Canada Life

Discounted Gift Trust
Discretionary Settlement Deed

Tax Notes

Background

Under the Discretionary Trust arrangements, you will take out a specially designed life insurance policy (the ‘policy’) with either Canada Life Limited, Canada Life International Limited or Canada Life International Assurance (Ireland) DAC (referred to together as the ‘Company’), which will confer various rights on its policyholder. You will immediately exercise the right to take regular withdrawals from the policy. The right to regular withdrawals rests with you for the rest of your life/until the fund is exhausted, and cannot be defeated (the ‘retained right’). You will then settle the remaining rights conferred by the policy (the ‘gifted rights’) into a specially designed trust (the ‘trust’). The trust is a discretionary trust, in favour of beneficiaries chosen by you and you cannot be a beneficiary of the Trust.

Practical implications

All trustees must sign any instructions given to the Company, including instructions regarding the switching of investment funds held within the policy (unless a Fund Adviser has been appointed) or a trustee resolution for fund variation (T26)* has been completed.

* cannot be used for a Canada Life Limited policy

Inheritance tax considerations

Gift with reservation of benefit

The assignment of the gifted rights into the trust should not constitute a gift with reservation of benefit by you, since you will, by the terms of the trust deed, be expressly excluded from being able to benefit from the gifted rights. Neither you nor any spouse/registered civil partner will be a life assured under the policy, so as to make sure that the arrangements are not considered to be a gift with reservation of benefit by virtue of paragraph 7, Schedule 20, Finance Act 1986.

Initial gift

The assignment of the gifted rights into the trust will be a chargeable transfer of value, as the trust will be a discretionary trust. Because the retained right cannot be defeated by the trustees of the trust, there will be a discount on the value of the chargeable transfer. The relevant Company will underwrite each client to provide an indication of the discount available.

The value of the chargeable transfer will be the market value, for inheritance tax (IHT) purposes, of the policy on the date of the assignment of the gifted rights, less the actuarial value of the retained right on that date. The result will represent the reduction in your estate at the date of the assignment of the gifted rights. If the result is greater than your annual exemption (if available, currently £3,000) and the available nil rate band on that date, there will be an immediate charge to IHT at the appropriate lifetime rate, presently 20%. The available nil rate band takes into account chargeable transfers of value made in the previous seven years. The nil rate band is currently £325,000. If you survive seven years from the settling of the trust, there will be no further IHT to pay on your death.

For example: Mr Smith was 79 years old and in good health in 2010 when he paid £250,000 into the policy. He immediately opted to take regular withdrawals of 5% of the premium paid, and settled the trust. He had already established a discretionary trust for his grandchildren in the previous year, making a chargeable transfer of £100,000 into that trust. The discounted value of the gifted rights is £171,030. Accordingly, even with his earlier chargeable transfer he is still within the nil rate band of £325,000, and thus no charge to IHT arises.

Ten-year periodic charge

At each ten-year anniversary there will be a periodic charge to IHT, which is calculated as if you had made a hypothetical chargeable transfer of the value of the trust’s property at the ten-year point. The nil rate band at the ten year anniversary is available in calculating the charge, but cumulative chargeable transfers made in the seven years before establishing the trust must also be taken into account. The rate applicable is 30% of the lifetime rate at the ten-year anniversary. The maximum charge to IHT that can currently arise is 6%. The value of the trust’s property at each ten-year anniversary should be the discounted value of that property at that time. The Company has agreed the methodology for calculating the initial discount with HM Revenue & Customs (HMRC) Inheritance Tax’s Chief Actuary.

Continuing the earlier example, ten years later (in 2020) Mr Smith is still alive and the trustees have to calculate the charge to IHT. The value of the policy is £300,000. The value of Mr Smith's discount, as a still healthy 89 year old, is £63,054, and so £236,946 is the deemed chargeable transfer. The nil rate band is £345,000 and the lifetime rate for IHT is still 20%.

The £100,000 chargeable transfer is applied first against the nil rate band, leaving £245,000 available against the value of the trust's property. As the value of the trust's property is less than the remaining nil rate band there is no IHT to pay.

