The Chartered Institute of Taxation

Application and Professional Skills

Inheritance Tax, Trusts & Estates

May 2021

Suggested answer

Report to the Trustees of the Cresswell Family Settlement

This report is prepared for the trustees of the Cresswell Family Settlement. It is based on the information provided by you and your correspondence of 1 May 2021 and is issued in accordance with our engagement letter dated 20 April 2021.

It considers the tax implications relating to the sale of assets to fund the trust's Inheritance Tax liability and the cessation of the trust.

1. Executive Summary

a. We recommend Bramble Cottage is sold at auction in May 2021 to facilitate payment of the outstanding Inheritance Tax ("IHT"). Slightly more Capital Gains Tax ("CGT") is payable on a sale of Bramble Cottage than the paddock, however, the paddock will qualify for 100% Agricultural Property Relief when IHT exit charges are imposed on assets leaving the Cresswell Family Settlement ("the Trust"). The IHT saving for the beneficiaries is far greater than the CGT saving obtained by selling the cottage.

b. IHT exit charges will arise on 18 September 2021 and 21 May 2023 when the beneficiaries each become entitled to their interest in the Trust. We have reviewed the business activities of Cresswell Garden Centres Ltd ("the Company") and conclude that IHT Business Property Relief at 100% will be available on the trustees' shareholding in the Company. This means £32,127 IHT will be payable by Amanda and £40,159 by Darcy.

c. A CGT disposal also arises when the paddock and Wilton House leave the Trust, but the "Crowe v Appleby" principle means that this is deferred until 21 May 2023 when Darcy becomes absolutely entitled. A CGT liability of £227,358 will be payable on the properties and holdover relief is available in respect of Darcy's share of the gain. This cannot be claimed on Amanda's share, as the CGT disposal does not coincide with her IHT exit charge.

d. For Amanda to avoid a large CGT liability, we recommend that the trustees exercise their power to advance Darcy's interest in the Trust to her on 18 September 2021. This will allow both Amanda and Darcy to claim holdover relief on the land and property gains and will provide Amanda with a CGT saving of £113,679 Darcy's IHT exit charge will reduce to £32,127, saving her £8,032 and both beneficiaries will be left with most of their inheritance from Lily.

e. A disposal also occurs when the shares leave the Trust, resulting in a CGT liability of £74,970. We recommend that a claim for holdover relief is made in respect of the shares, so no CGT is payable on the disposal and Amanda and Darcy will acquire the shares at the trustees' base cost.

2. Report to the Trustees

a. Sale of assets to fund the IHT liability

Additional IHT is payable because your mother, as the settlor, did not survive seven years from the transfer of assets into trust. The trustees have advised that the liability is £70,500 (to include interest) and the funding options are a disposal of either Bramble Cottage or the paddock. We have looked at each of these in turn.

i) Sale of Bramble Cottage

The disposal of Bramble Cottage will result in a capital gain on which CGT at the 28% residential rate is payable.

The trustees' CGT base cost is £88,000, which is Lily's £72,000 acquisition price, as holdover relief was claimed, plus £16,000 apportioned IHT from the Trust creation and on Lily's death which can be added to the cost. Assuming a sale price of £99,000 is achieved, after deducting the allowable costs and the 2021/22 trust annual exemption, a taxable gain of £3,365 will arise and £942 CGT will be payable (see Appendix 1).

Bramble Cottage is a residential property, so this liability must be paid and reported to HMRC within 30 days of completion. The trustees must set up an online CGT account with HMRC to facilitate the reporting requirements.

The period between exchange at auction and completion may be quite short, so you will need to ensure that the report is submitted before the 30 day period expires, as HMRC will charge a penalty of £100 if the deadline is missed.

ii) Sale of the paddock

The sale of the paddock will also result in a CGT liability for the Trust. Lily originally purchased the paddock for £150,000 in 2010, but by 2014 it had decreased in value due to planning permission issues, so a capital loss would have arisen on the transfer into trust.

It is only possible to claim holdover relief on capital gains not losses, so the paddock would not have been eligible. This means the trustees' CGT base cost is £70,000, the value on 12 August 2014, plus the £14,000 apportioned IHT relating to the property which can also be added.

The value of the paddock is £94,000, so after deducting the base cost, costs of the sale and the 2021/22 trust annual exemption, a taxable gain of £3,350 will arise. The paddock is not residential property, so the 20% rate applies, resulting in £670 CGT payable (see Appendix 1)

This is £272 less than the CGT liability on Bramble Cottage and in addition, the payment date for the CGT on the paddock and the reporting deadline to HMRC (on the 2021/22 trust tax return) is not until 31 January 2023.

