Sanlam

Discounted Gift (Bare) Trust

Adviser's Guide

Wealth

Adviser's Guide to the Discounted Gift (Bare)Trust

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The Sanlam Discounted Gift (Bare) Trust is an arrangement designed for individuals who wish to reduce their potential Inheritance Tax liability, whilst securing a regular stream of specified cash payments into the future.

In this document the term 'spouse' includes a registered civil partner under the Civil Partnership Act 2004 and 'married' also refers to a person who is in a registered civil partnership.

Section 1. The impact of Inheritance Tax

Inheritance Tax is becoming increasingly important for many people. With the tax biting on taxable estates of more than £325,000 in value many people, or more correctly many estates, will fall into the Inheritance Tax net simply because of their ownership of a private residence. And if the estate is subject to tax, the impact can be serious - a tax charge of 40% on assets worth more than the 'nil rate band'. Basically, this means that for every £10 of wealth exceeding the current nil rate band of £325,000, £4 will go to the taxman on death.

Note: A lower rate of Inheritance Tax applies where 10% or more of an estate is left to charity for deaths on or after 6 April 2012.

Section 2: Using lifetime gifts to reduce an Inheritance Tax liability

One very effective way to mitigate the tax charge is by making lifetime gifts. Lifetime gifts that are 'potentially exempt transfers' do not give rise to a tax liability when they are made. Also, if the donor survives for a full 7 years from the date of gifting, the property will not form part of his or her estate on death.

A common problem with gifting is that the donor must be able to afford to give the assets away. This is because he or she cannot retain any access to the property or the income from it, otherwise the 'gift with reservation' rules may apply (see Section 32). If these rules are found to apply, the value of the gift will be added to the donor's estate on death for tax purposes.

Another hurdle in making lifetime gifts was introduced by the changes to trust rules in the Finance Act 2006. The effect of these changes means that care must be taken when considering a lifetime gift into a trust arrangement. If the gift does not qualify as a potentially exempt transfer (see above), an immediate Inheritance Tax liability may arise.

The Sanlam Discounted Gift (Bare) Trust is able to offer many investors a potential solution to these problems. Before considering the arrangement, it is very important to have an understanding of how it operates. It should never be used by a client without taking appropriate specialist advice.

Section 3: The Inheritance Tax benefits of the Discounted Gift (Bare)Trust

The arrangement enables a client (known as the 'donor') to place an investment in trust that will be totally free of Inheritance Tax after 7 years. It also means that if the donor dies within 7 years, only a part of the value of the initial investment is added back to the estate to calculate Inheritance Tax. This part of the investment is known as the 'discounted gift'. For larger discounted gifts, taper relief may be used to reduce any tax payable if death occurs between 3 to 7 years after the date of the gift.

Section 4: The 'discounted gift'

The discounted gift really becomes relevant if the donor fails to survive for 7 years from the date of making of the gift, as it immediately reduces the value of the donor's estate for Inheritance Tax purposes.

Although the assets have been gifted, the donor retains the right to receive regular payments from the bond held under the trust. The amount of the payments is determined at outset, and can be up to a maximum of 5% a year (for up to 20 years) of the original value of the investment. The total sum of these regular payments is converted to a capital value, which is known as the 'Donor's Fund'.

This part of the fund is not added back to the donor's estate on death (even if death occurs within 7 years). This is because the donor's right to regular payments ceases on his or her death, and this right is not regarded as having an actual value.

The remainder of the initial investment (after the Donor's Fund) is known as the 'discounted gift'. This part does have a value for tax purposes, and is notionally added back to the donor's estate if death occurs at any time during the initial 7-year period.

At the end of 7 years, the entire investment is outside the scope of Inheritance Tax and does not have any impact on the donor's estate.

Section 5: The benefits of the Discounted Gift (Bare) Trust

The arrangement enables the donor:

- to make a tax efficient gift of assets into trust for the absolute benefit of named beneficiaries;
- to have peace of mind in knowing that these people (or their children) will ultimately benefit from the gift;
- to immediately reduce the value of his or her estate for Inheritance Tax purposes;
- to reduce, by way of a discount, the value of the gift that may become subject to Inheritance Tax if he or she does not survive for 7 years from the date of making the gift;
- to ensure that any growth on the original gift will immediately be free from Inheritance Tax;
- to avoid all Inheritance Tax on the full value of the investment into trust on his or her survival for 7 years from the date the gift was made;
- to enjoy a tax efficient 'income' supplement; and
- to avoid probate delays on death, as the trust assets can continue to be managed by the trustees or can be distributed by the trustees without going through probate.

