The By-Pass Trust

(This Fact Sheet is designed to give an overview of the benefits available from the use of a By-Pass Trust.)

Summary

A By-Pass Trust is a simple means of holding lump sum death benefits payable from the non protected rights of a SIPP rather than nominating those benefits to be paid to individual beneficiaries.

Using a By-Pass Trust to hold your death benefits has a number of advantages. From a practical point of view it is simple to set up, the trust wording is provided free of charge and you can appoint your own trustees to look after the ongoing administration of the trust. However the main advantage is a tax one in that the trust fund does not form part of any of the beneficiaries' estates yet they can still have access to the fund with the trustees' agreement.

What is a By-Pass Trust?

A By-Pass Trust is a simple, irrevocable discretionary trust which is used as a means of holding lump sum death benefits from a SIPP. Rather than the death benefits being paid to a specific nominee on your death, the lump sum is automatically paid into the By-Pass Trust. The trustees of which can then use their discretion in deciding who should benefit.

Since March 2006 using a trust which has flexibility to change beneficiaries, to make lifetime gifts can result in an immediate charge to IHT if the value of gift, plus any cumulative gifts, known as chargeable lifetime transfers, in the seven years prior to the original gift exceeds the nil rate band for IHT. However, one area where trusts can still be used very effectively is where death benefits are payable under a registered pension scheme.

However, in order to avoid any potential IHT implications of setting the trust up, it is important that you are in good health when you set it up. The reason for this is that creating a discretionary trust during your lifetime creates what is known as a "chargeable lifetime transfer".

This can have immediate IHT implications if the value of assets being placed into the trust exceeds your personal IHT threshold of £325,000 (after deducting the value of any chargeable transfers made in the last 7 years). However, provided you are in good health HMRC will usually accept that the death benefits have no value for this purpose at the time the trust is established, since the expectation is that you will survive and draw your pension and therefore no IHT implications will arise. If however you die within two years of creating the trust, HMRC would look to put a value on the assets placed into the trust and a tax charge could result.

What are the advantages of using the By-Pass Trust?

Although there should be no IHT implications on the lump sum being paid out of the SIPP on your death, IHT can become a problem on the death of the recipient, for example your surviving spouse, since any lump sum death benefit will form part of their estate on death.

The main advantages of using the By-Pass Trust to receive the SIPP death benefits are as follows:

- A range of beneficiaries can access the By-Pass Trust fund without the value of the By-Pass Trust forming part of their estate on their death for IHT purposes.

- Where funds are to be accessed by beneficiaries, the By-Pass trustees can lend the monies to them thereby creating a debt on their individual estate and reducing it further for IHT purposes.

- The value of the By-Pass Trust fund, for so long as it is within the trust, will not be assessable as capital for state benefit purposes including long term care.

- Using the By-Pass Trust means that you can have greater control over what happens to the funds in the event of the death, divorce or remarriage of the intended beneficiary i.e. the By-Pass trustees can ensure that the funds will pass to children rather than a new spouse.

- By appointing your own trustees on the By-Pass Trust, you don't need to rely on the trustees of the SIPP exercising their discretion to follow an expression of wish nomination.

Main features of the By-Pass Trust

The trust is a simple yet effective vehicle. The main features of which are as follows:

- The trust can be set up at any time, either at inception of the SIPP or at a later date during your lifetime provided you are in good health at the time.

- The trust is discretionary which means that the trustees can decide who benefits and when.

- Possible beneficiaries are pre-defined in the trust deed to include typical family members.

- You can amend these to include or exclude anyone either at outset of the trust or at a later date.

- Trustees have wide investment powers so they can invest trust monies in a wide range of investments.

- You will be a trustee during your lifetime.

- You have the power to appoint and remove trustees during your lifetime.

- The trust cannot last indefinitely however, the By-Pass Trust has been drafted to ensure that the trust can run for a few generations after your death.

- There is no cost for the trust.

Case study – example

David and Victoria Bookem have a significant potential Inheritance Tax liability and their assets are as follows:

	£
House	700,000
Villa in Spain	200,000
Investments	300,000
Contents	75,000
Jewellery	20,000
Boat	50,000
Cash in the bank	80,000
	1,425,000

In addition David has a SIPP which is valued at £500,000. He has nominated Victoria as his beneficiary. They have not made any gifts yet. After explaining to them the advantages of making lifetime gifts to reduce their estate Victoria explains that she is wary of making lifetime gifts in case she runs out of funds later in life. David is 50 and she is only 35. They have three sons together and David has two from a previous marriage.

Most of their assets are held jointly however they also have wills leaving everything to each other on first death.

Assuming David dies first, the IHT liability on second death (assuming an IHT threshold of £325,000 applies at the time of Victoria's death and based on current asset values) will be as follows:

	£
Value of combined estate	1,425,000
Pension death benefits	500,000
	1,925,000
Less nil rate band	650,000
	1,275,000
Tax @ 40%	**510,000**

Reducing the liability

One way of reducing this liability without having to make any significant lifetime gifts is for David to create a By-Pass Trust for his pension death benefits rather than have the death benefits nominated to Victoria. This means that on Victoria's death the value of the death benefits will not be included in Victoria's estate, thus saving IHT of £200,000 (i.e. £500,000 @ 40%).

As long as David is in good health when the trust is established, HM Revenue & Customs should accept that there is no value to the death benefits and therefore there will be no IHT implications of setting the trust up. The nomination in favour of Victoria will be required to be cancelled by David.

On death any lump sum Death Benefit payable will automatically drop into the trust and David does not need to rely on the trustees of the SIPP to exercise their discretionary powers. Once in the trust, the lump sum Death Benefit will be in the control of the By-Pass trustees that he has appointed under that trust to look after the money.

In this case, David has two children from a previous marriage as well as three children with Victoria. He may well be concerned that should Victoria receive the death benefits directly then on her subsequent death, she could choose to leave all benefits to the three children of their marriage rather than the two children from his first marriage. Or, if she remarries at some future time, the monies could perhaps pass to a future spouse and none of his, or indeed their children might benefit.

Using a By-Pass Trust to receive the death benefits can avoid these problems since the trustees of that trust decide who benefits and when. David may well feel that Victoria should be a trustee, so that she has a degree of control over what she receives from the trust. He could also, if he wishes, appoint any of his children over the age of 18 as trustees either with or without Victoria. However given that he has children from his previous marriage, it may be more appropriate that he appoints at least one additional independent trustee who can act as arbitrator if there is any dispute among the trustees or beneficiaries in the future.

As a potential beneficiary of the trust Victoria can have access to income, capital or even take loans from the trust subject to the agreement of the trustees. Loans are highly tax efficient since they can be made repayable on a beneficiary's death thereby creating a debt on Victoria's or any other beneficiary's estate. So if for example Victoria wants to borrow £10,000 from the trust to buy 20 pairs of Jimmy Choo shoes, this would reduce her IHT liability by a further £4,000.

David's children from his first marriage may also be beneficiaries of the trust, along with various categories of relatives such as parents, brothers, sisters etc. Therefore the trustees can decide to pay money to any other family members as appropriate, either during Victoria's lifetime or after her death, giving David reassurance that the funds will not fall into the wrong hands.

telephone 01772 781889 fax 01772 786756
email info@astutepensions.co.uk www.astutepensions.co.uk
87 Watling Street Road, Fulwood, Preston, PR2 8BQ