For adviser use only

nucleus

Nucleus Discretionary Bypass Trust for use with the Nucleus Pension account

Adviser guide

Edition 04

Contents

This document consists of five sections:

Important note:

The bypass trust should only be used with the Nucleus Pension account where the member has 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 discretionary trust for the benefit of the member's relatives.

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

In this document all references to a member refer to the Nucleus Pension account holder.

The Nucleus Discretionary 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 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

Where a person is a member of a registered pension scheme, such as the Nucleus Pension account, substantial lump sums can become payable on their death. Whilst this is good for the recipient's beneficiary(ies), unless the cash is spent during the beneficiary's lifetime then on that beneficiary's subsequent death it could potentially be subject to IHT. This problem is just as relevant 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.

If a pension account member establishes a bypass trust during their lifetime and lump sum death benefits are paid (either before a member has vested their benefits or while they 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 the member's surviving 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 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 surviving spouse's taxable estate.

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

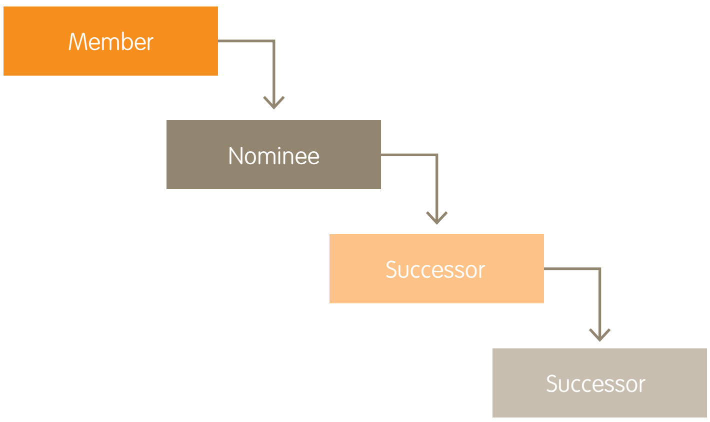
2.3 Dependants, nominees and successors

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:

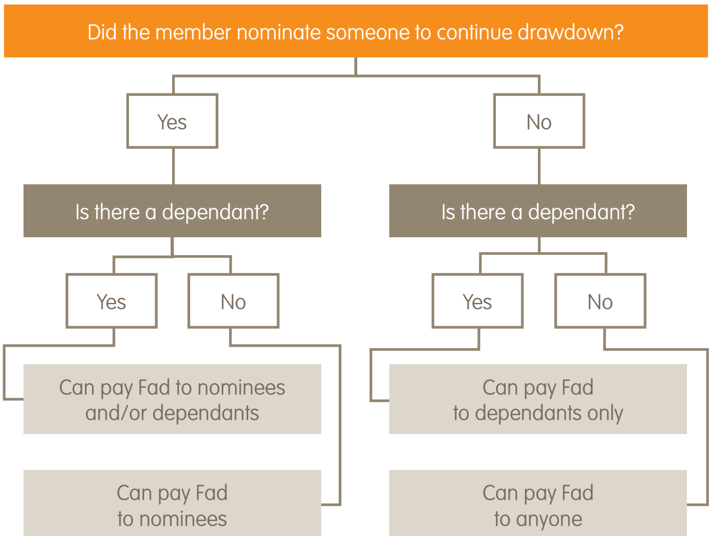
- a charity selected by the member or,
- if the member had not chosen a charity, a charity selected by the beneficiary.

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 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. An overview of the Nucleus Discretionary Bypass Trust

By setting in place arrangements so that death benefits could be paid to a separate bypass trust (such as a Nucleus Discretionary Bypass Trust), the member can secure several advantages.

As well as providing scope for future inheritance tax saving, because the scheme administrator can (at their discretion) then pay lump sum death benefits to a bypass trust, it will then be the trustees of that bypass trust who decide who receives benefits in the future. The use of a separate bypass trust in respect of the death benefits under the Nucleus Pension account therefore gives the member more control over who is to ultimately benefit under the trust, in that it will be the trustees of that bypass trust, and not the scheme administrator, who will be making the decision as to who benefits on a distribution from the trust fund.

