Trust-based solutions for reducing an inheritance tax bill

Key takeaways:
- Understanding how the schemes are typically structured
- A review of how the schemes are treated for tax purposes
- A consideration of which scheme(s) may be suitable for different clients with different circumstances

Category: Estate and trust planning

An overview of some of the main packaged trust-based IHT solutions offered by life assurance companies

There are a number of packaged trust-based inheritance tax (IHT) solutions available. Most are provided by life assurance companies and they generally involve an underlying investment bond as the trustee investment solution.

Rather than provide a detailed technical analysis, we have instead created a summary of the main trust-based solutions available.

Life insurance written in trust

One way of dealing with an IHT liability is to affect a life insurance policy. The sum assured, paid on the death of the life assured, can be made available to compensate the deceased's beneficiaries for the IHT paid or to provide liquidity to pay IHT.

Liability to IHT?

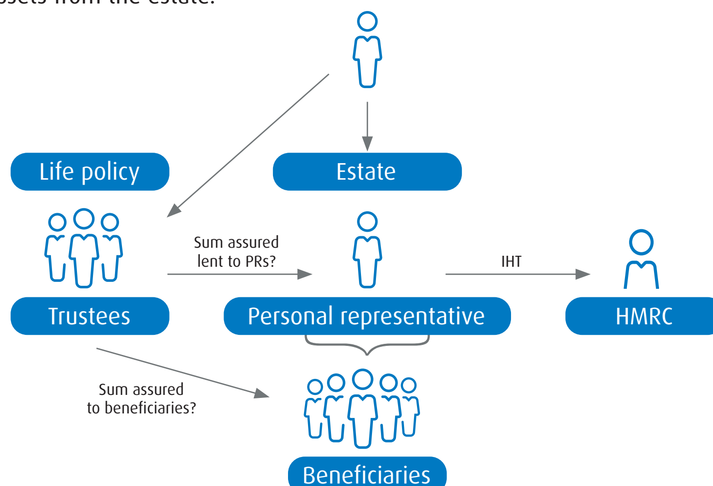
The IHT liability on the deceased's estate rests with the deceased's personal representatives (PRs). They pay the tax with cash or the sale proceeds of assets from the estate.

If the policy is not written in trust or owned by another person, then – even though paid after the death of the deceased, the sum assured would be included in the estate (IHTA s171). Having the sum assured paid to the estate would make the funds available to the PRs (perhaps to pay the IHT). However, it would also increase the value of the estate and thereby increase the IHT liability.

Writing the policy in trust

Writing the policy in trust means the sum assured will not be included in the deceased's estate. There is no need for grant of probate to release the sum assured, as the trustees will own the policy and be entitled to it.

The policy could be used to provide IHT-free legacies which may compensate the beneficiaries for the IHT that has been paid on the deceased's estate. Alternatively, the sum assured may be lent to the PRs to provide them with the liquidity to pay the IHT, thus allowing the PRs to release the assets of the estate.



Premiums paid to a life policy written in trust will be transfers of value for IHT purposes. If not covered by the £3,000 annual gift or normal expenditure from income exemptions, they will be chargeable lifetime transfers (CLTs) where a discretionary trust is used. Alternatively, these will be potentially exempt transfers (PETs) where a bare trust is used.

Gift trusts

Perhaps one of the easiest ways to mitigate a potential IHT liability is to simply give your money and/or assets (capital) away. There are, of course, major considerations involved in giving capital away, including the possibility of needing future access to that capital or income generated from it. Another major consideration is who will receive the gift?

This can be problematic, especially where the potential donor has a large family, complex family situations or may wish to make provision for those who may not even be born yet, for example unborn grandchildren.

Intergenerational wealth planning may require plans that are flexible and able to adapt to changing circumstances. Gifts into trust may achieve this.

Bare trust

A bare trust has fixed beneficiaries that cannot be changed. There may be multiple beneficiaries named on a bare trust deed, but their entitlements are also fixed. Although inflexible in terms of who the beneficiaries are, and their entitlements, bare trusts may be appropriate where the donor (the person making the gift) is quite happy to have a fixed trust.

Tax

Bare trusts are generally transparent for tax purposes, i.e. any income and capital gains are taxed on the beneficiaries. The trust assets form part of the beneficiary's estate for IHT purposes. The exception to this is a bare trust established by a parent for their unmarried minor child – where the settlements legislation stipulates that, where the trust has income of more than £100 in a tax year, it is taxed on the parent rather than the minor beneficiary.

There are tax planning opportunities using bare trusts where the beneficiaries have unused income tax allowances, nil rate bands or an unused capital gains tax (CGT) annual exemption. As bare trusts are often established for minor children who are unlikely to have other income or gains, the bare trust may prove very tax-efficient.

Control

The beneficiary of a bare trust may take direct control and ownership of the trust assets when they attain majority. This may not be appealing to those concerned about giving control over significant sums of money to 18-year olds (16-year olds in Scotland). A bare trust may not be appropriate for an adult beneficiary, as they can immediately demand control of the funds. An exception may be where an adult beneficiary is not willing or able to manage their own financial affairs, in which case a bare trust may provide a suitable mechanism for managing their financial affairs and to provide a safeguard.

Discretionary trust

Where a discretionary trust is used, the person making the gift into trust is referred to as the settlor. A discretionary trust is not a fixed trust: individual beneficiaries only have a hope, rather than a right – of benefitting from the trust.

The settlor gives up their rights to the capital in favour of the beneficiaries in the same way as with a bare trust, but the tax and control aspects are quite different.

Tax

Discretionary trust taxation can be complex and trustees should understand their self-assessment obligations. It may be prudent for lay trustees to employ the services of professional advisers to assist them. Some of the trustee self-assessment issues may be mitigated by the use of a non-income producing single premium investment bond as the underlying investment vehicle.

As already noted, many packaged trust-based solutions and template trust deeds are offered by life offices and are designed to be used with an investment bond as the trust investment vehicle. Even where investment bonds are used, there may be periodic and exit charges, as well as associated reporting. Ongoing quality advice will likely be critical to the lay trustee.

