



the bypass  
trust for **business**  
property



# why use the bypass trust?

**The bypass trust arrangement allows your client to take full advantage of 100% business property relief. It can also be used where assets qualify for 100% agricultural property relief.**

Business property relief and agricultural property relief are extremely valuable reliefs for inheritance tax purposes. In most cases the shares or interest in a business will qualify for **100% relief** from inheritance tax without any upper limit.

This means that businesses can be passed on to future generations without any inheritance tax being paid. But many people waste these generous reliefs because the shares or interest in the business is left to a surviving spouse.

This may not cause a problem where the spouse is able and the other owners are willing to allow them to take the place of a partner or shareholder who has died. But where the spouse intends to sell, inheritance tax often has to be paid on the death of the spouse because they now have cash in their estate, instead of shares in the business eligible for business property relief.

The trust is therefore particularly useful if there is a business protection arrangement in place under which the remaining shareholders or partners are likely to buy the shares or interest.

#### Source

<sup>1</sup> [www.hmrc.gov.uk](http://www.hmrc.gov.uk), September 2007.

# £3.5 billion

is the total of inheritance tax receipts in 2006/2007, against £2.2bn in 2000/2001 – an increase of 60%.<sup>1</sup>

# how the bypass trust would work

The following scenario gives two examples to show you firstly what would happen if your client didn't use the trust, and then how it would help them if they did.

A, B and C are all equal shareholders in an unquoted company worth £1,200,000. To provide a smooth buyout for the company's shares, they have each taken out a Bright Grey Business Protection Menu plan for £400,000 on their own lives and placed each policy under a Bright Grey Business trust for their co-shareholders.

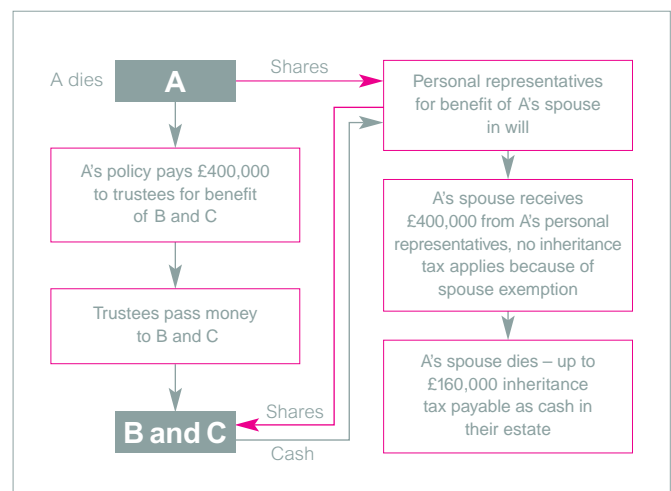
They have then entered into a cross option agreement, which gives the surviving shareholders an option to buy the shares in the business from the personal representatives if one of the shareholders dies.

Similarly the personal representatives have an option to **sell the shares** to the other shareholders. As the business is a trading company and the shares have been held for at least two years, 100% business property relief is available. All the shareholders are married with children and their wills currently leave all of their assets to their surviving spouses.

## What would happen without the bypass trust?

- A dies and the proceeds from the policy on A's life pay out to B and C.
- B and C use these proceeds to buy the shares from A's estate.
- A's personal representatives then pass the cash received to A's spouse.
- No inheritance tax applies because of the spouse exemption.
- However, when A's spouse dies the proceeds from the sale of the shares are part of their estate.
- There is therefore an inheritance tax liability on the death of the spouse of up to £160,000 (i.e. £400,000 x 40%), assuming the money has not been spent and their nil rate band has been used by other assets.

## Example without the bypass trust

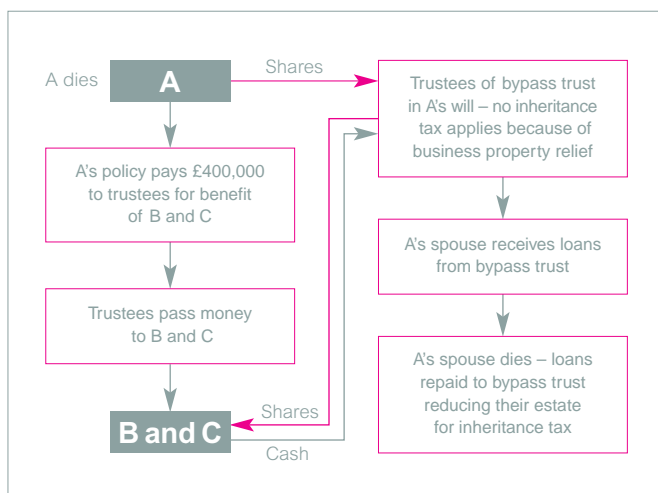


### What would happen with the bypass trust?

A could have established a bypass trust in their will and nominated that the shares in the business should be held in a discretionary trust for the spouse and children. The inheritance tax liability on second death will be as follows:

