

Discretionary discounted gift trust

Adviser's guide

Adviser's guide to the discretionary discounted gift trust

This guide is for use by financial advisers only. It is not intended for onward transmission to a private customer and should not be relied on by any other person.

In this document, the term 'spouse' includes reference to a registered civil partner under the Civil Partnership Act 2004.

Contents

- 3** Section 1: Objectives and suitability of the discretionary discounted gift trust
- 5** Section 2: Inheritance tax planning
- 7** Section 3: Probate
- 8** Section 4: Practical issues
- 10** Section 5: The trust provisions in detail
- 13** Section 6: The UK tax implications

Section 1: Objectives and suitability of the discretionary discounted gift trust

1.1 General purposes of the trust

The purpose of the discretionary discounted gift trust (the 'trust') is to facilitate effective lifetime inheritance tax (IHT) planning for an investor by using a single premium life insurance bond (the 'bond') without losing complete access to the investment.

Any of the onshore bonds currently available from Sanlam Investments and Pensions are suitable for this purpose. The bonds are taxed in the same way and offer similar withdrawal facilities (please refer to the relevant brochures and product guides for further details).

Where a new bond is to be made subject to a trust, any initial adviser fees should be taken prior to investment in the bond in order to maximise the availability of the 5% tax deferred withdrawal allowance.

The trust may also be used with an existing Sanlam Offshore Bond, provided by Royal London 360° Insurance Company Limited.

By using the trust with a life assurance bond, the individual is able to immediately reduce his or her taxable estate for IHT purposes to the extent of the discount, whilst retaining access to a fixed stream of payments from the investment.

The trust allows an investor (known as the 'settlor') to make a gift which will be totally free of IHT if he or she survives the gift by seven years (however, the trust may be subject to periodic/exit charges). In addition to this, if the settlor dies within seven years of setting up the trust, only part of the initial investment or the bond transferred to the trust is treated as a gift for IHT purposes. This is because IHT is calculated on the 'loss to the estate' principle, and the settlor retains a right to capital payments from the trust which has a present value.

1.2 The settlor's fund

The trust deed creates two interests in the trust fund. One part of the trust fund, called the settlor's fund, is held absolutely for the settlor and comprises a series of fixed specified payments at pre-specified frequencies.

The right to these capital payments has a value for IHT purposes and this remains in the taxable estate of the settlor, although no

IHT is payable on it on the settlor's death as the right to income ceases.

1.3 The beneficiaries' fund

The remainder of the trust fund, known as the beneficiaries' fund, is held for the settlor's intended beneficiaries, and this is the part that is gifted. It is expected that these beneficiaries will benefit from the trust following the settlor's death. The trust fund at that time will reflect the investment performance of the bond less any capital payments made to the settlor whilst he or she was alive.

1.4 Overview of tax advantages

The value of the trust fund available for the beneficiaries partly depends on how long the settlor remains alive, and therefore on the amount of capital payments drawn from the trust.

Because the settlor's right to capital payments has an economic value which is kept back for the settlor's own benefit, the value of the gift the settlor is treated as making is reduced. Hence the term 'discounted gift'.

Although, as stated, the value of the settlor's entitlement to capital payments remains in his or her estate during their lifetime, this value is nil when the settlor dies because the payments are only made if the settlor is alive and the value is ascertained immediately before death. Therefore, no value at all is included in the settlor's estate on his or her death.

Whilst the gift with reservation provisions can neutralise the IHT benefits of a trust under which the settlor can benefit, these rules do not apply in this case because the settlor's entitlement to withdrawals is clearly defined in the trust and is held by the trustees absolutely for the settlor. Therefore, the settlor cannot benefit in any way from the remainder of the trust fund, (the beneficiaries' fund).

The beneficiaries' fund is held on a fully discretionary trust. Previously, it was usual to use a flexible power of appointment (interest in possession) trust in discounted gift trust arrangements, as this had the additional advantage of the initial gift to the trust being

a potentially exempt transfer (PET). However, following the new rules introduced in March 2006 (and set out in the Finance Act 2006), the scope for making PETs has been severely restricted so that only outright gifts to other individuals or gifts to absolute trusts and trusts for the disabled still qualify as PETs. All other gifts to trusts are chargeable lifetime transfers. The discretionary discounted gift trust gives investors flexibility over the choice of their ultimate beneficiaries. Even though the gift to a trust is a chargeable lifetime transfer, no immediate tax liability arises unless the amount of the gift (plus any other chargeable transfers in the previous seven years) exceeds the nil rate band.

Full details of the UK taxation implications of the trust can be found in section 6 of this guide.

1.5 Suitability of the trust

The trust is likely to be suitable if:

- the investor, aged between 60 and 89, has a potential IHT liability on his or her estate which he or she would like to reduce, but is not prepared to make unconditional gifts;
- the investor needs to retain some access to the investment, but is happy to restrict this access to a series of fixed capital payments;
- the investor is happy, except for the capital payments to be fixed at outset, to give up access to the rest of the investment; and
- the investor is in reasonably good health.

Where the investor does not require any beneficial access to the bond, another type of trust may be more suitable. If the investor requires access to the whole of the bond at any time, the trust should not be used. Neither should it be used if the individual is in serious ill health already, as, in such circumstances, little or no discount is likely to be allowed on the gift.

