



DISCRETIONARY LOAN TRUST TECHNICAL GUIDE

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In this document the term “spouse” includes a reference to a registered civil partner under the Civil Partnership Act 2004



1. THE LONDON & COLONIAL DISCRETIONARY LOAN TRUST – OBJECTIVES AND SUITABILITY

The aim of the Discretionary Loan Trust is to facilitate effective lifetime inheritance tax (IHT) planning for an investor by using a London & Colonial Offshore Open Bond (“the Bond”) and a trust. The investor will be the Settlor of the Discretionary Loan Trust. By using the Discretionary Loan Trust with a Bond, the investor will be able to ensure that any investment growth accrues in an IHT efficient manner, achieve a gradual reduction in his estate for IHT purposes while retaining access to his original capital and without making an outright gift.

• **Discretionary Loan Trust objectives**

The more specific objectives of the arrangement can be summarised as follows:

- to gradually reduce the value of the Settlor's taxable estate and to reduce the IHT liability arising on his death;
- to allow the Settlor tax-efficient access to the amount originally invested through loan repayments;
- to ensure that all capital growth on the investment accrues outside the taxable estate of the Settlor and passes to his Beneficiaries in an IHT efficient manner; and
- to allow the Settlor, as Appointor under the trust, to exercise continuing control over who will finally benefit from the trust fund.

The Discretionary Loan Trust anticipates that a potential investor in a Bond who has these objectives could, instead of investing directly in his name, lend a sum of money to Trustees to invest in a Bond. The Trustees would hold the Bond on trust for the Beneficiaries indicated in the trust, subject to the right of the Settlor to have his loan repaid to him.

• **Discretionary Loan Trust suitability**

The investors for whom a Discretionary Loan Trust may be appropriate would normally:

- be over 50 years of age;
- have a net estate (either alone or with a spouse) for inheritance tax purposes exceeding the nil rate band (£312,000 in 2008/09);
- have capital to invest or realisable investments available for reinvestment without capital gains tax liabilities;



- require access to capital to periodically supplement their income;
- need to know that they can call upon the whole (or the remaining part) of the original capital invested at any time should they need to; and
- have identified the Beneficiaries whom they wish to benefit but wish to retain the right to change their mind about who benefits in the future and when.

To ensure that the Discretionary Loan Trust is effective for IHT purposes, the Settlor cannot benefit under the trust in any circumstances, although he is of course entitled to have his loan repaid to him at any time.

Full details of the UK taxation implications of the Discretionary Loan Trust can be found in section 5.

As well as providing important tax benefits, because the Bond is held subject to the Discretionary Loan Trust it will not be an asset of the Settlor's estate for probate purposes.

Should the Settlor be the sole life assured under the Bond, the Bond would automatically encash on his death. To avoid this automatic encashment, it is usually recommended that the Bond that is being effected by the Trustees should be effected on the lives of two or more persons, for example the Settlor, his or her spouse and/or children on a last survivor basis. This could provide greater flexibility as to the time of the final encashment of the Bond and could avoid an encashment at a time that is unsuitable for investment and/or tax reasons.

2. THE LONDON & COLONIAL DISCRETIONARY LOAN TRUST AND INHERITANCE TAX PLANNING

By establishing a trust under which the Settlor does not have any beneficial interest, the Settlor will, effectively, remove the trust fund (after deduction of any loan owed to the Settlor) from his taxable estate for inheritance tax purposes. The Settlor (as a creditor) has full access, at any time, to the amount of any loan outstanding which remains in his taxable estate for IHT purposes but the remainder of the trust fund (effectively any growth on the investment) is outside of the Settlor's estate for IHT purposes and not accessible to the Settlor.

HMRC Inheritance Tax accepts that the loan itself, even though it is interest-free, does not involve any element of gift as long as it is repayable on demand.

