DISCOUNTED GIFT TRUST

TECHNICAL GUIDE FOR FINANCIAL ADVISERS

INTRODUCTION

Usually, where an individual gifts an asset into a trust and subsequently they continue to retain access or obtain a benefit from it, it is considered by Her Majesty's Revenue and Customs (HMRC) to be a Gift with Reservation of Benefit (GROB).

However, HMRC does accept that properly structured trusts which carve out rights before a gift is made are not subject to GROB. One such structure is RL360's Discounted Gift Trust (DGT).

Our DGT allows your client to gift their offshore plan into a trust, which is held for the ultimate benefit of their nominated beneficiaries, whilst providing the client with a series of withdrawals (retained rights) which are payable for the client's life or until the trust fund is exhausted. These withdrawals must be specified at outset and cannot be varied thereafter. It is advisable for the client to spend these withdrawals otherwise they will increase the value of their estate for Inheritance Tax (IHT) purposes.

Prior to setting up the trust, the Settlor's life is underwritten to establish that they are insurable (in accordance with HMRC guidelines) thus attaching value to their retained rights.

As the retained rights are carved out for the Settlor absolutely, they are not deemed to be part of the gift they have made to the trust for IHT purposes. As such, the IHT value of the Gifted Fund is discounted.

Should the Settlor die within 7 years of creating the trust, providing they were deemed to be insurable by our underwriters, HMRC should agree to 'discount' the value of the transfer by the value of the Settlor's retained rights.[1]

Our DGT can be established with either a fixed or a flexible class of beneficiaries. If the Settlor is confident that they will never need to change their beneficiaries, the trust would be established on a 'Bare' Trust basis. If the Settlor is likely to require more flexibility, the trust would be established on a 'Discretionary' Trust basis.

Apart from the difference in the flexibility of beneficiary, the choice of trust provisions also determines whether there may be any initial and ongoing IHT charges on the trust fund.

When set up under a Bare Trust the value of the Gifted Fund is a potentially exempt transfer (PET) for IHT purposes. Providing the Settlor survives 7 full years from the date the trust is established, the full value of the Gifted Fund will be outside of their estate for IHT assessment purposes.

Where the trust is established using the discretionary trust provisions, the transfer to the trust is a chargeable lifetime transfer (CLT). If the value of the discounted gift is more than the Settlor's available nil rate band (the nil rate band is £325,000 for the tax year 2019/2020) the excess will be chargeable to IHT at 20%. This excess can potentially be reduced by a further £6,000 if the client(s) have not used their annual IHT exemption of £3,000 for both the current and previous tax years.

1 Whilst we can advise a discount, only HMRC can agree it.

RL360°

GENERAL FEATURES OF THE TRUST

- The trust can be established with single or joint Settlors.
- It can be created with just a Gifted Plan Segments (Gifted Fund) or with Gifted Plan Segments and Retained Plan Segments (Access Fund).
- The creation of the Gifted Fund part of the trust is either a 'discounted' PET or CLT.
- The Settlor is not a beneficiary of the Gifted Fund but is the sole beneficiary of the Access Fund (if established).
- The Access Fund is available to the Settlor upon request.
- The trust is established with a single payment plan as the underlying asset.
- It is also possible to make additional investments (however, not to an existing RL360° Services plan), or to incorporate other assets into the trust at a later date.
- The Settlor's income is not restricted to the initial capital but rather, provided for life or until such time as the trust fund is exhausted.
- The trust will avoid probate assuming there is a remaining trustee alive at the time of the death of the last life assured on the plan.

SUITABILITY

OUR DGT MIGHT BE SUITABLE FOR INDIVIDUALS WHO:

- are UK or deemed UK domiciled for Inheritance Tax purposes
- are looking to reduce the value of their estate for Inheritance Tax purposes
- can afford to gift away any potential growth on their existing capital
- are in good health
- require an immediate reduction in Inheritance Tax
- are nervous of making a gift of the whole of their investment and who may require access to pre-determined capital payments from the trust
- want to ensure that if necessary, there is access to an emergency cash sum
- may wish in the future to add further monies/assets to the trust.

