



BY-PASS TRUST FOR USE WITH DEATH BENEFITS UNDER A LONDON & COLONIAL SIPP

TECHNICAL GUIDE (April 2011)

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Important note:

This trust should only be used with the London & Colonial SIPP under which the Scheme Trustee has a discretion to pay lump sum death benefits to any person in the discretionary class and the discretionary class includes the trustees of a trust declared by the member of the SIPP.

1. INTRODUCTION - SIPPs AND INHERITANCE TAX

Where a person is a member of a registered pension scheme, such as a SIPP, substantial lump sums can become payable on that person's death. Such payments are free of inheritance tax if made within two years of the Scheme Trustee being notified (or, if earlier, being reasonably aware) of the member's death. Whilst this is beneficial to the receiving beneficiary, unless the cash is spent during that beneficiary's lifetime, on the subsequent death of the receiving beneficiary, it could be potentially subject to inheritance tax. This problem is likely to be particularly acute where the beneficiary is the member's surviving spouse. **It should be noted that Registered Civil Partners are treated as being married for IHT purposes and any mention of spouse in this Guide should be taken to also refer to a Registered Civil Partner.**

The London & Colonial By-Pass Trust seeks to overcome this problem. If a member of a SIPP establishes the By-Pass Trust during their lifetime and death benefits are paid before an annuity has been purchased (ie. before pension benefits have been vested or while in payment as a drawdown pension) to the trust rather than to a beneficiary, it will be possible to mitigate any future potential IHT tax liability on the lump sum without necessarily denying the member's spouse access to the trust assets.

The Trust can therefore incorporate flexibility over who benefits under it and, in particular, means that the trustees can pay some benefits to the pension scheme member's spouse without all of the trust assets forming part of their taxable estate. In other words, only amounts actually paid to the surviving spouse from the Trust would be part of the survivor's taxable estate. And even then there is a way to minimise this impact – see later.

While the By-Pass Trust offers the opportunity for effective inheritance tax planning, it also gives rise to a number of tax implications and these are considered in section 5 of this Technical Guide.

2. DEATH BENEFITS THAT CAN BE PAID UNDER A LONDON & COLONIAL SIPP

Before considering the By-Pass Trust in detail, it is first appropriate to look at the rules that apply to the payment of death benefits under the London & Colonial SIPP.

(i) Overview

The death benefits payable under the London & Colonial SIPP will depend upon a number of factors, including the following:

- Whether all or part of the member's benefits have been crystallised (ie. vested) and, if they have, what form those benefits have taken (e.g a lifetime annuity or a drawdown pension).

- Whether the member's benefits include any protected rights (ie. benefits that replace their entitlement to State additional pension benefits while the individual was contracted out under a suitable occupational, personal or stakeholder pension scheme).

(ii) The lifetime allowance charge

Under the pension tax regime a lump sum death benefit of up to the amount of the member's lifetime allowance (ie. £1.8 million in tax year 2011/12 reducing to £1.5 million in 2012/13 or such larger amount where the member is subject to transitional protection or fixed protection) may be provided on the member's death. Where lump sum death benefits exceed the member's lifetime allowance, a lifetime allowance charge will be levied on the recipient(s) of the lump sum equivalent to 55% of the excess lump sum. Where a death benefit is provided in the form of a spouse's/dependant's pension or drawdown benefits, its value will not normally be taken into account when assessing the amount of the member's lifetime allowance that has been utilised. The exception is in respect of a "related dependant's annuity" which was secured at the same time as a member's lifetime annuity when the purchase price of that "related dependant's annuity" will have been tested against the member's lifetime allowance.

It is important to note that in assessing whether a member's lifetime allowance has been breached, account will be taken of:

- the value of any pension benefits the member has already vested/crystallised;
- the return of any fund under a pension plan where it is paid as a lump sum death benefit for somebody with uncrystallised benefits; and
- the payment of any insured lump sum death benefit

Although a lump sum death benefit paid on the death of a member on or after their 75th birthday will not be tested against their lifetime allowance it will be subject to an automatic recovery tax charge of 55%.

(iii) Protected rights

Since October 2008, protected rights can now be transferred into any type of SIPP. Until 6 April 2012, the payment of protected rights on the death of a member prior to that date is, however, subject to different rules as described in section 3(1)(C) below.

In order for a member of a SIPP to facilitate a payment of protected rights to the By-Pass Trust they would need to make a binding nomination in favour of the trust. This is dealt with in greater detail in section 3(1)(C) below.

3. PAYMENT OF DEATH BENEFITS AND INHERITANCE TAX – THE GENERAL RULES

In this section we consider when death benefits may be paid and how they may be subject to inheritance tax.

(1) LUMP SUM DEATH BENEFITS PAID UNDER THE LONDON & COLONIAL SIPP

Death benefits can be paid under a SIPP in a number of situations. The use of the By-Pass Trust may be appropriate in the following two sets of circumstances:-

- before any retirement benefits are drawn - this is known as uncrystallised benefits;
- and
- where the member has opted for a drawdown pension.

(A) Member dies with uncrystallised benefits

Where a member of the London & Colonial SIPP dies before any retirement benefits have been drawn lump sum death benefits can normally be paid out free of inheritance tax provided the trustees make the payment, in general, within 2 years of the member's death. Lump sum death benefits will also be free of a recovery tax charge if the member dies before age 75. Otherwise they will be subject to a 55% recovery tax charge.

The question then arises as to who those death benefits can be paid.

