Inheritance tax legislation on additions to excluded property settlements and transfers between settlements

Finance Act 2020 will confirm that property added to a settlement or transferred between settlements after the settlor has become UK domiciled or deemed domiciled cannot generally be excluded property for inheritance tax purposes.

The current position

The legislation is intended to counter the effect of *Barclays Wealth Trustees* (Jersey) *Limited & Michael Dreelan v HMRC* (Dreelan) – you can see a summary of the case here. In Dreelan, the excluded property status of property transferred between trusts depended on whether a settlement was "made" when it was first established (as the taxpayer contended) or whenever property was transferred to the settlement (as HMRC contended).

The Court of Appeal held that in accordance with general trust law, a settlement is "made" when it is first established.

This means that non-UK property transferred between settlements retains its excluded property status, even if the settlor is UK domiciled at the time of the transfer – the only requirement is that the settlor of both trusts was non-UK domiciled when the settlements were originally established.

This gave trustees comfort that they had the flexibility to move property between trusts even after the settlor of the trusts became deemed domiciled, without jeopardising the excluded property status of the trust funds.

The excluded property status of property added to a settlement also depends on the domicile of the settlor at the time the settlement is "made". While the Court of Appeal refused to rule on the point, the logical conclusion of their judgment is that a settlor who established a trust while non-UK domiciled can continue adding property to that trust after he becomes UK domiciled or deemed domiciled, and that property will also be excluded property.

Changes – (i) Additions to a settlement

Unsurprisingly, the new legislation confirms that non-UK property added to a trust will only be excluded property if the settlor was non-UK domiciled when the property "becomes comprised in the settlement". This means that if a settlor adds property to a settlement after becoming UK domiciled or deemed domiciled, that property will be within the scope of inheritance tax (although the rest of the settlement will not be tainted and will remain excluded property).

The legislation will take effect for all inheritance tax charges after Finance Act 2020 is passed (likely to be June/July 2020), even if the settlor added property to the settlement before that date. This is unlikely to have a significant impact, as most advisors took the view (given the Court of Appeal's refusal to rule on the point) that adding property to a settlement after becoming domiciled or deemed domiciled was a risky approach.

If any settlors have added property to a settlement after becoming domiciled or deemed domiciled, the trustees could distribute the property from the trust before the Finance Act is passed. This would give them an argument that the added property is excluded property (by logical extension of the Dreelan case) so that there is no inheritance tax to pay as a result of the distribution. It would however need to be considered whether the distribution could give rise to any income tax or capital gains tax liability.

Changes – (ii) Transfers between trusts

Relevant property regime

The new legislation does not take a retrospective approach to transfers between trusts as far as the relevant property regime is concerned, so there will be a different set of rules for transfers between trusts before and after the Finance Act is passed.

Non-UK property transferred between trusts before the Finance Act is passed will be excluded property provided:

- the settlor of the transferring settlement was non-domiciled when the property became comprised in the settlement; and
- the settlor of the recipient settlement was non-domiciled when the recipient settlement was made (i.e. when it was first established).

This means that where a settlor has established two trusts before becoming UK domiciled or deemed domiciled, the trustees can still transfer property between the trusts after becoming UK domiciled or deemed domiciled but before the Finance Act is passed, without jeopardising the excluded property status of the transferred property.

The position will be different after the Finance Act is passed. Where trustees transfer non-UK property to another trust, the transferred property will only be excluded property if the settlor of the transferring settlement remains non-domiciled immediately before the transfer or has died.

This will mean that trustees have very little flexibility after a settlor has become domiciled or deemed domiciled to make transfers between his or her trusts, unless the settlor has died or the property is eligible for other reliefs (e.g. agricultural or business property relief).

Reservation of benefit

When working out whether property in a trust is excluded property under the reservation of benefit rules the rules are different. This is because the relevant tax charge is on the settlor's death and not under the relevant property regime.

The result of this is that, if the death occurs after Finance Act 2020 becomes law, assets transferred from one trust to another will only be excluded property if the settlor of the first trust was neither domiciled nor deemed domiciled in the UK when the transfer took place. This is the case even if the transfer took place before the changes in Finance Act 2020 took effect.

This is therefore a potential trap where a transfer has been made between settlements after the settlor became deemed domiciled in the UK and the settlor remains a beneficiary of the transferee settlement.

It should in any event be remembered that a transfer between trusts after the settlor has become domiciled or deemed domiciled in the UK will mean that the transferee trust cannot be a protected settlement for income and capital gains tax purposes.

Changes – (iii) Section 80 Inheritance Tax Act

The draft legislation also introduces a change to section 80 of the Inheritance Tax Act, which applies where the settlor or his or her spouse have a qualifying interest in possession immediately after the settlement comes into existence.

At present, non-UK property in such a trust is excluded property provided that:

- the settlor was non-domiciled when the settlement was made (i.e. first established); and
- the settlor or his spouse with the qualifying interest in possession (QIIP) was non-domiciled at the time they ceased to have their QIIP.

This most commonly arises where a settlor gives his or her spouse an immediate post-death interest in possession in his or her assets, with remainder on trust for their children – in that case, the excluded property status of the settlement would be re-tested on the spouse's death, and would be dependent on the spouse's domicile at the time of his or her death.

The new legislation requires that in addition to re-testing the domicile of the spouse losing their QIIP, the settlor of the original settlement must have been non-domiciled at the time the property in question became comprised in the settlement (which may have been after the settlement was originally made). It is difficult to see that this will have a significant impact, as in most cases, it would be surprising if the settlor had added property to the settlement after becoming domiciled or deemed domiciled in the UK.

Analysis

These changes were well trailed by HMRC, and are not a surprise. For settlors of excluded property trusts who are now UK domiciled or deemed domiciled, there is no way (if indeed there ever was) to add property and claim excluded property status over the added property.

There is still some flexibility to make transfers between settlements before the Finance Act is passed although, if the recipient settlement is a protected settlement for income and capital gains tax purposes or the settlor is a beneficiary of the transferee settlement, the trustees should consider this carefully as the transfer would mean the loss of protected status and a possible tax charge on the settlor's death under the reservation of benefit rules.

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