SQUARE PEGS IN ROUND HOLES – YOU LIKE “TO-MAY-TO” AND I LIKE “TO-MAH-TO”[1]

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Tags
Domicile
Foundations
Mobility
Residence
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Trusts
U.K.

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INTRODUCTION

In a post COVID19 world, anecdotal evidence suggests that sophisticated cross-border personal estate planning is back in vogue. There is increased incidence of individuals and families relocating to other jurisdictions. Equally, individuals have evidenced renewed vigor in acquiring and structuring assets across a range of jurisdictions. The reasons for this are myriad:

- A genuine desire to roam again following unprecedented travel restrictions.
- In some cases, the need for geographical diversification of assets.
- Geopolitical unrest and uncertainty of the highest degree.

People move. People invest internationally. Where individuals move around the world, or where assets are acquired in different countries, the cross-border tax and legal implications can be great but, in many cases, somewhat invisible at first sight.

This article provides a high-level overview of various issues that can arise, with a focus on cross-border tax. In real life, the analysis is inevitably highly fact-dependent as the technical outcome can vary dramatically between two similar cases with only slightly differentiated facts. But we believe that it is interesting to consider a range of points that should always be addressed in the context of a proposed change of residence, or cross-border asset acquisition, particularly with regard to real estate.

On occasion, there may be genuine opportunities to arbitrage the relevant tax systems, and achieve genuinely clean and clear tax mitigation. More often than not, however, it is more a question of avoiding the bear traps. This is due to significant differences between the tax regime in the new country and expectations based on tax residence in another country. What is common best practice planning in one country may be disastrous in the other, and vice versa.

As U.K. lawyers, we shall focus on particular U.K. issues that arise between the U.S. and the U.K., noting some key U.K. tax and succession concepts in passing. The general principles are, however, global in nature. Sometimes, tax errors can be corrected after the event – but more often than not, mistakes will have enduring consequences for clients.

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1 “Let’s Call the Whole Thing Off” (1937) George and Ira Gershwin.

GLOBAL MOBILITY AND CHANGE OF TAX RESIDENCE

An immediate point to note is that apparently familiar terms of art can have different technical meanings in different legal systems. This in itself can lead to inadvertent misanalysis of a client's position.

For the purposes of this article, we shall use the U.K. terms "tax residence" – a factual test of where an individual resides, based on a statutory multi-factor formula – and "domicile." Domicile is a notoriously complex and nuanced concept, based on a person's individual family history, as well as intentions for the future. It is a link to a particular jurisdiction, such as an individual state of the U.S., for example New York State and Florida. Within the U.K., England & Wales is a unitary jurisdiction. Scotland and Northern Ireland are separate.

Whether a person is U.K. tax resident is a key "gating" question. People who fail to recognize that they have exceeded the triggering point in a given tax year become resident in the U.K. notwithstanding any soft considerations such as intent. Nonresidents with regard to the U.K. generally are outside the scope of tax on U.K. income and capital gains, with a few limited exceptions. By contrast, U.K. residents generally are within the scope of U.K. income and capital gains taxes, and will likely need to file a tax return for the U.K. tax year, which runs from April 6th in one calendar year to April 5th in the next. Assessing a person's tax residence is essential. Residence impacts U.K. tax exposure in both the current and subsequent years. The consequences are wide-reaching, and for that reason, identifying the date a person becomes resident is key. It may be before a person is physically present in the U.K.

The starting point is that liability to income and capital gains tax is global. It can relate to a person's individual income and gains, as well as income and gains in trust and corporate structures to which they are connected. For that reason, global corporate structures need to be very carefully reviewed and understood. There are two important qualifications to global tax liability. First, being able to claim a domicile other than the U.K. Secondly, the potential impact of a double tax treaty.

Having (and, where necessary, formally claiming) nondomicile status is a powerful tool. When available, it limits the scope of tax to U.K. source income and gains, and any income or gains that are remitted to the U.K. "Remittance," here, is a broad concept that encompasses assets physically brought to the U.K. or otherwise enjoyed in the U.K. With careful planning, the use of "remittance basis taxation" can dramatically restrict a person's liability to U.K. tax. But there are points to watch.

Favorable remittance basis of taxation does not apply to certain assets such as cryptocurrencies and other cryptoassets, certain life insurance policies, and carried interest. It may also not apply to trading or employment income where any element of the trade or employment is carried on in the U.K. The source of income and the situs of assets is key, and in the U.K., the rules sometimes lead to counterintuitive results. For example, crypto assets and certain other assets such as debt instruments may be treated as U.K. situs if the owner is U.K. resident. This is H.M.R.C.'s current stated practice, but the position is controversial. The rules for debt instruments are different for purposes of capital gains tax and inheritance tax. It is not surprising that confusion can abound.

