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Foreign Death Duties and how to minimize them

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NATURE OF THE DUTIES

Introduction

Very generally speaking, an estate tax is on the estate of the deceased, whereas an inheritance tax (IHT) is on the beneficiary. The UK & US have estate taxes[2], whereas France, Germany & Italy have inheritance taxes. Gift taxes are usually a back-up to prevent during lifetime gifts being used to escape estate & inheritance taxes[3].

UK world-wide IHT is based on UK domicile or deemed domicile. Other countries use various combinations, or one of, residence, ordinary residence, nationality[4] or domicile, as the test for their world-wide IHT. Due to the potential for double taxation, the OECD has a *Model Double Taxation Convention on Estates and Inheritances and on Gifts* (1982). It contains a tie breaker to resolve different national rules relating to "fiscal domicile". For instance, the UK has entered into 10 estate tax treaties[5].

Generally speaking, as only individuals die, foreign estate & inheritance taxes have generally been overcome by holding assets in "entities", such as companies and trusts, which may either exist in perpetuity as with companies, or for trusts, subject to a rule against perpetuities where the perpetuity period may span several or more generations. Alternatively, debt secured over "taxable" assets may be used to reduce the value of the estate subject to IHT.

The French, have recently enacted law to attack such tax planning. The British have announced far reaching changes, but only in relation to UK residences with a value of £2M or more.

UK Estate & Gift Tax

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[2] Even though the UK legislation is termed Inheritance Tax Act 1984 & the estate tax referred to as inheritance tax (IHT).
[3] New Zealand retained its gift duty after abolition of its death duty, but the gift duty was repealed effective 1 October 2011.
[4] Austria, Germany, The Netherlands & Sweden.
[5] See generally, "Inheritance and Wealth Tax Aspects of Emigration and Immigration of Individuals", 56th IFA Congress, Oslo (2002) Vol 27a.

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Non-domiciles of the UK, who reside in the UK for 17 out of 20 years before their demise, are deemed domiciles, subject to UK IHT on their world-wide property[6]. The concept of deemed domicile is only relevant to IHT, and not to income or capital gains tax.

Main residences are not exempt from IHT, even though they are for UK CGT. Business assets[7] are excluded as is agricultural property[8].

Non-domiciles of the UK, who reside in the UK for <u>less</u> than 17 out of 20 years before their demise, are subject to UK inheritance tax (IHT) only on their UK *situs* property.

The threshold value of a net estate[9] to become liable to IHT for 2011-12 is £325,000 (the so-called "nil rate band"). For estates over the threshold, the IHT is at a flat 40% rate! Transfer from domiciled or deemed domiciled, spouse to spouse, or civil law partner to civil law partner is exempt from IHT[10]. However on the demise of the later spouse or civil law partner, the second estate is subject to IHT. The threshold for IHT on the second estate is £650,000 for 2011-12).

An Australian tax resident non-UK-domicile, who has UK *situs* property (with certain exemptions mainly for government bonds) will pay IHT on that property.

To prevent avoidance of IHT by emigrating near death, there is a provision deeming domicile if the deceased dies within 3 years of being domiciled in the UK[11].

To back up the IHT regime on death, the IHTA also deals with gifts while alive, to non-spouse or non-civil law partners. Gifts to non-spouse or non-civil law partners who are individuals totaling up the "nil rate band" can be made while alive, in any 7 year period, without being added back into the value of the deceased estate. Such gifts over the "nil rate band" may still fall outside the IHT net, as long as the donor lives for 7 years after making the gift (a so called "potentially exempt transfers" - PETs)[12]. If the donor dies between 3 and 7 years after making the PET, the IHT liability shades out. Gifts over the "nil rate band" to trusts in the UK or outside the UK, are usually not PETs, and will make the gift liable to an immediate 20% IHT liability[13].

The 2012 Budget announced the increase in Stamp Duty Land Tax from 7% to 15% on the purchase of UK residential houses with a cost of £2M or more by non-natural persons (principally companies), together with an annual charge (dubbed the "Mansions Tax").

[6] s 267(1)(b) IHTA 1984
[7] s104 IHTA 1984
[8] s116 IHTA 1984
[9] Debt secured over assets other than Excluded Assets is taken into account in calculating the value of the net estate: s5(3) & 162(5) IHTA.
[10] s18 IHTA
[11] s267(1)(a) IHTA
[12] s 3A IHTA
[13] The gift tax is generally payable by the donee, within 6 to 12 months of the gift, depending on when the gift is made. For gifted land & buildings, it may be payable over 10 years.

