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U.S.-UK Tax and Estate Planning: Advanced Techniques for Estate Planners and Tax Professionals

Reconciling U.S. and UK Law on Trusts, Cross-Border Ownership of Real Property, and Wealth Transfers

TUESDAY, JANUARY 24, 2023

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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BDB PITMANS

US/UK ESTATE PLANNING

Challenges and Opportunities

Presented by Marilyn McKeever, Partner and
Lara Mardell, Legal Director
BDB Pitmans LLP

OVERVIEW

- Part 1: The UK's Wealth Transfer Regime (domicile, inheritance tax)
- Part 2: US citizens holding UK real estate
- Part 3: UK domiciliaries owning US real estate
- Part 4: coordinating the estate plans

PART 1: THE UK WEALTH TRANSFER REGIME

- Inheritance tax (IHT)
- Liability is based on:
  - DOMICILE (actual domicile or ‘deemed domicile’)
    - Not citizenship/nationality
    - Not residence (but see deemed domicile); and
  - Location of assets
- Domicile is a UK general law concept
  - Similar to but different from US domicile
- An individual who is not actually UK domiciled may be deemed domiciled
- References to “years” generally tax years - 6 April to following 5 April

WHY DOMICILE MATTERS FOR INHERITANCE TAX

- UK domiciled individual
  - Taxable on worldwide estate
  - Does not matter if UK resident or not
- Non-UK domiciled
  - Taxable on UK located assets only
  - Does not matter if UK resident or not
- Non-UK assets in a trust set up by a non-UK domiciled settlor (grantor) is “excluded property” exempt from inheritance tax
- Also matters for tax on income and gains-outside scope of the webinar

WHAT IS DOMICILE?

- Broadly: the place where you have your permanent home
- Only one at a time
- Must be a jurisdiction connected with a single system of law
- Domicile of origin-follows you around-is always in the background
- Domicile of choice
- Abandoning a domicile of choice-what happens next?
- How His Majesty's Revenue and Customs (HMRC) approach domicile:
  - RDRM 23080 https://www.gov.uk/hmrc-internal-manuals/residence-domicile-and-remittance-basis/rdrm23080

DEEMED DOMICILE: TAX CONCEPT ONLY

- Only applies to a person who is non-domiciled for general law purposes
  - Treated as domiciled for all tax purposes
- A person who:
  - Was actually UK domiciled
  - Becomes actually domiciled somewhere else, say New York State
  - Deemed domiciled for three years from domicile change
- A person who:
  - Is actually non-UK domiciled
  - Has been resident in 15 of the 20 years immediately before the tax year in question
  - Is deemed domiciled in that year i.e. from year 16
- A person who:
  - Had a UK domicile of origin and was born in the UK
  - Became (and remains) domiciled elsewhere
  - Becomes UK resident
  - Is deemed domiciled whilst resident (“Formerly domiciled resident”)

DOMICILE: EXAMPLE

- Fred and Ginger were Brits
- They emigrated to the US 20 years ago and became domiciled in California
- Fred is seconded to the UK by his employer for the last two years before he retires
- Fred and Ginger's children live in New Jersey
- They decide that when they return to the US on Fred's retirement, they will not return to California but will make their home in New Jersey to be near their children
- Fred and Ginger die the year after they go and live in New Jersey

RESIDENCE

- Critical to establish date of tax residence, ideally well before this happens.
- Essential for advice and optimal structuring.
- Residence affects:
  - Date of deemed domicile
  - Liability on income and gains
- If spending a lot of time in the UK – get advice on how many days you can stay without becoming UK tax resident.
- Ensure clients are aware that tax residence is not the same as visa residence.

HOW DO I KNOW WHEN MY CLIENT IS UK RESIDENT?

- Apply the ‘Statutory Residence Test” – complex and fact specific.
- Need UK tax advice on this.
- Tax year in UK – 6 April one year to 5 April the next.
- Can become UK tax resident on 6 April *before* move to UK.
- Or on the following 6 April.
- Or at some time in between!

