Chartered Institute of Taxation

Excellence in Taxation

The Chartered Tax Adviser Examination

May 2018

Application and Interaction Question 1
Taxation of Individuals, Trusts & Estates

Suggested solution

REPORT

To: Mr and Mrs Green, Greenacre Farm
From: Jessica White, Black Tax Advisers
Date: May 2018

1. Introduction

This report is provided to Mr and Mrs Green in response to their letter dated 1 May 2018. The contents are based on the information provided in that letter, the assets statement provided to us, the professional valuation dated 30 April 2018 and the information we have on file.

Our advice is based on current legislation which is subject to change.

There will be non-tax considerations of making a lifetime gift of the farm and legal implications of the gifts. It is therefore important that you take legal advice before committing to the transfer.

2. Executive summary

(a) We would recommend that you make Wills as a matter of urgency as currently your assets would not devolve according your wishes.

(b) At present your combined estate would be subject to an estimated Inheritance Tax (IHT) liability of £292,000. This figure is low compared to the value of your estate at £9,348,500 as a result of reliefs and Nil Rate Bands (NRBs).

(c) A gift of Greenacre Farm to Alan would have no immediate IHT liability with an IHT liability only arising if you died within seven years of the transfer, subject to the availability of reliefs. For Capital Gains Tax (CGT) purposes the gift would be treated as a disposal at market value and gift relief could relieve the majority of the gain. The gift of the derelict cottages would not qualify for relief however this could be covered by your CGT annual exemptions if available. The gift of the farm now rather than on your death under the terms of your Will could result in higher CGT if Alan were to sell in future but we understand that this is not planned.

(d) We would therefore recommend you make the gift of the farm during your lifetime as Business Property Relief (BPR) would not be available to you following your retirement.

(e) A direct gift of Blue Row Cottages to Anne would have no immediate IHT liability but a CGT liability would arise on the transfer. We would recommend that you transfer the properties to trust for the benefit of Anne and your grandchildren as this would avoid a liability on the transfer and provide you with tax savings.

3. Wills

We would recommend that you instruct a solicitor to write Wills as a matter of urgency.

A Will is a written direction and instruction by which a person expresses their requirements and wishes as to the devolution of their property after death. To be valid it must be in writing, signed by the testator (the person making the Will) and the signature must be witnessed by two persons who are both present when the will is signed and are not themselves beneficiaries of the Will.

If you were to pass away with no Will in place your assets would not devolve as you wish instead your estate would devolve according to the intestacy rules. If you left a surviving spouse and issue (namely children, grandchildren etc.) that spouse would be entitled to your chattels, a legacy of £250,000 and an absolute interest in half the residue (the remaining assets). Your issue would be entitled to equal shares in half of the residue absolutely. If there was no surviving spouse the whole estate would pass to the nearest group of relatives

absolutely. Issue is classed as the nearest group and if there is more than one it passes to them equally.

4. Current IHT position

We have summarised the current position in relation to the IHT and succession of your estates under the various headings below.

IHT Rules

IHT is a tax on chargeable transfers. These include transfers made by an individual in the seven years prior to death and on the value of their estate on death. A NRB exists within which IHT is charged at 0% (currently £325,000). You each are entitled to a NRB, therefore your joint estate can have a chargeable value of £650,000 before any IHT would be payable.

An additional NRB is available when a main residence is passed on death to direct descendants, namely children and grandchildren. This allowance was initially set at £100,000 for 2017/18 increasing to £125,000 in 2018/19, £150,000 in 2019/20, and £175,000 in 2020/21. It will then increase in line with CPI from 2021/22 onwards. However, relief is restricted for those with estates (before any relief) of over £2 million so is unlikely to apply to you unless you gave away a substantial level of assets.

Projected IHT

A summary of your IHT position is provided (**APPENDIX 1**).

You will see that your combined estate would attract a projected IHT liability of £292,000. This figure is relatively low compared to the value of your estates as a result of reliefs and NRBs.

Your executors could pay the IHT liability in relation to land and buildings in ten equal annual instalments. These instalments would not be interest bearing where the asset qualifies for relief.

As illustrated in the calculation, at present your estates are likely to benefit from Agricultural Property Relief (APR) and Business Property Relief (BPR) which can provide relief from IHT of up to 100%.

