INCOME TAX ACT 2007

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 9: Special rules about settlements and trustees

Overview

Chapter 8: Trustees' expenses and beneficiary's income

Overview

1466. This Chapter is concerned with how trustees' expenses affect the income of a beneficiary. It has no application to discretionary payments by trustees, but relates to circumstances in which a beneficiary (and no-one else) is entitled to the whole of or a share in the income of a settlement. Such a beneficiary is often described as having an interest in possession.

1467. Much of this Chapter is new, as there is very little statutory guidance about how trustees' expenses affect the measure of a beneficiary's income. The principles set out in this Chapter are mainly derived from trust and tax law, but are well understood and have been the subject of guidance issued by HMRC. See *Change 91* in Annex 1.

Section 499: Application of Chapter

1468. This section sets out the circumstances in which the Chapter applies. It is new.

1469. The key factor is that there is a beneficiary who is entitled to some or all of the income of the trust before it is distributed.

Section 500: Restrictions on use of trustees' expenses to reduce the beneficiary's income

1470. This section sets out restrictions which apply in arriving at the amount of the trustees' expenses which are to be taken into account in measuring a beneficiary's income. It is new.

1471. *Subsection (1)* provides that expenses may be taken into account if they are incurred in the current tax year or an earlier tax year and are chargeable to a beneficiary's income in accordance with the following subsections. The critical issue is not in which year the expense is incurred, but in which year the beneficiary's income is reduced by reference to the expense. See *Change 91* in Annex 1.

1472. *Subsections (2)* and *(3)* provide that the expenses must either be chargeable to income under a term of the settlement (subject to any overriding law) or, if the deed contains no such term, they must be chargeable to income under trust law (subject to any overriding term of the settlement). See *Change 91* in Annex 1.

1473. *Subsection (4)* makes it explicit that expenses cannot be used to reduce the beneficiary's income if they have been or will be taken into account in calculating the trustees' liability to income tax for any tax year.

Section 501: *Non-UK resident beneficiaries*

1474. This section performs a similar function to section 487 (which applies to expenses taken into account in taxing *trustees* in receipt of accumulated or discretionary income) in providing that a proportion of expenses is to be disregarded if part of the *beneficiary's* income is untaxed income. It is based on section 689A of ICTA.

Section 502: *Meaning of "untaxed income" in section 501*

1475. This section defines "untaxed income" for the purposes of section 501. It is based on section 698A(1) and (5) of ICTA.

1476. The definition is the same as that in section 487(4) and (5) with beneficiary substituted for trustees.

Section 503: *How beneficiary's income is reduced*

1477. This section explains how trustees' expenses are taken into account in measuring a beneficiary's income. It is based on section 689B of ICTA.

1478. Trustees are liable at the normal rates on the income of the trust. The beneficiary receives income net of tax and expenses, but is entitled to the gross income after expenses. So to calculate the true measure of the beneficiary's income, the net income of each type is calculated, expenses are allowed against that income and what is left is grossed up at the normal rate for that type of income.

1479. *Subsections (1)* and *(2)* provide that, when trustees' expenses are taken into account, they reduce different types of income of the beneficiary in a particular order.

1480. *Subsection (5)*sets out the calculation in step form. See *Change 91* in Annex 1 and the overview commentary on this Chapter.