6. Tax on trust income

6.1 Introduction

Generally speaking, there will no income tax consequences on the transfer of an asset to a trust. The exception to this rule would be where either of the following applies:

- The settlor and beneficiary have an employer-employee relationship and the payment is not into a registered pension scheme; this is more of an employment tax issue and beyond the scope of this book.
- An investment is transferred which is subject to income tax on deemed capital gains – for example, an offshore non-reporting (roll-up) fund.

This chapter will therefore focus on the income tax position of the trustees and beneficiaries during the trust's existence.

The income tax position of trustees and trust beneficiaries largely depends on whether a beneficiary is entitled to trust income as of right (an interest in possession trust) or the trustees have power to decide who will benefit from income under a trust (a discretionary trust). In either case, trustees are *not* entitled to the personal allowance, the personal savings allowance (PSA) or the dividend allowance (DA).

6.2 Interest in possession trusts

6.2.1 When does a beneficiary have an interest in possession?

A beneficiary will have an interest in possession in one of three potential situations:

- he is absolutely entitled to trust capital and income (i.e. a bare trust);
- he is entitled to income whilst alive, with capital passing to another beneficiary on his death (a fixed life interest trust); or
- he is entitled to income in the absence of the trustees appointing income to another beneficiary (a flexible trust – see **12.10**).

If the trust asset is residential property, the beneficiary with the interest in possession for the time being may have an entitlement to occupy the property rather than receive income from it.

6.2.2 Tax effects

Where an interest in possession trust receives income, the trustees are liable to tax on that income at the basic rate (20% on savings income and 8.75% on dividend income). In a limited number of cases, tax will already have been deducted at source or be deemed to have been deducted at source. This will discharge the trustees' liability. In this connection, it should be noted that since 6 April 2016 no tax is deducted at source (or treated as deducted at source) on bank/building society interest or dividend income; and since 6 April 2017, interest distributions (from collectives invested in corporate bond funds) are also paid gross.

The beneficiary will be given a certification of deduction of income tax (R185). This informs the beneficiary of how much tax the trustees have paid on trust income and enables the beneficiary, when submitting his or her self-assessment return, to offset tax already paid.

Income will then be assessed on the beneficiary. An extra tax liability can arise if the beneficiary is liable to higher rate (or additional rate) tax. The income retains its original character in the hands of the beneficiary, so for a higher rate taxpayer the liability will be at 40% (an extra 20%) on savings income and rent and at 33.75%% (an extra 25%) on dividend income.

For an additional rate taxpayer, the liability in 2022-23 will be at 45% (an extra 25%) on savings income and rent, and at 39.35% (an extra 30.6%) on UK and most foreign dividend income. Because the beneficiary is treated as receiving the income direct, these extra liabilities only arise if savings income exceeds the higher rate taxpaying beneficiaries' PSA of £500, or dividend income exceeds the beneficiaries' DA of £2,000. Additional rate taxpayers are not entitled to a PSA. In cases where the tax already paid exceeds the beneficiaries' tax liability, tax can be recovered.

Trust income mandated direct to the beneficiary

In cases where the trustees have mandated the trust income direct to the beneficiary, the beneficiaries of interest in possession trusts will be assessed on all trust income as it arises, and the trustees will not need to declare it on a trust and estate return. In the *Paul Hogarth Trust* case, the FTT held that income will not be taxed on the trustees if the income is mandated to the beneficiary and paid to him or her directly from the source and not through the trust bank account.

In the above case, all the income was mandated to the life tenant and the trust did not have any chargeable gains for the tax years in question. There were therefore no other tax liabilities or reporting duties on the trustees.

Entitlement to income (not just receipt) is important in this respect; the beneficiary does not have to receive the income for it to be assessed on him – for example it may be accumulated within the trust but held for his or her sole future benefit.

Case: *Trustees of the Paul Hogarth Life Interest Trust 2008 v HMRC* [2018] UKFTT 595 TC

6.3 Discretionary trusts

6.3.1 Introduction

Under a discretionary (or an accumulation and maintenance) trust, the trustees will have the choice of either accumulating income or paying it to a beneficiary. The beneficiary is not entitled as of right. As a result of this, the income tax treatment of a discretionary trust can be a two stage process.

First, income received by the trustees is taxed at the standard rate and/or at the "trust rate". This is sometimes referred to as the rate applicable to trusts (RAT).

