Contents

Introduction 3

1. The main benefits of the Discretionary Gift Trust (DGT) – investor suitability 4

2. Who is the DGT not suitable for? 4

3. How does the DGT work? 4

4. The inheritance tax effects of the DGT 4

5. The Trustees and Beneficiaries 7

6. The investments of the DGT 8

7. Other important questions 9
The growing scope of inheritance tax

Inheritance tax (IHT) can significantly diminish the amount passing to a person’s beneficiaries on death. On a person’s death, IHT applies at a flat rate of 40% on the excess over the nil rate band. This is £325,000 for the 2014/15 tax year and will remain frozen until 2018.

For some married couples (including civil partners) the introduction of the transferable nil rate band by the Finance Act 2008 has helped to reduce the potential IHT bill on their estates. This is because any percentage of the nil rate band not used on the death of the first of such a couple to die can be utilised on the survivor’s subsequent death. Whilst this is a welcome relief, many married couples will find that the value of their combined estates may well still exceed the threshold above which IHT is payable. For example, based on a nil rate band of £325,000, on the death of a surviving spouse with a taxable estate of £1 million an IHT charge of £140,000 would still arise even though two full nil rate bands may be available.

Using lifetime gifts to reduce IHT

One very effective way to avoid IHT is to make lifetime gifts. Lifetime gifts that are potentially exempt transfers (PETs) give rise to no IHT when made. However, following the new rules introduced by the Finance Act 2006, the scope for making PETs has been severely restricted so that only outright gifts to other individuals or gifts to bare (or absolute) trusts and trusts for the disabled qualify as PETs. All other lifetime gifts to trusts will be chargeable lifetime transfers (CLTs). However, no immediate tax liability will arise unless the amount of the gift (plus any CLTs made in the previous seven years) exceeds the nil rate band at the time of the transfer. Also, once the donor has survived a gift by seven years, no liability can arise on the gift and it will not affect the amount of tax payable on the donor’s estate either.

For a gift to be effective for IHT, the donor cannot retain any access to the property gifted or the income from it as otherwise the gift with reservation (GWR) rules will apply. These rules, which apply when a donor makes a gift and continues to enjoy a benefit from the asset gifted without paying for that benefit, mean the value of the gift continues to form part of the donor’s taxable estate for IHT purposes and so no IHT saving results.

Special trust arrangements can be made if the prospective donor needs access to the funds. Under the DGT the Settlor (the donor) is excluded from all benefit.
1. The main benefits of the Discretionary Gift Trust (DGT) – investor suitability

The DGT enables an investor to:

- make a lifetime gift without an immediate IHT liability (as long as the nil rate band is not exceeded) whilst retaining flexibility over who will ultimately benefit from the gift;
- avoid any IHT implications for their estate on survival of the gift by seven years; and
- ensure that all investment growth accrues outside of their estate.

2. Who is the DGT not suitable for?

Broadly speaking, where the benefits summarised above are not required or valued by the investor, the DGT will not be suitable.

More particularly, the DGT is not suitable for persons who may require access to the capital invested in a Zurich International Portfolio Bond made subject to the DGT.

3. How does the DGT work?

(i) The Plan

The underlying investment of the DGT is a Zurich International Portfolio Bond (the Plan) that, depending on the version chosen by the Settlor, will be a whole of life insurance policy or a capital redemption policy. An investment in a non-income producing asset, such as a life insurance policy or capital redemption policy, means that trust administration is minimised and the investor is substantially sheltered from any personal income tax during the Plan’s existence.

Under the DGT, the Settlor can transfer a new or existing Plan to the Trust. If the life insurance version is chosen, the Plan should be effected on the lives of some or all of the Beneficiaries on a joint lives last survivor basis so that the Plan can continue until the last Beneficiary dies. Up to ten lives can be included. No life insured is necessary under the capital redemption version.

(ii) The Trust

The investor (who is known as ‘the Settlor’) and additional Trustees appointed by the Settlor execute a Deed of Trust which sets out the terms of the gift.

