The Chartered Institute of Taxation

Application and Professional Skills

Inheritance Tax, Trusts & Estates

November 2023

Suggested solution

REPORT TO AUDREY TALBOT – NOVEMBER 2023

INTRODUCTION

Further to your letter of 1 November 2023, this report will consider:

1) A review of the current Inheritance Tax exposure of your estate,
2) The implications of retaining Boundary Field in your estate,
3) The implications of gifting Boundary Field to a trust during your lifetime,
4) The impact on your estate of gifting Boundary Field to a trust during your lifetime,
5) The timing of your cash gift to friends
6) Other steps that may be taken to mitigate your tax exposure.

This report is based upon the information and valuations provided by you. This report assumes that the most recent valuations remain constant going forward and that the land agent's valuation for 2028 is accurate.

EXECUTIVE SUMMARY

A review of your current estate indicates that your assets total £1.55 million. After provision for the available tax reliefs your Inheritance Tax (IHT) exposure is £200,000.

The key reliefs available are Agricultural Property Relief (APR), your Nil Rate Band (NRB) and your late husband's Transferable Nil Rate Band (TNRB).

You have an asset, Boundary Field, which has been investigated by a land agent. This asset already has development potential, but this potential is expected to increase further in the next five years.

The value of this asset is expected to rise by £200,000. This will further increase your IHT exposure by £80,000.

We have reviewed whether it would be beneficial to transfer Boundary Field to a trust during your lifetime.

Creation of the trust would mitigate the IHT exposure on the expected increase in the value of Boundary Field. There would be an IHT charge on creation of the trust but this is considerably less than the £80,000 IHT if nothing is done.

However, as you and your family have plans to sell the land, at the right time, to a developer, we must also consider Capital Gains Tax (CGT).

If you retain the land, upon your death your executors / trustees will acquire the land with a CGT base cost equal to the probate valuation. This means that any subsequent sale in a timeframe relatively close to date of death will result in a minimal CGT charge if any.

If the lifetime trust is created, the transfer of the land to the trustees triggers a chargeable gain for CGT purposes. This initial charge can be held over but when the trustees subsequently sell the land, they will incur a significant CGT charge of £108,010.

This CGT charge overshadows the IHT saving and so we recommend that you do not create the lifetime trust but rather allow Boundary Field to form part of your estate on death.

You wish to make cash gifts to friends. On the basis that your trust is not created in your lifetime these can be made as soon as you wish. If you do go ahead and create the trust, then these gifts should be made after the creation of the trust to avoid negative IHT consequences for the trust going forward.

Our review of your estate has highlighted that we could mitigate IHT in other ways.

You are not currently spending the rental income from the field but rather you are accumulating it. You could gift this income away to your grandchildren during your lifetime and provided certain conditions are met this gift would be exempt for IHT at the point of gift.

Also, consideration should be given as to whether we position your estate to benefit from the Residence Nil Rate Band (RNRB). This is a relief worth £70,000 in IHT savings. Currently your estate would not qualify as you do not leave your residential property to your grandchildren absolutely but rather you leave all your assets to a discretionary trust.

CURRENT SITUATION

A review of your estate shows that your assets are valued at £1.55 million.

Your estate will benefit from your Nil Rate Band (NRB) of £325,000. In addition, as your late husband did not utilise any of his NRB on his death you can also claim a Transferable Nil Rate Band (TRNB) of £325,000.

Your estate will not automatically benefit from any Residence Nil Rate Band (RNRB) as your current Will leaves your assets to a discretionary trust and not to your direct descendants absolutely. This is a condition of the relief.

Relief is available on agricultural property if certain conditions are met. The conditions for Agricultural Property Relief (APR) in the case of let land are that land must have been used for agricultural purposes for seven years prior to the date of death. The rate of relief is 100% where the tenancy commenced after 1 September 1995 as it did in this case.

The conditions are met as the land has been let for 19 years, since 2004 and used for to grow crops so 100% relief is available.

Importantly, APR only relieves the agricultural value of the land not the market value. In this case the open market value of the land is currently £875,000 whereas the agricultural value is £400,000. The difference between these two valuations is exposed to Inheritance Tax (IHT).

Your assets, at their current values, will give rise to a £200,000 IHT charge (see Appendix 1).

