Don’t worry…

…be happy when you are dealing with the taxation of trusts, says Meg Saksida as she explains the important points to remember when a tax exam asks a question about a discretionary trust.

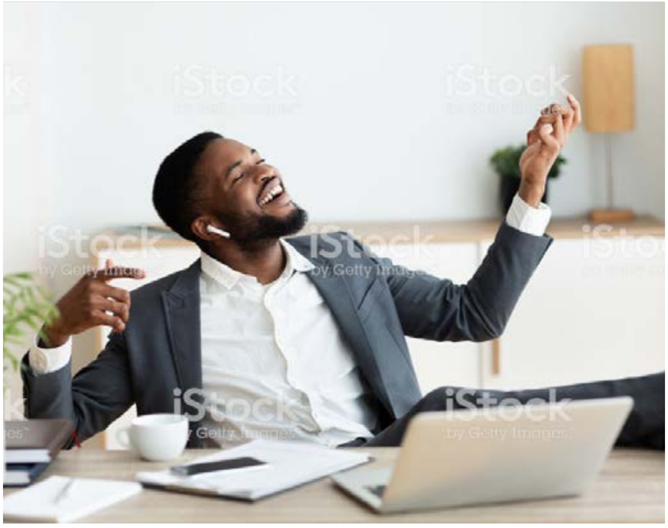
We all love dealing with tax don’t we? We love the challenges, helping clients, cutting through the legislation and guidance and arriving at the correct answer. If we are honest, of course, we would probably also admit that there are some areas of tax that we love more than others and trust taxation can cause a few concerns. But perhaps that’s because, for many of us we’re not dealing with the subject on a regular, day-to-day basis. So like meeting that distant cousin at a family gathering, it takes us a little while to get to know each other again. Once we remember that they like playing the banjo, holidaying in places you’ve never heard of, eating cheeseburgers and the books of Catherine Cookson, it’s as though you’ve been best friends forever.

> “A discretionary trust is a more flexible vehicle, the trustees can choose not to pay all or any income to the beneficiaries.”

Trust taxation can be a little like that. When you meet a discretionary trust appear in an exam question there are always four things you have to remember if you are to have a successful encounter.

Key points

- The four points to remember when dealing with trusts: the tax rate; the standard rate band; management expenses and calculating the tax pool.
- Imposing higher rates of tax on discretionary trusts discourages the hoarding of income in the trust.
- Trustees are not entitled to personal allowances, the starting rate band or the savings or dividend allowances.
- For discretionary trusts, the standard rate band applies to the first £1,000 of income.
- Income used to pay trust management expenses is chargeable to tax at the basic rate.
- Trustees must maintain a ‘tax pool’ which takes into account the 45% tax credit that applies to distributions to beneficiaries.



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- Apply the correct rates of income tax to the income received by the trust.
- Include the standard rate band available to the trust.
- Deal with the trust management expenses.
- Perform the tax pool calculation.

The rate of income tax

To understand the reasons why a discretionary trust (DT) is taxed in different way than an interest in possession (IIP) trust, let’s look at their taxable income from HMRC’s perspective. An IIP trust is obliged to pay all the income it has received throughout the tax year to the life tenant beneficiaries. The beneficiaries will then either reclaim the tax paid if they are not taxpayers (for example, if they are children) or pay any extra tax due (in the case of 40% and 45% taxpayers). The reclaim or payment is made through the beneficiaries’ self-assessment tax returns.

Because a discretionary trust is a more flexible vehicle, the trustees can choose not to pay all or any income to the beneficiaries. The impact of this is that if the trust was paying basic rates of income tax in the same way as the IIP trust, it could be years before HMRC received the extra tax due by a beneficiary who is subject to higher or additional rates of tax. This is because HMRC would have to wait until the income was distributed by the trustees for the beneficiary to pay this additional liability.

Thus, to discourage the hoarding of income in the trust, the rates that apply to income received by discretionary trusts are set at rates that mirror the rates paid by additional rate taxpayers. In this way, HMRC receives all the tax up front. Then, once the beneficiary receives the income, unless they are additional rate taxpayers, they can apply to reclaim the tax through their self-assessment return.

