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Are we going to see a resurgence of Loan Trust and Discounted Gift Trust solutions for both UK resident domiciled and UK deemed domiciled investors?

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The recent market correction provides an opportunity for investors to consider the merits of tax-deferment and inheritance tax optimisation/mitigation. Investors will clearly need to take advice before proceeding, but the prospect of capturing future investment gains in a gross roll-up vehicle while leaving them outside of the estate for inheritance tax purposes may be appealing.

As mentioned in our precedent bulletin, the challenging economic environment and costly rescue packages announced will likely put pressure on the UK government to hike tax rates.

On top of this, the coronavirus Pandemic has not only impacted families savings and wealth but also brought to light in many minds one's own mortality.

It should be pointed out that the UK government has not increased the nil rate band for inheritance tax (IHT) purposes since April 2009 (IHT tax free allowance), which currently stands at £325,000 per individual and £650,000 for couples and the IHT rate itself still stands at a whopping 40%, which is the joint 4th highest rate in the OECD. There is an additional allowance when you take into account the family home, of £175,000 per individual, effectively increasing the total allowance to £1,000,000.

Individuals resident in the UK will be subject to inheritance tax on their UK situs assets, but also on their worldwide assets if they are UK domiciled or UK deemed domiciled.

One can, however, mitigate the impact of inheritance tax by making gifts via potentially exempt transfers, or PETs, in which case one must survive 7 years for the PET to be inheritance tax free or 3 years to benefit from taper relief, which reduces each year thereafter. Importantly, there are no limits on the amounts that can be gifted. This contrasts with many mainland European jurisdictions where a gift tax may be payable above a certain threshold immediately at the point of the gift.

Depressed values of portfolios may offer an excellent opportunity to make gifts now at those lower values. The value of a gift is based on value at that time. A portfolio that was worth say £10m at the start of the year would have a value for IHT purposes of £4m whereas a portfolio currently worth £7m would only have a value for IHT purposes of £2.8m.* Not all clients are willing or able to make gifts as they still rely on these assets to fund their lifestyle. There are some life insurance structures which offer some interesting options for these clients.

Option 1

Loan Trust investing into a UK compliant Luxembourg Life Policy

One could consider an interest free loan into a discretionary trust (Loan Trust) by a UK domiciled or deemed domiciled individual. As it is funded via a loan there is no 20% entry charge above the nil rate band but there is a 10 yearly charge of 6%. It is worth noting however that the value of the loan is deducted. The trust then invests into a UK compliant Luxembourg life policy. The client can access his loan via 5% tax deferred withdrawals, which accumulate if not taken. Any growth within the policy held by the trust is outside the estate. Evidently, the longer the policy is held the greater the effect of compounding and the more potential growth will ultimately be outside the client's estate. The client could use the repayment of the loan to fund their lifestyle but it should be noted that any outstanding loan will fall within the client's estate on death.

Option 2

Discounted Gift Trust solution

Some clients may want to immediately mitigate the effects of inheritance tax on family wealth but at the same time need to live off the funds, rather than simply giving them away to children or grandchildren. Unfortunately, when you give funds away you cannot be seen to benefit. This is known as a gift with reservation of benefit and would undermine the intended potentially exempt transfer.

A Discounted Gift Trust (DGT) Policy may therefore be appealing as it allows one to make a gift, receive a right to an annual tax deferred 'income', receive an immediate discount for IHT purposes and allow the investment returns to roll-up gross of tax. This is recognised in practice by HMRC, with workings on the discount calculation on HMRC's website. So how does this work?

Let's use an example. I am 67 years old, an entrepreneur, and have 2 children. My portfolio is currently worth £7m (using the example above) due to the recent market correction. I require an annual 'income' from the assets of 3% p.a. or £210,000 to live off each year comfortably.

I want to also provide for my children but I do not want them to be able to access the funds until after I pass away and even then, only up to a certain amount each year.

I subscribe a DGT Policy for £7m. I assign the policy into bare trust for the benefit of my two children and carve out a right to an annual income of 3% of the initial value of the policy. As long as I am still alive my children will have no access to the funds and I will receive my £210,000 annually from the policy. The policy is invested on a discretionary basis with an approved investment manager.

As the funds invested in the policy are gifted away, I have no reporting or tax requirements, which simplifies administration.

From an IHT perspective, because I will receive an annual income for life (as long as there is value in the policy), the present value of these payments is calculated based on HMRC's guidelines and my health.

An example for a healthy 67 year old taking 3% p.a. could be a value of approximately 32% of the £7m i.e. £2.24m. This amount on day 1 would be immediately outside of my estate for IHT purposes. An immediate reduction of £896,000 in potential IHT would be achieved.

The remaining amount i.e. £7m - £2.24m = £4.76m would be seen as a PET and the normal 7 year rule would apply.

I am also concerned there could still be some substantial wealth left at my death, so I want to build in extra protection. I can do so by specifying that my children will have access to a maximum of, for example, 5% p.a. for the 10 years following the date of my death.

In short I have achieved the following with my planning:

> Made an immediate reduction in my potential IHT liability;

> Mitigated inheritance tax on the remainder, assuming survival for at least 3 years;

> Carved out a right to receive an annual tax deferred 'income';

> Protected the children by ensuring they do not receive the wealth during my lifetime;

> Protected my children from having access to too large a sum of money on my death.

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