CHAPTER 23

BENEFICIARIES OF DECEASED ESTATES

23.1 Types of legacies

A legacy will either take the form of a specified sum of money or a particular asset. The tax position of the recipient depends on the nature of the legacy.

A legacy of a specified sum of money is called a "**pecuniary legacy".** The beneficiary is entitled to that sum of money and no more. The beneficiary is not entitled to interest on the money, and therefore has **no tax liability** in respect of the legacy. If there is a delay in paying the legacy, the law requires the Executors to **pay interest once a period of 12 months has elapsed**. This interest is taxed on the beneficiary as it arises.

A legacy might also take the form of a **specific asset**, such as shares, land or buildings or personal chattels. If that asset does not produce income (for example, a painting or a motor car) the beneficiary has **no entitlement to income**, and therefore has **no tax liability** in respect of the asset.

The position is different if the beneficiary receives a legacy of an **income producing asset.** In this instance, the beneficiary is **entitled to the income** arising from the asset with effect **from the date of death**. The income will be paid initially to the Executors, who will include the income within their income tax return and pay tax on it in the usual way. However, the Executors must then redirect the income to the beneficiary, together with a tax certificate specifying the gross income and the tax deducted at source. The beneficiary is the taxed on the gross income – with an appropriate tax credit – in the year in which it arose to the Executors. This principle was established in the case of *CIR v Hawley* from 1927.

23.2 Residuary gifts

The other way in which a beneficiary can receive a legacy from an estate, is if he or she is entitled to all or part of the **residue of an estate**. The residue of the estate is what is left after the Executors have met all taxes, expenses and liabilities, and settled any specific or pecuniary legacies under the will.

A person may either be entitled to an "**absolute interest"** or a "**limited interest"** in the residue. A person who is entitled to all or part of the capital representing the residue, together with any income generated during the administration period from those capital assets, is said to have an "absolute interest". A beneficiary has a "limited interest" in the residue, if he or she is entitled to the income generated by those capital assets, but will not receive the capital assets themselves. A beneficiary with a limited interest has much the same entitlements as the life tenant of an interest in possession trust. For income tax purposes, the way we treat the beneficiaries is the same, regardless of whether they have an absolute or a limited interest in the residue.

23.3 Taxing residuary income

A beneficiary with a residuary interest is not treated as receiving income as it arises. Instead, the beneficiary is **only taxed on income actually distributed** by the Executors during the administration period.

When income is distributed to a beneficiary, it is **deemed to come from non-savings income** in priority to interest and dividends. As the income would have been taxed in the hands of the Executors via their own self-assessment return, the income paid to the beneficiary will carry an appropriate tax credit – i.e., 20% for non-savings income, 20% for interest and 10% for dividends. This will be **certified by the Executors** on form R185 (Estate Income). Any residuary income which is received by the Executors but not paid out to the beneficiary is carried forward.

If an asset is distributed to a beneficiary during the administration period, this is treated as a distribution of income equal to the value of that asset at that date. For example, if a chattel (such as a painting) is distributed to the residuary legatee and the painting is then worth (say) £10,000, the residuary legatee is deemed to have received net non-savings income of £10,000 at the date the painting is transferred. This principle applies to **any** asset (however trivial).

If distributions in the tax year exceed the income arising to the Executors in the year, the amount taxable on the beneficiary is restricted to the income arising. The beneficiary is deemed to have received any undistributed income in the tax year in which the administration of the estate is completed. This will be the total residuary income, less any income previously distributed, and less any expenses properly chargeable against the residuary income.

The estate **expenses** are deemed to have been **paid from the net dividend** income. If the estate has insufficient dividend income, expenses are next deemed to have come from **interest** income. If interest has been extinguished, expenses come **finally from non savings income**.

