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TECHNICAL SALES BRIEFING

UTMOST INTERNATIONAL ISLE OF MAN LIMITED'S ESTATE PLANNING BOND AND THE ISSUE OF FLEXIBILITY

The following information is based on our interpretation of current law and taxation practice in the Isle of Man and the UK as at 1 February 2019.

- This briefing looks at the suggestion that Utmost International Isle of Man Limited's Estate Planning Bond (EPB) is perhaps less flexible than other discounted gift schemes in the market. On the face of it this may appear to be true, as other schemes may have the ability, in theory, to make certain payments. However, such payments could potentially cause problems from a taxation perspective. The briefing explains why, in practice, this so-called flexibility does not necessarily exist or may not even be desirable.
- Essentially, a 'trust level carve-out' scheme and a 'bond level carve-out' scheme operate in the same manner. Whilst a 'trust level carve-out' scheme may appear to have more flexibility, in practical terms this flexibility is usually restricted to the trust level scheme's ability to change the underlying investment vehicle within the trust.

INTRODUCTION

Discounted gift schemes are available from many product providers and fall into two basic types:

A) A 'TRUST LEVEL CARVE-OUT'

– this is a scheme whereby the 'income' rights are paid to the Settlor by the Trustees. The Trustees are responsible for paying the pre-determined 'income' rights as defined in the trust instrument and must make provision to do this. Under this type of scheme it is possible to change the underlying investment vehicle.

B) A 'BOND LEVEL CARVE-OUT'

– under this type of scheme the 'income' rights are paid directly to the Settlor from the underlying investment, i.e. the investment bond inside the trust. This scheme does not depend on the Trustees to make an accurate payment of the pre-determined trust 'income' and will automatically make the payments at the pre-determined date. This releases the Trustees from having to make or account for the payments to the Settlor.

Both the Utmost International Isle of Man Limited EPB and DGT (the conversion scheme) are issued using a 'bond level carve-out'. Whilst the bond cannot be surrendered during the lifetime of the Settlor(s), the underlying investment funds linked to the bond within it can of course be changed by the Trustees.

Over the years, other providers have suggested that a 'trust level carve-out' provides more flexibility than a 'bond level carve-out' scheme. This briefing outlines how, whilst this may appear to be the case, the reality is that this flexibility cannot be utilised without potentially serious tax consequences.

IS FLEXIBILITY A GOOD THING?

Firstly, we need to understand why it may be suggested that 'trust level carve-out' schemes are more flexible.

› Under a 'trust level carve-out' scheme, assets / products within the trust can usually be changed, so, for instance, the original investment bond could be replaced with another investment bond from another provider.

› Other aspects of these schemes that are often cited as 'flexibility', including the ability for Trustees to pay any tax charge, are fraught with difficulties and we have outlined some potential problems in the following pages.

› Following the Finance Act 2006, changes to the trust rules meant that, in the main, providers no longer issue Interest in Possession trusts and adopted Discretionary trust drafts instead.

A) THE TRUSTEES OF A 'TRUST LEVEL CARVE-OUT' SCHEME ARE REQUIRED TO PAY THE INHERITANCE TAX DUE ON THE PERIODIC CHARGE AT THE FIRST 10 YEAR ANNIVERSARY.

The Trustees of such a scheme would therefore need to make a payment to cover this tax charge. This would either be done by way of **surrender of individual policies** or **withdrawal across all the policies**.

The Trustees are liable to pay the tax generally at 6% of the excess of the trust value over the Nil Rate Band at the 10 year anniversary, so they would calculate the liability using this rate and make the necessary surrender instruction. This instruction would be possible on a 'trust level carve-out' scheme as the Trustees remain in control of payments.

SURRENDER OF INDIVIDUAL POLICIES

The surrender of individual policies would mean that, after surrender, the bond had fewer remaining policies. The Settlor's 'income' level would have been based on the original premium and calculated on this basis. The Trustees now have to continue to make the payment but would have less 5% annual tax deferred entitlement available. Therefore, the surrender of individual policies to pay the inheritance tax and the ongoing 'income' payments to the Settlor would trigger chargeable events and potential income tax charges for the Settlor.

