

*These notes refer to the Income Tax Act 2007 (c.3)
which received Royal Assent on 20 March 2007*

INCOME TAX ACT 2007

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 9: Special rules about settlements and trustees

Overview

1335. This Part is about special rules that apply to settlements and trustees.
1336. Most income tax rules apply to persons in general, which includes trustees. This Part contains additional rules specific to trustees. Some of these rules apply generally. Others apply more specifically, to particular types of settlement, to certain types of settlement income or to the treatment of income of beneficiaries.
1337. Except for the special position of unauthorised unit trusts, the provisions in this Part do not apply to bare trusts, ie those where the beneficiary is absolutely entitled to both the income and capital.
1338. The provisions in this Part do not apply to personal representatives. Accordingly, the rates at which their income is taxed (the savings, dividend ordinary or basic rates depending on the income concerned) are the rates provided for in Chapter 2 of Part 2.
1339. Rules specific to charitable trusts are in Part 10.

Chapter 1: Introduction

Overview

1340. This Chapter contains an introduction to the Part and some basic definitions.
1341. There is no attempt to define a settlement or particular types of settlement, although Chapter 2 defines “settled property” and “settlor”.
1342. While it is often useful in practice to categorise a settlement either as an interest in possession settlement (under which the beneficiaries are entitled to the settlement income as it arises) or as an accumulation or discretionary settlement (under which income can be accumulated or paid to beneficiaries at the trustees’ discretion), some settlements are mixed (in that there are both sorts of beneficiary).
1343. The rules in this Part are written so that they apply having regard to the treatment of the income rather than the type of settlement.

Section 462: Overview of Part

1344. This section introduces the Part. It is new.

Section 463: Interpretation of Part

1345. This section provides definitions for the purpose of the Part. It is based on sections 686(6) and 687(4) of ICTA.

Section 464: Scottish trusts

1346. This section concerns beneficiaries of Scottish trusts. It is based on section 118(1) of FA 1993.
1347. For certain income tax purposes, trusts under which the beneficiaries have an equitable right in possession are treated differently to discretionary trusts. Scottish law does not recognise the concept of an equitable right in possession. So this section provides for the law of England and Wales to be applied for the purpose of determining whether beneficiaries under a Scottish trust have an equitable right in possession for income tax purposes.

Chapter 2: General provision about settlements and trustees

Overview

1348. This Chapter provides definitions for income tax purposes that are, as far as possible, aligned with those which apply for the purposes of capital gains tax (see sections 68A to 69 of TCGA). It is based on provisions inserted into ICTA by Schedule 13 to FA 2006.
1349. The definitions in the ICTA provisions apply for the purpose of the Tax Acts and thus extend beyond income tax to provisions of the Corporation Tax Acts. But the extent of their application for the purposes of the Corporation Tax Acts is in fact fairly limited. Accordingly, the ICTA provisions are repealed in favour of a new section 832(2A) in ICTA applying this Chapter for those purposes (see Schedule 1).

Section 465: Overview of Chapter and interpretation

1350. This section introduces the Chapter. *Subsections (1) to (6)* are new. *Subsections (7) and (8)* are based on section 685B(7) and (8) of ICTA.

Section 466: Meaning of “settled property” etc

1351. This section defines “settled property”. It is based on section 685A of ICTA.
1352. The definition corresponds to that in section 68 of TCGA. It also mirrors the effect of section 60 of TCGA in relation to bare trustees and nominees.
1353. In subsection (3), the expression “under a disability” in section 685A(1) of ICTA has been rewritten as “lacking legal capacity”. This does not change the substance.

Section 467: Meaning of “settlor” etc

1354. This section defines “settlor”. It is based on section 685B of ICTA.
1355. The definition corresponds to that in section 68A of TCGA.
1356. The section introduces a new term “disposable property”, defined in section 468.
1357. *Subsection (6)* is concerned with the case where one person makes or enters into a settlement in accordance with reciprocal arrangements with another person.
1358. As *subsection (8)* makes clear, a wider definition of “settlor” applies to the anti-avoidance provisions in Chapter 5 of Part 5 of ITTOIA.

Section 468: Meaning of “disposable property”

1359. This section defines the new term “disposable property”. It is based on section 685B(5) of ICTA.
1360. The definition covers the same ground as section 62(10) of TCGA.

Section 469: Person ceasing to be a settlor

1361. This section explains when a person ceases to be a settlor for income tax purposes. It is based on section 685B(6) of ICTA.

Section 470: Transfers between settlements

1362. This section and section 471 provide rules for identifying the settlor(s) of property in a settlement where property is transferred from one settlement to another for less than full consideration. The rules are the same as those that apply in section 68B of TCGA.
1363. This section explains when a relevant transfer occurs. It is based on section 685C of ICTA.

Section 471: Identification of settlor following transfer covered by section 470

1364. This section identifies the settlor(s) in circumstances where a transfer of property within section 470 takes place. It is based on section 685C of ICTA.

