Seize the moment

Kurt Rademacher and Patrick Harney consider what the new US estate tax legislation will mean for UK residents with US connections

ABOUT THE AUTHORS


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On 17 December 2010, President Obama signed into law the creatively titled *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* ('the Act'). Although the income tax provisions that were extended under the Act garnered a much greater level of interest in the press, the estate and gift tax changes are much more important in that they do not merely extend current law but fundamentally change the operation of the US federal transfer tax system. As such, the Act will have a substantial impact on UK-based clients with US connections.

Highlights of the US federal transfer tax provisions of the Act include:

1. a USD5 million[1] (per spouse) exemption from US federal estate tax, US federal gift tax[2] and US federal generation skipping transfer tax (GSTT);
2. transferable exemption amounts if one spouse's USD5 million estate tax exemption is not fully utilised on that spouse's death;
3. a top rate of 35 per cent; and
4. a sunset provision, meaning that these favourable transfer tax provisions automatically expire on 31 December 2012, after which the US federal estate tax exemption, the lifetime gift tax exemption, and the GSTT exemption will revert to USD1 million, and the top US federal estate tax, gift tax and GSTT rate will rise to 55 per cent.

Transferable exemption amounts

The UK very sensibly implemented transferable nil-rate bands in 2007. One policy justification for this legislative change was to avoid disparate treatment between well-advised taxpayers (who implemented nil-rate band trusts) and less well-advised taxpayers (who did not). UK private client advisors are therefore perfectly familiar with the concept of transferring an inheritance tax (IHT) exemption amount for use in the estate of a surviving spouse. However, since the US federal estate tax exemption amount of USD5 million far exceeds the current UK nil-rate band amount of GBP325,000, transferable US exemptions potentially create a greater opportunity for overall transfer tax savings than do transferable nil-rate bands for clients who fail to create tax-sensitive estate plans.[3]

Despite the availability of transferable US exemption amounts, it is usually preferable from an economic point of view to create a trust (or trusts) on the death of the first spouse that maximises current use of the US and UK exemptions. This planning ensures that any asset growth that occurs in the exempt trusts between the deaths of the first and second spouses also falls outside the scope of US federal estate tax and UK IHT. In addition, because of the scheduled repeal of the Act's provisions, a risk exists that transferable US exemption amounts will not survive past 2012, meaning that a significant transfer tax savings opportunity could be lost if the estate plan of a spouse who dies in 2011 or 2012 does not include a trust or trusts to fully utilise that individual's US federal estate tax exemption.

Practical 'alignment' of PET regime and the US gift tax regime for moderately wealthy clients

Because the USD5 million US federal lifetime gift tax exemption for each spouse (or USD10 million for each married couple) will exceed the accumulated wealth of many US citizens and domiciliaries, the US federal gift tax system has become even more generous for many UK-based clients than the UK's potentially exempt transfer (PET) regime. This result occurs because US citizens and domiciliaries may now each transfer USD5 million during their lifetimes without imposition of US federal gift tax. No seven-year period exists during which death of the donor may trigger a chargeback of US federal gift tax, as could be the case under the UK PET regime. In addition, the lifetime US federal gift tax exemption[4] can be used to transfer assets into trusts for the benefit of future generations. However, where the US donor is also a UK domiciliary or deemed domiciliary or is gifting UK situs assets, the impact of the *UK Finance Act 2006* needs to be considered. The effect of this is a 20 per cent lifetime inheritance tax entry charge on the excess of the relevant value contributed over the donor's available nil-rate band and entry into the 'relevant property regime' with consequent decennial charges of up to 6 per cent and charges on exit of principal of up to 6 per cent.

Despite the differences between the UK and US systems, under the assumptions that the client in question (i) owns assets worth less than USD5 million (or USD10 million for a married couple, (ii) is in reasonably good health and therefore likely to survive for seven years, and (iii) wishes to transfer assets directly to his or her children instead of into a trust, the US federal gift tax regime and the UK PET regime effectively permit the client to transfer any desired portion of his or her assets to the next generation free from all US federal transfer tax and UK IHT.[5]

In light of the Act, US citizens and domiciliaries who are non-UK domiciliaries for UK IHT purposes should consider making gifts of non-UK situate assets during the next two years to fully utilise their lifetime US federal gift tax and GSTT exemptions. Gifts could be made directly to children or grandchildren, but gifts into trusts may prove more beneficial because of the additional creditor protection, flexibility and tax advantages that trusts provide.[6] UK-resident clients, or clients who own UK situate assets, should of course review any such gifts with their UK tax advisors in

advance to prevent triggering unanticipated UK IHT charges. Subject to possibly triggering other UK taxes and tax issues in the process, it is possible to situs block UK assets prior to a gift by transferring their ownership to a non-UK company or otherwise converting their situs.

Beneficial class of testamentary discretionary trusts

Couples with UK/US-compliant estate plans should reconsider whether those estate plans carry out their dispositive wishes. For instance, an estate plan for a US citizen with a formula clause that passes the maximum US federal estate tax exemption amount into a discretionary trust for the benefit of his or her children may have been entirely appropriate when the US exemption amount was at its 2009 level of USD3.5 million, but may leave the surviving spouse with substantially less than he or she anticipated now that the US federal estate tax exemption has increased to USD5 million. To prevent an inadvertent disinheritance of the surviving spouse, the beneficial class of discretionary trusts should be reviewed in light of the client's wishes.

