
The Personal Tax Planning Review

DISCRETIONARY TRUSTS AND THE NEW DIVIDEND REGIME

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The new regime for taxation of dividends introduced by the Finance (No 2) Act 1997 came into force for dividends paid after 6th April 1999. The Revenue has recently published an "interpretation" setting out how trustees will be affected (in *Tax Bulletin* 39, issued February 1999), but this only gives part of the story.

The potential problem can be illustrated by considering the position of a higher rate taxpayer receiving income through a discretionary trust. Suppose the trustees receive £900 dividend income and wish to distribute all that they can to the beneficiary. Under the old regime, the beneficiary would have received, after tax, £675. He would receive the same amount if he owned the shares directly under either regime. Under the new regime, however, the beneficiary will receive only £540 if the income is paid through a discretionary trust.

This article explores the new regime and suggests how, with careful planning, the effects indicated above can often be mitigated.

The Old Regime

The system was quite simple. When discretionary trustees received income it was taxed at the rate applicable to trusts, 34%, whatever type of income. If the income was a dividend from a UK company it came with a tax credit of 25%, but tax was payable on the grossed up amount (i.e. dividend plus credit) (ICTA 1988 s.686). When those trustees made a distribution, it was treated in the recipient's hands as a net amount on which tax at 34% had been paid. The trustees had to account for this tax but might have set off against it any tax previously paid on the receipt of the income, including tax "paid" by the tax credit (s.687).

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Example

If trustees received a dividend of £900 it would have come with a tax credit of £225, and they would have had to meet a tax liability of 34% of £1,125 i.e. £382.50. All but £157.50 of this would have been covered by the tax credit. However, the total amount passed into the s.687(3) "tax pool" and was available to cover any liability the trustees had to meet on making a distribution. The trustees were left with £742.50 in hand.

If they then distributed this, the beneficiary was treated as receiving an amount on which tax at 34% had been paid. The trustees had no further tax to account for because their liability was covered by the tax credit plus the tax already paid. If the beneficiary was a higher rate taxpayer he or she was liable to 40% tax on the grossed up amount (i.e. £450 tax on £1,125) and had to pay the additional £67.50 himself. He or she was left with £675. If the beneficiary had received the dividend directly, or through an interest in possession trust, he or she would also have received £675 (after tax at 40% is deducted from the £900 dividend grossed up to £1,125).

The New Regime

When trustees of discretionary trusts receive a UK company dividend after 6th April 1999, the tax credit is 1/9 of the amount distributed and the rate of tax is the Schedule F trust rate of 25%. When the trustees make a distribution, however, it is still treated as an amount from which tax at 34% has been deducted, and the trustees have to meet that liability. Now they are only allowed to set against this the tax actually paid and not the tax credit. The result of this is that the most trustees can distribute if they wish to pay the tax from the dividend received is 66% of that dividend.

The Revenue's view is that the trust constitutes a new source of income and this was confirmed by Walker J in *Memec v IRC* [1996] STC 1346 at 1351. Although the Court of Appeal expressly declined to address the point ([1998] STC 754), the High Court decision is likely to be found persuasive by other judges. If the trust is UK resident, the income is taxed under Sch D Case III and if the trust is not UK resident, under Sch D Case V. However, it is not a payment of "interest" and so not taxable at the lower rate as "savings" (see ICTA s.1A(2)(a)(i)). A higher rate taxpayer will have to pay additional tax to meet the 40% liability. A recipient whose marginal rate is lower than 34% will be able to claim back the tax overpaid.

Beneficiaries receiving the dividends directly would have been taxed at the lower Sch F rates (namely the Sch F upper rate of 32.5% for higher rate taxpayers and the Sch

F ordinary rate of 10% for others) and would have had the benefit of the tax credit² (which covers the Sch F ordinary rate liability). Thus, using the discretionary trust gives rise to a twofold disadvantage, a fact that is not highlighted by the *Tax Bulletin*.

Example

If the trustees receive a dividend from a UK company of £900 after 6th April 1999, they will also receive a tax credit of £100, and will be assessable to tax at 25% on the total £1,000, i.e. £250. Accordingly they will have to pay £150, and will be left with £750 in hand. The trustees can give a beneficiary 66% of the dividend without tax credit, i.e. £594, keeping the balance of £156 in hand. This creates a tax liability of £306 (i.e. 34% of £900) against which is set the tax previously paid of £150, but not the credit of £100. The trustees pay the £156 which they have kept back to meet this liability. The beneficiary is treated as receiving a gross amount of £900. For a higher rate taxpayer, this means a liability of £360, of which £306 has already been paid. In the end, the beneficiary has £540 in his hands after a distribution of £900. A basic rate taxpayer would be left with £693 (i.e. £900 less tax at 23%) while a recipient within whose personal allowance the distribution fell would be able to claim back all the tax paid so as to be left with £900.

