CHAPTER 3

INCOME TAX ON DISCRETIONARY TRUSTS

3.1 The rates applicable to trusts

ITA 2007, s. 479

Because a discretionary trust is such a flexible vehicle, the rates of tax which apply to income received by discretionary trustees are higher than those which apply to interest in possession trustees.

Trustees of a **discretionary** trust pay income tax at **"the rates applicable to trusts" (RAT) "accumulated or discretionary income".** At the moment, there are two rates which are applicable to discretionary trusts. **Non-savings** income, such as rental income etc, is charged to income tax at a flat rate of **50%.** Bank or building society **interest** or interest on gilts etc, is also charged at the flat rate of **50%. Dividends** received by a discretionary trust are charged at **42½%.**

ITA 2007, s.479(3)(4)

The 50% and 42½% rates for discretionary trusts were introduced from 6 April 2010 in alignment with the top rate of income tax for individuals. For tax years up to and including 2009/10, the rates applicable to trusts were 40% and 32½%

The legislation concerning income tax and discretionary trusts is contained at Section 479 and onwards of ITA 2007. S.480 defines "accumulated or discretionary income" as income which:

(a) must be accumulated; or
(b) is payable at the discretion of the trustees.

ITA 2007, s.480

This means that the rates applicable to trusts - i.e. 50% or 42½% - only apply to income which the trustees are able (if they wish) to keep within the trust. This tells us two things.

1. If **any income is subject to an interest in possession** – i.e. if the beneficiary is entitled to income from part of the trust fund - the rates applicable to trusts **do not apply** to that income. Any income which is subject to an interest in possession is **charged at 20% or 10%** depending on the source of income.

2. In order to arrive at income which is chargeable at the rate applicable to trusts, **some relief is available for trust management expenses.** Remember that the rates applicable to trusts only apply to income which is available for distribution. Therefore if the trustees have received some income and that **income has been used to meet expenses** of the trust, such income is not available for distribution and is therefore **not chargeable at the 50% or 42½% rates**.

   Effectively therefore when putting together an income tax computation for a discretionary trust, we can take a tax deduction for trust management expenses (see paragraph 3.3).

3.2 The "basic rate" band

The rates applicable to trusts (i.e. 50% & 42½%) do not apply to the **first £1,000 of gross income** received by trustees of discretionary trusts. Instead such income will be **taxed at the basic or dividend rates,** effectively treating the first £1,000 of income in the same way as income from an interest in possession trust.

ITA 2007, s.491

The **"basic rate" band applies to non-savings income in priority to interest in priority to dividends**.

For example:

Non-savings income:	First £1,000 @ **20%** if some of the basic rate band still unused then…
Interest:	Within basic rate band, interest taxed @ **20%** if some of the basic rate band still unused then…
Dividends:	Within basic rate band, dividends taxed @ **10%**

Therefore where income is received net of tax (for example, bank interest or UK dividends), if that income falls within the £1,000 band, there will be no additional tax to pay.

If the settlor has made more than one trust, the **£1,000 band is divided between them, subject to a minimum band of £200** for each trust.

ITA 2007, s.492

Illustration 1

A discretionary trust has the following income in 2010/11:

	£
Rental profits (net of expenses)	800
Bank interest (net)	480
UK dividends	1,800

The tax payable for 2010/11 is as follows:

	Non savings	*Interest*	*Dividends*
	£	£	£
Rental income	800		
Bank interest			
$(£480 \times \frac{100}{80})$		600	
Dividends			
$(£1,800 \times \frac{100}{90})$			2,000
Gross trust income	800	600	2,000

Tax	£
"Basic rate":	
£800 @ 20%	160
£200 @ 20%	40
£1,000	
Rates applicable to trusts (RAT):	
£400 @ 50%	200
£2,000 @ 42½%	850
	1,250
Less tax credits	
Interest (£600 @ 20%)	(120)
Dividends (£2,000 @ 10%)	(200)
Tax payable by trustees	£930

3.3 Trust expenses

ITA 2007, s.484

To arrive at the income that is chargeable at the rate applicable to trusts we deduct trust management expenses from gross trust income.

