

## **Application and Professional Skills**

### **Inheritance Tax, Trusts & Estates**

**November 2024**

**Suggested answer**

## **Report to the trustees of the Susan Wood Will Trust**

This report is prepared for the trustees of the above trust (the "Trust"). It may not be relied upon by any other person or entity without our prior written consent. The report considers the tax implications of:

1. Terminating Paul's life interest in Fairview and Beach Farm, and the transfer of one of those assets to Shaun in February 2025 with the other continuing on discretionary trust; and
2. Transferring Sunnyside to Paul or, alternatively, retaining the property on the life interest trust until his death.

The advice contained in this report is based on the information held on our file and the legislation in force on today's date. A delay in implementing our recommendations, a significant fiscal event or a change in circumstances may affect our advice and confirmation of its continuing relevance should be sought.

### **1. Executive Summary**

#### Appointment to Shaun

There will be no immediate inheritance tax ("IHT") liability on an outright appointment of either Fairview or Beach Farm. An appointment of either asset on discretionary trusts will result in an immediate IHT liability but the tax payable in relation to Beach Farm will be considerably lower due to the availability of IHT Agricultural Property Relief ("APR").

An outright appointment of either asset will be a capital gains tax ("CGT") disposal. The CGT liability on an outright appointment of Beach Farm will be much lower than an appointment of Fairview if holdover relief is claimed.

We recommend that, following the agreed lifetime termination of Paul's life interest in Fairview and Beach Farm, the trustees appoint Fairview to Shaun and retain Beach Farm on discretionary trust.

This will result in a total of £404,500 tax payable, consisting of £309,700 of CGT and £94,800 of IHT which can be paid from the cash held by the trustees. This compares to total tax charges of £817,500 (£793,800 of IHT and £23,700 of CGT if holdover relief is claimed) if Beach Farm is appointed to Shaun and Fairview is retained on discretionary trust.

In addition, if the agricultural activity continues until the next ten year anniversary (TYA) in 2032 (noting that the trust is going to continue for the foreseeable future), Beach Farm will benefit from APR which will firstly, reduce the impact of the TYA charge and secondly, result in a lower exit charge rate for capital appointments made thereafter.

#### Sunnyside

If Sunnyside remains in the Trust then on Paul's death it will be held on the terms of the default discretionary trusts in Susan's Will. A subsequent appointment to Paul's descendants (as discretionary beneficiaries) will not make use of Paul's residence nil rate band allowance.

Alternatively, if the property is appointed to Paul and then passes to Poppy (or Poppy and Emily) under his Will it will be 'closely inherited' for residence nil rate band purposes. This could result in an overall IHT saving for Paul's estate of up to £140,000. We therefore recommend that the trustees transfer Sunnyside to Paul.

## **2. The Susan Wood Will Trust**

The Trust is an interest in possession trust which gives Paul an entitlement to the trust income and a right to occupy Sunnyside. The interest was created under the terms of Susan's Will which means that Paul has an 'immediate post-death interest' which satisfies the definition of a qualifying interest in possession ("QIIP"). This means that Paul is treated as beneficially entitled to the trust property for IHT purposes. If Paul holds the QIIP at his death, the value of the trust assets will be aggregated with his personal estate for IHT purposes with the IHT due thereon payable by the Trust.

### **a. Appointment to Shaun**

Paul is no longer reliant on the Trust's income and the trustees have decided to terminate his life interest in Beach Farm and Fairview, with one asset passing to Shaun and the other retained on discretionary trust for the benefit of the discretionary beneficiaries named in Susan's Will.

The trustees have confirmed that any immediate tax charges should ideally be met without selling any trust assets.

### **Option 1: Appoint Fairview to Shaun and retain Beach Farm on discretionary trusts**

#### **IHT: Fairview**

Paul has a QIIP so an outright appointment to Shaun will be a potentially exempt transfer ("PET") by him for IHT purposes whilst the retention of the other asset on discretionary trust will be a chargeable lifetime transfer (CLT). As Paul's annual exemptions for 2024/25 or 2023/24 are available and could be harnessed, the trustees should ensure that the PET of Fairview is made after the deemed CLT of Beach Farm (see below) so as to reduce the lifetime tax on that CLT. If Paul survives seven years from the date of the PET it will become fully exempt from IHT.

If Paul dies within seven years, the PET will become chargeable. Paul's nil rate band ("NRB") would apply to the failed PET in priority to his death estate but there will be no NRB available if, as recommended, the CLT is made first. Assuming that to be the case the maximum liable to IHT at 40% would be the full PET of £4.3 million. The IHT would be £1,720,000 assuming Paul's death was within three years of the appointment so taper relief would be unavailable.

The trustees would be primarily liable for any IHT due on the failed PET and should arrange appropriate insurance or indemnity protection.