Had the beneficiary paying tax at the higher rate received this dividend directly, he would have paid tax at 32.5% on the total of the dividend plus tax credit, and would have been allowed to use the tax credit to reduce his liability. In this case, the tax would have been £325, reduced by the credit of £100, and leaving the beneficiary with £675 net. The basic rate taxpayer would have received £900 because, as noted above, his liability of £100 (being 10% of the grossed up amount) is covered by the tax credit. If the dividends fell within the taxpayer's personal allowance, the total received would still be £900 (as after passing through the trust) because the tax credit is no longer repayable.

The New Regime and Tax Pools

After 6th April, the tax credit will get "trapped" in the trust because it does not form part of the "tax pool" under s.687(3), the tax previously paid by trustees which they can set against their liability on distribution ("franking" the distribution). This pool contains not only the tax paid on receipt of the dividend that is, in the examples

² It should be noted that the tax credit is no longer repayable if it exceeds the taxpayer's liability. This it will do to the extent that the dividend, being treated as the top slice of income, falls within the taxpayer's personal allowance (see F(No 2)A 1997 s.30(5)(b) amending TA 1988 s.231(3)).

above, immediately to be distributed, but also tax paid in previous years. If the trust has retained income, and possibly accumulated it to capital, the tax pool may have an historic surplus: more tax will have been paid than has been used to frank distributions. Tax paid (and tax credits received) before 6th April remains in the pool and can be used to frank distributions after that date. Accordingly, where such a pool exists, the trustees need not keep cash back to meet their liabilities when making distributions.

The effect of this is that some beneficiaries will actually be better off if dividends are routed through a discretionary trust with an historic trust pool than if they receive the income directly.

Example

The trustees receive a dividend of £900 as above, and pay £150 in tax. They distribute all £750 remaining. This is treated as an amount of £1,136 with tax paid at 34%. The additional liability of £236 is met from the tax pool.

A 40% marginal rate taxpayer would have to pay a further £68 tax and would thus keep £682, more than the £675 he would have received had the distribution been direct.

A 23% marginal rate taxpayer could claim back £135 making a total receipt of £875. However, such a taxpayer receiving a direct payment would only pay the Sch F ordinary rate of 10% which is entirely covered by the tax credit and would therefore have received all £900 distributed.

A taxpayer within his or her personal allowance could claim back all the tax, giving a receipt of £1,136. Had he or she received the distribution directly, he or she would only have received £900, and the tax credit would not have been repaid.

Offshore Trusts

Offshore trusts are treated in the same way when receiving dividends from UK companies and must account for the same amount of tax at that time, as onshore trusts.

Under the old regime, ESC B18 allowed beneficiaries receiving payments from offshore trusts to claim the same treatment as beneficiaries of onshore trusts when corresponding payments were made. The relevant wording was that "a UK beneficiary of a non-resident trust may claim credit for UK tax actually paid by the

trustees on the income out of which the payment [to him] is made as if the payment were from a UK resident trust." The apparent intention was that beneficiaries should be treated in the same way whether the distributing trust was UK resident or not.

The concession has been updated to take account of the legislative changes (see [1999] STI 729), although the central wording, quoted above, remains the same. An additional proviso is introduced:

"No credit will be given for UK tax treated as paid on income received by trustees which would not be available for set off under TA 1988 s.687(2) if that section applied, and that tax is not repayable (for example on dividends). However, such tax is not taken into account in calculating the gross income treated as taxable on the beneficiary under this concession."

On this basis, relief under the new regime should be allowed in the following way. The non-UK trustees distribute to a UK-resident beneficiary all the cash they have from UK-dividends (e.g. the £750 remaining after paying £150 actual tax under s.86). The UK beneficiary is treated as receiving the gross amount (i.e. £900) on which £150 has been paid and is liable for the balance of the 40%, leaving him or her with £540 in hand after paying an additional £210 tax. This puts him or her in the same position as the beneficiary of a UK trust (see the example above), albeit by a slightly different route.

As noted above, income from an offshore discretionary trust is taxed under Schedule D Case V and so is assessable on the remittance basis for recipients resident but not domiciled in the UK (or for citizens of Commonwealth countries or Eire who are resident but not ordinarily resident in the UK). In some circumstances, this may provide a simple way to avoid the problem.