APR

APR is available on the agricultural value of agricultural property owned and occupied for the purposes of agriculture. The agricultural value is defined as the value of the property if it were subject to a perpetual covenant prohibiting its use otherwise than as agricultural property. Any value in excess of the agricultural value (i.e. development value) will not attract APR. APR will only apply if the property has been owned and occupied for the purposes of agriculture either by the transferor throughout the period of two years before the transfer or owned by the transferor and occupied by another party for seven years prior to the transfer.

APR is available at the rate of 100% unless the property is let on a tenancy that commenced prior to 1 September 1995 and the agreement does not allow the landlord vacant possession within 24 months. We note that your partnership commenced in 1996 therefore any lease in place will be post 1995 and APR will be available at 100%.

We would expect that the farmhouse would attract APR but this could be challenged if the property is deemed not to be of character appropriate to the land. The meaning of 'character appropriate' has been considered by the courts. They have found no single factor determines this but points that have been deemed relevant include whether the house is appropriate with reference to the size and area being farmed, how long has it been a farmhouse and historically linked to the agricultural land, whether the land predominates so that the farmhouse is ancillary, what is the relationship between the value of the land and the commerciality of the land. From

the details noted on the valuation would appear that the farmhouse would pass these tests however if HMRC were successful in arguing that it was not of 'character appropriate' APR would not apply to the property at all.

Even if the farmhouse passes the character appropriate test, APR may still be restricted by reference to the agricultural value of the property. Previous cases have found the agricultural value is only 70% of the open market value of the property.

Additionally, in order to qualify as a farmhouse, the house must be occupied by the person who manages the farm on a day to day basis. This condition will be met at present by virtue of your occupation.

The farmland and farm buildings should qualify for APR but relief may be restricted if there is any value in excess of agricultural value e.g. development value.

The farm cottages let to tenants, The Lodge and the derelict cottages will not qualify for APR as they are not in agricultural use. The cottages occupied by the agricultural worker and Alan should qualify provided the occupation has been for two years prior to the transfer. The woodland should qualify for relief as it is a shelter belt to the fields.

BPR

BPR will be available on assets which qualify as relevant business property and this can apply to assets used in the farming business not fully covered by APR apart from the farmhouse. Relevant business property includes any land or building owned by an individual which was used for business purposes by a qualifying partnership where the individual was one of the partners. However, these assets only attract relief at 50%. Where assets are owned directly by a partnership these attract relief at 100%.

BPR will not apply if a business or interest in a business consists wholly or mainly of making or holding investments. The business activities must be 'mainly' trading. Case law has considered whether a business is a single business and whether the business is of 'wholly or mainly holding investments'.

This has established a requirement to look at business assets income over a reasonable period prior to a transfer. The *Farmer* case set out five factors which should be considered which are how the capital of the business is employed, turnover, profit, employee time and the overall context of the business. This must then be considered 'in the round'.

From reviewing your accounts, it would appear that the trading and rental elements of your business are carried on as a single business and the income and profit generated from the farming business is clearly in excess of income from investment activities. The value of the farming assets is significantly in excess of other assets. The farming assets owned personally but used in the partnership business would therefore qualify for BPR at the rate of 50%. Your other partnership assets would attract relief at 100%.

However, there is a restriction in BPR for 'excepted assets'. These are assets which have not been used wholly or mainly for the purposes of the business or required for future use in the business. As the derelict buildings are currently unoccupied and not used in the business they will not qualify for relief. Additionally, HMRC seek to restrict relief where there are large cash balances which may be surplus to the business needs. The accounts show a cash balance of £150,000 but due to the high turnover of the business there should be no restriction.

The Lodge would not qualify for BPR if it was not part of the farming business as it has been found in recent cases that FHL business are wholly or mainly investment businesses. However the property can qualify for BPR as part of the composite business as can the let properties. As your rental property in Greentown is not part of the farming business this will not attract BPR.

It is important to note that BPR would not be available to you following your retirement.

5. Lifetime gift – IHT rules

Outright gifts to an individual during a donor's lifetime are known as 'potentially exempt transfers' (PETs) and unless a benefit is reserved (see below) will only be chargeable to IHT if the donor dies within the seven year period following the gift.

