by SWBP has serious tax implications for the trust by reason of the potential loss of BPR on the trust shareholding.

Chloe is unaffected by this change due to her age and the timing of the implementation of the strategy change by the SWBP directors. However, the tax liabilities arising on David's share of the trust will significantly increase as a result of the change.

Subject to the non-tax considerations, the increased IHT liability can be mitigated by advancing the date of David's appointment.

Based upon an advancement date of 1 January 2020, this will save £59,284 in IHT assuming static market values going forward.

If the trustees do decide to appoint the trust fund to David at this point the most efficient method of appointment with regard to CGT, while retaining the IHT savings, will be to appoint the trust fund assets to David in their current form and claim CGT gift relief to defer the gain. A claim for CGT Gift relief should also be made with regard to the appointment to Chloe to enable the chargeable gains to be deferred.

Even if David were to sell the assets straight away upon receiving them subject to a holdover election there is still a CGT saving of £5,762 as against the trustees CGT exposure on realising the assets and distributed the cash proceeds.

The overall tax savings of structuring the capital appointments from the trust in this manner amount to over £65,000 which also enables David also receives a very high proportion of the trust fund after all taxes have been paid.

Chartered Tax Advisers
5 November 2019

Appendix 1

IHT exit charges if David's interest remains undistributed until he attains age 25.

David's capital appointment upon attaining 25 (If asset values constant)	£	£
Number of complete quarters = 18 years (18 July 2014) to 25 years (18 July 2021)		28 quarters
Effective rate		14.222%
Relevant fraction 30% x 28/40		21.000%
Assets remaining post Chloe's appointment (1/2 share)		
SWBP shares	1,675,000	
Quoted shares	1,025,000	
Cash	215,000	
Total assets	2,915,000	
Less: BPR – unavailable	-	
Chargeable value	2,915,000	
£2,915,000 x 14.222% x 21.000%		£87,060

IHT exit charge if David's capital appointment is advanced to 1 January 2020

Number of complete quarters = 18 July 2014 (18 years) – 1 January 2020		21 quarters
Effective rate		14.222%
Relevant fraction 30% x 21/40		15.750%
Assets remaining post Chloe's appointment (1/2 share)	2,915,000	
Less: BPR	(1,675,000)	
Chargeable assets	1,240,000	
£1,240,000 x 14.222% x 15.750%		£27,776

Appendix 2

CGT computations and IHT exit charges if the trustees sell all assets and then distribute to David on 1 January 2020.

Capital Gains Tax

	£	£
Sales proceeds		
50% of shares in SWBP	1,675,000	
50% of quoted share portfolio	1,025,000	
Total sales proceeds	2,700,000	2,700,000
Less capital gains base cost		
50% of shares in SWBP	562,500	
50% of quoted share portfolio	800,000	
Total cost	1,362,500	(1,362,500)
Chargeable gain		1,337,500
Annual exemption		(5,850)
Taxable gain		1,331,650
Tax at 20%		266,330
Net chargeable assets to distribute (£2.7 million - £266,330)		2,433,670
Cash to be distributed		215,000
Total assets available to distribute		2,648,670
IHT charge		
Effective rate		14.222%
Relevant fraction 30% x 21/40		15.750%
Exit Charge		
(£2,648,670) x 14.222% x 15.750%		£59,329

Appendix 3

CGT computations if the trustees appoint all assets to David (subject to a holdover election) on 1 January 2020 and then David sells all assets.

Capital Gains Tax

	£	£
Sales proceeds		
Shares in SWBP	1,675,000	
Quoted share portfolio	1,025,000	
Total sales proceeds	2,700,000	2,700,000
Less capital gains base cost		
Shares in SWBP	562,500	
Quoted share portfolio	800,000	
IHT paid on appointment from trust (excluding related to cash element)	22,960	
£27,776 (see Appendix 1) x £1,025,000 / £1,240,000		
Total cost	1,385,460	(1,385,460)
Chargeable gain		1,314,540
Annual exemption		(11,700)
Taxable gain		1,302,840
Tax at 20%		260,568

ASSESSMENT NARRATIVE

Structure

A simple pass or fail will be awarded.

Identification and Application

The following are the relevant topics for assessment with their weightings:

1	15%	Identify the taxation regime applying to the trust (18-25). Identify the basis upon which IHT charges will arise.
2	25%	Identify that the change in strategy by SWBP Ltd will result in a future loss of BPR. Identify and calculate the CGT implications of the share offer.
3	10%	Identify powers available to trustees to advance capital to beneficiaries.
4	30%	Identify the IHT implications of the timings of the advancements, including consideration to the plans of the beneficiaries.
5	20%	Identify the CGT implications of the timings of the advancements, including consideration to the plans of the beneficiaries.

A grade of 0,1,2,3, or 4 is awarded to each topic. The weighting is applied to that grade to produce a weighted average grade. Thus, supposing a candidate scores 3, 3, 4, 2, and 2 respectively on the above topics, this will equate to weighted scores of 0.45, 0.75, 0.4, 0.6 and 0.4. The total of these scores is 2.6. This is then converted to a final absolute grade by rounding up or down to the nearest grade. Thus, scores in the range 2.5 to 3.49 will be a grade 3. In this example, the candidate will score a grade 3 overall and secure a pass for this skill.

Relevant Advice and Substantiated Conclusions

The following are the topics for assessment with their weightings:

25%	Advice on the implication of the SWBP changes and how the impact on the beneficiaries can be mitigated.
30%	Advice and recommendations on what action should be taken regarding the capital appointment to Chloe.
45%	Advice and recommendations on what action should be taken regarding the capital appointment to David.

The final grade will be determined for this skill in the same way as for Identification and Application.