CHAPTER 4

INCOME TAX ON A & M TRUSTS

Statutory references in this chapter are to ITA 2007 unless stated otherwise

4.1 Definition

An accumulation & maintenance trust (A&M) was a special sort of "hybrid" discretionary trust, which could have been created before 22 March 2006. The rules regarding such trusts have **changed with effect from 22 March 2006**, so no new A&M trusts can now be created. IHTA 1984, s.71

Trusts made before 22 March 2006 will **continue until to run for income tax purposes** until such time as the trust comes to an end. The trust will usually end when a beneficiary becomes absolutely entitled to capital, which could be as much as 25 years after creation. You will still therefore need to be able to deal with A&M trusts, even though it is no longer possible to create any new ones.

The main distinguishing feature of an A&M trust, is that the beneficiaries' **entitlements under the terms of the trust will change at a "specified age" which cannot exceed the age of 25.** The "specified age" will usually be stipulated within the trust deed. You should note, however, that under the provisions of Section 31 of the Trustee Act 1925, if the trust deed does not stipulate a specified age, the beneficiary will attain an interest in possession at age 18.

At the "specified age", the beneficiaries must **either receive an interest in possession in part of the fund, or absolute entitlement to a share of the trust capital.** For example, assume an A&M trust has 3 beneficiaries. When the eldest beneficiary reaches the specified age (often 25), he will either be entitled to one-third of the trust income, or will be able to take one-third of the trust assets outright.

Therefore, **before the beneficiaries reach the specified age**, the trust is treated, for income tax purposes, as a **discretionary trust**. Therefore whilst no beneficiary has an interest in possession, we will tax the income using the discretionary trust rules. However, **once the beneficiaries are given an interest in possession** in part of the trust, we **tax the** trust income **using the interest in possession rules**. There are **no separate rules** for income tax on A&M trusts. We simply use the rules we looked at in the previous chapters.

4.2 Beneficiaries with no interest in possession

Where all the beneficiaries are under the specified age, none of the beneficiaries has a right to income and the trustees may accumulate the income within the trust at their discretion.

Assume an A&M trust gives beneficiaries an interest in possession at the age of 25, and a right to capital at the age of 35. This satisfies the conditions in s.71 IHTA 1984 and will therefore be a valid A&M settlement.

The trust has three beneficiaries aged 15, 19 and 21 respectively. At this current point in time, none of the beneficiaries has an interest in possession. During this period, the trustees will either accumulate the income, or use the income for the "maintenance, education or benefit" of the beneficiaries. Any distributions to the beneficiaries will be entirely at the discretion of the trustees.

In the period until the beneficiaries reach the age of 25, for income tax purposes **we treat the trust as a discretionary trust**. ITA 2007, s.480

Therefore the income will be subject to the rates applicable to discretionary trusts – i.e. the first £1,000 charged at the "basic rate", then 50% on non-savings income and bank interest, and 42½% on dividends. The trustees will receive tax relief for trust management expenses. As with discretionary trusts, expenses properly chargeable against the income of the trust will be grossed up and deducted from dividend income first. ITA 2007, s.491 ITA 2007, s.479

As is also the case for discretionary trusts, the trustees must maintain a tax pool to make sure that the tax credits claimed by the beneficiaries do not exceed tax paid by the trustees. Any distributions to beneficiaries in this period will be made net of a 50% tax credit.

4.3 Beneficiaries with an interest in possession

Consider the position where the beneficiaries have an interest in possession in the fund. Assume an accumulation and maintenance trust in which the beneficiaries are entitled to a share of the income at age 25, and an absolute entitlement to capital at age 35. The trust has 3 beneficiaries aged 26, 30 and 32 respectively.

In this situation, **all of the beneficiaries have reached the specified age** and they are thereby entitled to a share of the income of the trust. None of the beneficiaries is yet entitled to a share of the trust capital as they are all under the age of 35. Once the youngest beneficiary has reached the age of 35, all capital will have been distributed and the trust will be wound up. At the moment, all beneficiaries have an interest in possession in the fund. Therefore, for income tax purposes we treat the A&M trust **in exactly the same way as an interest in possession trust**. ITA 2007, s.686(1)

This means that the trust income will be charged at the basic and lower rates as appropriate. No relief will be given for any expenses of managing the trust. Trust expenses will only need to be taken into account in calculating the distributable income for each of the three beneficiaries. As we did for interest in possession trusts, we will work out each beneficiary's entitlement to the net trust income (after tax and expenses) and this net income will be certified by the trustees on Form R185.

4.4 "Mixed" A&M trusts

Finally, consider an accumulation and maintenance trust where **some of the beneficiaries have reached the specified age, and others have not**. Again assume we have an A&M trust under which the beneficiaries receive an interest in possession at age 25, and capital at age 35. There are three beneficiaries, one aged 23, one aged 27 and one aged 29.