OVERVIEW OF INHERITANCE TAX

- Inheritance tax (IHT) is charged:
  - On a person's estate on death
  - On outright gifts to an individual made within seven years of death (potentially exempt transfer or PET)
    - No tax at outset
    - Tax charged on death within the seven year period
  - On a gift to a trust or company
    - Tax charged at half the rates applicable on death
      - Additional tax on death within five years.

RATES OF INHERITANCE TAX

- Nil rate band
  - £325,000 (frozen until 2028)
  - Available on lifetime or death gifts
- Residential nil rate band
  - Only available on death
  - Additional £175,000 (frozen until 2028)
  - Only if home which is inherited by descendants
  - Tapers away if estate more than £2m
- Unused NRB and RNRB transferrable to surviving spouse
- NRB “renews” every seven years
- Above this:
  - Tax rate on death - 40%
  - Tax rate on chargeable lifetime gifts (eg into trust) - 20%

INHERITANCE TAX AND TRUSTS

- Gift to trust immediately taxable (20%)
- Trustees pay inheritance tax on assets of the trust
  - At each 10th anniversary of the establishment of the trust (ten year charge)
  - If assets leave the trust (appointed to beneficiary) (exit charge)
  - Maximum rate on each occasion:
    - 6%
    - Exit charge prorated depending on time since last ten year anniversary
      - E.g. rate at ten year anniversary = 6%
      - Assets distributed five years later: rate is 3%
- But NO IHT on “excluded property”
  - On transfer to trust/ten year charge/exit charge

INHERITANCE TAX AND TRUSTS

- Charles, domiciled (for UK purposes) in New York creates a discretionary grantor trust
- It holds US mutual funds and US stocks
- Charles becomes resident in the UK
- A grantor trust is a SUBSTANTIVE trust for UK tax purposes
- The US assets are **excluded property**
  - Outside the scope of inheritance tax
- The trustees invest in British Petroleum plc shares- **not** excluded property
  - When does this matter?

INHERITANCE TAX AND TRUSTS

- Charles likes the UK so much he is still here after 20 years and has married a Brit - Susie
- He became deemed domiciled in year 16
- Non-UK trust assets **remain** excluded property
- But potential income tax and capital gains tax on distributions

IHT: MAIN EXEMPTIONS AND RELIEFS

- Gifts between spouses (lifetime or by will) are exempt without limit
  - **Unless** donor spouse is UK domiciled and recipient spouse is non-domiciled
  - When exemption is equal to the nil rate band (£325,000)
- Non-domiciled spouse can **elect** retrospectively to be deemed domiciled for IHT purposes only
  - Deemed domicile status lost by four tax year's non-residence

GIFTS BETWEEN SPOUSES

- David (US domiciled) marries Jill (UK domiciled)
- David and Jill are UK resident
- Jill dies in 2022 and leaves all her estate to David
  - Spouse exemption is £325,000
- David elects to be deemed domiciled
  - Full spouse exemption applies
- David returns to US in August 2023
- He remains deemed domiciled until 6 April 2028
  - What if he dies before then?

IHT: OTHER RELIEFS

- Business relief
  - Exemption on sole trade/partnership interest/shares in unquoted company
  - Applies to lifetime gifts and on death
  - Applies to businesses anywhere in the world
  - Does not apply to investment businesses
- Agricultural property relief
  - Applies to farmland/other agricultural activities
  - In UK or certain European countries only
  - May also qualify for business relief

IHT: OTHER RELIEFS

- Gifts to UK registered charities – eg UK branch of a US charity
- Normal expenditure out of income exemption
  - No limit
- Annual exemption-£3,000
- Small gifts
- Outright gift to individual if donor survives 7 years.