The Trust operates as follows:

- The Trust Fund is held on discretionary trust. This means that no Beneficiary has a fixed right to any benefit. The Appointor (the Settlor during their life, and the Trustees after the Settlor’s death) decides who, from the class of Discretionary Beneficiaries, should receive what benefit from the Trust and when.
- The Settlor names the Default Beneficiary(ies) at outset. This is/These are the person/people the Settlor would ultimately like to benefit from the Trust after their death. However, the Default Beneficiary(ies) will only benefit if the Appointor makes an absolute appointment to them or when the Trust ends after 125 years with no appointment having been made by the Appointor.

4. The inheritance tax effects of the DGT

(i) Establishing the Trust

The DGT enables an investor to make a gift of their investment that will be totally free of IHT after seven years as long as the gift falls within the Settlor’s nil rate band for IHT. For these purposes, CLTs made in the previous seven years need to be taken into account. If the Settlor dies within seven years of establishing the DGT, the gift will be included in their taxable estate and may result in an IHT liability, depending on the size of the Settlor’s estate and their Will provisions. If the gift causes the Settlor’s nil rate band to be exceeded (on a seven year cumulative basis), there will be an immediate 20% IHT charge on the excess over the nil rate band.

If the Settlor is to pay the IHT, this will mean that the gift needs to be ‘grossed-up’ so that the actual amount of the loss to the estate on which tax is payable takes account of the tax payment.

Example

John transfers his Plan to a DGT which results in a CLT of £340,000. He has made no CLTs in the previous seven years and his annual exemptions have been used elsewhere. Either the Trustees can pay IHT of £3,000 (i.e. 20% of £340,000 – £325,000) or John can pay IHT of £3,750 (i.e. 20% of £343,750 – £325,000).
A further tax liability (at 20%) on the gift could arise if the Settlor dies within seven years of making the transfer (see point (iv) of this section).

It is generally not recommended that the Settlor makes a gift in excess of their available nil rate band. This is not only so that no immediate tax liability arises but also to avoid the practical difficulties that this may give rise to. For example, if the Trustees were to pay the tax, they would need cash to do so. This would not be possible if an existing Plan is being gifted. For a new investment, they would need to keep some of the cash gift back in order to fund the tax and so the amount of cash available for investment would be reduced. They would also need to open a bank account which the Settlor's gift cheque would have to be paid into first, so it would not be possible for the Settlor to simply make a cheque payable to Zurich. If, on the other hand, the Settlor were to pay the tax, the gift would have to be grossed-up and the grossed-up figure used in all IHT calculations, and this is likely to be more complicated.

For the purpose of this guide, we assume that the initial gift is fully covered by the Settlor's available nil rate band.

(ii) How is the size of the gift determined?
For new Plans, the investment made will be treated as a transfer of value for IHT purposes and will be a CLT. For existing Plans, the value of the gift will be the value of the Plan (or the initial investment made, if greater, less any part surrenders, less an allowance for any decrease in the value of units since allocation at inception of the Plan).

It is not recommended that gifts are made if they cause the Settlor's available nil rate band to be exceeded, as an immediate tax charge at 20% will then arise.

(iii) Does HM Revenue & Customs (HMRC) need to be informed about the DGT?
Whether a gift will need to be reported to HMRC depends on the amount of the gift and the nature of the asset gifted. The gift will need to be reported in the following circumstances:

(1) Where the gift is of cash (this includes a new Plan), it causes the donor to exceed the then nil rate band taking account of CLTs made in the previous seven years or;

(2) Where the gift is of an existing Plan, it either causes the donor to exceed 80% of the then nil rate band, taking account of CLTs made in the previous seven years or the amount gifted exceeds the then nil rate band less CLTs made in the previous seven years.

If the gifts need to be reported to HMRC Inheritance Tax, the Settlor must do so on forms IHT100, IHT100a and D34.

(iv) What are the IHT implications of the Settlor dying within seven years of establishing the DGT?
If the Settlor does not survive the gift by seven years, the IHT liability on the original CLT needs to be recalculated at death rates. If the gift was within the Settlor's available nil rate band (as is recommended), no IHT will be due on the gift itself. However, an equivalent amount of the nil rate band will no longer be available to the estate of the Settlor. If this passes to someone other than the surviving spouse, an IHT liability at 40% will arise on the amount in excess of the nil rate band.

If the nil rate band was exceeded, so that lifetime tax at 20% was paid, the rate of tax charged will increase to 40%. IHT taper relief will be available in which case the IHT liability may start to reduce after the third year because of this taper relief. However, it will never be possible to recover any IHT paid at outset.
What are the IHT implications for the Trust itself?

