

Income tax planning for trusts

Our drafting service

In anticipation of the 50 per cent trust tax rate due to come into effect on 6 April 2010, many advisors will be suggesting trustees give beneficiaries an income interest. This avoids the loss of the 10 per cent tax credit on dividend income, the payment of additional tax, improves cash flow and simplifies returns.

If you have clients that wish to proceed with this planning we will prepare a deed giving one or more beneficiaries a revocable income interest in the discretionary trust for a guideline fee of £500 plus VAT.

We will be happy to review any trust documentation to ensure that the appropriate powers exist to grant an income interest free of charge.

The guideline fee assumes that you will provide the appropriate trust and tax advice, but we can also advise on this if wished. We are happy to provide our services either by acting for your firm with no direct client contact or alternatively by liaising with the client directly.

The increase to the 50 per cent trust tax rate

As you will be aware, with effect from 6 April 2010 any discretionary trust with income in excess of £1,000 (and after the deduction of costs) will be taxed at 42.5 per cent on dividend income and 50 per cent on all other trust income.

Tax inefficiency can be caused where the trustees have no significant tax pool to carry forward and they wish to distribute dividend income. Dividend income is paid to the trustees with a 10 per cent tax credit which is non-repayable and which cannot be added to the tax pool.

Any income distributed to a discretionary beneficiary is treated as carrying tax credits at the trust tax rate, which must be deducted from the tax pool. Where the tax pool is insufficient, the trustees are liable to pay additional tax on the excess.

Where the trustees wish to distribute the income, they can either distribute only the income for which they have an available tax pool (and accumulate the remainder if the terms of the trust allow this) or alternatively suffer the additional tax charge on distribution.

The planning

Beneficiaries with an income interest in a trust are treated for income tax purposes as if they receive the income directly. As can be shown by the following example, it is tax efficient for income to be received this way.

Example

The following example shows the tax position where the trustees do not have a carried forward pool of tax credits and dividend income of £1,000 is received. The net receipt in the hands of the beneficiary depends upon his or her own tax status:

Trust income:		£	£
Net dividend received by trust			1,000.00
Add 10 per cent tax credit			<u>111.00</u>
Gross dividend			1,111.00
Tax @ 42.5 per cent on gross dividend	472.18		
Less 10 per cent tax credit	<u>(111.00)</u>		
Tax payable by trustee (creates a tax pool)			<u>(361.18)</u>
Net income available for distribution			<u>638.82</u>

The trustees in this example can distribute a maximum net amount of £500 which will be deemed to have a 50 per cent tax credit of £500. As only £361.18 is in the tax pool the trustees will have to pay an additional tax charge of £138.82 to meet the £500 tax credit. The total of the £500 distributed and the additional tax of £138.82 will exhaust the trust's net income of £638.82.

If the trustees wish to avoid any additional tax charge the maximum they can distribute is £361.18 as the tax pool will meet all the tax credit.

A beneficiary receiving a distribution from a trust can claim tax back if they pay a lower rate of tax than the trust rate.

The final column compares the position of a beneficiary with an income interest.

	Maximum Discretionary Payment (with additional charge) £	Maximum Discretionary Payment (without additional charge) £	Beneficiary with an income interest £
Non-taxpayer	500.00	361.18	1,000.00
Tax refund	<u>500.00</u>	<u>361.18</u>	<u> </u>
Net receipt	<u>1,000.00</u>	<u>722.36</u>	<u>1,000.00</u>
Basic rate taxpayer	500.00	361.18	1,000.00

Tax refund	<u>300.00</u>	<u>216.70</u>	<u>1,000.00</u>
Net receipt	<u>800.00</u>	<u>577.88</u>	<u>1,000.00</u>
Higher rate taxpayer	500.00	361.18	1,000.00
Tax refund/(liability)	<u>100.00</u>	<u>72.24</u>	(<u>250.00</u>)
Net receipt	<u>600.00</u>	<u>433.42</u>	<u>750.00</u>
Top rate taxpayer	500.00	361.18	1,000.00
Tax (liability)	— —	— —	(<u>361.18</u>)
Net receipt	<u>500.00</u>	<u>361.18</u>	<u>638.82</u>

The beneficiary who has an income interest only has to account for higher rate or top rate tax as applicable.

Granting a beneficiary a temporary income interest can be achieved with no Inheritance Tax or Capital Gains Tax consequences and has the following advantages:

- The benefit of the 10 per cent tax credit on dividend income is not lost.
- The trustees do not incur any additional tax charges.
- Improves cash flow as no tax refunds have to be claimed.
- Simplifies the completion of the annual tax return.

How to instruct us

- 1 Please let us have the information set out below and we will confirm (free of charge) that the appropriate trust powers exist. We will quote a fixed fee charge at that point.
- 2 Please confirm whether you would like us to act for your organisation or for the client directly.
- 3 We will open a file once you have let us have the documents to satisfy the anti-money laundering identification requirements.
- 4 We will prepare the deed and send a signature copy to you to arrange execution.

Information required

1 The Trust

1.1 Please let us have a copy of the following:

- The original trust deed.
- Any Deeds of Appointment altering the terms of the trust.

- Any Deeds of Appointment and Retirement of Trustees.

1.2 Please ensure that we have up to date addresses for the trustees if these have changed since the last document.

2 **The Beneficiaries**

We will need the full names and addresses of those beneficiaries who will take the income interest and if more than one, confirmation of whether this will be in equal shares.

3 **The Trust Fund**

Please confirm whether the income interest will take effect over the whole or just a proportion of the trust funds.

For further information, please contact:



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