Analysis

Inheritance tax problems in Finance Bill 2020

Speed read

The rules on excluded property trusts are due to change with effect from royal assent. These changes are complex, and the new rules can have an unexpected and retroactive effect where a settlor has added to an excluded property settlement after becoming deemed domiciled, or transfers of property have been made between trusts (without any settlor consent or involvement) after the settlor became deemed domiciled. Trustees should check what transfers and additions have been made in the past and the status of the settlor at each transfer or addition. It may be necessary to exclude the settlor going forward as a beneficiary, ideally before royal assent.

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The Finance Bill 2020 contains relatively few inheritance tax changes. However, clauses 72 and 73 introduce some important amendments to the excluded property provisions governing settlements and, in particular, to IHTA 1984 s 48(3) and ss 80–82.

Background

Generally, non-UK assets held in a trust established by a foreign domiciled settlor qualify as excluded property. Excluded property is not ignored for all IHT purposes, but importantly it is not subject to the relevant property regime nor charged under the reservation of benefit rules. Nor is the foreign domiciled settlor liable to an entry charge when settling such property into trust. The foreign settled property remains free of inheritance tax charges even if the settlor later becomes domiciled or deemed domiciled in the UK (IHTA 1984 s 48(3)).

When determining whether the trust holds non-UK assets, one looks at the situs of the property held by the trustees directly, not the property held in underlying holding companies. This means it is relatively easy to 'resite' UK property such as shares and art by holding it in trust in a foreign incorporated holding company. This process is sometimes called 'enveloping'.

It is no longer possible to envelope UK residential property; such 'Sch A1' property is no longer excluded property. Furthermore, if the settlor was foreign domiciled when he settled the trust but had a UK domicile of origin, was born here and later becomes UK resident, the trust can lose its excluded property status going forward while the settlor remains UK resident. These exceptions are not discussed further here.

Note that the domicile of any beneficiary, even the life tenant, is generally irrelevant for IHT purposes, as is the residence of the trustees. The only thing that matters is the domicile of the settlor at the time the 'settlement was made'.

Example 1: Mr X is foreign domiciled and on his death leaves foreign assets into an interest in possession trust for his wife, Mrs X. Mrs X dies domiciled in the UK. The settled property is still free of inheritance tax on her death, provided the settled property at that time is foreign situated (and is not Sch A1 property).

Example 2: Conversely, assume that Mr and Mrs X are deemed domiciled. On Mr X's death, he leaves his estate to his spouse, Mrs X, on a qualifying interest in possession trust. There is no tax on his death because the transfer qualifies for spouse exemption. However, Mrs X dies many years later having lost her deemed domicile because she returned to her country of origin. Although she is foreign domiciled at the date of death, IHT arises on her death. The one exception would be if Mrs X died non-UK resident and at that time the trust held certain qualifying UK government gilts, but that would not depend on her domicile.

The problems

A longstanding argument with HMRC relates to:

- additions to trusts where the trust was made when the settlor was foreign domiciled but the addition is made when the settlor is UK domiciled; and
- transfers between trusts which were made after the settlor has become actually UK domiciled or deemed domiciled.

Additions to trusts

Section 48(3) simply tests the settlor's domicile at the time the settlement is made. Read literally, this means that property added by the settlor to a settlement made when he was foreign domiciled will always be excluded property irrespective of his domicile. HMRC's view was that, in relation to any particular asset, 'a settlement was made' when that asset was transferred to the trustees to be held on the declared trusts. HMRC's *Inheritance Tax Manual* (at IHTM27220) notes:

> '[T]he legislation refers to the settlor's domicile at the time the settlement was made. You must proceed on the basis that, for any given item of property held in a settlement, the settlement was made when that property was put in the settlement… S, when domiciled abroad, creates a settlement of Spanish realty. Later he acquires a UK domicile and then adds some Australian property to the settlement. The Spanish property is excluded property because of S's overseas domicile when he settled that property. However, the Australian property is not excluded property as S had a UK domicile when he added that property to the settlement.'

In effect, HMRC considered that every addition to an existing settlement constituted the making of a new settlement in relation to that property. The example above makes it clear that adding property to an existing settlement which is excluded did not, in HMRC's view, jeopardise the exemption from inheritance tax for the original property, provided that it was kept segregated. It merely meant that the new property did not qualify for protection.

