TAX CHAMBERS
15 OLD SQUARE

Oliver Marre
Tax Chambers, 15 Old Square,
Lincoln's Inn, London WC2A 3UE
T: (020)7242 2744 F: (020)7831 8095
olivermarre@15oldsquare.co.uk

INHERITANCE TAX: THE NON-DOM SPOUSE EXEMPTION

Oliver Marre

These notes were prepared for a seminar hosted by Tax Chambers, 15 Old Square on 27 February 2012. They contain a discussion of the draft Finance Bill clauses published at that time.

1. Under the current law, whereas transfers between UK domiciled spouses are exempt for inheritance tax purposes, transfers made from a UK domiciled spouse to his or her non-UK domiciled spouse[1] are exempt only up to £55,000. This was the amount of the nil rate band until 15 March 1983. The logic for this capped spousal exemption from the point of view of the Treasury has been to counteract the risk that, otherwise, a non-UK domiciled spouse would be able to avoid inheritance tax on the assets he or she inherits from his or her UK domiciled spouse by taking the inherited assets outside the UK (a non-UK domiciled individual is, of course, not liable to inheritance tax on assets situated abroad).

2. Quite apart from the fact that the cap is based on the nil rate band of thirty years ago (a no-doubt deliberate but striking example of the effective reduction of a relief) the legislation is facing infringement proceedings from the European Commission as an disproportionately discriminatory measure. This talk will go on to look at the EU law aspect; but I will first consider the proposed changes.

3. The new rules for the inheritance tax treatment of non-domiciled spouses can be split into two parts.

<u>Part 1: exemption for non-domiciled spouses to be same as nil rate band</u>

4. The simpler change is that from 6 April 2013, transfers from a UK domiciled person to his or her non-UK domiciled spouse will be exempt from inheritance tax up to the amount of the nil rate band, i.e. currently £325,000 (and thereafter linked to the amount of the nil rate band). This addresses the fact that the cap has been 30 years out of date.

5. The increase in the exemption for transfers to non-domiciled spouses will be contained in the new section 18 (2A) IHTA 1984:

> *For the purposes of subsection (2), the exemption limit is the amount shown in the second column of the first row of the Table in Schedule 1 (upper limit of portion of value charged at a rate of nil per cent).*

[1] In this talk, the term "spouse" includes "civil partner".

Oliver Marre
Tax Chambers, 15 Old Square,
Lincoln's Inn, London WC2A 3UE
T: (020)7242 2744 F: (020)7831 8095
olivermarre@15oldsquare.co.uk

Part 2: election regime

6. The second proposed change is that in the future non-UK domiciled spouses will be able to elect to be treated as UK domiciled for inheritance tax purposes. This is introduced by new sections 267ZA and 267ZB IHTA 1984. Individuals who choose to make an election will be treated as though they are UK domiciled and will therefore benefit from an uncapped exemption from inheritance tax in respect of transfers from their spouses. However, this will also mean that any subsequent disposals by them would be liable to inheritance tax irrespective of the location of the assets. This will affect all their assets, and not just those assets received from the UK domiciled spouse.

7. The new sections are as follows:

267ZA Election to be treated as domiciled in United Kingdom

(1) A person may elect to be treated for the purposes of this Act as domiciled in the United Kingdom (and not elsewhere) if condition A or B is met.

(2) Condition A is that:

(a) the person's spouse or civil partner is domiciled in the United Kingdom at the time the election is made, and

(b) the person is not domiciled in the United Kingdom at that time.

(3) Condition B is that:

(a) the person's spouse or civil partner died on or after 6 April 2013 and was domiciled in the United Kingdom at the time of death, and

(b) the person was not domiciled in the United Kingdom at that time.

(4) An election under this section does not affect a person's domicile for the purposes of section 6(2) or (3) or 48(4).

(5) An election under this section is to be ignored -

(a) in interpreting any such provision as is mentioned in section 158(6), and

(b) in determining the effect of any qualifying double taxation relief arrangements in relation to a transfer of value by the person making the election.

