TECHNICAL SALES BRIEFING

ASSIGNMENT OF A BOND INTO A DISCOUNTED GIFT TRUST AND IHT PLANNING

This Technical Sales Briefing:

- looks at an area of overseas single premium bond taxation from the point of view of a UK resident investor
- looks at the use of an existing overseas bond and how its conversion (assignment) into a Discounted Gift Trust (DGT) can be beneficial for Inheritance Tax (IHT) planning.

Before looking at the conversion scheme in more detail, it is important to understand why the DGT can be a valuable tool in the context of IHT planning.

USING LIFETIME GIFTS TO REDUCE IHT AND THE DGT

An effective way to mitigate IHT is to make lifetime gifts.

There are three ways of making lifetime gifts; exempt transfers, potentially exempt transfers (PETs) and chargeable lifetime transfers (CLTs). Exempt transfers will include, but are not limited to, transfers to UK long-term resident spouses[1] and civil partners and transfers which do not exceed the annual exemption.

PETs do not cause an immediate IHT liability when made and will fall out of account providing the donor survives seven years. However, a PET only occurs when an outright gift of assets is made to another individual or an absolute (bare) trust.

Broadly, post 6 April 2006, all other lifetime gifts to trusts will be CLTs, which may be chargeable to IHT at outset and also during the lifetime of the trust. Such trusts are taxed under the relevant property (discretionary) regime which pins the IHT charges to the trust itself, rather than to any individual. They can arise at the time the trust is settled, periodically and when capital leaves the trust. Furthermore, following the changes announced in the 2024 Autumn Budget there can also be exit charges if the settlor becomes non-long term resident on or after 6 April 2025[1]. The potential IHT charges that may arise as a result of the trust being a relevant property trust are therefore the price to be paid for the flexibility provided by the discretionary nature of the trust.

In circumstances where a discretionary trust is being considered, a DGT could help mitigate IHT, especially as the settlor gets older.

A DGT usually takes the form of a lump sum investment into a trust that helps an investor to mitigate IHT whilst providing them with a regular stream of rights – ordinarily in the form of either regular cash payments or policy maturities. Here, life insurance policies, or capital redemption bonds, are commonly used as the underlying investment to make use of the favourable tax-deferred treatment of partial surrenders, i.e. the 5% tax-deferred entitlement.

The DGT can help mitigate the potential charge to IHT should the settlor not survive the necessary seven years for the CLT to fall out of charge.

[1] The 2024 Autumn Budget changed the UK IHT system from a domicile-based system to a residence-based system from 6 April 2025, although the domicile-based system still applies until this date. From 6 April 2025 a person will be liable to UK IHT if they are long-term resident at the time of their death, meaning that they have been UK tax resident for at least 10 of the last 20 tax years. From 6 April 2025 the spousal exemption only applies to transfers to spouses who are long-term resident with transfers to non long-term resident spouses still restricted to the prevailing Nil Rate Band (unless they have made an election to be treated as long-term resident).

WHY USE A DGT IF CONSIDERING A DISCRETIONARY TRUST?

A DGT on a discretionary trust basis enables the settlor:

- to make a tax-efficient gift that has a lower transfer of value for IHT purposes than the amount of the investment (on the assumption a discount is provided)
- to make the gift without incurring an immediate IHT liability (below the nil rate band)
- to appoint trustees who can retain flexibility over the ultimate beneficiaries of the gift
- to take the value of the gift outside of their estate if they survive seven years from the date of the gift
- to put any investment growth outside of the estate from the time of the gift
- to make a gift and continue to take tax efficient withdrawals of capital from the gift for the rest of their life (or until the fund is exhausted) without falling foul of the gift with reservation rules. Note, the level of withdrawals is fixed at outset and cannot be stopped during the settlor's lifetime. The 'income' from them must be spent or gifted or it will remain inside the settlor's estate for IHT purposes.

HOW DOES A DISCOUNTED GIFT TRUST WORK?

A DGT is made up of two parts. The first part is a trust with the second part being an investment which the trust owns.