To give maximum flexibility over who can benefit, a discretionary trust can be used for the Nucleus Bypass Trust. In this respect, the use of such a discretionary bypass trust will give greater continuing flexibility and control than a disposal of death benefits direct to beneficiaries via the scheme administrator.

In the case of the Nucleus Pension account, where the member dies having established a bypass trust and having elected for a lump sum death benefit to be paid, then if the member has indicated in a nomination form that the scheme administrator should consider paying the death benefits to the trustees of the bypass trust, the scheme administrator would normally comply with that wish. A subsequent payment out by the bypass trustees – even if a short time afterwards – could give rise to an exit charge for IHT. Therefore, in a case where it is likely that there will be an early distribution of all the benefits directly to an individual beneficiary, it will be worthwhile for such a payment to be made direct to that beneficiary or those beneficiaries by the scheme administrator within two years of the member's death.

Problems may sometimes arise where it is desired to make payments to minor beneficiaries. This is 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 the member's lifetime can avoid this problem.

We will now consider the Nucleus Bypass Trust in more detail through a series of appropriate questions.

4.1 What is the Nucleus Bypass Trust?

The Nucleus Bypass Trust is a discretionary trust to which death benefits can be paid in respect of a member of the Nucleus Pension account. The trustees of that bypass trust 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 for IHT purposes. The idea is that lump sum benefits payable on the member's death before pension benefits have commenced (or during a period of pension/drawdown) could be paid into this trust should the scheme administrator exercise their discretion to make such a payment to the trustees of the bypass trust. 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 scheme administrator of the Nucleus Pension account exercising their discretion to make such a payment. Provided the member has elected for death benefits to be paid solely as a lump sum and has indicated in any nomination form that they would like the scheme administrator to consider paying the death benefits to the trustees of the bypass trust, it is likely that the scheme administrator will follow the member's wishes unless they find compelling reasons not to.

4.2 How is the Nucleus Bypass Trust established?

The Nucleus Bypass Trust is established during the lifetime of the pension account 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 (the member) 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 trustees 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 the member's death.

4. An overview of the Nucleus Discretionary Bypass Trust

4.3 What type of trust is the Nucleus Bypass Trust?

The trust is a discretionary trust, which gives the trustees wide powers to appoint benefits to discretionary beneficiaries. The pension account member will declare the trust during their lifetime and so become the settlor of the trust. The trust document 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 tax consequences during the settlor's lifetime, (only relevant if larger amounts are held in trust), 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. For these reasons it is not recommended that the bypass trust is used to transfer substantial funds from the settlor or the settlor's spouse during their lifetimes.

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 bypass trust, it may be preferable, from an IHT standpoint, for it to be by way of loan rather than by way of capital appointments by the trustees. The loans should, of course, be spent by the surviving spouse if IHT is to be reduced.

A minimum of two trustees is required to make an appointment of benefits or to exercise a power under the trust (e.g. 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.

The 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.

4.4 Nomination of pension death benefits

Where a member of a Nucleus Pension account wants the death benefits to be paid as a lump sum to a Nucleus Bypass Trust that the member has already created, the following action should be taken:

(a) The member should indicate, on a nomination form, to the Nucleus scheme administrator that the member wishes their death benefits to be paid solely as a lump sum.

(b) The member should indicate, on a nomination form, to the Nucleus scheme administrator that the member would like them to consider paying the death benefits under the member's scheme to the trustees of the Nucleus Discretionary Bypass Trust. In order to ensure that such benefits pass free of IHT to the bypass trust the payment must be made at the discretion of the scheme administrator of their Nucleus Pension account. There can be no guarantee that the scheme administrator will follow the member's wishes, but they will normally do so.

This, of course, assumes that the pension account member would not wish death benefits to be paid directly to the surviving spouse, dependants or other beneficiary(ies) under the pensions account 's trust or rules.

4.5 Letter of wishes to trustees of the Nucleus Bypass Trust

The pension account member will be the settlor of the bypass trust. The member would normally complete a letter to indicate to the trustees of the Nucleus Discretionary Bypass Trust who should be considered as the primary beneficiary(ies). This could be the settlor's spouse in their capacity as widow/widower under the trust. Whilst the expression of wish within the letter would not bind the bypass trust trustees, it is thought that they would normally act in accordance with it.

4.6 Why is the bypass trust a discretionary trust?

Following changes made in the Finance Act 2006, all 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 the bypass 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.