Section 472: Settlor where property becomes settled because of variation of will etc

1365. This section identifies the settlor in certain cases where a will is varied after a person dies. It is based on section 685D of ICTA.
1366. The rules are the same as those that apply in section 68C of TCGA.
1367. *Subsection (2)* applies when property becomes settled property in consequence of the variation, but would not otherwise have become settled property. In that case a person specified in *subsection (3)* is treated as the settlor.
1368. In subsection (3), the expression “under a disability” in section 685D(3) of ICTA has been rewritten as “lacking legal capacity”. This does not change the substance.
1369. In *subsection (4)*, the expression “donatio mortis causa” has been retained, in the absence of any simple English expression that adequately summarises its meaning.

Section 473: Deceased person as settlor where variation of will etc

1370. This section deems the deceased person to be the settlor in certain cases where a will is varied after a person dies or that person dies intestate. It is based on section 685D of ICTA.
1371. The rules are the same as those that apply in section 68C of TCGA.

Section 474: Trustees of settlement to be treated as a single and distinct person

1372. This section provides that the trustees of a settlement are collectively regarded as a single person distinct from the persons who are the trustees from time to time. It is based on section 685E(1) and (8) of ICTA.
1373. The rule is the same rule as in section 69 of TCGA.
1374. This rule is of particular significance in relation to the determination of the trustees’ residence for income tax purposes.

Section 475: Residence of trustees

1375. This section sets out rules for determining whether trustees (treated as a single person under section 474) are resident and ordinarily resident in the United Kingdom. It is based on section 685E(2), (3), (4), (6) and (7) of ICTA.
1376. If all the persons who are trustees are UK resident then the single person is UK resident and ordinarily UK resident. If all those persons are non-UK resident then the single

person is non-UK resident and not ordinarily UK resident. If the trustees have mixed residence then a tie-breaker applies and the residence of the single person is determined by reference to whether there is a settlor who meets condition C (see *subsection (5)(b)* and section 476).

Section 476: How to work out whether settlor meets condition C

- 1377. This section applies for the purposes of working out whether a settlor in relation to the settlement meets condition C. It is based on section 685E(4) and (5) of ICTA.
- 1378. *Subsections (2) and (3)* each provide that a person who is a settlor in relation to a settlement meets condition C if the person was UK resident, ordinarily UK resident or domiciled in the United Kingdom at the time specified in the subsection.
- 1379. Subsection (2) applies if the settlement arose on the death of the settlor and requires the settlor's residence and domicile to be determined immediately before the settlor's death.
- 1380. Subsection (3) applies in all other cases and requires the settlor's residence and domicile to be determined at every time when a settlor makes, or is treated as making, the settlement (see, in particular, section 467(3)).
- 1381. Subsections (2) and (3) also each provide that a person who meets condition C in relation to a settlement at the time specified in the subsection continues to meet condition C at all subsequent times until the person ceases to be a settlor in relation to the settlement.
- 1382. Accordingly, the single person mentioned in section 474(1) will be treated as UK resident and ordinarily UK resident for as long as the settlement has mixed residence trustees and there continues to be a settlor who meets condition C in relation to the settlement.

Section 477: Sub-fund elections under Schedule 4ZA to TCGA 1992

- 1383. This section sets out the income tax position where the trustees of a settlement have made a sub-fund election under Schedule 4ZA to TCGA. It is based on section 685G of ICTA.
- 1384. The broad effect is that each sub-fund is treated as a separate settlement distinct from the principal settlement and with its own deemed single person trustees.

Section 478: References to settled property etc in regulations

- 1385. This section provides rules for interpreting terms in regulations. It is based on paragraph 37(1) of Schedule 13 to FA 2006.

Chapter 3: Special rates for trustees' income

Overview

- 1386. This Chapter provides the main rules about which income is to be charged at either the trust rate or the dividend trust rate.
- 1387. The main category is "accumulated or discretionary income" which, broadly, is income which is income of trustees under trust law and which is not assessable as income of any beneficiary.
- 1388. The Chapter also deals with other specific types of receipt to which one or other of the special trust rates apply.

Section 479: Trustees' accumulated or discretionary income to be charged at special rates

1389. This section applies one of two special trust rates to trustees' accumulated or discretionary income. It is based on section 686(1), (1AA), (2) and (5A) of ICTA.
1390. The special rates apply to the trustees even where the receipt will be taxed as the income of the settlor. The settlor will receive credit for the full amount of tax paid by the trustees.
1391. *Subsection (1)* introduces the term "accumulated or discretionary income" which is defined in section 480. The fact that this section does not apply to charitable trusts is given greater prominence than in the source legislation.
1392. *Subsections (2) to (4)* provide that accumulated or discretionary income is charged at either the dividend trust rate or the trust rate instead of the rates that would otherwise apply to that income.

