

# Nucleus Discretionary Loan Trust

Adviser guide

Edition

04

## Introduction

### This document consists of six sections:

1. The Nucleus Discretionary Loan Trust: an overview
2. Inheritance Tax (IHT) planning and the Nucleus Discretionary Loan Trust
3. The suitability of the Nucleus Discretionary Loan Trust
4. The Nucleus Discretionary Loan Trust – The trust and the loan agreement provisions in detail
5. The UK Tax implications of the Nucleus Discretionary Loan Trust
6. Frequently asked questions

The following points should be noted in respect of this document:

- (a) The term 'spouse' includes registered civil partner.
- (b) The term 'settlor' refers to both the settlor and the lender.

# 1. The Nucleus Discretionary Loan Trust: an overview

## 1.1 The aim

The aim of the draft Nucleus Discretionary Loan Trust is to enable a person to undertake effective and flexible lifetime inheritance tax (IHT) planning whilst retaining access to funds used in the planning. The draft trust and the loan agreement are provided on the basis that they will achieve the objectives and have the tax consequences specified in this document. However, it is essential that each client should confirm with their legal and professional advisers that the drafts are suitable for their purposes.

## 1.2 What is it and who is it for?

The Nucleus Discretionary Loan Trust is an estate planning scheme which has three components:

- A trust
- A loan
- An investment in the Nucleus wrap.

The types of investor who may be interested in using the Nucleus Discretionary Loan Trust are those who:

- are contemplating an investment in collective investments in a Nucleus General account (referred to in this guide as collectives) or a Nucleus Onshore or Offshore Bond in the Nucleus wrap (referred to in this guide as bonds)
- wish to carry out estate planning
- cannot afford to give up all access to the funds to be invested but can give up access to any investment growth on the amount invested

The discretionary loan trust anticipates that a potential investor in a Nucleus Wrap who has the above objectives could, instead of investing directly in their own name, lend a sum of money to trustees (free of interest) to invest in a bond or collectives to hold on trust for beneficiaries indicated in the trust, subject to the right of the settlor to have their loan repaid on demand. When the intended investment is a bond, the trustees will normally make an application for a policy on the lives of the settlor and some of the beneficiaries on a joint lives last survivor basis.

The loan trust can be used only by one individual – it is therefore not available to joint settlors. The reasons for this are explained in section 6 of this guide.

## 1.3 Tax effectiveness and flexibility

The trust is 'discretionary' which means that there is no need to decide at outset which beneficiary is entitled to the trust assets or when they become entitled to them and to what extent. There are several

classes of beneficiary and the settlor (and, following their death, the trustees) as the 'appointor' under the trust has discretion as to which of those beneficiaries should receive what, how much and when. On completing the trust deed the settlor can add a class of beneficiary(ies) to the pre-designated list. Further beneficiaries (excluding the settlor) can be added by the settlor notifying the trustees in writing at any time.

To ensure that the discretionary loan trust is effective for IHT purposes, the settlor cannot benefit from the trust assets in any circumstances but, of course, the settlor, as the lender, retains the right to have their loan repaid to them at any time.

The settlor can choose whether to include their spouse as one of the beneficiaries. Although this would have no adverse IHT implications, it has important income tax implications.

Full details of the UK tax implications of the Nucleus Discretionary Loan Trust can be found in section 5 of this guide.

## 1.4 Avoiding probate (confirmation in Scotland)

As well as important tax benefits, the investment that is held by the trustees in a Nucleus Discretionary Loan Trust will not be an asset of the settlor's estate for probate purposes which means that, in the event of the death of the settlor, the trustees can carry on dealing with the investment without waiting for probate on the settlor's estate.

However, to ensure that this is possible, there must be at least one trustee who survives the settlor. Under the Nucleus Discretionary Loan Trust the settlor is automatically one of the trustees and further trustees are appointed in the trust deed. If any of the additional trustees retires or dies before the settlor, a replacement trustee should be appointed.

If all of the additional trustees have resigned, died or have been removed so that there is no surviving trustee on the death of the settlor, the settlor will be the sole trustee at the time of their death. The trust will nevertheless continue to exist and be effective for IHT but the personal representatives of the deceased settlor will assume the role of trustee. This means that although the trust investments will not be part of the settlor's estate for IHT or probate purposes, securing probate to the settlor's estate will still be necessary to ensure that the personal representatives can act as trustee under the discretionary loan trust.

An appointment of additional trustee(s) is particularly important if the settlor is domiciled in Scotland as, without an additional trustee, the trust may not be validly created under Scots law.

It is very important that additional trustees are appointed who are likely to survive the settlor so as to ensure that any delays in being able to deal with the trust investments are avoided.

## 2. IHT planning and the Nucleus Discretionary Loan Trust

Trusts are commonly used in estate planning as they can allow a person to make a gift that will reduce their estate and so the potential IHT on it, but without having to decide immediately who should receive the gift, to what extent and when. However, to be effective for IHT, the donor must normally give up all access to the gifted property. For some, this can represent a serious obstacle that needs to be overcome if effective and 'acceptable' estate planning is to be possible.

The Nucleus Discretionary Loan Trust is designed to overcome this objection.

To ensure that the settlor makes an effective gift for IHT purposes, the settlor must not retain any benefit (actual or prospective) under the trust. By establishing a trust under which the settlor does not have any beneficial interest, the settlor will, effectively, make sure that the trust fund (after deduction of any loan owed to the settlor) will not form part of their 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 their taxable estate but the remainder of the trust fund from outset (effectively the growth on the investment) is outside of the settlor's taxable estate for IHT purposes and inaccessible to the settlor.

As the settlor takes loan repayments and spends the money without bringing equivalent value assets into existence, their taxable estate will gradually reduce.

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.

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 with the arrangement is also strengthened by the fact that the settlor does not actually make any gift when the trust is set up – the trust is simply declared with the initial trust property being lent – not gifted.

