



The Chartered Tax Adviser Examination

May 2020

Application and Professional Skills

Inheritance Tax, Trusts & Estates

SUGGESTED SOLUTION

Report to Jennifer Lewis & the Trustees of the Lewis Family Settlement

Introduction & Scope

This report is prepared for Jennifer Lewis and the Trustees of the Lewis Family Settlement. It is based on details held in our permanent records and the information provided in your letter of 1 May 2020.

It considers the tax implications of transferring assets to Anthony Lewis and Laura Anderson and is issued in accordance with our letters of engagement.

1. Executive Summary

- a. A gift of 25 shares in Lewis Timber Supplies Ltd (“the Company”) from Jennifer to Laura will result in a Capital Gains Tax (“CGT”) liability and will be a potentially exempt transfer (“PET”) for Inheritance Tax (“IHT”) purposes. However, holdover relief may be claimed to avoid payment of the CGT liability and no IHT will be payable on the gift if Jennifer survives for the following seven years.
- b. If the Trustees of the Lewis Family Settlement appoint 25 shares in the Company to Laura instead, this will also result in a CGT liability which can again be heldover. The transfer will give rise to an IHT exit charge, but as the shares are likely to qualify for 100% business property relief, no IHT will be payable.
- c. We recommend that Laura receives the 25 shares as a direct gift from Jennifer so the Trust may retain its current level of dividend income and avoid using the cash account to pay the annual IHT instalments due to HMRC. In addition, on the recommendation that a claim for holdover relief is made, Laura’s base cost following a direct gift will be £325,013, compared to only £50,000 if shares are appointed from the trust.
- d. It is more beneficial for the trustees to sell 3 Oaklands Avenue after Anthony and his family have lived in the property for two years and then for the net post tax cash proceeds to be appointed to him at the end of December 2022, instead of the property being appointed to Anthony to sell himself at this date..

This will result in a net cash payment of £739,966 to Anthony and will leave the trust bank account with a balance of approximately £40,130 more than it would hold if Anthony sells the property personally.

- e. The move to Larch Cottage by Jennifer should be delayed until after 10 January 2021 so that a Pre Owned Asset Tax charge does not arise.

2. Report to Jennifer Lewis and the trustees of the Lewis Family Settlement

a. Transfer of 25 shares in Lewis Timber Supplies Ltd to Laura

You have advised that you wish to transfer 25 shares in the Company to Laura and you would like this to be either a direct gift or an appointment from the Lewis Family Settlement. We will look at each of these options in turn.

i) Direct gift

For IHT purposes, the gift to Laura will be a PET so no IHT will become payable when it is made and provided you survive more than seven years post gift it will achieve full exempt status.

If you do not survive seven years, the gift will become chargeable, but the shares will qualify for 100% business property relief ("BPR") thereby avoiding a positive IHT charge provided the necessary conditions are met both at the date of the gift and at your date of death. The conditions are that you must have owned the shares for at least two years and they must be shares in an unlisted trading company which does not deal wholly or mainly in securities, stocks or shares, land or buildings or making or holding investments. In addition, the company 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. Laura should be advised to retain the shares during the seven year period from the date of the gift (or until your death if sooner) and to take advice if she ever considers selling them within the seven year period, as it is possible to retain BPR if replacement property is acquired.

For CGT purposes, parents and children are connected persons and any transfers between them are treated as disposals at market value, even though no consideration has passed hands. Therefore, a gift of shares to Laura will be a chargeable event resulting in a capital gain assessable on you.

The base cost of your 50 shares is half of the probate value when James died (£650,000) and half of Douglas's original acquisition cost (£25), as holdover relief was claimed when he gifted them. Therefore, the base cost of 25 shares is £325,013.

The current market value of 25 shares is £850,000, so a gain of £524,987 will arise on the gift. Assuming your CGT annual exemption has not already been utilised on disposals within your share portfolio, the £12,000, exemption can be deducted, leaving a taxable gain of £512,987. As you no longer work for the Company, the 10% CGT Entrepreneur's Relief rate will not apply, leaving the gain taxable at 20%, resulting in a liability of £102,597 (see Appendix A calculations).

However, as the Company is an unquoted trading company it is possible for holdover relief to be claimed to avoid the payment of CGT on the transfer. The gain can be heldover without any restrictions so long as the company does not hold any chargeable assets that are not used in the trade. The effect of a claim is that Laura's CGT base cost for future disposals will be £325,013 for the 25 shares.

ii) Appointment from the Lewis Family Settlement

The Lewis Family Settlement was created by Douglas on 10 October 2005 and provided a life interest to James. As it was created in lifetime before 22 March 2006, James' held a qualifying interest in possession and on his death the value of the trust assets were aggregated with his free estate for IHT purposes.

