Benefits and pitfalls

Robert Keylock provides an update on the usefulness of discounted gift plans after Watkins v HMRC *[2012]*

Robert Keylock is a solicitor in the private client team at Forsters LLP

When the tax on pre-owned assets came into force in April 2005, many advisers raised a quizzical brow at the Treasury's benign treatment of certain life assurance products, which unexpectedly slipped through the fingers of parliamentary draftsmen wholly unscathed. In spite of that, recent case law in the context of discounted gift plans (DGPs) highlights that despite falling outside the gifts with reservation of benefit legislation and the tax on pre-owned assets, DGPs will not always provide an answer to the estate-planning prayers of taxpayers.

The basic premise of a DGP is that a donor invests in a single premium life assurance bond, which is held in trust (either for their heirs absolutely, or on discretionary trusts for a wide class of discretionary beneficiaries). The declaration of trust, however, reserves to the donor a right to draw annually from the bond part of the initial amount invested (usually up to 5% annually).

The donor's transfer of value for inheritance tax (IHT) is the fall in value of their estate as a result of the gift, which HMRC calculates as the total sum invested less the value of the donor's retained rights. Where the donor is, say, middle-aged and in good health, the value of a right to 5% of the initial investment annually for life (or until the initial sum invested has been exhausted) may well be substantial, resulting in an attractive discount in the transfer of value.

On the donor's death, the value of the retained rights in the donor's estate is the value immediately before death. The IHT legislation does not require the donor's imminent death to be a known factor for valuation purposes, which suggests that such rights might occasionally have some value on death, particularly if the death resulted from, say, sudden physical trauma when the donor might otherwise have had a good life expectancy. In practice, however, it is understood that HMRC accepts the value is nil.

The effect, therefore, is that the value of the retained rights falls outside the donor's estate for IHT purposes immediately. This is all very attractive in theory, but if one scratches beneath the enticing veneer, there are many aspects of DGPs that leave them wanting as an estate planning tool. Great care should therefore be taken to weigh the practical and tax benefits against the pitfalls of DGPs before committing to the gift.

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The case for DGPs

Aside from the potential IHT discount, the main appeal of a DGP is that the retained benefits allow the donor to enjoy something akin to income from the gifted capital (although, strictly, the annual payments are partial surrenders of the bond, so bear no direct link to the actual income received from the underlying investments). This is of significant benefit to donors who, while wishing to pass capital to the next generation for IHT planning purposes, nonetheless need, or may in future need, income for their maintenance following the gift.

Provided the annual payments do not exceed 5% annually of the initial amount invested, the payments will not suffer income tax or capital gains tax in the donor's hands. There are, however, important caveats to this, which are set out below.

The main potential IHT benefit of DGPs, in comparison to other types of lifetime gift, is the immediate

IHT discount where the donor's life expectancy is such that the annual payments have some value. The donor will also have reassurance that the DGP falls outside the gift with reservation of benefit rules. Provided there is no possibility that the donor can benefit from any part of the bond other than their retained rights, HMRC regard the rights as having been carved out from the balance of the bond for IHT purposes.

HMRC also consider that DGPs fall outside the pre-owned assets tax (POAT charge) on intangible property. HMRC stated in its guidance on POAT that the retained rights are a separate asset held on a bare trust for the donor, so cannot be subject to the charge. Conversely, the balance of the bond is a separate asset from which the donor is excluded from benefit, so cannot fall within the POAT charge either. Nonetheless, some commentators claim this to be erroneous because the insurance bond is a single chose in action held in trust, and the donor therefore continues to benefit from part only of a single chose in action. Having provided clear guidance on the point, it would be very unfair for HMRC to change their position, but donors should be made aware that the point is not clear-cut.

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The case against DGPs

Valuation of the discount

HMRC take the view that where the donor is uninsurable, whether by reason of their age or ill health, the value of the donor's retained rights will be only nominal.

This point was addressed in the recent First-Tier Tribunal case of *Watkins v HMRC* [2012]. In 2004 Mrs Watkins paid £340,000 into an Isle of Man DGP with Skandia. She was 89 and nine months at the date of the gift. Mrs Watkins retained a right to withdraw 10% of her investment annually (by quarterly payments of £4,250). The balance was then held for her two sons in equal shares absolutely. On the basis of a medical assessment in 2004, Mrs Watkins was taken to have a life expectancy of just over three years. Skandia therefore valued her retained rights at the date of the gift as being just over three years' worth of quarterly payments of £4,250, ie £53,273. She died two years later in 2006, at the age of 91. As Mrs Watkins was uninsurable at the time of the gift, HMRC claimed that the retained rights only had a nominal value, amounting to no more than one quarter's payment, ie £4,250.

It was agreed that there was no market for the sale of retained rights in DGPs. However, HMRC was able to provide evidence that, in the context of sales of life interests, it is standard practice for the risk to a buyer to be mitigated by insuring the life tenant's life. Mrs Watkins' executors (who were represented by Mrs Watkins' son, David Watkins) conducted an 'informal survey of several organisations and people' to seek to establish whether Mrs Watkins' interest was capable of being sold on the open market despite her being uninsurable. The survey revealed that the rights might have been capable of sale on the open market without insurance on Mrs Watkins' life, provided that an alternative arrangement was agreed to reduce the buyer's risk. The alternative arrangements suggested by Mr Watkins were:

- a charge over some of Mrs Watkins' personal assets;
- retaining the capitalised value of the retained rights in an escrow account;
- phased payments by the buyer to match the release of income from the rights sold; or
- personal guarantees from Mrs Watkins' sons as beneficiaries of the balance of the DGP.

