MASECO

Estate Planning for US Families in the UK

Introduction

As a US expat living in the UK, the thought of getting your estate in order can be quite a complicated and overwhelming process. It is important to ensure that you have your estate plan in order to comply with both the US and UK jurisdictions. This may require legal and tax expertise as it is important to ensure that the strategy covers the various laws in both jurisdictions. The different tax laws between the UK and the US can alter the distribution strategy and ultimately the tax liability of distributed assets upon death, so it is important that there is a full understanding of these before devising an appropriate plan.

Below we cover some of the areas for consideration when designing a tax efficient strategy. Each individual circumstance is different, so it is important that there is a full understanding of these areas before deciding on which is the most suitable strategy for you.

Estate Tax Basics

For a US citizen, US estate taxes may be applicable regardless of where you reside. Whilst American expats can generally benefit from tax relief through foreign tax credits, the Internal Revenue Service (IRS) will look at the worldwide assets of a US citizen when assessing estate tax charges as a US citizen will always be considered US domiciliary resident for gift and estate tax purposes regardless of where they live in the world. We will go into this in further detail below.

It is important to have a good understanding of the basic concepts when devising an appropriate estate plan.

We summarise some of the basic concepts below:

US

US Domiciled Lifetime Exemption	$12,060,000
Annual Gift Tax Exclusion	$16,000
Non-US Inter Spousal Allowance	$164,000
Non-US Domiciled Exemption	$60,000 (US Situs assets only)

UK

Nil Rate Band	£325,000
Residence Nil Rate Band	£175,000
Annual Gift Allowance	£3,000
Potentially Exempt Transfers	Unlimited

US Inheritance Tax Basics – 2022 Tax Year

Lifetime Exemption - The lifetime gift tax exemption is the amount a US domiciliary resident (most often a US citizen, green card holder or US resident alien who has no intention of leaving the US in the future) can give away over the course of their lifetime before having to pay the federal gift tax. The IRS have announced that the 2022 tax exemption amount is $12,060,000. The tax rate applicable to transfers above this amount is currently 40%.

Annual gift tax exclusion - The gift tax annual exclusion allows taxpayers to make certain gifts without eroding the taxpayer's lifetime exemption amount. The gift tax annual exclusion in 2022 is currently $16,000 per individual. You are allowed to give away $16,000 to as many individuals in a given year as you would like. For US domiciliary residents, giving anything more than $16,000 to the same individual would generally trigger a gift tax filing requirement and use some of your lifetime exemption. Married couples are able to elect to 'gift split' meaning they can share gifts made by each other for federal gift tax purposes and effectively double the amount given to one individual.

Certain gifts and transfers, including educational, medical and health insurance expenses paid direct to the institution or facility may qualify for an exclusion, however, the rules around this can be quite complicated so needs careful consideration.

Inter Spousal Transfer (US citizens) – Gifts during your lifetime or upon death between US citizen spouses are unlimited and do not trigger the use of any lifetime exemption or annual gift exclusion.

Inter Spousal Transfer (Non-US citizens) – There is a separate annual gift tax exclusion for gifts made to spouses who are not US citizens. This annual exclusion is currently $164,000 for 2022.

Non-US Domiciled Exemption – For a non-US domiciliary resident, US gift and estate tax rules apply solely to US situs assets. A non-US domiciliary resident is allowed to gift $16,000 in US situs assets per individual before triggering US gift tax. To the extent that more than $16,000 is gifted in US situs assets to the same individual, there would be gift tax to pay (there is no lifetime exemption). When a non-US domiciliary resident dies, there is a $60,000 exemption available to offset against US situs assets. Anything above this amount will be subject to US estate tax.

The generation-skipping transfer (GST) tax – This tax is applied to gifts made to third generation (or beyond) family members or unrelated individuals who are at least 37.5 years younger than the grantor. This is a federal tax aimed at preventing someone from intentionally skipping over their children in their estate.

The tax only applies to transfers over an exemption amount, which is $12,060,000 for 2022. Any transfers over this amount are currently taxed at 40% and are in addition to the federal estate tax.

Gifts from a Non-US Resident - For US taxpayers (citizen or resident) inheriting or receiving a gift from a foreign person will generally be free from US income and transfer tax at the time of receiving the gift or inheritance. The beneficiary of an inheritance will also generally receive a step-up in cost basis.