Only expenses which are **properly deductible against the income of the trust** may be relieved. This means that any **expenses which should be charged against the capital** of the trust – for example legal fees associated with capital items or other professional fees regarding trust investments etc - **cannot be deducted** for income tax purposes.

As trustees will have several sources of income, it is important to identify an order of priority for the set off of trust management expenses. As is the case for interest in possession trusts, trust management expenses are **set against dividend income in priority** to other income.

ITA 2007, s.486

If there are insufficient dividends to meet the trust management expenses, the expenses are next set against any bank interest and finally the expenses are set against non-savings income.

When taking a deduction for trust expenses, we **must gross up the expenses at the appropriate rate.** For example, if expenses are being deducted from dividend income, the expenses must be grossed up at **100/90**. This is to make sure we are comparing "like with like". Having grossed up the income in the tax computation, it is only then fair that we should do the same with the expenses.

Another way to think about the grossing up of expenses, is that if a trust expense of, say, £900 has been incurred, the trustees must have earned a gross dividend of £1,000 to meet that expense.

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Illustration 2

A discretionary trust has income and expenses in 2010/11 as below:

	£
Rents (after expenses)	30,000
Bank interest (net)	16,000
UK dividends	9,000
Trust expenses	(1,800)

The income tax computation is as below:

	Non savings £	*Interest* £	*Dividends* £
Rental income	30,000		
Bank interest			
($£16,000 \times \frac{100}{80}$)		20,000	
Dividends			
($£9,000 \times \frac{100}{90}$)			10,000
Gross trust income	30,000	20,000	10,000
Less expenses:			
($£1,800 \times \frac{100}{90}$)			(2,000)
Income after expenses	£30,000	£20,000	£8,000

Expenses are **met from dividend income**, and accordingly must be **grossed up at 100/90**. The trust income is £30,000 of non-savings income, £20,000 of interest and £8,000 of dividends. The trustees have been able to deduct the trust expenses because the income used to pay the expenses – i.e. £2,000 – is not available to be accumulated within the trust.

The tax payable by the trustees is as below:

Tax	£
"Basic rate":	
£1,000 @ 20%	200
Rates applicable to trusts (RAT):	
£(30,000 – 1,000) @ 50%	14,500
£20,000 @ 50%	10,000
£8,000 @ 42½%	3,400
£2,000 @ 10%	200
	28,300
Less tax credits:	
Interest (£20,000 @ 20%)	(4,000)
Dividends (£10,000 @ 10%)	(1,000)
Tax payable by trustees	£23,300

£2,000 of gross dividends were used by the trustees to meet trust management expenses. This £2,000 of income is not charged at the rates applicable to trusts. However, the **dividend income earned by the trustees which has been used to pay the expenses, is chargeable to tax, but at only at the lower or basic rates as appropriate.** Therefore the £2,000 of dividend income used to pay the expenses will be charged to tax, but at the dividend rate of 10%.

An income tax computation for a discretionary trust differs from an income tax computation for an interest in possession trust in three main ways:

1. Discretionary trusts can receive some relief for trust management expenses. These expenses are grossed up and deducted from dividend income in priority to other income.
2. Discretionary trustees will pay tax at the basic or dividend rates on the first £1,000 of income then at 50% or 42½%.
3. When putting together a tax computation for a discretionary trust, the income which has been used to pay the trust expenses is taxable, but only at the basic or dividend rate.

3.4 Miscellaneous points

Under a discretionary trust arrangement, a fixed sum of income (i.e. an annuity) can be paid to a beneficiary on an annual basis. This essentially gives the annuitant an interest in possession in a part of the fund.

As with interest in possession trusts, the **gross amount of the annuity can be deducted as a deductible payment** in calculating the trustees' tax liabilities. The deductible payment is deducted from non-savings income in priority to other income.

The trustees must withhold tax at source on the annuity at the basic rate. Therefore the annuitant receives a net amount, and basic rate tax is deducted by the trustees and paid to HMRC at the end of the year. This will increase the trustees' liability at the bottom of the computation.