Taper relief can potentially reduce any tax payable if the donor survives at least three years after making the gift but as lifetime gifts are treated as using the NRB before other assets taper relief would only apply to any tax payable on the value of gifts over the NRB. An annual exemption of £3,000 per donor is available to reduce the value of gifts and to the extent unused the previous year's exemption can be carried forward for one year.

APR and BPR may be available to reduce the value of any PET falling into charge as a result of the death of a donor within seven years if the transfer qualified at the time of the gift and the asset is retained by the transferee until the death of the transferor and the property qualifies at the time of death, by reference to the donee. If assets were sold or no longer qualified, replacement property could be acquired to protect eligibility for relief.

Rules exist to prevent a donor from making a PET (and hoping to survive seven years) whilst still having full enjoyment of the gifted asset. If an individual gives away an asset but continues to be able to benefit from this it is a 'gift with reservation of benefit' (GWRB). The effect of this is that the gift is treated as if it still forms part of the donor's estate at death. Additionally, the 'Pre Owned Asset Tax' (POAT) legislation imposes an income tax charge on benefits received by the former owner of property where the GWRB rules do not apply. A POAT charge can apply where a person occupies land he had previously disposed of or if he supplied funds to someone to buy land which he then occupies.

From an IHT perspective a gift of the farm (excluding the Blue Row Cottages) to Alan would be classed as a PET from you both with no IHT payable if you each survived for seven years. Following this the value of your estate would be reduced for IHT. If you do not survive seven years the gift may still qualify for APR and BPR but it would need to continue to be owned by Alan and meet the conditions by reference to him at that time.

However if you continued to benefit from the land following the gift this could be deemed to be a GWRB and still form part of your estate for IHT purposes. HMRC have confirmed that where the benefit to the donor is 'insignificant' in relation to the gifted property a GWRB will not apply.

Care would therefore need to be taken in this regard in relation to the profit sharing ratios in the partnership as HMRC could contend that you retained a benefit in the gifted asset following the gift if your profit share was not in proportion to the capital you had invested in the partnership and the effort you put into the business. It may be that your share of the partnership income would need to reduce and the effect on your income requirements and the income tax implications of this for the family would need careful consideration.

A POAT charge should not apply as the occupation of the land by the partners in the farming partnership should not be considered occupation for POAT.

6. Lifetime gift – CGT rules

CGT is payable on the disposal of an asset. For gifts between connected parties the amount chargeable to CGT would be the market value of the asset at the date of the transfer, less any allowable expenditure. Allowable expenditure includes the acquisition cost of the asset and any expenses of acquisition or disposal. Gains made in a tax year above an individual's annual allowance (£11,300 for 2017/18) will be charged to CGT at 20% for a higher or additional rate taxpayer and either 10% or 20% for a basic rate taxpayer depending on the size of the gain and taxable income. Gains on residential property would attract a higher rate of 18% or 28%.

Gift Relief can apply to certain transfers and this allows gains to be deferred with the recipient of the gift effectively acquiring the assets at the transferor's CGT base cost. To qualify the asset must be a qualifying asset and this includes assets used in the business of the transferor and certain agricultural land and buildings used for the purposes of farming. Gift relief is restricted if an asset is partly used for business and partly non-business purposes and an apportionment needs to be made if land or buildings were not used for business purposes for the whole time they were owned.

Gains on chargeable assets transferred into trust can also qualify for CGT deferral relief regardless of the use of the asset.

This relief is not automatic and a joint claim would need to be made within certain time limits by the donee and donor.

When considering gifting assets, it should also be borne in mind that there is an advantageous CGT position in transferring assets on death instead of during lifetime. No CGT charge arises on assets which are transferred on death and the beneficiary is treated as acquiring the asset for CGT purposes at the value at that time (probate value). This uplift in the base cost of the asset is lost if the asset is gifted during lifetime.

The farm consists of various component parts and it is necessary to consider these parts separately as noted below. As you are considered connected parties for CGT purposes the transfer will be deemed to take place at market value.

