A Brief Guide to………
IHT Planning – Discounting Gift Trusts

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Inheritance Tax – a tax on personal wealth

Inheritance tax (IHT) is a personal tax imposed on estates and transfers of assets on your death. The rate is set at 40% of the amount of your estate in excess of the nil rate band. The nil rate band is £325,000 and is frozen at this level until at least April 2028. IHT is not payable on estates values below this amount.

Individuals may also increase their nil rate bands by £175,000 if a single main residence is left to a direct descendant (this is known as main residence nil-rate band). This amount is also frozen until at least April 2028. Any unused nil-rate band can be transferred to a surviving spouse. However, there will be a tapered withdrawal in relation to the main residence nil-rate band for estates with a net value of more than £2 million. This will be at a withdrawal rate of £1 for every £2 over this threshold.

Any unused IHT nil rate band set can be transferred to a surviving spouse or civil partner on your death. This means that the nil rate band that is available when the surviving spouse or civil partner dies will be increased by the proportion of the nil rate band that was unused.

If your estate is liable to IHT it will be over and above all of the income tax that you will have paid throughout your life. With the rate of IHT set at a flat 40% of the amount over the nil rate band it could make you the equivalent of a higher rate income taxpayer when you die.

A tax you can legally plan to reduce

Accountants have been known to call IHT “the voluntary tax” as there is much that you can do to reduce it. A few simple steps and a little planning could save HM Revenue & Customs (HMRC) potentially becoming your largest single beneficiary.

With the IHT nil rate band set at £325,000 and the average UK property £294,559*, even an average household with some savings, life assurance and property could potentially come within its reach.

*HM Land Registry, September 2022

What can a Discounted Gift Trust do for you?

A Discounted Gift Trust (DGT) is a type of UK trust arrangement usually set up in connection with an investment in either an onshore or offshore investment bond (insurance bond). It allows the gifting of a lump sum into a trust whilst retaining a lifelong 'income' from that money (technically withdrawals of capital), with the overarching aim of reducing the eventual IHT liability on death.

The name DGT was coined by the life insurance industry. In strict legal terms, it is a type of Carve Out Trust.

Furthermore, provided the settlor (the person making the gift into the trust) is in reasonable health, a calculation is made as to the likely total amount of 'income' that will be paid back to them by the trustees. This "bag of rights", normally known as the "discount", is deemed to be retained by the client. The remainder will be treated like any other gift into trust (a chargeable transfer in the case of a discretionary trust, or a potentially exempt transfer for a bare trust), leaving the IHT net after 7 years (or 14 years in some cases).

In the event of the settlor dying within seven years, this retained "bag of rights" should in theory be returned to their personal representatives. However, the accepted IHT treatment, as has been tested many times and accepted by HMRC, is that this right to an income for life has no value once the settlor has died, and therefore no money has to be returned.

The effect is that the discount is deemed to leave the settlors estate on day one of settlement of monies into the trust. The remainder will be treated like any other gift into trust and brought back into calculations if death occurs within 7 (in some cases 14) years. In effect, there is an immediate IHT reduction upon creation of a DGT.

A DGT is a very powerful planning tool for anyone in later life whose intentions are to draw income from their investments throughout their lifetime, then to pass on the remainder to their beneficiaries, as it allows for this and helps to reduce the amount of IHT that might eventually have to be paid.

Example:

Mr Smith gifts £100,000 into a DGT.

He selects £4,000 per year 'income' (withdrawals) for life.

Based on his age and gender and on HMRC guidelines (drafted with reference to mortality tables), his life expectancy is deemed to be 15 years.

£4,000 x 15 = £60,000 is the discount, or the amount of the gift which has technically been 'carved out' and retained (in reality this would be lowered a little to reflect the real cost of providing £4,000 over fifteen years assuming there is some return on capital held).

If he dies within seven years:

- £40,000 is brought back into the calculation for inheritance tax, reducing his nil rate band by this amount

- The value of the "right to withdrawals for life", which started as £60,000, is now deemed to be nil (as he is dead). Thus, the £60,000 does not come back into play in the IHT calculation.

Note - importantly - that Mr Smith will have no future access to any of the £100,000 capital; rather his only benefit will be the £4,000 per annum 'income'. Also, this 'income' is dependent on there being sufficient capital remaining in the investment so in this example 4% per annum net growth is needed just to stand still.

Who is it suitable for?

It may be suitable if you:

- want the potential for immediate and future IHT reduction
- are likely to survive seven years
- want fixed regular payments
- are in reasonable health

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It may not be suitable if:

- you are not likely to have an IHT liability
- you are older than 90 next birthday
- you might change your mind about when you want payments or how much you want back from the trust

Important notes

Anyone thinking of using the DGT, or doing anything under the provisions of a trust, must seek and rely on the advice of a suitable tax and trust practitioner. You should take appropriate professional advice before going ahead with any planning of this nature.

This is very important for a number of reasons.

- This trust will not be suitable in all cases. Other forms of tax and trust planning may be more suitable in individual circumstances.
- Creating a trust can have tax as well as legal consequences.
- Once a trust has been created it cannot be revoked.

The trustees have special duties to the settlor(s) and beneficiaries and the misuse of a trust power by a trustee can make him or her personally liable for resulting losses.

- Situations that may involve international or cross-border legal and taxation issues can be extremely complex.
- Tax and trust law can be open to differing interpretations.

Find out more

For further information, advice and guidance please contact one of our specialists:

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Information is believed correct at time of publication but may alter.

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