As well as providing important tax benefits, because the bond is held subject to the trust, it is not an asset of the settlor's estate for probate purposes.

The trust can be used regardless of whether the bond is owned or applied for by one individual or two. The person creating the trust is known as the settlor, and where two persons jointly own or invest in a bond, they are joint settlors. For IHT purposes, two settlements then exist (see section 6.1(a)). Joint settlors should contribute equally to the arrangement.

Where a trust is set up with a cash gift, it is the trustees who effect the bond under the arrangement. To avoid the bond encashing at the wrong time from a tax or investment standpoint, the bond should be effected on the lives of several beneficiaries on a joint lives last survivor basis. However, the bond must not be effected on the life of the settlor or the settlor's spouse (see section 4.3).

Section 2: Inheritance tax planning

The trust offers IHT advantages on several levels.

2.1 A tax effective gift, but retention of control and some access to the capital

In order to ensure that an effective gift can be made for IHT purposes, it is essential that the settlor does not retain any benefit under the trust. However, it is possible to allow the settlor access to some of the funds transferred to, or destined for an investment in, the trust without adverse IHT implications, provided those rights are pre-determined at outset and cannot be changed. Another term for this is that the settlor's rights are 'carved out' from outset and are therefore not gifted. In such circumstances, the 'gift with reservation' provisions do not apply.

Under the trust, the settlor specifies at outset the level and frequency of payments he or she wants to receive from the investment. Any gift that the settlor makes is subject to these pre-existing rights to capital payments. He or she only becomes entitled to such a payment on survival to the appropriate date in the future. In practice, capital payments are normally used to supplement the settlor's income, given that they will be paid at pre-specified frequencies (monthly, for example). Once determined when the trust is created, the level and frequency of capital payments cannot be changed as to do so would cause adverse IHT implications.

The remainder of the trust fund is known as the beneficiaries' fund and is held on discretionary trust for the benefit of the discretionary beneficiaries. The settlor cannot benefit from this fund. Because the settlor has the right to capital payments from the trust throughout his or her life, in practice benefits will only be paid to discretionary beneficiaries after the death of the settlor (or the death of the survivor of joint settlors).

Under the terms of the trust, the settlor is the appointor, which means that he or she (or they) has the power to appoint the benefits from the trust among any of the discretionary beneficiaries specified in the trust. On the settlor's death (or the death of both settlors), this power of appointment passes to the trustees.

As the trust is discretionary, no beneficiary is entitled to any benefit until the appointor makes an appointment of capital or income to the beneficiary.

Under present IHT rules, the retention of the power of appointment by the settlor does not constitute a gift with reservation of benefit if the settlor cannot exercise the power in his or her own favour. Avoiding any reservation of benefit is one of the requirements that must be met in order to ensure that the trust property is not treated as part of the settlor's estate for IHT purposes.

2.2 The discounted gift

Under the discretionary discounted gift trust, when the settlor creates the trust, he or she makes a gift to the trust. Because a right to capital payments on future dates is retained should he or she then be alive, the value of the gift is discounted to take account of the value of this retained right.

The present value of the settlor's right to these future capital payments is determined actuarially by taking account of a number of factors. These include the settlor's age and state of health as well as the amount and frequency of the payments.

The difference between the amount of initial funds transferred to the trust and the value of the settlor's fund (the present value of the future capital payments to which the settlor is entitled under the trust) is treated as a transfer of value (a gift) for IHT purposes. Because the trust of the beneficiaries' fund is discretionary, this gift is a chargeable lifetime transfer. However, no IHT liability arises in respect of the gift if it, together with any other chargeable transfers made by the settlor in the preceding seven years, does not exceed the then IHT nil rate band.

As the amount of the discount depends on the age and state of health of the settlor, medical evidence for underwriting purposes will be obtained when the trust is established. Section 4 considers the practical implications of establishing the trust, including underwriting aspects and the possible need to agree a discount with HM Revenue & Customs (HMRC).

2.3 The settlor's spouse is a beneficiary

In this paragraph, we assume that the spouse is not also the settlor of the trust. Under current IHT rules, the inclusion of the settlor's spouse as one of the discretionary beneficiaries of the beneficiaries' fund does not constitute a gift with reservation of benefit for IHT purposes. However, care must be exercised if any benefits are actually paid to the settlor's spouse during the lifetime of the settlor. If the settlor, as the appointor, exercises the power of appointment in favour of his/her spouse and trust benefits are actually paid to the spouse, it is absolutely essential that no part of the funds is used for the direct or indirect benefit of the settlor. If part of the beneficiaries' fund is used for the direct or indirect benefit of the settlor, the trust could be seen as one under which the settlor has reserved a benefit. This would jeopardise the effectiveness of the trust for IHT purposes.

In practice, because the trustees' prime responsibility is to make payments to the settlor (in respect of the settlor's fund), it is unlikely that payments are made to any of the discretionary beneficiaries, including the settlor's spouse, whilst the settlor is alive.

2.4 A discretionary trust

As explained above, the trust is fully discretionary which means that no beneficiary has a fixed right to any benefit. The trust fund is not in the estate of any of the beneficiaries and instead is subject to its own IHT regime (see section 6). Although the settlor names default beneficiaries under the trust, these people only benefit in the very unlikely event that no appointment is made by the end of the trust period (125 years).

