DISCRETIONARY DISCOUNTED GIFT TRUST TECHNICAL GUIDE

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In this document the term "spouse" includes a reference to a registered civil partner under the Civil Partnership Act 2004

1. THE LONDON & COLONIAL DISCRETIONARY DISCOUNTED GIFT TRUST – OBJECTIVES AND SUITABILITY

The aim of the Discretionary Discounted Gift Trust is to facilitate effective lifetime inheritance tax (IHT) planning for existing or potential investors in a London & Colonial Offshore Open Bond (the "Bond") without losing complete access to the investment. By using the London & Colonial Discretionary Discounted Gift Trust with an Offshore Open Bond, the individual will be able to immediately reduce his taxable estate for IHT purposes to the extent of the discount on the gift that is made, whilst retaining access to a fixed stream of payments from the investment in the future.

The Discretionary Discounted Gift Trust allows an investor to make a gift which will be totally free of IHT if he survives the gift by seven years. In addition to this, if the investor dies within seven years of setting up the Trust, only a part of the initial investment or the Bond transferred to the Trust is treated as a gift for IHT purposes. This is because IHT is calculated on the loss to the estate principle, and the Settlor retains a right to future capital payments from the Trust which has a present value.

The Discretionary Discounted Gift Trust deed creates two interests in the Trust Fund.

(i) The Settlor's Fund

One part of the Trust Fund, called the Settlor's Fund, is held absolutely for the Settlor and comprises a series of fixed specified payments at pre-specified frequencies made in the future.

The right to those capital payments has a value for inheritance tax purposes and this remains in the taxable estate of the Settlor though, as mentioned below, no inheritance tax will be payable on it on the Settlor's death.

(ii) The Beneficiaries' Fund

The remainder of the Trust Fund, known as the Beneficiaries' Fund, is held for the Settlor's intended Beneficiaries, and this is the part that is gifted. It is expected that these Beneficiaries will benefit from the trust following the Settlor's death. The Trust Fund at that time will reflect the investment performance of the Bond less any capital payments made to the Settlor whilst he was alive.

Because the Settlor's right to capital payments in the future has an economic value, this reduces the value of the gift the Settlor is treated as making. This reduction in the value of the gift gives rise to the expression "Discounted Gift".

Although, as stated above, the value of the Settlor's entitlement to capital payments remains in his estate during lifetime, this value will be nil when the Settlor dies because any value attributable to this entitlement depends on the Settlor remaining alive. Therefore, no value at all will be included in the Settlor's estate on his death in respect of his entitlement under the trust.

Whilst the IHT gift with reservation provisions can neutralise the inheritance tax benefits of a trust under which the Settlor can benefit, these rules will not apply in this case because the Settlor's right

to his capital payments is held by the Trustees absolutely for the Settlor - in effect it is carved out from the gift and held by the Trustees for the Settlor's absolute benefit. The Settlor cannot benefit in any way from the remainder of the Trust Fund i.e. the Beneficiaries' Fund.

The Beneficiaries' Fund is held on a discretionary trust. Until recently it was usual to use a Flexible Power of Appointment Interest in Possession Trust in Discretionary Discounted Gift Trust arrangements as this had the additional advantage of the initial gift to the trust being a potentially exempt transfer (PET). However, following the new tax rules introduced in March 2006 (and set out in the Finance Act 2006) the scope for making PETs has been severely restricted so that only outright gifts to other individuals or lifetime gifts to absolute trusts and trusts for the disabled qualify as PETs. All other lifetime gifts to trusts are chargeable lifetime transfers. The London & Colonial Discretionary Discounted Gift Trust gives an investor flexibility over the choice of their ultimate Beneficiaries. Even though the gift to a trust is a chargeable lifetime transfer, no immediate tax liability arises unless the amount of the discounted gift (plus any other chargeable transfers made in the previous seven years) exceeds the nil rate band.

Full details of the UK taxation implications of the Discretionary Discounted Gift Trust can be found in section 6 of this Guide.

The London & Colonial Discretionary Discounted Gift Trust is likely to be suitable if:

- the investor, aged between 60 and 89, has a potential IHT liability on his estate which he would like to reduce, but is not prepared to make unconditional gifts;
- the investor needs to retain some access to his investment, but is happy to restrict this access to a series of fixed capital payments;
- the investor is happy, except for the capital payments fixed at outset, to give up access to the rest of his investment; and
- the investor is in reasonably good health.

Where the investor does not require any beneficial access to the Bond, another type of trust may be more suitable. If the investor requires access to the whole of the Bond at any time, the London & Colonial Discretionary Discounted Gift Trust should **not** be used. Neither should it be used if the individual is in serious ill health already, as in such circumstances little or no discount is likely to be allowed on the gift.

As well as providing important tax benefits, because the Bond is held subject to the Discretionary Discounted Gift Trust it will not be an asset of the Settlor's estate for probate purposes.

The Discretionary Discounted Gift Trust can be used regardless of whether the Bond is owned or is being applied for by one individual or two. The person creating the trust is known as the Settlor and where two persons jointly own or intend to invest in a Bond they will be joint Settlors. For inheritance tax purposes, two trusts will then exist (see section 6(1)(c) below). Joint Settlors should contribute equally to the arrangement.

Where a Discretionary Discounted Gift Trust is being set up with a cash gift, it will be the Trustees who effect the Bond under the arrangement. To avoid the Bond encashing at the wrong time from a tax or investment standpoint, the Bond should be effected on the lives of several Beneficiaries on a

joint lives last survivor basis. However, the Bond must *not* be effected on the life of the Settlor or the Settlor's spouse (see section 4.3 below).