As this is a discretionary trust, this means that special IHT charging rules apply. Under these rules there may be IHT charges:

- on every ten-year anniversary of the Trust – ‘the Periodic Charge’ and/or,
- whenever property leaves the Trust (e.g. when capital is advanced to a Beneficiary) – ‘the Exit Charge’.

The Periodic Charge

Periodic charges at ten-yearly intervals are, broadly speaking, applied to the value of the assets in the Trust.

The effective rate of IHT will be determined based on an assumed transfer by an assumed transferor. This will mean that it will broadly be necessary to take account of:

- the value of the property in the Trust on the ten-year anniversary and any other trust set up on the same day (the assumed transfer) and,
- the Settlor’s cumulative total of CLTs made immediately before the Trust was established plus any sums paid out of the Trust in the ten years prior to the anniversary (the cumulative total of the assumed transferor).

The maximum liability will be 6% of the value of the trust property but frequently it will be much less or nil.

In cases where the Settlor has not made any CLTs in the seven years before the Trust is created, no payments have been made out of the Trust in the previous ten years and there has been no added property, there will be no liability provided the value of the Trust does not exceed the nil rate band applicable at the ten-year anniversary. Any excess over the then nil rate band will suffer IHT at 6%.

Example

Kevin creates a DGT in July 2009 for £250,000. Kevin has made no CLTs in the previous seven years. No payments are made out of the Trust in the first ten years.

In July 2019 the Trust Fund is worth, say, £385,000 and the nil rate band is, say, £400,000. No IHT is payable.

Had the value of the Plan (and so the value of the relevant property in the settlement) been £450,000, then IHT of £3,000 would have arisen (£50,000 @ 6%). This equates to a charge at 0.66% on the whole value of the trust property.

If all the Trust Fund is distributed before the tenth anniversary, no tax charge will arise (see next section). If assets remain in the Trust after a distribution (or in the unlikely event of further assets being added to the Trust), the Trustees will need to obtain specialist tax advice.

The Exit Charge

Exit charges will be based on the value of property leaving the Trust.

There will be no exit charges within the first ten years of the DGT’s existence if the value of the initial CLT going into the Trust (i.e. the gift) plus the cumulative total of the Settlor’s CLTs in the seven years prior to creating the Trust is below the nil rate band when the Trust is created, assuming no property has been added to the Trust. If an exit charge does arise, it will increase according to the number of quarters that have expired since the Trust was created.

The amount of any exit charge occurring after the first ten years will depend on the rate of tax charged at the previous ten-year anniversary (if any) and the length of time (in quarters) that the property has been in the Trust since the last periodic charge. If there is no periodic charge at the immediately preceding ten-year anniversary then there will be no exit charge in the next ten years.
Example
In 2025, six years since the first ten-year anniversary, the Trustees of Kevin’s Trust pay £50,000 to a Beneficiary. Assuming the rate of IHT paid at the last ten-year anniversary was 0.66%, the IHT charge will be £50,000 x 0.66% x \frac{24}{40} = £198.

No IHT charge will arise on property paid out of the Trust if there was no IHT charge at the last ten-year anniversary.

An exit charge will not arise on loans made by the Trustees to the Beneficiaries.

The occasion of a periodic charge and transactions that can give rise to an exit charge, such as capital payments to the Beneficiaries, may also need to be reported to HMRC on forms 100c and 100d (and form D34 where a life insurance bond is involved) if they exceed a certain amount.

If there are joint Settlors who have contributed equally, the Trust is effectively treated as two separate Trusts, each settled by one Settlor, for all IHT purposes. Where the Trust is to be created by a husband and wife and one (or both) are non-UK domiciled, specialist professional advice should be taken.

5. The Trustees and Beneficiaries
(i) Who can be Trustees of the DGT?
The Settlor will automatically be a Trustee. Additional Trustees should be appointed and this is contemplated in the Trust Deed at outset. Anyone over 18 years old and of sound mind may be appointed. It may be appropriate to appoint a professional adviser, such as a solicitor or accountant, as a Trustee, although such a person is likely to charge a fee for acting as Trustee. It is essential that at least one additional Trustee survives the Settlor if probate is to be avoided following the Settlor’s death.