Following the reasoning of Lewison J in *Bower v HMRC* [2009] (which also concerned the valuation of DGP rights retained by an uninsurable donor), the Tribunal concluded that it is first necessary to look at the existing marketplace for such rights, into which a hypothetical sale could then be posited for the purpose of s160 IHTA 84. As there is no such market for retained DGP rights, it was then necessary to survey an analogous market, ie the sale of life interests. The Tribunal appreciated a sale of a life interest would not be on all fours with a sale of retained DGP rights were such sales to occur in practice. Nevertheless, the Tribunal found it persuasive that, almost without exception, the evidence of previous life interest sales indicated that such an interest would only be sold if the buyer's risk could be mitigated by insuring the life tenant. By contrast, Mrs Watkins' executors provided no evidence that their four methods to protect the buyer had ever been used on a sale of a life interest in practice, so their proposed alternative arrangements had no foundation in reality. As the burden of proof to displace HMRC's valuation rested on the executors, the Tribunal found the executors had provided insufficient evidence, in light of existing market practices, to displace HRMC's conclusion that Mrs Watkins' retained rights could not be sold without insuring her life. Accordingly, the rights were valued at £4,250 rather than £53,273.

The implications of *Watkins* for donors is that those in their 80s and 90s, and younger donors in poor health, are unlikely to benefit from substantial discounts from the valuation of their retained rights, and only a nominal discount if they are uninsurable at the time of the gift. However, donors who are healthy and in, say, their 60s, might reasonably expect to survive at least seven years, and in which case the simplicity and cost-effectiveness of a potentially exempt transfer may be more attractive.

The rights are not 'income' for the purpose of the IHT gifts out of surplus income exemption

Although the donor might look upon the retained rights as income, in most cases the payments are in practice capital. The distributions cannot usually therefore be classified as income for the purpose of the IHT gifts out of surplus income exemption. HMRC amended their IHT manual in September 2011 to request that all claims for gifts out of surplus income where the donor withdraws sums annually from an insurance bond should be referred to their technical team (see IHTM14250).

Income tax charges

It is often seen as advantageous that the donor's 5% annual payments are free from income tax. In practice, however, that is slightly misleading. For basic rate taxpayers, no additional tax would have been due had the income instead been derived from, say, dividends or unit trust distributions, as these would attract tax credits and deduction of tax at source respectively, which would match the basic rate tax due. There is therefore no income tax advantage to basic rate taxpayers.

Where the trustees of the DGP have a discretion over who may receive the income from the balance of the bond (and are therefore taxed at the 50% trust rate), there will be an income tax charge when the bond is eventually surrendered, albeit with a credit for the basic rate tax deemed to be paid at source. There will also be an income tax charge on a surrender if the balance of the bond is held outright or on interest in possession trusts for one or more higher-rate taxpayers. The practical effect for discretionary trustees and higher rate taxpayers is that the higher rate income tax charge is just postponed and not circumvented. By deferring the income tax charge, it might be hoped that the investments within the bond will appreciate at a faster rate than had the trustees or beneficiary (as the case may be) been paying income tax annually. In many cases, that may well be a successful gamble, but it is a gamble nonetheless. It should also be noted that, although no higher rate tax would be paid during the life of the bond, the life company will be charging administration fees, which will reduce the anticipated appreciation.

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Depreciation and termination of the retained rights

The value of the annual payments will fall in real terms as inflation eats away at the cash value of the initial investment. The payments will also ultimately terminate once the donor has withdrawn the full value of the initial amount invested (which, in the case of 5% annual distributions would be at the end of the twentieth year). Donors who create DGPs in, say, their 50s and early 60s, will therefore see the annual payments dwindle in real terms, and might suddenly find themselves out of pocket as the retained rights become exhausted as they reach their 70s and 80s, at just the point when such funds might be essential for the cost of residential or nursing care.

Life companies' fees and penalties

The set-up fees, administration fees and penalties of some DGP schemes are often, to put it mildly, impenetrable. A lack of clarity on fees makes it very difficult for the donor to make an informed decision. It should also be noted that the DGP might increase the cost of administering the donor's estate if the executors have to correspond with HMRC to agree the value of the discount, and possibly to obtain evidence from an independent actuary, if the disputed value of a discount merits it.

Conclusion for trusts and estates practitioners

The various benefits and pitfalls of DGPs make it essential for individuals contemplating investing in a DGP to ensure they receive thorough guidance from a suitably qualified IFA with expertise in this area, and who can steer the donor through the myriad of DGPs available in the market and their respective charging structures. However, as a DGP is not simply an investment, but a trust structure, the IFA should ensure the DGP dovetails with the donor's estate planning arrangements. An early review of a draft DGP by both the donor's IFA and by their solicitor working together is essential to ensure the DGP is suitable, rather than an expensive, and ultimately misguided, investment. ■

Bower v HMRC
[2009] WTLR 619
Watkins & anor v HMRC
[2012] WTLR 677