As the assets are currently used in the farming business and/or qualify for APR it is possible that you could claim relief for a gift of a business asset if the conditions are met. A successful claim would mean that no tax liability would arise on the transfer and for CGT purposes Alan would acquire the asset at your acquisition cost. As John acquired the farm in 1983 and a half share was gifted to Sally following your marriage your base cost will be the 1983 value of the farm.

A restriction would apply to the gift relief if any part of the land or buildings was not used in the business or if the land or buildings had not been used in your business for the full time that you have owned it.

Traditional Farmhouse – as this is occupied by you as your main residence this should qualify for Principal Private Residence (PPR) relief. If any part of the residence was used exclusively for any business purposes, the gain must be apportioned with only the non-business gain qualifying for PPR relief. A room would only be considered to be exclusively used for business if it was not used by the family at all for a period.

Provided you have lived in the farmhouse for the whole period you have owned it, PPR relief should be available in full if the property is transferred with 18 months of you moving into your rental property. If it is transferred following this there would be a restriction to the relief.

Farmland – as the land is in use in the business gift relief would be available on a transfer.

Farm buildings – as the buildings are in use in the business gift relief should be available. There may be a restriction for any current or previous non-farming use.

The Lodge - the use of the cottage as holiday accommodation could allow a gift relief claim provided HMRC's qualifying criteria is met (the cottage must be available for letting for 210 days per year, must actually be let for 105 days and must not be let for periods of long term occupation, of over 31 days, for over 155 days per year).

Derelict cottages - as these are not in use in the trading business they will not qualify for gift relief and CGT could arise on a transfer. However, the gain arising would be only £20,000 (£40,000 - £20,000) and this could be covered by your joint CGT annual exemptions if they are available in the year of transfer.

Woodland - as the land is in used in the business gift relief would be available on a transfer. The woodland is not exempt from CGT as it is not managed on a commercial basis.

There is the possibility to elect to pay tax in ten equal annual instalments on the assets where no gift relief is available although each instalment will carry interest from the normal due date, which is 31 January following the end of the tax year of the transfer.

7. Stamp Duty Land Tax (SDLT)

SDLT is a tax applied to residential and commercial land and buildings transactions however a land transaction is exempt from SDLT if there is no chargeable consideration for the transaction. It is important to note that if an asset transferred is subject to finance that the assumption of any debt by the donee will be considered to be chargeable consideration for SDLT.

We understand that there is a mortgage of £148,000 outstanding on the farm and the assumption of debt by Alan could result in a liability if the amount of debt assumed is above the SDLT threshold. A transaction where there is a mixture of residential and commercial interests is treated as a non-residential transaction and will therefore be subject to the non-residential rates and bands. As the mortgage is under the commercial threshold of £150,000 no liability would arise.

8. Gift of property to Anne

You have mentioned that you would like to give Blue Row Cottages to Anne.

From an IHT perspective this gift would be classed as a PET with no tax payable if you both survived for seven years.

For CGT purposes, the gift would be deemed to take place at market value. A capital gain would therefore arise and there would not be an opportunity to claim gift relief on the let properties as use in a rental business is not sufficient for these purposes. There may be a possibility to claim gift relief on the cottage occupied by the farm worker and on the cottage occupied by Alan however this would be restricted for the period the cottage was let.

It may be attractive to transfer the cottages to trust for the benefit of Anne and her children as it could be possible to defer any CGT arising on the transfer depending on the terms of the trust and there could be income tax savings. This would also enable you to retain a degree of control over the assets.

A trust would involve you both (the settlors) transferring the cottages to trust for the benefit of Anne and her children (the beneficiaries). You would appoint trustees to administer the trust which could include yourselves and as the trust would hold land, at least two trustees would be required with a maximum number of four trustees. You could set up one trust which you both contribute to or two separate trusts but either way to ensure the trust is effective for tax purposes, it is important that neither of you benefit from a trust you have transferred assets to. It could be beneficial for each of you to set up a trust to allow each spouse to potentially benefit from the others trust following their death but not during the settlor's lifetime. However, we would assume that do not wish to benefit from this income and for ease of administration we would recommend that you create one trust.

