Discretionary loan trust

Adviser's guide

Countrywide Assured

Adviser's guide to the discretionary gift trust

This guide is for use by financial advisers only. It is not intended for onward transmission to a private customer and should not be relied on by any other person.

In this document, the term 'spouse' includes a reference to a registered civil partner under the Civil Partnership Act 2004.

Where we refer to Countrywide Assured plc ("Countrywide Assured") in this document, this includes CASFS Ltd ("CASFS") where appropriate.

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Section 1: Objectives and suitability of the discretionary loan trust

The purpose of the discretionary loan trust (the 'trust') is to facilitate effective lifetime inheritance tax (IHT) planning for an investor by using a single premium onshore life insurance bond (the 'bond').

Any of the onshore bonds currently available from Countrywide Assured is suitable for this purpose. The bonds are taxed in the same way and offer similar withdrawal facilities (please refer to the relevant brochures and technical guides for further details).

By using the trust with a bond, the client (known as the 'settlor') can ensure that any investment growth accrues in an IHT-efficient manner and can achieve a gradual reduction in his or her estate for IHT purposes, while retaining access to the original capital and without making an outright gift.

1.1 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 or her 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 estate of the settlor and passes to the beneficiaries in an IHT-efficient manner; and
- to allow the settlor to exercise continuing control over who will finally benefit from the trust fund.

The discretionary loan trust anticipates that a potential investor who has these specific objectives could, instead of investing directly in his or her name, lend a sum of money to trustees to invest in a bond.

The trustees hold the bond on trust for the beneficiaries indicated in the trust, subject to the right of the settlor to have the loan repaid.

1.2 Suitability

The investor for whom a discretionary loan trust may be appropriate would normally:

- be aged 50 or over;
- have a net estate for IHT purposes exceeding the nil-rate band (currently £325,000);
- have capital to invest or realisable investments available for reinvestment without capital gains tax liabilities;
- require access to capital to periodically supplement income;
- need to know that it is possible to 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 desire to benefit, but wish to retain control over who actually receives benefits in the future.

The trust is only suitable for individual settlors – it cannot be made jointly by two people.

To ensure that the trust is effective for IHT purposes, the settlor cannot benefit under the trust in any circumstances, although he or she is of course entitled to have the loan repaid at any time.

Full details of the UK taxation implications of the trust are set out in section 5 of this document.

As well as providing important tax benefits, because the bond is held subject to the 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 or her death. To avoid this automatic encashment, it is usually recommended that the bond is effected by the trustees 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 either investment or tax reasons.

Section 2: Inheritance tax planning

By establishing a trust under which the settlor does not have any beneficial interest, the settlor effectively removes the trust fund (after deduction of any loan owed to the settlor) from his or her taxable estate for IHT purposes. The settlor (as a creditor) has full access, at any time, to the amount of the loan outstanding which remains in his or her taxable estate for IHT purposes. However, 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.

HM Revenue & Customs (HMRC) 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 trust. The settlor's right to have the loan repaid does not amount to a reservation of benefit. The argument against any gift with reservation arising in connection to the arrangement is also strengthened by the fact that the settlor does not actually make any gift when the trust is set up.

The settlor retains considerable legal control over who will benefit from the trust fund during his or her lifetime. This is because, as well as being one of the trustees, the settlor is also the appointor under the trust. This means that he or she has the power to appoint the benefits from the trust among 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 or her 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 or her spouse, who is one of the discretionary beneficiaries under the trust, and trust benefits are paid out to the settlor's spouse, it is 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. However, no such problems arise on appointments to the settlor's spouse by the trustees after the settlor's death.

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. Historically, most 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 10-year periodic nor exit charges applied.

To preserve the flexibility of the trust arrangement, a discretionary trust is used as a 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 value of the trust property for IHT purposes is determined after deduction of the outstanding loan due to the settlor and is therefore less likely to cause a tax liability. This point, and the fact that no initial gift is made to the trust, means that the IHT implications for the trust are usually relatively minor.

For a detailed consideration of the IHT implications of the discretionary loan trust see section 5.

Section 3: 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 deed of trust. The settlor (as the appointor) has the power to appoint trustees.

It is important for the settlor to choose the trustees carefully. Even though the settlor is one of the original trustees and it is expected that he or she will remain as trustee during his or her lifetime, the trustees must act unanimously where the trust is governed by English law. In extreme circumstances of disagreement, the settlor has the power under the trust to dismiss a trustee but only if the remaining number of trustees is at least two and at least one of the trustees is somebody other than the settlor or the settlor's spouse.

