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# Transatlantic minefields

Patrick Harney TEP and Natalie Lim TEP explore safe navigation of the US-UK Income Tax Convention for the private wealth practitioner

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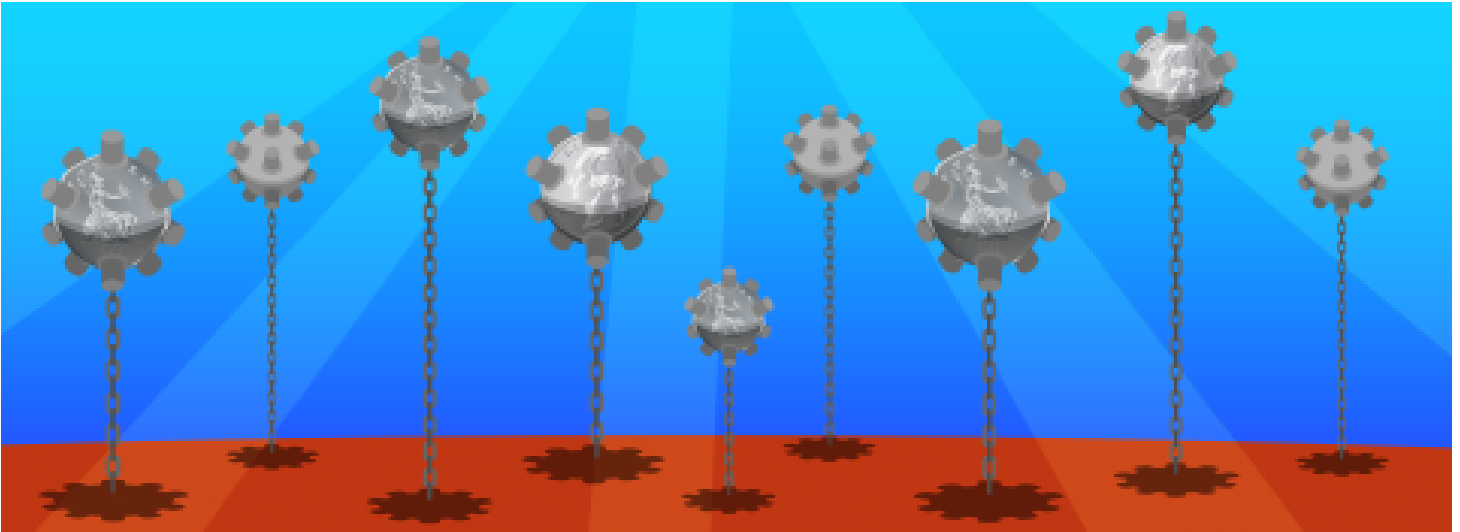

## What is the issue?

For individuals navigating the intricate landscapes of UK and US income taxation, the *US-UK Income Tax Treaty* (the Treaty) is both a compass and a potential minefield.

## What does it mean for me?

Practitioners advising any such clients should be mindful of the potential pitfalls, as the Treaty does not always manage to prevent double taxation.

## What can I take away?

UK-US cross-border income tax planning should not be undertaken without considering the Treaty, the impact of its exclusivity provisions, as modified by its savings clause, and the potential for reduced taxation for the well advised and double taxation for the badly advised.

This article provides an introduction to the *US-UK Income Tax Treaty* (the Treaty) and how it impacts private individuals.

The goal of the Treaty is to prevent double taxation by broadly allocating taxing rights as follows:

- Exclusive taxing rights to the country of residence, subject to a 'savings clause' in art.1(4), which retains the right of each country to tax its own nationals (this is only relevant to US citizens as the UK does not tax based on nationality).
- Primary taxing rights to the source country with respect to:
    - permanent establishment (PE) income, including the US concept of effectively connected income (ECI) with a US trade or business; and

- income derived from real estate.

Additionally, it provides a foreign tax credit (FTC) mechanism to avoid double taxation,[1] including provision to change the source of income to enhance the foreign tax credit.

## Exclusive vs primary

The words themselves suggest the point is obvious but in the authors' experience this distinction cannot be emphasised enough, as it is a common pitfall both for the taxpayer and the professionals who advise them. With reference to a particular item of income and/or gain, whereas a provision allocating ‘primary’ rights means that the UK and US both have a right to tax that item (albeit one country will have first rights to impose a tax liability without any reference to the tax exposure in the other country), ‘exclusive’ taxing rights means that only one country (usually the country of Treaty residence) has the right to tax the item.

> *The practical effect of art.1(4) is especially punitive for US citizens abroad, as it renders some provisions of the Treaty ineffective.*

### *Example 1*

Brad is a UK citizen and US green card holder. He is a dual resident of the UK and US under the UK Statutory Residence Test (SRT) and US Substantial Presence Test (SPT), respectively. Applying the relevant ‘tie-breaker’ test under art.4(4) of the Treaty, despite having a permanent home in both the UK and the US, Brad's centre of vital interests (CVI) is in the US and he is therefore Treaty-resident in the US. This means that the Treaty will give exclusive taxing rights to the US and he will not be taxed in the UK (except in respect of UK PE and real estate income), subject to the application of art.1(4). If the situation were reversed and Brad was a US citizen and Treaty-resident in the UK, the UK would not have exclusive rights because of art.1(4).

