

Taxing times for trustees

Anita Gatehouse*

Abstract

This article analyses the proposed income tax changes introduced by the 2008 Budget and the likely impact of those changes on trustee investments. It assesses the tax treatment of investment bonds, segmentation and the opportunity in the current economic climate for trustees to reassess their investment strategies.

As if the role of the trustee was not difficult enough, in the Pre-Budget report in November 2008, the Chancellor announced the proposed increase in income tax rates from the tax year 2011/12. The actual budget revealed the true extent of the increases and also a shorter time frame before these changes take effect, certainly adding to the trustees' load. His increase in the income tax rate to 50 per cent for those individuals with income of more than £150,000, brought with it a commensurate increase in the trustees tax rate which applies to income from the tax year 2010/11. Rather harshly, the increase for trustees is significantly worse than for highly paid individuals and is further evidence of the Government's dislike of trusts by disproportionately penalizing them.

The increase for trustees is significantly worse than for highly paid individuals

For individuals, the increased rate will apply to income above the £150,000 threshold, whereas for trustees of discretionary trusts, it will apply to all

income above the standard rate band, currently £1000. This disparity between the taxation of individuals and trusts does seem unfair when lined up together and will have significant impact on affected trusts.

Changes in tax rates

This trustees' income tax rate rise from 40 to 50 per cent gives the Chancellor an increase in the tax take of 25 per cent from this source assuming he does not increase the standard rate band for trusts. Dividend income is also affected; the increase from 32.5 per cent tax to 42.5 per cent represents a further 30 per cent increase in the tax take for the Chancellor. This represents a significant tax feast for the Government without too much political damage.

Let's look at some examples of how the changes will work, assuming income received is above the £1000 standard rate band. Trustees will normally receive deposit interest after a deduction of 20 per cent tax, so a payment of £1000 to the trustees would be grossed up by the 20 per cent tax credit to calculate the tax due, a gross figure of £1250. With tax due of £625.00 and a tax credit of £250.00, trustees pay an amount of £375.00 to HMRC, leaving the sum of only £625.00 for distribution to beneficiaries.

Dividends

Trustees will receive dividends after a deduction of 10 per cent tax which is not recoverable. A payment of £1000 to the trustees would be grossed up by the tax credit to calculate the tax due, a gross figure

*Anita Gatehouse, Founding member of Evidence Based Investment Solutions (EBIS Group) and principal of Cre8 Financial and Business Planners, cre8 Financial and Business Planners, 9 Church Street, Kidderminster, Worcestershire, DY10 2AD, UK; Tel: +44 1562 745730; Email: anita@cre8-fbp.com

of £1111.11. Trustees would pay tax at 42.5 per cent, an amount of £472.22, and after deducting the tax credit of £111.11, the trustees have to pay a further £361.11 in tax. If the trustees remit is to retain this income they will have an amount of £638.89 left for re-investment.

Depending on whose hands income is paid into will then determine how the tax position develops. Assuming this trust income is paid to one beneficiary, the beneficiary's own tax position will determine whether any tax can be reclaimed. Worst case would be a beneficiary whose taxable income levels are over £150,000, taking them into the new 'super' tax bracket as there will be no reclaim available.

The tax position for the beneficiaries is summarized in Tables 1 and 2.

Here is where things become more complicated: any trust income subject to the trustees tax rate, when distributed will have to be 'franked' as having suffered tax at 50 per cent, whether this arises from dividends or other income. Those trusts that distribute more income than can be franked by the trustees' tax pool will see an increase in the notorious

'tax pool charge'. In the example above, if the income of £638.89 is to be distributed, there will be a further tax liability because it has only been taxed at 42.5 per cent and should be franked at 50 per cent. The trustees can deduct the amount of tax they have actually paid, £361.11, but the 10 per cent tax credit cannot be used again for the second liability, thereby leaving a further £138.89 tax due and a net distribution of £500. From the notional starting point of £1111.11, tax on dividend income for some beneficiaries is at the extremely penal level of 55 per cent, a very unsatisfactory position.