2.5 The possibility of further gifts by the settlor

It is possible that some time after the trust is set up, the settlor may decide that he or she no longer needs the payments from the trust. To ensure that the trust is tax effective, the settlor is not allowed to give up the payments. However, the settlor could, for example, simply gift the cash that he or she receives from the trustees to anyone, including any of the intended beneficiaries. Alternatively, the settlor could waive some or all of the entitlement to payments by notifying the trustees of this intention. Such gifts, of course, have IHT implications and these must be considered by the settlor. The settlor should take independent advice if he or she wishes to achieve this. The tax implications of such action are further considered in section 6.

For a detailed consideration of the IHT implications of the trust, see section 6 of this guide.

Section 3: Probate

To ensure that there is no need to include the bond as part of the settlor's assets for UK probate purposes when the settlor dies, the legal ownership of the bond must be with a person or persons other than the settlor on his or her death. This is achieved by having the legal ownership of the bond vested in the trustees. However, this benefit is only secured if there is at least one trustee who survives the settlor, otherwise probate is necessary on the last trustee's estate to determine who the continuing trustee is. Under the trust, the settlor is automatically one of the trustees and further trustees are appointed at outset in the trust deed. If any of the additional trustees retires or dies before the settlor, a replacement trustee or trustees should be appointed.

Where the asset of the trust is an offshore bond issued by Royal London 360°, the need for Isle of Man probate on the settlor's death is also avoided. For this to be achieved, there must be at least one trustee who survives the settlor.

If no additional trustees have been appointed, or if they have been appointed and subsequently resigned, died or were removed, there is no surviving trustee on the death of the settlor because the settlor was the only trustee at the time of his or her death. In these circumstances, the trust nevertheless continues to exist but with the personal representatives of the deceased settlor assuming the role of trustee under the trust. This means that, although the bond is not part of the settlor's estate for IHT or probate purposes, it is necessary to secure probate of the settlor's estate to ensure that the personal representatives can act as trustee. This is why it is very important that additional trustees are appointed who are likely to survive the settlor, so as to ensure that, on the settlor's death, there are no delays in being able to deal with the bond.

Section 4: Practical issues

4.1 Creating a valid trust

The trust is made when the settlor and additional trustees execute a trust deed. The settlor can establish the trust with either a cash gift or an existing bond. If the trust is set up with a cash gift, the settlor transfers the amount intended for investment to the trustees, which is done by means of a cheque for the desired amount. Unless the trustees open a bank account especially for that purpose, the settlor gives the trustees the cheque. In the case of an onshore bond issued by Sanlam Investments and Pensions, the cheque should be made payable to 'Sanlam Financial Services UK Limited'. The bond is applied for by the trustees, who are the original owners.

Alternatively, the trust can be created by the settlor transferring an existing bond to the trustees.

4.2 The importance of additional trustees

As explained above, additional trustees must be appointed at outset as either the trustees make the investment into the bond or an existing bond is transferred to the trustees.

It is important for the settlor to choose the trustees wisely. Even though the settlor is one of the original trustees and it is expected that he or she will remain as trustee during his or her lifetime. Where the trust is governed by English law, the trustees must act unanimously. In extreme circumstances where the trustees disagree, the settlor has the power to dismiss a trustee, but at least one trustee who is someone other than the settlor or his or her spouse must remain.

The primary duty of the trustees during the settlor's lifetime (or during the lifetime of the settlor and the survivor of the settlor if there are two settlors) is to pay the capital payments specified in the trust to the settlor. These payments must be made every time the settlor survives to the appropriate date when his or her entitlement arises. The trustees cannot pay the settlor more than the entitlement on the specified date.

Although the trustees are the legal owners of the bond and can take withdrawals of any amount from the bond, it is not prudent to take more than the amount required to pay to the settlor.

4.3 The bond

When a cash gift is made, the original trustees, of whom the settlor is one, make an application for a bond using the cheque given to them by the settlor. As the bond is a life assurance policy, the trustees must indicate on whose life (or lives) the policy is to be issued. This should be two or more of the discretionary beneficiaries under the trust. To ensure the correct tax implications ensue, the settlor and the settlor's spouse should *not* be lives assured under the bond.

The bond is then issued on a last survivor basis to the trustees as the policyholder.

It is advisable for the bond to be issued on a number of lives on a joint lives last survivor basis to ensure greater flexibility in the timing of the final encashment of the bond. As the bond is automatically encashed when the last life assured dies, ideally the lives assured should be young.

If an existing bond is transferred to the trust, the settlor no longer has a choice over who is the life assured, and it may be that the settlor and/or the settlor's spouse is a life assured under the bond. In such a case, consideration should be given to the implications of the gift with reservation requirements and the settlor should discuss this with his/her legal advisers.

The trustees can exercise all the powers and options under the bond including taking withdrawals. When the trustees are due to make capital payments to the settlor in accordance with their obligation in respect of the settlor's fund, they have to make withdrawals/part surrenders from the bond in order to fund the repayment. It is possible for the trustees to request regular withdrawals from the bond to meet the settlor's entitlement and for those to be paid directly to the settlor on the specified dates.

4.4 Calculating the discount and underwriting the gift

As explained in section 2, the amount of the discount on the gift depends largely on the settlor's (or both settlors', if appropriate) age and state of health, as well as the amount and frequency of the capital payments the settlor is entitled to. In practice, the younger and healthier the settlor, the greater the value that will be

attached to his or her retained rights and therefore the smaller the amount of the discounted gift.

