Taxing Matters

Episode 3 - Unravelling the differences between the UK & US tax systems with Alex Jones and Graeme Privett

Alice	Hello, and welcome to Taxing Matters, your one stop audio shop for all things tax brought to you by RPC. My name is Alice Kemp and I will be your guide as we explore the sometimes hostile and ever-changing landscape that is the world of tax law and tax disputes. Taxing Matters brings you a fortnightly roadmap to guide you and your business through this labyrinth. In case any of you miss any crucial information or just want some bedtime reading, there is a full transcript of this and indeed every episode of Taxing Matters on our website at www.rpc.co.uk/taxingmatters.
Alice	Many of you listening may have travelled to the United States of America and experienced a moment of confusion where you thought but we all speak the same language what's happened here before realising that maybe we don't all speak quite the same language, and that is defo true of the tax and financial systems. Here to give us a crash course of the US tax system and how it might be working against you are Graeme Privett and Alex jones, partners at Accountant firm Rawlinson & Hunter. Alex has other 30 years' experience in navigating US & UK tax issues including personal income, capital gains, social security, LLC's, estate taxes, inheritance, pensions, the list goes on. Graeme also advises on a wide and diverse range of personal tax issues for UK and non-UK individuals particularly those involved in the US crucially for today, and he provides practical advice to tackle these thorny issues. So, Alex, Graeme welcome to Taxing Matters.
Graeme	Hello Alice.
Alex	Hello Alice.
Alice	So diving right in, Graeme but we do speak the same language so what could go wrong.
Graeme	Yes we do speak the same language albeit occasionally with different spellings for things. What could go wrong is, often I think people who speak the same language assume that everything is going to work exactly the same way in the other country. So American state that the UK system will work the same way and vice versa. In our experience whilst tax systems try to reach the same conclusion they often do it by a different route and a different methodology. From a US perspective the system is very much designed around the premise that anything that is foreign is generally regarded as alien. So anyone who is not a US person ie a citizen or a resident or a green card holder is described as a non-resident alien which pretty much tells you exactly where that part of the code will go and also how they will think about those individuals. Equally the other premise for US individuals, certainly living outside the US, is just assume that you are going to have to provide a lot of information. It's more to do with show and tell rather than hide and seek. This idea of a lot more disclosure which we really think is going to permeate through tax systems outside the US it is the way forward for the US, they are very much leading that and expanding that as well. The other premise as well that we obviously need to think about is assuming that all of our terms mean exactly the same thing whilst we have, in the UK, effectively have come up with a concept under common law of trusts the US has very much followed its own path in relation to trusts particularly individuals who come out of the UK and go into the US, we see time and time again that they create a trust in a local jurisdiction thinking that that has no tax consequences at all only to find later on that actually what they've done is potentially walked themselves into a very serious UK inheritance tax issue. So, for example, an individual who retires to Florida and it is very common for people to put their assets into what is called a living trust or a revocable trust as a probate avoiding mechanism in the US only to find that the UK looks at that in a different way. Where you've got substantial assets going into that trust that needs a careful consideration to ensure that you don't find yourself with a UK inheritance tax charge you hadn't even considered.
Alice	Thank you Graeme. So you have highlighted there some of the consequences but Alex really why would this matter?
