A matter of trust

The tax treatment of discretionary trusts is an important part of the ATT exam paper 5, explains JOHN COLVILLE.

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At the last count, in 2014-15, about 91,500 discretionary trusts were making a self-assessment tax return to HMRC. More strictly, these should be referred to as trusts that pay tax at the special rate for trusts; however, in this article we will refer simply to discretionary trusts. In total, these paid income tax of about £540m. So it is not surprising that examiners at ATT paper 5 regularly test knowledge of the income tax regime relating to them. The idea behind the income tax liability of a trust should be relatively straightforward but, as with most areas of tax, several complications need to be negotiated.

Legislative references in this article are to ITA 2007 unless specified otherwise.

The basic principles

As a starter, it is easiest to consider a trust as a separate taxable person. Under general principles, if a person receives income then it is liable to income tax. We then need to consider the big three questions:

- What income is taxable?
- How is the tax calculated?
- When is the tax payable?

The taxable income of a trust depends on its residence. We will only consider the liability of UK trusts here, but the legislation does define how a trust's residence is determined. Primarily, this depends on the residence of the trustees. For example, if all the trustees are UK resident it is a UK resident trust; if all the trustees are non-resident it is a non-resident trust. There are further provisions for a trust with mixed resident trustees (see s 474 to s 476).

Let us assume that the trustees are all UK resident so it is a UK resident trust. The trust is subject to income tax on its worldwide income and all the normal rules for determining the taxable income of an individual apply to a trust. For example, interest and dividends are taxed on a receipts basis. Similarly, the profits of a property business are calculated on the accruals basis by taking the rental income less the allowable expenses. Trusts are taxed on this gross income with no further deductions for general expenses or personal allowances.

KEY POINTS

- Discretionary trusts pay about £500m of income tax each year.
- A trust can be considered a separate taxable person.
- The residence of the trust will depend on the status of the trustees.
- Accumulated or discretionary income is charged at the trust or dividend trust rate.
- Trust expenses must be allocated to specific income types in order.
- Calculating the trust tax pool.

The trust tax calculation

Once we have determined the taxable income of a trust we need to calculate how much tax is payable. The legislation (see Part 9) starts off very simply and tells us that accumulated or discretionary income is taxed at either the trust rate or the dividend trust rate (ITA 2007, s 479 and s 9). Currently, these are the same as the additional rates that apply to individuals; in other words, 45% for non-dividend income and 38.1% for dividend income.

The general principle of discretionary trust taxation is straightforward: we determine the amounts of non-dividend and dividend income, and then apply the appropriate rates.

Delving a little further (s 491), we find that a discretionary trust is entitled to a basic rate band. However, instead of the significant amount (currently £11,500) for an individual, it is only £1,000. Indeed, this is reduced where the same settlor has set up more than one trust (s 492). The trust basic rate band is a relatively new idea and may already have outlived its usefulness. For many years trusts did not have a basic rate band and the tax calculation was relatively simple. However, a significant number of trusts had only a small amount of income. In most cases, this was either interest or dividends. Before 2016-17 this income was received net of basic or lower rate tax and these small trusts had

DISCRETIONARY TRUST

A discretionary trust has income and expenses in 2017-18 as below:

	£
Bank interest	12,000
UK dividends	8,000
Trust expenses	(1,850)

The income tax computation is as below:

	Interest £	*Dividends* £
Bank interest	12,000	
Dividends		8,000
Total trust income	12,000	8,000
Less: Expenses (1,850 x 100/92.5)		(2,000)
Income after expenses	12,000	6,000

The tax payable by the trustees is as below:

Tax	£
Standard rate	
1,000 at 20%	200
Rates applicable to trusts (RAT):	
(12,000 – 1,000) at 45%	4,950
6,000 at 38.1%	2,286
2,000 at 7.5%	150
Total tax payable	£7,586

to go through the rigmarole of calculating and paying a small amount of additional tax. To simplify matters, the basic rate band was introduced, under which the first £1,000 of income would be liable at the basic or lower rate only. For interest and dividends this liability would already have been or deemed to have been paid at source. Consequently, no tax would be payable by a trust with small amounts of income that was received net. This is tax simplification in action. The price to pay was a little extra complication in calculating the tax of larger trusts. However, this simplification may no longer apply. From 2016-17, bank interest and dividends are received gross and even small trusts may again end up having a small tax liability that needs to be accounted for.

Allocation of expenses

We have one further complication to build in to our calculation. The trust rates apply to income that can be accumulated – in other words retained within the trust – or is payable at the trustees' discretion. They do not apply to income that must be distributed to a beneficiary, which is why the trust rates do not apply to interest in possession trusts.

