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Application and Professional Skills

Inheritance Tax, Trusts & Estates

Suggested solution

REPORT TO THE EXECUTORS OF THE ESTATE OF ADAM JONES

Introduction & Scope

This report is prepared for the executors of Adam Jones and is based on information provided by them. It considers the tax implications of issues relating to the estate and is issued in accordance with our engagement letter of 15 April 2019.

1. Executive Summary

a. The executors have made disposals during 2018/19. They are now considering selling The Haven for £600,000 or deferring the sale for several years in the hope of achieving a higher sale price. If they proceed with the sale and no tax planning is undertaken, Capital Gains Tax ("CGT") of approximately £7,022.60 will become payable for 2018/19 and a potentially unusable capital loss of £201,280 will arise on the sale of The Haven.

b. We recommend the executors proceed with the sale of The Haven now and that a claim for Inheritance Tax ("IHT") loss relief should be made. This will allow the probate values of all properties sold to be replaced by their gross sale values, resulting in a loss of £165,000 on which £66,000 IHT relief will be due. The claim will also reduce the 2018/19 CGT liability to nil.

c. The sale of The Haven should not be deferred until after 9 October 2021. Even if a sale price of £650,000 is achieved after this date, an IHT loss relief claim will no longer be available and the additional £50,000 proceeds will not compensate for the £66,000 IHT relief lost.

d. Rose wishes to transfer either Red Cottage or 10 shares in Jones Pet Foods Ltd ("the Company") to her daughter, Abby, in July 2019. Our advice is to transfer Red Cottage to her instead of the shares; this is because Rose will no longer control the Company if 10 shares are transferred and 50% IHT business property relief will be lost on the value of The Factory.

e. We recommend that Red Cottage is redirected to Abby via a Deed of Variation including the appropriate CGT and IHT statements. This will avoid a £19,124 CGT liability and the IHT issues that may arise if Rose does not survive seven years from the date of the gift.

2. Report to the executors

a. Sale of The Haven and other disposals

Current position

During 2018/19 the executors sold Sandy Bay Chalet, Mulberry Lodge, the quoted shares and the household goods and chattels. Any capital gains on the household goods and chattels are exempt from CGT as the proceeds were less than £6,000 per item and there were no sets or collections of items included. The other disposals are chargeable based on the difference between the proceeds and the probate value.

The executors may claim a deduction of 0.16% of the probate value up to a maximum of £10,000 to represent the costs of obtaining probate on assets sold (or if higher, the actual costs incurred can be claimed instead) and the CGT annual exemption for the 2017/18, 2018/19 and 2019/20 tax years are also available. Any costs of sale (such as estate agent or stockbrokers' fees) are also deductible.

The estate's 2018/19 disposals result in a taxable gain of £26,177 prior to the deduction of costs of sale, on which £7,022.60 CGT is payable. The liability will decrease slightly once the costs of sale have been taken into account. The CGT is payable to HM Revenue & Customs (HMRC) by 31 January 2020. (See **Appendix A** for calculations).

If the executors accept the current offer of £600,000 for The Haven, a capital loss of £200,000 will arise in the current tax year based on the difference between the £800,000 probate value and the sale proceeds. The deduction of £1,280 is still available to account for the costs of obtaining probate (0.16% x £800,000), increasing the loss to £201,280 and any costs of sale will also be allowable.

The loss may only be offset against estate gains in the current or future tax years. As there are only a few chargeable assets left in the estate which the estate is unlikely to sell, the capital loss could remain unused.

An estate capital loss cannot be transferred to the beneficiaries, but The Haven may be assented to Abby and Steven, the residuary beneficiaries, to sell the property personally. This will result in a £200,000 personal capital loss (£100,000 each) which will increase slightly after accounting for any costs of sale incurred by Abby and Steven. Please note, the deduction for probate costs cannot be claimed personally.

I note that Abby and Steven both have unused capital losses from earlier years. Therefore, unless they have assets which they plan to sell at a large gain, the loss on The Haven will simply increase their existing loss total which is carried forward and may remain unused.

<u>Inheritance Tax (IHT) Loss Relief</u>

Another option is for IHT loss relief to be claimed instead of claiming the capital loss. This relief is available for land and buildings sold by the executors at a lower value than the probate value within four years from the date of death. It allows the lower value to be substituted for the probate value, thereby reducing the taxable value of the estate, creating an IHT reduction.