Discretionary trusts are subject to the relevant property regime for inheritance tax purposes. IHT periodic and exit charges could apply however these charges cannot exceed 6% of the trust fund.

4. An overview of the Nucleus Discretionary Bypass Trust

4.7 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 Nucleus Discretionary Bypass 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.

4.7.1 The Nucleus Pension account

The Nucleus Pension account is governed by a trust that is subject to the law of Scotland. Under the law of Scotland there is no perpetuity period. There is also an accumulation period of 21 years. This means that if a member becomes a member of the Nucleus Pension account and pays contributions (as opposed to just transferring benefits) they will be treated as creating a trust of the benefits representing those contributions and that trust will be subject to the law of Scotland. That 'individual' trust will therefore have no perpetuity period and a 21 year accumulation period.

4.7.2 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 (i.e. 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 will take account of when the member was deemed to create a trust (under English law) and whether the pensions trust was subject to the law of Scotland.

This means that in cases where lump sum death benefits are paid to the trust, the rules that apply to the perpetuity period and accumulation period 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 IHT calculation purposes at the 10-year periodic charge anniversaries. 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 benefits).

5. The taxation implications of the Nucleus Discretionary Bypass 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.

5.1 On execution of the Nucleus Bypass Trust

The member of the pension account would normally establish a Nucleus Discretionary Bypass Trust. They would therefore be the settlor. The inheritance tax implications would be as follows:

5.1.1 Gift to trust

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 and be exempt from IHT.

It is recommended that the Nucleus Discretionary Bypass 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 IHT 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 seven 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 seven years of making the transfer although IHT taper relief will be available if the settlor survives for at least three years. On the settlor's death within seven years of making the gift, the full value of the gift will also be taken into account in determining the IHT liability on the settlor's estate passing under their will or the laws of intestacy.

Additional later gifts to the bypass 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. 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.

5.2 IHT implications whilst the trust is in existence

In what follows it is assumed that the Nucleus Discretionary Bypass Trust is established with a nominal amount and no additional gifts are made to it by the settlor whilst alive.

5.2.1 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.

5.2.2 Payment of the death benefit to the Nucleus Discretionary Bypass Trust

The payment of the death benefit from the Nucleus Pension account to the bypass trust will be an additional payment to the trust. There should be no immediate IHT implications on the payment of death benefits to the bypass trust.

It should be noted that if the trustees of the bypass trust then distribute benefits to an individual beneficiary, there could be an IHT exit charge. If the trustees contemplate making an 'early' payment to an individual beneficiary, it may be more IHT efficient for the scheme administrator to make this direct rather than pay it into the trust.

5.2.3 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 10-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"

5.2.4 Periodic charge

Periodic charges at 10-yearly intervals may be applied to the value of the assets in the trust. The rate of IHT 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 10-year anniversary plus the value of any related settlements (i.e. same-day settlements) when they were established (the assumed transfer); and
- the settlor's seven year cumulative total immediately before they 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).

5. The taxation implications of the Nucleus Discretionary Bypass Trust

In this respect it is important to note that if the lump sum death benefit originates from a pension plan which is subject to a discretionary trust (as opposed to a deed poll when different rules will apply), HMRC 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 10-year periodic charge (and exit charge) which commenced when the first trust began. As the member will be treated as creating their own trust when they 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 pensions account, if there have been no transferred benefits, or
- the member joined the pension scheme from which benefits were transferred to the Nucleus Pension account.

In such cases there could, in effect, be two discretionary trusts for IHT purposes if the member transferred benefits to the pension account and then paid further contributions to it. Therefore it will be necessary to determine the chargeable transfers the settlor made in the seven years before he/she joined the pension account or transferring scheme, if earlier, in order to calculate the amount of any periodic charge.

In theory, because the Nucleus Discretionary Bypass Trust consists of property derived from both the pension account lump sum death benefits and the £10 property originally used to establish the trust, there could be different 10-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 at the 10-year anniversary but frequently it will be much less or even nil.

In cases where the settlor (i.e. the member) has not made any chargeable transfers in the seven years before they joined the pension account 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 10-year anniversary. Any excess value over the then nil rate band will suffer IHT at a rate of 6% with a credit for any time during that 10-year period that the property was still in the pension account.