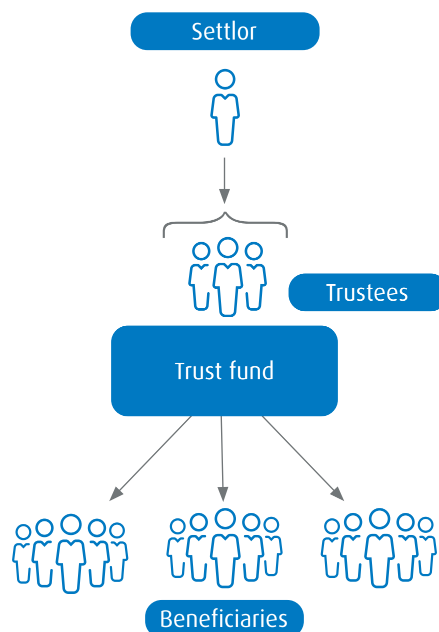
Control

A settlor may establish a discretionary trust with a wide range of beneficiaries. Furthermore to ensure the trust is appropriately flexible, they will bestow certain powers on the trustees.

Typically, the trustees will have discretion regarding the appointment of trust capital or income, meaning they can decide who (among the potential beneficiaries) will receive capital or income, how much they will receive and when they will receive it. That said, the trust will have a perpetuity period and the trust fund will have to be distributed by the end of this period (125 years for trusts created since 6 April 2010). The trustees cannot exercise their powers to permanently deprive the beneficiaries of the fund.

Flexibility

An advantage of a discretionary trust over a bare trust is flexibility. The settlor may be considering a trust because they do not want to make an outright gift. They may not know who will need the trust fund or when they will need it. The settlor may also want to avoid the funds passing into the beneficiary's estate at this time – perhaps to protect the fund from a potential beneficiary's divorce, bankruptcy or profligacy.



Transfers of value

To the extent not covered by exemptions or reliefs, gifts into a bare trust are PETs and gifts into discretionary trusts are CLTs.

Loan trusts

A loan trust, as the name suggests, involves a loan rather than an outright gift. The settlor lends money to the trustees, which is usually interest-free. The trustees then invest the money lent to them and the growth accrues to the trustees for the ultimate benefit of the beneficiaries.

Although the settlor has not given away capital, they have given up future growth on the money lent. The loan remains an asset of the settlor's estate until repaid or waived, but they have effectively frozen the value of this part of their estate. This slows down the future impact of IHT.

Flexibility

Loan trusts are flexible schemes that can be used:

- To freeze the value of part of the settlor's estate;
- To draw down on the loan repayments to supplement the settlor's income;
- To make gifts by waiving the loan, in full or in part; and
- To achieve all of the above at various times in the settlor's life to accommodate changing circumstances.

Loan repayment

The loan is repayable on demand by the settlor, or – in the event of the settlor's death – on demand from their personal representatives. The settlor may demand the loan be repaid all at once, on an ad-hoc basis, or they may take the loan repayments on a regular basis – perhaps monthly or annually.

Where a single premium investment bond is used, the trustees could take advantage of the 5% cumulative tax-deferred allowances to make periodic repayments.

Loan repayments not required

If the settlor does not require the loan repayments, they do not have to take them in their lifetime and can waive them (see below). It would improve the prospects for capital growth if the loan is not repaid and the trustees are able to realise growth on the full amount initially lent for as long as possible.

Where an investment bond is the investment vehicle, it is worth remembering that the 5% tax-deferred allowance is cumulative. If withdrawals are not made in the early years, it increases the ability to make larger tax-deferred withdrawals in later years, perhaps at a time when the settlor may need to supplement income, for example to cover care costs.

Cash loan rather than lending an investment bond

Loan trust deeds are worded to accommodate the loan of a cash sum by the settlor and subsequent investment of that cash sum into a single premium investment bond by the trustees. The loan of an investment bond to the trustees could, without appropriate wording of the loan agreement, result in the potential IHT advantage being lost. There is an argument that if the settlor has assigned an investment bond to the trustees as a loan then the bond itself is the debt, repayment of the debt would involve the reassignment of the bond (including any growth) to the settlor.

Trustee limited liability

Trustees are personally liable to repay the loan to the settlor. This could be problematic if the investments the trustees have selected (usually held via a single premium investment bond) have fallen in value below the value of the initial premium. For the effectiveness of the scheme, it is important that the trustees invest the money lent to them so that they can achieve growth for the beneficiaries. However, concerns over personal liability may disincentivise them from investing.

Loan agreements may include a trustee limited liability clause. The clause will limit the trustees' liability to repay the outstanding loan at any given time to the actual value of the trust property at that time. This protects the trustees, should the investments fall in value. It should be noted that, should the settlor die with the loan outstanding, it is likely that the full value of the outstanding loan would be included in the estate. Only irrecoverable loans may not be included (IHTA 1984 s166).

Limited liability clauses are intended to protect the trustees from poor investment performance. The inability to repay the outstanding loan because the trustees have previously appointed capital to beneficiaries may not be covered.

Waiving loans

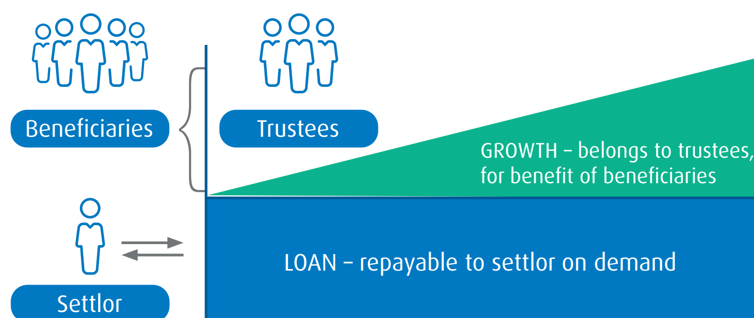
The settlor may decide at some point that they no longer require some, or all, of their loan to be repaid. Having originally been cautious about making a gift, they now decide they can afford to relinquish ownership of the capital. They could waive some, or all, of their outstanding loan via an appropriately worded deed.

The life company that issued the initial trust deed and loan agreement may well have template deeds for this purpose. It should be noted that – to the extent that it exceeds the settlor's available annual exemption – the loan waived would be a CLT (or PET if it is a bare trust version of a loan trust).