Being nondomiciled is also very significant for inheritance tax, which is the U.K.'s combined gift, estate, and trust wealth tax. A person who is not domiciled in the U.K. is within the scope of inheritance tax only on U.K. situs assets, which can include indirect interests in U.K. situs real estate. By contrast, a person who is domiciled in the U.K. is within the scope of inheritance tax on worldwide assets that are owned, potentially subject to treaty relief, as discussed further below.

Assessing a person's domicile status and monitoring that status on a year-by-year basis are essential. If a person becomes a British citizen, certain representations may conflict with the actual domicile position of the individual. Citizenship has other impacts, too, including the material scope of the U.K.-U.S. income and estate tax treaties.

In addition, a person becomes "deemed domiciled" in the U.K. once resident in 15 out of 20 tax years. This is a complicated area in itself – planning in advance of that date may be useful for some clients. After deemed domicile is established, an individual is fully in scope of all U.K. direct taxes, including worldwide inheritance tax. Even at that point, retaining a non-U.K. domicile as a matter of common law may still be important.

PARTICULAR TRAPS: TRUSTS, COMPANIES, CHARITIES, AND RELATED STRUCTURES

It is natural to focus on an immigrant's personal tax position. But a change of residence or just spending time in the U.K. can have a dramatic effect on global structures that may be owned directly or by trusts that have been established for the benefit of the immigrant and other persons.

A very clear preliminary point is that it is important for central management and control of foreign corporate (and like) structures be maintained outside the U.K. Failure to do so may result in an assertion of U.K. tax resident status for those companies, which will cause all relevant companies to become subject to U.K. corporation tax when the assertion cannot be rebutted. The risk is significant. Best practice is to carefully limit decision-making that occurs in the U.K. and to maintain substantial evidence of where decisions are made and who makes them.

Several risks arise when individuals are trustees of family trusts. A change of residence by the trustees as a body can cause a change in the residence status of the trust. A move to the U.K. by trustees can result in the establishment of U.K. tax residence. Worse, a subsequent change back to nonresident status of the trustees can result in a deemed sale of all trust assets at fair market value. Given that trusts are common tools in U.S. estate tax planning, any family trusts must be reviewed with care before a trustee move to the U.K.

Difficult questions of characterization may need to be answered.

- Is a foundation treated as a trust or a company?
- Who is properly taxed in connection with a *usufruct* arrangement?

- What is the U.K. tax characterization of (a) the rights of the holder of the bare legal title to the property and (b) the rights of the holder of the *usufruct* interest in the property?

- How might the U.K. residence of individuals affect the tax treatment of an underling group of companies?

What is a common structure in one jurisdiction may well not expressly be catered for in another. As a result, domestic concepts in the U.K. must be applied to foreign structures, which often is an exercise of fitting square pegs in round holes.

When placing those square pegs in round holes, the practice in the U.K. is to pay careful attention to the legal analysis of property rights, contractual arrangements, tax, and procedural questions in relevant foreign jurisdictions. This can be relevant for (i) characterizing corporate receipts as income or something else, (ii) determining whether a foreign entity is opaque or transparent, (iii) determining whether tax errors can be rectified, and (iv) identifying whether property transactions can be recharacterized retroactively, which the authors have seen successfully achieved in one case.

Another very real trap is that the same word may have a meaning that is different in two countries. To illustrate: just because something is a charity in the U.S. does not mean that it will be treated as charitable in the U.K. It may be exempt from taxation in one jurisdiction, but not the other. As a result, dual-registered charities must be structured with great care to ensure that exemptions are triggered in both jurisdictions. As Winston Churchill once said: the U.K. and the U.S. are separated by a common language.

In this context – and to the theme of "to-may-to / "to-mah-to" – estate planning using trusts may result in problems. Common trusts in U.S. tax planning can give rise to difficult U.K. tax and reporting obligations. An example involves the use of a revocable grantor trust. Depending on how the trust instrument is drafted, there may be an immediate tax consequence when the trustees move to the U.K. or subsequent tax consequences if the grantor dies or becomes incapacitated while in the U.K. Careful review and potential restructuring are always essential.