However, the US taxpayer needs to be mindful that special disclosure rules apply to gifts or bequests received from foreign persons. If the US taxpayer receives annual aggregate gifts or bequests from a non-resident alien or a foreign estate valued at $100,000 or more, the taxpayer must report the amounts and sources of these foreign gifts or bequests to the IRS via Form 3520. This must be filed at the same time as your individual income tax filing is due for the relevant tax year.

UK Inheritance Tax Basics – 2021/22

For an individual who is domiciled in the UK, their worldwide assets will be subject to assessment in the UK upon death. For someone who is non-UK domiciled, only UK based assets will be assessed. We will discuss who is considered UK domiciled in greater detail on page 6.

Nil Rate Band – the nil rate band is the amount of your estate which can be passed on to your beneficiaries free from UK inheritance tax after death. The current inheritance tax nil rate band is £325,000 per individual. If this is unused upon death, this allowance can be transferred to a spouse who is domiciled or deemed domiciled in the UK. This means that the spouse could end up with a nil rate band of up to £650,000. Similar to the US, the tax rate applicable to transfers above this amount is currently 40%.

Gifts made to a domiciled or deemed domiciled spouse during your lifetime or upon death are exempt from inheritance tax. If an individual leaves all their assets to their spouse, inheritance tax will not be applied, and the nil rate band would be transferrable with inheritance tax being assessed at the death of the second spouse.

Residence Nil Rate Band - In addition to the inheritance tax nil rate band, a residence nil rate band is also available depending on the size of the taxable estate. The residence nil rate band is only available when a UK residential property is left to direct descendants. A direct descendent is considered a child, grandchild, great grandchild or great-great grandchild of the deceased individual. The definition of a child includes step-child, an adopted child or a foster child. This allowance is £175,000, however, where an estate is valued at more than £2 million, the allowance will be reduced by £1 for every £2 that the value of the estate exceeds this threshold meaning the allowance is fully phased out when the estate exceeds £2,350,000.

Annual Gift Allowance – the annual gift allowance in the UK is £3,000 per annum and is an aggregate amount that applies to gifts across all individuals. This can be made from an individual's estate and will be excluded from inheritance tax. If an individual has not utilised their gift allowance in the previous tax year, it is possible to carry this forward to the current tax year. However, there can never be more than £6,000 excluded at any one time.

In addition, the following gifts made in the UK are considered exempt from inheritance tax:

1. Payments to help with living costs. These include payments to:

    - an ex-husband, ex-wife or former civil partner
    - a relative who's dependent on them because of old age, illness or disability
    - a child (including adopted and step-child) under 18 years old or in full-time education

2. Charities

    - There's no inheritance tax on gifts to charities, museums, universities or community amateur sports clubs.
    - If you are deemed domicile you need to make sure you are giving to a UK qualified organisation.

3. Political parties

There's no inheritance tax on gifts to political parties that have either:

- 2 members elected to the House of Commons; or
- 1 member elected to the House of Commons who received at least 150,000 votes in a general election.

Lifetime gifts - Whilst an individual is alive, they are able to make a gift known as a Potentially Exempt Transfer (PET). This gift will only generally be fully exempt from inheritance tax once the donor survives 7 years from the date the gift was made. The inheritance tax due reduces on a sliding scale between years 3 and 7 following the gift being made.

The difference between the US lifetime exclusion and the UK nil rate band is large therefore mitigating the UK inheritance liability may be a higher priority. Managing the use of PETs and the annual US gift allowance can be an effective method to minimising this liability.

Reduce Inheritance Tax Rate - The usual inheritance tax rate is 40% however this can be reduced to 36% if an estate donates 10% or more of its net value to UK charity. In order to receive this deduction, the value must be left to charities registered with the Charity Commission in England and Wales. If a charity is not registered but adheres to the Charities Act definition of a charity, your estate and beneficiaries will still benefit from inheritance tax relief.

Challenges for the expat/US family living in the UK

The estate tax regimes can differ between the UK and US but any established domicile in a US state may also need to be considered. It is important to be mindful of this when understanding your requirements for estate planning.

The following 12 states plus the District of Columbia have an estate tax (a tax based on the estate of a deceased individual) and the following 6 states have an inheritance tax (a tax based on what you receive as a beneficiary of an estate).