2. THE LONDON & COLONIAL DISCOUNTED GIFT TRUST AND INHERITANCE TAX PLANNING

The London & Colonial Discretionary Discounted Gift Trust offers inheritance tax (IHT) advantages on several levels.

2.1 IHT EFFECTIVE GIFT BUT RETENTION OF CONTROL AND SOME ACCESS TO THE CAPITAL

In general, in order to ensure that an effective gift can be made for IHT purposes it is essential that the Settlor must not retain any benefit under the Trust. However, it is possible to allow the Settlor access to a part of a Trust Fund without adverse IHT implications provided the Settlor's rights are pre-determined at outset and cannot be changed; and he cannot benefit from the part gifted. Another term for this is that the Settlor's rights are "carved out" from outset and are therefore not gifted. In such circumstances the gift with reservation provisions will not apply.

Under the London & Colonial Discretionary Discounted Gift Trust, the Settlor specifies at outset the level and frequency of payments he wants to receive under the Trust. Any gift that the Settlor makes is subject to these pre-existing rights to those capital payments. He will only become entitled to these payments if he survives to the appropriate date(s) in the future. In practice such capital payments would normally be used to supplement the Settlor's income, given that they will be paid at pre- specified frequencies e.g. monthly, annually, etc. Once the level and frequency of capital payments has been determined when the Trust is created, they cannot be changed as to do so would cause adverse IHT implications.

The remainder of the Trust Fund is known as the Beneficiaries' Fund and is held on discretionary trust for the benefit of the Beneficiaries. The Settlor cannot benefit from this Fund. Because the Settlor has the right to capital payments from the Trust throughout his life, in practice the Beneficiaries' Fund will only be distributed after the death of the Settlor (or the death of the survivor of joint Settlors).

In addition, the London & Colonial Discretionary Discounted Gift Trust provides that the Settlor is the Appointor under the Trust, which means that he has the power to appoint the benefits from the Trust amongst any of the Discretionary Beneficiaries specified in the Trust. The London & Colonial Discretionary Discounted Gift Trust further provides that after the Settlor's death (or the death of both Settlors), this power of appointment passes to the Trustees.

As the Trust is discretionary, no Beneficiary is entitled to any benefit until the Appointor makes an appointment of capital or income to the Beneficiary.

Under present IHT rules, the retention of the power of appointment by the Settlor does not constitute a gift with reservation of benefit if the Settlor cannot exercise the power in his own favour. Avoiding any reservation of benefit is one of the requirements that must be met in order to ensure that the Trust property is not treated as part of the Settlor's estate for IHT purposes.

2.2 DISCOUNTED GIFT

Under the London & Colonial Discretionary Discounted Gift Trust, when the Settlor creates the Trust he makes a gift to the Trust. Because he retains a right to receive capital payments on future dates should he or she then be alive, the value of the gift is discounted to take account of this retained value.

The present value of the Settlor's right to these future capital payments is determined actuarially by taking account of a number of factors, the most important of which are the Settlor's gender, age and state of health as well as the amount and frequency of the payments.

The difference between the amount of the initial amount transferred to the Trust and the value of the Settlor's Fund (i.e. the present value of the future capital payments to which the Settlor is entitled under the Trust) will be treated as a transfer of value (i.e. a gift) for IHT purposes and, because the trust of the Beneficiaries' Fund is a discretionary trust, it will be a chargeable lifetime transfer. However, no IHT liability will arise in respect of the gift if it, together with any other chargeable transfers made by the Settlor in the preceding 7 years, does not exceed the current nil rate band for IHT.

When an existing Bond is made subject to the Trust, the value of the gift will be calculated by reference to the value of the Bond at the time unless the value is less than the original investment in which case the relevant value will be the amount of the initial premium (taking account of any withdrawals previously taken) less an allowance for any decrease in the value of units since the inception of the Bond.

Because the amount of the discount will depend on the age and state of health of the Settlor, it is essential to obtain medical evidence when the Trust is established. In section 4 of this Guide we give consideration to the practical implications of establishing a Discretionary Discounted Gift Trust including underwriting aspects and a possible need to agree a discount with Her Majesty's Revenue and Customs (HMRC).

2.3 SETTLOR'S SPOUSE A BENEFICIARY

In what follows, we assume that the spouse is not also the Settlor of the Trust. Under current IHT rules, the inclusion of the Settlor's spouse as one of the Discretionary Beneficiaries of the Beneficiaries' Fund does not constitute a gift with reservation of benefit for IHT purposes; however, care must be exercised if any benefits are actually paid to the Settlor's spouse during the lifetime of the Settlor. If the Settlor, as the Appointor, exercises the power of appointment in favour of his spouse and Trust benefits are actually paid to the Settlor's spouse, it is absolutely essential that no part of the funds are used for the direct or

indirect benefit of the Settlor. If part of the Beneficiaries' Fund were used for the direct or indirect benefit of the Settlor, the Trust could be seen as one under which the Settlor had reserved a benefit, which would jeopardize its effectiveness for IHT purposes.

In practice, because the Trustees' prime responsibility is to make payments to the Settlor in respect of the Settlor's Fund, it is unlikely that payments will be made to any of the Beneficiaries, including the Settlor's spouse, whilst the Settlor is alive.

