DOMICILE AND INHERITANCE TAX

A non-UK domiciliary (sometimes called a "non-dom") is an individual who is domiciled outside the UK for the purposes of UK common law.

"Domicile" is a concept in UK law which is different from the UK tax concept of residence. It is possible for an individual to be resident in one country, domiciled (for UK law purposes) in a second country, and a national of a third.

Non-UK domiciled status can persist for a long time after an individual has become resident in the UK. Under UK common law, an individual may have been UK resident for decades, and may even have acquired British nationality, and yet have a domicile outside the UK. This will be the case if the individual had a "domicile of origin" outside the UK and he or she has never acquired a "domicile of choice" in the UK.

At birth an individual acquires a domicile of origin. That domicile is retained until an individual abandons that country and moves to another country with the intention of remaining there permanently or indefinitely. That country then becomes the individual's domicile of choice.

Under UK law the burden of proof regarding a change of domicile falls on the person alleging the change. Under English law the standard of proof is more onerous than in most civil law matters and if the question of a change of domicile had to be considered by the court the necessary elements of residence and intention have to be shown with "perfect clearness and satisfaction" to the court.

An individual with a non-UK domicile of origin will remain non-UK domiciled for as long as he can credibly say that he intends to cease residing in the UK at some point in the future. For example, it is common for individuals with foreign domiciles of origin to intend to leave the UK when their children cease to be in full-time education in the UK, on the termination of an employment with a UK employer, on their retirement, etc. As long as the intention to leave the UK is reasonable, the domicile of origin will be retained in these scenarios. However, if an individual moves to the UK late in life, an assertion of a foreign domicile will be more liable to challenge.

It is also possible for an individual with a domicile of origin in the UK to become a non-UK domiciliary, by residing in another country and forming the intention to reside there permanently or indefinitely. This will result in the acquisition of a domicile of choice in the other country. In principle such a domicile of choice may be retained if the individual ceases to reside in the other country, and even if he begins to reside again in the UK. However, if an individual who had a UK domicile of origin and was born in the UK becomes UK resident, he will be "deemed domiciled" in the UK and therefore ineligible for the remittance basis (see heading below).

Once a domicile of choice is acquired, that domicile is retained until that country is abandoned by the individual with the intention of never returning there. Further, once the domicile of choice is abandoned, unless another domicile of choice is immediately acquired, the domicile of origin reverts automatically even if the individual never sets foot there again.

However, once a domicile of choice has been acquired it is not lost simply because an individual subsequently changes his mind and intends to leave that country at some future date.

The UK Self Assessment system requires that taxpayers have to decide whether they are resident or domiciled in the UK and how that may affect their liability to UK tax. Where a taxpayer claims to have a foreign domicile, H M Revenue & Customs (HMRC) may enquire

whether or not that is correct. By its nature this sort of enquiry will be an in-depth examination of the taxpayer's background, lifestyle and intentions over the course of their lifetime. The enquiry will extend to wide areas of the taxpayer's life and that of his family and will ask questions and ask for information in support of the claim. One question that may be asked is "did you ever form the intention of remaining in the alleged domicile of choice permanently (or at least indefinitely)?" Unless that question can be answered in the affirmative a domicile of choice will not have been established.

As already noted, under the current rules an individual who has a domicile of origin outside the UK will remain non-UK domiciled, and therefore eligible to use the remittance basis, for as long as he has not formed an intention to reside in the UK permanently or indefinitely (subject to becoming "deemed domiciled" see below). This will be the case if he intends to leave the UK at some reasonably definite point in the future. However, it can be helpful in discussions with HMRC to point to a particular country, which may not be the individual's domicile of origin.

An individual's domicile of origin is regarded as hard to lose, but the longer an individual remains in the UK, the more risk there is of his or her status as not domiciled in the UK ("non-dom") being challenged by HMRC. Such a challenge may occur in the individual's lifetime or (more commonly) after his death, when his or her personal representatives will have to gather evidence regarding the deceased's intentions.

HMRC are becoming more aggressive in challenging filing positions based on a domicile outside the UK, not only in relation to individuals who have died as UK residents, but also in relation to living taxpayers. In view of this, it makes sense to take steps, in advance of any such possible challenge, to ensure that the evidence of foreign domicile is as strong as possible.