The HMRC Actuary has stated that he will not allow an initial discount where the client is aged 90 or over at outset, as the client would not be able to sell on his right to future regular withdrawals if the purchaser could not take out life insurance on the client (that is the HMRC Actuary has assumed that anyone aged 90 or above would be uninsurable, from a life insurance perspective). The situation here is slightly different, however, as it is the value of the relevant trust property that has to be agreed, not the value of the initial chargeable transfer made by you.

Ten-year periodic charge and failed potentially exempt transfers

It should be borne in mind that potentially exempt transfers (PETs) made in the seven years before the trust is established can impact on the calculation of the ten-year charge.

For example: In 2009, Mr Smith settled a discretionary trust for £100,000. At the same time, he made an absolute gift of £500,000 to his daughter, as a PET. In 2010, Mr Smith paid £250,000 into the policy. He immediately opted to take regular withdrawals of 5% of the premium paid, and settled the trust. Mr Smith died in 2014. The charge to tax at the ten-year anniversary now changes, as follows:

In 2020 the trustees have to calculate the charge to IHT. The value of the policy is £300,000. The value of Mr Smith's discount is nil as it died with him. The nil rate band is £345,000 and the lifetime rate for IHT is still 20%.

The £100,000 chargeable transfer is applied against the nil rate band as before, but now the failed PET (which has become a chargeable transfer) of £500,000 is also applied against the nil rate band meaning that none is available against the value of the trust's property. The charge to IHT is now calculated as follows:

£300,000 x 20% x 30% = £18,000, being an effective rate of 6%.

The exit charge

There is one other occasion on which IHT can become due, which is a proportionate amount payable on capital leaving the trust before the tenth anniversary and between each tenth anniversary. This is usually referred to as the 'exit charge' and is calculated in a similar manner.

The exit charge before the first ten-year periodic charge

Where the capital is paid out before the first ten year anniversary, the exit charge is calculated in a similar manner as at the ten-year point, that is as if you had made, at the time the exit charge falls to be calculated, a hypothetical chargeable transfer of value of the trust's property, but the crucial difference (in this context) is that the hypothetical chargeable transfer of value of the trust's property is calculated by reference to the value of the trust's property immediately after the trust commenced (again, taking into account previous chargeable transfers in the seven years before the trust commenced). The charge to IHT is calculated by reference to the 'appropriate fraction' of the effective rate at which IHT would be charged on the abovementioned hypothetical chargeable transfer of value. In short, the 'appropriate fraction' is 30% x the number of complete quarters since the trust was set up.

For example: In 2010, Mr Smith paid £450,000 into the policy. He immediately opted to take regular withdrawals of 5% of the premium paid, and settled the trust. The discounted value of the gifted rights was £307,854.

In 2018 Mr Smith dies and the trustees surrender the policy for £460,000, and pay the proceeds of surrender to the beneficiaries. Assuming the nil rate band in 2018 is £325,000, then, in relation to the hypothetical chargeable transfer, the IHT payable is:

(£307,854 - £325,000) = £0 x 20% = £0.

The effective rate of IHT is, therefore, £0/£307,854 = 0%.

Finally, it should be noted that any amount on which IHT is imposed under the exit charge regime has to be added to your previous chargeable transfers in the seven years before the trust commenced, in calculating the ten-yearly periodic charge.

The exit charge and failed potentially exempt transfers

As with the ten-year periodic charge, failed PETs can impact on the rate of IHT on the exit charge. A PET made before the trust is settled and which fails by virtue of your death will increase the cumulative chargeable transfers made in the seven years before establishing the trust.

For example: In 2009, Mr Smith settled a discretionary trust for £100,000. At the same time, he made an absolute gift of £500,000 to his daughter, as a PET. In 2010, Mr Smith paid £450,000 into the policy. He immediately opted to take regular withdrawals of 5% of the premium paid, and settled the trust. The discounted value of the gifted rights was £307,854.

In 2014, Mr Smith dies and the trustees surrender the policy for £500,000 and distribute the proceeds of surrender to the beneficiaries. The charge to IHT on exit is now calculated as follows;

£307,854 x 20% = £61,570.80

The effective rate of IHT is, therefore,
£61,570.80/£307,854 = 20%.