2.4 DISCRETIONARY TRUST

As explained above, the Trust is a discretionary trust which means that no Beneficiary has a fixed right to any benefit. The Trust Fund is not in the estate of any of the Beneficiaries and instead is subject to its own IHT regime - see section 6 below. Although the Settlor names Default Beneficiaries under the Trust, these people will only benefit if no appointment has been made by the end of the Trust Period, i.e. after 80 years (or any longer period that may be permitted under English law). In practice this is most unlikely.

2.5 THE POSSIBILITY OF FURTHER GIFTS BY THE SETTLOR

It is possible that some time after the London & Colonial Discretionary Discounted Gift Trust is set up, the Settlor may decide that he or she no longer needs the payments from the Trust. In order to ensure that the Trust is tax effective, the London & Colonial Discretionary Discounted Gift Trust does not allow the Settlor to give up his payments. However, the Settlor could, for example, simply gift the cash that he receives from the Trustees to anyone, including any of his intended beneficiaries. Alternatively, the Settlor could waive some or all of his entitlement to payments from capital by notifying the Trustees of his intention. Such gifts will, of course, have IHT implications and these will have to be considered by the Settlor. The Settlor would need to take independent advice if he wished to achieve this. The tax implications of such action are further considered in section 6.

For a detailed consideration of the inheritance tax implications of the Discretionary Discounted Gift Trust see section 6 of this Guide.

3. THE LONDON & COLONIAL DISCRETIONARY DISCOUNTED GIFT TRUST AND PROBATE

To ensure that there is no need to include the Bond as part of the Settlor's assets for probate purposes when the Settlor dies, the legal ownership of the Bond must be with a person or persons other than the Settlor on his or her death. This is achieved by having the legal ownership of the Bond vested in Trustees. However, this benefit will only be secured if there is at least one Trustee who survives the Settlor because otherwise probate will be necessary to determine the trustees (see below). Under the Discretionary Discounted Gift Trust, the Settlor is automatically one of the Trustees and further Trustees are appointed at outset in the trust deed. If any of the additional Trustees retires or dies before the Settlor, a replacement Trustee or Trustees should be appointed.

If any of the additional Trustees subsequently resign/die/are dismissed, there will be no surviving Trustee on the death of the Settlor (the Settlor therefore being the only Trustee at the time of his or her death). In these circumstances, the Trust will nevertheless continue to exist but with the personal representatives of the deceased Settlor assuming the role of Trustee under the Discretionary Discounted Gift Trust. This means that although the Bond will not form part of the Settlor's estate for IHT or probate purposes, it will be necessary to secure probate of the Settlor's estate to ensure that the personal representatives can act as Trustee under the Discretionary Discounted Gift Trust. This is why it is very important that additional Trustees are appointed who are likely to survive the Settlor so as to ensure that on the Settlor's death there are no delays in being able to deal with the Bond.

4. THE LONDON & COLONIAL DISCRETIONARY DISCOUNTED GIFT TRUST – PRACTICAL ISSUES

4.1 CREATING A VALID TRUST

The London & Colonial Discretionary Discounted Gift Trust is made when the Settlor and additional Trustees execute the Trust Deed. The Settlor can either make the Trust with a cash gift or an existing Bond. If the Trust is set up with a cash gift, the Settlor needs to transfer the amount intended for investment to the Trustees, which would normally be done by means of a cheque for the desired amount. Unless the Trustees were to open a bank account especially for that purpose, the Settlor should give the Trustees his cheque made payable to London & Colonial, which will be used to make the investment in the London & Colonial Bond. The Bond is applied for by the Trustees and they are the original owners of the Bond.

Alternatively the trust can be created by the Settlor transferring an existing Bond to the Trustees.

4.2 THE IMPORTANCE OF ADDITIONAL TRUSTEES

As explained above, additional Trustees must be appointed at outset because those Trustees will be making the investment into the Bond or an existing Bond will be transferred to those Trustees.

It is important for the Settlor to choose his Trustees wisely. Even though the Settlor will be one of the Original Trustees and it is expected that he/she will remain as a Trustee throughout his/her lifetime, where the Trust is governed by English law the Trustees must act unanimously. In extreme circumstances where the Trustees disagree, the Settlor has the power under the London & Colonial Discretionary Discounted Gift Trust to dismiss a Trustee but, if he does so, at least one Trustee must remain who is someone other than the Settlor or his/her spouse.

The primary duty of the Trustees during the Settlor's lifetime (or both Settlors' lifetime) is to pay the capital payments specified in the Trust to the Settlor. These payments must be

made every time the Settlor survives to the appropriate date when his entitlement arises. The Trustees cannot pay the Settlor more than his entitlement on the specified date.

Although the Trustees will be the legal owners of the Bond and can take withdrawals of any amount from the Bond, it would not be prudent to take more than what is required to be paid to the Settlor.

4.3 THE LONDON & COLONIAL OFFSHORE OPEN BOND

When a cash gift is made, the Original Trustees, of whom the Settlor is one, make an application for a London & Colonial Bond using the cheque given to them by the Settlor. As the Bond is a life assurance policy, the Trustees must indicate on whose lives the policy is to be issued. This should be two or more of the Discretionary Beneficiaries under the Trust. To ensure the correct tax implications ensue, **the Settlor and the Settlor's spouse should NOT be lives assured under the Bond**.

The Bond is then issued on a last survivor basis to the Trustees as the policyholder.

It is advisable for the Bond to be issued on a number of lives on a joint lives last survivor basis to ensure greater flexibility as to the time of the final encashment of the Bond. As the Bond would automatically encash when the last life assured dies, ideally the lives assured should be young.

