TECHNICAL INSIGHT PACK

JAMES HAY PARTNERSHIP

By-Pass Trust

Technical Note for Financial Advisers

This technical note is designed to be read in conjunction with the draft By-Pass Trust.

FEATURES

- A: The Benefit for Your Client
- B: The Terms of the By-Pass Trust
- C: Case Studies
- D: Appendix: Flowcharts of scheme rules and payment of benefits

For professional advisers only

A: The Benefit for Your Client

1 The Product

We have devised a simple method by which the lump sum death benefits payable from SIPPs held with James Hay Partnership can be held for the benefit of the member's family whilst significantly minimising the charge to inheritance tax (IHT). The facility is called a 'By-Pass Trust'.

The By-Pass Trust is a straightforward irrevocable discretionary family Trust. The benefit is paid into the Trust on the death of the member as covered in rule 10.1(2) of the James Hay Personal Pension Scheme Rules ('the Rules'). The establishment of the Trust is not to be regarded as a nomination under rule 5.1 or 8.1 of 'the Rules'.

2 The IHT Trap

The benefit to your client is to minimise the charge to IHT that might otherwise be payable. On the death of a member any discretionary distribution of a benefit arising from uncrystallised funds in a pension scheme by the scheme administrator/trustee will not be chargeable to IHT. Commonly such distributions will be to a surviving spouse/civil partner and an IHT charge may therefore arise on the death of that surviving spouse/civil partner when the property is passed to the next generation. At this point the charge to IHT can be significant. There is a tax-free allowance of £325,000 for the tax years 2013/14 to 2017/18 but over this tax-free amount the estate is subject to IHT of 40%.

The By-Pass Trust can help minimise the potential 40% charge to inheritance tax on the death of the surviving spouse/civil partner whilst ensuring that the surviving spouse/civil partner during their lifetime (or indeed other family members) may benefit under the Trust.

3 IHT Charges Compared

A charge to 40% will arise on the death of the member's spouse/civil partner in respect of all assets which are in that spouse's/civil partner's estate at the time of death, over and above the nil rate band. If however the By-Pass Trust is utilised, the potential inheritance tax charge may be significantly reduced.

The By-Pass Trust

The Trust is discretionary in form and the wide class of potential beneficiaries includes the surviving spouse/civil partner and children. Hence during the spouse's/civil partner's lifetime he or she can receive income, capital and/or a loan at the trustees' discretion. The Trust fund will not, however, form part of any beneficiary's IHT estate. The Trust may continue for the benefit of the next generation (it should, of course be stressed that the Trust is flexible so that if the spouse/civil partner has need of all the Trust Fund it can be distributed to him or her).

How is the Trust taxed?

In most cases, lump sum death benefits are paid at the discretion of the pension scheme trustees/providers even where there's a nomination that expresses a wish as to the beneficiary. They are not then part of the estate or chargeable to inheritance tax. On a payment of death benefits from the pension scheme to the By-Pass Trust the property is no longer held in the pension scheme and is treated in the same way as any other relevant property trust and is liable for 10 year and exit charges.

As the James Hay Partnership pension scheme is a trust based scheme the funds are moving from one settlement to another and IHTA 1984, s81 will apply to determine the date of the 10 year charge. The 10 year charge is applicable on each successive 10 year anniversary of the Trust, starting from the date when the member joined the SIPP.

However, while the member is alive there is no 10 year charge actually due. The 10 year periods are running but there should be no IHT payable during this time. This is because there will generally be no "value" within the trust until such time as a payment is made from the pension scheme to the By-Pass Trust.

Therefore, the initial 10 year anniversary which is taxable is the first 10 year anniversary falling after the death of the member.

The Trust may benefit from a nil rate band (currently £325,000) and thereafter the charge to tax is 30% of the rate of IHT which applies to lifetime gifts – currently 20% – i.e. a 6% rate.

Accordingly, this 6% charge is the maximum charge that can apply and will be less if the nil rate band is applicable to the Trust.