You could either set up a discretionary trust or an interest in possession (IIP) trust. A discretionary trust is where the trustees are given powers to exercise their discretion to pay or apply some or all or none of the trust income and capital to the beneficiaries, as they think fit. In an IIP trust, the beneficiaries have an immediate right to the trust income as it arises, so the trustees cannot keep it within the trust. The IIP can be revocable so that the trust becomes discretionary or the trust can be drafted as discretionary with an IIP carved out by deed. Where the IIP trust income is mandated to beneficiaries it can be reported by the beneficiaries under

Self Assessment and the trust would not need to include the income on a trust tax return but would need to report any gains if properties were sold or transferred in future. This could be an attractive option as it would ease the administration requirements of the trust and save on compliance costs.

The Income Tax treatment would vary depending on whether a discretionary or an IIP trust is created.

Trustees of discretionary trusts pay Income Tax on rental profits at the trust rate of 45% but the first £1,000 of income is taxed at basic rate (20%). If the trustees make an income payment to a beneficiary, the beneficiary is treated as receiving the payment net of a 45% tax credit. If the trust has paid less tax on its income than is required to cover the tax credits, the balance must be paid to HMRC and trustees must maintain a tax pool to keep track of this. The beneficiaries of a discretionary trust are only liable to tax on income distributions received by them or applied for their benefit during the tax year and if they do not pay tax at the 45% rate they can claim a refund.

If the rental income is subject to an IIP this will be taxed at 20% and is treated as income of the beneficiary in the year in which it arises to the trust. The beneficiary will receive a tax credit on the income at the basic rate and if they are basic rate tax payers they will have no further liability. A higher rate tax payer will pay an additional 20% on the gross income and additional rate taxpayers will pay an additional 25%.

You will appreciate therefore that either case there is likely to be Income Tax savings on creation of the trust as it may be possible to benefit from your grandchildren's tax rates and allowances. As the income is to be used for their school fees it could be beneficial to set up an IIP for this income to ease administration.

Although the transfer of value to a trust is a chargeable transfer for IHT no tax would be payable if it, together with other chargeable transfers you have made in the previous seven years did not exceed the value of your NRBs (currently £325,000 each). Any amount in excess of the NRB would be chargeable to IHT at a rate of 20% (or 25% if the tax is paid by the settlors). If you both settled funds in to a single trust this would be still treated as two trusts (of your respective settled amounts) for IHT purposes.

If you were to die within seven years following a transfer to trust, additional IHT up to the current rate of 40% would be payable if the transfer was not covered by your NRB. Taper relief could reduce the rate of tax payable on death, if you survived at least three years from the date of making the gift. Any future growth in capital value of the properties would be protected as the amount which would be taxable would be the original value when transferred.

The trust would be within the 'relevant property' regime and would be subject to an IHT exit charge (albeit this could be at 0%) when property (to include cash or assets) is distributed to beneficiaries. The charge is calculated as a proportion of the tax rate on the last ten year anniversary (or the initial transfer if the trust is less than ten years old) and is levied on the value of property leaving the trust. A charge could arise on every tenth anniversary of the trusts creation based on the value of the property in the trust at that time. The maximum rate of this 'principal charge' is 6%, to the extent that the value of the trust value exceeds the unused NRB of the trust.

A transfer to trust would constitute a deemed disposal for CGT purposes and tax would potentially be payable based on the market value of the assets at the time of the transfer. However, gift relief would be available to hold over this gain and defer the liability. The availability of gift relief is subject to the exclusion of you as settlor (or spouse) from benefitting from the trust assets. This gift relief means that no CGT liability would arise on the transfer to the trust and the trust would acquire the properties your CGT base cost. Holdover relief should also be available on the eventual distribution to the beneficiary. It should be noted however that the free CGT uplift on death would be lost.

Normally a disposal of an individual's home is exempt from CGT as a result of Principal Private Residence Relief (PPR) and this can apply even if the property is owned by a trust. However, the availability of PPR relief on a property gifted to trust, where deferral relief was claimed, under the rules for gifts to trust is restricted. If the trustees (or beneficiaries at some point) intend to sell on the property, they will not be able to claim PPR relief. This would only be a consideration if the property was likely to be occupied by a beneficiary of the trust at some point in the future.

9. Your retirement

You have mentioned that when you plan to retire you will leave your capital accounts on loan to the partnership.