ESTABLISHING THE TRUST AS A BARE TRUST MIGHT BE SUITABLE FOR INDIVIDUALS WHO:

- wish to create a discounted potentially exempt transfer for IHT purposes
- wish to avoid reporting requirements to HMRC
- have specific beneficiaries in mind.

ESTABLISHING THE TRUST AS A DISCRETIONARY TRUST WOULD BE SUITABLE FOR INDIVIDUALS WHO:

- require flexibility as regards their choice of beneficiaries.

FREQUENTLY ASKED QUESTIONS

HOW DOES THE DGT WORK?

Example: Mr and Mrs Adams have the following assets and liabilities.

Assets & liabilities		Income	
Other assets	£150,000	Pension income net	£15,000
Bank deposit	£450,000	Deposit income (net)	£15,500
Investments	£350,000	Investment income	£5,000
Total net worth	**£950,000**	**Net income**	**£35,500**

If Mr and Mrs Adams die today, they have a potential IHT liability of £120,000 on their combined estates of £950,000.

£950,000 gross estate less £650,000 (2 x NRB @ £325,000) = £300,000 * 40% = £120,000

On the recommendation of their IFA, they invest £450,000 in the DGT, taking annual withdrawals of 5% from the plan. Mr Adams' gift is valued at £225,000, giving a discount of £159,348 (70.8%). Mrs Adams' gift is also valued at £225,000, giving a discount of £159,348 (70.8%). £131,303 remains in their estate.

(Discounts are based on an age attained of 67)

Mr and Mrs Adams' taxable estate has been reduced by £318,696, saving a potential £127,478 in IHT, whilst their income has increased by £7,000 per annum. As follows:

Assets & liabilities		Income	
Other assets	£150,000	Pension income net	£15,000
Investments	£350,000	Investment income	£5,000
DGT	**£131,303**	DGT withdrawals	**£22,500**
Total net worth	**£631,303**	**Net income**	**£42,500**

HOW IS RL360'S DGT DIFFERENT FROM OTHER DISCOUNTED GIFT SCHEMES AVAILABLE?

Our DGT offers a number of features not commonly available with other schemes. The top five are listed below:

1. Our DGT is trust based.

This means that, although the trust is created by assigning a plan into trust, it is the trust that determines what the Trustees can and cannot do with the trust fund, not the plan itself.

If say, the tax treatment of plans changes in the future, the Trustees could surrender the plan and invest in a range of collective investments, even during the life of the Settlor.

Please note that while the plan may be surrendered, the DGT will remain in place.

2. Our DGT enables the Trustees to make payments to beneficiaries during the Settlor's lifetime.

The Trustees can make distributions to a beneficiary during the Settlor's lifetime; however they must be certain that the trust fund is sufficiently robust to ensure that the Settlor can still be provided with an income for life, even after a repayment has been made to a beneficiary.

Example: Three years after creating their DGT, George, one of Mr and Mrs Adams' grandchildren, has the chance of travelling with his school to Peru. The cost of the trip is £3,000 but his parents are finding it difficult to raise the cash due to temporary cash flow problems.

The Adams appointed themselves and their accountant as Trustees. With the accountant's help, they calculate that the trust fund is sufficiently large to maintain the specified income payments to the Adams, even after the advancement of £3,000 to George.

The Trust Fund stands at £450,000 and the Trustees withdraw £3,000, from the Gifted Fund and pay the same to George's school.

(Please note that where a Settlor is UK resident and currently receiving their maximum cumulative 5% tax deferred allowance, then any withdrawals made by the trustees from the plan to a beneficiary will create a chargeable excess which will be assessable on the Settlor if they are UK resident).

