



Discretionary Trusts - Terrorism, tax evasion and trusts: The unholy trinity targeted by the British Government in recent years

Terrorism, tax evasion and trusts: The unholy trinity targeted by the British Government in recent years. For trustees, it has been a difficult decade, with the introduction of non-repayable tax credits on dividends in 1999, the increase in the trust tax rate from 34% to 40% in 2004, the inheritance tax changes in FA 2006, the new rules for offshore trusts in 2008, and now a 50% income tax rate for discretionary trusts with non-dividend income. With such low income returns at present, it may be tempting to dismiss the increase as having little impact in actual terms. On the contrary, at a time of low returns it is more pressing than ever for trustees to minimise their income tax burden. This article looks at some of the options open to them.

Which trusts are affected?

The new 50% rate (42.5% for dividend income) applies to all discretionary trusts subject to UK income tax. That doesn't just mean UK trusts - it can include offshore trusts with UK source income. It covers will trusts as well as lifetime trusts. The new rate applies to all trust income above £1,000 – there is no £150,000 threshold as there is for individuals. The new rate will have the most impact on trusts where income is routinely accumulated.

Pay out the income

If trustees distribute income, the recipient beneficiary will be taxed on the income he receives at his marginal rate. That could well be less than 50%. The beneficiary will have a credit for the tax paid by the trustees and will be entitled to a refund. Trustees should therefore think very carefully about the personal tax position of their

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beneficiaries – far better to distribute trust income to non-tax paying children than their higher-rate tax paying parents.

Distributing trust income to beneficiaries who pay little or no tax themselves is sensible but not a total panacea. There will still be cash flow implications as well as compliance burdens, with the trustees and the beneficiary both needing to report the income on their tax returns.

Create interests in possession

If the trustees are relaxed about distributing most or all of the income, they might consider appointing an interest in possession for one of the beneficiaries. In that case the trust income should be mandated directly to the life tenant who will then be taxed on it at his own lower marginal rate. That not only reduces the tax but also simplifies the trust administration and reduces the compliance burden.

There is no reason why interests in possession should not be given to several beneficiaries. The interests can be equal or unequal, depending on the different needs and income levels of the beneficiaries. Where the trust contains both income producing and non-income producing assets, the trustees might decide to appoint interests in possession solely in relation to the income generating assets. The creation of life interests should have no inheritance tax implications as the assets will remain in trust and therefore within the same "relevant property" regime.

The trustees will need to think carefully about how they appoint interests in possession. The starting point is to check whether the trust deed even allows it. Any appointments should almost certainly be revocable so that the position can be reviewed if the tax rules change or a particular beneficiary is no longer a suitable income recipient.

Settlor-interested trusts

Where the trust is "settlor interested", the income will be treated as the settlor's and taxed at his marginal rate. That will often be less than 50%. In the past, trust draftsmen usually sought to avoid a trust being settlor-interested since the settlor's income tax rate was often higher than the trustees'. Moreover, there could have been inheritance tax and even capital gains tax disadvantages. That is no longer always the case and certainly for income tax purposes, a settlor-interested trust would be very attractive where the settlor only pays income tax at the basic rate, or even the higher rate, rather than at 50%.

Where the trust is settlor-interested, the trustees will still initially have to pay the tax at the trust rate but the income is then treated as if the settlor had received it direct. The settlor then has a credit for the tax paid by the trustees and is entitled to a refund if his own marginal rate is lower than 50%. The settlor should pay over the refund to the trustees. Although there is still a considerable tax compliance burden, the tax saving would hopefully make it worthwhile.

A trust will be settlor-interested if the settlor is a beneficiary. Unfortunately that is generally a disaster for inheritance tax (IHT) purposes. However, a trust will also be settlor-interested if the settlor's spouse or civil partner is a beneficiary even if they don't actually take any benefit and even if the settlor himself is excluded. In that case the trust income will be taxed on the settlor without the IHT reservation of benefit rules applying.

For new trusts, it may therefore make sense deliberately to include the settlor's spouse or civil partner as a beneficiary where the settlor pays income tax at a low rate, even if there is no intention for the spouse or civil partner ever to receive a benefit. It would be advisable to include a power to exclude the spouse as a beneficiary in case a future change in tax rules makes their inclusion unwelcome.