It is often advisable, therefore, for non-UK domiciled individuals to prepare a domicile statement. The purpose of a domicile statement is to set out supporting evidence of the individual's claim to be a non-dom. This is very useful in the event of a domicile challenge by HMRC. Such a statement is often enough to make HMRC back down and concede that non-dom status was retained until death, and should be kept up to date. In a dispute with HMRC about domicile, a recently written domicile statement has a lot more force than one written ten or twenty years ago.

Why is domicile important?

In English law, the significance of domicile goes beyond tax. In particular, a foreign domicile can affect succession to "movable" assets. The succession law of a country of domicile may contain "forced heirship" provisions which prevent the individual from disposing of their assets on death in the way that they wish. However, the most immediate impact of a foreign domicile is in reduced exposure to UK taxation, in recognition of the fact that the person is less closely connected to the UK. The tax advantages of being a non-dom are as follows:

- the remittance basis of taxation;
- the restriction of inheritance tax (IHT) to UK assets; and
- the scope to create a non-resident trust from which the individual can benefit, without the creation of the trust giving rise to IHT, and without various anti-avoidance rules applying to the trust's assets and income/gains generated within the trust.

Limited scope of IHT

Being non-UK domiciled is highly advantageous where IHT is concerned.

When a UK domiciliary dies, his or her estate is subject to IHT on a worldwide basis. IHT applies at 40% to assets both within and outside the UK, except to the extent that they are protected by the exemption for assets passing to a surviving spouse, or fall within the individual's "nil rate band", presently set at £325,000.

By contrast, when a non-dom dies, then provided that he or she is not deemed domiciled (see below) in the UK for IHT, the tax generally applies only to UK assets; generally there is no IHT on assets situated outside the UK.

The only notable exception to this relates to non-UK assets which derive their value from UK residential property (such as company shares), or have been provided as collateral for a loan used to acquire or improve such property. Such assets are effectively deemed to be UK assets for IHT purposes.

The same principles apply if a non-dom (who is not deemed domiciled) makes a lifetime gift of non-UK assets. As long as there is no connection with UK residential property, there is no IHT on such a gift, even if the gift is one which would potentially give rise to an immediate IHT charge for a UK domiciliary. Examples are gifts to trusts, or gifts to trust-like entities such as private foundations.

The deemed domicile concept

The concept of deemed domicile in the UK limits the length of time for which the tax advantages apply. A deemed domicile is typically acquired by a non-UK domiciled individual once he has been UK resident in 15 of the 20 preceding tax years. It follows that an individual with a foreign domicile typically becomes deemed domiciled for IHT purposes at the beginning of his 16th tax year of residence in the UK.

It is important to count tax years of residence correctly for these purposes. Under the rules which applied before the UK introduced its current statutory residence test, it was not uncommon for an individual moving to the UK to become taxable as a resident in a given tax year even if he only started spending time in the UK towards the end of the tax year. This can also happen under the statutory resident test, for example if the individual becomes UK resident on commencing full-time work in the UK. There is no doubt that, where an individual became UK resident partway through a tax year, that whole tax year must be counted for the purposes of the deemed domicile test

(even if he was taxable as a resident, in that tax year, for just a few days). Deemed domicile can therefore arrive sooner than expected, sometimes little more than 14 years after the individual's "arrival" in the UK.

The effect of being deemed domiciled in the UK is that the remittance basis no longer applies, and the scope of IHT extends from UK assets to all assets on a worldwide basis. This is relevant not only in the event of the individual's death, but also if the individual makes lifetime gifts, especially gifts to trusts or trust-like entities.

However, where an individual has not yet become deemed domiciled, this unwelcome extension of the scope of IHT can be countered by putting non-UK assets into what is known as an excluded property settlement. This is a trust, usually in discretionary form, of which the non-dom himself can be a beneficiary. The trust must be created and funded before the non-dom becomes deemed domiciled. If so, it can function as an indefinite shelter from IHT, not just in the non-dom's lifetime but potentially for many generations after his or her death. This is explained in more detail below.