3. Our DGT enables a Settlor to top up his or her arrangement.

The Settlor can choose to make additional contributions to the RL360 plan although not to an RL360° Services plan. These will be added to the Gifted Fund and (if chosen) the Access Fund, in the same proportions as the original transfer. Furthermore, the same percentage withdrawal on the plan as applied to the initial transfer will apply to any subsequent transfers. If the value of any additional transfer is to be discounted, the Settlor must be underwritten again to determine continued insurability. It is also possible to add other investments into the trust at a later date. In this situation the Settlor must specify whether the assets are to be held in the Gifted and/or the Access Fund and in what proportion. If no percentage split is indicated the additional investments will be assumed to be held in the Gifted Fund.

4. Our DGT offers an optional "rainy day" fund, known as the Access Fund.

With most Discounted Gift Trusts, the only part of the trust fund to which the Settlor has access is their retained rights, which having been fixed at outset, cannot be changed. What however, if a client is really interested in the benefits of a Discounted Gift Trust but is unsure of their future capital requirements? Our DGT has the added benefit of an optional Access Fund which is held for the Settlor absolutely.

Example: Mr and Mrs Adams, on the recommendation of their IFA, transferred £450,000 to the DGT, taking withdrawals of 5%. The plan is opened with 100 segments. Each segment is valued at £4,500.

However, as they are uncertain of their need for capital in the future, 15 plan segments (£67,500) are held in the Access Fund and £375,000 in the Gifted Fund. The discounted value of the Gifted Fund is £270,892, thus leaving £111,608 remaining in their estate.

Assets & liabilities		Income	
Other assets	£150,000	Pension income net	£15,000
Investments	£350,000	Investment income	£5,000
DGT[1]	£179,108	DGT "income"	£22,500
Total net worth	**£579,108**	**Net income**	**£42,500**
Taxable estate reduced by	**£270,892**	**Income increased by**	**£7,000**

[1] Including the Access Fund of £67,500

Mr and Mrs Adams' taxable estate has been reduced by £270,892, saving a potential £111.608 in IHT, whilst their income has increased by £7,000 per annum.

Should they find that their retained rights are insufficient, they can request that the trustees appoint some or all of the Access Fund back to them. Please note however, that this could create a chargeable gain for income tax purposes. This would be assessable on the Settlor.

Furthermore, should the clients find that they no longer need some or all of the Access Fund, the plan segments can be gifted to the Trustees. This will increase the trust fund available for the intended beneficiaries, whilst having the potential to further reduce the Settlor's estate for IHT valuation purposes at the same time. Depending upon the choice of trust provisions, any part of the Access Fund gifted to the trustees will be a PET or CLT at that time.

The value of the Access Fund is held by the Trustees for the Settlor absolutely and remains in their estate for IHT valuation purposes. As such, the creation of the Access Fund is neither a PET or CLT and is therefore, tax neutral.

If the Settlor dies, the value of the Access Fund will be taken into account for IHT valuation purposes. However, the Trustees do not have to appoint any part of the Access Fund remaining on the Settlor's death to his or her estate.

On death, the value of the Access Fund is passed automatically to the trust to be held for either the bare or discretionary beneficiaries.

Example: Mr Smith, aged 65, does not require income from his DGT at outset. He can choose to defer his income repayments for up to five years. This decision must be made at outset and cannot be changed at a later date. The effect of this will be to reduce the discount available.

Assuming £500,000 is invested, with no Access Fund, then if Mr Smith elects to receive income payments of £25,000 annually beginning at the end of the first year, the available discount will be £280,114.

As he has elected to receive income payments of £25,000 annually beginning at the end of the fifth year, the available discount will be £205,535 So although the discount is reduced if the income is deferred, the discount is still immediate and any growth on the initial transfer into the Gifted Fund is outside of the Settlor's estate from day one.

MUST THE SETTLOR'S LIFE BE UNDERWRITTEN?

