Business Trust

Tax notes

Background

This trust is used exclusively in business succession planning.

The principle is that the proceeds of the life assurance policy are given to the surviving partners/shareholders/members ("members") of a business when a colleague dies, via the trustees.

The money is then used to buy the deceased colleague's share of the business from their estate.

Each member effects a policy on their own life and places it into trust for the benefit of the individuals who are in business with him (the settlor).

The trust automatically caters for members joining or leaving the business without the need to vary the beneficiaries.

The procedure is that each policy is assigned to a settlement, the terms of which provide that:

- the individuals who benefit from the policy, in default of any other action being taken, are the members;
- the full name and type of business concerned is entered on the trust deed.

Inheritance tax considerations

1. The transfer of any relevant business property will receive tax relief [s103, IHTA 1984]. So leaving shares in a business to others on your death will have 100% or 50% inheritance tax (IHT) relief.

   However, any business property subject to a binding contract for sale is not relevant business property for these purposes and will not receive tax relief [s113, IHTA 1984]. You should make sure, therefore, that a buy and sell agreement or similar is not used. A double option agreement or automatic accrual method should be used instead.

2. The settlement of the policy is part of a wholly commercial agreement – assuming all members are party to the arrangement – and as such is not a transfer of value [s10, IHTA 1984].

   Similarly, the payment of the premiums is not a transfer of value.

3. A charge to IHT may arise on every tenth anniversary of the creation of the trust [s64 IHTA 1984] although in most cases the charge will be zero.

   In order to calculate any tax that may be due, it is assumed that a chargeable transfer had been made on the tenth anniversary [s66(3), IHTA 1984].

   The assumed transfer is equal to the total value of the relevant property in the trust immediately before the anniversary date, plus the value of any other trusts set up by the settlor on the same day, plus any other property that was put into the trust, plus all chargeable lifetime transfers (CLTs) made by the settlor in the seven years before the creation of the trust, plus any amounts exiting the trust in the previous 10 years [s66(4), IHTA 1984].

   In practice, for a protection policy without any investment value, there would only be property in the trust if the death benefit had been paid to the trustees and they had not yet distributed it.

However, there are other circumstances where the policy may have a value and there are also special rules applying to life assurance policies, which are not term assurance policies.

The value that applies for the purposes of the charge is the 'open market value'. This is the price the trust assets might reasonably fetch if sold in the open market at the time of the occasion (in this context, immediately before the tenth anniversary date).

Therefore, if the policy was the subject of a death claim that had not yet been paid, or the client was terminally ill, it would have an open market value.

Also, there are special rules for life policies which state that the value of the transfer is the total of the premiums paid under the policy [s167(1) and s167(5), IHTA 1984].

But there is an exemption for term assurance policies, and the rules do not apply to these policies [s167(3), IHTA 1984].

However, in all cases the charge is only levied on the amount by which the value of the deemed transfer exceeds the nil rate threshold at that time.

If this is the case, the rate of tax on the excess is 30% of the lifetime rate of IHT [s66(1) IHTA 1984] and is 6% currently.

It should be borne in mind that potentially exempt transfers made in the seven years before the trust is established can impact on the calculation of the ten-year charge, if the settlor dies within that seven-year period.

4. Any death benefit payable under the policy is paid to the trustees. When they distribute this to the beneficiaries, there will be an exit charge [s65(1) IHTA 1984]. This is known as the proportionate charge.

   The amount of the charge is the same as that applying at the previous anniversary and based on the amount by which the value of the relevant property in the trust is reduced.

   The rate of proportionate charge is reduced by a fraction based on the time elapsed since outset or the last ten-year anniversary. This fraction is calculated as one-fortieth for each complete quarter that has passed since the anniversary [s69, IHTA 1984].

   Of course, if the appropriate rate at the previous ten-year anniversary had been zero, there will be no exit charge.

   However, if regular premiums had been paid since the last ten-year anniversary, property has been added to the settlement and the rate of tax applicable at that anniversary is re-calculated as if the value had included the added property.

   In the first ten years, special rules apply – because there was not a previous ten-year anniversary.

   In this case the rate of tax is based on all the property in the trust at the time of its creation, plus any property subsequently added to the trust, plus any other property in any other trust made by the settlor on the same day, plus all CLTs made by the settlor in the seven years before the creation of the trust.

   The rate is worked out in the same way as the rate of the ten-year charge.

5. If the settlor pays any tax charge, or an exit charge is paid out of any relevant property remaining in the trust, the tax payable has to be grossed-up.

   In effect, the amount calculated is divided by 0.8 to give the gross amount payable.

6. Because the settlement of the policy was part of a wholly commercial arrangement, there is no element of gift involved.

   Accordingly, the transfer does not constitute a gift with reservation [p7(1), sch.20, FA1986].

7. In the event of a member ceasing to be part of the business, there is no further transfer subject to IHT.

Pre-owned assets tax

The member is not a potential beneficiary of their own policy and in these circumstances, a charge to pre-owned assets tax under paragraph 8 of Schedule 15, FA 2004 would not arise.

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