IMPACT OF FINANCE ACT 2006 INHERITANCE TAX CHANGES ON NON-UK RESIDENT TRUSTS

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This article is loosely[2] based on my Key Haven Intelligence Report *The Taxation of Trusts Post Finance Act 2006.* References other than internal references are to that Report.

1 The new inheritance tax regime for trusts in outline[3]

1.1 Terminology

This terminology of "**recognised interest in possession**" and "**unrecognised interest in possession**" is mine. If the draughtsman had used it, it would have saved a lot of space. Broadly speaking a recognised interest in possession is one which is treated the same way as before the 2006 Budget Speech on 22nd March 2006 (to which I refer as "B Day") and an unrecognised interest in possession is

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2 For obvious reasons, there is much in the Report not included in these notes. Conversely, these notes do contain a substantial amount of material not contained in the Report which is of particular relevance to offshore and excluded property settlements.

3 In order to assist the reader I have *italicised* words added to statutory provisions by Finance Act 2006.

one which is now largely[4] ignored for inheritance tax purposes (and for some capital gains tax purposes).

One advantage of the new regime, from the taxpayer's perspective, is that in a limited number of cases an interest in possession has the advantages of being, in a sense, both recognised and not recognised in that its existence qualifies the trust for favourable inheritance tax treatment (or at the least does not disqualify it from favourable treatment) but there is no charge to tax on the termination of the interest in possession. I shall call these "**privileged interests in possession**".[5]

1.2 Capital Gains Tax Consequences

Broadly speaking, a recognised interest in possession will be the only type of interest in possession which is relevant to the capital gains tax treatment of the trustees of a settlement (especially whether the tax-free uplift in the trustees' base cost of the settled property is available on the death of a beneficiary). However, an unrecognised interest in possession will still be an asset for capital gains tax purposes, although whether or not it is a chargeable asset will depend on the old rules. Similarly, an unrecognised interest in possession will not be ignored in determining whether the settlement is a settlor-interested one for various capital gains tax purposes. Hence, its existence might well be relevant to whether chargeable gains of the trustees are to be imputed to the settlor or whether holdover relief is to be available on a disposal to the trustees.

Certain persons were – and still are – deemed to have an interest in possession for inheritance tax purposes but not for capital gains tax purposes. Even if they now have a recognised interest in possession, the capital gains tax position is unchanged.[6]

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4 The exceptions to this rule are very limited but do exist. See, for example, Inheritance Tax Act 1984 section 55 (which is unchanged by Finance Act 2006) and section 58(1A) and (1B) (which have been added by Finance Act 2006).

5 These are certain interests in possession to which bereaved minors are beneficially entitled. See the discussion of the new Inheritance Tax Act 1984 section 71A in *The Taxation of Trusts Post Finance Act 2006* Chapter 12.

6 I deal further with the capital gains tax treatment of settlements post Finance Act 2006 in *The Taxation of Trusts Post Finance Act 2006* Chapter 16.

2 Subsisting and New Recognised Interests in Possession

2.1 Actual Subsisting Interests in Possession

The rule is that an interest in possession which was subsisting immediately before B Day (to which I shall refer as a "**pre-B Day interest in possession**") will be a recognised interest in possession.

This gives rise to the (sometimes difficult) question when an interest in possession is the same interest in possession. See *The Taxation of Trusts Post Finance Act 2006* at 3.5.

2.2 Deemed Subsisting Interests in Possession: Inheritance Tax Act 1984 section 46A

2.2.1 The Statute

Just to complicate matters, where the new Inheritance Tax Act 1984 section 46A (Contract of life insurance entered into before 22nd March 2006 which on that day is settled property in which interest in possession subsists) applies, what is in my view probably a new interest in possession in settled property will be deemed for most (but not quite all!) purposes to have been a pre-B Day interest in possession.[7]

3 New Recognised Interests in Possession

3.1 Definition

New interests in possession, i.e. those to which a person becomes beneficially entitled after 21st March 2006, will be Recognised Interests in Possessions only if they fall into one of three categories:

(a) an immediate post-death interest[8]

(b) a transitional serial interest, which can be any one of three different types[9] and

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7 Section 46A is discussed at *The Taxation of Trusts Post Finance Act 2006* 14.2.