5.2.5 Exit charge

The calculation of an exit charge depends on when the property leaves the trust (i.e. when the exit occurs).

(a) Exit occurring after a 10-year anniversary

If the exit occurs after a 10-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.

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 10-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 previous 10 years and the length of time (in quarters).

(ii) There is a quarterly discount that, in effect, reduces the tax charge by reference to the number of full quarter periods over the 10-year period that the property has been in a discretionary trust since the last 10-year anniversary.

(b) Exit occurring before the first 10-year anniversary after death

Where property is distributed before the first 10-year anniversary after death (but more than 10 years after the individual has been a member of the current or present pension scheme), one might think that no IHT will arise because the rate of IHT payable at the last deemed 10-year anniversary was zero on the basis that the benefits were then held in the pension scheme and were not therefore relevant property. Unfortunately, HMRC 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 10-year anniversary using the value of death benefits when they became relevant property (i.e. the full value on the member's death). This will establish the notional tax charge at the last 10-year anniversary and the exit charge will be based on that.

5. The taxation implications of the Nucleus Discretionary Bypass Trust

(c) IHT position of the Nucleus Discretionary Bypass Trust if death benefits are paid to it from several pension schemes

The IHT position of the Nucleus Discretionary Bypass Trust becomes more difficult when the member has accrued benefits under more than one pension scheme. Say, the death benefits were paid under three separate discretionary trust-based pension schemes with the death benefits under each of those schemes payable to the same discretionary bypass 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 10-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 the Nucleus Pension account they should complete an appropriate form to help the trustees of the bypass trust calculate IHT at the 10-yearly anniversaries or when property is paid out of the trust.

(d) 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 Nucleus Discretionary Bypass 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 IHT purposes provided the loan is fully repaid on death. 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.

(e) 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.

(f) Reporting requirements

Certain facts, such as the value of the trust property on 10-year anniversaries and capital payments to the beneficiaries, may also have to be reported to HMRC.

5. The taxation implications of the Nucleus Discretionary Bypass Trust

5.3 Special Lump Sum Death Benefits Charge

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%.

5.4 Income tax and CGT implications of the Nucleus Discretionary Bypass Trust following the death of the settlor (after receipt of pension death benefits)

5.4.1 Income tax

It is thought that in most cases the reason for paying the lump sum death benefits from the pension account to the bypass 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 Nucleus Discretionary Bypass Trust is not appropriate if the cash is to be immediately distributed to a beneficiary following receipt by the trustees of the bypass 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 38.1% (on dividends) or 45% (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 7.5% 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. The £1,000 standard rate band is reduced (to a minimum of £200) if the settlor has created more than one settlement.

- If grossed-up 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.

- Where income is to be distributed to a beneficiary, the trustees must first have paid 45% income tax on this and give the beneficiary a credit with the income they distribute. For these purposes, tax already paid will count. 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 the same beneficiary(ies) 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(ies) in question. Professional advice should 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.

- An investment by the trustees of the death benefits into a single premium investment bond may be viewed as an attractive option. A single premium investment bond is a non-income producing asset and so no natural income arises that may be taxed. In addition, 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. 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 Nucleus Discretionary Bypass 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.

5. The taxation implications of the Nucleus Discretionary Bypass Trust

5.4.2 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 Nucleus Discretionary Bypass Trust will be assessed to tax 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 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 £1,170 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 20% (or 28% where the gain is on residential property).

5.5 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 IHT implications as a result of such loans leaving aside, of course, any CGT liability that may arise on the disposal of any asset to realise the cash to make the loan.

5.6 Capital appointments out of the trust

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

If the capital is appointed in the form of cash there will be no CGT 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 CGT are transferred from the trust, the transfer of those assets to the beneficiary would be treated as a disposal for CGT purposes with the CGT liability falling on the trustees at the rate of 20% (or 28% where the gain is on residential property) on any gain arising in excess of the available annual exemption. On the basis that this could potentially give rise to an IHT charge at that time, it would be possible to make a CGT hold-over relief to defer a tax charge on any chargeable gain arising on the disposal.

5.7 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 Nucleus Discretionary Bypass Trust.

5.8 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 Nucleus Discretionary Bypass Trust.

Important note

The information contained in this guide is based on Nucleus' understanding of taxation, legislation and HMRC's 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.

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