Handbag secrets

Fiona Walker explains the income tax position for settlors and beneficiaries of trusts

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KEY POINTS

- **What is the issue?**
Understanding how trust income is taxable on beneficiaries and settlors
- **What does it mean to me?**
A guide to help recognise the types of trust and the tax treatment to expect for each
- **What can I take away?**
Increased confidence in dealing with R185s

I can picture the scene – it is November and there is a pile of tax returns on my desk. I have just taken my CTA awareness exam and ordered the advisory study materials for 'inheritance tax trusts and estates' that I am awaiting with bated breath.

In the pile are numerous letters from clients who mention that there is something about a trust from a generous relative in their documents that they are unsure about, but they have every confidence that I will deal with it.

To paraphrase *A Streetcar Named Desire*, in these circumstances a CTA student must always depend on the kindness of colleagues.

But there are key areas of which professionals need to be aware when dealing with trust income for clients who are the beneficiaries or settlors of trusts.

What is a trust?

At the simplest level, a trust is created when you ask a friend to hold on to your handbag, complete with all the secrets the accessory holds. A trust is established if a person (the 'settlor') gives property (cash, a handbag or any asset) to someone they trust (the 'trustee'). The trustees can only hand out assets and any income generated to particular people (the 'beneficiaries'). If substantial assets are involved, these are recorded in a document known as the 'trust deed' – a rulebook for the trust.

Many trusts (also called 'settlements') involve people wearing different hats. It is common for the settlor to be a trustee; and there is nothing to prevent the settlor being a beneficiary.

Why set up a trust?

There are many reasons to use trusts, including:

- To protect assets – you want to give away an asset now, but the recipient may be incapacitated, under 18 or a spendaholic and is unable to look after it. Trusts may also protect assets against divorce or bankruptcy.
- To keep assets in the family – you may want to give your son your prized collection of mint-in-box *Star Wars* figures but are worried he may sell them on eBay rather than pass them on to his children.
- For tax planning.

Trust deed fact-find

Your client may have provided form R185 giving details of the income and tax credits to put on their tax return. But without understanding the set-up of the trust it is difficult to be confident that you will enter the information correctly and explain to your client how the arrangement has affected their tax position.

It is useful if the client can provide you with a copy of the trust deed. Although students often hope to absorb information by osmosis, it is important to read it. Reading legal documents can seem bewildering, but it gets easier with experience.

You need to know:

- Who is the settlor? The settlor for tax purposes may not be who it appears to be if the trust was made after a 'deed of variation' to a will. Let's say a grandfather leaves assets in his will to his daughter. She does not need the money and would rather her young children benefit and asks her lawyers to change the will (with a deed of variation) so that the assets are held on trust for the children. The deed of variation means that, legally, we pretend the grandfather had left the assets to the grandchildren in his will so you might think that the he was the settlor. However, a deed of variation does not apply for income tax or capital gains tax (CGT) – this means that the daughter is the settlor (because she is the one who has given up her entitlement to the assets). Thus a 'parental settlement' is created (see later for what this means for her tax return).
- Who are the potential beneficiaries?
- How are the beneficiaries related to the settlor?
- Are any of the beneficiaries under 18 and unmarried in the tax year?
- Are the beneficiaries entitled to any of the income or the assets or do the trustees have discretion over when and how to distribute the income and assets?
- Offshore trusts are complicated so, if the settlor or any of the trustees are not UK-based, consult an expert.

Settlor interested trusts

Ask yourself: could the settlor, or their current spouse or civil partner, benefit in any circumstances from the trust assets? If yes, you have a settlor interested trust. So what?

- The trustees will prepare their tax return as normal.
- All the trust's income as it arises is also put on to the settlor's self-assessment tax return.
- The income 'retains its character' on the settlor's return. It is entered as non-savings income, savings income and dividend income.
- The non-savings income and savings income will come with a 45% tax credit at current rates, and the dividend income 37.5% (the rates applicable to trusts).
- If the settlor is an additional rate taxpayer there will be no more tax to pay on the trust income.
- But if the settlor's income is below the additional rate threshold the trust tax credits will either generate a tax refund or offset the tax due on their other taxable income.
- The settlor must repay this tax refund or the amount of reduction in their tax liability to the trustees because legally it belongs to the trust.
- If any of the trust income is paid to a beneficiary (other than the settlor) this will be non-savings income on their return with a ring-fenced 45% tax credit. There will be no further tax to pay on this income but the tax credit should not be offset against any other income or be refunded. Form R185 should be provided.
- These rules apply only while a settlor is alive even if the spouse or civil partner is still alive.
- Capital gains made by a UK resident trust are not reported on the settlor or beneficiary returns.

PROFILE

Name **Fiona Walker**
Company PEM
Position Tax Adviser
Tel 01223 728222
Email fwalker@pem.co.uk
Profile Before recently joining the private client team of PEM, an independent accountancy firm in Cambridge, Fiona worked as a chartered accountant in general practice. She was awarded her CTA qualification in January 2016 and in the May 2015 sitting won the Spoffoth Medal for the highest mark for the advisory paper on inheritance tax, trusts and estates.

Parental settlement

If the trust is not settlor interested, the next question is whether the trust has been set up by a parent and the beneficiaries include their children who are unmarried under-18s. If the answer is yes you have a parental settlement. This does not apply if the settlor is any other relation to the children. So what?

- Any income paid to the child is entered on the tax return of the parent or settlor as non-savings income with a 45% tax credit. As already noted, there will be no further tax to pay, but any refund or offset benefit of this credit should be repaid to the trustees.
- There is a de minimis of £100 for each beneficiary, but if this is breached it is all assessed on the parent.
- Any income accumulated in the trust while the child is a minor is not taxed on the parent at this stage but will be if it is later paid out.

Trusts that are not settlor interested or parental settlements

There are three main types of trust tax treatment remaining:

1. **Interest in possession.** The beneficiary has an entitlement to some or all of the income – the trustees have no discretion to accumulate this. Broadly, the trustees pay tax at basic rates. For the beneficiary, the trust income will retain its character and come with a basic rate tax credit. The R185 will give you the amounts to include. The dividend tax credit will never be recoverable, but your client may be due a refund on the tax paid by the trustees on the non-savings income and savings income. Any refund does not need to be repaid to the trust. Higher rate and additional rate taxpayers may have further tax to pay on the trust income.
2. **Discretionary interest.** If the trustees can choose whether to distribute income to beneficiaries and when to do it this makes the arrangement a discretionary trust. Broadly, the trustees pay tax at additional rates. The beneficiary is taxed as the income is distributed to them. All of the distribution is treated as non-savings income with a 45% tax credit. If they are an additional rate taxpayer, there is no further tax to pay, otherwise there will be a tax refund/offset of other tax due. The beneficiary can keep this benefit.
3. **Bare trust.** Your beneficiary is already absolutely entitled to the income and assets of the trust (even though the trustees are the legal owners), or if they are a child they will become entitled at 18. Here all income will be reported directly on the beneficiary's tax return and will not be taxable on the trustees (and so there will be no trust tax credit).

I 'trust' the above is a useful introduction. Good luck to all students starting their studies for the May sitting.