Discretionary or bare trust?

Discretionary trusts are generally used for reasons of flexibility, as discussed earlier. It is also important to bear in mind that the beneficiary(s) of a bare trust loan trust can demand their interest in the trust on attaining age of majority.

How a loan trust can be used to meet changing needs



Loan trust: case study 1

- Donald establishes a discretionary loan trust with a loan of £100,000 for the benefit of his grandchildren.

Three years later the £100,000 originally invested has grown to £120,000.

- The eldest grandson, Phil, has approached the trustees and asked if they would be prepared to give him £20,000 to help with a deposit on his first flat.
- The trustees have £20,000 of growth which they could indeed give Phil, but this would leave them with a fund of £100,000 and the potential for the investment value to drop below the outstanding loan amount – of £100,000.
- They have other potential beneficiaries to consider and the £20,000 growth represents the entire trust fund (after taking account of repayment of the loan).
- They decide not to make the £20,000 advance to Phil at this time.
- Phil puts back his plans to buy a flat.

Two years later the fund is valued at £150,000 – they have £50,000 growth.

- Phil would still like to buy his first flat.
- He has had an extra couple of years to save more towards his deposit, but still does not have enough.
- Phil approaches the trustees.
- As they now have £50,000 growth on the fund, they decide – taking various factors into account – that it is appropriate to advance him £20,000.
- This leaves them with £130,000 remaining in the fund.

Loan trust: case study 2

Consider the following hypothetical scenario:

- Janet is 65 and widowed.
- She can comfortably meet her expenditure from her various pensions.
- She has a substantial estate, including her home, investments and cash.
- Janet completes an income and expenditure analysis, as well as a cash flow modelling exercise.
- It is clear that Janet has more capital than she is ever likely to need.
- She can afford to make substantial gifts to reduce the value of her estate.

Janet is aware she has a potential IHT liability, but she is not particularly motivated by saving tax. She does, however, want to maximise any legacy she is able to leave to her two daughters and her grandchildren.

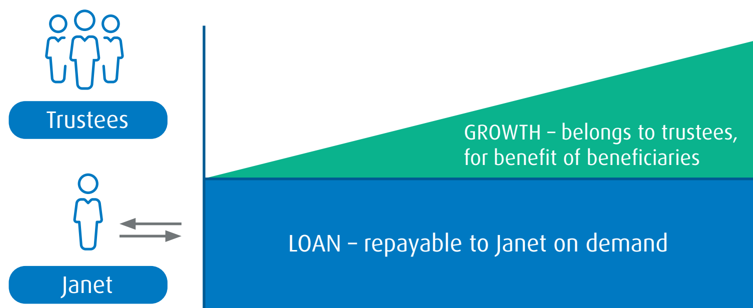
On face value, Janet can afford to make gifts of capital to reduce her exposure to IHT and should consider outright gifts or gifts into trust, but she is reluctant to do this.

Janet explains that her mother died recently and spent the last three years of her life in a care home.

She is concerned about the potential future cost of care and wants to know that she will be able to pay for the standard of care that she wants.

Loan trust

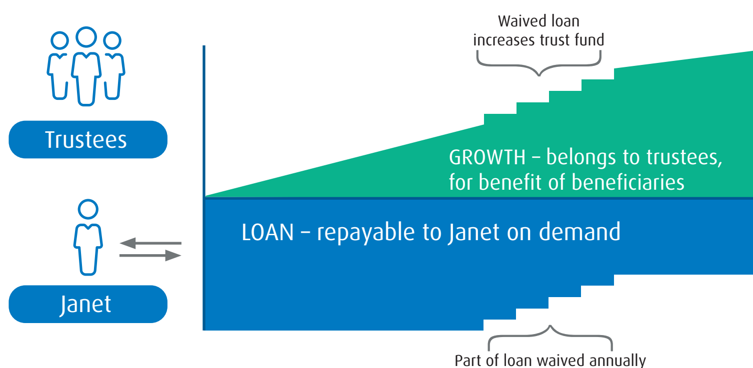
Janet establishes a loan trust and lends the trustees £300,000. She is meeting her expenditure from her regular income, so she does not require any regular repayment of the loan.



10 years later

Janet is still comfortably meeting her expenditure from her income and has now decided that she can afford to give away her capital. She considers calling in some or all of her loan to give the money to her family, but decides instead to waive some of her loan. The loan waived becomes the property of the trust which will ultimately benefit her family.

She repeats the exercise annually, waiving £30,000 p.a. It is important to note that – as the loan has not been called in by Janet, but rather waived – the underlying investment bond has not been touched. Therefore, the cumulative 5% allowances have not been used.

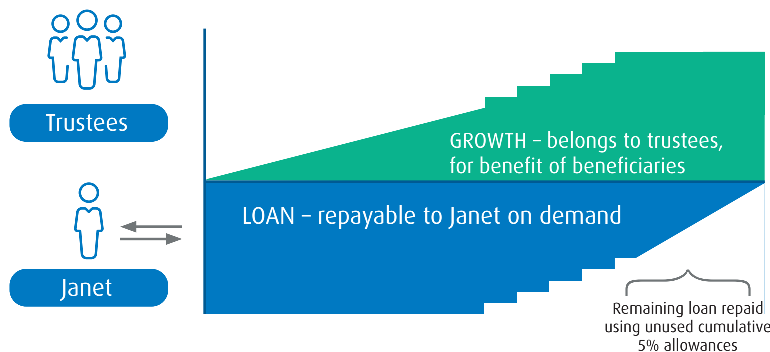


After 15 years

Janet is now 80 and her health has deteriorated. In order to pay for the level of care she wants, it is decided to call in the remaining loan over the remaining years of her life to supplement her income and avoid having to sell her home. At this point the trustees can utilise the cumulative 5% allowances that have built up over the previous 15 years of the scheme.

We are now in the 16th policy year, so 16 x 5% = 80% of the original loan amount (£240,000) could be drawn on a tax-deferred basis. There is, in fact, only £150,000 of the original loan remaining, as Janet has waived £30,000 p.a. for the previous 5 years. The entire outstanding loan could be repaid on a tax-deferred basis under the 5% cumulative allowances.

It has been possible to adapt the loan trust to Janet's changing circumstances.