Planning Consequences

Using discretionary trusts for passing UK dividend income to beneficiaries has become more expensive. If the trust has an historic s.687(3) tax pool, a higher rate taxpayer may be marginally better off (ignoring management expenses) and if the income is received within a personal allowance the recipient will be significantly better off. If possible, therefore, discretionary trusts with tax pools should try and make payments to beneficiaries with lower incomes in order to realise the value of the pool.

In the majority of cases, including all new trusts, other routes will have to be considered, depending on the powers available to the trustees and the circumstances of the beneficiaries.³

- Give the beneficiary a terminable interest in possession in the fund or part of it. Termination of the interest in possession is a transfer of value however (IHTA s.52) and chargeable at the lifetime rate unless a PET (s.3A(2), (6)). Particularly for larger trusts, it might be advisable first to divide the fund into an income producing fund (in which interests in possession could be granted) and a capital growth fund (which would remain subject to the discretionary trusts). This method is likely to be appropriate for minor beneficiaries who are (perhaps) less likely to die during the interest in possession period and whose nil rate band is more likely to be available if they do die.
- Buy units in split level unit trusts, in which some units receive the income and others benefit from any capital growth. This would be a more efficient way of achieving the result sought by the division of the trust investments into two funds (because the amount of income and growth in two parts would not depend on the trustees' selection of appropriate investments but would be determined by the terms of the unit). It might also be more expensive, although "zeros" (bonds with guaranteed capital growth of perhaps 6% a year but very limited income rights) are being increasingly marketed by investment funds.
- Accumulate the income and distribute as capital.⁴ This may not be possible in every trust, because the trustees do not have, or no longer have, a power to accumulate. The capital payment may trigger an exit charge if made otherwise than from an accumulation and maintenance settlement and to one of the minor beneficiaries. If the settlor (using the very broad definition in ICTA 1988 s.660G) is a parent of the beneficiary, a distribution of

³ All these suggestions will have to be considered in light of the proposed changes to TA 1988 ss.660A - 660G, i.e. the anti-avoidance provisions relating to settlements: see Finance Bill 1999 clause 58.

⁴ Although *prima facie* a payment of capital by trustees will be received as capital by the beneficiary, the Revenue might seek to argue that where the source of the capital is income, albeit accumulated, and the money is used by the beneficiary for income purposes, the reality is that the beneficiary has received an income payment. The beneficiary's defence could be bolstered by drafting the trust instrument so that the income is automatically accumulated after, say, thirty days and by restricting the trustees' power to make payments other than of capital.

accumulated income is deemed to be income of the settlor (s.660B(2)), and is treated as a payment made to him under s.687. For this reason, this route will only usually be appropriate for minor beneficiaries whose parents have not made the settlement.

- If all the income is accumulated, a £900 dividend will still attract a £150 charge when received by the trustees, leaving only £750 to distribute the following year. The trustees might instead distribute so much of the income as would result in a s.687 charge equal to the Sch F tax already actually paid under s.686. Thus a trust that receives £900, and so pays £150 tax, could distribute £291 (which would be treated in the recipient's hands as a gross amount of £441 on which tax at 34% of £150 had been paid) and accumulate the remaining £459. A basic-rate recipient could claim back £49, giving a receipt in the first year of £340, and receive capital of £459 in the second, giving a total receipt of £799. A higher-rate recipient of the same distributions, however, would pay additional income tax in the first year of £26 and receive only £724.
- Leave the settlor with an interest so that s.660A applies to deem the trust income his. He can then claim the benefit of the tax credit and Sch F rate, and recover the tax paid from the trustees (s.660D). A disadvantage is that any capital gains in the trust will also be deemed to be the settlor's (TCGA 1992 s.77).
- Invest in assets that do not produce Sch F income. Trustees diversifying into property should be aware that allowing a beneficiary to occupy a house may amount to granting an interest in possession (see SP 10/79).

In many cases, it will be possible to avoid the disadvantageous income treatment of discretionary trusts by using one or more of these methods. Typical examples follow.

Example 1

A discretionary trust was set up to utilise the deceased's nil rate band in 1993 (i.e. £150,000). The beneficiaries are the deceased's widow, his two adult children and his three minor grandchildren. By 1999 the fund has grown to £230,000 including £40,000 capital growth and £40,000 accumulated income (and a tax pool of some £20,000). In 1999 the fund will receive another £18,000 in dividends (i.e. £15,000 after payment of tax at the Sch F trust rate).