- A dies and the proceeds from the policy on A's life pay out to B and C as before.
- The personal representatives then transfer the shares to the trustees of the bypass trust to hold in trust for the spouse and children.
- No inheritance tax applies on the transfer to the trust because of the availability of 100% business property relief at the time of A's death.
- B and C use the proceeds to buy the shares from the trust.
- The trustees can use their discretion to pay or lend funds to any of the beneficiaries including A's spouse.
- Since the value of the trust fund will not be treated as part of the spouse's estate, then on their death, the inheritance tax liability on the proceeds from the sale of the shares is nil. Any loans made to the spouse from the trust will also reduce the value of their own estate, as these must be repaid to the trust.

### Example with the bypass trust



# your **questions** answered

**We know that trusts can be complicated.  
We hope the following helps to answer  
some of your questions.**

## **What is the inheritance tax position on A's death?**

No inheritance tax applies on the transfer to the trust because of the availability of 100% business property relief at the time of A's death.

## **How are trust assets used for the benefit of A's spouse?**

As and when A's spouse needs cash from the trust, the trustees, of whom the spouse can be one, can make irrevocable appointments of capital to A's spouse and pay them the necessary cash. Provided these are of irregular amounts and paid at irregular intervals, income tax charges should not arise at that time.

Alternatively, it may be more efficient for the trustees to make loans to A's spouse. These can be **interest free**. If interest is charged on the loan, it will be trust income and liable to income tax in the hands of the trustees.

## **What are the inheritance tax implications of appointments to A's spouse?**

Appointments within two years of A's death will be exempt because of the revert to settlor's widow(er) exemption. Transfers after two years would be appointments out of the trust potentially giving rise to an exit charge.

The amount of the charge in the first 10 years after A died will depend on how much money was transferred to the trust when it was created and how soon after A's death the appointment is made. The charge after the first 10 years will depend on how much tax was charged on the last 10-year anniversary of A's death and how soon after the last 10-year anniversary the appointment is made. The trustees should therefore take advice on how much tax is payable before making an appointment out of the trust.

## **What are the inheritance tax implications of loans to A's spouse?**

A loan or loans to A's spouse from the trust are not transfers of value out of the trust, so do not risk the possible tax charge that could arise when the capital is appointed to them. Furthermore, as long as A's spouse has not repaid the loan(s), they form a debt against their estate, meaning that the inheritance tax may be reduced on their death.

### **Is the bypass trust only of benefit where the shareholder is married?**

The main purpose of the bypass trust is to avoid a charge to inheritance tax on the estate of the surviving spouse. However, even if the shareholder is not married the trust may be beneficial providing there is more than one possible beneficiary.

On the death of the shareholder any business property relief available would still be used since the shares would be left to someone other than a spouse. However, if those shares were then sold, the proceeds would form part of the estate of the beneficiaries if a trust was not used.

Using a discretionary trust prevents the proceeds from forming part of the estate of any of the beneficiaries. But the trust may still have to pay inheritance tax on every 10-year anniversary and when any appointment is made in favour of one of the beneficiaries. The amount of inheritance tax will depend on how much the trust is worth and the timing of appointments, but it is likely to be much less than if a trust was not used and therefore an inheritance tax saving can still be made.

The trust also gives control of the proceeds to someone other than the beneficiaries. This can be particularly important if the beneficiaries are minors or your client would not feel comfortable with them receiving a large amount of money. The trustees are able to decide who out of all the possible beneficiaries will receive benefits, when they will receive anything and how much each beneficiary will receive.

### **Does the same tax treatment apply to people in a civil partnership?**

Civil partners enjoy the same inheritance tax treatment as married couples and so they too can take advantage of the benefits that the bypass trust offers.

### **When is the trust not appropriate?**

The trust is only appropriate where business assets qualify for 100% business property relief. In other cases the use of it may give rise to an inheritance tax liability so care must be taken. Also the will (including the trust) will need to be reviewed if circumstances change, for example if business assets are sold.

### **How do the parties establish the trust?**

This is incorporated within the will of each shareholder or partner. It is important that they take legal advice. Provided all the business assets are left subject to the trust and the balance of the estate in excess of the nil rate band is left to a surviving spouse, no inheritance tax should arise at that time.