Tax

The tax treatment of a loan trust will be determined by the type of trust used. Discretionary trust taxation can be complex and trustees should understand their self-assessment obligations. It may be prudent for lay trustees to employ the services of professional advisers to assist. However, loan trusts use non-income producing single premium investment bonds as the underlying investment vehicle and this simplifies the tax situation.

Periodic reviews

Even where investment bonds are used, there may be periodic and exit charges, as well as associated reporting. Regarding periodic charges: the charge is based upon the value of the relevant property in the trust. This does not include the loan outstanding to the settlor – this, after all, does not belong to the trust.

There is, however, a quirk in the reporting requirements. The outstanding loan is not discounted when establishing whether there is a reporting requirement at the 10-yearly anniversaries. Therefore, to be clear: it is the value of the investment bond – including the value of the outstanding loan – that is taken into account when establishing whether a periodic review should be reported to HMRC.

Transfers of value

A loan to the trustees is not a transfer of value. The loan remains an asset of the settlor, no value has been transferred and there is no CLT or PET when establishing a loan trust. Some schemes, referred to as 'gift and loan schemes', do require an initial small gift to establish the bond and the trust. The initial gift may be equivalent to the minimum premium for the investment bond. Where a gift and loan scheme is used, the initial gift would be a CLT or PET (depending on the type of trust used) to the extent it exceeds any available exemptions.

Discounted gift trusts

Discounted gift trusts (DGTs) have a long history and yet, may still be a difficult concept to explain to someone not acquainted with them. DGTs involve the settlor carving out rights to an asset (typically a single premium investment bond) before assigning it into trust.

The ability to create different rights or entitlements from a single asset may be a difficult concept to grasp initially, but an example that will be familiar is that of freehold and leasehold interests in property. The owner of the freehold owns the bricks and .mortar, while the owner of the leasehold may possess a right to reside in the property. There is one property, but there are separate rights and both rights will have a value.

Note: the above example is intended only to illustrate how separate rights may be carved from a single asset, but the DGT concept cannot be applied to real estate.

DGTs are typically established using single premium investment bonds and the process is broadly as follows:

- The settlor purchases a single premium investment bond
- They carve out rights to future withdrawals from the investment bond (their retained benefits)
- These rights are clearly defined (fixed) at the outset and paid on a regular basis
- These rights will end on the settlor's death (or depletion of the fund if earlier)
- The settlor then assigns the bond into trust
- The trustees are not permitted to distribute capital from the trust to the beneficiaries until the settlor's death

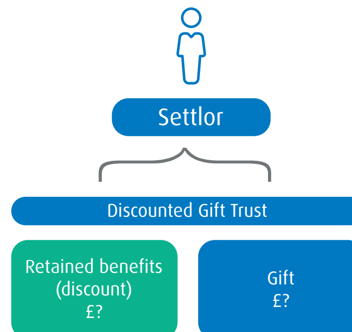
The above steps are usually completed in a single application process, such that the bond application and assignment into trust are done contemporaneously.

Gift with reservation of benefit

It is important that the carve-out of benefits for the settlor is clearly established and defined in the trust deed. Where the settlor's rights are not clearly defined, there could be a gift with reservation of benefit (GWR) by the settlor if they benefit from a trust they have established.

DGTs do not give rise to GWRs as the settlor's retained benefits were never given away (i.e. they were never part of the 'gift').

Consider an alternative approach: the settlor assigns an investment bond into trust, then demands regular withdrawals from the bond that now belongs to the trust. Because the settlor did not carve these rights out for themselves before assigning the bond into trust, they are now a beneficiary of the trust fund, therefore there is a GWR.



What are the IHT benefits of a DGT?

Consider:

- The retained rights carved out by the settlor for life have a value
- This value is referred to as the "discount"
- The value of the gift into trust (the PET or CLT) is the value of the investment bond premium minus the discount
- This is because the discount represents the value of rights the settlor has retained and not given away
- The settlor has only retained the rights to the regular withdrawals from the bond – and nothing else – therefore:
  - Any growth on the fund will accrue to the trustees
  - The trust deed prevents the trustees distributing funds to the beneficiaries until the settlor's death
  - On the settlor's death, their rights cease and any residual fund will belong to the trust for ultimate distribution to the beneficiaries

But what if the settlor does not need the regular withdrawals?

A DGT is unlikely to be suitable if the settlor does not require the withdrawals or at least has no intention of spending them or giving them away. The withdrawals will simply accumulate in the settlor's bank account. The withdrawals are fixed at the outset (although they may increase annually, at a prearranged rate), so this inflexibility may not be suitable for everyone.

Where the regular withdrawals are not required, it might be more appropriate to consider a gift trust.

How is the discount calculated?

The value of the settlor's right to future regular payments (i.e. the retained rights) is calculated by taking into account the settlor's – or both settlors', if it is a joint life DGT – age and state of health, as well as the amount and frequency of the payments.

This document is not intended to provide a technically exhaustive description of DGT schemes. Therefore, in simplified terms: the discount is essentially the open market value of the retained rights (IHTA 1984 s160). HMRC's position is that the insurability of the settlor's life is a factor in determining the open market value of their retained rights. Subsequent to the European Court of Justice decision in the Test-Achats case – and since 21 December 2012 – it is no longer possible to set insurance premium rates based on gender. The settlor's gender is therefore not a factor in calculating discount rates for DGTs – gender-neutral actuarial rates are used.

Consider for example:

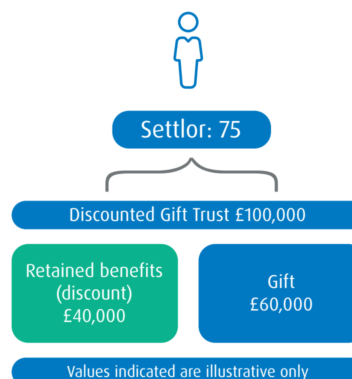
- Seth is aged 75
- He established a DGT with a £100,000 premium
- He retained rights to 5% withdrawals annually
- Seth will receive £5,000 annually until either he dies or the fund is exhausted

How much would a willing buyer in an open market pay the settlor for the right to those £5,000 withdrawals?

