Business trusts - key considerations

Synopsis: Why use a business trust and key provisions.

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The key considerations for business trusts are in relation to inheritance tax (IHT) and, since the pre-owned assets tax (POAT) rules were introduced by Para 15 of Finance Act 2004, the POAT income tax charges. It is also, since 22 March 2006, necessary to consider the IHT 'relevant property' discretionary trust regime in connection with business trusts.

When life assurance policies are written as part of business protection or share purchase arrangements (between partners in conventional partnerships, members of LLPs or co-shareholders), a special business trust is normally used to ensure that the funds provided by appropriate life assurance policies are provided to the right parties at the right time. Ideally, 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 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 will 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 could be named, with the trustees being given power to appoint benefits to other owners. This approach may be adopted where, for some reason, not all business partners / shareholders are 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 will 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 may 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 normally provide for the policy to revert to the settlor in the event of them leaving 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 (at arm’s length, i.e., as between unconnected parties, with no element of bounty intended), the premiums paid under the policies are not treated as gifts for the purpose of IHT and the gift with reservation

provisions in section 102 FA1986 will therefore not apply, even though the settlor may be able to benefit directly or indirectly under the arrangement. It is important to remember that only business partners should benefit under the trust. It should not be possible for anybody not connected with the business, such as the family of the settlor, to benefit in any circumstances.

In view of these tax implications, only special business trusts were used for this type of arrangement. In particular, it would have been extremely dangerous to use an ordinary flexible power of appointment trust commonly provided by life offices for use with ordinary protection policies.

This is because HMRC Capital Taxes has expressed 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...

1. cannot be classified as commercial and, as a result,
2. gives rise to a reservation of benefit for the purpose of section 102 FA1986 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 Capital Taxes 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. 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 can 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 will not be gifts and so will not need to fall within the usual exemption.

Where there is premium disparity, for example, because of the difference in ages and / or 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 April 2008 (or, if before 5 April 2008, other than the first change) other than as a result of death, when the trust will fall within the discretionary 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 discretionary 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 was permitted without triggering the discretionary trust regime provided it was made before 6 April 2008. A change of beneficiary at any time, if the change occurs because of the death of a beneficiary with an interest in possession, 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 April 2008 (or is the second or later post-21 March 2006 change of beneficiary before 6 April 2008) then the change will constitute a chargeable lifetime transfer for IHT and the discretionary 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 discretionary trust regime, the premiums are highly unlikely to constitute chargeable lifetime transfers (CLTs). In the context of commercial business arrangements, the premiums will not be gifts and even if (rarely) they are, they are likely to be exempt as normal expenditure out of income or failing that, under the annual-gifts exemption.

Post-21 March 2006 business trusts

Where these incorporate flexible or discretionary trusts outside of the registered pension regime, these will be subject to the discretionary trust regime. This is regardless of the fact that the premiums are not likely to be gifts and if (rarely) they are, they will be exempt.

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 this risk (possibly for protection plans, if the life assured were in serious ill health, or, only if the policy is other than a term plan, the premiums paid had been significant) where the total amount of cover on a life assured in the arrangement exceeds the nil rate band available to the trust, the life assured could effect a series of policies on

separate days. Under current law, each could then have its own nil rate band in accordance with the “Rysaffe” principle.

Business trusts and the 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, apply to many trusts and settlements from 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 the new 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 they leave 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 will be held absolutely for the settlor and will therefore not be held under a settlement, as long as the settlor cannot benefit from the trust in any other circumstances, it is our understanding that paragraph 8 of Schedule 15 Finance Act 2004, which would otherwise apply to give rise to a potential income tax charge, will not apply.

To make the business trust more flexible, especially in connection with critical illness cover, it is often felt appropriate to include in a business trust not only an automatic reversion in the event of the settlor leaving the business but also a power of appointment given to the trustees to appoint the benefits back to the settlor (in the case of critical illness) or back to the settlor’s estate in the case of death.

Whilst HMRC has recognised that the POAT charge was not intended for commercial arrangements effected between business owners, on a strict interpretation of Schedule 15 it appears that while the settlor can benefit by virtue of a power of appointment then such a trust may be caught by these provisions.

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. 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 HMRC rules.

The charge is calculated by applying the official rate of interest, so, for example, where that is 2.25% (the rate for 2023/24) then the value of the policy will have to

be in excess of £222,222 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.

If a business trust becomes subject to the discretionary trust regime, then, regardless of whether any IHT is due (please see above) this may well mean that HMRC does not pursue a POAT claim. This has not, to our knowledge, been confirmed.

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); and
- 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; and
- 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.

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