AF1/J02
Part 4: Taxation of Trusts (3) 2023/2024
Income Tax: Discretionary Trusts

The milestones for this part are to understand:

- How trustees of a Discretionary trust calculate their income tax liability.
- How income received by beneficiaries is taxed.
- How Trust Management expenses are dealt with.

Discretionary Trusts

As with an IIP trust the trustees are responsible for paying any income tax and there is no personal allowance.

The first £1,000 of income is taxed at 8.75%, or 20% depending on its source. This is known as the **Basic Rate**. If the trust has both different sources of income the basic rate must be applied in this priority order, first non-savings (rent), next savings (interest) and finally dividends.

If the settlor sets up more than one trust this £1,000 band
is shared to a minimum of £200 a trust.

All income above £1,000 is taxed at one of two rates:

Non-Dividend Income	45%
Dividend Income	39.35%

These are known as the **Rate applicable to Trusts (RAT)**

The Widmerpool trust receives £10,000 in gross interest

Tax due is

£1,000 @ 20% =	£200
£9,000 @ 45% =	£4,050
Total	£4,250

The same trust receives a share dividend of £1,000.

£1,000 @ 39.35% = £393.50

Tax on income distributed to beneficiaries

Unlike an IIP trust a Discretionary Trust does not need to distribute income. If income is paid the trustees must pay this with a tax credit of 45%.

When the beneficiary receives income from a discretionary trust, they must declare it on their tax assessment. In all cases it is

- Termed **Trust Income** and treated as **non-savings** income regardless of its original source.
- grossed up by multiplying the net amount received by 100/55
- Once the individual's tax liability is established they can reclaim the difference between their individual liability and the tax paid by the trustees

This is how you should show it in a calculation.

Mary has a salary of £50,270. She is a beneficiary of her family's discretionary trust. The trust receives a dividend of £15,000 and pays her £8,250 with a tax credit of £6,750

		Non-Savings
Salary		£50,270
Trust income £8,250 x 100/55		£15,000
		£65,270
Less PA		£12,570
		£52,700
£37,700 @ 20%		£7,540
£15,000 @ 40%	£6,000	£6,000
Less tax credit	£6,750	
	(£750)	(£750)
Total		£12,790

As a higher rate tax payer Mary can reclaim 5% of the tax paid by the trustees:

- a nil rate tax payer can claim back 45% tax.
- a basic rate tax payer can claim back 25% tax
- an additional rate tax payer has no further tax liability

If Mary had received the £15,000 dividend from her own share-holding or from an IIP trust, she could use the £1,000 dividend allowance. The remaining £14,000 would be taxed at 33.75% giving her a liability of £4,725. Her total tax liability would be:

Non- Savings	£37,700 @ 20% =	£7,540.00
Dividend	£14,000 @ 33.75%=	£4,725.00
		£12,265.00

Discretionary Trust Tax Pool.

Trustees must include a 45% tax credit on all distributions as this reflects the tax the trustees are deemed to have paid. However not all income received by the trustees since some could have been taxed at basic rate whilst dividends will have been taxed at 39.35%.

A discretionary trust receives £10,000 in dividend and incurs a liability of £381.

It decides to pay all of this to a beneficiary so pays £550 with a tax credit of £450.

The tax liability is insufficient to cover the tax credit by £69. The trustees don't need to pay this immediately but it will be taken into account in the final tax calculation. To do this the trustees operate a **tax pool**. This is a running total of all tax liabilities and the 45% tax credits when a distribution was made.

In its first year of operation the Smith trust receives £10,000 of interest and £15,000 of dividends. It makes a £10,000 distribution (£5,500 net £4,500 tax credit)

The trustees' tax liability is

£1,000 @ 20%	£200
£9,000 @ 45%	£4,050
£15,000 @ 39.35%	£5,902.50
Total	£10,152.50

It pays this to HMRC and records this in its tax pool. It deducts the tax credit of £4,500 so There is £5,652.50 in the pool at the end of the year

In the second year its tax liability is £5,498 and it makes a distribution of £15,000 (tax credit £6,750) to a beneficiary

Tax pool brought forward	£5,652.50
Tax liability	£5,498.00
	£11,150.50
Less tax credit	£6,750.00
Pool carried forward	£4,400.50