### **Do you provide a draft codicil?**

On the following pages you will find an example wording for the bypass trust that could be incorporated into your client's will. This is not intended as a form for your client to complete but can be given to **your client's solicitor** as the basis of drafting either an amendment to an existing will or a new will, if one does not already exist.

# Draft codicil incorporating trust of business interests. Clients and their solicitors must accept full responsibility for the legal and tax effects of basing any codicil or part of any will on this draft.

## SAMPLE FORM – TO BE USED AS A GUIDE ONLY

1

I, \_\_\_\_\_ of \_\_\_\_\_ wish to make a Codicil to my Will dated \_\_\_/\_\_\_/\_\_\_ and to the Codicil(s) if any specified in the Schedule (hereto) (altogether "my Will").

## 2 Definition

In this Codicil the following expressions shall have the following meanings and unless the context does not permit the singular shall include the plural and the masculine shall include the feminine and the neuter and vice versa:

- (a) "Trustees" means the Executors and Trustees of my Will  
"Discretionary Beneficiaries" means
- (i) Any widow/widower of mine.
  - (ii) Any of my children living at the date of my death.
  - (iii) Any grandchildren or remoter issue of mine whenever born.
  - (iv) Any person to whom any beneficiary in class (ii) or (iii) above shall be or shall have been married.
  - (v) Any person entitled to the whole or any part of my estate whether by virtue of my Will or otherwise.
  - (vi) [Other to be named]
- (b) "Trust Period" means the period starting with the date of my death and ending eighty years thereafter.
- (c) "The Act" shall mean the Inheritance Tax Act 1984 and any statutory modification or re-enactment thereof.
- (d) "The Discretionary Fund" shall mean
- (i) the maximum amount (if there shall be such an amount) of relevant business property (as defined in section 105(1) of the Act) and agricultural property (as defined in section 115(2) of the Act) as can be held on the trusts of this clause without Inheritance Tax becoming payable thereon by reason of my death,
  - (ii) all accumulations (if any) of income directed to be held as an accretion to capital, and
  - (iii) the money investments and other property from time representing the above.

## 3 Trusts

- 3.1 I direct the Trustees to hold the Discretionary Fund for such one or more of the Discretionary Beneficiaries in such proportions, on such terms and conditions and subject to such new or other Trust purposes, powers and provisions as to both income and capital (including power to accumulate during such period permissible by Law as the Trustees shall select) as the Trustees may revocably or irrevocably appoint in writing (such Trust purposes, powers and provisions to be exercisable at the discretion of the Trustees or of any other person).
- 3.2.1 Subject to 3.1 above and to any exercise of the power of accumulation in 3.2.2, I direct the Trustees to pay or apply the income of the Discretionary Fund or the unappointed part to or for the benefit of such one or more of the Discretionary Beneficiaries in such proportions as the Trustees shall think fit.
- 3.2.2 The Trustees shall have power during the period of 21 years from the date of my death to accumulate all or any part of the income arising during that period and may at any time or times pay or apply accumulated income as if it were income arising in the year of such payment or application.
- 3.3 In the event of the failure of these provisions, I direct the Trustees to pay and make over the Discretionary Fund or the unappointed part of the Discretionary Fund remaining in their hands to the estate of the last of the Discretionary Beneficiaries to die.
- 3.4 Any of the Trustees may join in exercising any of the powers contained in this clause notwithstanding that he is one of the Discretionary Beneficiaries and will or may benefit from any such exercise so long as there is another Trustee acting who is not benefited by such exercise.

## 4 Additional Administrative Powers

4.1 The following provisions shall apply to this Codicil:

- (a) The Trustees may appoint any person or persons as Trustee or Trustees notwithstanding that such person or persons may be resident domiciled carrying on a business or incorporated outside the United Kingdom and the receipt of such person or persons for the whole or such part or parts of the Discretionary Fund as may be paid or transferred to such person or persons pursuant to such appointment shall be a complete discharge to any other Trustee or Trustees.
- (b) Any Trustee being a solicitor or accountant or engaged in any profession or business including any company which is a Trustee shall be entitled to and be paid all usual and proper professional and other reasonable charges for any business or work done by it him or his firm or his company in relation to the administration of my estate including acts which a trustee or executor not engaged in any profession or business could have done personally.
- (c) A Trustee shall not be liable for any loss to my estate unless that loss is caused by his own fraud. Any liability of a Trustee shall be restricted to the liability arising from his own actions or omissions only.