To ensure that the arrangement is effective for IHT purposes, the Settlor must not retain any benefit (actual or prospective) under the trust as otherwise the gift with reservation rules can apply. As a result, the Settlor is excluded from all benefit under the Discretionary Loan Trust. The Settlor's right to have his loan repaid does not amount to a reservation of



benefit. The argument against any gift with reservation arising in connection with the arrangement is also strengthened by the fact that the Settlor does not actually make any gift when the trust is set up.

Furthermore, the Settlor can retain considerable legal control over who will benefit from the trust fund during his lifetime. This is because, as well as being one of the Trustees, the Settlor is the Appointor under the trust. This means that he has the power to appoint the benefits from the trust amongst any of the Discretionary Beneficiaries specified in the trust. After the Settlor's death the power of appointment passes to the Trustees.

The retention of the power of appointment by the Settlor does not give rise to a gift with reservation because the Settlor cannot exercise the power in his own favour.

The inclusion of the Settlor's spouse as one of the Discretionary Beneficiaries does not constitute a gift with reservation. However, if any benefits are actually paid to the Settlor's spouse during the lifetime of the Settlor, extreme care must be exercised. Should the Settlor exercise the power of appointment in favour of his spouse, who is one of the Discretionary Beneficiaries under the trust, and trust benefits are paid out to the Settlor's spouse, it is absolutely essential that no part of these benefits finds its way back to the Settlor. If this were to happen, the trust could be seen as one under which the Settlor reserved a benefit and because of the gift with reservation rules would make it ineffective for IHT purposes.

An appointment to the Settlor's spouse during the Settlor's lifetime should therefore be approached with extreme caution.

As the trust is a discretionary trust, no Beneficiary is entitled to any benefits until the Appointor makes an appointment in his or her favour. Until recently, most Discretionary Loan Trust arrangements offered by life assurance companies have been based on "flexible" interest in possession trusts. However, the IHT treatment of such trusts was changed by an announcement in the 2006 Budget and provisions in the Finance Act 2006. The changes removed the previous advantages of flexible interest in possession trusts, namely that gifts to such a trust were treated as potentially exempt transfers, and neither the ten-year periodic nor exit charge applied. In order to preserve the flexibility of the trust arrangement, a discretionary trust is used as the basis for the Discretionary Loan Trust. Although the IHT treatment of discretionary trusts can be complex, in the case of the Discretionary Loan Trust the amounts held subject to a Discretionary Loan Trust, after deduction of any outstanding loan due to the Settlor, are unlikely to be high. This point, and the fact that no initial gift is made to the trust, means that the IHT implications for the Discretionary Loan Trust are relatively minor.

For a detailed consideration of the inheritance tax implications of the Discretionary Loan Trust see section 5.



3. THE LONDON & COLONIAL DISCRETIONARY LOAN TRUST - SOME PRACTICAL ISSUES

3.1 Choosing the Trustees

The Settlor and at least one other individual (preferably two) must be appointed as Original Trustees by the trust deed. The Settlor (as the Appointor) has the power under the trust to appoint further Trustees.

It is important for the Settlor to choose his Trustees carefully. Even though the Settlor will be one of the Original Trustees and it is expected that he will remain as Trustee during his lifetime, under English law the Trustees must act unanimously. In extreme circumstances of disagreement, the Settlor has the power under the Trust to dismiss a Trustee but only if the number of Trustees under the Trust doesn't fall below two and at least one of the Trustees is somebody other than the Settlor or the Settlor's spouse.

The Trustees must understand their responsibilities to the Beneficiaries and to the Settlor (as Lender). Consequently, if the Trustees were considering paying a benefit to Beneficiaries, they should take account of the Settlor's outstanding loan. At the very least, it would be prudent for them to not deplete the value of the trust fund below the amount of any outstanding loan.

3.2 Making the loan

The Settlor (Lender) and the Trustees execute the loan agreement.

A cheque for the amount of the loan should be made payable to London & Colonial and handed over by the Lender to the Trustees.