FOR EXAMPLE

Sandra, aged 82 next birthday, invested £450,000 into a discounted gift scheme on 1 July 2006. The investment bond is established with 100 segments. Sandra takes 5% withdrawals monthly and the discount is calculated as £175,000. Sandra made no previous transfers in the last seven years so the chargeable transfer is below the Nil Rate Band (£285,000 for 2006/07) and there is no immediate tax charge. In this example the 5% annual tax deferred entitlement would equate to £22,500.

The value of the policy at the ten year anniversary on 1 July 2016 is £544,610. Sandra is still alive and now aged 92 next birthday. Using the Actuarial Assurance Factor, the Open Market Value (OMV) of the policy is £436,534.

The discount applicable to the OMV for a 92 year old is £101,683 - calculated using the methodology and actuarial tables currently in force. Therefore the value of the relevant property is £436,534 - £101,683 = £334,851. The value over the Nil Rate Band on 1 July 2016 is therefore £9,851.

The Trustees have to pay the periodic charge and this is calculated at £591 {(£334,851 - £325,000) x 6%}. So they surrender 1 segment to pay for this which equates to £5,446.10 which is more than the tax due on the periodic charge.

After the transaction, there are now only 99 policies remaining for them to make future payments of 'income' rights to the Settlor. These 'income' rights must be paid under the terms of the trust. The 5% annual tax deferred entitlement (post surrender) is now based on the original investment into the remaining 99 policies, which is calculated as £445,500 i.e. 99 x £4,500. This would therefore mean any 'income' over and above £22,275 (£445,500 x 5%) would create a chargeable event, i.e. all future payments of £22,500 would create chargeable events in the hands of the Settlor.

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It is also important to understand that the surrender of policies to pay for the inheritance tax bill in this way would create a tax charge and this would also be principally assessed on the Settlor, perhaps defeating the purpose of this transaction. The Trustees could potentially reduce the future 'income' to account for this, however, it is our understanding that this would create a further gift from the Settlor of the future 'income' rights, i.e. the Settlor would be making another gift which would need to be valued using the same actuarial principles applied to the original discount. This gift would further complicate matters for the Trustees. It may be that the Settlor has an available annual exemption that could account for this further gift. However, if the reduction is large, or the life expectancy of the Settlor is great, the gift could be substantial and the exemption may not cover this. We also need to bear in mind that any transfer of value here may interfere with planning in other areas and cause other inheritance tax issues.

*** Current guidelines from HMRC state that, rather than going through the lengthy process of re-underwriting clients at the 10 year point, the future 'income' rights can be assessed by adding 10 years to the client's actual or rated age at the outset of the policy.**

WITHDRAWAL ACROSS ALL THE POLICES

If the surrender was taken as a withdrawal across all policies, this is likely to create a tax charge assessable on the Settlor and they would have to pay any tax due – although this could, at least theoretically, be recovered from the Trustees.

This flexibility is therefore probably not so useful in practice. All that is happening is that, in order to pay a tax charge, a further tax charge is being created. Any tax charges paid by the Trustees, either by way of withdrawal or by full surrender of individual policies, could change the taxation treatment of the 'income' rights to the Settlor and potentially mean the Trustees would need to suggest altering these rights, perhaps against the wishes and 'income' needs of the Settlor.

B) THE TRUST ALLOWS THE INITIAL CHARGE TO BE PAID BY TRUSTEES.

The payment of such charge is again complicated (by the examples) in the above scenario. Whilst this is physically possible on a 'trust level carve-out' scheme, the payment would need to be made by withdrawal or surrender of individual policies, altering the potential taxation treatment of the 'income' to the Settlor.

C) THE TRUST ALLOWS THE SCHEME TO BE WOUND UP WITH THE AGREEMENT OF ALL TRUSTEES.

Whilst this is often seen to be a feature of 'trust level carve-out' schemes, in fairness this has perhaps been misunderstood. 'Trust level carve-out' schemes will allow the underlying asset to be surrendered by the Trustees but the trust itself must continue and pay the pre-determined 'income' rights. If the scheme allowed the trust to be dissolved, perhaps by agreement from the Settlor and Trustees, then it could be argued that any transfer into such trust is revocable, i.e. the Settlor can ask for their gift back at any time. Such a trust could be open to attack by HMRC on this basis as being a gift with reservation of benefit.