Where a member of the London & Colonial SIPP dies and has uncrystallised benefits, the Scheme Trustee has a discretion to pay a lump sum death benefit to anybody who falls within the definition of beneficiary in Rule 21.1 of the SIPP Rules. The potential beneficiaries include the member's relatives (ie. the member's spouse, children, grandchildren and anyone entitled under the deceased member's will to any interest in his estate. **In particular, the Scheme Trustee can make a payment to the trustees of a separate personal trust that has been established by the member during their lifetime for the benefit of those relatives.**

The SIPP member should indicate to the Scheme Trustee who he would wish to benefit on his death by completing a "nomination/expression of wish" form. The member can nominate the trustees of an existing "personal trust" as people who can receive death benefits. It is important to note that lump sum death benefits can only pass free of IHT because they are payable at the discretion of the Scheme Trustee and therefore any "nomination/expression of wish" form completed by the member is not binding on the Scheme Trustee. In considering a nomination the Scheme Trustee will need to first of all be satisfied that the person nominated is an appropriate Beneficiary to receive the death benefits.

The London & Colonial SIPP scheme offers a "nomination/expression of wish" form for the SIPP member to indicate who he would wish death benefits to be paid to.

Example - Jane

Under the rules of Jane's London & Colonial SIPP, the Scheme Trustee has a discretion to pay benefits to anybody who is in the discretionary class of beneficiaries. This includes the "trustees of any discretionary trust" nominated by the member.

Jane declares a London & Colonial By-Pass Trust with a gift of £10. She then gives the Scheme Trustee a non-binding expression of wishes form requesting that, in the event of her death, death benefits are paid to the trustees of her personal Discretionary (By-Pass) Trust. Separately, she gives those personal trustees a non-binding letter of wishes as to who she would wish them to pay benefits to and when. The trustees can then pay the cash out of the Trust or keep the cash in the Trust.

In order to achieve freedom from inheritance tax, the payment of the lump sum death benefit must be made within two years of the Scheme Trustee being notified (or, if earlier, being reasonably aware) of the member's death. This rule applies irrespective of whether the lump sum death benefits are paid to an individual or a trust – such as the By-Pass Trust. Therefore, even where the Scheme Trustee may have difficulty in deciding to whom the payment is to be made, the payment must be made within the two year period to avoid inheritance tax. Failure to pay the lump sum death benefit within this period may also result in the benefit being taxed as an unauthorised payment which would lead to substantial income tax liabilities. This will depend on the precise circumstances.

Example – Jason

Jason has a London & Colonial SIPP under which death benefits are paid at the discretion of the Scheme Trustee. He declares a By-Pass Trust for a nominal £10. He then completes a nomination/expression of wishes form requesting the Scheme Trustee to make the payment to the trustees of his Discretionary By-Pass Trust on his death. Jason also completes a further expression of wishes asking his trustees to keep the benefits in trust until his two grandchildren attain age 21 and then pay them.

On Jason's death, the death benefits are paid to the trustees. The grandchildren are then aged 11 and 13. In accordance with Jason's wishes, those trustees keep the death benefits in the Trust until Jason's grandchildren attain age 21 and then make payment to them.

(B) Death while taking a drawdown pension

Where a member of a SIPP dies whilst in receipt of a drawdown pension lump sum death benefits will be subject to a recovery tax charge of 55%. However, no inheritance tax charge will apply provided, in general, the payment is made within 2 years of the member's death.

Under the current pension tax regime there is no requirement for a member of a money purchase scheme, which includes a SIPP, to purchase an annuity when they draw benefits. Instead, where a member wishes to draw all or part of their retirement benefits on or after age 55 under a SIPP they will be able to take a drawdown pension.

Where a member dies while taking a drawdown pension, their residual drawdown fund is available to provide death benefits. Benefits can be paid, subject to the scheme rules, in total or in part as

- (i) a dependant's scheme pension
- (ii) a dependant's annuity
- (iii) a dependant's drawdown pension
- (iv) a lump sum death benefit paid at the discretion of the Scheme Trustee (to, for example, the trustees of a By-Pass Trust)

The Scheme Trustee would normally select the form of benefit to be paid. Should the lump sum option in (iv) be selected, the death benefits would normally be paid to the By-Pass Trust. Section (3)(C) below sets out how protected rights can be dealt with.

Clearly, where a lump sum death benefit is to be paid, payment to the By-Pass Trust will be an attractive option – especially when the surviving spouse does not require income because she has, for example, inherited other assets, including investments, on the member's death.

On the other hand, if following the death of the member, the surviving spouse takes a dependant's drawdown pension, on the surviving spouse's subsequent death the pension fund will most commonly be paid as a lump sum. At that point it may be desired that the benefits are not paid to one particular individual – for example, a child who may already have his/her own potential IHT liability. In these circumstances, it may be useful to have the facility to arrange for the payment to be made to the By-Pass Trust and used for different Beneficiaries at different times depending on their needs and the exercise of the trustees' discretion.

(C) Protected rights

Protected rights benefits are subject to special rules as they are provided in replacement of an employee's entitlement to State additional pension benefits (ie. in respect of the State Earnings Related Pension Scheme and/or the State Second Pension). Such benefits are payable under a money purchase pension scheme and arise where the member was contracted out of the State additional pension (SERPS/State Second Pension) by inclusion in a suitable personal pension, stakeholder pension or occupational pension scheme.

Where a member was contracted out under a final salary occupational scheme and transferred his benefits to a money purchase scheme (such as a SIPP) any transferred contracted out benefits will become protected rights under the receiving scheme.

Where the member of a pension scheme dies, any uncrystallised protected rights benefits must be used to buy a pension/annuity for a surviving spouse or civil partner.

If there is no surviving spouse or civil partner the cash value of the protected rights must be paid to Beneficiaries nominated in writing by the member. Failing this it is payable to the deceased member's estate.

The IHT position will therefore depend on the circumstances. If the member has made a nomination which can be revoked, or has not made a nomination, the death benefits will form part of his taxable estate.

On the other hand, if he has made an irrevocable nomination, provided this was made whilst he was in good health and he survived the nomination by 2 years, the death benefits should not be treated as part of his estate as, at the time of the nomination, the size of the transfer of value would be nominal.

