Full circle

Inheritance tax and trusts Personal tax

01 April 2016

Andrew Mortimer notes that after 17 years all UK income tax paid on dividends will once more be repayable and can therefore be credited to the trustee's 'tax pool'

Key Points

What is the issue?

The new major changes in the dividend taxation regime will adversely affect trust liabilities, and income interest in possession beneficiaries will receive smaller payments initially

What does it mean to me?

Likelihood of queries being received from clients and more trust tax return compliance work

What can I take away?

Appreciation of how income tax liabilities for trustees will either increase or commence and understanding of how beneficiaries will be affected

The last major change in the taxation of dividend income was on 6 April 1999 when the non-repayable tax credit came into effect. It was indirectly the source of some anguish for trustees of non-income interest in possession trusts and their advisers since if trustees do not have a power to accumulate income, they must distribute dividend income.

Whereas previously the income tax deducted from dividend payments was available for credit to the ‘tax pool’ (ICTA 1988, s 687 – now ITA 2007, s 497) the non-repayable tax credit could no longer enter it.

From 6 April 1999 it became necessary to give more thought to discretionary income distributions and often prepare ‘what if’ calculations.

Discretionary income distributions are treated as already having had income tax deducted (ITA 2007, s 494). So if the amount held in the tax pool is less than the income tax treated as paid on a distribution the shortfall has to be paid by the trustees (ITA 2007, s 496).

In the succeeding years the possibility of shortfalls has been compounded in three ways: the differences in the special rates (ITA 2007, s 479) of income tax chargeable on trust income received; the introduction of a first slice band (ITA 2007, s 491) of income not chargeable at the trust rate; and the amount of income tax treated as paid on a discretionary income distribution.

Year to 5 April 2016

If there is no available tax pool and all dividend receipts are distributed, up to 55% of these could be distributed to trust beneficiaries in the year ending 5 April 2016.

The rest would have to be paid to HMRC, as shown here:

Dividend trust rate	37.5%	
Trust rate	45%	
	£	**£**
Net dividend received	6,000.00	
Gross taxable dividend		6,666.67
Less first slice trust Standard rate band		-1,000.00
		5,666.67
Dividend trust rate tax Payable to HMRC		
(37.5% less 10%) ie tax pool entry	-1,558.33	
Initial available income	4,441.67	
Maximum discretionary distribution		
Using tax pool	-1,904.63	31.74%
Balance available	2,537.04	
Additional available		
Discretionary distribution	-1,395.37	
Tax on additional available discretionary		
Distribution payable to HMRC	-1,141.67	45.00%
Income balance	0.00	
Total income tax paid to HMRC	2,700.00	

Total discretionary income distribution	3,300.00	55.00%
Tax treated as paid on distribution	2,700.00	
Gross taxable income	6,000.00	
Total tax paid by trustees	2,700.00	
		Gross
Total distribution received by beneficiary from trustees	3,300.00	£6,000.00

How much a beneficiary would receive in the year ending 5 April 2016 from a discretionary distribution of £3,300 (gross £6,000 with £2,700 income tax treated as paid) after receiving an income tax repayment or after paying a liability would depend on their own personal income tax position:

Although the maximum receipts would vary with the dividend

	Available tax repayments for beneficiary (£)	**Maximum receipt including tax repayment (£)**	**Percentage**
No liability on trust income	2,700.00	6,000.00	100.00%
Basic rate (20%) on trust income	1,500.00	4,800.00	80.00%
Higher rate (40%) on trust income	300.00	3,600.00	60.00%
Additional rate (45%) on trust income	0.00	3,300.00	55.00%

received and therefore the amount available for distribution, the trust standard rate band (be it the maximum £1,000, £800, £600, £400 or minimum £200) available had no effect on the maximum receipt percentages.

The amount of the available standard rate band only affected the amount of the initial dividend trust rate tax payable to HMRC.