Any trust income subject to the trustees tax rate, when distributed will have to be 'franked' as having suffered tax at 50 per cent, whether this arises from dividends or other income

Capital gains tax

As can be seen from the above scenarios, trustees must, as well as considering the legislation relating to investment issues, also be very aware of the

Table 1 Interest—based on £1000 remitted by the trustees

Tax status	From trustees (£)	Tax refund (£)	Total income (£)	Effective tax rate ^a (%)
Non tax payer	625	625	1250	0
Basic rate	625	375	1000	20
Higher rate ^b	625	125	750	40
Higher rate £150k+	625	0	625	50

^aCalculated from the gross £1,250.

^bIn addition the income tax personal allowance will gradually be restricted for those with income of over £100,000. The personal allowance will in addition be reduced at a rate of £1 for every £2 over £100,000 until completely withdrawn.

Table 2 Dividends—based on £1000 remitted by the trustees

Tax status	From trustees (£)	Tax refund (£)	Total income (£)	Effective tax rate ^a (%)
Non tax payer	500	500	1000	10
Basic rate	500	300	800	28
Higher rate ^b	500	100	600	46
Higher rate £150k+	500	0	500	55

^aCalculated from notional gross £1111.11 and to the nearest whole number

^bIn addition the income tax personal allowance will gradually be restricted for those with income of over £100,000. The personal allowance will in addition be reduced at a rate of £1 for every £2 over £100,000 until completely withdrawn.

impact of tax on the trust income. Trustees will be reviewing portfolios which will have already felt the effects of the economic downturn resulting in capital losses. Now they will be experiencing dividend cuts and extremely low interest rates paid on capital on a scale not seen during most careers and the reduced income flow is about to be hit again by the increased tax rates. A change in emphasis may be rewarded in relation to trust assets by considering low or non income producing areas, looking instead to create capital gains with their associated 18 per cent tax rate over and above the trustees' capital gains tax exemption, which has now taken on more of an attractive air, bearing in mind that the allowance will be diluted where the settlor has created more than one trust. These realized gains may be distributed as 'cashflow' (assuming capital advancement is allowable under the trust). A word of warning here though: it will be vitally important to consider whether by focusing on tax efficiency and reduction, the Trustees could be seen to be favouring one type of beneficiary over another and so leave themselves open to criticism or worse. It will be vital, if this route is taken, to ensure that the reasons are agreed and well recorded to justify why this would be in the best interests of the trust as a whole.

Insurance company investment bonds

Despite their past 'overuse' by some investment advisers where highly charged contracts were the norm, use of the modern open architecture single premium insurance bonds could offer another an effective investment option. These products have been around since the 1970s but within these up to date single premium bonds, charges are transparent both on the bond itself and also on the underlying investments, a far cry indeed from the days when only an actuary could work out the true cost of these investment arrangements. These bonds, both onshore and offshore, can establish the framework for a non-income producing portfolio, reduce administration and create an effective shell inside which an investment portfolio sits.

Rebalancing asset allocation

The investment bond is basically a vehicle offered by life assurance companies, and although it is an investment, does not fall under the Capital Gains Tax regime as technically it is classed as a life assurance policy. Unlike in the case of a unit trust investment or an equity portfolio, switching funds does not result in a Chargeable Event and therefore no tax liability ensues. This is of real significance as the investments within the bond can be rebalanced regularly to the original agreed asset allocation without any concern over the tax implications, therefore, maintaining the agreed risk profile, an important responsibility for the trustees.

There are in the main, two types of life company investment bonds, those held in the UK classed as 'onshore' and those held outside the UK, 'offshore'. With an onshore bond, the life fund will be liable to tax at around 20 per cent which the UK insurer will settle within the fund. There will be tax on gains realised on the encashment of the bond, but there will be effectively a 20 per cent tax credit. Under an offshore bond the position is classed as gross roll-up. Gross roll-up means that any underlying investment gains are not subject to tax at source—apart from an element of withholding tax, consequently, there will be no tax credit on encashment. Both onshore and offshore bonds offer scope for tax efficient cashflow using the 5 per cent tax deferred entitlements to advance capital to beneficiaries to replace income (assuming this is allowable under the trust).

