By **Patrick Harney** & **Emma Cooper**

Uncle Sam or Aunt Elizabeth: Who Will Get Your Client's Tax Dollars?

How the U.K. Summer Budget 2015 impacts U.S. citizens

The close historical, commercial and familial ties and the long-standing special relationship that exists between the United Kingdom and the United States means that in the globalized 21st century world of internationally mobile families, the internationally minded U.S. advisor needs to have an understanding of the key U.K. tax and legal issues that can impact their U.S. citizen clients.

Let's take a look at U.K. income and estate taxation as it applies to U.K. resident U.S. citizens; examine the big picture impact of the U.S./U.K. Estate Tax Treaty for U.K.-connected U.S. citizens; consider the impact of the dramatic changes introduced by the U.K. Summer Budget; and identify the key planning opportunities for U.K.-connected and U.K.-bound U.S. citizens in the post-U.K. Summer Budget landscape.

Citizenship as Connecting Factor

In contrast to the equivalent U.S. position, U.K. citizenship isn't a connecting factor for U.K. tax purposes. It's but one of the facts and circumstances that has limited relevance in determining an individual's domicile. Instead, the U.K. tax connecting factors are just residence and domicile. Residence for U.K. income tax purposes is, since April 6, 2013, determined under the U.K. comprehensive statutory residence test. Domicile is determined under common law. Unlike the U.S. facts and circumstances domicile test, the U.K. equivalent permits individuals without U.K. domiciles of origin to be long-term residents of the United Kingdom without ever acquiring a U.K. domicile under common law. Small wonder that the United Kingdom has been described as a tax haven for the well-advised non-domiciled individual!

The U.K. inheritance tax (IHT) legislation has a concept of "deemed domicile" for IHT purposes. Currently, an individual will be deemed U.K.-domiciled if he's been resident in the United Kingdom (for income tax purposes) for 17 out of the previous 20 tax years.[1] In that case, his worldwide estate will be exposed to IHT as if he were domiciled in the United Kingdom under common law.

U.K. Estate Taxation

Territorial scope. Like the U.S. federal estate tax, IHT is a donor-based tax that depends on the domicile or deemed domicile of the donor and the situs of the assets. If an individual is U.K.-domiciled, his worldwide estate will be subject to IHT. If an individual is non-U.K.-domiciled, only his U.K. assets will be exposed to IHT. The IHT consequences for transfers by individuals that are within the IHT net are:

1. Transfers on death are subject to IHT at a rate of 40 percent; and
2. Lifetime transfers into trusts are subject to an immediate 20 percent IHT charge (increasing to 40 percent if the transferor dies within seven years).

By contrast, outright gifts to an individual made during his lifetime will be potentially exempt transfers (PETs). They will pass IHT-free provided the transferor survives the gift by seven years or will benefit from taper relief if the transferor survives at least three years. There's no limit on the value an individual can give away under the PET regime (although for U.S. citizens, this value will be restricted by reference to the U.S. gift and estate tax exemption).

When PET treatment isn't available, the key IHT

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exemptions are:

1. Each person has a nil rate band, or IHT exemption, of (currently) £325,000; and
2. Assets passing to a spouse or civil partner will, in most cases,[2] pass free of IHT.

Estate Tax Treaty. The U.S./U.K. Estate Tax Treaty 1978 (the Estate Tax Treaty) is considered a modern treaty and is a domicile treaty, as opposed to the situs treaties of the 1950s. Because it's a domicile treaty, its overall scheme is to confer exclusive taxing rights on the country of domicile except for:

- Immovable property and business property of a permanent establishment (BPPE)—where the taxing rights of the country of situs are preserved; and
- Each country retains the right to tax its own citizens.

As such, the Estate Tax Treaty can be useful in protecting U.S. domiciliaries from IHT on U.K. assets other than real estate or BPPE. See "Using the Estate Tax Treaty," this page.

Most U.S. citizens who move from the United States to the United Kingdom will be regarded as non-U.K.-domiciled.