After James' death the trust became a relevant property trust as the trustees thereafter hold the assets on discretionary trusts for Anthony and Laura. This means that the Trust is subject to IHT exit charges when assets leave the Trust and ten-year anniversary charges based on the original creation date. The next ten-year anniversary will be on 10 October 2025.

If 25 shares are appointed to Laura from the Trust, this is a chargeable event for IHT attracting an exit charge. This is calculated using the hypothetical anniversary charge rate that would have arisen at the date of the last ten year anniversary on 10 October 2015 substituting the trust value on 15 October 2015 when the Trust became a relevant property trust. The rate is then reduced to exclude any complete quarters that have passed between the hypothetical anniversary date and the date the trust became a relevant property trust.

However, in the case of the proposed appointment to Laura, the shares are in an unquoted trading company which the trustees have held for more than two years, so 100% BPR should be available to reduce the chargeable value to nil.

For CGT purposes, a transfer of the shares to Laura from the Trust will be a deemed disposal by the Trustees at market value.

A taxable gain of £794,000 will arise on the transfer as the Trustees' hold the shares at Douglas's original base cost of £50,000 (see Appendix 1 calculations).

The Trust was originally a qualifying interest in possession and therefore a deemed disposal at market value arose on James' death. In these circumstances, CGT does not usually become chargeable unless the original gain on transfer of assets into the Trust was heldover. In Douglas's case, such a holdover claim was originally made, so a CGT charge should have arisen on James' death. However, a second holdover relief claim was made on 30 November 2016 to defer the gain once more, resulting in Douglas's original base cost of £100,000 passing to the Trustees.

CGT is payable at 20% on the gain, resulting in a liability of £158,800. However, as the Trust is now a relevant property trust, holdover relief is available once more as an IHT exit charge arises on the same event. The effect of a holdover claim is that no CGT will be payable and Laura will acquire the shares at a base cost of only £50,000.

As Trustees, you and Helen are under a duty of care to carry out your duties with reasonable care and diligence, to protect the Trust property and to act in the best interests of the beneficiaries. We understand you have already discussed the proposed appointment and clearly wish to act impartially between Laura and Anthony, but in addition to considering the capital of the Trust you should bear in mind the income position and liabilities of the Trust.

An appointment of half the Trust shareholding to Laura will leave the Trust with only half the dividend income and we understand that in the past, all this income has been used to fund the IHT instalments to preserve the capital. You would need to consider how the remaining IHT instalments would be funded over the next five years.

Recommendation

Both options for transferring shares to Laura result in gains which can be held over and no immediate IHT charge. However, the share appointment from the Trust will result in a reduction in the Trust's dividend income and lead to a shortfall of cash used to settle the IHT instalments. As 3 Oaklands Avenue is not currently profit making, the only option until the property is sold in about two years' time would be for the Trust's capital to be used to make up the difference, which is contrary to the Trustees wishes.

In addition, following a transfer from the Trust, Laura's base cost for the shares will be only £50,000, compared to a base cost of £325,013 with a direct gift.

Therefore, we recommend that 25 shares are transferred to Laura as a direct gift from you and that a claim for capital gains holdover relief is made. The holdover claim must be submitted in writing to HMRC within 4 years following the end of the tax year of the gift, so by 5 April 2025 if the gift to Laura is made by 5 April 2021.

b) Giftling to Anthony

i) Transfer of 3 Oaklands Avenue

We note that the Trustees may allow the beneficiaries to occupy Trust property, so Anthony and his family will be able to live at 3 Oaklands Avenue for the suggested two year period.

As the settlement is a relevant property trust, if the Trustees choose to transfer the property to Anthony in two years' time in December 2022, this will result in an IHT exit charge calculated as outlined above.

We have used the probate value of the property on 15 October 2015 to calculate the potential exit charge, but recommend that you obtain confirmation from a qualified surveyor that this valuation is accurate.

Based on these figures and assuming the property is worth £850,000 in December 2022, the potential IHT charge will be £20,830 (see Appendix 2 calculations). Clearly, if the property increases in value by December 2022, the exit charge will be higher. The charge will be payable by 30 June 2023. It should also be noted that if the appointment of the property is left until after 9 January 2023, an additional quarter will commence and the exit charge will increase.

