LOAN TRUST

What is it?

With a loan trust arrangement, you are loaning an amount of money to the trustees. The trustees then invest those funds in an investment bond. As the funds are being loaned rather than given away, you keep full access to those funds and can ask for amounts of loan to be repaid to you as and when you wish. The growth on the funds doesn't belong to you – that is held in trust for your chosen beneficiaries.

A loan trust scheme is an arrangement which effectively allows you to freeze the value of the funds that are being loaned whilst retaining full access to the loaned funds during your lifetime. This arrangement is slow in achieving any inheritance tax benefit because the benefit comes from the fact that only the future growth on your investment is outside your estate for inheritance tax purposes. The amount of the outstanding loan remains within your estate and will be potentially liable to inheritance tax should your estate exceed your nil rate band on your death.

Usually an investment bond is chosen as the type of investment as its structure allows loan repayments to be made to you by way of regular or ad-hoc withdrawals within specified limits without immediate tax liability. Full details of the investment bond are available on a separate factsheet.

In order for the loan trust to be an effective inheritance tax mitigation solution, any withdrawals that you take should be spent as income otherwise these funds are being added back to the value of your estate. The inheritance tax benefit is that the growth on the investment will be outside your estate.

At some point in the future if the remainder of the loan is no longer needed, it could be waived or gifted. This would be a lifetime gift and fall out of your estate after seven years (unless covered by an exemption).

Assuming you haven't waived or gifted the outstanding loan during your lifetime, on your death any outstanding loan would be owed to your estate. The rest of the funds held within the trust (the investment growth) can either be distributed to the beneficiaries or continue to be held within the trust – these funds are free from inheritance tax. To avoid the bond having to be encashed to repay the loan and potentially causing an income tax charge, you can include a specific provision in your will leaving the right to loan repayments to a surviving spouse/civil partner or to the trust.

With any trust involving life assurance policies it is essential that you appoint at least one additional trustee to act with you during your lifetime and to deal with the trust after your death.

The loan trust can be set up using either a flexible/discretionary or an absolute/bare trust and both are described below.

Flexible/discretionary trust

A flexible trust, as implied by the name, is one which offers more flexibility than an absolute trust. This type of trust allows you to change the proportions in which each beneficiary benefits from the trust, remove beneficiaries or appoint new beneficiaries.

As the original amount placed in trust is a loan, and not a gift, there is no immediate inheritance tax effect.

HM Revenue and Customs has confirmed that this type of arrangement is not subject to the Pre-Owned Asset Taxation regime.

Once the scheme is in force, the trust will become a separate entity for inheritance tax purposes and additional tax charges could apply. However, since the value of the trust would exclude the amount of any outstanding loan, although not the growth on it, it is most unlikely that these charges would apply, however no guarantees can be given.

The first charge to consider is the 'periodic' charge which will be assessed against the trust every 10 years. This would apply only if the trust was then valued at more than the trust's nil-rate band, excluding any outstanding loan. The nil-rate band is currently set at £325,000 but any chargeable lifetime transfers or failed potentially exempt transfers made in the seven years before the trust was set up would reduce the available trust nil rate band.

The tax charge is, currently, a maximum of 6% of any value in excess of the nil-rate band.

The second occasion of charge will be when monies, excluding regular payments made to you, leave the trust. The rate of tax is based on the tax charged either when the arrangement was set up or at the ten year anniversary immediately before the payment is made. Again, a maximum rate of 6% would apply but if no tax was paid at outset (which would be the case with a loan trust) or at the ten yearly anniversary points no tax would be charged at exit either.

Should there be a chargeable event on the bond, an income tax charge could arise. This is explained further in the investment bond factsheet. The taxable person where the bond is held within a flexible trust would be yourself (as settlor) if the chargeable event occurs during your lifetime or in the tax year of your death, or the trustees if the chargeable event occurs in a tax year after your death. If the bond is able to continue after your death, due to having additional lives assured or no lives assured (capital redemption bond), the trustees may choose to assign the bond, or segments of it, to beneficiaries. When the beneficiaries then encash the bond they will be assessed for income tax purposes.

Absolute/bare trust

With an absolute trust, there is no facility to alter the shares of any beneficiary. In the event of the death of a beneficiary before a payment is made, their share would pass under their will (or laws of intestacy if there is no Will).

Should there be a chargeable event on the bond, an income tax charge could arise. This is explained further in the investment bond factsheet. The taxable person where the bond is held within an absolute trust is the beneficiary (apart from where the arrangement is set up by a parent with their minor unmarried child as the beneficiary – in this case, if a chargeable gain in a tax year exceeds £100 (per parental settlor) the full gain is taxed on the parent(s)).

Trust Registration Service (TRS)

The TRS is a government register of the beneficial ownership of trusts. From 6 October 2020 the scope of the TRS was extended. The new rules are to ensure that the UK has an anti-money laundering and counter terrorist financing regime that is; up to date, effective, and proportionate. The rules will improve transparency about the ownership of assets held in trust.

The Loan Trust will need to be registered on the TRS. The deadline for registration is 90 days from trust creation.

Where the investment within the trust is an offshore bond effected in Ireland, the trust also needs to be registered on the Irish Central Register of Beneficial Ownership of Trusts (CRBOT) although this isn't possible at time of writing while the Irish Revenue simplify the process for non-resident trustees (the current position is shown within the 'CRBOT FAQs and troubleshooting for UK trustees and advisors' document).

The trustees can designate a 'lead trustee' to register the trust or an 'agent'. The 'agent' would need to be a business which operates as an accountancy service provider.

Risk considerations

There are a number of risk considerations that need to be taken into account. It is important that you are aware of these.

- Past performance is no guarantee of future returns.
- If growth is low, charges may eat into the capital invested.
- The price of units and the income from them can fall as well as rise.
- The value of this investment is not guaranteed and on encashment the trustees / beneficiaries may not get back the full amount invested.
- A surrender penalty may apply if you encash this investment in the early years.
- If withdrawals are made at a rate which exceeds the net growth of the fund, capital will be eroded.
- Before making any withdrawals in excess of the cumulative 5% allowance, you should seek advice in respect of the most appropriate and tax efficient method of achieving this.
- Where regular withdrawals (loan repayments) are taken, if not spent as income they will simply accumulate in your estate, negating part of the inheritance tax benefits of the scheme.
- Similarly, if the loan repayments are not spent, but given away or waived, they will be subject to the usual gifting rules (to the extent that they are not covered by an exemption) and remain part of your estate for 7 years.
- You can't access any further capital once the loan part of the original investment has been withdrawn. At that stage, the remaining value of the trust belongs to your beneficiaries.
- Please be aware that there may be occasions when an individual fund or funds may have a higher risk rating than your overall stated attitude to risk. If this is the case, then the overall risk rating applied to all of the combined funds being recommended is still designed to meet your stated tolerance.