If an existing Bond is transferred to the Trust, the Settlor will no longer have a choice as to who should be the life assured under the Bond and it may be that the Settlor and/or his spouse is a life assured under the Bond. In such a case consideration should be given to the implications of paragraph 7 Schedule 20 Finance Act 1986. This should be discussed with the investor's professional advisers.

The Trustees can exercise all the powers and options under the Bond including taking withdrawals from the Bond. When the Trustees are due to make a capital payment to the Settlor in accordance with their obligation in respect of the Settlor's Fund, they will have to make withdrawals / part surrenders from the Bond in order to fund the payment. It is possible for the Trustees to request regular withdrawals from the Bond to meet the Settlor's entitlement to capital payments under the Trust and for those to be paid directly to the Settlor on the specified dates.

4.4 CALCULATING THE DISCOUNT AND UNDERWRITING THE GIFT

As explained in section 2 of this Guide, the amount of the discount on the gift will depend largely on the Settlor's (or both Settlors' if appropriate) gender, age and state of health as well as the amount and frequency of the capital payments the Settlor is entitled to. In practice the younger and healthier the Settlor, the greater the value that will be attached to his retained rights and therefore the smaller the amount of the discounted gift. Similarly, the discounted gift made by a man (assuming gifts of the same size) will be greater compared to a woman of the same age and in the same state of health taking the same capital payments because the value of his rights to future capital payments will be less.

It is necessary to ascertain the discounted gift at outset in order to make a return to HMRC Inheritance Tax of the chargeable lifetime transfer that is being made to the Trust (see section 6).

HMRC Inheritance Tax will frequently agree a standard basis of valuation with a life office, but as any particular discount depends on an evaluation of the Settlor's state of health at the time of establishing the Trust, HMRC can challenge that discount.

In particular, if the Settlor were to die soon after effecting the Discretionary Discounted Gift Trust, HMRC may question whether the Settlor was in good health when the Trust was established with a view to limiting the discount accordingly.

In order to estimate the amount of the discounted gift, London & Colonial would request details of the Settlor's state of health at the time of application and obtain a Personal Medical Attendant's (PMA) report. This will be used to estimate the amount of the discount when the Trust is established. This evidence will assist in agreeing the discount with HMRC should they dispute it when the Trust is established or in the event of the death of the Settlor within 7 years of making the gift.

HMRC will not currently accept that any discount will be available in the case of a Settlor who has an actual or underwriting age of 90 or more. For this reason London & Colonial will not accept applications for a Discretionary Discounted Gift Trust from investors aged over 89.

4.5 TYPE OF INVESTMENT

In theory, the Trustees could invest in a different type of investment, for example, unit trust units or shares in an OEIC instead of a Bond. However, any income arising from the underlying investment would then be assessed to income tax on the Settlor because the Settlor retains the right to capital payments under the London & Colonial Discretionary Discounted Gift Trust.

These problems do not arise with an investment bond, which is a non-income producing asset and the investment gains of which are not subject to capital gains tax. It is therefore more tax efficient as the underlying investment of the Discretionary Discounted Gift Trust.

4.6 HUSBAND AND WIFE PLANNING

It is not advisable that each of a married couple (or registered civil partners) sets up their own separate Discretionary Discounted Gift Trust arrangement because HMRC may argue that in such a case if the two arrangements are effected simultaneously or in contemplation of each other, they are associated and effectively, if merged, would constitute a gift with reservation i.e. husband invests with his wife as a Discretionary Beneficiary on condition that his wife invests with her husband as a Discretionary Beneficiary. In these circumstances, one joint Settlor Discretionary Discounted Gift Trust (where neither is a Discretionary Beneficiary but capital payments continue throughout both lifetimes) may be more appropriate.

4.7 WHAT HAPPENS ON THE SETTLOR'S DEATH?

If the gift is made with cash so that the Trustees make an application for the Bond, the Bond will normally be effected on the lives of two or more of the Discretionary Beneficiaries (but not the Settlor or the Settlor's spouse). The death of the Settlor after seven years have elapsed will not then have any consequences for the Trust as such, except that the Settlor's entitlement under the Trust will terminate. No value is included in the Settlor's estate in respect of the Settlor's Fund as the Settlor's entitlement depends on the Settlor being alive and therefore, on his death, will be valueless.

In joint Settlor cases, where the right to capital payments continues to the surviving Settlor, this fact would be taken into account in calculating the initial discounted gift made by each Settlor. HMRC have provided guidance on this calculation.

Following the death of the Settlor (or the death of both Settlors), the Trustees can either continue with the Bond as a long-term Trust investment or cash it in and distribute the proceeds to the Beneficiaries.

If an existing Bond is being transferred to the Trust, it may be that the Bond was originally effected on the life of the Settlor and/or the Settlor's spouse. As the lives assured under the Bond cannot be changed, the Trustees will then hold the Bond in its original form, ie. on the life of the Settlor. In this case, when the Settlor dies, the Bond will encash and its cash value will be paid to the Trustees. As the continuing right to payments to the Settlor will then cease, the Trustees will be free to distribute the Trust Fund to the Beneficiaries or invest it for their future benefit.

5. THE LONDON & COLONIAL DISCRETIONARY DISCOUNTED GIFT TRUST PROVISIONS IN DETAIL

5.1 TWO TRUSTS IN ONE

The Discretionary Discounted Gift Trust is effectively split into two parts. First, there is the Settlor's Fund under which the specified sums are reserved for the Settlor and are as stated in the Trust Deed. The Settlor's Fund is held on a bare trust for the benefit of the Settlor. Second, there is the trust of the Beneficiaries' Fund which is a fully discretionary trust.

