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Case study:

Onshore Bond and Discretionary Loan Trust in practice

Overview: Gift Trust

Discretionary Loan Trusts are a useful tool for individuals who want to reduce their Inheritance Tax (IHT) liability while still needing access to their investment or being unable to make outright gifts at the moment.

The process begins with the individual or settlor establishing a trust. To fund this trust, the settlor makes an interest-free loan to the trustees. This loan forms the initial trust fund, which the trustees then invest in a bond or another investment vehicle.

One of the key features of a loan trust is that the loan is repayable to the settlor on demand. This means that the settlor can request repayment of the loan at any time. Because of this arrangement, the loan amount remains part of the settlor's estate for IHT and succession purposes. However, while the loan amount stays within the settlor's estate, any growth from the investment accrues outside of the estate. This growth benefits the trust's beneficiaries, excluding the settlor.

Loan trusts offer several advantages. Firstly, they help mitigate IHT. The outstanding loan remains part of the settlor's estate, effectively freezing the value of the investment for IHT purposes. However, as the settlor receives loan repayments and spends them, their estate value decreases.

Secondly, the loan trusts provide the settlor with access to loan repayments (in place of the investment). The trustees use the investment to fund the loan repayments. Since the loan is repayable on demand, the settlor retains financial flexibility and can access the loan amount if needed.

Lastly, loan trusts are ideal for those who are not ready or able to make outright gifts but still want to plan for IHT efficiently. By creating a trust and making an interest-free loan to the trustees, the settlor can ensure that the investment growth benefits the beneficiaries while the loan amount remains part of their estate.

Case study: David and Therese's use of a loan trust and bond

Background:

David, aged 68, and Therese, aged 65, have an estate valued at £1.8 million. They have £400,000 that they wish to invest in a tax-efficient manner to mitigate Inheritance Tax (IHT). However, they are not ready to make outright gifts at this time, as they have recently made substantial gifts to their children to help with house purchases.

Solution:

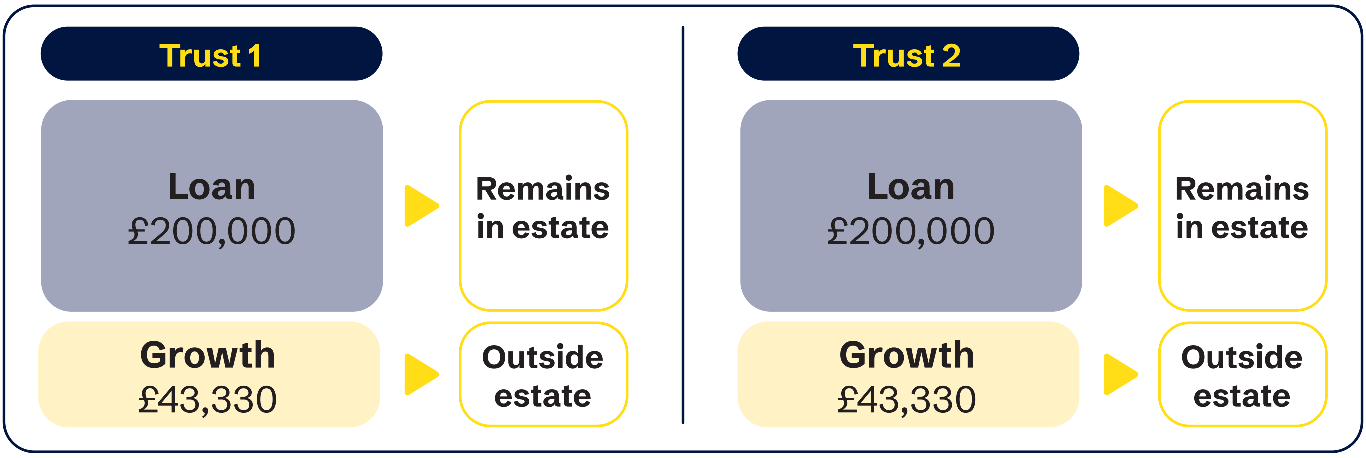
To achieve their goals, David and Therese decide to invest in an Onshore Bond in a Discretionary Loan Trust. This approach allows them to reduce their IHT liability while having access to the loan repayments (in place of the investment). They spread their investment across two separate trusts for added flexibility.

Implementation:

Initially, there is no reduction in their estate because they have not made a gift; instead, they have made loans that are repayable to them on demand. The bonds within the trusts are entirely comprised of the loan amounts, which remain part of David and Therese's estate for IHT purposes unless they are waived or repaid.