The appropriate fraction is 30% x 18/40 = 0.135.

The IHT due is, therefore,
0.135 x 20% x £500,000 = £13,500.

The exit charge after the ten-year periodic charge

The exit charge after a ten-year anniversary is based on whatever the effective rate of IHT was at the preceding ten-year anniversary, multiplied by the number of quarters elapsed since the last ten-year anniversary. So if this was 0% then the exit charge would be 0%. If it was 0.2%, as in one of the previous examples, the exit charge would be 0.2%.

Joint Settlors

Where there are joint settlors (that is you plus another person) of the trust, the gift into the trust will be treated as if it was comprised in two separate settlements for IHT purposes, with each settlement being created by a separate settlor.

Pre-owned assets considerations

The assignment of the policies into the trusts will not result in an income tax charge arising on the settlor or settlors under Schedule 15, Finance Act 2004. The rights held for the settlor or settlors are held subject to bare trust and as such are not within the definition of ‘settlement’ for the purposes of the Pre-owned Asset legislation and outside the scope of paragraph 8, Schedule 15, Finance Act 2004. In addition, the beneficiaries fund is held subject to a settlement from which the settlor or settlors are specifically excluded from benefit. For the purposes of Paragraph 8, Schedule 15 Finance Act 2004 the settlement would not be considered as ‘settlor interested’ under Section 624 Income Tax (Trading and Other Income) Act 2005 (ITTOIA) and is, therefore, outside the scope of pre-owned asset tax.

Income tax considerations

The assignment by the investor or investors of the policies to the trustees of the Discounted Trust (for nil consideration) will not give rise to a chargeable event. (S484 (1) (a) (ii) ITTOIA).

The premium payment into the policy gives the policy a withdrawal/partial surrender allowance equal to 5% of the payment in the year in which it is paid and the next 19 policy years (Section 507 ITTOIA).

The allowance is cumulative and any unused allowance may be carried forward for use in subsequent years. Effectively the legislation allows
for the return of the original premium tax-deferred but no more quickly than one-twentieth of the premium each year.
If a partial surrender in excess of the 5% allowance is taken then the amount above the allowance is treated as chargeable to tax irrespective of the actual underlying value of the policy. As the policy is held under trust any tax charge is a liability of the original investor (settlor) not the trustees. Where there are two settlors alive at the time each will be deemed to have a liability to tax on half the amount taken in excess of the 5% allowance (Section 467 ITTOIA).

Where the whole policy or segments of it are surrendered then a chargeable gain will arise if a profit has been made (Sections 484 and 491 ITTOIA).

Following the tax year of the death of the settlor, or the death of the last surviving settlor, it is the trustees who become liable to tax on any excess withdrawal, surrender or payment of death benefit following the death of the last life assured.

The following calculation is required to determine the chargeable gain that is the amount that is chargeable to tax on surrender or death.

(A + B) - (C + D)

Where:

A is the amount realised on surrender

B is the total of the previous partial surrenders/withdrawals taken from the policy

C is the original premium

D is the total of previous excesses over 5% that have been withdrawn from the policy.

In addition, following the decision of Special Commissioner, Dr Brice, in Sugden v. Kent (Inspector of Taxes) [2001] STC (SCD) pp158 – 169, the investor’s entitlement to the benefits of the partial surrenders and any payment made by the Company in relation thereto should not amount to an annuity. The regular payments should not, therefore, be taxable as income under Case V of Schedule D as annuity payments with a foreign source.

Reporting requirements

If the amount of the gift transferred (plus any other transfers made by the settlor) exceeds £325,000, a return has to be submitted to HMRC within 12 months of the transfer being made.

Note
This document is based on the Company's understanding of applicable legislation, law and current HMRC practice as at November 2016. It is provided solely for general consideration.

Please note that past performance is not a guide for the future. The value of units can fall as well as rise and currency fluctuations may also affect performance.

The information regarding taxation is based on our understanding of current legislation, which may be altered and depends upon the individual financial circumstances of the investor. We recommend that investors take their own professional tax advice.

Canada Life

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