## 5 Trustees Powers

The Trustees shall have the fullest powers of administration and management of the Discretionary Fund including the prospective or vested share of any beneficiary while retained by the Trustees as if they were the absolute owners thereof. In particular but without limitation the Trustees shall have the following powers:

**(a) To invest widely**

Power to retain, hold and realise property and investments made over to the Trustees and to re-invest the same in the purchase or on the security of such heritable or real property, corporeal moveables, investments, stocks, shares (including partly-paid shares), deposits and securities, real or personal (including bonds or securities payable to bearer) whether within the United Kingdom or abroad, including power to delegate the investment on a wholly discretionary portfolio management basis. Power also to hold and to invest in shares in unquoted private companies even if such investments comprise the entire Discretionary Fund and do not produce income.

**(b) To effect or take over Policies of Assurance**

Power to take out or take over policies of assurance on the life of any person with full power to surrender, vary or otherwise deal with any such policies as if they were the absolute owners of these policies. The Trustees shall apply only capital including accumulated income for such purposes.

**(c) To use nominees etc.**

(i) Power to have registered in the name of a nominee any property from time to time forming part of the Discretionary Fund and to pay reasonable fees to such nominee.

(ii) Power to hold investments in certificated or uncertificated form.

**(d) To repair and improve; to manage property etc.**

(i) Power to expend both capital and income of the Discretionary Fund in insuring, putting and keeping in good repair, improving, restoring and replacing any property forming part of my estate.

(ii) Power to manage and administer any property forming part of the Discretionary Fund as if they were beneficial owners including without limitation developing such property, planting, thinning and cutting down timber, working and letting minerals.

**(e) To borrow and to lend**

Power to borrow and lend money on such terms and with or without security as the Trustees think fit (including power to make loans with or without interest) and to apply money so borrowed in accordance with their powers. Power also to charge any property by way of security for any money borrowed by the Trustees.

**5 Trustees Powers (continued)**

**(f) To appropriate**

Power to appropriate specified assets of any description to represent the whole or part of any share of the Discretionary Fund (whether any beneficiary has a vested right to it or not) at such valuations as the Trustees shall determine. From the date of such appropriation the particular share shall have the whole benefit and the whole risk of the appropriated assets.

**(g) To settle legacies**

Power to settle any pecuniary legacies either in cash or by transfer of any part of my estate or partly in cash and partly by such transfer, the whole expenses of any settlement by transfer being payable out of the residue.

**(h) To pay over or retain shares of beneficiaries under the age of 16**

Power to make over the whole or any part of the Discretionary Fund and the income of it which may be payable to a beneficiary under the age of 16 to either parent or to the guardian of such beneficiary or to any person who may be acting or willing to act as guardian of such beneficiary although not legally appointed whose receipt shall be sufficient discharge, or to retain the whole or any part of the Discretionary Fund and the income of it falling to any beneficiary until he or she attains the age of 16 and either to apply the income (or even the capital) for or on behalf of such beneficiary or to re-invest the income for such beneficiary.

**(i) To transact with themselves**

Power to enter into any transaction concerning the Discretionary Fund even if one or more of them has or have some interest in such transaction other than as one of the Trustees provided that no such transaction shall be authorised unless at least one of the Trustees has no such interest in such transaction (other than as a beneficiary) and shall have been advised by professional advisers competent to consider the nature of such transaction that its terms are such as would be appropriate to a transaction between persons acting at arm's length.

**6 Effect of Codicil**

**6.1** This Codicil is intended to set out in full the trusts governing the Discretionary Fund and to the extent that any provisions contained in my Will are inconsistent with this Codicil and unless such provisions expressly so state no such provisions shall apply to the trusts powers and provisions declared in this Codicil which shall so far as possible be read construed and administered separately from all other testamentary dispositions made by me and save as aforesaid I hereby confirm my Will.

**In Witness**

In witness whereof I hereby executed this Codicil this \_\_\_\_\_ day of \_\_\_\_\_ in the presence of

Signature of Testator \_\_\_\_\_

Signature of First Witness \_\_\_\_\_

First Witness \_\_\_\_\_

Full Name & Address \_\_\_\_\_

**This is the Schedule referred to in the foregoing Codicil**

Codicil dated        /     /    

Codicil dated        /     /    

Codicil dated        /     /    

**Notes**

The above information and our understanding of legislation and Inland Revenue practice is current at the time of going to print. Whilst every care has been taken, it should be remembered that all legislation, particularly that relating to taxation, is open to differing interpretations and change, and the suitability of tax planning arrangements is always dependent on personal circumstances. For these reasons, it will be appreciated that we cannot accept legal responsibility for any taxation or other consequences of entering into the arrangement described above. Therefore individual legal advice should be taken in all cases.

You can also find further information and sample wording on our website, [www.brightadviser.co.uk](http://www.brightadviser.co.uk) under the business protection section.

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# business protection from Bright Grey

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