Discounted Gift Schemes (DGSs)

A technical note from HMRC

Background

Following recent press interest, this is an opportune moment to set out HMRC's approach to Discounted Gift Schemes (DGS) and their interaction with the Inheritance Tax (IHT) legislation. This note is particularly about valuation of lifetime transfers and the underlying valuation methodology. We are also taking this opportunity to set out the approach we will adopt in joint settlor cases, which, in some cases, will be more precise than that adopted up to now. It is emphasised that this note sets out HMRC's practice and is not seeking to prescribe the approach that **must** be taken to establish the chargeable value for IHT. Alternative approaches may be used to arrive at broadly similar results and HMRC continue to be open to considering and agreeing alternative valuation bases that achieve that aim.

HMRC has not made any fundamental change to its overall approach towards DGSs. But, as indicated at the end of this note, we are proposing to make a change to one element of the basis of valuation that we use to reflect current market conditions.

IHT treatment of DGSs

Essentially a DGS involves a gift of a bond from which a set of rights are retained, typically withdrawals or a set of successively maturing reversions. The retained rights are sufficiently well defined to preclude the gift being regarded as a gift with reservation (GWR) for IHT purposes.

The gift is a transfer of value for IHT purposes whose value is determined by the loss to the estate principle. This is set out in s.3(1) Inheritance Tax Act 1984 (IHTA), and quantified by the difference between the amount invested by the settlor and the open market value (OMV) – s.160 IHTA refers – of the retained rights.

Valuation issues

The OMV of the retained rights will depend on, inter alia, the settlor's sex, age, health and thereby insurability, as at the gift date. If the settlor were to be uninsurable, for any reason, as at the gift date the OMV of the retained rights would be nominal and the gift would be close to the whole amount invested by the settlor. This is because s160 IHTA 1984 provides that, in valuing the retained rights, we assume that a sale of them takes place.

The logic behind that premise is based upon sound open market evidence and fully endorsed by leading counsel from whom HMRC has taken advice. We have looked for evidence to sales of assets similar in nature to the retained rights, for example life interests or contingent reversions which are dependent upon the survival of the relevant life to a series of predetermined dates. This indicates that such rights are not saleable unless life assurance can be effected on that life by the open market purchaser (OMP) or it comes as part of the sale. If it cannot be effected market evidence shows that those assets will not sell. Without life cover being in place the OMP is at risk of anything up to the total loss of his investment should an early death of the settlor occur. We consider it to be fundamental that the open market valuation of the retained rights should be carried out having regard to what market evidence is available. Additionally we have been unable to find any evidence that it is possible to effect cover on lives older than 90 next birthday. HMRC therefore regard lives older than that, true or equivalent (mortality rated), as being uninsurable with the resultant ramifications in respect of the gift value.

Position where there are joint settlors

To date HMRC has taken a pragmatic approach to calculating the value transferred where there are joint settlors, usually husband and wife or civil partners. This approach has been to value the retained rights in their entirety and deduct this amount from the total sum invested. The value of the transfer has then been apportioned between the settlors in the proportions in which they provided the sum invested.

Example of HMRC's 'old' approach:

> Husband (H) aged 80 and wife (W) aged 80 invest £100,000 equally in a DGS with monthly withdrawals of £416.67 payable until the death of the last to die of H and W.
>
> Open market value (OMV) of the retained rights calculated as £46,300.
>
> Transfer of value calculated as £100,000 - £46,300 = £53,700
>
> Of this, £26,850 is attributable to H and £26,850 attributable to W.

In practice, where the joint settlors are of similar ages and in similar states of health the results of this pragmatic approach do not differ dramatically from the results where the value of each settlor's retained rights are considered individually.

Following the changes brought about by the Finance Act 2006, HMRC has seen a number of cases where DGSs have been taken out where there is a significant age difference between the joint settlors or where one of the joint settlors is in very poor health or even uninsurable. In such cases the pragmatic approach does not achieve a reasonable result. We have also been asked to clarify the correct method of valuation in these circumstances as different providers are calculating the transfer values using different methods, resulting in a lack of consistency. This also means that taxpayers and their advisers are unclear as to which approach is correct. In the light of this uncertainty we are setting out below what we consider to be the correct valuation approach. We intend to follow this approach for **all** DGSs where the transfer takes place after 1 June 2007. We will also use this method where a transfer has taken place before that date and the pragmatic approach would provide an unreasonable valuation of the settlor's retained rights and substantial sums are involved.

In HMRC's view, the correct approach is to value the retained rights in their entirety and to apportion this value between the joint settlors by reference to the OMV of each settlor's retained rights. In the case of joint settlors who are married or in a civil partnership, the related property provisions of s. 161 IHTA are to be taken into account in this valuation. The application of s. 161 IHTA has been considered in some detail in Arkwright and anor v IRC [2004] EWHC 1720 (Ch) – STC 2004 p1323.

The impact of this on the above example is as follows:

OMV of H’s retained rights = £16,400
OMV of W’s retained rights = £19,900
OMV of the total retained rights = £46,300

(The calculations of retained rights reflect the age, state of health and insurability of H and W respectively.)