Using the Estate Tax Treaty

Get complete protection from IHT

Brad, a widower and U.S. citizen, dies with a $5 million estate that includes $2 million of shares in Tesco PLC (a U.K.-quoted company). Under U.K. law,[1] the shares are U.K. assets and are subject to U.K. inheritance tax (IHT) at 40 percent on the excess over the IHT exemption of £325,000 (approximately $500,000), resulting in a tax bill of about $600,000. Even allowing for credits, this amount is a real tax cost since the estate won't actually be taxed in the United States. By claiming Estate Tax Treaty relief, Brad's estate can claim complete protection from IHT. If Brad had lived in the United Kingdom earlier in his life and acquired U.K. citizenship while he was there, this relief wouldn't be available—thus illustrating one of the few tax consequences of U.K. citizenship!

Endnote

1. The reference to "U.K. law" is a term of convenience because, strictly, there's no such thing as "U.K. law" as the United Kingdom is made up of three separate legal jurisdictions: England and Wales, Scotland and Northern Ireland.

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The Remittance Basis

Most U.S. citizens who move from the United States to the United Kingdom will be regarded as non-U.K.-domiciled. As such, they're entitled to claim the very favorable remittance basis of taxation. This means that they'll be taxed on:

- Their U.K. income and gains as they arise (known as the "arising basis"); and
- Their non-U.K. income and gains, only to the extent that they're remitted to the United Kingdom (hence the term "remittance basis").

Since 2008, longer term U.K. residents have had to pay an annual charge if they wish to use the remittance basis of taxation. Currently, this ranges from £30,000 for individuals who've been resident for seven out of the nine previous tax years, to £90,000 for those who've been resident for 17 out of the previous 20 tax years. In essence, and in stark contrast to the IHT position, there's currently no time limit on how long an individual can claim the remittance basis provided he remains non-U.K.-domiciled under common law.

For most non-domiciled individuals, the decision to pay the remittance basis charge is a simple economic

choice—the question is whether the global tax bill will be less if the benefit of the remittance basis of taxation is retained. For non-domiciled individuals who are U.S. citizens, the question isn't so simple. Avoiding U.K. tax under the remittance basis is only beneficial to the extent that the U.K. effective rate of tax that would have been paid is higher than the effective U.S. rate on that income. In August 2011, the Internal Revenue Service issued Revenue Ruling 2011-19, which confirmed that the remittance basis charge can be allowed as a foreign tax credit for U.S. taxpayers who elect to be taxed on the remittance basis.

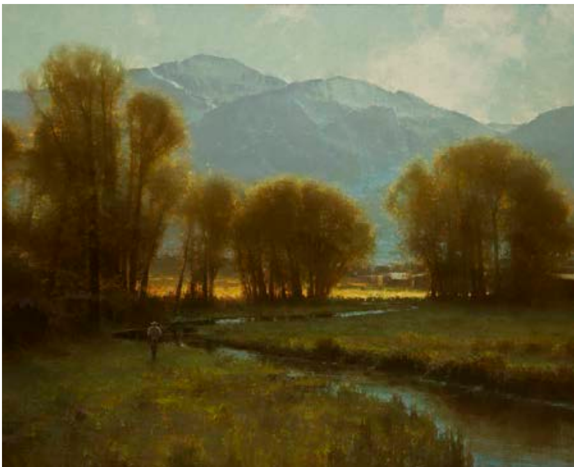
U.K. Summer Budget

To deflect criticism of the perceived unfairness of the non-domiciled regime, the U.K. government wished to bring an end to the permanency of the non-domiciled status and ensure that those who've chosen to make the United Kingdom their long-term home will pay tax on the same basis as U.K.-domiciled individuals. The U.K. Chancellor announced a series of reforms on July 8, 2015 in the Summer Budget. On Sept. 30, this was followed up with a consultation document,[3] which set out the U.K. government's thoughts on how to implement the reforms and invited submissions from interested parties during the consultation period, which ends on Nov. 11. Most of these changes are due to take effect beginning April 6, 2017. The headline changes that affect U.K.-connected U.S. citizens are:

1. New "deemed domicile" rule for all tax purposes;
2. Substantial changes to the taxation of offshore trusts to what appears to be a tax deferral until receipt of benefits regime;
3. End of non-U.K. corporate situs blocking of U.K. residential property;
4. Top effective rate of tax on dividend income for non-remittance basis users to increase from 30.6 percent to 38.1 percent (contrast this with the U.S. qualified dividend tax rate of 20 percent—for some it will be quite a shock to become U.K. taxpayers!)—this change is to become effective beginning April 6, 2016; and
5. Individuals with a U.K. domicile of origin who were born in the United Kingdom to be treated as U.K.-domiciled for all tax purposes while U.K.-resident for income tax purposes, irrespective of their domicile under common law.

