Hanbury Wealth Product Guide

Discounted Gift Trust

Created: 27th November 2024

Discounted gift trust

What is it?

The discounted gift scheme is an arrangement which allows you to make a gift for inheritance tax (IHT) purposes while retaining the right to a fixed income (in the form of regular withdrawals) for your lifetime (or until the trust fund is exhausted).

Firstly, from the amount of capital which is to be gifted you should calculate exactly the amount of 'income' which you require. It is possible to build in regular, fixed, increases in the level of 'income' to be taken but this must be decided at outset; once the arrangement has been set up it is not possible to vary the 'income' level other than through these pre-set increases, without jeopardising the IHT effectiveness of the arrangement.

Based on your age and state of health, the insurance company will place a value on this income using actuarial tables.

Usually an investment bond is used to hold the lump sum as its structure allows regular withdrawals to be made without immediate tax liability. Full details of the investment bond are available on a separate factsheet. A trust is then created which allows the remainder of the lump sum not required to provide your income to be gifted for your beneficiaries. Either a flexible or an absolute trust can be used and both are described below:

Flexible trust

A flexible trust for your beneficiaries is created with the capital sum. For inheritance tax purposes you will be making a chargeable transfer of the amount placed into trust discounted by the actuarial value of the regular 'income' payments that you wish to retain. This is because a transfer for inheritance tax purposes is valued as the amount by which your estate is reduced by making it. The 'income' remains yours and so is not included in the value of the gift.

A flexible trust, as implied by the name, is one which offers more flexibility than an absolute trust. This would allow you to change the proportions in which each beneficiary benefits from the gift, remove beneficiaries or appoint new beneficiaries.

Every ten years, however, there may be a tax charge on the trust itself. This would apply only if the trust (less the value of the discount) was then valued at more than the nil-rate band available to the trust. The nil-rate band is, currently £325,000.

Whilst your estate will be reduced by the full amount of the investment, the Chargeable Transfer made when you create the trust will be reduced by the discount and any available exemptions. Any amount of the Chargeable Transfer which exceeds the nil rate band will be subject to tax at the lifetime inheritance tax rate of 20%.

Provided that the transfer, together with any other chargeable transfers you have made in the previous seven years, is below the nil-rate band no inheritance tax will be payable.

If you were to die within the seven years following the creation of this scheme the discounted transfer would be deemed to be still part of your estate on death and your estate would receive a 'credit' in respect of any tax paid when the scheme was set up.

Once the scheme is in force, the trust will become a separate entity for inheritance tax purposes and, as mentioned above, additional tax charges could apply. If, however, there is no tax when you set the arrangement up it is most unlikely that these charges would apply, since they depend on future investment growth within the trust, however, no guarantees can be given.

The tax charge is, currently, a maximum of 6% of any value in excess of the nil-rate band.

The value of the trust will be taken as the value of the bond reduced by any discount, calculated as above, based on your age at that time. The discount will therefore reduce at the date of each periodic charge.

The second occasion of charge will be when monies, excluding regular payments made to you, leave the trust. The rate of tax will depend on the tax charged either when the arrangement is set up or at the ten year anniversary immediately before the payment is made. Again, a maximum rate of 6% would apply but if no tax was paid at outset or at the ten yearly anniversary points no tax would be charged at exit either.

Absolute trust

An absolute trust for your beneficiaries is created with the capital sum. For inheritance tax purposes a potentially exempt transfer of the amount placed into trust less the value of the regular payments you wish to retain to use as an effective income is made. This is because a transfer for inheritance tax purposes is valued as the amount by which your estate is reduced by making it. The ‘income’ remains yours and so is not included. On your eventual death the ‘income’ ceases and so, whilst it remains in your estate, it has no value for inheritance tax purposes. This is where the ‘discount’ comes from.

With an absolute trust, there is no facility to alter the shares of any beneficiary. In the event of the death of a beneficiary before a payment is made, their share would pass under their will (or laws of intestacy if there is no Will).