8 See *The Taxation of Trusts Post Finance Act 2006* Chapter 5.

9 See *The Taxation of Trusts Post Finance Act 2006* 3.2 and Chapters 6, 7 and 8.

(c) a disabled person's interest[10]

3.2 The Three Types of Transitional Serial Interest

These are now of three types. See Inheritance Tax Act 1984 section 49B:

> "*49B Transitional serial interests*
>
> *Where a person is beneficially entitled to an interest in possession in settled property, for the purposes of this Chapter that interest is a "transitional serial interest" only—*
>
> *(a) if section 49C or 49D below so provides, or*
>
> *(b) if, and to the extent that, section 49E below so provides.*"

3.3 The Four Types of Disabled Person's Interest

These are of four types, as defined by Inheritance Tax Act 1984 section 89B(1).[11] What the definitions have in common is that they involved a "disabled person" (as defined) or a person with a condition which it was reasonable to expect might lead to his becoming a disabled person. It is questionable to what extent any disabled person needs to have any interest at all under the settlement in question!

Where a disabled person was entitled to an actual interest in possession immediately before B Day, that interest will not qualify as a "disabled person's interest".

3.4 General Comment

An immediate post-death interest can be created indefinitely and will be of some use. So can a disabled person's interest, but will be of limited use and may conceivably be a nuisance in that it could spring up unexpectedly and prejudice pre-existing planning. The three types of transitional serial interest can be created only in property comprised in a Settlement existing before B Day (although neither the property in which the interest subsists nor property which it represents need necessarily have been comprised in the Settlement before B Day.)

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10 See *The Taxation of Trusts Post Finance Act 2006* 3.3 and Chapter 9.

11 See *The Taxation of Trusts Post Finance Act 2006* 9.1.1.

4 Other Inheritance Tax Changes

The Gifts with Reservation of Benefit Provisions and Previously Owned Assets Provisions have been altered in minor ways beyond the scope of this article. What is more important is the impact on the existing provisions of the Finance Act 2006 general changes to inheritance tax. The most important is that, because a person beneficially entitled for an unrecognised interest in possession is no longer deemed to own the settled property and the unrecognised interest in possession does not form part of his estate, it is much easier for the Gifts with Reservation of Benefit Provisions or the Previously Owned Assets Provisions to apply in relation to him than if he were entitled for a recognised interest in possession. See *The Taxation of Trusts Post Finance Act 2006* Chapter 19.

There are also new rules for Excluded Property Settlements. See 5.3

5 Factors of Special Relevance for Non-UK Resident Trusts

5.1 General Comment

As a general rule, the inheritance tax treatment of a settlement does not depend on where the trustees are resident. Broadly speaking a settlement escapes inheritance tax if the settlor was not domiciled in the United Kingdom at a material time and if the settled property is situate outside of the United Kingdom or otherwise qualifies for privileged treatment e.g. exempt gilts, interests in some OEICs and units in some unit trusts. In this section, therefore, I consider (a) the impact of the changes in determining whether a settlement is an excluded property trust and (b) the impact on such trusts.

5.2 What is Excluded Property? The Basic Rules

5.2.1 The Basic Rule: Non-UK Situate Property

The basic rule[12] is that one looks to the domicile of the settlor at the time the settlement was made. Inheritance Tax Act 1984 section 48 (Excluded property) provides:

> "(3) Where property comprised in a settlement is situated outside the United Kingdom—
>
> (a) the property (but not a reversionary interest in the property) is

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12 This is now subject to the changes introduced by Finance Act 2006 concerning purchased interests in possession in such trusts, discussed at 5.3.

> excluded property unless the settlor was domiciled in the United Kingdom at the time the settlement was made …"

Where the settlor has made additions to the settled property after creating the settlement, one must ask whether or not there subsist for inheritance tax purposes two or more different settlements. See *The Taxation of Trusts Post Finance Act 2006* at 3.4 and the highly unsatisfactory RI 166 (February 1997) *Excluded property settlements by people domiciled overseas*.

5.2.2 Exempt Gilts

Inheritance Tax Act 1984 section 48 (Excluded property) also provides:

> "(4) Where securities issued by the Treasury subject to a condition of the kind mentioned in subsection (2) of section 6 above are comprised in a settlement, that subsection shall not apply to them; but the securities are excluded property if—
>
> (a) a person of a description specified in the condition in question is entitled to a qualifying interest in possession in them, or
>
> (b) no qualifying interest in possession subsists in them but it is shown that all known persons for whose benefit the settled property or income from it has been or might be applied, or who are or might become beneficially entitled to an interest in possession in it, are persons of a description specified in the condition in question."[13]

The description normally specified is that the person in question is domiciled and ordinarily resident outside the UK, but it is understood that in the case of some recently issued stock the requirement is only that the beneficial owner is ordinarily resident outside the UK. The test of domicile is the common law test, not the extended inheritance tax test.