When the trustees make a capital payment to a beneficiary or the Trust is wound up there is an 'exit' charge: the 6% tax charge is pro-rated over the period since the last 10 year charge.

This is a brief explanation of the charges that may apply to the By-Pass Trust. Case studies are shown towards the end of this Technical Note.

Before leaving trust charges, it is important to mention that HMRC published its consultation paper on 31 May 2013 "Inheritance Tax: Simplifying Charges on Trusts - the next stage". This paper includes various proposals including simpler 10 year and exit charge calculations. It seems likely that legislation will follow Finance Bill 2014.

Setting up and administering Trusts

It is desirable, for ease of administration, for a member to have a separate Trust to hold the death benefit from each SIPP and commonly each trust should be set up on the date when the relevant SIPP is taken out.

In circumstances where there is more than one pension arrangement, or a SIPP that has been used to consolidate pension arrangements is placed in a By-Pass Trust, then there can be multiple settlement dates, nil rate bands and reporting requirements to deal with. This can add a degree of complexity and it is essential that good record keeping is maintained.

4 Capped or flexible drawdown or where member is aged 75 or over

The possibility of a member drawing income from the personal pension or when the member attains the age of 75, are both things that need to be considered when advising on the establishment of a By-Pass Trust.

The basic principle is that if a member dies during the period of income drawdown, or after attaining 75 years of age, any lump sum death benefit payable will be subject to a recovery charge at 55%. Of course, the spouse/civil partner may continue to take income drawdown from the fund deferring this charge, however, any lump sum eventually payable on their death will be taxed at 55%.

As a result of crystallising the fund, the lump sum payable on the death of the member will be taxed at 55%, regardless of whether it is paid outright to an individual or a trust, but there may still be IHT, as well as other non tax advantages of assigning the death benefits to a By-Pass Trust. Where a member under the age of 75 has fully crystallised or only partially crystallised part of the pension fund, it may be desirable to allow the spouse/civil partner to continue with drawdown, thus deferring the 55% recovery charge and have any uncrystallised pension fund paid tax free to the By-Pass Trust. Our Personal Pension Scheme rules provide the flexibility to achieve this. A draft Letter of Wishes is available which should be completed by the member if they wish for this to be considered by us as Pension Scheme Trustees.

Flowcharts outlining the operation of the scheme rules in relation to the pension fund following the member's death are included within the Appendix to this technical note. The flowcharts consider the scheme rules where the member dies before taking benefits and before age 75, as well as where the member dies while taking benefits or died aged 75 or over.

5 Suitability

The Trust is designed to minimise the 40% charge to IHT which might otherwise be payable on the death of the member's surviving spouse/civil partner. It is particularly suitable for High Net Worth individuals when the spouse's/civil partner's estate is in excess of the nil rate band.

Since October 2007 any unused IHT threshold can be transferred from a late spouse/civil partner when they die. This can increase the threshold of the second spouse/civil partner when they die to £650,000.

It is designed to be used with SIPPs held with James Hay Partnership. Careful thought should be given as to whether it is appropriate in the individual's circumstances, before making any recommendations.

The Trust has been developed in conjunction with a barrister, expert in taxes. Nevertheless, we would still recommend that the member consults their solicitor to adapt it for their personal circumstances.

B: The Terms of the By-Pass Trust

1 The By-Pass Trust – an Outline

We have covered the reasons why the Trust may be advantageous for your client and will now look more carefully at the Trust itself.

The Trust is structured so that the information specific to your client is contained in the Schedule to the Trust. (The Schedule is in the style of a form for you to complete).

The draft is intended for use with a SIPP held with James Hay Partnership. If the Trust is adapted, it is essential that advice is sought by the member (who is called 'the Settlor' in the Trust) to ensure that it is a suitable vehicle for use with that product. In any event, we would recommend in all cases that the member's solicitor should consider the draft in light of each individual's personal circumstances.