A willing buyer would make various assumptions, including how many payments they would receive and when they would receive them. The valuation would apply a discount factor to each payment to account for the fact that they will not receive them until some point in the future.

HMRC have issued guidance to DGT scheme providers regarding how to value discounts, which creates some degree of consistency.

DGT discount



Insurability and maximum age for discounts

HMRC's view is that there is no discount for settlors aged over 90 years. The legal case "HMRC v Bower" confirmed this position. It may still be possible, dependent upon the provider's terms and conditions, for a settlor over 90 to affect a scheme, but it would be on a nil-discount basis.

What happens to the value of the settlor's rights on their death?

The settlor's rights to withdrawals cease on their death, or the second death, in respect of a joint DGT. It is understood that, although there may have been an open market value to the settlor's rights immediately prior to death, IHTA 1984 s171 means that we can disregard this value as it ceases on the settlor's death.

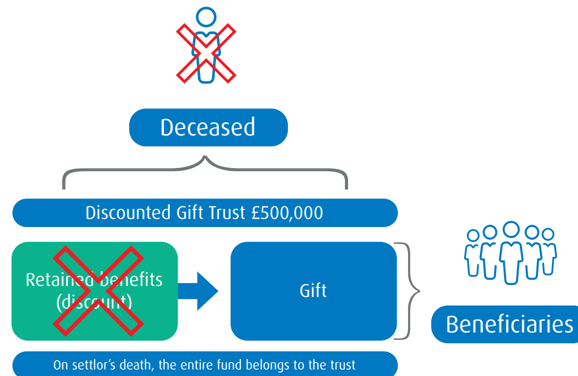
The right to regular withdrawals has created a discount in respect of the initial gift but this is disregarded as having no value on the settlor's death.

What happens after the settlor's death?

The trustees are not able to distribute the trust funds until the settlor has died, but on the settlor's death they are free – although not obliged – to distribute the fund.

They could exercise their discretion to distribute the whole fund – effectively bringing the trust to an end – but they may choose to retain some or all of the funds. The trusts are not automatically wound up on the settlor's death and it may be entirely appropriate to keep the trust for potentially many years after their death.

DGT trustee options on settlor's death



In summary:

- The settlor is able to remove capital from their estate whilst retaining a right to regular withdrawals
- The transfer into trust is a transfer of value, but the transfer of value for IHT purposes is discounted
- The gift will fall out of account for IHT purposes after seven years
- Growth on the bond is outside the settlor's estate
- On death, the entire residual fund is available for distribution to the beneficiaries
- The open market value of the settlor's right immediately prior to death can be ignored when calculating the value of their estate

DGT: case study 1

John and Mandy are married and retired. They have state and company pensions, but also rely upon the income from their investments to supplement their pensions and pay for some of life's luxuries. For example, they like to go on a cruise twice a year and this is funded from the income that their investments generate.

- John and Mandy own their home which has grown significantly in value over the last 30 years.
- They have ISA portfolios that they only stopped contributing to when they both retired.
- They have received a couple of inheritances over the years.
- They have invested much of this money into a portfolio of collective funds.
- Although they tend to spend their investment income (dividends and savings income) they have never needed to access any of the invested capital.

John and Mandy's IHT position (based upon 2019/20 IHT Nil Rate Bands):

• Their home	£600,000
• John's ISA	£250,000
• Mandy's ISA	£250,000
• Joint collectives portfolio	£325,000
• Cash in the bank	£25,000
	£1,450,000

Current IHT position:

Nil Rate Bands	= £650,000 (2 x £325,000)
Residence Nil Rate Bands	= £300,000 (2 x £150,000)
	£950,000

£1,450,000 – £950,000 = £500,000

£500,000 @ 40% **= £200,000 IHT**

Although they do want their three children to benefit from their estates, they do not feel their children really need the money now. They are also concerned about being able to continue to enjoy holidays and other luxuries that they feel they have saved hard to enjoy.

John and Mandy decide a Discounted Gift Trust (DGT) meets their requirements:

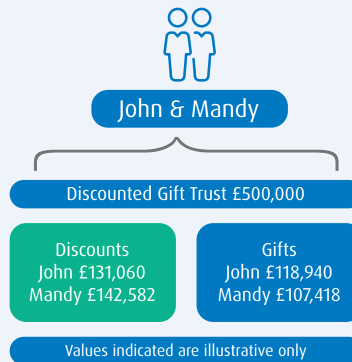
- It will provide an on-going "income"*
- They select withdrawals of 4% p.a.
- This will replace lost income from their investments
- They will not have access to their capital, but this is not a concern
- Their children do not get access to the capital until the second death
- This protects their "income" until that time**

*For tax purposes, a return of capital as their ongoing rights are derived from withdrawals from an investment bond

**Or until the fund is depleted

Continued

John and Mandy use their ISAs to fund the DGT premium.



John and Mandy's IHT revised situation

- Their home £600,000
- Joint collectives portfolio £325,000 (gradually re-invested into ISAs)
- Cash in the bank £25,000

£950,000

Current IHT position

Nil Rate Bands	£423,642 (£650,000 – £226,358*)
Residence Nil Rate Bands	£300,000
	£723,642
£950,000 – £723,642	£226,358
£226,358 @ 40%	**£90,543 IHT**

*Reflects the chargeable lifetime transfer remaining "on account" for seven years £500,000 – £273,642 total joint discount

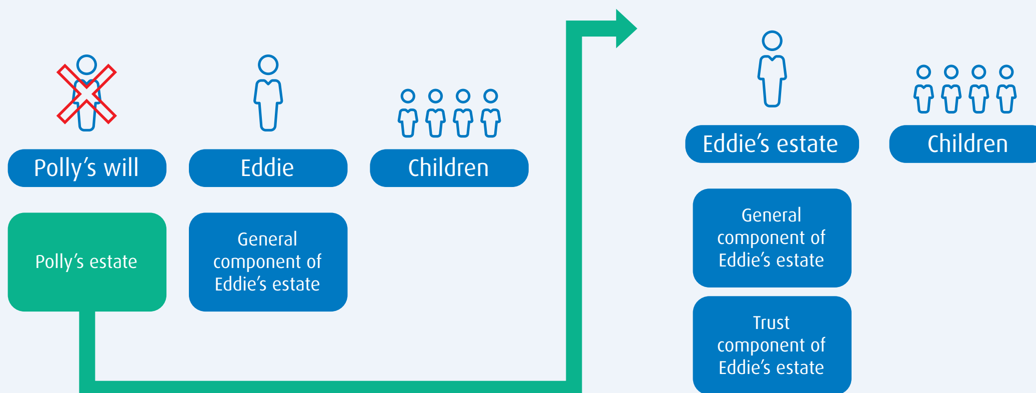
DGT: case study 2

Eddie is the life tenant of a trust established by his late wife, Polly's, will. Polly wanted to make financial provision for Eddie, but also wanted to preserve and protect assets for their children. Polly left cash and investments on trust for Eddie for life and, on his death, to their two children absolutely.