It is necessary to ascertain the discounted gift at outset in order to make a return to HMRC of the chargeable lifetime transfer that is being made to the trust (see section 6).

HMRC frequently agrees a standard basis of valuation with a life office, but as any particular discount depends on an evaluation of the settlor's state of health at the time of establishing the trust, HMRC can challenge that discount.

In particular, if the settlor dies soon after effecting the trust, HMRC may question whether the settlor was in good health when the trust was established with a view to limiting the discount accordingly.

HMRC does not currently accept that any discount is available in the case of a settlor who has an actual or underwriting age of 90 or more. For this reason, an application for a discretionary discounted gift trust from investors aged over 89 will not be accepted.

All underwriting in respect of the discretionary discounted gift trust will be carried out by a specialist underwriting services company, MorganAsh.

Underwriting

In order to estimate the amount of the discounted gift, each settlor is required to complete a medical questionnaire. This questionnaire is then passed to MorganAsh. As part of the underwriting process, MorganAsh will obtain a personal medical attendant's report (PMAR) and may require the client to attend a medical examination with his or her general practitioner or with a convenient medical practitioner. MorganAsh will not be able to underwrite the case until they are in receipt of all of the medical information required. The information received is used to estimate the amount of the discount when the trust is established. This evidence assists in agreeing the discount with HMRC, should it be disputed when the trust is established or in the event of the death of the settlor within seven years of making the gift.

An additional fee of £150 is charged, this covers the time spent in underwriting and establishing the level of discount available (joint donors each pay a single fee of £150). A separate cheque for this fee must be supplied at the time of the application, and should be made payable to 'Sanlam Financial Services UK Limited'.

While it is possible to set up a Discounted Gift Trust on a 'no underwriting' basis, Sanlam Investments and Pensions do not offer this

option. The reason for this is that, should the settlor die shortly after effecting the trust, there is no medical evidence to support the level of discount. This means that it may be difficult for the settlor's legal personal representatives to agree the discount figure with HMRC. This can lead to probate delays and increased costs on the estate. In some circumstances, HMRC may deem the entire amount of the original investment to be chargeable to inheritance tax.

4.5 Type of investment

In theory, the trustees could invest in a different type of investment, for example, unit trust units or shares in an OEIC, instead of a bond. However, any income arising from the underlying investment is then assessed to income tax on the settlor because the settlor retains the right to capital payments under the trust.

Also, all capital gains arising to the trust would be assessed on the settlor, even though the gains would be trust gains. This means that the trustees would not have an annual CGT exemption available.

These problems do not arise with a life insurance bond, which is a non-income producing asset and the investment gains of which are not subject to capital gains tax. It is therefore a more tax efficient investment for the trust.

4.6 Spousal planning

It is not advisable for each of a married couple (or registered civil partners) to set up their own separate trust arrangement. This is because HMRC may argue that in such a case, if the two arrangements are effected simultaneously or in contemplation of each other, they are associated and effectively, if merged, would constitute a gift with reservation (spouse 1 invests with spouse 2 as a discretionary beneficiary on condition that spouse 2 invests with spouse 1 as a discretionary beneficiary). In these circumstances, one joint settlor trust (where neither is a discretionary beneficiary, but cash payments continue throughout both lifetimes) may be more appropriate.

4.7 The death of the settlor

If the gift is made with cash so that the trustees make an application for the bond, the policy is normally effected on the lives of two or more of the discretionary beneficiaries (but not the settlor or the settlor's spouse). This means that the death of the settlor after seven years has no consequences for the trust as such, except that the settlor's entitlement under the

trust terminates. No value is included in the settlor's estate in respect of the settlor's fund, as the settlor's entitlement depends on the settlor being alive and therefore, on his or her death, this is valueless.

In joint settlor cases, where the right to capital payments continues to the surviving settlor, this fact is taken into account in calculating the initial discounted gift made by each settlor. HMRC has issued a technical note providing guidance on how this calculation should be made.

Following the death of the settlor (or the death of both settlors), the trustees can either continue with the bond as a long-term trust investment, or cash it in and distribute the proceeds to the beneficiaries.

If an existing bond is transferred to the trust, it may be that the bond was originally effected on the life of the settlor and/or the settlor's spouse. As the lives assured under the bond cannot be changed, the trustees then hold the bond in its original form (on the life of the settlor). In this case, if the settlor is the sole remaining life assured and he or she dies, the bond is encashed and its cash value is paid to the trustees. As the continuing right to payments to the settlor then ceases, the trustees are free to distribute the trust fund to the beneficiaries or invest it for their benefit.

Section 5: The trust provisions in detail

5.1 Two trusts in one

The trust is effectively split into two parts: the settlor's fund and the beneficiaries' fund. Under the settlor's fund, specified sums are reserved for the settlor should he or she be alive at the date the sums are payable as stated in the trust deed. The settlor's fund is held on a bare trust for the benefit of the settlor. The beneficiaries' fund consists of the balance of the trust benefits, which are held under a fully discretionary trust.

5.2 Trust clauses in detail

The following is a summary of the key provisions as they appear in the draft trust.

Section 1: Declaration

The trust offers alternative provisions depending on whether it is effected with cash or an existing bond is made subject to trust. The amount of cash gifted or the policy number, as appropriate, needs to be inserted.