In comparison, again using a dividend of £6,000, an interest in possession in income trust beneficiary or an individual personally receiving dividend income in the year ended 5 April 2016 would eventually have been in receipt of:

	Income tax liability (£)	**Net receipt (£)**	**Percentage**
No liability	0.00	6,000.00	100.00%
Basic rate: dividend ordinary rate (10%)	0.00	6,000.00	100.00%
Higher rate: dividend Upper rate (32.5% less 10% non-repayable tax credit)	1,500.00	4,500.00	75.00%
Additional rate – dividend Additional rate (37.5% less 10% non-repayable tax credit)	1,833.33	4,166.67	69.44%

If trustees of non-income interest in possession trusts did not make discretionary income distributions because they had the power to and did accumulate income – in other words capitalise it – they would have incurred an effective rate of income tax on net dividends received in excess of the available first slice trust standard rate band of 30.56%.

New dividend taxation regime

As part of his 2015 summer Budget, chancellor George Osborne announced reform of the way dividends are to be taxed.

Although we were advised that Finance Act 2016 would contain legislation to replace the existing non-repayable tax credit with a new dividend allowance and that there would be new dividend rates of 7.5% and 38.1%, all of the supporting detail referred to individuals. There was no mention of the effect, if any, these changes would have on trusts.

The draft Finance Bill 2016 confirms there will no longer be an a non-repayable tax credit added to dividends, there will be a 0% dividend nil rate, and individuals will be entitled to an annual £5,000 dividend tax allowance.

Trustees are excluded from this because they form a body of persons.

The draft did not include the reduction in the dividend ordinary rate to 7.5% or the increase in the dividend additional rate to 38.1%, both of which were announced in the Budget. Neither did it include any alterations to the trust rate or dividend trust rate.

I queried with HMRC the omission in the draft Finance Bill 2016 of any reference to the new dividend ordinary rate and dividend additional rate. A CT Structure official in CTIS replied: “The clause introducing these changes will be published in the Budget resolutions on Budget day, as is usually the case for rates.”

For those unaware of CTIS, it is “the wider HMRC directorate of Corporation Tax, International and Stamps” which “is itself part of the wider Business Tax operational group within HMRC”.

At the same time the official helpfully told me that the dividend trust rate would also be increased to 38.1% so that it continued to “mirror the dividend additional rate”.

Personally, I consider it to be somewhat disingenuous to fail to publish full detail as part of Budget announcements.
It is to be hoped the Budget resolutions will confirm the 38.1% dividend trust rate and there will be no nasty surprises that will affect this article, which was being prepared well in advance of Budget day 2016.

Year to 5 April 2017

Using the available information and the same £6,000 dividend as in the previous example, from 6 April 2016 the result for the trustees will be:

Dividend trust rate	38.1%	
Trust rate	45%	
	£	**£**
Net dividend received	6,000.00	
Gross taxable dividend		6,000.00
Less first slice trust Standard rate band		-1,000.00
		5,000.00
Dividend trust rate tax Payable to HMRC		
(37.5% less 10%) ie tax pool entry	-1,905.00	
Initial available income	4,095.00	
Maximum discretionary distribution		
Using tax pool	-2,328.33	38.81%
Balance available	1,766.67	
Additional available distribution	-971.67	
Tax on additional available discretionary		
Distribution payable to HMRC	-795.00	45.00%
Income balance	0.00	
Total income tax paid to HMRC	2,700.00	
Total discretionary income distribution	3,300.00	55.00%

Tax treated as paid on distribution	2,700.00	
Gross taxable income	6,000.00	
Total tax paid by trustees	2,700.00	
		Gross
Total distribution received by beneficiary from trustees	3,300.00	£6,000.00

Once their available standard rate band has been exceeded trustees will now have a higher initial dividend trust rate tax liability payable to HMRC. In the example given, this would equate to an extra £346.67.

	Available tax repayments for beneficiary (£)	**Maximum receipt including tax repayment (£)**	**Percentage**
No liability on trust income	2,700.00	6,000.00	100.00%
Basic rate (20%) on trust income	1,500.00	4,800.00	80.00%
Higher rate (40%) on trust income	300.00	3,600.00	60.00%
Additional rate (45%) on trust income	0.00	3,300.00	55.00%

From 6 April 2016 how much a beneficiary will eventually receive ‘in their hand’ from the same discretionary distribution of £3,300 (gross £6,000 with £2,700 Income tax treated as paid) following receipt of an income tax repayment or after paying an income tax liability again depends on their own

	Income tax liability (£)	Net receipt (£)	Percentage
No liability on dividend nil rate (0%)	0.00	6,000.00	100.00%
Basic rate – dividend ordinary rate (7.5%)	75.00	5,925.00	98.75%
Higher rate – dividend upper rate (32.5%)	300.00	3,600.00	94.58%
Additional rate – dividend additional rate (38.1%)	381.00	5,619.00	93.65%

personal income tax position. All things being equal, it will be no different from the year ended 5 April 2016:

However, in comparison, interest in possession in income higher or additional rate trust beneficiaries or individuals personally receiving dividend income will, if they are not using their allowance, be materially better off. Basic rate taxpayers, however, will be marginally worse off.