Under a SIPP, the member can make a nomination of protected rights death benefits in favour of the By-Pass Trust so that those death benefits can then be dealt with by the personal trustees in the same way as other death benefits. However, the nomination of protected rights benefits must be irrevocable.

Where a member dies while in receipt of a drawdown pension in respect of his protected rights benefits, their residual fund must be used to provide spouse's/civil partner's benefits where there is a surviving spouse/civil partner. Such benefits can be paid as a dependant's annuity or a dependant's unsecured pension. Where there is no surviving spouse/civil partner, the residual fund (less an automatic recovery tax charge of 55%), can be paid as a lump sum death benefit to one or more of the member's Beneficiaries in accordance with any direction given in writing by the member or to the member's estate. The member could therefore direct that the death benefits are paid to the By-Pass Trust.

(2) INHERITANCE TAX ON DEATH BENEFITS – THE GENERAL RULES

As mentioned above, in general no IHT liability will arise on the payment of lump sum death benefits within two years of the member's death. However, there are certain occasions when IHT considerations may arise.

An IHT charge could previously have arisen under section 3(3) of the Inheritance Tax Act 1984 if a member did not exercise their right to take pension benefits when first eligible to do so. This rule has now been abolished in relation to members of pension schemes who die after 5 April 2011.

(3) THE BENEFITS OF USING PERSONAL TRUSTS

By setting in place arrangements so that death benefits could be paid to a separate personal trust (such as the London & Colonial By-Pass Trust), the member can secure several advantages.

As well as providing scope for future inheritance tax saving, if the Scheme Trustee exercises their discretion to pay lump sum death benefits to a personal trust, it will then be the trustees of that personal trust who decide who receives benefits in the future. The use of a separate personal trust in respect of the death benefits under the SIPP therefore gives the member more control over who is to ultimately benefit under the Trust, in that it will be the trustees selected by the member, and not the Scheme Trustee, who will be making the decision as to who benefits on a distribution of capital from the Trust.

To give maximum flexibility over who can benefit, a discretionary trust can be used. In this respect the use of such a personal trust will give greater continuing flexibility than a disposal of death benefits direct to Beneficiaries via the Scheme Trustee.

Under the London & Colonial SIPP the Scheme Trustee will have power to pay the lump sum death benefits to an individual trust at their discretion. Where this happens, the death benefits will be deemed to have left the main scheme (ie. the SIPP) when they are paid to the trustees of the individual personal trust. This will mean that any benefits subsequently payable from the individual personal trust will be subject to the normal IHT charges which apply to mainstream discretionary trusts. This will apply even if the payment is made from the individual personal trust within 2 years following the member's death. ***Therefore, in a case where an early distribution of all the benefits directly to an individual is contemplated, it may be best for the SIPP Scheme Trustee to pay the benefits directly to the Beneficiary(ies) concerned.***

Problems may sometimes arise where it is desired to make payments to minor Beneficiaries because, in such cases, it would normally be appropriate for the Scheme Trustee to declare a new trust into which to pay death benefits to be held for those Beneficiaries. This is likely to complicate matters and probably result in a delay in making the lump sum payments. The use of a personal trust established during the member's lifetime (such as the London & Colonial By-Pass Trust) can avoid this problem.

In section 4 below, we will consider the London & Colonial By-Pass Trust in more detail.

4. AN OVERVIEW OF THE LONDON & COLONIAL BY-PASS TRUST

(1) What is the London & Colonial By-Pass Trust?

The London & Colonial By-Pass Trust is a discretionary trust to which death benefits can be paid in respect of a member of the London & Colonial SIPP. The trustees can then, at their discretion, pay benefits to the member's surviving spouse during the remainder of their lifetime but without that lump sum forming part of the surviving spouse's taxable estate. The idea is that lump sum benefits payable on the member's death before pension benefits have commenced (or during a period of unsecured pension/income drawdown) could be paid into this Trust should the Scheme Trustee exercise their discretion to make such a payment to the trustees of the By-Pass Trust. Those death benefits will then, in effect, "by-pass" the surviving spouse's taxable estate for IHT purposes.

It is reiterated that, under a SIPP, the payment of the death benefits to the trustees of the By-Pass Trust depends on the SIPP Scheme Trustee exercising their discretion to make such a payment. Provided the member has indicated in any "nomination/expression of wish" form that he would like the Scheme Trustee to pay the death benefit to the trustees of the By-Pass Trust, it is likely that the Scheme Trustee will follow the member's wishes unless they find compelling reasons not to.

(2) How is the London & Colonial By-Pass Trust established?

The London & Colonial By-Pass Trust is established during the lifetime of the SIPP member and contemplates that the property initially made subject to the trust will be a nominal sum, e.g. £10, and no additions will be made until after the death of the Settlor when the SIPP death benefits are paid to it. Even though the sum is nominal, it is essential that it is transferred to the trust to ensure that the trust is properly established. It is recommended that anyone who also wishes to carry out other inheritance tax planning with lifetime gifts should use a separate trust and establish it **after** creating the By-Pass Trust.

Once the London & Colonial By-Pass Trust is established, it is then in place to receive the payment of any death benefits under the London & Colonial SIPP by the Scheme Trustee on the member's death.

(3) What type of trust is the London & Colonial By-Pass Trust?

The Trust is a discretionary trust which gives the trustees wide powers to appoint benefits to Discretionary Beneficiaries. The member of the SIPP will declare the trust during his lifetime and so become the Settlor of the Trust. The Trust requires the Settlor to insert the names of the Default Beneficiaries when establishing the Trust. These are the people who will benefit in the very unlikely event that the trustees do not appoint the trust fund to other Beneficiaries within the trust period. It would be usual to include the member's children as Default Beneficiaries. Alternatively, a charity could be named.

