



The Chartered Tax Adviser Examination

Sample Paper

Application and Professional Skills

Inheritance Tax, Trusts & Estates

Suggested solutions

APPLICATION & PROFESSIONAL SKILLS – INHERITANCE TAX, TRUSTS & ESTATES

ANSWER TO PILOT PAPER QUESTION

REPORT

TO: TILLY SOAMES
FROM: PRESTIGE TAX SOLUTIONS LLP
DATE: 9 NOVEMBER 2018
RE: THE ESTATE OF JILL MASTERSON (DECEASED)

INTRODUCTION

This Report has been prepared by Prestige Tax Solutions LLP in response to our meeting with you on 28 October 2018 and your letter to us dated 5 November 2018 and the enclosures therewith.

This Report is intended solely for use by you. Prestige Tax Solutions LLP will accept no responsibility for any reliance placed on the contents of this Report by third parties.

This Report is based on tax law as it applies at the time of writing.

This Report will cover the following:

- Section A: The transfer of the holiday cottage to you in March 2018.
- Section B: The Inheritance Tax position on Jill Masterson's death.

EXECUTIVE SUMMARY

- A gain will arise on the transfer to you of the interest in Fort Lodge in March 2018. CGT of £12,370 is payable by 31 January 2019. As the property qualifies as furnished holiday accommodation, a claim for entrepreneurs' relief should be made when submitting Jill's 2017/18 tax return.
- The gift of Fort Lodge was a potentially exempt transfer (PET) for inheritance tax (IHT) so no tax was paid at the time. IHT of £25,200 will now be payable by you on this gift. This is due for payment by 30 April 2019 although it can be paid in instalments if a claim is made.
- An Application for Probate should be made as soon as possible. You should appoint a solicitor to help you with this. An IHT return (form IHT400) must be filed and the IHT paid before making the application. If necessary, a corrective return can be filed at a later date. As most of the estate liability will be in respect of the properties 23 Knox Terrace and the 50% share of Fort Lodge, a claim can be made to pay the tax in instalments so only 10% of the tax attributable to the properties is payable on application for Probate.
- A professional valuation is required in relation to Fort Lodge and Knox Terrace. Based on the values provided, IHT of £688,000 is payable by the estate. Of this only £157,000 is due on application for Probate.
- The key issue to address is the availability of Business Property Relief (BPR) in respect of the shares in Masterson Metalworks Ltd (MML). This rests on whether the leasing-out of surplus industrial units on the Chalkdown site means that MML is no longer "mainly" a trading company. Based on the information provided I consider that BPR will be available without restriction and the value of the shares is fully exempt from IHT. The Shareholders' Agreement (if applicable) should be checked before the IHT400 is filed in case it contains a buy-and-sell clause (this would deny BPR).

SECTION A:

TRANSFER OF HOLIDAY COTTAGE TO TILLY SOAMES

Jill transferred a 50% interest in Fort Lodge to you in March 2018. This has CGT and IHT implications.

Capital Gains Tax

As you are connected persons, Jill is deemed to have sold a 50% share to you for its value at that time. You therefore need to obtain a value for a 50% share.

Assuming Fort Lodge was worth £500,000 in March 2018, a 50% share would have been worth less than half that value, discounted to reflect the difficulty in selling a part-share. HM Revenue & Customs (HMRC) guidance and case law suggests that a discount of 10% would be appropriate. We will therefore assume that a 50% interest in Fort Lodge would be worth £225,000 in March 2018.

Jill's CGT base cost would be 50% of the probate value of the property in 1986 (£90,000), so the gain arising on the gift would be $£(225,000 - 90,000) = £135,000$.

The cottage is let throughout the year on short-term lets and will satisfy the definition of furnished holiday accommodation. The gain will qualify for entrepreneurs' relief (ER) and will therefore be taxed at 10%. The CGT payable will be $£(135,000 - 11,300) @ 10\% = £12,370$, payable by 31 January 2019 out of estate funds. The CGT would be a deductible liability when calculating the value of the chargeable estate.

If you wish to defer recognition of this charge, a gift relief claim can be made. The claim would be made when submitting Jill's 2017/18 tax return in January 2019. The effect of the claim is to reduce your own CGT base cost when you eventually dispose of the cottage. The claim transfers any CGT liability to you and postpones the charge until that point.

