Distributions from trusts may give rise to income tax or CGT. The tax treatment of distributions from trusts depends on whether a trust is a UK resident trust or an offshore trust. For income tax purposes regarding UK resident trusts we also need to consider the type of a trust (discretionary v interest in possession) and special anti-avoidance rules apply to settlor interested trusts irrespective of the type of trust. Reliefs are available for CGT purposes. When dealing with offshore trusts the charge to income tax depends on the source of income and whether it is a settlor interested or non-settlor interested trust. Trust gains may be attributed to the settlor or the beneficiaries.

The way in which a trust distribution is taxed will depend on where the trust is resident.

Any tax practitioners are unduly apprehensive of the tax treatment of distributions from trusts. The purpose of this article is to explain how distributions from trusts are charged to income tax and capital gains tax in a simple and digestible manner, so that practitioners can feel at ease when dealing with trust distributions.

The way in which a trust distribution is taxed will depend on where the trust is resident. A trust will not be resident in the UK if:
- all the trustees are non-UK resident; or
- some of the trustees are resident outside the UK and the settlor of the trust was not resident, ordinarily resident or domiciled in the UK when the trust was set up or funds were added.
All other trusts are UK tax resident.

**Tax on UK resident trusts**

A trust may distribute its income or capital to its beneficiaries. A trust distribution may give rise to income tax or CGT.

**Income tax**

The income tax position of trust distributions from a UK resident trust will depend on the type of trust that makes the distribution. Broadly speaking, there are two main types of trust:
- a discretionary trust; and
- an interest in possession trust.

However, where either the discretionary trust or interest in possession trust is ‘settlor interested’ special anti-avoidance rules apply and the trust income is taxable on the settlor and not on the trustees.

**Income tax on discretionary trust**

A discretionary trust is one where the trustees have discretion about how to use the trust’s income as it arises.

**Trust’s tax position:**

The trustees are treated as a single person separate from the persons who are the trustees. Income tax is assessable on the trust under self-assessment. The income tax computation of a discretionary trust broadly follows the same computation used for individuals except that:
- the trustees are not entitled to a personal allowance to set off against trust income;
- the first £1,000 of taxed income is taxed at the basic rate of 20%, assuming the settlor has not settled any other trusts (10% for dividends);
- any income used to pay annuities or general trust expenses are taxable at 20% (10% for dividends); and
- the remaining trust income is taxed at the trust rate of 50% (42.5% for dividends).

**Beneficiary’s tax position:**

**Payments of annuities:** The trustees may pay an annuity to the beneficiary net of basic rate tax. For example, if the trustee pays a gross of annuity of £1,000, the beneficiary will receive £800 with an attaching tax credit of £200. The beneficiary will be assessable to £1,000 of income but will be able to reduce his tax liability by the tax credit of £200.

Broadly speaking, if the trust does not have enough income to pay the annuity, the beneficiary will only be assessable to tax on the equivalent of the trust income received.

**Discretionary payments of income:** When the trustees make a discretionary payment of income to its beneficiary, a 50% tax credit is attached to that payment. This means that the payment is treated as if 50% tax has been paid on it. If the beneficiary is not a 50% tax payer he will be able to claim a repayment of the excess tax paid.

The trustee has to ensure that the trust has paid sufficient tax to cover the tax credit. This is done by way of a ‘tax pool’. The tax pool is the total amount of tax paid by the trust which is available to cover the tax credit on distributions made by the trust. If the tax pool is less than the tax credit attaching to the discretionary payment, the trustee will need to pay tax to HMRC to cover the balance. If the tax pool is more than the tax credit attaching to the discretionary payment, then the trust need not pay tax. Any excess tax credit can then be carried forward the remaining tax pool to the next tax year.

The trust distribution is always assessed as non-savings income in the hands of the beneficiary, even if the true source of the income was, say, dividend income.

**Income tax on interest in possession trust**

An interest in possession trust (IIP) is one where the...
beneficiary has an immediate and automatic right to the income from the trust after expenses. The trustee must pass all of the income received, less any trustees’ expenses, to the beneficiary.

Trust’s tax position: The trustee of an IIP is liable to tax at 20% on non-savings income and savings income and at 10% on dividend income. As savings and dividend income usually comes with a basic rate tax credit, the trustees do not usually have any further tax liability in relation to savings and dividend income.

Beneficiary’s tax position: The beneficiary of an IIP is automatically entitled to his share of trust income when it arises. That income is therefore assessable on the beneficiary when it arises. This is the case even if the trustee does not physically distribute the income to the beneficiary. The beneficiary will be entitled to a tax credit in relation to the tax paid by the trust. If the beneficiary does not have any other income he may be able to claim back the tax paid (but not the 10% tax credit on dividends). If the beneficiary is a higher or additional rate taxpayer he will need to pay the excess outstanding tax through his self-assessment tax return.