It may appear that selling the paddock is the best option, however, there is an IHT issue that the trustees must also consider. The beneficiaries will shortly become entitled to their share of the Trust assets and an IHT exit charge will arise at this time. Further details of the charge are provided later in the report, but you need to be aware that no IHT is payable if the assets transferred to the beneficiaries qualifies for 100% Agricultural Property Relief ("APR").

APR is available if agricultural land or buildings are let and used for agricultural purposes for at least seven years. In this case, the paddock has been used for growing crops which qualifies as an agricultural purpose and by 18 September 2021 when Amanda is 30, the trustees will have let the paddock for seven years, so the ownership period will be satisfied and the paddock will qualify for 100% APR.

APR is only available on the agricultural value of the land. We understand that the paddock does not have any market value premium, but we suggest you confirm this with a surveyor.

Recommendation

The sale of either Bramble Cottage or the paddock will provide sufficient net proceeds to settle the IHT liability and the CGT on the respective sales. However, if the paddock is sold, when Amanda and Darcy reach their 30th birthdays and an IHT exit charge is imposed, no APR will be available and as no reliefs are available on Bramble Cottage, their IHT liabilities will increase.

The calculations in Appendix 2 show that an IHT exit charge at the rate of 4.200% will apply on 18 September 2021, so Amanda's liability will increase by £2,000 (£47,629 x 4.200%) if Bramble Cottage is retained. Darcy's IHT exit charge will also increase, but IHT rate is higher at 5.250%, so her liability will increase by £2,500 (£47,629 x 5.250%).

The IHT increase is far greater than the CGT saving on selling the paddock, so we recommend that Bramble Cottage is sold.

b) Cessation of the Trust

Under the Trust terms, the beneficiaries become absolutely entitled to an equal share of the assets on their 30th birthdays. Amanda is 30 on 18 September 2021 and Darcy is 30 on 21 May 2023, after which the Trust will cease.

i) IHT

The Trust is a relevant property trust for IHT purposes, as it is a lifetime trust created by Lily after 21 March 2006, so IHT exit charges will arise when the assets leave the Trust on 18 September 2021 and 21 May 2023.

The exits will fall within the first ten years of the trust, so the IHT rate applicable to the assets leaving the Trust is calculated based on their initial value and the number of quarters that have elapsed since creation. As mentioned above, no IHT is payable on assets qualifying for 100% APR (where there is no market premium) and in addition, no IHT is payable on assets qualifying for 100% Business Property Relief (BPR).

BPR is available on relevant business property and 100% relief applies to unquoted shares if certain conditions apply. We understand that HMRC agreed 100% BPR was available on the shares on Lily's death. However, as the Company's business activities have changed recently, this should be reviewed.

The conditions for BPR are that the shares must have been owned for at least two years, they must not be listed on a recognised stock exchange, the Company must be trading and 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 business) and there must not be a binding contract in place for the sale of the shares at the relevant date.

In relation to the trustees' holding, the shares have been held over two years, the Company is unlisted and there is no indication of an offer in place for the sale of the shares, so these three conditions are met. The financial information provided shows there are no excepted assets held although HMRC can restrict BPR where there are large cash balances held which are surplus to a company's business needs. The balance sheet shows a cash balance of £103,000 at 31 March 2021 but given the size of the business this is likely to be needed for working capital so BPR should not be restricted. Please note, the land and buildings that are let out will not be treated as excepted assets as they are part of the overall business.

However, 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; essentially it must be carrying out mainly trading, not investment activities. As the Company commenced letting floor space to third-parties (an investment activity) during 2019 alongside the sale of plants and bulbs (a trading activity), we must consider whether the Company is still mainly trading for BPR purposes.

Case law has considered the meaning of "wholly or mainly holding investments" and where there are both trading and investment activities, it has been established that all aspects of a business over a reasonable period prior to a chargeable event must be considered. The leading case on this area set out five factors and this approach is followed by HMRC when considering 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".

From reviewing the financial information, the turnover from trading exceeds investment income with just over 54% relating to trading activities for the year to 31 March 2021. However, the investment side is more profitable, representing nearly 53% of profits for the same period. In comparison, the company's plant and equipment relates solely to the trading activities and you have advised us that 60% of each garden centre is still dedicated to your own stock. In addition, the total staff time dedicated to the trading side of the business far exceeds the investment business.