If Fort Lodge fails to satisfy the definition of holiday accommodation when you sell it, your gain will be taxed at either 18% or 28% (not the 10% rate which would be secured now). In addition, paying the CGT now means that we are using Jill's 2017/18 CGT exemption which would otherwise be wasted. Paying the CGT also reduces the IHT on the estate by 40% of the tax paid.

We would therefore advise that a claim for ER is made and the resulting CGT is paid from estate funds.

Inheritance Tax

The transfer to you was a potentially exempt transfer (PET) which has since become chargeable to IHT by reason of Jill's death within seven years.

To calculate the amount chargeable to IHT, we measure the loss to Jill's estate as a result of the transfer.

If Fort Lodge was worth £500,000 and a discounted 50% interest worth £225,000, the loss to Jill's estate would have been £275,000 and this is therefore the value of the transfer for IHT. This is different to the deemed sales proceeds for CGT which are based on the stand-alone value of the part gifted (i.e. £225,000).

Business property relief (BPR) is available on transfers of 'business property'. Although Fort Lodge is a 'business asset' for CGT purposes by virtue of being furnished holiday accommodation, these same rules do not apply for IHT. Recent case law decisions tend to support HMRC's opinion that holiday accommodation does not (normally) qualify for BPR so no relief is available against the value of the PET.

The transfer can be reduced by annual exemptions of £3,000 for both the current and preceding tax year (£6,000 in total) giving a PET of £269,000.

The tax due on the PET is affected by Jill's other lifetime gift which was £250,000 to the trust in 2013. This transfer can also be reduced by two annual exemptions leaving a chargeable transfer of £244,000.

The nil rate band on death is currently £325,000. However, when George died in 2016 he left a legacy of £200,000 to you and the balance of his estate to Jill. As George made no lifetime gifts, £125,000 of his nil rate band is unused. If a claim is made, this amount can be transferred Jill. We recommend you make this claim via Jill's IHT return.

Jill's nil band would then be £(325,000 + 125,000) = £450,000.

The IHT payable on the gift of the share of Fort Lodge would be:

	£	£
PET		269,000
Nil rate band	450,000	
Less: Transfer to trust 2013	<u>(244,000)</u>	
Nil band remaining		<u>(206,000)</u>
Taxable		<u>63,000</u>
IHT @ 40%		<u>25,200</u>

This tax is payable by you as recipient of the gift.

The tax is payable no later than 30 April 2019, although as the tax relates to land and buildings, you can elect to pay in 10 equal annual instalments with only 10% (£2,520) payable in April 2019. The instalments will be interest bearing so interest is added to the unpaid balance of tax each year.

Even if you claim the instalment option, the outstanding tax (with accrued interest) can be settled at any time. You are not obliged to continue to pay the tax over 10 years. If you sell or give away Fort Lodge, the unpaid tax (plus accrued interest) become immediately payable.

SECTION B:

THE INHERITANCE TAX POSITION ON JILL MASTERSON'S DEATH

B1: APPLICATION FOR PROBATE

As Executor you need to obtain a Grant of Probate before you can take possession of the assets in Jill's estate. Until Probate has been obtained, all assets in Jill's name are frozen.

The Grant of Probate officially gives you - as Executor - the power to administer the estate. Once Probate is issued, you can sell the assets (if appropriate) and distribute the estate. We recommend you appoint a solicitor to help you deal with this as a matter of priority.

Before making the Probate application, you should examine Jill's records and files to establish her assets and liabilities. You should obtain a valuation of both Fort Lodge and Knox Terrace from an estate agent and obtain a professional valuation for the shareholding in Masterson Metalworks Ltd.

The Executor must pay the IHT before the Probate application is submitted. An IHT return (form IHT 400) needs to be submitted with the payment. The IHT400 requires details of all the deceased's assets at the date of death. Appropriate valuations must be included.

Any liabilities owed by the deceased at death must also be included, these being allowable deductions for IHT purposes. This will include any loans, credit card liabilities and other liabilities such as the CGT due on the gift of the interest in Fort Lodge and income tax (which we will ascertain once the income tax returns to the date of death have been prepared). Funeral expenses (including the cost of the headstone) are also deductible. Reasonable estimates can be made if necessary and a corrective IHT return filed once final information becomes available.

The estimated IHT due on the estate is £688,000 (see Appendix 1). Where the major assets of the estate are property and/or shares (as in this case), the IHT attributable to those assets can be paid in instalments such that only 10% of the tax is payable on application for Probate. We recommend that the instalment option is claimed (this is done on the IHT return). This will reduce the up-front IHT which needs to be paid to £157,000.