Alex	It matters if you are American and by that we would broadly mean citizens and also in almost all cases a green card holder or somebody physically present in America, somebody spending enough time in America

to be regarded as a tax resident of America and when we say America we mean the Federal United States of America and also potentially state or local jurisdictions in America who might also have the power to impose taxes. In addition to those individuals we also mean non-Americans who have American stuff. So somebody who has got US stock, somebody who is participating in some sort of reward mechanism, somebody is in private equity or hedge funds or real estate and has carried interests and the principal entity happens to be American so it is all structured for Americans, but it could also mean people who simply spend some time working in the United States of America. Again, we tend to assume that simply working in America will be fine, there's a treaty between the two countries, that means that I can't possibly owe any tax in America, the accountant will say, when you say can't owe tax in America do you mean the Federal United States of America or do you mean the state or local jurisdiction in America because it could be different. It could be a completely different answer, did you consider both of those, well no I just sort of thought that probably it wasn't an issue. So the issue is that you might have US stuff or you might be an American and if you are an American and if you are an American anywhere on the planet, you have worldwide income tax. In America income and gains are essentially regarded as the same thing so when I say income tax we mean income and gains. So if you are American, you live in London, you still have to file a US tax return, you're still a US taxpayer, you still have to report and do everything else but now you've made it more complicated for yourself because you've involved British English in some of the financial things that you do and those might be different. That's the why does it matter, these are legal obligations, you've signed tax returns on the penalties of perjury. The US, as Graeme mentioned has a whole bunch of additional information reporting obligations which are essentially designed to say give us the foreign stuff that we don't get directly from the bank or the broker or the company because they are not American so they don't necessarily have to give us stuff directly, give us information on all of those things and because some Americans have historically taken some persuading to fulfil those obligations, the penalties that the US impose as a result of the failure to comply with these information reporting obligations are generally far in excess of any likely income tax or capital gains tax or certainly any interest or penalties that might apply on the tax itself. So there are very penal rules that say if you don't play the game, if you don't show and tell, we are going to hit you with a big stick and it is a big stick. In terms of differences, just to expand on some of that, Graeme mentioned that trusts can be different and you can fall into having things like trusts in America, if you live in California and you're buying a property or something and your lawyer doesn't say stick it into some form of entity and stick it in some form of trust for probate purposes, has no tax affect in America at all but you do that to make a couple of other things easier for yourself in the event that you die or easier for your family in the event you die, then you will end up with one of these funny vehicles. It might be completely ignored in the US but the UK will look at it and go that's interesting because we think that's a real thing and because it's a real thing it's got a consequence. That's at the more complicated end, picking stuff that's a bit simpler in the UK we have things called ISAs, Individual Savings Accounts, which as we all know are tax free wrappers in the United Kingdom. So why on earth would you think that they are tax free in the United States of America, completely different country and they didn't invent them. Why would they want to specifically give American tax breaks to people who are British living in the UK, they didn't. An ISA from a US point of view isn't a tax-free wrapper. The US will look at it and go it's an investment stuff, you made some money there's probably some tax so you are going to have to report it and you are going to have to calculate whether you owe something. If you have things like a principle residence, again we all know that you buy a principle residence, you live in it, you sell it, the gain is exempt in the UK but in America they have a completely different rule, they don't do things like that, these days in America what they do is they say if you've got a principle residence and if you make a gain of up to $250,000 per owner and you don't sell properties more regularly than every two out of five years then you will get $250,000 worth of exemption but if you have gain above and beyond that we are going to tax you. The UK is actually pretty unusual in not taking any principle residence gains. It's engrained in us, it's difficult for us to think that that shouldn't be the case everywhere else. It's not and it's not in America. It gets worse than that, the US has a different currency to us, dollars and if you were unfortunate enough to travel to America shortly around the time of the Brexit vote as I did and you somehow didn't think it was going to happen and therefore didn't realise that the exchange rate was going to change in a space of two weeks then your dollars were a lot more expensive when you travelled shortly after the vote and again, earlier this year, probably in the last six to eight weeks, there was a momentary fall in the value of sterling 18%-20% fall in the value of the currency in case of a matter of weeks. Everything they do is in dollars so when you buy something capital asset, they are going to say how many dollars did you buy it for at the point you bought it using that exchange rate, how many dollars did you sell it for, using the current exchange rate when you sell it. The comparison between UK and US tax you could end up with a situation where you have capital gain in the UK when you sell some stock capital loss in America because of the different currency. Or you can get a capital loss in the UK and a capital gain in America and they are going to tax that even though locally you're thinking I don't owe any capital gains tax in the UK I've got no gain or loss or I'm covered by my annual capital gains exemption which the US of course doesn't have so the US will go, know you've got a gain