Exercise of trustees' overriding power of appointment

For US citizens or domiciliaries who are either domiciled or deemed domiciled in the UK for UK IHT purposes, a typical estate plan would involve passing the lesser of the UK nil-rate band (GBP325,000) or the US federal estate tax exemption amount (USD5 million) into a discretionary trust for the benefit of the surviving spouse and/or the children. The remaining assets would generally pass into a trust that qualifies for the UK IHT spouse exemption, and a qualified terminable interest property (QTIP)[7] election would be made for a portion[8] of that trust to qualify it for the US federal estate tax marital deduction.

Such estate plans would typically grant the trustees an overriding power of appointment that they could exercise in favour of the children over the non-QTIP portion of the spouse exemption trust. This overriding power of appointment allows the trustees to appoint assets directly to the children, which is treated as a PET for UK IHT purposes. Assuming the surviving spouse lives for seven years following the trustee's appointment to the children, the appointed assets will not attract UK IHT on the death of the surviving spouse.[9]

With an increase in the US federal estate tax exemption amount from USD3.5 million in 2009 to USD5 million in 2011, the portion of such trusts over which the overriding power of appointment applies will increase.[10] Hence, it is even more important that trustees consider exercising their overriding powers of appointment during the surviving spouse's lifetime, in fact at least seven years before the surviving spouse's death, to ensure that assets with a total value of USD5 million will pass to or for the benefit of the children without imposition of UK IHT or US federal estate tax.

Larger tax-free transfers available for same sex couples

Unlike the UK, which has adopted civil partnership laws to safeguard the marital rights of same sex couples, the US federal tax system only recognises marriages between a man and a woman, even if same sex marriages are permitted under the laws of the relevant US state. Accordingly, no federal marital deduction applies on transfers between civil partners during life or on death. This mismatch in the UK and US rules creates potential for double tax if the US estate tax liability arises on the death of the first civil partner, and the UK IHT liability arises on the death of the second civil partner.

At least until 31 December 2012, the USD5 million US federal gift and estate tax exemption amounts permit a US citizen or US domiciled civil partner to transfer more assets to his or her partner than might otherwise be possible without imposition of US federal transfer tax or UK IHT.

A few caveats

The Act is set to expire on 31 December 2012. Upon expiration, the US federal estate tax, gift tax and GSTT exemption will be set at USD1 million, and the US federal estate tax, gift tax and GSTT rate will increase to a maximum level of 55 per cent. It is not possible to predict at this stage whether Congress will act to retain the current USD5 million exemption or the current 35 per cent rate, and much will depend upon the political landscape in 2012 when Congress again debates extension of these provisions. However, prudent clients should take advantage of the exemptions that are currently available through lifetime gifts to guard against any future tax increases should the political winds shift direction in future.

Irrespective of the rates and exemptions that are ultimately agreed upon in Washington, it seems likely that the idea of transferable exemption amounts will survive into 2013 and beyond since the idea has appeared on the legislative agenda for some time, is relatively non-controversial and makes good tax policy sense. However, transferable exemptions should not replace exemption trust planning for well-advised clients.

In light of the uncertain US federal transfer tax position after 31 December 2012, it is crucial that estate plans for UK residents with US connections implemented over the next two years retain maximum flexibility to adapt to the changing US federal transfer tax landscape. To that end, discretionary trusts should be favoured over fixed interest trusts where possible. Letters of wishes should be used to spell out the details of the clients' desires without tying the trustees' hands in the event of unexpected tax changes. ■

1. This contrasts with the UK trend where the nil-rate band amount is reducing in real terms: it is frozen at GBP325,000 until 6 April 2015.
2. Any US federal gift tax exemption used during life reduces the US federal estate tax exemption available on death.
3. To preserve any unused federal exemption amount, the estate of the first spouse to die must file a US federal estate tax return even though non-taxable estates have traditionally not been required to file such returns.
4. In conjunction with the USD5 million US federal GSTT exemption.
5. Lifetime gifts will be added back to the gross estate on death in order to arrive at the US federal taxable estate. Therefore, a portion of this benefit would be recaptured if the US federal estate tax exemption falls below USD5 million on 1 January 2013, and if the donor dies thereafter.
6. Under the trust laws of some US states (e.g. Alaska and Nevada), it may be possible to name the settlor as a beneficiary of this trust without causing inclusion in the settlor's US federal taxable estate.
7. A Qualified Domestic Trust, or QDOT, would be required to defer US federal estate tax until the death of the second spouse if the surviving spouse is not a US citizen.
8. The portion that exceeds the total US federal estate tax exemption.
9. Where making PETs from trusts or otherwise, it is often sensible (subject to obtaining the donor's instructions) to include a clause in his/her will providing that any inheritance tax resulting from failed PETs should be paid from the residuary estate. Otherwise the donee could find himself lumbered with a tax bill a number of years after receiving the gift–and perhaps after spending it.
10. For decedents dying after 31 December 2010.