IHT – THE US/UK ESTATE TAX TREATY

	Type of Assets	US tax?	UK tax?	Who gives credit
US Resident **US Citizen**	UK non-real estate	Yes	No	No double tax
	UK real estate	Yes	Yes	UK has priority taxing right US gives credit
US Citizen **UK Treaty domiciled**	All UK assets US non-real estate	Yes	Yes	UK has priority taxing right US gives credit
	US real estate	Yes	Yes	US has priority taxing right UK gives credit

PART 2: US CITIZENS OWNING UK REAL ESTATE

- Individual ownership usually the best option
  - Or joint ownership for couples
- The UK property will be in estate of individual for IHT
- A company may be an option if the property is to be rented
  - But **not** an LLC

FUNDING THE PURCHASE OF UK REAL ESTATE

- A difficult area!
- Take advice on specific circumstances – ideally before UK residence.
- Mortgages:
  - Helpful for IHT-loan generally deductible: but
  - Sterling mortgage - may be currency/exchange rate issues
  - May be UK income tax issues
  - May be IHT complications

US CITIZENS OWNING UK REAL ESTATE

- If UK resident:
  - UK tax on income, gains and death/gifts
  - UK primary taxing rights
  - Credit must be claimed in US

RENTAL PROPERTIES AND INCOME TAX: US RESIDENTS WITH UK INCOME

- Most UK income received by non-residents is non-taxable eg
  - Dividends
  - Interest
- Rental income remains taxable at recipient's normal rates
  - Tax on net rent: rules on deductions may be different from US rules
    - Up to 45%
- Must submit UK tax return
- Non-resident landlord scheme

US CITIZEN NON-UK RESIDENT: CAPITAL GAINS TAX (CGT)

- General rule: non-UK residents not subject to CGT even on UK assets
- Exception UK real estate: taxable
- Applies to gifts as well as sales
- Applies to:
  - Residential property – gains from April 2015
  - Non-residential property - gains from April 2019
  - Interests in “property rich companies” (share sales) - gains from April 2019

CGT ON SALE/GIFT OF REAL ESTATE - RATES

- Depends on whether real estate is residential or non-residential, and whether it is a direct sale
- Rates of tax on direct disposal of **residential** property
- Individuals
  - 18% if basic rate taxpayer
  - 28% if higher rate taxpayer
- Trustees
  - 28%
- Companies
  - Corporation tax: 19%

CGT ON PROPERTY DISPOSALS - CONTINUED

- Rates of tax on direct disposals of **non-residentia**l property
- Individuals:
  - 10% if basic rate taxpayer
  - 20% if higher rate taxpayer
- Trustees:
  - 20%
- Companies:
  - 19% Corporation tax

CGT ON PROPERTY DISPOSALS-CONTINUED

- Tax rates on indirect disposals (share sales): residential or non-residential
- Individuals
  - 10% if basic rate taxpayer
  - 20% if higher rate taxpayer
- Trustees
  - 20%
- Companies
  - 19% (Corporation Tax)

CGT ON PROPERTY DISPOSALS-CONTINUED

- Summary of tax rates on gains

	Individuals	Trustees	Companies
Direct disposal residential	18%/28%	28%	19%
Direct disposal non-residential	10%/20%	20%	19%
Indirect disposal (shares)	10%/20%	20%	19%

SALE/GIFT OF INDIRECT INTEREST IN UK LAND

- Indirect disposals (share sales) only taxed if:
  - The shares are in a “property rich company”;
    - 75% of value of company derived from UK land; and
  - The individual must have at least a 25% investment
    - Interests of certain family members treated as owned by the individual
- NB: an LLC is an opaque company in the UK

COMPLIANCE (FOLLOWING DISPOSALS)

- Tax return and payment of any tax due:
  - Individuals and trustees: within 60 days
  - Companies: normal corporation tax cycle
  - Running total if more than one disposal
- Normal self-assessment dates for:
  - Disposals between spouses
  - Sale of main residence
- Penalties for late returns/late payment
  - Non-resident unaware of the rules: “reasonable excuse”???