Firstly, it should be noted that while section 48(4) has not been directly amended by Finance Act 2006, section 48(7) provides "In this section "qualifying interest in possession" has the same meaning as in Chapter III of this Part of this Act". Yet section 59, which contains a definition of the phrase for the purposes of Chapter III, has been so amended. Whereas before B Day virtually any interest in possession to which an individual was beneficially entitled was a qualifying interest in possession, now, only a recognised interest in possession (and not even a privileged interest in possession) will be a qualifying interest in possession.

13 If reliance is sought to be placed on section 48(4)(b), subsections (5) and (6) also need to be taken into account.

The result is that the number of cases in which settled exempt gilts will constitute "excluded property" has been very much reduced. For example, before B Day, a settlor, ordinarily resident outside the UK, who was domiciled abroad in reality but deemed domiciled in the United Kingdom for inheritance tax purposes, could settle property on trust for himself for life with remainders over on whatever trusts and for whatever beneficiaries he liked. Provided the settled property consisted of exempt gilts on his death, there would be no charge to inheritance tax on that occasion.

Were a settlor to do the same today, his interest in possession would be unlikely to constitute a recognised interest in possession and thus a "qualifying interest in possession". While he could no doubt still avoid any charge to tax on creating the settlement by ensuring that what he settled was exempt gilts, the settled property would thereafter be subject to the normal periodic and exit charges to inheritance tax unless the range of beneficiaries were restricted so as to comply with section 48(4)(b).

While Finance Act 2006 introduced provisions denying excluded property status where an interest in possession in such a trust has been purchased, the new provisions do not apply to excluded property falling within section 48(4). This is not really a loophole as a beneficiary who could rely on section 48(4) by virtue of a purchased interest could as easily set up a new settlement of his own and obtain the same advantages.

5.2.3 Holdings in Authorised Unit Trusts or Open-ended Investment Companies

Inheritance Tax Act 1984 section 48((3A), added by Finance Act 2003, provides:

> "Where property comprised in a settlement is a holding in an authorised unit trust or a share in an open-ended investment company[14]—
>
> (a) the property (but not a reversionary interest in the property) is excluded property unless the settlor was domiciled in the United Kingdom at the time the settlement was made, and
>
> (b) section 6(1A) above applies to a reversionary interest in the property but does not otherwise apply in relation to the property; but this subsection is subject to subsection (3B) below."[15]

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14 These terms are defined in section 272.

15 This is now subject to the changes introduced by Finance Act 2006 concerning purchased interests in possession in such trusts, discussed at 5.3.

Thus the general intention is that trustees of potentially excluded property settlements should be encouraged to invest in the United Kingdom through these particular types of collective investment schemes. As will be seen, whether as a result of Machiavellian cunning or sheer incompetence, investment in such property may not be as advantageous in United Kingdom inheritance tax terms as investment in foreign situate property. See 5.7.3.

5.3 Finance Act 2006 Anti-Avoidance Legislation

5.3.1 The Old Strategy

It became common for persons domiciled in the United Kingdom to purchase a valuable interest in possession in an excluded property settlement. The excluded property would in effect not be treated as part of his estate for inheritance tax purposes. Matters were so structured that the purchase would not normally give rise to any transfer of value for inheritance tax purposes. The interest in possession would usually continue after the death of the purchaser and would in reality constitute a valuable asset of his estate. The strategy could be implemented as a death-bed scheme. It was particularly useful where the purchaser did not have liquid assets or did not want to dispose of assets during his lifetime for capital gains tax purposes.

5.3.2 The New Legislation

The strategy had been viable since 1975. After thirty years, the Revenue appears to have woken up to it. Inheritance Tax Act section 48 has been amended by the addition at the end of paragraph (3) (and of paragraph (3A)) of the words "*; but this subsection is subject to subsection (3B) below.*" and by the addition of new subsections (3B) and (3C) in the following terms:

> *"(3B) Property is not excluded property by virtue of subsection (3) or (3A) above if—*
>
> *(a) a person is, or has been, beneficially entitled to an interest in possession in the property at any time,*
>
> *(b) the person is, or was, at that time an individual domiciled in the United Kingdom, and*
>
> *(c) the entitlement arose directly or indirectly as a result of a disposition made on or after 5th December 2005 for a consideration in money or money's worth.*
>
> *"(3C) For the purposes of subsection (3B) above—*

> *(a)* *it is immaterial whether the consideration was given by the person or by anyone else, and*
>
> *(b)* *the cases in which an entitlement arose indirectly as a result of a disposition include any case where the entitlement arose under a will or the law relating to intestacy."*

5.3.3 Commentary on Finance Act 2006 Anti-Avoidance Legislation

Thus, once there is a person who is beneficially entitled to an interest in possession in the property at any time and that person is at that time an individual domiciled in the United Kingdom, then if his entitlement arose directly or indirectly as a result of a disposition made on or after 5th December 2005 for a consideration in money or money's worth, the settled property in which the interest in possession subsists cannot from that time forward constitute excluded property by virtue of section 48(3) or (3A).

