THE INTEREST CHARGE
AN ATTEMPT TO SHOW ITS EFFECT

John F Avery Jones, Solicitor[1]

What follows is an attempt to show in figures the effect of the interest charge on postponed gains of an existing non-resident trust, by comparing it with not having a trust at all, in an attempt to demonstrate whether such trusts still serve a useful purpose. The pre-budget regime will also be included for comparison. To make this comparison we must make some assumptions, which are that we are dealing with a top rate taxpayer who has used up his capital gains tax annual allowance elsewhere. Indexation is assumed to be a constant 5 per cent. Less realistically, we have assumed that gains are realised each year: if this assumption is not made it becomes difficult to compare the trust regime with personally-owned assets, since trust gains must be realised if they are to be distributed. It is also a worst case assumption; if trusts are viable on that assumption, they are likely to be in real life.

What is shown in the following figures is the after-tax value to the beneficiary at a given point, for example after a given number of years the place on the line is the after-tax amount which the taxpayer would have in the case of a non-resident trust after paying all taxes if the whole trust were distributed to him at that time, or what he actually has in the case of personally-owned assets. The pre-tax amount is shown only on figure 1 (the line with open squares) but this is not particularly relevant, except to show how much of the money which would otherwise have gone in tax is being invested by the trustees. We shall compare having no trust with both life interest and discretionary non-resident trusts, taking two cases of each: those where gains are made regularly, and those where there is a large initial gain, for example on the sale of shares in a private company, followed by regular gains, as this is a fairly common use for non-resident trusts. In all cases the trust starts with £100 at year 0.

---

1 John F Avery Jones, Partner in Speechly Bircham, Bouverie House, 154 Fleet Street, London EC4A 2HX
Tel: (071) 353 3290 Fax (071) 353 4825
Joint Editor of The British Tax Review.

This article is an updated version of a lecture to the British Branch of the International Fiscal Association in June 1991. If any reader would like to see the effect of recalculating the figures on any other assumptions, I should be willing to provide them.

Life interest trusts

[Fig.1]

Figure 1 shows the effect of an existing life interest non-resident trust making regular gains. Since all the income is distributed, and, we shall assume, spent, only the rate of making capital gains is relevant to the value of the fund, whether in trust or personally held. The rate at which capital gains are made (and, we have assumed, realised) is 10 per cent per annum, with indexation at 5 per cent. As already mentioned the top line (with open squares) shows the pre-tax value of the fund, which will not be shown in subsequent figures. As will be seen, the other three, after-tax, lines do not diverge until after year 6, indicating that during this period a non-resident trust, on these assumptions, is no worse and no better than having no trust.

[Fig.2]

These after-tax lines are shown more clearly in Figure 2, which is exactly the same as Figure 1 but without the before-tax line, and the after-tax lines can therefore be shown slightly less condensed. The pre-budget non-resident trust regime (triangles) wins after about year 7 but the new non-resident trust regime (squares) and the no trust regime (diamonds) only begin to separate after year 13. Clearly there is nothing in non-resident trusts on this assumption.

[Fig.3]

Figure 3 shows the effect of increasing the rate of making capital gains to 15 per cent, with indexation staying at 5 per cent. The three lines diverge much more clearly, with the new regime for non-resident trusts being intermediate between the pre-budget regime and no trust. The new regime wins over no trust, but only from about year 10, which is hardly exciting.

[Fig.4]

We next repeat the last two examples but assuming now that the £100 at year 0 wholly represents a gain (yet another extreme example) made in an earlier transaction, such as the sale of private company shares. Indexation has been ignored on this gain on the basis that the cost of the shares is negligible. Figure 4 starts with subsequent gains being made at 10 per cent per annum, as before. It is easier to demonstrate what is happening here with the new interest charge. If the initial gain is £100 and the potential tax £40, at the end of the first year the tax on the non-resident trust is increased by £4 (or would do if the first year counted), while £100 is invested and making gains of £10, or £8 after potential tax allowing for indexation, the tax on which will itself increase by 10 per cent per annum. The fund is therefore growing at a greater rate than the tax. The effect is that although the after-tax value is still increasing, because of the interest charge the value starts below that of the personally owned assets. It catches up and overtakes the no trust case in year 7, after which it shows a healthy increase over the no trust case. Although this might be thought to be a case where there was little benefit in having a non-resident trust because of the size of the initial gain, the reverse is true.

[Fig.5]

Figure 5, with capital gains at 15 per cent, shows a similar trend, being virtually the same as the no trust case for the first 6 years and then diverging more sharply in favour of the non-resident trust.

The conclusion on life interest trusts is therefore that, on these somewhat extreme assumptions, there is not much in it for non-resident trusts, at least unless there is a large initial gain or the rate of return is high.

Accumulating trusts

We now turn to accumulating trusts, which have the main difference that income, as well as gains, is included to swell the value of the fund, and we also assume that in the no trust case income is accumulated and not spent. The position of income is unchanged from the pre-budget regime since the interest charge only applies to gains. On the other hand there is no indexation allowance and inflationary income is taxed. We shall start, as before, with regular income and gains.

[Fig.6]

Figure 6 shows the effect of making gains but no income, which is, of course, the same as the life interest case in Figure 3.

[Fig.7]

Figure 7 now includes both income and gains, 5 per cent income and 10 per cent gains per annum. As will be seen the new regime for non-resident trusts is close to the pre-budget regime, and substantially better than no trust, but only after about year 8.

[Fig.8]

Reversing the income and gains yields to 5 per cent gains and 10 per cent income per annum results in two lines only in Figure 8, since the pre- and post-budget regimes coincide (although they are shown as squares representing the post-budget regime), because there is no capital gains tax on which to charge interest because this is covered by indexation. Both regimes are better than no trust from about year 7.

[Fig.9]

Finally in Figure 9 we assume no gains but 15 per cent income, which again results in the pre and post budget regimes being identical, and again diverging from the no trust case after about year 6.

[Fig.10]

The last four Figures are repeated but with a large initial gain of 100 per cent of the fund followed by regular income and gains. The first, Figure 10, is the same as the life interest case in Figure 5, since there is no income.

[Fig.11]

Figure 11 shows 10 per cent gains and 5 per cent income. This diverges in favour of the non-resident trust earlier than the case of regular income and gains, this time from about year 6, after which it is not far behind the pre-budget regime.

[Figs.12 and 13]

Figures 12 and 13 are again almost as good as the pre-budget case, particularly the former, diverging from the no trust case after about year 6.

Conclusion

It may be unwise to draw too definite a conclusion based on these rather arbitrary assumptions, but the figures do seem to show that accumulating non-resident trusts are still worthwhile, while life interest trusts are borderline in the short term, but still worthwhile in the long term.