MEDICAL & DENTAL

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A guide to IHT: Loan Trusts

1. The Loan Trust

Under a loan trust an interest free loan is made by the settlor to the trustees, this is then used by them to buy an investment, most commonly an investment bond (which is ideally suited to investments within a trust).

The loan is repayable on demand, which means the settlor keeps full access to the original capital.

The growth is out of the estate from day 1, with no access to any growth for the settlor.

The loan trust effectively freezes the value of that part of the estate.

Loan repayments can be increased (or decreased) at any time, and ad hoc lump sum withdrawals can be taken at any time, either for the settlor or for the beneficiaries. There is flexibility to change a loan trust to a gift trust in the future, however this cannot be done in reverse.

On the death of the settlor, any outstanding loan remains as part of their estate and liable to IHT.

The settlor could state in their will that the loan is to be repaid or to continue with the outstanding loan being left to a specific beneficiary such as their surviving spouse.

The trust can be set up under either a discretionary or an absolute basis.

Discretionary and absolute trusts have different tax rules (in certain areas) applied to them.

2. The Settlor

The person who sets up the trust is called the settlor. The settlor of the trust is automatically a trustee.

The settlor can receive a repayment of the loan, either as a lump sum or by regular repayments, commonly up to 5% pa (the investment bonds tax-deferred allowance) over a 20 year period.

3. The Trustees

The trustees are the people who control the trust and the investment therein, it is important that they are chosen carefully.

The trustees have discretion over how and when any beneficiary benefits from the trust growth.

The trustees can be changed by the settlor during his/her lifetime, they have the power to appoint and remove trustees.

There are many options that are appropriate to use and it is very much dependent on your own personal circumstances and objectives.

A qualified financial planner can assess your situation and review and plan what may arise in the future with regards to any IHT liability.

Example

Mr. and Mrs. Jones both 62, good health, with two children and four grandchildren

Their estate is some £2.2m made up of:

House	£500,000
Pension fund	£400,000
Bonds	£400,000
Unit trusts	£200,000
ISAs	£600,000
Cash	£100,000
	= £2,200,000

They have regular income as follows:

State pensions	£20,000
Bond withdrawals	£20,000
ISAs	£20,000
	= £60,000

This covers their annual expenditures of £60,000, the emergency fund of £50,000 is part of the £100,000 cash.

Challenges within the current setup:

a. Inheritance Tax (IHT) liability of some £320,000
Estate £2.2m less £400,000 (pensions exempt) - £1,000,000 (2 times nil rate bands), i.e £800,000 at 40% tax
b. ISAs while free of income tax and CGT are not free of IHT
c. Unit trusts and bonds are income tax-efficient, however both subject to IHT on existing capital and all growth
d. If no action taken the IHT liability will get bigger over time

Objectives

a. As clients are relatively young, flexibility within their planning is a key objective
b. To mitigate IHT liability where practical
c. Too young to be making significant gifts
d. To be able to take flexible withdrawals from investments

Recommendations

a. Encash bonds and half the unit trusts, total £500,000
b. Invest £500,000 in a loan trust, with withdrawals initially set at £25,000 pa
c. As growth is outwith estate from day 1 this freezes the value of a large part of the estate and stops liability getting worse
d. If growth of 5% then IHT saving over say 10 years of £100,000 (£500,000 x 5% x 10 years at 40%)
e. As no IHT saving on day one this is a longer-term plan, more suitable to younger clients
f. The outstanding loan is always repayable on demand meaning that there is flexibility should 'what if scenarios' mean either the client or the family needs money in the future

Summary

This planning provides flexibility for the future, and also stops the current IHT liability from getting any larger.