MAIN RESIDENCE RELIEF

- A gain on a person's "only or main residence" is fully exempt from CGT
  - May still be US tax on the gain: credit under Double Tax Treaty
- Must have been occupied as the main residence at **some time** during the person's **"period of ownership"**
- Where property is not the main residence throughout the period of ownership
  - Gain apportioned on a time basis
  - Gain attributable to non-occupation period is taxable
  - Certain absences count as period of occupation
- Spouses/civil partners – only one main residence between them

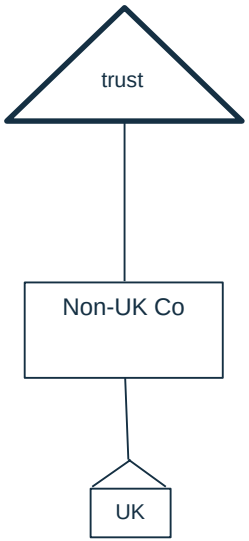
MAIN RESIDENCE RELIEF: US RESIDENTS

- If US and UK home - can nominate the UK residence as their main residence and get private residence relief: BUT
- A year is not a year of occupation unless
  - The individual and/or spouse spend at least 90 days in the UK property in the tax year
- Consider impact on US tax?

US RESIDENT PPR: EXAMPLE

- Wayne and Mary are resident in New Jersey
- They buy a house in London in 2020 for £1m
- In 2020/21
  - Wayne spends 45 days in the house
  - Mary spends 45 days in the house
- In 2021/22
  - Wayne spends 30 days in the house
  - They both spend 25 days in the house
  - Mary spends 34 days in the house
- In 2022/3
  - Mary spends 60 days in the house
- In 2023/24 the house is sold for £2.5m
- They nominate the house as their main residence
- Only 2020/21 qualifies as a year of occupation
- Only 1/3 of the gain (£500k) is exempt; £1m is chargeable

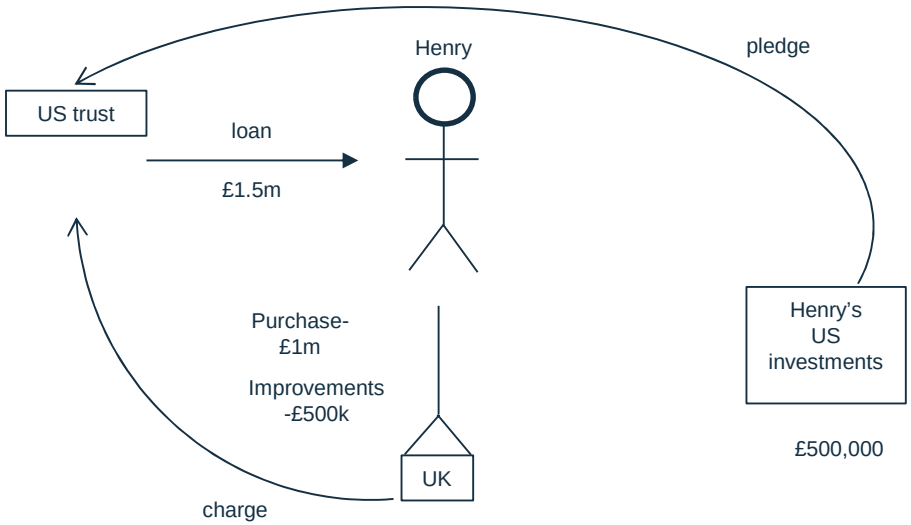
IHT AND PROPERTY STUCTURES: A HISTORY LESSON



RESIDENTIAL PROPERTY AND IHT

- All structures (trust/partnership/company) owning UK residential real estate will be subject to UK IHT
- Taxable assets include:
  - Shares in a non-UK company that owns UK residential property
    - Directly or indirectly
  - Benefit of any sort of loan or financing used to buy or improve UK residential property
  - Non-UK assets used as security/collateral/guarantee for such financing
    - Potential for double counting
- Does NOT apply to commercial property/farmland, other non-residential real estate or non real estate assets