Section 6: Suitability of the Discounted Gift (Bare) Trust

The arrangement may be suitable for a client with a potential Inheritance Tax liability on death, who would like to reduce the value of his or her estate, but still needs access to a regular source of 'income'.

The investor should also have already formed clear views on who should benefit from the trust assets after his or her death, and may be seeking a solution to provide this certainty.

There may, however, be other solutions that would be more appropriate for the investor's personal circumstances, and clients should take appropriate professional advice before proceeding.

The Discounted Gift (Bare) Trust is not suitable for investors who may require full, immediate or unrestricted access to the capital invested. It also may not be suitable for clients whose income needs are likely to vary significantly, or who are likely to require 'income' payments for a period exceeding 20 years.

Section 7: How does the Discounted Gift (Bare) Trust work?

The arrangement has two main parts; a single premium onshore or offshore life assurance bond and a bare trust.

The Life Assurance Bond
Initially, the donor applies for a single premium unit linked life assurance bond (see Section 8: What life assurance bonds are available?). Under the bond policy conditions, the donor is entitled to fixed withdrawals for the rest of his or her lifetime.

The bond is effected on the lives of the intended beneficiaries, who are often the donor's children or grandchildren.

The Bare Trust
Once the bond commences, the donor immediately transfers it into a bare trust, which is drafted to retain his or her entitlement to withdrawals. The trustees appointed under the new trust become the legal owners of the bond.

The beneficiaries and their shares must be named at the commencement of the trust, and there is no flexibility whatsoever to make changes at a later date. It is very important that the donor is absolutely certain at the outset that these are the people he or she really intends to ultimately benefit from the trust.

During the lifetime of the trust, the trustees will regularly withdraw funds from the life assurance bond to finance the donor's entitlement to payments. Certain assumptions are made at the outset in order to calculate a notional capital value for the payments. This part of the plan becomes known as the 'Donor's Fund'.

The balance of the investment is the discounted gift, which, together with any future growth, becomes known as the 'Beneficiaries' Fund'.

Section 8: What life assurance bonds are available?

The donor can choose to invest in any of the single premium onshore life assurance bonds available from Sanlam Investments and Pensions; or an existing Sanlam Offshore Bond issued by Royal London 360° in the Isle of Man and administered by Sanlam Financial Services UK Limited.

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.

Please refer to the relevant brochures and product guides for further details.

Section 9: Is there a cooling-off period?

The donor will normally have a 30 day right to cancel the life assurance bond once the policy has commenced. Further details can be found in the Key Features Document for the life assurance bond chosen for the investment.

The right to cancel does not cover the creation of the trust, as this is a separate legal document and is not covered by the cancellation rules.

Section 10: What are the charges?

For the underwriting an initial consultation fee of £150 is charged, which covers the time spent in underwriting and establishing the level of discount available (joint donors each pay a 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'.

Please refer to the relevant Key Features Document and brochure for charges which are specific to the selected bond.

Any Ongoing Adviser Charges will be agreed between the Financial Adviser and the Trustees.

Section 11: How is the discount determined?

The value of the Donor's Fund is calculated from assumptions made using the donor's age, state of health and the amount and frequency of capital payments he or she is entitled to.

The difference between the value of the Donor's Fund and the amount of the initial investment is the discounted gift. The discounted gift is treated as a transfer of value for Inheritance Tax purposes, and is a 'potentially exempt transfer'. This means that if the donor survives for 7 years from the date of the gift, no tax liability will arise on the value of the gift.

For example, if a man aged 75, who is a non-smoker and in good health, invests £100,000 and chooses to receive capital of £5,000 per annum in arrears from the bond, the value of the gift could reduce by £36,980. This means that the value of the transfer for tax purposes would be £63,020. In practice, whilst the HMRC Trusts and Estates Office accepts this general basis of calculating the discount following the death of a donor they may decide to challenge the discount applied.

Section 12: What basis of underwriting is used?

