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The three most common tax traps for US persons moving to the UK

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There are a number of important US and UK tax issues that a US citizen or green card holder should consider prior to becoming a tax resident in the UK; however, people often fail to take advice prior to moving. This article discusses the three most common tax traps that we see on a day-to-day basis when people move to the UK without taking proper tax advice.

Tax trap – improper investments

The US and UK each tax investments in a different manner. An investment that produces a favourable tax result in one jurisdiction may produce a larger than expected tax bill in the other jurisdiction. Many US individuals come to the UK with existing relationships with US investment advisors who are unfamiliar with the UK tax issues, or unaware that the US individual has moved to the UK. It is also becoming increasingly common for US individuals to invest their assets directly without an investment advisor. Ultimately, there is usually a failure to consider the tax result in both jurisdictions, and this failure can result in additional to tax pay which would ultimately reduce the investor's return.

For example, a tax free municipal bond may look like a wonderful investment for US federal tax purposes because the bond provides tax exemption from US federal income tax. In the UK, however, this investment does not benefit from a UK tax exemption so the UK taxation may decrease the attraction of the investment.

US individuals should be especially cautious if they invest in mutual funds or collective investment funds. A non-US mutual fund is usually a passive foreign investment company (PFIC) for US federal tax purposes. A US individual who owns a PFIC is subject to a punitive tax regime which is meant to put the taxpayer in a similar position to which he or she would have been if they had purchased a US mutual fund; however, the PFIC regime does a poor job achieving this objective. Various elections are available to the US individual which would allow him or her to be taxed on the PFIC income and growth on an ongoing basis; however, he or she is typically unable to make such an election either because the PFIC is not publicly traded or it does not provide the individual with the additional information required. Absent an election, the US individual pays tax at a higher rate, and is subject to an interest charge which is meant to approximate the deferral of the tax paid. Unless there is a very good investment reason for purchasing a PFIC, US taxpayers should avoid purchasing them. A US individual who invests his or her assets directly without an advisor will often purchase non-US funds, not realising that they are purchasing a US income tax disaster. One positive by-product of FATCA is that local UK advisors are now more likely to recognise whether or not they are able to assist a US individual.

To complicate things further, the UK tax system subjects the profits generated by most non-UK funds to income tax rather than capital gains tax. US funds are likely to trigger a higher rate of UK tax for UK resident individuals. There are, however, a limited number of US mutual funds which also have a favourable tax status in the UK, and by purchasing these US funds it may be possible to avoid the punitive PFIC rules and reduce UK tax liabilities (although the investment credentials of such funds will need to be carefully considered).

To avoid these tax inefficient investments, the US individual should have his or her investment portfolio reviewed by qualified US and UK tax advisors to determine the tax consequences of current and future potential investments prior to moving across the Atlantic. We at Withers, unfortunately, do not give investment advice; therefore, if the US individual intends to hire an investment advisor, we recommend that he or she hires an investment advisor who is qualified to give both the US and UK investment advice, and who is familiar enough to spot the potential US and UK tax issues and to seek advice to avoid unexpected tax issues arising in the future.

Tax trap – serving as trustee of a US trust

A US individual rarely revises his or her estate plan before moving to the UK. A typical US estate plan involves a US individual (a 'settlor') creating a revocable trust which the settlor funds during his or her lifetime to serve as a substitute for a will. The settlor is typically the sole beneficiary and trustee of the trust during his or her lifetime. The terms of the trust often allow the settlor to do almost anything that he or she could do with the trust assets as if he or she continued to own the assets outright.
The settlor also executes a will which transfers all of his or her directly owned assets to the trust when he or she passes away. This is colloquially referred to as a pour-over will.

After the settlor dies, the successor trustees or co-trustees hold the trust assets for the benefit of the beneficiaries in accordance with the terms of the trust. Trusts can be a useful vehicle to pass wealth to future generations. The revocable trust also can provide additional privacy, ease of administration, disability planning as well as the avoidance of probate.

For US federal income tax purposes, the trust is a 'grantor trust,' which means the settlor is treated as the owner of all of the trust assets. The settlor of a grantor trust must include in his or her personal US tax computation all items of income, gain, deductions and credits generated from the trust assets.

For UK tax purposes, this very basic estate plan can cause a potential disaster. If the US individual becomes UK resident while he or she is sole trustee of the revocable trust, the trust will become a UK resident trust. The assets within the trust will then be subject to UK income and capital gains tax on an arising basis. The aggregate amount of tax paid by the US settlor and the UK trustee is typically higher than it would be if the US settlor owned the assets outright and perhaps claimed the remittance basis of taxation in the UK. More worryingly, if the trust is UK resident and then becomes non-UK resident, for example because the settlor/trustee moves back to the US, then there will be a deemed disposal of trust assets from a UK tax perspective, which could trigger significant UK capital gains tax charges. UK tax advice should therefore be sought to avoid having the trust unintentionally become UK tax resident. It is sometimes possible to contend that a revocable trust established under US trust law is a 'bare' trust for UK purposes avoiding the potential disaster scenario. However, we are aware of situations where the UK tax residence status of a revocable trust comes to light once the settlor is a long term UK tax resident and as such 'deemed domiciled' in the UK for inheritance tax purposes. In these cases successfully contending that the trust is a 'bare' trust can undo an effective excluded property trust, causing inclusion of the trust assets in the estate of the settlor for UK inheritance tax purposes.

Careful planning ahead of a move can prevent the need to seek a 'least worse' outcome after the event. For instance, consideration should be given to the settlor stepping down as trustee, or appointing additional non-UK resident co-trustees before moving to the UK.

Tax trap – failing to file US tax returns

A US citizen or green card holder is taxed on his or her worldwide income no matter where he or she lives. An individual makes a big mistake if he fails to file US federal income tax and informational returns following his move to the UK and therefore, fails to pay any US federal tax which would otherwise be due.

Substantial civil penalties exist for failure to file US federal tax and informational returns regardless of whether any tax is due. In addition to the punitive civil penalties, if an individual is aware that he or she must file a US tax return and he or she intentionally does not file, he or she has committed a crime.

Most individuals, however, do not possess the requisite intent which would otherwise give rise to a crime. Instead, they simply have a mistaken belief that they did not have to file once they move to a high tax country, usually wrongly believing that either (i) the US tax system is based on residency in the form of physical presence and not citizenship, or (ii) the UK tax they have paid is higher than the US tax owed and is automatically credited against US tax and, therefore, he or she is under no obligation to file US tax returns because no tax would be due. These beliefs are clearly wrong, but may sound reasonable to an individual with no experience in US taxation.

If an individual has not been filing his or her US federal tax returns, he or she should act quickly to resolve the noncompliance. This mistake is so common that the IRS has created special procedures for US individuals who do not reside in the US to file delinquent tax returns. This program is referred to as the 'Streamlined Filing Compliance Procedures,' and it offers individuals who qualify the ability to file a limited number of delinquent US federal tax and informational returns without being subject to additional civil penalties or criminal prosecution.

The IRS also has an ongoing compliance program for individuals who knew they needed to file, but intentionally disregarded that legal obligation, and who therefore have potential criminal exposure. The Offshore Voluntary Disclosure Program offers a form of amnesty from criminal prosecution along with a fixed civil penalty framework which is more favourable than the potential civil penalties which the individual would be subject if audited by the IRS.

We strongly recommend that US individuals who have not filed past due US federal tax or informational returns come to our office and discuss their situation on a basis which preserves the attorney client privilege. This will ensure that they can make an informed decision on how best to forward with their US tax compliance obligations.

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