Illustration 1

Roy died in July 2009. His Executors completed the administration of his estate in September 2010. His will left a specific legacy of shares in XYZ plc to his son. The residue of his estate was left to his wife absolutely. The residue consisted of a private house, a holiday cottage and cash deposits. Details of the Executors' income and expenses for 2009/10 and 2010/11 are as below:

	2009/10	*2010/11*
	£	£
Rental income	9,000	6,000
Bank interest (net)	5,000	4,000
XYZ plc dividend	9,000	-
Expenses paid	(1,500)	(1,000)
Income distribution to wife	(2,000)	-
Car transferred to wife (MV)	(3,000)	

As the wife has an absolute entitlement to the residue of the estate, she will receive the capital of the residue together with any income generated by those assets.

Whilst the estate is in administration, she will only be taxed on distributions actually made to her by the Executors. In 2009/10 the Executors made an income distribution of £2,000 and transferred a capital asset worth £3,000. The total deemed income distribution is therefore £5,000 which is treated as made from the rental income received by the Executors in 2009/10, on which tax at 20% was paid under self-assessment. Therefore the wife is deemed to have received the £5,000 net of basic rate tax.

The Executors will therefore complete form R185 as below:

R185 (Estate income)	*Gross*	*Tax*	*Net*
	£	£	£
Estate income	6,250	1,250	5,000

The son was left a specific legacy of the XYZ plc shares. As this is a legacy of an income-producing asset, the dividends on the shares should be redirected by the Executors to the son, and taxed on the son in the year they arose. The Executors will certify the income on form R185 as below:

R185 (Estate income)	*Gross*	*Tax*	*Net*
	£	£	£
Estate income	10,000	1,000	9,000
(and non repayable credit)			

The son will pay any higher rate tax on the dividend if appropriate. As the dividend has been mandated to the son, it will not form part of the wife's income entitlement from the estate.

The administration period ended in September 2010, i.e. in 2010/11. The wife is entitled to the net income of the residuary estate, therefore any income which has not yet been distributed by the Executors, will be deemed to have been distributed on 30 September 2010. We therefore need to work out the total net income of the estate in order to calculate what the wife is taxed on in 2010/11.

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	Rents	*Interest*
	£	£
Gross income 2009/10	9,000	6,250
Gross income 2010/11	6,000	5,000
Total gross income	15,000	11,250
Less: tax paid/suffered:		
£15,000/£11,250 @ 20%	(3,000)	(2,250)
Net income	12,000	9,000
Less: expenses		
2009/10		(1,500)
2010/11		(1,000)
Distributable income	12,000	6,500
Less: distributed 2009/10	(5,000)	-
Balance to be distributed at end of AP	£7,000	£6,500

This will be certified by the Executors on form R185:

R185 (Estate income)	Gross	Tax	Net
	£	£	£
Non savings income	8,750	1,750	7,000
Savings income	8,125	1,625	6,500
			£13,500

The beneficiary will enter the gross figures on her self-assessment return for 2010/11, and pay any additional tax as appropriate. If the beneficiary is a non-taxpayer, these tax credits may be reclaimed.

23.4 Discretionary interests in residue

It is possible for a beneficiary to have a discretionary interest in the residue of the estate. There are two situations where a beneficiary might be given a discretionary interest in the residue.

1) The Executors might be given discretionary powers to select the beneficiaries who are to receive the residue of the estate.
2) Once the administration is completed, the will could direct that the residue be transferred to discretionary trustees who will thereafter have discretionary powers over the income.

Where the Executors are given power to select beneficiaries at their discretion, HMRC's treatment of the income is dealt with by SP 4/93. Any income distributed to a beneficiary, is taxed on the beneficiary in the year in which it is paid. The income is deemed to have been paid after the deduction of tax at the "applicable rate". The "applicable rate" is the **basic, or dividend rate, depending on the source of income**. Income distributions are deemed to be made from non-savings income in priority to interest or dividends. The Executors will provide the beneficiary with a tax deduction certificate, detailing the gross income and the income tax withheld.