As Eddie's life interest came about on Polly's death, the trust is referred to as an Immediate Post Death Interest trust, or IPDI. The trust fund forms part of Eddie's estate for IHT purposes.

On Polly's death her estate passes into trust for Eddie for his lifetime.

Eddie's estate now includes the trust assets, which will pass to his children on his death.



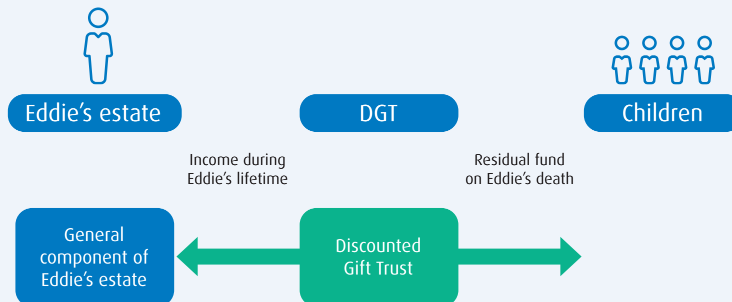
Eddie is now concerned about his own IHT planning. He would like to maximise his legacy for his children and reducing his exposure to IHT would help achieve this. The trust fund represents a significant part of his estate.

He would like to remove the trust fund from his estate, but he does rely on the income to maintain his standard of living. Revoking his interest in possession would affect Eddie's standard of living and the trustees don't want to cause him financial hardship.

The trustees have a power to appoint capital to the life tenant (Eddie). Their adviser suggests a meeting between the trustees, Eddie and Eddie's children to discuss a potential solution. It is decided to appoint the trust property to Eddie absolutely and effectively wind the trust up.

Eddie will use the funds to affect a Discounted Gift Trust selecting a level of withdrawals that will broadly match the level of income he had received from the Interest in Possession trust. Using a bare trust, Eddie names his children as the beneficiaries, ensuring they will receive the residual fund on his death.

The withdrawals from the DGT replace Eddie's income from the trust, his children are still the ultimate beneficiaries



The appointment of the trust fund to Eddie has no IHT implication as the property was already deemed in his estate for IHT purposes. The withdrawals from the DGT, broadly matching the income from the IIP trust, protects and preserves Eddie's standard of living. Naming the remaindermen of the trust as the beneficiaries of the DGT means they will benefit from the fund on Eddie's death, which replicates their entitlements under the IIP trust.

The DGT will be a PET with no immediate IHT implications and will be exempt should Eddie survive seven years. Should he die within seven years, the amount chargeable will reflect the discount relating to the withdrawals that Eddie had selected at outset.

Discounted Gift Trusts

Tax

The tax treatment will depend upon which type of trust has been used. Typically, discretionary and bare trust versions are available. Discretionary trusts may be preferred for reasons of flexibility, but bare trusts may be preferred for very large premiums where the discounted gift exceeds the available IHT NRB. Assuming an investment bond is used, income tax issues will arise when withdrawals exceed the cumulative 5% tax-deferred allowances.

Periodic and exit charges

Periodic and exit charges will not apply in respect of bare trusts, but may apply in respect of discretionary trusts. Exit charges will not apply in respect of payments to the settlor. This is because exit charges apply to appointments of trust capital (relevant property), while the payments to the settlor come from their retained fund, which is not relevant property. On the settlor's death, appointments of capital to beneficiaries may attract exit charges.

Periodic charges may apply, and the calculation will depend on whether the settlor is alive or dead at the time of the periodic review. Where the settlor has died, the valuation of the trust fund is relatively simple, as it would be based on the normal valuation procedure for a discretionary trust.

Where the settlor is alive, it will be necessary to discount the value of the fund. Periodic charges are based on the open market value of the trust fund. The open market value of the relevant property does not include the continuing rights of the settlor to withdrawals. HMRC produced a technical briefing outlining how they expect DGT periodic charges to be calculated: https://www.gov.uk/government/publications/revenue-and-customs-brief-22-2013-discounted-gift-schemes

Transfer of value

To the extent not covered by exemptions or reliefs, gifts into bare trust DGTs are PETs and gifts into discretionary trust DGTs are CLTs. The PET/CLT is the discounted value.

Flexible reversionary interest trusts

Flexible reversionary interest trusts – sometimes referred to as Flexible Reversionary Trusts (FRTs) or Reversionary Interest Trusts (RITs) – are a very similar concept to the discounted gift trust. Both involve the 'carve-out' principle, but whereas the settlor's rights under a DGT are fixed, the FRT is more flexible.

There are a number of different versions of the FRT scheme available, but most use non-qualifying single premium investment policies as the trustee investment. The policies may be single premium investment bonds or single premium endowment policies. Where endowments are used, multiple policies will be established with different maturity dates. Where a single premium investment bond is used, it will be comprised of multiple segments.

There are variations between the different schemes, but what follows is a general overview.

The settlor pays the premiums for the policies, with themselves as the life assured.

The policies may carry certain rights such as:

- Maturity proceeds (endowments)
- Reversionary dates (investment bond segments)
- Surrender benefits
- Death benefits

The settlor will retain the maturity rights under the endowment policies. Alternatively, in the case of an investment bond, the settlor will carve out a reversionary interest, such that the segments will "revert" back to them on fixed future dates.