RETAINING BOUNDARY FIELD IN YOUR ESTATE

Working with the assumption requested that you die in five years' time, if you retain Boundary Field in your estate your IHT exposure will increase.

The land agent's report suggests that the open market value of Boundary Field will increase by £200,000 once the new bypass is completed.

The agricultural of value of the land is expected to remain the same meaning that the APR claim will also remain the same.

The £200,000 increase in estate value will therefore result in an additional £80,000 IHT (£200,000 x 40%).

Upon your death, your executors / trustees will acquire Boundary Field with a CGT base cost equal to the probate valuation which will be market value. This means that if your trustees chose to sell Boundary Field to a developer shortly after your death they would have no or minimal CGT to pay.

As you will continue to receive the rent from the field you would continue to pay the Income Tax. On the assumption you remain a higher rate taxpayer this would be 40% of the rental profit. Assuming you have minimal costs as the tenant is responsible for repairs, you would be able to deduct an allowance known as the property allowance which is £1,000. Based on the current rental income your annual Income Tax liability would be £2,960 (£8,400 - £1,000 = £7,400 x 40%).

CREATION OF A TRUST DURING YOUR LIFETIME

The creation of a discretionary trust during your lifetime for the benefit of your grandchildren has IHT, CGT and Income Tax implications.

A gift to a trust during lifetime is a Chargeable Lifetime Transfer (CLT) for IHT purposes. This means that an immediate charge to IHT can arise.

The IHT charged during lifetime is at a rate of 20% if the tax is paid by the trustees. The value of the gift is based upon the loss to your estate which is equal to the market value of Boundary Field. The IHT charge can be reduced by utilising any available NRB, annual exemptions and by claiming APR.

As you have not made any previous gifts you can reduce the chargeable value by a total of £731,000, being £325,000 relating to your NRB, £6,000 relating to two annual exemptions and £400,000 of APR.

The IHT charge, if met by the trustees, is therefore £28,800, see Appendix 2 for calculation.

This charge would be payable by your trustees so thought would be needed as to how this could be funded. It would be possible to pay the tax over 10 equal annual instalments. This is interest bearing but the annual rental income could be used to settle this liability.

A gift to a trust is a disposal at market value for CGT purposes. A significant tax charge of £72,540 would arise by default (£875,000 (market value) - £500,000 (cost) - £12,300 (annual exemption) x 20%).

This CGT charge would remain payable in full even though the expectation is that the gift will also be assessed to IHT on your death as we are working on the assumption that you will only survive for five years from the date of gift.

However, as the transfer also gives rise to an immediate IHT charge it is possible for you to make an election resulting in this gain being held over.

This means that no CGT would be payable, rather the trustees would acquire the field at a base cost of £528,800 being the £500,000 plus £28,800 IHT paid on creation. .

No Stamp Duty Land Tax arises on the creation of the trust as the transfer of the field is a gift and so there is no consideration.

Following the transfer of the field the trustees would be in receipt of the rental income and liable to Income Tax on this.

The first £1,000 of income (after allowable expenses) each year would be taxed at 20% with the balance of income taxable at 45%. The trustees would be unable to claim the £1,000 per year property allowance so their expense claim would be limited to actual expenses incurred each year.

It is possible to distribute the net after tax income of the trust to the beneficiaries at the discretion of the trustees. When income is distributed from a trust of this type it carries a 45% tax credit which can be utilised by the beneficiary. If the beneficiary is a basic or higher rate taxpayer, then part of this tax credit will be repayable to them.

In addition, a trust of this type does result in IHT charges every ten years or when assets leave the trust based upon the chargeable value held by the trustees.

IMPACT ON YOUR ESTATE ON CREATING A TRUST

Upon your death, the trustees will need to revisit the CLT as we are working with an assumption that your death will be within five years of the gift to the trust.

Upon revisiting the CLT there are two significant aspects to consider:

Firstly, the trustees need to review the usage of Boundary Field. As APR was claimed on the initial transfer to the trust, the land must still be used for agricultural purposes to ensure that the APR is not clawed back. It is therefore of critical importance that the land remains let and used for the purpose of agriculture. This also means that the trustees need to wait until your death, assumed within five years, before they sell the land to a developer to ensure no APR clawback occurs. The loss of APR would result in a tax charge of £160,000 (£400,000 x 40%) and so we recommend that the field continues to be rented in its current form to protect the APR position.