It is immaterial whether or not the interest in possession is a recognised interest in possession or an unrecognised interest in possession.

It is immaterial whether the individual was domiciled in the United Kingdom when the disposition in question was made. It is enough that he becomes domiciled in the United Kingdom at a later time, if he is then entitled for an interest in possession.

It is immaterial whether the individual gave the consideration or was even a party to the disposition.

It is immaterial whether what was acquired under the disposition was an interest in possession, provided as a direct or indirect consequence of the disposition a United Kingdom domiciliary becomes entitled to an interest in possession. Hence, one cannot avoid the anti-avoidance provisions by purchasing an interest in reversion which ripens into an interest in possession.

Thus, if X, who is not domiciled in the United Kingdom, buys a reversionary interest in an excluded property settlement, which he then gifts to Y, who is not at that time domiciled in the United Kingdom either, but at some time in future Y is both entitled for an interest in possession and domiciled in the United Kingdom, then subsection (3B) will then bite. If Y subsequently wills his interest in possession to Z, who is not domiciled in the United Kingdom, subsection (3B) continues to bite. If Y instead settles his interest in possession on discretionary trusts, even ones under which he is excluded from benefit, subsection (3B) still continues to bite. If Y subsequently ceased to be United Kingdom domiciled while still owning the interest in possession, subsection (3B) still bites.

Subsections (3B) and (3C) have no application to property which is excluded property by virtue of section 48(4) to (7) (exempt gilts).

Subsections (3B) and (3C) have no application unless what is purchased is or gives rise to an entitlement to an interest in possession. While I understand that commercial schemes are available under which what is purchased never does give rise to an entitlement to an interest in possession, they appear to involve the purchaser making a potentially exempt transfer, so that they are not suitable for death-bed schemes.

Schemes have been suggested under which what is purchased is and remains a reversionary interest. The problem is that a purchased reversionary interest is not excluded property and forms part of the purchaser's estate.

Schemes have also been suggested under which what is purchased is an interest which is neither in possession nor in reversion. The problem here is the interest will have a value and will form part of the purchaser's estate.

By contrast, schemes under which a United Kingdom domiciliary does become entitled for an interest in possession can in my view still fall outside subsections (3A) and (3B).

5.4 Initial Interest in Possession of Settlor Or Spouse

5.4.1 Inheritance Tax Act 1984 Section 82

Where the settlor or his spouse is entitled for an initial interest in possession, there are special rules which have been affected by Finance Act 2006.

Inheritance Tax Act 1984 section 82 (Excluded property) provides:

> "(1) For the purposes of this Chapter[16] (except sections 78 and 79) property to which section 80 or 81 above applies shall not be taken to be excluded property by virtue of section 48(3)(a) above unless the condition in subsection (3) below is satisfied (in addition to the conditions in section 48(3) that the property is situated outside the United Kingdom and that the settlor was not domiciled there when the settlement was made)
>
> …

16 i.e. Chapter III of Part III of the Inheritance Tax Act 1984, which imposes the charges to inheritance tax on all but recognised interest in possession trusts.

(3) The condition referred to in subsections (1) and (2) above is—

(a) in the case of property to which section 80 above applies, that the person who is the settlor in relation to the settlement first mentioned in that section, and

…

was not domiciled in the United Kingdom when that settlement was made."

5.4.2 Inheritance Tax Act 1984 section 80

While section 82 has not been amended by Finance Act 2006, section 80 (Initial interest of settlor or spouse or civil partner) has. It now provides:

(1) Where a settlor or his spouse or civil partner is beneficially entitled to an interest in possession in property immediately after it becomes comprised in the settlement, the property shall for the purposes of this Chapter [i.e. Chapter 3 of Part III, which imposes the charge to tax on, *inter alia*, relevant property trusts] be treated as not having become comprised in the settlement on that occasion; but when the property or any part of it becomes held on trusts under which neither of those persons is beneficially entitled to an interest in possession, the property or part shall for those purposes be treated as becoming comprised in a separate settlement made by that one of them who ceased (or last ceased) to be beneficially entitled to an interest in possession in it.

(2) References in subsection (1) above to the spouse or civil partner of a settlor include references to the widow or widower or surviving civil partner of a settlor.