ITA 2007, s.449

Some receipts received by the trustees are charged at the rate applicable to trusts even though they are not strictly income. A common example of this is a **lease premium**. If trustees grant a lease on a property for less than 50 years, part of the premium received for the grant of the lease is charged to income tax and the balance is charged to capital gains tax.

Premium received	X
Less 2% x P x (n – 1)	(X)
Income element	X

ITTOIA 2005, s.277

For trust law purposes, the receipt of a premium is a **capital item** and does not constitute "income" which can be accumulated within the trust under s. 480 ITA 2007. However, under s.482 ITA 2007 the 50% rate **does** apply to such a receipt.

Illustration 3

A discretionary trust has income & expenses as follows in 2010/11:

	£
Rents (after expenses)	18,000
Lease premium (20 year lease)	25,000
Bank interest (net)	12,000
Dividends (net)	2,700
Trust expenses	(3,500)

Under the terms of the trust, Andrew is entitled to a fixed sum of income of £5,000 per annum.

We will calculate the tax due by the trustees for 2010/11:

	Non savings	*Interest*	*Dividends*
	£	£	£
Rents	18,000		
Interest (x 100/80)		15,000	
Dividends (x 100/90)			3,000
Less deductible payment	(5,000)		
Total income	13,000	15,000	3,000
Less: expenses;			
(i) From dividends			
(£2,700 x 100/90)			(3,000)
(ii) From interest			
(£800 x 100/80)		(1,000)	
Income after expenses	£13,000	£14,000	Nil

The gross annuity of £5,000 to Andrew is deducted as a deductible payment, and is taken from non-savings income first.

Trust management expenses are deducted from dividend income in priority to other income. You will see that **all of the dividends have been used in meeting part of the trust expenses.** The **remainder of the trust expenses** will be **met from the bank interest**. These are **grossed up at 100/80**, giving a gross deduction for expenses of £1,000.

You will note that we have not yet dealt with the lease premium. The trustees received a premium of £25,000 for the grant of a 20 year lease. After stripping out the capital element, the lease premium chargeable to income tax is as below:

	£
Lease premium (20 years)	25,000
Less 2% x £25,000 x (20 – 1)	(9,500)
Income element	£15,500

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The taxable element of the lease premium is charged at the trust rate of 50%.

Tax	£
"Basic rate":	
£1,000 @ 20%	200
Rates applicable to trusts (RAT):	
£(13,000 – 1,000) @ 50%	6,000
£14,000 @ 50%	7,000
Add: tax on annuity (£5,000 @ 20%)	1,000
tax on premium (£15,500 @ 50%)	7,750
Expenses: £3,000 @ 10%	300
£1,000 @ 20%	200
Tax liability	22,450
Less credits (3,000 + 300)	(3,300)
Tax due	£19,150

3.5 Tax position of beneficiaries

Beneficiaries of a discretionary trust have no entitlement to income, and only receive income at the discretion of the trustees. ITA 2007, s.493

Any income distributed to a beneficiary is deemed to have been paid net of a 50% tax credit. This 50% rate applies irrespective of the income actually received by the trustees.

ITA 2007, s.494

For example, if the trustees' only source of income is UK dividends on which tax is paid at 42½%, then if that income is subsequently distributed to a beneficiary, it will always carry a 50% tax credit.

If a discretionary trust makes a distribution to a beneficiary, the distribution, and the tax deducted therefrom, is certified on Form R185. ITA 2007, s.495

For tax years up to and including 2009/10, the income distribution was deemed to have been paid net of a 40% tax credit.

Illustration 4

Assume that a discretionary trust distributes £5,000 to a beneficiary. The beneficiary has received a net amount of £5,000. If we gross this up by 100/50, the beneficiary is deemed to have received gross income from which 50% tax has been deducted at source.

This will be certified as "trust income" on the form R185.

R185:	*Gross*	*Tax*	*Net*
Trust income	£10,000	£5,000	£5,000

Unlike as is the case with interest in possession trusts, there is no "**transparency principle**" for discretionary trusts.

