

Tax pool issues for discretionary trusts (Lecture P1389 – 22.59 minutes)

Since the early 1970s, the trustees of discretionary (and accumulation) trusts have been obliged to maintain a running total of income tax suffered less income tax treated as deducted from their income distributions which are known as annual payments. This is commonly referred to as the trust's 'tax pool' and is computed by taking the balance brought forward (if any) from the previous tax year, adding the tax paid by the trustees for the current year and subtracting the 45% tax treated as deducted from annual payments in that year.

Example 1

On 6 April 2023, the Angela Family Settlement (a discretionary trust) had a tax pool balance brought forward of £506.

During 2023/24, the trustees receive non-dividend income of £2,800, on which they pay:

	£
On first 1,000 @ 20%	200
On next 1,800 @ 45%	<u>810</u>
	<u>£1,010</u>

Towards the end of that tax year, the trustees exercise their discretion to distribute income of £1,320 to a beneficiary. This is treated as a gross annual payment of $£1,320 \times 100/55 = £2,400$. The trustees must account to HMRC for the 45% tax (£1,080) which is deemed to have been deducted from this payment, but of course they have a credit of $£506 + £1,010 = £1,516$ so that no further tax is payable. The trustees are left with a balance of $£1,516 - £1,080 = £436$ to be carried forward in the tax pool.

This sounds straightforward enough, but, where the trust includes dividends, there are problems. In 1999, when the then Chancellor decided that dividend tax credits should no longer be repayable, he ordained that they were not to go into the trust's s.497 ITA 2007 tax pool. Only tax actually paid over to HMRC was allowed to enter the tax pool for the purpose of franking the tax on income distributions to beneficiaries.

However, in 2023/24, dividend tax credits no longer exist and so the question to determine is how much of this income tax goes into the tax pool in line with ss497 and 498 ITA 2007. Since the end of the 1990s, non-repayable tax credits were not permitted to be added to the tax pool because of concerns that this could otherwise lead to them becoming repayable in the hands of an appropriate beneficiary.

Rather oddly, the 2016 dividend tax legislation contained no express announcement about a change in the tax pool provisions. This was clearly anomalous. Eventually, it was confirmed at the Committee Stage that this was a drafting oversight. Accordingly, an amendment was tabled to Sch. 1 FA 2016 which ensures that all of the income tax paid on dividend receipts will be included in the tax pool.

Having said all this, where, say, a discretionary trust regularly distributes all of its dividend income, this can give rise to a somewhat capricious result.

Example 2

The Edward Discretionary Settlement received dividends totalling £1,360 in 2023/24. At the end of the year, the net trust income was distributed to one of the discretionary beneficiaries. Assume that there is no undistributed income in the trust and that the tax pool is empty.

The trustees' tax position is as follows:

Dividends received	£1,360
The trust's tax liability for 2023/24 is:	
	£
On first 1,000 @ 8.75%	87
On next 360 @ 39.35%	<u>142</u>
	<u>£229</u>
The trust's distributable income (ignoring expenses) is:	
Dividends received	1,360
Less: Income tax paid by trustees	<u>229</u>
	<u>£1,131</u>

A net payment of £1,131 is made to the beneficiary in question and the trust certificate will show a tax figure of $45/55 \times £1,131 = £925$. But, in view of the fact that only the £229 paid by the trustees goes into the tax pool, the end result of an income distribution of £1,131 is:

	£
Tax certified ($45/55 \times 1,131$)	925
Less: Tax paid by trustees	229
Tax due under s.496 ITA 2007	£696

In other words, the trustees have effectively overdistributed and they must pay this sum to HMRC.

If, in Example 2, the trustees had chosen simply to rely on the trust dividend income to fund both the payment to the beneficiary and their s.496 ITA 2007 charge, they will only have sufficient funds to release 55% of their dividend receipts, i.e., $55\% \times £1,360 = £748$. This translates into gross income for the beneficiary of £1,360, from which tax of £612 has been deducted. The trustees' s.496 ITA 2007 liability is £383 (£612 less the £229 which goes into the tax pool). As a result, the trustees will have paid £748 to the beneficiary and £383 to HMRC. This exactly equals the £1,131 cash which the trustees had in hand.

An article in Issue 39 of 'Tax Bulletin' suggested that there was nothing untoward with the above analysis. However, the only realistic conclusion which can be drawn from all this is that, where a discretionary trust is wholly or mainly invested in equities and where the trustees distribute all or most of their available income to the beneficiaries, there is a tax penalty for holding such investments via a discretionary trust.

If, in Example 2, an additional rate taxpayer had personally held the shares which paid the dividends of £1,360, his after-tax position – he is assumed already to have utilised his dividend tax allowance – would have been as follows:

Dividends received	£1,360
Tax @ 39.35%	£535

In other words, the taxpayer would have ended up with net cash of £1,360 – £535 = £825.

On the other hand, if this same individual were a discretionary trust beneficiary and if he received the maximum distribution which the trustees could make out of their income (£748), his after-tax position is rather different:

Trust income (x 100/55)	£1,360
	£
Tax @ 45%	612
Less: Tax deducted at source	<u>612</u>
Tax payable	<u>£NIL</u>

Thus, he would have net cash amounting to £748, i.e., £77 less.

If taxpayers were attempting to gain some sort of advantage by holding shares in discretionary trusts, it would be understandable that the Government might wish to end such a benefit. But this is not the case. The truth of the matter is that the Government are penalising those who hold shares in this way.

Consequently, it may be worth converting some discretionary trusts into settlements with a revocable life interest. Not only would this end the handicap of artificially high tax rates suffered by discretionary trusts, but it would:

- allow beneficiaries to receive the dividend tax allowance; and
- remove the need for beneficiaries with taxable incomes of less than £125,140 to claim tax repayments.

There should be no IHT or CGT drawbacks to the creation of a revocable life interest trust.

Since FA 2006, there has been no IHT charge on a transfer from a discretionary trust to a life interest trust;

S.71(1) TCGA 1992 should not normally be relevant for CGT purposes.

Contributed by Robert Jamieson