Section 480: Meaning of "accumulated or discretionary income"

1393. This section defines "accumulated or discretionary income". It is based on section 686(2), (6ZA), (6ZB) and (6A) of ICTA.
1394. "Accumulated or discretionary income" is a single concept rather than the sum of two separate elements.
1395. *Subsection (2)* is based on section 686(2)(a) of ICTA. This provision spells out the nature and extent of the discretion concerned in more detail than in the source legislation.
1396. Income is not included within "accumulated or discretionary income" simply because trustees have discretion over what expenses to incur or how those expenses are to be charged.
1397. *Subsection (3)(a)* excludes from the meaning of "accumulated or discretionary income" any income to which a beneficiary is entitled as it arises. This is the case where a beneficiary has an interest in possession.
1398. *Subsection (3)(b)* and *subsection (4)* exclude income that arises to certain pension funds, provided that the property giving rise to the income is not held as a member of a property investment LLP (see the definition in section 1004).
1399. *Subsection (3)(c)* and *subsections (5) and (6)* exclude income from service charges held on trust by certain bodies.

Section 481: Other amounts to be charged at special rates for trustees

1400. This section applies one of the special trust rates to certain receipts of trustees that are taxed as income. It is based on sections 686 and 686A of ICTA.
1401. The special rates apply to the trustees even where the receipt will be taxed as the income of the settlor. The settlor will receive credit for the full amount of tax paid by the trustees.
1402. *Subsection (1)* sets out the circumstances in which the section applies. The exemption for charitable trusts, which was in section 686A(4)(c) of ICTA before it was amended by FA 2006, has been reinstated. See *Change 85* in Annex 1.
1403. *Subsections (2) to (4)* apply the trust rate or dividend trust rate to the receipt arising to the trustees instead of the rate that would otherwise apply to that income. The only receipt to which the dividend trust rate applies is Type 1 within section 482.

1404. *Subsection (5)(a) and (b)* ensure that receipts are not caught by this section if they are accumulated or discretionary income (and so within section 480) or would be but for the exceptions in section 480(3)(a) or (c). This exemption, which was in section 686A(4)(a) before it was amended by FA 2006, has been reinstated. See *Change 85* in Annex 1.
1405. *Subsection (5)(c) and subsection (6)* correspond to the exception in section 480(4)(a). That exemption, which was in section 686A(4)(d) before it was amended by FA 2006, has been reinstated. See *Change 85* in Annex 1.

Section 482: Types of amount to be charged at special rates for trustees

1406. This section lists the types of receipts arising to trustees that are taxed at one of the special trust rates under section 481. It is based on section 686A(2) of ICTA.
1407. Section 686A(2) did not include amounts taxed on trustees under the accrued income scheme and liable at the trust rate by virtue of section 720(5) of ICTA. As it is intended that all amounts that are always liable at the trust rate are treated in the same way, those amounts are included here as Type 2 income. See *Change 86* in Annex 1.

Section 483: Sums paid by personal representatives to trustees

1408. This section concerns the treatment of sums paid by personal representatives to trustees. It is based on section 686(6) of ICTA.
1409. The section applies if personal representatives have received income or other amounts which would have been liable at the special trust rates had they been trustees, and they pay a sum to trustees representing income. In such a case, the sum is treated as income of the trustees and as having borne tax at the rate referred to in section 663(1) of ITTOIA.
1410. Following its substitution by FA 2006, section 686A of ICTA no longer includes the provision that specifically applied this rule to receipts within section 686A. But the reference in section 686(6) of ICTA to income to which section 686 applies includes receipts deemed to be such income as a result of section 686A. Accordingly, it is made explicit that this rule applies to all receipts within this Chapter.

Chapter 4: Trustees' expenses and special rates for trustees

Overview

1411. This Chapter provides for expenses incurred by trustees to reduce the amount of income chargeable at the special trust rates.
1412. Beyond a few basic rules, it is left to trust law to determine what expenses may be taken into account. Generally, it is only expenses incurred in the course of exercising the trustees' duties and powers and solely in managing the trust assets to produce or maintain an income flow which are allowable.
1413. The label "management expenses" has not been used. It does not carry any weight and omitting it avoids giving the impression that all expenses incurred in the course of managing a trust will necessarily be allowable.

Section 484: Trustees' expenses to be set against trustees' trust rate income

1414. This section concerns the trustees' expenses which are to be taken into account in calculating the extent of the income chargeable at the special trust rates. It is based on sections 686(2AA) and 689B(1) of ICTA.
1415. *Subsection (1)* provides that the section applies where the trustees incur allowable expenses. This is in contrast to the source legislation which requires the expenses to have been defrayed. See *Change 87* in Annex 1.

1416. *Subsection (4)* provides that where allowable expenses are set against income chargeable at the special rates, the income is instead charged at the rate that would normally apply to that type of income.
1417. *Subsection (5)* provides basic rules regarding what constitute allowable expenses.
1418. *Subsection (6)* makes it explicit that expenses are not allowable if they are taken into account (otherwise than under this section) in calculating the trustees' liability for any tax year.

Section 485: Carry forward of unused expenses

1419. This section specifies how expenses are relieved if the amount paid exceeds the income of the year taxable at the special trust rates. It is new.
1420. In essence, if expenses incurred exceed income they are carried forward and allowed as soon as there is sufficient trust rate income. See *Change 87* in Annex 1.

