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Tax

Excerpt from Trusts and Estates 2019/20 – Chapter 11 – Deceased Estates, Income Tax and CGT

TAXATION OF DISTRIBUTIONS TO BENEFICIARIES

The basic principles

11.12

Income received by the PRs suffers the equivalent of basic rate tax, either by deduction at source (if received prior to 6 April 2016) or by direct assessment in their hands, with dividends being taxed at the rate of 7.5% on or after 6 April 2016 (10% prior to 6 April 2016). From this taxed income the PRs deduct administration expenses chargeable against income, leaving a net sum available for distribution to beneficiaries entitled to the income from the estate. These different types of income fall to be divided between beneficiaries as is just and reasonable having regard to their different interests (*ITTOIA 2005, ss 663* to *670*). The legislation does not specify against which types of income administration expenses are to be deducted. The best approach used to be to set expenses first against income carrying a non-reclaimable credit (ie dividend income received prior to 6 April 2016), then against income bearing tax at basic rate.

For income received on or after 6 April 2016 the position is more complex. If a beneficiary benefits from the savings allowance (£5,000, £1,000 or £500) or the dividend allowance of £2,000 from 2018/19 (was £5,000 in 2017/18) it may be more beneficial to use estate expenses against non-savings income first, then savings income followed by dividend income. The income tax position of the beneficiary will determine the most tax efficient use of administration expenses.

If the PRs have a discretion whether to deduct administration expenses from income or capital, they may consider the tax position of a beneficiary (if any) absolutely entitled to the residue of the estate. When that beneficiary has a large income, they may deduct their expenses from income so as to reduce the beneficiary's income and, therefore, the higher-rate tax bill. Conversely, if the beneficiary has only a small income or is a charity, they may deduct expenses from capital so as not to prejudice any claim that the beneficiary may have for a repayment of income tax.

The relevant provisions can be found in *ITTOIA 2005, ss 649–682*.

General legatees

11.13
A general legatee is a person who is entitled to a sum of money (a pecuniary legacy) not charged on any particular fund. This sum is capital and the legatee is generally not entitled to any interest unless:

(1) the will directs the PRs to pay him interest; or
(2) the legacy remains unpaid at the end of the executor's year, in which case he is entitled to interest at the rate payable on funds in court, in the absence of a contrary direction; or
(3) the legacy is a 'statutory legacy' arising on intestacy (eg to a surviving spouse), in which case he is similarly entitled to interest at the rate indicated above from the date of death to the date of payment.

Interest is paid gross by the PRs, and the legatee is assessed directly to tax under *ITTOIA 2005, s 369* on the interest (unless the interest is paid to a person whose usual place of abode is outside the UK, when basic rate tax must be deducted by the PRs: see *ITA 2007, s 874(1)*). If that interest is neither claimed nor paid, there is no income to be assessed in the beneficiary's hands (*Dewar v IRC* [1935] 2 KB 351). Once a sum has been set aside to pay the legacy it may, however, be too late to disclaim any income (*Spens v IRC* [1970] 3 All ER 295, 46 TC 276). For the PRs, interest is ignored in computing their tax liability and so does not appear on their tax returns: this follows from the basic principle that the payment of interest does not attract tax relief. Such interest may, however, be treated as an administration expense and properly be deducted from the net income that is available for allocation and vouching to the residuary beneficiaries (*ITTOIA 2005, s 666*).

Focus
PRs are meant (subject to anything in the will) to pay legacies within the 'executor's year', ie a year after death. Interest on a legacy paid thereafter is paid gross (subject to income tax for the beneficiary).

Specific legatees

11.14
A specific legatee is entitled to a particular item of property and to any income produced by it as from the date of death. Therefore, once the PRs vest the asset in the beneficiary, any income from it that arose during the administration period is related back and taxed as the legatee's income for the tax year(s) when it arose (*IRC v Hawley* [1928] 1 KB 578). It will have suffered tax either through deduction at source or as a result of direct assessment on the PRs. Accordingly, the net income will be passed to the beneficiary together with a tax deduction certificate, form R185, completed by the PRs.