If that income were paid through the trust to the widow, a higher rate taxpayer, she would receive only £13,636 after payment of tax, and the tax pool would be reduced by some £7,727. If the widow were given an interest in possession for the year, she would receive income of £13,500 and the tax pool would remain intact. But, at the end of the year, she would make chargeable transfer of the entire fund, triggering a charge of 20% of the value of the fund (i.e. £46,000). Some mitigation of this could be achieved by giving someone else, before termination, an interest in possession subject to the widow's, so that she would at least only be making a PET.

Alternatively, the income could be paid to the minors in equal shares. They would be treated each as receiving a net amount of £5,000 on which tax of £2,576 had been paid. The tax pool would again be reduced by £7,728, but the minors would be able to claim back all the tax bar £550 each (after the new allowance of £4,335 and the new rate of 10% on the next £1,500 are taken into account). They would receive a total of £7,026 each, more than the £5,000 they would have received had the dividends been paid directly.

The widow could be paid from the accumulated income. This would not diminish the tax pool, and would not trigger an exit charge (or "proportionate charge") because the total value of the original settlement (£150,000) and the added property (the accumulations of £40,000) is less than the nil rate band available for 1999 of £231,000.

Example 2

An accumulation and maintenance settlement is established *inter vivos* in 1998 to provide for the settlor's grandchildren. The fund contains securities worth £750,000. The trustees have invested most of the fund in unit trusts aiming for capital growth, but £270,000 in a high income fund, which will produce £27,000 in 1999. The beneficiaries, who will become entitled at age 25, are Rachel (who is 9 years old), James (11) and Charlotte (17). In the meantime the trustees must accumulate any income not used for the maintenance, education or benefit of the beneficiaries. All three children are at fee-paying schools, with fees of £5,000, £5,000 and £10,000 respectively. None of them have other sources of income. The income that arose before 6th April 1999 has been paid out to meet the fees.

The trustees could continue this approach. The trust would receive £22,500 after tax and £4,500 would accrue to the tax pool:

- In order to pay Rachel's and James's fees, the trustees must distribute enough to leave them with £5,000 after tax. In order to receive this amount net, the children would need £5,075 gross. Thus the trustees should

distribute £3,350 and pay the s.687 charge of £1,725. The beneficiaries are treated as receiving £5,075 with tax paid at 34%. Their liability however is only £74 (i.e. 10% of the income over the personal allowance of £4,335), so they can reclaim most of the tax paid. This leaves them £5,001 with which to pay the fees. However, dividends of £5,075 would have been used.

- In order to pay Charlotte's fees, the trustees would need to give her £11,439 gross so that she has £10,000 net. They should distribute £7,546 and pay the charge of £3,887. Charlotte could reclaim most of the tax and be left with £10,000. Dividends of £11,439 would have been used.
- The trustees will be making distributions totalling £14,246 attracting a liability of £7,339 under s.687. Against this can be set the £4,500 tax actually paid, but the remaining £2,839 must be met from the net dividend receipts. This leaves the trustees £5,415 to accumulate, although nothing remains in the tax pool.

Instead, the trustees might consider giving the beneficiaries interests in possession. This would only use £20,000 of dividends, since none of the beneficiaries are liable to the higher rate of tax and the 10% Sch F ordinary rate liability would have been balanced by the tax credit. This would leave £5,833 to be accumulated and £1,167 to go into the tax pool (which could be used to frank payments within Rachel's and James's personal allowances the following year and so be reclaimed by them).

The interests in possession would prevent that part of the trust falling within s.71 IHTA 1984 for so long as they subsisted, so that the beneficiaries will not be able to claim hold over relief under TCGA 1992 s.260 on becoming absolutely entitled to the income fund. However, this part of the settled property, being part of the income fund, should not have increased greatly in value. If the relief is desired the interests could be terminated say six months before Charlotte's 25th birthday. The beneficiaries would all make PETs when this happened, but almost certainly within their nil rate bands and insurable in any event. The whole fund would once more fall within s.71 and Charlotte could claim the relief.

Example 3

The trustees hold assets worth £2m on discretionary trusts for beneficiaries including a UK resident and domiciled higher rate taxpayer (who is not the settlor). In 1999 the trust generates £135,000 in dividend income.

If the trustees distribute everything as income, the beneficiary will receive £81,000 after tax. If they give him an interest in possession, he will receive £101,250. They could, however, distribute £43,665 and accumulate the remaining £91,335. The beneficiary will receive £39,690 after tax, but with £91,335 in the trust to be distributed as capital the following year. This policy would allow him to recover a total of £108,540 from the distribution, and avoids the trust property becoming part of his estate for inheritance tax purposes (although there may be capital gains tax concerns).