Only very few *interest in possession trusts* are taxed at special rates. However, in some cases special rates may apply, for instance when a company buys back own shares from the trustees or where the trust involves *vulnerable beneficiaries* (these are beneficiaries that need special protection).

10.4. Discretionary Trust

The trustee has more discretionary power as to the use of income generated by the trust assets. Even if he has received instructions on who the beneficiaries should be, he can decide on the amount to be paid, which beneficiaries or groups of beneficiaries are to receive the payment, how often, and on the terms of the payments.

It is in his discretion to distribute or retain income realised. If the trust income is not distributed to the beneficiaries, it becomes part of the trust assets.

Taxation

The trustees are subject to taxation at special rates for the income earned. Dividends and similar other income are to be taxed at the dividend trust rate (32.5% since 2004-2005), and further income is to be taxed at the rate applicable to trusts (40% since 2004-2005). Since 2005-2006, the first GBP 500 of the trust income are, depending on the nature of the income, either subject to a basic rate of currently 22%, a reduced rate of 20%, or the normal dividend rate of 10%. (Before 2005-2006, this amount was subject to a special rate.)

The income received by the beneficiaries has already been subject to a 40% deduction which is the rate currently valid for trusts. The payments are thus treated as if they were made after deduction of tax. If, however, the beneficiaries are base-rate taxpayers or are not tax-liable at all, they may have the tax refunded. If they are subject to a higher tax rate than the 40% applied, no further tax will be due.

If the trustee is authorised to retain income, he can transform the income into capital. If this capital is then paid out in later years, it is no longer considered a distribution of income, but capital paid out, which is not subject to taxation.

Since 2004/2005, particular regulations apply to beneficiaries deserving special protection; these are persons who are mentally or physically disabled or persons who are under the age of 18.

10.5. Accumulation and Maintenance Trust

The beneficiaries have a claim to the assets (or at least to the income from the assets) only after they have reached a certain age (age of 25 at the latest). In the meantime, the trustees may either use the income to maintain the beneficiary or retain the income generated in the trust.

Taxation

During the period in which the income is retained in the trust (accumulation period), both the trustee and the beneficiaries are subject to taxation (as in the case of a *discretionary trust*).

If the oldest beneficiary is over a certain age – usually 25 – and the accumulation period is not over yet, the trust is treated like a *mixed trust* for tax purposes.

When the accumulation phase has ended, the applicable tax rules depend on what is going to happen with the trust. If the trust is to be dissolved and the trust assets are to be transferred to the beneficiaries, the trustees may have to pay *capital gains tax* on the profits earned as of that date.

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10.6. Tax Pool

The managers or trustees of *discretionary trusts* or *accumulation and maintenance trusts* must make sure that the taxes have been paid before they distribute income to the beneficiaries.
The tax pool is composed of taxes that have been paid by the trustee at the rate required (trust or dividend-trust rate) and of taxes paid at the standard rate applicable to the first GBP 500 of income. The tax credits, such as for dividends, are not included in the tax pool. When the trustees distribute income to the beneficiaries, the tax pool is reduced by the amount of the tax credit on this portion of income.

If the taxes in the pool do not completely cover the tax credit for the beneficiaries, the trustee must come up with the remainder himself.

10.7. Mixed Trust

Most trust forms may also be combined, such as, for example, an *interest in possession trust* with a *discretionary trust* or an *accumulation and maintenance trust*. These trusts are then called *mixed trusts*.