RESIDENTIAL REAL ESTATE AND IHT:EXAMPLE



- Loan is subject to IHT
- US investments are subject to IHT
- Net value of the house is zero but growth in in Henry's estate for IHT
- Value of property subject to IHT
  - benefit of loan in trust £1.5m
  - offshore investments £500K

PLANNING POINTS

- UK residential real estate, however held, will be subject to IHT
- Loans **secured on the property** will reduce the IHT value
- Avoid holding in LLC or grantor trust
- Be careful with borrowing unless from bank
- Avoid providing additional collateral for loan
- Hold in personal name(s)
- Make suitable UK will
- For married couples, can defer tax to second death
  - NB low nil rate band: may be IHT but no Estate Tax

STAMP DUTY LAND TAX (SDLT)

- Duty payable on purchase of real estate
- Residential rates:
  - 0% on first £250,000
  - 5% on slice £250,001-£925,000
  - 10% on next slice up to £1.5m
  - 12% on the balance
  - BUT additional 3% on each slice for second residential property
    - Home or let
  - AND another additional 2% on each slice if non-resident
  - So up to 17% on properties over £1.5m
- Non-residential or mixed use-maximum rate 5%: no surcharges

PART 3: UK DOMICILES OWNING US REAL ESTATE

- If US resident
  - No UK income tax on rent
  - No UK capital gains tax on sale
    - Unless Temporarily Non-Resident
    - Broadly non-resident for five tax years or less
- If UK resident
  - UK tax on rent
    - Credit for any US tax
  - UK tax on capital gains
    - Credit for any US tax

UK DOMICILES/US ESTATE: IHT AND ESTATE TAX

- UK domiciled **not** US citizen
- UK IHT on worldwide estate
- US Estate Tax on real estate
  - Estate Tax exemption $60,000
  - UK gives credit for US tax
- Assets other than US real estate/certain business assets
  - Sole taxing rights to UK under Double Tax Treaty
- UK domiciled/deemed domiciled US citizens
  - Spouse exemption and marital deduction available

UK DOMICILE/US REAL ESTATE: EXAMPLE

- Jane and Ed are a UK married couple (not US citizens) with
  - A holiday home in Florida worth $3m
  - US bank account $100,000
- Their wills give their whole estate outright to the survivor. Then to children on second death
- First death
  - UK IHT
    - In principle on worldwide estate but spouse exemption-no IHT
  - US Estate Tax
    - Tax on Florida home: $60,000 exemption only
    - No tax on bank account (Treaty protected)
- Second death
- IHT on worldwide estate and Estate Tax on Florida home only
  - Treaty credit for tax on second death, but no credit for tax on first death: double taxation

UK DOMICILE/US REAL ESTATE: EXAMPLE

- Instead of outright gifts, Jane and Ed make wills which:
  - Give assets other than US real estate to survivor outright
  - Create a QDOT for the survivor of US real estate only
  - Estates outright to children on second death
- First death:
  - No UK IHT
    - QDOT qualifies as “immediate post death interest”: spouse exemption applies
  - No US Estate Tax on non-real estate (Treaty) or Florida Home (QDOT)
- Second death
  - UK IHT on worldwide estate
  - US Estate Tax on Florida home
  - Treaty credit: no double taxation

PART 4: COORDINATING THE ESTATE PLANS

- Focussing on US Citizens who are
  - Resident in the UK and/or
  - UK domiciled or deemed domiciled
- Issues with
  - Transparent entities
  - Sole trustees
  - Living trusts and other trusts
  - Pour over wills
  - Premature US planning
  - Wills and the exempt amount