Example 11.4—Rental income
Alfie died in September 2018, leaving one of his 'buy-to-let' properties to his nephew Terry. The PRs continue to collect the monthly rental on the property. The administration is completed and the property vests in Terry in May 2019 together with the rental income. Terry must include the net rental

income (after expenses) in his income tax return for the tax years 2018/19 and 2019/20 as it arose, rather than all the income in 2019/20 when received.

Annuitants

Definition

11.15
An annuity is a pecuniary legacy payable by instalments. The payments are income from which the PRs must deduct basic rate income tax (see *ITTOIA 2005, s 426*). The net sum will be paid to the annuitant, who will be given a certificate of tax deducted.

Modern wills rarely provide for the payment of an annuity.

Use of formula

11.16
A testator may want the annuitant to receive a constant sum, despite fluctuations in the tax rates. The two methods most commonly employed are:

(1) The testator provides for the payment of 'such sum as will after deduction of income tax at the basic rate for the time being in force leave (say) £1,000 pa'. The PRs must pay £1,000 grossed up at the current basic rate to give a gross equivalent of £1,250. They must pay basic rate tax on that grossed-up figure, but they are not liable to indemnify the annuitant against any higher rate income tax for which he may be liable. Conversely, if the annuitant can reclaim all or any of the basic rate tax paid, he need not account for it to the PRs.

(2) If the testator provides for the payment of '£1,000 pa free from income tax', this imposes an obligation on the PRs to pay such sum as, after deducting basic rate income tax, leaves £1,000. However, it also means that the annuitant can recover from the PRs any higher rate tax that he may have to pay on the annuity, and any basic rate tax that he reclaims must be repaid to the PRs. In effect, he will never be left with more or less than £1,000 (see *Re Pettit, Le Fevre v Pettit* [1922] 2 Ch 765, 127 LT 491).

Setting aside a capital sum and purchased life annuities

11.17
An annuitant can insist on a capital sum being set aside to provide for his annuity (thereby creating an interest in possession trust for IHT purposes). If the capital in the estate is insufficient, he can demand that the actuarial value of the annuity be paid to him, abated if necessary (*IRC v Lady Castlemaine* [1943] 2 All ER 471, 25 TC 408). This capitalised annuity is not subject to income tax, either in the PRs' or the annuitant's hands.

If the will directs the PRs to purchase an annuity for the beneficiary, he will be charged to income tax on the full amount of each annual payment and cannot claim relief under *ITTOIA 2005, s 717* which taxes only the income element. The beneficiary should, therefore, request that the PRs give him the appropriate capital sum so that he can buy the annuity himself and claim *s 717* relief.

Beware top-ups!

11.18

Where there is insufficient income in the estate to pay the annuity in full, the will may direct the PRs to make up the income from capital. If they do so, that capital is treated as income from which basic rate tax must be deducted (*Brodie's Will Trusts v IRC* (1933) 17 TC 432, 12 ATC 140). The unfortunate result of such 'top-up' provisions is to convert capital into income and it is, therefore, better to give the PRs a discretion to make good any shortfall in the annuity by capital advances.

Residuary beneficiaries

11.19

A beneficiary may have a limited interest, an absolute interest in residue or a discretionary interest in residue. A limited interest exists where he is entitled to income only; for example, if the will leaves residue to 'my wife for life, remainder to my children', the wife is entitled only to income from the estate. An absolute interest exists when the beneficiary is entitled to both the income and capital of the residue, as where the residue is left to 'my wife absolutely'. A discretionary interest exists where a discretion must be exercised in favour of a residuary beneficiary to pay any income to him.

Beneficiary with a limited interest in residue

11.20

Any income paid to the beneficiary during the administration period will be paid net of tax deducted by the PRs. The beneficiary must gross up these sums, at the tax rate applicable in the year of *receipt by him* to that category of income, as part of his total income in the year of receipt for the purposes of his excess liability or to obtain a repayment of tax (as appropriate). Where any sum remains payable on completion of administration, it is treated as being the income of the beneficiary in the tax year in which the administration ends (see *ITTOIA 2005, ss 654–655*).

