



## DISCRETIONARY LOAN TRUST KEY FEATURES AND BENEFITS

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

### 1. WHAT IS THE LONDON & COLONIAL DISCRETIONARY LOAN TRUST?

The London & Colonial Discretionary Loan Trust is an inheritance tax (IHT) planning arrangement which is made up of three parts:

- A trust
- A loan and
- An investment in a London & Colonial Offshore Open Bond (“Bond”).

It is well known that potential IHT liabilities may be reduced by making lifetime gifts of assets. It is equally well known, however, that not many individuals can realistically give up all access to their assets, in which case effective IHT planning becomes more difficult.

The Discretionary Loan Trust has been designed for investors who wish to carry out some IHT planning but cannot afford to give up all access to the funds intended to be used in the planning. However, such investors would be prepared to give up access to any investment growth on the assets.

Under the Discretionary Loan Trust an individual lends a sum of money to the Trustees of a trust which he or she has established with the specific purpose of receiving such a loan. The Trustees of the trust then use the loan to invest in a Bond. This will be the trust asset held by the Trustees for the Beneficiaries. However, the Lender (who is also the Settlor of the trust) retains the right to have his or her loan repaid to him or her at any time.

There is no initial gift as such and so no immediate reduction in the Settlor's estate for IHT purposes but as the trustee investment grows in value, all the investment growth will be outside the Settlor's estate for IHT purposes and held for the Beneficiaries under the trust. The Settlor can request the repayment of the whole outstanding loan or a part of it at any time and as repayments are made by the Trustees, and spent by the Settlor, the Settlor's taxable estate will also reduce for IHT purposes.



Thus the Discretionary Loan Trust enables investment growth to accrue free of IHT outside the Settlor's taxable estate and also enables a gradual reduction in the potential IHT liability on the Settlor's estate to take place.

A trust is a legal relationship which exists when an asset is held by a person or persons (called the Trustees(s)) for the benefit of another person or persons (called the Beneficiary(ies)). The Trustees have the control and legal ownership of the asset but must use it for the benefit of the Beneficiaries.

A Bond is particularly well suited to this type of arrangement as it does not produce any "real" income – the use of an income-producing investment would have potential tax and practical drawbacks.

In order to ensure that the trust is effective for inheritance tax, the Settlor cannot benefit from the Bond in any way under the Discretionary Loan Trust. The Settlor will, however, be one of the Trustees and the initial Appointor under the trust. The Appointor decides who (from the classes of Beneficiaries specified in the trust) should benefit from the trust fund (ie. the Bond) and when. After the Settlor's death, the Trustees take over the power of appointment.

If the Appointor makes no appointments by the end of the Trust Period (80 years) then the individual or individuals named by the Settlor as Default Beneficiaries will benefit. In practice it is most unlikely that all of the trust property will not have been distributed within this 80 year period.

The main objectives of the Discretionary Loan Trust are the gradual reduction of the Settlor's estate as loan repayments are made to him which he spends and the IHT free growth of the Bond investment outside of the (inheritance) taxable estate of the Settlor.

## **2. WHAT ARE THE KEY OBJECTIVES IN USING THE DISCRETIONARY LOAN TRUST?**

You should consider using a Discretionary Loan Trust if you:

- wish to make an investment in a London & Colonial Bond but do not wish to make a gift of your investment;
- have total assets in excess of £312,000 and are concerned about future IHT liabilities;
- need to retain access to the capital you intend to invest for your own benefit but can afford to give up access to the investment growth;

and



- wish to retain flexibility over which individual(s) should benefit under the trust.

### **3. WHEN SHOULD THE DISCRETIONARY LOAN TRUST NOT BE USED?**

The Discretionary Loan Trust should not be used if you:

- are not interested in IHT planning; or
- can afford to make a gift of the capital used in the planning without retaining any access; or
- wish to retain total control and access to the whole investment not just the original capital; or
- are certain that a named individual should be absolutely entitled to benefit under the trust and that you will not want to change your mind over this.

London & Colonial offer other trusts which may be suitable depending on your needs.