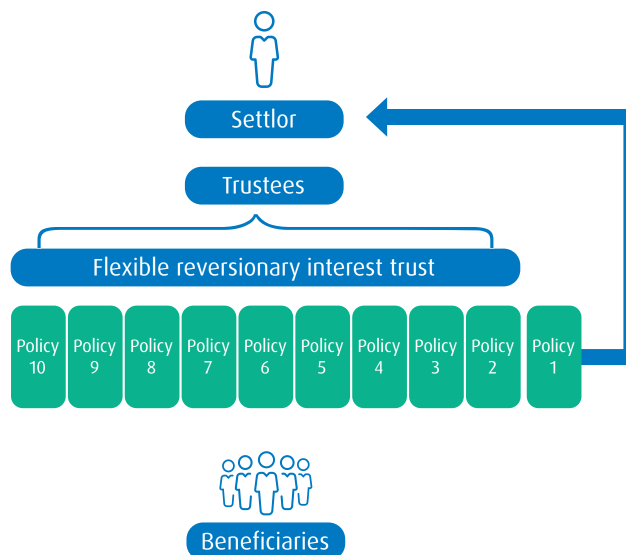
The policies are then assigned into trust with the trustees owning the surrender and death benefits. At the maturity/reversion date, the policies will revert back to the settlor, but If the settlor dies, the death benefit will belong to the trustees. The trustees will typically possess the right to surrender the policies although the settlor's rights to the reversions may pass across to any replacement assets, unless the surrender proceeds are distributed to beneficiaries.

An example

Amy takes out 10 endowment policies each with a different maturity date ranging from 1 to 11 years.

She carves out the maturity benefit for herself then assigns the policies into trust. In one year, the first policy will mature and revert back to Amy. (Where an investment bond rather than an endowment policy is used, segments will revert back to Amy on the reversion date).

Flexible reversionary interest trust – benefits revert to settlor



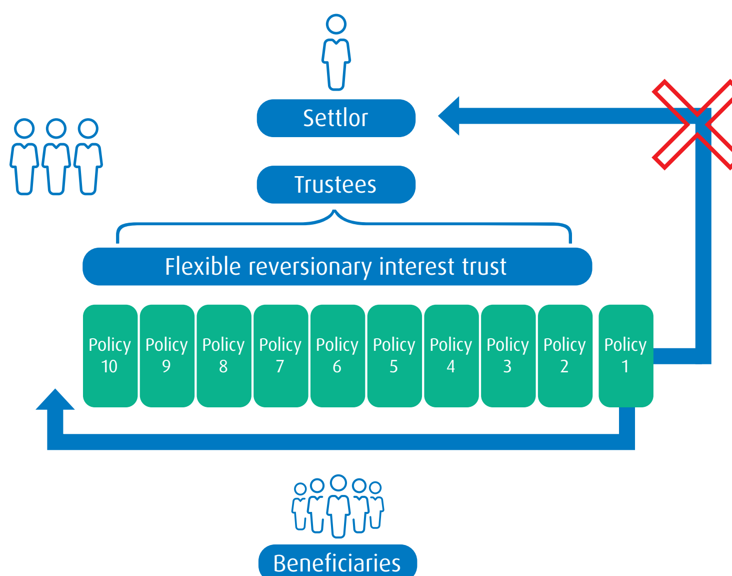
As a non-qualifying policy, the maturity will be a chargeable event and the settlor (Amy) will be liable to any tax due on any gain from the maturity proceeds. (Where segments of an investment bond have reverted back to Amy, she will be able to decide when to surrender the segments and will therefore be able to control her tax position).

How does this differ from a discounted gift trust?

Although Amy is entitled to the maturities, the trustees have the power to defeat these maturities by extending the maturity date. Usually the trustees will have a window (perhaps 60 days) prior to the maturity date to advise the life company that they want to defer the maturity date.

Back to our example: a policy is due to mature, but Amy does not require the policy proceeds. She advises the trustees that she does not require the proceeds and would rather they deferred the maturity date. The trustees notify the provider and the policy maturity date is deferred, perhaps for one year or for longer. This is sometimes referred to as a 'conveyor belt' scheme, because policies that mature fall off the conveyor belt back to the settlor, or they go back to start of the conveyor belt to mature at some future time (see diagram below).

Flexible reversionary interest trust – reversions defeated by the trustees



Trustees defeating maturities

In this scenario it is assumed that the trustees have agreed to defer the maturity of the policies at Amy's request. It is important to note that the right to defeat the maturity rests with the trustees and they do not actually require Amy's consent. The corollary to this is that they could, in fact, defeat the maturity even if Amy objects.

It is assumed that the trustees and the settlor would generally agree whether a policy should be allowed to mature/revert to the settlor or not, and conflict between the trustees and the settlor are unlikely to arise often. There has been some debate in technical circles regarding the trustees' duties to protect the trust fund for the benefit of the trust beneficiaries and whether allowing policies to revert back to the settlor (allowing the fund to be depleted) satisfies their duty to the beneficiaries.

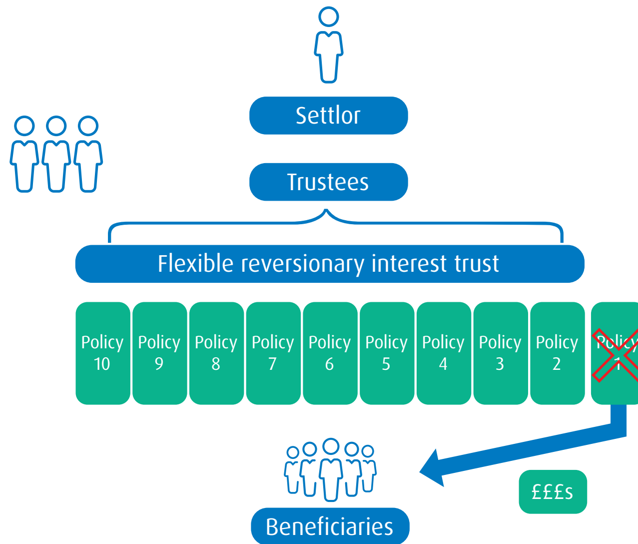
Discounts

Because the settlor's rights can be defeated by the trustees, they have no open market value. Unlike a DGT, where the settlor's rights are fixed, the settlor's rights under an FRT are precarious: a willing buyer in an open market who is looking to purchase the settlor's rights cannot guarantee they would receive the maturities in the future, hence, there is no open market value. For this reason, there is no discount on the initial transfer of value.

