

# TAXING TRUSTS

**Peter Rayney** says trustees will now need to get to grips with the recent dividend tax changes

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**T**he Finance Act 2016 changes in dividend tax for individuals received widespread publicity (see Where are we now, p30, Apr 2016). However, very little has been mentioned about the impact of these changes on trusts and their beneficiaries. With many trustees now starting to deal with 'their' trust tax returns for 2016/17, this article takes a look at the income tax treatment for different types of trusts, concentrating in particular on the impact of the new dividend tax regime.

## SETTLOR-INTERESTED/PARENTAL TRUSTS

We start by highlighting some very important anti-avoidance rules, which effectively take precedence over all the other provisions. Where they apply, the trust's income is deemed to be the income of the settlor, the person who created the trust, for tax purposes (see Chapter 5, Part 5, Income Tax (Trading And Other Income) Act 2005 (ITTOIA 2005)). Common examples where this legislation can apply include trusts from which the settlor or their spouse/civil partner can benefit, or trusts which provide income for the parent's (unmarried) minor children.

Where these anti-avoidance rules apply, the settlor must report the relevant income on their own personal tax return (even though it is

**F** received by the trust). This income is taxed under the normal rules, although the settlor can apply to be reimbursed for the tax from the trustees (section 646, ITTOIA 2005).

Where the settlor is personally taxed on dividend income under these rules, the same tax treatment applies as if it were their own income. They will, therefore, be subject to the personal dividend tax rates and can benefit from the £5,000 dividend nil-rate band (which will be reduced to £2,000 from 6 April 2018).

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### DIVIDEND TAX RATES 2016/17 AND 2017/18

Taxable dividend income received	Tax rate
Up to basic rate threshold	7.5%
Between basic rate threshold and £150,000	32.5%
Above £150,000	38.1%

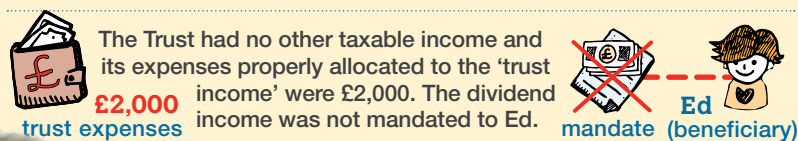
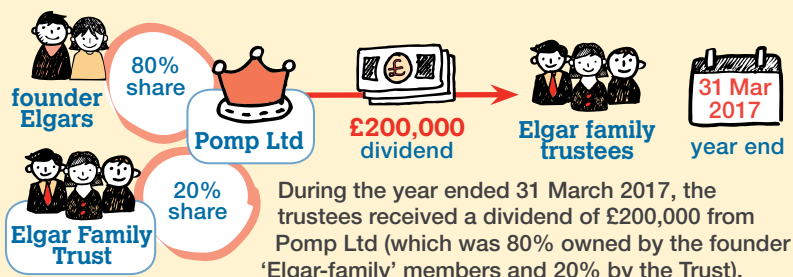
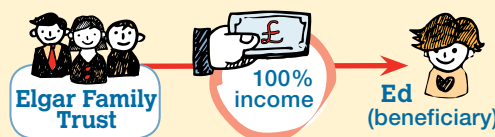
## BARE TRUSTS

A bare trust is the simplest form of trust and is commonly used to hold assets for minor children

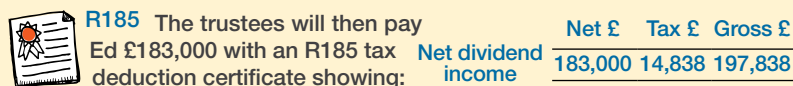
EXAMPLE 1

DIVIDEND RECEIVED BY INTEREST IN POSSESSION TRUST (2016/17)

