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Planning for Inheritance Tax as an American in the UK

Many people don't like to think about what will happen in the event of their death. For persons with connections to the US and the UK, the subject of inheritance tax is one that can be very important due to the large differential in the nil rate inheritance tax bands available in the UK as compared to the US. A lack of understanding about how inheritance tax works can end up costing beneficiaries hundreds of thousands, if not millions, of dollars. However, proper planning can help minimise the amount of inheritance tax payable and help ensure that loved ones are left with an estate that will provide for their needs. Proper strategies will largely depend on whether an individual is deemed to be UK domicile or non-UK domicile at the time of death.

What is inheritance tax?

Inheritance tax is a levy that is assessed by the government based on the net value of an estate. In its simplest definition, the net value of an estate is based on the fair market value of all assets on the date of death less any debts. Includable assets are most often, among others:

- Cash in the bank
- Investments
- Any personal property
- Any real property or businesses owned
- Cars
- Life insurance policy pay-outs

In the UK everyone is currently allowed a net estate valued up to £325,000 before any inheritance tax is assessed. This is called the nil-rate band. Any estate valued above this threshold is subject to tax at 40% (or 36% if at least 10% of the residual assets are left to a HMRC qualified charity).

Generally, at death, any assets left to a spouse or civil partner, are exempt from inheritance tax as long as they are considered to be UK-domicile (it is possible to make an election to be treated as UK-domicile, if appropriate). This means that together a couple can currently pass on an estate worth up to £650,000 before being subject to UK inheritance tax.

Increased UK Inheritance Tax Thresholds

An additional nil rate band of £175,000 is available when a main residence is passed on to an immediate family member (defined as children, step-children and grandchildren). So, the nil rate band totals £1 million before UK inheritance tax will be payable for couples with a main residence that will be passed on to children or grandchildren.

This additional allowance is phased out on estates worth £2 million or more. Individuals will lose £1 of the allowance for every £2 that the estate value exceeds £2 million. So, the allowance would be fully phased out when an estate is worth in excess of £2,350,000.

During an individual's lifetime the UK allows gifts to be made to individuals free of tax if the gift meets certain conditions. This is known as a potentially exempt transfer or PET. A gift will be free of inheritance tax as long as the individual giving the gift does not die within seven years of the date of the gift. If the individual who makes the gift does die within seven years' then part or all of the value of the gift will be added back to the taxable estate.

There are some exceptions to the potentially exempt transfer 7 year rule:

- Individuals are allowed to gift up to £3,000 each tax year.
- Contributions to charities and political parties are excluded
- Gifts in consideration of marriage up to a certain amount.
- Regular gifts out of income (as opposed to capital) that do not affect the lifestyle of the individual who is making a gift.

Domiciled versus non-domiciled for UK inheritance tax purposes

Many Americans living in the UK are considered to be non-domiciled for UK inheritance tax purposes. Currently, a non-domiciled individual becomes deemed domicile for inheritance tax purposes when they have been resident in the UK for at least 15 out of the last 20 years. When an individual is deemed domiciled for UK inheritance tax purposes, the UK will generally apply its inheritance tax rules on an individual's worldwide assets.

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Until an American meets the UK deemed domiciled rules, it is likely that they will be considered non-domiciled in the UK and will remain domiciled in the US for inheritance tax purposes. There are a number of important considerations when this is the case. First, while an American remains non-domiciled the UK inheritance tax threshold and associated rules remain relevant for any assets that are held inside the UK. Assets held outside of the UK generally remain outside of the UK inheritance tax net.

A US person typically remains domiciled in the US and subject to the US inheritance tax rules on their worldwide assets. A US domiciliary resident for gift and estate tax purposes enjoys a lifetime allowance of $12.06 million (2022, adjusted annually). During an individual's lifetime, money can generally pass freely between two US citizen spouses without any limitations applying (if one spouse is not a US citizen, lifetime transfers to the non-citizen spouse is currently limited to $164,000 per year before reducing the US citizen's lifetime allowance). Any gifts to individuals other than a spouse in excess of the annual gifting allowance ($16,000 in 2022) will reduce the individual's lifetime allowance that will be applied to their residual estate value at death.

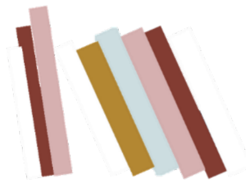
How planning for becoming deemed domicile in the UK for inheritance tax purposes can help

In the lead up to becoming deemed domiciled it is especially important to review the planning opportunities available given the modest thresholds present in the UK for inheritance tax. One option open to non-domiciled individuals prior to becoming deemed domiciled in the UK is the ability to fund an excluded property trust for assets that are held outside of the UK. Generally, any assets held within this type of trust, while remaining offshore, will be excluded from UK inheritance tax even after becoming deemed domiciled. For some this could be a way to equalise the differential between the US and the UK inheritance tax bands.

A simplified example is probably the easiest way to illustrate potential savings:

Let us assume an individual with a total estate worth $12.5 million held in the US. To keep round numbers, let us also assume the UK threshold of £325,000 equates to $500,000. Therefore $12 million of assets would potentially be subject to a 40% UK inheritance tax once the individual becomes deemed domiciled in the UK. Under current UK rules, the $12.5 million estate will pay inheritance tax of $ 4.8million. Under US rules, the $12.5 million estate will pay only $176,000 inheritance tax. Funding an excluded property trust results in an inheritance tax savings of over $4.5million.

The opportunity to fund an excluded property trust ceases when the deemed domicile threshold has been crossed. So, what else can be done? Developing a lifetime gifting strategy remains a viable option provided the requisite PET seven years has been outlived. For some people a strategy of passing on wealth during their lifetime may be an effective way to meet long-term gifting priorities and objectives. It is essential for the adviser and individual to work together to put an appropriate and individual strategy in place as everyone has differing needs and requirements. Additionally, an adviser can help determine the best way to go about implementing the lifetime transfer of wealth. What will remain of utmost importance, is understanding precisely when the rules will begin to apply and take any relevant action appropriately.



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enquiries@masecopw.com
+44 (0) 207 043 0455 | +1-888-MASECO1

MASECOPRIVATEWEALTH.COM