Where the trust is governed by Scottish law, the trustees can act by a simple majority which means that, if there are more than two trustees, the settlor's wishes can be overridden.

The trustees must understand their responsibilities to the beneficiaries and to the lender. Consequently, if the trustees are considering paying a benefit to beneficiaries, they should take account of the settlor's outstanding loan. At the very least, it is prudent for them to not deplete the value of the trust fund below the value of the outstanding loan.

3.2 Making the loan

The settlor (the lender) and the trustees execute the loan agreement. A cheque payable to CASFS Ltd Client Account should be handed over by the lender to the trustees.

The amount of the loan will be the amount shown on the cheque or, where an initial adviser fee is to be paid prior to investment in the bond, the amount that will be invested in the bond. Note Countrywide Assured only facilitates the payment of initial adviser fees before investment in the bond as this maximises the availability of the 5% tax-deferred allowance.

On the basis that the lender provides the trustees with a cheque made payable to the life assurance company, there is no need for the trustees to open a bank account at this stage. This is only necessary if the lender wishes 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 cheques, the trustees have to pay the cheque into their own bank account and subsequently draw a cheque from that account in favour of the life assurance company. 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, and is not drawn on a joint account such as one held by the settlor and his/her 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 may be negated.

3.3 Loan repayments

Loan repayments will be requested by the settlor when he or she requires capital, and the trustees will have to make part encashments from the bond to facilitate repayments.

Loan repayments, and thus withdrawals, are made on demand. Alternatively, the automatic withdrawal facility could be used to facilitate loan repayments.

It is 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 annual allowances (5% per year of the original premium for 20 years), a chargeable event gain may arise (see section 5.6). In some instances, a surrender penalty may apply during the first five years of the contract (please refer to the relevant brochures and technical guides for further details).

3.4 Type of investment

In theory, the trustees could invest in another type of investment instead of a bond, such as unit trusts or shares in an OEIC. However, if any income were to arise from the underlying investments, it would be assessed to tax on the settlor because of the special 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. Also, all capital gains would be assessed on the settlor even though the gains would be trust gains.

These problems do not arise with a bond which is a non-income producing asset, the capital gains of which are subject to income tax (not capital gains tax) and only on encashment of the bond, unless a chargeable event giving rise to a chargeable gain arises in the interim.

3.5 Spousal planning

It is not recommended that each of a married couple sets up their own discretionary loan trust arrangement. This is because HMRC may argue that the two arrangements effected simultaneously or in contemplation of each other are associated and effectively, if merged, constitute a gift with reservation. This is the case if spouse 1 invests with spouse 2 as a discretionary beneficiary on condition that that spouse 2 invests with spouse 1 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 or her advisers on this issue in advance.

3.6 Further planning possibilities

Can further investments be made by the settlor?

This is possible, provided no gift is made to the trust. If further sums are made available, 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 recipient or to another trust. This is important to maintain the IHT effectiveness of the trust. If, however, a further loan is made, the trustees can either effect a new bond or top up the existing one (subject to the terms of the policy).

Can the loan be written off by the lender?

This is possible, but it would 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 discretionary, the gift is a chargeable transfer for IHT purposes and it can 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.

3.7 Probate

Under the 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 in the UK. For this to work, the legal ownership of the bond must be with a person or persons other than the settlor on his or her 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 trust, the settlor is automatically one of the trustees and further trustees are appointed in the specimen trust deed provided. If any of the additional trustees retires or dies before the settlor, a further trustee or trustees should be appointed.

Section 4: The trust provisions in detail

4.1 The trust

Under the trust, the appointor is the settlor during lifetime and the trustees after the settlor's death. The trust gives the appointor power to appoint benefits under the trust among a wide class of beneficiaries (called discretionary 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 benefit in the unlikely event that no other appointment has been made by the end of the trust period. The fact that the trust is discretionary means that the trust 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 trust provided by Countrywide Assured.

Section 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.

Section 2 – Definitions

In this part of the trust, the terms used throughout are defined to avoid repetition. The most important definitions are those of the discretionary beneficiaries and the default beneficiaries.

Discretionary beneficiaries: persons to whom the appointor may appoint benefits. The appointor is the settlor during his or her lifetime and thereafter the trustees.
The discretionary beneficiaries 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 and 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 cannot be added to the class at any time, as otherwise a gift with reservation would occur.

Default beneficiary(ies): 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 (125 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 tax consequences.

Section 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 (the settlor during his or her 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 is the trustees.