At the point that the bond is gifted into the DGT, the value of the existing bond is then split into two notional parts. These parts are treated differently for IHT purposes:

THE GRANTEE'S FUND OR THE SETTLOR'S 'RETAINED' FUND

This is often referred to as the 'discount' and is an estimate of the present value of the total amount that will be paid to the settlor in regular withdrawals of capital or policy reversions from the trust throughout their lifetime. The amount they actually receive could be more or less than this estimation. These rights are then either carved out under the terms of trust ("trust level carve out") or under the terms of the underlying bond ("bond level carve out").

The estimated discount is based on a number of factors including:

- the chosen amount and frequency of withdrawals
- the settlor's life expectancy (age and state of health)
- any withdrawals taken from the bond before setting up the trust.

The discount reduces the transfer of value and so reduces the amount that will fall back into charge should the settlor not survive seven years. Providing the subsequent monies are spent by the settlor then these will also not be within the estate on death and any subsequent growth will be held within the trust for the beneficiaries. As the settlor carves out the settlor's rights prior to settlement, and the settlor cannot benefit from the gifted fund, DGTs do not fall foul of the gift with reservation rules.

All DGT schemes are fully underwritten to accurately reflect the value of the settlor's open market rights.

THE GIFTED FUND

- Sometimes referred to as the Residuary Fund, this is the gift into trust, and is the value of the transfer into trust minus the estimate of the total amount that will be paid in regular withdrawals (the discount).
- The gift is outside the settlor's estate after seven years. If the settlor dies within seven years of making the gift, the gift will fail and could become potentially liable to IHT.

SETTING UP A DGT

When used with life policies there are two ways in which a DGT can be established. A new investment bond can be purchased by the trustees following a gift of cash. Alternatively, an existing bond can be assigned into a DGT.

This briefing focusses on the latter arrangement, how it works in practice and the advantages of using this method to create a DGT.

WHAT IS DIFFERENT ABOUT THE CONVERSION?

Where an existing bond is to be placed into trust by the policyholder, they become the settlor of the trust and complete a DGT deed. This deed will name the pre-existing bond which incorporates an assignment of the bond to the trustees.

Legislation in this area (para 7 Schedule 20 Finance Act 1986) confirms that the use of a life assurance bond for a DGT can be problematic for conversion schemes. This is because the trust will give rise to gift with reservation if the settlor, or their spouse, are also the life assured and the rights the beneficiaries are entitled to can vary dependent on the rights of the settlor. Where a conversion scheme is being used it is therefore important that the policy is a capital redemption bond or a life policy written on the life of someone other than the settlor, as the provisions of this specific legislation do not then apply.

WHY USE THE CONVERSION OPTION IN CONJUNCTION WITH A BOND?

In situations where an immediate solution to an IHT issue is necessary the option to convert will not be helpful.

However, in many situations, the conversion option may be very appealing for a policyholder who is concerned they could have an IHT problem in the future and wants to start planning now.

By taking out an overseas bond which is compatible with a DGT conversion, they can start to benefit immediately for a number of reasons:

› an overseas bond structure can invest into gross share classes so that growth in the underlying fund is not taxed at source, meaning better growth in the trust fund
› the tax-deferred 5% entitlements can begin to accrue immediately, increasing the withdrawal flexibility down the line
› as top-slicing relief on surrender goes back to the inception of the policy, the longer the bond is held, the more potential relief will be available
› if the policyholder's needs change, they are not immediately committed to the DGT structure and fixed income
› they can also wrap the bond into an alternative trust, such as a conventional gift trust if their circumstances demand it.

Once the bond has been placed into the DGT structure, in order to be effective for IHT planning, it cannot be surrendered or assigned during the lifetime of the settlor.

EXAMPLE 1

Clive, who is 64 and single, has £300,000 in savings from income to invest. He is aware that his elderly mother will be leaving him a legacy in her will but of course does not know when he will receive it. Further, Clive's mother is reluctant to tell him the potential value of her estate and also unwilling to discuss the precise details of the will as she feels this is her personal business.

Clive owns a property as well as other assets upon which his executors will have to pay IHT when he passes away. He is concerned that his IHT bill may increase if he receives a legacy from his mother, much of which will depend on how she's structured her will.

He decides to invest into an overseas capital redemption bond, which includes an option to transition to a DGT at a later date.

The bond is issued on 1 September 2020 and is comprised of 60 identical policy segments.