### **4. HOW IS THE DISCRETIONARY LOAN TRUST ESTABLISHED?**

The Discretionary Loan Trust is based on three elements.

First, a trust is established by the investor specifically with the intention of making a loan to the Trustees. No gift is made at that time. It is accepted that under English law a valid trust can be created in this way.

The Discretionary Loan Trust is suitable only for a single Settlor, ie. it cannot be set up jointly by two persons. The trust is established by the Settlor and the additional Trustees completing the trust deed. The Settlor is one of the Original Trustees together with the additional Trustees.

Second, once the trust is established the Settlor enters into a formal agreement with the Original Trustees to make an interest-free loan repayable on demand. The intention is that the Trustees will invest the loan moneys into a London & Colonial Bond. The loan is satisfied by the Settlor handing over to the Trustees his cheque payable to London & Colonial.



Third, the Trustees will make an application for the Bond on the lives of some of the Beneficiaries. Once the Bond is purchased by the Trustees, any subsequent dealings with the Bond will be between the Trustees (as the legal owners) and London & Colonial.

## **5. KEY PROVISIONS OF THE DISCRETIONARY LOAN TRUST**

- During the Trust Period (80 years) the Appointor (the Settlor and, after the Settlor's death, the Trustees) may appoint the trust benefits (capital or income) to any of the Discretionary Beneficiaries. These Beneficiaries include the Settlor's spouse, children and grandchildren, brothers and sisters and their issue as well as any person nominated by the Settlor to the Trustees in writing.
- An appointment to the Settlor's spouse during the Settlor's lifetime should be approached with extreme caution as if the Settlor enjoys any indirect benefit the gift with reservation rules may apply. Such appointments should therefore only be considered in extreme circumstances.
- 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. If any income arises to the Trustees from the trust investments (not relevant while the sole trust asset is the London & Colonial Bond) they can accumulate it for up to 21 years - this is the maximum time income can be accumulated under English law. After that time the Trustees will have to distribute all income to whichever Beneficiary they decide. However, no Beneficiary will have the right to any income – distributions will continue to be at the discretion of the Trustees.
- The Settlor cannot benefit from the trust in any circumstances (except that he is, of course, entitled to have his loan repaid to him).
- The Settlor names (as Default Beneficiaries) the individual or individuals who are to benefit from the trust fund at the end of the Trust Period (if no appointment is made before then), and if more than one the shares in which they are to benefit.
- The Trustees have wide powers to invest and deal with trust property.
- The value of the trust fund available for the Beneficiaries will increase as the value of the investment grows.
- The Settlor remains entitled to have his loan repaid at any time and the amount of the outstanding loan remains in his estate for IHT purposes.
- To be IHT effective the loan must be repayable on demand and interest-free. From time to time the Settlor will request part repayments of his loan which will be made by



the Trustees after making withdrawals/part surrenders from the Bond. The Lender can choose to include an additional clause in the Loan agreement specifying that until further notice (and always subject to the lender's right to have the full outstanding loan repaid on demand), the Trustees shall repay the loan at a fixed rate per year. This would make the administration of the arrangement easier. The Settlor would normally spend these loan repayments so his taxable estate would reduce at that time.

## **6. THE LAW OF THE TRUST**

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

## **7. THE TRUSTEES**

The Settlor is automatically one of the original Trustees. At least one additional Trustee must be appointed at outset. The additional Trustee(s) executes the trust deed with the Settlor.

The Settlor can appoint further Trustees later on and the Settlor may also dismiss a Trustee provided at least one Trustee other than the Settlor or Settlor's spouse remains.

The Trustees must act unanimously which is one of the reasons why the Settlor should take great care in deciding whom to appoint.

The liability of individual Trustees is limited so that they will not 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. The Trustees are permitted to take part in transactions and Trustees' decisions in which they have a personal interest.



## **8. THE UK TAX IMPLICATIONS OF THE DISCRETIONARY LOAN TRUST**

In all cases, it is assumed that the Lender, the Beneficiaries and the Trustees are UK resident and domiciled - special rules apply where this is not so and appropriate professional advice should be sought.