Section 2: Definitions

In this part of the trust, the terms used throughout are defined to avoid repetition. The most important definitions are those of the discretionary beneficiaries and the default beneficiaries.

The discretionary beneficiaries are those persons to whom the appointor may appoint benefits. The appointor is the settlor during his or her (or their) lifetime and thereafter, the trustees. The discretionary beneficiaries include the spouse (except where the spouse is a joint settlor), widow or widower of the settlor, the children and the remoter issue of the settlor, their spouses, the brothers and sisters of the settlor and their issue, anybody who would benefit from the estate of the settlor on the settlor's death as well as any person nominated in writing to the trustees by the settlor or any charity. The class of discretionary beneficiaries is therefore very wide and can be added to by the settlor by providing written notification to the trustees.

However, the settlor himself or herself cannot be added to the class at any time, as otherwise a gift with reservation occurs.

The default beneficiary(ies) is the individual(s) who benefits in the unlikely event that the power of appointment is not exercised by the appointor by the end of

the trust period (125 years from the time the trust is created). They are named by the settlor in the trust deed. At least one person must always be named and if more than one is named, the shares in which they are to benefit must be stated. This is necessary to ensure that the trust has the desired tax consequences.

Section 3: Principal trust terms

3A: The settlor's fund

The settlor's fund is held on a bare trust for the settlor.

The settlor specifies the amount and frequency of the payments he or she wishes to receive. The settlor can postpone the start of the entitlement to some date in the future. For example, if the settlor wants to delay the start date of the cash payments, he or she can state that payments should commence a specified number of months or years from the date of the trust.

In determining the amount of the cash payment, the settlor can specify a cash sum or a percentage of the amount paid to the trustees to purchase the bond or, in the case of an existing bond, a percentage of the initial premium. The frequency should also be specified, which could be yearly, half-yearly, quarterly or monthly.

3B: The beneficiaries' fund

The beneficiaries' fund is held on a discretionary trust for the beneficiaries.

In this part, the power of appointment is defined as well as the default entitlement if the power of appointment is not exercised during the trust period of 125 years.

The power to appoint capital and income under the trust is vested in the appointor (the settlor(s)) during his or her (or their) lifetime and thereafter the trustees. The power is exercisable at the appointor's discretion and includes the power to appoint further trusts in favour of beneficiaries.

Where there are two settlors, the appointor is both settlors whilst alive and then the survivor of them. After the death of the settlor(s), the appointor is the trustees.

In the unlikely event that an appointment of all of the trust assets has not been made by the end of the trust period, the default

beneficiaries benefit. These are the people initially named by the settlor in the trust deed. However, it is most unlikely that the trust fund will not be distributed within 125 years.

There is also a special provision dealing with any potential conflict of interest. In many cases, the trustees are family members who are also beneficiaries under the trust. If the power of appointment is exercised by the trustees (after the death of one or both settlors), such trustees are often also the beneficiaries (for example, the settlor's spouse in single settlor cases and/or children of the settlor). If an appointment of benefits is made in favour of a beneficiary who is also a trustee, then suspicion of a conflict of interest could arise. For this reason, there is a provision in the trust which states that, if a beneficiary is also one of the trustees, the trustees can only make an appointment in favour of that beneficiary if there is at least one other trustee who does not benefit directly or indirectly from the appointment being made.

The trustees have wide powers to advance capital from the trust fund to the beneficiaries and to make loans to beneficiaries. In practice, this only takes place after the settlor's death. In particular, the power to lend may give rise to tax planning opportunities where, after the settlor's death, the settlor's widow/widower requires funds from the trust but there is a desire to reduce the potential IHT liability on his or her subsequent death. In such a case, the trustees can make an encashment or withdrawal from the bond (see section 6 for the tax consequences) and make an interest-free loan, repayable on demand, to the widow/widower. Provided the loan is fully spent by the widow/widower, his or her taxable estate does not increase but, because the loan is repayable on death, it then effectively reduces the net estate of the borrower for IHT purposes. If the settlor's surviving spouse needs cash after the settlor's death, it may therefore be appropriate to consider a loan to him or her.

However, care needs to be taken. If the widow or widower has previously made lifetime gifts to the settlor, this may affect the ability to make a deduction from the surviving spouse's taxable estate on his or her subsequent death.

Section 4: Administrative powers of the trustees

The trustees have wide administrative powers to deal with the bond and to reinvest the proceeds in any way they wish. They also have power to borrow funds, to make payments to parents or guardians of minor beneficiaries and to delegate certain powers.

Section 5: Appointment, dismissal, retirement and remuneration of trustees

The trust contains comprehensive provisions that regulate the activities and powers of the trustees.

The power to appoint new or additional trustees is vested in the appointor. The appointor is the settlor, whilst alive, and then the trustees. The settlor also has power to dismiss any trustee provided at least one trustee, other than the settlor and the settlor's spouse, remains after such dismissal. There is no power to dismiss a trustee after the death of the settlor and it must be remembered that under a trust subject to English law, trustees must act unanimously. In Scotland, trustees can make decisions by a simple majority. There are also powers to deal with the retirement of trustees and corporate trustees.

Under the terms of the trust, trustees who act in their professional capacity are entitled to charge fees.

Section 6: Further trust provisions

These deal with the trustees' duty of care and liability for loss to the trust fund.

