Friends Provident International

Keeping all options open

Case study

For advisers only. Not for use with customers.

Tax efficient trust solution

With more people finding themselves caught in the Inheritance Tax (IHT) net as a result of the frozen Nil Rate Band (NRB) and rising asset values, IHT planning is an area where advisers can demonstrate the value of quality, fee-based advice.

A Discounted Gift Trust (DGT) is a popular IHT planning structure, combining a specialist trust with an offshore bond. DGTs are attractive to people who require:

- an immediate discount on the value of the gift for IHT purposes
- a tax efficient fixed income stream, when drawing down the capital using the offshore bond's 5% withdrawal allowance

David

- 63 years of age
- Two adult children and two grandchildren
- House worth £650,000
- Recently sold his business – retained as a consultant for 2-3 years (3 day week)
- Annual consultancy fees of £45,000 – making him a high rate tax payer
- Widower – late wife's full transferable NRB available to his executors

Retaining IHT planning options

This case study shows how David can enjoy the benefits of an offshore bond, knowing that he has the flexibility to assign it to a DGT at a later date, when IHT planning becomes a bigger priority.

David's recent business sale, after entrepreneur's relief and all expenses were paid, has left him with net proceeds of £800,000.

When his capital was tied up within the business, IHT was not a concern, as his shareholding qualified for IHT Business Property Relief. However, having sold the business, David knows that on his death, this capital will be subject to IHT at 40%.

David is aware that one way of reducing his liability to IHT is to gift assets to other individuals during his lifetime, which will fall outside of his estate if he survives the gift by seven years. However, given his age and good health, David only feels comfortable making outright gifts to his children of £50,000 each at this stage, although he hopes to be able to make further gifts at a later date.

He wishes to retain access to the remaining £700,000 plus £100,000 he has saved into ISAs during his life. He does not have a pension; his mantra throughout his working life has always been 'my business is my pension'.

Investing for retirement

On the advice of his former accountant, David seeks a meeting with a financial adviser with whom the accountant has formed a professional connection.

Although David's main objective is to invest the proceeds of the business sale as wisely as possible, the financial adviser suggests that an immediate priority is to amend his will, as it has not been updated to take account of the birth of his grandchildren, the death of his wife or the sale of the business.

David's financial adviser recommends investing the remaining £700,000 business sale proceeds into an offshore bond, written on a capital redemption basis. The main reasons for this recommendation are:

- David has limited earnings for the last year since selling his business and under pension rules he only qualifies for tax relief on a maximum of 100% of his relevant UK earnings.
- He will only be able to invest £15,000 into an ISA.

An offshore bond will provide David the following benefits:

All investment income and gains will roll up gross of tax.

He would pay up to 40% tax on investment income if he invested into collective investment schemes directly.

The ability to make **tax-free assignments** of the policy segments comprising the bond.

Access to the bond's cumulative **5%** annual tax deferred withdrawal allowance.

The bond will act as a means of **deferring tax on the investments if, as expected, he becomes a basic rate tax payer when he retires.**

Additionally David's financial adviser explains that the offshore bond could, at a later date, be made subject to a DGT, at no extra charge to him. This will provide him with a valuable IHT planning option in the future, enabling David to immediately reduce the value of his taxable estate, as a result of the potential discount he could receive.

In the meantime, in order to cover the potential IHT liability on the offshore bond and ISA, David's financial adviser suggests taking out a suitable term assurance policy.

Retirement

David retires at 66. At this point his bond, which was issued as 100 policy segments, is worth £810,000 based on annual growth of 5% net of all bond and underlying fund charges.

David decides he wants to help his two grandchildren with their university education tuition fees and expenses at this point, by assigning six policy segments to each of them.

The assignments are not chargeable events from an income tax perspective. The grandchildren become the new legal owners of the assigned segments and are responsible for any tax liability.

As non-earners they will be able to use their personal allowance to absorb any gains.

