The Nucleus Bypass Trust for use with the Nucleus Pension account

Client guide

Edition 04

Contents

Welcome to the guide for the Nucleus Bypass Trust for use with the Nucleus Pension account. This section explains how the document is structured and defines some of the terms we will be using.

This document consists of five sections:

Important note:

The bypass trust should only be used with the Nucleus Pension account where you (the member) have chosen for the death benefits to be paid solely as a lump sum, under which the scheme administrator 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 Nucleus Pension account holder.

All references to a spouse, widow or widower in this guide should be taken to also refer to a registered civil partner.

In this document all references to member refer to you, as the Nucleus Pension account holder.

The information contained in this client guide is based on Nucleus's understanding of taxation, legislation and HM Revenue and Customs' practice as at 1 April 2018, all of which may change with or without notice.

Tax rates and allowances quoted are those for the tax year to 5 April 2019.

The Nucleus Bypass Trust Deed is provided on the strict understanding that it is presented as a draft to be considered by the settlor and their legal advisers. Ultimately, its legal and tax effects will depend on the circumstances of each particular case. Accordingly, neither Nucleus Financial 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.

1. Introduction – personal pension plans and inheritance tax

1.1 The impact of inheritance tax

Inheritance tax (IHT) can significantly diminish the amount of a person's estate that is inherited on death. On a person's death, IHT generally applies at a rate of 40% to the extent that the value of the deceased's assets (after all available exemptions and reliefs) that are not left to the surviving spouse exceed the available nil rate band. The nil rate band is currently £325,000 and will be fixed at this level until tax year 2020/21.

The spouse exemption is important for IHT purposes. This exemption prevents IHT arising on the transfer of an unlimited amount of assets between UK domiciled spouses. A spouse who is non-UK domiciled can elect to be treated as UK domiciled for IHT purposes. It should be noted that registered civil partners are treated as being married for IHT purposes and any mention of spouse, widow or widower in this guide should be taken to also refer to a registered civil partner.

Any percentage of the nil rate band not used on the death of the first of a married couple to die can be utilised on the survivor's death if that survivor dies after 8 October 2007. While this is a welcome relief, many married couples will find that the value of their combined estates may well still fall into the IHT net.

For married couples, the fact that an individual can leave an unlimited amount of assets to a UK domiciled surviving spouse free of IHT may act as a disincentive for them to carry out any planning to minimise the liability. But, of course, this will cause both sets of assets to be aggregated in the taxable estate of the survivor and, even though two nil rate bands may be available on the survivor's death, any excess value may then be fully exposed to IHT.

An additional nil-rate band may be available when a residence is passed on death to a direct descendant.

This is:

- £100,000 in 2017 to 2018
- £125,000 in 2018 to 2019
- £150,000 in 2019 to 2020
- £175,000 in 2020 to 2021

It will then increase in line with Consumer Prices Index (CPI) from 2021 to 2022 onwards. Any unused nil-rate band will be able to be transferred to a surviving spouse or civil partner.

The additional nil-rate band will also be available when a person downsizes or ceases to own a home on or after 8 July 2015 and assets of an equivalent value, up to the value of the additional nil-rate band, are passed on death to direct descendants.

There will be a tapered withdrawal of the additional nil-rate band for estates with a net value of more than £2 million. This will be at a withdrawal rate of £1 for every £2 over this threshold.

1.2 Pension schemes and IHT

Where you are a member of a registered pension scheme, such as the Nucleus Pension account, substantial benefits can become payable on your death. Pensions are generally free of IHT, except in some circumstances such as a non-discretionary disposal or transfers in poor health where death occurs within two years.

The Nucleus Bypass Trust seeks to overcome this problem. If you, as a member of the Nucleus Pension account, establish a Nucleus Bypass Trust during your lifetime and lump sum death benefits are paid either before you have vested your benefits or while you are in receipt of a drawdown pension, then if the payment is 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 your surviving spouse access to the trust assets.

