DOUBLE TROUBLE

PATRICK HARNEY AND **GEORGE MITCHELL** EXPLORE THE OPTIONS FOR MITIGATING DOUBLE TAXATION OF US CITIZENS WHO ARE UK-RESIDENT BENEFICIARIES OF US TRUSTS

KEY POINTS

WHAT IS THE ISSUE?
Beneficiaries of US trusts who are both US citizens and UK tax resident potentially face cross-border double taxation and difficulties obtaining tax credits.

WHAT DOES IT MEAN FOR ME?
Practitioners serving any such beneficiaries must carry out careful cross-border planning to avoid double taxation.

WHAT CAN I TAKE AWAY?
Without proper advice, a US citizen who is UK resident and benefits from US trusts may suffer an unfair impediment on the trust's income and capital. However, with care, the potential double taxation cost can be mitigated.

THE 'PRICE WE pay for civilisation'[1] can be too steep if the same income or capital gain is taxed twice. Because of the overlapping scope of UK and US taxation,[2] and the different tax treatment of US trusts in each jurisdiction, beneficiaries of US trusts who are US citizens and resident in the UK may suffer cross-border double taxation. A mismatch in the timing of tax liabilities and the taxpayer's identity under each jurisdiction's domestic law may hamstring the ability of the *UK/USA Double Taxation Convention*[3] (the Treaty) to act as the knight in shining armour it was designed to be.

The double taxation cost can represent an unfair impediment on a trust's income and capital. However, with care, it is possible to mitigate the exposure to double taxation so that the beneficiary is not penalised for receiving benefits while a UK resident.

US DOMESTIC TRUSTS AND DOUBLE TAXATION

This article examines the potential for cross-border double taxation in the case of the following types of US domestic trust:

- **grantor trust:** a US income tax concept, broadly meaning a trust that is transparent for US income tax purposes;[4]
- **intentionally defective grantor trust (IDGT):** a variant of a grantor trust, with the key difference being that the grantor makes a completed gift so that they are not treated as the owner of the transferred property for US federal gift and estate tax purposes; and
- **non-grantor trust (NGT):** essentially a trust that is not a grantor trust, and is considered a 'stand-alone' taxpayer.

A mismatch in timing and the identity of the taxpayer can pose difficulties when claiming treaty relief and may result in double taxation.

TAXPAYER'S IDENTITY: GRANTOR TRUST AND IDGT

The grantor is subject to US income tax on the trust's income and gains as if they owned the underlying trust assets. By contrast, for UK tax purposes, liabilities to tax:

- arise only on the receipt of payments or benefits from the trusts by the beneficiary; and
- are imposed on the UK-resident beneficiary.

The 'exchange of notes' to art.24 of the Treaty deems a beneficiary's tax liability to be the grantor's liability, where the same item of income or gain is treated as taxable in the hands of a grantor in the US and a beneficiary in the UK. Therefore, the Treaty mitigates the mismatch in the taxpayer's identity, although technical issues regarding the sourcing of income and gains at the grantor level may need to be considered.

TAXPAYER'S IDENTITY: NGT

The trustees are subject to US income tax on the trust's income and gains as they arise, except to the extent that distributable net income is distributed to a beneficiary. A tax liability arises in the UK only on receipt of payments or benefits from the trusts. The UK tax liability rests with the beneficiary, rather than the trustees.

TAX PAYMENTS AND TAX CREDITS

Where a US citizen is UK resident under UK domestic law and the Treaty, the US has primary taxing rights only on the following categories of income:

- US source dividend income up to the permitted 15 per cent Treaty withholding;
- income and gains from US real estate; and
- income and gains effectively connected with US trade or business.

In the cases where the US has the primary taxing rights, there is generally no time limit on claiming a credit for the US tax suffered against the UK tax on remittance of that income. If the primary taxing rights rest with the UK, then the time limits on claiming foreign tax credits in the US apply.

APPLICATION TO US TRUSTS

Assuming that the 'paid' basis of foreign tax credits applies, if the UK-resident

beneficiary does not pay the UK tax during either the year in which the income or gain arose[5] or the subsequent calendar year, then a foreign tax credit cannot be claimed against the US tax liability on the same income or gain.

