

Discretionary Loan Trust

A customer guide

Discretionary Loan Trust

What is the Discretionary Loan Trust?

The Discretionary Loan Trust is a trust that allows you to make a loan to the trustees who then invest into investment bonds and/or collective investments. You instruct the trustees to repay the loan on demand to you, and as such you can supplement your income through regular or specified withdrawals from the investment.

Who is it suitable for?

It may be suitable for anyone who wants to reduce their potential inheritance tax (IHT) bill, but needs to keep access to their capital.

What products can I use it with?

The trustees can invest in an onshore Aviva investment bond or a holding of collective investments.

Remember that these products will involve investment in the stock market, so the value can go down as well as up and may fall below the amount of the original investment. Before investing, you and the trustees should read the relevant Key Features document carefully. It's important to understand the product fully and make sure it is suitable.

How do I apply?

You must complete the Loan Agreement and Discretionary Loan Trust Deed. The trustees (appointed in the Deed) then apply for the Aviva bond or collective investments of their choice. If the trustees are investing in a bond the trust documents must be sent to Aviva together with the bond application and your payment.

If the trustees are investing in collective investments only, you should not send the Discretionary Loan Trust Deed and Loan Agreement to us. However, you should still complete them fully and carefully and keep them safe.

Please note:

In this booklet, references to 'spouse' are intended to include 'civil partner' and references to 'widow' or 'widower' to include 'surviving civil partner'.

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The objective – how to leave more for your family by reducing your IHT liability

You've worked hard all of your life. You own your own home and have built up a reasonable 'nest egg' for your retirement. You will probably be unhappy to learn that, unless you take steps to prevent it, HM Revenue & Customs could be one of the main beneficiaries of your estate when you die.

The steady improvements in the standard of living and the value of property over the years have resulted in more and more people becoming concerned about leaving an inheritance tax bill for their children. One way to reduce inheritance tax is to make lifetime gifts. However, you might not want or be able to make unconditional gifts, and lose control over what happens to the money gifted. For example:

- you might need the income from your investments to top-up your earnings or pension, and an unconditional gift would mean that you would lose that income;
- you may want to retain some control over how the money you want to give away is invested;
- where your gift is intended for children or grandchildren who are still under 18 and unmarried, an outright gift may not be appropriate;
- you may want to keep control over who will benefit from the gift, e.g. you may want to ensure that future (unborn) children or grandchildren can benefit from the gift as well;
- you may want your widow or widower to be able to benefit from the gift after your death.

A possible solution – Discretionary Loan Trust

The Discretionary Loan Trust ('the Trust') is designed for use with both Aviva investment bonds and/or collective investments. The benefits of writing Aviva investments under the Trust are as follows:

- potential inheritance tax savings as any investment growth within the Trust is outside of your estate (see section headed 'UK inheritance tax');
- you retain the right to get loan repayments and this can replace the income stream from your investments (until the loan is fully repaid);
- you decide the amount and timing of the loan repayments, and these can be changed at any time;
- you and/or your trustees can retain control over which of the beneficiaries receive benefits, and when;
- unlike assets in your estate, payments to the trustees on your death will not be delayed by the need to obtain probate (or equivalent), provided there is at least one trustee in place at that time;
- professional investment management (for investment policies) through leading fund managers;
- trust documentation is provided with no additional charges over and above those within the investment chosen.

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How does the Discretionary Loan Trust work?

You set up the Trust by completing the Trust documentation and making a loan (interest free and repayable on demand) to your trustees. In practice, you may agree with your trustees to pay the loan monies directly to Aviva.

Within the deed you appoint trustees and name your beneficiaries. You will automatically be included as a trustee. We recommend that you appoint at least one other trustee to act with you. You and/or your trustees can change the beneficiaries at any time.

Once the trust has been set up, the trustees apply for the investment of their choice. They will normally have to draw a cheque in favour of Aviva for the investment amount unless they have agreed that you do this on their behalf.

Aviva will pay withdrawals on the instructions of the trustees, and the trustees may use these to make loan repayments. The trustees must make sure that you, the settlor, do not receive more than your entitlement to loan repayments under the trust. Once the loan has been fully repaid payments to you or for your benefit must stop and your beneficiaries are entitled to the remaining trust fund.

In summary:

- You complete the Discretionary Loan Trust Deed and Loan Agreement.
- Within the Discretionary Loan Trust documentation you set out the loan details, choose your trustees and name your beneficiaries.
- You make a loan, interest free and repayable on demand, to the trustees. Please note that the trustees have an obligation to repay on demand the full amount of the outstanding loan even if the value of the trust investments is less than that.
- The trustees apply for the appropriate Aviva single premium investment bond and/or collective investments and normally draw a cheque in favour of Aviva (unless you have drawn a cheque on their behalf). We will also accept a telegraphic transfer from a Trustee account or a telegraphic transfer from the settlor.
- There are two classes of beneficiary: the potential beneficiaries and the default beneficiaries. At the outset, you choose the 'default beneficiaries' who will benefit if no other appointment is made to one or more of the potential beneficiaries defined in the trust deed within the trust period (125 years). If circumstances change and you would like to consider appointing all or part of the trust fund to other beneficiaries, you should complete a 'letter of wishes' to the trustees detailing your revised intentions.
- You should not include yourself in the class of potential beneficiaries (as that would have adverse tax implications).