Yes! If the Settlor is not underwritten at the time the trust is created, then should they die within 7 years of creating the trust, HMRC are unlikely to agree to any discount. We will not offer underwriting services to those clients aged 85 or over.

WHY IS THIS?

HMRC argue that the Settlor's retained rights have little or no value if a hypothetical purchaser could not insure the life of the Settlor against the value of those rights. Furthermore, in their Discounted Gift Schemes Technical Note, HMRC confirmed that they had been unable to find any evidence that it is possible to effect cover on lives older than 90 next birthday. HMRC therefore regard lives older than that, true or equivalent (mortality rated), as being uninsurable with the resultant ramifications in respect of the gift value.

We have experienced difficulties in the past in assisting the personal representatives of deceased Settlors in negotiating a discount with HMRC. One reason for this is the lack of life cover available for Settlors aged 85 or over. Therefore, we believe that 84 is the maximum age that the majority of UK insurers would provide life cover on a whole of life basis. For this reason, we will not underwrite any Settlor who is 85 or over.

Whilst we will not underwrite any Settlor either aged or rated 85 or more, we will issue an illustration indicative of the amount of discount that could be achieved subject to successful negotiations between the personal representatives of the estate and HMRC. However, due to the fact we will not have underwritten the Settlor's life, we will not be able to assist in helping to prove that the deceased was insurable at the time the trust was established.

This could also affect Settlors in good health who are under the age of 85 attained at the time of the establishment of their DGT but who are over that age when a top up is made.

DOES THE PLAN NEED TO BE ENCASHED ON THE SETTLOR'S DEATH?

Providing there is a surviving life assured, or a capital redemption version (CR) has been selected, the plan can remain in force as a tax efficient investment of the trust.

CAN THE TRUSTEES MAKE DISTRIBUTIONS TO A BENEFICIARY DURING THE SETTLOR'S LIFETIME?

Yes they can. However, they must be certain that there are sufficient monies in the trust fund to provide the Settlor with an income for the rest of his or her life. Furthermore, if UK resident, any distributions from the plan in excess of the plan's cumulative 5% allowance will trigger a chargeable excess which will be assessable on the Settlor.

ARE THERE NOT ANTI-AVOIDANCE RULES THAT TARGET THE USE OF INSURANCE PRODUCTS FOR THIS KIND OF PLANNING?

The 1986 Finance Act contains rules to prevent the avoidance of Inheritance Tax where life assurance plans or a combination of plans are used to provide income to a Settlor, whilst giving investment returns to the beneficiary of a trust. These rules were specifically aimed at the PETA plans that were being marketed in the 1980s. Schedule 20 Paragraph 7 of this Act reads as follows:

'where arrangements are entered into under which:

a) *There is a disposal by way of a gift which consists of or includes, or is made in connection with a policy of insurance on the life of the Donor or his spouse or on their joint lives and*

b) *The benefits which will or may accrue to the donee as a result of the gift vary by reference to benefits accruing to the Donor or their spouse (or both of them) under that policy or under another policy (whether issued before, at the same time as or after that referred to in paragraph (a) above, the property comprised in the gift shall be treated for the purposes of (s102) as not enjoyed to the entire exclusion … of the Donor'.*

This would catch the use of a conventional single payment insurance plan on the client's life written in trust, where under the plan regular repayments are paid to the Settlor for the rest of his life, with the balance of investment benefits paid to the beneficiaries of a trust. Clearly the client would not know at outset how long he or she is going to live and how many repayments he or she will receive. The longer the client lives the more the client will take from the trust fund and conversely, the sooner he or she dies, the less he or she will take. This will clearly have an impact on how much or how little is left in the trust for the beneficiaries so the donee's benefits (i.e. those remaining within the trust fund) clearly vary by reference to the benefits being paid to the Donor under the plan.

WHY ISN'T THIS A PROBLEM?