MITIGATING DOUBLE TAXATION COST

A remittance basis user would not be subject to UK tax on trust distributions received outside the UK. However, a later remittance of the distribution to the UK would result in double taxation if not made by the year subsequent to the income or gain arising in the US trust. Some options for mitigating such costs are as follows.[6]

LOANS TO BENEFICIARIES[7]

The trustees could make interest-free, repayable on-demand loans to the beneficiary. If the amount of interest actually paid were less than the amount lent multiplied by the official rate of interest (currently 2.5 per cent), then the benefit of not paying interest at such rate would be subject to UK income tax. However, the beneficiary would not be chargeable to UK tax on the principal lent, provided they genuinely intend to repay the loan and have sufficient assets to do so.

Currently, an additional-rate taxpayer would be subject to annual income tax at an effective rate of 1.125 per cent on the loan outstanding.

GIVING BENEFICIARIES A LIFE INTEREST

The trustees could distribute the trust's net income to the beneficiary each quarter. The beneficiary would remit the income to the UK shortly after receipt and pay UK income tax on it, preferably in the calendar year in which it arose or, at the latest, by the end of the following calendar year.

The source of the income payments for US trust law purposes may need to be determined, because difficulties obtaining double tax relief can arise if each jurisdiction taxes the same person on a different source. In practice, however, Her Majesty's Revenue & Customs indicates in its international tax manual at INTM166040[8] that it will give a credit where the beneficiary is treated as only having a right to account for the income after expenses[9] and not a specific equitable interest in the income.[10]

MATCHING CAPITAL PAYMENTS

Capital gains realised by the US trust also give rise to double tax issues that are more difficult to solve due to various complications. For example, multiple trusts formed under a single instrument may constitute a single settlement[11] for capital gains tax (CGT) purposes, so that trust gains arising in a trust for the benefit of a US resident may be matched against capital distributions made under a trust benefiting a UK resident.

The grantor or trustee (as applicable) would be chargeable to US federal income tax on the capital gains in the year in which they arose. In contrast, the beneficiary would be subject to CGT on the trust's gains only to the extent that they were matched under complex rules with a capital payment (which include distributions or other benefits, except for those already subject to UK income tax) that they receive while UK resident.

One possibility is to make capital payments to the UK-resident beneficiary in the same calendar year as the trust gain arose. This option relies on there being no 'relevant income' available to match against the capital payment. (The term relevant income for these purposes includes offshore income gains, so investments in non-UK collective funds without reporting status should be avoided.)

Stripping the gains out of the trust each year does reduce the benefit of the trust's excluded property status for UK inheritance tax and may further be undesirable where the trust benefits from generation-skipping transfer tax-exempt status in the US. On the other hand, there is no immediate benefit to rolling up the trust's gains free of UK tax because the gains are chargeable to tax at the same rate (20 per cent) in each jurisdiction. This parity in rates excludes the supplemental CGT charge that can result in a rate of up to 32 per cent and the impact of any exchange-rate fluctuations.

CONCLUSIONS

In summary, to manage the UK-resident beneficiary's exposure to double taxation:

- The trustees could lend sums to the beneficiary on interest-free and repayable-on-demand terms, although this is probably not a long-term solution where the beneficiary is not planning to leave the UK.
- The exposure on the trust's income should be avoided if the beneficiary is entitled to the trust's income as of right.
- Each year, capital payments equal to the amount of the trust's gains realised in the same year could be made to the beneficiary, provided that no relevant income has accumulated in the trust.
- Care is required to ensure that UK tax is paid within the time limits for obtaining foreign tax credits to offset against US tax.
- Investment tax advice should be obtained, because some investments, such as US mutual funds without reporting status, are not appropriate.

1 Oliver Wendell Holmes Jr. **2** One being based on residence and the other on residence and citizenship. Note: Patrick and George are qualified to advise on UK not US law. However, comments about the US tax position are based on years of experience of advising on matters with a US connection. **3** Signed on 24 July 2001, amended by a protocol dated 19 July 2002 and entered into force on 31 March 2003. **4** The income and gains are allocable to the settlor. **5** Thereby accelerating the tax payment by at least 13 months **6** More complex alternatives, such as making the trust resident of both the US and the UK and thereby 'dual resident', are beyond the scope of this article. **7** This article focuses on the position of the beneficiary. However, when considering an interest-free/below-market rate interest loan, the trustees would need to consider the trust level exposure to potential imputed interest charges by reference to IRC s.7872. **8** Although the offshore personal tax team would review the first claim INTM166030. **9** *Archer-Shee* v *Garland* [1931] AC 212 **10** *Baker* v *Archer-Shee* [1927] AC 844 **11** *Roome* v *Edwards* [1981] STC 96 and *Bond* v *Pickford* [1983] STC 517

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