We would therefore imagine that any such perceived facility in other provider's schemes is simply the ability for the trust fund to be re-invested elsewhere if desired. Again, this flexibility may be of little practical use:

› If the bond has performed well it is unlikely that the Trustees would want to move the underlying bond to another provider

› If the bond has performed badly then it is likely that the premium on any reinvestment exercise would be less than the original premium on the original bond. The result would be that the regular withdrawals required to fund the 'income' would create chargeable events, especially if the Settlor had selected the full 5% annual tax deferred entitlement to maximise the discount provided. Again, the trustees could reduce the Settlor's 'income' to account for this but this would give rise to further complications for inheritance tax planning as described earlier.

D) SPECIFIC ISSUE CONCERNING BARE TRUSTS

Due to the precedent established by the case of Saunders v Vautier 1841, it is difficult to see how a 'bare' version of the 'trust level carve-out' scheme can avoid the beneficiaries bringing the arrangement to an end. This case established that, if all the beneficiaries of a trust are of sound mind and of the age of majority, then they can order the Trustees to transfer the trust fund to them and thereby terminate the trust. This begs the question how then can the 'income' payments, and therefore open market right (discount), be ascertained to be secure at outset? After all, if the beneficiaries can bring the trust to an end, it surely contradicts the entire concept of a fixed payment for life which cannot be amended.

Again, we believe that the 'trust level carve-out' scheme is more vulnerable to attack from HMRC here, as there is an argument that any open market buyer would be discouraged by this potential conflict.

The bare trust version of Utmost International Isle of Man Limited's scheme cannot fall foul of this as the policy conditions (of the underlying bond) do not allow surrender during the Settlor's lifetime.

OTHER CONSIDERATIONS

If the Settlor is still alive at the 10 year anniversary then it is important to remember that the value of the trust will be the value of the bond less the Settlor's ongoing rights to receive the selected level of 'income', i.e. 'the carve-out' effectively takes place again. The value of the trust fund would therefore be reduced by this right to 'income' and, of course, the trust would currently benefit from its own Nil Rate Band.

As this is a complicated area, Utmost International Isle of Man Limited have produced an on-line calculator to help the Adviser assess what the potential future trust value will be, including the appropriate reduction for future carve-outs. The Adviser can input certain variables to assess if there will be an entry charge and the likelihood of any future periodic charges. As the calculator is based on selected variables that may change in future, it cannot guarantee that there will be no such charges, however, it can give an early indication to the Adviser that such charges may arise. It may therefore be sensible to use such tools in advance to limit the possibility of such charge rather than focusing on a future solution that, if utilised, will cause potential taxation issues for the client.

Other factors must also be considered such as will the Settlor still be alive at the first and subsequent 10 year anniversaries? If he or she is not then it is of course possible that the bond may have already been surrendered and the trust terminated, so there will be no periodic charge. Even if the bond has been kept in force, then, following the death of the Settlor, the Trustees could simply take withdrawals or surrender segments to cover any tax liability that may be due. Therefore if the Settlor has died within the first 10 years there is simply, tax issues aside, no additional flexibility provided by the 'trust level carve-out'.

CONCLUSION

The ability for Trustees to make payments to cover tax charges, although attractive on the surface, is perhaps neither particularly practical nor desirable. Whilst 'trust level carve-out' schemes do, in theory, allow more flexibility, as the control rests with the Trustees, in practice they are restricted by the same terms that cover a 'bond level carve-out'. It may be argued that the only flexibility that is over and above a 'bond level carve-out', is the ability to change the underlying investment bond provider. Perhaps hardly a flexibility that is likely to be utilised given that this could create charges for the Trustees and income tax charges for the Settlor on any chargeable gain. Utmost International Isle of Man Limited EPB and DGT structure allows Trustees to access a full 'open architecture' fund range, allowing Trustees to diversify the trust fund within the underlying investment bond wrapper without the need to surrender the bond.

A 'trust level carve-out' cannot allow the scheme to be wound up for the same fundamental reasons as a 'bond level carve-out', i.e. the future 'income' rights once established cannot be altered if the discount is to stand good.

We are still happy that our scheme is sufficiently robust to avoid potential challenges, and sufficiently straightforward to make a complex area of estate planning relatively easy to understand for all concerned.

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