Secondly, the trustees need to revisit the IHT calculation and in particular the allocation of the NRB and TNRB in reducing the chargeable value. When the lifetime calculation is carried out, only the NRB can be allocated. However, when the calculation is revisited to assess if any additional tax is due as a result of death the TNRB is available for use. The TNRB can only be allocated as part of the death estate.

The inclusion of the TNRB reduces the chargeable value of the gift from £144,000 to £nil so no additional IHT is due. It is very important to note that the £28,800 IHT paid during lifetime is not refundable.

Boundary Field is expected to increase in value significantly over the five year period but this will not cause any extra tax when the CLT is revisited. The value of the gift remains fixed at the value on creation of the trust and this is a significant advantage of this method.

Utilising part of the TNRB on the lifetime gift does mean that a reduced amount of £181,000 (£325,000 - £144,000) will be available for use in the death estate.

In Appendix 1, the IHT calculation has been adjusted to show the IHT position should you gift Boundary Field to a trust during your lifetime. The overall IHT charge is now £197,600. This is a slight reduction on your current exposure of £200,000 due to the use of the annual exemptions on the CLT.

When the land is subsequently sold this will have no impact on your estate as it will already belong to the trustees. The trustees will incur the CGT charge. As hold-over election will have been made the trustees base cost for CGT purposes will be £528,800 (£500,000 plus the IHT paid of £28,800) . The trustees do benefit from an annual exemption but it is only half the value of an individual so £6,150.

The CGT charge of £108,010 would arise by default (£1,075,000 (market value) - £528,800 (cost) - £6,150 (annual exemption) x 20%.

RECOMMENDATIONS

If you retain Boundary Field in your estate and let it pass into the trust for your grandchildren via your Will your IHT exposure will increase by £80,000. As your executors / trustees benefit from the CGT rebasing of your assets on death they would not incur any CGT if they sold the Field shortly after your death as the base cost for CGT would be the probate valuation.

The other option is that you establish a trust during your lifetime. The establishment of the trust would incur an immediate IHT charge of £28,800. This is ignoring any interest charges associated with paying the IHT liability in instalments.

Establishing the trust, initially appears to be the better option when only IHT is considered. The trust would cost £28,800 in IHT to set up but would mean that the £200,000 expected increase in the asset value would not be reflected in your death estate saving £80,000.

However, the CGT implications are very different. If Boundary Field is retained in your estate the asset will be rebased to its probate valuation upon your death. This means that if your executors / trustees sold the land relatively quickly after they would have no or very little CGT due.

If the trust is created either a CGT charge arises on you when the field is transferred into trust or the trustees when the land is sold. On the assumption that the gain is held over as recommended, the trustees would incur a CGT charge of £108,010.

Your estate at the presumptive date of death is valued at £1.75 million (£1.55 million Appendix 1 plus £200,000 extra on land). After deducting the projected IHT exposure of £280,000 (£200,000 Appendix 1) plus £80,000 extra on land) your trustees would receive £1.47 million to benefit your grandchildren.

If you create the lifetime trust, this trust will contain assets of £932,430 (£1,075,000 (land) - £28,800 (IHT) - £113,770 (CGT)). Your Will trust would contain additional assets of £477,400 (£675,000 - £197,600). The total assets over the two trusts that could benefit your grandchildren would therefore be £1,409,830.

We therefore recommend that Boundary Field is retained in your estate and allowed to form part of your Will trust upon your death. The increased IHT exposure of £80,000 that this route causes is less than the IHT and CGT incurred by creating the trust which total £136,810. This route is also far simpler as no additional trust is required to be set up and administered.

TIMING OF CASH GIFTS

You wish to gift £65,000 to a selection of friends. A gift of cash to individuals gives rise to a potentially exempt transfer (PET) so no immediate charge to IHT will occur.

If an individual survives seven years from making a PET, it falls outside the estate for IHT purposes, however, as we are working with the assumption that you will not survive for seven years from the date of gift, your PET will fail and become chargeable so the gifts will not save any IHT. This is because the NRB on death is allocated to lifetime gifts made in the last seven years before it is allocated to the assets in the death estate. A relief known as Taper Relief can apply to gifts when individuals have survived between three and seven years but only when the lifetime gifts themselves result in a tax charge and are not relieved by the NRB available.