Oliver Marre
Tax Chambers, 15 Old Square,
Lincoln's Inn, London WC2A 3UE
T: (020)7242 2744 F: (020)7831 8095
olivermarre@15oldsquare.co.uk

(6) For the purposes of subsection (5)(b) a qualifying double taxation relief arrangement is an arrangement which is specified in an Order in Council made under section 158 before the coming into force of this section (other than by way of amendment by an Order made on or after the coming into force of this section).

(7) In determining for the purposes of this section whether a person making an election under this section is or was domiciled in the United Kingdom, section 267 is to be ignored.

267ZB Section 267ZA: further provision about election

(1) For the purposes of this section -

(a) references to a lifetime election are to an election made by virtue of section 267ZA(2), and

(b) references to a death election are to an election made by virtue of section 267ZA(3).

(2) A lifetime or death election is to be made by notice in writing to HMRC.

(3) A lifetime election takes effect from the day on which it is made.

(4) A death election -

(a) must be made within 2 years of the death of the spouse or civil partner, and

(b) is treated as having taken effect from immediately before any transfer treated as made by section 4 immediately before the death of the spouse or civil partner.

(5) Subsection (6) applies if -

(a) a death election is made,

(b) a disposition is made, or another event occurs, between the time when the election is treated by virtue of subsection (4)(b) as having taken effect and the time when the election is made, and

(c) the effect of the election being treated as having taken effect from that time is that the disposition or event gives rise to a transfer of value by the person making the election.

(6) This Act applies with the following modifications.

Oliver Marre
Tax Chambers, 15 Old Square,
Lincoln's Inn, London WC2A 3UE
T: (020)7242 2744 F: (020)7831 8095
olivermarre@15oldsquare.co.uk

(a) subsections (1) and (6)(c) of section 216 have effect as if the period specified in subsection (6)(c) were the period of 12 months from the end of the month in which the election is made, and

(b) sections 226 and 233 have effect as if the transfer were made at the time when the election is made.

(7) A lifetime or death election cannot be revoked.

(8) If a person who made a lifetime or death election is not resident in the United Kingdom for the purposes of income tax for the whole of any period specified in subsection (9), the election ceases to have effect at the end of that period.

(9) That period is any period of three successive tax years, beginning -

(a) (in the case of a lifetime election) at any time after the election takes effect, or

(b) (in the case of a death election) at any time after the election is treated by subsection (4)(b) as having taken effect.

8. There is not, at the moment, a date from which this change will be effective. The legislation is silent on the matter. According to the Treasury, the initial plan was that these sections would come into force also on 6 April 2013, although if they were passed as currently published the sections providing for elections would be effective from Royal Assent, and so elections could only be made from that time.

9. As a result of consultation feedback, the Treasury has said that they are now considering their options. They may make the change retrospective by seven years, to cover current potentially exempt transfers. This would seem to be sensible because it is a necessary feature of a PET that whether or not it turns out to be chargeable cannot be known until it ceases to be a PET (i.e. 7 years after it is made or when the transferee dies). A decision on this will not be made public before the Finance Bill is published next month.

When an election can be made

10. The chance to elect will be available to a person's spouse in two circumstances: either where a person is domiciled in the UK at the time the election is made, but the person's spouse is not domiciled in the UK at that time; or where a person dies domiciled in the UK and the person's spouse is not domiciled in the UK at the time of the person's death. Under the draft legislation as currently published, the death must take place on or after 6 April 2013. It is not clear whether this date is also under review. It would seem sensible, if the Treasury is willing to go so far as to factor in PETs at all, to factor them in also in the case of people who are already dead.

Oliver Marre
Tax Chambers, 15 Old Square,
Lincoln's Inn, London WC2A 3UE
T: (020)7242 2744 F: (020)7831 8095
olivermarre@15oldsquare.co.uk

How an election must be made

11. In either case, under section 267ZB (2) IHTA 1984 the election must be made in writing to HMRC. Currently there is no prescribed form of writing. In due course we can expect a form to be produced. The election may be made at any time after marriage or registration of the civil partnership. It cannot be done in advance of marriage to take effect at the time of marriage.