On the basis that the Lender provides the Trustees with a cheque payable to London & Colonial there will be no need for the Trustees to open a bank account at this stage. This would only be necessary if the Lender wished to make the loan in cash or by cheque payable to the Trustees. In such a case, as it is generally no longer possible to simply endorse a cheque, the Trustees would have to pay the cheque into their own bank account and subsequently draw a cheque from that account in favour of London & Colonial. However, it may be necessary for the Trustees to open a bank account in due course when they start requesting withdrawals from the Bond.

It is important that the cheque should come from the Settlor's own account, ie. that it should not be drawn on a joint account, for example, held by the Settlor and his spouse. This is because the Settlor's spouse, as a potential Beneficiary under the Trust, should not make **any** payment to it. Otherwise the IHT benefits could be negated.



3.3 Loan repayments

Loan repayments will be requested by the Settlor from time to time when he requires capital and the Trustees will have to make part encashments from the Bond to facilitate repayments. Alternatively, the Lender and the Trustees can agree to make regular repayments, but always subject to the Lender's right to have the full outstanding loan repaid on demand. It is considered that it is possible for the Trustees to set up a regular withdrawal facility, provided the wording is clear that the interest-free loan is still repayable on demand and is not a term loan (e.g. for 20 years if a 5% rate of withdrawal per annum is specified) which could have adverse inheritance tax consequences. A more cautious investor may wish to avoid setting up a regular withdrawal facility although this may prove less convenient than an automatic withdrawal facility.

It is, of course, possible that the Settlor will request a repayment of more than 5% in a policy year and the Trustees will have to encash more than 5% of the original investment. Where the withdrawal exceeds the cumulative unused annual allowances (5% p.a. of the original premium for 20 years) a chargeable event gain will arise - see section 5.6.

3.4 Type of investment

In theory the Trustees could invest in another type of investment, for example unit trust units or shares in an OEIC, instead of a Bond. However, if any income were to arise from the underlying investments it would be assessed to tax on the Settlor because of the special income tax anti-avoidance provisions which apply when the Settlor's spouse can benefit under the settlement or where the Settlor has made a loan to the trust.

These problems do not arise with a Bond which is a non-income producing asset, the capital gains of which are not subject to capital gains tax.

3.5 Planning for spouses

It is not recommended that each of a married couple sets up their own Discretionary Loan Trust arrangement.

The reason for this is that HMRC may argue in such a case that the two arrangements effected simultaneously or in contemplation of each other are associated and effectively, if merged, would constitute a gift with reservation i.e. husband invests with his wife as a Discretionary Beneficiary on condition that that the wife invests with her husband as a Discretionary Beneficiary. Although some reassurance on this point may be taken because there is no initial gift under the arrangement, care must be exercised before taking this approach and the investor should consult with his advisers on this issue in advance.



3.6 Further planning possibilities

Can further investments be made by the Settlor?

Yes, provided no gift into the Trust is made. If further sums are to be made available then these should be solely by way of further interest-free loans by the Settlor to the Trust. If the Settlor wishes to make an outright gift, the gift should either be made directly to the donee(s) or to another trust – this is important to maintain the IHT effectiveness of the Discretionary Loan Trust. If, however, a further loan is made the Trustees could either effect a new Bond or top up the existing one.

Can the loan be written off by the Lender?

Yes. This would, however, constitute a gift to the Trust by the Settlor/Lender. It is important not to mix gifted sums and lent sums in a single trust. Therefore any loan write-off should only occur in respect of the whole amount of the outstanding loan. As the Trust is a discretionary trust, the gift would be a chargeable lifetime transfer for IHT purposes and it could result in an IHT liability, potentially at 20%, if the value of the gift, together with the cumulative total of other chargeable lifetime transfers made by the Settlor in the preceding seven years, exceeds the then nil rate band. It is generally not recommended that chargeable transfers are made during lifetime that cause the nil rate band to be exceeded. Any waiver of loan should be made by deed to be valid from a legal and tax standpoint.