- Estate Tax – Maine, Vermont, Massachusetts, Connecticut, Rhode Island, New York, Maryland, Illinois, Minnesota, Washington, Oregon, Hawaii and Washington DC
- Inheritance Tax – Maryland, Pennsylvania, New Jersey, Kentucky, Iowa and Nebraska

The estate tax can vary between 8% - 12% and the inheritance tax can be up to 16% for specific US states.

There is also another layer of complication if a US citizen is married to a non-US citizen. There may be assets in various jurisdictions either held separately or jointly titled. The amount and timing of any tax liability may differ between the US citizen and non-US citizen; therefore, the ownership of various assets may also need to be reassessed when devising one's estate planning strategy.

Citizenship, residency and domicile

When devising an appropriate estate plan, it is important to understand your relevant citizenship, residency and domicile. These have been defined below:

Citizenship – status of a person recognised under the custom or law as being a legal member of a sovereign state or belonging to a nation along with the rights, duties and privileges of being a citizen.

Residence – usually used for tax purposes, generally considered to be the country that you are present in for 183 days or more in a given tax year. It is possible for an individual to be considered a resident if present fewer days as well depending on the country in question.

Domicile – the country that a person treats as their permanent home, or lives in and has a substantial connection with. There are two types of classification under law: domicile of origin and domicile of choice.

- Domicile of origin – The law assigns a domicile of origin to every person at the time of birth. If a child's parents were married before the child was born (i.e. legitimate), the child would automatically acquire its father's domicile. If a child's parents were unmarried at the time of birth (i.e. illegitimate), the child would automatically acquire its mother's domicile. This domicile of origin continues until a new domicile i.e. a domicile of choice is obtained.
- Domicile of choice – this is a self-acquired domicile. It is a domicile which a person chooses to replace their former domicile, which may be either a domicile of origin or domicile of choice. The individual must be able to demonstrate an intention for the country to be their permanent residence. It should be noted that there is often a high burden of proof required to assert a domicile of choice that is not the UK when an individual is born with UK domicile of origin.

Deemed Domicile – if you aren't domiciled in the UK under common law you are treated as domiciled in the UK for all tax purposes if either condition A or condition B is met:

Condition A

- You are born in the UK
- UK is your domicile of origin
- You are resident in the UK post 2017

Condition B

- You are UK resident for at least 15 out of the 20 tax years immediately before the relevant tax year. Any tax year where there is part year UK residency is considered a full year of UK residence for the purposes of determining deemed domicile status.

Key things to consider when assessing domicile:

- A US citizen is always going to be considered to have US domicile (in addition to possible domicile elsewhere) regardless of where they live in the world.
- Gift and estate tax rules in both the US and the UK are generally applied based on an individual's domicile (or deemed domicile) as opposed to income tax residency.
- A domiciliary non-US resident for gift and estate tax purposes is only exposed to US gift and estate tax on their US situs assets.
- A non-domiciled individual in the UK is only exposed to UK IHT on UK situs assets prior to becoming deemed domicile.
- Once an individual is deemed domicile in the UK, they will be exposed to UK IHT on their worldwide assets.

It is important to have a full understanding of your citizenship, domiciliary and residency as this will help determine the tax rules which need to be considered within one's estate planning strategy.

What are US and UK Situs Assets?

Situs is Latin for "position" or "site". The situs of an asset is generally the place where an asset is considered to be located for legal purposes. For example, the situs of real property is the country where the property is situated. In the case of a company, this will be where it is incorporated or where the share register is maintained.

It is important to note that shares incorporated in the US will be considered a s US Situs asset regardless of where the brokerage account is based (for example Apple shares). For individuals who will be subject to UK inheritance, they may be entitled to foreign tax credits and thus avoiding double taxation, which we will discuss later on.

US situs assets (for purposes of Estate Tax) includes:

- Real and tangible personal property located in the US
- Business assets located in the US
- Stock of US corporations (ADRs are non-US situs)
- US regulated Mutual Funds
- Money Market Funds or cash in a brokerage account (deposits in US banks are non-US situs)
- Qualified Retirement Plans
- Privately offered debt instruments issued by US organisations (publicly traded bonds including Treasuries are non-US situs)
- Life insurance and annuities issued by US licensed insurance company

It should be noted that situs is viewed slightly different for the purposes of gift tax. US gift tax is generally only on gifts of US real estate and tangible personal property located in the US. Cash gifts made by cheque or wire transfer do not attract gift tax. Also, there is no gift tax on gifts of securities of a US company, however these may be subject to estate tax as noted above.