The Nucleus Discretionary Loan Trust is expressed as being irrevocable and the only persons who can benefit are the beneficiaries specified in the trust deed. As the settlor is not and cannot be a beneficiary the trust is therefore effective for IHT purposes.

The settlor's spouse may be included as a beneficiary if the settlor so desires and this by itself will not have any adverse IHT implications (i.e. it will not amount to a gift with reservation of benefit). However, great care should be exercised if any payments are to be made from the trust to the settlor's spouse during the settlor's lifetime. If in such circumstances the settlor enjoys a direct or indirect benefit (for example if the funds were used for common family expenses), the trust could then be caught by the gift with reservation of benefit provisions thus making it ineffective for IHT purposes.

The gift with reservation of benefit provisions could, however, apply if each of a couple were to effect their own separate discretionary loan trust under each of which the other was a beneficiary, so this should be avoided.

The inclusion of the settlor's spouse as a beneficiary under the trust would give rise to income tax implications – see section 5 of this guide.

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

## 3. The suitability of the Nucleus Discretionary Loan Trust

### 3.1 Suitability

The Nucleus Discretionary Loan Trust may be suitable for an investor who would:

- like to gradually reduce the value of their taxable estate so as to reduce the IHT liability arising on their death
- like to retain tax-efficient access to the amount originally invested (possibly to supplement their income) through repayment of their loan in whole or in part, at any time should they need to
- like to ensure that all capital growth on the trust investments accrues outside of their estate and passes to the beneficiaries free of IHT
- like to retain control and flexibility over who should ultimately benefit from the investments
- like the benefits of the investments to be outside their estate for probate purposes when they die.

The Nucleus Discretionary Loan Trust will not be suitable for an investor who requires access to their entire investment or, conversely, who is happy to make a gift of the investment, without retaining any access. Other trusts offered by Nucleus may be suitable to meet these or other objectives. The choice of trust should always be discussed with professional advisers. Nucleus provide a 'Trust Selector' to assist in this process.

Full details of the tax implications of the discretionary loan trust are set out in section 5 of this guide.

### 3.2 Matters to consider before establishing the trust

A discretionary loan trust is suitable only if there is cash available to lend to the trustees/invest on their behalf, i.e. it cannot be set up with any existing investments. So, if existing investments in the Nucleus wrap are to be used to provide the cash for the loan, they will need to be realised. The tax implications of such a disposal should be fully considered before any such realisation takes place.

Before recommending the Nucleus Discretionary Loan Trust, it would be appropriate to determine:

- the potential IHT liability on the investor's estate (including the history of previous gifts) if no action is taken
- the practical objectives of the investor – namely, how much flexibility is required, who the potential beneficiaries should be and, in particular, whether the spouse should be included amongst the beneficiaries
- that the settlor will not require access to the entire investment in the future
- the settlor's need for access to the funds committed to the arrangement, e.g. the level of periodic loan repayments that may be required
- the choice of the initial investment (i.e. onshore or offshore bond or collectives)
- if the investment is to be in collectives, whether the income from the collectives should be accumulated or distributed.

## 4. The Nucleus Discretionary Loan Trust – The trust and the loan agreement provisions in detail

### 4a. The trust

For tax purposes the Nucleus Discretionary Loan Trust is a discretionary settlement. The trust gives the appointor power to appoint benefits under the trust among a wide class of beneficiaries. The settlor is the first appointor and, after the settlor's death (or mental incapacity), the appointor will be the trustees. No beneficiary is entitled to any benefit until the appointor so decides – the ultimate default beneficiaries named in the trust will benefit only if no other appointment has been made by the end of the trust period which is 125 years.

The following is a summary of the key provisions as they appear in the draft Nucleus Discretionary Loan Trust.

#### Recital

The deed, if thought to be suitable and after taking advice, would be executed by the settlor and the named additional trustees. Their details, and the date the trust deed is to be executed, are all required in this 'opening' part of the trust deed.

#### Part 1 – Declaration

No gift is made when the settlor declares the trust. Instead, the settlor makes a non-binding promise to make a loan to the trustees. The trust will become completely constituted when the trustees invest the loan monies and the investment will become the trust asset. The settlor also chooses the name for their trust.

#### Part 2 – Definitions

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

The discretionary beneficiaries are those in favour of whom the trustees may make an appointment of benefits. They include the 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, any person nominated in writing to the trustees by the settlor and any charity. The settlor can add any other individuals not covered by the standard wording.

The settlor can choose whether to include their spouse in the class of discretionary beneficiaries. This will have important income tax implications if the investments of the trust are collectives – see section 5 below. The settlor is excluded as a beneficiary.

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 of a 'new beneficiary' to the trustees. However, the settlor cannot add themselves to the class at any time.

The default beneficiary(ies) is/are the individual(s) who will benefit if the power of appointment is not exercised by the appointor by the end of the trust period, i.e. 125 years from the time the trust is created. They are named by the settlor in the trust deed at outset. 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 the trust is valid and the property will not return to the settlor or the settlor's estate.

#### Part 3 – The main 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 previously indicated, the power to appoint capital and income under the trust is vested in the appointor. This is the settlor during their lifetime whilst they have full mental capacity and then the trustees. The power is exercisable at the appointor's discretion and includes the power to appoint further trusts in favour of beneficiaries.

The trustees have power to accumulate any trust income. The accumulation can be made without time limit if the trust is governed by English law, and for 25 years if the trust is governed by Scots law (this is the maximum period allowed under Scots law). Such income is then reinvested.

If not all of the trust property has been appointed by the end of the 125 year trust period then the default beneficiaries will benefit.