3.7 The Discretionary Loan Trust and probate

Under the Discretionary Loan Trust the benefits are held outside the estate of the Settlor and the benefits can be paid by the Trustees without the need to obtain a grant of representation to the Settlor's estate. For this advantage to operate, the legal ownership of the Bond must be with a person or persons other than the Settlor on his death. This can be achieved by vesting legal ownership of the Bond in Trustees. Of course, this benefit will only be secured if there is at least one Trustee who survives the Settlor. Under the London & Colonial Discretionary Loan Trust the Settlor is automatically one of the Trustees and further Trustees are appointed in the trust deed. If any of the additional Trustees retires or dies before the Settlor, a further Trustee or Trustees should be appointed.



4. THE LONDON & COLONIAL DISCRETIONARY LOAN TRUST PROVISIONS IN DETAIL

4.1 The Trust

The Discretionary Loan Trust gives the Appointor (the Settlor during his lifetime and the Trustees after the Settlor's death) power to appoint benefits under the Trust among a wide class of Beneficiaries which includes the Settlor's spouse. No Beneficiary is entitled to any benefit until the Trustees decide – the ultimate Default Beneficiary(ies) named in the Trust will only benefit if no other appointment has been made by the end of the Trust Period – an unlikely event. The fact that the Trust is a discretionary trust means that its assets are not in the estate of any Beneficiary for IHT purposes.

The following is a summary of the key provisions as they appear in the draft Discretionary Loan Trust provided by London & Colonial.

Part 1 – Declaration

The trust deed is made between the Settlor and the Original Trustees of whom the Settlor is one. The Declaration confirms the intention of the Settlor to make a loan to the Trustees and the Original Trustees agree to receive it and to hold it on the terms of the Trust.

Part 2 – Definitions

In this part of the Trust the terms used throughout the Trust are defined to avoid repetition. The most important definitions are those of the Discretionary Beneficiaries and the Default Beneficiaries.

The Discretionary Beneficiaries are those persons to whom the Appointor under the trust (the Settlor during his lifetime and thereafter the Trustees) may appoint benefits. They include the spouse, widow or widower of the Settlor, the children and the remoter issue of the Settlor, their spouses, the brothers and sisters of the Settlor and their issue, anybody who would benefit from the estate of the Settlor on the Settlor's death as well as any person nominated in writing to the Trustees by the Settlor as well as any charity. The class of Discretionary Beneficiaries is therefore very wide and can be added to by the Settlor - all that is necessary is a written notification to the Trustees. However, the Settlor himself cannot be added to the class at any time.

The Default Beneficiary(ies) is the individual(s) who will benefit in the unlikely event that the power of appointment is not exercised by the Appointor by the end of the Trust Period, (i.e. 80 years from the date the Trust is created). They are named by the Settlor in the trust deed. At least one person must always be named and, if more than one is named, the shares in which they are to benefit must be stated. This is necessary to ensure that the trust has the desired effect.



Part 3 – Principal trust terms

In this part the **power of appointment** is defined as well as **the default entitlement** if the power of appointment is not exercised.

As mentioned above, the power to appoint capital and income under the trust is vested in the Appointor – that is the Settlor during his lifetime and thereafter the Trustees. The power is exercisable at the Appointor's discretion and includes the power to appoint further trusts in favour of the Beneficiaries. After the death of the Settlor, the Appointor will be the Trustees.

The Trustees have power to accumulate any trust income for 21 years from the date of the Trust – this is the maximum accumulation period allowed under English law.

In default of an appointment of all trust assets being made by the end of the Trust Period, the Default Beneficiaries will benefit. These are the people initially named by the Settlor in the trust deed. It will be appreciated that it is most unlikely that the whole of the trust fund will not have been distributed within 80 years.

The Trustees have wide powers to advance capital from the trust fund to the Beneficiaries and to make loans to Beneficiaries. In particular, the power to lend may give rise to tax planning opportunities where, after the Settlor's death, the Settlor's widow/widower requires funds from the Trust but there is a desire to reduce the potential IHT liability on his or her subsequent death. In such a case the Trustees could make an encashment or withdrawal from the Bond (see section 5 for the tax consequences of this) and make an interest-free loan, repayable on demand, to the widow/widower. Provided the loan is fully spent, the widow/widower's taxable estate would not increase but because the loan is repayable on his/her death it would then effectively reduce the net estate of the borrower for IHT purposes. If the Settlor's surviving spouse needed cash after the Settlor's death, it may then be appropriate to consider a loan to him/her.