Example 11.5—Life interest in residuary estate

Suzy died on 6 March 2018, leaving a life interest in her residuary estate to Frances and, after Frances's death, to her son Michael. The interest income of the estate was:

Tax year	***Amount before tax***	***Amount after tax***
	(£)	*(£)*

2017/18 (gross) *	6,000	4,800
2018/19 (gross)*	25,000	20,000
2019/20 (gross)*	2,000	1,600
Total	33,000	26,400

* As the tax liability for 2017/18 to 2019/20 exceeds £100 in each tax year, the transitional measure announced by HMRC does not apply – see **11.9**. The PRs will have to pay income tax of £1,200 in 2017/18, £5,000 in 2018/19 and £400 in 2019/20

Payments made to Frances were:

Tax year	***Amount***
	(£)
2017/18	nil
2018/19	18,000
2019/20	8,400
Total	26,400

Frances is taxed on the payments in the tax years of receipt, ie in 2018/19 and 2019/20.

Note: if, at the end of administration, there is an undistributed income balance, it is deemed to have been paid to the beneficiary in the tax year when the administration ended (this being the one exception to the receipts basis). For instance, if the administration of Suzy's estate had been completed on 4 April 2019, the undistributed income balance of £8,400 would be taxed on Frances in 2018/19, even though she did not receive it until the following tax year.

Beneficiary with an absolute interest in residue

11.21

Such a beneficiary is entitled to receive both income and capital from the estate. They can, of course, only be charged to income tax insofar as any payments that they receive represent income. The position is that:

(1) payments during administration are taxed as income up to the amount of the aggregate income entitlement of the beneficiary for the year of assessment in which the sum is paid (see *ITTOIA 2005, s 652*): ('aggregate income entitlement' means the net income to which the beneficiary is entitled);

(2) if, on completion of the administration, the beneficiary has not received his full aggregate entitlement to income, the shortfall is treated as having been paid to him immediately before the end of the administration period; and

(3) the beneficiary must gross up the sums treated as income, at the tax rate applicable in the year of receipt by him to that category of income, as part of his total income in the year of receipt for the purposes of his excess liability or to obtain a repayment of tax (as appropriate). **Focus**

Payment of income to a residuary beneficiary will be made after deduction of basic rate tax. The beneficiary will be given form R185 (Estate Income), which takes into account dividend tax at 7.5% as well as income tax at 20% for 2019/20. The applicable tax rate is that in the year of distribution (and not in the year of receipt).

Example 11.6—Absolute interest in residuary estate

Serena died on 6 March 2018, leaving her entire estate to Garry. Savings income arising to the estate was as follows:

Tax year	*Net income*
	(£)
2017/18 (gross) *	11,250
2018/19 (gross)*	37,500
2019/20 (gross)*	3,750
Total	52,500

* The transitional measure does not apply to the income of Serena's estate, as the tax liability exceeds £100 for 2017/18 to 2019/20 – see **11.9**. The PRs will have to pay £10,500 income tax on the interest received – the simplified procedure applies to Serena's estate.

(1) *Tax year 2017/18*: Assuming that no payment is made to Garry, £9,000 is carried forward to 2018/19. Therefore, as at 5 April 2018, Garry's aggregated income entitlement is £9,000.

(2) *Tax year 2018/19*: At 5 April 2019, Garry's aggregated income entitlement, assuming no payments in 2018/19, is £39,000 (£48,750 less tax at 20%). As a result, if a payment of £72,000 is made to him in this year, the first £39,000 is treated as income.

(3) *Tax year 2019/20*: Assuming the administration period has ended and the estate is distributed, Garry will be taxed on the remaining income of £3,000 (£3,750 received gross less tax due £750).

Focus

(a) The timing of the payment in the tax year is irrelevant: it could, for instance, occur on 6 April 2018 but nonetheless it is the beneficiary's aggregated income entitlement at 5 April 2018 that is crucial.

(b) The rules apply to the payment of 'any sum': it is not possible for the PRs to specify that the payment is 'of capital'. Furthermore, HMRC consider that, for these purposes, the payment of 'any sum' includes a transfer of assets or release of a debt. They will therefore treat the

value of such assets as income up to the amount of the beneficiary's aggregated income entitlement (see *ITTOIA 2005, s 681*).

