STEP
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Managing Trust Income

This technical note provides an overview of the treatment of income generated by assets held by the trustees of a discretionary trust (relevant property trust). Such trustees have an absolute discretion over whether, or the extent to which, the income is to be paid, and how much of the income is to be distributed to any particular beneficiary.

In addition, this note also introduces solutions available to simplify the management of the income generated by the trust fund.

Key Learning Points

- Income tax rates applicable to relevant property trusts
- Main tax responsibilities of trustees
- Potential to reclaim the income tax by the beneficiary
- Settlor Interested Trusts
- Parental Settlements
- Potential Solution
- Summary

Income Tax rates applicable to trusts

All beneficiaries named in a discretionary trust are ‘Potential Beneficiaries’ and so do not have a right to any benefit from the Trust. As no beneficiary is entitled to income, the taxation of any income generated by the discretionary trust assets is the responsibility of the Trustees and is taxed according to the following rates (also known as ‘the rate applicable to trusts (RAT’):

TYPE OF INCOME RECEIVED	INCOME TAX RATE
Dividend Income (including foreign-source dividend income)	38.1%
All other income (including interest)	45%

Note: The first £1,000 of the gross trust income will be taxed according to the standard rate band of 7.5% for dividends and 20% for other income. If the settlor created more than one settlement, the £1,000 will be split equally between each trust, subject to a minimum of £200 per trust.

Tax responsibilities of Trustees

Trustees are responsible for reporting and paying tax on behalf of the trust.

If the trust becomes liable to tax, the trustees must register the trust with HMRC and complete a 'Self-Assessment Tax Return' to report any income generated by the trust fund.

They are required to file the report electronically after the end of each tax year by 31st of January. Alternatively, they can use a paper form 'SA900' which must be posted to HMRC by 31st of October.

In addition, Trustees may also be required to complete form R185 to inform beneficiaries of any income and tax paid by the trust if they decide to distribute the income.

Potential to re-claim the income tax by the beneficiary

If the trustees decide to pay income to one of the potential beneficiaries of a discretionary trust and that individual is a non-taxpayer or pays tax at a lower rate than the rate applicable to trusts, the beneficiary may be able to claim the 'additional rate' of tax back.

This can be done using form R40 or through Self-Assessment.

This should always be remembered as whilst the trust is going to pay a higher rate of income tax, the beneficiaries once in receipt of any taxed income, may be able to claim some back.

Settlor Interested Trusts

For the duration of his/her lifetime, the settlor is responsible for any income tax on income generated by the assets settled by him/her into trusts which he/she has the potential to benefit from.

From an income tax perspective, a trust is deemed to be settlor interested where either the settlor or their spouse / civil partner can benefit under the terms of the trust.

Nevertheless, the trustees must first report the income to HMRC and pay the income tax due.

The Settlor will then also treat the trust income as being part of their personal tax return but will be able to offset from the final tax bill, any tax which has been paid by the trustees.

This may mean that more income tax is payable, or that a refund will be due.

Parental Settlements

It is often assumed that a parent can create a settlement for their minor child and pay the income to such minor child in order to apply the minor child's allowances and income tax rate against whatever income is produced.

However, anti-avoidance legislation applies to such 'parental settlements' and any income is taxed at the rate of the settlor. This applies where any minor children physically benefit from the income and so in theory, the income could be retained in the trust, income tax paid which could be reclaimed once the beneficiary is over the age of 18 years.

It is important to note that the same does not apply to trusts settled by grandparents and this may create further planning opportunities, i.e. the parental settlement provisions only applies where the parent settled the trust, if a grandparent has instead settled it, the same rules do not apply.

Potential Solutions

Appoint and Mandate Income

To simplify the dealings with any income within discretionary trusts, trustees could simply 'mandate the income' to the intended beneficiary. This can be done by producing a suitable document which will have to be signed by the trustees and the recipient of the income.

In addition to the mandate, provided there is also an appointment of a right to income prepared, then there is no statutory basis for taxing the trustees, the trust provides for an interest in possession and income is being mandated.

As soon as the mandate (and appointment if applicable) is fully executed, the income will go directly to the beneficiary and will be taxed at that beneficiary's rate of tax.

The recipient of the income will become responsible for the reporting that income on their Self-Assessment Tax Return and paying income.

In other words, the mandate of income can be used to effectively re-direct any income generated by the trust to reduce the administrative work required to manage it within the trust.

This administrative shortcut does however only apply, provided the trust is non-settlor interested for income tax purposes and the parental settlement rules do not apply.

If investing within the trust, consider investment bonds

Noting the issues as listed above in regards to income tax, if trust funds are used to invest money, then any income such an investment may produce will also be taxable. It is therefore worth considering as a trust investment, an investment bond.

Investment bonds are administratively cheap and the income tax is only triggered as and when the investment bond / or individual segments of the bond are surrendered.

This means that the funds within a trust could be invested for many years without there being any need for an income tax liability to be accounted for by the trustees.

Summary

- Income generated by the assets held by the Trustees of a discretionary trust is generally taxed at the rates applicable to trusts (dividends 38.1% and all other assets 45%)

• It is the trustees responsibility to report any income to HMRC and pay income tax

• Beneficiaries receiving income from the trustees of a discretionary trust may be able to re-claim any extra tax paid by the trustees but the process is time consuming

• Trustees have an option to mandate the income to the intended beneficiaries to ensure that the income passes directly to them and thus avoiding a separate extra return but this benefit only applies to trusts which are non-settlor interested and are not caught by the parental settlement rules

• As soon as the income is mandated, it becomes the beneficiary's responsibility and is payable at the beneficiary's rate of tax.