The OMV of H’s retained rights, calculated in accordance with s. 161 IHTA is

$$\frac{£16{,}400}{(£16{,}400 + £19{,}900)} x £46{,}300 = £20{,}900$$

The OMV of W’s retained rights, calculated in accordance with s. 161 IHTA is

$$\frac{£19{,}900}{(£16{,}400 + £19{,}900)} x £46{,}300 = £25{,}400$$

So the values transferred by H and W are:

Value transferred by H = £50,000 - £20,900 = £29,100

Value transferred by W = £50,000 - £25,400 = £24,600

It is recognised that where there are significant differences in the ages of the settlors (whether their actual ages or their effective ages for insurance purposes) it is technically possible for the value of the retained rights to be calculated as a negative amount using the above approach. It is also technically possible to calculate the value of the retained rights as exceeding the contribution of the settlor. The value of the lifetime transfer is calculated, in accordance with section 3(1) IHTA, as the loss to the transferor’s estate. If the value of the retained rights is negative the loss to the transferor’s estate cannot exceed the amount contributed, i.e. there cannot be a negative ‘discount’. If the value of the retained rights exceeds the settlor’s contribution, there would be no loss to the estate and therefore no transfer of value.

We do not propose to re-open cases where the values transferred have been accepted in accordance with our previously adopted approach.

Underwriting approach

As far as DGS contracts are concerned, it is clear that insurance companies adopt differing practices with regard to underwriting the settlor’s life ranging from no underwriting through the so-called “sealed-envelope” to full underwriting. HMRC’s preference is that full underwriting should be carried out prior to the DGS being effected.

The open-market based valuation method requires that evidence of the settlor’s health exists at the transfer date that is sufficient for the settlor’s life to be underwritten to the standards required for whole of life assurance. If no evidence of health has been obtained at the outset, HMRC take the view that a discount is not justified unless medical evidence sufficient to underwrite the settlor’s life to the standards required for whole of life assurance was already in existence and can be produced, should it be necessary to quantify the gift at a later date.

HMRC adopt this stance because problems can and do arise if no evidence of health has been obtained at the outset **and** therefore is **not** reflected in the estimate of the value of the gift. On the death of a settlor, for example, where no evidence has been obtained HMRC will often need to ask the settlor's personal representatives to obtain evidence about the settlor's health at the time the gift was made. We recognise that this is undesirable as the surviving family may face intrusive and upsetting enquiries at a difficult time. This can be avoided if the information is obtained in advance. Problems also arise where medical evidence is not collected until after the transfer occurs and it then becomes apparent that up to date medical details are not held. This would be insufficient evidence on which to underwrite to the standards required for whole of life assurance and would therefore result in no discount. Additionally survivors may not have been party to the transaction entered into by the settlor. They may feel entitled to particular treatment based on expectations given by financial advisors and then feel aggrieved when HMRC begin investigating.

HMRC's current basis of valuation

The retained rights fall to be valued on an open market basis in accordance with s160 IHTA 1984. In investing in the retained rights the open market purchaser (OMP) will need to take account of the rate of return he requires and the cost of insuring the settlor(s) life.

The annual amount to be paid under the retained rights, net of any income tax liability that the purchaser may suffer, is multiplied by a purchase factor generated from a suitable formula e.g. a Jellicoe formula (see for example "*Actuarial Valuations of Interests in Settled Property*" – Beard FIA & Prevett FIA Institute of Actuaries 1973 page 15).

$1 - p / p + i$ where

p is the annual premium expressed as a decimal and

i is the OMP's rate of return also expressed as a decimal.

The present value of the retained rights is arrived at from the product of the net annual amount of the retained rights and the purchase factor. The OMV is 97% of that present value (rounded to the nearest £50) to reflect the OMP's costs of say 3%.

As mentioned at the start of this note, the aim is to set out HMRC's practice, not to prescribe the approach that **must** be taken to establish the chargeable value for IHT. Alternative approaches may be used to arrive at broadly similar results and HMRC continue to be open to considering and agreeing alternative valuation bases that achieve that aim. HMRC's current mortality and interest rate basis is

- Mortality : 70% of AM / AF 80 Mortality (reflecting the improvement over the table for assured lives for males and females published by the Continuous Mortality Investigation Bureau in 1990 reference CMIR 10)
- Interest rate : 5.25% pa
- Open market purchaser's costs: 3% (as a deduction from the present value of the retained rights).

HMRC has recently reviewed its interest rate basis. In the light of recent rises in interest rates, HMRC are proposing to change that basis with effect from 1 June

2007 when a valuation rate of interest of 6% pa will be adopted. Our analysis indicates clearly that such a rise in that rate is warranted and reintroduces the differential over base rate and corresponds to a 1% differential over short term Gilts as at 2 April 2007. The valuation basis is kept under review to ensure that it continues to reflect open market conditions. It is our intention to publish details of any future changes to our valuation basis on the HMRC website.

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