

# Unsettled trust



*Simon McKie* is anxious to prevent many years of worrying uncertainty

An anomaly exists in respect of settlements creating interests in possession for the settlor and/or his spouse that have existed since 22 March 2006, or in which an immediate post-death interest subsists. Unless the relevant legislation is amended or the matter is clarified by the Courts, that anomaly will continue to create for many years a worrying uncertainty as to the tax consequences that will result when such settled property vests absolutely.

## Section 80

Section 80 of Inheritance Taxes Act 1984 applies 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 a settlement. Where the section applies, the property is treated, for the purposes of Chapter III of Part III (concerning relevant property settlements), as not becoming comprised in a settlement at the time the trust is made but rather, at the time when the property becomes held on trusts under which neither the settlor nor his spouse have an interest in possession. In that

## KEY POINTS

- An anomaly exists in respect of settlements creating interests in possession for the settlor and/or his spouse, creating uncertainty over the tax consequences when settled property vests.
- Sections 80, 82 and 49 of IHTA 1984 should be considered.
- With HMRC anxious to maximise tax revenues, it would help taxpayers to know HMRC's views on whether a charge would arise.

## PROFILE



**Name** Simon McKie

**Position** Managing Director

**Company** McKie & Co (Advisory Services) LLP

**Tel** 01373 830956

**Email** simon@mckieandco.com

**Profile** Simon McKie (MA(Oxon) Barrister, FCA, CTA(Fellow) APFS,

TEP is a designated member of McKie & Co (Advisory Services) LLP, the consultancy specialising in providing taxation advice to advisers of private clients.

case it is treated as becoming comprised in a settlement (the "Hypothetical Settlement") made by that one of them who was last entitled to an interest in possession in the property.

An "interest in possession" for this purpose is restricted to a "postponing interest" (an immediate post-death interest or a disabled person's interest) but only if the first occasion on which the property became comprised in the settlement is on or after 22 March 2006 as per section 80(4). Reference in section 80(1) to the spouse (or civil partner) of the settlor include references to settlor's widow or widower or surviving civil partner in section 80(2).

## Section 82

Where section 80 applies, under section 82 the property will not be treated as excluded property unless the settlor of the actual settlement was not domiciled in the United Kingdom at the time that the settlement was actually made *and* the deemed settlor of the Hypothetical Settlement was not domiciled in the UK at the time he is deemed to have made that settlement. Section 82 also applies only for the purposes of Chapter III of Part III.

Sections 80 and 82 together create a curious anomaly where, as is not uncommon, a life interest for the settlor, or a life interest for the settlor's spouse,

is succeeded by an absolute interest. Typically that absolute interest will be for the settlor's children. I shall illustrate the anomaly by reference to the facts set out in Example I.

## On Mr Fillbarrell's death

Section 49 applied to Mrs Fillbarrell's life interest because her interest was an immediate post-death interest within section 49(1A)(a), and so she was treated as beneficially entitled to the property in which her interest subsisted.

## Mrs Fillbarrell's death

On Mrs Fillbarrell's death, her interest in possession came to an end. The trust property was deemed to form part of her estate immediately before her death under section 49, with the result that the transfer of value deemed, by virtue of section 4, to take place immediately before her death included the value of the settled property. Sections 80 and 82 did not apply for this purpose because they apply only for the purposes of Chapter III of Part III, which applies only to property that is relevant property. Property to which section 49 applies is not relevant property, per sections 49(1A) and 58(1B). Therefore, section 48(3) applied because the settlor, Mr Fillbarrell, was not domiciled in the UK at the time



## EXAMPLE 1

On 1 January 2009, Mr Fillbarrell died. Under his will he settled substantial non-UK situs assets on trusts under which his wife had an initial life interest, with an absolute interest in remainder to his son, Duffin. Immediately before Mr Fillbarrell's death, Mr and Mrs Fillbarrell were resident and ordinarily resident in the UK but were not domiciled in a country of the UK, nor were they deemed to be so domiciled under section 267.

