Trust Practitioner's Handbook (2nd edition)

By

Gill Steel

with contributions by Robert Mowbray and Charles Christian

Published by: The Law Society
ISBN: 978-1-85328-648-3

Income tax & trusts – Chapter 11 (update)

Nothing stays the same in the tax world and since writing the second edition of the Trust Practitioner's Handbook some things have changed which make a short summary worthwhile.

This is not intended to be exhaustive but should help the practitioner spot significant developments.

Tax rates

Except where they are liable at 'the trust rate', trustees are normally liable at the lower rate of income tax (20%) on savings income and the standard rate (22% for 2007/8; 20% for 2008/9) on other income, the trust income being determined using the principles applicable to each source. Effectively, any income taxable by direct assessment is taxed at the standard rate, e.g. rent.

For trusts without an interest in possession, the tax credit inclusive dividend is taxed at 32½% (42.5% 6 April 2010), called the **dividend trust rate** [s.479(3) ITA 2007]. Other types of income will remain chargeable at 40% (50% from 6 April 2010), which is now called the **trust rate** [s.479(4) ITA 2007]. These two rates together are known as the **special trust rates**.

The government announced increases in the special trust rates in the Pre Budget Report in 2008 but even before the changes were due to come into effect on 6 April 2011 the Budget 2009 announced that the rates were to go even higher and be brought in earlier. They will have a significant impact on trusts. If a beneficiary is a non-tax payer there will be a lower net of tax payment which can be distributed by the trustees necessitating a larger re-claim with at the other end of the spectrum a probably small claim for settlor-interested trusts where the settlor has less than £150,000 pa income and where the differential rate between the tax deducted at source and the settlor's own rate of tax may only be 10%.

Whilst the capital value of trust assets may have slumped this may be a sensible time to review a trust's investment strategy away from income to capital growth if this meets the needs of the beneficiaries since income will

simply be taxed to higher special trust rates and switching capital assets now is likely to make a loss or only cost 18% capital gains tax.

Trust expenses

The leading case of Trustees of Peter Clay Discretionary Trust v Commissioners of HMRC [2008] EWCA Civ 1441 progressed from the Special Commissioners to the High Court and recently the Court of Appeal during 2008. This case provides guidance on how trust expenses are to be dealt with.

The Court of Appeal largely agreed with the Special Commissioners overruling the High Court decision of Lindsay J by confirming that where costs could be apportioned by careful record-keeping between income expenses and capital expenses then they should be apportioned.

The large trust fund in this case was arguing that:

- Trustees fees
- Investment management fees
- Bank charges
- Custodian fees; and
- Professional accountancy & administration fees

Should be subject to apportionment instead of automatically being treated as a capital expense simply because it was an expense incurred for the benefit of both income and capital beneficiaries.

The Court of Appeal confirmed that the principle to be applied to all of the charges was whether or not it was possible to demonstrate that part of the expense relates to the trustee's duties to the income beneficiaries alone and was identifiable as such. If so it could be apportioned and set against income.

As to the fees of the investment managers the Court of Appeal agreed that the Special Commissioners were correct in that the first question to determine is whether the expenses were incurred in connection with the investment before or after the trustees had made the decision to accumulate that income. If the expenses were incurred after the trustees had made the decision to accumulate they cannot be incurred exclusively for the benefit of the income beneficiaries.

Time recording records are therefore now an essential component in the assessment of the amount of the expenses incurred which can be set against income. For most practitioners this will necessitate a change in practice and its significance should be noted in trusts of high value.

Settlor- interested trusts
Settlor-interested trusts treats as the income of the Settlor the trust income and the provisions for these anti-avoidance measures were changed to ss. 619 – 648 Income Tax (Trading and Other Income) Act 2005 [ITTOIA 2005].

The system used to be that the Settlor who retained an interest in a trust subject to the special trust rates was taxed at his personal rates of income tax on the trust income and was exempted from the special trust rates.

From 6 April 2006 the trust income is subject to tax on the trustees at the special trust rates and no credit or exemption for the Settlor is given whose income it is deemed to be. Whilst this would appear to be double taxation HMRC have confirmed this will not happen, since the Settlor will receive a tax credit for the tax paid by the trustees.

s.624(1) ITTOIA treats income of a Settlor-interested trust as "income of the Settlor and of the Settlor alone". S.622 ITTOIA states that the person liable to tax is the Settlor and s.646(8) ITTOIA says that "nothing in s.624…is to be read as excluding a charge to tax on the trustees as persons by whom any income is received."

There has been an overlapping charge on both the trustees and on the Settlor since 1995. To avoid double taxation tax paid by Settlor-interested trusts does not enter the tax pool and is not therefore available to other beneficiaries. However, s.646 sets out the relationship between the Settlor and trustee and, recognising the fact that the Settlor is being taxed on the income he or she may never receive, gives the Settlor power to require the trustees to reimburse any tax liability suffered by the Settlor under s.624. Without s.646(8) no tax would be payable by the trustees but they would be required to make good the tax paid by the Settlor on the income deemed to be the Settlor's under s.624.

Published by: The Law Society
ISBN: 978-1-85328-648-3

Effectively, the trustees as recipients of the income pay the tax on the fund out of the fund and as such this tax paid is treated as tax paid on behalf of the Settlor. If he is a higher rate tax payer no further income tax in respect of this income will be required but if he is a standard rate taxpayer then, apart from the 10% non-repayable credit on any dividend income, the excess tax paid will be available for repayment to the Settlor.

The Settlor does not receive an R185 as this is only for beneficiaries who receive a ***distribution*** of income from the trust. Instead the trustees and the Settlor have to liaise to ensure that the correct tax outcome is achieved.

Income paid to non-Settlor beneficiaries from a settlor-interested trust are treated as having the income franked currently with a notional 40% tax credit but this tax credit is never repayable.

Under the statutory ordering of income from trusts prior to 6 April 2006 this income is charged to tax before savings and/or dividend income. This results in a beneficiary of a settlor-interested trust who also has savings and/or dividend income facing the prospect of his non-trust income being pushed into higher rates of tax and paying more income tax overall.

The Finance Act 2008 amended this unintended consequence of the trust modernization legislation by altering the ordering rule such that income from a settlor-interested trust is treated as one of the highest slices of income within s.1012 ITA 2007.

For income tax purposes a Settlor retains an interest if there are any circumstances in which the property or any related property is payable to:

- the Settlor; or
- the Settlor's spouse or civil partner, or
- is applicable for the benefit of the Settlor or the Settlor's spouse or civil partner – s.625 ITTOIA 2005; or will or may become so payable or applicable; or
- is paid to or for the benefit of a relevant child of the Settlor or would otherwise be treated as income of a relevant child of the Settlor (unless the total of income for the tax year is £100 or less) – s.629 ITTOIA 2005.

Trust Practitioner's Handbook (2nd edition)

By

Gill Steel

with contributions by Robert Mowbray and Charles Christian

Published by: The Law Society
ISBN: 978-1-85328-648-3

A three page guidance note on the impact of the FA 2006 changes on Settlors, trustees and beneficiaries can be found at www.hmrc.gov.uk/CTO/sett-int-trusts.pdf

Practice points

- Trust administrators should be helping trustees review trust investment strategies with 6 April 2011 in mind
- Keep excellent records apportioning time and effort between income related work and other work as this will help to evidence the expenses incurred as an income expense deductible in trusts where there is no interest in possession before the special trust rates are applied
- Accounting for the income tax on Settlor-interested trusts is not straightforward and with the new penalty regime in place from 1 April 2009 care should be taken to handle the income tax correctly

24 April 2009