DEATH DUTY - WHAT'S IN A NAME?

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In today's world, investment portfolios are usually structured on an international basis, and people are becoming increasingly mobile. One of the consequences of these developments is the potential for creating a liability to tax in several jurisdictions, where different taxes are imposed in a wide variety of ways, and in circumstances where double tax treaties may provide little or no relief. Not least of these taxes, but one which is perhaps most frequently overlooked, is the tax on death.

Despite the fact that, generically, this is known as 'death duty', in practice this term encompasses a number of different taxes - the only common thread being the time at which the tax is imposed. Some countries, such as the UK, tax the deceased's estate, whilst many others tax the recipient of the assets. In some jurisdictions, residence is sufficient to impose a liability to the tax, whilst in others a more permanent attachment to the country is necessary. At the other end of the scale, a citizen of the US remains liable to US estate duty even if he has not set foot in the country for many years. Most countries also claim the right to tax assets situate within their jurisdiction.

With such a wide range of taxes masquerading as one and the same, it is not difficult to guess that double taxation treaties are unlikely to provide much help. In particular, problems are likely to arise either where a citizen of one state invests in assets located in another state, or when a citizen resident in one country leaves assets to relatives living in another country.

Canada: Taxation mismatches

Particular problems arise in relation to Canada:

It is well known that Canada does not levy any form of death duty. However, the deceased's assets held immediately prior to death are revalued to their fair market value, and any deemed gains are charged to income tax. Such form of tax will

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obviously create problems where, for example, a person resident outside Canada invests in real estate located there.

If this investor dies domiciled or deemed domiciled in the UK, his estate will be liable to UK inheritance tax on his worldwide assets. In addition, a liability to Canadian income tax will arise on the Canadian real estate. The UK/Canadian Death Duties Agreement (1946) ceased to have effect with regard to individuals dying after 1st October 1978, and there can be no unilateral UK relief as the two taxes levied are fundamentally different in nature. However, the UK Inland Revenue have sought to circumvent this in practice. On 1st August 1978, they issued a statement announcing that, by concession, when computing the UK inheritance tax liability, they will treat any Canadian income tax arising on death as a liability of the estate under s.171 Inheritance Tax Act 1984. The Canadian tax will normally be treated as reducing the value of property outside the UK, regardless of whether that property is subject to UK taxation. Where the amount of the Canadian tax exceeds the value of the property, the excess will be set off against the value of any UK situs property.

So far as the UK is concerned, therefore, the authorities have, by concession, attempted to achieve at least a partial solution to the mismatch between the two tax systems applying on death. However, the position is less satisfactory in a number of other countries:

For example, in Germany, the tax levied on death is a true form of inheritance tax (as distinct from an estate tax) with the recipient suffering a charge to tax based on the amount he receives, at rates of tax determined by his or her relationship to the deceased. Therefore, where a person resident in Germany dies and leaves Canadian real estate to his German heirs, it is probable that the property will suffer a double liability to tax.

The same problem will apply where a person living in Canada dies and leaves part of his estate to a German resident. In that instance, the whole estate will suffer Canadian income tax based on the gains deemed to arise on death, and, in addition, the recipient will be assessed to inheritance tax in Germany on the assets received. Clearly, in neither case can a taxation convention between the two countries relieve this double charge to tax. Further, the German taxation authorities take the view that the Canadian income tax does not qualify as an "inheritance tax" so that they will not allow any credit in respect of this liability against the German inheritance tax. However, in 1992, one of the lower Tax Courts in Germany held that this view is incorrect since both taxes arise by virtue of death, and that the Canadian income tax should therefore be available as a credit. The taxation authorities have appealed this decision to the Federal Tax Court and the hearing is pending. Unless the Federal Tax Court finds in favour of the taxpayer, the situation is clearly disastrous, since it is possible in some circumstances for the combined rate of tax suffered in both countries to exceed the value of the property bequeathed.

In practice, of course, it would have been possible for the deceased to have taken steps during his lifetime to ensure that this situation did not arise, and indeed it may be possible even after his death to reduce the overall liability, but it is clearly not an enviable position. Bequests from Canada to residents in other European countries which levy an inheritance tax are likely to suffer the same fate.

Luxembourg: Difficulties with rates of taxation

Different problems may be suffered by those living in low tax jurisdictions. For example, in Luxembourg, gifts to children are either exempt from donation or gifts tax or, in very limited circumstances, are liable only to registration tax at a maximum rate of 1.2% (2.4% in special cases). If a citizen of Luxembourg has invested in a jurisdiction which levies an inheritance tax on assets situated within that country, as there is no inheritance tax liability in Luxembourg in most cases, the estate will pay more tax than under local tax rules. A simple solution to this problem would be to use a Luxembourg resident company to own any foreign situs property, since this frequently ensures that the assets are liable to tax in Luxembourg (and hence will frequently pass tax free) rather than in the country in which the underlying investments are situated.

Conclusions

The types of difficulties outlined above are not new. However, they are likely to become far more common in the future as we all become increasingly international. At the same time, record levels of wealth have accumulated in Europe since the Second World War, this wealth is currently held by an ageing population and, as a result, huge sums of money are likely to pass from one generation to the next within a relatively short time frame. For example, it has been widely reported in the German press that a huge DM 1,800 billion (£720 billion) will pass by way of inheritance by the end of the century. With the general lifting of exchange controls around the world, and freer movements of capital, it will become even more important to ensure that double or even triple taxation is avoided when providing international estate planning advice.