5.2 TRUST CLAUSES IN DETAIL

The following is a summary of the key provisions as they appear in the draft Discretionary Discounted Gift Trust provided by London & Colonial.

Part 1 - Declaration

The Trust offers alternative provisions depending on whether the Trust is to be effected with cash or an existing Bond is to be made subject to trust. The amount of cash gifted or the Bond number, as appropriate, needs to be inserted. The name of the trust also needs to be inserted. This will assist

with record keeping and any correspondence with HMRC.

Part 2 - Definitions

In this part of the Trust the terms used throughout the Trust are defined to avoid repetition. The most important definitions are those of the Discretionary Beneficiaries and the Default Beneficiaries.

The Discretionary Beneficiaries are those persons to whom the Appointor under the Trust (the Settlor during his or her (their) lifetime and thereafter the Trustees) may appoint benefits. They include the spouse (except where the spouse is a joint Settlor), widow or widower of the Settlor, the children and the remoter issue of the Settlor, their spouses, the brothers and sisters of the Settlor and their issue, anybody who would benefit from the estate of the Settlor on the Settlor's death as well as any person nominated in writing to the Trustees by the Settlor as well as any charity. The class of Discretionary Beneficiaries is therefore very wide and can be added to by the Settlor - all that is necessary is a written notification to the Trustees. However, the Settlor himself/herself cannot be added to the class at any time.

The Default Beneficiary(ies) is the individual/individuals who will benefit in the unlikely event that the power of appointment is not exercised by the Appointor by the end of the Trust Period, (i.e. 80 years from the time the Trust is created). They are named by the Settlor in the Trust Deed. At least one person must always be named and if more than one is named, the shares in which they are to benefit must be stated. This is necessary to ensure the Trust is valid.

Part 3 - Principal trust terms

Part 3 A - The Settlor's Fund

The Settlor's Fund is held on a bare trust for the Settlor.

The Settlor specifies the amount and frequency of the payments he wishes to receive. The Settlor can postpone the start of his entitlement to some date in the future. For example, if he wants to delay the start date of his capital payments, he can state that payments should commence a specified number of months from the date of the Trust.

In determining the amount of his capital payment, the Settlor can specify a cash sum or a percentage of the amount paid to the Trustees to purchase the Bond or, in the case of an existing Bond, a percentage of the initial premium. He also specifies the frequency which could be yearly, half-yearly, quarterly or monthly.

Part 3B – The Beneficiaries' Fund

The Beneficiaries' Fund is held on discretionary trust for the Beneficiaries.

In this part the **power of appointment** is defined as well as **the default entitlement** if the power of appointment is not exercised.

The power to appoint capital and income under the trust is vested in the Appointor - that is the Settlor(s) during his/her/their lifetime and thereafter the Trustees. The power is exercisable at the Appointor's discretion and includes the power to appoint further trusts in favour of Beneficiaries.

Where there are two Settlors, the Appointor will be both Settlors whilst alive and then the survivor of them. After the death of the Settlor(s) the Appointor will be the Trustees.

The Trustees have power to accumulate any trust income for 21 years from the date of the Trust – this is the maximum accumulation period allowed under English law.

If an appointment of all of the Trust assets has not been made by the end of the Trust Period, the Default Beneficiaries will benefit. These are the people initially named by the Settlor in the Trust Deed. It will be appreciated that it is most unlikely that the Trust Fund will not be distributed within 80 years.

There is also a special provision dealing with any potential conflict of interest. In many cases the Trustees of the Trust would be family members who would also be Beneficiaries under the Trust. If the power of appointment were to be exercised by the Trustees (after the death of one or both Settlors) such Trustees would often also be the Beneficiaries (for example the spouse and/or children of the Settlor) and if an appointment of benefits were to be made in favour of a Beneficiary who is also a Trustee then suspicion of a conflict of interest could arise. For this reason there is a provision in this Trust which states that if a Beneficiary is also one of the Trustees, the Trustees can only make an appointment in favour of that Beneficiary if there is at least one other Trustee who does not benefit directly or indirectly from the appointment being made.

The Trustees have wide powers to advance capital from the Trust Fund to the Beneficiaries and to make loans to the Beneficiaries. In particular, the power to lend may give rise to tax planning opportunities where, after the Settlor's death, the Settlor's widow/widower requires funds from the Trust but there is a desire to reduce the potential IHT liability on his or her subsequent death. In such a case the Trustees could make an encashment or withdrawal from the Bond (see section 6 for the tax consequences of this) and make an interest-free loan, repayable on demand, to the widow/widower. Provided the loan is fully spent, the widow/widower's taxable estate would not increase but, because the loan is repayable on his/her death, it would then effectively reduce the net estate of the borrower for IHT purposes. If the Settlor's surviving spouse needed cash after the Settlor's death, it may then be appropriate to consider a loan to him/her.

One word of warning should be heeded. If the widow/widower had previously made lifetime gifts to the Settlor, this may affect the ability to make a deduction from the surviving spouse's taxable estate on his/her subsequent death.

It may well be the case that where benefits are intended to continue throughout the joint lifetimes of the Settlor and his/her spouse that the Trust should be established on a joint Settlor basis.

Part 4 - Administrative provisions

The Trustees also have wide administrative powers to deal with the Bond and to reinvest the proceeds in any way they wish. They also have power to borrow funds, to make payments to parents or guardians of minor Beneficiaries and to delegate certain powers.

Part 5 - Appointment, dismissal, retirement and remuneration of Trustees

The Trust contains comprehensive provisions applying to the Trustees.