One word of warning should be heeded. If the widow/widower had previously made lifetime gifts to the Settlor, this may affect the ability to make a deduction for the outstanding loan from the surviving spouse's taxable estate on his/her subsequent death.

Part 4 – Administrative provisions

The Trustees also have wide administrative powers to deal with the Bond and to reinvest the proceeds in any way they wish. They also have power to borrow funds, to make payments to parents or guardians of minor Beneficiaries and to delegate certain powers.

Part 5 – Appointment, dismissal, retirement and remuneration of Trustees

The trust contains comprehensive provisions applying to the Trustees.



The power to appoint new or additional trustees is vested in the Appointor. The Settlor also has power to dismiss any Trustee provided at least one Trustee, other than the Settlor or the Settlor's spouse, remains after such dismissal. There is no power to dismiss a Trustee after the death of the Settlor and it must be remembered that Trustees under a trust subject to English law must act unanimously.

There are also powers to deal with the retirement of Trustees and corporate trustees.

Trustees who act in their professional capacity are entitled to charge fees.

There is also a special provision dealing with any potential conflict of interest. In many cases the Trustees of the trust would be family members who would also be Beneficiaries under the trust. If the power of appointment were to be exercised by the Trustees (after the death of the Settlor) such Trustees would often also be the Beneficiaries (for example the spouse and/or children of the Settlor) and if an appointment of benefits were to be made in favour of a Beneficiary who is also a Trustee then suspicion of a conflict of interest could arise. For this reason there is a provision in this Trust which states that if a Beneficiary is also one of the Trustees, the Trustees can only make an appointment in favour of that Beneficiary if there is at least one other Trustee who does not benefit directly or indirectly from the appointment being made.

Part 6 – Further trust provisions

These deal with the Trustees' duty of care and liability for loss to the trust fund.

The statutory duty of care contained in section 1 Trustee Act 2000 has been extended to apply to all functions of the Trustees. This statutory duty of care is a duty to act with such care and skill as is reasonable in the circumstances having regard in particular to any special knowledge or experience that the Trustee has or holds himself out as having and, in the case of a Trustee acting in a professional capacity (eg. a solicitor, accountant, stockbroker or independent financial adviser), to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

The liability of individual Trustees is limited so that they will not, generally, be held liable for any loss to the trust fund provided they act in good faith. Trustees who are paid for their services are also liable for negligence.

Professional trustees are permitted by the trust deed to charge normal professional fees.

Part 7 – Proper Law

The Discretionary Loan Trust is governed by the law of England and Wales. However, it can also be used in Scotland or Northern Ireland as there is nothing in the laws of those countries which would preclude its use. In particular, the objectives of the Discretionary Loan Trust, as indicated above, will be achieved throughout the UK.



4.2 The loan agreement

Once the Trust is established the Settlor makes an interest-free loan, repayable on demand, to the Trustees. The Settlor, as Lender, and the Trustees together execute a formal loan agreement to this effect. It is envisaged that the Trustees invest this loan in a London & Colonial Bond and, with this in mind, the Settlor should draw the cheque in favour of London & Colonial. The Bond will represent the only asset of the Trust.

The Lender can choose to include an additional clause specifying that until further notice (and always subject to the lender's right to have the full loan repaid on demand), the Trustees shall repay the loan at a fixed rate per year. It is recommended that the rate should be not more than 5%.

Alternatively, from time to time the Settlor will request a part repayment of his loan. The Trustees will encash part of the Bond to make the repayment - see section 5 for the tax implications of encashment. The part repayment of the loan to the Settlor will be tax free in the hands of the Settlor as a capital repayment.

It is important that the loan is expressed to be interest-free and repayable on demand as loans repayable by fixed instalments have different (less favourable) tax consequences, as explained in 3.3 above.