The gross proceeds of all land and buildings sold from the estate up to 9 October 2020 (three years from Adam's date of death) must be considered ignoring the costs of sale and the 0.16% deduction referred to above. Therefore, the gains of £5,000 and £30,000 on Sandy Bay Chalet and Mulberry Lodge, respectively, must be offset against the £200,000 loss on The Haven. This produces a net loss of £165,000 resulting in an IHT reduction of £66,000 (£165,000 x 40%).

If the administration period of Adam's estate continues into a fourth year after his death, any property sales made at a loss during the period 10 October 2020 to 9 October 2021 must also be included.

The loss relief is available on submission of a claim to HMRC by the executors and an interest supplement will be paid from the original IHT payment date if a tax refund arises.

Once the claim is made, the reduction in the gross value arising on sale cannot also be claimed as a capital loss for CGT purposes. The probate value will be reduced to the same value as the gross sale proceeds although a small capital loss will still arise on any allowable costs of sale incurred. These losses will be offset against the 2018/19 gain on the quoted shares and any remaining gains will be covered by the CGT annual exemption. As a result, no CGT will be payable by the executors for 2018/19.

If the executors take the property off the market and sell it after 9 October 2021 it will not be possible to claim IHT loss relief, as more than four years will have elapsed since Adam's date of death. Furthermore, even if the executors obtain a sale price of £650,000 after this length of time, the additional £50,000 proceeds will not compensate for the £66,000 IHT relief lost and the 2018/19 CGT of £7,022.60 on the other disposals will still be payable. In addition, the estate (or Abby and Steven, if the property is assented to them) will have to accept the lower level rental income and pay income tax on this and the executors (or beneficiaries between them) will have a capital loss of £150,000 to offset against current / future gains, which may remain unutilised.

Recommendation

We recommend the executors to accept the offer of £600,000 and sell The Haven now. A claim for IHT loss relief can then be made to obtain an IHT reduction of £66,000 and no CGT will be due for 2018/19.

b) Transfer of assets to Abby

Rose wishes to gift assets to Abby, starting with a gift of either Red Cottage or 10 shares in the Company in July 2019.

(i) Red Cottage

There are two different ways in which Red Cottage may be transferred to Abby. Firstly, Rose can make a direct gift to Abby in July or alternatively, Rose can enter into a Deed of Variation (DOV) of Adam's Will in July to redirect Red Cottage to Abby from the estate.

- Direct gift to Abby

Should Rose make a direct gift of Red Cottage to Abby this will be a chargeable event for CGT purposes. Parents and their children are treated as connected persons for CGT and any transfers between them are treated as disposals at market value, even though no consideration passes hands.

Red Cottage has increased in value since the probate valuation and assuming it is still valued at £480,000 in July, a capital gain of £80,000 will arise on the transfer to Abby. Rose usually utilises her CGT annual exemption against quoted share disposals, but it would be beneficial to allocate the exemption against the Red Cottage gain in this case because it will be taxed at the 28% rate as Rose is an additional rate taxpayer. This will leave a taxable gain of £68,300 on which £19,124 CGT will become payable, Red Cottage is not a business asset, so no CGT reliefs will be available to reduce or defer the payment due to HMRC by 31 January 2021.

The gift of Red Cottage will be a potentially exempt transfer (PET) by Rose for IHT purposes. No IHT will become payable when the gift is made and provided Rose survives at least seven years, the value of the gift will become exempt from IHT. If Rose does not survive seven years, the gift will become chargeable and will utilise the nil rate band in priority to Rose's estate. A tapering relief is available to reduce the IHT payable if she survives more than three years from the date of the gift.

- Using a Deed of Variation (DOV)

The alternative to a direct gift is the use of a DOV. This allows assets to be redirected from an estate to new beneficiaries, so could be used to redirect Red Cottage from Rose to Abby. There is a two-year time limit from Adam's date of death for making a valid DOV, so this option is available until 10 October 2019.

For CGT purposes, the DOV will be treated as a disposal of Red Cottage by Rose as she has given up her entitlement to the property. However, if the DOV is made in writing, for no consideration and a specific CGT statement is made, there will be no CGT disposal and Abby will acquire Red Cottage at the probate value.

