

# Taxing times

## Michael Barr on the effect of tax on net investment return



### ABOUT THE AUTHOR

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The new tax rates on trust income announced in the April 2009 budget will drive many trustees to review the way they manage and distribute income to beneficiaries. Although the tax increase applies only to the trustees of discretionary trusts, for them it is a very significant figure.

Before the 22 April Budget there had been speculation from tax planners and economists that a hard-pressed government could be taxing high earners at 50 per cent. Well, for some beneficiaries receiving dividend income, a 50 per cent tax rate is now on the table – and some more.

### Difficult times

Trustees will also be reviewing what may have turned out to be unexpectedly poor investments, or weak tax planning strategies, or poor advisor support. This is a good thing as it avoids complacency and gives the trustees the perfect platform from which to conduct a thorough review. The fiduciary responsibilities of the trustees include a review to ensure a robust management process.

Equity investors have already felt the effects of the credit crunch with capital losses. Now they will be experiencing dividend cuts and capital losses on a scale not seen during most careers, and the reduced income flow is about to be hit again by a tax increase from a revenue-hungry government.

Trustees have additional problems to juggle with, including the record-breaking reductions in deposit interest rates, and how best to satisfy the needs of beneficiaries relying on trust

income. The proposed new 50 per cent tax rate for individuals will apply to their total income in excess of GBP150,000, and an additional tax cost is the loss of the personal allowance. For the trustees affected, the new 50 per cent tax rate will be applied to all the income except the first GBP1,000, which represents the standard rate band.

The increase in the tax rate from 40 per cent to 50 per cent represents a hike of 25 per cent. When the final legislation is produced and enacted, income that is distributed and subject to the trustees tax rate, must be 'franked' with 50 per cent tax deducted before distribution. This will apply to dividends, interest and all other income. For those relying on dividend income, the effective tax take increase will be well over 30 per cent, as the rate rises to 42.5 per cent from 32.5 per cent.

Settlor interested trusts will not be affected unless the settlor already has an income in excess of GBP100,000, the level at which the personal income tax allowance begins to be lost, and for those above the GBP150,000 level when the 50 per cent tax rate starts.

### Trustee reviews

In this 'new world' of volatile markets, low interest rates and high taxation, trustees will be aware that such significant changes would prudently merit a review of the present investment strategy. There is case law precedent and the provisions of the *Trustee Act 2000* for England and Wales and other similar legislation for other parts of the UK requiring the trustees to obtain proper advice. In particular, the issues of portfolio diversification and suitability in each trust's particular circumstances should be reviewed.

If there are beneficiaries relying on a significant portion of their income from the trust, careful thinking will be required to achieve a suitable outcome, and possibly a move away from the idea of simply distributing

dividends and income to beneficiaries. An alternative is to consider the portfolio's 'total return' potential and to plan a long-term cash flow on this basis. The remit of the trustees will be paramount but the merit of the total return approach is to avoid large annual fluctuations in the income to be distributed to beneficiaries, but more on this later.

### Reclaiming tax

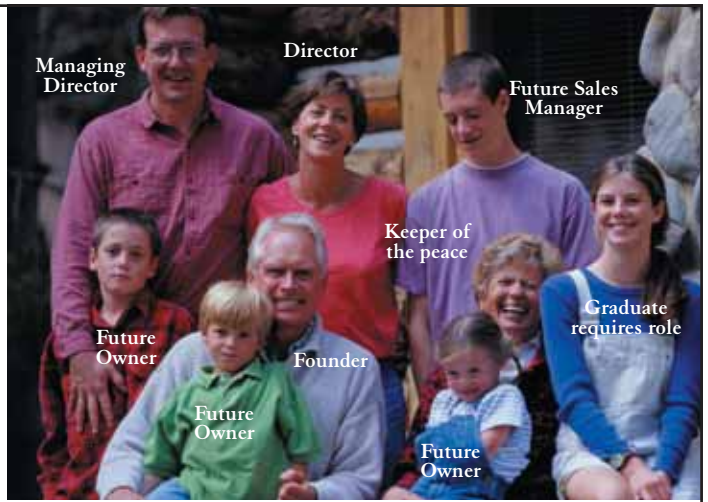
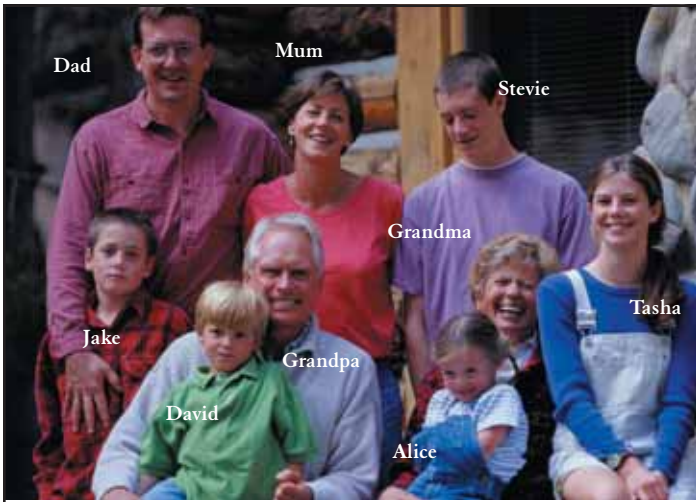
Some beneficiaries should be able to reclaim some of the tax remitted to HMRC by the trustees.

Trustees distributing deposit interest will already be noticing the significant falls since the Bank of England reduced the base rate to a record low of 0.5 per cent. Compared to recent interest rates, beneficiaries will be having their income reduced by two-thirds or more. The position will be exacerbated from 2010/11 with a further reduction due to the increase in tax.

