The Chartered Institute of Taxation

Application and Professional Skills

Inheritance Tax, Trusts & Estates

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Suggested solution

Report to the Trustees of the Hartley Settlement

This report is prepared for the trustees of the Hartley Settlement. It is based on the information provided at their meeting with Caroline Robinson on 2 May 2022 and is issued in accordance with our engagement letter dated 18 June 2021.

The report considers the tax implications of the sale of the farm shop and land and barns at West Fields. It also advises on the appointment of funds or assets to Peter Hartley and the cessation of his interest in possession in the Hartley Settlement.

1. Executive Summary

a. A direct sale of the farm shop, land and barns at West Fields will result in a capital gains tax ("CGT") liability of £435,020 for the trustees of the Hartley Settlement (the "Trust") and will leave net funds of £1,884,980 available to appoint to Peter.

b. In comparison, if West Fields is appointed to Peter, CGT holdover relief can be claimed on the gains relating to the goodwill and the assets used in the farm shop business, leaving a CGT liability of £397,820 payable by the trustees.

c. Once the West Field assets have passed to Peter, he can transfer these into joint names with Saskia prior to the exchange of contracts, so that she is also a party to the sale to the third-party purchaser. This will allow her capital loss to be utilised as well as two annual exemptions. Peter and Saskia will have a joint CGT liability of £17,220 on the sale but the net cash funds available will be £1,904,960, resulting in a tax saving of £19,980.

d. If Peter's interest in the Trust ends and the Trust continues with Luke as a new life tenant, a lifetime Inheritance Tax ("IHT") charge of £53,385 will become payable by the trust, but no CGT will be due.

e. If the Trust ends when Peter gives up his interest and the assets pass to Luke absolutely, there will be no lifetime IHT payable by Peter (provided he survives seven years). A CGT liability of £85,500 will arise on the transfer of East Fields to Luke, as the land is not eligible for CGT holdover relief at the present time.

2. Report to the Trustees

Trust Background

The Trust is an interest in possession ("IIP") settlement created by Geoffrey Hartley on 8 May 1995. It provides Peter with the right to receive the income generated by the trust assets.

The Trust was created during Geoffrey's lifetime and prior to 22 March 2006, so Peter's interest is a qualifying interest in possession ("QIIP"), meaning the value of the Trust assets will be aggregated with Peter's estate on his death.

a. Sale of West Fields

There has been an offer to purchase the goodwill and assets of the farm shop, barns and land at West Fields and the trustees intend for the net proceeds to pass to Peter.

There are two options in this respect: the first is a direct sale by the trustees followed by an appointment of the net cash proceeds to Peter; the second is for the assets to be appointed out of the trust to Peter prior to the sale followed by a transfer into joint names with Saskia. They can then personally sell the assets to the purchaser. The tax implications of each option are detailed below.

i) <u>Direct sale by the trustees and appointment of cash funds to Peter</u>

A sale by the trustees will result in a capital gain for them based on the difference between the base cost of each chargeable asset and the selling price.

The settlor did not claim holdover relief on the land and barns at West Fields when he created the Trust, therefore, the trustees' CGT base cost is the value of each asset on 8 May 1995. The expenditure incurred on converting the derelict barn and land into a farm shop and car park is also allowed for CGT purposes.

On this basis, a taxable gain of £2,175,100 will arise on the sale after deducting the Trust's annual exemption.

The disposal would normally qualify for Business Asset Disposal Relief (BADR) because Peter holds an IIP in the West Fields assets and the farm shop is a business owned by the trustees but run by him (the beneficiary holding the IIP). The developed barn, goodwill and parking area have been used within this business during the two year period to the date of sale.

However, trustees are only able to claim BADR jointly with the beneficiary if that beneficiary's BADR lifetime limit of £1 million is available. In this case, Peter has already fully utilised his lifetime limit when he and Saskia sold their architect practice. This means the 10% BADR rate will not be available and the whole gain will be taxable at 20%, resulting in a CGT liability of £435,020 (see Appendix 1 calculations). Assuming the sale goes ahead before 5 April 2023, this will become payable to HMRC by 31 January 2024.

