Discretionary Gift Trust

Tax Notes

Background

The Discretionary Gift Trust allows you to make a gift of a policy into trust. As you have given the policy away, you have no right to receive any future benefits, such as withdrawals, surrender or maturity benefits from the policy.

The policy is assigned to a settlement, the terms of which provide that:

- You are excluded from benefiting from the policy
- The trustees may distribute the trust fund to any beneficiary (whether named individually or as a member of a class), as they, in their complete discretion, see fit
- The individuals (whether named or as members of a class) who could possibly benefit from the policy are as stated in Part 5 of the trust deed
- The trustees can include an individual, or class of individuals as a beneficiary. If not already mentioned within the trust deed.

Inheritance tax considerations

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

2. The 'open market value' of the policy on the day it is placed in trust or the payment of the premiums, to the extent that they are not otherwise exempt, is treated as a chargeable lifetime transfer (CLT) by the settlor(s) [s3(3) IHTA 1984]. The open market value is the price the policy might reasonably fetch if sold in the open market. This would probably be the surrender value of the policy on the day immediately before the trust was effected. If the premiums paid exceed the open market value, this figure is used instead.

   Any transfers made by a settlor in any one tax year are exempt if they do not exceed £3,000 [s19(1), IHTA 1984].

   In addition, any transfer is exempt to the extent that:

   - It was part of the normal expenditure of the settlor, and
   - It was made out of net income, and
   - The settlor was left with sufficient income to maintain their usual standard of living [s21(1), IHTA 1984].

3. If the amount of the transfer (after exemptions) and the total of all CLTs made by the settlor within the previous seven years (the settlor's cumulative total) exceeds the nil rate band at that time (currently, £325,000), IHT will be payable on the excess at the lifetime rate.

   The lifetime rate is half the standard rate of inheritance tax [s7(2) IHTA 1984].

   If top-up premiums or regular premiums are paid, the settlor's cumulative total must be checked to see if it exceeds the nil rate band at that time.

   If there are joint settlors, the premiums are treated as being divided between them and each will have a cumulative total to be checked against their own nil rate band.

4. If a settlor dies within seven years of making a CLT, the transfer may be liable to IHT at the full rate (assuming that part or all of the CLT does not comprise the settlor's inheritance tax nil rate band) [S7(2) & (4) IHTA 1984].

   However, any tax payable will be reduced by taper relief if death occurs more than three years after the date of the transfer.

   Any tax already paid at outset, will be deducted from any liability [p2, sch 2, IHTA 1984], but if this produces a negative result there will be no refund.

   It should be noted that potentially exempt transfers (PETs) made in the seven years before the trust is established can impact on the calculation of the tax on death. This will only occur if both the PET and CLT were made in the seven years before death.

5. A potential charge to IHT will arise on every ten yearly 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 CLTs made by the settlor in the seven years before the creation of the trust
   - Plus any amounts distributed to beneficiaries in the previous ten years [s66(4), IHTA 1984]

   The value that applies for the purposes of the relevant property is the open market value. For a policy with an investment element this would probably be the surrender value of the policies held in the trust at the time of the occasion (in this context, immediately before each ten yearly anniversary date).

   For a protection policy without any investment element, if it was the subject of a death claim that had not yet been paid, or the client was terminally ill, it would have an open market value.

   Also, there are special rules for life policies which state that the minimum value of the transfer is the total of the premiums paid under the policy [s167(1) and s167(5), IHTA 1984].

   But there is an exemption for term assurance policies, and the rules regarding premiums paid do not apply to these policies [s167(3), IHTA1984].

   However, the charge is only levied on the amount by which the value of the deemed transfer exceeds the nil rate band 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 noted that PETs made in the seven years before the trust is established can impact on the calculation of the ten yearly charge, if the settlor dies within that seven year period.

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 ten-yearly 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-yearly anniversary. This fraction is calculated as one-fortieth for each complete quarter that has passed since the anniversary [s.69, IHTA 1984].

   If the appropriate rate at the previous ten-yearly anniversary had been zero, there will be no exit charge.

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

   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, 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.

   This may mean that an exit charge is payable.

7. If the settlor pays any tax charge, or an exit charge is paid out of any relevant property remaining in the trust, 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(s) have no interest under the trust and any benefits are only payable to the beneficiaries.

   Accordingly, the transfer does not constitute a gift with reservation [p7(1), sch.20, FA1986].

9. In the event of an appointment by the trustees whereby a beneficiary's possible interest comes to an end, there is no further transfer subject to IHT.

10. If the amount invested in the trust fund (plus any other CLTs made by the settlor) in the previous seven years exceeds the nil rate band, a return has to be submitted to HMRC before the end of six months after the end of the month in which the transfer was made.

Pre-owned assets tax

The assignment of the policy into the settlement will not give rise to an income tax charge on the benefits received by the settlor(s) under Schedule 15, FA 2004.

This is because the settlor(s) are expressly excluded from benefiting from the trust.

Income tax considerations

1. The initial assignment of the policies into the settlement is not 'for money or money's worth' and is thus not a chargeable event for tax purposes [s484(1), Income Tax (Trading and Other Income) Act 2005].

2. 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 proceeds would be assessed to tax on the chargeable gain [s468(1), IT(TOI)A 2005].

3. If the policy 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].

This document is based on our understanding of applicable legislation, law and current HMRC practice as at March 2021. 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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