The trustees have power to accumulate any trust income for 21 years from the date of the trust, which is the maximum accumulation period allowed under Scottish law. There is no such restriction of accumulating income under the law of England and Wales or Northern Ireland.

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 is appreciated that it is unlikely that the whole of the trust fund will not have been distributed within 125 years.

There is also a special provision dealing with any potential conflict of interest. In many cases, the trustees of the trust are family members who are also beneficiaries under the trust. If the power of appointment is exercised by the trustees (after the death of the settlor), such trustees are often also the beneficiaries (for example, the settlor's spouse and/or children of the settlor). If an appointment of benefits is 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.

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/er 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/er. Provided the loan is fully spent, his or her taxable estate would not increase, but because the loan is repayable on death it effectively reduces the net estate of the borrower for IHT purposes. If the settlor's surviving spouse needs cash after the settlor's death, it may be appropriate to consider a loan.

However, care needs to be taken. If the widow/er 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 or her subsequent death.

Section 4 – Administrative powers of the trustees

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.

Section 5 – Appointment, dismissal, retirement and remuneration of trustees

The trust contains comprehensive provisions that regulate the activities and powers of 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. In Scotland, trustees can make decisions by a simple majority. There are also powers to deal with the retirement of trustees and corporate trustees.

Under the terms of the trust, trustees who act in their professional capacity are entitled to charge fees.

Section 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 by the trust to apply to all functions of the trustees where the trust is subject to the law of England. 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/herself out as having and, in the case of a trustee acting in a professional capacity (such as 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 liable for their 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.

Section 7 – Proper law

The settlor may choose whether the trust is to be governed by the law of England and Wales, Scotland or Northern Ireland. This choice will normally be determined by the settlor's domicile (where his or her permanent home is). This does not affect the beneficial provisions of the trust or the tax implications in the UK, but may be relevant to the settlor/trustees should they need to clarify any legal points in connection to the trust or in the event of a dispute.

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 life assurance bond. The settlor should draw the cheque in favour of CASFS Ltd Client Account. The bond represents the only asset of the trust.

From time to time, the settlor will request a part repayment of his loan. The trustees 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 is 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 regular instalments have different (less favourable) tax consequences.

4.3 The bond

The original trustees (of whom the settlor/lender is one) make an application for a 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 beneficiaries. The bond should then be issued on a last survivor basis, with the trustees as policyholders.

If the settlor were the sole life assured under the bond, the bond would automatically encash on his or her death. Effecting the bond on the lives of two or more persons on a last survivor basis, as indicated above, avoids 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 either investment or tax reasons.

The trustees can exercise all the powers and options under the policy including taking withdrawals from the bond. When the settlor (lender) requests repayment of the loan at any time, the trustees have to encash an appropriate part of the bond in order to fund the repayment. Normally this will be done by using the part surrender facility.

Section 5: UK tax implications

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 does not give rise to a transfer of value by the settlor for IHT 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 these types of arrangement.
- There are no capital gains tax or income tax implications at the time the trust is established, although a capital gains tax charge may arise if the settlor (lender) realises investments 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 20 years without an immediate tax charge (the tax charge is deferred). Any 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 accessed tax efficiently 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 means that:

i) 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 trust; and

ii) 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 or she is UK resident) will be assessed on the settlor for income tax purposes under the usual rules governing chargeable events (see also 5.6).

5.3 Inheritance tax while the trust is in existence

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

i) on every 10-year anniversary of the trust (the 'periodic charge'); or

ii) whenever property leaves the trust, such as when capital is advanced to a beneficiary or an absolute appointment of benefits is made (the 'exit charge').

a. The periodic charge

The trust fund is subject to periodic charges at every 10-year anniversary of 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 the outstanding loan.

The rate of inheritance tax charged is determined by assuming a transfer is made by an assumed transferor. This means that it is broadly necessary to take account of:

- the value of the property in the trust on the 10-year anniversary, the value of 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); and

- 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), the value of property added to other trusts on the same day the trust in question was funded, 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 rate of tax will be established. The maximum rate is 20%, and 30% of this effective rate is the rate applied to the value of the trust property. The maximum liability is therefore 6% (30% of 20%) of the value of the trust property over the available nil-rate band. Frequently, this means that the effective rate of tax on the whole trust fund will be much less or nil. Each case will depend on its own facts.

In cases where the settlor has not made any chargeable transfers in the seven years before he or she created 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 IHT 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 10-year anniversary.

Any excess over the then nil-rate band suffers IHT at an effective rate of 6%.