The power to appoint new or additional Trustees is vested in the Appointor. The Settlor also has power to dismiss any Trustee provided at least one Trustee, other than the Settlor and the Settlor's spouse, remains after such dismissal. There is no power to dismiss a Trustee after the death of the Settlor and it must be remembered that Trustees under a trust subject to English law must act unanimously.

There are also powers to deal with the retirement of Trustees and corporate Trustees.

Professional trustees are permitted by the Trust Deed to charge normal professional fees. The Trustees are permitted to take part in transactions and Trustees' decisions in which they have a personal interest.

Part 6 - Further trust provisions

These deal with the Trustees' duty of care and liability for loss to the Trust Fund.

The statutory duty of care contained in section 1 Trustee Act 2000 has been extended to apply to all functions of the Trustees. This statutory duty of care is a duty to act with such care and skill as is reasonable in the circumstances having regard in particular to any special knowledge or experience that the Trustee has or holds himself out as having and, in the case of a Trustee acting in a professional capacity (eg. a solicitor, accountant, stockbroker or independent financial adviser), to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

The liability of individual Trustees is limited so that they will not, generally, be held liable for any loss to the Trust Fund provided they act in good faith. A Trustee who is paid for his services is also liable for negligence.

Part 7 - Proper law

The law of this Trust is that of England and Wales but the Trust can be used by investors domiciled in the remainder of the UK if they are happy for English law to govern the trust. The tax implications of the Trust will be the same throughout the UK. It is not thought possible, for legal reasons, to effect a similar Trust subject to the law of Scotland.

6. THE UK TAX IMPLICATIONS OF THE LONDON & COLONIAL DISCRETIONARY DISCOUNTED GIFT TRUST

In what follows it is assumed that the Settlor, the Beneficiaries and the Trustees of the Trust are all UK resident and domiciled. Special rules apply when this is not the case.

6.1 INHERITANCE TAX (IHT)

(a) Establishment of the trust

- When the Trust is established, the Settlor will be treated as having made a discounted gift for inheritance tax purposes. The size of this gift will be equal to the difference between the amount of cash used to buy a new Bond (or the value of the existing Bond, adjusted as appropriate, as explained in section 2.2 above) and the value of the Settlor's retained right to capital payments which will depend on the Settlor's gender, age, state of health at outset and the amount and frequency of the capital payments.

- For IHT purposes the gift will be a chargeable lifetime transfer (CLT). If this amount plus the amount of any other CLTs made by the Settlor in the previous 7 years does not exceed the nil rate band for IHT (£312,000 in tax year 2008/09) there will be no IHT liability when the gift is made and, if the Settlor survives for seven years after investing in the Trust, no IHT liability will arise at all in respect of the gift. If the Settlor's nil rate band is exceeded there will be a lifetime liability at 20% on the excess, increasing to 40% if the Settlor dies within 7 years (although IHT taper relief may then be available).

Example

Hanna creates a Discretionary Discounted Gift Trust in October 2008 which results in a chargeable transfer of £327,000. She has made no chargeable transfers in the previous 7 years and her annual exemption has been used elsewhere. If the Trustees were to pay the IHT on this gift, the tax will amount to £3,000, ie. 20% of (£327,000 - £312,000). This would reduce the amount going into the Trust. If Hanna is to pay the IHT on this transfer, the gift will have to be grossed up, with the amount of tax being £3,750 (i.e. 20% of (£330,750 – £312,000). A further liability at 20% could arise if Hanna dies within 7 years of the gift.

For the above reason it is generally not recommended that gifts to the Discretionary Discounted Gift Trust should be made if it would mean that the Settlor's available nil rate band is exceeded.

- Where there are two Settlors (say husband and wife), they should contribute equally to the Trust by, say, providing a cheque on a joint bank account.

  Where a husband and wife invest as joint Settlors using jointly owned funds, each will be treated as making an investment of 50% of the total investment and each will be treated as a Settlor of one trust made up of that person's discounted gift into the trust. However, the calculation of the present right to future capital payments will

take account of the fact that payments can be made throughout their joint lifetime and the lifetime of the survivor; and HMRC has issued guidance notes on how this should be done.

- Where a person makes a gift that is a CLT he may need to report it to HM Revenue and Customs on Forms 100 and 100a.

  Whether a gift will need to be reported depends on the amount of the gift and the nature of the assets gifted. The gift will need to be reported if:-

  (1) Where the gift is of cash, it causes the donor to exceed the then nil rate band taking account of CLTs made in the previous 7 years.
  (2) Where the gift is of an existing Bond, it either causes the donor to exceed 80% of the then nil rate band taking account of CLTs made in the previous 7 years or the amount gifted exceeds the then nil rate band less CLTs made in the previous 7 years.

  If the gift is of an existing Bond, form D34 will also need to be completed.

(b) Death of the Settlor

- On the death of the Settlor (or, where relevant, either of the Settlors) more than 7 years after the creation of the Trust, the value of the Bond will be outside of the Settlor's estate for IHT purposes.

- If the Settlor does not survive his gift by 7 years, the potential IHT liability on the original chargeable lifetime transfer will have to be recalculated at the full death rates applicable at the date of death. However, no IHT will arise if the gift was within the Settlor's available nil rate band. If the nil rate band was exceeded, so that lifetime tax at 20% was paid, the charge will increase to 40%. IHT taper relief may be available in which case the IHT liability will start to reduce after the third year.