The member's widow(er), as well as the member's children, grandchildren and other specified individuals, are included amongst the Discretionary Beneficiaries.

To avoid adverse income tax and capital gains tax consequences during the Settlor's lifetime, neither the Settlor nor the Settlor's spouse may benefit from the Trust in any way. The fact that the Settlor's widow(er) is one of the Beneficiaries has no adverse tax consequences. Given that it is not intended that substantial assets should be transferred to this Trust before the death of the Settlor, this should not present any practical difficulties in terms of loss of access to the Settlor and Settlor's spouse.

The trustees also have power to lend funds, interest free, to a Beneficiary. The power to lend may give the opportunity (subject to section 103 Finance Act 1986) to reduce IHT by creating debts for IHT purposes on the estate of, say, a surviving spouse of the Settlor to whom an interest-free loan has been made. Because of this, if a surviving spouse did need to have access to funds from the By-Pass Trust, accessing them by way of loan rather than by way of capital appointments by the trustees would probably be preferable from an IHT standpoint (see section 5(2)(iv) below).

A minimum of two trustees is required to make an appointment of benefits or to exercise a power under the trust (eg. grant an interest-free loan to a Beneficiary) where the appointment is in favour of a Beneficiary who is also a trustee. This is to avoid any potential conflict of interest that could arise where a trustee is also a Beneficiary.

Trustees have wide powers to invest the funds received by them in any asset, including non-income producing assets such as single premium investment bonds with UK or offshore insurance companies. This may offer additional tax advantages (see section 5(3)).

(4) Nomination/Expression of wish to the scheme trustees

Where the member sets up a London & Colonial By-Pass Trust, it is envisaged that they will then make a non-binding nomination to the SIPP Scheme Trustee requesting that death benefits will be paid in favour of the trustees of the London & Colonial By-Pass Trust. This, of course, assumes that a SIPP member would not wish death benefits to be paid directly to the surviving spouse, dependants or other Beneficiary(ies) under the SIPP's Trust or Rules.

It is important to note that the Scheme Trustee will not be bound in any way by any such nomination that may be made but would usually take it into account in making their decision.

(5) Expression of wish to trustees of the London & Colonial By-Pass Trust

The scheme member will be the Settlor of the By-Pass Trust. Having established it, they would normally complete an "expression of wish" form to indicate to the trustees of the London & Colonial By-Pass Trust the person they would wish them to consider as the prime Beneficiary under the Trust. This would usually be the Settlor's spouse in their capacity as widow/widower under the Trust. For this reason, it would be best to specifically name them rather than just refer to them as "spouse". Whilst the expression of wish would not bind the trustees, it is thought that they would normally act in accordance with it.

(6) Why is the By-Pass Trust a Discretionary Trust?

Following changes made in the Finance Act 2006, all new lifetime trusts, other than bare trusts and certain trusts for the disabled, are treated for IHT purposes in the same way as discretionary trusts. As a discretionary trust gives the maximum possible flexibility to trustees to appoint benefits, it makes sense to use this type of trust to hold pension scheme death benefits. This is especially so given that it is not intended to hold substantial assets in this Trust (other than the original nominal gift) until the death of the Settlor, which means that until that time the usual charging regime and the reporting requirements will not have any practical application.

However, it is important to remember that as the London & Colonial SIPP is constituted by a discretionary trust, then when the SIPP death benefits are paid to the trustees of the By-Pass Trust HMRC will, for inheritance tax purposes, treat such a settlement as having commenced on the date that the individual joined the **pension scheme** from which the benefits arose. If this is the member's first pension scheme then the date of joining the SIPP will be taken.

Where benefits were previously transferred to the SIPP and those benefits were from a pension scheme subject to a discretionary trust, then for inheritance tax purposes the settlement of those transferred benefits will be treated as commencing when the member first joined that pension scheme. This is regardless of when the London & Colonial By-Pass Trust was actually made by the individual. This means that it is relatively easy for the Trust to be treated for inheritance tax as having run for more than 10 years and, where death benefits have been paid and they exceed the current nil rate band (which very often they would), the potential inheritance tax periodic and exit charges will need to be considered (see section 5).

(7) Accumulation and Perpetuity Periods

Following the introduction of the Perpetuities and Accumulations Act 2009 (PAA 2009), the perpetuity period for all trusts established under the law of England after 5 April 2010 - including the London and Colonial By-Pass Trust - is 125 years from the date the trust is established. There is no longer any maximum accumulation period (except for charitable trusts).

However, the rules are different where a settlement commenced before 6 April 2010 – see below - and there are special rules governing pension schemes.

Where an individual joins a pension scheme, he is then deemed to create a trust of his/her pension scheme rights. This deemed trust will have perpetuity and accumulation periods which will carry over into the trust of the death benefits that applies under the By-Pass Trust. The perpetuity and accumulation periods that will apply to this deemed trust depends on the circumstances, as follows:-

(i) Death benefits payable from a scheme the member joined after 5 April 2010

Where the member joined the pension scheme after 5 April 2010 and the pension scheme commenced after 5 April 2010, the perpetuity period of the death benefit cash part of the Trust will be 125 years from the date the member joined the scheme.

Of course, many pension schemes will have commenced before 6 April 2010. Here, although the pension scheme started before 6 April 2010 (and one could then argue that this is when the instrument creating the power of appointment took effect) the better view is that section 19 PAA 2009 (which applies where provision is made “other than by instrument” which, as regards each member, is probably the case here) will apply to mean that the instrument deemed to have created the power of appointment was entered into when the member joined the scheme.

On the basis that this interpretation is correct, the By-Pass Trust instrument, which now holds the death benefit cash, will be governed by the perpetuity period applicable to the trusts of the scheme in which the funds were held prior to their transfer. Thus, the perpetuity period of such By-Pass Trusts will be 125 years from the date when the member joined the pension scheme because section 6(3) of the PAA 2009 is the reference point for the commencement of the perpetuity period.

