

Three case studies on income tax and trusts

(Lecture P1081 – 26.16 minutes)

The changes to the tax treatment of dividends in FA 2016 have been widely reported, but relatively little has been written about the impact of these rules on trusts and their trustees.

With regard to the dividend tax allowance, trustees are not entitled to this £5,000 relief, which reduces to £2,000 for 2018/19 onwards, because that benefit is only available to individuals (see S13A ITA 2007). However, given that interest in possession trusts are transparent for income tax purposes (while discretionary trusts are not), this means that the 7.5% dividend tax charge will be credited to the life tenant and he may therefore be entitled to a tax refund if the trust income falls within his dividend nil rate band.

What follows is a collection of three short case studies showing the impact of this new regime on the income of interest in possession and discretionary trusts for 2017/18.

Case study 1

Rupert is entitled to all the income in the Connie Family Settlement until he reaches the age of 25. During the year ended 31 March 2018, the trustees received a dividend of £200,000 from a family company (dividends are not mandated directly to Rupert). The trust had no other taxable income and the expenses properly allocated to the trust income amounted to £1,200.

Given that the trustees are not entitled to a dividend allowance, the trust's taxable income for 2017/18 is:

Dividend income	£200,000
Tax @ 7.5%	£15,000

The trustees will have to pay income tax of £15,000. Following the decision in *Aikin v Macdonald's Trustees* (1894), they are not allowed to deduct the trust management expenses for tax purposes.

The amount of trust income that is distributed to Rupert is:

	£	£
Dividend income		200,000
Less: Tax	15,000	
Trust expenses	1,200	
		<u>16,200</u>
		<u>£183,800</u>

The trustees will therefore pay Rupert £183,800, accompanied by an R185 (Trust Income) tax deduction certificate showing:

Net	Tax	Gross
£	£	£
183,800	14,903	198,703

The dividend income is deemed to have suffered tax at 7.5% and so the gross amount in Rupert's hands is £198,703. On the assumption that Rupert has already used his £5,000 dividend tax allowance, he will be taxed at his marginal dividend rates on £198,703, but with a trust tax credit of £14,903.

If, on the other hand, the trustees had mandated the dividend income directly to Rupert, there would be no relief for the trust management expenses (but, of course, they might not have been incurred). The trustees would not have to complete Form R185 (Trust Income). Rupert would be treated as having received dividend income of £200,000, on which he would be liable to tax in the normal way.

For 2017/18, discretionary trusts are taxed as follows:

- The first £1,000 of taxable income (known as the standard rate band limit) is taxed at the basic rate, ie. 7.5% for dividends and 20% for all other sources of trust income (S491 ITA 2007). The order of priority – where there are different types of trust income – is that non-savings income takes the first slice of the £1,000 band, savings income comes next, with dividends being treated as representing the top part.
- Subject to this, all trust income is taxed at 45% (or 38.1% in the case of dividends). Remember that discretionary trustees – as well as their interest in possession counterparts – are not allowed to use the dividend tax allowance.
- Trust management expenses that are properly chargeable against income can be deducted in computing the additional rate tax payable by the trustees (S484 ITA 2007). This deduction takes effect for the tax year in which the expenditure is incurred, and not the tax year in which the expenditure is paid (if different).

Case study 2

The trustees of the Richard Family Settlement (a discretionary trust) received the following sources of income in 2017/18:

	£
Dividends from listed UK companies	16,000
Rents (net of property expenses)	27,400
Bank interest	10,300

The trust incurred administrative costs of £1,850. The net income was, for the time being, accumulated within the trust.

The trustees' tax position is:

	£	£
Property business income		27,400
Bank interest		<u>10,300</u>
		37,700
Dividends	16,000	
Less: Trust expenses (x 100/92.5)	(2,000)	

		14,000

		<u>£51,700</u>

Note: Trust expenses are set off against dividend income first, then against any other savings income (eg. bank interest) and finally against non-savings income (eg. rents) – see S486 ITA 2007. Because these expenses are not deductible for basic rate purposes, they must be grossed up – in this case, at the dividend basic rate.

The trust's income tax liability for 2017/18 is calculated as follows:

	£	£
Trust tax @ 20%		
On 1,000 (rental income)		200
Trust tax @ 45%		
On 26,400 (rental income)	11,880	
On 10,300 (bank interest)	<u>4,635</u>	
		16,515
Trust tax @ 38.1%		
On 14,000 (dividends)		5,334
Adjustment for non-deductible trust expenses		
7.5% x 2,000		150

		<u>£22,199</u>

Income distributions made by discretionary trustees are always deemed to have suffered tax at 45%. Thus, a payment of, say, £2,200 is treated as a gross receipt of £4,000 from which tax of £1,800 has been taken. This gross £4,000 is classified as income of the beneficiary, with no further tax being due or tax being repaid (as the case may be). The trustees must provide the beneficiary with an R185(Trust Income) certificate, showing the net distribution and the accompanying tax credit.

The underlying income from which the distributions are made loses its original character. Thus, where the trustees distribute dividend income, this ranks simply as an 'annual payment' (ie. non-savings income) in the beneficiary's hands. It does not attract the dividend tax allowance or the lower dividend tax rates.

The legislation provides a special mechanism to enable the trust distributions to carry a 45% tax credit in the beneficiary's hands. This has to be matched by the tax paid by the trustees which is tracked in a 'tax pool'. The tax pool contains the cumulative total of the tax paid by the trustees. When the trustees distribute income, they have to deduct the 45% tax credit attaching to the distribution from the tax pool. This tax pool, therefore, represents the total tax paid by the trustees during the lifetime of the trust less the amount of tax credits used to frank distributions (S497 ITA 2007). However, the tax pool never includes:

- the 10% non-repayable tax on pre-6 April 2016 dividends; and
- any basic rate tax adjustments for non-deductible trust expenses.

If the tax pool exceeds the 45% tax credit for the latest income distribution, no further action is required. On the other hand, if the tax pool balance is insufficient to cover the tax credit, the trustees have to pay HMRC a further amount to deal with the shortfall (S496 ITA 2007).

Notice that, unless the trustees have enough capacity in the tax pool, the full distribution of dividend income which has been taxed on the trustees at 38.1% will invariably lead to an additional 6.9% becoming due under the S496 ITA 2007 charging procedure.

Case study 3

On 31 January 2018, the trustees of the Timothy Discretionary Settlement made an income distribution of £27,500 in cash to the principal beneficiary of the trust. The balance on the trustees' tax pool stood at £21,200 on that date.

The tax credit attaching to this distribution is $45/55 \times £27,500 = £22,500$, making a gross annual payment of £50,000.

However, since the balance on the tax pool is only £21,200, the trustees must make up the deficit ($£22,500 - £21,200 = £1,300$) by paying the sum to HMRC under S496 ITA 2007. This is normally done as part of the completion of the trust tax return for the relevant tax year.

On the assumption that the beneficiary's marginal rate of tax for 2017/18 is 40% (so that his liability on the annual payment is $40\% \times £50,000 = £20,000$), he will be entitled to make a tax repayment claim of $£22,500 - £20,000 = £2,500$.

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