in dollars therefore you've economically made money therefore you will owe tax, that's the rules here. When you borrow a mortgage, if you're American the question you ask yourself is how many dollars did I borrow in the currency exchange rate at the point of borrowing then when you pay it off, perhaps when you sell the property you ask the question how many dollars did I just pay off, how many dollars did I pay back over that debt and the US will look at it and say well if there's a difference between the dollars you borrowed and the dollars you paid back you either made some sort of income or some sort of loss in dollar terms. Anything that produces economic return from a US point of view is income and is taxable. So, if you are the unfortunate situation of borrowing £100,000 and the exchange rate is 1.5 and then you pay back the £100,000 and the exchange rate is 1.3, well you borrowed $150,000 you paid back $130,000 that's less so you economically are $20,000 better off in dollar terms. Well the US look at that and say you made money you sort of invested in a foreign currency debt, somehow you generated 20,000 of return so that will be taxable then. That's alien, I like the word alien because it really does say what that means to a natural British tax thinker, that's really alien. I didn't do anything or I borrowed 100,000 I paid by 100,000 nothing happened no tax consequence in the UK but in America oh dear, actually may be I have generated income and that's therefore going to be taxable. So that's not in a nutshell, but why it matters because it is just so so easy to trip up because we don't speak the same language when it comes to tax.

Alice So how can you tell if you are in fact American?

Alex There's the usual signs, you wear a big hat, thin leather tie, cowboy boots, those are all good clues to American, an accent that we all recognise from watching movies, but in reality in the legal world the question is well were you born in America, simply being born in America makes you a US citizen. It doesn't matter whether you apply for a passport, a passport is just a travel document, born in America means you are American and we have a very good example of a person in that situation, it's widely reported in the press, so I can mention his name quite freely, it's Boris Johnson. So, our soon to be former Prime Minister, Boris' dad Stanley used to work for some world bank or something and he was seconded to America and Boris was born in America unlike I think his other siblings and lived there until he was four before he returned to the UK but it makes him American. So if he's American he's got worldwide taxation on everything and I think it came to head to do with a principle residence disposal where it became obvious there would be tax due in America even though there was nothing due in the UK quite properly under UK law. Being born in America will make you American whether you like it or not unless you choose to do something about it, to do which we will talk about later but it also requires you to be essentially the age of 18 or above. Other people can be American if your parent is American, if you were born outside the United States of America and both of your parents are American you are American, you may never have set foot in America but you are American and all the same rules apply to you. The last group is not quite as certain as those two which is maybe only one of your parents is American and if only one of your parents is American and if they spent enough time in America effectively during their minority then you are going to be American too. So for that it is fact specific in terms of the immigration law that applied at the time that they were born and how much time they spent in America and blah blah blah. If you were born outside America and one parent is American you may well be American. As an industry we tend to refer to those as accidental Americans, it wasn't their fault they just happened to be on holiday in America when they were born or one of their parents was on secondment to America or it just so happened that one of their parents was American and they were born in Kensington and Chelsea or Hammersmith or wherever and that parent had lived in America until they were at college years then they got a job, was seconded to the United Kingdom and 20 years later had a child, having married a proper Brit. It's really easy to be American and sometimes it is actually quite hard to know whether you are or not. If you have a passport that says you were born in Boise Idaho then even a US immigration officer is going to look at you and go hold on a second you're American and yet you've given me this currently burgundy passport which is not an American one. I'm looking for the dark blue one that we give to Americans where your one of those. It's that obvious if you're born in America that you are probably American even US immigration officials will spot that. So will your bank when you send them your KYC or anti-money laundering information when you send them a copy of your passport your bank will go oh hold on a second you were actually born in Cincinnati and therefore aren't you American, the exchange of information between different countries as Graeme alluded to earlier requires lots of information to transmit back and forwards and it is really important for accountants, financial institutions to understand who you are in a tax consequence and one of those things is are you American or not. Very easy for normal people to accidentally be American and therefore fall into the system. The other thing would be Brits acquiring US interests. You work for a company in the UK and spend time working in America, we can generally assume that most people in that situation probably aren't exposed to US federal Tax because of a treaty between the two countries but actually it's not uncommon, particularly in things like banks that the offshore entities or indeed the UK entities are in fact are a branch of the proper business that is somewhere else or the US entity is a branch of the UK bank and as a

	result of that the treaty doesn't quite work as well and when you spend time working in America that may actually be properly US federally taxable as well as likely state taxable and the agreement between the two countries essentially then says we can't exempt that income in America what we will do is we will give a credit in the UK. So simply doing your job could expose you to a US tax consequence if you spend time working in America in the same way that if you acquire assets or get rewards from your company if there's an American involved then you may have a US tax consequence associated to that.
