

Inheritance Tax Election for Non-UK Domiciled Spouses and Civil Partners

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As the UK becomes more diverse, there are more couples with just one UK domiciled spouse or civil partner ("mixed-domicile couples"). The European Commission previously criticised the limited inheritance tax (IHT) spouse exemption available for such couples on the basis that it was discriminatory. In response to this, two key changes to the IHT position of mixed-domicile couples were introduced by Finance Act 2013. This note summarises these changes and considers the practical consequences of the current regime. (For simplicity, references below to "spouses" also include civil partners).

Background

In order to put the Finance Act 2013 changes in context, we set out below a brief summary of the way in which the IHT charging regime operates.

IHT is charged on the value of an individual's property on death and also on certain lifetime gifts. The first £325,000 worth of gifts made in any seven year period does not give rise to an IHT liability (this is known as the nil-rate band). In addition, lifetime gifts made between individuals are potentially exempt transfers (PETs) and therefore are not charged to IHT provided the donor survives for at least seven years after the date of the gift.

As a general rule, transfers between spouses (whether made during lifetime or on death) are exempt from IHT. However, if the donor is domiciled in the UK but the recipient spouse is non-UK domiciled, a limited spouse exemption applies (prior to 6 April 2013 this was capped at £55,000). The rationale for this limited exemption is that assets moving from a UK domiciled individual to a non-UK domiciled spouse are more likely to pass outside the UK IHT net altogether, as IHT is charged on the worldwide assets of a UK domiciliary, but only on the UK assets of a non-UK domiciliary.

Finally note that, broadly, a person is domiciled in the UK if he lives in the UK and intends to remain here permanently or indefinitely. Further, an individual who is UK resident for tax purposes for at least 17 out of the previous 20 tax years will be deemed to be domiciled in the UK for IHT purposes.

Summary of Finance Act 2013 changes

Finance Act 2013 increased the IHT spouse exemption for transfers from a UK domiciled individual to his non-UK domiciled spouse to £325,000 from 6 April 2013. It has been confirmed that this exemption will be linked in future to the level of the nil-rate band. This means that where a UK domiciled individual has a full nil-rate band



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available, he will be able to transfer an amount equal to double the nil-rate band (currently £650,000) to his non-UK domiciled spouse free from IHT.

This increase in the limited spouse exemption (which has been fixed at £55,000 since 1982) was very welcome and enables a greater proportion of UK domiciled individuals with non-UK domiciled spouses who survive them to leave their estate to their spouse on death with no IHT liability.

However, for wealthy couples, the increase in the limited spouse exemption to £325,000 was not sufficient to allow them to leave their estate to their non-UK domiciled spouse without incurring an IHT liability. The second change introduced from 6 April 2013 addressed this issue. This provides that individuals domiciled outside the UK, who have a UK domiciled spouse, can elect to be treated as domiciled in the UK for IHT purposes, so enabling them to benefit from the unlimited IHT spouse exemption.

Election to be treated as UK domiciled

Effect of the election

It is important to note that an election to be treated as UK domiciled under the new provisions has effect only for IHT purposes; it does not affect an individual's domicile status for income tax or capital gains tax purposes. In addition, an election will be ignored when applying the provisions of double tax treaties.

When may an election be made?

An election may be made by a non-UK domiciled individual ("the elector") either during the lifetime of his UK domiciled spouse (a "lifetime election") or following the UK domiciled spouse's death (a "death election"). Generally, death elections must be made within two years of the spouse's death (although HMRC has discretion to extend this period).

How is an election made?

There is no form for making the election: it is simply made by notice in writing to HMRC.

Conditions for making an election

In order to make an election, the elector must, at some point after 5 April 2013 and during the seven year period ending either on the date the election is made (for a lifetime election) or on the date of the spouse's death (for a death election), have been married to a UK domiciled spouse.

An individual's domicile status is determined without reference to the special IHT deemed domicile rules noted above. However, if a person who is non-UK domiciled under general law is deemed to be UK domiciled for IHT purposes, an election under the new provisions will not be relevant as he will qualify for the full spouse exemption in any event.

Effective date of election

An election will take effect on the date stated in the notice of election submitted to HMRC. This date must be:

“ Individuals domiciled outside the UK, who have a UK domiciled spouse, can make an election to be treated as domiciled in the UK for IHT purposes, so enabling them to benefit from the unlimited IHT spouse exemption ”

- 6 April 2013 or later; and
- within the seven year period ending with the date the election is made for a lifetime election, or within the seven year period ending on the date of the UK domiciled spouse's death for a death election.

In addition, the elector must be married to the UK domiciled spouse on the effective date of the election. However, note that the elector does not necessarily need to be married to the UK domiciled spouse at the date the election is made. The new rules permit an individual whose marriage has been dissolved to make a retrospective election to cover the period he was previously married to a UK domiciliary. Similarly, a UK domiciled individual who was previously non-UK domiciled may make a retrospective election to cover the period when he was non-UK domiciled.

The ability of the elector to specify the date on which the election takes effect is very useful as it is possible, by selecting an appropriate date, to ensure that any spousal gifts made in the seven year period prior to the election date for lifetime elections (or in the seven year period prior to the date of death for death elections) qualify for the unlimited spouse exemption.

As the election applies to all gifts made after the effective date of the election, this could have the effect of bringing gifts that were previously outside the scope of IHT into the charging regime, retrospectively, so that they give rise to an IHT liability. Therefore care needs to be taken when selecting an appropriate effective date for the election.

Irrevocability of elections

An election is irrevocable so long as the elector remains UK resident for tax purposes. Therefore the downside of making an election is that, from the date of the election, the worldwide assets of the elector (rather than just those situated in the UK) will be subject to IHT.

However, an election will cease to have effect if the elector subsequently becomes non-UK resident for four successive tax years. In such circumstances his non-UK assets will fall outside of the scope of IHT after the end of the fourth year of non-residence, provided that the IHT deemed domicile rules do not continue to treat him as UK domiciled for IHT purposes.

Conclusion

The Finance Act 2013 changes significantly improved the IHT position of mixed-domicile couples, providing them with more flexibility to mitigate IHT as regards inter-spousal transfers. However, the following should be noted:

- A decision as to whether an election should be made needs careful consideration. This is because, once made, it has the effect of bringing the elector's entire estate within the scope of IHT. In other words, usually the benefit of making an election will be just to postpone the IHT liability until the time of the second death, rather than allowing the couple to escape the IHT liability completely. Consequently, an election could be particularly disadvantageous for a non-UK domiciled individual with substantial property outside the UK.

- Conversely, an election may be beneficial for a non-UK domiciled individual who is expecting to inherit substantial UK property from his UK domiciled spouse. This is particularly the case if the non-UK domiciliary intends to use the inherited property to make lifetime gifts which would qualify as PETs (so that it is possible that the property will not be included within his estate for IHT purposes at the time of his death). It may also be advantageous to make an election if it is likely that the individual will move overseas following his spouse's death (so that the election will cease to apply after four years' non-residence).
- Ultimately, the issue as to whether an election should be made will depend on a variety of factors some of which will not be known until the date of the UK domiciled spouse's death (eg the location and value of the couple's assets at the time of their respective deaths). In view of the opportunity to postpone an election until after the death of the UK domiciled spouse, it may be sensible in appropriate cases to defer any decision until just before the two year deadline for a death election, as the potential benefits should be clearer at that stage.

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