The trust is called a bypass trust because the pension scheme death benefits are not paid to the surviving spouse and are not part of your taxable estate. Instead, they are paid to a trust under which your family (including your spouse) can benefit. The trust can therefore incorporate flexibility over who benefits under it and, in particular, means that the trustees can pay (or lend) some benefits to your surviving spouse without all of the trust assets forming part of their taxable estate. In other words, only amounts actually paid to your surviving spouse from the bypass trust would be part of their taxable estate and, of course, if those amounts are spent, your surviving spouse's taxable estate will not be increased.

While the bypass trust offers the opportunity for effective IHT planning, it also gives rise to a number of tax implications. Some of these are touched on in this document.

A consequence of the introduction of pensions freedoms is that, in most cases, pension death benefits can pass down through generations, free of inheritance tax, provided they remain within the pensions "wrapper". However at some point wealth will have to leave the pension wrapper to be enjoyed by, and used by, succeeding generations.

On the death of a dependant or nominee the funds pass to a successor nominated by that dependant or nominee rather than to someone nominated by the original member (you). This means that in certain circumstances wealth can pass out of the family. A bypass trust can avoid this loss of control.

2. Payment of death benefits – the general rules

Death benefits can be paid under a personal pension either where a member dies before drawing retirement benefits (i.e. with uncrystallised benefits) or while they are in receipt of retirement benefits. The amount of death benefits payable will depend upon the rules of the scheme and, in the case of retirement benefits, the type of benefit being drawn (e.g. annuity or drawdown pension).

Unused pension funds can be passed to whoever a pension scheme member nominates, whether they are related or not. If the pension scheme member dies before age 75, then there is no income tax to pay on receipt of these benefits. Furthermore, if when the beneficiary subsequently dies and there remains unused pension funds, then these too can be passed onto others (successors).

However, the rules surrounding who these benefits can be passed on to, and the format they may be passed on, are complex.

2.1 The two-year rule

Pension funds have to be designated to beneficiaries within two years from the earliest of the scheme administrator first being notified of the member or subsequent owner's death (or when they could have reasonably known about their death). Otherwise the funds will be taxed as if the member had died after age 75.

2.2 The rules

The tax position of pension death benefits significantly improved from 6 April 2015. The main difference in the tax treatment is if the member, or beneficiary or successor dies before age 75 or after.

	Die before 75	Die after 75
Lump sums if no money has yet been withdrawn (uncrystallised funds)	Tax-free	Marginal income tax The fund can be paid to a trust as a lump sum less a 45% tax charge
Lump sum from drawdown	Tax-free	Marginal income tax The fund can be paid to a trust as a lump sum less a 45% tax charge
Income from drawdown	Tax-free	Marginal income tax

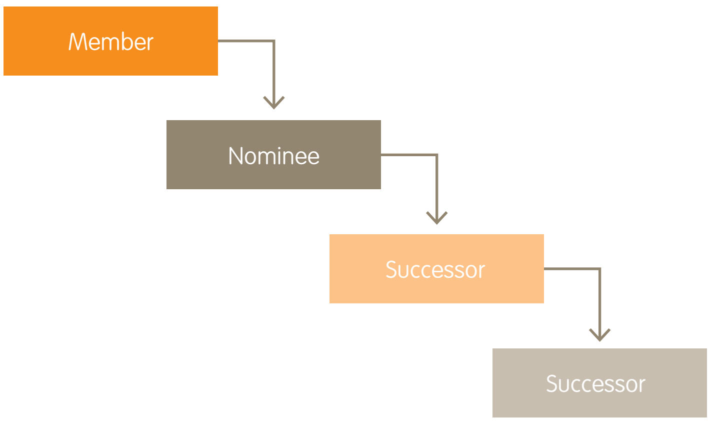
2.3 Dependants, nominees and successors

Under the pension death benefit regime it is possible to pass on death pension benefits – either lump sum or income from either drawdown or annuity – to anyone the member chooses.