The US/UK tax treaty will determine which country has the primary right to tax each asset first. The situs of the asset, type of asset and domicile status of the individual will all be important factors in determining taxation. There are various forms of relief so it is very important to understand the treaty in order to determine whether US estate tax and UK inheritance tax would apply.

What is the process once an Individual passes away?

The estate of an individual will vary from person to person therefore the specific conditions and requirements upon passing will always differ. However, there are a few steps that are imperative to the distribution of an estate which are summarised below.

- If the deceased has left a valid Will, it is sensible to review this to understand if it deals with the assets held overseas along with the deceased's assets in the UK.
- It is a requirement to obtain a date of death valuation for the relevant assets that the individual owned. Once a valuation has been obtained, the asset holder/provider will be able confirm the necessary requirements in order to dispose of the asset. This will normally include a copy of the death certificate and grant of probate however the requirements can vary between institutions.
- Once it has been established that a Grant of Probate is required, it may be worth seeking legal advice both in the UK and the country in which the asset is held. A Grant of Probate is the British equivalent of Letters of Testamentary in the US.
- If a US Will is in place, you will usually need to apply to the UK probate court. The Probate Registry will ask for an affidavit of foreign law (which is something that would be provided by a US lawyer) which essentially confirms that the Will is valid and admissible under local law. This will allow England and Wales to administer the estate. If probate has been granted in the US, the Probate Registry will usually accept a court copy of the US Will along with the Letters of Testamentary to probate in the UK without the affidavit. Once satisfied, the UK Grant of Probate will then be issued to the US executor. The opposite will usually occur if you have a UK Will in place that are intended to govern assets located in the US.

It is important to note that estates of non-US residents must obtain a Transfer Certificate from the IRS before the assets can be distributed. The Transfer Certificate issued by the IRS represents evidence that the decedent's estate has met its US federal estate tax liability.

How Tax treaties avoid double taxation of your Estate

Currently, the US has estate and gift tax treaties with sixteen sovereign nations, including the UK. These treaties will determine which country holds primary taxing rights on global assets and can have the potential to alleviate estate taxes by minimising the possibility of double taxation.

- It will determine the country in which the decedent/ donor is domiciled for transfer tax purposes.
- The tax treaty between the UK & US can alleviate some of the tax liability that can occur when a US person is domiciled or resident in the UK. It is important to understand the interplay between these tax regimes and how this will affect the overall tax liability as this can alter an individual's estate planning strategy.

Tiebreaker rules

Tiebreaker rules are included within the tax treaties and will determine which country has the primary right to tax an individual. It is possible for an individual to qualify as a resident (for tax purposes) in more than one country.

The treaty rules establish taxation priority by first determining which jurisdiction the individual was domiciled in when they passed away. The domiciliary country may tax all property within the entire estate, while the non-domiciliary country may typically only tax property with situs in that country. Foreign transfer tax credits may be issued for taxes paid to the non-domiciliary country and thus avoiding double taxation.

The tiebreaker rules apply a step-by-step analysis of an individual's circumstance to determine this.

1. The first criterion is to assess a permanent home. If the individual has a permanent home in only one country this would be considered as the country of residence.
2. However, if the individual has a permanent home in two countries (i.e. UK & US), then you have to determine in which of the two countries their 'vital interest' lies by considering factors such work and family.
3. If the country of residence cannot be determined based on these factors, the next step is to look at which of the two countries they reside in. If the individual resides in both countries, the tax residency will be determined according to their nationality.
4. However, if they are a national of both countries, then dual residency cannot be solved by the tie-breaker rules. In this case, it is left up to the tax authorities of both countries to mutually decide who has primary taxing rights.

To put this simply, if your life and home is situated in the UK and you qualify under the deemed domicile rules, then it is very likely that the UK would have the primary taxing rights. If you spend your time between the UK and US, then it is more of a grey area and nationality alongside a full set of facts and circumstances will also need to be taken into account.

It is important to understand which country has the primary taxing rights, based on your circumstances as this could alter your estate planning strategy.

