

Pick and mix

Trustees are required by law to diversify their investments to spread risk. But with all the options available, each with its own tax implications, how can trustees decide which investment vehicle is best for their needs? **Stuart Bushell** explains

The dramatic volatility of stock markets over the past decade has shaken investors' belief in the traditional approaches to investment, and trustees are in danger of exposing their beneficiaries to undue risk by failing to review their portfolios. This article looks at two major investment vehicles which facilitate diversification – collective investment schemes and investment bonds – and what the tax implications of using those vehicles are for trustees of the two principal types of trust.

DIRECT AND COLLECTIVE INVESTMENT

Traditionally, responsibility for the investment of trust funds was delegated to stockbrokers in the belief, which was encouraged by the courts, that investment involved achieving a suitable balance between fixed-interest securities (usually gilts) and shares (mainly UK), and that stockbrokers were the professionals best equipped to provide the requisite advice.

The Trustee Act 2000 coincided with the bursting of the 'dotcom' bubble and the most vicious decline in stockmarket values since the early 1970s, and the act correctly identified the importance of diversification as a means of reducing risk. Not only was the vulnerability of individual equities exposed – as, indeed, it was again recently exposed by the BP oil spillage – but the importance was also recognised of diversifying investments between asset classes other than fixed interest and equities.

Research conducted in 1991 by distinguished US academics concluded that 90% of portfolio performance could be attributed to the selection of asset classes (Gary P Brinson, Brian D Singer and Gilbert L Beebower, 'Determinants of Portfolio Performance II: An Update', *Financial Analysts Journal*, 47, 3 (1991)).

This has had a profound effect on portfolio construction, and some investment professionals now rely wholly on asset allocation techniques, using low-charging index-tracking funds and exchange-traded funds. Property, commodities and structured products are recognised as mainstream portfolio components, and equity and fixed-interest investment is viewed not on the basis of UK versus overseas, but of developed markets versus emerging markets.

The benefits of diversification will be enhanced if the portfolio components react differently to changing economic, political and climatic developments. The desirability of non-correlation has therefore become a vital override to the pursuit of diversification

by selecting an investment vehicle, the tax treatment of which is appropriate to that of the individual trust.

In this respect, the distinction which needs to be drawn is between interest in possession (IIP) and bare trusts on the one hand, and discretionary trusts on the other.

TRUST TAXATION

Capital gains are taxed similarly in IIP and discretionary trusts, and the advantage which collective investment funds have over direct investments is that gains made within such a fund are exempt from capital gains tax (CGT).

The treatment of income is very different. In the case of IIP trusts, savings income is subject to 20% tax at source,

When the 'dotcom' bubble burst, not only was the vulnerability of individual equities exposed – as, indeed, it was again recently exposed by the BP oil spillage – but the importance was also recognised of diversifying investments between asset classes

– though its own limitations were exposed by the unprecedented conditions created by the 2007 global credit crunch which dragged all markets down in its wake.

Only very large trust portfolios will be able to achieve the levels of diversification which can be achieved through pooled investment schemes, and some investments, such as commercial property, can only be accessed via such schemes. However, diversification is not the only merit of such schemes. Different schemes confer different tax advantages and, if trustees are to satisfy the other main requirement of the Trustee Act, namely suitability, they should seek to minimise tax

and trustees of such trusts receiving savings income have no further liability, while beneficiaries to whom such income is distributed are entitled to a credit for the basic rate tax. Dividend income received from UK companies and distributions from authorised unit trusts, investment trusts and open-ended investment companies (OEICs) is accompanied by a 10% tax credit, the benefit of which is available to the beneficiaries.

The tax treatment of income arising in discretionary trusts has become much less favourable. As far as savings income is concerned, the trustees are subject to tax at 30%, which, when added to the 20%

deducted at source, amounts to a charge of 50%. In the case of dividends, tax is charged at 42.5%, to take account of the 10% tax credit. However, when dividend income is distributed to beneficiaries, it ceases to be regarded as such for the purposes of tax credits and is regarded instead as income from a trust, with the result that beneficiaries are doubly penalised; they both lose the benefit of the dividend tax credit and suffer from the fact that the income is still deemed, for the purposes of their tax liability, to have been franked at 50%, even though the actual rate of tax applied is 42.5%. Consequently, all categories of taxpayer receiving dividend income from discretionary trusts suffer a 20% higher tax charge than they would on savings income from the same trust.

