

Inheritance Tax (IHT) & Domicile

UK inheritance tax is charged on the value of a UK domiciled individual's worldwide estate at death. If the individual is domiciled outside the UK at the time of death, then only their UK located assets are liable to IHT. Thus, any assets held by someone domiciled outside the UK at death are not liable to IHT.

Clearly therefore it is beneficial to be domiciled outside the UK from an inheritance tax perspective.

Domicile:

An individual takes the domicile of their father at birth (their domicile of origin) and that remains with them until two events occur: either they change their domicile to another country (domicile of choice) or they die.

In order to change his or her domicile an individual needs to move to a new country and form the intention that that is now their permanent home where they intend to remain indefinitely. In addition to that, they need to be able to prove that he or she has changed their domicile by providing sufficient documentary evidence to demonstrate this; i.e. the burden of proof rests with he or she who asserts the change.

Inheritance Tax:

The first £325,000 of an individual's estate at death is subject to IHT at the nil rate, and this is called the "nil rate band"; everything over this value is tax at 40%. So, for instance on an individual estate of £1m IHT would be due of £270,000 ($£1m - £325,000 = £675,000 \times 40\%$).

For married couples where both spouses are either UK or non-UK domiciled and assets pass from one to the other on the first death (either on survivorship - assets held as joint tenants, or under a Will) there is an unlimited Spouse Exemption which ensures that IHT is payable only on the second death.

To the extent that assets of the first to die are left to others, such gifts can be made up to the value of the nil rate band without incurring IHT, however if none of the nil rate band is used by the first to die, the surviving spouse has their own and their late spouse's available, and therefore £650,000 taxed at 0% on the second death with IHT charged at 40% on the excess.

Example: Estate of £1m passes tax free to spouse on first death and then valued at £1m on second death: $£1m - 2 \times £325,000 = £650,000$ = IHT bill of £140,000 on second death.

Note, that if an individual die within seven years of making a Potentially Exempt Transfer (PET) which is a gift to another individual then that value is included in the value of the estate for IHT purposes; with tapering relief given as a tax reducer if the gift was survived by more than two but less than seven years.

It is important to note that in the example above both spouses must have either a UK or a foreign domicile.

Spouses of mixed domicile:

Spouses with mixed domiciles i.e. one UK domiciled the other non-UK domiciled only qualify for a reduced spouse exemption, if the first to die is the UK domiciled spouse. The value of that exemption now amounts £325,000 (previously £55,000 until 5 April 2013).

UK-Domicile dies first

So, if the first to die is the UK domiciled spouse leaving assets to the non-UK domiciled spouse then the first £325,000 would be covered by the nil rate band, the next £325,000 covered by the spouse exemption, but everything over that value would suffer IHT at 40%.

Example: Estate valued at £1m and UK domiciled spouse dies first leaving all assets to non-domiciled spouse:

£1m less £325,000 - £325,000 (£650,000) = £350,000 x 40% = IHT bill of £140,000 on first death.

On the second death, assuming the estate remains the same, the £860,000 balance (£1m less £140,000) would have set against it the nil rate band of £325,000 leaving £535,000 taxable at 40% being IHT of £214,000.

Total IHT paid of £354,000 on the £1m.

Non-UK Domicile dies first

If the first to die is the non-UK domiciled spouse, leaving assets to the UK domiciled spouse then the full exemption applies on the first death and both nil rate bands are then applied on the second death and what is left is taxable.

This gives the same position as detailed above where both spouses are either UK or non-UK domiciled.

It should be noted that there are options available for non-UK domiciled individuals married or not to plan their affairs and hold assets offshore to avoid IHT altogether which is why there is such a penal system for assets passing from a UK to a non UK-domiciled spouse.

Election for “deemed UK domicile”

From 6 April 2013 a non-UK domiciled surviving spouse of a deceased UK domiciled individual has the option to make an election to HMRC to be “deemed UK domicile” for Inheritance tax purposes only to avoid an IHT charge arising on the death where all assets pass to the surviving non-domiciled spouse.

The election can be made up to 2 years after the date of death and can be advantageous in certain circumstances.

See <http://www.hmrc.gov.uk/manuals/ihtmanual/IHTM13040.htm> onwards for HMRC’s guidance on this.

Statutory declaration

In order to strengthen a claim to having changed your domicile, you might consider drafting a statutory declaration.

This is a legal document sworn before a Commissioner of Oaths or equivalent, which sets out in intricate detail a compelling story of your life. It illustrates, with reference to supporting documentary evidence and detailed explanation, the motives behind your decisions and emotional ties to Hong Kong. It details how you started off life with a UK domicile which, over time and subject to certain circumstances and occurrences throughout life, changed to a domicile in Hong Kong. It clearly shows that Hong Kong is now your permanent home and where you intend to remain indefinitely.

Attached to the declaration would be copies of birth certificates, club memberships, permanent ID cards, certification of right of abode, retirement visas, work visas, passports, property deeds, driving licence, memberships of professional associations, etc. This collection of evidence should be kept safe with a copy of your Will which should be drafted ideally under Hong Kong law, together with any other legal documentation such as an Enduring Power of Attorney, notices of severance or declarations of trust.

These documents would then be available to the executors of the Will for use if required to rebut any attempts by HMRC to levy IHT on the estate.

Wills

Wills should be clear and unambiguous documents drafted generally under the law of the country in which you are domiciled.

The Will should set out who the executors and guardians are, deal with testamentary expenses, any declaration of domicile and burial or cremation instructions. Thereafter any specific wishes would be dealt with.

Everything else would fall into what is called the residuary estate.

In simplest form everything can pass to the survivor and then on to the children with a provision for default beneficiaries if something happens to the whole family.

If your wishes are more complicated and you require more flexibility then your will can be drafted such that the executors and trustees of the Will can hold the estate for a period of up to 2 years to administer in accordance with the terms set out in a letter of wishes or memorandum found with your Will or in your papers at death.

This gives some flexibility over cash gifts and heirlooms and any resulting trusts for beneficiaries. For instance, and instead of re-writing the Will, a new letter of wishes can be written to reflect changes of one's mind. To the extent that there is no such letter then the sum and chattels fall back into the residue to be dealt with as part of the rest of the estate.

Spouses of mixed domiciles

Where one spouse is UK domiciled and the other is not UK domiciled and there are significant non-UK assets, it is favourable for IHT purposes for the non-domiciled spouse to own the non-UK assets so as to avoid IHT on that portion of the estate.

Further to this, when writing Wills for spouses of mixed domiciles, the use of a lifetime offshore pilot trust for the benefit of the family generally should be considered by the non-UK domiciliary, which should be established during lifetime in order to receive the non-UK estate from the foreign domiciliary and lock in the IHT protection for the next generation.

If you need any further assistance or advice in relation to any of the above please contact Chris Brown on 2537 6369 or cbrown@lutea.com.hk .

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