It is very important to note that this will convert these assets from business assets to non-business assets and no BPR would be available on the loans. If your assets are in excess of the available nil rate bands at that stage it would be beneficial to gift these to Alan whilst they qualify for relief.

The withdrawal of your capital from the partnership would not be liable to Income Tax in your hands and it will be worth reviewing the likely level of each family member's income following the changes to ensure all basic rate bands and allowances are used where appropriate. You have mentioned that you plan to continue to provide advice to Alan and it may be appropriate for you to receive remuneration for the continued support you provide to the business.

10. Summary and recommendations

The gift of the farm to Alan would not have any immediate tax liability provided your annual CGT exemptions were available in the year of transfer. The gift would remove the assets from your estate after seven years and would potentially save IHT. A gift during your lifetime would ensure you banked relief whilst the assets qualified for APR/BPR and whilst you would lose the free CGT uplift on death you have confirmed that is not intended that the farm will be sold so this would be unlikely to be of concern.

A direct gift of Blue Row Cottages to Anne would have no immediate IHT liability. However, a CGT liability would arise on the transfer. You have mentioned that you would like the income to be used to pay school fees for your grandchildren and we would recommend that you transfer the properties to trust for the benefit of Anne and your Grandchildren as this would avoid the CGT charge on the transfer, provide you with Income Tax savings and remove the assets from your respective estates for IHT purposes after seven years.

We hope this report is helpful in answering your queries. Please do not hesitate to contact us if you require any further explanations.

APPENDIX 1

Mr & Mrs Green

Estimated IHT Calculation

	£
Value of non-farming assets	815,000
Value of capital accounts (£355,000 + 339,000)	694,000
Value of farm less mortgage (£7,987,500 – 148,000)	7,839,500
	9,348,500
Less reliefs:	
APR (note 1)	(6,944,500)
BPR (note 2)	(1,024,000)
Chargeable estate	1,380,000
Less NRBs (£325,000 x 2)	(650,000)
	730,000
Projected IHT (£730,000 @ 40%)	292,000

Note 1

APR

	£
Farmland (£5,895,500 + 425,000 – 148,000)	6,172,500
Farmhouse (agricultural value)	455,000
Farm buildings	150,000
Farm cottages ((£640,000/8) x 2)	160,000
Woodland	7,000
	6,944,500

Note 2

BPR

	£	£
Farm cottages (£640,000/8 x 6)	480,000	
The Lodge	180,000	
	660,000	
BPR (£660,000 x 50%)		330,000
Capital accounts	694,000	
BPR (£694,000 x 100%)		694,000
		1,024,000

MARKING GUIDE

TOPIC	**MARKS**
Devolution of estate	
Wills	2
Distributions on intestacy	3
	5
Inheritance Tax position	
General IHT and NRB/RNRBs	2
Instalment option	1
Definition of APR	2
Rates of APR	2
APR on farmhouse	3
APR on cottage	1
APR on other farming assets	1
APR on other assets	1
Definition of BPR	1
Rate of BPR	1
Trading requirement/analysis	3
Excepted assets	2
BPR on FHL/rental properties	1
	21
IHT on Gift to Alan	
PET	1
Taper/annual exemption	1
APR/BPR on gifts	2
GWRB (including income tax implications)	4
POAT	2
	10
CGT on gift of farm	
Connected parties	1
General CGT	1
Gift relief	2
Death uplift	1
Base cost	1
PPR on farmhouse	2
Farmland and farm buildings	1
FHL	1
FHL conditions	3
Derelict cottage	2
Woodland	1
	16
Stamp Duty	
Consideration	1
Treatment of debt	1
Application of commercial rates and threshold	2
	4
Direct gift of cottages	
PET	1
CGT	2
	3
Gift to trust	

Definition of trust	2
Discretionary v IIP	2
Income tax on discretionary trust	3
Income tax on discretionary trust beneficiary	1
Income tax on IIP trust	2
Income tax on IIP trust beneficiary	1
IHT on transfer	1
Trust IHT	2
CGT on transfer	2
	16
Retirement plans	
Income tax following retirement	2
IHT following retirement	1
	3
Presentation and higher skills	22
TOTAL	**100**