The Personal Tax Planning Review

A EURO-PITFALL

Hilda Wilson, Barrister[1]

A situation which not infrequently occurs in this country is that one of two spouses, both British citizens, domiciled in the United Kingdom, dies leaving the whole of his or her estate, consisting entirely of UK situate property, to the other spouse. This has the disadvantages that the deceased spouse's zero-rated band of transfers for inheritance tax purposes (at present £150,000) is not used up and that the estate of the surviving spouse is increased together with the potential inheritance tax liability in respect of it. The situation is corrected by the surviving spouse entering into a deed of variation re-directing property comprised in the estate of the deceased spouse to the value of £150,000 to their child or children. The deed of variation is made within the two year time limit of the death of the deceased spouse and is otherwise made in such a way and in such circumstances that it does not give rise to liability to inheritance tax or capital gains tax on the disposition made by it and that it is effective to prevent inheritance tax becoming payable on the death of the deceased spouse. The surviving spouse and his or her advisers may well think that that is the end of the matter so far as the fiscal consequences of the deceased's death are concerned, and so it will be if the child or each of the children who benefit under the deed of variation is resident in the United Kingdom. But that may not be the case if the child or any of the children is living in another EEC country, a situation which is likely to arise more frequently after the beginning of 1993. The other EEC countries have their own inheritance and gifts taxes and, in the case of one or two countries, notably Germany, a person benefiting from a deceased's estate or a gift can incur liability to the tax merely because he is resident there. What then would be the position if the deed of variation in the case of the spouses postulated above re-directed £150,000 worth of the property comprised in the estate of the deceased spouse to their only child, a son who, though domiciled in the English sense in the United Kingdom, worked and lived in Germany?

The German Inheritance and Gift Tax Act imposes tax on (inter alia) transfers of property by reason of death and inter vivos gifts of property if the beneficiary of

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[1] Hilda Wilson, Gray's Inn Chambers, Gray's Inn, London WC1R 5JA
Tel: (071) 242 2642 Fax: (071) 831 9017
Author of *Capital Gains Tax Retirement Relief* (updated to August 1991); *Independent Taxation of Husband and Wife* (September 1990); *Tax-Efficient Extraction of Cash from Companies* (April 1989) all published by Key Haven Publications PLC; and *A Practical Guide to Capital Transfer Tax* (April 1975) published by Oyez Publishing Limited.

the transfer or gift is resident in Germany. 'Residence' has the same meaning for German inheritance and gifts tax purposes as it has for all German tax purposes. Generally, an individual is resident in Germany if he maintains a residence there in circumstances which indicate that he will retain it and use it not merely temporarily. It follows from this that an individual who is resident in Germany in this sense may be resident in more than one country if his German residence is not his only residence. Moreover, an individual can be regarded as resident in Germany if he maintains an habitual abode within Germany, an habitual abode existing where a person is physically present in Germany under circumstances which indicate that his stay will not merely be a temporary one, and an habitual abode being irrefutably presumed to exist if the person's stay exceeds six months or, in the case of a person in Germany only for private purposes (for example, visiting friends or relatives), one year. Under this definition of residence, a non-German student at a German university might well be regarded as resident in Germany. The son, in the case postulated above, who, let us assume, has been working in Germany for more than two years and has been living there during that period in rented furnished accommodation or in a rented unfurnished flat found for him in the first case by his employer and in the second case by himself, would clearly be resident in Germany within the definition. The fact that he was domiciled in the English sense in the United Kingdom would be irrelevant.

Certain types of property are not liable to German inheritance tax or gift tax but, assuming that the UK situate property re-directed to the son by the deed of variation consisted (as no doubt it would) of real property (not of interest to the public), cash or shares or securities, none of the exemptions for non-taxable transfers or gifts would apply.

That being so, it would be necessary to establish on what date the liability to the German tax in respect of the disposition to the son arose. The date the tax liability arose would be of considerable importance since it would be on this date that the personal tax liability would arise; that the property re-directed to the son would fall to be valued; and, generally, the date on which everything affecting the amount of the tax liability would fall to be determined.

The date the tax liability arises varies according to whether a transaction is a transfer by reason of death or a gift inter vivos. If a transaction is a gift inter vivos, the date the tax liability arises is the date of consummation of the gift. This is, broadly, the date on which the donee actually receives the economic benefit of the gift. In the case of real property, this can be the date on which the donor has done everything on his part to convey the property to the donee, even though the donee has not been entered in the land register; in the case of other property, it is the date on which the property is at the free and unfettered disposal of the donee. If a transaction is a transfer by reason of death, the date the tax liability arises is, generally, the date of death, although in certain circumstances the date is deferred. These include cases in which the rights of the beneficiary are subject to a condition precedent, when the date the tax liability arises is the date on which the condition

is met, and cases in which there is a disclaimer of inheritance or a waiver of the right to a testamentary gift in return for compensation, when the date the tax liability arises is the date of disclaimer or waiver. (The deferral of the date the tax liability arises to the date of waiver, and the deferral to the date of disclaimer if compensation is also necessary for that deferral, could rarely, if ever, be relevant in relation to a re-direction of property comprised in a deceased's estate by way of a deed of variation such as is now envisaged since, if the deed of variation was to be effective for purposes of UK tax, it would not have to be made for consideration unless the consideration was of the very restricted nature which is permitted.)