#### **IHT: Beach Farm**

If Paul's life interest in Beach Farm is terminated and the assets held on discretionary trust, Paul will be treated as having made a CLT of Beach Farm. After deducting his NRB and any reliefs and exemptions, the CLT would be charged to IHT at a rate of 20%.

APR can reduce an IHT transfer of value and is potentially available on the 'agricultural value' of land owned and occupied for the purposes of agriculture. Any development value above the agricultural value will not attract APR. Where land is tenanted, it must have been both owned by the transferor and occupied for the purposes of agriculture for at least seven years leading up to the transfer. As the beneficiary of the QIIP, Paul is regarded as the owner for APR purposes, so the ownership condition is met as Paul has held the QIIP in the farm for over seven years.

Long Field and Bulls Paddock are agricultural land that is being cultivated to produce food. Both areas have been subject to the QIIP and occupied for the purposes of agriculture for the last seven years and will therefore qualify for APR.

The three barns do not have the required period of agricultural occupation to qualify for APR as they were unused prior to being leased to John Croft in 2019, which is less than seven years ago. Red Cottage is a holiday let, so not occupied for the purposes of agriculture and will not qualify for APR.

Farm cottages qualify as agricultural property if they are occupied by a farm worker and there is a sufficient connection between the occupation and the agricultural activities on the land. The cottage must also be 'of a character appropriate to the property' and HMRC guidance suggests this means proportionate in size and nature to the relevant farming activities. Although HMRC might argue that the value of Beach Cottage is disproportionate to the labourer's activities, it is a similar value to Red Cottage (rather than appearing to be a more substantial farmhouse). It is therefore likely to be considered proportionate to the farming activities and eligible for APR. Farm cottages can also qualify for APR where they are occupied by a retired farm worker but only if the employee is a statutorily protected tenant or the occupation is under a lease granted for the employee's life and that of any surviving spouse as part of the contract of employment. Beach Cottage will therefore not continue to benefit from APR if the labourer continues to live there following their retirement and no lease is put in place. The labourer's retirement should not affect the availability of APR now as it will occur next summer after the appointment in February 2025. It may however affect the availability of APR on the Trust's TYA or the IHT position if Paul dies within seven years of the appointment.

APR is available at the rate of 100% for tenanted land unless one of several conditions is met, one of which is that the tenancy commenced prior to 1 September 1995. As Beach Farm was farmed in hand by Susan's uncle until 2007, none of the farm tenancies will have commenced prior to 1995. A 100% rate of relief will therefore apply where the other APR conditions are met.

The deemed CLT will be £799,000 after deducting APR and the available annual exemptions. After deduction of Paul's NRB this will result in 20% IHT of £94,800 (see Appendix 1). The trustees will have primary responsibility for paying the IHT and Paul will need to give notice to them within six months of the transfer to make use of his annual exemptions. The trustees must submit form IHT100 to HMRC reporting the CLT and pay the IHT within six months of the end of the month of the transfer (by 31 August 2025 if the transfer occurs in February 2025). The trustees could make a claim to pay the tax in equal instalments over 10 years, with the first instalment due on the normal payment date (31 August 2025). Interest will be payable on the unpaid balance running from the normal due date.

Beach Farm will be subject to the IHT relevant property regime when the QIIP ends. This means that the property will be potentially liable to IHT on appointment out of the Trust and on each subsequent TYA of the Trust's creation. When this charge is calculated relief will be given for complete quarters counting from the last TYA when Beach Farm was not relevant property. Following the termination of Paul's life interest a seven year period of ownership by the trustees will be required before APR is potentially available again (unless the trustees farm the land in hand to meet the two-year occupation test). As the next TYA (in June 2032) is more than seven years after the proposed termination of the QIIP, APR may be available. The occupation condition will need to be met, which will be the case where the existing leases and farming activities have continued.

IHT Business Property Relief ("BPR") is potentially available where a transfer is attributable to relevant business property, including a business or interest in a business. As the land at Beach Farm is not farmed as a business run by the trustees it will not be eligible for BPR but the relief may be in point if the trustees later farm the land in hand.

If Paul does not survive seven years from the CLT there will be a recalculation with further tax potentially payable at 40%. APR may be unavailable on the death calculation if the trustees no longer own the agricultural assets or the property has not continued to be occupied for the purposes of agriculture. Credit will be given for the lifetime IHT and once Paul has survived for three years the death charge is subject to taper relief, starting with a 20% reduction in the 40% tax rate for death between years three and four.

## CGT

The appointment of Fairview to Shaun will be a market value disposal for CGT purposes. Capital gains can be deferred where the disposal is also a chargeable transfer for IHT but as the transfer is a PET the relief is not available. The Trust will be liable to 20% CGT, resulting in a liability of £309,700 (see Appendix 2) payable to HMRC by 31 January 2026.

