Business trusts

Synopsis: What they are and key provisions.

Date published: 11.01.2023

When life assurance policies are written as part of business protection or share purchase arrangements (between partners in conventional partnerships, members of limited liability partnerships (LLPs) or co-shareholders in a limited company), a special business trust is normally used to ensure that the funds are provided by appropriate life assurance to the right parties at the right time.

Ideally, inheritance tax (IHT) will also be avoided or minimised and appropriate flexibility will be incorporated into the trust terms to ensure that changes in the parties involved in the business can be dealt with.

Pre-22 March 2006 business trusts

The trust would normally be an interest in possession (IIP) trust. Apart from the beneficial clauses, the trust would be modelled on the commonly used flexible trust.

The beneficial clause would often be written in such a form that the beneficiaries would be defined as all the remaining partners/members/co-shareholders or all the partners/members/co-shareholders for the time being, without naming specific beneficiaries. In such cases there will be an automatic change of beneficiaries on owners leaving/joining the business. Alternatively, the current (default) beneficiaries might be named, with the trustees being given power to appoint benefits to other owners.

This approach may have been adopted where for some reason not all business partners/shareholders were participating in the arrangement. In such a case, in the event of a change of business owners, trustees would have to exercise their power of appointment to ensure that the “correct” individuals (i.e. the then current co-partners etc) are the current beneficiaries.

The beneficiaries would normally be confined to the remaining (other than the settlor) partners/members or shareholders at the time the policy benefits become payable in appropriate shares although in some cases the settlor might be included as a potential beneficiary. This may be especially useful for policies providing critical illness cover – but please see below regarding the POAT implications.

The trusts will often provide for the policy to revert to the settlor in the event of them leaving (other than by reason of death) or retiring from the business, or give the trustees power to appoint benefits to the settlor in such circumstances. HMRC has confirmed that provided the arrangement is commercial (i.e. at arm’s length as between unconnected parties, with no element of bounty intended) then the premiums paid under the policies will not be treated as gifts for the purpose of IHT and the gift with reservation provisions in section 102 FA 1986 will therefore not

apply, even though the settlor may be able to benefit directly or indirectly under the arrangement.

It is important that only special business trusts are used for business protection (rather than standard flexible or discretionary trusts) because HMRC takes the view that where a trust used in such a business context includes beneficiaries other than the persons involved in the business as partners/members/co-shareholders, the arrangement…

- cannot be classified as commercial and, as a result,
- gives rise to a reservation of benefit for the purpose of section 102 FA 1986 by virtue of the associated operations provisions.

This is because, even though a life assured might not be a beneficiary under the trust of the policy they effected on their own life, they will be a beneficiary under the policies effected by their co-partners/members or co-shareholders and they will be beneficiaries under their own policy. This means that each party could indirectly benefit and there could therefore be a reservation of benefit by associated operations.

HMRC has however confirmed that in most arrangements between otherwise unconnected partners, provided the beneficiaries under the trust are confined to persons involved in the business, the arrangements will usually be treated as commercial and so there will be no gifts involved.

It follows that if there are no gifts, there can be no gifts with reservation within section 102 Finance Act 1986. This, in turn, means that under such “restricted” business trusts, the life assured (who is also the proposer) can also be a potential beneficiary under their own trust so that benefits can automatically revert to them, say on leaving the business, or be appointed to them at that time. Either an automatic revert-to-settlor clause could be included or a power of appointment given to the trustees. However, please see below regarding the POAT implications.

To ensure that the commerciality argument is not upset, only the business partners taking part in the arrangement should be able to benefit. Premiums paid under such a commercial arrangement (provided each partner/shareholder pays a premium that is fair in the circumstances) will not be gifts.

Where there is premium disparity, for example, because of the difference in ages/health of the partners/members/shareholders, a premium redistribution (or “equalisation”) exercise should be carried out. In principle, each party to the arrangement should be paying premiums commensurate with the benefit they are likely to receive from the co-partners’ policies.

From 22 March 2006, business trusts executed before that date and written as described above will continue to be treated in the same way for IHT until…

- There is a variation to the policy other than an "allowed variation".

or

- There is a change of beneficiary after 5 October 2008 (or if before 5 October 2008 other than the first change of a particular interest in the trust) other than as a result of death, when the trust will fall within the relevant property trust regime.

Continued premium payments at the same level (or at a different level if permitted under the terms of the policy) will not cause the policy trust to be treated as a relevant property trust. Any other variation provided for under the terms of the policy will also not affect the IHT treatment of the policy.

A single change of beneficiary of a particular trust interest was permitted without triggering the relevant property trust regime provided it was made before 6 October 2008. A change of beneficiary at any time if the change occurs because of the death of a beneficiary with an IIP will also preserve the "non-discretionary trust" treatment of the policy trust. This relaxation may prove useful for business trusts.

However, if a business owner ceases to be beneficially entitled under a business trust because they leave the business and this takes place after 5 October 2008 (or was the second or later post-21 March 2006 change of beneficiary before 6 October 2008) then the change will constitute a chargeable lifetime transfer for IHT and the relevant property trust regime will operate. The commencement date, for the purpose of the ten-year charge will be the date the trust actually commenced, not the date of the change in beneficial interest.

Even if the trust becomes subject to the relevant property trust regime the premiums should not constitute chargeable lifetime transfers.

In the context of commercial business arrangements, the premiums will not be gifts. It is stressed that with business trusts it is essential that there is "commerciality" to ensure that the gift with reservation provisions do not apply which could be the case if premiums were treated as gifts (given that in most cases the settlor would be a possible beneficiary under the trust or the gift with reservation by associated operations (by virtue of benefiting under the other partners' policies) would apply).