## Income tax treaty vs remittance basis

The traditional approach is to claim the remittance basis, albeit this is only beneficial for US citizen taxpayers to the extent that the UK effective rate of tax that would have been paid is higher than the

effective US rate on the same item of income/gains.

However, relying on the remittance basis requires careful pre-arrival planning, including (as a minimum) setting up segregated bank accounts and realising sufficient clean capital to fund their UK expenditure, e.g., by triggering income receipts and capital disposals prior to becoming UK resident. For US citizens, the very triggering of income receipts and capital gains may cause US taxation before arriving to the UK.

Where the fact pattern supports a claim, Treaty planning presents an infinitely better alternative for US citizens or non-US citizens who are dual residents of the UK and US and Treaty-resident in the US, as the US will have exclusive taxing rights (except on UK real estate and PE income). Due to the generally higher UK tax rates compared to the US federal rates, this can result in significant global tax savings depending on the categories of income arising to the taxpayer. Moreover, unlike the pre-arrival planning required for the remittance basis, Treaty planning provides a simple and effective solution that eliminates the need for bank account segregation and clean capital planning.[2] Dual-resident taxpayers who are Treaty-resident in the US are also able to invest in US mutual funds and US municipal bonds, which would otherwise be taxed in the UK at up to 45 per cent.[3]

Treaty planning also represents a significant hedge for wealthy US-citizen UK-connected taxpayers concerned about the potential abolition of the remittance basis, if they are able to arrange to be Treaty-resident in the US. This is because, whereas it is relatively easy for governments in power to change domestic legislation where they have a majority vote in parliament, it is significantly harder to make changes to tax treaties between two sovereign countries as it requires the cooperation of both states.

## US grantor trusts and UK-resident beneficiaries: who is the taxpayer?

Difficulties may arise in relation to trusts, where there is a mismatch in the taxpayers' identity. This is particularly relevant in the context of US grantor trusts, where the same item of income/gain is treated as taxable in the hands of:

- the grantor, in the US; and
- a beneficiary, in the UK.

The *Exchange of Notes* to art.24 of the Treaty deems a beneficiary's tax liability to be the grantor's liability,[4] where the same item of income or gain is treated as taxable in the hands of the grantor in the US and a beneficiary in the UK. Therefore, the Treaty mitigates the mismatch in the taxpayer’s identity, although technical issues regarding the sourcing of income/gains at grantor level may still

arise.[5]

## Tax payments and tax credits

Where a US citizen is UK resident under UK domestic law and the Treaty, the US has primary taxing rights on the following categories of income:

- US-source dividend income up to the permitted 15 per cent Treaty withholding rate;
- income from US real estate; and
- US ECI income.

In the cases where the US has the primary taxing rights, there is generally no time limit on claiming a credit for the US tax suffered against the UK tax on remittance of that income. If the primary taxing rights rest with the UK, then the time limits on claiming foreign tax credits in the US apply.

Assuming that the 'paid' basis of FTCs applies, if the beneficiary is a UK-resident remittance basis user and they do not pay the UK tax on the income over which the UK has primary taxing rights during either the year in which the income or gain arose to them or the subsequent calendar-year, then an FTC cannot be claimed against the US tax liability on the same income or gain.

### *Example 2*

Jane is a US-citizen UK-resident remittance basis user and is Treaty-resident in the UK. On 1 June 2023, she makes a capital gain of USD1 million on the disposal of shares in Amazon and she retains the proceeds outside the UK and does not remit the gain until 2026. Although she will already have paid her US tax on this gain, the UK will not give her a credit for the US tax against her UK tax on the remittance of that same gain to the UK because the UK had primary taxing rights over this gain.

## Hybrid entities

The prime example of ‘problem’ hybrid entities is US limited liability corporations (LLCs), which, notwithstanding *Anson* v *Commissioners for Her Majesty's Revenue and Customs*,[6] are generally classified as transparent in the US but opaque in the UK. The effect of this mismatch is that UK-resident taxpayers with interests in US LLCs could be subject to US taxes on the profits of the LLC as they arise but only subject to UK taxes upon receipt of distribution of the profits. Consequently, the taxpayer would pay US and UK taxes on the same profits, with no tax credit available under the Treaty.

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[1] For completeness, the authors understand that as the US *Internal Revenue Code* distinguishes between US federal income tax and net investment income tax (NIIT), the US is not obliged under the Treaty to provide an FTC against NIIT. However, in the recent case of *Christensen* v *United States*, it was held that whereas FTCs cannot be used to offset NIIT liability under US domestic law, this restriction could be overridden by a US-France tax treaty provision.

[2] By definition, clean capital refers to income or gains realised before you become UK tax resident under the statutory residence test.

[3] Or 20 per cent with respect to US mutual funds that have UK 'reporting fund' status, although this is uncommon.

[4] https://bit.ly/443fmtg

[5] For a more detailed discussion on how to mitigate double taxation in the case of US trusts with UK-resident beneficiaries, see Patrick Harney and George Mitchell, 'Double Trouble', *STEP Journal,* Vol Iss9, pp.52-52

[6] [2015] UKSC 44

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