(3) This section shall not apply if the occasion first referred to in subsection (1) above occurred before 27th March 1974

(4) Where the occasion first referred to in subsection (1) above occurs on or after 22nd March 2006, this section applies—

(a) as though for "an interest in possession" in each place where that appears in subsection (1) above there were substituted "a postponing interest", and

(b) as though, for the purposes of that subsection, each of the following were a "postponing interest"—

(i) an immediate post-death interest;

(ii) a disabled person's interest."

Before the Finance Act 2006 changes, the effect of section 80 was that property was deemed to be comprised in a settlement in which the settlor or his spouse was beneficially entitled for an interest in possession only at the first time when neither of them was so beneficially entitled. Moreover, by a statutory fiction, the settlement was deemed to be made for the purposes of, *inter alia,* calculating the rate of the ten-year and exit charges under the relevant property rules, by the one who was last so beneficially entitled.

Neither before nor after the Finance Act 2006 amendment was or is there any requirement as to the domicile status of the settlor or his spouse at any material time.

5.4.3 Traditional Tax Planning Using Inheritance Tax Act 1984 section 80

This meant that, say, a wife who wished to create two nil-rate discretionary trusts could create two separate settlements on the same day. Under the first, her United Kingdom domiciled spouse would take a short interest in possession. Under the second, she would create immediate discretionary trusts of income. The settlements would not be related settlements, as they would be treated as made on separate days. Her husband would be treated as making the first settlement on the termination of his interest in possession, whereas she would in reality make the first and also be so treated for inheritance tax purposes. Provided neither had made any chargeable or potentially exempt transfers of value in the previous seven years and provided the value of the settled property contained in each did not exceed the upper limit of the nil-rate band, there would be no charge to inheritance tax on the settled property itself.

Another way of using the section was for the settlor to create what was in reality one settlement under which he (and/or his spouse) had an initial interest in possession, but for it to be terminated in tranches, say, every seven years, with discretionary trusts then supervening, so that he (or she) was thereby deemed to make two or more separate settlements. The termination would not normally have given rise to any disposal for capital gains tax purposes.

5.4.4 Tax Planning Using Inheritance Tax Act 1984 Section 80 Post Finance Act 2006

Finance Act 2006 has imposed, in the new subsection (4), a restriction on the operation of the section which is in some ways much less severe than one would have expected. An additional complication is that in the Finance Bill as originally

Ordered to be Printed, the proposed amendments to the section were manifest nonsense. In the actual Finance Act, the amendment produces an even greater degree of nonsense. All that can be said in its favour is that (a) the nonsense is less manifest and appears only on closer inspection and (b) the nonsense works entirely in favour of the taxpayer!

Subsection (4) now limits the application of the section where "the occasion first referred to in subsection (1) above occurs on or after" B Day. Now that occasion is not that on which neither the settlor nor his spouse is beneficially entitled to an interest in possession but the occasion on which the property becomes comprised in the settlement.

Where a settlor before B Day settled property on himself for an interest in possession with remainder over on discretionary trusts and his interest in possession terminates, then it is clear that for the purposes of Chapter 3, he is treated as having made the settlement at the time of the termination, whether or not this was before B Day.

It is equally clear that where a settlor after B Day settled property on himself for an interest in possession with remainder over on discretionary trusts and his interest in possession terminates, then for the purposes of Chapter 3, he is treated as having made the settlement on the date he actually made it. This is the case even if his interest in possession was a recognised interest in possession (provided it is not a disabled person's interest).

Where a settlor before B Day settled property on himself for an interest in possession with an interest in remainder for his spouse with remainder over on discretionary trusts, where his interest in possession terminated and his wife thereupon became entitled to an interest in possession, which then terminates, it is clear that for the purposes of Chapter 3, the spouse is treated as having made the settlement at the time of the termination of her interest. This is the case even if the termination is after B Day and even if her interest in possession is not a recognised interest in possession! If the reader is by now thoroughly perplexed, I can only say that he should at least by now have discovered that perplexity, even bewilderment, is the lot of anyone trying to make sense of the new legislation.

Before Finance Act 2006, one would not have needed at any time before the termination of the spouse's interest in possession to ask, for the purposes of Chapter 3, who was the settlor of the settlement and when they created it. Now, however, the settled property will become relevant property on the termination of the settlor's interest in possession. Suppose that his wife is still entitled to an (unrecognised) interest in possession on the occasion of a ten-yearly charge? She is deemed not yet to have created the settlement! How can one calculate that charge? One cannot. Indeed, one cannot even calculate the date of the charge!

The only practical result, it seems to me, is that no charge can be levied. In other words, section 80 will have become a provision which does not merely operate to calculate the quantum of any charge but actually prevents any charge arising!

