

Investment bonds in trust (Lecture P1349 - 13.29 minutes)

We see investment bonds in trust in various circumstances. Here we are talking about a single premium investment bond of the type which falls within the chargeable event gain regime. They can be used in certain IHT planning tools such as discounted gift trusts or gift and loan trusts, but they can also be a way of getting funds out of a person's estate into a trust where there is no automatic income generated by the investment such that there is no tax liability or reporting of the income. The ability to withdraw 5% of the initial capital without an immediate tax charge is often utilised in the tax planning ideas referred to above but the income does not have to be drawn. Any growth in value of the asset is outside of the estate of the settlor unless the trust is settlor-interested.

The taxation of these products falls within the chargeable event gain regime, but the legislation is complex, mainly because it does not follow the usual rules of trust taxation. The trust will always be subject to the trust rate of taxation (even if it is an interest in possession trust) but any gains will be taxed on the settlor of the trust during their lifetime unless they are no UK resident. In fact, that treatment applies up to the end of the tax year in which the settlor dies. The only deviation from this would be if it was a bare trust since the beneficiary would always be taxable on the chargeable event gain in that situation.

If there is a tax charge on the settlor, it will be assessed as if the settlor owned the bond, so it is possible to claim top slicing relief and the basic rate tax credit will attach to the bond if it is an onshore insurance company. The settlor has the right to reclaim any tax paid from the trustees.

Once the end of the tax year of death of the settlor has passed, the gain will be taxed at the trust rate of tax (other than on the first £1,000 in some cases) with the tax credit still being available. However, trustees cannot use top slicing relief to reduce the tax payable on such gains.

This gives rise to an interesting planning opportunity. The assignment of this type of bond for no consideration to a beneficiary would not create a chargeable event for the purposes of this legislation. The beneficiary would then be treated as holding the bond since commencement and would be able to claim top slicing relief, if beneficial, for the whole lifetime of the bond. Of course, the appointment of capital would also be a chargeable event for IHT purposes and so any potential IHT liability would need to be considered, although the transfer of cash out of the trust after the bond was encashed would also be caught.

Example

A single premium insurance policy is taken out; no withdrawals have been made. This is held in a discretionary trust.

On the death of the settlor, the bond is standing at a gain of £50,000, with total value of £150,000.

The bond has been in place for five complete years.

There is a single beneficiary of the trust who has income of £40,000 before allowances.

What is the tax position:

- (a) For the trust if they encash?
- (b) If the bond is assigned to the beneficiary before encashment?

For the trust

The trust gain of £50,000 is taxed as follows:

1,000 x 20%	200
49,000 x 45%	<u>22,050</u>
Total	22,250
Less tax credit	<u>(10,000)</u>
To pay	<u>£12,250</u>

If this was an offshore bond, then no tax credit would be available, so the tax would be £22,250.

Assignment to the beneficiary

No tax on assignment but the individual's gain is £50,000.

Their other income is £40,000 so £10,270 of the basic rate band is still available, with the balance taxed as follows:

10,270 x 20%	2,054
39,730 x 40%	<u>15,892</u>
Total	17,946
Less tax credit	<u>(10,000)</u>
To pay	<u>7,946</u>

If top slicing was claimed (£50,000/5), all of the gain would be within the basic rate band so no additional tax to pay. This would clearly be a much better situation than if the trust encashed the bond.

Discounted gift trust (DGT)

This is a lump sum investment into a single premium life assurance bond or capital redemption bond held subject to a special trust that gives the right to regular cash payments to the settlor for life with the balance of the trust fund being held for the benefit of the trust beneficiaries.

In particular:

- As the underlying investment is normally a single premium bond, the settlor's regular annual cash entitlement under the trust will typically be equal to 5% of the single premium to utilise the partial surrender rules
- A DGT can be used by joint settlors so that income can continue through both lifetimes
- The DGT can be used with a discretionary trust or a bare trust.

The tax analysis is as follows:

- The DGT involves a 'discounted gift' so the value of the gift for IHT purposes is less than the physical cash introduced into the trust because it is discounted for the income stream due to the settlor. HMRC have set out their view on how such gifts should be valued so there is some certainty about their attitude.
- There is no value remaining within the estate as the retained right has no value at death.
- Cash payments are capital so will be free of tax in the hands of the settlor.
- The initial gift falls out of the estate entirely if the settlor survives for 7 years.
- If the DGT is a discretionary trust, then it will be a chargeable lifetime transfer; if it is a bare trust then it is a potentially exempt transfer.
- If the DGT is a discretionary trust, then there are periodic and exit charges but the value of the assets continues to be discounted for the income stream so that if the initial value was less than the nil rate band (and assuming growth in value is not high) then there is unlikely to be any charge arising.
- No income tax is payable if withdrawals from the bond are within the 5% limit.
- The gift with reservation rules do not apply because the trust carves out the settlor's retained interest from the remaining property from which he cannot benefit.

There are disadvantages however:

- It is only appropriate for those who want a regular cash withdrawal as the amount to be withdrawn must be set at the time the trust is set up and cannot be varied. The investment also cannot be varied.
- The investor must be less than 90 and in good health or there is no discount.
- The investor should spend the cash received as if it is retained then no IHT advantages are received. This is rarely a problem as these types of trusts are typically established because the donor needs to retain income. If the settlor no longer needs the payments once the DGT has been established, they could simply gift the money away to a suitable recipient or waive the right to receive the money (although this will depend on the terms of the trust).
- There will be a gain accruing for the trust on encashment due to the 5% withdrawals being taken and there is no rebasing of the asset at the date of death.

Loan trusts

A loan trust would involve an individual loaning money to a trust of which he is settlor. The loan is typically interest free and repayable on demand. The trustees invest the loan in a single premium bond and can take encashments from this to fund the repayment of the loan.

The way that this operates:

- The settlor would have no ongoing rights under the trust other than the repayment of the loan and the growth of value of the assets are outside the estate.
- Loan repayments are capital and free of tax. As with the DGT, this needs to be spent or given away to give a permanent IHT advantage.
- Some flexibility is possible as loan repayments can be deferred if there is no requirement for income (although the repayment of the loan which is then spent is the key to getting the IHT advantages).
- No gift is made so there are no initial IHT implications.
- There is no gift with reservation as there is no benefit to the settlor under the trust other than the repayment of the loan.
- It would be usual to have a discretionary trust which means that there are 10-year charges but the value of the trust is always reduced by the loan so there is rarely any IHT to pay. No exit charges arise as the money is distributed not as capital but to the settlor as a creditor of the trust. A bare trust could be used if any of these are problematic.

Problems with these types of arrangements are as follows:

- The loan is an asset of the estate and so the planning is only effective over time as the loan is repaid so the settlor must live for a reasonable time.
- The loan will have to be repaid by the trustees and this might cause a problem if the value of investments has fallen as the trustees would then be personally liable. There are mechanisms for limiting this problem by restricting the amount repayable to the value of the underlying assets but there are issues with this type of restriction and so specialist advice should be taken.
- The total amount of income that can be paid to the settlor is limited to the amount of the initial loan so the repayment period must be matched to the age and health of the settlor.

Contributed by Ros Martin