There is also a special provision dealing with any potential conflict of interest. In many cases the trustees of the trust would be family members who would also be beneficiaries under the trust. If an appointment of benefits were to be exercised in favour of a beneficiary who is also a trustee then a suspicion of 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 (as appointor after the settlor's death) 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 included in the trust to advance capital from the trust fund to the beneficiaries and to make loans to beneficiaries. The power to lend may be more appropriate than the power to advance in many circumstances.

#### Part 4 – Trustees' administrative powers

The trustees also have wide administrative powers to deal with the trust fund and to reinvest the proceeds of any investment in any way they wish. They also have the power to borrow funds, to make payments to parents or guardians of minor beneficiaries and to delegate certain powers. There is a useful power to delegate any administrative functions in connection with investment of the trust fund to any two of their number. In such a case only two of the trustees will need to sign any instructions, e.g. to sell assets.

## 4. The Nucleus Discretionary Loan Trust – The trust and the loan agreement provisions in detail

### Part 5 – Appointment, dismissal, retirement and remuneration of trustees

The power to appoint new or additional trustees is vested in the appointor, i.e. the settlor during their lifetime and with full mental capacity and after their death in the trustees. The settlor, whilst alive and of full mental capacity, also has the power to dismiss any trustee provided at least one trustee other than the settlor and/or the settlor's spouse remains after such a dismissal.

There is no power to dismiss a trustee after the death of the settlor and it must be remembered that trustees under an English trust must act unanimously. In Scotland trustees can make decisions by a simple majority.

There are also powers dealing with the retirement of trustees and corporate trustees.

Trustees who act in their professional capacity are entitled to charge fees.

### Part 6 – Further trust provisions

These mainly deal with the trustees' liability for any loss to the trust fund.

The liability of individual trustees is limited so that they will not 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 negligence.

There are also comprehensive provisions excluding the settlor from all benefit (and the settlor's spouse unless the settlor specifically included the spouse as a discretionary beneficiary at outset).

### Part 7 – Proper law

The trust gives the settlor the choice of law to govern it – either the law of England or the law of Scotland. Those domiciled in Scotland will usually choose Scots law to apply to their trusts but there is no compulsion to choose the law of the Settlor's domicile. The tax implications of the trust are the same throughout the UK.

### The schedule

The amount of the Intended loan is identified in the schedule.

### Part 8 – Signatures

The trust deed is executed by all the parties by signing and having their signatures witnessed.

### 4b. 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 bond or collectives in the Nucleus wrap and, with this in mind, the settlor should draw a cheque in favour of (or make a BACS transfer to) Nucleus Financial Services and the trustees will apply for the chosen investment(s) in the usual way. The trustees acknowledge receipt of the loan using the form of 'Acknowledgment of receipt of loan by trustees' available from Nucleus.

The bond or collectives invested in by the trustees will represent the only asset of the trust.

The liability of the trustees for the repayment of the loan is limited to the amount of the trust assets except where there has been a breach of trust or the trustees have advanced capital to a beneficiary where there were insufficient funds in the trust after taking into account the outstanding loan.

From time to time the settlor will, typically, request a part repayment of their loan. Nucleus provides standard forms of 'Request to trustees for loan repayment' and 'Receipt of repayment'. It is important that all repayments are properly documented. To facilitate the repayment the trustees will encash part of the bond or collectives – see section 5 for the tax implications of encashment. The part repayment of the loan to the settlor will be tax free in the hands of the settlor as a capital repayment (although there may be some income tax and capital gains tax implications if the underlying investment is in income-producing collectives – see section 5 for full details).

It is recommended that loan repayments are not made on a regular basis and for the same amounts so as to avoid any possibility of the inference that the loan is in fact repayable by instalments and therefore payable within a fixed time frame (which may give rise to adverse IHT implications).

As the loan is expressed to be repayable on demand the repayment of the whole of the outstanding loan can be demanded by the settlor at any time.

It is important that the loan is expressed to be interest-free and repayable on demand as loans repayable by instalments have different (less favourable) tax consequences.

## 5. The UK tax implications of the Nucleus Discretionary Loan Trust

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 where this is not the case.

### 5.1 Inheritance tax

#### (i) Establishing the trust

Since no gift is made by the settlor when the trust is established, the creation of the trust will not give rise to a transfer of value by the settlor for IHT purposes as long as the correct procedures advised by Nucleus 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 settlor/lender.

As the settlor is entitled only to their loan repayments and is not a beneficiary of the trust, the arrangement is not caught by the 'gift with reservation of benefit' provisions.

HMRC has confirmed that the income tax pre-owned assets tax rules in Schedule 15 Finance Act 2004 should not apply either.

#### (ii) Does HMRC need to be informed about the discretionary trust?

The trust must be registered using HMRC's online trust registration service when it first becomes liable to any of the following taxes:

- Capital Gains Tax
- Income Tax
- Inheritance Tax
- Land and Buildings Transaction Tax (in Scotland)
- Stamp Duty Land Tax
- Stamp Duty Reserve Tax or Stamp Duty

The relevant deadline for registration is, in the case of income tax or capital gains tax, 5 October following the end of the tax year in which a liability first arises. For the other taxes listed above, the relevant deadline is 31 January following the end of the tax year in which a liability first arises.

Each year the trustees will then receive the Trust and Estate Tax Return (Form SA900), which they have to complete under self assessment if they have any liability to income tax or capital gains tax.

As no gift is made at outset, there is no need for any other reporting for IHT purposes.

Trustees of discretionary trusts may have to submit special IHT returns on 10-year anniversaries and when distributions from

the trust are made even though IHT charges may then not apply. The forms to use here are Form IHT 100 and Form 100c (for exit charges) and Form 100d (for 10-year anniversary (periodic) charges). In practice, given the amounts involved before any reporting is required, and that the value of the trust fund in each case will be net of the outstanding loan, it is unlikely that Nucleus investors will have to satisfy these requirements.

#### (iii) What are the IHT implications of the settlor dying within seven years of establishing the discretionary loan trust?