> It should be noted that for U.S. citizens impacted by the new deemed domiciled rule, the Estate Tax Treaty is likely to have an increased role in protecting them from IHT.

New deemed domiciled rule. The government will treat an individual who's been resident in the



SPOTLIGHT

Quick Catch
"Springtime in the Valley" (32 in. by 40 in.) by Brent Cotton, sold for $9,360 at the 2015 Jackson Hole Art Auction in Jackson, Wyo. on Sept. 18-19, 2015. An outdoors man who enjoys fishing, Cotton could be the figure walking in this piece. A move to Maui in 1999 inspired a more moody vibe to his work.

United Kingdom for at least 15 of the past 20 tax years as deemed U.K.-domiciled for income tax, capital gains tax and IHT purposes. Once deemed domiciled, the individual won't be able to access the remittance basis of taxation and will be subject to IHT in relation to his worldwide estate. An individual may reset the clock if he leaves the United Kingdom for six or more consecutive tax years before returning. He could then claim his non-U.K.-domiciled status for another 15 years and access the remittance basis of taxation (assuming he retains his foreign domicile status under common law).

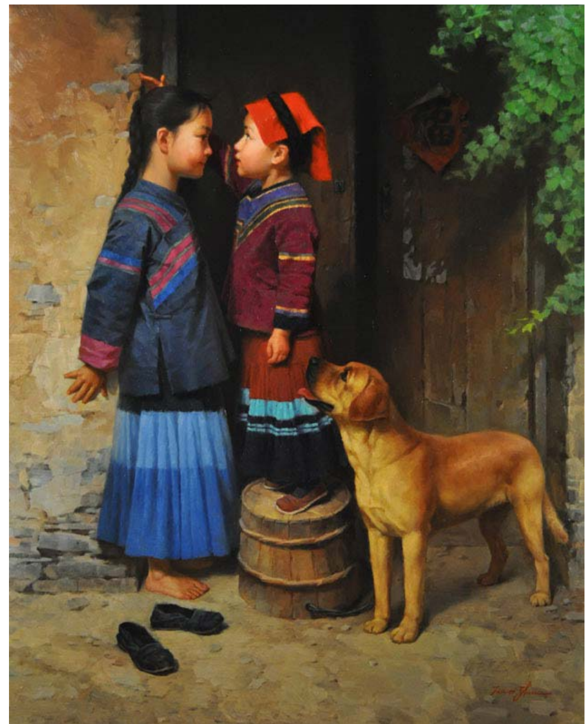
The new deemed domicile rule applies to children under the age of 18, which means that a U.S.-domiciled child of a U.S. citizen born in the United Kingdom could be deemed U.K.-domiciled for U.K. tax purposes before he reaches adulthood.

Once an individual becomes deemed U.K.-domiciled, it will no longer be relevant whether a benefit is received in the United Kingdom or overseas; the benefit will be treated as taxable, regardless.

It should be noted that for U.S. citizens impacted by the new deemed domiciled rule, the Estate Tax Treaty is likely to have an increased role in protecting them from IHT. When a formerly long-term U.K. resident U.S. citizen returns to the United States after April 5, 2017, he'll have a 6-year U.K. IHT tail hanging over him. Nevertheless, if he's not a U.K. citizen, he may be able to use the Estate Tax Treaty to establish that his domicile for Estate Tax Treaty purposes[4] is in the United States, and hence, he's protected from IHT on his worldwide assets except for U.K. real estate and BPPE.

