Taking the long view

Inheritance tax and trusts

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Ray Magill considers transfers to a non-domiciled spouse or civil partner

Key Points

What is the issue?

The usual inheritance tax (IHT) exemption for gifts and bequests between spouses and civil partners is restricted to a cumulative amount equal to the nil-rate band where the spouse or civil partner is non-domiciled but the transferer is UK domiciled.

What does it mean to me?

Executors of someone UK domiciled whose spouse or civil partner is a beneficiary may need to explore the deceased's financial history for much more than the last seven years before death.

What can I take away?

You must take into account the amounts allowed under earlier transfers to a spouse or civil partner whether or not they were domiciled or treated as domiciled in the UK at the time in considering whether the restriction
is exceeded.

Executors of someone UK domiciled whose surviving spouse or civil partner is, or has been, non-domiciled may need to explore the deceased's financial history for much more than the last seven years before death. This is because the usual inheritance tax (IHT) exemption for gifts and bequests between spouses and civil partners is restricted to an amount equivalent to the nil-rate band in such cases.

The Inheritance Tax Act (IHTA) 1984 s 18(2) says:

> 'If, immediately before the transfer, the transferor but not the transferor's spouse or civil partner is domiciled in the United Kingdom, the value in respect of which the transfer is exempt (calculated as the value on which tax is chargeable) shall not exceed the exemption limit at the time of the transfer, less any amount previously taken into account for the purposes of the exemption conferred by this section.'

Note that the final phrase refers to the exemption conferred under 'this section', not under 'this sub-section'. When the restriction is applied (to a transfer to a non-UK domiciled spouse or civil partner), the executors must take into account the totality of inter-spouse transfers, both to the surviving spouse or civil partner and to all previous spouses and civil partners, regardless of the recipient's domicile or the time of those transfers. One wonders how often the result of this distinction has been overlooked.

The totality of inter-spouse transfers

This consequence is well known to HMRC, although perhaps easily missed by the average taxpayer, or their advisers.

Thus, the Inheritance Tax Manual at IHTM 11033 says:

> ‘You must take into account the amounts allowed under earlier transfers to a spouse or civil partner whether or not they were domiciled or treated as domiciled in the UK at the time in considering whether the restriction is exceeded. Since the exemption applies to transfers made by an individual, if that person has been married or in civil partnership with more than [one] person, the restriction applies to the cumulative total of all transfers to all spouses or civil partners.’

HMRC’s Example 2

In January 2013, Mr Costa transfers a UK property worth £200,000 to Mrs Costa. Both are domiciled outside the UK. Exemption under IHT Act 1984 s 18(1) is available in full.

In June 2013, Mr Costa is deemed to be domiciled in the UK and then gives another UK property worth £300,000 to his wife, who remains domiciled outside the UK. The restriction on the exemption under IHTA 1984 s 18(2) applies at this point.

At the time of the transfer that triggered the restriction, the spouse exemption available to Mr Costa was £325,000. He has already made a gift to Mrs Costa that qualified for exemption under IHT Act 1984 s 18 of £200,000, so the exemption available against this transfer is £125,000. This is because s 18(2) reduces the amount of the limited exemption available by ‘any amount previously taken into account for the purposes of the exemption conferred by this section’.

This means that £175,000 of the transfer will be a PET to Mrs Costa and chargeable to tax if Mr Costa dies before July 2020.

Note that HMRC is conscious that there is no time limit on the earlier transfers.

Another example

Adam gives his wife Eve (both being UK domiciled) £1m in 1991. That is all he gives her which isn’t covered by the ‘normal expenditure out of income’ exemption or s 11

(dispositions for maintenance of family). Adam and Eve are subsequently divorced, and in January 2006 Adam marries Flora (not UK domiciled). Adam makes no gifts to Flora in his lifetime, as he was advised that there would be only limited exemption. Adam dies in April 2019 and leaves his estate of £3m to Flora.

There is no exemption under s 18 available on Adam's death, nor would there have been on any lifetime gifts he might have made to Flora, because the £325k otherwise available is eliminated by the £1m given to Eve 28 years earlier. Adam's executors might be forgiven for overlooking this!

It's worth noting that if Adam's gift to Eve had been made before they married, that early gift would have had no inheritance consequences on his death. Furthermore, if he had given Flora £3m in 2011 rather than on his death, that too would have been a potentially exempt transfer, and escaped tax when he survived the gift by seven years.

If a change were made to s 18(2), a more pragmatic closing phrase would be to limit its application to the seven years immediately preceding the date of the transfer. Certainly, there is much more chance that executors would be able to comply with the law. Without such a change, executors of a 'UK domiciled' individual whose surviving spouse or civil partner is non-domiciled might need to explore the finances of the deceased over many decades.