Where the capital is initially in the hands of the spouse with the higher marginal tax rate, it may be tempting for him to gift the assets to the other spouse. The intention (documented or otherwise) may then be for the recipient spouse to settle those assets on a trust under which the original spouse is a

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beneficiary, with a view to the income being taxed on the recipient spouse as settlor at their low marginal rate. The danger is that HMRC would treat the original spouse as the settlor, having indirectly settled the assets via a gift to the spouse who is expressed to be the settlor in the trust deed. That would be most unwelcome both for income tax and IHT purposes.

Where the trust is settlor-interested, the income can even be distributed to a beneficiary who pays tax at 50% and yet the income would only ever be taxed at the settlor's own marginal rate. In other words, the settlor trumps both the trustees and the recipient beneficiary when determining whose marginal rate should apply to the trust income.

For a new trust, it is easy to make it settlor-interested. However, for existing non-settlor interested trusts, it may not be possible to make the necessary changes. In many cases, the trust draftsmen went to great lengths to avoid any possibility of the trust being settlor-interested. The irony will not be lost on trustees.

Paying income to the settlor's children or grandchildren

If there is no power to add the settlor's spouse or civil partner as a beneficiary to make the trust settlor-interested, instead the trust income could be distributed to the settlor's minor unmarried children assuming they are, or can be added as beneficiaries. In that case the trust will effectively become settlor-interested to the extent of the actual income distributed to them. Even if the children are over 18, or the beneficiaries include the settlor's minor grandchildren rather than children, it may still be worth distributing income to them if their own marginal tax rates are low. In that case, the trust will not be settlor-interested but the recipient adult children or minor grandchildren will be able to use the trustees' tax credit and claim a potentially significant tax refund. That will be preferable where the recipient beneficiary's marginal tax rate is lower than the settlor's.

Invest for capital growth

One way to minimise the amount of trust income taxed at 50% is simply to reduce the amount of trust income. Investing for capital growth is a superficially attractive option, particularly while the capital gains tax rate is only 18%. The trustees will, however, have to consider their investment duties carefully. Investing entirely in zero dividend preference shares may not be altogether wise.

What if the trustees invest for capital but the beneficiaries actually need income from the trust? In that case it should be possible to supplement the limited income with capital distributions. These should ideally be irregular and of differing amounts to avoid HMRC arguing that they look like income and should be taxed at such. Alternatively the trustees might consider making loans to beneficiaries who need money from the trust. These should be properly documented. In time the trustees may decide to waive part or all of the loans, and such waivers ought to be treated as capital distributions. The trustees will, however, have to consider the IHT consequences of making outright capital distributions from a discretionary trust.

Insurance Bonds

Another option for avoiding a 50% tax charge on trust income is for the trustees to invest via a tax free wrapper such as an insurance bond. In that case a tax charge only arises when the bond is encashed. Moreover, the trustees would be able to withdraw and distribute 5% of the initial bond value tax-free every year. The trustees' tax compliance burden would also be greatly reduced although the costs of investing in bonds can be high.

When the bond is eventually encashed, any growth will be subject to tax on the settlor if he is then alive and UK resident. His tax rate may well be less than 50%. Otherwise the growth element will be taxed on UK resident trustees at 50%. In either case, it would be open to the trustees to appoint the bond in specie to one or more adult beneficiaries rather than encash it themselves. The appointment itself would not be a chargeable event although it may have IHT consequences. The recipient beneficiaries could then encash the bond and pay income tax on the growth. If their marginal rate is less than the settlor's or the trustees' rate then there will be a tax saving.

Conclusions

No one knows how long the 50% income tax rate will last, and it could even increase. Nor does it look likely that a new government will tax trusts with any more leniency. With that in mind, the trustees of discretionary trusts need to think very carefully about their tax and investment strategies. They need to look closely not only at the financial requirements but also the personal income tax circumstances of all the potential beneficiaries. At the same time they need to consider both their investment duties and their fiduciary duties. Finally, it's worth remembering that today's friendly beneficiary might tomorrow sue the trustees for action or inaction. With this in mind, the trustees' best policy is to consider all of these matters carefully, take professional advice as appropriate, and record and minute all trustee decisions. Facing up to an increasingly hostile tax regime is one thing. Having to deal with a potential law suit is quite another.



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