canada life

The value of the discount

One of the main benefits of a discounted gift trust is the ability of the settlor to receive regular fixed payments which, in turn, potentially allows for an immediate reduction in the value of their estate for inheritance tax purposes. This reduction is known as the 'discount'.

It is important that the discount is calculated in line with HMRC guidance, reducing the possibility of it being challenged by HMRC at outset or at a later date.

How the discount is calculated

At outset, the settlor requests a series of regular payments payable for their lifetime, or until the fund is exhausted.

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, they can calculate the market value of the 'income' stream being provided to the settlor – the amount 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; which therefore will 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.

HMRC guidance

Once the medical underwriting is complete, HMRC have provided guidance on the actual calculation of the discount and, if this is followed, the amount should be similar whichever provider is used. There is no discount available where the settlor is aged 90 or over or has a rated age of over 90.

The guidance from HMRC is available here:

https://www.gov.uk/government/publications/revenue-and-customs-brief-22-2013-discounted-gift-schemes/revenue-and-customs-brief-22-2013-discounted-gift-schemes--2

For the purposes of this calculation, HMRC require that the settlor is assumed to be a higher rate taxpayer once the cumulative 5% tax-deferred allowances from the underlying investment bond have been exhausted. For an onshore bond, the tax will be 20% on the excess, as there will be a basic rate tax credit to reflect the fact that tax has already been suffered within the life fund. For an offshore bond, the tax will be 40% on the excess.

The 5% tax-deferred allowances will be used up by the regular payments back to the settlor and any adviser charges that will be deducted.

HMRC can scrutinise and challenge the level of discount at any time, even if the settlor dies after more than seven years. If the discount is considered to be too high, the net amount would have to be adjusted. This could have the effect of bringing the gifted amount above the nil rate band, creating a 20% liability as well as potential exit charges on any benefits paid out to beneficiaries within the first ten years. HMRC may not know about the existence of the trust at outset if gifted rights are under the reporting limit. When HMRC become aware of it, such as on the settlor's death or at a ten-yearly anniversary, there would be nothing to stop them going back to query the amount of the discount.

It is therefore important that the discount is calculated using the assumptions provided by HMRC to help reduce the likelihood of any discount being challenged.

Ten-year anniversary charges

If the trust is on a discretionary basis then inheritance tax charges could fall due on each tenth anniversary and on any distributions to beneficiaries in the future. When valuing the trust at each tenth anniversary, if the settlor is alive and the value of the bond is greater than 80% of the nil rate band, then a new discount calculation will be required in order to establish the net value of the trust.

HMRC have agreed that, when calculating the discount in such circumstances, the age of the settlor used to calculate the discount at outset can be increased by the number of years to the relevant ten year anniversary. For example, if the settlor was 65 years of age, but after medical underwriting they were rated and treated as a 69-year-old, on the tenth anniversary the recalculated discount (if required) would be based on a 79-year-old, and on the twentieth anniversary, an 89-year-old and so on.

If the settlor had died then there would be no need to calculate a discount as the full value of the trust would be used.

When comparing providers, a larger discount may appear attractive, however, this can lead to complications in the future.

MAR01518 – 321R/B