



Financial Challenges for Overseas Americans

Andrea Solana of MASECO Private Wealth discusses some of the challenges that are important to understand in order to develop optimal wealth planning strategies

Rules and regulations

US connected individuals living in the UK not only have reporting obligations to HMRC but also to the IRS. The US taxes the worldwide income and capital gains of all US citizens regardless of where in the world you live. In addition to annual tax filing obligations, the US Bank Secrecy Act requires that every US citizen, Green Card holder or resident alien must file an annual report of Foreign Bank and Financial Accounts (more commonly called FBAR or FinCEN Form 114) if you have a financial interest in (or signatory authority over) foreign accounts in aggregate worth \$10,000 or more on any one day during the tax year. This includes US beneficiaries of foreign trusts.

The passing of the Hiring Incentives to Restore Employment (HIRE) Act in the US and its Foreign Account Tax Compliance Act (FATCA) provisions were set up in 2010 with the explicit aim of tackling offshore tax evasion. The Act requires all Foreign Financial Institutions (FFIs) to report all significant accounts held by US taxpayers to the US Internal Revenue Service (IRS). So, in addition to the self-reporting mechanism of annual tax return filings, the IRS receives reports from various jurisdictions outlining foreign account information related to US individuals.

The UK's previous introduction of a 'stay-related' threshold (resident for seven of nine years) automatically attracts UK income tax residency status. Once you are resident for more than seven tax years, a UK resident non-domicile individual has to pay either an annual levy to HM Revenue & Customs (HMRC) to continue paying tax on a remittance basis, or UK tax must be paid on all worldwide income and gains as it arises each year. Anyone resident in the UK for more than 15 out of the last 20 years are now required to pay tax on an arising basis. The vast majority of Americans living in the UK elect to pay tax on an arising basis anyway and are therefore taxed by the UK on their global portfolios.

Tax issues

When dealing with the taxation of your global portfolio it is important to know how investments are viewed in both jurisdictions from a tax perspective. Investing in non-US regulated collective investments such as offshore Exchange Traded Funds,

Unit Trusts and Open Ended Investment Companies (OEICs) will cause US individuals to fall foul of the IRS's Passive Foreign Investment Company (PFIC) rules. PFICs are taxed aggressively by the IRS and all gains may be subject to taxes and penalties of up to 100% of the growth in value of the investment.

Utilising UK-based savings arrangements such as Individual Saving Accounts (ISAs), investment bonds, and Self-Invested Personal Pensions (SIPPs) may have unattractive US tax consequences for US citizens resident in the UK. ISAs are not a recognised tax wrapper in the eyes of the IRS, investment bonds give rise to PFIC issues and the US tax consequences of SIPPs can be complex.

The way the IRS classifies UK pensions is a complex and grey area often requiring advice from a qualified tax adviser. Most SIPPs would be classified in the US as 'foreign trusts'. As a 'foreign trust', annual growth within a SIPP is exposed to US taxation. Fortunately, the UK has a treaty with the US that may allow the US taxpayer to treat the SIPP as a Foreign Pension and thus the growth in value will be tax deferred until distribution. The US-UK treaty may also protect the growth in company pension arrangements from becoming US taxable. Additional US trust reporting may arise for individuals with pensions as well.

Many US citizens may consider using a QROPS as a potential pension structure. However, care should be taken as the transfer of assets from a UK pension to an offshore QROPS is usually considered a US taxable event, and certain QROP structures may also not be covered by the valuable treaty protection on any future growth in value. The UK may also assess a 25% charge on transfer if certain criteria aren't met.

From a UK perspective, HMRC classifies the growth of most US Mutual Funds and Exchange Traded Funds (ETFs) as Offshore Income Gains (OIG) unless the fund has gone through the process to gain UK reporting status. If the fund does not have UK reporting status then the growth is taxed at the individual's marginal income tax rate rather than at capital gains tax rate. This would mean being taxed at either 20%, 40% or 45% on all gains made on their portfolios as opposed to 10% or 20%. Additionally, it can mean the difference between being able to utilise the UK capital

gain allowance each year. This can be exacerbated if the foreign exchange rate moves in an unfavourable direction. The net result is that there is a much larger gross UK tax liability for Americans who own US Mutual Funds or US based ETFs that do not also have UK reporting status.

Investment considerations

It is essential to appreciate that Americans are taxed on a worldwide basis, irrespective of where income and gains arise. Coupled with the various changes to the domiciliary rules in the UK, this creates an additional set of challenges for US citizens living and working in the UK. Their investments need to be risk-managed, currency-sensitive and tax-compliant.

There are a number of key considerations in developing an appropriate investment strategy and it is important that they are not looked at in isolation:

- ★ Are any of the current investments US Mutual Funds and possibly taxed at UK income tax levels?
- ★ Are any of the current investments considered PFICs for US purposes?
- ★ Are US education (529) plans structured appropriately for UK residents?
- ★ Have appropriate tax wrappers been used to ensure that the currency of assets matches long-term liabilities?
- ★ Are excess foreign tax credits being used effectively?
- ★ For couples with multiple nationalities, are assets being structured in a way to take advantage of opportunities available in both tax jurisdictions?
- ★ Have wealth plans been developed with an understanding of legacy plans for American families? ★

As an American living in the UK, almost nothing related to your financial affairs is easy. The consequences of seemingly simple decisions – such as how to pay for a new home or purchase a mutual fund - may create unnecessary tax charges and complexities. There are a number of complex challenges when it comes to allocating and investing assets. Not only do you have reporting obligations in two jurisdictions that require consideration but you also need to take into account conflicting tax considerations in building a tax-efficient investment portfolio to suit your financial needs.

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THE ULTIMATE FINANCIAL VIRGIL FOR US EXPATS

STEP

38



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