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## **Section 73: excluded property etc; Section 74: transfers between settlements etc**

These relatively short sections introduce some exceedingly complex changes to the inheritance tax (IHT) treatment of excluded property trusts. Prior to the changes in the Finance Act 2020 (FA 2020), excluded property trusts was defined to mean trusts settled by individuals who were, at the time when the settlement “was made”,<sup>1</sup> non-UK domiciled. Such trusts were not subject to IHT even if the settlor later became UK domiciled provided no UK situated property was held directly by the trustees.<sup>2</sup>

The changes affect two types of transaction, whether done in the past or future but only in respect of IHT charges arising after Royal Assent on 22 July 2020:

1. Where a settlor adds to an excluded property settlement after becoming UK domiciled. Example 1: Amber sets up a trust with \$1 million when domiciled in the US. Shortly after becoming deemed domiciled in the UK Amber adds another \$500,000. What is the IHT status of the \$500,000?<sup>3</sup>
2. Where trustees move property from one trust to another after the settlor becomes domiciled in the UK what is the status of the property in the new trust? See Example 2, below. The settlor may have had no involvement or even knowledge of this transaction between trustees but nevertheless past transfers to a transferee trust will be affected by FA 2020.

<sup>1</sup> See later discussion in text for meaning of when a settlement is made.

<sup>2</sup> Or from 6 April 2017 no UK residential property held in foreign companies was held by the trustees. See BTR 2017 Finance Act commentary. IHTA Sch.A1.

<sup>3</sup> Note: Amber could become domiciled in the UK either because Amber has decided to settle in the UK permanently and has therefore acquired a domicile of choice or Amber has been tax resident in the UK for longer than 15 out of the last 20 years and is therefore deemed domiciled in the UK. References to UK domicile in this note embrace either or both of these possibilities.

## Background

The changes follow a longstanding disagreement with HMRC on the status of:

- additions to trusts of the sort set out in Example 1, above, where the trust was made when the settlor was foreign domiciled but an addition is later made after the settlor has become UK domiciled; and
- transfers between trusts which were made after the settlor has become UK domiciled. See Example 2, below.

### *Additions to trusts*

Until FA 2020, section 48(3) of the Inheritance Tax Act 1984 (IHTA) simply tested the settlor's domicile at the time the settlement "was made". The settlement was treated as made when property first became comprised in it. Read literally, this meant that property added many years later by Amber in Example 1, above, to a settlement made when Amber was foreign domiciled would always be excluded property irrespective of Amber's domicile at the time of the addition. HMRC disagreed with this view: their view was that, in relation to any particular asset, "a settlement was made" for the purposes of section 48(3) each time an asset was transferred to the trustees to be held on the declared trusts.<sup>4</sup> HMRC argued that every addition to an existing settlement therefore constituted the making of a new settlement in relation to that property and that addition was a separate settlement for the purposes of working out whether it was excluded property or not. This view did not jeopardise the excluded property status of the original property but did not fit easily with the wording either in section 43(2) IHTA, which defined settlement as meaning "any disposition or dispositions of property"; or in section 44(2) IHTA, 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 (CI) Ltd v IRC*<sup>5</sup> was also unhelpful for HMRC. Ultimately HMRC's view was found to be wrong in *Barclays Wealth Trustees (Jersey) Ltd and Another v HMRC*<sup>6</sup> and this led to the 2020 changes outlined below.

Where property has been or is in future 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 22 July 2020 (when FA 2020 came into effect), it will not be protected from *future* IHT charges arising after that date (including on the settlor's death) if the settlor was domiciled in the UK at the date of addition.<sup>7</sup> (See section 73(1)).

Section 73 FA 2020 achieves this broadly by amending section 48(3)(a) IHTA to remove references to "when the settlement was made". Instead

<sup>4</sup> HMRC, Internal Manual, *Inheritance Tax Manual* (published 20 March 2016; updated 23 September 2020), IHTM27220, "Foreign property: property excluded from Inheritance Tax: foreign settled property with non-UK domiciled settlor".

<sup>5</sup> *Rysaffe Trustee Co (CI) Ltd v IRC* [2003] EWCA Civ 356; [2003] STC 536.

<sup>6</sup> *Barclays Wealth Trustees (Jersey) Ltd and Another v HMRC* [2015] EWHC 2878 (Ch); and *Barclays Wealth Trustees (Jersey) Ltd and Another v HMRC* [2017] EWCA Civ 1512; [2017] STC 2465.

<sup>7</sup> FA 2020 s.73(1).

“property comprised in [the] settlement...is excluded property unless the settlor was domiciled in the United Kingdom at the time the property *became comprised* in the settlement...”<sup>8</sup>

Loss of excluded property status only affects the added property (\$500,000 in Example 1, above), not the property originally settled when the settlor was foreign domiciled although it may not always be possible to keep additions separate. There are no rules determining how any tracing exercise is to be done when the original and added property have become intermingled. If the settlor is a beneficiary of the settlement, the change will mean not only that future 10 year charges are payable on that added property (maximum 6 per cent) but also that there is a 40 per cent IHT charge under the reservation of benefit provisions on the added property on the settlor’s death.

What is the position if trustees accumulate income rather than distributing the income after 22 July 2020? 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. Fortunately, section 73 FA 2020 provides that accumulations of income are treated as having become comprised at the same time as the original property (producing that income) became comprised in the settlement. Therefore, accumulations of income from property that was originally settled when the settlor was foreign domiciled remain excluded property for all IHT purposes whenever such accumulations are made.