Section 486: How allowable expenses are to be set against trust rate income

1421. This section explains in step terms how allowable expenses are to be set against the trust rate income. It is based on sections 686(2AA) and 689B of ICTA.
1422. The section makes it explicit that it is the grossed up amount of expenses that is set against income charged at the special rates. (The meaning of "grossing up" is given in section 998.) See *Change 88* in Annex 1.
1423. Before the grossing up process, *Step 1* eliminates a proportion of expenses in the case of non-UK resident trustees in receipt of untaxed income (see section 487).
1424. *Steps 2 to 6* require dividend, savings and other income to be considered in turn.
1425. Dividend income not within *subsection (2)* corresponds to foreign income within section 689B(2A) of ICTA.

Section 487: Non-UK resident trustees

1426. This section specifies that a proportion of the allowable expenses of the trustees is ignored if a proportion of their income is not liable to income tax ("untaxed income"). It is based on section 686(2A) and (2B) of ICTA.

Chapter 5: Share incentive plans

Overview

1427. This Chapter is based on sections 686B and 686C of ICTA.
1428. Under a share incentive plan, shares which are not "plan shares" (see paragraph 99(1) of Schedule 2 to ITEPA) are held on accumulation or discretionary trusts. So the trustees' dividend income arising from such shares is potentially chargeable at the dividend trust rate under section 479. But this Chapter provides that such a charge on approved plans does not arise if the shares are awarded to participants in the plan within an "applicable period" (defined in section 489).

Section 488: Application of section 479 to trustees of approved share incentive plans

1429. This section sets out the circumstances in which section 479 applies to approved share incentive plans. It is based on sections 686B(1), (2) and (6) and 686C(3) of ICTA.
1430. *Subsection (1)* gives the basic condition that the section applies to dividends or other distributions received by the trustees of approved share incentive plans.

1431. *Subsections (2) to (4)* provide that the charge at the dividend trust rate under section 479 arises only if and when the shares are disposed of or the “applicable period” comes to an end without the shares having been awarded to participants in accordance with the plan.
1432. *Subsection (5)* provides that, if shares of the same class are acquired by the trustees at different times, they are treated as awarding shares acquired earlier before shares acquired later.
1433. *Subsection (6)* explains that, for the purposes of this section, shares are also treated as awarded when they are acquired on behalf of a participant as dividend shares.

Section 489: “The applicable period” in relation to shares

1434. This section explains the meaning of “the applicable period”. It is based on sections 686B(3) to (5) and 686C(4) and (5) of ICTA.
1435. *Subsections (2) to (4)* state the basic rule that the applicable period ends at the earliest of:
- five years from the acquisition of the shares;
 - two years from the acquisition of the shares if any shares in the company were readily convertible assets at that time; and
 - two years from the date that any shares in the company became readily convertible assets.
1436. *Subsections (5) and (6)* provide that the basic rule is varied in a case where the shares were acquired in consequence of a contribution to the plan by the company for which it is allowed a deduction under paragraph 9 of Schedule 4AA to ICTA. In such a case the applicable period ends ten years after the shares were acquired.

Section 490: Interpretation of Chapter

1437. This section makes provision about the interpretation of the Chapter. It is based on sections 686B(7) and 686C(1) and (2) of ICTA.

Chapter 6: Trustees’ first slice of trust rate income

Overview

1438. This Chapter is based on sections 686D and 686E of ICTA.

Section 491: Special rates not to apply to first slice of trustees’ trust rate income

1439. This section provides for the first £1,000 of any trustees’ income that would otherwise be chargeable at one of the special trust rates to be taxed instead at the rate or rates that normally apply to the income. It is based on section 686D of ICTA.
1440. *Subsections (3) and (4)* set out the steps to be taken in identifying the first slice of income (if it exceeds £1,000) and in determining the rate of tax to apply to income within that slice.
1441. The order is established by reference to the rules regarding ordering of income in section 16. The effect is that, so far as possible, the first slice consists first of income for which the normal rate is the basic rate, then, of income for which the normal rate is the savings rate and finally, of income for which the normal rate is the dividend ordinary rate. The first slice is then taxed at the normal rates appropriate to the types of income of which it consists.

Section 492: Cases where settlor has made more than one settlement

1442. This section reduces the band of income charged at normal rates if a settlor of that settlement has made other settlements. It is based on section 686E of ICTA.
1443. The £1,000 band is divided by the total number of existing settlements made by the settlor, but not so as reduce the band below £200. If there is more than one settlor for the settlement in question then the lowest threshold arrived at by this calculation is used.

Chapter 7: Discretionary payments

Overview

1444. This Chapter concerns the tax treatment of a payment made by trustees to a beneficiary in the exercise of a discretion. It is mainly concerned with the taxation of the trustees, but contains some provisions affecting the beneficiary.
1445. The discretionary payment is treated as a net amount corresponding to a gross amount from which the trustees have deducted income tax at the trust rate.
1446. That gross amount is chargeable to income tax on the beneficiary as an annual payment within Chapter 7 of Part 5 of ITTOIA, and the beneficiary is treated as having paid the income tax deducted. The deduction of income tax at source provisions that normally apply to annual payments are disapplied by section 899(5)(d) and (e) of this Act.
1447. The trustees, who will be charged to tax on the income of the trust at either the dividend trust rate or the trust rate, with the total tax paid going into a “tax pool”, have to account for the tax deemed to have been deducted only to the extent that there is insufficient tax in the tax pool.