Further, the trust rates do not apply to income that cannot be distributed because it has already been spent (s 484). This is income that has been used to pay trust expenses. The relevant outlay here is the everyday revenue costs of managing the trust. This would include, for example, paying the tax adviser to deal with the annual self-assessment return, but it would not include capital expenses. However, note that this income is not exempt; it is just not subject to the trust rates, so it is still taxed at the basic or lower rate as appropriate. The legislation goes on to identify which sources of income are used to fund trust expenses (s 486). These are specified in the following order of preference:

- dividend income;
- savings income; and
- non-savings income.

Because the income used to pay expenses is still subject to basic or lower rate tax the amount of gross income needed to cover this cost is the amount of the expenses grossed up at the basic or lower rate tax. For example, if expenses of £1,850 are to be paid out of dividends, the gross dividends necessary would be £2,000 (in other words, £1,850 x 100/92.5).

We can put this together and look at an illustration of the calculation of the trust tax as shown in ***Discretionary Trust***. Here, the tax of £7,586 would be payable under the normal self-assessment regime. Any payments on account would be paid on 31 January 2018 and 31 July 2018. The balance is then payable on 31 January 2019.

The beneficiary's liability

What about the beneficiary's tax liability? With all this consideration of the trust's liability we must not lose sight of why it was established in the first place. It would have been set up for the benefit of the specified beneficiaries. If appropriate, the trustees will exercise their discretion to make payments of income to beneficiaries. If lucky enough to receive such a distribution they will receive a cheque from the trustees together with the appropriate R185 form detailing the associated tax credit. Any payment of income from a discretionary trust is deemed to be net of 45% tax.

> ***"With all this consideration of the trust's liability we must not lose sight of why the it was established in the first place."***

Let us suppose that the beneficiary receives a payment of £11,000 from a discretionary trust. This will be net of a 45% tax credit; in other words, £9,000. The gross income of £20,000 will be included in the beneficiary's personal self-assessment and will always be taxed as non-savings income. The tax payable is reduced by the associated tax credit.

If the beneficiary is an additional rate taxpayer the income will be taxed at 45%, which will be matched by the tax credit. If they are a basic or higher rate taxpayer, they will receive a repayment of part of the tax credit. Finally, if they are a non-taxpayer the whole of the tax credit will be repaid.

TAX POOL

The trustees in the ***Discretionary Trust*** example decide to distribute £11,000 to a beneficiary and the tax pool had a balance of £1,000 brought forward at 6 April 2017. We can set out the tax pool calculation as follows.

Tax pool	£
Balance brought forward at 6 April 2017	1,000
Add: Tax paid by trustees (7,586 – 150)	7,436
	8,436
Less: Tax credits claimed by beneficiaries	
(11,000 × 45/55)	(9,000)
Deficit	(564)

The trustees must pay an additional £564 of tax to HMRC. This assumes, of course, that the trust has enough income and cash available for distribution.

Tax mismatch

However, there may be a mismatch between the tax credit received by the beneficiary and the tax paid by the trust. For example, if the trust receives dividend income, it is taxed at 38.1 %, whereas the tax credit is always 45% (s 494). It is not altogether surprising that the government is not going to give the taxpayer a repayable tax credit unless it has first received that tax from the trust. Consequently, as part of its self-assessment, the trust is required to carry out what is known as a tax pool calculation (s 497). This compares the tax credit for the beneficiary with the tax paid by the trust. If the trust has underpaid tax the deficit must be settled with HMRC as part of the self-assessment return.

Because there may be a timing difference between the years in which income is received by the trust and when it is paid out to the beneficiary the tax pool works cumulatively. Tax paid by the trust that has not been used to fund a tax credit can be carried forward to fund the credit in a later year. However, one other consideration must be borne in mind.

The tax pool compares tax paid by the trust on distributable income with the tax credit on the income actually distributed. Consequently, tax paid on income used to fund the trust expenses does not enter the tax pool. This is illustrated by ***Tax Pool***.

Summary

Trust taxation should be relatively straightforward. However, there are several pitfalls for the unwary. This article should clarify not only the basic rules of how a discretionary trust suffers income tax, but also in some cases why some rules, that might otherwise appear to be rather odd, exist. ■

John Colville is a senior tax tutor at Tolley Exam Training. He can be contacted on 020 3364 4500 or examtraining@lexisnexis.co.uk. Visit www.tolley.co.uk/products-and-services/exam-training.