On the death of the settlor – at any time – the assets in the trust will be outside of the settlor's estate for IHT purposes. However, the amount of the outstanding loan will be an asset in the settlor's estate for IHT purposes.

A settlor who is married or in a registered civil partnership may, in their will or a codicil to their will, leave the right to the repayment of the outstanding loan to their spouse or registered civil partner. In such a case, if the spouse survives the settlor, no IHT will be due on the outstanding loan entitlement on death and loan repayments can continue to the spouse. A special form of words for inclusion in a will or a codicil to achieve this, 'Draft legacy of loan entitlement' is available from Nucleus.

#### (iv) What are the IHT implications for the trust?

As the trust is a discretionary trust, this means that the special relevant property rules apply. Under these rules there may be IHT charges:

- on every 10-year anniversary of the Trust – 'the periodic charge' – and/or
- whenever property leaves the trust (e.g. when capital is advanced to a beneficiary) – 'the exit charge'.

As mentioned earlier, since no initial gift is made to the trust there will be no IHT considerations on the creation of the trust.

#### The periodic charge

Periodic charges at 10-yearly intervals from the creation of the trust are, broadly speaking, applied to the value of the assets in the trust at the time of the relevant 10-year anniversary. Remember that under the discretionary loan trust the value of the trust assets will be determined after deducting the amount of the outstanding loan.



## 5. The UK tax implications of the Nucleus Discretionary Loan Trust

The effective rate of IHT will be determined based on an assumed transfer by an assumed transferor. This will mean that it will broadly be necessary to take account of:

- the value of the property in the trust on the 10-year anniversary and the value at commencement of any related trusts set up on the same day (the assumed transfer), and
- the settlor's cumulative total of chargeable lifetime transfers (CLTs) made immediately before the trust was established (or immediately before any property was added to the Trust) plus any sums paid out of the trust in the 10 years prior to the anniversary (the cumulative total of the assumed transferor).

The maximum liability will, in effect, be 6% of the value of the trust property above the nil rate band available to the trust. This means that, in many cases, the effective rate on the whole of the trust property will be much lower than 6%, possibly nil.

In cases where the settlor has not made any CLTs in the seven years before the trust is created, no payments having been made out of the Trust in the previous 10 years, there are no related trusts and there has been no added property, there will be no liability provided the value of the trust fund (after deduction of the outstanding loan) does not exceed the nil rate band applicable at the 10-year anniversary. Any excess over the then nil rate band will suffer IHT at an effective rate of 6%

If the capital in the trust fund at the anniversary includes income that has been accumulated by the trustees and added to the trust capital, there will be a reduction in the IHT rate that applies to this capital to allow for the period of time before which the accumulated income was added to the capital.

### Example

Alan creates a discretionary loan trust on 10 March 2019. The loan of £300,000 is invested in a general account in the Nucleus wrap. He has made no chargeable transfers in the previous seven years. No payments are made out of the Trust in the first 10 years except for loan repayments of £150,000 in total. No property is added to the trust.

On 10 March 2029 the value of the shares in the account is £450,000 which means that the value of the trust fund (i.e. after deducting the outstanding loan) is £300,000. This will be within the nil rate band and so there will be no IHT charge. For comparison, if the trust fund was worth £500,000 and the nil rate band was £450,000, the IHT periodic charge would be calculated as £50,000 at 6% = £3,000. This equates to 0.6% of the total value of the trust fund.

If all the trust fund is distributed before the 10th anniversary, no tax charge will usually arise (see next section). If assets remain in the trust after a distribution (or if further assets are added to the trust), the trustees will need to seek specialist tax advice.

### The exit charge

Exit charges will be based on the value of property leaving the trust.

#### (i) First 10 years

Exit charges will not apply to loan repayments (or loans made to beneficiaries out of the trust by the trustees).

Under a discretionary loan trust it is highly unlikely that there would be any 'exits' other than 'inoffensive' loan repayments. However, if capital were to be appointed to a beneficiary, the following rules will apply.

On the basis that no gift is made to the trust, there will be no exit charges within the first 10 years following the creation of the discretionary loan trust if the cumulative total of the settlor's CLTs in the seven years immediately prior to creating the trust is below the nil rate band when the trust is created and no assets have been added to the trust. If an exit charge does arise, it will increase according to the number of quarters that have expired since the trust was created.

#### (ii) After the first 10-year anniversary

The amount of any exit charge occurring after the first 10 years will depend on the rate of tax charged at the last 10-year anniversary (if any) and the length of time (in quarters) that the property has been in the trust since the last periodic charge. In many cases with a discretionary loan trust, there will have been no periodic charge (see above) at the previous 10-year anniversary and so no exit charge would arise.

### Example

Let's assume that on the first 10-year anniversary of Alan's trust a periodic charge of 0.5% was made (see above) and the nil rate band remains the same.

In 2035, six years since the first ten-year anniversary (when a 0.6% IHT rate was charged), the trustees of Alan's trust sell some of the shares and pay £50,000 to a beneficiary. The IHT charge will be  $£50,000 \times 0.6\% \times 24/40 = £180$ .

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

The occasion of a periodic charge and transactions that can give rise to an exit charge, such as capital payments to the beneficiaries, may also need to be reported to HMRC on forms 100c (exit) and 100d (periodic) if they exceed a certain amount. For the purpose of reporting 10 year anniversary events, the outstanding loan is not deductible so Form IHT100 may have to be completed even if there is not tax charge.

## 5. The UK tax implications of the Nucleus Discretionary Loan Trust

### 5.2 Income tax

The income tax implications of the discretionary loan trust depend on whether the asset held by the trustees is an onshore or offshore bond (see 5.2.2.1 (a) below) or collectives in the general account (see 5.2.2.1 (b) below).

#### 5.2.1 Creation of the trust

As the discretionary loan trust can only be set up with cash, there will be no income tax implications at this stage.

