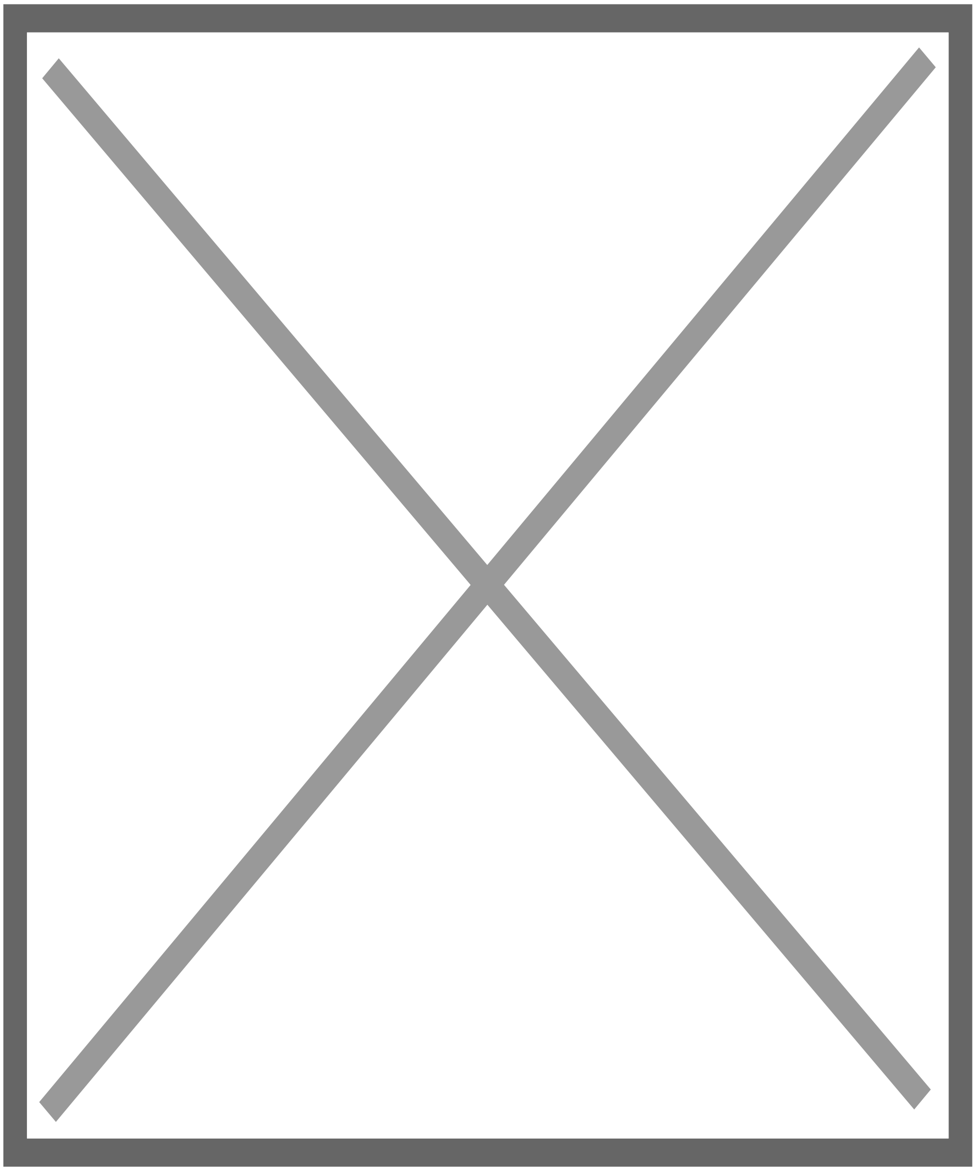
Coming of age



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Tanya Hiscock explains how trusts with no income entitlement can enable distributions charged to income tax

Key Points

6 April 2010, the trust rate increased from 40% to 50%; 6 April 2013, the trust rate reduces to 45% (with the higher tax rate); and the dividend trust rate increased to 42.5% (from 32.5%) and then reduces to 37.5% from 2013/14

Calculating income distributions available for beneficiaries can be a daunting task, particularly when the trust concerned is taxed at the rate applicable to trusts.

Income tax computation

The income tax computation of a trust taxed at the rate applicable to trusts is assessable under the self-assessment rules. The trustees are not entitled to a personal allowance; however, they pay tax at the basic rate on the first £1,000 gross income (the standard rate band). Note that the standard rate band is shared between the trusts where more than one trust has been created by the same settlor (to a maximum of five).

Essentially, a tax pool is the record of the trustees' tax position, ie:

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

Where the only income received is non-dividend, eg rent and bank interest, then this is much easier to administer. Where this income is paid to beneficiaries, who pay tax at the basic rate, they are able to reclaim the tax credit when they receive an income distribution. However, once the trust receives dividend income, this complicates the trustees' tax pool.

Income distributions

Distributions of any form of income (including dividend income) must be treated as though 50% income tax has been paid by the trustees. The beneficiary receives the **R185 Tax Deduction Certificate** for this tax credit, which they may be able to reclaim depending upon their personal tax position. This could cause HMRC to be paying more tax to the beneficiary than has been paid by the trustees ie if the beneficiary receives a 50% reclaimable tax credit, but the trustees, have paid 32.5% tax on the dividend income, then HMRC would be paying an additional 17.5% to the beneficiary.

The trustees must therefore ensure they have paid tax equal to the amount reclaimable by the beneficiary. They can do this either by paying the additional 17.5% tax or, more likely, paying out a lower amount of income to the beneficiary. If the trustees choose to pay out the reduced income, then the income balance will accumulate in the trust, ultimately becoming capital.

The terms of trusts for children, grandchildren, etc, which may give rights to capital at a later age, vary, but it is common practice for the income to be taxed at the rate applicable to trusts up to the age of 18, and then the terms of the trust change and the beneficiary becomes entitled to the income.

Beneficiary at age 18

When the beneficiary reaches age 18, the trustees will either need to pay the additional tax, which the beneficiary can then reclaim to clear the tax pool, or the trustees can choose not to pay out the income, which will then be capitalised.

HMRC have included a calculator on their website which will assist trustees with deciding whether they should make income distributions, and if so, for how much.

Once an income distribution is made, then the trustees have a duty to provide the beneficiary with an R185 Tax Deduction Certificate. This details the amount of the income distribution, together with the total tax paid by the trustees.

The beneficiary must then include this in their personal tax return, or if they do not fall under the self-assessment rules, then they can use a form R40, to reclaim the tax paid by the trustees, if they are a basic rate taxpayer. This can be a very effective way of removing the income from the trust, with basic rate taxpayer beneficiaries reclaiming the trust rate of tax.

Creating an income entitlement

Typically, the tax pool issue occurs when the trust has a discretionary nature, whereby the beneficiaries only have a hope of receiving a distribution, and not a right.

If the settlor's intention is to pay out income regularly, then the trustees could avoid the tax pools calculations, and pay tax at the rate applicable to trusts, by granting one or more beneficiaries a revocable income entitlement. The trust deed must be reviewed by a solicitor to ensure this option is available to the trustees. From a practical point of view, this needs to be monitored from time to time to establish if any changes are needed.

A revocable income entitlement, giving a right to income until that right is revoked, is less flexible than a discretionary trust, where you can look back at the income received to decide how that is divided.

When looking forward at future income, you don't have the benefit of hindsight!

EXAMPLE