Alice	Thank you Alex. Graeme is it possible to become American without intending it?

Graeme	Yeah there are almost an extension of the accidental American that is being dragged in almost slightly voluntarily as well so as Alex says working in the US will drag you in certainly for state tax as I think we generally pick two jurisdictions two states that are certainly more aggressive than others which is New York and California and for those in the UK tend to be the two jurisdictions you would probably gravitate towards. Apologies to anyone listening from either Illinois or Massachusetts or elsewhere we don't necessarily see them quite as much but both of those jurisdictions are very keen to ensure that people coming to work in their jurisdiction are paying tax generally speaking you can get credit for state taxes paid on your UK return but obviously that drags you into a system where you weren't necessarily thinking that you had any obligations. The other point, you could be working merrily for a UK company and all of a sudden you're bought overnight by a US business and we see that quite regularly and that US business is structed in a slightly different way. If you have a shareholding the UK company you are exchanging it for something else and what is the something else you're exchanging for, is that a company and that company is paying dividends or giving you some sort of income flow as a shareholder that then brings you into potential additional reporting requirements there and what happens if you sell those shares, who is taxing that gain. Typically it would be the UK but actually we often see businesses that operate over a number of jurisdictions potentially having UK resident owners with obligations to file in the US because that business has a very significant US footprint. The other obvious one is marrying an American. People move around a lot, Americans coming to the UK will marry Brits but equally from a British perspective the individual marrying an American all of a sudden finds that they've got other considerations so they might own assets jointly, what reporting requirements around that, particular the family home. As Alex said earlier on, the US wants to tax the gain so one of the things that we often advise on is how to own that property between two individuals one of whom is a US and one of whom is not a US person, structuring that perhaps a little bit more tax efficiently, particularly at the moment with a very volatile currency arrangement whereby you can end up with an economic profit without even making a profit locally on the asset itself. The last one is more for the lawyers, friends that went to the US, got married in California and then returned back to the UK only to find that they got married in the community property regime, the matrimonial rules around that therefore the tax rules around that are slightly different as well. This is where it gets very complicated where you've got two legal systems butting up against each other and often around life events, if anything happens to that marriage, then the tax consequences are going to be different from a UK or English law perspective in the same way domestically in the UK that we would look at that and the English rules and the Scottish rules are different. It is quite common to find ourselves delving into the actual legal rules in terms of community property or regimes and how they impact upon the taxation as well.
Alice	So what can you do if you find yourself accidentally American? Is there a way to remove yourself from the US tax system?