From when an election will be effective

12. In the case of an election made in the lifetime of the UK domiciled person, the election will be effective from the day on which it is made. This may be impractical in many cases, when, in order to benefit from a full exemption from inheritance tax, an election would have to be made in advance of any gift from a UK domiciled spouse to a non-UK

    domiciled spouse. It would not, as things currently stand, be possible to receive a gift and subsequently elect to be treated as UK domiciled because of the gift. Often, the transfer will be a potentially exempt transfer which turns out to be exempt because the transferor spouse lives the requisite seven years; but this will not be every case. This is another reason that it would be sensible to allow elections to be made retrospectively by up to seven years, which the draft legislation does not currently do.

13. In the case of an election when the UK domiciled person is dead, the election must be made within two years of the death of the spouse. It will then be treated as having taken effect from immediately before any transfer which is treated as being made on death (Sections 267ZA (3) and 267ZB (4) IHTA 1984).

14. If a person makes an election which is treated as being effective from the date of an on-death transfer, and between the time of the death and the time of the election that person has made a transfer of his or her own (such as a transfer into trust), it must be remembered that the transfer made by the electing spouse will in principle become a chargeable transfer of value.

15. In such a case, the time limits for payment of that inheritance tax, for the delivery of an inheritance tax account, and the due date of any interest, are all dated from the date of the election (and not the date of the transfer) (Sections 267ZB (5) and 267ZB (6) IHTA 1984).

Elections to be irrevocable?

16. Once made, an election will be *prima facie* irrevocable (section 267ZB (7) IHTA 1984). However, if a person who has made an election is subsequently non-resident for income tax purposes for three successive years, beginning any time after the election has taken place, the election ceases to have effect at the end of that three year period.

17. There is no requirement that an electing spouse needs to be UK resident at the time of making an election. Therefore it would be possible for a non-resident non-domiciled spouse of a UK domiciliary to make an election on the death of the UK domiciled (or more likely deemed domiciled spouse) and subsequently remain non-resident so the election ceases to have effect.

Oliver Marre
Tax Chambers, 15 Old Square,
Lincoln's Inn, London WC2A 3UE
T: (020)7242 2744 F: (020)7831 8095
olivermarre@15oldsquare.co.uk

The effect of s. 267

18. A person who wishes to make an election to be treated as UK domiciled for inheritance tax cannot, of course, be UK domiciled at the time they make the election. The draft legislation provides that in order to ascertain whether or not a person is UK domiciled, and hence whether it is open to them to make an election, the deemed domicile provision in section 267 IHTA 1984 should be ignored. Therefore, a person can elect to be UK-domiciled under the new provisions even if he or she is already deemed domiciled in the UK under s. 267 IHTA 1984. (If it were not for this section such a person might have thought him or herself ineligible to make the election by virtue of being already deemed to be UK domiciled). This might be relevant if, by virtue of timing, the person then ceased to be deemed domiciled in the UK under s. 267 IHTA 1984, but wished to remain UK domiciled under the new provisions. This seems sensible but does leave the slightly odd position of someone deemed to be UK domiciled able to make an election which would effectively "take effect" in the future; whereas someone who is actually UK domiciled would not be able to do so.

19. It should be noted that the deemed domicile provision is still relevant for determining the domicile of the UK domiciled spouse. This highlights another potential problem with the fact that a post-death election can only be made within two years of the death of the UK domiciled spouse. If the spouse in question believed himself to be non-domiciled, but was in fact deemed domiciled under s. 267 IHTA 1984 (for example because they have believed themselves to be non-resident but HMRC subsequently contend that they were resident for the requisite seventeen of the last twenty years), the non-domiciled spouse could quite happily labour under a misapprehension for several years before received a demand for inheritance tax, by when it would be too late for him or her to elect to be treated as UK domiciled. The same problem would arise if a claim for relief is denied by HMRC; or a gift with reservation is contended. In these cases, too, a non-domiciled spouse might wish to benefit from electing to be treated as a UK domiciliary for inheritance tax purposes in order to avail him or herself of the full spousal exemption, but it might well be too late to do so.