Another way of passing capital from the trust to a beneficiary is by assignment. Assigning a policy absolutely to a third party is not a chargeable event for tax purposes. Once the policy has been assigned, the assignee (beneficiary), as the legal owner of the policy, can surrender the policy, providing that the assignee is over 18. Tax will then fall on the assignee and if they are a basic-rate or non-taxpayer, this can be a simple way of passing on the benefits to them

Assigning a policy absolutely to a third party is not a chargeable event for tax purposes

in a tax-effective manner instead of the tax falling on the trustees.

Many trusts are designed to pass the trust property to a number beneficiaries. This being the case, where the trust makes use of an investment bond then segmentation is invaluable as a means of splitting the benefits between beneficiaries. The bond can be divided into identical mini bonds commonly known as segments. Giving some thought at the start of the plan on how many segments to choose may be useful, creating ease of administration at a later date. For example, where there are three established beneficiaries, choosing a number of segments divisible by three—say, 90 rather than the common default 100—may help the trustees to dispose of the trust property where the benefits are to be paid in equal parts. But, as is sometimes the case, what if the number of beneficiaries is not known? Choosing a number of segments at the outset that will give trustees an element of flexibility, for example, the number 60 can make things easier. This number of segments can be split equally between two, three, four, five or six potential beneficiaries, rather than a default of 100 segments, which limits the choice to two, four and five.

Where the trust makes use of an investment bond then segmentation is invaluable as a means of splitting the benefits between beneficiaries

Taxation of investment bond funds

Onshore investment bond	Offshore investment bond
Investment funds are subject to tax on income and capital gains realized within the funds, normally around 20%	Investment funds are not subject to capital gains tax or income tax at source. The only exception is irrecoverable withholding tax, which will be deducted from dividends and certain interest received by the fund. Withholding tax is the tax deducted before the dividend or interest is paid. Fund therefore benefits from Gross Roll up

Taxation of proceeds on assignment of segments

	Onshore investment bond	Offshore investment bond
Non-tax payer	No further tax liability on any gains (unless chargeable gains push income into the higher rate tax band). 0% payable Effective rate 20% Tax deducted at source on the underlying fund cannot be reclaimed.	Income tax is payable on the chargeable gain at applicable rate(s) only if the gain takes the investor into or beyond the starting rate tax band. 0% payable
Starting rate tax payer ¹	No further tax liability on any gains (unless chargeable gains push income into the higher rate tax band) 0% to pay Effective rate 20%	Income tax is payable on the chargeable gain at rate(s) applicable to the investor. 10% or 20% to pay
Basic rate tax payer	No further tax liability on any gains (unless chargeable gains push income into the higher rate tax band) 0% to pay Effective rate 20%	Income tax is payable on the chargeable gain at rate(s) applicable to the investor. 20% to pay
Higher rate tax payer	Any chargeable gain will be subject to the difference between basic rate and higher rate income tax. 20% or 30% if 'Super' tax payer Effective rate 40% or 50%	Chargeable gain taxed at higher rate. 40% or 50% to pay

Opportunity to review

With the historically low values applying to most investment areas, crystallising some gains on trust assets at the moment may be an opportunity to tactically move away from more penal future tax rates. For some trusts, a fresh look at the investment strategy, perhaps considering the advantages of a low cost passive route, may also be an opportunity to be considered during these volatile times.

1. As chargeable events are subject to the savings rate of income tax, the starting rate can still apply depending on the level of non-savings income.

Interestingly, in the US, fiduciary responsibilities include justifying why trustees would choose *not* to use a passive approach to the investment strategy.