Income tax on settlor interested trusts

Settlor’s tax position: If the settlor is able to directly or indirectly to benefit from the trust, the trust income is assessable on him directly under ITTOIA 2005 s 624, even if it is not paid out to him. The settlor is able to benefit from the trust if he or his spouse (or civil partner) is a beneficiary or potential beneficiaries of the trust. Unless the settlor and his spouse (or civil partner) is explicitly excluded from the trust, they will usually be potential beneficiaries of the trust as, at least in theory, the trustees may at any time add them to the class of beneficiaries. A trust will not be a settlor interested trust if the settlor’s widow is able to benefit from the trust.

A revocable trust is one where the trust property may be returned to the settlor. Therefore, a revocable trust will be a settlor interested trust.

Trust’s tax position: Although the trust income is assessable on the settlor, the trustees are still liable to tax under the normal rules. Therefore, broadly speaking, the trustees of a discretionary trust will pay tax at 50% or 42.5% and the trustees of an IIP will pay tax at 20% or 10%. The settlor will receive credit for the tax paid by the trustees, the tax deducted at source (eg, bank interest) and tax credits (eg, on dividends).

The purpose of this anti-avoidance rule is to ensure that trust income is taxed at the settlor’s marginal tax rate. The settlor is therefore able to recover the tax paid in relation to trust income from the trustees.

Beneficiary’s tax position: Where the trustees of a discretionary settlor interested trust distribute trust income to another beneficiary, that beneficiary is deemed to have received the income net of a 50% tax credit. The payment is taxable on the beneficiary as non-savings income at their highest marginal rate, ie, after the beneficiary’s personal savings and dividend income. However, as the settlor has already been assessed on this income and may have received a refund, the tax credit is not repayable to the beneficiary.

CGT

Where the trustees distribute a capital asset to a beneficiary, the trustees are deemed to dispose of that asset at its current market value. Where the transfer gives rise to an IHT exit charge, gift relief should be available under TCGA 1992 s 260. Where gift relief is not available under s 260, it may be available under s 165. Where gift relief applies, the trust will not make a capital gain (or loss) on the disposal of the asset. The beneficiary will acquire the asset at the trust’s base cost. A joint election must be made by the trustees and the beneficiary for gift relief to apply.

The taxation of offshore trusts

Income tax

If a trust is not resident in the UK its income and distributions are not assessable on the trustees under general principles unless they receive UK source income. Non-UK source income may still be taxable in the UK if it is attributable to the settlor and/or the beneficiaries.

UK source income: The trustees of an offshore trust, will be taxable on UK source income, such as rental income from UK land. Where the trustees have paid tax on UK rental income a credit may be available to the settlor or beneficiary in relation to the tax paid by the trust.

Income tax on settlor interested trusts

Where the settlor has an interest in the offshore trust the trust income will be taxable under ITTOIA 2005 s 624 (see above). If the settlor is not resident or ordinarily resident in the UK, the trust income will not be taxable on the settlor unless it would have been taxed on him had he received it directly. If the settlor is not domiciled in the UK, he will be taxed on UK source income within the trust. He will also be taxable on relevant foreign income within the trust which is remitted to the UK, such that if the settlor remitted it himself, he would be taxable on it.

Income tax on non-settlor interested trusts

Where the settlor does not retain an interest in the trust, the trust income may be taxable under the transfer of assets abroad provisions (ITA 2007 ss 720 and 731).

Income tax chargeable on the settlor: There may be a charge to income tax on a trust distribution to the settlor of a trust under ITA 2007 s 720. Section 720 applies where an individual, who is ordinarily resident in the UK, transfers assets abroad as a result of which income becomes payable to
Where the settlor does not retain an interest in the trust, the trust income may be taxable under the transfer of assets abroad provisions.

CGT

A distribution of trust property may give rise to a capital gain. If a trust is not resident in the UK, the gain is not assessable on the trustees under general principles. The trust's gain may, however, be attributed to either the settlor of the trust or to the beneficiaries.

**Trust gains assessed on the settlor:** A trust gain will be assessed on the settlor of the trust where, under TCGA 1992 s 86:
- the settlor has an interest in the trust;
- the settlor is domiciled and resident or ordinarily resident in the UK in the tax year; and
- the trust is not resident or ordinarily resident in the UK.

**Trust gains assessed on the beneficiaries:** Where a distribution of trust property gives rise to a gain, and that gain is not assessed on the settlor under s 86, the gain may be attributed to a beneficiary of the trust under TCGA 1992 ss 87 and 97. Capital payments are matched with the trust gains. For this purpose a capital payment is any payment which is not chargeable to income tax. It includes but is not limited to:
- cash distributions;
- distributions of assets;
- conferring a benefit (eg, the right to occupy a property on a rent free basis).

Conclusion

As can be seen from the above, the taxation of trust distributions can lead to some unexpected liabilities for beneficiaries. Care always needs to be taken when dealing with any trust distributions, especially where an offshore connection is involved.

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