Elections from beyond the grave?

20. There is no express provision for a deceased person's personal representatives to make an election after that person's death but it should be expected that personal representatives will be able to avail themselves of the election procedure. If not, this

    could be dealt with in many cases by making a variation of the UK domiciled spouse's will to direct assets to the beneficiaries of the non-UK domiciled spouse's will. The fact that such a variation is treated as a disposition by the first deceased testator (in this case the UK domiciled spouse) is accepted by HMRC in Inheritance Tax Manual IHTM35011.

Minor exceptions

21. The draft legislation provides that the election will not have effect for the purposes of securities issued by the treasury and the holders of certain government bonds who are domiciled in the Channel Islands or the Isle of Man; or for the purposes of settled property when that property is securities issued by the treasury (section 267ZA (4) IHTA

Oliver Marre
Tax Chambers, 15 Old Square,
Lincoln's Inn, London WC2A 3UE
T: (020)7242 2744 F: (020)7831 8095
olivermarre@15oldsquare.co.uk

1984). The election is to be ignored for the purposes of double tax treaties and inter-governmental arrangements (s. 267ZA (5) IHTA 1984).

Cost to the Treasury

22. The Treasury has calculated that the combined effect of the increase of the exemption and the availability of the election is expected to reduce HMRC's receipts by approximately £5 million per annum from 2014-15.

European law: compliance issues

23. This is not a vast amount of money, but considering the hole in public finances, it does raise the question of why the change has been made. The answer lies not with the Treasury's innate sense of fairness but in European law.

24. On 24 October 2012 the European Commission announced that it has formally requested that the UK government should review the inheritance tax treatment of non-domiciled spouses:

> *This difference in tax treatment of transfers between domiciled and non-domiciled spouses is of a discriminatory nature and contrary to EU rules (Article 18 TFEU). The Commission's request takes the form of a reasoned opinion (the second step of the infringement procedure). If there is no satisfactory reaction within two months, the Commission may decide to refer the matter to the Court of Justice of the European Union.*

25. Article 18 of the Treaty on the Functioning of the European Union states:

> *Within the scope of application of the Treaties, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited.*

26. It is also likely that Article 63 TFEU (free movement of capital) will be engaged. The interaction between the various provisions of the TFEU is beyond the scope of this talk, but the difference in treatment between UK domiciled spouses and non-UK domiciled spouses stands contrary to one or other, if not both, of these Articles.

27. Discrimination for these purposes is the different treatment of people in the same situation; and as regards inheritance tax on transfers between spouses, there is unquestionably a difference in treatment. This is not prima facie discrimination on the basis of nationality. However, indirect as well as direct discrimination is prohibited. Indirect discrimination arises when a provision is likely to affect one class of person to a greater extent than another class of person. In the majority of circumstances, a non-domiciliary will also be of a different nationality and this seems to be the basis for the European Commission's infringement proceedings.

28. Having established discrimination, the next question to ask for EU law purposes is whether the discrimination can be justified. One of the justifications permitted is that under the balanced allocation of fiscal jurisdiction, the member states of the EU, including the UK, are permitted to set their own tax laws. Within that framework, it is justifiable for the UK to attempt to prevent assets which are liable to tax in the hands of

Oliver Marre
Tax Chambers, 15 Old Square,
Lincoln's Inn, London WC2A 3UE
T: (020)7242 2744 F: (020)7831 8095
olivermarre@15oldsquare.co.uk

the UK domiciled spouse from escaping the net. The next question to be asked is whether any justified restriction is proportionate to the matter it is trying to deal with.

Do the new rules help?

29. The CJEU analyses proportionality in two stages: is a restriction appropriate; and does it go beyond what is necessary?

30. The ability of the non-UK domiciliary to make an election to be treated for inheritance tax purposes as UK domiciled has the effect of bringing into the inheritance tax net all the assets of the previously non-domiciled spouse, which would (apart from UK situs assets) previously not have been within the scope of inheritance tax. This would appear to go beyond what is necessary to ensure that assets previously owned by the UK domiciled spouse do not escape inheritance tax.