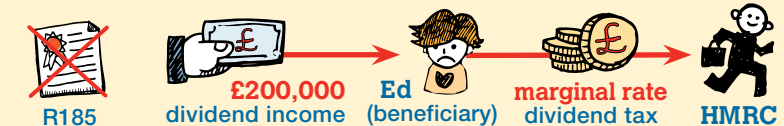
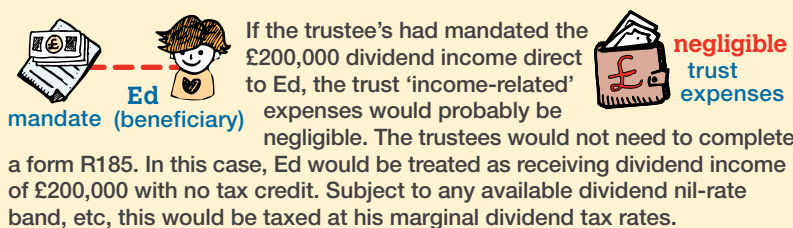
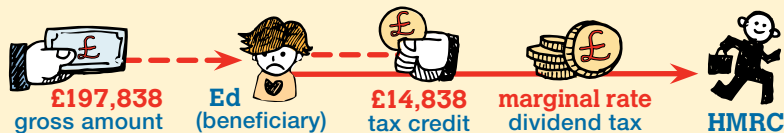
Ed is entitled to 100% of the income of the Elgar Family Trust until he reaches his 25th birthday.



The amount of trust income that can be distributed to Ed is calculated as:



The dividend income of £183,000 is deemed to have suffered tax at 7.5%, so the gross taxable amount in Ed's hands is £197,838. Subject to any dividend nil-rate band, etc, Ed would be taxed at his marginal dividend rates on the gross amount of £197,838 but with a tax credit of £14,838.



until they reach their 18th birthday (or in Scotland, their 16th birthday). Bare trusts are usually evidenced by a simple trust deed. One or more trustees will hold the relevant assets on behalf of the beneficiary, who has an absolute right to the income and capital of the trust.

Where the trust is for the benefit of a minor child, the child can demand that the trust assets are passed to them when they reach 18. This does not trigger any form of tax charge since there is no change in the beneficial ownership of the relevant assets.

Broadly, the tax rules treat the trust assets as though the beneficiary owned them.

The beneficiary will, therefore, return the 'bare trust' income (including dividend income) on their self assessment return and pay income tax on that income at the relevant tax rates (depending on the type of income).

However, many trusts created by parents are generally caught by the 'parental settlement' rules. Consequently, they would not be effective for income tax purposes since the income would be taxed on the settlor-parent (except where the annual income arising is less than £100 per child). On the other hand, this problem does not arise where grandparents set up » 38

**EXAMPLE 2**

**DISCRETIONARY TRUST INCOME TAX COMPUTATION**

The trustees of The RV Williams Family 2008 Discretionary Settlement received the following income during the tax year ending 5 April 2017:

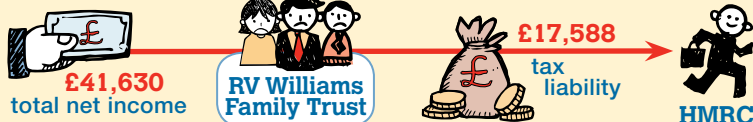


The trust incurred administrative expenses (charged against 'income') of £897. The net income is accumulated within the trust.



The trust's total tax liability for 2016/17 would be calculated as:

Rental income £24,700 + bank interest £2,900 = £27,600	First Balance	£1,000	x 20%	£200
		£26,600	x 45%	£11,970
Dividend income £15,000 – exps £970 (grossed up) = £14,030	Net dividend income	£14,030	x 38.1%	£5,345
Adj for grossed up trust exps not deductible at basic rate	£897 x 100/92.5	£970	x 7.5%	£73
	<b>Total tax liability</b>			<b>£17,588</b>



bare trusts, since they are not subject to the 'parental settlement' rules. In such cases, the income is reported and (beneficially) taxed in the child's hands.

Under the pre-6 April 2016 dividend regime, dividends received by grandchildren rarely had to be reported on a tax return since the 10% tax credit attached to dividends often cancelled their 10% basic rate tax liability. However, for 2016/17, unless the dividends are 'sheltered' by the £5,000 dividend nil-rate band and the £11,000 personal allowance, the grandchildren must pay income tax of 7.5% on dividends received (over £5,000) or 32.5% on amounts exceeding the basic rate threshold (£32,000 for 2016/17).

