

UK Tax Treatment of US Revocable Trusts

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Overview

1. Typical US revocable trusts
2. Potential UK pitfalls
3. Analysis
4. Conclusions



1. Typical US revocable trusts

- By far the prevalent form of estate planning in most states
- Sometimes referred to as a “living trust”
- Used as will substitute to avoid probate
- Can reduce cost of probate (though a will is still required) and prevent delay in vesting assets in hands of trustees
- Can provide greater confidentiality than a will
- Can avoid court supervision of estate and the need to apply to court to change trustees
- Generally, fully transparent for US tax purposes
- Many UK-resident clients have them, as US citizens taxed on worldwide basis



1. Typical US revocable trusts

- **Typical form:**
 - Settlor retains full power to amend or revoke
 - Settlor entitled to the income and may call on capital freely
 - Settlor names self as sole or co-trustee to retain day-to-day control of assets
 - Successor trustees are named, but settlor may change them
 - May provide that while settlor is living no other beneficiary has any enforceable rights
 - Clients typically encouraged to settle most of their assets *inter vivos*
 - Settlor also executes “pour-over” will that leaves any remaining assets to the trustees
- Many states require execution formalities similar to those for a will



2. Potential UK pitfalls

Income and Capital Gains Tax

- Settlor is or becomes UK resident not domiciled in the UK
- Settlor is a (or sole) trustee
- Trust therefore resident in the UK and worldwide trust income and gains subject to UK tax
- Settlor believes trust income and gains are taxable on remittance basis

Inheritance tax

- Since FA 2006, settlement by UK domiciliary (actual or deemed) subject to immediate 20% charge and ten-yearly charge as relevant property
- Conversely, non-domiciled settlor may wish revocable trust assets to be treated as excluded property settlement



2. Potential UK pitfalls

Non-Tax

- Wills Act
- Perpetuities issues



3. Analysis

- Several theories advanced to negate unwelcome UK income and capital gains tax consequences:
 - Income and gains attributed to settlor rather than trustees
 - Settlor entitled to remittance basis for such income and gains
 - To avoid doubt, clients often advised to appoint non-UK trustees or collapse trust (but beware of triggering tax charge on trust gains)
- “Sham” argument
 - Perhaps, if settlor-trustee ignores the formalities (but occasionally they don’t!)
 - No developed “sham trust” concept across US states
 - Hague Trust Convention/Recognition of Trusts Act 1987



3. Analysis

- Adverse UK tax consequences apply to “settlements”
- What is a settlement?
- **Income tax**
 - s. 620(1) ITTOIA: “includes any disposition, trust, covenant, agreement, arrangement or transfer of assets”
- **Capital gains tax**
 - s. 97(7) TCGA: incorporates s. 620(1) ITTOIA for CGT purposes
 - S. 68 TCGA: “settled property” is “any property held in trust other than property to which section 60 applies”



3. Analysis

- **Capital gains tax (continued)**
 - s. 60 TCGA [“Nominees and Bare Trustees”] applies to “property held by a person as nominee for another person or as trustee for another person absolutely entitled as against the trustee ...” [s. 60(1)] namely “a case where that other person has the exclusive right, subject only to satisfying any outstanding charge, lien or other right of the trustees to resort to the property for payment of duty, taxes, costs or other outgoings, to direct how that property shall be dealt with” [s. 60(2)]



3. Analysis

➤ Inheritance tax

➤ s. 43(2) IHTA 1984 “Settled property” defined as

“any disposition or dispositions of property, whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being-

(a) held in trust for persons in succession or for any person subject to a contingency, or

(b) held by trustees on trust to accumulate the whole or part of any income of the property or with power to make payments out of that income at the discretion of the trustees or some other person, with or without power to accumulate surplus income, or



3. Analysis

- **Inheritance tax (continued)**

- s. 43(2) IHTA 1984 (continued)

“(c) charged or burdened (otherwise than for full consideration in money or money's worth paid for his own use or benefit to the person making the disposition) with the payment of any annuity or other periodical payment payable for a life or any other limited or terminable period.

or would be so held or charged or burdened if the disposition or dispositions were regulated by the law of any part of the United Kingdom; or whereby, under the law of any other country, the administration of the property is for the time being governed by provisions equivalent in effect to those which would apply if the property were so held, charged or burdened.”



