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Adviser factsheet

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The bypass trust

Introduction

This factsheet is designed to give an overview of the benefits available from the use of a bypass trust.

Features

- Executive summary
- Summary of Key Features
- Taxation of lump sum death benefits
- Case study
- Appendix: Flowchart of scheme rules and payment of benefits

Executive summary

A bypass trust is a simple means of holding lump sum death benefits payable from a SIPP rather than those benefits being paid outright to individual beneficiaries.

Using a bypass trust to hold a client's death benefits has a number of advantages. It is simple to set up, specimen trust wording is provided free of charge and the member can appoint their own trustees to look after the ongoing administration of the trust. The trust can save Inheritance Tax (IHT) on the payment of a lump sum death benefit to the trust because the trust fund does not form part of any of the beneficiaries' estates yet they can still benefit from the fund with the trustees' agreement.

Furthermore, it also provides the financial adviser with the opportunity to offer investment advice to trustees or beneficiaries who receive these funds.

The technical note for financial advisers on the bypass trust provides more detail on how the trust works, the detailed advantages and tax implications. This factsheet contains the following:

- A summary of the key features of the trust.
  - Expanding on the advantages of the bypass trust, when it can be set up, who can be appointed as trustees and beneficiaries, and whether they can be changed.
- A case study illustrating how the trust works in practice and the tax savings that can be made.
  - Assesses the value of the estate, the effect a bypass trust can have on IHT and examples regarding the selection of trustees.

Summary of key features

What is the bypass trust?

A bypass 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 outright to a specific beneficiary on the death of the member, the lump sum may be paid to the trustees of the bypass trust. The trustees can then use their discretion in deciding who should benefit.

What are the advantages of using the bypass trust?

Although there should be no IHT implications on the lump sum being paid out of the SIPP on the death of the member, IHT can become a problem on the death of the recipient, for example, the surviving spouse, since any lump sum death benefit will form part of their estate on death assuming all or part of it remains unspent or has not left their estate from an IHT point of view. For example the surviving spouse could gift the money to a child though this will only become an exempt transfer if the surviving spouse survives seven years from the date of the gift. The main advantages of using the bypass trust to receive the SIPP death benefits are as follows:

- A range of beneficiaries can benefit from the bypass trust fund without the value of the Trust fund forming part of their IHT estate.
- The bypass trustees can lend the money to a beneficiary thereby creating a debt on their individual estate and, assuming it remains outstanding on death, reducing the value of their IHT estate.
- The value of the bypass 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 bypass trust may afford greater protection in terms of retaining capital for the member's intended beneficiaries in the event of the death, divorce or remarriage of the intended beneficiary.
- Where a client has used the bypass trust, there is the possibility of future business from the trustees who may need investment advice on dealing with the trust fund or from beneficiaries who are looking to invest any funds received from the trust.

Main features of the bypass 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 the member's lifetime provided they are in good health at the time.
- The trust is discretionary in form which means that the trustees can decide who benefits, the amount by which they benefit, and when.
- Potential beneficiaries are pre-defined in the trust deed to include typical family members.
- The member can add or exclude anyone from the class of potential beneficiaries either at outset of the trust or at a later date.
- Trustees have wide investment powers so they can invest trust money in a wide range of investments.
- The member is a trustee during their lifetime.
- The member can appoint and remove trustees during their lifetime.
- The trust cannot last indefinitely, however, the bypass trust has been drafted to ensure that the trust can run for a few generations after the member's death.
- There is no cost for the provision of the specimen trust wording.

Taxation of lump sum death benefits

From 6 April 2015, with the exception of any potential charge for exceeding the lifetime allowance, the payment of a lump sum death benefit is tax free if the member dies under the age of 75 and the benefit is paid within 2 years of the member's death. If the member dies aged 75 or over and the benefits are paid to the bypass trust a tax charge at the rate of 45% applies.

When a trust beneficiary effectively receives all or part of the death benefit from the trust they will also receive a tax credit representing the 45% tax paid on that sum and the tax credit can be used towards settlement of their tax liability in that year or all or part of the tax refunded depending on the beneficiary's tax position.

The high tax environment of a discretionary trust and the potential 45% tax charge at outset has reduced the appeal of the bypass trust. That said factors such as controlling who and when individuals can benefit still means it is an option to consider.

Case study

You have recently been reviewing the file for your clients David and Victoria Bookem and you have noticed that they have a significant potential Inheritance Tax liability.

Their assets are as follows:

	£
House	900,000
Villa in Spain	250,000
Investments	300,000
Contents	75,000
Jewellery	20,000
Cash in the bank	5,000
	1,550,000

In addition David has a SIPP which is valued at £500,000.

They have not made any gifts yet. After explaining to them the advantages of making lifetime gifts to reduce their IHT 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 nil rate band of £325,000, a residence nil rate band of £175,000 applies at the time of Victoria's death and based on current asset values) will be as follows:

	£
Value of combined estate	1,550,000
Pension death benefits	500,000
	2,050,000
Less nil rate band x 2	1,000,000
	1,050,000
IHT @ 40%	420,000

Reducing the IHT liability

One way of reducing this liability without having to make any significant lifetime gifts is for David to create a bypass 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 her estate, thus saving IHT of £200,000 (£500,000 @ 40%).

Case study continued

As long as David is in good health when the trust is set up, HM Revenue & Customs should accept that there is no value to the death benefits and therefore there will be no IHT implications on the setting up of the trust.