Quite simply, we believe that paragraph 7 does not apply, even though the donees' benefits vary by reference to the Donor's. This is because the Donor's benefits arise under the terms of a trust deed and not under a plan (as would be required for Para 7 to apply).

In addition, the assignment of the gifted rights into the trust should not constitute a gift with reservation, as the Donor is specifically excluded by the terms of the trust deed from being able to benefit from the gifted rights.

HAS RL360'S DGT BEEN INDEPENDENTLY APPRAISED?

The documentation used for our DGT has been produced in consultation with Tax Counsel.

FOR A JOINT SETTLOR TRUST, WHAT ARE THE IMPLICATIONS OF EITHER ONE OR BOTH SETTLORS DYING WITHIN SEVEN YEARS OF CREATING THE TRUST?

If a husband and wife or civil partners set up the plan jointly for Inheritance Tax purposes, each is treated as having made half the investment. However since the capital repayments will continue until the death of the last surviving Settlor, each Settlor's expected repayment stream will be actuarially calculated on a separate basis. Therefore, if each Settlor were to die during the initial seven year period, they would each have a different discount amount with which to offset against their own gift.

Where a Settlor dies, the repayment stream will continue until the death of the surviving Settlor.

ASSUMING THERE IS AN ADDITIONAL LIFE ASSURED OR A CAPITAL REDEMPTION VERSION SELECTED, WHAT ARE THE TRUSTEE'S OPTIONS UPON THE DEATH OF THE LAST SETTLOR ON EITHER A SOLELY OR JOINTLY SETTLED TRUST?

If they wish, the trustees can continue to hold the bond in trust or distribute all or part of the trust fund to the beneficiaries.

In this latter situation the trustees can choose whether to cash in the plan themselves, take advantage of any unused 5% cumulative allowance or assign the legal ownership of an appropriate number of individual plan segments to the beneficiaries for possible encashment outside the trust.

By assigning the ownership of the relevant plan segments to the beneficiaries prior to surrender, this moves the income tax liability for a chargeable gain from the Settlor, if within the same tax year as the Settlor passing away or trustees if in the new tax year, to the beneficiary at his/her own marginal rate. As a result, the relative tax positions of the Settlor, the trustees and the beneficiaries are likely to influence the decision of the trustees.

WILL THE SETTLOR BE CHARGED INCOME TAX UNDER THE PRE-OWNED ASSETS LEGISLATION?

Schedule 15 of the Finance Act 2004 does not apply to the settled property of the DGT and therefore in this respect, an income tax charge cannot be fixed on the Settlor. In addition it has been confirmed that the Settlor does not reserve any benefit in the settled property for IHT purposes, apart from his or her contingent interest and neither does he or she have an interest in possession in the settled property. In short therefore the pre-owned assets legislation does not have any impact on the DGT.

WILL THE REGULAR CAPITAL REPAYMENTS TO THE SETTLOR BE TREATED AS INCOME AND TAXED ACCORDINGLY?

In considering this aspect of the DGT, Counsel cited Stevenson v Wishart (1987) 1 W.L.R. 1204, where it was established that recurring capital repayments to which the payee is entitled as capital (and not merely to top up his income) are not to be treated as income. The Trust wording supplied by us has been carefully drafted following advice from Counsel to insure that a Settlor's entitlement is to capital repayments only.

IMPORTANT NOTES

For financial advisers only. Not to be distributed to, nor relied on by, retail clients.

Inheritance Tax is a complex area and as such your client must take professional advice.

Please note that every care has been taken to ensure that the information provided is correct and in accordance with our current understanding of the law and Her Majesty's Revenue and Customs (HMRC) practice as at June 2019 You should note however, that we cannot take on the role of an individual taxation adviser and independent confirmation should be obtained before acting or refraining from acting upon the information given. The law and HMRC practice are subject to change. Legislation varies from country to country and the plan owner's country of residence may impact on any of the above.

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