3. Analysis

- **Inheritance tax (continued)**
 - But HMRC acknowledge that a bare trust is not a settlement for IHT purposes (*see, e.g., Correspondence between HMRC and CTP/CIOT from September to December 2006, HMRC answer to Question 33*)
 - No single statutory definition of “bare trust” and its meaning will depend on its context. *See Underhill and Hayton, Law of Trusts and Trustees*, 17th ed. [2007], paras 4.1(1) and 4.3



3. Analysis

➤ General trust principles

- *CIR v. Plummer*, 54 TC 1: Settlement must have element of gratuity
- *Armitage v Nurse* [1998] Ch 241 at p. 252.] (Millett, LJ): In English law, “there is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts.” (Emphasis added)
- Kessler, *Taxation of Foreign Domiciliaries 2011-12*, s. 72.11: “A US revocable trust [in which trustee’s only duty is to settlor] is not an IT/CGT settlement as the property is not held “in trust”. ... [It] is similarly not an IHT settlement, since
 - (1) if the settlor is sole trustee there is no trust;
 - (2) If the settlor is not sole trustee there is only a bare trust.”



3. Analysis

- **“American” law principles**

- *Scott and Ascher on Trusts, 5th ed.* [2007], s. 16.5:

- “the courts and the legislatures have only just begun to see their way to identifying the holder of a power of revocation as the primary focus of the trustee’s fiduciary duties. ... One might speculate that one of the reasons for this deficiency was the need to paper over the dirty little secret that, in terms of trust theory, a revocable trust has always had but a tenuous claim to being a real trust. Indeed, ... as recently as the middle of the last century, there remained serious questions whether, in certain circumstances, a revocable trust was not invalid, under the statute of wills, as a “testamentary transfer.” One of the primary theoretical steps in defending the revocable trust against this charge was that the creation of such a trust immediately conferred “interests” upon other “beneficiaries.”



3. Analysis

- **“American” law principles**

- *Scott and Ascher on Trusts, 5th ed.* [2007], s. 16.5 (continued):

- “A power of revocation is the functional equivalent of ownership and is ordinarily held in an individual, rather than a fiduciary, capacity, even if the power holder is also the trustee. ...

- “The rights of the beneficiaries of a revocable trust are, therefore, subject to the settlor’s control for so long as the settlor retains the power to revoke and remains competent.”



3. Analysis

- **“American” law principles (continued)**
 - Statutes and case law differs among states
 - **s. 603 Uniform Trust Code (UTC):**

“While a trust is revocable [and the settlor has capacity to revoke the trust], rights of the beneficiaries are subject to the control of, and the duties of the trustee are owed exclusively to, the settlor.”
 - UTC adopted in 21 jurisdictions: Alabama, Arkansas, District of Columbia, Florida, Kansas, Maine, Missouri, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota and Arizona, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Virginia and Wyoming



3. Analysis

- **“American” law principles (continued)**

- **s. 15800 California Probate Code (*e.g.*):**

“Except to the extent that the trust instrument otherwise provides or where the joint action of the settlor and all beneficiaries is required, during the time that a trust is revocable and the person holding the power to revoke the trust is competent:

(a) The person holding the power to revoke, and not the beneficiary, has the rights afforded beneficiaries under this division.

(b) The duties of the trustee are owed to the person holding the power to revoke. While a trust is revocable and the settlor has capacity to revoke the trust, rights of the beneficiaries are subject to the control of, and the duties of the trustee are owed exclusively to, the settlor.”



4. Conclusions

- US estate planning revocable trusts may in many cases not be settlements for UK tax purposes
- Depends on specific facts (including express terms) and governing law
- Express provision depriving beneficiaries other than settlor helpful, as is a statute similar to UTC s. 603 (but beware incapacity provisions)
- Safest not to fund (except nominally) *inter vivos*
- Beware of joint settlors
- Other contexts:
 - *Inter vivos* QDOT marital trust settled by surviving spouse
 - Pension arrangements structured as trusts?
 - Excluded property settlement – here the client wants the trust to be treated as a settlement – avoid revocable trust, or draft around UTC s. 603



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