Offshore trusts. The following two paragraphs from the consultation document are informative and illustrative of the U.K. government's new approach to the taxation of offshore trusts of which non-U.K.-domiciled individuals are settlors or beneficiaries:

> The government thinks it is fair to ask any individual who becomes deemed-domiciled in the UK to pay tax on benefits they receive from any offshore trust and any underlying entities.
>
> However, the government does not intend that non-domiciliaries who become deemed-UK domiciled should have to pay UK tax on income and gains in offshore structures which were set up before they became deemed-domiciled simply



SPOTLIGHT

Face to Face

"Yep, You're Taller! (2015)" (30 in. by 24 in.) by Jie Wei Zhou, sold for $6,435 at the 2015 Jackson Hole Art Auction in Jackson, Wyo. on Sept. 18-19, 2015. Zhou sent canvases of his works to a gallery in America, the proceeds of which were used to fund his dream of painting and teaching in America. A realist, Zhou is known for both his portraits and nature scenes.

because the individual was the settlor of the trust or was considered a transferor under the Transfer of Assets Abroad legislation. As part of these reforms, the government will ensure that any individual who becomes deemed-UK domiciled will continue to be protected from UK tax on offshore trusts that they have settled while neither they nor their spouse or children receive any benefit from their trust.[5]

Commentary. Whereas the government released draft legislation on the 15-year rule at the same time as the consultation paper, it hasn't yet released draft legislation on the offshore trust changes, and so we must await the details. Nevertheless, it's clear that the government intends to base the new rules on the taxable value of benefits received by a deemed domiciled individual without reference to the income and gains arising in the offshore structure. This change will significantly alter the way in which income and gains arising in offshore trusts and their underlying entities are taxed. Once an individual becomes deemed U.K.-domiciled, it will no longer be relevant whether a benefit is received in the United Kingdom or overseas; the benefit will be treated as taxable, regardless.

These changes raise significant practical Income Tax Treaty tax credit issues for U.K. resident U.S. citizens, many of which aren't new. The consultation paper refers to offshore trusts. To the man on the street in the United Kingdom, the term "offshore trust" connotes perhaps many things, including discreet trust arrangements in places such as the Cook Islands or Liechtenstein. Nevertheless, offshore trusts include all U.S. trusts. After April 5, 2017, when a U.K. resident U.S. citizen receives a benefit from a U.S. trust, the new legislation will subject that individual to U.K. taxation (presumably income tax but the legislation should confirm this). The U.S. trust will have already suffered U.S. tax on its income, and whereas there may not be any additional U.S. tax for the recipient on the benefit, it seems unlikely that a credit will be available for the U.S. tax suffered by the trustee, leading to double taxation. The solution in some cases will be to give the U.K. resident U.S. citizen an interest in the income so that U.S. and U.K. tax is triggered at the same time, hence facilitating Income Tax Treaty credits.

U.K. residential property. Notwithstanding the introduction of the Annual Tax on Enveloped Dwellings legislation (broadly, a penal annual tax levied on residential property held through companies in which the property isn't let to unconnected third parties), the government intends to bring all U.K. residential property held directly or indirectly by non-domiciled persons into charge for IHT purposes, even when the property is owned through an indirect structure, such as an offshore company, partnership or other opaque vehicle. The measure will apply to all U.K. residential property, whether it's occupied or let and of whatever value. It should be noted that this provision doesn't apply to other U.K. assets. For example, the use of a non-U.K. corporation, including a U.S limited liability company (LLC),[6] remains an effective form of situs blocking for U.K. commercial property.

> An excluded property trust preserves the flexibility for U.S. citizens to engage in additional planning using trusts long after becoming domiciled or deemed domiciled in the United Kingdom.

Pre-April 6, 2017 Opportunities

Despite the changes introduced by the Summer Budget, there are still a number of planning opportunities available. U.K. resident U.S. citizens should consider:

1. Undertaking an integrated U.S./U.K. tax review to determine the bottom line if nothing is done and to what extent positive action might improve their position. In doing so, they should consider:
   - whether the cost of U.K. compliance will escalate and, if so, by how much; and

- how U.S. tax-advantaged investments (for example, municipal bonds) will fare when exposed to U.K. taxation.

