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Case study:

Onshore Bond and Discounted Gift Trust in practice.

Replacing buy to let income

Overview: Discounted Gift Trust

One type of trust or investment bond-based estate planning solution you might encounter is known as the **Discounted Gift Trust**.

This type of trust is specifically designed to provide the person who sets up the trust, known as the settlor with regular payments throughout their lifetime. However, the settlor will not have any other access to the trust fund beyond these regular payments.

Typically, a Discounted Gift Trust is set up as a discretionary trust. This means that the initial gift made by the settlor is considered a chargeable lifetime transfer. However, the value of this transfer is usually less than the total amount invested, as the settlor retains certain rights under the trust, which reduces the value of the gift.

To determine the value of the settlors chargeable lifetime transfer, an actuarial calculation is performed. This calculation takes a number of factors into account, including the settlor's life expectancy at the time the trust is established, the level of retained payments, age and gender (for more details, see **HMRCs Inheritance Tax Manual**). The value of the settlor's retained rights is then subtracted from the total amount invested, resulting in a "discounted" value for the gift.

The settlor's retained rights are considered to have no value immediately before the settlor's death. This results in an immediate reduction in the value of the settlor's estate for Inheritance Tax (IHT) purposes, equal to the actuarially calculated value of the retained rights. Additionally, the amount gifted into the trust is considered to be outside of the settlor's estate after seven years.

Case study: Michael's estate planning with a Discounted Gift Trust

Background:

Michael, aged 70, owns three buy-to-let (BTL) properties, each valued at approximately £300,000. These properties generate a total rental income of £3,600 per month before tax. Michael wishes to simplify his affairs by selling the properties but needs to replace the rental income. Michael is considering tax-efficient alternatives for his £900,000 of property assets.

Michael is currently a higher rate taxpayer. He hasn't done any tax planning to date, so his inheritance tax nil-rate band is currently available.

Solution:

After discussing his situation with his adviser, Michael decides to sell two of the properties. He plans to invest £450,000 of the after-tax proceeds into a Discounted Gift Trust arrangement.

Implementation:

Michael retains the right to receive regular payments of £1,500 per month for life from the trust. This amount is slightly more than what he was receiving after tax from the sold properties. The retained rights are actuarially valued at £180,850, based on his life expectancy determined by medical evidence at the outset. Consequently, Michael makes a chargeable lifetime transfer of £269,150 when he creates the trust.

Inheritance tax implications:

- No immediate IHT: Since Michael's discounted gift is below his available nil rate band, there is no immediate IHT when the trust is created. The chargeable lifetime transfer will be excluded from his estate for IHT purposes after seven years, thereby reducing his estate and IHT liability.
- No gift with reservation: Despite receiving regular payments for life, Michael has not given away the right to these payments and cannot otherwise benefit from the plan*. Therefore, there is no gift with reservation.

IHT benefits:

One of the significant IHT benefits of the Discounted Gift Trust is that while Michael's retained rights have a value at the outset, HMRC accepts that these rights will have no value on the open market at the point of his death. This results in an immediate reduction of £180,850 in his estate, saving his beneficiaries £72,340 in IHT. This saving could be even more significant if the gift reduces his estate below the £2m threshold for the tapering of the residence nil-rate band, which means £175,000 is potentially available to those passing on a qualifying residence on death to their direct descendants.

Additional tax benefits:

The replacement monthly 'income' is free from any immediate liability to income tax (as the regular payments are below the 5% cumulative tax deferred allowance), ensuring Michael is not out of pocket. Additionally, this arrangement reduces his tax status from higher to basic rate concerning other income.

This case study illustrates how a Discounted Gift Trust can be an effective estate planning tool, enabling potentially significant IHT benefits while retaining regular payments.

*Additional information on the risks of gifts with reservation of benefit is available in the customer guide and deeds.

The information in this leaflet is based on our understanding of current legislation and HM Revenue & Customs' practice. Both of these are likely to change in the future. Tax treatment will depend on personal circumstances.

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