The key features are:

- Flexibility is allowed for the Settlor of the Trust to name beneficiaries (see section 3)
- Similarly, the Settlor has the power to appoint and remove a Trustee during their lifetime (see section 2)
- The Trustees can distribute Trust income and capital to the Beneficiaries (see section 4)
- The By-Pass Trust is designed to maximise the benefits available in the following ways:
  - the Trust is drafted to last for as long as legally permissible (see section 5), and
  - the Trustees are directed to review the position periodically (see section 6)
- It is an irrevocable discretionary trust.

2 Trustees

The names of the Trustees need to be inserted in the definition of Trustees in the Schedule (they should also execute the Trust – along with the Settlor).

It is strongly advised that at least one of the Trustees is a Professional Trustee (called 'Professional Trustee' in the Trust). The administration of the ongoing discretionary Trust means that a Professional Trustee is desirable – for instance, to ensure the preparation of annual income tax returns and accounts. The definition of Professional Trustee sets out the criteria that such a person should meet. These criteria are taken from the Trustee Act 2000.

Whilst it is desirable to appoint a Professional Trustee it is not a legal requirement. Family members and others may also be appointed as Trustees. The draft Trust provides for two such Trustees (called 'Non-Professional Trustees'). There may be more than two Non-Professional Trustees of the Trust if that is appropriate for the individual's personal circumstances (but the total number of Trustees should not exceed four).

3 Beneficiaries

The potential trust beneficiaries are listed under the definition of 'Discretionary Beneficiaries'. They include the member's spouse/civil partner, children, grandchildren and other relatives. If the settlor would like to add a person to the class of trust beneficiaries because they are not included within the definition of "Discretionary Beneficiaries" they can do so as described at (e) or they can name them within the trust deed at (f) from outset. This could include dependants and friends as well as relatives not included within the definition of discretionary beneficiaries.

The Settlor will also need to appoint an 'Ultimate Default Beneficiary'. This is the person, or persons, to whom the Trust Fund will be distributed at the end of the perpetuity period (see section 5) in the absence of an appointment by the Trustees. This may be a living person or perhaps a charity, but would typically be the Settlor's spouse/civil partner or children.

4 Payment of benefits from the Trust

The Trustees powers in relation to the Trust fund are set out in clauses 3 and 4. They include a power to pay the Trust capital and income to any of the beneficiaries and also to accumulate income. The payment of trust capital to a beneficiary could result in an exit charge, however, the current maximum charge is 6% and in many cases will be less or nil.

They may also lend Trust assets to the beneficiaries. Power to lend (eg cash) is useful as the loan would not lead to an exit charge and any outstanding loan should be deductible from the beneficiary's estate on their death.

B: The Terms of the By-Pass Trust

5 Duration

All Trusts are caught by the technical rules relating to perpetuity or remoteness of vesting. The law states that Trusts cannot last forever. In general;

- for individuals who take out a SIPP on or after 6 April 2010 then in accordance with the Perpetuities and Accumulations Act 2009 (applicable to trusts established in England & Wales) the trust has a 125 year perpetuity period.
- for individuals who took out a SIPP prior to 6 April 2010 then the trust has a perpetuity period of the longer of:
    1. the Settlor's life plus 21 years
    2. 21 years from the date of death of the last survivor of all direct descendants of the late Majesty King George the Fifth who shall be living at the date the trust is created.

In determining the perpetuity period, it is the date the member took out the SIPP rather than the date that the By-Pass Trust is set up that is relevant. This should ensure that no matter when a member took out their SIPP the Trust should be able to continue until the individual's children and/or grandchildren can benefit.

6 Review of the Trust Assets

Provisions have been included in the Trust Deed to require the Trustees to review the purpose and assets of the Trust before each 10th anniversary of the date when the Settlor took out their SIPP (see clause 5 of the trust deed).

The Trust should be reviewed from time to time. An ideal time to review may be just before the 10 year charge. A 10 year charge is based on the market value of the trust fund immediately before the 10 year anniversary.