2. Whether they can maximize the remittance basis of taxation for the tax years 2015/2016 and 2016/2017 (for individuals who become deemed U.K.-domiciled beginning April 6, 2017);
3. Whether it's possible to lose their U.K. resident status for six complete U.K. tax years so as to re-start the 15-year clock (for long-term U.K. resident U.S. citizens);
4. Reviewing the ownership of U.K. residential property through overseas companies, including U.S. LLCs; and
5. Establishing an excluded property trust before becoming deemed domiciled (for non-domiciled individuals who aren't yet deemed U.K.-domiciled for IHT purposes). This would:
   - protect their assets from IHT;
   - preserve the ability to engage in trust planning in the future, long after becoming deemed U.K.-domiciled; and
   - defer U.K. income tax until receipt of benefits from the trust (subject to considering the position with tax credits under the Income Tax Treaty).

Even after the Summer Budget, the United Kingdom remains a fiscally attractive jurisdiction for the well advised U.S. citizen.

Excluded property trusts. When the settlor of a trust is a non-U.K.-domiciled individual and trust assets are situated outside the United Kingdom, the trust will be wholly excluded from IHT, even if the settlor subsequently becomes domiciled or deemed domiciled in the United Kingdom. Furthermore, the trustees of an excluded property trust can realize a gain without it being automatically imputed to the U.K. resident non-domiciled settlor. This provides a good vehicle to defer capital gains, even on U.K. assets including U.K. real property (other than residential property).[7] Income is automatically attributed to the settlor of a settlor interested trust, subject to the remittance basis of taxation. As indicated above, it appears that the income will be taxed on a receipts basis after April 5, 2017.

For U.S. citizens, an excluded property trust can take one of two forms:

1. A trust that's a completed gift for U.S. purposes; or
2. A revocable trust or other kind of trust that's not a completed gift for U.S. purposes.

An appropriately drafted revocable trust will be a completed gift for U.K. tax purposes (placing the assets beyond the scope of IHT).

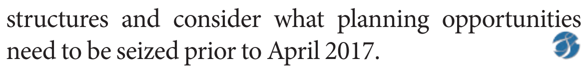
U.S. citizen clients may ask whether there's any point in creating an excluded property trust for them to save 40 percent IHT if they have to pay U.S. estate tax at the same rate anyway. The reality is that, for U.S. citizens, the benefit of an excluded property trust is an IHT saving of 40 percent of the difference between the U.K. IHT exemption (£325,000) and the U.S. gift and estate tax exemption amount or the value of their worldwide estate if lower. Therefore, in 2015, based on a £/$ exchange rate of 1.52, the IHT savings on the first $5.43 million would be $1.97 million (or $3.94 million per couple).

Moreover, an excluded property trust preserves the flexibility for U.S. citizens to engage in additional planning, using trusts long after becoming domiciled or deemed domiciled in the United Kingdom. "Excluded Property Trusts," p. 49, illustrates this flexibility.

Review Wealth Holding Structures

The only constant is change! Even after the Summer Budget, the United Kingdom remains a fiscally attractive jurisdiction for the well advised U.S. citizen. Excluded property trusts, blocker corporations and both the Income Tax and Estate Tax Treaties will remain key tools in the armory of the well prepared U.S./U.K. advisor. We must await the detail on the offshore trusts legislation, but subject to that, wealthy U.S. citizens with U.K. connections need to review their wealth holding

structures and consider what planning opportunities need to be seized prior to April 2017.



