# CHAPTER 2

# INCOME TAX ON INTEREST IN POSSESSION TRUSTS

## 2.1 General rules

A body of trustees is a legal body of persons with a **separate legal capacity** and identity. Therefore trustees are liable to income tax on any income arising from trust property in their capacity as trustees.

The tax affairs of the trust are always kept separate from the individual tax affairs of the various trustees. A change of trustees will have no effect on the income tax treatment of trust income.

The same categorisation system applies for trustees as that which applies for individuals. Rental profits will be taxed under the rules for property businesses, bank interest is taxed under the interest rules, and so on.

Income tax computations are prepared on a tax year basis.

The **same self assessment rules** apply to trustees as they do for individuals. For example, trustees will file a trust return no later than 31 January (if filed online), following the end of the tax year, and they should accompany that return with a calculation of the income tax due. Penalties for late filing and for late payment of tax apply in exactly the same way. TMA 1970, s.8A

Personal allowances are available for individuals only – **no personal allowances are available to reduce trust income**. Also when we are preparing income tax computations for trusts, no deductions will be taken for such things as pension contributions or gift aid payments. ITA 2007, s.34

When calculating the income tax liability of a trust, usually the **same rate of tax will apply regardless of the level of trust income.** For example, **the various rate bands** which apply for individuals, **do not apply for trusts**.

For this reason, an income tax computation for a trust is usually far less complicated than it is for an individual. The computation is further simplified by the fact the trustees usually have very few sources of income. Trustees will normally invest funds in either land or buildings producing rental income, in Government stocks or cash deposits producing interest income, or in shares or securities which produce dividend income.

It is possible for a trustee to carry on a trade – for example if a sole trader died leaving his business to a trust – although this is relatively unusual.

A trustee cannot be an employee, therefore trustees will never receive employment income. The **sources of income** in a trustee's tax computation are **usually** restricted to **rents, interest and dividends**.

## 2.2 Interest in possession trusts

The income tax position for the trustee of an interest in possession trust is relatively straight forward.

If an interest in possession trust receives rental income, the rental profits, after allowable expenses, are fully charged at the **basic rate of 20%**. The same rate applies regardless of the level of income. Property income **deductions are exactly the same** as they are for individuals. These will include genuine repairs, interest on a loan taken out to purchase the property, and wear and tear allowance for furnished lettings. If the trustee grants a short lease and receives a premium in return, part of that premium is chargeable to income tax, again at the basic rate of 20%.

Any **interest** received by a trustee, whether on bank or building society accounts, or on government stocks, is wholly charged at the **basic rate of 20%** regardless of the **level** of the income. Therefore, if an interest in possession trust receives **bank** or **building society** interest or **gilt** interest which has **already suffered tax at source**, the **tax liability** of the trustee is **fully covered by the 20% tax credit**. Interest in possession trusts will therefore **only** pay **additional income tax on untaxed interest**.

**Dividend** income is taxed on the trustees at the normal **dividend rate of 10%.** As all UK dividends are deemed to have been received net of a 10% **tax credit**, this credit **will extinguish the trustees' liability** leaving no further tax payable. Credit for tax deducted at source is given at the bottom of the computation in the normal way. **Interest in possession trusts will only therefore pay additional tax on untaxed income**. In the majority of cases, this will be rental income charged at the basic rate.

## 2.3 Trust expenses

ITA 2007, s. 503

Interest in possession trusts are **not allowed to take a deduction for any expenses** incurred in managing the trust. These expenses can be likened to personal expenses incurred by an individual – i.e. they cannot be deducted anywhere in the income tax computation. The **only expenses that can be deducted are those relating specifically to a source of income**. These will generally be restricted to such things as **letting expenses** which are deducted in arriving at property business profits.

## 2.4 The life tenant

Remember that in an interest in possession trust, the beneficiary - i.e. the life tenant - is **entitled to the net income** of the trust and the trustees have no power to accumulate or withhold the income. Therefore income received by an interest in possession trust will **flow through** the trust and out to the life tenant.

An interest in possession trust can be likened to a "money-box". Money comes into the trust, the trustees will incur some expenses and pay some income tax, and what is left in the box at the end of the year must be paid to the life tenant. We shall look at the tax position of the life tenant later in this chapter.