In the third year the trust's tax liability is £5,000 and it pays out £28,000 (tax credit £12,600)	
Pool brought forward	£4,400.50
Plus tax liability	<u>£5,000.00</u>
Total	£9,400.50
As the amount in the tax pool is insufficient to cover the tax credit the trustees must pay HMRC £3,199.50 (£9,400.50 less £12,600) in addition to their liability of £5,000. There is nothing to carry forward into the following year	

To summarise the rules:

- When income is received, the trustees' tax liability enters the pool.
- When they pay out an income to beneficiaries, this must be paid with a 45% tax credit and the tax credit reduces the amount in the pool.
- At the end of each tax year if the tax liability in the pool is higher than the tax credits this will roll over to the previous year (the pool is in credit)
- If the tax paid is lower than the tax credits, the trustees make a payment to HMRC to cover the difference.

If there is not enough money in the pool and the trustees wish to pay out the net income after tax, the following method should be used

A DT receives dividend income of £8,000.		
The trustees tax liability is	£1,000 @ 8.75%	£87.50
	£7,000 @ 39.35%	<u>£2,745.50</u>
		£2,833.50
They can pay the beneficiary		£8,000.00
Less tax		<u>£2,833.50</u>
Net income paid to the beneficiary		**£5,166.50**
The trustees must calculate the 45% tax credit on the net income		
	£5,166.50 x 45/55	£4,227.14
Less tax paid		<u>£2,833.50</u>
Trustees must pay additional tax		£1,393.64
The R185 would be		
Gross	£9,393.64	
Tax credit	£4,227.14	
Net	£5,166.50	

If they had sufficient credit in the pool and just paid the gross with a 45% tax credit the R185 would be:

Gross £8,000
Tax Credit £3,600
Net £4,400

Trust Management Expenses

In a Discretionary Trust TME reduce the amount of tax payable at the rate applicable to trusts.

- TME are deducted firstly from dividend income, then savings income, and finally non-savings income.
- The TME are grossed up at the appropriate rate (100/91.25 for dividends 100/80 for savings and non savings)
- They are offset against the appropriate source of income (Dividend first, Savings second, non dividend third)
- The grossed up expenses are taxed at either 8.75% or 20%
- The total income less grossed up expenses is taxed at either 39.35% of 45%

A Discretionary trust has income and TME as follows

Interest		£20,000
Dividends		£10,000
TME		£1,825
<u>Tax calculation</u>		
Interest £1,000 @ 20%		£200
£19,000 @ 45%		£8,550
Dividends	£10,000	
Less Grossed up expenses	<u>£2,000</u> (£1,825 x100/91.25)	
	£8,000	
£2,000 @ 8.25%	£165	
£8,000 @ 39.35	<u>£3,158</u>	
	£3,323	<u>£3,323</u>
		£12,073

The tax treatment for all three types of trusts can be summarised as follows:

	Tax on trustees	Tax on beneficiary	TME
Bare	None	Liable for all tax Can use PA, PSA, 0% savings rate and Dividend Allowance	Not Allowed
Interest in Possession	Liable to tax on all income Cannot use PA, PSA, 0% savings rate or Dividend Allowance All income taxed at basic rate	Income is paid to beneficiary either gross or with tax credit if trustees paid tax. Income retains its type, savings income stays savings income, dividend income remains dividend. Taxed on beneficiary's situation and can use all allowances	Reduces the net income to the beneficiary Tax liability of trustees remains the same. They cannot deduct TME TME offset against dividends first, then savings and finally non savings
Discretionary	First £1,000 of income taxed at basic rate. Priority order is non-savings, savings, dividends All other non-dividend income taxed at 45% Dividend income taxed at 39.35%	All income taxed as non-savings income regardless of its origin. Income is paid with 45% tax credit	Grossed up TME at basic rate increases the amount trustees pay at basic rate rather than Trust rate TME offset against dividends first, then savings and finally non savings

That completes this part so you should now understand:

- How trustees of a Discretionary trust calculate their income tax liability.
- How income received by beneficiaries is taxed.
- How Trust Management expenses are dealt with.

Further Reading

https://www.peterrayney.co.uk/pdfs/taxing-trusts.pdf

The above, in my opinion, is the best guide to trustees' income tax liability. It was written in 2017 but apart from the new rates for dividends is still up to date

https://www.gov.uk/trusts-taxes/trusts-and-income-tax