

CHAPTER 16

TRUST INCOME TAXED ON THE SETTLOR

References to a "spouse" in this chapter should also be taken to be references to a "civil partner".

16.1 General principles

In this chapter, we shall look at the circumstances in which trust income is taxed on the settlor.

In many instances (particularly on the creation a family trust), the settlor will often be one of the trustees in order that he may retain some degree of control over the future application of trust income and capital.

There is no reason, in trust law, why the settlor or his spouse cannot also be included within the class of beneficiaries. If an **individual sets up a trust from which he or his spouse can benefit, there are special rules for income tax, capital gains tax and inheritance tax**. We shall look at the rules for income tax within this chapter. In Chapter 16 we will look at capital gains tax and IHT.

The rules essentially work by **deeming the trust income to have arisen to the settlor**. Therefore these rules will only apply to trusts set up by the settlor during his lifetime, and will cease to apply once the settlor has died.

16.2 Section 624 ITTOIA 2005

Under s.624:

"income which arises under a settlement is treated, for income tax purposes, as the income of the settlor and of the settlor alone if it arises:

- (a) during the life of the settlor; and
- (b) from property in which the settlor has an interest.

This means that if a **settlor has an "interest" in a trust** - i.e. he can benefit either from the trust income or the trust capital - the **whole of the trust income is taxable in the hands of the settlor**.

The discretionary trustees are liable to tax at the rates applicable to trusts on all trust income. The settlor will then make an entry on the Trusts supplementary pages of his tax return, showing the trust income deemed to be his under s.624. This income retains its character in the hands of the settlor, as if it had arisen to him directly. Therefore he will be treated as receiving non-savings income, interest income or dividend income as appropriate.

[ITTOIA 2005, s.619](#)

The settlor will also have the benefit of a tax credit of 50% or 42.5% on the trust income attributed to him. In many cases, the settlor will have the same marginal rate of tax as the trustees and so no further adjustment will be necessary. However, if the settlor's income (including the trust income attributed to him) is less than £150,000, some of the tax paid by the Trustees will be repaid.

If any income is paid out to a beneficiary of the trust other than the settlor during the year, the trustees will provide the beneficiary with a Statement of income from trusts (R185). This will show the amount of income paid to the beneficiary which he must include in his own tax return. However, this income is treated as having had tax paid on it at 50%. This tax credit is not repayable nor can it be set against any other income tax liability of the beneficiary. So the beneficiary will not have any further tax to pay but he will not be able to claim any tax repayment.

16.3 Settlor "interests"

The definition of a "settlor interest" is given at s.625(1) which tells us that...

[ITTOIA 2005,
s.625\(1\)](#)

"a settlor is treated for the purposes of s.624 as having an interest in property if there are any circumstances in which the property or any related property:

- a) is payable to the settlor or the settlor's spouse;
- b) is applicable for the benefit of the settlor or the settlor's spouse; or
- c) will or may become so payable or applicable.

This means that if a settlor creates a trust from which either **he or his spouse** can benefit, the whole of the trust income is assessed on the settlor under s.624.

The normal rules for taxing the income of UK trusts only apply if both the settlor and his spouse are excluded from benefiting from the trust. Therefore if a settlor sets up a trust from which he is excluded, but from which his spouse can benefit, the whole of the trust income is chargeable on the settlor under s.624.

16.4 Settlor's "spouse"

S.625(4) deals with the definition of one's "spouse". A spouse **does not include one's future spouse**- one's spouse is the person to whom one is legally married (or with whom one has entered into a civil partnership), at the point at which the income arises. This means that trusts set up for one's boyfriend, girlfriend, etc, are not caught by s.624.

[ITTOIA 2005, s.625\(4\)\(d\)](#)

A spouse **does not include a spouse from whom the settlor is separated**, either under Court Order or Separation Agreement, or in circumstances where it is likely that the separation will become permanent. Therefore, for s.624 purposes, a settlor ceases to be related to his spouse at the date of separation, even if at that point their relationship is not yet legally dissolved.

[ITTOIA 2005, s.625\(4\)\(a\)](#)

[ITTOIA 2005, s.625\(4\)\(b\)](#)

Spouses **do not include former spouses of the settlor**. This means that a trust set up by a settlor on his death for his widow, would not be caught by s.624. Bearing in mind that under s.624 the trust income is taxed on the settlor via his or her own personal self assessment return, **such attribution cannot apply once the settlor has died**. Therefore if a trust was previously caught under s.624, once the settlor has died, s.624 no longer applies, and the income of the trust is taxed in the hands of the trustees in the usual way.

[ITTOIA 2005, s.625\(4\)\(c\)](#)

Under s.626, the settlor anti-avoidance rules **do not apply to outright gifts made by a settlor to his or her spouse**. For tax planning purposes, it is sensible to make sure that assets such as bank accounts or shares are held in joint names so as to make sure that the personal allowances and the lower and basic rate bands of each of the spouses is fully utilised. This is sensible tax planning and is not attacked by HMRC under the anti-avoidance rules.

However, this only applies to **outright gifts**. Therefore if a settlor makes a gift to his spouse and attaches conditions to that gift, any subsequent income arising to the spouse will be taxed by the settlor. Under S.620, the definition of a settlement..." includes any disposition, trust, covenant, agreement, arrangement or transfer of assets...". Because the word "settlement" has such a wide meaning, HMRC has said that where a gift between spouses is a gift of income only, this will constitute a "settlement" for one's spouse and s.624 will apply.