**Illustration 1**

Jeremy is the life tenant of an interest in possession trust. The income of the trust for the tax year 2010/11 is as below:

| | £ |
|---|---|
| Rental income | 26,000 |
| Bank interest (net) | 4,800 |
| UK dividends | 9,000 |
| | |
| Expenses: | |
| Letting expenses | 6,000 |
| Management expenses | 1,800 |

| | *Non savings* | *Interest* | *Dividends* |
|---|---|---|---|
| | £ | £ | £ |
| Rental profits | | | |
| £(26,000 – 6,000) | 20,000 | | |
| Bank interest | | | |
| (£4,800 x $\frac{100}{80}$) | | 6,000 | |
| UK dividends | | | |
| (£9,000 x $\frac{100}{90}$) | | | 10,000 |
| Total Income | £20,000 | £6,000 | £10,000 |
| | | | |
| @ 20% | 4,000 | | |
| @ 20% | | 1,200 | |
| @ 10% | | | 1,000 |
| Less tax credits | | (1,200) | (1,000) |
| Tax due | £4,000 | Nil | Nil |

As you will see, the income tax computation is very straight forward and you may not feel that such an elaborate computation is necessary. It is perfectly acceptable in this instance to say that the trustees' liability is **simply the net rental income multiplied by the basic rate of 20%.**

Finally note that no relief has been taken for the trust management expenses of £1,800 as these are not deductible in calculating the income tax liability.

## 2.5 Tax position of the beneficiary

The net income of the trust after taxes and expenses, will flow through to the beneficiary. No income will be accumulated in the trust.

In the previous illustration, the interest in possession trust received rental income, bank interest and dividends. We calculated that the trustees' tax liability for the year is £4,000. The final outgoing of the trustees in 2010/11 is £1,800 of trust management expenses. The remaining cash in the trust at the year end will thereafter flow to the life tenant.

The **next** stage is therefore to work out the amount of **income which the trustees can distribute** to the beneficiary. This is as below:

| | *Non savings* | *Interest* | *Dividends* |
|---|---|---|---|
| | £ | £ | £ |
| Gross Income | 20,000 | 6,000 | 10,000 |
| Less tax paid | (4,000) | (1,200) | (1,000) |
| Net income | 16,000 | 4,800 | 9,000 |
| Less expenses | ______ | ______ | (1,800) |
| Distributable income | £16,000 | £4,800 | £7,200 |

This income is **taxed on the beneficiary in the year in which it arises.** As this income will already have been taxed in the hands of the trustees, the life tenant will receive taxed income, and this income will need to be reflected on his self assessment return.

**Trust management expenses are deemed to have been paid from dividend income** in priority to interest and rents. We therefore deduct the £1,800 of expenses from the dividend column leaving income distributable to the beneficiary as above. If the trust has **insufficient** dividend income, expenses are next deemed to have come **from interest income**. If interest has been extinguished, expenses come **finally from rental** income. If expenses exceed income for the year, there is no distributable income and the expenses will be carried forward and deducted from income arising in future years.

Once the trustees have arrived at the figure of distributable income, they will certify that income (and the tax deducted at source) to the beneficiary on a **tax deduction certificate (form R185)**.

| *R185* | *Gross* | *Tax* | *Net* |
|---|---|---|---|
| | £ | £ | £ |
| Non savings | 20,000 | 4,000 | 16,000 |
| Interest | 6,000 | 1,200 | 4,800 |
| Dividends | 8,000 | 800 | 7,200 |
| | | | £28,000 |

The trustees will certify that the beneficiary has received net rental income of £16,000, bank interest of £4,800, and dividends of £7,200. Therefore the total income payable to the beneficiary for 2010/11 is £28,000.

This is net income from which tax has already been deducted at source. The £16,000 is rental income net of a 20% tax credit. Essentially the beneficiary has received rents of £20,000 from which tax of £4,000 has been deducted. Secondly the beneficiary received net bank interest of £4,800. This is gross interest of £6,000 with an appropriate 20% tax credit. Finally the beneficiary is deemed to have received a net dividend of £7,200. If we gross up the £7,200 at 100 over 90, this gives a gross dividend of £8,000. The tax credit attaching to this dividend is £800.

The appropriate **gross figures will be entered on to the beneficiary's tax return**. If the beneficiary is a higher rate (40%) taxpayer, he will pay an additional 20% on the rental income, an additional 20% on the bank interest and an additional 22½% on the dividends.

If the beneficiary's total income exceeds £150,000 such that his income is taxed at the additional rates of 50% or 42½%, he will pay an additional 30% tax on rental income and interest, and an extra 32½% on dividends.