#### 5.2.2 During the trust's existence

##### 5.2.2.1 Income tax implications of loan repayments

###### a) Where the investment is an onshore or offshore bond

Under current legislation, the Trustees can make a withdrawal from the bond of up to 5% of the amount invested, each year for 20 years, without an immediate tax charge. 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 (e.g. 5% per year of the original investment) can be tax effectively accessed by the trustees to facilitate loan repayments. Of course, the level of repayments depends entirely on the circumstances and the wishes of the settlor/lender.

If more than 5% of the initial capital is withdrawn by the trustees each year to finance loan repayments, this will mean that:

- if such a level of repayment continues, the loan will be repaid quicker and therefore the settlor/lender will have no further rights under the trust; and
- 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 (if he is UK resident), be assessed on the settlor for income tax purposes under the usual rules governing chargeable events (see also 5.2.2.2 below).

In determining the level of loan repayments and ensuring that the withdrawals made by the trustees do not trigger a chargeable event, account should be taken of any additional amounts withdrawn by the trustees to pay adviser charges.

###### (b) Where the investment is in collectives

Even if the spouse of the settlor is not a beneficiary under the trust, the settlor will be assessed on trust income because he is entitled to receive capital from the trust – the entitlement to loan repayments counts in this respect.

Thus, to the extent that the trustees have received any income this will be assessed on the settlor as it arises. There will be no income tax on the capital payments received by the settlor.

If loan repayments are funded from the proceeds of the sale of units or shares any capital gains will be assessed on the trustees and not the settlor.

In determining whether any gains from encashment will give rise to any liability to CGT for the trustees, account should be taken of any disposals made to pay adviser charges.

##### 5.2.2.2 The taxation of chargeable event gains under a bond (onshore or offshore)

When a bond held subject to a discretionary loan trust is encashed (fully or partially) e.g. to make a loan repayment or to meet the trustees' liability to pay an adviser charge, a chargeable event gain can arise that will be subject to income tax. Who that gain is taxed on depends on whether the settlor is alive or not, and whether they are UK resident.

###### (i) During the settlor's lifetime and in the tax year in which the settlor's death occurs

For income tax purposes, any chargeable event gains arising under the bond will be assessed on the settlor provided the settlor is alive and UK tax resident or died before the end of the tax year in which the chargeable event occurs. A 20% tax credit will apply if the bond is a Nucleus Onshore Bond which means that a liability will only arise if the settlor is a higher rate (40%) or additional rate (45%) taxpayer. This credit will not be available for gains made under offshore bonds. Please refer to the relevant Nucleus Onshore and Offshore Bond literature for full details of the relevant bond taxation. The settlor would have the statutory right to reclaim any such liability from the trust and any failure to do so would amount to a gift to the trust which is to be avoided.

###### (ii) After the end of the tax year in which the settlor's death occurs or in a year in which the settlor is non-UK resident.

Any chargeable event gains arising in a tax year after that in which the settlor died (or in a year in which the settlor is non-UK resident) will be assessed on the trustees if they are UK resident. The first £1,000 of gain (assuming the settlor has not made other trusts) is taxed at the 'standard rate' which is 20% and the rest at the special rate of 45%. A 20% tax credit will apply if the bond is an onshore bond but this credit is not available for offshore bonds.

## 5. The UK tax implications of the Nucleus Discretionary Loan Trust

If the trustees are not UK resident there are special rules and specialist advice should be sought if this is the case.

### 5.2.2.3 Income arising to the trustees from investments in collectives.

The income tax position will depend on whether the settlor's loan is still outstanding, the type of collective in question and whether the settlor's spouse is included as a discretionary beneficiary.

#### (i) UK funds and offshore reporting funds

##### (a) If the settlor's spouse is excluded from benefit under the trust and the loan has been repaid

If the spouse of the settlor is excluded from benefit under the trust (the settlor will always be excluded), and the loan has been repaid in full then, for income tax purposes, the trustees are taxed as the owners of the trust investments and are assessed to income tax on any trust income (e.g. dividends).

The first £1,000 of gross income in a tax year is taxed only at a standard rate of 7.5% for dividend income and 20% for all other income. If the settlor has more than one trust, this £1,000 is divided by the number of trusts they have. However, if the settlor has set up 5 or more trusts, the standard rate band for each trust is £200. If the settlor has more than one trust, the £1,000 is divided by the number of trusts they have. However, if the settlor has set up 5 or more trusts, the standard rate band for each trust is £200.

The income that exceeds the standard rate band is assessed on the trustees at a special trust rate which is either 38.1% (on dividends) or 45% (on other income).

Where income is to be distributed to a beneficiary, the trustees must first have paid 45% income tax on the income they have actually received regardless of its source. Before distributing dividend income or the income only taxed at the standard rate to a beneficiary, a further income tax liability will therefore arise on the trustees.

The beneficiary will then be taxed on the income received from the trust grossed-up to take account of the tax credit in respect of the tax paid by the trustees. Where the beneficiary is not an additional 45% rate taxpayer, a tax reclaim may be made. However, as this income is classed as "trust income" neither the PSA nor the dividend allowances will be available.

If the beneficiaries include the settlor's minor unmarried children who are not in a civil partnership and any income from the collectives held in trust is actually paid to such a child or for their benefit, it will be assessed to tax on the settlor if this income and income from all other gifts the settlor has made to or for the benefit of that child exceeds £100 gross in a tax year. In such cases the settlor will be entitled to use his PSA and/or dividend allowance.

