

EXPLANATORY NOTE

SCHEDULE 4: AMENDMENTS RELATING TO THE RATE APPLICABLE TO TRUSTS

SUMMARY

1. This Schedule makes various changes related to the change in the rate applicable to trusts, from 34 per cent to 40 per cent, as provided for in clause 29. The changes mostly apply to the anti-avoidance legislation in section 677 Income and Corporation Taxes Act 1988 which charges tax on settlors (individuals who put funds into a trust) in respect of loans or other capital payments made to them or their spouse by the trustees of that trust. This amendment will ensure that the (notional) tax credit received by the settlor does not exceed the tax actually paid by the trustees. The changes will have effect for the tax year 2004-05 onwards.

DETAILS OF THE SCHEDULE

2. Paragraph 1(1) provides for section 677 Income and Corporation Taxes Act 1988 (ICTA88) to be amended.
3. Paragraph 1(2) clarifies the existing wording of section 677(2)(h) ICTA88.
4. Paragraph 1(3) amends section 677(7) ICTA88 to restrict the notional tax credit the settlor receives with their capital payment so that the tax credit more closely reflects the tax actually paid by the trustees.
5. Paragraph 1(4) inserts new subsections (7A), (7B) and (7C) into section 677 ICTA88.
6. The new subsection (7A) provides an ordering rule so that where a capital payment is made to a settlor or their spouse it is possible to match that payment to income that has arisen to trustees in previous years. The rule treats a capital payment as made up first out of the oldest income that arose to the trustees, working forward in time so it is always the older income that is included before more recent income.
7. The new subsection (7B) defines "the grossed up amount". This is the amount which is treated as the settlor's income under section 677 ICT88. Broadly the grossed up amount is the total of the actual capital payment made and the tax paid on that income.

8. The new subsection (7C) gives the rate of tax to be used to calculate the “grossed up amount” in the new subsection (7B). The rate is either;
 - 0 per cent where the income was non UK income and arose to non-resident trustees, or
 - 34 per cent for income that arose in 2003-04 or earlier years, or
 - 40 per cent for income that arose in 2004-05 or later years.
9. Paragraph 2 amends the descriptive heading for section 694 as this is now incorrect and confusing.
10. Paragraph 3 provides that the amendments to section 677 ICTA88 take effect for the tax year 2004-05 and later years.

BACKGROUND NOTE

8. The legislation in section 677 ICTA88 is anti-avoidance legislation which prevents a settlor (the person who created a trust), or their spouse, from extracting funds from that trust without attracting a tax liability in certain circumstances.
9. If income has arisen to a trust and that income is then paid out as income it would be taxable in the hands of the recipient. So if £1,000 was received in 2003-04 and taxed at 34 per cent, tax of £340 would be paid by the trustees leaving £660 in the trust. If that £660 was paid out as income it is treated as a payment of £1,000 from which tax of £340 has been deducted. A higher rate taxpayer would then have £60 to pay (£1000 @ 40 per cent = £400, less £340 paid by trustees leaves £60 to pay.)
10. If instead of making an income payment a capital payment is made then £60 of tax could be avoided as capital payments from a trust are not normally taxable. Section 677 ICTA88 prevents this avoidance by taxing the settlor in certain circumstances where capital payments, including loans, are made to them or their spouse. The amount treated as the income of the settlor is restricted to the amount of the available undistributed income in the trust. So, for example, if income arising to a trust since it was set up totalled £500,000 and none of that income had been paid out, then a capital payment to a settlor of £600,000 would only give rise to a £500,000 charge under section 677 ICTA88.
11. The amount chargeable is defined at section 677(6) ICTA88 which provides that the capital sum treated as the income of the settlor shall be equal to the actual capital sum paid plus “notional” tax at a rate equal to the rate applicable to trusts. That total amount is charged upon the settlor by section 677(7) ICTA88.

12. The settlor gets relief for the “notional” tax when calculating any further tax due, however the “notional tax cannot be repaid to a non-taxpayer for example.
13. The change to section 677 ICTA88 ensures that when the rate applicable to trusts is 40 per cent the credit given to the settlor does not increase to 40 per cent for years prior to 2004-05. Otherwise the settlor would get credit for tax not actually paid by the trustees. For example:

A trust has accumulated £1m of income (tax has been paid at 34 per cent on all of it giving £340,000 paid). If the trustees made a loan of £660,000 to the settlor in 2003/04 that amount would have been treated as a payment of £1m and the settlor given credit for tax paid at the rate applicable to trusts of 34 per cent. (£660,000 plus notional tax credit of £340,000.) Assuming the settlor is a higher rate taxpayer, tax at 6 per cent would be due, i.e. £60,000.

If the trustees waited until 2004/05 then tax is still due from the higher rate settlor at 40 per cent on £1m but without this amendment section 677 ICTA88 would give credit at 40 per cent (i.e. £400,000). So no tax would be due even though the trustees have only paid £340,000 tax which is insufficient to fund the tax credit.

13. When the trustees have received income that has not suffered tax at 34 per cent or 40 per cent, the tax credit available to the settlor will more closely reflect the actual tax suffered by the trustees on the equivalent undistributed income. As a result some settlors of non resident trusts will have to pay more where the trustees have paid little or no UK tax on their income.