If the beneficiary is a basic rate tax payer, or has losses etc to set against this income, the tax credit attaching to the non-savings income and bank interest can be recovered. The tax credit attaching to the **dividend income** is a **notional credit and will never be repaid**.

If the beneficiary receives an overseas dividend from the trust, it will be grossed up both for the UK tax and the notional overseas tax credit, if appropriate.

It is common in practice for the life tenant to receive **interim distributions** during the year from the trustees. Such interim distributions are **ignored** for tax purposes as it is the distributable income - as certified on the form R185 - which is taxable. For example, in the above illustration the trustees may make monthly distributions of, say, £2,000, so the beneficiary will receive £24,000 of income during the year. Once the trust accounts and trust tax return have been prepared, the income will be certified on the form R185 and a balancing payment – in this instance £4,000 – will then be made to the beneficiary.

## 2.6 Annuities

It is unusual for trustees to have deductible payments from total income, but the most common deductible payment in practice is the **payment of an annuity to the beneficiary**. If a beneficiary has an annuity, he or she has the right to receive a **fixed sum of income from the trust each year**. In this sense, an annuity is very similar to an interest in possession as it gives a beneficiary a right to income from the trust. Unlike a normal interest in possession, the annuity will be fixed and will not vary year on year depending on trust income.

If a beneficiary is entitled to receive an annuity from an interest in possession trust, he will do so **net of basic rate tax**. In most circumstances, the annuity is expressed as a gross amount. The trustees will withhold 20% tax at source, and pay the net amount to the annuitant. The **gross annuity is deducted by the trustees as a deductible payment.** ITA 2007, s.449

As is the case for individuals, the deductible payment is **deducted from non savings income in priority** to interest and dividends. The **basic rate tax withheld** from the annual payment is paid by the trustees to HMRC at the end of the year on the normal due date. This has the effect of **increasing the trustees' liability** in the income tax computation.

The trustees will provide a tax deduction certificate to the beneficiary certifying that he or she has received a net payment from which basic rate tax has been withheld. The recipient of the annuity will pay any higher rate tax on the annuity via his self-assessment return.

**Illustration 2**

The trustees of an interest in possession trust have income and expenses for 2010/11 as below:

| | £ |
|---|---|
| Rental income | 30,000 |
| Gilt interest (gross) | 15,000 |
| Dividends | 1,800 |
| | |
| Expenses: | |
| Bank charges | 1,000 |
| Accountancy fees | 1,500 |
| Portfolio valuation fee | 750 |

The trustees are obliged to pay an annuity of £5,000 to Albert and the rest of the income to the life tenant, Lionel. Albert is entitled to gross income of £5,000. However, the trustees will withhold basic rate tax at source. Albert will therefore physically receive £4,000, and the tax withheld of £1,000 will be paid by the trustees to HMRC at the end of the year. Albert will receive a tax deduction certificate from the trustees certifying that he has received taxed income.

| | *Non savings* | *Interest* | *Dividends* |
|---|---|---|---|
| | £ | £ | £ |
| Rental profits | 30,000 | | |
| Gilt interest (gross) | | 15,000 | |
| Dividends (x $\frac{100}{90}$ ) | | | 2,000 |
| Less: deductible payment | (5,000) | | |
| Taxable income | £25,000 | £15,000 | £2,000 |

| | |
|---|---|
| £25,000 @ 20% | 5,000 |
| £15,000 @ 20% | 3,000 |
| | 8,000 |
| Add: Tax on annuity (£5,000 @ 20%) | 1,000 |
| Tax payable | £9,000 |

The tax liability, before accounting for tax on the annuity is £8,000. However, the trustees need to account for basic rate tax on the annuity. The tax on the annuity is £1,000, taking the total tax liability of the trust up to £9,000. The tax of £1,000 withheld from the annuity and paid to HMRC can be claimed by Albert as a tax credit.

To complete this example let us look at the tax position of the two beneficiaries. The trustees will provide Albert with a Form R185 certifying that he has net income of £4,000 from which £1,000 has been deducted at source. If Albert is a higher rate taxpayer, he will pay an additional 20% on this income under self assessment.

| | *Gross* | *Tax* | *Net* |
|---|---|---|---|
| *R185* | *£* | *£* | *£* |
| Annual income | 5,000 | 1,000 | 4,000 |

The **life tenant is entitled to the balance of income** in the trust, after the annuity has been paid to Albert.

| *R185 for Life tenant* | *Non savings* | *Interest* | *Dividends* |
|---|---|---|---|
| | £ | £ | £ |
| Gross income | 25,000 | 15,000 | 2,000 |
| Less tax | (5,000) | (3,000) | (200) |
| | 20,000 | 12,000 | 1,800 |
| Less expenses: | | | |
| Bank charges | | | (1,000) |
| Accountancy | | (700) | (800) |
| Distributable | 20,000 | £11,300 | Nil |

The trustees also incurred a portfolio valuation fee of £750. **Expenses incurred in relation to the capital value** of the trust **do not reduce the income entitlement of the life tenant.** This £750 will instead be deducted from the **capital** of the trust and will ultimately reduce the value of the **remainderman's** share.