Before April 2015, the pension fund could only be inherited by dependants (normally a spouse, partner or a child under 23). Now, the member can choose for a dependant to inherit, or they can choose a 'nominee' – who can be anyone nominated by the individual (even if they are not related to them). If the member made no nomination and there are no dependants, the scheme administrator can nominate an individual to become entitled to the funds.

That beneficiary can also nominate a successor to 'inherit' the pension funds on their subsequent death. A successor can again be anybody. If no nomination has been made by the beneficiary then the scheme administrator can nominate someone.

If there are any funds still remaining, then it's possible for the successor to nominate yet another successor. Again, this can be anybody. This way it's easy to see how pension wealth can cascade down the generations – or indeed, more widely.



2.4 IHT and pension death benefits

Usually any pension funds are free of inheritance tax (IHT) as they are paid out under the discretion of the trustees or a scheme administrator. If the member dies before age 75 – and the benefits are tax-free – then keeping funds within the pension wrapper is a tax-advantageous way of passing wealth to the client's family.

Even if the member dies after age 75, then the beneficiary's marginal income tax rate may be lower than the IHT tax rate of 40% – for example in the case of grandchildren. Again, keeping the funds within the pension wrapper may mean more money can be passed to the family.

2. Payment of death benefits – the general rules

2.5 Nominating a charity

Any benefits paid to a registered charity are always tax free. A charity lump sum can only be paid where there are no surviving dependants of the member. If the lump sum is being paid because of the death of a beneficiary it must be paid to either:

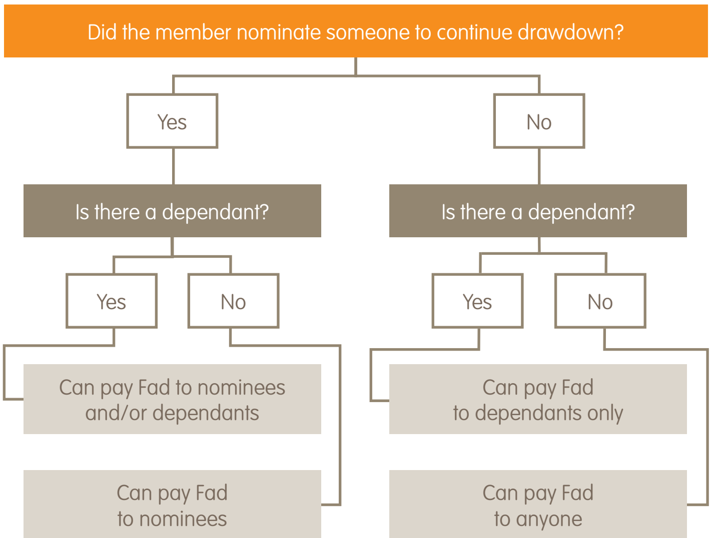
- a charity selected by the member or,
- if the member had not chosen a charity, a charity selected by the beneficiary.

The scheme administrator cannot choose the charity receiving the payment.

2.6 The importance of nomination

One of the most appealing aspects of pension savings is that on death they usually sit outside the estate when calculating inheritance tax. This is because pension schemes are set up as discretionary trusts. Therefore, when a pension scheme member dies they cannot dictate who receives unused pension funds, instead the scheme administrator has the discretion to decide who the beneficiary(ies) or successors are.

However, the member (or beneficiary/successor) can express their wishes about who should inherit pension funds, and, because of the tax rules, it's important that they complete a nomination form. If they do not nominate someone, then the scheme administrator may not be able to pay pension income to that person – particularly if there is a dependant:



It's important to remember, the scheme administrator always has discretion as to who the benefits should be paid. And that they always retain the discretion to pay a lump sum to anyone regardless of who has been nominated and whether there are any dependants.

Members should make sure they keep their nomination (or expression of wish) forms up-to-date. It's important they nominate who they want to receive benefits. Giving a percentage split of how the funds are distributed is not as important – but recording the names of who they wish to benefit is.