The donor is required to complete a medical questionnaire at the outset, and the donor's life expectancy is underwritten by a specialist underwriting services company, MorganAsh, before the bond and the trust are established. The client may be required to attend a medical appointment with his or her General Practictioner or with a convenient independent medical practitioner. MorganAsh will not be able to underwrite the case until they are in receipt of all the medical information required.

Subject to the parties being satisfied with the value of the discounted gift, the investment and the trust can then proceed and the donor receives a personalised discount certificate from Sanlam Investments and Pensions.

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 donor die shortly after effecting the trust, there will be no medical evidence to support the level of discount. This means that it may be difficult for his or her 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.

Section 13: What happens with joint donors?

Where spouses or civil partners gift as joint donors, each is treated as making a gift of 50% of the total investments into the life assurance bond.

The value of discount available will depend on the donors' age, state of health and the amount of fixed withdrawals they have requested. The discounted gift made by each spouse or civil partner will not be of the same value, due to the differing mortality factors. However, the same level of payments will continue to the surviving spouse or civil partner on first death, which is accounted for in the underwriting.

For joint donors, the investment monies can be paid from either a joint account or individual accounts (provided that 50% of the monies originate from each donor's individual account). Care should be taken where there is a sole donor, in which case the monies must be seen to come from that person and should not be paid from an account in joint names.

Where the trust is created by spouses or civil partners and one (or both) are non-UK domiciled, there are further tax implications and specialist tax advice should be taken.

Section 14: Can spouses or civil partners each set up their own trust?

Spouses or civil partners can set up separate arrangements, for example if they wish to benefit children from previous marriages (i.e. they each wish to appoint different sets of named beneficiaries).

This would mean that 50% of the regular 'income' payments would cease on first death, whereas payments would continue at the same level where there are joint donors.

Setting up separate trusts would not be advisable where the surviving spouse/civil partner is likely to suffer a shortfall of income.

Section 15: Who can act as trustee?

The donor is automatically appointed as trustee. He or she should appoint an additional trustee, which can be done through the trust deed at the outset. In some circumstances, it may be appropriate to appoint a professional adviser, such as a solicitor or an accountant, as an additional trustee. A maximum of 3 additional trustees can be appointed under the Sanlam Discounted Gift (Bare) Trust.

For ease of administration, it is always preferable to have a minimum of 2 trustees (including the donor). Sanlam Investments and Pensions can supply a specimen deed for the appointment of new trustees by the donor.

Section 16: Who are the named beneficiaries?

The named beneficiaries are those who will ultimately benefit from the trust fund, and are usually the children or grandchildren of the donor. Once a beneficiary has been named at the outset of the trust, there is no flexibility for the donor or the trustees to change this.

It is recommended that independent legal advice is sought if you wish to include minors as beneficiaries of the trust. This could have the effect, as a result of the intestacy rules, of causing the trust benefits to revert to the donor (in the situation where the donor is the parent).

The donor's spouse or civil partner cannot be named as a beneficiary, as this may defeat the tax planning purpose of the arrangement.

If however, the named beneficiaries decide after the death of the donor that they don't require any benefit from the trust, it may be possible to assign the bond to their adult children. This would be a 'potentially exempt transfer' from the beneficiary, but would not trigger a chargeable event for Income Tax purposes. Any liability to Income Tax arising on a subsequent chargeable event would then be assessed on the new owners, and top-slicing relief may be available to reduce the amount of the tax liability.

Section 17: What are the Inheritance Tax implications for beneficiaries?

Should a named beneficiary die, a proportionate share of the trust assets will form part of his or her estate for Inheritance Tax purposes. The value includes the beneficiary's interest in the Beneficiaries' Fund, as well as a share of the Donor's Fund.

This could give rise to an Inheritance Tax liability if the deceased beneficiary's total estate exceeds the Inheritance Tax nil rate threshold at the time of death.

A beneficiary should make provision in his or her Will for their share of the trust fund, so that their executors are aware of the asset and have clear instructions on who is entitled to benefit from the policy.

There will be no Inheritance Tax implications where the policy is left to the beneficiary's spouse or civil partner, as the gift is covered by the spousal exemption, however, specialist advice must be sought for a non-domiciled spouse or civil partner.

Section 18: How is the donor provided with an 'income'?