Smith Discretionary Trust 1

For 2019-20, the Smith Discretionary Trust has property income of £500, building society interest of £300 and UK dividends of £600. It has no other income or expenses. The settlor has made no other settlements.

The tax liability of the trust for 2019-20 is as follows.

Standard rate band (£1,000)	£
Property income: £500 @ 20% (basic rate)	100.00
Gross interest: £300 @ 20% (basic rate)	60.00
Dividends: £200 @ 7.5% (dividend ordinary rate)	15.00
	175.00
Income exceeding standard rate band	
Dividends: £400 @ 38.1% (dividend trust rate)	152.40
Total trust tax liability	327.40

Note. The property income and building society interest form the lowest slice of the total income. This all falls within the standard rate band and is charged at basic rate. £800 of the £1,000 standard rate band is now used up. The remaining £200 of the standard rate band is allocated against the dividend income which is charged at the dividend ordinary rate. The remainder of the dividend income is charged at the dividend trust rate.

Subject to the standard rate band discussed below, the rates of income tax paid by the trustees of a discretionary trust are 'the rates applicable to trusts' as follows.

- Non-savings income is charged at 45%.
- Savings income is charged at 45%.
- Dividends are charged at 38.1%.

Trustees are not entitled to any allowances such as the personal allowance, the starting rate band or the savings or dividend allowances, so all interest or dividends received are chargeable to income tax in full.

The standard rate band

For discretionary trusts there is a standard rate band within which the rates applicable to trusts do not apply. The standard rate band applies to the first £1,000 of income. This income is taxed at the basic rate (or the dividend ordinary rate). To apply the standard rate band to income, we use the same procedure as for the personal allowance, working left to right in our proforma columns so we will always allocate the band to non-savings income first, before moving on to savings income and then finally allocating any remaining band to dividend income.

We can illustrate this as follows.

Non-savings income → Savings income → Dividend income

Order of using the standard rate band

See also the ***Smith Discretionary Trust 1*** example.

The settlor cannot use the standard rate band more than once, so if they have more than one discretionary trust, they must divide the £1,000 by the number of current trusts (those that exist at some time during the same tax year) that the settlor has made. For example, if the settlor has settled assets on two discretionary trusts, they will each have a £500 standard rate band. However, if the settlor has created more than five, the standard rate band is never reduced to less than £200.

Trust management expenses

In a discretionary trust, just as in an IIP trust, the management expenses cannot be offset in full against income for tax purposes but instead any income used to fund these costs is chargeable to tax at the basic rate (or dividend ordinary rate). In an IIP trust, this is because all income would be taxed at the basic rate (or dividend ordinary rate) but in a discretionary trust, this is because the rates applicable to trusts apply only to income that can be distributed to beneficiaries. If the income has already been spent on management expenses, it is not available for distribution.

To calculate this part of the tax liability, we need to remove the trust management expenses from the other income taxable at the rates applicable to trusts, so we can isolate the amounts to be charged at basic rate (or dividend ordinary rate) before we apply the trust tax rates to the other income. This time we work 'backwards' in the proforma and remove the management expenses first from dividend income, then from interest and finally any remaining expenses are removed from non-savings income – so we are working right to left instead of left to right.

Non-savings income ← Savings income ← Dividend income

Order of removing the trust management expenses

> "The settlor cannot use the standard rate band more than once, so if they have more than one discretionary trust, they must divide the £1,000 by the number of current trusts."

However, there is a problem: if we simply subtract the amount we have spent on the trust management expenses from the income, we are not comparing like with like. We insert income arising to the trustees as a *gross* figure in the income tax computation, but we are spending income that has already been taxed on the management expenses. Therefore, to compare like with like, we must gross up the expenses, so they are also gross figures in the income tax computation. Once grossed up at the applicable rate, we can remove them from the dividend/interest or non-savings income, and then tax the income used for the management expenses at the basic rate (or dividend ordinary rate) and the remaining income at the rates applicable to trusts.