There is no CGT disposal of Beach Farm as it is continuing in trust.

### **Option 2: Appoint Beach Farm to Shaun and retain Fairview on discretionary trust**

#### IHT: Beach Farm

An outright appointment from the QIIP will be a PET for IHT purposes. APR will initially apply to reduce the PET in the same way as described above for the CLT of Beach Farm. If Paul dies within seven years of the transfer the APR position will be reassessed by reference to Shaun's ownership and IHT will be payable at a rate of 40% on the PET after deduction of reliefs and exemptions. The same considerations regarding payment of IHT by the trustees and insurance cover apply, as stated above for Fairview.

#### IHT: Fairview

If Fairview continues to be held on discretionary trust after termination of Paul's life interest, there will be a deemed CLT by Paul.

IHT will be due at the lifetime rate of 20% on the CLT (net of deduction of available reliefs and exemptions) on the excess of Paul's NRB (assuming the recommendation to make the CLT before the PET is followed). If Paul does not survive seven years from the date of the termination additional IHT will become payable at the death rate of 40%, with credit given for the lifetime tax. Taper relief is available to reduce the IHT charge if Paul survives more than three years.

The value of the CLT will be £4,294,000, after deduction of Paul's IHT annual exemptions for this tax year and the preceding tax year. After deduction of Paul's NRB of £325,000, £3,969,000 is taxable at 20% resulting in an IHT liability of £793,800.

The same reporting and IHT payment deadlines (and option to pay by instalments) for a CLT of Beach Farm will apply to a CLT of Fairview. Fairview will be subject to the relevant property regime with the same implications as stated above for Beach Farm, except that there is no possibility of APR being available.

## CGT

The appointment of Beach Farm to Shaun will be a disposal by the trustees at market value, resulting in a chargeable gain of £1,625,000 (£4,175,000 - £2,550,000).

"Agricultural property" within the meaning of the IHT legislation for APR will benefit from CGT holdover relief where it qualifies for an IHT deduction on a simultaneous chargeable transfer, or would so qualify if there were a chargeable transfer on the disposal. Therefore, the gain on the land and buildings that qualify for APR will benefit from holdover relief. Assets used for the purpose of a trade carried on by the transferor will benefit from holdover relief and the business of letting furnished holiday accommodation on a commercial basis is specifically included as a trade for this purpose. Red Cottage will therefore also benefit from the holdover relief. As the three barns used for storage do not qualify for APR they cannot be included in a holdover relief claim. If a claim is made, the CGT on disposal of the barns will be £23,700 (see Appendix 2) and Shaun would inherit the trustees' base cost in relation to the remaining land and buildings. To claim holdover relief a joint election between the trustees and Shaun will need to be made within four years from the end of the tax year of disposal (on or before 5 April 2029).

There will be no CGT disposal of Fairview if it continues in trust.

## Recommendation

Our recommendation is to retain Beach Farm on discretionary trust and appoint Fairview to Shaun, ensuring that the CLT of Beach Farm occurs first. This will result in a total tax liability of £404,500 (CGT of £309,700 plus IHT of £94,800) which can be settled using the cash held by the trustees. This compares with £817,500 (IHT £793,800 plus CGT £23,700) if Beach Farm is transferred to Shaun. If the land at Beach Farm still qualifies for 100% APR on 8 June 2032 there will be considerably less IHT to pay than if Fairview had continued on discretionary trust, assuming the values remain similar or increase at similar rates between now and then.

### **b. Sunnyside**

Paul would like to continue to use Sunnyside, either by virtue of his life interest or by becoming the absolute owner following an appointment from the Trust.

The residence nil rate band ("RNRB") is potentially available where a testator leaves a residence, or an interest in a residence, to lineal descendants (and certain other qualifying beneficiaries). To "inherit" for the purpose of the allowance, the beneficiary must take an interest in the residence outright or become entitled under certain qualifying trusts. A percentage of any unused RNRB can be transferred between spouses and civil partners on death.

If the QIIP continues until Paul's death, Sunnyside will become subject to the discretionary trust under the terms of Susan's Will. Neither that nor a subsequent appointment to Poppy will result in Sunnyside being "closely inherited" for the purpose of the RNRB and the relief will not be available on Paul's death. Alternatively, if Sunnyside is appointed to Paul and gifted to Poppy (or Poppy and Emily) under Paul's Will, the RNRB may be available provided Paul's assets do not exceed £2.35 million, after which the relief is tapered away to nil. Paul's personal assets together with Sunnyside are likely to be below the RNRB tapering threshold.