The statutory duty of care contained in Part I of the Trustee Act 2000 has been extended by the trust to apply to all functions of the trustees. This statutory duty of care is a duty to act with such care and skill as is reasonable in the circumstances having regard in particular to any special knowledge or experience that the trustee has or holds himself or herself out as having and, in the case of a trustee acting in a professional capacity (such as a solicitor, accountant, stockbroker or financial adviser), to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

The liability of individual trustees is limited so that they will not, generally, be held liable for any loss to the trust fund provided they act in good faith. Trustees who are paid for their services are also liable for their negligence.

Professional trustees are permitted by the trust deed to charge normal professional fees. The trustees are permitted to take part in transactions and trustees' decisions in which they have a personal interest.

Section 7: Proper law

The settlor may choose whether the trust is to be governed by the law of England and Wales, Scotland or Northern Ireland. This choice will normally be determined by the settlor's domicile (where his or her permanent home is). This does not affect the beneficial provisions of the trust or

the tax implications in the UK but may be relevant to the settlor/trustees should they need to clarify any legal points in connection with the trust or in the event of a dispute.

There is some uncertainty however, over whether discounted gift trusts can be validly made under the law of Scotland, and it is possible that the IHT gift with reservation rules may apply. Where the settlor still chooses to select the law of Scotland, a written statement is required from the settlor as acknowledgement of this risk.

Section 6: The UK tax implications

In the following, it is assumed that the settlor, the beneficiaries and the trustees of the trust are all UK resident and domiciled. Special rules apply when this is not the case.

6.1 Inheritance tax (IHT)

a. Establishment of the trust

- i) When the trust is established, the settlor is treated as having made a discounted gift for IHT purposes. The size of this gift is equal to the difference between the amount of cash used to buy a new bond (or the value of the existing bond, adjusted as appropriate, as explained above) and the value of the settlor's retained right to capital payments, which depends on the settlor's age and state of health at outset and the amount and frequency of the capital payments.
- ii) For IHT purposes, the gift is a chargeable lifetime transfer. If this amount, plus the amount of any other chargeable transfers made by the settlor in the previous seven years, does not exceed the nil rate band for IHT (currently £325,000) there is no IHT liability when the gift is made and, if the settlor survives for seven years after investing in a trust, no IHT liability arises at all in respect of the gift (although the bond may be subject to periodic/exit charges). If the settlor's nil rate band is exceeded, there is a lifetime liability at 20% on the excess, increasing to 40% if the settlor dies within seven years (although IHT taper relief may then be available).

Example

Elaine creates a discretionary discounted gift trust in May 2007, which results in a chargeable transfer of £330,000. She has made no chargeable transfers in the previous seven years and her annual exemption has been used elsewhere. If the trustees pay the IHT on this gift, the tax amounts to £1,000 [20% of £5,000 (being £330,000 less £325,000)]. This reduces the amount going into the trust. If Elaine pays the IHT on this transfer herself, the gift has to be grossed up, with the amount of tax being £1,250 [20% of £6,250 (being £331,250 less £325,000)]. A further liability could arise if Elaine dies within seven years of the gift.

For the above reason, it is generally not recommended that gifts to the trust

are made if this means that the settlor's available nil rate band is exceeded.

- iii) Where there are two settlors (such as spouses), they should contribute equally to the trust by, providing a cheque on a joint bank account for example. Where spouses invest as joint settlors using jointly owned funds, each is treated as making an investment of 50% of the total investment and each is treated as a settlor of one trust made up of that person's discounted gift. However, the calculation of the present right to future cash payments takes account of the fact that payments can be made throughout their joint lives and HMRC has issued a guidance note on how this should be calculated.
- iv) HMRC set the limits for reporting chargeable lifetime transfers. Where the settlor gifts cash to the trustees to invest in a new policy, the transfer is excepted (there is no reporting requirement) where the cumulative total of the chargeable transfers made by the settlor in the last seven years (including the current transfer) does not exceed the nil rate band (currently £325,000). Gifts which are not excepted must be reported to HMRC using forms IHT100 and 100a. In addition, it is necessary to complete form D34, as a life assurance policy or payment of a premium to a life assurance policy is involved.

b. Death of the settlor

- i) On the death of the settlor (or, where relevant, either of the settlors), the value of the trust fund (the bond) is outside of the settlor's estate for IHT purposes.
- ii) If the settlor does not survive the gift by seven years, the potential IHT liability on the original chargeable transfer must be recalculated at the full death rates applicable at the date of death. However, no IHT arises if the gift was within the settlor's available nil rate band. If the nil rate band was exceeded, so that lifetime tax at 20% was payable, the charge increases to 40%. IHT taper relief may be available, in which case the IHT liability starts to reduce if the settlor has survived the gift by at least three years.
- iii) It is strongly recommended that the bond is not effected on the life of the settlor/settlor's spouse. However, if the settlor

or his/her spouse does happen to be the sole or last life assured to die under the bond (perhaps in the situation where an existing bond has been transferred to the trust), the cash value of the bond is paid free of inheritance tax to the trustees. An income tax chargeable event may then arise – the tax consequences of this are detailed later in this document. Professional advice should be taken before transferring an existing bond to the trust if it is on the life of the settlor/settlor's spouse.