For IHT purposes, a DOV will be treated as a transfer of value by Rose and seven years must pass before this falls out of account. However, if the DOV is made in writing, for no consideration and a specific IHT statement is included, Red Cottage will be treated as though it has passed to Abby under the terms of Adam's Will.

The IHT and CGT statements are separate, but in this case, it is advisable for both statements to be included. For CGT purposes, Red Cottage has increased in value, so including the CGT statement will avoid a CGT liability, although it does mean that Abby will acquire the property at the probate value of £400,000, not the current value of £480,000. For

IHT purposes, including the IHT statement will avoid issues that may arise if Rose does not survive seven years from the DOV.

A DOV is not retrospective for Income Tax and as Red Cottage was a specific gift to Rose in Adam's Will any rental income arising from the property up to the date of the DOV will be taxable on Rose and then transferred to Abby after the DOV is in place.

(ii) <u>10 shares in the Company</u>

The gift of 10 shares to Abby could also be made directly from Rose or via a DOV. The tax issues relating to both options are explored below.

- <u>Direct gift to Abby</u>

As referred to above, a direct gift of the shares to Abby will be a chargeable event for CGT purposes as Rose and Abby are connected persons.

Rose's current holding in the Company is 56 shares, which is made up of 28 shares inherited from her father and a further 28 shares from Adam's estate. For CGT purposes, both sets of shares will be pooled together, so the base cost of 28 shares from Adam's estate is the probate value of £1,344,000 and the cost of the other 28 shares is £210,000 (the 1988 probate value of £7,500 x 28 shares), resulting in a total base cost of £1,554,000 for her 56 shares.

This means the base cost of 10 shares will be £277,500 (£1,554,000 x 10/56) and as their current market value is £480,000, a gain of £202,500 will arise for Rose on the gift to Abby. The Company is trading and holds no investment assets, Rose has worked for the Company for many years and has held at least 5% of the Company's shares and voting rights for more than 12 months, so the transfer will qualify for Entrepreneur's Relief (ER). This means a 10% CGT rate will apply to the gain (assuming Rose has not exceeded the ER lifetime limit), resulting CGT of £20,250 on the gift.

The Company is an unquoted trading company, so it is possible for a CGT hold-over relief claim to be made jointly by Rose and Abby to avoid the payment of CGT by Rose on the transfer. However, the effect of a claim is that the base cost of Abby's 10 shares for future share disposals will be only £277,500.

For IHT purposes, the gift of shares will be a PET, so no IHT will become payable when the gift is made and provided Rose survives at least seven years, the gift will become exempt from IHT. If Rose does not survive seven years, the gift will become chargeable but should qualify for 100% business property relief (BPR) if the necessary conditions are met both at the time when the gift is made and at the date of Rose's death.

It appears that the BPR conditions are currently met; the shares are in a qualifying company, that is an unquoted trading company with no investment assets and there are no contracts in place for the sale of the Company. It is usually necessary for the donor of a gift to have owned the asset for at least two years for BPR to be available but in this case, Rose has not owned all her shares for the requisite two year period (as Adam's death was in October 2017). However, the BPR two year ownership requirement is waived where there have been two successive transfers in a two year period, provided the earlier transfer qualified for BPR and one of the transfers was made on death. In this case, the proposed transfer to Abby is being made within a two year period from Adam's death and the transfer from Adam to Rose on his death qualified for BPR.

It should be noted that the Company must retain its unquoted trading status and Abby must retain the shares for a seven year period from the date of the gift (or if earlier, to the date of Rose's death) in order to avoid a clawback of BPR (unless she acquires replacement property qualifying for BPR).

- Using a Deed of Variation (DOV)

Instead of a direct gift, Rose could enter into a DOV to transfer the shares to Abby. Since Adam left his shares to Rose as a specific legacy, it is not necessary for Steven to be party to the DOV in this case.

As with Red Cottage, CGT and IHT statements are advisable. For CGT purposes, including the statement will allow Abby to acquire the shares at probate value, giving her a base cost of £480,000 (£2,688,000 x 10/56). In addition, the CGT liability of £20,250 will be avoided by Rose and the holdover claim referred to above will not be required. For IHT purposes, a statement will avoid issues arising if Rose does not survive seven years from the DOV if BPR is no longer available.