INVESTMENT BONDS

Some trustees have sought to mitigate this tax charge by investing in growth funds or other non-income producing assets, but the most flexible solution is to invest through an investment bond tax-wrapper, which is essentially a single premium life policy and therefore produces no income as such. The investment returns are rolled up within the bond but, by virtue of a convenient tax concession, permits up to 5% of the initial value to be distributed each year with no immediate liability to tax.

A chargeable event for income tax will take place if the trustees surrender an investment bond or withdraw more than the cumulative 5% per annum entitlements, or if the last of the lives insured dies. If, at that time, the settlor is a UK resident and alive, or has died in the same tax year as the chargeable event, any gain will be assessed on the settlor. If the settlor were a higher rate or additional rate taxpayer, the liability would be equal to the difference between the 20% savings rate and the appropriate higher rate tax.

If the chargeable event is caused by the death of the settlor (for example, in the case of a bond written on a single life), the gain is deemed to form part of the settlor's income for the year of assessment in which the death occurs. In order to avoid policy gains crystallising in the hands of the trustees upon the death of the settlor, it would normally be appropriate for the bond to be written on the lives of the beneficiaries, rather than on the life of the settlor (minors would not be able to give a valid receipt).

If the creator of the trust were dead or a non-UK resident when the chargeable event occurred, then the tax charge would fall on the trustees, at the rate applicable to trusts – 50% for the 2010/11 tax year – less the basic rate of 20%, which is assumed to have been paid by the life company; if the amount of the withdrawal were then distributed to beneficiaries, no further tax would be payable.

These tax charges could be avoided if the trustees, instead of surrendering the bond themselves, were to assign segments of the bond *in specie* to a non-higher rate taxpayer beneficiary or beneficiaries for nil consideration. The assignment would not constitute a chargeable event, and assuming that, after the top-sliced addition of any gain on subsequent encashment,

from investment bonds, though cautious trustees might consider it prudent to ensure that their payments are irregular in amount and timing.

The fact that the increased tax charge attaching to dividends only affects discretionary trusts means that there is no need to resort to the now well-tried solution of investment bonds for IIP trusts, and in any event, their use would not be appropriate for such trusts, because the beneficiaries of IIP trusts are entitled to receive a true income.

TRUST REVIEWS

In addition to requiring the diversification and suitability of investments, the Trustee Act 2000 requires that trustees who do not themselves possess the requisite expertise

The benefits of diversification will be enhanced if the portfolio components react differently to changing economic, political and climatic developments. The desirability of non-correlation has therefore become a vital override to the pursuit of diversification

the beneficiary was still not a higher rate taxpayer, he or she could proceed to encash the segments – preferably in the following tax year – without any liability to tax. This approach can only be adopted if the beneficiary is, at the date of the assignment, either aged 18 or over, or under 18 but married.

It has been suggested that regular payments of capital to beneficiaries might be regarded as assuming the nature of income and be taxable as such (advancement of capital could also result in an exit charge for inheritance tax purposes, but this might be very small and might not arise at all, depending on the circumstances). However, in the case of *Stevenson v Wishart* [1987] STC 266, the Court of Appeal held that, in topping up income payments with capital to fund the nursing home fees of an elderly beneficiary of a discretionary trust, the trustees were exercising a power over capital, and that the payments retained their nature as capital and should not be taxed as income. The conclusion may therefore be drawn that no problem should arise from the payment to beneficiaries of 5% withdrawals

should seek professional investment advice, and that they should review the trust investments on a regular basis, taking advantage of each year's CGT exemption, and testing portfolios for risk, cost efficiency and tax efficiency.

Most reputable financial advisers have software systems which can test portfolios for risk and produce risk ratings on a scale of, usually, one to 10. Trustees who are able to produce an audit trail of independent reviews and risk analyses will be protecting their own interests as well as those of their beneficiaries, and it must always be remembered that risk levels are subject to constant change, as the value of investments in each asset class rise and fall. For smaller trust funds, a convenient solution might be to delegate responsibility for asset allocation by investing in some of the multi-asset collective investments which are now available, with income, growth or absolute-return objectives. ■

Stuart Bushell is legal affairs director at Solicitors Independent Financial Advice.