In these circumstances, there would be no maximum accumulation period for any of the trust fund made up of property received from the pension scheme because the trust is deemed to commence after 5 April 2010.

(ii) Death benefits payable from a scheme where the member joined before 6 April 2010

For members who joined the pension scheme **before** 6 April 2010, the old rules will still apply – on the basis that the instrument creating the power of appointment will dictate the perpetuity period of the new trust and so the pre 6 April 2010 position will apply. Section 19 will not help because the member joined the scheme before 6 April 2010 and before the new Act took effect.

On the basis that the pension scheme consists of a number of individual trusts for each member, for the purpose of ascertaining the perpetuity period appropriate to property received from a pension scheme by the By-Pass Trust for a particular member, the Trust would be deemed to have commenced when that member originally joined the scheme. This means that as the “old law” applies, the most appropriate perpetuity period would be a life in being (the member) plus 21 years. As far as the trusts of the lump sum death benefits are concerned, the By-Pass Trust would therefore cease 21 years after the member’s death.

As far as accumulation periods are concerned, the old restriction of 21 years (from the date of the member’s death) would continue to apply to the property paid into the Trust from the personal trust of the member’s rights under the pension scheme.

(iii) Transfers

As mentioned above, the new rules appear to apply only to By-Pass Trusts that receive payments made from pension schemes that a person joined after 5 April 2010. Difficulties can arise in the case of a transfer (eg. if a person transferred from a pre 6 April 2010 personal pension scheme to a post 5 April 2010 personal pension scheme which subsequently resulted in a payment of death benefits to the London and Colonial By-Pass Trust). In these circumstances, it is probably legally correct to apply the perpetuity period of the original trust to the assets transferred into the new trust and this would be the best approach to adopt.

For this approach to be adopted, the payment between trusts needs to be made under a special power of appointment and the problem is that it is not at all clear that the transfer of pension rights can be regarded as being made under the exercise of a special power of appointment or advancement which, in turn, could mean that the trust would be treated as commencing when the receiving scheme began.

The wording adopted in the Trust does however deal with this issue – see (iv) below.

(iv) The terms of the Trust

Clearly, a number of permutations can arise depending on the circumstances of a particular case.

To cater for all of these permutations, the Trust has been drafted :

- (a) as regards the initial nominal trust property, to give effect to the position under the new law in England (ie. a perpetuity period of 125 years and no accumulation period)
- (b) as regards the property received from the pension scheme, to automatically adopt the appropriate perpetuity and accumulation periods depending on the source of the pension scheme assets.

This means that in cases where lump sum death benefits are paid to the Trust, the rules that apply to the accumulation of income on these assets may be different from the rules that apply to assets that are placed in the Trust when it is established. It is therefore important that the trustees are able to distinguish between these different parcels of property within the Trust and keep appropriate records. This could also be important for inheritance tax calculation purposes at the ten-year periodic charge anniversaries – see section 5 below - although, given that the initial property will always be a nominal amount, this should not create great difficulties.

It should, of course, also be borne in mind that it would be unlikely that the Trust will run for 125 years (or whatever shorter perpetuity period applies as regards the pension death-in-service benefits).

5. THE TAXATION IMPLICATIONS OF THE LONDON & COLONIAL BY-PASS TRUST

In the following section, 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.

(1) On execution of the London & Colonial By-Pass Trust

The member of the pension scheme would normally establish a London & Colonial By-Pass Trust. They would therefore be the Settlor. The tax implications would be as follows:-

Capital gains tax (CGT)

No CGT would arise on a gift of cash.

Inheritance tax (IHT)

The creation of the Trust will give rise to a transfer of value by the Settlor for IHT purposes. However, on the basis that only a nominal gift of £10 is made, this should fall within the Settlor's available annual exemption (of, usually, £3,000) and be exempt from IHT.

It is recommended that the London & Colonial By-Pass Trust is established with only a nominal amount.

In the unlikely event that larger amounts are paid to the Trust then, to the extent that the transfer exceeds the Settlor's available annual exemption of £3,000 (£6,000 if the exemption for the previous tax year has not been used), it will be a chargeable lifetime transfer for inheritance tax purposes. This means that a potential liability to IHT, at the lifetime rate of 20%, may arise immediately if the value of the gift, plus the value of all other chargeable lifetime transfers made by the Settlor in the previous 7 years, exceeds the IHT nil rate band at the time the Trust is established. A further tax liability (at 20%) on the gift could arise if the Settlor dies within 7 years of making the transfer although IHT taper relief will be available if the Settlor survives for at least 3 years. On the Settlor's death within 7 years of making the gift, the full value of the gift will also be taken into account in determining the inheritance tax liability on the Settlor's estate passing under their Will or intestacy.

Additional later gifts to the By-Pass Trust are also not recommended. If they are made they will be chargeable lifetime transfers and so could give rise to an immediate IHT liability if they cause the Settlor to exceed their annual exemptions and the available nil rate band. They can also affect the calculation of the periodic charge – see below. Professional advice should be taken if substantial additional gifts are contemplated. If the Settlor wishes to make lifetime gifts into trust, it may be appropriate to use separate trusts but appropriate legal advice should first be taken.

(2) IHT implications whilst the trust is in existence

In what follows it is assumed that the London & Colonial By-Pass Trust is established with a nominal amount and no additional gifts are made to it by the Settlor whilst alive.

(i) Before the death of the Settlor

Provided the Trust is created with a nominal amount and no assets are added to the Trust after its creation, there will be no IHT charges while the Settlor is alive.