Endnotes

1. Due to the wording of the legislation, it's possible to become deemed domiciled in the United Kingdom after only 15 years and one day of residence. For example, if an individual became a resident in the United Kingdom on April 5, 2000, he would become deemed domiciled on April 6, 2015 assuming he'd been a U.K. resident in all of the intervening tax years.
2. Assets moving from a U.K.-domiciled spouse to a non-U.K.-domiciled spouse are only entitled to a limited spouse exemption of £325,000. This exemption can be made unlimited if the surviving spouse makes an irrevocable election to be a U.K.-domiciled spouse for U.K inheritance tax purposes. This treatment is much more generous than a U.S. qualified domestic trust because if the surviving non-U.K. spouse ceases to be U.K. resident for four consecutive U.K. tax years (six years from April 6, 2017), the election ceases to have effect, but the relief given isn't clawed back. Partial relief is also potentially available under Articles 8(3) and 8(4) of the Estate Tax Treaty.
3. *www.gov.uk/government/consultations/reforms-to-the-taxation-of-non-domiciles/reforms-to-the-taxation-of-non-domiciles.*
4. Article 4 of the Estate Tax Treaty contains the fiscal domicile article that includes an interesting seven-year rule and then reverts to the standard Organisation for Economic Co-operation and Development tie-breaker provisions.
5. *www.gov.uk/government/consultations/reforms-to-the-taxation-of-non-domiciles/reforms-to-the-taxation-of-non-domiciles* at paragraph 3.2. The Transfer of Assets Abroad legislation is, broadly, U.K. income tax anti-avoidance legislation contained in Section 720 U.K. Income Tax Act 2007, the effect of which is to treat the income of non-U.K. resident persons as the income of the transferor to that person if the transferor has power to enjoy the income.
6. This is the position notwithstanding the U.K. Supreme Court decision in *George Anson v. Commissioner for Her Majesty's Revenue and Customs (HMRC)* (2015) UKSC 44, which held that a Delaware limited liability company (LLC) was transparent for the purposes of U.K. income tax and specifically allowed a U.K. resident partner in a Delaware LLC to obtain credit for the U.S. tax on his share of the U.S. effectively connected income of the LLC in his U.K. income tax return. HMRC issued a practice announcement on Sept. 25, 2015 (*www.gov.uk/government/publications/revenue-and-customs-brief-15-2015-hmrc-response-to-the-supreme-court-decision-in-george-anson-v-hmrc-2015-uksc-44/revenue-and-customs-brief-15-2015-hmrc-response-to-the-supreme-court-decision-in-george-anson-v-hmrc-2015-uksc-44*), confirming that it will treat LLCs as opaque and regards the *Anson* case as limited to its own facts.
7. Under current rules, care needs to be taken if the funds are eventually distributed to a U.K. resident non-domiciliary not claiming the remittance basis of taxation or a U.K.-domiciled resident, as the additional charge could cause the rate of capital gains tax to increase to 44.8 percent.

Excluded Property Trusts

Keep them outside the estate

Jack and Jill, age 32, are U.S. citizens resident in the United Kingdom with their two young children. Jill is a principal in a private equity firm. Their combined wealth in 2016 is $30 million.

Jack and Jill each gift $6 million into excluded property trusts in 2016. Although these amounts are in excess of the then-U.S. gift and estate tax exemption, it shouldn't matter since they're incomplete gifts for U.S. tax purposes because Jack and Jill are fully able to benefit from the trusts. The trusts are drafted with the assistance of U.K. counsel and so, crucially, they're completed gifts from a U.K. perspective and, therefore, outside Jack and Jill's estates for U.K. tax purposes.

It's now 2036, and Jack and Jill are deemed domiciled in the United Kingdom. Jill has had a stellar private equity career. Jack and Jill's combined wealth is now $100 million. As they have more wealth than they can possibly spend, they decide to engage in typical U.S. gift planning using trusts and leveraging their U.S. gift and estate tax and generation-skipping transfer tax exemptions. They're able to do so by amending the terms of the excluded property trusts so that carved out portions of the trust funds equal to the U.S. gift and estate tax exemption move to separate subtrusts that are outside their estates, and completed gifts take place for U.S. tax purposes. The key takeaway point is that had Jack and Jill not settled excluded property trusts 20 years earlier, they would have been completely prevented by their deemed U.K.-domicile from creating any kind of new trusts in excess of the comparatively paltry U.K. inheritance tax-exempt amount in 2036. Because the 2036 changes were drafted with the assistance of U.K. counsel, the changes were non-events from a U.K. tax perspective, as no assets ever left the 2016 excluded property trusts for U.K. tax purposes.

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