2.7 Age 75

The tax treatment of death benefits changes depending on whether the member (or beneficiary or successor) dies before the age of 75 or after. If they die before, then (usually) there will be no income tax paid on the pension funds passed on. But if they die after age 75 the beneficiary or successor may have to pay income tax (at their marginal rate of tax).

As they approach their 75th birthday, members (and beneficiary(ies) and successors) will want to review their nominations of who will inherit pension funds, and possibly make changes to mitigate tax paid.

3. The benefits of using the Nucleus Bypass Trust to receive death benefits

The aim of the Nucleus Bypass Trust is to provide a flexible structure to receive death benefits from a Nucleus Pension account which can provide for the payment of those benefits to a wide range of beneficiaries including your widow/er and dependants. Where you have elected for a lump sum to be paid, have declared a bypass trust and completed a nomination form the scheme administrator may exercise their discretion to pay death benefits to the trustees of the bypass trust.

The Nucleus Bypass Trust can continue for a maximum period of 125 years. However, if benefits have previously been transferred to the Nucleus Pension account from other schemes that you joined before 6 April 2010, the trusts of these benefits may cease 21 years from the date of your death. All payments made to the bypass trust from the pension account should be free from IHT. There could be an IHT charge on a later payment out of the bypass trust to a beneficiary.

Your surviving spouse (as widow or widower) will be one of the discretionary beneficiaries under the trust and the trustees (of whom the surviving spouse could be one) can make appointments of trust capital, if necessary, to the surviving spouse without the trust fund being treated as forming part of the estate of the surviving spouse.

The trustees have power to grant interest-free loans to a beneficiary (including the surviving spouse) and this can represent a particularly attractive IHT planning opportunity.

By setting in place arrangements so that death benefits could be paid to the Nucleus Bypass Trust, you can therefore achieve several advantages as follows:

(a) As well as providing scope for future IHT saving, where death benefits are paid to a bypass trust it will then be the trustees of that bypass trust who decide which person benefits in the future. The use of a separate personal bypass trust to receive the death benefits under the Nucleus Pension account therefore gives you more control over who is to ultimately benefit under the trust, in that it will be the trustees as selected by you, and not the scheme administrator, who will be making the decision as to who benefits on a distribution of capital from the trust.

(b) To give maximum flexibility over who can benefit, a discretionary trust can be used. In this respect the use of such a personal bypass trust will give greater continuing flexibility than a disposal of death benefits direct to beneficiaries via the scheme administrator, and will also prevent the death benefits being consolidated in the estate of the beneficiary, for example your surviving spouse.

(c) Problems may sometimes arise where it is desired to make payments to children/grandchildren who are minor beneficiaries because, in such cases, it would normally be appropriate for the scheme administrator 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 bypass trust established during your lifetime can avoid this problem.

4. Some questions on the Nucleus Bypass Trust

(i) What is the Nucleus Bypass Trust?

The Nucleus Bypass Trust is a discretionary trust, which you, as the member of the Nucleus Pension account, establish during your lifetime. Then, provided you have elected for a lump death benefit and indicated that you would like the benefit paid to your trustees, the scheme administrator of the pension account can exercise their discretion to pay the lump sum death benefit to the trustees of the bypass trust.

The trustees of the bypass trust can then, at their discretion, pay benefits to your surviving spouse (if appropriate) during the remainder of their lifetime but without the remaining (unpaid) lump sum death benefit forming part of your surviving spouse's taxable estate. The idea is that lump sum benefits payable on your death before pension benefits have commenced (or during a period of unsecured pension/income drawdown) could be paid into this trust rather than directly to a beneficiary, such as your surviving spouse. Those death benefits will then, in effect, 'bypass' the surviving spouse's taxable estate for IHT purposes.

It is reiterated that, under the Nucleus Pension account, the payment of the death benefits to the trustees of the bypass trust depends on the pension account scheme administrator exercising their discretion to make such a payment. Provided you have indicated that you would like the scheme administrator to pay the death benefits to the trustees of the bypass trust, it is likely that the scheme administrator will follow your wishes unless they find compelling reasons not to.