The requirement to pay IHT in advance can be problematic as the Executor cannot normally access the deceased's assets to pay the tax. However as there is enough money in Jill's bank accounts to cover the initial IHT payment, it is possible to arrange a direct payment from her bank account to HMRC. You can indicate this on the IHT400 and complete form IHT423 which accompanies the return.

B2: 50% INTEREST IN FORT LODGE

As the property was held as tenants-in-common [*Scots Law – joint ownership with no survivorship clause*] the remaining 50% interest in Fort Lodge will be in Jill's estate and will pass to you under her Will.

Jill's half should be valued in isolation without reference to the part owned by you. An independent valuation should be obtained for a discounted 50% share at the date of death. For illustration we have assumed there has been no change in the value of the property since March 2018 and that a 50% interest is therefore worth £225,000.

Even if the property is qualifying holiday accommodation for income tax and CGT, as the business is primarily that of letting land, no BPR is available.

B3: THE SHAREHOLDING IN MASTERSON METALWORKS LTD (MML)

For IHT purposes, the shares are valued at their open market value being the price they could reasonably be expected to fetch if sold on the open market. The Finance Director has suggested that the company is worth £7.5 million, but a professional valuation is advisable. The value of the shares can be discounted because they are a minority holding, but as most of the estimated value comes from the Chalkdown site (worth £7 million), the discount may be relatively small. For illustration, we will assume a discount of 25% although this will need to be agreed with HMRC.

BPR is available if a two-year ownership period has been satisfied at the date of death. Jill acquired her shares under George's Will and died less than two years later. Where an individual acquired the shares from a spouse on death, the ownership period is extended to include the ownership period of the deceased spouse. As George acquired the shares in MML many years ago, the two-year ownership period is satisfied.

As MML is an unlisted trading company, BPR should be available. The rate of BPR on unlisted shares is 100% meaning that the full value of the shares would be covered by BPR and no IHT would be payable.

BPR is not available where the business carried on by the company consists wholly or mainly of dealing in land and buildings or making or holding investments. "Mainly" in this context means more than 50%. BPR will accordingly be denied where less than half of the activities carried on by MML are metalworking.

MML has non-trading activities being the letting of the surplus industrial units. MML seems to be run as one single business therefore as long as its metalworking arm is more significant than its letting arm, the shares will qualify for BPR. We therefore need to look at the activities of the business as a whole to see if MML's rental business jeopardises BPR.

We must examine various factors to determine whether the business is "mainly" trading. An analysis of the financial information for the two years to 31 March 2018 will give us a reasonable indication of whether BPR will be available. The factors to be considered in assessing the availability of BPR are:

- 1) How turnover is split between the respective metalworking and rental parts of the business. In the two years to March 2018, turnover from metalworking business was significantly more than the rental income.
- 2) The profit generated by the respective parts of the business. Here the position is less clear as the metalworking profits are slightly less than the rental profits. We may therefore need to go back and look at the 2016 and 2015 accounts to see if this is a consistent pattern.
- 3) Capital employed in the business (i.e. the value of the assets used in the "trading" and "investment" parts of the business). The factory is worth more than the units being let-out.
- 4) Expenditure and time spent by directors and employees. Looking at the profits from the rental activities, it seems that there are very few costs incurred in relation to the lettings which infers that this side of the business effectively "runs itself". It appears that the work of the directors and employees is significantly weighted towards the metalworking activities.
- 5) The overall context of the business. This is and always has been a metalworking business which, due to a change in the economic climate and the demand for its products, moved gradually towards renting surplus space as a means of maintaining profit levels.

While these factors may be considered individually, the business must be assessed as a whole. Looking at this as a whole, on balance I would not consider the business to be one of mainly holding investments. For this reason we consider that BPR will be available.

The next question is whether BPR applies to the full value of the shares.

BPR is restricted where the value of shares consists partly of assets which are neither:

- i). Used in the business at the date of the transfer; nor
- ii). Required at the date of transfer for future business use.

If the “excepted assets” restriction applies, the value of such assets is excluded from the share value when calculating BPR. This dilutes the relief and leaves part of the share value liable to IHT.

We are comfortable that the rental properties were being used in MMLs business at Jill’s death. “Business” in this context has a wider meaning than “trade”. MMLs trade is metalworking. The letting of the surplus industrial units is an ancillary activity carried on as part of MML’s wider business without it being the main activity. Even though the units produce investment income for the company, case law supports the view that they are nevertheless still used in MML’s wider business and as such do not restrict BPR.