SP 4/93

A discretionary will trust set up on death, is an example of an instance where a beneficiary has a discretionary interest in an estate. In this instance, the testator will direct in his will that the whole of his estate be left on discretionary trust, thereby giving powers to his Executors to distribute his estate entirely at their discretion.

If the Executors make income distributions whilst the estate is in administration, such distributions will be made net of tax at the "applicable rates" – i.e., 20% or 10%.

Once the administration period is complete, the capital assets (and any accumulated income from those assets), will pass to a discretionary trust. Any subsequent income distributions by the trustees will be deemed to carry a 50% tax credit, in accordance with the normal rules for discretionary trusts. The trustees will pay income tax at the rates applicable to trusts, being "basic rate" on the first £1,000 and thereafter at 50% and 42½%.

23.5 Deeds of Variation

In the inheritance tax course, we looked at the IHT & CGT effects of a deed of variation. Here we shall consider the income tax implications.

Illustration 2

Assume that Walter dies, leaving his estate to James. James entered into a deed of variation, under which he redirected his legacy to his two daughters, Susan and Amy.

A deed of variation **cannot apply retrospectively for income tax purposes**.

Therefore if James received any income from the estate before he made the variation, the income will be taxed on James in the usual way, with a corresponding tax credit.

For income tax purposes, the variation is **effective from the date it is made** – it cannot be backdated to the date of death as it can be for IHT purposes. Any income which has arisen to the Executors, but which has not been paid out to James by the date of the variation, thereafter belongs to the new beneficiaries – i.e., to Susan and Amy. Any subsequent distributions of income are taxed on Susan and Amy at the date of receipt, with the balance of the estate income taxed on the new beneficiaries at the end of the administration period.

The settlor of any trust set up under a variation will be James as the person who was entitled to a redirected legacy before the variation.

S.629 ITTOIA will apply here, if Susan and Amy are the minor unmarried children of James and are unmarried and not in a civil partnership.

You will recall from the session on settlor anti-avoidance, that if a parent sets up a trust for such minor children, any distributions to the children will be assessed on the settlor under s.629. This rule will apply here, as James will be deemed to have made a parental settlement for income tax purposes.

23.6 Adjustment for inheritance tax paid

An adjustment is made in the beneficiary's income tax computation where part of the income of the estate has already been charged to inheritance tax.

ITTOIA 2005, s.669

In certain instances, income received by the Executors after the date of death, may have been included within the value of an asset in the death estate and subsequently charged to IHT. For example, if a taxpayer died owning a gilt-edged security at the date of death, included within the value of the security, would be an element of accrued interest. This interest will therefore be charged to inheritance tax as part of the chargeable estate.

The interest is actually paid to the Executors after death. Remember, that for income tax purposes, the Executors are taxable on any interest they receive after death, even if part of the interest was earned before death. This will means that the some of the interest will be charged to IHT in the hands of the estate, and also to income tax when it is paid to the residuary beneficiary. An adjustment will therefore be required to reflect this double-taxation.

S.669 ITTOIA 2005 lays down steps to follows to calculate the adjustment:

1. Calculate the "net pre-death income". This is:

	£
Gross income accruing pre-death but received post death	X
Less: tax at basic rate	(X)
"Net pre-death income"	X

2. Calculate the IHT attributable to the net pre-death income, ie

"Net pre-death income" x average estate rate

3. Gross-up the IHT at the basic rate and deduct this from the gross income distributable to the residuary beneficiary.

The adjustment **applies for higher rate purposes only**. Therefore the amount of the IHT paid on the pre-death income, is charged at the basic and lower rates, but not at the higher rates of 40% and 32½% (or 50% and 42½%).

The relief is **only available to beneficiaries with an absolute interest** in the residue of the estate.

The adjustment will typically apply to assets such as gilts and bonds whose value includes an element of accrued interest, and to shares whose value may have been enhanced to the right to receive a future dividend.

It can also apply to normal bank accounts, as the interest earned (but unpaid) at the date of death, will be an asset of the estate for IHT purposes.