"Breaking" actual and deemed domicile for IHT purposes

The "three year rule" applies to individuals previously actually domiciled in the UK. Such an individual is deemed to remain UK domiciled for three calendar years after he has in fact lost his UK domicile. However, the "long-stayer rule" imposes deemed domicile on such individuals for the three tax years following departure, so both these rules need to be considered, often meaning that domicile for IHT purposes is not lost until the fourth tax year of non-UK tax residence.

Where an individual has already become deemed domiciled for IHT purposes, his deemed domicile can in principle be "broken" by a period of non-UK residence. In a typical case, six entire tax years of non-UK residence are required if the individual plans to resume residence in the UK after the non-resident period. But if return is not contemplated then "breaking" is achieved after three tax years of non-UK tax residence.

If an individual plans to "break" his deemed domicile, close attention must be paid to the provisions of the UK's statutory residence test, to ensure that he will qualify as a non-UK resident throughout the required period. Deemed domicile will not be "broken" if the individual resumes UK residence too soon.

The domicile mismatch trap

Non-dom status is generally beneficial, but there is one situation in which it can have unwelcome IHT consequences – where there is a "domicile mismatch". This occurs when:

- a UK domiciled spouse dies leaving his or her estate to a non-dom spouse who is not yet deemed domiciled; or
- a non-dom spouse who is deemed domiciled for IHT purposes dies leaving his or her estate to a non-dom spouse who is not yet deemed domiciled.

Normally, assets passing from one spouse to another are free of IHT, by virtue of the spouse exemption. However, in the scenarios mentioned above, the spouse exemption is limited to £325,000 – unless the surviving spouse makes an election to be treated for IHT purposes as domiciled in the UK. If so, the spouse exemption is unlimited, but the worldwide assets of the surviving spouse will be within the scope of IHT on his or her own death (unless the surviving spouse then spends sufficient time outside the UK to shed his or her deemed domiciled status).

Mixed domicile couples, and non-dom couples who became UK resident at different times, should consider putting special Wills in place to cater for the possibility of a domicile mismatch on the first death. Consideration should also be given to transferring non-UK assets of the non-UK domiciled and non-deemed domiciled spouse into an excluded property settlement, to forestall the acquisition of deemed domiciled status in the event that an election is required to avoid IHT on the first death.

Establishing an excluded property settlement

As mentioned above, non-doms generally lose their favoured IHT status once they become deemed domiciled, when their non-UK assets fall within the scope of IHT.

However, if a non-dom gives non-UK assets to an excluded property settlement before he becomes deemed domiciled, these assets will remain ring-fenced from IHT even after the individual becomes deemed domiciled (or actually UK domiciled) and beyond his death, so that the assets are protected from IHT for future generations. The individual can, and normally should, be a beneficiary of the trust. It is also possible for the trust to be revocable, so that the individual has the ability to bring it to an end at any time. These features of the trust do not affect its efficacy as a shelter from IHT.

If the trust has non-UK resident trustees, it offers an additional advantage, because neither the non-UK domiciled settlor nor any other UK resident beneficiary will be liable to CGT in respect of capital gains realised by the trustees, or liable to income tax in respect of non-UK income received by the trustees, until a benefit is received from the trust. This means that income and gains can, in principle, roll up inside the trust without tax being paid on them.

We would normally recommend that a professional offshore trust company is appointed as trustee, to ensure that the non-UK resident status of the trust is maintained. If the intention is to defer tax on income and gains through the use of an offshore trust, it is crucial that the settlor does not become actually domiciled in the UK (trust income and gains would then be taxable as they arise), and also that the trust assets are carefully selected.

Although an excluded property settlement will save IHT at 40% of the value of the assets on the settlor's death, there will be ongoing trustee fees. Prospective settlors should compare these costs against the cost of life assurance which could be used to settle IHT liabilities.

Where a non-dom might be interested in establishing such a trust, to ring-fence assets from IHT, it is strongly recommended that advice is taken at the earliest opportunity. Ideally, an adviser should be consulted more than a year before the anticipated date of acquisition of a deemed domicile in the UK.

Contacts

If you would like further advice or information in relation to the issues outlined within this document, please do not hesitate to get in touch with your usual BDO contact or any of the individuals listed below:

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