

How effective are discounted gift trusts for Inheritance tax planning?

Discounted gift trusts (DGTs) are the most popular life assurance based inheritance tax (IHT) structure. Financial advisers regularly recommend them to clients who wish to reduce inheritance tax, whilst retaining access to an ongoing income. But how effective are these schemes? We will compare the financial return, i.e. after both IHT and any other taxes for the following scenarios:

1. No planning – a unit trust holding is retained within the estate
2. Discounted gift trust utilising an onshore bond
3. Discounted gift trust utilising an offshore bond
4. Tax efficient discounted gift trust utilising offshore bonds
5. Reversionary interest trust utilising unit trusts
6. Reversionary interest trust utilising offshore bonds

We will look at two different holding periods, ten and twenty years, assuming that in both cases the investor dies and the entire capital is paid to the beneficiaries on death in the most tax efficient manner available. DGTs must pay an income and so most are set up with a 5% per annum income payment, which we will use as the benchmark to compare each planning structure. Returns will be shown for different scenarios where the investor and beneficiaries are either higher or basic rate taxpayers.

Further assumptions:

- An initial investment of £250,000, providing an income of £12,500 per annum (5% of initial capital)
- Multiple trusts are utilised so no IHT periodic or exit charges are payable
- The IHT nil rate band and trustees CGT exemption rate grow by 3% per annum
- The investment return is 6% per annum gross (assuming a zero dividend yield)
- An onshore life assurance bond is subject to tax of 18% reducing the net return to 4.92% per annum
- Charges within each holding structure are the same, and the investment return is net of charges
- The no planning scenario assumes that the full capital will be subject to IHT at 40%

Table 1: Death of investor and appointment of capital in year 10, £125,000 of previous withdrawals

Scenario		1	2	3	4	5	6
Investor tax rate	Beneficiary tax rate	No planning Unit Trust in estate	DGT Onshore Bond	DGT Offshore bond	Tax efficient offshore DGT	Reversionary Interest Unit Trust	Reversionary Interest Offshore Bonds
40%	40%	£169,771	£222,995	£219,771	£264,626	£260,594	£217,882
40%	20%	£169,771	£247,494	£251,362	£264,626	£260,594	£241,254
20%	40%	£169,771	£222,995	£219,771	£274,401	£260,594	£225,931
20%	20%	£169,771	£247,494	£251,362	£274,401	£260,594	£250,166

Table 2: Death of investor and appointment of capital in year 20, £250,000 of previous withdrawals

Scenario		1	2	3	4	5	6
Investor tax rate	Beneficiary tax rate	No planning Unit Trust in estate	DGT Onshore Bond	DGT Offshore bond	Tax efficient offshore DGT	Reversionary Interest Unit Trust	Reversionary Interest Offshore Bonds
40%	40%	£205,195	£194,754	£205,178	£259,371	£299,410	£187,972
40%	20%	£205,195	£243,442	£273,571	£259,371	£299,410	£223,671
20%	40%	£205,195	£194,754	£205,178	£305,088	£299,410	£221,104
20%	20%	£205,195	£243,442	£273,571	£305,088	£299,410	£263,096

Over both 10 and 20 years periods the returns are shown net of any tax liabilities, and no IHT is payable under any of the IHT schemes (scenarios 2 – 6) as the investor has survived for seven years from the date of the initial gift. All options would provide the same £12,500 per annum income.

Key findings

- On death at 10 years each IHT plan would provide greater net proceeds to beneficiaries than by undertaking no planning. The tax efficient DGT would provide the highest proceeds with **53% more than with no planning**.
- **Over 20 years not all schemes would provide a higher amount to beneficiaries than by undertaking no planning.** Where the beneficiaries are higher rate taxpayers then the standard onshore and offshore DGTs and reversionary interest trust offshore bond would provide net returns below those provided by 'no planning'. However, the **unit trust reversionary interest scheme would provide beneficiaries with £299,410 net proceeds or some 45% more** than the 'no planning' scenario.
- The tax efficient DGT provides superior returns to all the other schemes over the 10 year period and in three out of the four scenarios over 20 years, where for a higher rate investor it would underperform the standard offshore bond DGT and unit trust reversionary scheme.
- The unit trust reversionary scheme provides greater net proceeds than the other schemes, bar the tax efficient DGT. However, it outperforms the tax efficient DGT over 20 years when the investor is a higher rate taxpayer.
- The unit trust reversionary scheme provides superior returns than the offshore bond reversionary scheme for both periods and across all tax scenarios. Over 20 years the unit trust variant would provide 60% more where the investor and beneficiaries are high rate taxpayers.
- The onshore DGT provides broadly similar returns to the offshore scheme over 10 years, but the offshore DGT is superior for all tax scenarios over 20 years, showing the advantage of 'gross roll-up' offshore.
- The onshore and offshore DGTs and offshore reversionary scheme are unattractive when the beneficiaries pay higher rate tax. The **tax efficient DGT would provide proceeds 48% higher than the offshore DGT over 20 years**, where the investor is a basic rate taxpayer but the beneficiaries pay higher rate tax.

Conclusion

The figures illustrate the importance of undergoing a detailed analysis of all options for each individual client situation. A one size fits all approach is seldom suitable. The charging basis, revenue acceptance, investment options and trust flexibility all need to be considered in light of specific client requirements. However, the figures clearly demonstrate that standard discounted gift trusts compare very unfavourably to the tax efficient DGT and the unit trust reversionary scheme. Most insurance companies only offer basic schemes, which are not nearly as flexible or tax efficient as the more specialist schemes such as the tax efficient DGT and reversionary unit trust. Therefore, it is imperative that specialist independent advice is sought before any immutable schemes are implemented.

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