For some trusts, a fresh look at the investment strategy, perhaps considering the advantages of a low cost passive route, may also be an opportunity to be considered during these volatile times

Economic evidence shows that the major markets in this country are highly efficient, in the sense that available information is rapidly digested and reflected in the market prices of securities. As a result, fiduciaries and other investors are confronted with potent evidence that the application of expertise, investigations, and diligence in efforts to 'beat the market' in these publicly traded securities ordinarily promises little or no payoff, or even a negative payoff after taking account of research and transaction costs. Empirical research supporting the theory of efficient markets reveals that in such markets skilled professionals have rarely been able to identify under-priced securities (that is, to outguess the market with respect to further return) with any regularity. In fact, evidence shows that there is little correlation between fund managers' earlier success and their ability to produce above-market returns in subsequent periods. (The American Law Institute Third Restatement of Trusts (2007); S227 *The Prudent Investor Rule*)

This path is truly mainstream in the United States with the likes of Vanguard managing \$1.5 trillion on a passive basis. Within the UK this strategy is gaining momentum, so it is worth explaining the principles behind this investment method.

Active or passive

The term 'passive' conjures up a perhaps *laissez faire* image which is in fact certainly not the case. There is significant evidence to prove that 'active' management, i.e. trying to beat the market, after fees and expenses, over time is unlikely to add

real value. There is significant empirical evidence to show that virtually all managers are fooled by the randomness of markets, which are moved on unpredictable news. This is, on the face of it, quite an idea to take on board. Two respected academics, Gareth Quigley & Rex A Siquefield, published a report in the *Journal of Asset Management* in February 2000 entitled 'Performance of UK Equity Unit Trusts.' Their summary and conclusions described poor performance as being the only kind of performance that persists. They summed it up this way—'losers repeat, winners do not.'

Another significant piece of research, 'The Efficient Market Hypothesis' (Eugene F. Fama University of Chicago 1965), concludes, prices reflect value and information accurately and quickly, it is nearly impossible to capture returns in excess of a market return without taking greater risk than market levels of risk. It explains the process of the efficient markets—first, information about stocks, is widely and inexpensively available to all investors, second, all known and available information is already reflected in stock prices, third, the price of a stock agreed on by a buyer and seller is the best estimate of the true value of that stock. If current market prices offer the best available estimate of real value, stock mispricing should be considered a rare condition that cannot be systematically exploited through fundamental research or market timing. Finally, stock prices change almost instantaneously as new, unpredictable information appears in the market. The hypothesis states that investors may be best served through passive, structured portfolios. Rather than trying to out-research other players in the market, a passive investor looks to asset class diversification to manage uncertainty and position for long-term growth in the capital markets.

When taking responsibility for the investment of client's assets, the most prudent way of minimizing risk and maximizing the probability of achieving the expected return from an asset class in a diversified portfolio is to hold the entire index. Going back to the US fiduciary responsibilities, to choose an investment strategy other than this lower cost, lower risk

route must be justified and reasons given for using an active management approach. As this investment strategy continues to gain recognition as the prudent approach in the UK, trustees may be wise to consider whether this should be explored, together with the effects that the changes in the taxation of trusts will bring.

When taking responsibility for the investment of client's assets, the most prudent way of minimizing risk and maximizing the probability of achieving the expected return from an asset class in a diversified portfolio is to hold the entire index

The significance of the evidence is not that passive will always outperform active investing, but that when an investor has to make a decision about which way to invest, the probability of success always lies in favour of passive investment (Keane, Simon. (2000) 'Index Funds in a Bear Market', Glasgow University)

Conclusions

By using all the different tax regimes in conjunction, a better outcome may result. Certainly capital gains at

18 per cent tax rates seem more attractive now and Investment Bonds enjoy their own tax rules and with the right guidance open up many tax planning and investment opportunities. By using careful consideration of the timing and ownership of any encashments, possibly assigning bond segments to a non tax paying or basic rate paying beneficiary, this would not give rise to a chargeable event on assignment, therefore possibly reducing the rate of tax payable. Timing of the assignment of benefits where a trustee becomes non-resident could also be a useful route for some trusts. Opting for a low cost passive investment strategy could also help offset higher taxes as £1 saved in charges is certain, £1 in investment return is uncertain. The buy and hold nature of passive investment can also reduce trading costs and taxes when compared to an active approach.

Once these changes are embodied in the legislation after receiving Royal Assent, the increases in tax rates for trusts will bring more difficulties for trustees. Balancing the differing aspects of successfully managing trust assets, and the needs of different beneficiaries, indeed make these taxing times for trustees.