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Also, only such properties will become subject to CGT in the hands of a non-resident non-natural person. The indirect effect of these measures is that non-doms will find it less attractive to buy and hold such properties in foreign non-resident companies. This will increase the attractiveness of such properties being owned by natural persons, or trustees of offshore settlements, but purchased with borrowings secured over the property, either from financial institutions or related non-resident individuals or entities, to reduce the value of the UK *situs* estate subject to IHT. Nominees can be used to maintain anonymity. Other UK real estate and other taxable assets are not affected.

US Estate & Gift Tax

The position for calendar 2011 & 2012 is that the top rate of estate & gift tax is 35% with a threshold of US$5M (for citizens & domiciliares). This was a compromise to get a law passed rather than the sunset provision of the 2001 law cause reversion to 2001 tax rates of up to 55% with a threshold of US$1M. In fact, the compromise resulted in there being no Federal estate tax for those dying in 2010 unless the estate elected[14]. As the current law again sunsets at the end of the 2012 calendar year, US estate tax planning is highly uncertain, except that the current threshold of gift tax may make it wise to make up to US$5M lifetime gifts before the end of 2012, as the threshold is very generous[15]. There are also some state based estate & gift taxes.

US citizens and domiciliaries are subject to Federal estate tax on their world-wide estates. Non-citizens and non-domiciliaries are only subject to estate tax on their US *situs* assets, and the threshold for them is only US$60,000.

Domicile for US purposes has been described[16] as like "habitual abode", in contrast to tax residence, which is a more formulistic test of counting days in the US. US domicile is essentially living in the US with an intent to remain in the US indefinitely i.e. a very subjective test. However, the holding of a "green card" (or resident alien status) would be one of the facts & circumstances which would be relevant.

A US domicile will not be lost until a new domicile has been established[17], and absent a relevant treaty, the person may be exposed to US and another country's estate tax due to different rules in each.

To avoid a loss of estate tax by passing assets to grandchildren rather than children, there is a back-up Generation Skipping Tax (confusingly for us "GST").

[14] which would allow a step-up in the cost base of the assets in the hands of the beneficiaries, which otherwise would not apply.

[15] As at the date of writing, the Obama administration has indicated its support for continuation of the Bush era tax rates except for the "wealthy" (income over US$250,000). As there is a Presidential election in November this year, the position of the candidates may become clearer before then.

[16] Dicey Morris, and Collins "The Conflict of Laws" 14th ed Sweet & Maxwell, London (2006) ¶ 6-133

[17] As to new exit rules for losing that status to avoid income and inheritance tax, see: "Winners and losers", G Warren Whitaker, STEP Journal Sept 2008; "Expatriation: time to go", Paul A Sczudlo, STEP USA, Oct 2008; "Giving up US citizenship – at what cost?", Marshall Langer, Offshore Investment, Dec 2009/Jan 2010.

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US *situs* property includes US real estate, tangible property physically located in the US, and equity interests in US entities, but generally not US bank accounts or debt securities.

Accordingly, planning for non-citizens and non-domiciliaries involves holding US *situs* property in foreign entities. Where such a person is moving to the US, consideration should be given to a pre-immigration trust owning the foreign entity to own the US *situs* property. Unlike the UK, non-domiciliaries can only deduct debt in determining the value of their net US *situs* estate, limited in proportion of their US assets to their world-wide assets.

FRANCE

Inheritance and Gift Tax

Tax is not imposed on the donor, or on the estate of the deceased, but on each beneficiary in respect of what that beneficiary receives.

Tax is due on worldwide assets when either the deceased or the beneficiary is a tax resident of France, but only on French assets when both the deceased and the beneficiary are resident outside France.

The rate of taxation is dictated by the degree of relationship to the deceased[18]. Since 2007 there has been no inheritance tax between man and wife, or between those in a French civil partnership. A child is taxed at rates ranging from 5 per cent, to 45 per cent (from 31 July 2011 for €1,805,677 & over), collateral relations are taxed at rates ranging from 35 per cent to 45 per cent, while for unrelated beneficiaries the rate is 60 per cent.

Although, as a general rule, gift tax is due at the same rates as inheritance tax, but does apply to gifts between husband and wife and those in a French civil partnership. It was reduced by 50 per cent when the donor was less than 70 years old and by 30 per cent when the donor was at least 70 years, but under 80 years old, although those concessions were reduced in 2011.

