

Technical Briefing Note – 21 May 2018

Pension Scheme Death Benefits – Spousal Bypass Trusts

The new pension freedoms introduced in April 2015 have revolutionised how individuals are able to take their pension savings. The new death benefit rules are far more generous than anyone anticipated when the Chancellor first announced in the 2014 Budget that he would look at the 55% charge. The removal of the 55% death tax charge requires a re-appraisal as to how death benefits should be dealt with. From a tax standpoint there is little to recommend taking funds out of a pension if they are not immediately required which may reduce the appeal of a spousal bypass trust. However, if control over the destination of the death benefits is the primary concern a spousal bypass trust still has a vital role.

Using a spousal bypass trust

Most modern pension arrangements are established under a discretionary trust. On joining a pension scheme the member will be provided with an expression of wish form which enables the member to let the scheme administrator know who they would like the lump sum death benefit paid to should the member die before drawing their pension. This is not binding on the administrator who will ultimately decide who is to benefit, but it does provide guidance as to whom the pension scheme member would wish to benefit. The administrator would generally follow the expression of wish unless there had been a significant change in the member's circumstances. In addition to individuals named in the expression of wish letter it is also possible to include any trusts that have been established by the member during their lifetime.

Lump sum death benefits are free from Inheritance Tax (IHT) provided that:

- payment is made within two years of the scheme being notified of the member's death
- the total lump sum death benefit does not exceed the member's lifetime allowance, and
- the discretionary power to distribute the lump sum death benefit rest with the trustees or scheme administrators.

Why use a spousal bypass trust?

On death, an individual's estate is liable to inheritance tax if its value is in excess of the IHT threshold, currently £325,000. The lump sum death benefit from a pension scheme could be substantial and if paid to the member's surviving spouse can create, or increase, the IHT liability on the second death, unless the value of the death benefits is spent before the death of the surviving spouse.

To prevent this, a spousal bypass trust can be established to receive any lump sum death benefits that become payable. The pension scheme rules will need to be checked to ensure that the death benefits can be passed to a trust. In practice a spousal bypass trust is a discretionary trust of which the surviving spouse is a potential beneficiary who may benefit from income or capital of the trust as the trustees see fit. The spouse can, therefore, benefit from the lump sum death benefit without it falling into their estate and becoming subject to IHT.

In addition to the spouse, the trust would include a wide class of other potential beneficiaries which would include children and descendants of the settlor (the person who creates the trust), former spouses, widows, widowers, civil partners, charities, and anyone the member specifically named in the trust.

What is a spousal bypass trust?

A spousal bypass trust is a discretionary trust set up by the pension scheme member during their lifetime. The pension scheme member would write a letter of wishes to the pension scheme administrators nominating the spousal bypass trust to receive any lump sum death benefits that become payable. The trust prevents lump sum death benefits from becoming liable to IHT on the death of the surviving spouse/civil partner. The pension scheme member would write a letter of wishes to the trustees of the bypass trust guiding them as to whom the member would like to benefit in the event of their death.

How it works in practice

With the introduction of the transferable nil rate band, married couples and civil partners now benefit from a joint nil rate band of up to £650,000 on the second death, depending upon the proportion of the nil rate band that was unused on the first death. Transfers between spouses and civil partners are exempt, so if one spouse leaves everything to their surviving spouse there will be no IHT payable on the first death and their nil rate band will not have been used and this can be claimed by the executors on the second death.

No Trust	Trust
	David sets up a spousal bypass trust and writes to his pension scheme nominating the trust to receive the death benefits.
David dies June 2014	
Kate receives the death benefits of £350,000 from the trustees of the pension scheme.	The £350,000 death benefits are paid into the spousal bypass trust.
The family home and other assets are valued at £635,000.	Kate's estate of £635,000 is within her joint nil rate band of £650,000.
Kate's estate is now valued at £985,000.	
Kate dies November 2015	
IHT liability on Kate's death	The spousal bypass trust does not form part of Kate's estate.
Estate £985,000	Estate £635,000
Less nil rate band* <u>£650,000</u>	Less nil rate band <u>£650,000</u>
Taxable estate £335,000	
IHT @ 40% £134,000	The estate is within the nil rate band so no IHT is payable.
IHT Saving £134,000	
*assumes David did not utilise his nil rate band which is transferred to Kate.	

After death of the scheme member

The trustees of the bypass trust can change the beneficiaries and their entitlements as they see fit. They could advance capital to the surviving spouse but if it is not spent it will form part of the estate of the spouse and could become liable to IHT. Alternatively, the trustees can make loans from the trust which will form a debt on the survivor's estate which would have the effect of reducing the size of their estate for IHT purposes. If the surviving spouse was sufficiently wealthy they could use the proceeds of the loan and gift the amount of that loan to beneficiaries of their choice directly, or via a trust, which would fall out of their estate on surviving seven years from the date of the gift. Meanwhile, there would still be an outstanding debt against the spouse's estate reducing its value for IHT purposes.

In addition to the IHT savings a spousal bypass trust can also provide important asset protection measures. In the above example it is possible that Kate could re-marry or enter into a new relationship and her new Will could leave much of her estate to her new spouse or partner. David may prefer that the value of the lump sum death benefits are enjoyed by their children and this can be achieved by using a spousal bypass trust. David can leave a letter of wishes setting out his guidance to the trustees in that regard. If the benefits are left to Kate their destination will be controlled by her Will, or the rules of intestacy if she has no Will.

Continuing to hold the lump sum death benefits in trust will mean that they will not form part of the estate of the beneficiaries and this can further protect the funds in the event of the beneficiaries suffering bankruptcy or divorce. Had the benefits been paid directly to the beneficiaries they could be seized by the trustee in bankruptcy or used in a divorce settlement. It is unlikely that David would have wished for the funds to be used in this manner.

Summary

A spousal bypass trust can eliminate or reduce an IHT liability. It enables trustees to provide for beneficiaries as they see fit, but taking account of the members' letter of wishes. Holding assets in trust provides control and asset protection of the funds from undesirable events.

Should death benefits become payable into a spousal bypass trust, potential tax liabilities may arise on certain later events, such as the ten year anniversary and exit charges when there is a payment of trust capital to a beneficiary. While any liability is likely to be substantially lower than IHT on the equivalent capital, it is important that any future potential liability is understood in advance, and we therefore strongly recommend clients take specialist advice when setting up this type of Trust.

For further guidance please contact us at HFS Milbourne on 01483 468888.