Trustees will normally receive deposit interest after a deduction of 20 per cent tax so a payment of GBP1,000 to the trustees would be grossed up by the 20 per cent tax credit to calculate the tax due, a gross figure of GBP1,250. With tax due of GBP625 and a tax credit of GBP250, trustees pay a further GBP375 to HMRC, leaving the sum of only GBP625 for distribution to beneficiaries.

### Dividends

Trustees will receive dividends after a deduction of 10 per cent tax, which is not recoverable. A payment of GBP1,000 to the trustees would be grossed up by the tax credit to calculate the tax due, a gross figure of GBP1,111.11. Trustees would pay tax at 42.5 per cent, an amount of GBP472.22, and after deducting the tax credit of GBP111.11, the trustees have to pay a further GBP361.11 in tax. If the trustee's remit is to retain this income they will have an amount of GBP638.89 left for reinvestment



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Table 1.  
Interest – based on GBP1,000  
remitted by the trustees

Tax status	From trustees	Tax refund	Total income	*Effective tax rate
Non taxpayer	GBP625	GBP625	GBP1,250	0 per cent
Basic rate	GBP625	GBP375	GBP1,000	20 per cent
Higher rate(1)	GBP625	GBP125	GBP750	40 per cent
Higher rate £150k+	GBP625	GBP0	GBP625	50 per cent

\*Calculated from the gross GBP1,250

Table 2.  
Dividends – Based on GBP1,000  
remitted by the trustees

Tax status	From trustees	Tax refund	Total income	**Effective tax rate
Non taxpayer	GBP500	GBP500	GBP1,000	10 per cent
Basic rate	GBP500	GBP300	GBP800	28 per cent
Higher rate(1)	GBP500	GBP100	GBP600	46 per cent
Higher rate £150k+	GBP500	GBP0	GBP500	55 per cent

\*\*Calculated from notional gross GBP1111.11 and to the nearest whole number

(1) In addition, the income tax personal allowance will gradually be restricted for those with income of over GBP100,000. The personal allowance will, in addition, be reduced at a rate

There is a further complexity if the trustees are distributing all of the dividend income. In the example above, GBP638.89 is available for distribution, but the income has to be franked at 50 per cent from tax year 2010/11. It has only so far been taxed at 42.5 per cent. The tax credit has already been taken into account in calculating the trustee's initial tax liability, so the extra tax is at a rate of 50 per cent on the GBP1,000 dividend remitted. The resulting figure of GBP500 can be reduced by the GBP361.11, calculated earlier, so the extra amount of tax to pay before the dividend distribution is GBP138.89, leaving a final net distribution of GBP500.

In any other walk of life, this would result in riots and demonstrations as the tax take on dividends, from the notional starting point of GBP1,111.11, is actually 55 per cent.

### The beneficiary's tax

The tax paid by trustees is of course only one part of the equation as there is the beneficiary's tax to consider. A taxpayer earning over GBP150,000 will have no entitlement to reclaim any of the tax deducted by the trustees, whereas non-tax payers, basic rate taxpayers and higher rate tax payers can reclaim tax paid via their tax return.

The tax position for the beneficiaries is summarised in *Tables 1 and 2*, above.

### Capital gains tax

Although the capital gains tax (CGT) exemption each year is only one half of the individual rate, this is now relatively more significant and trustees should consider using

the allowance each year. These realised gains can be distributed as 'income' (if advancement of capital is allowable under the trust) and tax free in the hands of beneficiaries.

Consideration should also be given to rearrange trust assets into low or non-income producing investments. Reducing the income in the hands of beneficiaries, and substituting a transfer of capital from tax free gains reduces tax for the beneficiaries.

Capital gains realised over and above the annual exemption would be taxed at only 18 per cent, which is a significant improvement compared to the higher rates of income tax.

### Single premium investment bonds

The single premium bond has unfortunately become frowned upon due to the over-enthusiastic activities of commission hungry sales forces and investors, who in the past have led trustees and non-trustees alike into products that have high charges (charges that have been difficult and even impossible to calculate) and poor investment strategies.

However, there is now transparent architecture available that could provide trustees with a useful tool. In many circumstances it will help them kill more than two birds with one stone. The benefits can be reduced administration, reduced taxation and a smoothing of income to beneficiaries.

The single premium investment bond provides a good framework from which to design a non-income producing portfolio. Income producing investments held within the bond are not subject to tax in the hands of the beneficiary until the bond is encashed, and there is a well-known 5 per cent

allowance each year to distribute tax deferred capital to pay an income to beneficiaries.

### A time of opportunity

In recent years, trustees wishing to review a trust's investment policy have had their hands tied. Usually the problem is the capital gains tax liability that would result in a rearrangement of the trust investments.

With stock markets low, the CGT barriers may have been largely removed, so there should be an incentive to bring trust investment strategies up to modern standards in terms of diversification and suitability; both expressed in an investment policy statement. As large equity holdings have reduced in value, they will form a much lower percentage of the asset allocation, and as a result the portfolio will not benefit as much when the markets recover, unless it is rebalanced.

There may be a change of government before long and a different party may change the tax rules again. The problem in waiting to see the outcome is that whatever the colour of the government, trustees are an easy target for tax revenue.

The recent and unexpected sharp rally in stock market prices may or may not be the beginning of a new bull market. Even if this current stock market rally ultimately fizzles out, it offers a preview of what the real thing might look like – a powerful upswing against a backdrop of very discouraging news. When it comes, it will leave behind those trustees on the sidelines, and those who have deferred reviews will be watching in frustration from the sidelines, having missed the opportunity. ■