Cross-border pitfalls with Trust Accounts

It can be very dangerous to rely upon the US estate planning that was done before leaving the US and is generally advisable to review an existing estate plan when relocating abroad. US estate planning techniques do not always travel well and may fail to protect wealth in cross-border situations.

If your estate plan includes Trusts, a move overseas with your old domestic estate plan can be fraught with unknown pitfalls as the UK government may not recognise certain Trust structures in the same way. For example, it is very popular for US people to have Revocable Living Trusts set up when they arrive in the UK. Revocable Living Trusts are a common structure used within the US to help primarily bypass US probate and also protect the assets for future generations. Whilst, Revocable Living Trusts are transparent for US purposes, it is possible for these trusts to be structured in a way that falls within the UK settlement rules. It is important to understand whether the Trust will be viewed as a Bare Trust or other type of trust in the UK as this could affect the way the assets are ultimately subject to tax and whether the assets are considered to be included in your estate.

Estate Planning Strategies

The following estate planning methods could be considered as part of an overall inheritance strategy:

- Wills - either a US or UK will - accompanied by a "situs will"
- Trusts
- Pension Contributions
- Gifting Strategies
- Family Limited Partnerships
- College Savings Plans
- Non-Citizen Gift Allowance

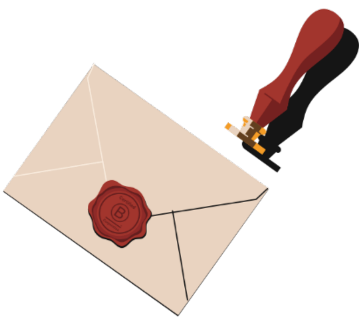
Utilising Wills in estate planning

A traditional Will provides written directions on how the individual (the "testator" of the will) wishes to distribute their assets upon their death.

Within the cross-border context, it is advisable that individuals seek advice with a focus on estate planning both in the US and UK.

- It is possible to have multiple "situs" Wills which will individually govern the distribution of the assets in the country that the Will is executed.
- It is also possible that a geographical Will can incorporate the laws of the various jurisdictions. The validity of the Will can depend on the particular laws of the relevant jurisdiction therefore it is important that the Will is designed in a way that will covers all basis. This tends to be the more preferred route as it can often make the process less cumbersome.

As an American in the UK, a question you may have is whether to have a US or UK Will. It is possible to have a separate Will in both jurisdictions or you may be able to have one that covers your assets in both the US and the UK. Regardless of which route you decide to go down, it is important that you ensure all your worldwide assets have been considered, particularly if you have relocated to a different country.



Trusts

For estates larger than the lifetime exclusion limit, alternative estate planning strategies may be required, which could include setting up various trust structures.

Some of the common Trusts used within the US include the following:

Revocable Trust (US) – Living Trust

- These Trusts are created during the lifetime of the Grantor and can be altered, changed, modified or revoked entirely during the Grantor's lifetime.
- Their main purpose is to remove assets from the estate for inheritance tax purposes.
- The Trust usually becomes Irrevocable (a separate legal entity) at the death of the Grantor
- Assets will be included within the Grantor's estate.
- As mentioned earlier, a Revocable Living Trust may be treated as a Bare Trust or as Excluded Property for UK purposes depending on the structure and trustee set up.

Irrevocable Non-Grantor Trust

- Unlike Revocable Living Trusts, these cannot be altered, changed, modified or revoked after they are established.
- These will use an individual's lifetime estate and gift allowance upon settling trust
- The Trusts are treated as a separate legal entity for tax purposes and generally will be subject to tax at Trust income tax rates (unless current year income is distributed out of the trust to beneficiaries) .
- The assets will generally be held outside of individual's estate at death.

Intentionally Defective Grantor Trust

- Generally, some right to alter or change the trust deed remains.
- These will use an individual's lifetime estate and gift allowance upon settling trust
- The Trust is considered a separate legal entity, however, due to the retained right to modify with the Trust in some fashion, all income within the Trust is taxed at the Grantor's personal income tax rates as opposed to Trust tax rates.
- The assets will generally be held outside of individual's estate at death.

Irrevocable Life Insurance Trust (ILIT)

- The purpose of the structure is to hold a life insurance policy.
- Once created and an insurance policy established, you cannot take the policy back into your own name.
- You are able to choose the beneficiaries and define terms under which they will receive benefits. You are also able to choose the trustee(s). Generally, the trustee cannot be either yourself or your spouse.
- The life insurance policy remains outside of your taxable estate at death.