Graeme	So long as you have citizenship elsewhere, by definition an accidental American will typically do so, the US allows you to give you your nationality, a process sometimes referred to as renunciation or expatriation, that is done at the local embassy, typically for those living in the UK it will be in London, you can actually get it done in Belfast or in Edinburgh and that is a formal immigration process whereby you complete paperwork, that is checked and then you go and have a formal interview to hand back your passport. From a tax perspective that has also consequences and for most accidental Americans that is when you definitely want to take tax advice in advance. Firstly the regime was changed in the US from June 2008 to ensure that when you left the US on expatriated that you effectively pay tax on the way out, on a deemed disposal of all of your assets. However, helpfully there are some let-outs and those let-outs particularly can help accidental Americans, dual-nationals, only for those individuals going back to their other nationality from birth, so if it's an individual who was a UK national from birth and returned back to the UK that can help but the other requirement is that you are up to date with your tax and have been for five years and this where a lot of people tend to fall down. So you need to get the tax sorted out first and make sure that there are no issues, no houses that you've sold and forgot to pay tax on, or mortgages you've repaid or ISAs you've got any reporting, so information reporting, once that is tidied away and you've made sure you're happy with that then you can think about expatriating. The other consequence is if you do fall into effectively a bad leaver, the other sting in the tail for those individuals is that there is provision in the code for any US persons receiving gifts or bequests from this bad leaver to pay inheritance tax on that. Now that was introduced as part of the code in 2008 however we have never seen the way of collecting it. So that seems a little bit more up in the air and anyone that advises on tax hates uncertainty so our advice to clients is to make sure wherever possible that you tidy up all of your tax and when you do leave you are absolutely certain that there are no outstanding tax liabilities that can come back and bite you later on. Individuals that want to expatriate they have to be 18 to be able to do it, it's an act that a parent cannot do for a child, equally if an individual has lost capacity they can't expatriate either, an attorney can’t do that for the individual. There is window between 18 and 18.5 where an individual can expatriate no questions asked but again you need to ensure that you have

	sorted out the tax parts because again the IRS isn't going to necessarily respect the fact that the individual is expatriated if they have tax liabilities they will collect those tax liabilities.
Alice	Thank you Graeme. Following on from that, Alex, what can you do to fix the problem?
Alex	There might be a fix, both UK and US have really complicated ie long tax legislation and quite a bit of both systems is what do you do to try and fix if you've paid tax to a foreign country. Both UK and US have systems for foreign tax credits, if you pay tax somewhere else we might give a credit, that might word is really important because of course we all assume that we understand intrinsically the direction that those credits will flow in, we don't and that doubt is enshrined within the documents, it's above the domestic legislation of both countries, which is called the income tax treaty or the double tax treaty between the United Kingdom and the United States of America which is sort of the agreement between the two governments as to what we will do in order to mitigate unacceptable instances of double taxation, again those are deliberate words, I didn't say prevents double taxation you will notice, mitigate unacceptable double taxation which leaves the possibility yeah you can still have double taxation just not unacceptable double taxation. So, often the direction of the credit is not the way you think and that is particularly onerous for an American living over here because very very frequently if they are taxable in both countries at the same time on the same stuff the UK will win. But the problem is you don't file a UK tax return until after you've typically filed a US return because we've obviously got our fiscal year ending 5 April, they've got fiscal year ends on 31 December, so typically you file the US return reporting the US income and of course everything else, may be that's UK wages, your claim of credit of the UK payroll taxes on the US tax return but then you'll go oh look I've got some bank interest in America I'll pay tax on that in America, I'll probably get a credit when I do my UK tax return in three or six months time, oh no you won't cries the income tax treaty, it should be the other way round and that causes a timing problem and slightly bizarrely that timing problem can become permanent really easily. It can take as little as a year of passage of time to basically say, well you would have been able to get a credit for the UK tax against that US stuff but because you wanted too long now you can't, you've got real taxation in both countries in relation to the same stuff at different points but that's double taxation, that's 100 of bank interest, taxable in UK it may be 45% oh but actually you can't get the credit for that because you didn't pay it quick enough and so actually you've still got the 37% in America and all of a sudden you know you're in the 80%-80% range of taxes on that 100 of income. So sometimes there isn't a fixed particularly in retrospect, the mantra of all of this is, be aware, plan for it, it's not simple, it's not straightforward, it's not obvious as to what the answer is necessarily going to be unless you spend a lot of time reading legislation, plan for it, figure it out and then potentially