What US Trustees and their UK resident beneficiaries need to know about UK tax

Trusts have long been a part of US estate and succession planning. They are important vehicles for protecting family wealth through the generations and can provide flexible solutions for families. Tax rules in relation to trusts and beneficiaries are complex in both the US and the UK, and there is an additional layer of complexity when considering the interaction between the two jurisdictions.

We have seen a recent increase in advising US trustees of irrevocable trusts and their UK resident beneficiaries in relation to the UK tax consequences of trust distributions. This article sets out the reoccurring themes which those affected need to be aware of.

Top five misconceptions and problems

1. Where a trust (or the grantor) pays tax in the US on the trust's income and gains there is no UK tax consequence of a UK resident beneficiary receiving a trust distribution

In our experience, this is the leading reason why UK resident beneficiaries have not sought UK tax advice in relation to distributions from their US trusts. There is a common belief that as tax has been paid in the US there is no UK tax consequence of distributions to consider. Unfortunately, the UK rules mean that this is not the case. A distribution to a UK resident beneficiary may be taxable in the UK if the beneficiary is a long-term resident or has remitted the distribution or benefit to the UK.

2. Where the beneficiary has disclosed their distributions on their US tax return there is no UK disclosure required

Under the terms of the US-UK Double Tax treaty, the UK has primary taxing rights on a trust distribution to a UK resident beneficiary and distributions need to be disclosed on their UK tax returns. Tax credits may be available in the US for the UK tax paid (but this is subject to timing and other considerations).

3. When is an inheritance not an inheritance?

In the US, a termination distribution from a trust on the death of an individual is usually from principal and therefore free of US tax. Unfortunately, the same is not true in the UK. Whilst an inheritance directly from an individual's estate is free of tax, any 'inheritances' which derive from trust distributions will be 'matched' to the trust's accumulated gains and can be taxed at a rate up to 45%.

4. Difficulties with tax credits

There are multiple difficulties with tax credits. These are specific to a trust and beneficiary's specific situation, but include:

- US capital gains tax paid by trustees is not available for offset against UK tax on distributions to beneficiaries of the same capital gains.
- US income tax paid by trustees is not available for offset against UK tax on distributions to beneficiaries of the same income.
- The availability of tax credits can be counterintuitive. For example, there are instances where tax paid in the UK by a UK resident beneficiary may be available for offset against a grantor's US tax liability on the same income.
- Where tax credits are available, the timing differences of the US and UK tax year ends must be considered and planned for to ensure that credit offset opportunities are not lost.

5. Increased interest by HM Revenue & Customs regarding sources of wealth

HM Revenue & Customs (HMRC) are increasingly interested in high net worth individuals in the UK, particularly where they may own properties or other assets which seem to be higher value than expected when compared to an individual's UK tax filings. During 2019, HMRC increased the number of letters to taxpayers requesting an explanation of property purchases. Undisclosed trust distributions may be an individual's main source of unexplained wealth.

Top five tips for regulating UK tax positions and forward planning

1. Review beneficiaries' UK position as soon as possible

In many cases beneficiaries may have been receiving distributions for a number of years and will need to regulate their position with HMRC. The number of years which need to be corrected varies from four to twenty depending on circumstances.

HMRC may also charge penalties on historic tax liabilities. These penalties can be reduced through a voluntary disclosure. It is therefore advantageous to make a disclosure to HMRC before they raise their own enquiries into an individual's position.

2. Review the beneficiary's power of appointment and confirm whether they have exercised their power

Under some trust deeds a beneficiary may have the power to appoint the trust funds under their Will which results in the termination of the trust. If the power is not exercised then in many cases the assets remain in trust. If a beneficiary has exercised their power to appoint in favour of a UK resident family member, then the consequences of such an appointment should be analysed and understood as UK taxes may be mitigated through a different course of action.

3. Review the trust's position in the context of the family devolution of assets as a whole

Parents will often have arranged their affairs so that their children inherit equally between trust and other family assets. Where there is a mixture of UK resident and non-UK resident children then a different split of bequeathed assets may be more tax efficient and can result in the children receiving higher (and equal) post-tax amounts.

4. Be aware of termination dates (and take timely UK advice)

Many trusts terminate on a specific date, such as the end of a non-perpetuity period or an age or death event. Advanced planning may help mitigate any UK tax which would otherwise be payable on termination. Planning may involve decanting the trust or amending the terms of the beneficiaries' entitlement and so should be reviewed as far ahead of the relevant date as practicable.

5. Post-termination, all is not necessarily lost...

In an ideal world, advice should be taken pre-termination, but where this is not possible planning with the use of tax credits can help to mitigate a beneficiary's worldwide tax rate on a termination distribution. Assets advanced to a beneficiary will (in the absence of an election) pass to the beneficiary at cost basis for US purposes but with an uplift in basis to market value at the date of entitlement for UK purposes. This can give rise to double taxation where the assets are sold in a subsequent tax year as the distribution is taxed in the UK in the year of termination and the gain on disposal is taxed in the US in the year of disposal. It may therefore be advantageous for a beneficiary to sell those assets in the year of termination so they are able to match tax credits in the US for payments made in the UK.

Summary

There are many pitfalls for trustees and beneficiaries to be aware of and whilst this article covers only the most common points there is an over-arching theme that pro-active advice can mitigate UK tax problems and exposure in relation to US trust distributions. It is also important to consider the family's position in its entirety, including trusts and other assets, across generations and with consideration to cross-border issues.

Our US-UK Trust and Estates advisory team is a market leader in understanding and advising on these issues for cross-Atlantic families, and we would be happy to discuss your specific requirements.

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