From 6 April 2016 trustees of non-income interest in possession trusts who do not make discretionary income distributions but instead accumulate the dividend will have an effective rate of income tax on net dividends received in excess of the available first slice trust standard rate band of 38.1% – an increase of 7.54% on the 2015/16 rate!
There will be anomalies and additional income tax liabilities for individuals with different rates of income tax liability and also trustees who accumulate dividends. However, I feel that the following comparisons make interesting reading:

Percentages of net dividend of £6,000 available after income tax paid			
	2015/16	**2016/17**	**Difference**

Percentages of net dividend of £6,000 available after incometax paid			
Discretionary trust beneficiaries			
No liability	100.00%	100.00%	Same
Basic rate (20%) liability	80.00%	80.00%	Same
Higher rate (40% liability	60.00%	60.00%	Same
Additional rate (45%) liability	55.00%	55.00%	Same
Income interest in possession beneficiaries and individuals with full dividend tax allowance			
No liability	100.00%	100.00%	Same
Basic rate (10% less 10%) and 7.5 liability	100.00%	98.75%	Minus 1.25%
Higher rate (32.5% less 10%) and 32.5% liability	75.00%	94.58%	Plus 19.58%
Additional rate (37.5% less 10%) and 38.1% liability	69.44%	93.65%	Plus 24.21
Trustees accumulating dividends			
Received in excess of first slice	69.44%	61.90%	Minus 7.54%

Clearly the percentages of net dividend available will reduce the larger the dividend received.

However, having crunched some numbers, I note that under the new dividend regime anyone with a liability to income tax at the additional rate will still be better off in the tax year ending 5 April 2017 than the previous one as long as the dividend income they receive is less than about £14,000.

Further sting in the tail

It seems to me that the changes in the taxation of dividends along with the fairly wide-scale abolition of tax deduction at source on interest paid will cause additional compliance work for trustees of income interest possession trusts as well as non-income interest in possession trusts.

Neither the new dividend tax allowance nor the personal savings allowance will apply to trustees.

Trustees of income interest in possession trusts currently do not have any liability to income tax if the only income received is taxed at source – for example dividends and pre-6 April 2016 bank and building society interest.

Neither do trustees of non-income interest in possession trusts have any additional liability if they only receive savings income taxed at source, which is less than their available first slice and they do not make discretionary income distributions.

For years HMRC has, in these circumstances, been both discouraging the annual issue of tax returns and agreeing to requests not to issue them every year, subject to the trustees notifying them if a liability to income or capital gains tax does arise.

Therefore it is likely that there could be thousands of trusts receiving dividends or interest taxed at source where there is no requirement to complete annual tax returns since they have no liability to income tax.

Dividend income can normally be mandated to be paid directly to an income interest in possession beneficiary rather than to the trustees. In this case I imagine HMRC will agree to the 7.5% dividend ordinary rate liability being paid by the income interest in possession beneficiary rather than the trustees.

However, if a trust has more than one income interest in possession beneficiary unless separate funds together with designated investments are put in place for each beneficiary then mandating dividends or interest payments is unlikely to be possible.

Unless mandating is possible or further procedures are instigated by HMRC to mitigate the need for trustees to submit annual tax returns for the year ended 5 April 2017 onwards, as I understand it all dividend receipts and bank or building society interest they receive will be taxable at 7.5% and 20% respectively.

Although any new income liabilities will not need to be paid until 31 January 2018, the requirement to notify chargeability (TMA 1970, s 7) should not be overlooked.

Not only will the new dividend regime and the changes to the interest taxation at source rules possibly result in additional compliance work for trustees and their advisers but also possibly increase HMRC workload, bearing in mind the department appears to be struggling to cope at present.