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Canada Life

How to make the most of discounted gift trusts

Advisers should understand, and carefully consider, the implications of discounted gift trusts when recommending them to clients.

UK inheritance tax (IHT) may well reduce the amount that clients are able to leave to their families or other intended beneficiaries, so everyone needs to be aware of the solutions available to them during their lifetime.

One solution widely used is the Discounted Gift Trust (DGT). This allows individuals to invest a lump sum whilst retaining the right to fixed regular payments, and reducing the amount of IHT that might eventually have to be paid from their estate.

But what about the long-term implications?

There are various pitfalls to be avoided with DGTs - not least when the settlor dies.

The discount explained

At outset of the DGT, the settlor requests a series of regular capital payments payable for their lifetime, or until the fund is exhausted. This series of payments is generated from partial withdrawals from an investment bond subject to a suitable trust.

The total value of the payments is ‘carved out’ from the original gift and is retained within the estate for IHT purposes as it is not given away. This retained amount is known as the ‘discount’. In effect, it is an exchange of part of the initial gift for an income stream.

The product provider medically underwrites the settlor in order to establish their life expectancy based on their state of health and lifestyle. Using their age, or rated age, the provider calculates the market value of the ‘income’ stream being provided to the settlor – the capital someone would pay to buy the regular payments.

The younger and healthier the settlor, the higher the market value of the income stream, as payments could potentially continue for longer. This will therefore give a larger discount. If the settlor is older or in poor health then the payments may not continue for as long and, therefore, the market value is lower and the discount is smaller.

Advisers may receive varying levels of ‘discounts’ from different providers based on each underwriting interpretation; the reasons for the differences will be due to a number of factors, including assumptions on future interest rates, costs, taxation and mortality.

Canada Life, for example, follows the guidance from HMRC (HMRC Brief 22/13, section 2.3) and assumes withdrawals will be taxed at 40% once outside the 20-year period (for 5% withdrawals each year). Some other providers may assume 0%, which results in their discount being uplifted at inception. This indeed may look more attractive but, by not following the HMRC guidance, there is a real risk that the calculation of the discount will be challenged by HMRC after the settlor’s death, leaving the executors to negotiate with HMRC, or even court action, and the beneficiaries receiving less inheritance than expected!

The following case study provides you with further understanding on other various implications.

Paul and Louise

Paul was a successful businessman and determined that HMRC would not get more than its fair share of his money in taxes, even after his death. He wants his children, Peter and Harry, to inherit his wealth when he and his wife have passed on.

After discussions with their professional adviser, Paul and Louise decide to invest £1million of their joint assets in an international bond. This is assigned to a discretionary discounted gift trust, of which they are the trustees.

The lives assured of the bond are their children, Peter and Harry and, as neither Paul nor Louise are lives assured, the trust does not fall foul of the provisions of the Finance Act 1986, schedule 20, paragraph 7.

Paul and Louise choose a discretionary trust, as opposed to a bare trust, in case anything happens to deter the trustees from giving Peter and Harry the beneficial interest. It also gives the opportunity for generation skipping so that potential grandchildren may also benefit.

The trust is set up so that Paul and Louise have the right to an annual payment of £50,000 for the rest of their lives.

Although they are wealthy, and not in need of the income, they have to receive it to obtain the discount. The danger here is that they let this accumulate in their estate, which reduces the effectiveness of any estate planning for IHT purposes.

Hopefully they will spend it, or give it away, although they need to be aware that any gift made cannot be claimed as normal expenditure out of income. Also, any gift over £3,000 will exceed their annual exemptions.

Based on their ages (both are 74) and following medical underwriting, the actual gift into the trust is valued at £463,520 from their £1m joint investment. The remainder is the discounted 'carved out' amount to provide their regular payments.

As they are both underwritten individually, this is split as Paul making a gift of £254,016 and Louise making a gift of £209,504.

As the net values are less than each of their nil rate bands, and as they have not made any other chargeable transfers in the previous seven years, there is no IHT entry charge.

Unfortunately, Paul suddenly dies five years later. The transfer is now included in the IHT calculation for his estate. Even though £500,000 was paid into the trust by Paul, and this amount is reflected in the trust fund held for the beneficiaries, the nil rate band available to Paul's estate is reduced by only £254,016, not the full £500,000. The value of Paul's future payments passes to Louise and is covered by the inter-spousal exemption.

The annual payment of £50,000 will continue to Louise. However, this may exacerbate the concerns about her not being able to spend or dispose of all of it, thereby accumulating funds in her estate now.

Louise's professional adviser strongly recommends that she now appoints additional trustees; otherwise there could be problems and delays after she dies. So she asks her brother and her solicitor to be additional trustees with her.

Unfortunately Louise passes away just over 4 years later. At that time, the international bond held in trust is valued at £996,000. The value of Louise's entitlement that was carved out at the outset immediately falls to zero and, as she survived for more than seven years since the chargeable transfer, nothing from the DGT will impact the IHT on her estate. However, her personal representatives will not be able to transfer a full 100% enhancement to her nil rate band, since some of Paul's nil rate band was used on his death.

The bond can remain in force because their children, who were the lives assured, are still fit and well.

The trustees however decide, in their absolute discretion, to distribute the trust fund to Peter and Harry.

Their tax adviser points out:

- If they distribute the trust fund before the 10th anniversary of commencement, there will be no IHT exit charge. This is because there was no IHT charge at outset.
- If they wait until after the 10th anniversary, there will be a periodic charge. If we assume that the nil rate band has increased to, say, £400,000 by this time, the amount of the periodic charge will be (£996,000 – (2 x £400,000)) x 6% = £11,760. There will then be a subsequent exit charge based upon the effective rate of 1.18072%.
- If they fully surrender the international bond in a tax year after the tax year of Louise's death, there will be a chargeable gain of £496,000 assessed on the trustees. The first £1,000 of this will be taxed at 20% and the remainder at 45%. This is an income tax lability of £222,950.
- As Peter has now retired, and Harry is not a UK resident as he moved abroad some years ago, it may be an option for the trustees to assign half of the bond segments to each of them as a distribution from the trust. This would not be a chargeable event;
- When Harry cashes in his entitlement, the tax payable will depend on the tax laws of the jurisdiction in which he resides.
- As a basic rate taxpayer, if Peter fully surrenders his segments, he would have a chargeable gain of £248,000, resulting in a loss of his personal allowance and his personal savings allowance. However, top-slicing is available and, based on the 9 years available, this amounts to £27,555.
- Peter could take up to 5% tax-deferred withdrawals from his bond or surrender segments. Alternatively, if he has no need for any proceeds, he could assign segments to his wife or family as a gift; all of which could keep him out of the higher rate tax bracket.
- Whatever his strategy, it is likely that basic rate tax will eventually be payable on Peter's chargeable gain. No IHT has been payable, but if Peter assigns segments to one or more family members, any amount falling outside available exemptions will be potentially exempt transfers from Peter.

As you can see, it is important for advisers to ensure they are familiar with all the implications of DGTs for their clients, both at outset and on death, and to impress on their clients' trustees that they should seek professional advice when making any significant decisions.

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