4.3 The Bond

The Original Trustees (of whom the Settlor/Lender is one) make an application for a London & Colonial Offshore Open Bond using the cheque given to them by the Lender. As the Bond is a life assurance policy, the Trustees must indicate on whose lives the Bond should be issued. Normally this should be the Settlor and one or more of the Default Beneficiaries. The Bond is then issued on a last survivor basis in the names of the Trustees as the policyholder.

If the Settlor were the sole life assured under the Bond, the Bond would automatically encash on his death. Effecting the Bond on the lives of two or more persons, as indicated above, will avoid this automatic encashment assuming the Settlor dies first. It could therefore provide greater flexibility as to the time of the final encashment of the Bond and could avoid an encashment at a time that is unsuitable for investment and/or or tax reasons.

The Trustees can exercise all the powers and options under the Bond including taking withdrawals from the Bond. When the Settlor/Lender requests repayment of the loan at any time the Trustees will have to encash an appropriate part of the Bond in order to fund the repayment.



5. THE UK TAX IMPLICATIONS OF THE LONDON & COLONIAL DISCRETIONARY LOAN TRUST

In what follows it is assumed that the Settlor, the Beneficiaries and the Trustees of the trust are UK resident and domiciled. Special rules apply when this is not the case.

5.1 Establishment of the Trust

- Since no gift is made by the Settlor when the Trust is established, the creation of the Trust will not give rise to a transfer of value by the Settlor for inheritance tax purposes as long as the correct procedures are followed.
- As long as the loan is expressed to be interest-free and repayable on demand, the granting of the loan should have no immediate tax implications for the Lender.
- As the Settlor is entitled only to his loan repayments and is not a Beneficiary under the Trust, the arrangement is not caught by the “gift with reservation of benefit” provisions. Furthermore, HMRC has confirmed that the income tax pre-owned assets tax rules in Schedule 15 Finance Act 2004 do not apply to this type of arrangement.
- There will be no capital gains tax or income tax implications at the time the Trust is established although, of course, a capital gains tax charge may arise if the Settlor/Lender realises investments in order to make the loan.

5.2 The income tax implications of loan repayments

- Under current legislation, the Trustees can withdraw from the Bond up to 5% of the amount invested, each year for twenty years, without an immediate tax charge. Any 5% allowable amount not withdrawn in a year can be carried forward to the next year and so on. Therefore, a convenient level of capital (5% per year of the original investment) can be tax effectively accessed by the Trustees to facilitate loan repayments. Of course, the level of repayment depends entirely on the circumstances and the wishes of the Lender.
- If more than 5% of the original investment is withdrawn by the Trustees each year to finance loan repayments, this will mean that:
 - (a) if such a level of repayment continues, the loan will be repaid quicker and, once repaid, the Settlor will have no further rights to payments from the Trustees; and



- (b) any amounts withdrawn over and above the cumulative unused 5% annual allowances in any policy year will amount to chargeable event gains and, during the Settlor's lifetime and while he is UK resident, be assessed on the Settlor for income tax purposes under the usual rules governing chargeable events (see also 5.6 below).

5.3 Inheritance tax whilst the Trust is in existence

As this is a discretionary trust, this means that special IHT charging rules apply. Under these rules there may be IHT charges

- on every ten-year anniversary of the Trust – “the Periodic Charge” or
- whenever property leaves the Trust (e.g. when capital is advanced to a Beneficiary or an absolute appointment of benefits is made) – “the Exit Charge”

THE PERIODIC CHARGE

Periodic charges at ten-yearly intervals may be applied to the value of the assets in the Trust. It is important to note that under the Discretionary Loan Trust the value of the trust assets will be determined AFTER deducting the amount of any outstanding loan.

The rate of inheritance tax charged will be determined on the basis of an assumed transfer by an assumed transferor. This will mean that it will broadly be necessary to take account of:

- the value of the property in the Trust on the ten-year anniversary, certain additions made to the Trust and the value, when they were set up, of any other trusts created on the same day (the assumed transfer);
- the Settlor's cumulative total of transfers made in the seven years immediately preceding the creation of the trust (assuming there has been no added property) and any sums paid out of the trust in the 10 years prior to the anniversary (the cumulative total of the assumed transferor).