(ii) Payment of the death benefit to the London & Colonial By-Pass Trust

The payment of the death benefit from the SIPP to the London & Colonial By-Pass Trust will be an additional payment to the Trust. Provided the payment from the SIPP is made under a discretion exercised within two years of the Scheme Trustee being notified of the Settlor's death (or, if earlier, within two years from the time the Scheme Trustee could have been reasonably aware of the Settlor's death), there will be no immediate IHT implications on the payment of death benefits to the By-Pass Trust.

It should be noted that if the trustees of the By-Pass Trust then distribute benefits to an individual Beneficiary, there could be an IHT exit charge (see below) – even though the payment is still made within two years of the member's death. For this reason if the trustees contemplate making an "early" payment to an individual Beneficiary, it may be more IHT efficient for the Scheme Trustee to make this direct rather than pay it into the Trust.

(iii) After the death of the Settlor

As this is a discretionary trust, special IHT charging rules apply. Under these rules there may be a potential IHT charge

- on every ten-year anniversary of the trust - "the periodic charge" or
- whenever property leaves the trust (e.g. when capital is advanced to a Beneficiary) - "the exit charge"

(a) Periodic charge

Periodic charges at ten-yearly intervals may be applied to the value of the assets in the Trust. The rate of inheritance tax charged will be determined by considering an assumed transfer by an assumed transferor. In this calculation, it will be necessary to take account of:-

- the value of the property in the Trust on the ten-year anniversary plus the value of any related settlements (ie. same-day settlements) when they were established (the assumed transfer); and
- the Settlor's seven year cumulative total immediately before he or she made the Trust and any sums paid out of the Trust in the 10 years prior to the anniversary (the cumulative total of the assumed transferor)

In this respect it is important to note that if the lump sum death benefit originates from a SIPP which is subject to a discretionary trust (as opposed to a deed poll when different rules will apply), HM Revenue and Customs will apply section 81 IHT Act 1984 which states that when property moves between different discretionary trusts, the discretionary trusts will be treated as one trust for the purpose of the ten-year periodic charge (and exit charge) which

commenced when the first trust began. As the member will be treated as creating his own trust when he joined the pension scheme, this means that it is important to establish when the original (pension) trust began in order to calculate any IHT charges. The trust will have begun when either:-

- the member joined the SIPP, if there have been no transferred benefits, or
- the member joined the pension scheme from which benefits were transferred to the SIPP

Thus it will be necessary to determine the chargeable transfers the Settlor made in the seven years before he joined the SIPP or transferring scheme, if earlier, in order to calculate the amount of any periodic charge.

In theory, because the London & Colonial By-Pass Trust consists of property derived from both the SIPP lump sum death benefits and the property originally used to establish the Trust, there could be different ten-year anniversaries with the value of the trust property apportioned between those dates. However, in practice, it seems that as the property used to establish the trust is only a nominal sum, HM Revenue and Customs will ignore this.

In calculating the IHT charge, it is necessary to remember that there would not have been any periodic or exit charges prior to the payment of the death benefits because the death benefits were held subject to a registered pension scheme which is exempt from these charges (section 58 IHT Act 1984). Professional guidance is likely to be necessary in connection with the potential IHT charges in the more substantial and/or complex cases.

The maximum liability will be 6% of the value of the trust property in excess of the available nil rate band at the ten-year anniversary but frequently it will be much less or even nil.

In cases where the Settlor has not made any chargeable transfers in the 7 years before he joined the SIPP or earlier pension scheme (as appropriate), no payments have been made out of the Trust in the previous 10 years and there has been no added property, there will be no liability provided the value of the Trust at the time of the periodic charge does not exceed the nil rate band applicable at the ten-year anniversary. Any excess over the then nil rate band will suffer IHT at an effective rate of 6% with a credit for any time during that ten-year period that the property was still in the SIPP.

Example - Frank

Frank, who had made no previous chargeable lifetime transfers at that time, joined his pension scheme on 5 October 1992 and transferred benefits to a London & Colonial SIPP. On 1 May 2011 Frank establishes a By-Pass Trust with a nominal gift of £10. He signs a letter of wishes requesting the pension scheme administrator to pay any death benefits to the By-Pass Trust. Frank dies on 1 October 2011. The scheme administrator exercises their discretion to pay death benefits to a separate discretionary trust (ie. the London & Colonial By-Pass Trust) on 5 October 2011. For IHT purposes there are in effect two discretionary trusts, one established on 1 May 2011 for £10 and one established when Frank joined the pension scheme. However, HMRC will ignore the discretionary trust for the nominal amount for IHT purposes.

The first ten-year anniversary charge on the trust of Frank's pension scheme benefits would have arisen on 5 October 2002 but at that time the death benefit had no value (because Frank was still alive) and, in any event, because Frank was still a member of the pension scheme the exemption in section 58 IHT Act 1984 would apply.

The second ten-year anniversary charge will arise on 5 October 2012. If the value of the trust fund on 5 October 2012 is £390,000, with the nil rate band then £325,000, the IHT charge would be £65,000 @ 6% and so equal £3,900. This equates to 1% of the total value of the trust fund. However, this rate would be reduced to take account of the fact that during the ten-year period, the property in the trust was only outside the pension scheme for 4 out of the previous 40 quarters, namely from 5 October 2011 to 5 October 2012. The rate would be 4/40ths of 1% and would therefore be 0.1%. The IHT payable at the ten-year anniversary would therefore be £390,000 at 0.1% which equals £390.

Numerically the IHT would be calculated as follows:-

£65,000 @ 6% x 4/40 (the period of time the trust property has been relevant property).

The IHT charge would therefore be £390.

So the main rate of 1% has been reduced to 0.1% to reflect the period of time the death benefits were 'inside' the pension scheme (and not subject to IHT).

Where the member has benefits from more than one pension scheme he should complete the form "Details of Original Pension Schemes" to help the trustees calculate inheritance tax at the ten-yearly anniversaries or when property is paid out of the Trust.

(b) Exit charge

The calculation of an exit charge depends on when the property leaves the Trust (ie. when the exit occurs).