- Other IHT issues

There is a further IHT issue which needs to be highlighted as it is likely to be a deciding factor for Rose in choosing whether to transfer Red Cottage or shares in the Company to Abby.

Rose owns The Factory, the property from which the Company trades, and this property will only qualify for 50% BPR if it is owned by the same individual who controls the Company. Following the inheritance from Adam, Rose's shareholding has increased to 56 shares out of the 100 shares in issue, so she controls the Company and as a result, The Factory currently qualifies for 50% BPR. Given that The Factory is worth £990,000, this is very valuable IHT relief.

However, if Rose gifts 10 shares to Abby, she will be left with only 46% of the shares and will lose control of the Company and also lose £495,000 BPR on The Factory, increasing her personal IHT exposure by £198,000 (£495,000 @ 40%).

Recommendation:

Due to the level of BPR that Rose will lose on The Factory, we would not recommend a transfer of 10 shares to Abby (either as via a direct gift or a DOV). As Red Cottage and 10 shares in the Company are currently valued at £480,000 and Abby will receive a similar income stream from either asset, we advise that the property is transferred to her instead.

A direct gift of Red Cottage will result in CGT with no reliefs for Rose as well as a PET for IHT purposes. Therefore, a better option will be for Rose to enter into DOV to redirect Red Cottage to Abby thereby avoiding these issues.

In the future, Rose may want to consider transferring five shares in the Company to Abby. This will allow Rose to retain control of the Company (56 – 5 = 51% holding) and 50% BPR on The Factory. Once Abby has held the shares for 12 months, they should qualify for CGT ER, assuming the Company and Abby meet the other qualifying conditions and after two years, Abby's shares should also qualify for BPR.

Appendix A

2018/19 CGT Computations

Sandy Bay Chalet	£	£	£
Gross sale proceeds*	355,000		
Less: Probate value	(350,000)		
Deduction for costs of probate (0.16% x £350,000)	(560)		
Gain		4,440	
Mulberry Lodge			
Gross sale proceeds*	280,000		
Less: Probate value	(250,000)		
Deduction for costs of probate (0.16% x £250,000)	(400)		
Gain		29,600	
Total gains		34,040	
Less: 2018/19 Annual Exemption		(11,700)	
Residential property gains			22,340
Quoted shares			
Proceeds*	857,200		
Less: Probate value	(852,000)		
Deduction for costs of probate (0.16% x £852,000)	(1,363)		
Gain			3,837
Taxable gains			26,177
CGT - residential property	22,340	@ 28%	6,255.20
CGT – other	3,837	@ 20%	767.40
	26,177		
Total CGT due 31 January 2020			7,022.60

* A deduction will also be allowed for any costs of sale incurred (eg. estate agents, lawyers and stockbrokers fees)

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 and calculate CGT due on sale of assets already sold within the estate in 2018/19. Calculate capital loss on proposed sale of The Haven and comments on future use of the loss.
2	25%	Identify that post-mortem IHT loss relief will be available on proposed sale of The Haven. Calculate loss (offsetting gains) and explain effect on estate's CGT position. Comment on importance of time limits for the relief.
3	15%	Identify CGT and IHT implications of a direct gift of Red Cottage to Abby and compare to CGT and IHT issues of using a Deed of Variation (DOV) instead.
4	25%	Identify CGT and IHT implications of a direct gift of ten shares in Jones Pet Foods Ltd to Abby (including identifying correct base cost of shares for CGT and BPR issues for IHT). Compare CGT and IHT issues if DOV is used.
5	20%	Identify that gift of ten shares to Abby (either direct or via DOV) will result in Rose no longer controlling the company and therefore, losing 50% BPR on The Factory.

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. 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 Recommendations

The following are the topics for assessment with their weightings:

40%	Advice and recommendations on whether The Haven should be sold now for a lower price or retained in the hope of achieving a higher price.
50%	Advice and recommendations on the gift of either Red Cottage or ten shares in Jones Pet Foods Ltd to Abby.
10%	Recommending whether the chosen gift to Abby should be a direct gift or via a Deed of Variation.

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