We have some concerns over the amount of cash held by MML. The company balance sheet at 31 March 2018 includes cash of £200,000. This sum could be excluded if it is not needed for working capital, or held as a reasonable reserve or earmarked for a specific purpose.

It can be difficult to identify how much (if any) of the cash is “not required” for business use (by definition, any excess is held as an investment). This will depend on the facts and circumstances of each case.

However every trading company needs some working capital. Case law suggests that the cash needed by the company as working capital is around 25% of its turnover.

On balance we would be confident of sustaining an argument that the cash on the balance sheet is required for future business use and is not held as an investment. For this reason, full BPR should be available and no IHT is due on the shares.

Before completing IHT returns on the basis that full BPR is available, it would be prudent to check with the Finance Director at MML whether there is a Shareholders’ Agreement in existence. Shareholders’ Agreements typically contain clauses dealing with the rights of the shareholders in the event of death. Such clauses could also have been incorporated in the company’s Articles of Association or in a private agreement between Jill and another shareholder and this will need to be looked at.

The IHT legislation says that if the Shareholders’ Agreement (or other similar agreement) constitutes a “binding contract” under which either the Executors are obliged to sell or the other shareholders are obliged to buy the shares, BPR is denied.

B4: 23 KNOX TERRACE

An independent valuation should be obtained.

The chattels and personal effects should also be valued. The value to be placed on these items will be the value one would obtain if selling them on the open market - for example via an online auction site or car-boot sale.

As Jill is leaving her home to a lineal descendant, a “residence nil rate band” (RNRB) is potentially available. In addition, an extra RNRB can be claimed as George did not use his RNRB on his death.

However, where the net estate exceeds £2 million, the RNRB is tapered away. The “net estate” means the total value of assets, less deductible liabilities but before deducting BPR. Given that MML is worth £7.5 million, the value of a 30% shareholding (around £1.7 million in itself) when added to the rest of the estate would mean that the RNRB would be tapered to zero.

B5: BANK DEPOSITS & ISAs

The value of the bank deposits for IHT purposes should include accrued interest earned on the account until the date of death. Any accrued interest will not however be included on Jill's 2018/19 income tax return and the interest will instead be taxed on the Executors as estate income at the point it is paid.

The ISAs (including accrued interest) are also chargeable assets for IHT (tax exemption only applies for income tax).

The tax-free status of the ISA continues at death. No further funds can be paid into the ISA after death but it will continue to benefit from ISA tax advantages so interest and gains are tax-free. This 'continuing ISA' status lasts until either the ISA is closed, the administration of the estate is complete or three years have passed since death (whichever is sooner).

B6: ESTIMATE OF IHT PAYABLE

IHT of £25,200 is payable on the gift of Fort Lodge. This is payable by 30 April 2019 although a claim for the instalment option will mean that only 10% of this tax is due by this date.

Provisional figures indicate that the IHT liability on Jill's estate will be £688,000 (see Appendix 1). Most of this can be paid in instalments such that only £157,000 needs to be paid on application for Probate. The rest can be paid in annual yearly instalments every 30 April until the tax is discharged (or the assets are sold).

Given that more than this is held in Jill's bank accounts, you shouldn't need to obtain a short-term loan or use an external source to help meet this liability.

Prestige Tax Solutions LLP
9 November 2018

APPENDIX 1

ESTATE OF JILL MASTERSON - ESTIMATE OF IHT PAYABLE

	£	£
23 Knox Terrace		1,250,000
50% interest in Fort Lodge		225,000
Shares in Masterson Metalworks Ltd (30% x £7.5 million)	2,250,000	
Less: Discount for minority holding (say 25%)	<u>(562,500)</u>	
Value of 30% interest	1,687,500	
Less: BPR @ 100%	<u>(1,687,500)</u>	
		Nil
Bank deposits & ISAs		<u>275,000</u>
		1,750,000
Less: Funeral costs and credit card bills	17,630	
Less: CGT on gift of Fort Lodge	<u>12,370</u>	
		<u>(30,000)</u>
Taxable estate		<u>1,720,000</u>
IHT @ 40%		<u>688,000</u>
Payable in instalments:		
£(1,250,000 + 225,000) / 1,720,000 x £688,000		<u>590,000</u>
Due on application for Probate:		
Instalment tax (10%)		59,000
Non-instalment tax		<u>98,000</u>
		<u>157,000</u>