##### (b) If the loan remains outstanding or the settlor's spouse is included as a beneficiary under the trust

If any amount of the loan remains outstanding, or if the spouse of the settlor is included as a discretionary beneficiary under the trust, all trust income will be treated as income of the settlor. However, the Trustees will still be liable to income tax at the trust rates which are 38.1% on dividend income and 45% on non-dividend income on income in excess of the standard rate band. The trustees will therefore effectively pay tax on behalf of the settlor. If the settlor pays a lower amount of tax on the income than that paid by the trustees, the tax overpaid by the trustees can be reclaimed from HMRC. Any such reclaimed tax must be paid back to the trust. In such cases the settlor will be entitled to use his PSA and/or dividend allowance.

Because trustees normally pay income tax at the highest rate, this means that for those settlors who are not additional rate taxpayers (i.e. those whose taxable income does not exceed £150,000) the inclusion of the settlor's spouse may result in a reduced overall income tax liability. However, it will not reduce the amount of administrative work for the trustees. While the tax consequences will be relevant there are likely to be other factors contributing to the settlor's decision as to whether to include their spouse or civil partner as a beneficiary under the trust.

#### (ii) Offshore non-reporting funds

Where the collective is an offshore non-reporting fund there will normally not be any real income distributions from the fund. Instead, when units/shares are disposed of, e.g. on sale, the gain (known as an offshore income gain) realised by the investor (the trustees) will be taxed as income. The offshore income gain will be calculated in the same way that a capital gain would be calculated but without the benefit of the annual exemption from capital gains tax. This means that any income that arises to the fund effectively suffers income tax when an offshore income gain is made by the investor (the trustees).

Who is assessed to tax on an offshore income gain made by the trustees depends on whether the settlor's spouse can benefit under the trust or not and whether the loan has been repaid in full.

## 5. The UK tax implications of the Nucleus Discretionary Loan Trust

- (a) Where the settlor's spouse is excluded from all benefit under the trust and the loan has been repaid in full

The trustees are liable to tax at the special rate of 45% on offshore income gains. Any amount of the offshore income gain that falls within the £1,000 standard rate band will be taxed at 20%, with income in excess of £1,000 being taxed at 45%.

Where a payment is made out of the trust by the trustees to a beneficiary it is treated as capital without any further liability to tax.

- (b) Where the spouse of the settlor may benefit under the trust or some of the loan is still outstanding

If any of the loan is still outstanding or if the spouse of the settlor is included as a discretionary beneficiary under the discretionary loan trust, all trust income (including offshore income gains) will be taxed on the settlor at their personal rates of income tax. This rule does not apply if only the widow or widower of the settlor can benefit.

However, despite this, the trustees will still be liable at the 45% trust rate described above, effectively paying tax on behalf of the settlor. The settlor will receive a credit for the tax paid by the trustees. If the settlor is not a higher rate or additional (45%) rate taxpayer and the trustees have paid income tax on the income at 45%, the settlor can reclaim any excess tax paid by the trustees from HMRC. Even if the settlor is a higher rate (i.e. 40%) taxpayer, but not a 45% taxpayer (i.e. their taxable income is less than £150,000), the settlor will be able to recover the 5% tax difference. Any tax recovered must be paid to the trustees.

Where a payment is made out of the trust by the trustees to a beneficiary it is treated as capital without any further liability to tax.

Special rules apply if the settlor is non-UK domiciled and offshore income gains arise but this is not something contemplated with investments in a Nucleus wrap.

### 5.3 Capital gains tax

#### 5.3.1 Creation of the trust

There are no CGT implications when the trust is created. There may be the usual CGT implications if the settlor has to sell investments that they own in order to raise the cash for the loan.

#### 5.3.2 Trust capital gains (only relevant to collectives held in the general account)

- The trustees are assessed to CGT on any capital gains arising when they sell the shares/units held as trustee investments in the Nucleus General account or transfer those shares/units to a beneficiary. The fact that the investments are held by the nominee company is ignored. However, where the fund is an offshore non-reporting fund the offshore income gain will be subject to income tax – see section 5.2.2.3(iii) above.

- Unless the settlor has created more than one settlement the trustees are entitled to an annual CGT exemption equal to £5,850 in 2018/19 (i.e. equal to 1/2 of the exemption available to individuals) before any tax is actually payable. The trustees will pay tax at a special trustee rate which is 20% on capital gains that exceed their available annual exemption. If the settlor has created more than one settlement since 1978 the annual exemption is divided between such settlements, but will not fall below one tenth of the full exemption available to individuals, i.e. £1,170 for each settlement. There is a higher rate, 28% where the asset disposed of is an interest in residential property.

The fact that the loan may be outstanding or that the settlor's spouse may be a beneficiary under the trust is of no consequence for CGT purposes.

### 5.4 Advancement of assets out of the trust

Instead of encashing collectives or onshore or offshore bonds prior to advancing capital to a beneficiary (assuming an absolute appointment in the beneficiary's favour has been made) the trustees could transfer the actual investments 'in specie' to the beneficiary. Please note that this route cannot be used for loan repayments, which must be made in cash.

The tax effect of this would depend on the asset advanced.

#### (i) Onshore or offshore bond

The advancement to an appointed beneficiary would not give rise to a chargeable event and so there could be no income tax liability at the time of the advancement.

Any gains arising on subsequent encashment by the 'receiving' beneficiary would be subject to tax at the rate of tax relevant to that beneficiary.

#### (ii) Collectives

The appointment of a collective to a beneficiary would be a disposal for CGT purposes deemed to be at the market value of the investment at the time of appointment (with the exception of shares/units in an offshore non-reporting fund when the gains would be subject to income tax as offshore income gains) with the usual consequences for the trustees as described above. However, as the transfer out of a discretionary trust is also a chargeable transfer for IHT purposes, any chargeable capital gain (but not an offshore income gain) can be held-over, i.e. deferred until a subsequent disposal by the beneficiary – when the beneficiary's own annual CGT exemption would be available. For this purpose the fact that the beneficiary may be a child or a spouse of the settlor is not relevant.

It would be necessary for a new general account to be opened in the name of the beneficiary and for the shares/units to be re-registered in the beneficiary's name.