Clive's mother passes away five years later and the significant cash legacy she leaves to Clive means that he has a potential IHT problem to solve. He needs some income from his bond investment to supplement his pension income, but wants the growth on the investment to be outside his estate and to begin to pass some assets to his children and grandchildren.

Clive has options here; he could vary his mother's will using a deed of variation to bypass him and pass the inheritance straight onto his children and/or grandchildren or perhaps set up a trust via the variation. He could also disclaim the legacy which would then pass to the residuary beneficiaries.

Clive certainly doesn't want to spoil his grandchildren by making outright gifts to them. Further, if he disclaims the legacy, then under the terms of the will the monies will end up with his children, which is not in line with his requirements.

He considers varying the will to create a trust, but instead he opts to simply wrap his entire overseas bond into a discretionary DGT making use of the conversion scheme. Clive has made no other gifts prior to making this settlement.

On 2 September 2025 the bond is valued at £380,000. Clive has taken no withdrawals from the policy since inception, but under the DGT elects to withdraw 5% of his original premium of £300,000. He takes these withdrawals on a monthly basis, meaning he will receive £1,250 per month until his passing or until the fund is exhausted.

Once Clive has completed the conversion, his bond provider sends him a certificate of valuation which confirms the following:

The value of his gift is	£229,752
Therefore the discount is	£150,248

This gives Clive an immediate potential IHT saving of £60,099 should he die within seven years of making the gift. Conversely, had he simply transferred the policy into a discretionary trust then the value of the gift would be £380,000 resulting in a chargeable transfer of £374,000 after utilising the annual exemptions for 2025/26 and 2024/25. As this exceeds the nil rate band of £325,000 for 2025/26 then the transfer of value would give rise to IHT charges. Here the discount has allowed a greater amount to be settled into trust and given rise to a potential IHT saving should Clive die within seven years.

EXAMPLE 2

We will now consider Clive's twin brother, Robert. Robert is anticipating a smaller legacy from his mother having received some significant financial assistance from her following a costly divorce. Following his mother's death, the cash legacy he receives is, as predicted, half the amount that his brother received.

Robert is retired and is already receiving a pension and thus his need for bond income is lower than that of his brother. He still has an IHT issue as a result of the legacy from his mother and therefore the DGT scheme could still be an option. The regular withdrawals it pays will supplement his pension income and allow him to maintain his lifestyle.

In September 2025, Robert's bond provider allows him to split his bond consisting of 60 identical policy segments into a separate cluster of policies, which holds exactly half of his original policy segments. (Note: this is not a chargeable event as the individual polices have not been varied – they were simply held under one schedule previously.)

Following this split Robert can then convert the 30 policies comprising the new cluster policy into a DGT, whilst retaining full ownership of the first cluster of policies which he may need to access beyond the fixed withdrawals.

For conversion purposes, the new cluster of policies contains 30 segments and therefore has a total policy value of £190,000. After the conversion, withdrawals will be £625 per month.

The value of his gift is	£74,624
Therefore the discount is	£115,376

This gives Robert an immediate potential IHT saving of £29,849 should he die within seven years of making the gift.

In the examples above, we can see that the policyholder has been able to benefit by taking the bond out immediately, rather than waiting until an IHT issue arose. Following the settlor's death the trustees can then assign policies to the beneficiaries to enable them to use their own rates of tax and potentially benefit from top-slicing relief on surrender – with the relief based on the entire period the bond has been owned.

For further details, refer to our **Technical Sales Briefing for Top-Slicing Relief,** available at **www.utmostinternational.com**

SUMMARY

In summary, a bond with an option to later place the investment into a discretionary DGT provides:

- an immediate investment into a tax-efficient structure
- the flexibility to gift the investment into trust later down the line
- the ability to retain access to the capital and growth within the policy should circumstances change
- the option to use the DGT conversion option on all or just part of the existing bond (subject to provider and their terms and conditions).

In summary, a bond with an option to later place the investment into a discretionary DGT provides:

- an immediate investment into a tax-efficient structure
- the flexibility to gift the investment into trust later down the line
- the ability to retain access to the capital and growth within the policy should circumstances change
- the option to use the DGT conversion option on all or just part of the existing bond (subject to provider and their terms and conditions).

A WEALTH *of* DIFFERENCE

UL PR 00318 | 01/25