

Revocable Trusts

Perhaps it's just an illusion

The complexities and idiosyncrasies of the US and UK legal systems come together when assets and individuals span both jurisdictions. The legal and tax systems have their similarities, but to understand the nature and effect of the revocable trust you have to delve more deeply into the esoteric nature of trust law in both jurisdictions.

Whilst this might just feel like an academic exercise, it does have real practical application, particularly when assessing the UK tax consequences resulting from the creation of a US revocable trust.

Defective trusts, sham trusts, illusory trusts: Expressions, if used interchangeably, will cause some confusion, but a US revocable trust could, in theory, be any one of these. This article looks at the meaning behind these expressions in the context of one specific US estate planning scenario – the use of the revocable trust and the complications that can arise in the UK.

The classic planning scenario in the US involves a US person creating a revocable lifetime trust which is funded either during their lifetime or immediately on death. This avoids potentially long lasting Will trusts which would remain subject to the jurisdiction of the Probate courts and the significant cost and administrative burden of getting the Will admitted to Probate in the USA.

Let's take an example:-

Assume you have a client who is a US citizen domiciled in New York State and he has been resident in the UK for the last fifteen years. Before leaving the US, he puts a revocable trust into place, transfers substantial assets into it and appoints himself as sole trustee. Having been resident in the UK for some time, and acquired a home and other assets here, the client comes to you for help with his UK estate planning.

Whilst the client remains subject to US estate tax because he is a US citizen, he is also subject to UK inheritance tax (IHT) on his UK assets. You enquire in the usual way about the provisions the client has made to address his estate planning and it becomes clear that he has set up a revocable trust to avoid Probate in the US. He wants to understand whether he can put more assets into his revocable trust and keep his affairs simple.

This scenario raises two main issues:-

- how is the existing revocable trust classified under UK law (i.e. is it a trust under UK law?) and what are the UK tax consequences of the arrangement; and
- can the client make use of his existing revocable trust arrangements as part of the planning he undertakes with you?

Classification of a US revocable trust

A revocable trust in the form commonly used in many states in the US is likely to have a settlor who is also the trustee and beneficiary and who retains powers to amend, restate and revoke the trust instrument, to remove capital from the trust and to call for or direct the distribution of income and capital. On the death of the settlor, the trust becomes irrevocable and contains administration and distribution powers similar to those found in Wills.

The classification of this type of arrangement will determine the UK tax consequences that flow from it. It is tempting perhaps to call this type of arrangement a sham. The settlor is the only beneficiary during his lifetime, he is also the trustee and he has a power to call for all of the assets to be returned to him – has he really divested himself of the

assets?

The basic principles to determine whether a trust exists under English and US law are similar. English law requires certainty of intention, certainty of beneficiaries and of trust property. In the US, the settlor must have the capacity to transfer property, a manifest intention to create a trust and an identifiable beneficiary. So far, so good. But is there a risk it is a sham or defective trust?

A defective trust, perhaps, is one which doesn't satisfy the basic principles, but what of trust arrangements like the one described above where the formalities are observed?

Sham trusts

Sham trusts are trusts that are not intended to take effect according to their terms. The result is that the settlor remains owner of the trust property. There is limited example of sham trusts in English case law and those that do exist *Midland Bank v Wyatt*¹, *R v Allen*² and *Rahman*³ can be distinguished because the settlor lacked the appropriate intention to establish a trust, and this was apparent from the settlor's behaviour.

Just because the settlor retains extensive powers and is the sole trustee does not, under English law, mean that the trust doesn't exist.

¹ [1995] 1 FLR

² [2001] STC 1520 (HL)

³ *Abdel Rahman v Chase Bank CI Trust Co* [1991] JLR103

Illusory trusts

John Mowbray QC delivered a lecture in 1999 in which he drew a very helpful comparison between sham trusts (where the settlor lacked the intention to set up a trust) and those that are, what he called, illusory.

The terms of an illusory trust are intended to take effect but "are so insubstantial that, at least during the settlor's life, they carry no interest of any substance to any other beneficiary. The result is that they either create a mere agency for the settlor or constitute a testamentary disposition that does not take effect until the settlor's death which, if revocable, makes the trust instrument into a testamentary instrument that needs to be executed like a Will if it is going to be enforceable⁴."

So, an illusory trust might give rise to no more than a nominee arrangement or an agency during the settlor's lifetime. The difference between an illusory trust and a conventional trust is likely to turn on the terms of the interest retained by the settlor and the powers he has reserved to himself.

Reservation of trust powers

In England, if the reserved powers are seen to be so extensive that the equitable interest remains with the settlor, then the document would take effect only as a disposition on death. To be valid, its execution would need to satisfy the provisions of the Wills Act if the testamentary gift is going to be enforceable.

The reservation by the settlor of a power to amend or revoke a trust does not, in most states of the US, make it testamentary⁵. This is the case even where the settlor retains a right to withdraw capital from the trust⁶.

Some revocable trusts used in the US can contain extensive provisions to cater for the incapacity of the settlor, so that the trustee (and there is provision for the automatic appointment of a new trustee for the purpose) has real duties to perform and

powers and discretions to exercise. In these circumstances, it is more likely that the trust instrument is intended to take effect during the settlor's lifetime and is not testamentary.

