

For financial advisers only

# Trustee investment – a guide to tax on UK collective investments

This guide looks at the tax implications of investing in a UK-authorized unit trust and a UK open-ended investment company.

## What's a UK unit trust/open-ended investment company?

Authorised UK unit trusts and UK open-ended investment companies (OEICs) are collective investment schemes. A manager looks after the funds on the investors' behalf.

## How are the underlying investment funds taxed?

The underlying investment funds aren't liable for further tax on UK dividend income. Other income the funds earn, such as interest on gilts and dividends from foreign shares, is liable for corporation tax at 20%. Changes in the funds' underlying investments won't give rise to capital gains tax charges. However, investors will have to pay this tax if they sell their investments at a profit.

## Do the trustees have to pay capital gains tax under a unit trust/OEIC?

The trustees could be liable for capital gains tax if they:

- sell any units or shares, or
- switch their investments between different funds, for example from a European into an American fund

In most cases, chargeable gains arising from the sale of units or shares will be assessed on the trustees at 18%. The trustees will normally be entitled to a capital gains yearly exempt allowance – but only 50% of the amount available to individuals. If the settlor has created more than one trust, then this allowance is divided equally between the trusts. It won't fall below 10% of the full exemption though. If the units or shares are held in a bare trust then the full yearly exemption – rather than 50% of that amount – applies.

If the settlor or the settlor's husband, wife or civil partner can benefit under the trust then the settlor will have to pay any capital gains tax.

## Do unit trusts/OEICs generate income tax liabilities?

A unit trust/OEIC pays out its income in dividends or interest, with a tax credit of either 10% or 20% respectively. Any further income tax liability depends on the type of trust the units or shares are held in.

## What's a bare trust?

With a bare trust, the beneficiary(ies) have an absolute right to the trust income and capital. Our range of bare trusts includes the gift trust and the loan trust.



## What other income tax liabilities are there under a bare trust?

### The beneficiary

Unless the beneficiary is a higher rate taxpayer they won't have to pay any extra tax on the trust income. A beneficiary who doesn't pay tax can reclaim the 20% tax they had to pay on interest received from the unit trust/OEIC. They can't reclaim the 10% tax credit on the dividend income received from the unit trust/OEIC.

A beneficiary who pays higher rate tax will be liable for an extra 20% if the unit trust/OEIC income carries a 20% tax credit and a further 22.5% if the unit trust/OEIC income carries a 10% tax credit.

### The settlor

The settlor will only have to pay income tax on the income generated within the trust during their lifetime when:

- they or their husband, wife or civil partner can benefit in any way under the trust, or
- the trust is created by a parent on or after 9 March 1999 in favour of their children under 18. For income on funds added to pre-9 March 1999 trusts on or after that date, income is taxed as that of the settlor if the gross income is more than £100 each year

These rules apply whether the dividend is paid out, kept in the trust or reinvested in the unit trust/OEIC. Whether the parent/settlor is liable for any extra tax will depend on their personal circumstances.

## What's a discretionary trust?

With a discretionary trust, the beneficiaries don't have any rights or entitlements to the income or the capital received by the trust. It's up to the trustees whether to build up the income received within the trust or make payments to any one or more of the beneficiaries. Our range of discretionary trusts includes the gift trust, loan trust and discounted gift trust.

## What income tax liabilities are there under a discretionary trust?

### The trustees

Normally the trustees of a discretionary trust pay 40% tax on income, apart from dividend income which is taxed at 32.5%. When working out how much to pay to the Revenue, trustees can take account of the tax credits on income received, at 10% or 20% as appropriate. A special trust tax rate was introduced on 6 April 2006. This applies to the first £1,000 of trust income that would otherwise be charged at the 40% rate applicable to trusts or the dividend rate of 32.5%. The first £1,000 of trust income is taxed at 20% or 10%, depending on whether it's interest or dividend income.

Where the trustees decide to pay out income to a beneficiary, the income is paid net of 40% tax. The trustees can't count dividend tax credits at 10% as tax they've paid when calculating how much of the tax deducted from the beneficiaries' income they have to account for. Trustees might have to pay extra tax to the Revenue when they want to distribute income to beneficiaries.

Trustees will have to choose between:

- paying out a smaller proportion of the yearly income the trust fund receives to beneficiaries, or
- paying out the same proportion of income to beneficiaries but eating into the trust capital to meet the additional tax burden

The trustees of discretionary trusts who intend to invest in assets that give rise to dividends carrying a 10% tax credit should get professional advice about the suitability of such investments. This is because they could face allegations of negligence if they don't consider whether alternative, less heavily taxed assets would be more suitable.

### The beneficiaries

Where the trustees decide to pay out income to a beneficiary, they must forward a tax voucher showing that they've deducted 40% tax.

Any income paid to beneficiaries is net of 40% tax and so they won't have to pay any extra tax. A beneficiary can reclaim any tax over their marginal rate.

### The settlor

The settlor will have to pay income tax on the income generated within the trust during their lifetime when:

- they or their husband, wife or civil partner can benefit in any way under the trust, or
- the income the trustees receive is over £100 and is paid to a beneficiary who is the settlor's unmarried minor child

These rules apply whether the income is paid out, kept in the trust or reinvested into the unit trust/OEIC.

### What's an interest in possession trust?

With an interest in possession trust, one or more persons has a right to the trust income. Following the Finance Act 2006, the IHT treatment of interest in possession trusts created on or after 22 March 2006 became the same as discretionary trusts. Because of this, we decided to stop offering this type of trust. The income tax and capital gains tax treatment hasn't changed.

### What other income tax liabilities are there under an interest in possession trust?

#### The trustees

The trustees aren't liable for any extra income tax. This is because the tax credit of either 10% or 20% covers the basic rate income tax liability for individuals and trustees of interest in possession trusts.

### The beneficiaries

Unless the beneficiary is a higher rate taxpayer they won't have to pay any extra tax on this income. A non-taxpayer can reclaim the 20% tax suffered on interest received by the unit trust/OEIC. They can't reclaim the 10% tax credit suffered on dividend income received by the unit trust/OEIC.

A higher rate tax-paying beneficiary will be liable for an extra 20% if the income of the unit trust/OEIC carries a tax credit of 20%, and an extra 22.5% if the income of the unit trust/OEIC carries a tax credit of 10%.

### The settlor

The settlor will only have to pay income tax on the income generated within the trust during his or her lifetime when:

- they or their husband, wife or civil partner can benefit in any way under the trust, or
- the income received by the trustees is over £100 and is paid to a beneficiary who is the settlor's unmarried minor child

These rules apply whether the dividend is paid out, kept in the trust or reinvested in the unit trust/OEIC.

This information is based on AEGON Scottish Equitable and AEGON Scottish Equitable International's understanding of current taxation law and practice in the United Kingdom, which may change.

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You should read this document together with the appropriate AEGON Scottish Equitable investment bond brochures.