

Improving the Income Tax treatment of Discretionary Trusts

Introduction

On 6 April 2010 the Income Tax rate applicable to Discretionary Trusts increased from 40% to 50%, and the tax on dividend income increased from 32.5% to 42.5%. This information sheet explains how the tax treatment of Discretionary Trusts can be improved by changing the way in which income is paid out to beneficiaries.

Please refer to our information sheet 'Discretionary Trusts' for an explanation of the usual tax and administrative implications of such trusts.

Discretionary Income Payments

When income is distributed to beneficiaries, they must receive a tax credit at the rate applicable to trusts (50% from tax year 2010/2011). A beneficiary (other than a 50% taxpayer) will be able to recover some or all of the tax paid by the trustees, depending on his or her personal rate of Income Tax.

However, the tax rate for a beneficiary will be higher where dividends are concerned, as a result of the special rules which apply when this type of income is paid out. These rules prevent a beneficiary from having the use of the non-repayable 10% tax credit which attaches to most dividends. As a result, the effective tax rates on dividends for beneficiaries with different marginal rates of Income Tax, and based on payment of a net dividend of £1,000 (gross equivalent of £1,111 for the trustees) are as follows:

Beneficiary's tax rate	Income received by beneficiary including tax refund	Effective tax rate
Non	£1,000	10%
Basic	£800	28%
Higher	£600	46%
Top	£500	55%

Fixed Interests in Income

As an alternative to maintaining day to day discretion over income payments, trustees should consider giving an entitlement to trust income to one or more of the beneficiaries by way of a deed of revocable appointment. Such fixed interests in income can last for as long as the trustees decide, up to the lifetime of a particular beneficiary. They could take the form of a share of trust income, or an entitlement to income from a specified part of the trust fund.

Advantages

By appointing fixed interests:

- 1 trust income will be taxed on the beneficiaries and not on the trustees, enabling a beneficiary's lower rates of tax to be used and, in the case of dividends, the non-repayable 10% tax credit to count in or towards satisfaction of his or her tax liability;
- 2 beneficiaries will receive income directly, so that there is a cash flow advantage;

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- 3 the need for beneficiaries to make tax repayment claims will be avoided, except for non-taxpayers in respect of income other than dividends;
- 4 income can be mandated directly to beneficiaries, so simplifying the preparation of trust Tax Returns and trustees' annual accounts and thereby saving administration costs.

Other Tax Implications

There should be no adverse Inheritance Tax (IHT) implications provided that the trustees are careful not to create any fixed interests in income within two years of the date of death where the Discretionary Trust is established under a Will. Moreover, if beneficiaries do not become absolutely entitled to trust capital, there will be no Capital Gains Tax (CGT) consequences either.

Any Disadvantages?

The trustees would lose some of the flexibility previously enjoyed in relation to distributions of income to beneficiaries, but this should not be overstated. Where revocable appointments are made, the trustees retain the ability to cancel existing income entitlements and create new ones as the circumstances of beneficiaries change over time.

Settlor-Interested Trusts

In the case of a settlor-interested trust (or one where income is paid for the benefit of the settlor's minor unmarried children and the gross amount exceeds £100), income is taxed on the settlor at his/her personal

rates, which may be lower than 50%. The settlor is given credit for the higher rates of tax paid by the trustees. Any tax recovered by the settlor is payable to the trustees.

In these situations, where income is taxed at the marginal rate of the settlor and there is no disadvantageous treatment of dividend income, it will not be worth appointing fixed interests in income unless the trust ceases to be a settlor-interested (or parental) settlement.

Alternative Strategies

As alternatives to creating fixed interests in income, one or more of the following could be considered as a means of ameliorating the impact of the new trust tax rates:

- 1 rearranging trust investments in order to produce capital growth rather than income;
- 2 realising capital gains within the trustees' CGT annual exemption for distribution to beneficiaries;
- 3 distributing a combination of capital and income to beneficiaries, although the potential cost of preparing IHT Accounts and paying the IHT itself would need to be assessed beforehand;
- 4 taking advantage of the special Income Tax rules applicable to single premium investment bonds.

However, in all these instances the trustees must consider their actions within the context of the trust's governing documents, and the CGT and other tax rates applicable at the time.

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Timing

Action may be taken at any time.

Disclaimer

This information sheet is written as a general guide. As any course of action must depend on your individual circumstances, you are strongly recommended to obtain specific professional advice before you proceed. We do not accept any responsibility for action which may be taken as a result of having read this information sheet.

NOTE: The law is stated as at 1 July 2010.

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