



Loan trusts: a flexible IHT planning tool

Estate planning is still an important issue for many people, despite the effective doubling of the nil rate band for married couples and civil partners bringing their total exempt amount to £650,000 (tax year 2011/2012).

An effective way of reducing IHT is to use a trust, but it can be difficult to know which type of trust is most suitable. Does the client need income? Are they able to make an outright gift? Is a mix of both required? Clients are often reluctant to make lifetime gifts as although the money may be surplus to their current needs, they fear they may have to fund future, unforeseen requirements. In cases such as this, a loan trust could be the answer.

A loan trust allows the settlor access to his or her original capital, with any growth falling outside the estate. So while it doesn't provide an immediate IHT saving, it does 'freeze' the estate for IHT purposes. Plus, it provides the flexibility many clients seek. It can be suitable for individuals who need to take a regular 'income' or who want flexible access to a certain amount of capital, and for those who do not require 'income' now, but may in the future.

How does it work?

A trust is set up and the individual lends cash to the trustees who then invest it on behalf of the beneficiaries. The loan remains in their estate and they can call upon it at any time – it is not considered to be a gift for IHT purposes.

No income required?

How can a flexible loan trust benefit a person who doesn't require 'income' from it? If their nil rate band is used by other assets, such as their home, using a loan trust can help prevent their eventual IHT bill increasing.

It is important to remember that a flexible loan trust is a discretionary trust and therefore periodic and exit charges will apply. The periodic charge will apply at the tenth anniversary, and an exit charge will apply when the trustees distribute the assets. The maximum periodic

John invests £200,000 in a life assurance investment bond and decides not to withdraw any money from it. Ten years later, assuming a compound growth rate of 4.8% a year and after charges, the fund has grown to £319,626. On his death and assuming his nil rate band has already been used, IHT will be payable on the fund value, giving a charge of £127,850 (£319,626 x 40%), leaving a net amount of £191,776 (£319,626 - £127,850) to be distributed to John's beneficiaries. However, if John uses a loan trust the IHT payable on his death would be just £80,000 (£200,000 x 40%), as all growth immediately falls outside his estate. The net return on the bond is therefore £239,626.

£200,000 investment, making no withdrawals (growth rate after charges 4.8% a year compound)

| Term | No loan trust | | Loan trust | |
|----------|---------------|----------------|------------------|----------------|
| | Value | Net of 40% IHT | Outstanding loan | Net of 40% IHT |
| 10 years | £319,626 | £191,776 | £200,000 | £239,626 |

Investing the funds

The trustees must decide how the funds should be invested. Most choose to invest the money in an investment bond with one of the major providers. Investment bonds give access to a range of investment funds across a diverse range of assets and sectors, together with the ability to switch between funds at a reasonable cost should the trustees wish to do so. It is important to achieve an asset allocation that matches the aims and objectives of the trust and the level of risk that trustees deem to be acceptable. The performance should be reviewed regularly against these objectives and risk level and rebalanced if it has deviated.

However, an investment bond is not always the most appropriate investment vehicle. Lighthouse-Carrwood has extensive experience in advising clients on ways of reducing an IHT liability, including the use of trusts, and advising trustees on investing the funds.

WEALTH MANAGEMENT ALERT

Continued from previous page

charge which would be payable if the nil rate band has already been used would be 6% of the value of the trust minus the outstanding loan. In the example on the previous page this would be:

| | |
|-----------------------|------------|
| Value of trust fund | £319,626 |
| Less outstanding loan | (£200,000) |
| | £119,626 |
| x 6% | £7,178 |

Therefore, if a discretionary trust is used, John's beneficiaries are £40,672 (£239,626 - £191,776 - £7,178) better off. If the trustees distribute the assets within three months of the tenth anniversary there will be no exit charge.

Income required?

If the person making the loan requires 'income', the loan can be repaid to them in regular instalments. This is usually done by withdrawing up to 5% of the initial amount invested each year on a tax-deferred basis. This will gradually reduce the value of the loan and therefore of the individual's estate. However, it is important that the individual does actually spend this money – if they don't it will simply accumulate in their estate, defeating the purpose of setting up the trust in the first place.

As the example on the right demonstrates, even after taking a periodic charge at the tenth anniversary into account, Fiona's beneficiaries would be better off. There is also likely to be an exit charge when the fund is eventually distributed.

The flexibility to change

Clive, a widower aged 60, sets up a loan trust (creating fixed trust interests) and lends the trustees £80,000 which they invest in an onshore life assurance bond. For IHT purposes the loan is frozen at its original value. Clive doesn't make any withdrawals for the first five years and by year six his circumstances have changed for the better. He therefore decides to waive repayment of half the loan. This is treated as a potentially exempt transfer and if Clive survives for seven years from waiving the repayment, the £40,000 will fall outside his estate for IHT purposes. He still has the option of making withdrawals from the remaining £40,000 if he so wishes.

Fiona decides to invest £200,000 in a life assurance investment bond and withdraw 5% of her initial investment each year. Ten years later, after taking withdrawals into account, assuming a growth rate of 4.8% a year compound and after charges, the fund value is £195,015. On Fiona's death, assuming her nil rate band has already been used, IHT will be payable on the fund value at 40%, £78,006 (£195,015 x 40%), leaving a net amount of £117,009 (£195,015 - £78,006) to be distributed according to her will. However, if Fiona had set up a loan trust and invested £200,000 into it, the IHT payable on her death would be just £40,000 (£100,000 x 40%). As she had taken 5% repayments a year for ten years which she used to fund her living expenses, only £100,000 of the loan remains. (Remember, all growth in a loan trust over and above the initial investment falls outside the estate for IHT purposes.) Therefore, with a loan trust the net return is £155,015 (£195,015 - £40,000). Fiona's beneficiaries are £38,006 better off.

£200,000 investment, 5% tax deferred withdrawals a year (growth rate after charges 4.8% a year compound)

| Term | No loan trust | | Loan trust | |
|----------|---------------|----------------|------------------|----------------|
| | Value | Net of 40% IHT | Outstanding loan | Net of 40% IHT |
| 10 years | £195,015 | £117,009 | £100,000 | £155,015 |

Potential to reduce IHT still further

Although a client may not require income now, they may be uncertain as to whether they will in the future. If their situation becomes clearer and they are certain they won't require 'income' from part or all of the trust they can waive part or all of the loan, as the example on the left demonstrates. This must be effected by deed to be effective as a potentially exempt transfer (bare trust version) or chargeable lifetime transfer (discretionary trust version) for IHT purposes.

LighthouseCarrwood is one of the UK's leading providers of financial planning services to professional practices. We would be delighted to work with you to help your clients reduce their potential IHT liability and optimise their investments. To discuss how we could work with your firm in a way that suits your practice, please contact: Mark Dallas, Managing Director, on 07899 981607 or Mark.Dallas@lighthousegroup.plc.uk. www.lighthousecarrwood.co.uk

Lighthouse Group is proud to have won the prestigious IFA of the Year award for the second year in succession.



These examples are based on a trust term of ten years. More IHT charges may arise depending on the term of the trust. We would like to thank Scottish Widows for their input into this article.