£1,884,980 of cash funds (ie. £2,320,000 - £435,020) less any costs of sale will be available to appoint to Peter from the Trust. There will be no IHT implications as he is the life tenant of a QIIP, so the trust assets will already be aggregated with his estate and no CGT implications will arise as only cash will be appointed.

ii) <u>Appointment of West Fields and onward sale by Peter and Saskia</u>

If the goodwill, land and barns are appointed out of the Trust to Peter prior to the exchange of contracts and he then transfers the assets into joint names with Saskia, they can then sell the assets personally. A transfer between spouses is a nil gain/loss transaction and Saskia will acquire her share of the assets at Peter's base cost.

The appointment of the West Fields assets to Peter will not have any IHT implications as he is the life tenant of a QIIP trust.

For CGT purposes, the appointment will be a disposal by the trustees at market value, resulting in a chargeable gain of £2,181,250 (see previous calculations at Appendix 1). However, part of this gain (£186,000) relates to the goodwill, the farm shop and car park which are all business assets, so CGT holdover relief may be claimed in respect of that part of the gain.

The effect of the claim is that the trustees will have no CGT liability on this element of the gain and Peter will acquire the assets at the trustees' base cost, in this case the value on 8 May 1995 together with the enhancement costs. This a joint claim between the trustees and Peter and must be made within four years from the end of the tax year of the appointment.

The remaining gain cannot be held over as it does not derive from business assets and the appointment to Peter as life tenant does not result in an IHT charge. Therefore, a CGT liability of £397,820 will arise for the trustees (see Appendix 2 for calculation) payable by 31 January 2024.

On the subsequent disposal by Peter and Saskia (following a transfer into their joint names) to the purchaser, there will be no gain on the undeveloped barns and 35 acres, as they will acquire this property at market value deemed equal to the sale price.

However, a capital gain of £186,000 will arise on the goodwill, converted barn and car park as they will take on the trustees' base cost. Saskia's £75,300 capital loss and their annual exemptions can be offset against this, reducing the taxable gain to £86,100. CGT will be due at 20%, resulting in a liability of £17,220 due for payment by 31 January 2024.

The net cash sum available to Peter and Saskia after tax will be £1,904,960 (£2,320,000 – (£397,820 + £17,220)).

Recommendation

We recommend that the trustees appoint West Fields to Peter subject to a joint claim for CGT holdover relief being made in respect of the goodwill of the farm shop, developed barn and car park.

Following the appointment, the assets should be put into joint names with Saskia in order to utilise her capital loss and both of their annual exemptions on the onward sale of the West Fields assets.

Peter and Saskia will receive a net cash sum of £1,904,960 following the sale, compared to £1,884,980 if there is a direct sale from trustees, so a tax saving of £19,980.

b) Cessation of the Peter's QIIP

There are various IHT reliefs currently available to the trustees and they would like the Trust to continue but with Luke as the new life tenant. However, as requested, the tax implications of the assets passing to Luke absolutely are also explained.

i) Ending Peter's QIIP and the Trust continuing with Luke as life tenant

IHT

If the Trust continues after Peter gives up his interest, this will be deemed a chargeable lifetime transfer (CLT) by him for IHT purposes and the Trust will fall within the Relevant Property Trust (RPT) regime with effect from that date.

IHT will be payable at the lifetime rate of 20% on the CLT exceeding Peter's nil rate band ("NRB") and after the deduction of any reliefs and exemptions. The value of the CLT will fall outside of Peter's estate once seven years have passed, but if he does not survive this period, additional IHT will become payable at 40%, although credit will be given for the lifetime IHT paid. If he survives more than three years, a tapering relief will be available to reduce the IHT rate applicable.

As the majority of the Trust's assets are used for agricultural purposes, Agricultural Property Relief (APR) will be available to reduce the value of Peter's CLT.

APR is available on the agricultural value of land and buildings occupied for agricultural purposes. The rates of APR are 50% or 100% depending upon the type and use of the asset.

100% APR is available where qualifying land and buildings are owned and occupied for agricultural purposes for two years and are farmed in hand. 100% APR is also available where the land has been owned for seven years and occupied throughout by someone else during that period for agricultural purposes. The 50% APR rate applies if land used for agricultural purposes has been let on a tenancy that commenced prior to 1 September 1995 and which does not allow the landlord to obtain vacant possession within 24 months.

APR is only available on the agricultural value of the assets, so if the market value exceeds the agricultural value, the excess will not qualify for APR, although Business Property Relief (BPR) may be available.