The beneficiary aged 23 has **not yet attained the specified age**, and does not have an interest in possession in the fund. This beneficiary therefore has no income entitlement and can only receive income if the trustees exercise their discretion in his or her favour. However, the **two elder beneficiaries have reached the specified age** and each will be entitled to a one-third share of the trust income.

As one of the three beneficiaries does not have an interest in possession, one third of the trust income is taxed under the discretionary trust rules. Therefore **one third** of the income will be charged at the **rates applicable to discretionary trusts** (basic rate, then 50% and 42½%), with relief for trust expenses. As two of the beneficiaries are entitled to income, **two thirds of the income is charged to tax under the interest in possession rules**. Therefore two thirds of the trust income will be charged at the basic and lower rates, with no relief for expenses.

Illustration 1

An A&M trust has three beneficiaries; Peter is 29, Paul is 27, and Mary is 23.

The trust provides for each beneficiary to be given an interest in possession in one third of the trust at age 25, and an absolute entitlement to their share of trust capital at age 35. Peter and Paul have both reached the specified age, and therefore have an interest in possession in one-third each of the fund. Mary has not yet reached the age of 25, so she does not have an interest in possession. The income and expenses of the trust are as below:

	£
Rents	48,000
Interest (net)	12,000
Dividends	8,100
Trust expenses	(2,700)

Our requirement is to calculate the income tax payable by the trustees for 2010/11.

We start by preparing the computation in the normal way. We then **strip out any income received by the trustees which is subject to an interest in possession.**

Peter and Paul are both above the age of 25, so each of them is entitled to a one third share of the trust income. We therefore remove two thirds of the rental income, two thirds of the bank interest, and two thirds of the dividend.

What we are left with, is the income which is not subject to an interest in possession – we have called this "Mary's fund". This one third of trust income will be taxed under the discretionary trust rules.

As this income is taxed as if it was income received by a discretionary trust, a measure of relief is available for trust management expenses. The trust expenses in the year were £2,700. These must be grossed up and deducted from dividend income. However, as we are only taxing one-third of the income under the discretionary trust rules, we only take a deduction for one third of the trust management expenses.

	Non savings	*Interest*	*Dividends*
	£	£	£
Rental profits	48,000		
Interest (x 100/80)		15,000	
Dividends (x 100/90)			9,000
Less: income subject to IIP (2/3)	(32,000)	(10,000)	(6,000)
"Mary's fund"	16,000	5,000	3,000
Less expenses:			
(£2,700 x 100/90 x 1/3)	______	______	(1,000)
Income after expenses	£16,000	£5,000	£2,000

The income is then taxed as below:

	£
"Basic rate":	
£1,000 @ 20%	200
Rates applicable to trusts (RAT):	
£(16,000 – 1,000) @ 50%	7,500
£5,000 @ 50%	2,500
£2,000 @ 42½%	850
£1,000 @ 10%	100
	11,150
Less tax credits:	
Dividends (£1,000 + 300)	(1,300)
Tax on Mary's fund	9,850
Add: Tax on Peter & Paul's fund	
Rents (£32,000 @ 20%)	6,400
Tax due	£16,250

The tax on the discretionary part of the trust - i.e. on Mary's fund – is £9,850.

Both Peter and Paul have reached the age of 25 so are entitled to an interest in possession in the trust. The income arising in Peter and Paul's fund is therefore charged at the interest in possession rates of 20% and 10%.

Interest in possession trusts pay tax at the basic rate on rental income, so the tax liability here is £6,400. The trustees also had bank interest and dividends, both of which suffered tax at source. Trustees of interest in possession trusts do not pay any further tax on taxed income. The only tax on the interest in possession part of the fund, is therefore basic rate tax on the rental income. The total tax payable by the A&M trust is therefore £16,250.

As you have seen, there are no special rules for calculating income tax liabilities for A&M trusts. We simply work out what proportion of the trust income is subject to an interest in possession. Having done this, we tax part of the income using interest in possession trust rules, part using discretionary trust rules, and then add the two tax liabilities together.

Tax position of beneficiaries ITA 2007, s.494

In the previous illustration, Mary was aged 23 and therefore had no interest in possession in the trust. Mary will therefore only be taxed on discretionary distributions made to her by the trustees.

One of the conditions of an accumulation and maintenance trust, is that if the beneficiary does not have an interest in possession, the trustees can either accumulate income or distribute it for the "maintenance, education or benefit" of the beneficiary. As is the case for distributions from a discretionary trust, if an A&M trust makes a distribution to a discretionary beneficiary, it is made net of a 50% tax credit.

Any **distributions to Mary will be certified by the trustees on Form R185**. Mary will enter the gross amount of the trust income on her self assessment return, and will **receive a 50% tax credit**. If Mary pays tax at the 50% rate, no extra tax will be due. However, beneficiaries of accumulation and maintenance trusts tend to be relatively young - and therefore have relatively low incomes – so if Mary's income is less than £150,000, some or all of this 50% tax credit will be repaid.