Looking at the overall context of the business, even though the profit from the investment side is higher, all other factors point to the Company carrying out mainly trading activities and assuming this does not alter by the time Amanda and Darcy become entitled to the trust assets, 100% BPR will be available on the Company shares. We should keep this under review.

A calculation of the IHT exit charges at 18 September 2021 and 21 May 2023 are provided in Appendix 2. Amanda's IHT liability will be £32,127 and is payable to HMRC by 31 March 2022 and Darcy's IHT liability will be £40,159 and payable by 30 November 2023.

Please note, we have used the current market value of the assets for the purpose of these calculations. It will be necessary to obtain updated valuations of the assets on the actual exit charge dates.

ii) <u>CGT</u>

<u>Shares in the Company</u>

For CGT purposes, there is a disposal at market value by the trustees when the beneficiaries become absolutely entitled to the shares. Holdover relief was claimed on the shares on the Trust's creation, so the trustees will take on Lily's base cost. She acquired 500 shares on incorporation for £500 and inherited 500 shares from Percy at the probate value of £7.5 million, so her total cost was £7,500,500. This means the trustees' CGT base cost for 300 shares is £2,250,150 (300/1,000 x £7,500,500).

Amanda and Darcy will become entitled to the shares during the 2021/22 and 2023/24 tax years respectively, and the gain on each shareholding is £187,425. The shares do not qualify for Business Asset Disposal Relief, as this only applies where a beneficiary of an interest in possession trust is an employee or office holder of the company and personally holds at least 5% of the shares so the normal 20% CGT rate will apply. A CGT liability of £37,485 will be due by 31 January 2023 in respect of Amanda's entitlement and £37,485 due by 31 January 2025 for Darcy (see Appendix 3).

Alternatively, the trustees and beneficiaries are able to jointly claim CGT holdover relief in respect of the gains because Amanda and Darcy's entitlement to the shares is a chargeable event for both IHT and CGT purposes.

The effect of a holdover claim is that no CGT will be payable and Amanda and Darcy will acquire their shares at the trustees' base cost, not the current market value, for future CGT disposals.

<u>Recommendation</u>

We recommend that claims for holdover relief are made in respect of the gains on the shares to avoid the payment of £74,970 CGT across the two tax years. As Amanda and Darcy intend to retain the shares for the foreseeable future and there are no current plans to sell the Company, acquiring the shares at the trustees' lower base cost should not be an issue for them.

The paddock and Wilton House

The CGT position differs for the Trust land and property due to the rule in "Crowe v Appleby". This provides that where a beneficiary becomes entitled to an undivided share in land or property, there is no disposal by the trustees until such a time as all the beneficiaries become entitled.

In this case it means a CGT liability will not arise on 18 September 2021 when Amanda becomes entitled and instead recognition of the gain will be deferred until 21 May 2023, when Darcy also becomes absolutely entitled.

The CGT liabilities arising are calculated at Appendix 3 and are £2,000 for the paddock and £225,358 for Wilton House. The CGT on the paddock is payable by 31 January 2025 and the disposal of Wilton House would normally be reportable to HMRC online and the CGT payable within 30 days of completion.

As mentioned above, holdover relief is available if an event results in both a CGT disposal and a chargeable event for IHT purposes or if the asset transferred is a business asset. In this case, the paddock and Wilton House are not business assets, but the transfer to Darcy results in both a CGT disposal and an IHT exit charge, so holdover relief may be claimed on her half share of the gains. No CGT will be payable if the relief is claimed and Darcy will acquire the property at the trustees' base cost (as shown in Appendix 3) for future CGT purposes.

In comparison, Amanda's IHT exit charge arises on 18 September 2021 but the CGT disposal of the properties does not occur until 21 May 2023, so holdover relief will not be available on her share of the gain. This leaves her with a CGT liability of £112,818 to pay on the properties (that is, £1,000 on the paddock and £111,818 on Wilton House).

We note that the terms of the Trust include the power to advance a beneficiary's capital entitlement to them prior to reaching the age of 30. If the trustees exercise this power in respect of Darcy and advance her capital entitlement to her on 18 September 2021 (i.e. on Amanda's 30th birthday), this will effectively end the Trust and the CGT disposal of the properties and the IHT exit charge will arise at the same time for both beneficiaries, allowing Amanda to also claim holdover relief on the land and property gains.

