Case Study 1 – Loan Trust

Background

Catherine and David are married and in their late 60s. They have sufficient income for day to day needs but use savings for ad hoc expenditure e.g. holidays.
They have accumulated savings of approximately £350,000 which they are confident will be sufficient to maintain their lifestyle for the rest of their lives.
They have a potential Inheritance Tax (IHT) liability which they would like to address but are not yet ready to make large gifts of capital as they want the security of having access to their savings.
Their three children are the intended beneficiaries of their estate upon second death. There are currently no grandchildren.

Advice

The adviser considers the situation and identifies these important facts about Catherine and David -

- Sufficient income but require ad hoc access to savings.
- Potential IHT liability needing addressed without making large gifts of capital.
- Children will likely inherit but only after second death.

The adviser recommends the use of a discretionary Loan trust and explains it's for those -

- With a potential IHT liability.
- Requiring access to original capital as necessary.
- Looking for flexibility to waive/write off parts of the loan in due course.
- Willing to give up access to growth on the investment.
- Wanting to retain flexibility with regard to those who will potentially benefit in the future.

Outcome

Catherine and David set up a joint discretionary Loan Trust and they are the initial trustees. Additional trustees can be appointed in the future. The trust deed contains an agreement that personally they will lend funds to the trustees (interest free and repayable on demand) so that the trustees can then apply for an Insurance Bond. They decide on an appropriate loan amount and insert that figure in the trust deed. The right to repayment of the loan belongs to them jointly while they are both alive. A trustee application for a bond is duly completed with Catherine and David funding the purchase of the Insurance Bond.

The adviser explains that neither has made a Chargeable Lifetime Transfer (CLT) for IHT purposes because they have simply loaned rather than gifted funds to the trustees. For IHT purposes, any growth arising on the bond is outside their estates from day one, since it accrues within the trust fund where the pre-printed class of discretionary beneficiaries automatically includes their children (and grandchildren) but excludes them. With growth accruing outside of their estates, the potential IHT liability on the loaned amount has been frozen.

The outstanding loan balance remains inside their IHT estates but further IHT savings will be achieved when loan repayments are taken and spent. Although they can set up a regular withdrawal facility from the bond, they decide to take ad hoc withdrawals when required. In addition, the Insurance Company offers a deed to waive the loan, or more realistically, chunks of it, if they decide that they no longer need access to the full amount. Given it is a discretionary trust, any amounts

written off would give rise to a CLT, or could be exempt if they are waiving the annual exemption of £3,000 each. The amount waived will then form part of the trust fund for the beneficiaries.
They also learn that if one of them dies, the right to repayment of the loan will rest solely with the survivor. When the survivor dies, any remaining loan balance will be inside Catherine or David's estate for IHT purposes.

Finally, the adviser draws their attention to a box in the trust deed which should be ticked if they wish the loan to be cancelled on the survivor's death. If not ticked, then on second death the outstanding loan balance will be repaid to the deceased's estate with the funds then distributed under the terms of the will or intestacy. If the bond has not paid out, it will need to be surrendered in full or part and chargeable event implications will arise. If the box is ticked, the outstanding loan balance is not repaid, and instead it will be distributed to potential beneficiaries of the trust. There would be no immediate necessity therefore for the bond to be surrendered. Regardless of whether the box is ticked, the outstanding loan balance will be inside the survivor's IHT estate.

Summary
The discretionary Loan Trust provides a flexible IHT efficient solution giving Catherine and David access to the outstanding capital on demand to fund ad hoc expenditure needs.

Case study 2 – Discounted Gift Trust

Background
Eleanor and Felix are a married couple who are 68 and 70 respectively. They have four children, several grandchildren and possibly more in the future. Both are in good health and expect to live for at least the next seven years. Having recently downsized from their old family home, Eleanor and Felix have a significant amount of cash in the bank, and are aware that there will be a potential Inheritance Tax (IHT) liability on second death. They have not previously made any significant gifts. They want to mitigate IHT but are conscious that their desired day to day expenditure is greater than their pension income. Rather than making outright gifts to family now, they simply want their family to benefit after second death.

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Advice

The adviser considers the situation and identifies these important facts about Eleanor and Felix -

- Potential IHT problem needing addressed.
- Capital 'rich' but income 'poor'.
- Requirement to top up their regular income.
- Both healthy and under 90.
- Beneficiaries to benefit after second death.

The adviser recommends they each establish a discretionary Discounted Gift Trust (DGT) and explains -

- It's for those with a potential IHT liability but unable to lose full access to their investment.
- Access is provided to each by means of a series of pre-set capital payments.
- Each has the opportunity to choose the level of payment and its frequency.
- An analysis of their forecasted income and expenditure needs will help establish the payments required.
- The term discounted is used because the value transferred on establishing the trust is less than the amount invested.
- Both in good health so discount will be available and that is immediately outside their estate.
- Their respective discounted gifts will be comfortably below £325,000 and so will avoid a lifetime 'entry' charge on the Chargeable Lifetime Transfers (CLTs).
- If either of them had been aged, or rated, over 90 then the discount would be negligible.
- The two discretionary trusts ensure flexibility over those who will potentially benefit from the remaining capital after death of the settlor. Potential beneficiaries will include future grandchildren (and great-grandchildren).