### *Transfers between trusts*

FA 2020 also deals with transfers between trusts where the position is somewhat more complicated as not only section 48(3) but also sections 81 and 82 IHTA are engaged.

Example 2: assume that trustees of Trust 1 transfer property from Trust 1 (made when 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 UK 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? What happens if Trust 2 then transfers to Trust 3 made after Mr X has died? Dead settlors cannot have a domicile. Does this mean the property becomes excluded property on entry into Trust 3 even if the settlor was UK domiciled throughout his life and Trusts 1 and 2 had never been excluded property?

In these circumstances, not only section 48(3) but also sections 81 and 82 IHTA were in point under the old legislation. Section 81 provided that when property passed from one settlement to another, it was treated for the purposes of the relevant property regime *only* as remaining comprised in the first settlement. Section 82 provided that the property transferred to Trust 2 was not 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

<sup>8</sup> IHTA s.48(3)(a) as amended by FA 2020 s.73(2)(a).

Example 2, Trust 2 would therefore have not held excluded property even under the pre-2020 rules. The transfer to Trust 2 lost that favoured treatment. However, HMRC accepted in correspondence that was published in *Dymond's Capital Taxes* that where both trusts were settled when the settlor was foreign domiciled but the transfer was made by the trustees when the settlor was UK domiciled, it nevertheless remained excluded property for all IHT purposes. Again one looked not at when the property *becomes comprised in the settlement* but when each settlement “was made”. Going forward section 82 IHTA has no application on trust to trust transfers on or after 22 July 2020.

Section 82A IHTA as inserted by section 74 FA 2020 now covers the position. The settlor’s domicile is now, from 22 July 2020, retested on each occasion when the settled property moves between and becomes comprised in a new settlement: this is termed “a qualifying transfer”. It is not just the date when each trust is “made” that matters. If on any of those occasions the settlor has an actual or a deemed UK domicile, any excluded property status resulting from the settlor’s foreign domicile at the time the property became comprised in the original settlement is lost. However, the settlor’s domicile at the time of the original settlement remains relevant due to sections 48(3) and 81 IHTA. Hence, even though a dead settlor does not have a UK domicile,<sup>9</sup> the subsequent loss of UK domicile due to death does not enable a trust to trust transfer to create an excluded property trust where such status did not previously exist.

However, if the settlor set up Trust 1 when foreign domiciled which transferred to a new trust set up after the settlor became UK domiciled, the second trust would not be excluded property under either section 82 or section 82A IHTA, that is, under either the old or new regimes. But if the settlor then died, a transfer from Trust 2 to Trust 3 would restore excluded property status under section 82A IHTA.

The change will not affect resettlements made before 22 July 2020 where both trusts were set up when the settlor was foreign domiciled but the transfer took place after the settlor acquired UK domicile and before 22 July 2020, except in one respect. If the settlor is a beneficiary of the transferee trust the assets transferred will be included in the settlor’s estate on death under the reservation of benefit rules after FA 2020. This would not have been the case if the settlor had died before July 22 2020.

Example 3: Ivy set up two trusts when foreign domiciled with £1 million in each. In 2016, when Ivy 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 for Trust 2 if no UK situated property is held by the trustees at that time, as the transfer was done prior to Royal Assent of 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 exit or 10 year charges should arise.

However, the transfer 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 Ivy was domiciled. Therefore, if Ivy is a beneficiary of Trust 2, there is IHT payable on death on the added property at 40 per cent.

<sup>9</sup> IHTA s.82A(7).

Note that if the transfer between these two trusts had taken place on or after 22 July 2020 the second trust would not have been excluded property for any IHT purposes (including reservation of benefit purposes or for the purposes of the relevant property regime).

### Loans

There have been suggestions that property becomes comprised in a settlement every time a loan is made to a trust. This seems misconceived. The “property comprised in the settlement” as referred to in the legislation at section 48(3)(a) as amended by FA 2020 must refer to the net value of the property. Hence, if trustees later borrow after the settlor is UK domiciled but the settled property was placed into trust when the settlor was foreign domiciled, the borrowing is not added property. It should make no difference if the loan is interest free as no property becomes comprised in the settlement simply because interest is foregone. Even if the value of the settled property is increased by the lender not charging the trust interest, the omission to charge something is not, as such, added property. How would such an increase in value ever be quantified because the actual value increase may be completely different to the interest foregone?

### Other anomalies

The legislation refers to property becoming comprised in the settlement but does not deal with additions of *value*. Unlike the legislation in Schedule 8 to the Finance (No.2) Act 2017 on tainting for income tax and capital gains tax purposes, there are no express provisions covering additions of value for IHT purposes.

Example 4: Rosie set up and funded an excluded property trust made many years ago. The trust owns a foreign company and, after becoming UK domiciled, Rosie decides to make a gift not to the trust but to the company Holdco owned by the *trust*. This would be a chargeable transfer for IHT purposes under both the old and new regimes. But the property comprised in the settlement is still Holdco. The company has just become more valuable but nothing has been added to the trust. In these circumstances is the full value of the company still excluded property going forward even after 22 July 2020? It appears possible that this point has been missed although on a purposive interpretation the Court may decide that additions of value do constitute property becoming comprised in the settlement. <sup>Ⓒ</sup>

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<sup>Ⓒ</sup> Excluded property trusts; Foreign domiciliaries; Inheritance tax; Loans  
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