From an IHT perspective the policy assignments made by David are potentially exempt transfers.

David still wants to have unlimited access to the bond for the time being, although his plan is to cash in sufficient policy segments each year to fund his retirement income of approximately £40,000 per year:

Age	Segments cashed in	Proceeds	Gain	Maximum Tax payable on gain
66	5	40,517	5,517	20%
67	5	42,543	7,543	20%
68	5	44,670	9,670	20%
69	5	46,903	11,903	20%
70	5	49,249	14,249	20%
71	4	41,369	13,369	20%
72	4	43,437	15,437	20%

Gains based on assumed growth rate of 5% net of charges.

When David reaches 73 his financial adviser recommends making the bond subject to a discretionary DGT as a means of mitigating his IHT liability and ensuring the controlled distribution of the remaining trust fund to his heirs after his death.

This does not involve surrendering the existing bond. The bond is simply assigned to a DGT which is not a chargeable event and therefore there is no tax to pay at this point.

David's remaining 55 policy segments are worth £627,000. He wishes to receive an income of £35,000 per year from the bond using the accumulated 5% annual withdrawal allowance. This equates to 9.1% per year of the premium of those 55 segments. It is possible to take withdrawals of this size over the next 11 years without any immediate income tax charge because the 5% annual withdrawal allowance is cumulative and no previous withdrawals have been taken.

In summary, because David has not used the allowance in the first 10 years, it is stored up so that it can be used in later years, **without creating a chargeable excess.**

The IHT discount

Based on the proposed withdrawals, and provided David is in good health, this will result in an **immediate IHT discount of 49%**, making the value of the gift for IHT purposes approximately £320,000. Therefore if David were to die within the next seven years, IHT would be levied on this amount rather than the £627,000 transferred to the DGT. Once David has survived seven years from making the transfer, the gift will fall outside of his estate completely.

On David's death

On David's death at the age of 82, the remaining trust fund is available to the trustees for distribution to the beneficiaries. The trustees would normally distribute the trust assets by making tax free assignments of the policy segments to the beneficiaries, for them to cash in and pay tax at their own rates.

The beneficiaries are his children and grandchildren, including his daughter Rose, who works part time on a salary of £25,000. Rose's share of the trust fund is 15 of the remaining segments, valued at approximately £154,000, of which £135,000 represents taxable gain. Without top slicing relief she would pay higher rate tax on a large proportion of the gain.

However, one of the benefits of top slicing relief is that it takes into account the fact that the gains have been made over a number of years and works by effectively extending the basic rate band. **The result is that Rose pays tax at a maximum of the basic rate on the entire gain.**

Risk factors

When David assigns the bond to the DGT, the withdrawal amounts he selects are fixed and cannot be changed. Also, he has no access to the trust fund beyond this entitlement.

If the withdrawal amounts selected are excessive and/or investment performance is poor, capital may be eroded and may not be able to fund the withdrawals he needs for his retirement.

Careful consideration of these points is required.

Get in touch

To find out more about how a Discounted Gift Trust could benefit your clients:

Call us on +44 1624 821153 or email us at alt@fpiom.com

Benefits

David's plan has provided him with:

A large discount for IHT purposes.

Top slicing relief for the beneficiaries.

Gross roll up/tax deferral until he starts taking the benefits in retirement.

Tax efficient trustee distribution of policy segments to the beneficiaries.

Tax-free policy assignments.

Tax efficient withdrawals to fund his retirement.

About Friends Provident International

We are a leading financial services provider, with a reputation for trust, commitment and integrity, offering financial solutions to customers throughout their lives.

Friends Provident International has over 35 years of international experience in offshore savings and investments.

Important notes

The information in this document is based on Friends Provident International Limited's understanding of UK and Isle of Man tax law and HM Revenue & Customs practice as at January 2016, which may change in the future. No liability can be accepted for the personal tax consequences of this Trust or for the effect of future tax and legislative changes.

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