

Trusts and the 50% Tax Rate

What are the changes?

Following the 2009 Budget, you will no doubt be aware that the higher rate of income tax will rise from 40% to 50%, effective from 6 April 2010, for individuals earning over £150,000 of annual income.

What you may not be aware of is that this new 50% rate will also apply to most income received in excess of £1,000 by Discretionary Trusts and Accumulation and Maintenance Trusts (which were originally taxed at 40%) and some income received by other Trusts.

On the face of it this is bad news for Family Trusts and makes setting up a Discretionary Trust or an Accumulation and Maintenance Trust somewhat less favourable than it once was, however the good news is that there are steps that Trustees can make in order to help mitigate the extra tax charges that will arise as a result of these changes.

How will this affect my Trust and what can be done?

The impact of these changes will differ for different types of Trusts and we have given some examples of these below.

Interest in Possession Trusts

Settlor interested Interest in Possession Trusts

As interest in possession Trusts are not charged to tax at the higher rate on the majority of their income, these changes will have the least impact on

these Trusts. Certain types of income received by interest in possession Trusts are however taxed at the higher rate, for example, accrued income received and gains realised on offshore non-distributor funds, which will, from 6 April, be taxable at 50% instead of 40%.

Trustees should bear this in mind when making decisions about what types of securities the Trust should be invested in. Investments that when sold, trigger an income gain will pay tax on that income at the 50% rate, whereas investments that when sold trigger a capital gain will be charged at the capital gains tax rate, which remains at 18% for 2010/11.

If your Trust already has investments in offshore income funds that are currently carrying losses then you may consider taking this opportunity to move Trust funds out of this type of investment and invest in securities that trigger capital gains tax. If your Trust is not invested in offshore non-distributor funds, then there is nothing to be done and the Trust should carry on as it was.

We are happy to discuss any of the above with you in more detail and can work through the tax implications of choosing to invest in each type of investment.

Accumulation and Maintenance Trusts

Discretionary Trusts

The changes coming into effect on 6 April 2010 will have the biggest impact on Accumulation and Maintenance Trusts and Discretionary Trusts as they are taxed at the higher rate (also known

as the rate applicable to Trusts). From 6 April 2010, the rate of tax charged on most income received by these Trusts (in excess of £1,000) will increase from 40% to 50% and the tax rate charged on dividends received by the Trust will increase from 32.5% to 42.5%.

In addition to the increased level of tax suffered by these Trusts from 6 April, there are a number of other potential tax concerns that these changes will give rise to, examples of which are detailed below;

Concern: Discretionary income payments

Discretionary income payments made from the Trusts to beneficiaries after 6 April 2010 will carry a 50% tax credit. The beneficiary is assessed on this payment using their own income tax rates and can potentially claim a refund of some or all of the tax paid by the Trustees. The Trustees need to have sufficient tax in the Trust tax pool in order to 'frank' this 50% tax credit. The tax pool is an accumulation of all the income tax suffered by the Trustees and is reduced each time an income distribution is made to a beneficiary. There are situations where the credits in the tax pool might be insufficient to 'frank' an income distribution made, i.e. deductible Trust expenses are offset against income before it is taxed or the income is in the way of UK dividends, which are only taxed at 42.5% and also carry a 10% notional tax credit that is not added to the tax pool. Any deficit in the tax pool will trigger an extra tax charge on the Trustees in order to fully

'frank' income payments to beneficiaries with the 50% tax credit.

Possible solutions:

1. Invest for Capital growth rather than generating income.

Capital gains tax arising on gains remains at 18% for 2010/11 so, in essence, it is more favourable from a tax saving perspective to have trust monies invested in assets that achieve capital growth rather than those that generate income. However, this is not necessarily the most practical course of action for all Trusts, for example where the beneficiary relies on the income that they receive from the trust. It is also worth noting that, post budget there is still an expectation that the capital gains tax rate will rise in the near future, although the extent of the increase is not clear.

2. Delay distributions to lower income beneficiaries until after 6 April 2010

Payments made after 6 April 2010 will be received by the beneficiary with a 50% tax credit attached. Again, providing that the Trust has built up a tax pool to support this, there will be no additional tax for the trustees to pay and lower income beneficiaries will be able to claim a refund of most if not all of the tax paid by the trustees. The extent of the refund will depend upon the amount distributed and the beneficiary's other income.

3. Accumulate the retained income within the Trust into the capital account before 6 April 2010.

The Trustees could then make capital advances of the accumulated

income to the beneficiaries. This will trigger an Inheritance tax charge of up to a maximum of 6% of the amount advanced as opposed to paying the extra income tax to cover the tax pool deficit. If the payment is made in the form of assets other than cash, then there will also be a possible capital gains tax charge to consider. The drawback of this option is that any built up tax pool will remain unutilised.

4. Convert the Trust into a life interest Trust.

This option may be unsuitable for some Trusts due to their circumstances as it would essentially mean that the beneficiaries will be entitled to receive their share of the income as it arises each year. The Trustees pay income tax at the basic rates of 10% on dividends and 20% on other income. The drawback is that the Trustees will lose their discretion over income payments. This change will necessitate a Deed prepared by a solicitor. The Deed could be drafted so that it is revocable giving Trustees the flexibility to alter the terms at some future point.

Settlor Interested Discretionary Trusts

Although the tax paid by the Trustees on income received in excess of £1,000 will also increase to 50% from 6 April 2010, this is returned on the settlor's personal tax return and dependent upon their other income they could potentially claim a tax refund. However, the Budget proposals include provisions that will require the settlor to return any tax refund to the trust.

Longer Term solutions

If you were thinking of exporting your Trust abroad so it does not fall within the UK tax system or thinking of bringing your Trust to an end. There are Capital Gains Tax and Inheritance Tax issues to be carefully considered.

In summary, the changes to the tax charged on Trusts from 6 April 2010 will have a significant impact on Discretionary and Accumulation and Maintenance Trusts but as the examples above show, there are ways to mitigate the effects of this impact.

We are happy to discuss any of the above with you in more detail and can work with you to come to the most tax efficient course of action for your Trust.