## 6. Frequently asked questions

### Who can be a trustee of the discretionary loan trust?

The settlor will automatically be a trustee. Additional trustees must be appointed at outset and this is contemplated in the trust deed. Anyone over 18 years old and of sound mind may be appointed. It may be appropriate to appoint a professional adviser, such as a solicitor or accountant, as a trustee, although such a person is likely to charge a fee for acting as trustee. It is essential that at least one additional trustee survives the settlor if the need for probate to determine who the successor trustee will be is to be avoided following the settlor's death.

### Why is it necessary to name a default beneficiary?

The settlor must name (as 'default beneficiaries') the individual or individuals who the settlor would like to benefit from the trust fund if no other appointment is made during the trust period. As this is 125 years from the date the trust is created, this is an unlikely outcome. Nevertheless, this is necessary, not just to ensure that there is certainty as to who is a beneficiary at all times, but also to avoid potential unwanted tax implications. If there is no certain default beneficiary under a trust, there can be a 'resulting trust' in favour of the settlor. Although this will not upset the IHT treatment of the trust, for income tax purposes the trust may then be treated as a 'settlor-interested' trust, even if the spouse of the settlor is excluded from all benefit. This means that there may be a risk that the POAT (pre-owned assets tax) income tax charge could arise.

### What investments can be held in the discretionary loan trust?

The discretionary loan trust is only available for use with investments held in a Nucleus wrap: collectives in a general account or a Nucleus Onshore or Offshore Bond. The Trustees are free to reinvest elsewhere if they so choose in due course. Once the trust is created, the nature of the underlying investments does not impact on the validity of the trust.

### Should each of a couple set up their own individual discretionary loan trust?

This is not recommended except where neither can benefit under the trust created by the other. If the settlor's spouse or civil partner is included as a discretionary beneficiary under each trust, the trusts could then be regarded as reciprocal arrangements and so cause the IHT gift with reservation of benefit provisions to apply. Although some reassurance on this point may exist because the arrangement involves no gift, the investor should consult with their advisers on this issue if such an approach is contemplated.

### Is the discretionary loan trust available for joint settlors?

No. First, if there were joint lenders/settlors, the arrangement would become very complicated. For example:

- One would need to consider if each settlor had contributed to the loan equally.
- It would be necessary to ascertain whether each loan repayment was being made equally between the two Settlers or on some other basis.
- It would be necessary to be able to deal with independent loan repayments since any one lender could not be precluded from requesting a repayment of their part of the loan only as this would be against the 'repayable on demand' principle. This would put a considerable administrative burden on the trustees.
- Special provisions would be needed in the loan agreement to determine what the position is on death and this is difficult to provide for in a 'standard' draft as it would depend on the individual circumstances.

Second, if the joint lenders were both settlors then neither could be beneficiary under the trust. On the other hand, by having one settlor, the partner or spouse of the settlor could be a beneficiary under the loan trust and potentially benefit from the trust after the settlor's/lender's death.

### Do the trustees need to open a bank account?

On the basis that the lender provides the trustees with a cheque payable to NFS (or arranges for a BACs transfer to NFS) when the trust is created, in satisfaction of the commitment to make an interest free loan to the trustees, there will be no need for the trustees to open a bank account at the outset. This would only be necessary if the lender wished to make the loan in cash or by cheque payable to the trustees. In the case of a cheque, as it is generally no longer possible to simply endorse cheques the trustees would have to pay the cheque into their own bank account and subsequently draw a cheque from that account in favour of NFS. However, it may be necessary for the trustees to open a bank account in due course when they start requesting withdrawals from the bond or selling collectives.

### How are loan repayments made?

Loan repayments will be requested by the settlor from time to time when they require capital and the trustees will have to make part encashments from the bond or collectives to facilitate repayments. Although in theory it is possible for the trustees to set up a regular withdrawal facility from a bond, it is not recommended that such an arrangement is set up in advance as to do so could give rise to the inference that the interest-free loan repayable on demand is, in reality, a term loan (for 20 years if a 5% rate of withdrawal per annum is specified) which could have adverse IHT consequences.



## 6. Frequently asked questions

It is therefore recommended that loan repayments, and thus withdrawals, are only made on demand. Ideally, loan repayments, and thus requests for withdrawals, should be for different amounts and made at irregular intervals.

In the case of an investment in a bond, it is of course 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 from a bond exceeds the cumulative annual allowances (5% p.a. of the original premium for 20 years), a chargeable event gain will arise – see section 5.2.2.2. This needs to be considered if it is anticipated that the trustees will need to make withdrawals from a bond to meet adviser charges.

### Which type of investment is more suitable to the discretionary loan trust?

In theory the trustees could invest in any type of investment. However, if any income were to arise from the underlying investment, it would be assessed to tax on the settlor, because of the special income tax anti-avoidance provisions which apply where the settlor is entitled to receive capital payments (such as loan repayments in respect of an outstanding loan) from the trust that he has created.

It may also be more complicated for the trustees to manage encashments of units or shares to fund any loan repayments.

These problems do not arise with an investment in a bond, which is a non-income producing asset. Therefore, a bond will often be seen as a preferred investment from a tax administration standpoint.

### Can the settlor make further investments into the discretionary loan trust?

The settlor can add to their investment provided no gift into the trust is made. If further sums are to be made available then this should be solely by way of a further interest-free loan by the settlor to the trustees with the trustees effecting a further investment. If the settlor wishes to make an outright gift, the gift should either be made directly to the donee(s) or to another trust. It is important to maintain the IHT effectiveness of the Nucleus Discretionary Loan Trust by making no further gifts to it. In this context it is important that the settlor does not meet any liability of the trustees in a way that could be construed as a gift, e.g. by meeting an adviser charge that is the responsibility of the trustees, or paying the tax on a chargeable event gain under a bond and not reclaiming the amount paid from the trust.