Therefore when a beneficiary receives a distribution of income from a discretionary trust, it is simply certified as "trust income" on the Form R185 and is **always treated as non-savings income** in the hands of the recipient. Therefore the beneficiary will enter a sum of £10,000 on his or her self assessment return, and this is classed as non savings income.

If the beneficiary pays tax at the 50% rate, no extra tax will be due on the gross trust income. If the taxpayer pays tax at the basic rate or at 40%, a tax repayment will be due. The beneficiary will send the Form R185 to HMRC in support of his repayment claim.

3.6 The "tax pool"

ITA 2007, s.497

As beneficiaries in receipt of income distributions can always claim a tax credit of 50%, HMRC must have a method of making sure that any tax reclaimed by beneficiaries does not exceed the tax originally paid by the trustees. HMRC do this by asking the trustees to maintain a "tax pool".

The "tax pool" is essentially a **running total of tax paid by the trustees less any tax credits which have been taken out of the pool by the beneficiaries**. A record of the tax pool is maintained on a form which is sent to HMRC along with the trustees' tax return.

Every year tax will enter the pool. However when the trustees pay income tax **not all tax paid by trustees will be allowed as a "credit" to the tax pool**. The credits to the tax pool are as follows:

ITA 2007, s.478

Basic rate band:	Any tax paid at 20% (not at 10%)
Non-savings income:	Any tax paid at 50%
Interest:	Any tax paid at 50%
Dividends:	Dividends (after expenses) @ $32\frac{1}{2}$%

Therefore, the 10% tax credit attaching to dividend income is NOT allowed as a credit into the tax pool. This is because the 10% credit is a notional tax credit which can never be repaid.

Tax on income used to pay expenses does not enter the pool (even if such income is taxed at 20%).

Whenever **tax credits** on distributions are **claimed by beneficiaries**, the balance in the pool will go down. The tax claimed by beneficiaries is the total of the centre columns on the form R185. For example, if a beneficiary receives a distribution of £5,000, this is net of £5,000 of tax, and this credit of £5,000 will therefore leave the pool.

Proforma tax pool:

	£
Balance b/fwd at 6 April	X
Add:	

Tax paid by trustees:	
Basic rate band @ 20%	X
Non savings income @ 50%	X
Interest income @ 50%	X
Dividends after expenses @ 32½%	X
	X
Less: Tax credits claimed by beneficiaries	
= Net distributions x 100%	(X)
Balance c/fwd at 5 April	£X

If at the end of the year, the **tax pool is in credit,** this credit will be **carried forward** as a positive balance at the start of the next tax year.

However, problems arise when the tax pool goes into deficit. Essentially, if a pool goes into **deficit**, this means that the **tax paid** by the trustees is **less than tax that has been claimed** by the beneficiaries. If at the end of the year the tax pool is negative, the trustees are required to make up the difference. This will **increase the trustees' liability** for the year and an additional payment will be required under self assessment.

ITA 2007, s.496

Illustration 5

A discretionary trust has the following income and expenses in 2010/11:

	£
Rental profits (net of expenses)	5,000
Bank interest (net)	4,800
UK dividends	18,000
Trust management expenses	(450)

The tax pool at 6 April 2010 is £1,000. In 2010/11, the trustees made an income distribution of £10,000 to a beneficiary.

First calculate the tax payable by the trustees:

	Non savings	*Interest*	*Dividends*
	£	£	£
Rental income	5,000		
Bank interest			
(£4,800 x 100/80)		6,000	
Dividends (£18,000 x 100/90)			20,000
Gross trust income	5,000	6,000	20,000
Less expenses			
(£450 x 100/90)			(500)
Income after expenses	£5,000	£6,000	£19,500

Tax	£
"Basic rate":	
£1,000 @ 20%	200
Rates applicable to trusts (RAT):	
£(5,000 – 1,000) @ 50%	2,000
£6,000 @ 50%	3,000
£19,500 @ 42½%	8,287
£500 @ 10%	50
	13,537
Less tax credits:	
Interest (£6,000 @ 20%)	(1,200)
Dividends (£20,000 @ 10%)	(2,000)
Tax payable by trustees	£10,337