you can fix it or at least you're in the best shape to fix it as best you can but if you don’t plan for it the risk is that you end up in paying tax in both countries and that's tax rates, as I say, in the 70%-80% type range. Aligning what you are doing in both countries, hugely important, if the thing that happens, let's call that the sale of the stock, if that is regarded in the same way by both countries at the same time, that's good because you've got the same event, you can work with that and then may be you need to get the timing of the taxes, which country do you really owe it in and which one should you pay it first in and then you can align the taxing but you've got to understand the risks. What happens if in the UK you've got something which isn't a recognised transaction today but in America it was, well you're going to have US tax because of the US recognised transaction and may be in the UK we don't recognise that anything has happened until a little while later and then a little while later the UK will go oh actually yes, something has happened and we can tax that. Now the two countries are taxing different things so the US is taking one thing and the UK is taxing something completely different in its mind and both countries are sort of going, we think we've got the right to tax that stuff and it's just that they are having two different arguments. It doesn't matter the intransigence or the futility of their argument, you're talking about two different things, it's alien again. So, knowing the risks, figuring out the risks, when you know what the risks are, trying to align the risks, trying to align the actions. The only real way of fixing the issue and ultimately that means taking advice, generally it is quite specialist advice. Firms like ours, businesses like ours, we do both UK and US, Graeme and myself practice UK and US taxes and that's important because we can mentally translate what is going on. You can do it with accountants in both countries, the problem is neither of those two, unless they are really experienced and work in this space quite a lot, will have any understanding of the other system and they will, not always, but often fall into exactly the same trips that normal mortals that don't spend time reading lots of tax legislation fall into which is well it works here so its probably the same when hopefully what we've demonstrated is it almost definitely not the same, it's almost definitely going to be different. The rule of thumb is, when in doubt there's a problem, no matter how obvious it might sound that there isn't a problem in the United Kingdom, when it comes to America there probably is, it probably is an issue and it's probably not going to be nice to solve it and particularly if a lot of time has elapsed between whatever it was and whenever it becomes reportable or obvious to the revenue authority, the longer the time has passed the worse that it will become. So, identify, fix, plan, ideally do it before the thing happens and then you've got the best shot of trying to fix the issue or at least manage the problem.

Alice	So Graeme, Alex, we're nearly out of time for today's episode. In the final minutes, what would you say are the main things that people should keep in mind when considering UK/US cross border matters?
Alex	America is a really nice place a lot of the time and so actually we end up there quite a lot. It's very very easy for Brits to spend time there. Therefore, it's really really easy to fall into this stuff because somebody retires to Florida or somebody buys a holiday home, the issue is it's too easy to mess this up, it's too easy to fall into the trap that you need a fix for because as countries go we are pretty aligned in lots of things so I think that will be the generally message is, it's really easy to mess it up.
Graeme	I totally agree with everything Alex has said. I think one of the mantras that we use when dealing with UK/US, certainly in relation to aligning things, is make sure you pay the right tax at the right time, to the right jurisdiction. Which sounds really straightforward and actually once you've done the analysis, for a lot of things it can be quite straightforward however the more complicated an individual's affairs are the more difficult this becomes so getting specialist advice, thinking ahead is also very important particularly in relation to the here and now but actually the longer term, we haven't particularly covered individuals estates and what they might want to do when they are not here and how they might want to gift and how they want to engage with lots of things in life, the rules are different and getting advice upfront clearly is the way forward. I think, where we are used to dealing with that whilst the rules are difficult and occasionally we find that we have to make compromises, the hope is that you end up, certainly when it comes to planning, trying to ensure that you get the commercial outcome you want, or that you undertake the planning that an individual wants for their estate, however it is complicated, taking advice upfront I think is always the way forward.

Alice	Unfortunately, that is all we have time for in this episode. Alex, Graeme, thank you very much for providing your insights on how the US and UK are less similar than people might think and how this might lead well meaning taxpayers astray. You can find Alex Jones and Graeme Privett on Rawlinson Hunter's website and on LinkedIn. Now as ever a full transcript of this episode together with our references can be found on our website www.rpc.co.uk/taxingmatters. If you have any questions for me or for Alex or Graeme or any topics you would like us to cover in a future episode, please do email us on taxingmatters@rpc.co.uk. We would love to hear from you. If you like this episode please take a moment to rate, review and subscribe and remember to tell a colleague about us. Thank you all for listening and talk to you again in two weeks.