The tax pool

Beneficiaries who do not pay tax or who only pay tax at the basic or higher rates, will be reclaiming income tax if they receive income from a discretionary trust. Because the trust pays 45% tax on non-savings income, the beneficiary is issued with a tax credit for 45% and they can then set this against the tax they are due to pay personally (0%, 20% or 40%), and reclaim the difference.

However, let's look at this again from HMRC's point of view. If the trust did not receive non-savings income, but received only dividend income of, say, £10,000, the trustees would pay only 38.1% rather than 45% in tax, so tax of £3,810 (ignoring the standard rate band here for simplicity). They would then have £6,190 in cash to pay to the beneficiary (£10,000 – £3,810). However, the trustees will still issue the beneficiary with the standard 45% tax credit. So, if the trust paid out all the cash left, being £6,190, the beneficiary would gross this up in their tax computation at 100/55, leading to a taxable income figure of £11,255. They would then be entitled a tax credit at 45%, so £5,065. Remember, the trustees only paid out £3,810 to HMRC so, potentially, the Revenue would be left short by up to £1,255.

"When calculating the payments on account for a trust for the following tax year, this additional tax pool liability will be counted as tax for the year."

To counter this issue, the trustees need to keep an 'account' of what they have paid to HMRC and this needs to be compared to the maximum that the beneficiary may potentially reclaim from HMRC. If this account goes into a negative position, the trustees would need to pay an extra amount of income tax to HMRC. Keeping a tally of this account is done by way of the 'tax pool'. Using the figures above, the tax pool would be as follows:

Tax pool	£
Tax pool brought forward	-
Tax paid to HMRC on income available to be distributed to beneficiaries	3,810
Less: Tax credit given to beneficiaries on amounts paid out to beneficiaries (£6,190 x 45/55)	5,065
Over/(underpayment) to HMRC	(1,255)

Any overpayment would be carried forward to be used for future years.

Any underpayment is an additional tax payment to be paid to HMRC with the income tax due in the tax year. When calculating the payments on account for a trust for the following tax year, this additional tax pool liability will be counted as tax for the year.

Note that, because the tax that entered the tax pool is only tax paid to HMRC on income available to be distributed to beneficiaries, any tax paid on trust management expenses will therefore not be included here. This is because this tax can never be reclaimed by beneficiaries since it is already spent so it cannot be distributed to beneficiaries in the first place.

See the ***Smith Discretionary Trust 2*** example.

Conclusion

This brief guide to the basic principles of the taxation of discretionary trusts should enable you to greet them like an old friend when your paths next cross, rather than avoiding them while frantically trying to remember what you have in common.

Smith Discretionary Trust 2

As shown in *Smith Discretionary Trust 1*, the trust income and tax liability is:

	£
Property income	500.00
Gross interest	300.00
Dividends	600.00
Total income	1,400.00
Less: Trust tax liability	327.40
Net trust income	1,072.60

If the trustees distribute the whole of the net income of £1,072.60 to the beneficiaries, they – the beneficiaries – will be entitled to a tax credit of 45%. Thus, there will be further tax to pay (assuming no balance, or insufficient balance, brought forward from earlier years in the trustees' tax pool) as follows.

	£
Net income £1,072.60, so tax credit at 45/55 =	877.58
Less: tax already paid on trust tax return	327.40
Balance payable (assuming no balance brought forward from tax pool)	550.18

This tax, as well as the normal trust tax liability will be payable on 31 January following the end of the tax year in which the income is received and distributions are made.

Planning point

A settlor cannot use the standard rate band more than once, so if they have more than one discretionary trust, they must divide the band by the number of current trusts, up to a maximum of five.

Author details

Meg Saksida BA, FCA, CTA, TEP is a freelance tutor teaching for Tolley Exam Training and other training organisations. The views expressed are her own.
Meg can be contacted at Tolley by telephone on 020 3364 4500 or email: examtraining@lexisnexis.co.uk.
Visit: www.tolley.co.uk/products-and-services/exam-training

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