(ii) How is the Nucleus Bypass Trust established?

The Nucleus Bypass Trust is established during your lifetime 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 your death when the pension account 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 IHT planning with lifetime gifts should use a separate trust and establish it after creating the bypass trust.

Once the Nucleus Bypass Trust is established, it is then in place to receive the payment of any death benefits under the Nucleus Pension account by the scheme administrator on your death.

(iii) What is the nature of the Nucleus Bypass Trust?

The trust is a discretionary trust, which gives the trustees wide powers to appoint benefits to discretionary beneficiaries. The trust requires you, as 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 your children as default beneficiaries. Alternatively, a charity could be named.

Your widow(er), as well as your children, grandchildren and other specified individuals, are named among the discretionary beneficiaries.

To avoid adverse tax consequences during the settlor's lifetime, neither you as the settlor nor your spouse may benefit from the trust in any way. However, the settlor's widow/widower can.

The trustees also have power to lend funds, interest free, to a beneficiary. The power to lend may give the opportunity to reduce IHT by creating debts for IHT purposes on the estate of, say, your surviving spouse 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 bypass trust, payment by the trustees to the beneficiary by way of loan rather than by way of capital appointments would probably be preferable from an IHT standpoint.

(iv) What is the purpose of the nomination to the scheme administrator?

When you set up a Nucleus Bypass Trust it is envisaged that you will first make an election for death benefits to be paid as a lump sum. You should then propose the trustees of the Nucleus Bypass Trust as possible recipients of death benefits. This, of course, assumes that you would not wish death benefits to be paid directly to your surviving spouse, dependants or other beneficiary(ies) under the trust or rules of the pension account. The implications of such payments will be explained to the member by their financial adviser.

It is important to note that the scheme administrator 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.

4. Some questions on the Nucleus Bypass Trust

(v) How is the member's nomination to trustees of the Nucleus Bypass Trust made?

You will be the settlor of the bypass trust. Having established it, you would normally complete a letter of wishes to indicate to the trustees of the Nucleus Bypass Trust the person you would wish them to consider as the primary beneficiary under the trust. This would usually be your 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'. While the nomination would not bind the trustees, they would normally act in accordance with it.

(vi) Why is the bypass trust a discretionary trust?

New lifetime trusts, other than bare trusts and certain other trusts, 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 your death, which means that until that time the usual IHT charging regime and the reporting requirements will not have any practical application.

However, it is important to remember that once the pension account death benefits are paid to the trustees of the bypass trust, this trust will then hold substantial assets on which there ay be an IHT charge.

(vii) What are the income tax implications of a discretionary bypass trust?

Prior to age 75, the lump sum death benefits will generally be paid with no deduction of tax (subject to available Lifetime Allowance) where it is paid within 2 years of the scheme becoming aware of the member's death.

Post age 75, the lump sum death benefits will be paid to the trust net of a 45% special lump sum death benefit tax charge. To the extent that subsequent payments of capital to the beneficiary are attributable to the pension lump sum death benefits, the 45% tax charge deducted by the pension scheme trustees will be available as a credit to frank the income tax liability. This credit is reclaimable by the beneficiary to the extent that their marginal tax rate is lower than 45%.

5. The Nucleus Bypass Trust provisions in detail

For tax purposes, the Nucleus Bypass Trust is a discretionary trust. The trust gives the trustees power to appoint benefits under the trust among a wide class of beneficiaries. No beneficiary is entitled to any benefit until the trustees so decide – the ultimate default beneficiaries named in the trust will benefit only if no other appointment has been made by the end of the trust period which will not be earlier than 21 years from your death as settlor (and pension account member).

The following is a summary of the key provisions of the Nucleus Bypass Trust deed.

Part 1 – The trust declaration

The deed is executed by the settlor and the named additional trustees. It is assumed that the settlor will establish the trust with a nominal amount, say, £10.