The RNRB available to Paul's estate is the lower of the net value of the qualifying residence and £175,000. A transferable RNRB ("TRNRB") is available from a spouse who has not used their available allowance. Paul does not have any TRNRB from Susan's estate because it exceeded the net estate threshold for the RNRB. However, as Paul's first wife left her entire estate (less than £2 million) to Paul, her full TRNRB of £175,000 will be available. An outright appointment of Sunnyside would therefore give a potential IHT saving on Paul's death of £140,000. See example calculation at Appendix 3 on the basis Paul survives seven years from the proposed appointments.

There is no transferable NRB ("TNRB") from Susan's estate as the cash gift to Rebecca used Susan's NRB. However, the full TNRB will be available from Paul's first wife, as her entire estate passed to Paul exempt from IHT.

Where assets in a QIIP pass to the life tenant outright there is no transfer of value for IHT purposes. The transfer would be a market value disposal for CGT purposes but since Paul has by virtue of his life interest occupied Sunnyside since Susan's death the trustees can claim the benefit of CGT principal private residence relief to extinguish the gain. The trustees will need to report the disposal and claim the relief in the annual trust return.

If Paul died within seven years of the Fairview and Beach Farm appointments recommended above, his NRB would not be available to his estate as it would have been used by the deemed CLT of Beach Farm. Paul's TNRB would also be used in priority against the CLT. However, Paul's RNRB and TRNRB would be available to reduce his chargeable death estate.

If Paul retains the QIIP, on his death the value of Sunnyside will be aggregated with his free estate for IHT purposes. The QIIP is likely to consist of Sunnyside only at this point as the remaining cash in the QIIP is to be used for other costs. The trust will bear the IHT on Sunnyside, and Paul's NRB and TNRB will be apportioned between the QIIP and Paul's free estate. Paul's executors would have less IHT to pay if Sunnyside remains subject to the QIIP (as the IHT in relation to Sunnyside would be payable by the trustees) but the Trust's IHT liability

may in any event be deducted from assets passing to Poppy (or Poppy and Emily) as intended beneficiaries of Sunnyside under the Trust's remainder discretionary trusts.

We recommend that Sunnyside is appointed to Paul outright as there would be no immediate tax charges for the Trust and it would potentially give an overall tax saving of £140,000. It will also reduce the administrative burden on the trustees and avoid any practical issues with funding an IHT liability on Paul's death.

#### Appendix 1

##### **IHT on deemed CLT of Beach Farm**

	(£)	(£)
Transfer of value		4,175,000
Less: 100% APR on AV		
420 acres arable land	(2,450,000)	
80 acres cattle	(620,000)	
Beach Cottage	(300,000)	
		<u>(3,370,000)</u>
		805,000
Less: Annual exemptions (2024/25 & 2023/24 b/fwd)		<u>(6,000)</u>
CLT		799,000
Less: 2024/25 NRB		(325,000)
		<u>474,000</u>
IHT @ 20%		<u><u>£94,800</u></u>

#### Appendix 2

##### **CGT on appointments to Shaun**

	Fairview	Beach Farm
	(£)	(£)
Proceeds	4,300,000	4,175,000
Less:		
Probate value 8 June 2012	(2,750,000)	(2,550,000)
Gain / (Loss)	1,550,000	1,625,000
Less: holdover relief - Beach Farm (N1)		(1,505,000)
Less: 2024/25 Trust Annual Exemption	(1,500)	(1,500)
Taxable Gain	<u>1,548,500</u>	<u>118,500</u>
CGT @ 20%	<u><u>309,700</u></u>	<u><u>23,700</u></u>

**N1:** The gain eligible for holdover relief under s.165 TCGA 1992 is the total gain less the gain in relation to the three barns of £120,000 (£220,000 - £100,000).

Appendix 3

**IHT on Paul's death where Sunnyside remains in QIIP**

	<u>Settled property</u> (£)	<u>Free estate</u> (£)
Sunnyside / cash & investments	850,000	400,000
Less: NRB/TNRB	<u>(442,000)</u>	<u>(208,000)</u>
	<u>408,000</u>	<u>192,000</u>
IHT payable by trustees £408,000 @ 40%	<u>163,200</u>	
IHT payable by executors of Paul's estate £192,000 @ 40%		<u>76,800</u>
Total IHT payable £163,200 + £76,800	<u><u>240,000</u></u>	

**IHT on Paul's death if Sunnyside forms part of free estate**

	(£)
Sunnyside and cash/investments	1,250,000
Less: NRB/TNRB	(650,000)
Less: RNRB/TRNRB	<u>(350,000)</u>
Taxable estate	<u><u>250,000</u></u>
IHT payable by executors of Paul's estate £250,000 @ 40%	<u><u>£100,000</u></u>
Overall IHT saving with RNRB/TRNRB	£140,000