Discretionary Gift & Loan Trust

Tax notes

These tax notes relate to policies issued by:

- **Canada Life Limited**
- **Canada Life International Limited**
- **Canada Life International Assurance (Ireland) DAC Limited**
- **CLI Institutional Limited**

Background

The Discretionary Gift & Loan Trust allows investors to make a small gift of £10 into trust, followed by an interest-free loan. The investor(s) has (have) the right to demand repayment of the loan at any time and can choose to receive regular repayments each year if required.

The loan is invested in an investment bond and all investment growth will benefit the chosen beneficiaries.

The investor(s) make(s) a £10 cash gift under a settlement, the terms of which provide that:

- the settlor is excluded from benefiting from the trust; however, he is entitled to receive repayments of the loan;
- the individuals (whether named individually or as a member of a class) who could possibly benefit from the trust are as stated in Part 4 of the trust deed;
- The trustees can include at a later date an individual or class of individuals as a beneficiary if not already mentioned in Part 4.

The investor then makes an interest-free loan to the trustees of this settlement. The trustees invest the loan amount in an investment bond.

Inheritance tax considerations

1. The settlement assets are treated as relevant property for the purposes of inheritance tax (IHT) [s58(1), IHTA 1984].

2. Unless one or more exemptions are available, the initial £10 cash gift will be a chargeable lifetime transfer (CLT) [s2, IHTA 1984].

3. The grant of an interest-free loan is not a transfer of value but it is a gift due to the interest foregone. However, the granting of such a loan is not, in itself, a gift with reservation.

   This is because all the conditions laid down in section 102 FA 1986 are not fulfilled and the gift with reservation provisions cannot apply. In addition, the ability to demand loan repayments – which is a contractual entitlement – is not regarded as a gift with reservation for these purposes.

4. A potential charge to inheritance tax will arise on every tenth anniversary of the creation of the trust [s64, IHTA 1984].

   In order to calculate any tax that may be due, it is assumed that a chargeable transfer had been made on the tenth anniversary [s66(3), IHTA 1984].

   The assumed transfer is equal to the total value of the relevant property in the trust immediately before the anniversary date, plus the value of any other trusts set up by the settlor on the same day, plus any other property that was put into the trust, plus all CL Ts made by the settlor in the seven years before the creation of the trust, plus any amounts leaving the trust in the previous ten years [s66(4), IHTA 1984].

   The value that applies for the purposes of the charge is the 'open market value'. This is the price the trust assets might reasonably fetch if sold in the open market at the time of the occasion (in this context, immediately before the tenth anniversary date).

   This would probably be the surrender value of the policy less the outstanding loan amount.

   However, the charge is only levied on the amount by which the value of the deemed transfer exceeds the nil rate threshold at that time.

   If this is the case, the rate of tax on the excess is 30% of the lifetime rate of inheritance tax [s66(1) IHTA 1984] and is 6% currently.

   It should be borne in mind that potentially exempt transfers made in the seven years before the trust is established can impact on the calculation of the ten-year charge, if the investor dies within that seven-year period.

5. Where the surrender value of the policy plus any distributions to any beneficiary (this doesn't include loan repayments to the settlor) plus the value of any CLT made, by the settlor, seven years prior to the start of the trust exceeds £260,000 (80% of the IHT nil rate band) the trustees need to send forms IHT100 and IHT100d to HMRC within six months of the tenth anniversary.

6. When any payments are made to the beneficiaries, there will be a potential exit charge [s65(1) IHTA 1984]. This is known as the proportionate charge.

   The percentage amount of the charge is the same as that applying at the previous anniversary and based on the amount by which the value of the relevant property in the trust is reduced.

   The rate of proportionate charge is reduced by a fraction based on the time elapsed since outset or the last ten-year anniversary. This fraction is calculated as one-fortieth for each complete quarter that has passed since the anniversary [s.69, IHTA 1984].

   Of course, if the appropriate rate at the previous ten-year anniversary had been zero, there will be no exit charge.

   However, if top-up premiums had been paid since the last ten-year anniversary, or property has been added to the settlement then the rate of tax applicable at that anniversary is re-calculated as if the value had included the added property.

   In the first ten years, special rules apply – because there was not a previous ten-yearly anniversary.

   The rate of tax is based on all the property in the trust at the time of its creation (which excludes the loan amount), plus any property subsequently added to the trust, plus any other property in any other trust made by the settlor on the same day, plus all CLTs made by the settlor in the seven years before the creation of the trust.

   The rate is worked out in the same way as the rate of the ten-yearly charge.

7. If the settlor pays any tax charge, the tax payable has to be grossed-up.

   In effect, the amount calculated is divided by 0.8 to give the gross amount payable.

8. The settlor has no interest under the trust apart from the loan repayment and all other benefits are only payable to the beneficiaries. Accordingly, the transfer does not constitute a gift with reservation [p7(1), sch.20, FA1986].

9. The loan agreement states that the trustees shall not incur any personal liability. This means that the trustees' liability to repay the loan is limited to the value of the trust fund at the time the loan repayment is demanded. However, where this applies, please note that the whole of the balance of the outstanding loan (not the limited amount) will be potentially assessable to IHT in the settlor(s) estate.

Income tax considerations

1. If benefits are payable under the policy, a chargeable event may occur.

   If so, as the policy is held under trust, any tax charge is a liability of the settlor [s465(3), IT(TOI)A 2005].

   If the settlor is 'absent' because they are non-UK resident or they have died in a previous tax year, any tax charge is a liability of the trustees, provided that the trustees are UK resident [s467(1), IT(TOI)A 2005].

   If the trustees are not UK resident, any individual who is ordinarily UK resident and benefits from the bond would be assessed to tax on the chargeable gain [s468(1), IT(TOI) A 2005].

2. If the investment bond is issued by a UK resident company, income tax on the gain at basic rate is treated as having already been paid [s530, IT(TOI)A 2005].

Pre-owned assets tax

1. HM Revenue & Customs (HMRC) have confirmed in writing to the Association of British Insurers that they would not seek to apply the pre-owned assets tax rules to a gift and loan plan. This has been reconfirmed by HMRC in their guidance notes.

This document is based on our understanding of applicable legislation, law and current HMRC practice as at June 2019. It is provided solely for general consideration. 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.

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