Under the terms of the trust, the donor is entitled to specified cash sums on specified dates. This means that each time he or she survives to the specified date, an entitlement to a capital sum arises. To finance this entitlement to capital payments, the trustees must withdraw funds from the life assurance bond.

The level of capital payments and the frequency are chosen by the donor at the outset of the trust. The donor can specify a fixed amount for the payments or a fixed percentage of the initial investment. The maximum annual payment to the donor is 5% of the initial investment, which can be paid over a 20-year period and is effectively a return of capital.

The payments can be made monthly, quarterly, half-yearly or yearly, subject to a minimum single payment of £50.00. For simplicity, the trustees can arrange for withdrawals to be paid directly to the donor by providing the relevant account details.

Section 19: Can the donor change the level of 'income'?

Once the trust is established, the donor cannot make any changes to the level or frequency of payments, as this may affect the benefits of using the arrangement.

Section 20: Can 'income' continue to be paid to the donor's spouse after his or her death?

Where just one party settles the trust, payments do not continue to a surviving spouse.

However, if for example, spouses are joint donors, the full level of payment will continue to be made to the survivor for his or her lifetime.

Section 21: How is the donor's 'income' taxed?

The donor is entitled to a stream of 'income' payments at specified dates. These payments are effectively a return of capital, and therefore not subject to Income Tax at the time of payment provided they do not exceed 5% pa of the initial investment or continue for more than 20 years. The payments are funded by the trustees taking withdrawals from the life assurance bond subject to the bond continuing to have sufficient value to meet the payments.

In addition where the trustees have agreed that Ongoing or Ad-hoc Adviser Fees be paid from the bond such fees will count towards the 5% allowance.

The capital payments are taken into account when calculating any gain on the happening of a chargeable event under the life assurance bond (see Section 30: What are the Income Tax implications on surrender?').

Any income or growth on the investments underlying the funds allocated to an onshore life assurance bond are subject to Corporation Tax. The tax is calculated and recovered by Sanlam Investments and Pensions.

Section 22: Can the donor increase the level of withdrawals?

The level and frequency of withdrawals are set at the outset and are used in the calculation of the discounted gift. The level of the payments is fixed and cannot be changed, as this would jeopardise the value of the discounted gift and could defeat the purpose of the tax planning.

In the event that the total of withdrawals (and the payment of any Ongoing and or/Ad-hoc Adviser Fees) should exceed 5% of the original investment per policy year, or the total amount withdrawn exceeds the original investment amount, thereby giving rise to a chargeable event under the policy, then it is likely that any chargeable gain arising will be assessed on the donor.

Section 23: Can the donor surrender the right to withdrawals?

The donor would have to continue receiving the fixed regular payments under the terms of the trust. If the 'income' is not needed to support the donor's standard of living, he or she may decide to gift away the cash received. These gifts may be exempt from Inheritance Tax under the 'normal expenditure out of income' rules and specialist advice should be sought.

Section 24: Can additional capital be added to the bond?

It is not possible to add any further capital to an existing Discounted Gift (Bare) Trust, although a new arrangement could be started with a fresh lump sum investment. Specialist advice should be taken to consider the tax effects of making a new gift into a trust.

Section 25: What if the bond loses value?

The donor's entitlement to withdrawals is only subject to the trust fund being sufficient to meet the payments.

In the scenario that the trust fund can no longer support the capital payments when they become due, the trustees have no personal liability to the donor.

Section 26: Can the trustees or the beneficiaries surrender the bond during the donor's lifetime?

The trustees, rather than the beneficiaries, are the legal owners of the policy and are the decision-makers. However, as the donor is entitled to withdrawals from the bond, it would be very difficult (if not impossible) for the bond to be surrendered during the donor's lifetime. Encashing the policy would defeat the donor's specific interest, which the trustees are not allowed to do.

If the donor and beneficiaries collectively agree that they wish to terminate the trust, specialist legal advice should be sought.

Section 27: What are the Inheritance Tax implications of the donor dying within 7 years of establishing the trust?

If the donor does not survive for 7 years, the 'potentially exempt transfer' made when the plan is set up becomes a chargeable gift.

The value of the original discounted gift (subject to agreement with HMRC) is added to the donor's estate for Inheritance Tax purposes.

No tax is generally due on the value of the gift if this falls within the donor's Inheritance Tax allowance (i.e. the 'nil rate band') at that time. However, this will depend on whether the donor has made any chargeable transfers in the 7 years before the date of the gift.