Second, if the income is then paid out to a beneficiary, it will be taxed as trust income of that beneficiary who will normally get some credit for the tax already paid by the trustees.

6.3.2 Taxation of income received by trustees

As stated at **6.3.1**, trustees of discretionary trusts can pay income tax at the standard rate and/or the trust rate.

Standard rate

The trustees are entitled to an annual standard rate income tax band of £1,000. This is subject to an anti-fragmentation rule which means the standard rate band is divided by the number of trusts created by the same settlor. However, for any trust the minimum standard rate band will never be less than £200. Income falling within the standard rate band is taxed at 8.75% (dividends) and 20% (interest/rent).

Trust rate

Where the trust income (grossed up if appropriate) exceeds £1,000 in a tax year, the trust rate applies. In 2022-23 this is 45% (39.35% on dividends). Trustees are therefore taxed at the same rates as additional rate taxpayers (i.e. individuals with taxable income exceeding £150,000).

Thus the rate of income tax for a discretionary trust in 2022-23 is:

8.75% or 20%	for income (dividends/income) falling within the standard rate tax band
39.35%	For excess dividend income received
45%	For excess income other than dividend income

It should be noted that since 6 April 2016, dividend income and savings income is no longer paid with a tax credit. From 6 April 2017, interest distributions from corporate bond funds have also been paid gross. Furthermore, trustees are not entitled to a personal allowance, the personal savings allowance or the dividend allowance.

On savings income and dividend income that exceeds the standard rate band, trustees will therefore pay 45% and 39.35% income tax respectively.

Tax paid by the trustees goes into their tax pool which is available as a credit against a trustee tax liability when income is distributed to a beneficiary (see below).

Essentially, a tax pool is the record of the trustees' tax position, i.e.:

- total tax paid by trustees from the previous tax years; plus
- total income tax paid by the trustees during the current tax year; minus
- the total of any reclaimable tax credits attached to income payments made to the beneficiaries during the current tax year.

Notional tax that is treated as paid on UK life insurance chargeable event gains and tax credits on UK and certain foreign dividends for 2015-16 and earlier do not go into the tax pool. This is because of ITA 2007, s. 498, which sets out the types of income tax that go into the tax pool.

This provision includes a restriction on the amount of tax going into the tax pool in respect of chargeable event gains on certain life insurance policies. As a result, where trustees are treated as having paid income tax on chargeable event gains on a UK bond at 45%, the actual tax of 25% paid will be allowed as part of the tax pool but not the notional tax credit of 20% (nominal rate) which applies to chargeable event gains where income tax is treated as paid.

In this respect s. 498(3) defines what is meant by the term "nominal rate" in the legislation. It is the difference between the trust rate (45%) and the savings rate (20%).

Of course, where trustees pay income tax at 45% on the chargeable event gains on offshore bonds, the whole 45% tax paid will form part of the tax pool.

Even though this tax paid would form part of the tax pool, it would not be relevant to capital payments made to beneficiaries, perhaps funded by encashment of the bond, on which the beneficiaries should have no further liability. However, it could frank a tax liability on later income payments made by the trustees to a beneficiary.

From 6 April 2016, dividends are no longer paid with a tax credit and this significantly simplifies the position as regards the trustees' tax pool.

Example – taxation of trustees of a discretionary trust on trust income in 2022-23

In the chart that follows, the trustees:

- already have other income that absorbs their standard allowance; and
- receive gross interest or a dividend of £100 which comes from a UK source.

Income received

Interest	**£**	**Dividends**	**£**
Interest	100.00	Dividend	100.00
Tax at the trust rate of 45% on gross interest	45.00	Tax at the dividend trust rate of 39.35	39.35
Retained in the trust	55.00	Retained in the trust	60.65

Where the trustees receive income from two sources, the standard rate band is always set off first against the income that is taxed most heavily. So, for example, if a trust receives £1,000 interest and £1,000 dividends, the standard rate band would be set off against the interest of £1,000.

Summary	**Summary**
The trustees have to meet an income tax liability of 45% of the interest (which, in general, is now paid gross).	The trustees have to meet an income tax liability of 39.35% of the dividend. Dividends are no longer paid with a tax credit.

Trustees are not entitled to any of the tax-free dividend allowance of £2,000. As mentioned above, trustees are subject to income tax at 39.35% on dividend income that exceeds the £1,000 standard rate tax band.