Section 493: Discretionary payments by trustees

1448. This section sets out what payments come within this Chapter. It is based on section 687(1) and (5) of ICTA.
1449. *Subsection (1)* provides that an annual payment is within this Chapter if it is made by trustees in the exercise of a discretion (exercised by the trustees or any other person) and provided that condition A or B is met. And it is made explicit that the trustees must be UK resident. See *Change 89* in Annex 1.
1450. Condition A is that the payment is income of the beneficiary for either income tax or corporation tax purposes. “Beneficiary” is used instead of the phrase “person to whom [the payment] is made” in section 687(1)(a) of ICTA. The reference to corporation tax provides a link to section 687A of ICTA.
1451. A discretionary payment from an employment-related settlement may be taxed on a beneficiary as employment income. Such a payment is excluded from this section. But the income arising to the trustees out of which the payment is made is taxable at the special trust rates. In such circumstances there is effectively double taxation and the trustees may be able to claim a payment from HMRC. See ESC A68.
1452. Condition B is that the payment is treated as income of a settlor under section 629 of ITTOIA.

Section 494: Grossing up of discretionary payment and payment of income tax

1453. This section provides for the grossing up of discretionary payments and sets out the treatment of the tax deemed to have been deducted. It is based on section 687(2) of ICTA.

1454. *Subsections (1) and (2)* provide for the amount of the actual payment to the beneficiary to be grossed up by reference to the trust rate for the year in which the discretionary payment is made.
1455. The amount by which a payment is grossed up represents income tax. *Subsections (3) and (4)* provide that the beneficiary or the settlor (in a case where the discretionary payment is treated as income of the settlor), is treated as having paid the tax deemed to have been deducted.

Section 495: Statement about deduction of income tax

1456. This section provides for the recipient of the discretionary payment to be able to obtain a statement from the trustees giving details of the payment and tax treated as deducted. It is based on section 352 of ICTA as it applies to payments under section 687 of ICTA.
1457. In a case where the income is treated as that of the settlor, it is the settlor rather than the recipient who will need these details. Accordingly, this section gives authority to the appropriate person to require a statement from the trustees. See *Change 90* in Annex 1.

Section 496: Income tax charged on trustees

1458. This section sets out the tax effect on the trustees of making a discretionary payment. It is based on section 687(2) of ICTA.
1459. The source legislation provides for all the tax deemed to have been deducted to be assessed on the trustees, subject to set-off under section 687(3) of ICTA (the “tax pool”). But the charge under this section is only on the amount of tax by which the amount treated as deducted exceeds the amount of the tax pool for that year. This is similar to the approach adopted in section 424 (gift aid).

Section 497: Calculation of trustees’ tax pool

1460. This section sets out the calculation of the trustees’ tax pool available for a tax year, in order to determine whether a charge on the trustees arises under section 496. It is based on section 687(3) of ICTA.
1461. To make the comparison in section 496, the amount of the tax pool available for a tax year is the amount at the end of the tax year (including tax going into the pool in that year) before reduction in respect of amounts of tax deemed to have been deducted from payments in the tax year. It follows that the amount of the pool available for the previous year has to be adjusted at *Step 1* for the amount of tax deemed to have been deducted in the previous year in order to arrive at the correct brought forward figure. See also the transitional provision in Part 10 of Schedule 2.
1462. *Subsections (2) and (3)* ensure that tax only goes into the pool if it is tax paid at a time when the trustees were UK resident. This is a corollary to trustees having to account for tax only on discretionary payments made while UK resident, See *Change 89* in Annex 1 and the commentary on section 493. It is also provided that the opening pool is nil if the settlement is established during the year.

Section 498: Types of income tax for the purposes of section 497

1463. This section sets out the types of income the tax on which goes into the tax pool. It is based on section 687(3) and (3A) of ICTA.
1464. The section streamlines many of the references to other provisions made by section 687(3) of ICTA. For example, following the amendments made by ITTOIA, section 687(3)(a2) and (aa) of ICTA are unnecessary because the sections mentioned there are within Chapter 3 of Part 4 of ITTOIA and so are already covered by section 687(3)(a1) of ICTA.

1465. Following its substitution by FA 2006, section 686A of ICTA brings together the charges on items that were previously charged at the trust rate under various separate provisions. This means that there may have been overlap between paragraph (bc) and other paragraphs of section 687(3) of ICTA and uncertainty about the amount of tax to go into the pool. That uncertainty is removed by this section.

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.

Chapter 9: Unauthorised unit trusts

Overview

1481. This Chapter provides rules about unauthorised unit trusts (UUTs).
1482. There are related sections about UUTs in Chapter 13 of Part 15. Those sections provide for the trustees to be treated as making deemed payments representing the gross amount of the income they receive. They also provide for the trustees to be treated as deducting income tax from those payments at the basic rate, and for the collection of that income tax.