Qualified Domestic Trust (QDOT)

A popular Trust used in estate planning strategies where both spouses are not US citizens is a QDOT. If a surviving spouse is not a US citizen, a QDOT can allow the surviving spouse to defer an assessment of estate taxes on assets above the lifetime allowance until their own death providing the capital remains in trust over their remaining lifetime.

As mentioned earlier, in the instance that both spouses are US citizens, a surviving spouse is entitled to an unlimited marital deduction for estate taxes on assets inherited at first death. However, when a married couple consists of one spouse who is a non-US citizen, the marital deduction does not apply. Having a QDOT provision included in your estate plan and transferring assets above the lifetime exclusion to this trust with the non-citizen spouse named as lifetime beneficiary allows the non-US citizen to qualify for this exemption.

The surviving non-US citizen spouse would be allowed to benefit from the income generated by the trust assets during their remaining lifetime. The surviving spouse could then pass on the trust assets to their children or another named beneficiary at their own death. If you have a sizable estate then having a QDOT provision in your

US estate plan can be worth it to ensure the timing of any estate tax is aligned with the death of the second spouse as it would be for UK purposes, thereby preventing the possibility of double taxation and preserving as much of your estate as possible for your heirs.

Excluded Property Trust

For US individuals who will soon become 'deemed domicile' in the UK, there is an estate planning opportunity to consider which involves funding an excluded property trust in order preserve the difference between the large US federal estate tax exemption and the much smaller UK nil rate band.

For any non-domiciled UK resident, anyone who is a UK resident for more than 15 out of the last 20 tax years will be 'deemed domiciled' in the UK for inheritance purposes. This means, as noted earlier, that UK inheritance tax will not only be applied to your UK situs assets but rather to your worldwide assets.

The US estate tax and UK inheritance tax rate are both 40% however the US exemption is currently $12,060,000, which is significantly larger than the UK inheritance exemption of £325,000. Excluded property trusts allow UK non-domiciliaries to keep their US assets outside the scope of UK inheritance tax on the condition that the trust is established and funded before 6th April of the 16th year of tax residence. The timing of establishing and funding this trust is extremely important as it can determine the scope the UK has on your worldwide assets for inheritance tax purposes.

It is worth noting that the assets must be situated outside of the UK for them to be considered for an excluded property trust.

Taxation on Trusts

Trusts can be considered US resident, UK resident or dual US and UK resident for income tax purposes, depending on where the trust is established and where the trustees are located. When US trusts have UK resident settlors or beneficiaries, or UK trusts have US resident settlors or beneficiaries, it is very important to receive tax advice from a knowledgeable tax adviser in both the US and the UK to ensure that you are managing the tax impacts in both jurisdictions as efficiently as possible.

Generally, if a trust is considered UK tax resident, then the UK trust will pay tax on all income and gains at the highest marginal rates in addition to US tax.

If a trust is considered to be non-resident for UK tax purposes, UK tax will generally arise when there is UK situs income, or benefit is deemed to have been received by a UK resident settlor or beneficiary. When a UK resident beneficiary receives a distribution from a US trust, the UK taxation of that distribution is typically dependent on whether it is considered to be income or principal (often referred to as capital). Generally, an income distribution will be taxable in the UK and chargeable to income tax rates. If the income distribution is derived from an entitlement to specific income, then it can often be taxed at the rate of tax associated with that type of income (i.e. if there is an entitlement to specific dividend income then this would generally be chargeable at dividend tax rates versus income tax rates). A distribution of capital is much more complicated. Capital distributions need to generally be matched against historical income and gain pools within the trust. What this looks like can vary dramatically between different trusts depending on the type of assets held within the trust, the type of trading activity which has taken place, the length of time the trust has been in existence and whether there have been any historical distributions at different points in time before and after years in which the UK changed its trust rules. The exercise that is often required is quite involved and requires specialist tax advice.

A US trust is generally taxed in the US according to whether the trust is considered to be a grantor or non-grantor trust. If the trust is considered to be a grantor trust, then the individual settlor will pay tax on the income that arises within the trust at their person income tax rates. If the trust is considered to be a non-grantor trust, then the trust will generally pay tax on the income that arises each year at trust income tax rates unless the current year income is distributed to beneficiaries in which case the beneficiary will pay tax on the distributed income at their personal income tax rates.