The gift is of cash and so there are no CGT implications as cash is not a chargeable asset for CGT purposes.

As you are considering setting up a lifetime trust it is important to note the ordering of gifts should you choose to do this.

If you were to make a PET (which later fails) before setting up the trust and making the CLT, the failed PET would impact the trust forevermore. IHT charges that apply to trusts such as ten-year charges and exit charges are impacted by the NRB. This NRB would be reduced by failed PETs made in the seven years prior to setting up the trust.

It is our recommendation that if you wish to set up the lifetime trust you should do this prior to making any PETs (which will fail given the five year survival period) to avoid any long term negative impacts on the trust created.

If you choose to follow our recommendation that the trust is not created in your lifetime then the timing of the gift is not important and so the gifts to your friends can be made as soon as you wish. These gifts will however impact the NRB available to your executors increasing the IHT due on your death estate.

OPTION FOR INHERITANCE TAX MITIGATION

If our recommendation is followed and Boundary Field is retained, we note that the rental income is currently accumulating unneeded in your Building Society account.

In addition to the gift of the capital already accumulated, it is possible to gift this income away, as it arises, say to your grandchildren, during your lifetime.

The gifts can be exempt from IHT straight away meaning that no seven-year rule applies and your NRB is not impacted by the gifts.

The conditions are that the gifts must be made from surplus income, which they would be as you are not using the funds. The gifts must also be regular so you would need to start to gift away the rents monthly and intend to carry on with this arrangement. You would not be able to do it for a few months then stop and restart in the future. You would also need to keep records of your income and expenditure to allow your executors to make the claim.

This would save £10,880 ((£8,400 p.a - £2,960 Income Tax) x 5 (years) x 40%) in IHT if you commenced straight away.

Your estate will not automatically benefit from any RNRB. Your Will leaves your assets to a discretionary trust and not to your direct descendants absolutely which is a requirement of the relief.

If your Will was changed to leave your main residence to your grandchildren absolutely then your estate would benefit. The reduction in IHT would be £70,000 (£175,000 x 40%).

An alternative to changing your Will would be to update your Letter of Wishes that accompanies your Will trust to inform your trustees that you are open to this idea. They can then consider the appropriateness balancing the tax savings with the individual circumstances of the beneficiaries. If the trustees were to distribute the property to your grandchildren within two years of your death obtaining the RNRB would still be possible.

The maximum value of this relief is limited to the value of the main residence which is £175,000 so no Transferrable RNRB claim would be possible unless the value of the main residence increases.

We recommend that you consider allowing your estate to benefit from the RNRB. You would not be able to retain the trust protection on the value of the house so this tax saving must be weighed up against the non-tax considerations and the reasons why you want the trust structure.

Should you have any queries on this report please do not hesitate to contact us.

Chartered Tax Advisers

6 November 2023

APPENDIX 1

Summary of current and proposed estate and Inheritance Tax exposure

	Current Estate		Proposed Estate	
	£	**£**	**£**	**£**
Land and Property				
12 Carnival Way, Bolton	175,000		175,000	
Boundary Field	875,000		Gifted	
		1,050,000		175,000
Bank account balances				
Cash ISA	20,000		20,000	
Current Account	35,000		35,000	
Building Society Account	65,000		65,000	
		120,000		120,000
Investments				
Stock and Shares ISA		380,000		380,000
Total assets		1,550,000		675,000
Inheritance Tax Calculation				
Total assets		1,550,000		675,000
Available Reliefs				
Agricultural Property Relief	400,000		-	
Nil Rate Band	325,000		Utilised	
Transferrable Nil Rate Band	325,000		181,000	
		(1,050,000)		(181,000)
Taxable estate		500,000		494,000
Tax at 40%		200,000		197,600

APPENDIX 2

Chargeable Lifetime Transfer – Lifetime IHT Charge

	£	£
Value of transfer		875,000
Agricultural Property Relief	400,000	
Annual Exemption (2023/24 & 23022/23)	6,000	
Nil Rate Band	325,000	
	731,000	731,000
Taxable value		144,000
Tax at 20%		28,800