Section 504: Treatment of income of unauthorised unit trust

1483. This section sets out the basis of the taxation of the trustees of a UUT. It is based on section 469(1), (2) to (2B) and (9) of ICTA.
1484. The taxable income of the trustees of a UUT is treated as that of the trustees rather than the unit holders (*subsection (2)*).
1485. All income of the trustees is to be charged at the basic rate (*subsection (3)*). The special trust rates do not apply (see *subsection (4)(a)* and section 481(1)(b)).
1486. Accordingly, certain sums that would ordinarily be treated as carrying a tax credit, or where the recipient is treated as having paid income tax, are not so treated if received by UUT trustees (*subsection (4)(b) to (d)*).
1487. *Subsection (5)* provides that annual payments to unit holders do not come within the special discretionary payments regime in section 494. The general provision for trustees to provide statements of tax deducted, in section 352 of ICTA, is rewritten in section 495. But the provisions concerning such statements by UUT trustees are in section 975 in Chapter 19 of Part 15, where they more naturally belong. So section 495 is also excluded by subsection (5).

Section 505: Relief for trustees of unauthorised unit trust

1488. This section gives relief to the trustees of a UUT for the payments to unit holders treated as made under Chapter 13 of Part 15. It is based on sections 348(1) and 835(6) of ICTA.
1489. The relief is given by deduction in calculating net income. This is in line with the approach adopted generally to rewriting the provisions about charges on income. See *Change 81* in Annex 1 and the overview commentary on Chapter 4 of Part 8.

1490. The relief is limited by reference to two factors:

- the case law enacted in section 450 (see the commentary on that section and *Change 82* in Annex 1); and
- the trustees' modified net income for the tax year.

Section 506: Special rules for trustees affected by section 733 of ICTA

1491. This section is based on section 733(2) of ICTA.

1492. Sections 731 to 735 of ICTA are anti-avoidance provisions. They are concerned with cases where:

- a person ("the first buyer") buys securities and subsequently sells them to someone else; and
- the first buyer becomes entitled to receive any interest payable on them.

1493. Section 733(2) of ICTA addresses the case where:

- interest is payable to the UUT trustees as the first buyer;
- that interest, or some part of it, would be exempt, but is not so, because section 733(1) of ICTA cancels the exemption; and
- the trustees of the UUT are treated as making one or more deemed payments in the same tax year as that in which the interest arises.

1494. The source legislation provides that an annual payment is to be treated as "paid out of profits or gains not brought into charge". It follows that, even though the exemption is cancelled by section 733(1) of ICTA, leaving interest in charge to income tax, the payment must not be treated as paid out of that interest.

1495. This is rewritten so that relief is only given if, and to the extent that, the trustees have "non-affected income" equal to the payment treated as made. Non-affected income is defined as modified net income less affected income. On modified net income, see the commentary on sections 448 and 1025.

1496. Because this is a rule relating to a very specific type of income, it is necessary to apply it before applying section 505(7).

Chapter 10: Heritage maintenance settlements

Overview

1497. A heritage maintenance settlement (an HMS) is a settlement that holds property ("heritage maintenance property") solely for the maintenance of, or for making provision of public access to, "qualifying property" designated under section 31 of IHTA. And the heritage maintenance property itself must be the subject of a direction under paragraph 1 of Schedule 4 to that Act.

1498. The provisions of this Chapter grant income tax benefits to complement inheritance tax benefits granted under IHTA provisions. So many of the definitions in section 507 cross-refer to IHTA provisions.

1499. "Qualifying property" is defined in paragraph 3(2) of Schedule 4 to IHTA, and includes:

- land of outstanding scenic, historic or scientific interest;
- buildings of such outstanding historical or architectural interest that special steps should be taken to preserve them, and land essential to protect the character and amenities of such buildings; and

- objects historically associated with such buildings.
1500. An HMS does not usually own the qualifying property itself. Its role is to hold the heritage maintenance property that has been settled for the purpose of maintaining the qualifying property and providing access to it. The IHTA rules specify that the heritage maintenance property must be subject to the terms of the trust for at least six years from the time it goes into the trust.
1501. An HMS may also have subsidiary purposes, such as the maintenance of property held under the trust for maintenance of the qualifying property. During the six-year period the trust must provide that any other application or devolution of income or capital outside these main and subsidiary purposes must be for the benefit of a charity with heritage purposes or a body listed in Schedule 3 to IHTA.
1502. In the absence of the rules in this Chapter, the ordinary income tax rules would apply for charging the settlors of certain settlements under Chapter 5 of Part 5 of ITTOIA. In such cases all income, and certain capital sums paid to the settlor, are charged on the settlor as income. (The nature of an HMS means that any settlor of any HMS will fall within both the definition of settlor in section 467 of this Act and the definition in section 620 of ITTOIA.)
1503. By contrast, sections 508 and 509 make it possible for the trustees of an HMS to elect, for a tax year, that:
- the income not be treated as that of the settlor; and
 - any sum applied out of the heritage maintenance property not be treated as the income of an owner or occupier of the qualifying property.
1504. But the trustees may not consider it appropriate to make such an election. In such cases section 510 ensures that, if in a tax year any sum applied for a property maintenance purpose is greater than the trustees' income for that year, the settlor is not charged to tax on the excess.
1505. And, in the absence of an election, section 511 protects the settlor from double taxation if the trustees' income is applied for a property maintenance purpose through a trade carried on by the settlor and would therefore ordinarily be a receipt of that trade. The settlor is only charged under Chapter 5 of Part 5 of ITTOIA, not also on the trading receipt.
1506. The Chapter also charges the trustees to tax in cases where the conditions for property to be qualifying property, or the rules concerning the purposes of the HMS, are breached (sections 512 to 517).