Under German rules relative to the conflict of laws, the estate of the deceased spouse in the case now postulated would be governed by the succession law of the state of which the deceased spouse was a citizen at the time of his death. Since the deceased spouse was a British citizen at the time of his death, this would be UK law, and since UK law would regard the disposition effected by the deed of variation as made by the deceased spouse, it seems prima facie that the disposition in favour of the son would be regarded for the purposes of German inheritance and gift tax as a transfer of property by reason of death. However, it would be essential to get advice from some person competent to advise on the relevant German law on whether the disposition was a transfer of property by reason of death or a gift inter vivos and, whichever it was, on the date the tax liability would arise because only when these two points were established would it be possible to compute the German tax liability and to consider whether any action could be taken to avoid or mitigate it. For example, if the disposition in favour of the son was a transfer of property by reason of death and the date the tax liability would arise would be the date of the death of the deceased spouse, the son, then resident in Germany, could not avoid the German tax liability by ceasing to be resident in Germany. Conversely, whether the disposition in favour of the son was a transfer of property by reason of death or a gift inter vivos, if the date the tax liability would arise would be some date later than the date of the death of the deceased spouse, for example, the date of the deed of variation, which might be made at any time up to two years after the death of the deceased spouse, the son might avoid liability to the German tax by ceasing to be resident in Germany before that later date. Again, if the disposition in favour of the son was regarded as a gift inter vivos and the date the tax liability would arise would be the date of the deed of variation or some later date, it might be possible to avoid or mitigate the German tax liability by providing in the deed of variation that the property which the son was to take from the estate of the deceased spouse was to be a sum of £150,000 which was to be used to purchase specific real property in Germany. German real property is valued on a favourable basis and a gift of money is deemed to be a gift of the real property if the donor indicates that the precise purpose of the gift of money is the acquisition of specific German real property.

If no such steps as are mentioned above designed to avoid or mitigate the liability were taken, the German tax liability in respect of the disposition to the son by the

deed of variation (assuming no prior gifts to the son by the spouse regarded as making the disposition) would be arrived at as follows: the (UK) property taken by the son under the deed would be valued at the date the tax liability arose and, whether it was real property in the United Kingdom or other property, it would be valued at that date at its fair value. If, as no doubt would be the case, the valuation made was a sterling valuation, it would be converted into DM at the rate prevailing on the date the tax liability arose. From the amount in DM so arrived at, the son, as a child of the transferor or donor, would be able to claim a personal exemption of DM90,000 plus an additional exemption ranging from DM10,000 to DM50,000. The balance of the DM valuation would then be liable to tax at progressive tax rates and at the lowest such rates (varying from 3% to 35%) applicable to transfers or gifts to a surviving spouse or children. The balance of the DM valuation would be taxable at these rates in bands, the first DM50,000 of the balance being taxed at 3%, the next DM75,000 being taxed at 3.5%, the next DM100,000 at 4%, the next DM125,000 at 4.5% and so on, the bands and rates and the differences between them increasing in size as the valuation increases, with marginal relief. Thus, assuming that the property taken by the son under the deed of variation, as valued at its fair value on the date the tax liability arose, was precisely £150,000; that this fell to be converted into DM at a rate of 2.4DM to the £; that the additional allowance to which the son was entitled was the minimum additional allowance of DM10,000; and that the son claimed this allowance and the personal allowance of DM90,000, the amount on which the son would be liable to German inheritance or gift tax would be -

DM(150,000 x 2.4) - (90,000 + 10,000)
= DM260,000.

The tax liability on this, at the rates indicated above would be DM9,700 or, at a DM/sterling exchange rate of DM2.4, £4,042. Unilateral relief would have been available by way of tax credit against the German tax if any tax had been paid on the property taken by the son under the deed of variation in the United Kingdom but, since no tax would have been so paid, no unilateral relief would fall to be given and the tax liability as computed above would be the final liability.

In the case now postulated the German tax liability would be fairly modest and the son, even if he was able to take action to avoid or mitigate the tax liability, might well think that it was a small price to pay for the tax advantages in the United Kingdom mentioned at the beginning of this article and that avoiding or mitigating it was not worth the disturbance in his life which would or might be involved. But in another case, and particularly where the transferee or donee was a more remote relative of the transferor or donor than a surviving spouse or child, or was a stranger to the transferor or donor, and the German tax liability was consequently higher, possibly much higher, the transferee or donee might not be able to be complacent about the position.