Recommendation

You have advised us that the beneficiaries wish to settle the tax liabilities on the cessation of the trust, however without a claim for holdover relief on the properties, Amanda's liability will be £144,495 (£112,818 CGT plus £32,127 IHT). This will leave her with a balance of only £5,055 out of her £150,000 inheritance.

Therefore, we recommend that the trustees exercise their power to advance Darcy's share of the trust assets to her at the same time as Amanda and for CGT holdover relief to be claimed in respect of both beneficiaries on the gains arising on the paddock and Wilton House. They both intend to keep the properties as long term investments, so it is less of an issue that they will acquire the properties at the trustees' base cost plus the IHT attributable to each property on exit from the trust for future CGT purposes.

In addition, if Darcy's capital is advanced to her earlier, her IHT exit charge will decrease to the same level as Amanda's, providing her with a saving of £8,032 over her original IHT liability.

After making CGT holdover claims on the Company shares and the properties, Amanda and Darcy will have the IHT exit charge of £32,127 each to settle by 31 March 2022, leaving them with £117,873 each out of their £150,000 inheritance. This is a tax saving of £112,818 for Amanda and £8,032 for Darcy.

Appendix 1 - CGT Computations for sale of the Paddock or sale of Bramble Cottage

	Bramble Cottage	The paddock
	£	£
Proceeds	99,000	94,000
Less: Costs of sale	(1,485)	(500)
Net proceeds	97,515	93,500
Less: Trustees base cost	(88,000)	(84,000)
Chargeable Gain	9,515	9,500
Less: 2021/22 Trust Annual Exemption	(6,150)	(6,150)
Taxable Gain	3,365	3,350
CGT @ 28% / 20%	£942	£670
Proceeds	97,515	93,500
Less: IHT due	(70,500)	(70,500)
Less: CGT on sale	(942)	(670)
Proceeds after tax	£26,073	£22,330

Appendix 2 - Cessation of Trust IHT Exit Charge Calculations

Initial values on 12 August 2014	£	£
300 shares in the Company	2,400,000	
Wilton House	1,335,000	
The paddock	70,000	
Bramble Cottage	80,000	
Cash (bank account)	5,000	
Less: IHT paid by trustees on creation	(233,000)	
		3,657,000
Nil rate band on exit	325,000	
Less: Settlor's CLTs in seven years prior to trust creation PETs made by Lily on 5 July 2014 & 10 July 2014 are now chargeable	(411,000)	
		(0)
		3,657,000
Notional tax @ 20%		731,400

Effective rate $\frac{£731,400}{£3,657,000} \times 100$ 20.000%

<u>On Amanda's entitlement:</u>

Complete quarters 12 August 2014 to 18 September 2021 28 quarters

Actual rate $\frac{28}{40} \times 30\% \times 20.000$ 4.200%

	£
Assets ceasing to be relevant property:	
150 shares in the Company (100% BPR available)	0
½ share of Wilton House	750,000
½ share of the paddock (100% APR available)	0
½ share of cash (£3,800 in bank account + £26,073 post tax proceeds after sale of Bramble Cottage)	14,936
	764,936
IHT payable by Amanda = £764,936 x 4.200%	£32,127

On Darcy's 30th entitlement: £

Complete quarters 12 August 2014 to 21 May 2023					35 quarters	
Actual rate	35/40	x	30%	X	20.000	5.250%	
Assets ceasing to be relevant property (from above)							764,936
IHT payable by Darcy = £764,936 x 5.250%							£40,159

Appendix 3 - Cessation of trust CGT computations

	Shares	Paddock	Wilton House
2021/22			
Amanda's entitlement – 18 Sept 2021	£	£	£
Proceeds	1,312,500		
Less: Trustees base cost	(1,125,075)		
Taxable gain	187,425		
Trust annual exemption already utilised on Bramble Cottage			
CGT @ 20%	£37,485		
2023/24			
Darcy's entitlement – 21 May 2023			
Proceeds	1,312,500	94,000	1,500,000
Less: Trustees base cost	(1,125,075)	(84,000)	(689,000)*
Gain	187,425	10,000	811,000
Less: 2023/24 Trust annual exemption	-	-	(6,150)
Taxable gain	187,425	10,000	804,850
CGT @ 20% / 20% / 28%	£37,485	£2,000	£225,358

* the base cost of Wilton House is Lily's acquisition cost, £420,000, due to the holdover claim on creation of the trust plus £269,000 apportioned IHT.