Case Study - Exploring Income Options

Understanding different income solutions now will mean clients have the right level of income flexibility.

This document is based on London & Colonial Assurance PCC Plc's understanding of applicable UK tax legislation and current HM Revenue & Customs practice, as of November 2024, which could be subject to change in the future.

Elsa:

- aged 70,
- currently receiving an annual gross pension of £20,000 and
- has accumulated wealth of £800,000 (including the family home, ISAs, and various cash deposits).

Since her partner died six months ago, Elsa has been struggling to manage the family home and everyday bills. After discussions with her family, she has decided to move into nearby rented sheltered accommodation, however, the rent and service fees are currently £26,000[1] a year.

Elsa speaks to her financial adviser to discuss her future income needs. Below we compare a discounted gift trust versus purchasing a London & Colonial Assurance PCC Plc's ('LCA') Flexible Life Annuity.

[1] The Average Retirement Home Costs in the UK (2024) | Lottie

Discounted Gift Trust

Under a Discounted Gift Trust ('DGT') solution Elsa invests a lump sum into an investment bond, which is then transferred to a trust, under which Elsa is entitled to a fixed income for life. After Elsa's death, the remaining fund is held in trust for her chosen beneficiaries.

Because Elsa retains a right to a fixed income, the gift into trust is "discounted". In order to calculate this discount, Elsa will need to be medically underwritten.

Under a DGT, the income is fixed at outset and cannot be changed or cancelled. Her financial adviser explains that this is because the discount is based on the value of the future income payments that Elsa will receive. Therefore, for example, if Elsa's circumstances change and she needs more income to meet any future increases in rent, she won't be able to vary the income amount.

Her financial adviser explains that the fixed regular payments (including any adviser fees) are normally set to 5% of the investment each year due to the potential UK income tax liability. Under chargeable event rules, each year 5% can be taken without an immediate income tax liability. If the withdrawals go above 5% then the excess would be a chargeable gain. Once the tax deferred allowance has been exhausted (5% for 20 years), any subsequent payments are treated as a chargeable gain and are assessable to UK income tax at Elsa's marginal rate of tax.

Whilst Elsa currently needs the income stream, her financial adviser reminds her that the income payments cannot be changed. This means that if her circumstances change and she no longer required the income, on her death, any accumulated (unspent) income could potentially increase her inheritance tax ('IHT') bill.

Whilst there is an immediate IHT saving (depending on whether a discount is given and the level of the discount), the remainder of the gift into trust will be outside Elsa's estate after seven years. Nevertheless, any growth made on Elsa's whole investment will be immediately outside of her estate.

Flexible Life Annuity

The Flexible Life Annuity ('FLA') is a unit-linked purchased life annuity which, like a discounted gift trust, is designed to provide an income. However, as Elsa retains control of the annuity, during her lifetime, she can increase, decrease, pause, and resume the income depending on her needs. This means that Elsa can make sure that future increases in living costs can be effectively managed.

The annuity payments that Elsa withdraws, like with the Discounted Gift Trust, may be liable to UK income tax. Under the FLA, a tax-exempt sum is calculated at the start of the annuity. This is the amount of annuity that can be taken tax-free each year. In any year, if the annuity payments exceed the tax-exempt sum, the excess is treated as savings income and potentially liable to UK income tax. However, where the annuity payments are less than the tax-exempt sum, the unused amounts may be carried forward to future years. Unlike the DGT, where the tax deferred allowance can be exhausted, the tax-exempt sum calculated is available throughout the life of the annuity.

As Elsa purchases the FLA and retains control over how much income she draws during her lifetime, there is no need for medical underwriting and there is no trust involved.

Elsa is unsure what happens on her death. Her financial adviser explains that the FLA ceases, and no further annuity payments are made from the contract. However, when the FLA is purchased, Elsa also has the option to purchase a Preference Share in London & Colonial Assurance PCC Plc, a Protected Cell Company. The purchase of the Preference Share is totally separate to the purchase of the FLA but if Elsa decides to purchase the Preference Share, the Share will be linked to the Cell which holds all the assets that back her FLA. When Elsa dies her personal representatives must value her Estate, which includes the value of the Preference Share (the value of the remaining investments held within the Cell,) for inheritance tax ('IHT') purposes.

Under current IHT legislation, there are reliefs and exemptions which allow assets to be passed on to a deceased's beneficiaries tax-free or at least at a reduced rate of IHT. One such relief is Business Relief. Currently (and up to 05 April 2026), where the asset is a share in an unlisted trading company, 100% Business Relief is available, provided the asset was owned by the deceased person for at least two years before they died and continued to be held on death. London & Colonial Assurance PCC Plc is an unlisted trading company.

From 06 April 2026, the proceeds of the Preference Share, up to £1m, are 100% exempt from IHT. Any proceeds that exceed the £1m allowance will benefit from 50% Business Relief and IHT will be payable on the excess.

Summary

	Discounted Gift Trust (DGT)	Flexible Life Annuity (FLA)
Income	Fixed at outset and cannot be cancelled or varied.	Initial income calculated at outset but can be varied between 0% and 100%.
Taxation of Income	5% tax deferred for 20 years then taxed at marginal rate of UK income tax.	Each year the excess above the tax-exempt sum is taxed at marginal rate of UK income tax.
Control	Uses a trust, trustees become the legal owners but during the client's lifetime have a duty to pay the income to the client. Trust must be registered on HMRC's Trust Registration Service.	No trust, client remains the sole owner. No registration required.
Underwriting	Full underwriting required to calculate discount.	No underwriting required.
Inheritance tax	Discount outside estate immediately with the remainder after seven years.	Currently (and up to 05 April 2026), tax-free after two years of owning a Preference Share. From 06 April 2026, tax-free after two years of owning a Preference Share if, on death, the value of the residual assets in the client's Cell does not exceed £1m.

Deciding whether a DGT or a FLA is the best solution for a client's needs depends on that client's individual circumstances, so the help of a financial adviser is paramount.

Want to know more?

If you would like further details on our Flexible Life Annuity or any other product we offer, please contact your dedicated business development manager or email sales@stmgroup.online.

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