

Technical Points Relating to a Discounted Gift Trust

Many moons ago we had the very favourable 'have your cake and eat it' situation, whereby an individual could create a trust for the benefit of, let's say, his or her children. That trust would be effective for what was then, a capital transfer tax purpose. If the settler required money back at any stage in the future, he or she could get it. This form of planning existed even after the Inheritance Taxes Act of 1984.

Many investors were using these arrangements extensively, so it was no surprise when the Revenue introduced anti-avoidance provision within the Inheritance Tax legislation as part of the 1986 Finance Act.

The section of this legislation aimed at the life assurance industry came in the form of Paragraph 7 of Schedule 20 of the Finance Act 1986.

7-(1) where arrangements are entered into under which:

(a) There is a disposal by way of gift which consists of or includes, or is made in connection with, a policy of insurance on the life of the donor or his spouse or on their joint lives

(b) The benefits which will or may accrue to the donee as a result of the gift vary by reference to benefits accruing to the donor or his spouse (or both of them) under that policy or under another policy (whether issued before, at the same time as or after that referred to in paragraph (a) above), the property comprised in the gift shall be treated for the purposes of the principal section as not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor.

To fall foul of the gift with reservation rules, both conditions need to be satisfied.

Firstly, under (a) There has to be a gift involving a policy of insurance on the life of the donor or their spouse. Secondly, under (b), the benefits that are effectively enjoyed by the beneficiaries have to vary by reference to what the donor or his spouse receives. If that is the case, the gift shall be treated as not enjoyed to the entire exclusion of the donor.

So how is the problem overcome? This is achieved by [Section 7- (10) (a)] having a policy of insurance that is not on the life of the donor or their spouse. Therefore we need a product that has no life or lives assured, simply applicants.

We can achieve that by using a discounted gift trust. This is a policy of insurance but not life assurance. It has a term of 99 years and a maturity value of double the premium. It is defined from a chargeable event perspective in ICTA '88, the same legislation defining the more traditional 'single premium whole of life non-qualifying bond'.



The next step is to have a split benefit trust. The trust separates the entitlement into two distinctive parts: the settler's fund and the residual fund.

The settler's fund at outset is the amount that will support the level of withdrawals that the settler has selected to be paid for the rest of his or her life. A gift can only be made once and therefore, only valued once. Therefore, the withdrawal rights of the investor need to be valued from inception.

Any other amount put into the investment contract will not belong to the settler and will be a gift in the form of a Potentially Exempt Transfer. Therefore, if the client dies, the Potentially Exempt Transfer will become chargeable but there will be nothing else to declare to the CTO. Thus, part of the value transferred originally will fall outside the Inheritance Tax equation. In other words, this is the capitalized value of future rights to withdrawals.

Going back to the basic principle of how one measures a gift for Inheritance Tax purposes, the CTO look at the loss to the individual's estate. Under the Discounted Gift Trust, that will be the total amount invested, less today's value of the payments requested by the settler (the capitalized value of future rights to withdrawals).

The settler creates the trust and he or she can act as trustee along with others. The amount invested is held in the trust with distinctive rights expressed via the trust provisions.

The Discounted Gift Trust uses a principle first established by the life industry in 1987.

Counsel's 'Opinion' on the scheme is regularly reviewed and the views of the Q.C. G.R. Bretten are most favourable;

" ... the gift of the Residual part will not be a gift with reservation within section 102 of the Finance Act 1986 as the Settler will be wholly excluded from benefit ... as the bond will not be 'a policy of insurance on the life of the donor or his spouse or on their joint lives', I agree that paragraph 7 of schedule 20 to the Finance Act 1986 will not apply."

'Information is given for general guidance only and specific advice should be taken before acting on any suggestions made. All information is based on our understanding of current legal and tax practices which are subject to change.'