7 When should a By-Pass Trust be established?

It is recommended that the Trust is set up at the same time as the SIPP is taken out but it may be set up at any time during the member's lifetime. The date the Trust is set up is called the Date of Declaration.

The Trust Deed and the notes in relation to its use are for general guidance only and are based on current understanding of United Kingdom law and HM Revenue & Customs practice. No responsibility is taken by James Hay Partnership or any associated company, for the interpretation of the law (including tax legislation), future changes in the law or revenue practice. Tax liabilities and the ability of the Settlor in law to set up a Trust are dependent on individual circumstances and no assurance can be given that the use of this form is suitable for your circumstances. We strongly recommend that you seek separate legal and taxation advice prior to signature and during the life of the Trust.

It is important that the Settlor is in good health at the time the Settlor sets up the trust. Assigning death benefits to the Trust is a lifetime chargeable transfer for IHT purposes - however providing the Settlor is in reasonable health at the time of the assignment, the death benefits should have a nominal value.

If the Settlor were in poor health at the time of assigning the death benefits into trust and died within two years of doing so, HMRC could assess the assignment of the death benefits as having significant value and raise an assessment for IHT. Therefore, it is not recommended that pension death benefits are placed in trust if the Settlor is terminally ill.

C: Case studies - IHT Calculations

Case studies

We consider the IHT position of 3 case studies involving the payment of lump sum death benefits.

We have assumed for the purposes of these case studies that the 2013/14 allowances and rates of tax apply in respect of IHT. Therefore the IHT rates on the death of an individual on assets over the available nil rate band are:

- 0% on first £325,000, and
- 40% on the balance.

1 Case study - Mr White

Mr White died in 2005 and on his death a lump sum benefit of £500,000 was payable from his SIPP with James Hay Partnership. The SIPP Trustees exercise their discretion to pay the sum to his wife and consequently no IHT is payable.

Mrs White dies in 2013. As Mr White left his entire estate to her, it is possible to offset two nil rate bands (£650,000) against her estate. For ease we will assume that the value of her estate excluding the lump sum death benefit is £650,000. She leaves her estate to her children.

We assume that she has not spent any part of the death benefit sum and there has been no investment growth. On her death, IHT of £200,000 will be payable on the lump sum of £500,000 (£500,000 x 40%).

2 Case study - Mr Green

Contrast the case study with Mr White, with the position of Mr Green who set up a By-Pass Trust at the time he took out a pension in 1990. Following his death in 2005, the death benefit of £500,000 was paid to the By-Pass Trust.

The same sum was held in the Trust on his wife's death in 2013. On Mrs Green's death the Trustees decide to wind up the By-Pass Trust and the assets are distributed to the children.

When Mrs Green dies an IHT charge will arise on the assets comprised within her estate if the value exceeds the nil rate band taking account of any unused nil rate band transferred from her late husband. The death benefit of £500,000 paid to the By-Pass Trust does not form part of Mrs Green's estate.

What IHT charges would apply to the trust?

- As the James Hay Partnership pension scheme is a trust based scheme the funds are moved from one settlement (the pension scheme) to another (the By-Pass Trust). IHTA 1984, s81 applies to determine the date of the 10 year anniversary. As Mr Green joined the James Hay Partnership pension scheme in 1990, the 10 year anniversaries arise in 2000 and 2010. There will be no IHT payable on the first 10 year anniversary in 2000 as the value of the assets held in the By-Pass Trust are nominal.

- The second 10 year anniversary is 2010. As the lump sum death benefit was paid to the By-Pass Trust in 2005 the trust is said to have held relevant property for a period of 5 years rather than the full 10 years. The IHT calculation will be:

Calculation of 10 year charge	£
Relevant property at anniversary	500,000
Less nil rate band	(325,000)
Value to determine rate of tax	175,000
Tax at 20%	35,000
Initial rate of tax (35,000/500,000)	7%
7% x 30%	2.1%
£500,000 x 2.1% x 5/10	5,250

The 10 year charge is reduced to reflect that the trust fund has only held value since 2005, when the lump sum death benefit was paid to the trustees of the By-Pass Trust.