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UK taxation

The following tax sections describe the position of the trustees of your Discretionary Loan Trust if invested in an investment bond. As the Trust gives the trustees wide powers of investment, your adviser may recommend investing into other assets such as collective investments or cash accounts. In these circumstances your adviser will be able to provide you with the tax implications of their recommendation.

Please note tax laws may change.

UK inheritance tax

There is no chargeable lifetime transfer when you create the Discretionary Loan Trust. The making of an interest-free loan that is repayable on demand is not a transfer of value. Hence there is no immediate charge to inheritance tax regardless of the size of the loan. Loan repayments are not distributions from the trust and are therefore not subject to exit charges.

Any investment growth that takes place within the Trust does not form part of your estate for inheritance tax purposes. However, any outstanding loan will always be part of your estate regardless of how long the trust has lasted.

The trust fund may be subject to periodic inheritance tax charges at every 10 year anniversary of its creation. A charge will arise on the relevant value of the trust fund that exceeds the then available nil rate band. Any chargeable lifetime transfers you made in the 7 years up to creating the trust will also be taken into account in the calculation. The charge is half of the current death rate (20%) of 30% of the excess. This equates to a rate of 6%.

The value of the trust fund for the purpose of the 10-yearly charge (which determines the exit charge for the ensuing 10 years) will be reduced by the amount of any outstanding loan. Thus, it is effectively the value of the investment growth that could be subject to periodic and exit inheritance tax charges.

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. The charge will be based on the rate calculated at the last 10 year anniversary or at the start of the trust. The charge will be multiplied by the factor $X/40$ where X is the number of full 3 month periods since the last 10 year anniversary. Payments made to you as settlor (under the terms of the loan agreement) will not be subject to Exit Charges.

The inheritance tax treatment of trusts is complex and the above is simply a brief summary. Further information can be found on the HM Revenue & Customs website at www.hmrc.gov.uk or from your professional tax adviser.

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Example

Malcolm is married and aged 66. He has an estate valued at £1,200,000 including £100,000 in liquid assets available for re-investment. Malcolm's will leaves his estate to his children, and he realises that they could have an inheritance tax bill.

Malcolm would like to lessen the potential inheritance tax bill. However, whilst he is not spending any of his capital, he needs the income stream from his investments to support his standard of living and can't make any unconditional gifts.

He discusses investment bonds as a possible option with his financial adviser. Malcolm understands that the value of an investment bond can fall, but is happy to take this risk. So he decides to set up an Aviva Discretionary Loan Trust with a loan of £100,000, investing in a single premium investment bond. The loan repayments will replace the income stream from his investments, at least until the loan is fully repaid. Initially, Malcolm intends asking his trustees to make repayments of £4,000 each year but he is aware that this amount can be increased or reduced.

There is no immediate charge to inheritance tax and no Exit Charges apply to Malcolm's loan repayments. Assuming the value of the relevant trust property is within the nil rate band at future 10 year anniversaries there will be no periodic charges.

Assume that the investment bond grows at 4% per annum after all charges, that Malcolm takes loan repayments at 4% per annum, and that he dies after 12 years.

The investment bond will still be worth £100,000 and the outstanding loan will be £52,000 (i.e. £100,000 less $12 \times £4,000$ repayments). £52,000 will be included in Malcolm's estate and £48,000 will not, giving an inheritance tax saving of $40\% \times £48,000 = £19,200$.

Remember that this is only an example – in practice, the bond may grow more or less than this, or it may fall in value. These figures are only illustrative.

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UK income tax where a UK insurance bond is chosen

You, as the settlor of the trust, will be liable to income tax on any gain that arises under the investment bond whilst you are living (or in the tax year in which you die) provided you are resident in the UK. (See **'What is a chargeable gain under an insurance policy?'** in the **'Questions & Answers'** section.)

If a gain arises in a tax year after your death or when you are not UK resident, then the trustees (if they are UK resident) are liable to income tax at the rate applicable to trusts (currently 45%) but with a tax credit of 20% because of tax suffered within the insurance bond. If the trustees are not UK resident then any beneficiary ordinarily resident in the UK may be liable to income tax at their marginal rate on any money received from the trust, with no credit for corporation tax payable in the UK on policyholder funds.

You should note that a chargeable gain might affect eligibility for income related benefits and allowances such as child benefit.