On a payment of the lump sum death benefit to the trustees of the bypass trust, the money will be under the control of the trustees David has appointed under that trust to look after the money.

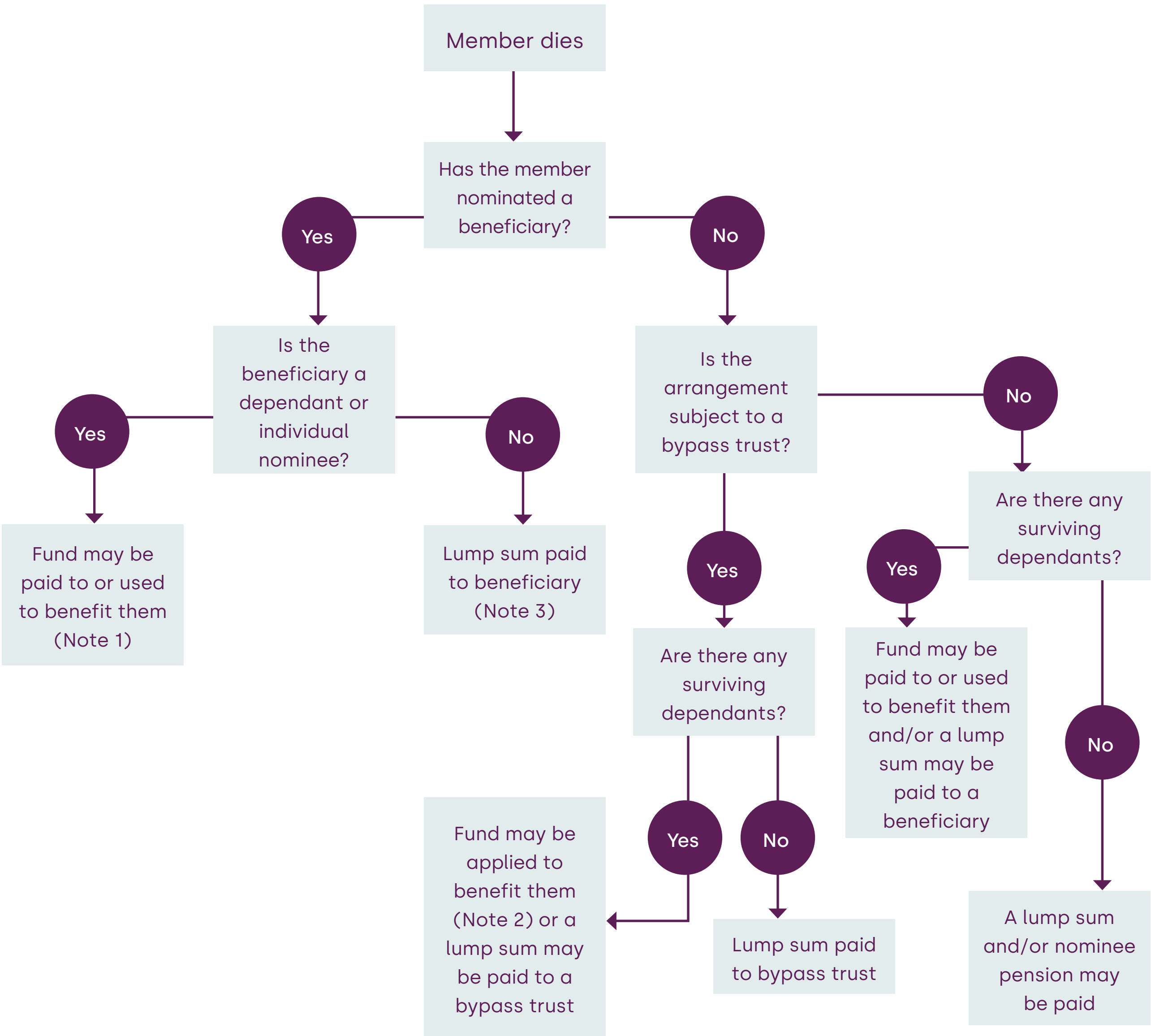
David has two children from a previous marriage as well as three children with Victoria. He may be concerned that should Victoria receive the death benefits directly then on her subsequent death, she could choose to leave all benefits to the three children of their marriage and exclude the two children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

Using a bypass trust to receive the death benefits can avoid these concerns 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 happens to the trust money including who is to benefit. He could also, if he wishes, appoint any of his children over the age of 18 as trustees. As David has children from his previous marriage, he could appoint 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 trust beneficiary, Victoria may benefit from income, capital and loans subject to the agreement of the trustees. Loans can be tax efficient since any outstanding loan is repayable on the death of the beneficiary of the loan thereby creating a debt on their estate. So if, for example, Victoria required to borrow £30,000 from the trust to buy a car, this could reduce her IHT liability by a further £12,000.

David's children from his first marriage may also benefit from the trust, along with other relatives such as parents, brothers, sisters etc. Therefore the trustees can decide to pay money to family members as appropriate, during Victoria's lifetime and following her death.

Appendix: Flowchart of scheme rules and payment of benefits



Note 1

A dependant/individual nominee can choose from an annuity, drawdown pension or lump sum death benefit.

Note 2

Dependant(s) benefits in the form of an annuity, drawdown pension or lump sum death benefit may be paid but generally only if a letter of wishes exists.

Note 3

In these circumstances, the beneficiary is likely to be a trust or charity.

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