In *Revenue Interpretation RI 166*, HMRC said: 'If assets added at different times have become mixed, any dealings with the settled fund after the addition may also need to be considered.'

Most commentators doubted that this view was correct. It is true that property becomes comprised in the settlement at the time when it is added, but this is different from saying that a new settlement is 'made' when the settlor adds the property. As a matter of trust law, there are not two separate settlements and there is no deeming provision in the IHT legislation to treat additions as separate settlements.

HMRC justified its view on the basis of the definitions of settled property and settlement in IHTA 1984 s 43. It considered that each gift to a settlement was a disposition and that each disposition represented a new and separate settlement. However, this view did not easily fit with the wording either in s 43(2), which itself defined settlement as meaning any disposition or dispositions of property; or in s 44(2), which provides for separate settlements where two settlors add property to the same settlement. Such a section would be largely unnecessary if every disposition of property was treated as a separate trust. The case of *Rysaffe Trustee Co v IRC* [2003] STC 536 was also unhelpful for HMRC.

Transfers between trusts

Example 3: Assume that trustees of trust 1 transfer property from trust 1 (made when the Mr X was foreign domiciled) to a new trust 2 (made when Mr X was UK domiciled). Does the requirement that the settlor is not domiciled at the time 'the settlement was made' focus on the settlor's domicile at the time trust 1 is created or on the domicile of the settlor when trust 2 is created?

In these circumstances, not only s 48(3) but also ss 81 and 82 are in point. Section 81 provides that when property passes from one settlement to another, it is treated for the purposes of the relevant property regime as remaining comprised in the first settlement. Section 82 provides that the property transferred to trust 2 is not thereafter excluded property for the purposes of the relevant property regime unless the settlor of trust 2 was neither domiciled nor deemed domiciled in the UK when trust 2 was made. In this example, trust 2 would not hold excluded property even under the old rules. The transfer to trust 2 has lost that favoured treatment.

Example 4: More complicated scenarios often arise. For example, the trustees may transfer property from Trust 1 to Trust 2. Both trusts might have been made when the settlor was foreign domiciled but the transfer actually takes place when he is UK domiciled. In these circumstances, is the property transferred excluded property? HMRC accepted that where both trusts were settled when the settlor was foreign domiciled and the transfer was made by the trustees when the settlor was deemed domiciled, it nevertheless remains excluded property for all purposes.

The *Barclays Wealth* case

These points were considered in *Barclays Wealth v HMRC* [2015] EWHC 2878 (Ch) and [2017] EWCA Civ 1512. The facts were as follows. In 2001, Michael Dreelan settled property, including company shares, into a trust when he was not deemed domiciled in the UK. In 2008, when deemed domiciled here, the shares were appointed to a new trust that he had set up after he was deemed domiciled here (effectively example 3 above). The shares or sale proceeds were deemed to remain in the 2001 trust for the purpose of the relevant property regime by virtue of s 81 (and so the ten year anniversary of Trust 1 operated) but were not excluded property, as that would have required the second trust to have been made by a non-domiciled settlor.

Subsequently just before the ten-year anniversary of the first trust in 2011, the cash was appointed back from the second trust to the first trust. The question was whether the cash had become excluded property. HMRC argued that the cash had lost its status as excluded property once appointed to the second settlement, as this transfer was made when Dreelan was UK domiciled and was therefore caught by s 82; and that the cash could not regain excluded property status when appointed back to the first trust. The taxpayer argued that since the first settlement was 'made' when he was not domiciled in the UK, subsequent additions of property, including appointments back of the original cash, were irrelevant; and the cash could thereby reacquire its excluded property status. In a sense then, the case raised both problems outlined above.

> HMRC intended to legislate to reverse the effect of *Barclays Wealth*. The draft legislation was published on 11 July 2019 and has been slightly modified in the republication in Finance Bill 2020. It is not easy to follow

The High Court found in favour of HMRC and determined that the word 'settlement' is capable of describing both the making of the original settlement and the subsequent addition of property to that settlement. It is not merely referring to the 'trust structure'. The result of this was that if, at the time of any subsequent addition to an existing settlement, the settlor was domiciled in the UK, the property added is not 'excluded property', despite the settlor being non-domiciled at the time the settlement was set up.