(i) Exit occurring after a ten-year anniversary

If the exit occurs after a ten-year anniversary, when a periodic charge arose, the exit charge is based on the rate of IHT paid at that last periodic charge with no discount in the rate for the period of time the trust fund was not relevant property in the previous 10 years.

Example:

Frank's trustees distribute £200,000 from the trust fund on 5 October 2014

The tax charge is

£200,000 @ 1% x 8/40 = £400

Two points should be noted here:-

- (i) *The amount of any exit charge occurring after the first 10 years will depend on the rate of IHT charged at the last ten-year periodic anniversary (if any) but disregarding any reduction in the rate on account of the fact that the property in the trust was not relevant property for the whole of the prior ten years and the length of time (in quarters). This means that the rate applied in the above example is 1%.*
- (ii) *There is a quarterly discount that, in effect, reduces the tax charge by reference to the number of full quarter periods over the ten-year period that the property has been in a discretionary trust since the last ten-year anniversary. Here the property has only been in the trust for 2 years (8 quarters) out of the ten-year (40 quarter) cycle and so the amount of tax payable is reduced to 8/40 of the calculated amount.*

(ii) Exit occurring before the first ten-year anniversary after death

Where property is distributed **before** the first ten-year anniversary after death, one might think that no IHT will arise because the rate of IHT payable at the last ten-year anniversary was zero because the benefits held in the pension scheme were not then relevant property. Unfortunately, HM Revenue and Customs does not share this view and, on the basis of sections 69(2)(b) and 69(3) IHT Act 1984, state that a recalculation must be made of the hypothetical tax charge that would have arisen at the last ten-year anniversary using the value of death benefits when they became relevant property (ie. the full value on the member's death). This will establish the notional tax charge at the last ten-year anniversary and the exit charge will be based on that.

Any payments should only be made to the surviving spouse if that spouse can spend the cash. Otherwise it will accumulate in their taxable estate

(c) IHT position of the London & Colonial By-Pass Trust if death benefits are paid to it from several pension schemes

The IHT position of the London & Colonial By-Pass Trust becomes more difficult when the member has accrued benefits under, say, 3 separate discretionary trust based pension schemes with the death benefits under each of those schemes payable to the same discretionary By-Pass Trust. HMRC has confirmed that the property derived from each scheme would, in effect, need to be treated as a separate settlement, each with a separate ten-year anniversary date fixed by reference to the date the member joined each scheme. Therefore, the trust assets will need to be apportioned to each settlement for valuation purposes in order to determine any periodic or exit charges.

How then is section 81 IHT Act 1984 applied where an individual is a member of a personal pension scheme, which has received transferred benefits from a previous occupational scheme? Here HMRC advocates a pragmatic approach. If there are no funds in the recipient pension scheme at the time of transfer, HMRC's view is that there is only one settlement. On the other hand, if the recipient fund did have funds in it at the time of transfer there would be two separate settlements and the trust assets would need to be apportioned (as described above). Professional advice and guidance would be essential.

Exit charges should not arise on loans made by the trustees to Beneficiaries (see below).

Where the member has transferred benefits from other pension schemes to a SIPP he should complete the form "Details of Original Pension Schemes" to help the trustees of the By-Pass Trust calculate inheritance tax at the ten-yearly anniversaries or when property is paid out of the Trust.

(iii) Payments by the trustees to the Beneficiaries (including the surviving spouse after the Settlor's death)

Any payment of trust capital by the trustees of the London & Colonial By-Pass Trust to the Beneficiaries should not give rise to any income tax liability. It is, however, recommended that any such payments should not be made on a regular basis nor should they be of identical amounts so as to avoid any (albeit remote) possibility of an argument that the payments of capital have acquired the character of income with potentially unwanted income tax consequences.

The IHT implications on payments would be as explained for exit charges in (b) above.

Depending on where the trustees invest the cash given to them, there may be capital gains tax implications either on the trustees encashing investments to raise cash to pay to a Beneficiary or transferring assets out of the trust to a Beneficiary, although in the latter case a claim for CGT hold-over relief should be possible if this is a problem.

Where the estate of the surviving spouse is already substantial, but perhaps illiquid, the trustees should consider, as an alternative to an outright appointment of benefits, making a loan to the surviving spouse. Such a loan would normally be interest-free and repayable on demand.

To the extent that such a loan remains outstanding on the death of the borrower, there will be a corresponding liability for repayment on the estate of the "borrowing" Beneficiary, which will have the effect of reducing that Beneficiary's estate for inheritance tax purposes. The exception to this would be when the funds originated from that Beneficiary, e.g. if they originally made gifts to the member/Settlor whilst the member/Settlor was alive. In such cases section 103 Finance Act 1986 precludes the debt from reducing the borrower's estate to the extent of the amount(s) gifted.

(v) Death of a Beneficiary

As no Beneficiary is actually entitled, or deemed to be entitled, to anything until the trustees make an appointment, the death of a Beneficiary has no IHT implications for this Trust.

(vi) Reporting requirements

Certain facts, such as the value of the trust property on ten-year anniversaries and capital payments to the Beneficiaries, may also have to be reported to HM Revenue & Customs on forms 100, 100c or 100d and form D34 (if a life assurance policy is involved) even if no actual tax liability arises. However, no reporting is required if the sole asset of the Trust is the nominal sum.

(3) Income tax and CGT implications of the London & Colonial By-Pass Trust following the death of the Settlor (after receipt of pension death benefits)

(i) Income tax

Assuming the initial asset of the Trust is only £10 and this does not produce any income, no income tax implications should arise until the death benefits are paid to the trustees of the By-Pass Trust.