It is fairly common to come across scenarios where there are US resident trusts with UK beneficiaries which can often result in a timing mismatch of taxation between the US and the UK. This is due to the fact that from a US perspective the trust or settlor has generally been paying tax annually regardless of distributions and from a UK perspective, tax would only arise at such points a distribution actually takes place. Where there is a timing mismatch, this can lead to double taxation as tax credits are unable to be claimed.

When there are these potential mismatches, it is important to understand how the trust funds are ultimately going to need to be used and whether (and to what extent) the funds will be needed when the beneficiary or settlor are UK residents. Depending on individual circumstances and requirements, there are strategies which can be used to try to minimise the instances that the timing mismatch occurs. To the extent that the trust has owned assets that are considered to be tax efficient from both a US and UK perspective, this may help mitigate some of the taxation from being assessed at income tax rates versus the more favourable capital gains tax rates.

As mentioned, the tax considerations can be quite involved therefore it is recommended to seek the advice of a tax specialist if Trusts are a strategy you wish to use within your estate plan.

Pension Contributions

UK Pensions – UK pensions do not fall within the scope of UK inheritance tax and usually let you pass on your pension to your beneficiaries, tax-free if you die before you reach age 75. After age 75, your beneficiaries may pay income tax at their marginal rate, but this is only if they draw income from the plan. Pension arrangements can be a tax efficient method to keep your savings for future generations.

Depending on your income levels, you may be able to contribute up to £40,000 per UK tax year into a pension arrangement. Ensuring you are utilising your pension annual allowance each year can be an effective strategy within an estate plan.

UK pensions differ from US pensions as they do not have required minimum distributions in retirement therefore it is possible to build a sizeable balance that can be left to the beneficiaries. However, any funds that are in excess of the lifetime allowance (currently £1,073,100) will be subject to a lifetime allowance charge of 55% which is worth bearing in mind.

US Pensions – Traditional IRA's and 401ks are subject to estate tax when you die, and your beneficiaries will have to pay income tax as the assets are distributed from the pension. However, there may be an offsetting deduction for the estate that the beneficiary may be able to utilise. The estate tax and offsetting deduction may not necessarily be a wash, but your beneficiaries would not be hit with a double taxation either.

Similarly, Roth IRAs are also not exempt from US estate tax however as the funds are 'post tax', the distributions received from the beneficiaries will not be subject to a further income tax charge. In addition, Roth IRAs are not subject to required minimum distributions (throughout the owner's lifetime) and therefore give the ability to leave a larger balance to your beneficiaries than you would with a Traditional IRA.

In addition, Traditional IRA and 401k pension arrangements are outside the scope of UK inheritance tax which is not necessarily the case for Roth IRAs.

The tax benefits may not be as favourable on US pensions as they are for UK pensions however both investment vehicles can play an important part within one's estate plan.

Gifting Strategies

As mentioned, an individual in the UK can make unlimited Potentially Exempt Transfers (PETs) which will be outside of one's estate once a seven-year period has passed.

In addition, there is also the ability to make gifts out of regular income as long as this does not affect the individual's normal standard of living. The seven-year rules do not apply for this type of gift.

For US taxpayers (citizen or resident) inheriting or receiving a gift from a foreign person, generally will be free from income and transfer tax at the time of receiving the gift or inheritance. The beneficiary will also generally receive a step-up in cost basis on the inheritance.

Alternatively, if a US citizen gives more than the annual exclusion ($16,000) in a given year then the excess above the exclusion is applied against their lifetime exclusion.

Even if an expat's spouse obtains US permanent resident status, gifts and bequests to the non-US citizen spouse are not eligible for the unlimited marital deduction and would be applied to their lifetime exclusion.

Non – US Citizen Spouse Gift Allowance

Whilst a US citizen can gift unlimited assets to a fellow US citizen spouse during their lifetime, there is a special limit allowed for gifts to non-US citizen spouses of $164,000 annually (2022). A gifting strategy can be implemented to shift non-U.S. situs assets from the US citizen spouse to the non-US citizen spouse over time, thereby shrinking the taxable estate of the US citizen spouse. This strategy is even more valuable when the asset is more tax efficient for the non-US citizen spouse to hold. For example, it may be beneficial to hold the main UK residence property in the name of the non-US citizen spouse to avoid a potential US capital gains tax in the future should the property be sold.