100% BPR is available on assets which qualify as relevant business property in the hands of the owner and have been owned for two years. This includes assets used in a business which are not fully covered by APR. Where both APR and BPR are available on the same asset, APR is always applied first.

Looking at the Trust assets, the trustees grow crops on the 120 acres of arable land at North Fields and it has been held within the Trust for more than two years, so this will qualify for 100% APR. In addition, the 30 acres of surrounding woodland performs a function in the business as a shelter for the crops and the six barns are used wholly in the business, so 100% APR will also be available on the agricultural value of these assets.

South Fields has also been used for agricultural purposes by the trust for over two years, so this area will qualify for 100% APR on the agricultural value only. Both North Fields and South Fields are farmed by the trustees and so long as this continues up until Peter gives up his life interest, the excess market value over the agricultural value will qualify for 100% BPR.

The 90 acres at East Fields are let to a neighbouring farmer who is using the land for sheep farming which qualifies for agricultural purposes, however, this did not start until June 2017. This means the land has not been occupied for agricultural purposes for seven years, so APR will not be available.

Furthermore, no IHT reliefs are available on the cash held in the trust bank account, so the value of the CLT will be £591,925 (ie. £585,000 value of East Fields (£6,500 x 90 acres) plus £6,925 cash balance).

Other than using his IHT annual exemption, Peter has made no lifetime gifts, so his full NRB of £325,000 will be available. This leaves £266,925 taxable at 20%, resulting in an IHT liability of £53,385 payable six months following the end of the month in which Peter's interest ceases. The trustees have the option of paying the IHT relating to East Fields in ten equal annual instalments over ten years if they wish.

It should be noted that if Peter does not survive seven years from the date of the CLT and the trustees have either sold any of the assets and not replaced them with another qualifying asset, or if the assets are no longer used for agricultural purposes, the APR and BPR previously given can be clawed back. This will mean that the CLT will utilise Peter's IHT nil rate band in priority to the rest of his free estate.

Going forward, the Trust will become a RPT and liable to IHT charges when assets leave the Trust and on each ten year anniversary of the creation. The original creation date will be used in this respect, therefore, the first ten year charge will be on 8 May 2025.

Tax relief will be given when this charge is calculated because the assets will not have been relevant property for the full ten year period. In addition, if the Trust has farmed the land for at least two years or let out any land for qualifying agricultural purposes for at least seven years at the anniversary date, APR should still be available. BPR will also be available to cover the market value of any land exceeding of the agricultural value where the land is farmed in hand by the trustees.

CGT

There will be no CGT consequences for the trustees when Peter's life interest ends because the Trust will continue with Luke as the life tenant and the Trustees will remain holding the assets at their original base costs.

i) Ending Peter's QIIP and passing the assets to Luke absolutely

IHT

If Peter's life interest ceases and the assets pass to Luke absolutely, thereby ending the Trust, this will be a potentially exempt transfer (PET) by Peter for IHT purposes.

The PET of the gifted Trust assets will no longer be aggregated with Peter's estate if he survives seven years from making the PET. However, if he does not survive seven years, the PET will become chargeable and its value will utilise Peter's IHT NRB on death in priority to the rest of his estate.

The value charged to IHT if Peter does not survive seven years can be reduced by APR and BPR so long as the assets qualify for these reliefs both at the date of the PET to Luke and on Peter's death.

As referred to above, both North Fields and South Fields currently qualify for 100% APR on their agricultural value and 100% BPR will be available on the excess market value, so long as the trustees farm the land up until the date of the PET. Therefore, if Luke retains North Fields and South Fields and still uses them for agricultural purposes, or if he has sold them and replaced them with other APR/BPR qualifying assets, then the reliefs will be available if Peter does not survive seven years from making the PET.

The value after tax reliefs exceeding the NRB on death will become liable to IHT at 40%. The tax will be payable by Luke as donee. If Peter survives more than three years, a tapering relief will be available to reduce the IHT rate applicable.

<u>CGT</u>

The cessation of Peter's IIP in this scenario will result in a disposal of the Trust assets at market value by trustees. The CGT is based on the difference between the current values and the trustees' original base costs, which are the values at 6 October 1983 for North Fields and South Fields due to Geoffrey's previous holdover claim and for East Fields, the value on 8 May 1995.