Taper relief may be available in some circumstances (i.e. if the donor has survived the gift by at least 3 years and if the nil rate band is exceeded by the value of the discounted gift).

The value of the Donor's Fund will not be added to the estate, as the entitlement to regular capital payments ceases on the donor's death (or on second death for joint donors) and the fund does not carry a value for Inheritance Tax.

Section 28: What are the Inheritance Tax implications of the donor dying after 7 years of establishing the trust?

After 7 years the entire investment is outside of the donor's estate and is not subject to Inheritance Tax.

Section 29: What happens on the death of the donor?

Following the donor's death (or the second death for joint donors), the specific right to withdrawals ceases and the whole of the bond investment is held on bare trust for the benefit of the named beneficiaries. The trustees must decide whether to continue the trust for the beneficiaries, to surrender the bond and distribute the proceeds proportionately to the beneficiaries or to assign the bond proportionately to the beneficiaries.

If the beneficiaries have sufficient capital for their own means and do not require any future access to the trust fund, the policy can be assigned by the beneficiaries to their children (i.e. the grandchildren of the donor). The bond should only be assigned to adult children.

The gift of the bond does not trigger a chargeable event, but it is a 'potentially exempt transfer' from the beneficiaries, who should take appropriate tax advice on any implications.

Any subsequent chargeable event gains will then be assessed on the new owners, i.e. the grandchildren, who may be lower taxpayers than their parents. Top-slicing relief may be available and will apply for the full number of years that the bond has been in existence.

Section 30: What are the Income Tax implications on surrender?

As the donor has an entitlement to receive withdrawals from the bond, it is not advisable for the trustees to try to surrender the bond during his or her lifetime.

After the donor's death, surrendering the policy gives rise to a chargeable event and any gain may be subject to Income Tax. The gain is split proportionately between the beneficiaries and is added to the individual's income to calculate any tax payable. Top slicing relief may be available, and the normal rules for chargeable event gains apply.

A beneficiary who is a higher rate taxpayer and who surrenders an onshore bond will have to pay 20% Income Tax on the value of the gain, an additional rate tax payer will have a 25% liability on the value of any gain, and so may wish to consider assigning the bond before surrender if he or she does not require access to the capital (see Section 29: What happens on the death of the donor?).

Section 31: What are the Capital Gains Tax implications?

During the lifetime of an onshore life assurance bond, Corporation Tax is paid by Sanlam Investments and Pensions on any income and realised gains from the underlying assets.

On surrender of the bond, Income Tax on the gain may be payable by the named beneficiaries (see Section 30: What are the Income Tax implications on surrender?). The single premium life assurance bond does not produce gains that are subject to Capital Gains Tax.

Section 32: Why is the Discounted Gift (Bare) Trust not subject to the gift with reservation of benefit rules?

On the face of it, the trust enables an individual to make a tax-efficient gift and benefit from a regular flow of cash payments, which may otherwise have Inheritance Tax implications.

However, the gift with reservation rules do not apply, as the donor's entitlement to withdrawals is effectively carved out from the fund and he or she does not retain any rights over the remaining Beneficiaries' Fund.

Also, the policy is written on the lives of the named Beneficiaries (typically the children), rather than the donor or his/her spouse/civil partner.

Section 33: What are the pre-owned assets rules and do they apply?

These rules are effective where the donor of an asset continues to enjoy a free benefit and the gift is not caught by the gift with reservation rules (above). Application of the rules requires the assets to be held on a 'settlement' and the donor to be able to receive a benefit from the assets.

Neither of these conditions applies to the Discounted Gift (Bare) Trust, as the arrangement is a bare trust (rather than a settlement) and the donor does not have right of access to the Beneficiaries' Fund.

Section 34: In summary, the Discounted Gift (Bare) Trust provides:

- an immediate reduction in the donor's taxable estate for Inheritance Tax purposes;
- a regular flow of tax-efficient cash payments to the donor(s), which cannot be defeated by the beneficiaries;
- total Inheritance Tax freedom for the investment after 7 years from the date of the gift;
- for investment growth to be outside of the donor's taxable estate from day one; and
- peace of mind for the donor in knowing that those intended to benefit from the gift will really do so.

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