Whilst your estate will be reduced by the full amount of the investment, the Potentially Exempt Transfer (the amount which would be added back to your estate if you were to die within 7 years of setting the arrangement up) would be the ‘discounted’ amount, less any available exemptions.

Potentially exempt transfers are treated as exempt transfers when made. If you survive for seven years or more after making the transfer it becomes exempt. The transfer then falls out of account for inheritance tax purposes.

If you die within this seven-year period the transfer becomes chargeable. In this event, inheritance tax may become payable on the original gift.

If a PET were to become a chargeable transfer due to your death within seven years it will be added back into your taxable estate. The value used is, usually, the lower of the value of the asset at the time of the PET and its value at the date of death. The PET will be taxed at the lower of the rates of tax applying on your death and those which applied when the PET was made.

In addition to the above, if the PET exceeds the Inheritance Tax nil rate band (either alone or cumulatively) there may be inheritance tax due on the recipients of the gift (i.e. the trust beneficiaries). This liability is reduced on a sliding scale (known as Taper Relief) if you survive at least three years from the date of gift but less than seven years.

Discount

By entering into this arrangement (assuming that the 'income' valuation is not challenged by the Revenue) your estate for inheritance tax purposes will be immediately reduced by the income you expect to take over the duration of the plan, with the remainder of the gift falling outside your estate after seven years.

The discounted value is subject to agreement by the Inheritance Tax department of HM Revenue & Customs and is calculated actuarially on the assumption that you are in good health for your age.

In practice, while HM Revenue & Customs may accept the general basis of calculation, each case may be considered individually for negotiating a value and any figures provided serve as a guide only and there is no guarantee given that they will be accepted by the Revenue, especially if a claim arises in the early years of the plan.

Trust Registration Service (TRS)

The TRS is a government register of the beneficial ownership of trusts. From 6 October 2020 the scope of the TRS was extended, the new rules are to ensure that the UK has an anti-money laundering and counter terrorist financing regime that is; up to date, effective, and proportionate. The rules will improve transparency about the ownership of assets held in trust.

The Discounted Gift Trust will need to be registered on the TRS. The deadline for registration is 90 days from trust creation.

Where the investment within the DGT is an offshore bond effected in Ireland, the trust also needs to be registered on the Irish Central Register of Beneficial Ownership of Trusts (CRBOT). It isn't possible to do this until the Irish Revenue complete a simplification of the process for non Irish residents.

The trustees can designate a 'lead trustee' to register the trust or an 'agent'. The 'agent' would need to be a business which operates as an accountancy service provider.

Risk considerations

There are a number of risk considerations that need to be taken into account. It is important that you are aware of these.

- Past performance is no guarantee of future returns
- If growth is low, charges may eat into the capital invested
- The price of units and the income from them can fall as well as rise
- The value of this investment is not guaranteed and on encashment the trustees/beneficiaries may not get back the full amount invested
- A surrender penalty may apply if you encash this investment in the early years
- If withdrawals are made at a rate which exceeds the net growth of the fund, capital will be eroded
- There is no guarantee that HM Revenue and Customs will accept the discounted value

- Before making any withdrawals in excess of the cumulative 5% allowance, you should seek advice in respect of the most appropriate and tax efficient method of achieving this
- Where regular withdrawals are taken, they will simply accumulate in your estate, negating the IHT benefits of the scheme if they are not spent
- Similarly, if the withdrawals are not spent, but gifted away, they will be subject to the usual gifting rules (to the extent that they are not covered by an exemption) and remain part of your estate for 7 years
- The arrangement involves the absolute transfer of capital to the trust. Apart from the 'income' withdrawals described above you will have no access to the capital once the plan is in force
- Please be aware that there may be occasions when an individual fund or funds may have a higher risk rating than your overall stated attitude to risk. If this is the case, then the overall risk rating applied to all of the combined funds being recommended is still designed to meet your stated tolerance.