Family Limited Partnership (FLP)

A Family Limited Partnership is a holding company owned by two or more family members, created to retain a family's business interests, real estate, publicly traded and privately held securities, or other assets contributed by its members. The creation of this entity can reduce gift and estate taxes while maintaining control over the management and distribution of the assets.

FLPs are generally suited towards clients who can justify forming an entity for business reasons rather than simply gifting assets. The Limited Partners (generally the children) will be pay income and capital gains tax on their proportionate share of income within the FLP each year and will file associated tax returns. Yet, the General Partners will maintain control of the management and distributions of the assets.

An individual may seek to reduce their estate by making gifts to the FLP whilst still maintaining control over the assets. The control includes the power to invest and disinvest its assets, as well as the power to control the timing and amount of distributions.

For individuals domiciled or 'deemed domiciled' in the UK, a transfer into a trust would ordinarily give rise to upfront inheritance tax charge however a transfer to family members through an Family Limited Partnership is deemed as a potentially exempt transfer and will not trigger a UK inheritance tax charge at outset so long as the transferor survives the transfer by seven years. For US federal estate and gift tax purposes, the transfer is treated as a gift and will diminish the transferor's lifetime estate and gift tax exemption.

For UK resident individuals who are either taxed in the UK on an arising basis (or are remittance basis taxpayers who transfer UK situs assets), a transfer of assets can trigger a UK capital gains tax charge. However, the transfer will not trigger a taxable capital gain from a US tax perspective. This could give rise to a tax mismatch in future years and should be considered when assessing if it is most appropriate to gift appreciated assets or cash.

College Savings Plans

529 college savings plans give parents the opportunity to give funds for educational purposes which offer tax free growth similar to an IRA or UK pension. This is also an opportunity that can be utilised by grandparents and other relatives.

The money in a 529 account is exempt from federal estate tax and does not count towards your taxable estate. As a result, placing money in a 529 account can reduce your estate and subsequent tax liability.

US expats must be aware of the UK rules regarding the gains and how they are treated from a tax perspective. The reason for this is because 529 plans are structured as trusts in the US, not as individual accounts owned by the taxpayer. As a result, the UK most likely considers 529 plans to be foreign trusts, rather than investment accounts and are not explicitly discussed within the income tax treaty. Therefore, many tax advisers do not believe that 529 accounts can receive tax benefits in the UK and to the extent that you are considered the owner and settlor of a 529 as a UK resident you need to be conscious of the settlor interested trust rules. If you will be contributing funds to your child's 529 plan ideally you would want any funding to take place prior to becoming 'deemed domicile' in the UK in order for the 529 to be deemed to be a protected settlement under the trust income tax rules thereby preventing taxation in the UK until future distributions take place. If the trust was not deemed to be a protected settlement under the settlor interested rules, then income may be considered taxable in the UK as it arises.

As noted earlier, there is also an opportunity for 529 funding that may be able to be utilised by US resident grandparents. While it wouldn't help lower your own taxable estate, it is often very common for US resident grandparents to establish and fund 529 plans for their grandchildren as part of their own estate planning strategy. To the extent this is possible, it may be a better strategy to consider if you ultimately want to keep things as simple as possible from a UK perspective.

Conclusions

Multinational families do have an additional layer of complexity when it comes to estate tax planning, particularly when you take citizenship, domicile and residency into account. A US expat living in the UK needs to understand that the standard US estate plan may no longer protect wealth as intended when relocating to the UK. However, if you have the relevant knowledge and understanding of the of US and UK rules, it is more than possible to create an investment strategy that is tax efficient in both jurisdictions.

It is also important to note that the various tax allowances/exemptions in both the UK and US are constantly changing, therefore it is vital to re-assess your estate plan on a regular basis. It is important to be informed about any potential tax consequences as this will help design a tax efficient estate plan for your future heirs. Estate planning can seem like a problem that can be addressed tomorrow rather than today however one never knows how the future will unfold and with continuing tax law changes it is important to act sooner rather than later as this could make a significant difference to the amount left to your heirs.

The Legal Stuff

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