However, the judgment was reversed by the Court of Appeal at [2017] EWCA Civ 1512. The taxpayer argued that:

- the property was comprised only in Trust 1 (the 2001 Settlement) made in 2001 when Mr Dreelan was non-UK domiciled; and
- the appointment back to Trust 1 could not be regarded as a disposition of property within the definition of 'settlement' because the appointed property was already deemed by s 81 to be comprised in Trust 1 when the appointment was executed. If the property already formed part of Trust 1 by virtue of s 81, it could not simultaneously be the subject of a disposition settling it on the trusts of Trust 1.

HMRC argued that a new trust had been made when the trustees of trust 2 transferred the sale proceeds back to trust 1 in 2011; i.e. a separate settlement is created for inheritance tax purposes whenever a settlor (or trustee) adds property to an existing trust. As Mr Dreelan was then deemed domiciled in the UK, HMRC's view was that the sale proceeds were not excluded property and were therefore subject to the anniversary charge.

The leading Court of Appeal judgment was given by Henderson LJ. First, he held that once the 2011 appointment moving the cash back from trust 2 to trust 1 had been made, the deeming effect of s 81 was spent and it was no longer property to which s 81 applied for the purposes of s 82. There was no need to deem the cash derived from the sale of the shares to be comprised in trust 1 since that was now the reality. Hence, the issue of whether the cash was then excluded property depended on s 48(3), and particularly on the answer to the question of when the settlement was made [para 45].

Here, Henderson LJ held that it was implausible to suppose that in s 48(3) the same word 'settlement' was intended by Parliament to have two different meanings. A settlement is a single settlement, as it is constituted from time to time even if a number of transfers are made into the settlement. The settlement is made when the settlor first executes the trust document and provides the initial trust property and it is at that point only that his domicile is tested. As the cash was deemed to have remained throughout in Trust 1, it could not be treated as the subject of a separate disposition into Trust 1 at the same time. There was nothing surprising in the conclusion that the cash was excluded property.

Example 5: Christina is foreign domiciled when she sets up and funds trust 1 with foreign cash. Some years later when deemed domiciled here, she adds £1m to the trust. This is an immediately chargeable transfer and 20% inheritance tax is due. However, going forward the £1m may be excluded property and not subject to exit and ten year anniversary charges, although this point was left open by the Court of Appeal.

The proposed legislation

HMRC quickly announced that it intended to legislate to reverse the effect of *Barclays Wealth.* The draft legislation was published on 11 July 2019 and has been slightly modified in the republication in Finance Bill 2020. It is not easy to follow. The proposed revisions are as follows:

1. Additions

Where property is added to an existing settlement, the domicile of the settlor will be considered for the purposes of the excluded property rules at the time of the addition, rather than at the time the settlement was first created. Even if property was added to an excluded property trust before Finance Act 2020 comes into effect, it will not be protected from future inheritance tax charges arising after that date (including on the settlor's death) if the settlor was domiciled in the UK at the date of addition.

The proposed draft legislation at clause 72 amends s 48 so that instead of referring to when a settlement is made, it tests the settlor's domicile by reference to when property 'becomes comprised' in an existing settlement. Loss of excluded property status only affects the added property, not the property originally settled when the settlor was foreign domiciled. However, the change raises some serious issues if the settlor remains a beneficiary at the date of his death, as the added property is no longer excluded property.

Example 6: Sharma set up a discretionary trust when foreign domiciled in 2009, settling £10m into it. In 2015, when deemed domiciled for IHT purposes, Sharma added some business property to it (thus avoiding an entry charge). In 2019, there is no ten year charge as all the property is excluded; additions are not counted. Post-2020 (in 2029), there will be a ten year anniversary charge on the value of the business property (subject to the availability of any BPR), as this will no longer be treated as excluded property for the purpose of the relevant property regime. In addition, there is a potential reservation of benefit on Sharma's death in relation to the addition if Sharma can still benefit from the settled property as it is no longer excluded property.

2. Transfers between trusts

Clause 73 provides that where property is transferred from one trust to another or from trust 2 back to trust 1 after FA 2020 is enacted, the settlor must be foreign domiciled at the time of each transfer, not just when each settlement was first made for the settled property to remain excluded property. If the settlor has died deemed or actually domiciled and the transfer takes place later (not on his death) then that transfer will not lose excluded property status. Hence, on that basis, in both examples 3 and 4 the settled property in trust 2 will no longer be excluded property.

It is hard to know why HMRC would object to example 4 as no new property has come into the excluded property regime at a time when the settlor is UK domiciled. Of course, since April 2017 transfers between settlements can no longer be made anyway if a settlor is deemed domiciled and UK resident, as the recipient trust would lose protected trust status for income tax and CGT purposes by being tainted.