Aviva onshore policies and UK income tax

Any gain arising under an Aviva onshore policy will not be subject to basic or starting rates of tax. This is because of corporation tax paid by Aviva on its policyholder funds. You will only pay tax on any gain if you already pay higher rate income tax, or if the gain takes you into the higher rate band. Where appropriate, top slicing relief can be claimed by an individual to reduce the tax payable. Where income tax is payable it is at the difference between basic rate and the marginal rate you pay.

UK capital gains tax

Your investment bond will generally be exempt from capital gains tax.

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Questions & Answers

1. Who is the settlor/lender?

The person(s) who set(s) up the trust and makes the loan. They should be 18 or over and of full mental capacity.

2. Who can be a trustee?

Any adult who is of sound mind may be a trustee. Also, a trust corporation may be appointed. There are a number of considerations to be borne in mind when choosing trustees, and you should speak to your own professional advisers about this.

3. Who has the power to change the beneficial interest under the trust?

The settlor has this power during her/his lifetime, and the trustees thereafter. Whilst the potential beneficiaries will automatically include the settlor's spouse, children and grandchildren, the settlor can extend this to include anyone else apart from her/himself.

4. Who should be the applicants for the investment bond?

All trustees should be applicants.

5. Who can be the lives insured?

Usually, two of the beneficiaries will be the lives insured, or the settlor and one of the beneficiaries.

6. Can spouses/civil partners each take out their own Loan Trust arrangement?

No. HM Revenue & Customs will apply the 'gift with reservation' provisions if each spouse is a potential beneficiary under the other's Discretionary Loan Trust. This would be the case if our standard documentation is used. This would cancel out any inheritance tax advantage.

7. Can spouses/civil partners establish a joint Aviva Loan Trust arrangement?

Yes, this can be done using the Discretionary Loan Trust documentation.

When the first settlor/lender dies under a joint Discretionary Loan Trust, their share of the loan is repayable by the trustees to their estate (unless they have made arrangements in their Will for the loan to be 'written off' at that time). The trustees would then have to withdraw money from the investment to repay the loan, and that would have tax implications.

8. How can the trustees invest the loan money?

The Loan Trust gives the trustees wide powers to invest eg in life insurance bonds, Unit Trusts and OEICs. However, the trust is designed to hold a single premium investment bond. The trustees should take professional advice regarding their investment.

9. Are loan repayments by the trustees taxed as the settlor's income?

Despite the common expression that the settlor is receiving an 'income', these are repayments of the outstanding loan and should not be subject to income tax.

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10. What happens when the trustees have repaid all of the loan?

The settlor(s) must not receive any further payments once the loan has been fully repaid.

11. Can the settlor receive loan repayments only at 5% per annum of the amount loaned?

No. The loan is repayable on demand. If the settlor(s) ask(s) in writing for repayment in full then the trustees must repay the whole of the loan outstanding.

12. Can the settlor give up her/his right to repayment of the loan?

Yes. The settlor(s) can waive this right by means of a Deed. The amount of loan outstanding at that time would then be a chargeable lifetime transfer for inheritance tax purposes, and as such could be subject to IHT charges.

13. Does the settlor have to state how loan repayments are to be made at the outset?

No. The settlor(s) can make separate requests to the trustees for each loan repayment. However, it is possible to ask for regular loan repayments, subject of course to the right to repayment in full on request.

14. What happens to any loan outstanding when the settlor dies?

This will form part of the settlor's disposable estate. Either the loan will be repaid to the settlor's personal representatives to be distributed with the estate, or the outstanding loan could be left to the trust (in the settlor's will).

15. What is a chargeable gain under an investment bond?

The tax treatment of the investment bond is set out in the tax legislation. When a chargeable event occurs a calculation is required to decide whether there is a chargeable gain. Before making a withdrawal, the trustees should consult her/his professional adviser regarding the tax consequences as there are various options which can be considered. The following are chargeable events for the investment bond:

- (a) death resulting in payment under the bond ie when the last or only life insured dies;
- (b) fully cashing in the bond, or an entire segment of the bond;
- (c) assignment of the bond for money or money's worth;
- (d) and partial cashing in of the bond in excess of the 5% 'allowance'.

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Important notes

This booklet is not intended to give advice. Anyone thinking of using a Discretionary Loan Trust or doing anything under the provisions of the trust, must rely on the advice of their own legal and/or financial advisers. We would urge you to seek appropriate professional advice relevant to your own circumstances before proceeding. This is important for a number of reasons.

- Creating a trust has taxation as well as legal consequences.
- Once the trust has been created it cannot be revoked.
- The trustees have a special duty to the beneficiaries and the misuse of a trust power by a trustee can make her/him personally liable for any resulting loss to the beneficiary.

References to tax treatment in this booklet are based on Aviva's understanding of current legislation and HM Revenue & Customs' practice. Both of these are likely to change in the future, and this could result in tax being suffered under an existing arrangement. Every care has been taken as to its accuracy. However, neither Aviva nor its representatives can accept responsibility for loss, however caused, suffered by any person who has acted or refrained from acting as a result of material published in or in conjunction with this booklet.

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