From the tax calculated based on these assumptions, an effective lifetime rate of tax will be established with a maximum of 20%. 30% of this effective rate will be the rate applied to the actual value of the trust property at the ten-year anniversary. The maximum liability will thus be 6% (30% of 20%) of the value of the trust property over the available nil rate band but, frequently, it will be much less or nil. Each case will, of course, depend on its own facts.

In cases where the Settlor has not made any chargeable transfers in the 7 years before he creates the Trust, no payments have been made out of the Trust in the last 10 years and there has been no added property, there will be no liability provided the value of the trust property at the time of the periodic charge does not exceed the nil rate band applicable at the ten-year anniversary. Any excess over the then nil rate band will suffer IHT at an effective rate of 6%.



EXAMPLE

Alan creates a Discretionary Loan Trust in October 2008.

A loan of £200,000 is invested by the Trustees in a London & Colonial Offshore Open Bond. Alan has made no chargeable transfers in the previous 7 years. No payments are made out of the Trust in the first 10 years and no property is added to the Trust.

After 10 years, in October 2018, loan repayments of £100,000 in total have been made. Assuming growth has been at a net 5% pa, the trust fund (net of the outstanding loan) will be worth £200,000 - £100,000 = £100,000. If the nil rate band in October 2018 is £400,000, there will be no IHT charge.

On the other hand, if on the ten-year anniversary in October 2018 Alan's Trust is worth £550,000, the value of the trust for the purposes of the periodic charge will be £450,000 after the outstanding loan is deducted. Based on a then nil rate band of £400,000, the IHT charge will be £3,000 (£50,000 @ 6%). This equates to 0.66% of the value of the trust fund.

If all of the trust fund is distributed before the tenth anniversary, in many cases no tax charge will arise (see next section). If assets remain in the Trust after a distribution, or if further assets are added to the Trust, the Trustees will need to take specialist tax advice.

It should be remembered that for the purpose of calculating the value of the trust fund at any time the amount of the outstanding loan must be deducted in order to arrive at the value for IHT purposes.

THE EXIT CHARGE

Exit charges will be based on the value of property leaving the Trust or being absolutely appointed to a Beneficiary.

No exit charge will arise on loan repayments (or loans granted by the Trustees to a Beneficiary).

Exit charges within the first 10 years will be nil if the value of the initial amount going into the Trust (before applying any IHT exemptions or reliefs) but after deducting the initial value of the loan and taking account of any added property is nil. If there is an initial value (which is highly unlikely) then it will be necessary to take into account the cumulative total of the Settlor's chargeable transfers in the 7 years prior to creating the Trust. If the total of these, together with any added property, is below the available nil rate band when the Trust was created, there will be no exit charge.

Under a Discretionary Loan Trust it is highly unlikely that there would be any "exits" other than "inoffensive" loan repayments. However, if there were, the amount of any exit charge occurring after the first 10 years will depend on the rate of tax charged at the previous ten-year anniversary (if any), the length of time (in quarter years) that the property has been in



the Trust since the last periodic charge and whether any property has been added since the last periodic charge. In many cases, with a Discretionary Loan Trust there will have been no periodic charge (see above) so no exit charge would arise.

EXAMPLE

Let's assume that on the first ten-year anniversary of Alan's Trust a periodic charge of 0.66% arose (see above). In October 2024, 6 years since the first ten-year anniversary, the Trustees of Alan's Trust make a part encashment of the Bond and pay £50,000 to a Beneficiary. The IHT charge will be $£50,000 \times 0.66\% \times 24/40 = £198$.

No IHT charge will arise on property paid out of the trust if there was no IHT charge at the last ten-year anniversary.

Exit charges should not arise on loan repayments or loans made by the Trustees to Beneficiaries.