### Can the loan be written off?

If the settlor decides that access to the capital lent is no longer needed, the outstanding loan could be written off. This would, however, constitute a gift to the trust by the settlor and 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 outstanding amount. As the trust is a discretionary trust, the gift would be a chargeable lifetime transfer (CLT) for IHT purposes and it could result in an IHT liability, potentially at 20%, if the value of the gift, together with the cumulative total of other CLTs made by the settlor in the preceding seven years, exceeds the then nil rate band. It is generally not recommended that CLTs are made in excess of the nil rate band.

### Is stamp duty payable?

With effect from 1 December 2003, stamp duty on documents was abolished which means that a declaration of trust no longer needs stamping. A transfer of shares/securities is normally subject to stamp duty but under the discretionary loan trust no such transfer takes place when the trust is set up.

### Can the trustees encash investments held in the Nucleus wrap and pay the proceeds to the beneficiaries?

This is possible if the appointor first makes an irrevocable appointment of benefits in favour of the beneficiary. In practice no advancements should be made to a beneficiary as long as there is any loan outstanding.

### Why should extreme care be taken in relation to payments made by the trustees to the settlor's spouse whilst the settlor is alive?

While the inclusion of the settlor's spouse as one of the discretionary beneficiaries does not constitute a reservation of benefit for IHT purposes, care must be exercised if any benefits are actually paid to the settlor's spouse during the lifetime of the settlor.

Firstly, it should be noted that any appointment to the settlor's spouse can only be made by the trustees. Secondly, should the trustees actually exercise their power of appointment in favour of the settlor's spouse, and trust benefits are paid out to the settlor's spouse, it is absolutely essential that no part of these benefits finds its way back to the settlor in any way, directly or indirectly. If this were to happen, the Trust could be seen as one under which the settlor has reserved a benefit and this would make it ineffective for IHT purposes. In practice, therefore, it may be advisable to avoid making such appointments altogether whilst the settlor is alive.

## 6. Frequently asked questions

### Can the settlor get their money back under the cooling-off rules?

No. As the application for the investment (be it a bond or general account) will be made by the trustees, if they exercise their right to cancel the refund cheque (which may be less than the amount invested) will be sent to the trustees. For full details of the cooling-off procedure please refer to the relevant product literature. The settlor is free to request the repayment of their loan at any time.

### How do the trustees find cash to pay income tax if they invest in accumulation shares/units in their general account?

If all the funds are invested in accumulation units/shares, the trustees may have to sell some of the shares/units to raise the necessary cash.

### What are the charges associated with an investment in the discretionary loan trust?

There is no charge for setting up the trust. Professional trustees may charge. The charges relating to the Nucleus General account and the Nucleus Onshore and Offshore Bonds are covered in the relevant product literature. The financial adviser is, however, likely to make a separate charge for advice given in relation to the establishment of the trust.

### How do you set up a discretionary loan trust?

As explained earlier, the Nucleus Discretionary Loan Trust has three components.

First, the trust is established by the settlor, and their chosen additional trustees completing the discretionary loan trust deed. No gift is made at that time but the settlor makes a promise to make an interest-free loan, repayable on demand, to the trustees.

Second, once the trust is established the settlor enters into a formal agreement with the trustees to make an interest-free loan repayable on demand. The intention is that the trustees will invest the loan moneys in the Nucleus wrap. The loan is satisfied by the settlor handing over to the trustees a cheque payable to, or making a BACS transfer to, Nucleus Financial Services. The trustees acknowledge receipt of the loan using a special form.

Third, the trustees collectively make the application to invest.

All of the above needs to be done with the assistance of a financial adviser (and with reference, where appropriate, to the settlor's legal advisers) who has access to the Nucleus online processing system. Full details of the procedures are covered in the Nucleus guides on the platform-related processes. Remember, the discretionary loan trust and the loan agreement are provided as drafts.

### How do the trustees find cash to pay the fees of their investment advisers?

The fee for the initial advice (leading to the investment and the trust creation) will be the responsibility of, and will be invoiced to and paid by, the settlor. The responsibility for adviser charges made in relation to the trust and trustee investments after its creation ('ongoing charges') will usually be that of the trustees of the trust. As a matter of trust law, such fees are normally paid out of trust capital (not the trust income).

If there is available uninvested cash (that is not trust income) in the general account then the adviser charges can be paid from that. To the extent that additional amounts are needed then the trustees may have to sell some of the shares/units of the collectives in the general account to raise the necessary cash. If the underlying investment is a bond, the trustees may need to take a part-withdrawal to meet the adviser charges. As explained earlier in this guide there will be the usual potential income tax implications (for bonds and non-reporting offshore funds) or CGT (for collectives other than non reporting offshore funds in the general account).

In some cases the settlor may offer to pay the advisers' fees so as not to deplete the trust funds. As the settlor will, in effect, pay the fees on behalf of the trustees, any such payments will be treated as gifts (CLTs) made by the settlor which may have IHT consequences. As indicated above it is not recommended that gifts should be made to a loan trust. Professional guidance should be sought in such circumstances.

## Important note

Tax law is subject to change. In particular, at the time of publication of this guide, HMRC is consulting on the IHT taxation of discretionary trusts and changes in this area are likely to take place in the future. The information in this guide is based on our understanding of current law and HMRC practice as at January 2019. Although every care has been taken in the preparation of this guide and the draft trust deed, neither Nucleus nor any of its officers, employees or agents accept responsibility for the operation of the trust.

This document is provided strictly for general consideration only. Any action taken or refrained from in connection with the Nucleus Draft Discretionary Loan Trust must be preceded by discussion with the settlor's legal and other professional advisers. Accordingly, neither Nucleus nor any associated or affiliated company nor any of their representatives, officials or employees can accept any responsibility for any loss occasioned as a result of the use of the Nucleus draft.





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