## 2.7 "Free of tax" annuities

Although in practice, most annuities are expressed as a gross amount from which basic rate tax is deducted at source by the trustees, annuities can be **expressed as a net amount**. Such annuities are called "free of tax" annuities. The purpose of a "free of tax" annuity is to guarantee the beneficiary the same net amount each year. This ensures that the annuitant will **receive the same amount** each year **even if the basic rate of tax subsequently changes**.

The payment received by the annuitant is then grossed up for basic rate tax. At the moment, payments will be grossed up at 100 over 80 to reflect a basic rate of 20%. As with normal annuities, the gross amount of the annuity is deducted from non savings income in the trust as a deductible payment. The trustees are required to account for the basic rate deducted to HMRC. This increases the tax liability of the trustees for the year.

If the **annuitant is due a tax repayment** – for example because his income for the tax year is covered by personal allowances etc - **the tax deducted at source by the trustees** (or a proportion of it), **must be repaid to the trust.** This is because the annuitant is reclaiming tax that was paid by the trustees.

**Illustration 3**

Wesley is entitled to an annuity of £2,000 from an interest in possession trust. This is expressed to be "free of tax". This means that Wesley will physically receive £2,000, after the deduction of basic rate tax at source.

| R185 | *Gross* | *Tax* | *Net* |
|---|---|---|---|
| Annuity | £2,500 | £500 | £2,000 |

Wesley has a part-time job paying a salary of £5,000 per year.

| 2010/11 | £ |
|---|---|
| Employment income | 5,000 |
| Annuity | 2,500 |
| | 7,500 |
| Less PA | (6,475) |
| Taxable | £1,025 |
| | |
| @ 20% | 205 |
| Less credits | (500) |
| Tax repayment | £(295) |

Let us now look at Wesley's tax position for 2010/11.

The **proportion** of the repayment that relates to the annuity is:

$$\text{Total tax repayment} \times \frac{\text{gross annuity}}{\text{total income}}$$

i.e. £(295) x (2500/7500) = £(98)

The tax repayment relating to the annuity income is therefore £98. Wesley must therefore repay this £98 to the trustees.

Note that the need to refund tax repayments to the trustees only applies in the case of "free of tax" annuities. If an annuitant receives a **gross annuity** - from which tax is withheld at source - and the annuitant is in a **tax repayment** situation, **no part of that repayment needs to be returned to the trustees**.

**Example 1**

Paula is the life tenant of an interest in possession trust. In 2010/11 the trustees had the following income and expenses:

| | £ |
|---|---|
| Rental income | 50,000 |
| Bank interest (net) | 2,000 |
| Trust expenses | (3,000) |

**Calculate the tax payable by the trustees in 2010/11.**

**Example 2**

Paula is the life tenant of an interest in possession trust. In 2010/11 the trustees had the following income and expenses:

| | £ |
|---|---|
| Rental income | 50,000 |
| Bank interest (net) | 2,000 |
| Trust expenses | (3,000) |

**Calculate the gross income assessable on Paula in 2010/11.**

**Answer 1**

| | Non savings | Interest |
|---|---|---|
| | £ | £ |
| Rental profits | 50,000 | |
| Interest (x $\frac{100}{80}$ ) | ______ | 2,500 |
| Taxable | £50,000 | £2,500 |
| | | |
| @ 20% | 10,000 | |
| @ 20% | | 500 |
| Less tax credit | _____ | (500) |
| Tax due | £10,000 | Nil |

**Answer 2**

| | Non savings | Interest |
|---|---|---|
| | £ | £ |
| Gross income | 50,000 | 2,500 |
| Less: income tax | (10,000) | (500) |
| | 40,000 | 2,000 |
| Less: expenses | (1,000) | (2,000) |
| Distributable income | 39,000 | Nil |

| R185 | Gross | Tax | Net |
|---|---|---|---|
| Rental income | £48,750 | £9,750 | £39,000 |