The occasion of a periodic charge and transactions that can give rise to an exit charge, such as capital payments to the Beneficiaries, must be reported to HM Revenue & Customs on forms 100c and 100d (and form D34 where a policy of life assurance is involved) if they exceed a certain amount.

5.4 Payment of benefits

Any payment of trust capital to the Beneficiaries (where the Bond is and always has been the sole asset of the Trust) should not give rise to any income tax or capital gains tax liability. The IHT implications on payments would be as explained for exit charges in 5.3 above. Chargeable event gains on encashment of the Bond to fund such payments are dealt with in 5.6 below. It is, however, recommended that any such payments should not be made on a regular basis nor should they be of regular amounts so as to avoid any (albeit remote) possibility of an argument that the payments of capital have acquired the character of income with potentially unwanted income tax consequences.

5.5 Death of the Settlor

On the death of the Settlor, the Bond will be outside of the Settlor's estate for IHT purposes but the amount of any outstanding loan will be in his estate and pass to a Beneficiary under his Will (or intestacy). The IHT consequences will depend on who benefits under the Settlor's Will or intestacy.

If the Settlor is an individual who has a spouse and wishes to avoid an IHT liability on this amount, he can leave the right to the repayment of the outstanding loan to his spouse. London & Colonial can provide a draft wording for inclusion in a Will or a codicil which can be utilised to achieve this.

Following the Settlor's death, the value of the Bond, after the loan repayment, will be available to the Trustees. If the Bond is encashed and the proceeds distributed to



Beneficiaries, the IHT implications of this are as explained in 5.3 above. The encashment of the Bond will give rise to a chargeable event and may give rise to an income tax liability – see 5.6 below.

5.6 Chargeable event gains made under the Bond

During the Settlor's lifetime and in the tax year in which the Settlor's death occurs

Any chargeable event gains arising from an encashment or a part surrender of the Bond held in trust will, during the Settlor's lifetime and in the tax year of the Settlor's death, be assessed to tax on the Settlor provided he is UK resident. This is so notwithstanding the fact that the Settlor cannot benefit under the Discretionary Loan Trust. However, where the Settlor does incur a tax liability following a chargeable event, he can recover the tax from the Trustees and this will not give rise to a reservation of benefit for IHT purposes.

After the end of the tax year in which the Settlor's death occurs

In any tax year following that in which the Settlor's death occurs any chargeable event gains will be assessed on UK resident Trustees at the special rate of 40%. There is no 20% tax credit as for a UK bond so the Trustees would pay the full 40% rate. To the extent that chargeable event gains fall within the £1,000 standard rate tax band, (which would be available to the Trustees following the Settlor's death), there will be a 20% charge. These rules also apply if the chargeable event gain arises at any time that the Settlor is non-UK resident.

If a chargeable event gain arises when the Settlor is dead or non-UK resident and the Trustees are not UK resident, there are special provisions for charging tax on UK ordinarily resident Beneficiaries when they receive benefits from the trust. The method of calculating gains and the tax assessment is different and so in such circumstances professional advice must be sought by the Trustees and/or the Beneficiaries.

In all other respects the taxation of the Bond is the same as that for any other Bond held directly by an investor - for full details see the Offshore Open Bond brochure. In particular, the Trustees can also take partial withdrawals within the cumulative 5% annual allowances without incurring an immediate tax charge.

Prior transfers to a Beneficiary

It may be that after the death of the Settlor and the Settlor's spouse, the Trustees will consider encashing the Bond and releasing the proceeds to a Beneficiary. As an alternative to encashing the Bond prior to making a payment to a Beneficiary, the Trustees could make an absolute and irrevocable appointment of benefits in favour of an adult Beneficiary. They could then assign the Bond to the Beneficiary who is to benefit. That assignment would not give rise to a chargeable event. Any chargeable event gain arising on any subsequent encashment by the Beneficiary would then be assessed to tax on that Beneficiary.



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If you require further information please contact us on:

T: 0870 7566696

W: www.londoncolonial.com

Alternatively you can write to us at the following address:

London & Colonial
38-42 Perrymount Road
Haywards Heath
West Sussex
RH16 3DN