TAXATION | FATCA

# Negotiating THE AMERICAN CLIENT MAZE

*Legislative changes in the UK and the US during the past 10 years have increased the complexity of dealing with US-connected clients. With more and more US citizens coming to the UK and British citizens moving the other way, **Cormac Naughton** asks what do advisers need to know before they can successfully deal with such clients?*

**"Absolutely outrageous"** was the London Mayor's response last year as he became aware of the reality that faces all American taxpayers in the UK. Almost uniquely among other nations, the US has a citizenship-based taxation system, which means American citizens have to file a US tax return and pay tax on all income they earn – anywhere in the world regardless of where they live. As a US passport holder, Boris Johnson was horrified to discover, despite paying all his UK taxes, he still had to pay US tax on the sale of his main residence.

He is not alone. According to the 2011 Census, there are 177,000 US citizens resident in the UK – with 64,000 of these concentrated in London. They have a large presence in the City as lawyers or in financial services, hedge funds or private equity and are also represented in industry, creative professions, the arts and academia, while entrepreneurs are also coming to the UK and starting businesses. For many American expatriates, their time abroad can represent the most financially rewarding period of their professional lives and the stage when they have the greatest need for the services of financial advisers and planners to ensure the financial security of their families and their own retirement planning. While we may share the same language there are still significant differences between the British and American tax systems, which advisers need to understand when dealing with US-connected clients.

## US crackdown

Many US expatriates would seem to share Mr Johnson's initial reaction and certainly his lack of awareness of their fiscal obligations to the US. Anecdotally, out of 7 million US expats around the globe less than half a million are said to file the US tax return they are all legally obliged to complete. As a result, in 2010 the US launched a crackdown on what it felt was tax evasion by these recalcitrant taxpayers, which resulted in legislation such as the Foreign Account Tax Compliance Act (FATCA). This came into effect in July 2014 and banks and financial institutions around the world are required to report on accounts held by their customers who are "US persons".

In the past five years it has become increasingly commonplace for many financial institutions to give American clients a wide berth, with FATCA often cited as one of the main reasons. Since 2010 a raft of private banks, investment managers and platforms have all closed accounts for US-connected clients or made it known that they will no longer accept such business. This has left many advisers desperately trying to find investment solutions and providers for their US clients in a market that often seems unwilling to assist them.

It is not just new US legislation that has complicated life for US expats. In 2008, the UK introduced a 'stay-related' threshold for individuals who had been resident in the UK for tax purposes for at least seven out of the previous nine tax years. From 6 April 2008, UK resident non-domiciliaries have had the choice between paying either an annual £30,000 remittance basis charge (RBC), or they have had to declare their income and gains on their US (and offshore) assets and pay tax in the UK annually on an arising basis. The vast majority of US citizens living in the UK elect to pay tax on an arising basis and are therefore also subject to taxation by the UK on their global portfolios.

Advisers with longstanding US expat clients or relationships with an extended family where one family member has taken an American spouse, or even gone to work in the US for a period and acquired US citizenship, have had little choice but to try to keep up with these US and UK rule changes. Capable and responsible financial planners do not want to damage such valued relationships or feel like they are letting down their client in some way. Often the client will inform them that they plan to return to the UK in a few years and need a solution to cover the intervening years but that they wish to maintain their relationship with the adviser. This is not an uncommon situation as, according to the Institute of Public Policy Research, in 2006 there were 678,000 British citizens living in the US – meaning it is something many advisers will encounter at some point.

Many advisers will also have come across an 'accidental American'. This is someone who does not ostensibly seem like a US client and who presented a UK passport as their identification document for anti-money laundering purposes but who (like Mr Johnson) also has a US passport, which comes to light many years later. Often this can be hard to detect unless advisers specifically question clients if they have any links to the US, a Green Card or US relatives. Although the furore around FATCA has increased adviser awareness of the need to check if clients have US links, many are still unaware of what to do once they have established that the client is a US taxpayer.

Advisers must consider the compliance and regulatory implications as to whether or not they can advise American clients. It is important to understand who is a "US person" and to draw a distinction between US taxpayers and US residents.