TRANSPARENT ENTITIES: LLCS US CITIZEN UK RESIDENT SHAREHOLDER

- US treats an LLC as transparent
- UK treats as “opaque” company
- Income taxation:
  - US: shareholder taxed on pro-rata share of LLC income
  - UK: taxes dividend/distribution only
  - Normally, no DTA credit as not the same income
- Capital Gains
  - US: shareholder taxed on pro-rata share of LLC’s gains
  - UK: normally taxed only on disposal of shares/liquidation
  - If UK tax on disposal/liquidation no DTA credit for US tax paid on underlying gain as not the same gain

TRANSPARENT ENTITIES: US GRANTOR TRUSTS

- US treats a grantor trust as transparent
- UK treats as substantive Protected Trust
  - No IHT on non-UK located assets (“excluded property”)
  - No income tax on non-UK source income
  - No capital gains tax on any gains (except UK real estate)
  - UK income and capital gains tax only if:
    - Distribution to UK resident beneficiary
    - Settlor/Grantor becomes UK actually domiciled (not just deemed)
- Protected trust good for UK estate planning-no IHT; but
  - Potential double tax on income and gains if distributions

US NON-GRANTOR TRUST UK RESIDENT BENEFICIARY

- Would be a “Protected Trust”: no UK IHT on non-UK assets; but
- Income and gains
  - Trustees taxed in US
  - Beneficiaries taxed in UK on distributions
  - Generally no DTA credit

TRUSTS: THE SOLE TRUSTEE

- Melinda is a US citizen
- She is the sole trustee of a trust for the benefit of her family set up by her mother
- Melinda becomes UK resident
- The trust is UK resident and, as trustee, Melinda is liable for:
  - Tax on WORLDWIDE trust income
  - Tax on WORLDWIDE trust gains
- If Melinda now appoints new US trustees in her place:
  - She is deemed to make a market value sale of all the trust assets crystallising gains which will be taxable
- Moral: appoint new US trustee(s) before becoming UK resident

LIVING TRUSTS

- Common US planning tool
- Typically:
  - Revocable
  - Grantor control during lifetime
  - Income to surviving spouse
  - Separate trusts for children on second death
- US Estate tax
  - Marital deduction if spouse survives
  - Potential Estate tax on second death

LIVING TRUSTS

- UK IHT
  - **Usually** a “bare trust”
    - Not a trust for UK tax purposes at all
    - All property treated as Grantor’s property; but
  - **May** be a substantive trust or, more commonly, become a substantive trust
    - On incapacity
    - On death of spouse (especially if community property)
    - On Grantor’s death
  - Potential 20% IHT charge
  - 10 year and exit charges
  - Gift with reservation of benefit charge on Grantor’s death
- Ideally revoke prior to UK residence – avoid the question arising.

POUR OVER WILLS

- Used in conjunction with Living Trusts
  - Estate added to Living Trust on death
- US Estate tax
  - Marital deduction available on
    - Assets held in the Living Trust; and
    - Assets added by will
- UK IHT
  - Spouse exemption available on assets added by will (provided trusts for spouse qualify as Immediate Post Death Interest)
  - **No** spouse exemption for assets already in the trust
    - Subject to IHT

DOMICILE: PREMATURE US PLANNING

- Thelma and Louise are Brits
- They move to New York to work and see if they like living in the US
- Five years later they decide to remain permanently in New York and take US citizenship
- Two years after that, their US attorney recommends they put all their assets into a grantor trust

WILLS AND THE ESTATE TAX EXEMPT AMOUNT

- US citizens resident in UK: what will?
- Consider discretionary trust of Estate Tax exempt amount
  - By definition: no US Estate Tax
- If testator **NOT** UK domiciled or deemed domiciled at death
  - Non-UK assets “excluded property”
    - No IHT on death or in future
- If testator **IS** UK domiciled or deemed domiciled (or for UK assets)
  - Assets can be appointed:
    - Outright
    - On trusts
  - Within two years of death
  - For spouse and be eligible for spouse exemption
- Preserves flexibility/avoids double taxation

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