Example

George creates a discretionary loan trust in November 2007 by making a loan of £200,000 to trustees. The loan of £200,000 is invested by the trustees in a life assurance bond. George has made no chargeable transfers in the previous seven 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 November 2017, loan repayments of £100,000 in total have been made. Assuming growth on the bond has been at 5% a year, net of charges, the trust fund (net of the outstanding loan) is worth £225,780 (£325,780 - £100,000). If the nil rate band in November 2017 is £325,000, there is no IHT charge.

On the other hand, if on the 10-year anniversary in November 2017, George's trust is worth £550,000, the value of the trust for the purposes of the periodic charge is £450,000 after the outstanding loan is deducted. Based on a then nil-rate band of £325,000, the IHT charge is £7,500 (£125,000 at 6%). This equates to 1.66% of the value of the trust fund.

If all of the trust fund is distributed before the tenth anniversary, it is often the case that no tax charge arises (see next section). If assets remain in the trust after a distribution, or if further assets are added to the trust, the trustees should seek 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 from the total in order to arrive at the value for IHT purposes.

b. The exit charge

Exit charges are based on the value of property leaving the trust or being absolutely appointed to a beneficiary.

No exit charge arises on loan repayments (or loans granted by the trustees to a beneficiary).

Exit charges in the first 10 years

Exit charges within the first 10 years are 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 seven years prior to creating the trust. If the combined total of this, together with any added property, is below the available nil-rate band when the trust was created, there is no exit charge.

Exit charges after the first 10 years

Under a discretionary loan trust, it is highly unlikely that there would be any 'exits' other than loan repayments. However, if there were, the amount of any exit charge occurring after the first 10 years depends on the rate of tax charged at the last 10-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. If there was no charge at the previous 10-year anniversary, there is no exit charge in the following 10 years.

Example

Let's assume that on the first 10-year anniversary of George's trust, a periodic charge of 1.66% was charged (see above). In November 2023, six years since the first 10-year anniversary, the trustees of George's trust make a part encashment of the bond and pay £50,000 to a beneficiary. The IHT charge is £498 (£50,000 at 1.66%) 24/40.

No IHT charge will arise on property paid out of the trust if there was no IHT charge at the last 10-year anniversary.

Where an exit charge is calculated following a periodic charge, the rate of IHT that is charged must be updated to reflect any increases to the nil-rate band.

Exit charges should not arise on loan repayments or loans made by the trustees to beneficiaries.

Certain transactions, such as the value of the trust property on 10-year anniversaries and capital payments to the beneficiaries, also have to be reported to HMRC on forms 100c and 100d (and form D34 where a policy of life assurance is involved), even if no actual tax liability arises.

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 such payments would be as explained for exit charges in 5.3. Chargeable event gains on encashment of the bond to fund such payments are dealt with in 5.6. 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 the outstanding loan will be in his or her estate and pass to a beneficiary under the will (or intestacy). The IHT consequences depend on who benefits under the settlor's will or intestacy.

If the settlor is married and wishes to avoid an IHT liability on this amount, the right to the repayment of the outstanding loan can be left to his or her spouse. To achieve this, the settlor should take appropriate advice on suitable wording for inclusion in his or her will.

Following the settlor's death, the value of the bond, after the loan repayment, is 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 and 5.4. The encashment of the bond is a chargeable event and may give rise to an income tax liability (see 5.6).

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 or she 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, the tax can be recovered from the trustees and this does 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 and when the settlor is non-UK resident

In any tax year following that in which the settlor's death occurs (or at any time if the chargeable event gain arises while the settlor is non-UK resident), any chargeable event gains are assessed on UK-resident trustees at the special rate of 45%. However, for investment bonds issued by UK insurance companies, the trustees are entitled to a lower rate tax credit so only pay tax on the gain at the special rate less the lower (20%) rate tax. This means the rate of tax payable by the trustees is 25% on a UK 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 is no further charge to tax under a UK investment bond.

For offshore bonds, any gains that fall within the standard rate tax band are taxed at 20%. Any gains that fall outside the standard rate tax band are taxed at the special rate.

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 appropriate key features document). 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 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.

This guide is based on Countrywide Assured's current understanding of UK law and HMRC practice, both of which are likely to change in the future. While every care has been taken as to the accuracy of this booklet, neither Countrywide Assured nor its representatives accept any 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. Potential investors are strongly recommended to take independent professional advice relevant to their own circumstances before proceeding with the arrangement.

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8664/12.23