Section 507: Overview of Chapter

1507. This section draws together a number of important definitions. It is based on sections 690, 691(1), 692(1), 693 and 694(1) of ICTA.
1508. "Heritage maintenance property" is defined as property to which a direction (a "heritage direction") under paragraph 1 of Schedule 4 to IHTA has effect. The property here is not the qualifying property mentioned in paragraph 3(2) of Schedule 3 to IHTA, but the property in the trust set up for the maintenance of that qualifying property.
1509. A "heritage maintenance settlement" is defined as a settlement that comprises heritage maintenance property.
1510. If there is in the settlement some property that is heritage maintenance property and some that is not, the two blocks of property are treated for the purposes of this Chapter, and for three other purposes, as being comprised in separate settlements – the "separate settlements rule".

- 1511. The first of those purposes relates to certain trade losses under Chapter 2 of Part 4. The source legislation refers only to sections 380 to 387 of ICTA, thus excluding sections 388 and 389 of that Act (terminal loss relief) from the operation of the rule.
- 1512. The second purpose of the separate settlements rule relates to sections 686 to 689B of ICTA, now rewritten in Chapters 2 to 8 of this Part.
- 1513. The third purpose of the separate settlements rule concerns amounts assessed on the settlor of a settlement under Chapter 5 of Part 5 of ITTOIA. The right to make an election under section 508 can therefore only apply to that part of the settlement that comprises heritage maintenance property. And the special rules about capital sums paid to the settlor (see section 633 of ITTOIA) will also apply only to that part.

Section 508: Election by trustees

- 1514. This section provides that the trustees of an HMS may make an election for this section to have effect for a tax year. It is based on section 691(1), (2) and (4) of ICTA.
- 1515. The first effect of an election is that income of the HMS is not to be treated as income of the settlor, as it otherwise would be under Chapter 5 of Part 5 of ITTOIA. So such income will be taxed on the trustees and at trust rates.
- 1516. The second effect is that certain sums applied from the trust are not to be treated as income of the recipients.
- 1517. *Subsection (4)(a)* is concerned with any person who has an interest in, or occupies, the qualifying property in respect of which the sum is applied. One example is a sum applied in repairing qualifying property when the occupier is an employee not wholly exempted from the benefit of such expenditure by section 315 of ITEPA. Another example is a sum applied in reimbursing an expense of an owner or occupier (other than the settlor, see section 511) who is carrying on a trade in respect of the qualifying property.
- 1518. *Subsection (4)(b)* is concerned with section 633 of ITTOIA. Under that provision a capital sum paid to the settlor is taxable on the settlor as income. But if the sum is applied for a property maintenance purpose, the effect of the election is that the sum does not form part of the settlor's income.
- 1519. The election is to be made to an officer of Revenue and Customs, rather than to the Commissioners for Her Majesty's Revenue and Customs. See *Change 5* in Annex 1.
- 1520. Accordingly, parts of section 691(4) of ICTA are no longer necessary and are omitted. The election is one to which Schedule 1A to TMA applies, as it is not made on the trustees' self-assessment tax return. So paragraph 2(1) of that Schedule is sufficient to ensure that the election is to be made to an officer of Revenue and Customs. And paragraph 2(3) of that Schedule is sufficient to ensure that it "shall be in such form as the Commissioners may require".

Section 509: Change of circumstances during a tax year

- 1521. This section provides for the splitting of a tax year if there is a change of circumstances, eg if a heritage direction takes effect, or ceases to have effect, during the year. It is based on section 691(5) of ICTA.
- 1522. Without this provision, if a heritage direction were not in force for the full tax year, no election could be made for that year. The effect of the section is to treat each of the parts of the tax year (before and after the change of circumstances) as a separate tax year, in respect of which an election may be made.
- 1523. For this section to apply it must be the case, in one of the two parts of the tax year, that a heritage direction applies and the HMS income is taxable on the settlor under Chapter 5 of Part 5 of ITTOIA. In the other part of the tax year, either or both of these statements will not be true.

Section 510: Sums applied for property maintenance purposes

1524. This section addresses a particular issue where an election under section 508 has not been made, and so the income for the year is taxable on the settlor. It is based on section 691(3) of ICTA.
1525. The issue is the treatment of any sum applied for a property maintenance purpose that exceeds the income for the year. Such a sum may already have been taxed on the trustees or the settlor in past years, but it may also be subject to a charge to income tax for one or other of the reasons referred to in *subsection (2)*.
1526. This section cancels such a charge to tax on the excess. The result is that all the income of the HMS for the year is taxable on the settlor solely under Chapter 5 of Part 5 of ITTOIA. There is no other charge on any sum in excess of that income to the extent that the excess is applied for a property maintenance purpose.