It may be necessary for a tax return to be completed on the child's behalf. Trustees frequently pay the relevant tax on the beneficiary's behalf.

**INTEREST IN POSSESSION TRUSTS**

Settlers generally set up interest in possession trusts (also known as 'life interest' trusts) where they wish to provide an income entitlement to one or more beneficiaries during the course of their life (or for some other fixed period). When the 'income' beneficiary's interest comes to an end, the trust assets will subsequently be used for the benefit of another beneficiary (or group of beneficiaries).

For example, a will trust may grant a surviving spouse with an interest in possession, but on the death (or perhaps remarriage) of the surviving



**A will trust may grant a surviving spouse with an interest in possession, but on the death, the assets may then pass to the children**

spouse, the trust assets may then pass to the children.

A beneficiary of an interest in possession trust is legally entitled to the income generated by the trust, as it arises. The trustees must hand over the income (after any expenses and tax) to that beneficiary. The beneficiary is taxed on the net income arising in the tax year, irrespective of whether they actually receive it.

Where the trust has different sources of income, the trust management expenses (grossed up) are allocated first against dividend income, then interest income, and finally other income.

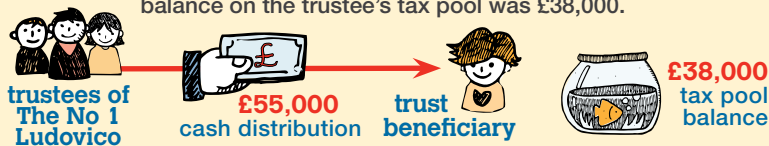
Where the income is not paid direct to the beneficiary, the trustees must account for basic rate tax on it, being 7.5% for dividend income and 20% all other income, such as bank and building society interest (which since 6 April 2016 is paid gross (s6, s11, and s14, Income Tax Act 2007 (ITA 2007)). The trustees are not entitled to any personal allowances or reliefs/exemptions (such as the £5,000 dividend nil rate band).

Importantly, trustees can avoid paying tax on the trust income and filing trust tax returns, if they arrange for the income to be paid (mandated) directly to the beneficiary/beneficiaries. Since 6 April 2016, trustees have an even greater incentive to mandate income direct to the beneficiaries. This prevents the trustees paying the 7.5% dividend tax or 20% tax liability on other income. Furthermore, this avoids the trustees having to complete R185 certificates or tax returns.

**EXAMPLE 3**

**S496 TAX CHARGE ARISING ON TRUST DISTRIBUTIONS**

**31 Mar 2017** On 31 March 2017, the trustees of The No 1 Ludovico Discretionary settlement made a cash distribution (on income account) of £55,000 to one of its beneficiaries. At that date the balance on the trustee's tax pool was £38,000.



The tax credit attributable to the distribution is £45,000 (£55,000 x 45%/55%) and the gross distribution is £100,000.



However, since the balance on the tax pool is only £38,000, the trustees must pay a further £7,000 (£45,000 less £38,000) tax to HMRC under s496, ITA 2007.



Assuming the recipient beneficiary's marginal rate of tax is (say) 40%, the beneficiary will be able to reclaim a tax repayment of £5,000 (£100,000 x 40% = £40,000 less tax credit of £45,000).



In all cases, beneficiaries will be personally liable to income tax at their marginal tax rates on the income received by the trust (net of the trust expenses).

Where the trustees have suffered 7.5%/20% tax on the initial receipt of the income, this tax can be credited against the beneficiary's tax liability. However, no 7.5%/20% tax credit is available to the recipient beneficiary to the extent the income has been used to satisfy the trust expenses. A simple worked example shows the relevant mechanics of dealing with the tax liability on dividend income for 2016/17 (see example 1).

The beneficiary of the trust must be provided with a form R185 (trust income) showing the trust income (broken down between the relevant income sources) and the tax which is deemed to be deducted.

**DISCRETIONARY TRUST TAX**

Section 479, ITA 2007 requires that income received by discretionary trusts be taxed at the special trust rates, or in the case of dividend income, the dividend trust rate. Once again, this is subject to the overriding rule relating to settlor-interested trusts, which requires the trust income to be taxed on the settlor.