Care also needs to be taken in relation to U.S. L.L.C.'s holding assets that generate profits potentially within the scope of U.K. tax. H.M.R.C.'s starting point is that an L.L.C. is opaque, meaning that income is taxed at the level of the L.L.C. rather than the members. As a result, distributions are taxable as separate income of the members, with potential for double taxation and denial of treaty tax credits. This thorny issue was addressed in *Anson v. Commissioners for Her Majesty's Revenue and Customs*,[2] where the U.K.'s Supreme Court was prepared to accept that based on the particular drafting of the L.L.C. documents in that case, the L.L.C. should be regarded as transparent for U.K. tax purposes. But since H.M.R.C. does not accept this as the general position with respect to all L.L.C.'s, close attention should be paid when setting up such structures where a U.K. nexus is envisaged. It is understood that regulations issued by the I.R.S. may cause U.K. resident members of the L.L.C. to be subject to full 30% withholding tax in the U.S. on their respective shares of dividends, income, and royalties income received by the L.L.C.[3]

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2 [2015] U.K.SC 44.

3 Treas. Reg. §1.8945-1(d)(1).

TREATY RELIEF

A discussion of tax treaties covering (i) income and gains and (ii) estate taxes would require several articles to cover the rules. Sometimes treaties give rise to outcomes that are surprising, helpful, or both. But not always. This is particularly because the same economic item of income or gain may be taxed at different times by each treaty partner jurisdiction. Equally, the same item of income or gain may be assessed on one entity or person in one treaty partner jurisdiction, but on another entity or person in the other treaty partner jurisdiction. That is a particular problem because of the way the U.K. taxes settlors and beneficiaries of trusts, and owners and funders of companies. Relief will not always be available.

"Structuring the ownership of real estate in a foreign jurisdiction is another arena in which mismatched legal and tax regimes often clash."

Regardless of whether a treaty can and should be invoked in a given case, ensuring correct filing of U.K. and U.S. accounts is essential, not least given that the tax years and filing deadlines are different, which can lead to cashflow challenges. And a change of residence may also affect internal and cross-border reporting regimes, such as F.A.T.C.A. and the common reporting standard. The U.K., itself, has recently expanded reporting in relation to trusts and companies, and is consulting on further new regimes.

PLANNING FOR ASSETS

Structuring the ownership of real estate in a foreign jurisdiction is another arena in which mismatched legal and tax regimes often clash.

Classically, foreign owners of U.K. real property have utilized corporate structures, or in the case of U.S. purchasers, L.L.C.'s. Successive changes to the U.K. tax regime have generally made such structures unattractive compared to personal ownership (particularly for property intended for personal use as a second home) because of increased stamp duty land tax ("S.D.L.T.") and the annual tax on property held in corporate structures ("A.T.E.D."). And the U.K.'s recently introduced public register of foreign entities owning U.K. real property means that corporate structures no longer offer the level of confidentiality they once did.

However, for a person domiciled in the U.S., the U.K.-U.S. Estate Tax Treaty may still provide protection from inheritance tax for property held in corporations, which could justify the additional tax costs of S.D.L.T. and A.T.E.D., particularly in light of the relatively minimal tax-exempt amount for inheritance tax compared to the current amount of the Unified Tax Credit in the U.S. For U.S. families, debt structuring may also help to mitigate inheritance tax exposure. This must be assessed on a case-by-case basis.

Where trusts are involved, particular care is required to avoid difficulties arising from a mismatch between the U.K. and U.S. tax treatment of U.S. revocable grantor trusts noted earlier and succession issues that can arise in relation to U.K. real property because the U.K. does not recognize the concept of lifetime testamentary trusts.

NON-TAX CONSIDERATIONS

Life is rarely about tax, exclusively. Numerous non-tax considerations surround a change of residence and domicile. From the U.K. perspective, the following should be considered, where relevant:

- Change of status may impact where a person can be served with process in civil proceedings. The rules are complex.
- In particular, the threshold for service of divorce papers in England is relatively low.
- If a person becomes domiciled in England & Wales, then succession to worldwide estate becomes subject to English law. For some clients, this may not seriously impact their succession plans. But for others, such as those from civil law jurisdictions with forced heirship, this can be a dramatic difference. The conflict of law rules in succession planning – including renvoi – are notoriously complicated in an area where different domestic systems of law vary massively.

We are not talking about subtle distinctions, necessarily, here. Bluntly, it might be possible to disinherit an heir in one jurisdiction, but not in another. The consequences can plainly be severe.

CONCLUSION

Even if you like "to-may-to" and I like "to-mah-to," let's not "call the whole thing off." Exploring the very different approaches of legal systems to the same underlying facts is an interesting and important exercise. Not falling into traps is of course important. But every now and then, genuinely worthwhile planning opportunities may be found.