Illustration 3

Mr Adams died on 1 April 2010. He left his entire estate to his son, Martin. The estate consisted of his private house and chattels, a bank deposit account, shares in XYZ plc and some government securities. The gross estate was £680,000 and the IHT payable was £152,000.

The administration of the estate ended on 31 January 2011, and details of the income and expenses in 2010/11 are as below:

	£
Income:	
Bank interest (net)	2,000
Dividends on XYZ plc shares	9,000
Interest on Treasury Stock	4,000
Total	15,000
Expenses:	
Estate management expenses	£500

Martin is a company director earning £60,000 per annum. The Executors made no income distributions in the period.

The income above includes the following income accrued at death, but not received by the Executors until after death:

	£
Accrued Income:	
Bank interest (net)	500
Dividends on XYZ plc shares	3,600
Interest on Treasury Stock	1,000
Total	5,100

The income payable to Martin at the end of the administration period is:

	Interest	*Dividends*
	£	£
Gross income 2010/11:		
Bank interest (x 100/80)	2,500	
Dividends (x 100/90)		10,000
Gilt interest	4,000	
Total gross income	6,500	10,000
Less: tax paid/suffered:		
£6,500 @ 20%	(1,300)	
£10,000 @ 10%		(1,000)
Net income	5,200	9,000
Less: expenses		(500)
Distributable income	5,200	8,500
Gross equivalent	£6,500	£9,444

Martin will be taxed on this net distributable income, however we need to make an adjustment for the pre-death income charged to IHT.

This is done as follows:

1. "Net pre-death income"

	£
Gross income accruing pre-death but received post death:	
Bank interest (£500 x 100/80)	625
Dividends on XYZ plc shares (£3,600 x 100/90)	4,000
Interest on Treasury Stock	1,000
	5,625
Less: tax at basic rate	(1,125)
"Net pre-death income"	4,500

2. IHT attributable to the net pre-death income

$\frac{152,000}{680,000} \times 100 = 22.35\% \times £4,500$ £1,006

3. Gross-up IHT at basic rate and deduct from distributable income

£1,006 x 100/80 £1,257

	Interest	Dividends
	£	£
Gross distributable income	6,500	9,444
Less: IHT adjustment (Note)	(363)	(894)
Income liable to tax at higher rates	6,137	8,550
Additional tax payable by Martin (@ 20% / 22½%)	£1,227	£1,924

Note: IHT adjustment apportioned based on gross income accruing pre-death i.e.

	Interest	Dividends
	£	£
Gross income accruing pre-death	1,625	4,000
Apportioned:		
1,625 / 5,625 x £1,257	363	
4,000 / 5,625 x £1,257		894

Example 1

Executors of Mary's estate have the following income in 2009/10 and 2010/11:

	2009/10	*2010/11*
	£	£
Rental profits	12,000	10,000
Bank interest (gross)	8,000	6,000
Dividends (net)	4,500	2,250
Expenses	(3,000)	(1,950)

Income of £10,000 was distributed in 2009/10. The administration period ended on 5 April 2011.

Calculate the gross income chargeable on the beneficiary in 2010/11.

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Answer 1

2009/10	*Rents*	*Interest*	*Dividends*
	£	£	£
Gross income	12,000	8,000	5,000
Less: tax suffered	(2,400)	(1,600)	(500)
	9,600	6,400	4,500
Less expenses			(3,000)
	9,600	6,400	1,500
Less: distribution	(9,600)	(400)	
Excess income c/fwd	NIL	6,000	1,500

2010/11			
	£	£	£
Gross income	10,000	6,000	2,500
Less: tax suffered	(2,000)	(1,200)	(250)
	8,000	4,800	2,250
Less expenses			(1,950)
	8,000	4,800	300
Add b/fwd	-	6,000	1,500
	8,000	10,800	1,800

R185 (Estate income)	Gross	Tax	Net
	£	£	£
Rents	10,000	2,000	8,000
Interest	13,500	2,700	10,800
Dividends	2,000	200	1,800
	£25,500		