(ii) Who are the Beneficiaries under the Trust?
The trust benefits are held on discretionary trust for such of the Beneficiaries as the Appointor decides. As the Trust is discretionary, no Beneficiary is entitled to anything until the Appointor makes an appointment in their favour. If any income arises to the Trustees from the trust investments (not relevant while the sole trust asset is the Zurich International Portfolio Bond), they can either accumulate it during the Trust Period or distribute it (or some of it) to whichever Beneficiary they decide. However, no Beneficiary will have the right to any income – distributions will be at the discretion of the Trustees.

The Trustees have powers to deal with the trust property, including wide powers to invest, as well as the power to advance capital to any Beneficiary.
Discretionary Beneficiaries are the people to whom the Appointor can appoint benefits and include the following persons:

- The Settlor’s spouse/civil partner (if he/she is not also a Settlor).
- Children and remoter issue of the Settlor.
- Any spouse, widow or widower of the Settlor’s children and remoter issue. For this purpose spouse includes a registered civil partner.
- Any other person (other than a Settlor) whom the Settlor may appoint to the class of potential Beneficiaries.

An appointment should not be made to the Settlor’s spouse during the Settlor’s lifetime as this could give rise to a reservation of benefit if the Settlor enjoys an indirect benefit.

The Settlor cannot benefit in any way under the DGT. The Settlor names (as ‘Default Beneficiaries’) the individual or individuals who the Settlor would like to benefit from the Trust Fund if no other appointment is made. However, in order for these people to become entitled to benefits, the Appointor at that time (the Settlor or the Trustees – see below) must appoint benefits in their favour. If no appointment is made during the Trust Period, they will become entitled to the Trust Fund at the end of the Trust Period.

(iii) Who is the Appointor under the DGT?
The Appointor is the Settlor(s) whilst alive and then the Trustees. However, if the appointment is in favour of the Settlor’s spouse or civil partner, it must always be made by the Trustees.

6. The investments of the DGT
(i) What investments can be held in the DGT?
The Trust is only available with a Zurich International Portfolio Bond (the Plan), new or existing, and regardless of whether it is based on the life insurance or capital redemption version.

(ii) What are the income tax implications of the DGT?
An income tax chargeable event gain can arise in the event of the Plan being encashed or a part surrender of more than the cumulative 5% tax deferred annual allowances being taken.

If the life insurance version is chosen, the death of the last life insured will also be a chargeable event. For a capital redemption policy, the maturity will be a chargeable event.

As the Plan is an offshore investment plan, there is no UK tax deemed to have been paid on any gain, with the result that the full amount of the gain is subject to UK income tax. Whether any tax is payable and, if so, how much, will depend on the circumstances.

Chargeable event gains will be taxed on the Settlor if alive and UK resident in the tax year in which they arise. Liability to tax will be at the Settlor’s marginal rate(s). For the purposes of the liability to higher rate or additional rate (income over £150,000) tax only, top-slicing relief will apply so, in general, the gain will be divided by the number of whole years the Plan has been in force.

If the Settlor is not alive in the tax year in which the chargeable event occurs, or is not resident in the UK for tax purposes, the Trustees, if they are UK resident, will be liable for any tax on the gain. The gain will be taxed at the trust rate – currently 45% – except for the gains falling within the £1,000 standard rate tax band available to the Trustees, where the tax charge will be at the rate of 20% only.
If the Trustees are not UK resident, the chargeable event gains will be assessed on any UK ordinarily resident Beneficiaries when, and to the extent that, they receive any benefits from the Trust.

The above rules apply regardless of whether the Plan is based on the life insurance or capital redemption version.

7. Other important questions
(i) Should spouses each set up their own individual DGT?
This is not recommended because under the trust underlying each individual DGT, the Settlor’s spouse is a potential Beneficiary and these could then be regarded as reciprocal arrangements and so invoke the gift with reservation provisions. It would be better for spouses to effect one joint Settlor DGT, but neither could then benefit from the Trust. If a DGT is effected jointly, for IHT purposes it will be treated as two separate settlements.

(ii) What are the capital gains tax implications of the DGT?
A life insurance or capital redemption bond, such as the Zurich International Portfolio Bond, does not produce gains that are subject to capital gains tax.