On this basis, total capital gains of £2,720,500 will arise (£1,735,500 for North Fields, £557,500 for South Fields and £427,500 for East Fields - see Appendix 3 for calculations) on which CGT will be payable at 20%. Assuming Peter gives up his IIP during 2022/23, the Trust annual exemption will have already been used, so a liability of £544,100 will arise.

North Fields and South Fields are assets used in the Trust's farming business and they qualify for 100% APR, therefore, it is possible for business asset holdover relief to be extended to the gains relating to them.

The effect of the holdover claim is that no CGT will be payable on North Fields or South Fields, leaving only the gain of £427,500 on East Fields liable to 20% CGT. The resulting liability for the trustees will be £85,500 payable by 31 January 2024.

The holdover claim must be made jointly with Luke, and he will acquire North Fields and South Fields at their values on 6 October 1983 for future CGT purposes. In comparison, his base cost for East Fields will be the current market value.

<u>Recommendation</u>

If Peter's QIIP ends and the Trust continues with Luke as life tenant, an IHT liability of £53,385 will become payable but no CGT will be due. In comparison, if the Trust ends and the assets pass to Luke absolutely, there will be no immediate IHT charge, but £85,500 CGT will be payable on East Fields as full holdover relief will not be available. Therefore, purely from a tax perspective, our recommendation is that the Trust should continue with Luke as life tenant, as a £32,115 tax saving will be achieved.

The trustees also need to bear in mind that the Trust will become an RPT so IHT exit charges and ten year anniversary charges will arise and if the land ceases to be used for agricultural purposes in the future, APR may not be available. Furthermore, the trustees must take into account their duty of care to the beneficiaries and ensure that they are always acting in their best interests.

Appendices

Appendix 1

CGT on sale of goodwill of farm shop, land and barns at West Fields by the trustees

	Total	Goodwill	Developed barn & 5 acres of land	Undeveloped barns & 35 acres of land
	£	£	£	£
Proceeds	2,320,000	120,000	150,000	2,050,000
Less: Cost (value on 8 May 1995)				
Land				
£1,250 per acre	(50,000)	(0)	(6,250)	(43,750)
Barns				
£2,750 each	(13,750)	(0)	(2,750)	(11,000)
	2,256,250	120,000	141,000	1,995,250
Less: Enhancement expenditure	(75,000)		(75,000)	
Chargeable Gain	2,181,250	120,000	66,000	1,995,250

All assets are taxable at 20%, so the annual exemption ("AE") can be allocated against any element of the gain.

Less: Trust AE	(6,150)
Taxable Gain	2,175,100
CGT @ 20%	£435,020

Appendix 2

<u>CGT on sale of goodwill of farm shop, land and barns at West Field by Peter & Saskia following appointment from the Trust</u>

1) Trustees gains on appointment of assets to Peter

	Total £	Goodwill £	Developed barn & five acres of land £	Undeveloped barns & 35 acres of land £
Chargeable Gain from above	2,181,250	120,000	66,000	1,995,250

Gains on the goodwill, developed barn and five acres can be held over, so the annual exemption will be allocated against the remaining assets

Less: Trust AE	(6,150)
Taxable Gain	1,989,100
CGT @ 20%	£397,820

2) <u>CGT for Peter & Saskia on sale to third-party</u>

	Total £	Goodwill £	Developed barn & 5 acres of land £	Undeveloped barns & 35 acres of land £
Proceeds	2,320,000	120,000	150,000	2,050,000
Less: Base cost	(2,134,000)	(0)	(84,000)	(2,050,000)
Chargeable Gain	186,000	120,000	66,000	0

All assets are taxable at 20%, so Saskia's capital loss and the annual exemptions can be allocated against any element of the gain.

Less: Capital loss b/fwd	(75,300)
Less: AE's x 2	(24,600)
Taxable Gain	86,100
CGT @ 20%	£17,220

Appendix 3

CGT on cessation of Peter's IIP

	North Fields	South Fields	East Fields
	£	£	£
Proceeds (MV)			
Land	1,800,000	625,000	585,000
Woodlands	132,000		
Barns	60,000		
	1,992,000	625,000	585,000
Less: Base costs			
Value 6 Oct 1983:			
Land	(240,000)	(67,500)	
Woodlands	(10,500)		
Barns	(6,000)		
Value 8 May 1995:			(157,500)
Chargeable Gain	1,735,500	557,500	427,500