One other IHT issue to be aware of is that the transfer of the property out of the Trust to Anthony will trigger full payment of the remaining IHT instalments. By December 2022 there will be three IHT instalments outstanding, amounting to £37,500 plus accrued interest charges. There is currently £65,000 in the trust bank account, so the Trust has just enough funds to settle the IHT exit charge and the three IHT instalments, but only if the bank balance remains at this level when the property is transferred to Anthony. However, the trust bank account will only be left with approximately £6,670 once the liabilities are settled.

For CGT purposes, the appointment of the property to Anthony will be a deemed disposal at market value. As mentioned above, James's death resulted in a deemed disposal of the Trust assets at market value, therefore, the Trustees' base cost for the property is the probate value of £550,000. Using the current value of £850,000, this means a gain of £300,000 will arise (see Appendix 3 calculations).

The Trustees may claim the principal private residence (PPR) exemption for the two year period during which Anthony will have lived in the property to reduce the gain. However, after deducting the Trust annual exemption of £6,000 this will still leave a taxable gain of £259,049 on which £72,534 CGT will be payable.

In order to avoid this CGT liability, a joint claim for holdover relief could be made as this event also gives rise to an IHT exit charge. However, the effect of a claim is that Anthony will acquire the property at the Trustees' base cost of £550,000 and in addition, he would be unable to claim the PPR exemption when he sells the property. This is an anti-avoidance provision to prevent both holdover relief and the PPR exemption being claimed on the same property.

The knock on effect is that when Anthony sells the property, a gain of £300,000 will arise (again assuming no increase in the value) and if he transfers the house into joint names with Tiffany to utilise her annual exemption, there will be a taxable gain of £276,000 on which £77,280 CGT will become payable. This will leave Anthony and Tiffany with £772,720 after tax to purchase a new house, which exceeds the ideal amount you have advised they should need.

ii) Transfer of cash proceeds from the Trust

If the Trustees sell the property to an unrelated third party in two years' time in December 2022, the CGT liability of £72,534 referred to above will become payable by 31 January following the end of the tax year of sale. In addition, the sale will also trigger the payment of the £37,500 remaining IHT instalments but this could be met from the sale proceeds rather than deplete the Trust's cash fund.

Assuming a sale price of £850,000 is achieved then after deducting the CGT and IHT instalments, £739,966 will be left to appoint to Anthony which should still provide him with sufficient funds to purchase a new house. Please note, any costs of sale incurred, such as estate agent and solicitor fees, will also be deductible in arriving at the CGT liability but these have not currently been included for the purposes of these calculations.

An IHT exit charge will arise on the net cash appointment of £739,966 to Anthony and the calculations at Appendix 2 show that this will amount to £18,134. This could be settled from the Trust bank account so that Anthony and Tiffany are left with enough cash fund to purchase the new house without depleting the cash account by a significant amount.

Recommendation:

The transfer of 3 Oaklands Avenue to Anthony will result in an IHT exit charge of £20,830 and trigger payment of £37,500 IHT instalments. The cash funds in the Trust bank account will cover these sums but only a small cash balance of approximately £6,670 will remain.

Whilst it is beneficial for the Trustees to avoid the CGT liability on the deemed disposal to Anthony by claiming holdover relief, this passes the CGT burden on to Anthony and prevents him from claiming the PPR exemption on the sale of the property. However, the resulting CGT liability of £77,280 still leaves Anthony with £772,720.

In comparison, if the Trustees sell the property once Anthony has lived there for two years and then appoint a cash lump sum to him, a CGT liability of £72,534 will become payable as well as triggering the £37,500 IHT instalments and an IHT exit charge of £18,134.

However, in these circumstances, the Trustees can settle the CGT and IHT instalments from the sale proceeds, leaving £739,966 for Anthony. The IHT exit charge can then easily be settled from the Trust bank account, leaving just over £46,800 cash funds.

In the first scenario Anthony will receive more cash with which to purchase a new property (£772,720 compared to £739,966), but the big difference is that the Trust bank account will be left with approximately £40,130 more cash (£46,800 compared to £6,670). Therefore, we recommend the Trust sells the property and appoints the net proceeds to Anthony.

c) Larch Cottage

If you move to Larch Cottage after Hillfield House is sold in the summer of this year an income tax charge will be imposed on you under Pre Owned Assets Tax (POAT) rules. The charge will apply as you provided the original consideration for the purchase of the cottage when you made the cash gift of £250,000 to Laura on 10 January 2014.