It is thought that in most cases the reason for paying the lump sum death benefits from the SIPP to the By-Pass Trust would be to enable medium to long term investment of the fund with the trustees being able to distribute amounts to Beneficiaries as and when required. The London & Colonial By-Pass Trust is not appropriate if the cash is to be immediately distributed to a Beneficiary following receipt by the trustees of the By-Pass Trust.

Following receipt of the death benefits and investment of this by the trustees, the following income tax implications will arise:-

- For income tax purposes, the trustees are treated as the owners of the trust assets and are assessed to income tax on any trust income (e.g. dividends or interest). The trustees currently pay tax at a special trustee rate which is either 42.5% (on dividends) or 50% (on other income). However, the first £1,000 of gross income in a tax year is taxed only at a “standard rate” which is 20% or 10% depending on the type of income received. This means that no additional tax is payable by the trustees on income falling within this band if income is received with a tax credit, eg. UK interest or dividends. The £1,000 standard rate band is reduced if the Settlor has created more than one settlement.
- If income exceeds the £1,000 standard rate band limit and the trustees accumulate it they will have a credit for any tax deducted at source (eg. 20% on interest and a 10% dividend tax credit). This will currently reduce their tax rates to an additional 30% or 32.5% tax, as appropriate.
- Where income is to be distributed to a Beneficiary, the trustees must first have paid 50% income tax on this and give the Beneficiary a credit with the income they distribute. For these purposes, tax already paid will count, but the 10% tax credit on dividend income cannot be taken into account. Before distributing dividend income to a Beneficiary, a further income tax liability will, therefore, arise on the trustees. If it was desired to distribute income to a Beneficiary on a regular basis in the future, these income tax problems could be avoided by the trustees granting an interest in possession to the Beneficiary in question. Professional advice should first be sought.

The Beneficiary will be taxed on the income received from the Trust, grossed up to take account of any tax credit in respect of tax paid by the trustees. Where the Beneficiary is not an additional rate taxpayer, a tax reclaim may be made (but it is not possible to recover the tax credit on dividends).

- An investment by the trustees of the death benefits into a single premium bond may be viewed as an attractive option. A single premium bond is a non-income producing asset and so no natural income arises that may be taxed. Furthermore, it is possible to switch between different investment funds underlying the bond without a tax charge and withdrawals within the annual 5% part surrender allowance are tax-deferred. Of course, thought needs to be given to encashment of the bond as this can give rise to a taxable chargeable event gain at that time.
- Any payment of trust capital to the Beneficiaries of the London & Colonial By-Pass Trust should not give rise to any income tax liability. It is, however, recommended that any such payments should not be made on a regular basis nor should they be of identical amounts so as to avoid any (albeit remote) possibility of an argument that the payments of capital have acquired the character of income with potentially unwanted income tax consequences.

(ii) Capital gains tax

Depending on where the trustees invest the cash received by them, there may be capital gains tax implications, either on the trustees encashing investments to raise cash to pay to a Beneficiary or transferring assets out of the Trust to a Beneficiary, although in the latter case a claim for CGT hold-over relief would be possible if this is a problem.

Any capital gains arising under the London & Colonial By-Pass Trust will be assessed on the trustees. The tax position of the Beneficiaries is irrelevant. The trustees are entitled to their own annual CGT exemption, equal to one half of that available to individuals (ie £5,300 for tax year 2011/12), if the Settlor has created only one trust. If there were more than one trust created by the same Settlor after 6 June 1978, the trustee exemption will be apportioned equally between the trusts but it will not fall below £1,060 per trust.

Any gains arising on the disposal of any chargeable assets held in the Trust that exceed the available annual exemption would give rise to a capital gains tax liability at the rate of 28%.

(4) Loans to Beneficiaries

Generally speaking, it is assumed that if loans are to be made to Beneficiaries they will be made on an interest-free/repayable on demand basis. Loans can be made to any of the Beneficiaries.

There will be no income tax, capital gains tax or inheritance tax implications as a result of such loans leaving aside, of course, any capital gains tax liability that may arise on the disposal of any asset to realise sufficient liquidity to make the loan.

(5) Capital appointments out of the trust

If trust capital is appointed to a Beneficiary there could be an exit charge for inheritance tax purposes (see earlier).

If the capital is appointed in the form of cash there will be no capital gains tax implications or income tax implications on the appointment. However, if the trustees have realised assets to generate the cash, this could give rise to CGT implications.

If assets that are potentially subject to capital gains tax are transferred from the Trust, the transfer of those assets to the Beneficiary would be treated as a disposal for capital gains tax purposes with the capital gains tax liability falling on the trustees at the rate of 28% on any gain arising in excess of the annual exemption. On the basis that this could potentially give rise to an inheritance tax charge at that time, it would be possible to make a CGT hold-over claim to defer any CGT arising at that time.

(6) Gift with reservation rules

As the Settlor may not benefit from this Trust in any circumstances, the IHT gift with reservation rules, introduced by Finance Act 1986 and which apply to certain settlements, will not apply to the London & Colonial By-Pass Trust.

(7) Pre-owned assets tax charge

As the Settlor may not benefit from this Trust in any circumstances, the pre-owned assets income tax provisions introduced by Schedule 15 of the Finance Act 2004, which apply to certain settlements, will not apply to the London & Colonial By-Pass Trust.

Further information

The information contained in this Guide is based on London & Colonial's understanding of taxation, legislation and HM Revenue and Customs' practice as at 6 April 2011, all of which may change with or without notice.

Tax rates and allowances quoted are those for the tax year to 5th April 2012.

The London & Colonial By-Pass Trust Deed is provided on the strict understanding that it is presented as a draft to be considered by the Settlor and his or her legal advisers. Ultimately, its legal and tax effects will depend on the circumstances of each particular case. Accordingly, neither London & Colonial nor any associated or affiliated company nor any of their representatives, officials, employees or professional advisers can accept any responsibility for any loss occasioned as a result of its use in any circumstances whatsoever.

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