What of the retention by the settlor of administrative powers, e.g. a power of veto over trust investments? There is sufficient English and US authority to demonstrate that this, of itself, does not cause the trust to be a sham or illusory. Some jurisdictions (Bahamas, Cayman Islands) have introduced legislation which makes this explicit.

New York State (where our client is domiciled) has provision in its Estates, Powers and Trusts Law⁷ to prevent the invalidation of a trust because a settlor is also the sole trustee – provided that another person holds a beneficial interest during their lifetime, whether vested or contingent. However, assets capable of registration must be transferred into the name of the trust or the trustee.

Cynically, this does prompt the question that if jurisdictions have not introduced legislation to this effect, then extensive reserved powers could still cause a trust to be treated as illusory. Certainly in *Midland Bank v Wyatt*, the English court were ready to disregard a trust where the settlor is the sole trustee and also a beneficiary.

Making sense of the theory

So, how does all this impact upon our client's circumstances? In a typical lawyer's fashion, the answer must be – that it depends. It certainly does depend on the terms of the "trust" the client has purported to create and the interpretation of it under US and UK law.

If a trust is said to exist, then the UK tax consequences of the sole trustee having become UK resident is to cause the trust also to be UK resident with the following UK tax implications:-

- Worldwide income will be charged on the settlor in his personal capacity.
- Capital gains will be charged on the

settlor in his capacity as trustee. In most cases (particularly trusts created after March 2006), there will not be an uplift (step up) in the base cost of the assets on the client's death in the way there would be if he remained the owner of the assets.

- For inheritance tax (IHT) purposes, the trust will either be (i) a gift with reservation of benefit and the assets will form part of the client's estate on death, or (ii) the trust assets will constitute Excluded Property and will be outside the scope of UK IHT even if the client lives in the UK long enough to be subject to IHT on his worldwide estate. A close analysis of the facts would be required to determine which of these circumstances applies.

To avoid the income and capital gains tax charges, the client might be tempted to resign as sole trustee and appoint in his place another family member who is resident in the US. Doing so will give rise to a deemed disposal of the trust assets for capital gains tax purposes if the client is resident in the UK, so this option would have to be approached with caution.

The income and capital gains tax downsides could have been avoided if, before the client became UK resident, he either resigned in favour of another non UK person who becomes sole trustee or he appointed another non UK person to act with him.

If a trust does not exist (perhaps the powers that have been reserved are so extensive that the arrangement gives rise to a nominee or agency arrangement), then the client will have remained the owner of the assets. This improves the UK income and capital gains tax position but restricts the long term IHT efficiency of the arrangement:

⁴ Shams, Pretences, Blackmail and Illusion: Part 2 PCB [2000]

⁵ Scott on Trusts s57

⁶ *Richard v Worthen Band & Trust Co* 552SW2D28 s52 S.W 2d 28

⁷ 17—1.1

- Income will be charged on the settlor in his personal capacity, but he will still have the remittance basis available to him, which means that he could shelter foreign income and capital gains from taxation. This is not possible if a trust exists and the sole trustee is UK resident.
- A capital gains uplift will be available on the death of the client, which means his beneficiaries will inherit the assets at the then market value. Any capital gains realised during the client's lifetime will be subject to the remittance basis if they are foreign gains. This means the client has the option to shelter those gains from UK taxation.
- For IHT purposes, the assets will continue to belong to the client, which means that if he stays in the UK long enough to become deemed domiciled here (he is resident for 16 out of the last 20 tax years) those assets will fall within the UK IHT net. There is no scope for the arrangement to provide a long term IHT shelter for foreign assets. This tax interpretation is much closer to the US tax consequences of creating a revocable trust, where the trust is treated as transparent for US tax purposes.

There is sufficient UK tax difference between the two scenarios (trust v. nominee) to make it worthwhile scrutinising the terms of the trust arrangement to understand whether the client has inadvertently put himself, and his trust arrangement, into a disadvantageous UK tax position.

If the client wants to make use of his existing revocable trust as part of his latest estate planning, not only will you need to have interpreted the arrangement to understand whether a trust exists but, you will need to be mindful of not giving rise to UK IHT consequences.

If a trust does exist and the client transfers UK assets into that trust, this will give rise to

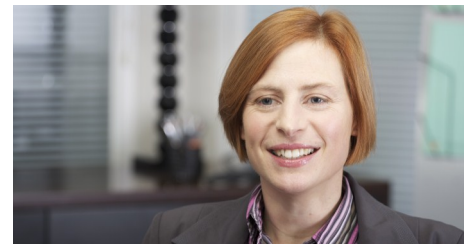
a chargeable lifetime transfer, with an IHT charge of 20% of value transferred over and above the UK nil rate band (currently £325k).

This analysis only scratches the surface of some of the issues relevant to this type of US/UK estate planning and its nuances. In determining a client's liability to US and UK taxation, the relevance of the UK/US estate and gift tax treaty would also need to be considered.

What is clear however is that the advantages to be gained in the US from using a revocable trust may outweigh the UK tax and succession issues associated with it if, at the very least, the US person makes sure that he resigns as trustee before he comes here.

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