In practise

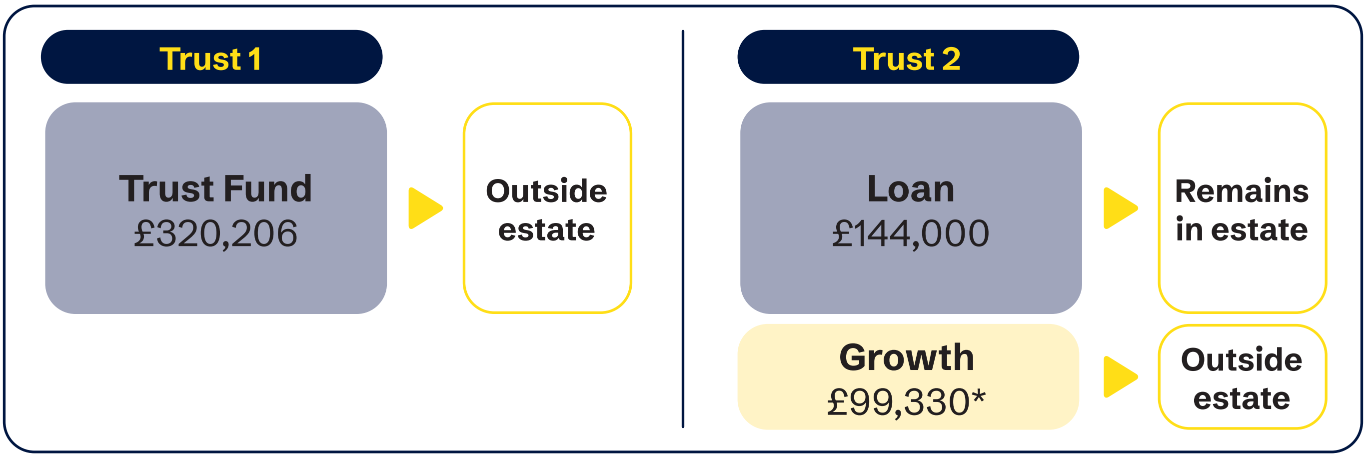
For the next five years, David and Therese do not take any repayments from their plans. During this period, each bond grows by 4% per annum. After five years, each bond is worth **£243,330**, consisting of the original **£200,000** loan and **£43,330** in growth.



Waiving the loan and taking repayments

Feeling more comfortable about their financial position, David and Therese decide to waive the loan of one of their two plans. Each of them makes a Chargeable Lifetime Transfer (CLT) of **£100,000**. They also start taking loan repayments from the other trust at a rate of **4% per annum** to supplement their pension income now that they have retired.

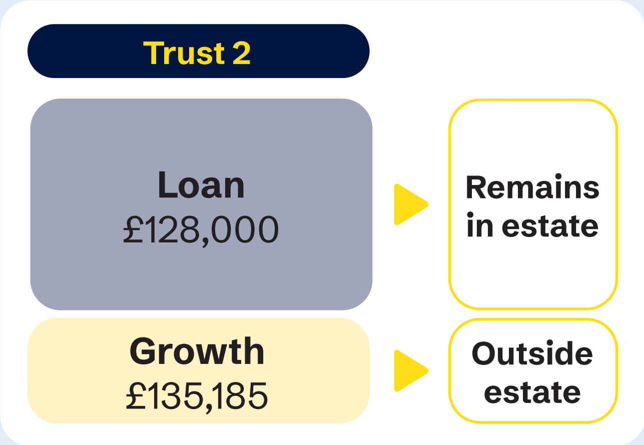
Seven years later, the CLT made by David and Therese will have dropped out of account for IHT purposes. The only remaining part of their estate is the outstanding loan on the second trust, which has decreased in value due to the repayments they have received and spent in the interim period.



Managing the trust after David's death

Two years after the CLT drops out of account, David passes away. There is no IHT or chargeable event because the outstanding loan transfers to Therese, and the bond is written on multiple lives. At this point, Therese stops taking withdrawals as she no longer needs the additional income. She updates her will to waive any outstanding loan balance in favour of the trust upon her death.

After Therese's death



When Therese dies two years later, the outstanding loan of **£128,000** owed to her from trust two forms part of her estate for IHT purposes. However, her executors do not need to call in the loan because it has been left to the trust by her will. The growth, along with the value of the other bond held in trust one, passes free of IHT to the trust beneficiaries. This means that both bonds can now be surrendered by the trustees with the proceeds passed to the beneficiaries, or assigned to the intended beneficiaries for surrender if this would be more tax-efficient. Exit charges might apply to capital distributed to beneficiaries. These will apply where there has been a charge to inheritance tax at the last 10-year anniversary or at the start of the trust if within the first 10 years.

In this example, the outstanding loan due to be repaid to the settlor's estate from the loan trust was waived upon death due to a provision in the settlor's will. This meant that the trustees did not need to surrender the bond and pay tax at trust rates to repay the loan to the estate. If no such provision had been included in the will, assignment is a method of repaying the loan instead of withdrawing proceeds to repay the loan in cash - any assignment is made partly in satisfaction of a loan owed to the beneficiary. The assignment is therefore deemed to have been made for consideration and so results in a chargeable event, taxable on trustees.

The information in this leaflet is based on our understanding of current legislation and HM Revenue & Customs' practice. Both of these are likely to change in the future. Tax treatment will depend on personal circumstances.

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