The special 'discretionary trust' tax charges arise on income that is either accumulated or payable to the beneficiaries at the trustees' discretion (s480, ITA 2007). This is different from an interest in possession trust where a life-tenant beneficiary has an absolute right to the income.

There are broadly two main aspects to discretionary trust tax. First, there is the tax

charge arising on the trust income. Second, in some cases, an additional tax charge may arise when the trust distributes income to a beneficiary (where the trust has paid insufficient tax to 'frank' the 45% tax credit that attaches to the income distribution).

Provided the parental settlement rules can be side-stepped, discretionary trusts still remain efficient vehicles for funding school and university fees, and so on. Sometimes, trustees can grant a (temporary) revocable life interest to a beneficiary so that the income can be taxed at lower tax rates under the interest in possession rules (thus avoiding the special tax charges on discretionary trusts). Under the current inheritance tax rules, this should be a tax-neutral event, as discretionary trusts and (post-March 2006) interest in possession trusts are both 'relevant property'.

From 2016/17 onwards, discretionary trusts are taxed as follows:

- the first £1,000 of taxable income (known as the standard rate band (SRB)) is taxed at the basic rates with dividend income taxed at 7.5% and all other trust income taxed at 20% (s491, ITA 2007). The order of priority for income attracting the SRB is non-savings income, savings income, and finally, dividends. The £1,000 SRB may be divided by the number of trusts set up by the same settlor, subject to a minimum of £200 per trust.
- subject to the above, all trust income is taxed at 45%, with a special 38.1% rate

applying to dividend income. The trustees cannot claim the benefit of the personal savings allowance or the £5,000 dividend 'nil-rate' band.

- trust management expenses that are properly chargeable against income can be deducted in computing the tax payable at the higher rates (but not the 7.5% or 20% basic tax rate elements) (s484, ITA 2007). Trust expenses are set against dividend income before other income (s486, ITA 2007). See worked example 2 showing the tax liability calculation for a discretionary trust.

#### DISCRETIONARY TRUST DISTRIBUTIONS

Income distributions made by the trustees are deemed to have suffered tax at 45%. The trustees will provide the recipient beneficiary with an R185 certificate stating the net distribution and the grossed-up amount (with the tax credit of 45%). Beneficiaries will pay income tax on the 'gross' distribution and will often be able to claim a repayment where the 45% tax deemed to have been suffered exceeds their actual tax liability.

The underlying income from which the distributions are made effectively loses its original 'character'. Thus, for example, where the trustees distribute dividend income, this is simply treated as a trust distribution (non-savings income) in the beneficiary's hands. Consequently, since this is taxed as 'trust income' it does not attract personal dividend tax rates or benefit from the dividend nil-rate band.

The legislation provides a mechanism to enable the trust distributions to carry a tax credit of 45% in the beneficiaries' hands. This has to be matched by the tax paid by the trustees, which is tracked by the 'tax pool'. The tax pool will contain the cumulative total of the tax paid

by the trustees. When the trustees distribute income, they must deduct the 45% tax credit attaching to the distribution from the tax pool.

The tax pool, therefore, represents the total of tax paid by the trustees during the lifetime of the trust less the amount of tax credits used to frank distributions. However, the tax pool never included the 10% (non-repayable) tax on pre-6 April 2016 dividends and excludes 'basic rate' tax adjustments charged on the trust expenses).

If the tax pool exceeds the 45% tax credit, no further action is required. On the other hand, if the balance on the tax pool is insufficient to cover the 45% tax credit, then the trustees are required to pay a further amount of tax to cover the shortfall (s496, ITA 2007). This calculation is illustrated in example 3.

From a conceptual viewpoint, unless the trustees have a sufficient capacity in the tax pool, the full distribution of dividend income that has been taxed on the trust at 38.1%, will inevitably lead to an extra 6.9% (45% less 38.1%) tax being paid under the s496 charging procedure.

#### SOME FINAL THOUGHTS

Trustees of all types of trusts (and their advisers) must now be familiar with the consequential tax changes of the new dividend regime. These are likely to affect a number of tax calculations and may also affect the amount that can be prudently distributed to the trust's beneficiaries.

**Income distributions made by the trustees (of discretionary trusts) are deemed to have suffered tax at 45%**



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