- When the By-Pass Trust is wound up in 2013, a proportion of the 10 year charge, known as an exit charge, will be payable:

Calculation of exit charge	£
Relevant property at anniversary	500,000
Less nil rate band	(325,000)
Value to determine rate of tax	175,000
Tax at 20%	35,000
Initial rate of tax (35,000/500,000)	7%
7% x 30%	2.1%
£500,000 x 2.1% x 12/40	3,150

The trust is wound up and the assets are distributed in the 13th quarter after the second 10 year anniversary.

Comparison of IHT Charges in the case studies of Mr White and Mr Green

- Amount payable on death of Mrs White = £200,000
- Amount payable on By-Pass Trust set up by Mr Green = £8,400
- IHT saving of £191,600

3 Case study - Mr Black

Mr Black took out a pension in 1989 and set up a By-Pass Trust at the same time. He died in 2000 and the death benefit of £500,000 was paid to the By-Pass Trust. His wife survived him by 11 years, dying in 2011. The Trustees of the By-Pass Trust decide to wind the Trust up in 2018 and distribute the trust fund to the beneficiaries.

- 10 year charges will apply in 1999, 2009 and an exit charge will arise in 2018. There will be no IHT payable for the first 10 year charge. In 1999 the value of the trust fund is nominal as death benefits have not yet become 'relevant property'.
- The first 10 year charge will apply in 2009. For ease, we will assume the value of the fund at that date is £500,000 and therefore the IHT payable is £9,450. This is calculated as shown below:

Calculation of 10 year charge	£
Relevant property at anniversary	500,000
Less nil rate band	(325,000)
Value to determine rate of tax	175,000
Tax at 20%	35,000
Initial rate of tax (35,000/500,000)	7%
7% x 30%	2.1%
£500,000 x 2.1% x 9/10	9,450

The 10 year charge is reduced to reflect that the trust fund has held value since 2000, when the lump sum death benefit was paid to the trustees of the By-Pass Trust.

- By 2018 the trust assets are worth £750,000. If the Trust is wound up before the next 10 year anniversary (2019), the rate of IHT that applies on the trust being wound up and the trust fund being distributed to the beneficiaries is fixed according to the value of the fund at the last 10 year anniversary – i.e. at £500,000. This gives an IHT rate of 2.1%. If this is the case the tax payable will be £14,175 as opposed to a 10 year anniversary charge of £25,425.