- iv) If the settlor is survived by another life assured under the bond, the bond continues unaffected by the settlor's death.

c. IHT while the trust is in existence

As this is a discretionary trust, special IHT charging rules apply. Under these rules, there may be IHT charges:

- on every 10-year anniversary of the trust, (the 'periodic charge'); or
- whenever property leaves the trust, such as when capital is advanced to a beneficiary or an absolute appointment of benefit is made, (the 'exit charge').

i) The periodic charge

The trust fund is subject to periodic charges at every 10-year anniversary. Special rules apply to determine the value of trust property for discounted gift trusts. The rate of IHT charged is determined by assuming a transfer being made by an assumed transferor. This means that it is broadly necessary to take account of:

- the value of the property in the trust on the 10-year anniversary, the current value of the settlor's retained rights, the value of certain additions made to the trust and the value, when they were set up, of any other trusts created on the same day (the assumed transfer); and
- the settlor's cumulative total of chargeable transfers made in the seven years immediately preceding the creation of the trust (assuming there has been no added property), the value of property added to other trusts on the same day as the trust in question was funded, and any sums paid out of the trust in the 10 years prior to the anniversary (the cumulative total of the assumed transfer).

As a result of the calculation of the tax on the assumed transfer, an effective rate is established. The maximum rate is 20%, and 30% of this effective rate is the rate applied to the value of the trust property. The

maximum liability is therefore 6% (30% of 20%) of the value of the trust property over the available nil rate band, but frequently it will be much lower or even nil. Each case will, of course, depend on its own facts.

In cases where the settlor has not made any chargeable transfers in the seven years before he or she creates the trust, no payments have been made out of the trust in the last 10 years and there has been no added property, there is no liability provided the value of the trust property at the time of the periodic charge does not exceed the nil rate band applicable at the 10-year anniversary. Any excess over the then nil rate band suffers IHT at an effective rate of 6%.

Example

Graham creates a discretionary discounted gift trust in October 2007 for £300,000. The value of Graham's retained rights is £150,000 and so the discounted gift is £150,000. This is based on an annual cash payment of £15,000 (5% of the premium to the bond).

Graham has made no chargeable transfers in the previous seven years. No payments are made out of the trust (other than those to Graham from the settlor's fund) in the first 10 years. In October 2017, the trust fund is worth £300,000 and the nil rate band is £325,000. No IHT is payable.

For the purposes of calculating the value of the trust fund for the periodic charge, HMRC has confirmed that the present value of the settlor's right to future cash payments at that time (at the 10-year anniversary) should be deducted from the value of the trust fund (the bond). This means that an amount in respect of the then value of the settlor's rights needs to be deducted from the value of the bond.

Had the value of the bond been £475,000 after 10 years with the settlor's rights valued at £25,000, then the value of the relevant property in the settlement would have been £450,000 and IHT of £7,500 would have arisen (£125,000 at 6%). This equates to a charge at 1.66% on the whole value of the trust property.

If all of the trust fund is distributed before the 10th anniversary, it is often the case that no tax charge arises (see 'The exit charge' below). If assets remain in the trust after a distribution, or if further assets are added to the trust, the trustees should seek specialist tax advice.

ii) The exit charge

Exit charges will be based on the value of property leaving the trust or being appointed absolutely to a beneficiary.

HMRC has confirmed that no exit charge will arise on payments made to the settlor under a discretionary discounted gift trust because this property is already held absolutely on bare trust for him or her.

Exit charges in the first 10 years

Exit charges within the first 10 years are nil if the value of the initial chargeable lifetime transfer (before applying any IHT exemptions or reliefs) to the trust is below the available nil rate band at the time of the exit. This includes the cumulative total of the settlor's chargeable transfers in the seven years prior to creating the trust and the value of any added property. This means that, if the available nil rate band when the trust was created was not exceeded, there is a good chance that there will be no exit charge. If an exit charge does arise, it will increase according to the number of quarters (three-month periods) that have expired since the trust was created.

Exit charges after the first 10 years

The amount of any exit charge occurring after the first 10 years depends on the rate of tax charged at the last 10-year anniversary (if any) and the length of time (in quarter years) that the property has been in the trust since the last periodic charge. If there was no charge at the previous 10-year anniversary, there will be no exit charge in the following 10 years.

Example

In October 2023, six years since the first 10-year anniversary (when a 1.66% IHT rate was charged), the trustees of Graham's trust make a partial encashment of the bond and pay £50,000 to a beneficiary. The IHT charge is £498 ((£50,000 × 1.66%) 24/40).

Where an exit charge is calculated following a periodic charge, the rate of IHT that is charged must be updated to reflect any increases to the nil-rate band.

As stated, no IHT charge arises on property paid out of the trust if there was no IHT charge at the last 10-year anniversary.

Exit charges should not arise on loans made by the trustees to beneficiaries. The occasion of a periodic charge and transactions that can give rise to an exit charge, such as capital payments to the beneficiaries, also have to be reported to HMRC even if no actual tax liability arises. The forms to use here are IHT 100c and IHT 100d and, where a life policy is involved, form D34.