Gielen

31. There is relevant case law from the European Court in this regard. In case C-440/80 *Gielen* the CJEU ruled in fairly strident terms that allowing an election between what the CJEU referred to as "a discriminatory regime and one which is ostensibly not discriminatory…is not…capable of remedying the discriminatory effects of the first of those two tax regimes".

32. As a result, if system is currently discriminatory, the new election cannot anyway not bring it into line with EU law if *Gielen* is followed. In *Gielen,* the CJEU continued:

> *…if such a choice were to be recognised as having the effect described, the consequence would be to validate a tax regime which, in itself, remains contrary to Article 49 TFEU by reason of its discriminatory nature.*
>
> *…In addition…the fact that a national scheme which restricts the freedom of establishment is optional does not mean that it is not incompatible with European Union law.*

A possible answer to EU compliance?

33. One more proportionate measure might be to ring fence the assets transferred by the UK domiciled spouse and provide that an election can be made in respect of these assets only. In that way, there would be no inheritance tax on the transfer of value to the spouse, but the relevant assets (i.e. the ones which would otherwise "escape" tax) would then be caught by UK inheritance tax on a subsequent transfer of value by the non-domiciled spouse, regardless of where they are situated. Assets already belonging to the non-domiciled spouse would not be affected.

34. This might seem proportionate but *Gielen*, if followed, would appear however effectively to prevent an election of this sort even as regards assets transferred from the UK domiciled spouse, since the discriminatory regime exists notwithstanding the option to elect out of it. An alternative possibility might therefore be to design the provision to deem a non-UK domiciled spouse automatically UK-domiciled for the purposes of assets transferred to them from a UK domiciled spouse, so that such transfers would be exempt from inheritance tax.

Oliver Marre
Tax Chambers, 15 Old Square,
Lincoln's Inn, London WC2A 3UE
T: (020)7242 2744 F: (020)7831 8095
olivermarre@15oldsquare.co.uk

35. The obvious problem with both this proposal and the suggestion that an election could be made as regards specific transfers is that it will, in many cases, be very difficult or practically impossible to trace the assets (or assets representing them) which should be subject to an inheritance tax charge. In this regard, in case C-371/10 *National Grid Indus,* the CJEU stated that a situation where the taxpayer is able to elect whether to pay the tax upfront or otherwise would carry the administrative burden of tracing and have a deferred payment would be a proportional way to address this difficulty. In the case of a non-domiciled spouse, this might mean that the non-domiciled spouse can elect whether to pay the inheritance tax charge arising (above the nil rate band), i.e. to be treated as a non-domiciliary; or otherwise to defer payment, i.e. be treated for the purposes of those assets as a UK domiciliary, and bear the burden of the tracing. The most satisfactory solution under EU law might therefore be to have an automatic deemed domicile with respect to specific assets received from a UK spouse, with the potential to opt out and pay any requisite inheritance tax.

When to transfer?

36. As there is currently little doubt that the pre-Finance Act law is not EU compliant, there is an argument in favour of advising UK domiciliaries with non-domiciled spouses to make a transfer to a non-UK domiciled spouse now, before any changes are instituted. That would allow the non-domiciled spouse to rely on the fact that the discriminatory and disproportionate provision should be disapplied by the courts in this country. Logically, the non-domiciled spouse should then be able to avail him or herself of the full spousal exemption, and once he or she has done so to continue to be non-domiciled and reap the benefits of that.

37. Once changes are instituted, it seems that a non-domiciled spouse would still have a good argument under European Law that, if he or she chose to make an election to be treated as a UK domiciliary, the part of the provision which had the effect of bringing their previously owned assets into charge would be disproportionate and should be disapplied. So a person making an election could elect as regards transfers from his or her UK domiciled spouse and rely on EU law to disapply the measure as regards the rest of his or her assets. However, the potential to face a robust argument from HMRC on the European question is likely to increase after the new provisions are brought in.

27 February 2013