Next we put together the tax pool:

Tax pool	£
Balance b/fwd at 6 April 2010	1,000
Add: Tax paid by trustees	
£1,000 @ 20%	200
£4,000 @ 50%	2,000
£6,000 @ 50%	3,000
Dividends after expenses @ 32½%	
= £19,500 @ 32½%	6,337
	12,537
Less: Tax credits claimed by beneficiaries	
= £10,000 x 100%	(10,000)
Balance c/fwd at 5 April 2011	£2,587

The beneficiary receives net income of £10,000 with a 50% tax credit. This will be certified as "trust income" on the form R185.

R185:	*Gross*	*Tax*	*Net*
Trust income	£20,000	£10,000	£10,000

Illustration 6

Assume in the above illustration, that the income distribution to the beneficiary in 2010/11 was **£15,000** (instead of £10,000). All other information is as before.

The beneficiary receives net income of £15,000 with a 50% tax credit. This will be certified as "trust income" on the form R185.

R185:	*Gross*	*Tax*	*Net*
Trust income	£30,000	£15,000	£15,000

This changes the tax pool as follows:

Tax pool:

	£
Balance b/fwd at 6 April 2010	1,000
Add: Tax paid by trustees	
£1,000 @ 20%	200
£4,000 @ 50%	2,000
£6,000 @ 50%	3,000
£19,500 @ 32½%	6,337
	12,537
Less: Tax credits claimed by beneficiaries	
= £15,000 x 100%	(15,000)
Balance	£(2,463)

Where a tax pool becomes negative, the trustees must make up the difference, and they will **pay this tax on the normal self-assessment deadline**. This liability falls on the trustees by virtue of s.496 ITA 2007. It will affect the payments on account to be made for 2011/12.

The trustees' tax payable for 20010/11 will now be:

	£
Tax due as before	10,337
Add: S.496 liability	2,463
Revised tax payable	£12,800

Therefore, as at 6 April 2011, the **balance in the tax pool will be zero**. Note that only positive balances are carried forward. There is no negative balance to carry forward as this tax will have been discharged by the trustees.

Example 1

The Alpha discretionary trust has the following income and expenses in 2010/11:

	£
Rental income	24,000
Gilt interest (gross)	6,000
UK dividends	4,500
Trust expenses	(3,000)

Calculate the tax due under self assessment for 2010/11.

Example 2

The Beta discretionary trust has the following income and expenses in 2010/11:

	£
UK dividends	72,000
Trust expenses	(9,000)

The tax pool at 6 April 2010 was £2,000. The trustees made an income distribution of £30,000 to a beneficiary in 2010/11.

Show the tax pool for 2010/11.

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Answer 1

	Non savings	Interest	Dividends
	£	£	£
Rents	24,000		
Gilt interest		6,000	
Dividends			
(£4,500 x $\frac{100}{90}$)			5,000
Less expenses			
(£3,000 x $\frac{100}{90}$)			(3,333)
Income after expenses	£24,000	£6,000	£1,667

Tax	£
"Basic rate":	
£1,000 @ 20%	200
Rates applicable to trusts (RAT):	
£(24,000 – 1,000) @ 50%	11,500
£6,000 @ 50%	3,000
£1,667 @ 42½%	708
£3,333 @ 10%	333
	15,741
Less tax credits:	
Dividends (£5,000 @ 10%)	(500)
Tax payable by trustees	£15,241

Answer 2

	£	£
Tax pool @ 6.4.10		2,000
Add:		
Taxable dividends above basic rate band @ 32½%		
Gross dividends	80,000	
Less expenses £(9,000 @ 100/90)	(10,000)	
Taxable dividends	70,000	
Charged at 10%	(1,000)	
Chargeable at higher rate	69,000	
@ 32½%		22,425
		24,425
Less: credits claimed (£30,000 x 100%)		(30,000)
Trustees liability		£(5,575)
Balance at 6.4.2011		NIL