If there are joint settlors (who should contribute equally), the trust is effectively treated as two separate trusts, each settled

by one settlor, for all IHT purposes. IHT calculations are then applied to each of the settlements. The trust fund is effectively divided into proportions reflecting the value of the discounted gift made by each settlor for the purposes of calculating the 10-year periodic charge and any exit charge.

d. Settlor giving up some or all of his/her entitlement to payments of capital

Although the trust does not give the settlor a specific power to give up his or her right to the capital payments (as this could jeopardise its IHT efficiency), there is nothing to stop the settlor from either gifting cash after receiving the payment from the trustees or waiving some or all of his or her entitlements. The tax implications of any such action have to be considered. If the settlor simply gives cash to the intended beneficiaries (having received it from the trustees), such a gift is normally a PET unless it falls within the settlor's annual exemption.

If, on the other hand, the settlor gives up a payment or a series of payments before he or she receives them, the IHT consequences are different. If a payment or a series of payments are given up, there is a chargeable transfer for IHT purposes. If it is one payment, it may well be covered by the settlor's annual exemption. However, if a series of payments is being given up, there is a need for an actuarial valuation based on the settlor's age and state of health at that time and the payments being gifted to determine the value given up. Clearly, professional advisers need to be involved at that time to ensure that any tax liabilities are minimised.

6.2 Income tax

In this section, it is assumed that the settlor, the beneficiaries and the trustees are UK resident and domiciled (special rules apply where this is not so and professional advice should be taken in such cases).

a. Payments to the settlor

The settlor's cash entitlements are funded by the trustees making encashments from the bond. The trustees are entitled to withdraw from the bond, free of tax at that time, an amount of up to 5% of the premiums invested each year for 20 years. To the extent that such a 5% allowance is not used in one year, it can be carried forward to the next year and so on. As long as payments are kept within the cumulative total of unused annual 5% allowances, no income tax implications arise for the trustees or the settlor at the time of the withdrawal, but may do so on the occurrence of a chargeable event giving rise to a chargeable gain.

Where the trustees have agreed that ongoing or ad hoc adviser fees are to be paid from the bond, such adviser fees will count towards the 5% allowance.

b. Chargeable event gains

i) During the settlor's lifetime and in the tax year in which the settlor's death occurs

For income tax purposes, any chargeable event gains arising under the bond are assessed on the settlor. If there are joint settlors, each is assessed on a portion of the gain based on the proportion of his or her contribution (assumed to be equal).

ii) After the end of the tax year in which the settlor's death occurs

Following the settlor's death, any chargeable event gains arising in a tax year after that in which the settlor died, are assessed on UK resident trustees at the rate of 45%. In the case of an onshore bond, a tax credit is given for the tax paid by the life company. This is currently 20%, which reflects the tax suffered in the life fund for a policy issued by a UK insurance company. This means that, if the lower rate were 20%, the rate of tax payable on the gain would be 25%. To the extent that chargeable event gains fall within the £1,000 standard rate tax band (which is available to the trustees following the settlor's death), there is no additional charge to tax under a UK life insurance bond, and a 20% charge under an offshore bond.

c. Payments to beneficiaries

If the trustees make an encashment of, or a withdrawal from, the bond to make a payment to beneficiaries (normally after the death of the settlor), the income tax consequences of the chargeable event and the IHT consequences of the payment are as outlined above. As long as payments to beneficiaries are made and documented as an advancement of capital and do not acquire the character of income, there should be no income tax implications for the settlor or the beneficiaries.

d. Prior transfer to the beneficiaries

It may be that after the settlor's death, the trustees consider encashing the bond and releasing the proceeds to a beneficiary.

As an alternative to encashing the bond prior to making a payment to a beneficiary, the trustees could make an absolute appointment of benefits in favour of an adult beneficiary. They could then assign the bond to the beneficiary who is to benefit.

That assignment would not give rise to a chargeable event. Any chargeable event gain arising on any subsequent encashment by the beneficiary would then be assessed to tax on that beneficiary.

The assignment of a bond to a beneficiary may give rise to an IHT exit charge (see above). It should be noted that a change of trustee and the death of a trustee have no tax implications.

e. Tax on pre-owned assets (POAT)

The POAT is a special income tax charge, which has applied since 6 April 2005. It can apply in cases where a trust is created under which the settlor can potentially benefit and the trust is not subject to the IHT gift with reservation rules. In the case of the discretionary discounted gift trust, the trust is effectively split into two. The settlor's rights to capital payments are held for the benefit of the settlor (the settlor's fund) under a bare trust. The remainder, known as the beneficiaries' fund, is held under a discretionary trust from which the settlor cannot benefit.

For the purpose of the POAT charge, both the settlor's fund and the beneficiaries' fund have to be tested separately. As the settlor's fund is held on a bare trust for the settlor, the POAT charge cannot apply as, for this charge to apply, there must be a settlement. Although the beneficiaries' fund is a settlement, the settlor cannot benefit from this part and therefore the POAT charge cannot apply to this fund either. HMRC issued a guidance note on this issue in March 2005 confirming this interpretation.

6.3 Capital gains tax

No capital gains tax should arise in relation to any dealings with a bond held subject to the trust.

This guide is based on Sanlam's current understanding of UK law and HMRC practice both of which are likely to change in the future. Whilst every care has been taken as to the accuracy of this guide, neither Sanlam Investments and Pensions nor its representatives accept any responsibility for any loss, however caused, suffered by any person who has acted or refrained from acting, as a result of material published in or in conjunction with this guide. Potential investors are strongly recommended to take independent professional advice relevant to their own circumstances before proceeding with the arrangement.

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