There are versions of FRTs that do offer discounts – these schemes give the settlor – as opposed to the trustees – the right to defer maturities. Because the settlor controls the maturities, their rights are not "precarious" and may be valued. The downside of this feature is that, should the settlor defer a maturity, this will be a new transfer of value for IHT purposes.

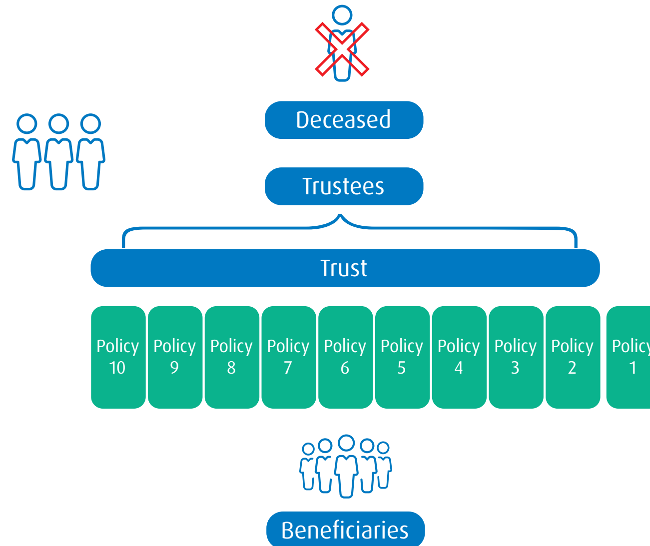
Back to our example: the trustee decides to defeat Amy's future rights to a policy by surrendering it (assuming there is a surrender option under the policy). It is likely that Amy will retain the right to the proceeds of the surrendered policy under the terms of the trust. To defeat Amy's interest completely, the trustees could distribute the surrender proceeds to the beneficiaries as an appointment from the trust. The trustees may be unwilling to make a distribution if they cannot identify a beneficiary who needs the funds, or if all the beneficiaries are currently minors.

Flexible reversionary interest trust – benefits assigned to beneficiaries



On Amy's death, the death benefits will be paid to the trustees. Amy's reversionary interests fall away and the trustees now have discretion regarding whether to retain the funds or distribute amongst beneficiaries.

Flexible reversionary interest trust – death of the settlor



Tax

The tax treatment will depend on which type of trust has been used. Typically, discretionary trusts are used.

Assuming an investment bond is used, income tax issues will arise when withdrawals exceed the cumulative 5% tax-deferred allowances.

Periodic and exit charges

Exit charges will not apply in respect of reversions to the settlor. This is because exit charges apply to appointments of trust capital (relevant property), and the reversions to the settlor are not relevant property. On the settlor's death, appointments of capital to beneficiaries may attract exit charges.

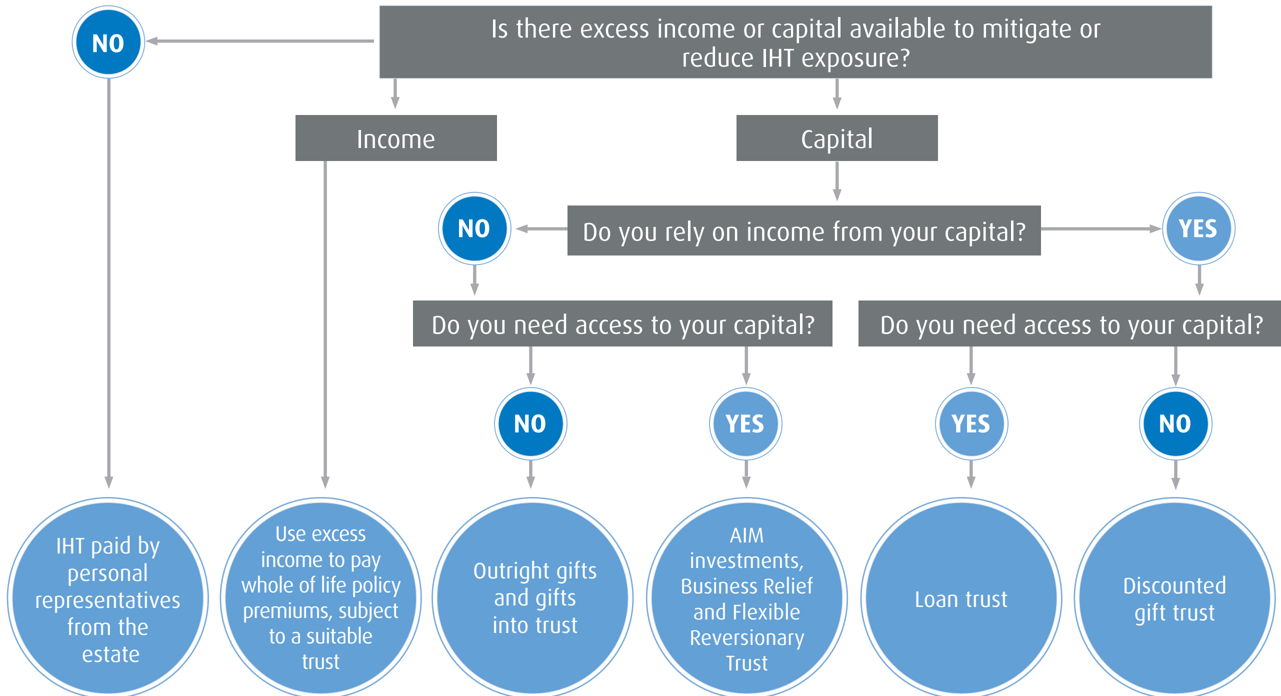
Periodic charges may apply and the value will be based on the open market value of the policies held by the trustees. There will be no discount to consider (unless a discount version of the scheme has been used).

Transfer of value

To the extent not covered by exemptions or reliefs, gifts into bare trust FRTs are PETs. Gifts into discretionary trust FRTs are CLTs. Apart from discounted versions, the PET/CLT value is the same as the initial premium.

Continued

Inheritance tax mitigation – potential solutions



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