Mrs Fillbarrell died on 31 December 2011 when she was domiciled in England.

the settlement was made and so the non-UK situs property in the settlement was excluded property. In respect of the deemed transfer of value arising under section 4 immediately before Mrs Fillbarrell's death, therefore, the property in which her life interest subsisted did not suffer inheritance tax.

Immediately on Mrs Fillbarrell's death, the trustees held the trust property for Duffin absolutely. Under general principles it was therefore held on trust. As soon as Duffin's absolute interest arose, however, the property ceased to be settled property within section 43 because it was no longer "held in trust for persons in succession or for any person subject to a contingency".

Since, on Mrs Fillbarrell's death, the property that the trustees held on trust ceased to be settled property within section 43, one might have thought that section 80 could not apply. Section 80, however, applies where an interest in possession for a settlor or his spouse has existed in property immediately after it has become comprised in a settlement. Where this condition is satisfied:

"...the property shall for the purposes of this Chapter 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".

It will be noticed that where section 80 applies, the property is treated as becoming comprised in the settlement

"when the property or any part of it becomes held on trusts under which neither of those persons [the settlor and his spouse] is beneficially entitled to an interest in possession". So the event that triggers the application of the section is the property becoming held on trusts under which neither the settlor nor his spouse has an interest in possession, whether or not those new trusts amount to a settlement within section 43. The only requirement for there to be a settlement within the section 43 definition is for there to be a settlement immediately on the property first being settled.

It has been argued that in the context of section 80 the "trusts" referred to in section 80 must be trusts under a settlement within section 43. There is nothing in the wording of the section, however, to suggest that that is the case. It appears that the draftsman has deliberately adopted the words "settlement" and "trust" because their meanings are not co-extensive. Indeed, the whole scheme of the application of inheritance tax to trusts depends on "settlement" being a more limited term than "trust". It is very deliberately limited by the statutory definition in section 43.

Normally, where the application of the inheritance tax legislation to an interest under a trust is to be limited to an interest arising under a settlement, the draftsman expressly limits the relevant provision in that way. For example, section 47 defines a reversionary interest as "a future interest *under a settlement*" (emphasis added). Section 51 applies "where a person beneficially entitled to an interest in possession in *settled property* (emphasis added) disposes of his interest". Section 49A applies "where a person ... is beneficially entitled to an interest in possession in *settled property* (emphasis added)." If the "trusts under which neither of... [the settlor or his spouse]... is beneficially entitled to an interest in possession" referred to in section 80 were intended by the draftsman to be restricted to trusts under a settlement within section 43 one would have expected the draftsman to use some such phrase as "held on the trusts of a settlement".

Immediately on Mrs Fillbarrell's death, therefore, it is arguable that section 80 would have the result that

the property is to be treated, but only for the purposes of Part III Chapter III, as becoming comprised in a settlement settled by Mrs Fillbarrell. The question is what is the effect of that? The deeming provision in section 80 does not provide that the property is to be treated as continuing to be settled property. So it might be argued that the effect of section 80 is that the property would be settled property (and therefore relevant property) only for an instant. If that were correct, the property would immediately thereafter cease to be relevant property because it would not be property "held in trust for a person in succession or for any person subject to a contingency", so there would be an exit charge under section 65 but, because the property would have been relevant property for an instant only, that charge would be at zero percent.

On the other hand, it might be argued that if the property is deemed to be comprised in a settlement it must remain comprised in that settlement until an event occurs to remove it. That event might be thought to occur when the trustees transfer the assets to the absolute owners. In that case, if the transfer took place more than three months after the relevant death, there would be an exit charge under section 65. Because of sections 80 and 82, the foreign situs assets would not be exempt property in respect of that charge. What is more, in calculating the rate of tax at which the charge was made one would apply sections 80 and 82 to the hypothetical chargeable transfer under section 68(4) so that the foreign situated property in the settlement immediately before Mrs Fillbarrell's death would not be treated as exempt property for that purpose.

At a time when HMRC is increasingly anxious to collect the maximum amount of tax, interest and penalties in respect of inheritance tax, it is important for taxpayers to know whether a charge can arise in these circumstances. It would be interesting to know HMRC's view of the matter.

## FURTHER INFORMATION

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