

# Discounted Gift Trusts: Bare Trust and Discretionary Trusts

## Introduction

Since March 2006, making a gift into an interest in possession (IIP) trust is treated in the same way as a gift into a discretionary trust for inheritance tax (IHT) purposes.

Most discounted gift trust (DGT) providers now offer discretionary and bare trust versions, enabling the adviser to recommend whichever trust will suit their client's circumstances.

## Value of the gift

The choice of trust will have no impact on how the value of the gifted element of the plan is calculated. The gift will be the value of the investment less the value of the settlor's rights under the plan (the estimated value of the regular withdrawals which are likely to be paid over their lifetime). However, the choice of trust will determine whether the gift will be taxed as a potentially exempt transfer (PET) or as a chargeable transfer.

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## Bare trust

If the settlor is absolutely certain about their choice of beneficiary or beneficiaries, they might choose a bare trust. However, they would have to accept that they would not be able to add or remove a beneficiary if their family circumstances changed.

A gift to a bare trust continues to be classed as a PET with no immediate tax charge. If someone is considering a DGT, and can live with the lack of flexibility, a bare trust might be chosen to avoid the IHT charges which would apply if a discretionary trust is used.

## Discretionary trust

This trust would be suitable if the client wants flexibility over who eventually benefits from the trust. The trust has a very wide class of beneficiaries including:

- the settlor's children and their direct descendants,
- the settlor's parents and their direct descendants,
- anyone married to, or in a civil partnership with, any of the above people,
- anyone entitled to benefit under the settlor's will.

The client does not actually name anyone as an intended beneficiary. However, a letter of wishes can be completed which will indicate the current choice of beneficiaries to the trustees, although the trustees are under no obligation to follow this indication. Some trusts also allow the settlor to add to the list of potential beneficiaries if required.

The IHT issues must be taken into account when using a discretionary trust.

### Possible immediate tax charge:

If the value of the settlor's discounted gift, together with any chargeable transfers made by them within the previous seven years, exceeds the then current nil-rate band, there will be an immediate IHT charge of on the excess. The current rate is therefore 20% (that is half of the 40% death rate). For more details, please see Inheritance Tax - Chargeable Lifetime Transfers.

### Possible ongoing tax charges:

There could also be a tax liability on every 10th anniversary of the trust's commencement and when money leaves the trust. For details, please see Inheritance Tax - Ongoing Tax Treatment of Trusts.

## The rights of beneficiaries under a DGT

### Bare trust

The beneficiaries of a bare trust have a clear entitlement to their share of the remaining capital on the death of the settlor. If one of the beneficiaries under a bare trust dies, their rights form part of their estate and pass under the terms of their will or the laws of intestacy. Although it is possible to estimate the value for tax purposes of this right, the true value cannot be determined until after the settlor's death.

Therefore, the beneficiaries of a bare trust, or anyone else claiming under/against these rights, is unlikely to be allowed access to that beneficiary's share of the trust fund during the settlor's lifetime. Those claiming against the beneficiary's rights would include creditors, executors and divorce lawyers.

### Discretionary trust:

In contrast, the beneficiaries of a discretionary trust have no rights until an appointment is made in their favour. If an appointment was made after the settlor's death, the value of the appointed beneficiary's share is apparent. Prior to the settlor's death, the value can only be estimated.

## Planning to avoid the IHT charges associated with discretionary trusts

It is important to remember that it is the value of the discounted gift, not the value of the bond investment, which is taken into account when calculating the potential initial IHT charge.

If a client wishes to set up a DGT using a discretionary trust, they will be keen to ensure that the value of their discounted gift is below their available NRB. Care is required when setting up a discretionary trust DGT if the value of the discounted gift is for an amount just below the current NRB. Future growth might increase the gifted element to an amount which triggers a small periodic charge as subsequent 10-year anniversaries, because the then value of the gifted element is in excess of the NRB applicable at that time. Advisers may wish to consider leaving a suitable margin between the settlor's available NRB and the value of the discounted gift.

Up-front underwriting, offered by some providers, will assess the value of the client's discount before the investment is made, enabling the amount of the investment to be adjusted, if necessary.

## Using a combination of a discretionary and a bare trust

For applicants with larger amounts to invest, they may be advised to set up two DGTs:

- investing an amount in a discretionary trust DGT which produces a discounted gift value which is below their available nil rate band, and
- investing the surplus amount in a bare trust DGT.

Ideally, both trusts should be set up on the same day. What this means in practice is:

- the policies should be issued on the same day where the trusts become effective when the policy is issued, or
- the date the declaration of trust is completed if the plan is set up using a settlement followed by a trustee investment.

If the plans cannot be set up simultaneously, the plan using the discretionary trust should be set up before the plan using the bare trust.

Either action avoids the possibility of the bare trust gift being included when a 10-yearly charge is calculated under the plan using a discretionary trust, if the settlor dies within seven years of creating the bare trust plan.

## Multiple applications on the same day and related settlements

Some advisers may have concerns about the related settlements legislation when creating both trusts on the same day. If the related settlements legislation were invoked, when the periodic charges under the discretionary trust are calculated at a 10-yearly review, the gifted element of the bare trust would be included in the calculation.

However, HM Revenue & Customs have confirmed that a bare trust would not constitute a 'settlement' for IHT purposes. Therefore, the gifted element of the bare trust can be ignored for this purpose.

## Important information

This factsheet is based upon our understanding of current tax and other legislation at the release date and may be subject to change in the future. Whilst every care has been taken to ensure the accuracy of this information, Friends Life can accept no responsibility for any actions taken as a result of this release.

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