The Offshore & International Taxation Review

IHT SPOUSE EXEMPTION ON DEATH OF A FOREIGN DOMICILIARY

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Suppose:

(1) H (not UK domiciled) dies leaving:

(a) UK property (not excluded property) and

(b) foreign situate property (which is excluded property).

(2) Part of H's estate passes[2] to his wife W (who survives him).

This raises the interesting question of the interaction of the excluded property rules and the IHT spouse exemption.

The relevant statutory provisions of the IHTA 1984 provide:

> 4 Transfers on death
>
> (1) On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death.
>
> 5 Meaning of estate
>
> (1) For the purposes of this Act a person's estate is the aggregate of all the property to which he is beneficially entitled, except that the estate of a person immediately before his death does not include excluded property.

The following propositions are clear:

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[2] By will, by survivorship or by the relevant succession law; this makes no difference.

(1) IHT is charged as if H made a transfer of value ("the deemed transfer of value").

(2) The estate of H immediately before his death did not include his excluded property.

(3) The value transferred by the deemed transfer of value is equal to the value of H's estate (which is the value of the UK situate property).

Suppose first that on the death of H only his foreign situate (excluded) property passes to his spouse. Does the spouse exemption apply?

Section 18, IHTA 1984 provides:

> (1) A transfer of value is an exempt transfer to the extent that the value transferred is
>
> [a] attributable to property which becomes comprised in the estate of the transferor's spouse or
>
> [b] so far as the value transferred is not so attributable, to the extent that that estate is increased.[3]
>
> (Paragraphing added)

The deemed transfer of value is not exempt under s.18(1)[a]. The value transferred is not attributable to property which becomes comprised in the estate of the spouse.

That leaves the exemption in s.18(1)[b]. A transfer of value is an exempt transfer to the extent that the estate of the spouse is increased. The estate of the spouse is increased on the death of H.[4]

It is therefore considered that the spouse exemption does apply on a plain reading of the words.

Is this result so absurd that the courts should not adopt a plain reading? I do not see why it should be regarded as absurd. If W is UK domiciled, the consequences of the example is that W's estate is increased and the property W receives will be subject to tax on the death of W.

It might be said to be anomalous because a lifetime gift of excluded property by H to his spouse would not qualify for the spouse exemption. But of course in such a case the spouse exemption is not needed.

The end result is consistent with the exemption for funeral expenses: s.172, IHTA

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3 In the case considered here, the restriction in section 18(2) does not apply since H (the transferor) is not domiciled in the UK.

4 This is the case even if the property is excluded property in the hands of W (which will be the case if W was not UK domiciled). Excluded property is in principle "property" for IHT.

1984.

If the contrary view were adopted, then the practical consequence should not be to raise more funds for the Revenue, but only to pose a trap for taxpayers and their advisers.

Now suppose H leaves W a pecuniary legacy. CTO Manual M.210 provides:

> **M.210. Deceased domiciled outside the UK**
>
> Where the will of a person domiciled abroad disposes of his UK estate and some or all of his world estate, exemption for pecuniary legacies to his spouse or to a qualifying charity should be given against the UK estate in the proportion which that bears to the world estate, and not wholly against the UK estate. Where there is difficulty in obtaining details of the world estate, or where the official practice meets resistance, Pre-grant (Foreign) may be able to assist. Scottish cases should be referred to your Group Leader.

This is correct in relation to charities. The IHT charity exemption is more narrowly worded. But for spouses, it is equally difficult to reconcile with the words of s.18(1)[b]. It is suggested that the spouse exemption applies to the extent of the pecuniary legacy. It makes no difference whether the pecuniary legacy is subsequently paid out of UK or foreign situate property.

Chapter III Part II IHTA 1984 is headed "Allocation of Exemptions". It does not shed much light on the issue. S.36 provides that these rules apply:

> "Where any one or more of s.18 ... above apply in relation to a transfer of value but the transfer is not wholly exempt ..."

In these circumstances we are envisaging the transfer will be "wholly exempt" if the value given to the spouse equals the value of the UK situate property. What happens if the value given to the spouse is less than the value of the UK situate property? In that case let us assume that what the spouse receives is a "specific gift" as defined in s.42(1). S.38 provides that:

> "(1) such part of the value transferred shall be attributable to specific gifts as corresponds to the value of the gifts ..."

This rather tends to confirm the view taken above.

Implications for Drafting Will of Foreign Domiciliary

Where a foreign domiciled testator has chargeable (not excluded) property and excluded property, the safe strategy will be:

(1) to give the chargeable property to exempt beneficiaries, e.g.:

(a) spouse;

(b) trust where spouse has an interest in possession; (better where the spouse is UK domiciled)

(c) UK charities;

(2) to give excluded property to other persons.

A pecuniary legacy to an exempt beneficiary should be charged on UK situate property. This will avoid a dispute with the Revenue. However, it is not necessary.

Instruments of Variation

CTO Manual provides:

> **P.61 No *bona fide* variation**
>
> Attempts to reduce the tax on death without there being a *bona fide* variation may take different forms, for example ...
>
> (3) a deceased who dies domiciled outside the UK may leave property in this country to chargeable beneficiaries and excluded property (such as government securities and foreign property) to the spouse. A variation may then be used for the spouse's entitlement to be switched from excluded property to the ordinary UK estate without any change in the amount the spouse receives.
>
> You should refer cases of the third type immediately above to the TA Team Leader without making any preliminary enquiries provided the basic facts are clear.

I do not understand in what sense it could be said that this is not a "*bona fide* variation".[5] S.142(5), IHTA 1984 expressly envisages deeds of variation relating to excluded property.

A variation of this kind cannot sensibly be challenged if properly carried out. If the author's view of the spouse exemption is right, however, a deed of variation would not be necessary. (It may nevertheless be desirable as a useful precaution where a will has not been drafted in the manner recommended above.)

The second edition of the author's *Taxation of Foreign Domiciliaries* is due to be published in September 2003.

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[5] It would be different if there were an arrangement under which the spouse later swapped the UK property for the excluded property.