Peter and Paul are both over the age of 25, so they each have an interest in possession in the trust. Each is entitled to a one third share of trust income. The Trustees are therefore obliged to distribute the income to each of the beneficiaries, after any tax and expenses have been withheld.

The **net income, and the tax deducted** from the income, will **also be certified to the beneficiaries on Form R185**. Again if Peter and Paul are higher rate taxpayers, they will pay additional tax on the trust income. However, this time there is a **"look through" principle** – i.e. each beneficiary is deemed to have received rental income net of a 20% tax credit, bank interest net of a 20% tax credit, and dividends net of a 10% tax credit. Higher rate tax on these different sources of income will be paid in the usual way.

Illustration 2

In the above illustration Peter is entitled to one-third of the gross income of the trust as below:

	Non savings	*Interest*	*Dividends*
	£	£	£
Gross income (1/3)	16,000	5,000	3,000
Less tax	(3,200)	(1,000)	(300)
Net income	12,800	4,000	2,700
Less expenses:(£2,700 x 1/3)			(900)
Distributable	£12,800	£4,000	£1,800

Peter is therefore entitled to net income of £18,600. This income must be certified by the trustees on Form R185.

R185	*Gross*	*Tax*	*Net*
	£	£	£
Non savings	16,000	3,200	12,800
Interest	5,000	1,000	4,000
Dividends	2,000	200	1,800
Total			£18,600

4.5 Beneficiary attaining interest during year

If a beneficiary becomes entitled to income **part way through the tax year**, an **apportionment will be required** to work out the income of the trust before and after the beneficiary's birthday.

Illustration 3

A beneficiary becomes entitled to income from an A&M trust at the age of 25. The beneficiary reaches the age of **25 on 6 January 2011** - i.e. part way through the tax year 2010/11. Therefore, the beneficiary does not have any entitlement to trust income received by the trustees between 6 April 2010 and 5 January 2011. Any income arising in this period may be accumulated by the trustees or distributed at their discretion.

However, any income received by the trustees on or after 6 January 2011, cannot be accumulated within the trust. The beneficiary has an interest in possession from 6 January 2011 onwards, so any income received by the trustees after this date, must be paid out to him.

The final question to consider here is how we apportion the income either side of 6 January 2011?

This **depends entirely on the type of income** received by the trustees.

For income such as bank **interest or dividends**, the income is allocated to the period in which it is **physically received**.

For example, if the trustees receive a dividend in December 2010, it is allocated to the first period and is not therefore income to which the beneficiary is entitled. However, if the trustees receive bank interest on, say, 31 March 2011, this income must be paid to the beneficiary. Note we do not time apportion here – interest and dividends are identified on a receipts basis.

Rental income is apportioned on an **accruals basis**. This is the normal basis of assessment for rental income. For example, if the trustees receive rental income of, say, £12,000 in the tax year 2010/11, we would simply say that 9/12ths of this income (£9,000) fell before 5 January 2011, and may therefore be accumulated within the trust. However, the remaining 3/12ths of rental income (£3,000) is income to which the beneficiary is entitled.

ITTOIA 2005, s.275

If the trustees had a trade and therefore had trading profits, such profits would also be apportioned on an accruals basis.

Trust expenses may also be dealt with on a similar basis. Therefore **trust expenses are deemed to have accrued evenly throughout the year**. Therefore 9/12ths of the trust expenses will relate to the discretionary part of the fund, and will receive a measure of tax relief.

For trusts in which there are a large number of beneficiaries, this is a very important practical issue, as year on year it is highly probable that one or more of the beneficiaries will become entitled to income part way through the year.

The apportionment of income either side of the beneficiary's birthday is not a particularly technical exercise, however when putting together the trust return, it is important that you adopt the correct basis and identify dates of receipt for interest and dividends.

Example 1

An A&M trust gives beneficiaries a right to income at 21 and capital at 25. The trust has 2 beneficiaries, Niall (aged 24) and Robbie (aged 19). The trustees have the following income and expenses in 2010/11:

	£
Rental income	50,000
Bank interest (net)	24,000
Trust expenses	(4,000)

Calculate the tax due for 2010/11.

Answer 1

	Non savings	*Interest*
	£	£
Rental income	50,000	
Interest (x $\frac{100}{80}$)		30,000
Less: income subject to interest in possession (½)	(25,000)	(15,000)
"Robbie's fund"	25,000	15,000
Less expenses:		
£4,000 x $\frac{100}{80}$ x ½	______	(2,500)
Income after expenses	£25,000	£12,500

Tax	*£*
"Basic rate":	
£1,000 @ 20%	200
Rates applicable to trusts (RAT):	
£(25,000 – 1,000) @ 50%	12,000
£12,500 @ 50%	6,250
£2,500 @ 20%	500
	18,950
Less tax credits (£15,000 x 20%)	(3,000)
Tax on Robbie's fund	15,950
Add: Tax on Niall's fund:	
Rents: £25,000 @ 20%	5,000
Interest	Nil
Total tax due	20,950