## Who is a US taxpayer?

The US Internal Revenue defines a US person as:

(A) A citizen or resident of the US;
(B) A domestic partnership;
(C) A domestic corporation;
(D) Any estate (other than a foreign estate, within the meaning of paragraph (31)); and
(E) Any trust if:
  (i) A court within the US is able to exercise primary supervision over the administration of the trust; and
  (ii) One or more US persons have the authority to control all substantial decisions of the trust.

In addition, foreign nationals resident in the US are described as "resident aliens" if they hold a Green Card – issued by the US Immigration and Naturalisation Service making them lawful permanent residents of the US according to the immigration laws – or if they meet a 'substantial presence' test. To meet the substantial presence test, an individual must have been physically present in the US on at least: (i) 31 days during the current year; and (ii) 183 days during the three-year period that includes the current year and the two years immediately before. To satisfy the 183 days requirement, they would count:

- All of the days they were present in the current year; and
- One third of the days they were present in the first year before the current year; and
- One sixth of the days they were present in the second year before the current year.

## Advising US clients

From a regulatory perspective, advisers who are authorised and regulated by the Financial Conduct Authority (FCA) in the UK can advise British residents even if they are US taxpayers – as long as they are acting within their permissions. Advising US residents is also possible for UK advisers from a regulatory perspective as the US regulator – the Securities and Exchange Commission (SEC) – has a foreign adviser exemption rule, which allows foreign advisers to advise up to 15 US residents with no more than $25m in assets under management.

Notwithstanding this, the key consideration is likely to be professional indemnity (PI) insurance as many PI insurers specifically exclude advice to US residents from their policies. It is a decision for the individual firm and adviser as to whether they wish to extend their PI cover to allow them to advise US residents and how this fits in with their own internal compliance policies. If the relationship with the individual client or family is important to the advisory firm then the additional cost may be well worth paying, particularly if the firm also has other clients or potential clients in the same position.

One of the main practical considerations for advisers to ensure that they can follow the best practices with US clients is to build a specialist team, which can provide them with a professional support network to share best practice and ideas with. One of the two key components will be a specialist US/UK tax adviser to provide the client with the correct tax advice, which can then be referenced by their financial adviser when producing suitability reports, investment policy statements or recommendations for the client. The other will be an investment manager specialising in US-connected clients, who can ensure that all investments are both US and UK tax efficient.

Preferably, the manager should be licensed by the SEC in the US and the FCA in the UK. SEC-registered firms are required to file what is known as an ADV, which discloses specific information about the firm such as the number of investment employees, their assets under management and the percentage of their business that is made up of US persons. All of this should be checked when conducting due diligence to ensure that any prospective investment manager is both committed to the US client market and has the necessary operational scale to make it viable as a business.

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Fortunately, the SEC makes all this information available on its website at: www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx

The importance of the support from this 'specialist team' can also be judged by examining some of the tax issues presented when investing for US taxpayers in the UK. Almost all non-US collective investment schemes – such as UK or offshore exchange-traded funds (ETFs), unit trusts, open-ended investment companies, and wrappers such as offshore bonds – fall foul of Internal Revenue Service (IRS) passive foreign investment company rules. They are taxed aggressively by the IRS and all gains may be subject to taxes and penalties up to 100% of the growth in the value of the investment if it is held for a number of years. Furthermore, UK-based savings schemes such as ISAs do not enjoy tax-deferred status in the eyes of the IRS.

HMRC classifies the growth in US collectives, such as mutual funds and ETFs, as offshore income gains, which are taxed at the individual's marginal income tax rate rather than the capital gains rate. This is because the vast majority are without UK reporting fund status. For most wealthy US citizens, this would mean being taxed at up to 45% on all gains made on their portfolios, which can also be exacerbated if the sterling/dollar foreign exchange rate moves in an unfavourable direction.

## Need for guidance

While the US-connected client market can offer considerable opportunities for advisers, the legislative changes and developments of the past decade have meant these clients face a more challenging environment. This increases the need for advisers that can guide and support clients through what can often feel like a maze of technical discussions with specialists such as investment managers and tax advisers.

Those advisers that can build their own support networks with other professional firms to act as their own specialist team will be well positioned to flourish in this environment and to attract and retain quality client relationships.

*Cormac Naughten is head of MASECO Institutional at MASECO Private Wealth*