Of course, that will not have prevented the settlor from making a chargeable transfer of value on the termination of his interest in possession. Yet it does mean that during his spouse's life, so long as her interest in possession lasts, there can be no ten-year charge and, very likely, no exit charge either. Likewise, there will be no charge to inheritance tax on her death, as her interest in possession will be an unrecognised interest in possession!

It might be thought that the opportunities for planning are very limited in that the trusts must have been carefully constructed before B Day. Yet that is not the case. In the case of any trust created before B Day under which the settlor has an initial interest in possession which has not yet terminated, it is possible to create the interest in possession for the spouse now. Of course, one will wish to ensure that her interest in possession is not a recognised interest in possession. In effect, that means that one must ensure that her interest in possession is neither a transitional serial interest nor a disabled person's interest. (It cannot, in the circumstances envisaged, qualify as an immediate post-death interest.) The former requirement can normally be easily ensured, even if the interest is created before 6th April 2008. The latter is, of course, more difficult if she is in fact a "disabled person".

Where the property becomes settled on or after B Day, section 80 will apply only if the interest of the settlor and/or his spouse is an immediate post-death interest or a disabled person's interest. As each of these is a recognised interest in possession, there is no anomaly. However, in such a case one can in principle still ensure, as one could prior to B Day, that several separate relevant property trusts are deemed to be created by the relevant person.

5.4.5 Indirect Effect on Inheritance Tax Act 1984 Section 82 of Finance Act 2006 Amendment of Section 80

In the case of a settlement created *inter vivos* on or after B Day, section 80 will not apply to it unless the initial interest in possession of the settlor or his spouse is a disabled person's interest.

In the case of a trust arising on the death of the settlor on or after B Day under which the surviving spouse takes an initial interest in possession, section 80 will still apply to it for as long as that spouse is entitled to the same interest in possession or to a disabled person's interest.

A word of warning: an interest in possession to which a surviving spouse does not in fact become entitled on the death of the deceased may nevertheless be deemed to be such by Inheritance Tax Act 1984 section 144: see *The Taxation of Trusts Post Finance Act 2006* at 15.6.

A planning tip: if the widow of the settlor is likely to become United Kingdom domiciled in future, the effect of section 80 will be spent if she now ceases to be entitled to her immediate post-death interest, even if she becomes immediately entitled to another interest in possession, provided the new interest in possession is not a disabled person's interest.

5.6 Transfers Between Settlements

Inheritance Tax Act 1984 section 81 (Property moving between settlements) provides:

> "(1) Where property which ceases to be comprised in one settlement becomes comprised in another then, unless in the meantime any person becomes beneficially entitled to the property (and not merely to an interest in possession in the property), it shall for the purposes of this Chapter be treated as remaining comprised in the first settlement.
>
> …"

Inheritance Tax Act 1984 section 82 (Excluded property) provides:

> "(1) For the purposes of this Chapter (except sections 78 and 79) property to which section 80 or 81 above applies shall not be taken to be excluded property by virtue of section 48(3)(a) above unless the condition in subsection (3) below is satisfied (in addition to the conditions in section 48(3) that the property is situated outside the United Kingdom and that the settlor was not domiciled there when the settlement was made)
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> …
>
> (3) The condition referred to in subsections (1) and (2) above is—
>
> …
>
> (b) in the case of property to which subsection (1) or (2) of section 81 above applies, that the person who is the settlor in relation to the second of the settlements mentioned in the subsection concerned,

was not domiciled in the United Kingdom when that settlement was made."

The effect of these rules has not been changed as the result of Finance Act 2006.

5.7 Periodic and Exit Charges on Excluded Property

5.7.1 The General Rule

Excluded property is in general not "relevant property": see Inheritance Tax Act 1984 section 58(1)(f). It thus in principle escapes the periodic and normal exit charge to inheritance tax.

5.7.2 Employee Trusts

However, by what appears to be the draftsman's incompetence, property which falls within Inheritance Tax Act 1984 section 86 (employee) trusts would appear to be "relevant property" **even if it is excluded property**, if there subsists an interest in possession in it (whether or not the interest in possession is a recognised interest in possession)!

Inheritance Tax Act 1984 section 58 (Relevant property) now provides:

> (1) In this Chapter "relevant property" means settled property in which no qualifying interest in possession subsists, other than—
>
> (a) property held for charitable purposes only, whether for a limited time or otherwise;
>
> (b) property to which section 71, *71A, 71D,* 73, 74 or 86 below applies *(but see subsection (1A) below)*;
>
> (c) property held on trusts which comply with the requirements mentioned in paragraph 3(1) of Schedule 4 to this Act, and in respect of which a direction given under paragraph 1 of that Schedule has effect;
>
> (d) property which is held for the purposes of a registered pension scheme or section 615(3) scheme;
>
> (e) property comprised in a trade or professional compensation fund; and
>
> (f) excluded property.