- It is strongly recommended that the Bond is not effected on the life of the Settlor/Settlor's spouse but if the Settlor or his/her spouse does happen to be the sole or last life assured to die under the Bond (perhaps in the situation where an existing Bond has been transferred to the Trust), the cash value of the Bond will be paid free of inheritance tax to the Trustees. (An income tax chargeable event may then arise - see later for the tax consequences of this). Professional advice should be taken before transferring an existing Bond to the Trust if it is on the life of the Settlor/Settlor's spouse.

- If the Settlor is survived by another life assured under the Bond, the Bond will continue unaffected by the Settlor's death.

(c) IHT whilst the trust is in existence

As this is a discretionary trust, this means that special IHT charging rules apply. Under these rules there may be IHT charges

- on every ten-year anniversary of the trust - “the Periodic Charge” or

- whenever property leaves the trust (e.g. when capital is advanced to a Beneficiary or an absolute appointment of benefit is made) - “the Exit Charge”

THE PERIODIC CHARGE

Periodic charges at ten-yearly intervals may be applied to the value of the assets in the Trust (although special rules apply to determine the value of trust property for discretionary discounted gift trusts - see below). The rate of inheritance tax charged will be determined based on an assumed transfer by an assumed transferor. This will mean that it will broadly be necessary to take account of

- the value of the property in the trust on the ten-year anniversary, certain additions made to the rust and the value, when they were set up, of any other trusts created on the same day (the assumed transfer)

- the Settlor’s cumulative total of chargeable transfers made in the seven years immediately preceding the creation of the Trust (assuming there has been no added property) and any sums paid out of the Trust in the 10 years prior to the anniversary (the cumulative total of the assumed transferor)

As a result of the calculation of the tax on the assumed lifetime transfer an effective lifetime rate of tax will be established. The maximum effective rate will be 20% and this will only apply in extreme cases. 30% of this rate is taken and that is the rate that will be applied to the actual value of the Trust property at the ten-year anniversary.

The maximum liability will thus be 6% (30% of 20%) of the value of the Trust property over the available nil rate band but frequently it will be much less or nil.

In cases where the Settlor has not made any chargeable transfers in the 7 years before he creates the Trust, no payments have been made out of the Trust in the last 10 years and there has been no added property, there will be no liability provided the value of the Trust property at the time of the periodic charge does not exceed the nil rate band applicable at the ten-year anniversary. Any excess over the then nil rate band will suffer IHT at an effective rate of 6%.

Example

Alan creates a Discretionary Discounted Gift Trust in October 2008 for £300,000. The value of Alan’s retained rights is £150,000 and so the discounted gift is £150,000 based on an annual cash payment of £15,000 (5% of the premium to the Bond).

Alan has made no chargeable transfers in the previous 7 years. No payments are made out of the Trust (other than those to Alan from the Settlor's Fund) in the first 10 years. In October 2018 the trust fund is worth £300,000 and the nil rate band is £400,000. No IHT is payable.

For the purposes of calculating the value of the trust fund for the periodic charge, HMRC has confirmed that the present value of the Settlor's right to future capital payments at that time (i.e. at the ten-year anniversary) should be deducted from the value of the trust fund (ie. the Bond). This means that an amount in respect of the then value of the Settlor's rights would need to be deducted from the value of the Bond.

Had the value of the Bond been £475,000 after 10 years with the Settlor's rights valued at £25,000, then the value of the relevant property in the Trust would have been £450,000 and IHT of £3,000 would have arisen (£50,000 @ 6%). This equates to a charge at 0.66% on the whole value of the trust property.

If all of the trust fund is distributed before the tenth anniversary, in many cases no tax charge will arise (see the "Exit charge" below). If assets remain in the Trust after a distribution, or if further assets are added to the Trust, the Trustees will need to take specialist tax advice.

THE EXIT CHARGE

Exit charges will be based on the value of property leaving the Trust or being appointed absolutely to a Beneficiary.

HMRC has confirmed that no exit charge will arise on payments made to the Settlor under a Discretionary Discounted Gift Trust because this property is already held absolutely on bare trust for him.

Exit charges within the first 10 years will be nil if the value of the initial chargeable lifetime transfer (before applying any IHT exemptions or reliefs) going into the Trust (including the cumulative total of the Settlor's chargeable transfers in the 7 years prior to creating the Trust and the value of any added property) is below the available nil rate band at the time of the exit. This means that if the available nil rate band when the trust was created was not exceeded there is a good chance that there will be no exit charge. If an exit charge does arise, it will increase according to the number of quarter years that have expired since the trust was created.

The amount of any exit charge occurring after the first 10 years will depend on the rate of tax charged at the last ten-year anniversary (if any) and the length of time (in quarter years) that the property has been in the Trust since the last periodic charge. If there was no charge at the previous ten-year anniversary there will be no exit charge.

Example

In October 2024, 6 years since the first ten-year anniversary (when a 0.66% IHT rate was charged), the Trustees of Alan's Trust make a part encashment of the Bond and pay £50,000 to a Beneficiary. The IHT charge will be £50,000 x 0.66% x 24/40 = £198.

As stated above, no IHT charge will arise on property paid out of the Trust if there was no IHT charge at the last ten-year anniversary.

Exit charges should not arise on loans made by the Trustees to Beneficiaries.

The occasion of a periodic charge and transactions that can give rise to an exit charge, such as capital payments to the Beneficiaries, may also need to be reported to HMRC if they exceed a certain amount. The forms to use here are IHT 100c and d and, where a life policy is involved, form D34.

