# AF1/J02
# Part 4: Taxation of Trusts (2) 2023/2024
# Income tax IIP Trusts

The milestones for this part are to understand:

- how the trustees of an IIP and Discretionary Trust pay tax.
- How the trustees of an IIP trust calculate their income tax liability
- How a beneficiary is taxed on income from an IIP trust
- How Trust Management Expenses in an IIP trust are dealt with

## How trustees pay Income tax

These rules apply to both an IIP and Discretionary Trust

- A trust is a legal entity and trustees are jointly and separately liable for paying income and CGT. This is separate from their own tax affairs.
- The trustees must register for self-assessment and complete a tax return each year
- Interim payments on account based on last tax year's liability must be made by 31 January in the year of assessment and by the following 31 July.
- The balancing payment must be made by 31 January following the end of the tax year

## Income Tax on Interest in Possession Trusts

The basic rules are:

- The trustees are liable for the tax.
- The trust has no personal allowance and tax is payable on every £ of income it receives.
- The trust cannot use the Personal Savings Allowance nor the £1,000 dividend allowance.
- Savings income is taxed at 20%
- Dividend Income is taxed at 8.75%
- The trust has no liability for higher or additional rate tax

This regime is described as **basic rate taxation**.

Since April 2016 interest from deposit accounts are paid gross so the trustees should pay tax at 20%. Dividends are also paid gross so the trustees are liable for tax at 8.75%.

These changes mean that trustees must pay tax on interest and dividends whereas before 16/17 basic tax was deducted at source which satisfied the trustees' liability. Alternatively, trustees can **mandate income**, that is it instructs the bank/company/collective investment to pay the gross income directly to the beneficiary rather than being paid to them. This passes the responsibility for paying any tax to the beneficiary. However, if the trustees receive the income, they become liable to pay the tax even if they pay it immediately to the beneficiary.

**Tax on income received by beneficiaries**

Any income from an IIP trust must be paid to the beneficiaries. They are liable to tax on the income from an IIP trust but can offset tax already paid by trustees.

The trustees will prepare **HMRC Form R185** which gives details of the source of the income, the gross income received any tax deducted. If trustees pay the tax the form would look like this

| **Form R185** | **Gross** | **Net** | **Tax** |
|---|---|---|---|
| Interest | £2,000 | £1,600 | £400 |
| Dividends | £3,000 | £2,737.50 | £262.50 |

Income from an IIP trust retains its character, that is savings income remains savings income and dividend income remains dividend income. Put another way the income the beneficiaries receive will be taxed as if they owned the asset. The beneficiary should enter the **gross income** in the relevant column of their tax calculation. They can use their Personal Savings Allowance, the £5,000 0% starting rate band and the £1,000 Dividend Allowance.

Assuming this person had a salary of £20,000 therefore a basic rate tax payer, the position on savings and dividend income would be

**Savings**

| | |
|---|---|
| £1,000 @ 0% | 0 |
| £1,000 @20% | £200.00 |
| Less savings tax credit | (£400.00) |
| Refund | £200.00 |

**Dividend**

| | |
|---|---|
| £1,000 @ 0% | 0 |
| £2,000 @ 8.75% | £175.00 |
| Less dividend tax credit | (£262.50) |
| Refund | £87.50 |

The trustees must prepare a R185 form both for their records and to allow the beneficiary to include this in their tax calculation

If the beneficiaries salary was £60,000 and therefore a higher rate tax payer the calculation of their tax on savings and dividend income would be as follows.

**Savings**

| | |
|---|---|
| £500 @ 0% | 0 |
| £1,500 @40% | £600 |
| Less savings tax credit | (£400.00) |
| Additional tax | £200.00 |

**Dividend**

| | |
|---|---|
| £1,000 @ 0% | 0 |
| £2,000 @ 33.75% | £675.00 |
| Less dividend tax credit | (£262.50) |
| Additional Tax | £412.50 |

## Trust Management Expenses

These are expenses incurred by trustees. The most common example would be money used to pay the costs of financial advice or legal fees. They do not include the expenses incurred in running a property such as management agent's fees or costs of insurance. These would be deducted as a normal business expense before arriving at the net income due to the trust.

TMEs are treated differently depending on the type of trust.

**Bare trusts and settlor interested trusts**

These trusts are not allowed to offset any TMEs.

## Interest in Possession Trusts

TME reduce the income a beneficiary receives. They cannot be used to reduce the tax payable by the trustees.

Any TME must first be set against dividend income, then savings income and finally non savings income. TME are deducted from net income

An IIP has income and expenses of:

- Gross Interest £10,000
- TME £500

The TME cannot be used to reduce the tax payable by the trustees so their liability is:

Interest £10,000 @ 20% =£2,000.00 Turning now to the beneficiary. The trustees must deduct the TME from the income after tax (£8,000) so the trustees pay the beneficiary £7,500.

This is paid to the beneficiary but the R185 has to reduce the Gross income by deducting the grossed up expenses

Grossed up amount £500 x 100/80 = £625
£10,000 less £625 = £9,375

They would give the beneficiary form R185 completed as follows:

| | Gross | Tax | Net |
|---|---|---|---|
| Interest | £9,375 | £1,875 | £7,500 |

You can se that by applying the basic rate of 20% to £9,375 we would get a tax credit of £1,875.

If there were no TME (and assuming the trustees paid the tax) the beneficiary would have received £8,000 and a tax credit of £2,000

The same procedure would be followed if there was dividend income

An IIP has income and expenses of:

- Dividend £10,000
- TME £500

The TME cannot be used to reduce the tax payable by the trustees so their liability is:

£10,000 @ 8.75% = £875.00

The trustees deduct the TME from the income after tax (£9,125) so the trustees pay the beneficiary £8,625.

The expenses are grossed up but this time by 100/91.25

Grossed up amount £500 x 100/91.25 =£547.94
£10,000 less £547.94 = £9452.06

They would give the beneficiary form R185 completed as follows:

| | Gross | Tax | Net |
|---|---|---|---|
| Interest | £9,452.06 | £827.06 | £8,625 |

Again £9,452.06 @ 8.75% = £827.06

That concludes this part so you should now understand:

- how the trustees of an IIP and Discretionary Trust pay tax.

- How the trustees of an IIP trust calculate their income tax liability
- How a beneficiary is taxed on income from an IIP trust
- How Trust Management Expenses in an IIP trust are dealt with