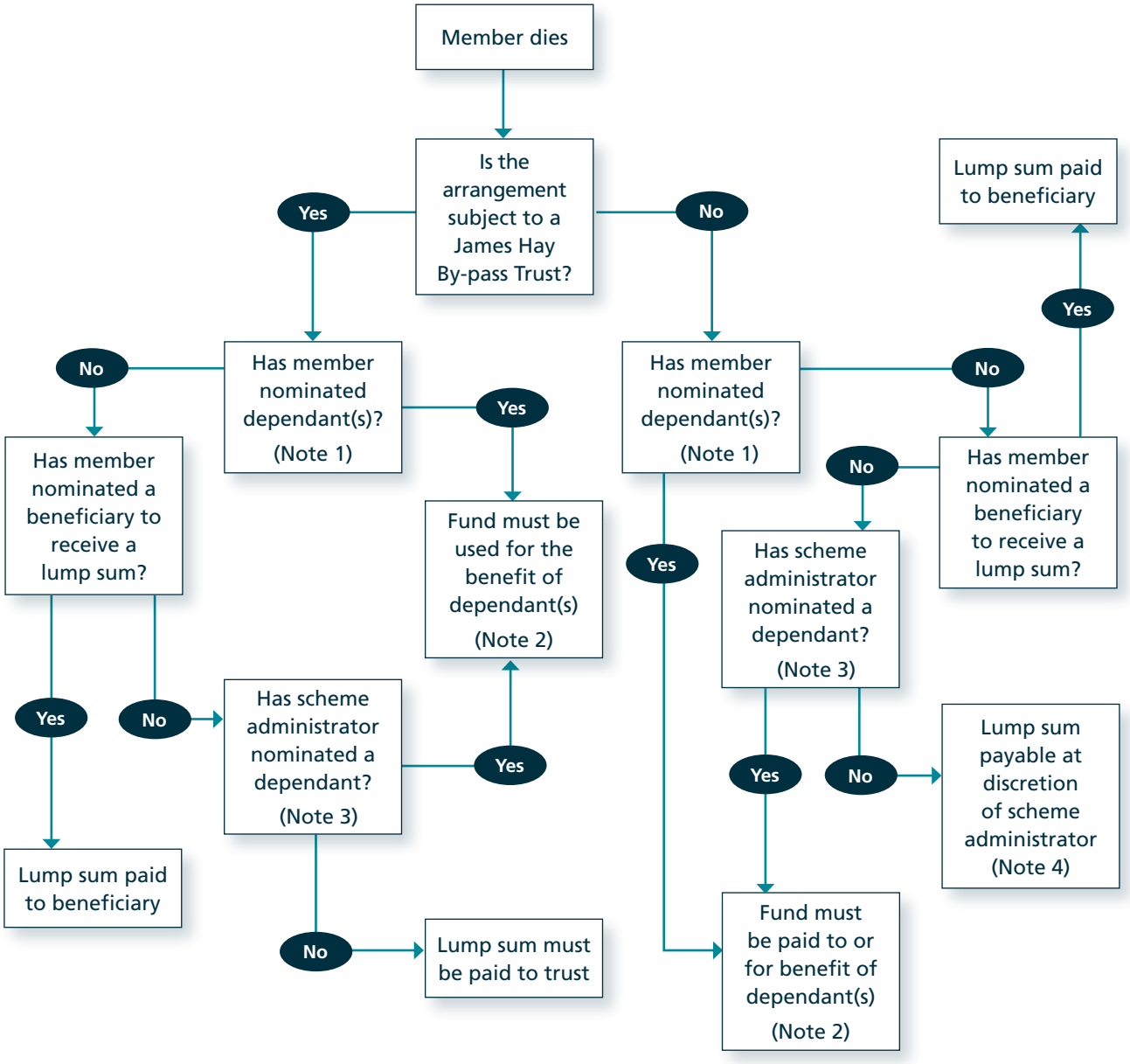
* The calculation is as follows:

	£
Value in 2009	500,000
Less nil rate band	(325,000)
Value to determine rate of tax	175,000
Tax at 20%	35,000
Effective rate of tax (35,000/500,000)	7.0%
Actual rate (7% x 30%)	2.1%
Appropriate fraction 36/40	1.89%
IHT on £750,000 =	**14,175**

Should you require any assistance in relation to this trust, our Technical Support Unit can help. Tax benefits depend on individual circumstances and you should bear in mind that the Government could alter or withdraw these benefits at any time.

D: Appendix: Flowcharts of scheme rules and payment of benefits

Payment of benefits where member dies before taking benefits (pre 75)



Note 1

Member can nominate a dependant to or for whom the pension fund will be applied. A dependant means a spouse, civil partner or other person who is a dependant of the member in terms of the rules of the James Hay Personal Pension Plan.