The POAT charge on Larch Cottage will be equal to the rental value of the property assuming this exceeds £5,000 per tax year

and the tax payable is collected annually via the self-assessment system. Alternatively, it is possible to elect out of the POAT rules by choosing for the gift to Laura to be treated as a "gift with reservation of benefit", which means the value of the property will then form part of your estate for IHT purposes.

Neither of these options is favourable, however there is an exclusion from the POAT which applies if a cash gift was made more than seven years before the donor of that gift obtains a benefit from the asset purchased from such gifted funds. Therefore, if you wait until after 10 January 2021 to move into Larch Cottage more than seven years will have passed since the original gift to Laura and the POAT rules will not apply.

Recommendation:

We recommend that you do not move into Larch Cottage until after 10 January 2021 to avoid the POAT income tax charge provisions applying.

Appendix 1**Transfer of 25 shares to Laura – CGT Computations without a holdover relief claim**

| | <u>Direct gift</u> £ | <u>Transfer from trust</u> £ |
|---|-------------------------|---------------------------------|
| Proceeds | 850,000 | 850,000 |
| Less: Base cost (from share pool workings below) | (325,013) | (50,000) |
| Gain | 524,987 | 800,000 |
| Less: Annual Exemption | (12,000) | (6,000) |
| Taxable Gain | <u>512,987</u> | <u>794,000</u> |
| CGT @ 20% | <u>102,597.40</u> | <u>158,800.00</u> |

Jennifer's share pool

| <u>Date & Event</u> | <u>No</u> | <u>Cost (£)</u> |
|---|-------------|------------------|
| 1990 - Gift to Jennifer from Douglas. | | |
| Holdover relief claimed. | 25 | 25 |
| 15/10/2015 – inheritance from James | 25 | 650,000 |
| | 50 | 650,025 |
| 2020/21 – Proposed gift to Laura | (25) | (325,013) |
| Share pool c/fwd | <u>25</u> | <u>325,012</u> |

Appendix 2
Transfer to Anthony - IHT Exit Charge Calculations

Value of Trust property on 15 October 2015
 (probate values have been used for the purpose of
 these calculations)

| | £ | £ |
|---|--------------------|------------------|
| 3 Oaklands Avenue | 550,000 | |
| Cash | 205,000 | |
| 50 shares in the Company | <u>1,300,000</u> | |
| | 2,055,000 | |
| Less: 100% BPR on shares | <u>(1,300,000)</u> | 755,000 |
| Less: 2022/23 nil rate band | (325,000) | |
| Less: Settlor's CLT's in 7 years prior to trust | 0 | |
| Less: Distributions in the past 10 years | <u>0</u> | |
| | | <u>(325,000)</u> |
| | | <u>430,000</u> |

Notional tax @ 20% 86,000

Effective rate $86,000 / 755,000 \times 100$ 11.391%

Complete quarters 10 October 2015 to say 31
 December 2022 28 quarters

Actual rate $28/40 \times 11.391\% \times 30\%$ 2.392%

If 3 Oaklands Avenue is valued at £850,000 in December 2022

IHT exit charge will be:

$£850,000 \times 2.392 / 100 - 2.392$ £20,830

If the property is sold and £739,966 cash is appointed in December
 2022

IHT exit charge will be:

$£739,966 \times 2.392 / 100 - 2.392$ £18,134

Appendix 3
Transfer to Anthony - CGT calculations

| | Sale by trustees £ | Sale by Anthony & Tiffany £ |
|------------------------------------|-----------------------|-----------------------------------|
| Proceeds | 850,000 | 850,000 |
| Less: Base cost | <u>(550,000)</u> | <u>(550,000)</u> |
| Gain before reliefs | 300,000 | 300,000 |
| Less: PPR relief | | |
| Ownership 10/10/2005 to 31/12/2022 | | |
| = 206 months | | |
| 24/206 x £300,000 | <u>(34,951)</u> | <u>(0)</u> |
| Gain after reliefs | 265,049 | 300,000 |
| Less: Annual exemption | <u>(6,000)</u> | <u>(24,000)</u> |
| Taxable gain | <u>259,049</u> | <u>276,000</u> |
| | | |
| CGT @ 28% | <u>£72,534</u> | <u>£77,280</u> |
| | | |
| Proceeds after CGT | <u>£777,466</u> | <u>£772,720</u> |