(iii) Is stamp duty payable?
With effect from 1 December 2003, stamp duty on documents was abolished which means that a declaration of trust no longer needs stamping.

(iv) Can the Plan be added to at a future date?
Further investments in the Plan are permitted. These would be further CLTs for IHT. This is likely to complicate the calculation of periodic and exit charges and so it is not recommended.

(v) Can the Trustees encash segments of the Plan and pay the proceeds to the Beneficiaries?
If the Trustees wish to make an advancement of capital to a Beneficiary they can encash a part of or the whole of the Plan and advance cash to the Beneficiary. Alternatively, the Trustees could make an absolute appointment of capital to an adult Beneficiary and assign segments to that Beneficiary in satisfaction of their interest. The Beneficiary must then encash the segments themselves and, in such a case, chargeable event gains will be taxed on that Beneficiary which may produce a lower tax liability than if the Trustees had encashed.

(vi) Why should payments not be made to the spouse of the Settlor whilst the Settlor is alive?
While the inclusion of the Settlor’s spouse as one of the Beneficiaries does not constitute a reservation of benefit, care must be exercised if any benefits are actually paid to the Settlor’s spouse during the lifetime of the Settlor. In practical terms, where the Trustees, as the Appointor in these circumstances, exercise the power of appointment in favour of the Settlor’s spouse, who is one of the Beneficiaries under the Trust, and trust benefits are paid out to the Settlor’s spouse, it is absolutely essential that no part of these benefits finds its way back to the Settlor in any way, directly or indirectly. If this were to happen, the Trust could be seen as one under which the Settlor reserved a benefit and this would make it ineffective for IHT purposes.

In practice therefore, it may be advisable to avoid making such appointments altogether.
(vii) Can an investor get their money back after making the investment?
Yes, they can. When we issue the Plan documents, we’ll send your client details of how to cancel their Plan. They will have 30 days from receiving these documents to do this.
If they decide to cancel, we’ll give them their money back. However, what they get back may not be the amount they invested – they may get back less.

The amount they will get back will be the lower of the amount they invested and the value of their transaction account after we have sold the assets that they have already invested in.

They can also cancel before they receive their Plan documents by calling us, or you notifying us on their behalf.
If they invest in assets that are not priced daily, there may be a delay in paying the cancellation value until all trades have been completed.

Please refer to the Plan’s Terms and Conditions for full details.

(ix) What are the charges associated with an investment in the DGT?
You should look at Zurich Life Assurance plc’s literature on the International Portfolio Bond in order to determine the charges made on such an investment.

(x) How do you set up a DGT?
The Settlor and the additional Trustees complete the DGT Deed. Completion instructions are included in the Trust Deed.

(viii) Is there any income tax on final encashment of the Plan?
Chargeable event gains arising on full encashment of the Plan can be taxable. The full implications were described in the answer to the above question ‘What are the income tax implications of the DGT?’ in section 6(ii).
Creating a trust is an important matter and has lasting legal and tax consequences. This guide is for your general information only and cannot cover every situation. If you are in any doubt about the purpose or effect of this Trust, you should consult your own legal advisers.

The Trust, once created, is irrevocable and the Plan and its benefits must be held according to the terms of the Trust. The Trustees will be in control of the operation of the Trust, which means that they may need to set up a Trustee bank account. Any benefits arising because of the exercise of options available under the Plan will also be held subject to the Trust.

Taxation law is subject to change. Such changes cannot be foreseen. The information in this guide is based on our understanding of current law and HMRC practice (January 2015). Although every care has been taken in the preparation of this guide and the draft Trust Deed, neither Zurich Life Assurance plc nor any of its officers, employees or agents accept responsibility for the operation of the Trust.

Your attention is drawn to the ‘Important information for the Settlor’ section of the Trust Deed.

Important notes
The Zurich International Portfolio Bond is provided by Zurich Life Assurance plc.

Zurich Life Assurance plc is authorised and regulated by the Central Bank of Ireland and subject to limited regulation by the Financial Conduct Authority for the conduct of insurance business in the UK. Registered office: Zurich House, Frascati Road, Blackrock, Co Dublin, Ireland. Registered in Ireland under company number 58098.

We may record or monitor calls to improve our service.