A plan that's not too taxing

The discounted gift trust (DGT) is a recognised inheritance tax planning vehicle, available through investment bonds from life assurance companies. It allows you to gift cash to a trust, held for the ultimate use of your beneficiaries.

The aim is to avoid inheritance tax on this money. Normally when you make a gift, you have to survive seven years for it to fully escape inheritance tax at 40 per cent. The rules dictate that you can't use the asset once gifted, otherwise it is a "gift with reservation of benefit" and is caught for inheritance tax.

The DGT, however, gets around these problems quite legitimately. When setting up the DGT, a condition is that you take a fixed regular capital withdrawal for life from the trust, normally a tax-efficient five per cent per annum, which you can spend as income. On setting up the arrangement, an actuarial forecast (based on age, gender and health) is made as to how much you are going to withdraw over your lifetime. This amount is known as the donor's fund.

Because the withdrawals are fixed, you are carving out this amount for your own benefit and so it is deemed not part of the gift you have made to the trust. This means the gift element for inheritance tax purposes is less than the amount you have actually gifted to the trust and hence a discounted gift.

As an example, a female aged 60 in good health, gifting £100,000 and taking five percent withdrawals (£5,000) each year, results in a donor's fund (or discount) of £67,000. For IHT purposes, she has made a gift of only £33,000, which takes the usual seven years to fall outside the estate.

The really interesting part is what happens to the £67,000 donor's fund. Although this amount was carved out of the gift for tax purposes, it is still part of the trust fund itself. It therefore does not remain within the estate and so there is no inheritance tax on it any time.

The net result is that on setting up the trust, the £67,000 is immediately exempt from inheritance tax and the full benefits of the DGT in this example would be:

- 67 per cent of the amount placed in the trust is immediately exempt from inheritance tax.
- A five per cent p.a. income is provided for life (no income tax on this for the first 20 years).
- 33 per cent of the amount placed in the trust is exempt from inheritance tax after seven year.
- On death, the trust fund simply pays out to the beneficiaries the full value of the trust's assets (the donor's fund and the gift element).
- Any growth in the fund is free of inheritance tax.

The above figures do of course work for larger sums as well, so a wealthy individual gifting, say, £1 million would save an enormous amount in inheritance tax immediately, not to mention deriving a generous £50,000 tax-efficient income for life — a compelling proposition. The above example assumed a "bare trust" DGT was used.

This means the beneficiaries cannot be changed once selected at outset and there is no limit as to how much one can gift to this type of trust. In certain cases, a discretionary trust arrangement would be more appropriate, because it allows a change in beneficiaries at any time, for example to accommodate future grandchildren, or perhaps to safeguard against divorce.

Historically, however, there have been limits to how much you can gift to a discretionary trust, because if you gift more than the available nilrate band (currently £325,000) you have to pay a tax charge of 20 per cent on the excess. With a discretionary trust DGT, it is the discounted gift that is relevant here. Taking our example above, providing the 33 per cent deemed gifted element does not exceed £325,000, one can gift significantly more than the usual limit to a discretionary trust without triggering a tax charge —£985,000 in this case.

No other vehicle allows you to gift such a large amount to a discretionary trust arrangement without having to pay a 20 per cent tax charge. The DGT is unique in that it achieves an immediate reduction in the estate and fully exempts an asset from inheritance tax after seven years, yet it allows you to take an income for life and HMRC even recognise it as legitimate tax planning.

One must appreciate though, the absolute need for professional and experienced financial advice from an advisor specialising in estate planning. This must not be left to the layman and I generally work together with clients' lawyers and accountants when advising on and setting up this vehicle.

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