(1A) Settled property to which section 86 below applies is "relevant property" for the purposes of this Chapter if—

(a) an interest in possession subsists in that property, and

(b) that interest falls within subsection (1B) or (1C) below.

(1B) An interest in possession falls within this subsection if—

(a) an individual is beneficially entitled to the interest in possession,

(b) the individual became beneficially entitled to the interest in possession on or after 22nd March 2006, and

(c) the interest in possession is—

(i) not an immediate post-death interest,

(ii) not a disabled person's interest, and

(iii) not a transitional serial interest.

(1C) An interest in possession falls within this subsection if—

(a) a company is beneficially entitled to the interest in possession,

(b) the business of the company consists wholly or mainly in the acquisition of interests in settled property,

(c) the company has acquired the interest in possession for full consideration in money or money's worth from an individual who was beneficially entitled to it,

(d) the individual became beneficially entitled to the interest in possession on or after 22nd March 2006, and

(e) immediately before the company acquired the interest in possession, the interest in possession was neither an immediate post-death interest nor a transitional serial interest."

At first blush, the new section 58(1A) appears to provide an alternative ground on which settled property may qualify as "relevant property", so that it does not matter that it does not fall within section 58(1) by virtue of section 58(1)(f). Would it be possible to persuade a Court that it would be so ridiculous that e.g. Irish situate property settled by an Irish domiciled and settlor for the benefit of only Irish domiciled and resident beneficiaries should fall within the charge to United Kingdom inheritance tax that it would construe section 58(1A) as applying only for the purpose of determining whether section 86 property fell to be treated as not constituting "relevant property" simply on the ground that it fell within section 86?

5.7.3 Property Ceasing to be Relevant Property

5.7.3.1 Property Becoming Non-UK Situate Excluded Property

Suppose a settlement to have a settlor who was not domiciled in the United Kingdom at any material time but the settled property to constitute or comprise property which is at some times situate in the United Kingdom and at other times not, whether because the change is in the situs of the same settled property or in the assets concerned.

Prima facie, if settled property ceases to be non-excluded property and then becomes excluded property, there would be an exit charge to inheritance tax on the occasion. For the condition in Inheritance Tax Act 1984 section 65 (Charge at other times) (1)(a) would be satisfied. It provides:

> "(1) There shall be a charge to tax under this section—
>
> > (a) where the property comprised in a settlement or any part of that property ceases to be relevant property (whether because it ceases to be comprised in the settlement or otherwise) …"

Section 65(7) provides:

> "(7) Tax shall not be charged under this section by reason only that property comprised in a settlement ceases to be situated in the United Kingdom and thereby becomes excluded property by virtue of section 48(3)(a) above."

Hence, if the settled property becomes property falling within Inheritance Tax Act 1984 section 58(3) (non-UK situate) property, there is no charge to tax. One would expect the same consequences to follow if it became excluded property for some other reason.

5.7.3.2 Settled Property Becoming Exempt Gilts

Now section 48(3)(a) applies only where the settled property is "situated outside the United Kingdom". Yet property can be "excluded property" even though it is not "situated outside the United Kingdom", whether by virtue of section 48(4) (exempt gilts) or section 48(3A) (holdings in authorised unit trusts or open-ended investment companies).

In the case of exempt gilts, section 65(8) provides some limited relief. It provides:

> "(8) If the settlor of a settlement was not domiciled in the United Kingdom when the settlement was made, tax shall not be charged under this section by reason only that property comprised in the settlement is invested in securities issued by the Treasury subject to a condition of the kind mentioned in section 6(2) above and thereby becomes excluded property by virtue of section 48(4)(b) above."

It will be recalled that exempt gilts which are settled property can constitute excluded property under section 48(4) no matter what the domicile status of the settlor when the settlement was made. Hence, there could be an exit charge when settled property becomes excluded property by being invested in exempt gilts.

One way to avoid a charge is for the settled property to be first converted into non-UK situate property before being converted into exempt gilts. That should be relatively easy, in that the United Kingdom situate property will either be, or will be converted into, cash, which can be placed on deposit offshore.

Of course, enormous care should be taken in paying the price for the gilts. If the price is brought onshore just before it is paid, the planning will normally be thwarted. In that regard, attention will have be paid to some rather complicated case law.

5.7.3.3 Settled Property Becoming Holding in Authorised Unit Trusts or Open-ended Investment Company

Section 48(3)(a) applies only where the settled property is "situated outside the United Kingdom". Yet property can be "excluded property" even though it is not "situated outside the United Kingdom", by virtue of section 48(3A) (holdings in authorised unit trusts or open-ended investment companies).