Note 2

Dependant can choose from:

- Annuity
- Drawdown pension
- Lump sum

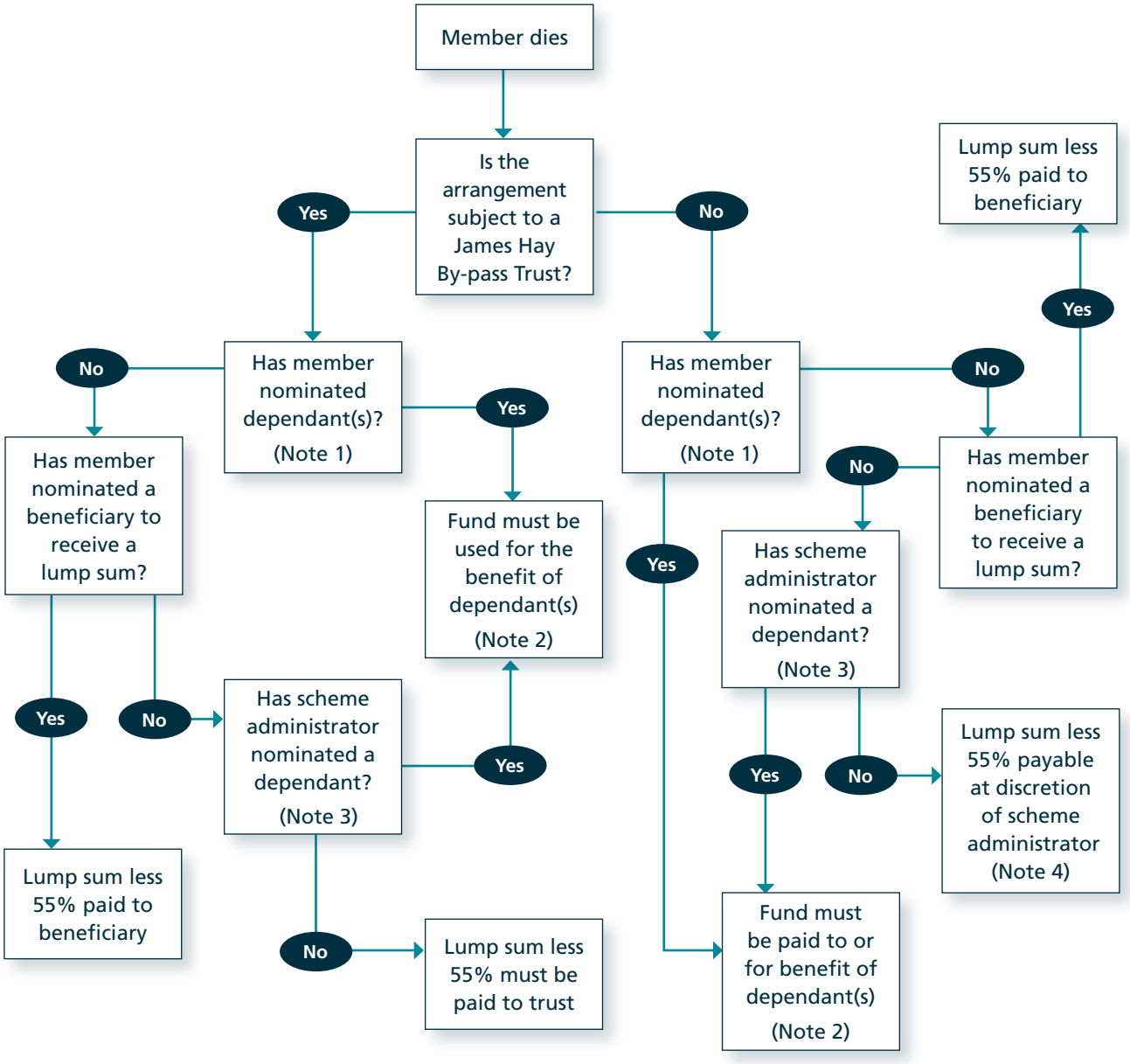
Note 3

If member has not chosen a dependant or a beneficiary, scheme administrator can, but need not, choose a dependant.

Note 4

Scheme administrator will normally pay the lump sum to a member-nominated beneficiary but is not obliged to do so.

Payment of benefits where member dies while taking benefits or aged 75 or over



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