[ITTOIA 2005, s.624\(3\)](#)

16.5 Trusts for children

Special rules also exist where a parent sets up a trust for his or her children. These rules are contained at Section 629.

[ITTOIA 2005, s.629](#)

S.629 applies where a parent sets up a trust in which the **beneficiaries include the minor children of the settlor who are unmarried and not in a civil partnership**. "Minor" means **under the age of 18**. In the absence of s.629, a parent could set up a discretionary trust for his children, and ensure that gross distributions in the year are made to the children so as to utilise either their personal allowances or lower or basic rate bands. S.629 makes this sort of tax planning ineffective.

However, it is very important to appreciate that s.629 does not work in the same way as s.624. If a parent sets up a trust for his or her children, and any **trust income is accumulated** within the trust - i.e. it is not distributed to the children - then the trust income for the year is **taxed in the hands of the trustees**, and is not automatically attributed to the settlor. Therefore s.629 is not a "mirror image" of s.624.

S.629 applies to **attribute income to the settlor only when income is paid to or for the benefit of the settlor's minor children who are unmarried and not in a civil partnership**. In essence, the income is only taxed in the hands of the settlor when it is **distributed** to the children by the trustees. Again, this used to be more important when trust rates were lower than the top rate of income tax for individuals.

[ITTOIA 2005,
s.629\(1\)\(a\)](#)

If distributions are made to such minor children of the settlor, there is a **de-minimis threshold of £100**. If the gross income distributed to the child does not exceed £100, it is taxed in the hands of the child. If the gross income distributed to the child exceeds £100, all of it is assessed in the hands of the settlor. This means that if a parent puts money into a building society account for the benefit of a minor child, if the annual interest is less than £100, it will be taxed in the hands of the child and will be covered by personal allowances. This rule enables parents to make small deposits on behalf of their children without falling foul of s.629.

[ITTOIA 2005,
s.629\(3\)](#)

Illustration 1

A father creates a discretionary trust, and the beneficiaries of the trust are his two children. Andrew is aged 20 and Zoe is aged 16. Neither is married or in a civil partnership. As neither the settlor or spouse has an interest in the trust, s.624 does not apply, and the trust income is taxed on the trustees at the rates applicable to trusts - i.e. "basic rate" band of £1,000, then 50% for non savings income and interest and 42½% for dividends. The trustees will therefore file a self assessment return and pay income tax in the normal way.

The trustees make an income distribution to Andrew. All income distributions made by discretionary trusts, are made net of 50% tax and will be certified to the beneficiary on Form R185. Because the distribution is made to a beneficiary **over the age of 18, s.629 will not apply**, and the gross trust income will be fully taxed on Andrew. Andrew can therefore use his personal allowances and, assuming he is not a higher rate taxpayer, claim a tax repayment.

Assume also that the trustees make an income distribution to Zoe. Again such a distribution will be made net of a 50% tax credit, and certified to Zoe on Form R185. **However, as Zoe is under 18, this distribution is caught under s.629.**

The gross income - per the R185 - will therefore be **treated as arising to the settlor and not to Zoe**. Zoe's father, assuming he is a higher rate taxpayer, will therefore declare the trust income on his self-assessment return. However, he will not have any additional tax to pay. If his marginal rate is less than 50%, some of the tax credit will be repaid.

16.6 Payments of capital

Under s.631, a **payment of capital** to a minor beneficiary who is unmarried and not in a civil partnership can be treated as a **distribution of income if the trustees have retained or accumulated income** within the trust. This rule is there to prevent trustees making distributions of capital to such minor, children in an attempt to avoid falling foul of s.629.

[ITTOIA 2005,
s.631\(1\)\(b\)](#)

16.7 S.633 ITTOIA 2005

S.633 deals with the situation where **capital sums are paid to or for the benefit of the settlor**. Under s.633, any capital payments made by the trustees to the settlor, will be **deemed to be income if the trustees have income within the trust which is available for distribution**. The effect of this is to treat the settlor as receiving trust income in the year in which the capital sum is paid. If the capital sum exceeds the income then available for distribution, the excess capital sum can be treated as income for future years and taxed on the settlor in those future years.

[ITTOIA 2005,
s.633\(1\)\(2\)](#)

S.633 also deals with situations where a loan is made by the trustees to the settlor or his spouse. In this situation, the settlor is treated as having "enjoyed" a capital sum from the trust, and is taxed under s.633 to the extent that the trustees have accumulated income.

[ITTOIA 2005,
s.634](#)

Example 1

Mr Parent created an interest in possession trust for his son aged 15. In 2010/11 the trustees received bank interest (net) of £15,000. Trust expenses were £1,000.

The trustees distributed £9,900 of income to the beneficiary in January 2011.

Calculate the gross trust income assessable on Mr Parent in 2010/11.

Answer 1

Gross trust income	
$£15,000 \times \frac{100}{80}$	£18,750

Settlement for minor unmarried child.
S.629 ITTOIA 2005 applies

Son entitled to:	£
Gross income	18,750
Less: tax @ 20%	(3,750)
Less: expenses	<u>(1,000)</u>
Distributable income	<u>£14,000</u>

$\times \frac{100}{80}$	<u>£17,500</u>
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£17,500 is taxed on the settlor in 2010/11. The income is deemed to have been received net of a 20% tax credit.

Note: All of the trust income is deemed to have been paid out to the beneficiary as he has an interest in possession.