I can find no provision corresponding to section 65(7) or (8) where settled property becomes excluded property by being invested in holdings in authorised unit trusts or open-ended investment companies. Hence, there could be an exit charge when settled property becomes excluded property by being so invested.

It is ironic that investment of the trust fund in excluded property of this type could actually precipitate a charge to inheritance tax!

As in the case of investment in exempt gilts, one way to avoid a charge is for the settled property to be first converted into non-UK situate property before being converted into the relevant holding. So my comments at 5.7.3.2.

5.8 Special Exit Charges

Settled property which escapes being "relevant property" because it falls within some privileged regime can be subject to a special exit charge in certain circumstances. For example, where property ceases to be held on "temporary" charitable trusts, a charge can be levied under Inheritance Tax Act 1984 section 70.

The tax, which is levied at a penal rate, depends on the length of time the settled property benefited from the privileged regime. If, at the time of charge, the settled property constitutes "excluded property", there is no blanket exemption from charge! Instead, section 70(7) provides:

> "*Where the whole or part of the amount on which tax is charged under this section is attributable to property which was excluded property at any time during the relevant period then, in determining the rate at which tax is charged under this section in respect of that amount or part, no quarter throughout which that property was excluded property shall be counted.*"

Thus the position could be far worse than if the settled property had been relevant property all along until it was converted into excluded property!

Note that the charge is not levied simply because non-excluded property becomes excluded property, but in both cases is within the privileged regime. It is only when it ceases to fall within the privileged regime that an occasion of charge can occur and it is at that point that the onus will be on the trustees to prove during what periods since it became subject to the privileged regime (but not before 13th March 1975 and not counting any period in excess of the first fifty years) and to what extent the settled property consisted of excluded property.

The section 70 provisions are adopted, with modifications to the following special exit charges:

- on Section 71 qualifying accumulation and maintenance Trusts

- on Section 71A Trusts (for bereaved minors)[17]

- on employee trusts and newspaper trusts (see Inheritance Tax Act 1984 section 72)

- on pre-1978 protective trusts (under section 73)

- on pre-1981 trusts for disabled persons (under section 74)

The section 71F and section 71G charges on Section 71D Trusts (being trusts for bereaved young persons and certain accumulation and maintenance trust trusts in existence before B Day), while having much in common with the exit charge on relevant property trusts, operate in much the same way as the section 70 charge as regards excluded property: see section 71F(6), discussed in *The Taxation of Trusts Post Finance Act 2006* Chapter 13, especially at 13.6.4 and 13.6.4.3, and section 71G(7), discussed at 13.6.5.

5.9 Unrecognised Interests in Possession

5.9.1 General Comment

Where there subsists an unrecognised interest in possession in the settled property, planning will, ironically, be easier than before. One will generally know in advance when the next occasion of charge will be. One will certainly know the date of the next ten-year anniversary – at least if one bears in mind all the complicated rules relevant thereto. One will also in general – although not always – have control over the timing of any exit charge, at least where the settlement will not come to an end on the happening of an uncertain event, such as the death of the beneficiary.

Thus, it may be possible for the trust fund to be invested in property situate within the United Kingdom for most of the life of the trust, provided that steps are taken to ensure that it is invested outside the United Kingdom at the date of any potential charge to tax.

5.9.2 United Kingdom Residence Occupied by Beneficiary

This will be particularly helpful in the case where a residence situate in the United Kingdom is comprised in the trust fund and is occupied by a beneficiary entitled for an interest in possession. And it will not matter whether the beneficiary has a express interest in possession or whether the Revenue simply claim that he has by virtue of the trustees allowing him to occupy the property. One will no longer

17 See The Taxation of Trusts Post Finance Act 2006 Chapter 12 and especially at 12.10

need to hold this residence through a company, with all the income tax problems associated with *de facto* directors and all the capital gains tax problems associated with the residence status of the company.[18] One will not be concerned about a charge to tax on the death of the beneficiary.

Instead, one will simply need to ensure, say, once every ten years, that for a brief period either the residence is not technically comprised in the trust fund or that, if it is, it is effectively devalued for inheritance tax purposes. One will naturally be concerned to avoid any charge to stamp duty land tax.

An advantage of this route, as compared with holding the property through an offshore company, is that the trustees and the beneficiary will be able to make a joint election that it be treated as his principal residence for capital gains tax purposes, so that no capital gain on a sale of the property enters into the Taxation of Chargeable Gains Act 1992 section 87 pool of stockpiled gains.

18 See *R v Allen* [2001] UKHL 45 [2001] STC 1537.