If there are joint Settlors (who should contribute equally), the trust is effectively treated as two separate trusts , each settled by one Settlor, for all IHT purposes. IHT calculations are then applied to each of the trusts. The trust fund would effectively be divided into proportions reflecting the value of the discounted gift made by each Settlor for the purposes of calculating the ten-year periodic charge and any exit charge.

(d) Settlor giving up some or all of his entitlement to payments of capital

Although the London & Colonial Discretionary Discounted Gift Trust does not give the Settlor a specific power to give up his right to the capital payments (as this could jeopardise its IHT efficiency) , there is nothing to stop the Settlor from either gifting cash after receiving the payment from the Trustees or waiving some or all of his entitlements. The tax implications of any such action will have to be considered. If the Settlor simply gives cash to his intended beneficiaries (having received it from the Trustees), such a gift will normally be a PET unless it falls within the Settlor's annual exemption. If, on the other hand, the Settlor gives up a payment or a series of payments before he receives them, the IHT consequences will be different.

If a payment or a series of payments are given up, there will be a chargeable transfer for IHT purposes. If it is one payment, it may well be covered by the Settlor's annual exemption. However, if a series of payments is being given up, there will be a need for an actuarial valuation based on the Settlor's age and state of health at that time and the payments being gifted to determine the value given up. Clearly, professional advisers will need to be involved at that time to ensure that any tax liabilities are minimised.

6.2 INCOME TAX

(In all cases, it is assumed that the Settlor, the Beneficiaries and the Trustees are UK resident and domiciled - special rules apply where this is not so and professional advice should be taken in such cases).

(a) Payments to the Settlor

The Settlor's capital entitlements will be funded by the Trustees making encashments from the Bond. The payments made to the Settlor are capital payments and not subject to income tax. The Trustees are entitled to withdraw from the Bond each year, free of tax at that time, an amount of up to 5% of the premiums invested for 20 years. To the extent that such a 5% allowance is not used in one year it can be carried forward to the next year and so on. As long as payments are kept within the cumulative total of unused annual 5% allowances no income tax implications will arise for the Trustees or the Settlor at the time of the withdrawal. These 5% withdrawals will be taken into account in determining the taxable chargeable event gain when the Bond is finally encashed.

(b) Chargeable event gains

(i) During the Settlor's lifetime and in the tax year in which the Settlor's death occurs

For income tax purposes, any chargeable event gains arising under the Bond will be assessed on the Settlor. If there are joint Settlors, each will be assessed on a portion of the gain based on the proportion of his contribution (assumed to be equal). Please refer to the London & Colonial Offshore Open Bond literature for full details of Bond taxation.

(ii) After the end of the tax year in which the Settlor's death occurs

Following the Settlor's death, any chargeable event gains arising in a tax year after that in which the Settlor died will be assessed on UK resident Trustees at the special rate of 40%. No credit is available as the Bond is an offshore bond. To the extent that chargeable event gains fall within the £1,000 standard rate tax band (which would be available to the Trustees following the Settlor's death), there will be a 20% charge. These rules also apply if the chargeable event gain arises at any time that the Settlor is non-UK resident.

(c) Payments to Beneficiaries

- If the Trustees make an encashment of or withdrawal from the Bond to make a payment to Beneficiaries (normally after the death of the Settlor), the income tax and IHT consequences of this are as outlined above.

- As long as payments to Beneficiaries are made and documented as an advancement of capital and do not acquire the character of income, there should be no income tax implications for the Settlor or the Beneficiaries.

(d) Prior transfer to a Beneficiary

- It may be that after the Settlor's death the Trustees will consider encashing the Bond and releasing the proceeds to a Beneficiary.
- As an alternative to encashing the Bond prior to making a payment to a Beneficiary (obviously, after the Settlor's death), the Trustees could make an absolute and irrevocable appointment of benefits in favour of an adult Beneficiary. They could then assign the Bond to the Beneficiary who is to benefit. That assignment would not give rise to a chargeable event. Any chargeable event gain arising on any subsequent encashment by the Beneficiary would then be assessed to tax on that Beneficiary

It should be noted that a change of Trustee and the death of a Trustee have no tax implications.

(e) Tax on pre-owned assets

This is a special income tax charge which can apply since 6 April 2005 when a trust is created under which the Settlor can potentially benefit and the trust is not subject to the IHT gift with reservation rules. In the case of the London & Colonial Discretionary Discounted Gift Trust, the Trust is effectively split into two. The Settlor's rights to capital payments are held for the benefit of the Settlor (the Settlor's Fund), under a bare trust. The remainder, i.e. the Beneficiaries' Fund, is held under a discretionary trust under which the Settlor cannot benefit. For the purpose of the pre-owned assets tax charge, both Funds have to be tested separately. As the Settlor's Fund is held on a bare trust for the Settlor, the pre-owned assets tax charge cannot apply as for the charge to apply there must be a settlement. Although the Beneficiaries' Fund is a settlement, the Settlor cannot benefit from this part and therefore the pre-owned assets tax charge cannot apply to this fund either. HMRC issued a Guidance Note on this issue in March 2005 confirming this interpretation.

6.3 CAPITAL GAINS TAX

No capital gains tax should arise in relation to any dealings with a Bond held subject to a London & Colonial Discretionary Discounted Gift Trust.

This Guide is based on London & Colonial's understanding of UK law and HMRC practice as at 1 November 2008. While every care has been taken, neither London & Colonial nor any of its representatives, officials or employees can accept any responsibility for any loss occasioned as a result of the information contained in this Guide in any circumstances whatsoever. Potential investors are strongly recommended to take independent professional advice before creating the Trust.