It is recommended that the settlor should appoint at least two additional trustees to ensure that there are two trustees able to act upon the death of the settlor.

Part 2 – Definitions

In this part of the trust the terms used throughout the trust are defined to avoid repetition. The most important definitions are those of the discretionary beneficiaries and the default beneficiaries.

The discretionary beneficiaries are those in whose favour the trustees may make appointments of benefits. They include the widow or widower of the settlor, the children and the remoter issue of the settlor, your spouses, the brothers and sisters of the settlor, and your issue, anybody who would benefit from the estate of the settlor on the settlor's death, any person nominated in writing to the trustees by the settlor, as well as any charity. The settlor can add any other individual not covered by the standard wording. The settlor's spouse is not a beneficiary while the settlor is alive but the settlor's widow/widower is.

The class of discretionary beneficiaries is very wide and can be added to by the settlor – all that is necessary is a written notification to the trustees. However, the settlor and the settlor's spouse cannot be added as a class at any time.

The default beneficiaries are the individuals who will benefit if the power of appointment is not exercised by the trustees by the end of the trust period which will not be less than 21 years from the date of death of the settlor (the pension account member). They are named by the settlor in the trust deed. At least one person must always be named and, if more than one is named, the shares in which they are to benefit must be stated. This is necessary to ensure that the trust is valid. It is essential that, where more than one default beneficiary is named, the cumulative shares add up to exactly 100%, as otherwise adverse tax consequences may arise to the trust.

Part 3 – Principal trust terms

In this part the trustees' power of appointment is defined as well as the default entitlement if the power of appointment is not exercised by the end of the trust period.

As previously indicated, the power to appoint capital and income under the trust is vested in the trustees. The power is exercisable at the trustees' discretion and includes the power to appoint further trusts in favour of beneficiaries.

The trustees have power to accumulate any trust income for the period, which is appropriate to the benefits held within the trust. This will not be less than 21 years from the date of the death of the settlor.

In default of appointment by the end of the trust period, the default beneficiaries will benefit.

There is also a special provision dealing with any potential conflict of interest. In many cases, the trustees of the trust would be members of your family who would also be beneficiaries under the trust. If an appointment of benefits were to be made in favour of a beneficiary who is also a trustee then a suspicion of conflict of interest could arise. For this reason, there is a provision in this trust which states that if a beneficiary is also one of the trustees, the trustees can only make an appointment in favour of that beneficiary if there is at least one other trustee who does not benefit directly or indirectly from the appointment being made.

The trustees have wide powers included in the trust to advance capital from the trust fund to beneficiaries and to make loans to beneficiaries. These loans can bear interest or be interest free. A loan may be more appropriate than an advance of capital in many circumstances.

Part 4 – Administrative provisions

The trustees have wide administrative powers to deal with the trust fund and to reinvest the proceeds of any investment in any way they wish. They also have the power to borrow funds, to make payments to parents or guardians of minor beneficiaries and to delegate certain powers.

5. The Nucleus Bypass Trust provisions in detail

Part 5 – Appointment, dismissal, retirement and remuneration of trustees

The trust contains comprehensive provisions applying to the trustees.

The power to appoint new or additional trustees is vested in the settlor during their lifetime and after their death in the trustees. The settlor also has power to dismiss any trustee, provided at least one trustee, other than the settlor, remains after such a dismissal.

There is no power to dismiss a trustee after the death of the settlor, and it must be remembered that trustees under an English trust must act unanimously. There are also powers dealing with the retirement of trustees and corporate trustees.

Trustees who act in their professional capacity are entitled to charge fees.

Part 6 – Further trust provisions

These mainly deal with the trustees' liability.

The liability of individual trustees is limited so that they will not be held liable for any loss to the trust fund, provided they act in good faith. Trustees who are paid for their services are also liable for negligence.

Part 7 – Proper law

The trust is governed by the law of England and Wales.

Part 8 – Signatures

Here you (as settlor) and the trustees sign the trust deed and all signatures are witnessed.