Post-21 March 2006 business trusts

Where these incorporate flexible or discretionary trusts these will be subject to the relevant property trust regime. This is regardless of the fact that the premiums should not be treated as gifts, as long as the arrangement is "commercial". It is simply because the trusts themselves are settlements for the purposes of s43 IHTA.

The risk of a periodic charge will be dependent on the value of the trust property exceeding the nil rate band available to the trust. To protect against the risk of a periodic charge occurring at a time when the value of the trust property exceeds the nil rate band (for example, shortly before or after the death of the life assured),

consideration could be given to effecting a series of policies on separate days. Each could then benefit from its own nil rate band in accordance with the "Rysaffe" rule.

Commerciality?

The need for commerciality arises because...

- It is good business practice (i.e. the parties want to pay for the true benefit they get).
- A commercial arrangement displaces a gratuitous intent and therefore means that the IHT gift with reservation rules cannot arise.

Commerciality can be evidenced by...

- All participating individuals paying a premium commensurate with or proportionate to their likely benefit under the arrangement.
- The payment of policy being limited to business partners (not members of the deceased's family) i.e. family members must be excluded from benefit under the trust.

Business trusts and POAT (pre-owned assets tax)

The POAT provisions, which introduced a charge to income tax on benefits received by the former owner of gifted property, have applied to many trusts and settlements since 6 April 2005. If the settlor of a business trust is also one of the beneficiaries of the trust, the question may arise as to whether a POAT charge will be relevant.

Generally speaking, there are two types of business trust which need to be considered separately.

Under one type of business trust, the only time the settlor can benefit under the business trust is by an automatic reversion of the beneficial rights under the trust to the settlor when he leaves the business, thus making the arrangement for share purchase and the life assurance in trust for their co-owners redundant. In such a case, because the rights of the settlor are held absolutely for the settlor and are not therefore deemed to be held under a settlement, as long as the settlor cannot benefit from the trust in any other circumstances, paragraph 8 of Schedule 15 Finance Act 2004, which would otherwise apply to give rise to a potential income tax charge under the POAT regime, will not apply.

In cases where the trustees have a power of appointment enabling them to appoint the benefits back to the settlor (e.g. in the case of critical illness) or back to the settlor's estate in the case of death, HMRC take the view that while the settlor can benefit under the trust, then the POAT charge will apply.

It should be added that even where a POAT charge does apply it will be based on the value of the asset, i.e. the life assurance policy in question at the time (i.e. on 6

April in the tax year in question). Given that, generally speaking, in business assurance arrangements a temporary life assurance policy would be recommended, its value would be negligible unless the life assured was in serious ill health. Where the value is negligible it is likely to be excluded from the provisions because of the de minimis rule which provides that no tax will be charged if the benefit is less than £5,000 per annum.

This £5,000 refers not to the value of the policy but to the value of the potential “income” benefit that will be subject to income tax which would be calculated according to the 2004 Finance Act. Using the 2% official rate of interest currently in place (2022/23 tax year) then the value of the policy will have to be in excess of £250,000 for a charge to apply. As stated above, given that a temporary life assurance policy will have no surrender value, its market value will be negligible unless the life assured is in serious ill health. This means that even if, strictly, the POAT charge could apply, in practice no tax liability will arise.

Personal pensions term assurance (PTA) and business trusts

New or amended PTA policies after 2007 ceased to attract tax relief so all but ceased to exist. However, an adviser may come across an existing pre-2007 arrangement where business partners have used their PTAs as a funding vehicle for share purchase buyout.

In theory business partners of the life assured could be nominated as beneficiaries of the cover and so the Scheme Administrator could legally pay benefits to the co-owners of the life assured. However, this could never be guaranteed as the Scheme Administrator would ultimately choose who benefits through the exercise of their discretion. In some cases, it may have been possible to declare a personal trust over death benefits. In such cases the relevant documentation would need to be carefully verified.

Could the Scheme Administrator, pay benefits to a business trust?

Whilst payments to trusts are generally permitted Scheme Rules would often preclude the scheme administrator from making a lump sum payment to the trustees of any trust where the settlor has a beneficial interest. This means that no “special business trust” (as typically used with ordinary life assurance) which includes the settlor as a beneficiary would be possible with a personal pension term assurance. This would therefore apply to most business trusts which provided for policy benefits to revert to the settlor if they leave the business.

However, it was always possible to include within the discretionary class of beneficiaries to whom an appointment of the benefits could be made, the co-partners/co-shareholders together with family members of the member but excluding the settlor.

On the other hand, if the trust is discretionary, it cannot be guaranteed that the co-partners/co-shareholders will receive the funds to enable them to make the purchase of the deceased’s share.

RISK ASSURED
LIFE INSURANCE SPECIALISTS

Relevant life policies

These should not be used for business assurance purposes for a number of reasons.

The first is that the relevant life policy (RLP) trust is a discretionary trust and so it would not be possible to guarantee that the benefit would be actually paid to the other shareholder(s)/co-partner(s) even if such shareholder(s)/co-partner(s) as individual(s) are included in the class of beneficiaries under the RLP trust.

Secondly, as RLPs are designed as form of “employee benefit”, HMRC may look closer at an arrangement between, say, shareholding directors, and deny premium deductibility on the grounds that it is not wholly and exclusively for the purpose of the business (being for the benefit of the business owners instead).

020 7183 3931
www.riskassured.co.uk

Risk Assured is authorised and regulated by the Financial Conduct Authority This information is based on our understanding of current legislation, regulations and HM Revenue and Customs practice at the published date. This technical paper should not be relied upon as it may be subject to change and should not be construed as advice. We take no responsibility for any advice given or contracts entered into on the basis of this technical paper. This information is intended for professional advisers only.
E&OE