The Loan Trust

Introduction

The Loan Trust enables the Settlor to make a gift of the growth on the loan whilst still having unrestricted asset to the original loan capital.

It is for those individuals who are keen to undertake Inheritance Tax planning but who still require access to their capital by way of regular or ad-hoc loan repayments.

The growth on the trustee's investment is outside the Settlor's estate for Inheritance Tax purposes. The trustees can pay back the loan by taking withdrawals from the bond.

How does it work?

The Settlor makes an interest-free loan to the trustees who invest in a RL360° offshore bond for the benefit of beneficiaries. The Settlor retains access to the value of the outstanding loan and has the right to have the loan repaid in whole or in part at any time.

Any growth on the loan accumulates for the benefit of the beneficiaries. It is outside of the Settlor's estate and is therefore free of Inheritance Tax on the Settlor's death. The balance of the outstanding loan remains in the Settlor's estate for Inheritance Tax purposes.

The Settlor has the option of establishing the trust on a bare or discretionary basis. There are important differences between the two trust provisions in their Inheritance Tax treatment.

If the Bare Trust form is selected, the creation of the Trust will not be a transfer of value for Inheritance Tax purposes. Thereafter, any growth will arise inside the estates of the named beneficiaries.

By contrast, if the Discretionary form is selected, while the creation of the Trust will not be a transfer of value for Inheritance Tax purposes the Trust Fund will be treated as being "relevant property" for Inheritance Tax purposes. This means there will be periodic charges to tax at 10 yearly intervals and tax on property exiting the Trust or on the possible termination of the Trust where the value of the Trust Fund less the outstanding amount of the Loan at the relevant time exceeds the nil rate band.

The Settlor must not be named as a beneficiary. If he is, then this will prejudice the tax effectiveness of the Trust.

For further information regarding the Loan Trust and the implications of establishing it on either a Bare or Discretionary basis, please refer to our *Guide to Trusts*.

Case study

Steven Harper, who is UK-domiciled, has recently retired from the National Health Service where he was a consultant surgeon. He has an annual pension of £50,000. He owns a London flat and has a holiday home in Scotland where he intends to take an extended break in the early part of his retirement. He has £200,000 in liquid assets to invest, from which he would like to receive £10,000 per year to supplement his pension and to meet the maintenance costs of his Scottish property.

He is aware that his assets will potentially create a liability for Inheritance Tax and that one way to reduce this exposure would be to make gifts to his children or grandchildren. However at this point Steven does not want to make significant gifts to his children whom he regards as financially secure, preferring to benefit his grandchildren at a time when they are financially mature.

Steven contacts his financial adviser and expresses his desire to undertake some planning to mitigate the potential Inheritance Tax liability without making outright gifts. His financial adviser, after appropriate research recommends an offshore bond from RL360° to be held within a Loan Trust.

The Loan Trust is established (Steven being the Settlor) with Steven's children, Paul and Emma, as trustees and his grandchildren and future grandchildren as beneficiaries.

Steven gives the trustees an interest-free loan of £200,000. The trustees invest the loan in a RL360° offshore bond (Steven, Paul and Emma being the lives assured) and arrange for withdrawals of 5% each year to be paid to Steven.

After 20 years the loan will be repaid and Steven can receive no further payments, but the value of the bond will be outside his Inheritance Tax estate. Should he die before he has received the full amount of the loan, the value of the loan then outstanding will be taken into his estate for Inheritance Tax purposes but not the actual value of the bond. The growth on the bond has escaped Inheritance Tax.

Important notes

For financial advisers only. Not to be distributed to, nor relied on by, retail clients.

Finally, please note that every care has been taken to ensure that the information provided is correct and in accordance with our understanding of current law and practice with Her Majesty's Revenue and Customs (HMRC) as at July 2012. You should note however, that we cannot take on the role of an individual taxation adviser and independent confirmation should be obtained before acting or refraining from acting upon the information given. The law and HMRC practice are subject to change.

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