Relief against a double charge

11.22

Income which accrued before death, but is received by the PRs after death, is included in the value of the deceased's estate for IHT purposes and is also taxed as the income of the estate. Some relief against this double taxation is provided by *ITTOIA 2005, s 669* that allows a reduction in the residuary income for the purposes of any liability to higher rate tax of a residuary beneficiary absolutely entitled to residue. The reduction is of an amount equal to the IHT chargeable on that income at the estate rate, and the resultant sum is then grossed up at the basic rate of income tax or dividend ordinary rate for the tax year in which the charge to higher rate arises.

Example 11.7—Relief against double charge

Xavier died on 30 April 2019. He left his residuary estate including 1,000 debentures in B Ltd to his daughter Deborah. His PRs received interest of £200 from B Ltd in November 2018. (B Ltd's accounting year ended 31 October 2019). The whole interest is taxed as the income of the estate but, as half the interest accrued before death, that portion is included in Xavier's estate for IHT purposes. Under *ITTOIA 2005, s 669*, if Deborah is a higher rate taxpayer, one half of the interest is eligible for relief. Assume that the estate rate of IHT is 30%.

	£
Interest (gross)	200
Sum accrued before death	100
Less: income tax for year of death	20
	80
The relief is calculated as:	
£80 × 30% (IHT estate rate)	24
Grossed-up (at 20%) amount that can be deducted from the residuary income to reduce D's liability to higher rate income tax only	30

Beneficiary with a discretionary interest in residue

11.23

A beneficiary with a discretionary interest in residue is taxed on the amount paid to him in the tax year the discretion was exercised. The beneficiary is assessed on the basic amount grossed up at the

applicable tax rate.

The 'bunching' effect

11.24
Under the receipts basis, all the income is taxed in the year of receipt. That could have the unfortunate consequence of pushing a beneficiary up from being a non-taxpayer to a basic rate taxpayer, if, for example, the income year by year would have been within the personal allowance or a basic rate taxpayer up to a higher rate taxpayer. It is always open to the PRs to avoid this result by distributing income as they go along, but to do so they need to have some awareness of the personal income tax circumstances of each of the beneficiaries and, except from within a closely knit family, this might be quite difficult.

There is a further problem: the payment of capital or the release of a debt although capital in nature, might trigger an income tax liability on the beneficiary to the extent that there is during that tax year, or a previous tax year of the estate, undistributed income (*ITTOIA 2005, s 681*). Accordingly, a distribution of chattels to beneficiaries may trigger income tax liabilities: beware. There is an example below. The effect of *ITTOIA 2005, ss 649, 652, 681, 665, 660* and *656* (most helpfully, in that order) is that, assuming no distribution of income, the value of the chattel is grossed up at 'the applicable rate' for the year, as defined in *ITTOIA 2005, s 663*, which varies according to the rate of income tax borne by the various elements of income of the estate and, therefore, in relation to a particular distribution of income, the income out of which the payment is made.

Example 11.8—A trap for the unwary
Susan's estate is worth £500,000. The residuary beneficiary is her daughter, Ursula. The residuary income for 2017/18 is £5,000, and for 2018/19 it is £6,000. In 2018/19, while the estate administration continues, the executors transfer to Ursula a collection of silver owned by her mother worth £15,000. No other distributions are made.

In 2018/19, Ursula is treated as having received income of £11,000 gross, subject to deduction of tax of £2,200 (at 20%), which she should therefore record in her self-assessment return. The executors are not paying out income and therefore need not deduct and account for it to HMRC. This is simply a consequence of the statutory rule. However, they should issue form R185 which shows the receipt of income of £8,800 net.

Assuming Ursula is a higher rate taxpayer who pays income tax at the rate of 40%, she may have to pay a further £2,200 (additional 20%) in income tax on transfer of the silver to her.

As and when, say, in 2019/20, the executors distribute income to Ursula, they will need to take into

account, on form R185 (Estate Income), the fact that £11,000 of the estate income has already been

treated for tax purposes as income arising in her hands.

For more information about Trusts and Estates 2019/20:

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