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Planning for deemed domicile with excluded property trusts

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With 5 April only a few weeks away, it is time for long-term UK residents to think about whether they are coming up to their deemed domicile date for UK inheritance tax purposes. Those who arrived between 6 April 1998 and 5 April 1999 will become deemed domiciled on 6 April 2014. For US persons facing deemed domicile, there is a planning opportunity with excluded property trusts to preserve the difference between the large US federal estate tax exemption and the relatively small UK nil rate band amount.

It may seem as though the new year has just begun, but time is running out for pre-5 April planning. This is particularly true for any non-domiciled UK residents who will become deemed domiciled in the UK for inheritance tax purposes on 6 April 2014. Anyone tax resident in the UK in 17 out of 20 UK tax years (remembering that the tax year runs from April to April and that partial years count) will be deemed domiciled in the UK for inheritance tax purposes 6 April of the 17th year of tax residence. In practical terms, this means that UK inheritance no longer applies solely to UK situate assets, as is the case for non-domiciliaries, but rather to your worldwide estate.

US citizens or green card holders resident in the UK will already be familiar with the concept of worldwide taxation. The rates of US federal estate tax and UK inheritance tax are the same at 40%, but as US persons currently have a US$5.34 million exemption from US federal estate and gift tax and UK domiciliaries and deemed domiciliaries still only have a £325,000 exemption from UK inheritance tax, there is now a huge disparity between the two exemptions that most US persons would prefer to preserve. Excluded property trusts allow US persons (and other UK non-domiciliaries) to keep non-UK assets outside the UK inheritance tax net as long as the trusts are established and funded before 6 April of the 17th year of tax residence. By establishing and funding a trust prior to becoming deemed domiciled, a US person is able to preserve the difference between the US federal estate tax and UK inheritance tax exemptions, resulting in more assets passing tax-free to the next generation.

US persons may consider taking an extra step in establishing the trust as a completed gift trust for US gift tax purposes in order to utilize the $5.34 million exemption from US federal estate and gift tax. This has the effect of decreasing the available estate tax exemption on death with the advantage of not only removing the exemption amount from a US person's taxable estate, but also any appreciation on those assets placed in trust. Further, although the current exemption is 'permanent', there have been so many fluctuations and uncertainties in this area of taxation in recent history that making a current gift of the exemption is the only way to guarantee the exemption from estate tax on death. This can be prudent planning, particularly for those US persons with estates well in excess of the exemption amount.

An excluded property trust is income tax neutral, meaning the settlor will continue to be subject to US and UK income tax on any trust income as though the trust did not exist (e.g. UK remittance basis taxpayers will still be subject to UK income tax any income from the trust remitted to the UK and will continue to be liable to the remittance basis charge, if applicable). It is extremely important that excluded property trusts are carefully drafted to take into account the relevant UK and US tax considerations. If a UK resident has already become deemed domiciled without setting up an excluded property trust, there may still be opportunities to establish life insurance trusts, which can provide the cash necessary to cover death tax exposure, but whose proceeds are not included in the taxable estate.

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