If the settlor has died deemed or actually domiciled but the transfer to trust 2 takes place sometime after his death, then that transfer will not lose excluded property status if trust 1 was an excluded property settlement. However, until then trustees have very little flexibility after a settlor has become domiciled or deemed domiciled to make transfers between trusts.

More worryingly, problems now arise if trust 1 and trust 2 were set up when the settlor was foreign domiciled but he was deemed domiciled at the time the transfer was made and the transfer was done many years ago before FA 2020 was enacted. In that event, the assets transferred will not be subject to relevant property charges, but if the settlor is a beneficiary of the transferee trust the assets transferred will be included in his estate on death meaning the excluded property rules no longer trump the reservation of benefit rules after Finance Act 2020.

Example 7: Kingsley set up two trusts when he was foreign domiciled with £1m in each. In 2016, when he was deemed domiciled for IHT purposes, the trustees transferred all the property from trust 1 to trust 2 and ended trust 1. Trust 2 now holds all the property.

There are no relevant property charges going forward if no UK situated property is held by the trustees at that time, as the transfer was done prior to FA 2020 and both trusts were actually funded when the settlor was foreign domiciled. The property in trust 2 remains excluded property for the purposes of the relevant property regime and no ten year charges should arise.

However, the addition to trust 2 is *no longer* excluded property for reservation of benefit purposes, as property has become comprised in a trust at a time when Kingsley was deemed domiciled. Section 48(3) no longer protects the property in trust 2. If Kingsley is a beneficiary of trust 2, then there is IHT payable on his death at 40%. Kingsley should be excluded – ideally before FA 2020 receives royal assent to prevent a seven year run off. Otherwise, he is deemed to make a PET under FA 1986 s 102(4).

Accumulations of income

There has been a welcome change to the provisions on accumulated income since the 2019 draft. On the basis that accumulated income 'becomes comprised' in the settlement when it is accumulated, a change in the domicile status of the settlor from non-UK domiciled to UK domiciled between the date of the settlement and the date when income is accumulated would result in such accumulations becoming relevant property comprised in the settlement at the time when the settlor was UK domiciled, even though arising out of excluded property. A new clause 72(2)(d) has been inserted, to become new IHTA 1984 s 48(3F), which 'provides that accumulations of income are treated as having become comprised at the same time as the property (producing that income) became comprised in the settlement'. See also new IHTA 1984 ss 64(1BA) and 65(8BA). In effect, the legislation ensures that accumulations of income from property that was originally settled when the settlor was foreign domiciled remain excluded property.

> Trustees will now need to look carefully at all inter trust transfers and additions and the status of the settlor at the date of each transfer

Conclusions

As STEP commented in its recent submissions on these clauses: 'Sections 80-82 are already complex and difficult to understand… [T]he proposed new legislation only adds to those uncertainties.' The legislation on additions can be justified on the basis that this simply represents what HMRC always considered to be the case. Practitioners who ignored this advice did so knowingly. Transfers made between trusts where they were both funded when the settlor was foreign domiciled generally had no tax avoidance purpose and often fall within the facts of example 4 above, which HMRC previously confirmed gave rise to no IHT problems. It is particularly worrying, however, that such transfers could now end up losing excluded property status going forward for the purposes of the reservation of benefit rules. Such transfers will no longer qualify as excluded property for the purposes of the reservation of benefit rules, as in effect property has been 'added' when the settlor was deemed domiciled. This seems most unfair for those trustees who relied in good faith on HMRC practice and assurances (and indeed the view was sound in law as confirmed in the Court of Appeal *Barclays Wealth* judgment). Trustees will now need to look carefully at all inter trust transfers and additions and the status of the settlor at the date of each transfer.

No changes were made in committee to these clauses. The sensible approach would be to deal with additions of value but ensure that transfers between settlements funded where the settlor was foreign domiciled remains excluded property for all IHT purposes, not just for the purposes of the relevant property regime. However, it seems too late to achieve this objective now. The best option may be to obtain clear HMRC guidance. ■

For related reading visit www.taxjournal.com

- Draft Finance Bill 2019/20 changes to IHT and settlements (Nicholas Harries, 7.8.19)
- Private client briefing for November 2017 (Andrew Goldstone & Natalie Quail, 15.11.17)