Section 511: Prevention of double taxation: reimbursement of settlor

1527. This section prevents a double charge to income tax that may arise if the settlor is carrying on a trade. It is based on section 692 of ICTA.
1528. The source legislation (section 692(1) of ICTA) refers to expenditure that “is (or would apart from the reimbursement be) deductible in computing ... profits”. The bracketed words have been omitted from *subsection (1)(c)* because the amount reimbursed is, strictly, income of the business that is ignored in computing profits. It does not cancel the real expenditure, which in principle remains allowable.

Section 512: Charge to tax on some settlements

1529. This section makes provision for a charge to income tax on income arising to the trustees in a number of circumstances. It is based on section 694(1) and (5) of ICTA.
1530. Most of the circumstances involved (cases A to C) involve a breach of the main IHTA conditions.
1531. But no charge will arise under this section if the settlor has already been charged on the income as trust income: see section 517. This charge can, therefore, only arise if an election under section 508 has been made.
1532. Case D is an anti-avoidance provision to guard against loss of tax if a non-heritage beneficiary with a reversionary interest in property comprised in the HMS sells that interest to another heritage body (H1).
1533. The charge under this Chapter would not ordinarily arise when the property leaves the HMS on reversion, because the recipient is a heritage body or a charity. But the non-heritage person would have effectively obtained money from the heritage property.
1534. So it is provided that if, earlier or at the time, H1 (or any other heritage body) has paid monetary consideration for any interest under the settlement, a charge on the trustees will arise. But if H1 has acquired the interest from another heritage body, there is no charge.

Section 513: Income charged

1535. This section sets out the measure of the income to be charged to tax under section 512. It is based on section 694(2) and (4) of ICTA.
1536. Other than income applied for a property maintenance purpose or for the benefit of a heritage body, the charge is on all the income that has arisen from the time the HMS came into being to the occasion of charge. But if there has been a previous charge to tax under section 512, the period over which income is measured starts from the date

of that previous occasion of charge. There is no credit for any other tax charge on any part of the income that has arisen over the relevant period.

Section 514: Persons liable

1537. This section provides that the persons liable for the tax under section 512 are the trustees of the HMS. It is based on section 694(4) of ICTA.

Section 515: Rate of tax

1538. This section sets out the rate at which the income charged under section 512 is to be taxed. It is based on section 694(2A) of ICTA.
1539. That rate of tax is arrived at by subtracting the trust rate from the higher rate of income tax. This applies to income of all types, including dividend income.
1540. In the particular case of dividend income, the provision does not seek to reinstate the effect of charging the settlor instead of the trustee. (Dividend income would generally be charged on an individual at the dividend upper rate, and on the trustees of the HMS at the dividend trust rate. But the difference between these rates is not necessarily the same as that between the rates referred to by this section.)
1541. From the tax year 2004-05 onwards, the trust rate has been aligned with the higher rate. So, at present, there can be no charge under section 512. But the situation could change in the future.

Section 516: Transfer of property between settlements

1542. This section addresses occasions when heritage maintenance property leaves the HMS and becomes comprised in another settlement either:
- without a charge to inheritance tax arising on the transfer; or
 - when the property does not cease to be heritage property on the transfer.
- It is based on section 694(6) and (7) of ICTA.
1543. The “default rule” is that inheritance tax is charged when property leaves an HMS (paragraph 8 of Schedule 4 to IHTA).
1544. But no such charge arises if, within 30 days of the property leaving the HMS, it becomes comprised in another HMS. This is because the exemption for transfers into an HMS overrules the charge when the property leaves an HMS (paragraph 9(1) and (2) of Schedule 4 to IHTA). The only exception to this is when the value of the property leaving the first HMS is greater than its value on entering the second. In that case, inheritance tax is charged on the excess (paragraph 9(4) of Schedule 4 to IHTA). But that charge is ignored in considering the effect of this section (see the words in brackets in *subsection (4)(a)*).
1545. In some circumstances, a charge to income tax under section 512 could still arise, there being, for example, no 30-day permitted period in Case B set out in section 512 to match the “permitted period” in the inheritance tax provision.
1546. *Subsection (2)* ensures that no charge to income tax arises at the time of the transfer of the property if the transfer is also exempt for inheritance tax purposes, or if the property transferred remains heritage property throughout. Instead, the amount chargeable to income tax is deferred and added to any income taxable on the trustees of the later HMS if an occasion of charge occurs.
1547. Accordingly, *subsection (3)* determines the period over which the income to be charged is measured, applying the following modifications to the provisions in section 513:

*These notes refer to the Income Tax Act 2007 (c.3)
which received Royal Assent on 20 March 2007*

- the date of the last occasion of charge of the earlier HMS (see section 513(2)(a)) is attributed to the later HMS; and
- the date on which the earlier HMS took effect (see section 513(2)(b)) is likewise attributed to the later one.

1548. The result is that any income of any earlier HMS (however many tax-free transfers have occurred) will be charged on the chargeable settlement to the extent that it has not been subject to this charge already.

Section 517: Exemption for income treated as income of settlor

1549. This section excludes from the charge to income tax under section 512 income of the trustees that is treated as income of the settlor. It is based on section 694(3) of ICTA.