Outcome

Eleanor and Felix learn that a gift into a DGT is a transfer of value where the value is determined by the 'loss to the estate'. That will comprise the amount invested less the value of the right to the repayments (see below). The open market value of these repayments depends on age, health and size of the repayments. The adviser explains that HMRC's preference is that full underwriting should be carried out prior to the DGT being effected. The actual amount of the discount may need to be ultimately agreed with HMRC, but the Insurance Company offers an indication of the value at inception based on medical evidence provided.

Both Eleanor and Felix apply for a UK Insurance Bond on a single owner, single life basis. Each then completes a DGT deed. In their deed, each selects the size of the payments and the frequency (e.g. monthly, quarterly etc.). In both cases, the withdrawals selected are within 5% limits, even accounting for ongoing adviser charging. Assuming no shortfall, both have the right to these regular payments for life, and on death that right ceases and so does not swell the value of the deceased's estate. The trustees then have the discretion to distribute the remaining capital to any of the class of beneficiaries. This includes children and remoter descendants but excludes the settlor. The surviving spouse is however a potential beneficiary. What this means is that when one of them dies, the survivor will still enjoy the regular payments from their own DGT but in addition, the trustees of the first deceased's DGT have discretion to advance any remaining funds to the survivor should that need arise.

The adviser explains that it would have been possible, instead, to have set up a joint DGT and in that event the total joint repayments would have continued after first death, and simply ceased after second death. That would be less flexible, but would probably have created a bigger discount. The adviser however clarifies that the main objective of the DGT is to mitigate IHT and carve out access to pre-determined capital payments for expenditure needs. Although the discount provides an immediate reduction in the estate, it is only relevant for death within seven years – both however are in good health.

They learn that it is not sensible to maximise the pre-determined capital payments just to increase the size of the discount. If a settlor carves out access to more capital than actually needed for expenditure then it could be counterintuitive to the overall IHT mitigation strategy, as the excess would build up inside the estate.

When each spouse dies, the bond in their DGT will pay out if the deceased was the sole life assured. The chargeable gain will be taxed on the deceased in the year of death. Given their low level of income it is not anticipated there will be any tax to pay, and the proceeds can then be distributed as the trustees see fit.

Summary

Both Eleanor and Fred are setting up a tax efficient arrangement offering the prospect of regular, fixed repayments for life which they require to top up their income. An immediate IHT discount is available because the value transferred on establishing the trust is less than the amount invested. After first death the survivor can benefit from any capital remaining in the deceased's trust at the discretion of the trustees.

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Case study 3 – Gift Trust

Background
Peggy is a 65 year old widow with a potential Inheritance Tax (IHT) liability.
She has not made any significant gifts in the past but regularly uses her annual IHT exemption. Peggy has earmarked £300,000 to help her grandchildren with future University costs.
She currently has four young grandchildren but wants a tax efficient solution with flexibility to also benefit any future grandchildren.
She requires no access.

Advice
The adviser considers the situation and identifies these important facts about Peggy -

- Any future grandchildren need to be potential beneficiaries meaning that a discretionary trust is required rather than an absolute trust.
- No lifetime access to the trust fund is required.
- Estate is in excess of the available Nil Rate Band and Residence Nil Rate Band.
- No previous Chargeable Lifetime Transfers (CLTs) have been made which means that Peggy can gift up to £325,000 with no lifetime IHT due.
- A tax efficient solution requires consideration of IHT and any other relevant taxes (in this case income tax).

The adviser recommends she invests into an Offshore Bond and places it into a discretionary Gift Trust. She learns that this type of trust is for those -

- Whose previous CLTs in the last seven years are below £325,000.
- Requiring no personal access to the bond whatsoever.
- Wanting flexibility with regard to those who will potentially benefit in the future.

Outcome
Peggy applies for a £300,000 Offshore Capital Redemption Bond and then completes a discretionary Gift Trust deed such that that the Bond is issued into the trust from outset. This is achieved simply by inserting into the deed the date she applies for the Bond. She is automatically a trustee and appoints her son and daughter as additional trustees. She can change trustees in the future if necessary.

The trust deed includes her children and grandchildren as pre-printed potential beneficiaries. Any future grandchildren will automatically be potential beneficiaries.

For Inheritance Tax (IHT) purposes, the £300,000 gift into trust gives rise to a CLT but no lifetime tax is payable as she is comfortably within the £325,000 limit. The trust fund will be subject to the relevant property regime. There will however be no ‘exit’ charges in the first 10 years for any capital paid out of the trust assuming the Nil Rate Band does not fall below £300,000. Also, for 10th anniversary purposes, Peggy has not made any CLTs in the seven years prior to set up that would reduce the Nil Rate Band available to the trustees.

With regard to the Offshore Bond, Peggy learns that no tax will be due for any income received or gains made on the investments within the offshore bond. There will be no income tax due unless a chargeable event arises and a gain is calculated on that event. That simplifies the trustees’ Self-Assessment obligations. The adviser explains that a Capital Redemption Bond has no lives assured and cannot therefore pay out on the death of a (last) life assured but will instead run until maturity after 99 years, although in practice the Bond will almost certainly be surrendered prior to that date. That gives the trustees greater control over the timing of a chargeable event. It is also explained to Peggy that once the grandchildren are over 18 and start attending university, then the trustees can assign segments to them in order that they can subsequently encash with the gain falling on the appropriate beneficiary.

Under current income tax rules gains can be offset against -

- Unused personal allowance
- Unused £5,000 0% Starting Rate for Savings
- Unused Personal Savings ‘Allowance’

Summary

The discretionary gift trusts delivers a flexible arrangement which is both IHT and income tax efficient.