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Section 29 and Schedule 2: estates in administration and trusts

Income from estates in the course of administration

Personal representatives are not entitled to personal income tax allowances and at present are liable to pay income tax on all income albeit only at basic rate. The abolition of deduction of tax at source from bank and building society interest in 2016 meant that personal representatives with very small amounts of income had all the hassle of filing a tax return and dealing with self-assessment procedures as basic rate tax was no longer deducted at source. HMRC by concession and as a temporary arrangement introduced a narrowly targeted arrangement that removed trustees and personal representatives from income tax where the only source of income for the trust or estate was savings interest and the tax liability was below £100. If this did not apply, HMRC had all the administrative costs of processing small amounts of estate income above this limit and then a beneficiary who had little other income had to file a return to reclaim the basic rate tax paid by the personal representatives!

Following a consultation in 2022,¹ from 6 April 2024 a £500 annual exemption is introduced. This means that neither the personal representatives nor the estate's beneficiaries will have any income tax liability if total estate income (of any kind) is below the annual threshold of £500.² Where estate income exceeds the threshold, all of it is taxed so that the normal rules apply. Although an exemption inevitably introduces a cliff-edge at borderline, this is a sensible reform that will simplify the position for small estates particularly where family members act as personal representatives.

Trusts

The position for trusts is rather different perhaps because unlike the estate of a deceased person, a trust is not a one-off event and may continue for many years. Nevertheless the proposals do not genuinely simplify the taxation of small trusts but provide a trap for the unwary. Currently, the basic rate and dividend ordinary rate of tax applies to the first £1,000 slice of discretionary trust income.³ From 2024/25 this is abolished.

Instead a £500 annual exemption is applied to the income arising to the trustees of a settlement. Where a settlor has a number of current trusts, the £500 limit will be proportionately reduced, by the total number of the current trusts to a minimum of £100. This mirrors the approach adopted in relation to the CGT annual exemption for trusts. Interest in possession trusts, settlor-interested trusts, vulnerable beneficiary trusts and heritage maintenance trusts are not taken into account. Otherwise if the £500 threshold is exceeded, from April 2024 all income including the first £1,000 will be taxable at the following rates:

Dividend income: 39.35 per cent.

¹ See HMRC, consultation outcome, *Income Tax: Low income trusts and estates* (published 25 April 2022; last updated 15 March 2023), <https://www.gov.uk/government/consultations/income-tax-low-income-trusts-and-estates> [Accessed 27 September 2023].

² Finance (No.2) Act 2023 (F(No.2)A 2023) Sch.2 Pt 2 Ch.1 paras 10 and 11.

³ Income Tax Act 2007 s.491.

All other income: 45 per cent.

However, even where the £500 exemption applies, Schedule 2 of the Finance (No.2) Act 2023⁴ does *not* then exempt the trust income if it is distributed to the beneficiaries. In relation to interest in possession trusts, the beneficiary who is entitled to the income will receive the trust income of up to £500 gross, that is, free of any tax. The trustees will have no liability to report or pay. Where the life tenant is a non-taxpayer nothing further needs to be done. If the life tenant is a taxpayer (or the additional trust income pushes him into basic rate or higher rate tax) then tax will be due on the whole amount. Currently some life tenants may not be filing a tax return at all as their basic rate liability will have been met by the tax deducted by the trustees. This measure means that they will now have to file.

The position for discretionary trusts (where no one is entitled to income) is more complicated. The trustees will not have to report exempt income under £500 but no “deemed” tax credit on that £500 goes into the tax pool. Any discretionary distribution of income made to a beneficiary is treated as a new source of income separate from that of the underlying income in the trust. Distributions from a UK discretionary trust are taxable under section 683 of the Income Tax (Trading and Other Income) Act 2005 as annual payments not otherwise charged to tax and section 494 of the Income Tax Act 2007 still requires the trustees to operate deduction at source in relation to income distributions and to offset the tax due on the distributions against tax on their income as it arose. This means that trustees must be careful to ensure that, before they pay the £500 income out to the beneficiary, they have sufficient tax in the pool from earlier accumulated and taxed income to frank the income they are paying out now. The beneficiary is treated as receiving the distribution net of 45 per cent tax and receives an R185 form⁵ from the trustees evidencing the deduction. The beneficiary can reclaim the tax (or part of it) if they are not an additional rate taxpayer.

Hence if trustees in the first year receive no more than £500 but pay this out and this has been the trust’s only income so far on which no tax has been paid, the trustees will be treated as having made a net payment of £500 and are liable to account to HMRC for £409 of tax. In these circumstances the trustees are better off granting a revocable interest in possession to a beneficiary to ensure that the complicated discretionary tax regime does not apply. Alternatively, they must ensure they still deduct 45 per cent tax on the £500 (£225) and only pay the beneficiary the net amount of £275. The £225 will have to be paid over to HMRC by the trustees and the beneficiary will then reclaim part or all of it if not an additional rate taxpayer. That is not a simplification!

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⁴F(No.2)A 2023 Sch.2 Pt 3 para.13.

⁵HMRC, *Statement of income from trust* (R185) (trust income).

*PCTC.