### **(1) INHERITANCE TAX (IHT)**

#### **(a) Establishment of the trust**

- As no gift is made when the trust is established, there are no IHT implications at that time.
- The loan made to the Trustees also has no IHT implications provided it is interest-free and repayable on demand (as is the case when using the standard draft Discretionary Loan Trust documentation provided by London & Colonial).

#### **(b) Death of the Settlor**

- On the death of the Settlor the amount of the outstanding loan will be in the Settlor's estate for IHT purposes. However, the balance of the value of the trust fund (represented by the Bond) will be outside his estate.
- If the Settlor is married he may, in his Will, leave the right to the repayment of the outstanding loan to his spouse. In such a case, if his spouse survives him, no IHT will be due on the outstanding loan entitlement on death and loan repayments can continue to be made by the Trustees to the surviving spouse.
- If the Settlor is the sole or last life assured to die under the Bond, the Bond will encash and the cash value of the Bond will be paid free of inheritance tax to the Trustees. (There may be income tax chargeable event implications – see (2) Income Tax below).
- If the Settlor is survived by another life assured under the Bond, the Bond will continue unaffected by the Settlor's death.

#### **(c) 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 based on 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 chargeable 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)

As a result of the calculation of the tax on the assumed lifetime transfer, an effective lifetime rate of tax will be established. The maximum rate will be 20% and this will only apply in a limited number of cases. 30% of the effective rate is taken and that is the rate that will be 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.

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%.

If all the trust fund is distributed before the tenth anniversary, in many cases no tax charge will arise (see the “Exit charge” below). 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 any outstanding loan must be deducted from the total 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 appointed absolutely to a beneficiary.

### **Exit charges will not apply to loan repayments (or loans made to Beneficiaries out of the trust by the Trustees).**

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 last ten-year anniversary (if any) and the length of time (in quarter years) that the property has been in the trust since the last periodic charge. In many cases with a loan trust there will have been no periodic charge (see above) so no exit charge would arise.

The occasion of a periodic charge and transactions that can give rise to an exit charge, such as capital payments to the beneficiaries, may have to be reported to HM Revenue & Customs even if no actual tax liability arises. The forms to use here are IHT 100c and d and, where a life policy is involved, form D34.

## **(2) INCOME TAX**

(In all cases, it is assumed that the Settlor, the Beneficiaries and the Trustees are UK resident - special rules apply where this is not so).

### **(i) Chargeable event gains**

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

For income tax purposes, any chargeable event gains arising under the Bond will be assessed to income tax on the Settlor. Please refer to the London & Colonial Offshore Open Bond literature for full details of Bond taxation.

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



Any chargeable event gains arising in a tax year after that in which the Settlor died will be assessed on UK resident Trustees at the special rate of 40%. There will be no entitlement to the 20% tax credit available in respect of a UK investment bond. 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.

### **Prior transfer to a Beneficiary**

It may be that after the Settlor/Settlor's spouse have died, 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 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.

## **(ii) Loan repayments funded by encashments from the Bond**

Loan repayments will be funded by the Trustees making encashments from the Bond. The Trustees are entitled to withdraw up to 5% of the original investment each year, for 20 years (on a cumulative basis), without incurring any immediate tax liability. As long as the repayments are kept within these 5% allowances there will be no immediate income tax implications for the Settlor or Trustees. Otherwise the rules for charging tax on the chargeable event gains will apply as explained above.

## **(iii) Payments to Beneficiaries**

- If the Trustees make an encashment of or withdrawal from the Bond to make a payment to Beneficiaries, the income tax and IHT consequences of this are as outlined above.
- As long as payments to Beneficiaries are made and documented as an advancement of capital and do not acquire the character of income, there should be no income tax implications for the Settlor or the Beneficiaries.

It should be noted that a change of Trustee or the death of a Trustee have no tax implications.

## **(3) CAPITAL GAINS TAX**

No capital gains tax should arise in relation to any dealings with a Bond held subject to Discretionary Loan Trust.



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