"Resident" in France for a deceased means he had his main home in France; or

- if France is the place where he performs his principal professional activities; or
- if France is the centre of his economic interests; or
- spent more than 183 days a year in France.

"Resident" in France for a beneficiary means "resident" as above for at least 6 out of the 10 years preceding death of the deceased.

[18] The election of a socialist President earlier in 2012 is likely to ensure rates will increase in the immediate future, although at this stage the hiking of the top marginal income tax rate to 75% is not to be introduced to 2013. Thresholds are also to be reduced e.g. the 5% starting rate for inheritance tax is being reduced from €159,329 to €100,000 for children from 17 August 2012.

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Wealth tax

This tax is payable by all individuals whose assets exceed a certain value on 1 January of each year (€800,000 on 1 January 2012, down from €1,300,000 on 1 January 2011, which was up from €800,000 on 1 January 2010), reflecting the change to a socialist President.

For a French resident, the world-wide assets are taken into consideration. A non-resident, however, is subject only to wealth tax on French assets.

However, since 1 January 2008, for a person who becomes a French resident after that date, for the first five years of residence, there is an exclusion of foreign assets

French assets include, among others, real property situated in France, shares in property investment companies, debts owed by debtors established in France and personal property situated in France.

Debts relating to the estate subject to wealth tax are allowed as deductions in determining the tax base. However, from 1 January 2012 the value of shares in French property investment companies (SCI) cannot take into account debt owed to shareholders, which was a common way to reduce wealth tax for non-residents.

Business assets and 25% or more participations in trading companies are exempt.

Financial investments by non-residents are expressly exempt from wealth tax.

The rates of wealth tax now vary from 0.55 per cent (from worth of €800,000) to 1.8% per cent (from worth of €16.79M).

In contrast, the rates were from 0.25 per cent (from worth of €1,300,000) to 0.5 per cent (from worth of €3M) from 1 January 2011. The change reflects the change to a socialist President.

German Inheritance & Gift Tax

Tax is not imposed on the donor, or on the estate of the deceased, but on each beneficiary in respect of what that beneficiary receives.

The rates vary from 7% to 50% and depend on the relationship between the donor and the beneficiary and the value of the inheritance or gift. There are three tax classes:

(i) First tax class are spouses, children & step-children, grandchildren & great grandchildren, parents & grandparents;
(ii) Second tax class are siblings, nieces and nephews, step-parents, parents-in-law, sons-in-law, daughters-in-law, & former spouses;
(iii) Third tax class is everyone else.

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There are two main categories of liability[19]:

(i) Unlimited tax liability applies if the deceased or the beneficiary is resident in Germany, in which case world-wide asset are taxed;

(ii) Limited tax liability applies if neither the deceased nor the beneficiary was resident in Germany, in which case only German *situs* assets are taxed;

A resident is someone who has permanent residence or normally resides in Germany, or a German citizen who has not lived outside Germany from more than 5 years.

Under some circumstances family homes used by spouses or children are exempt if personally used for 10 years after the transfer.

Certain transfers of business assets are entitled to an 85% tax credit if the transferee keeps the asset for 5 years, and meets conditions as to remuneration of employees of the business.

In determining the taxable amount, different types of beneficiaries are entitled to deduct a tax free amount as follows:

Relationship	Tax Free Amount
Spouses and registered life partners	€500,000
children/step-children (or their issue if the children/step-children predecease)	€400,000
children of the still living children	€200,000
all other members of the first tax class	€100,000
members of the second and third tax class	€20,000

The rate that apply to the taxable amount are as follows:

Taxable Amount in €		Tax Rate/Tax Class	
	First	Second	Third
€75,000	7%	15%	30%
€300,000	11%	20%	30%
€600,000	15%	25%	30%
€6,000,000	19%	30%	30%
€13,000,000	23%	35%	50%
€26,000,000	27%	40%	50%
over €26,000,000	30%	50%	50%

[19] There is a third category: Extended limited tax liability, which may apply where neither the deceased nor the beneficiary was resident in Germany, but the deceased used to reside in Germany and still had substantial economic interests in Germany e.g. a majority of shares in a German company. For this category, the deceased must also have been a German citizen who resided outside German in a country with lower taxes for more than 5 but less than 10 years

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Italian Inheritance & Gift Tax

Inheritance and gift tax were reintroduced in Italy on 24 Nov 2006 (having been abolished in 2001). For Italian nationals, IHT applies on a world-wide basis, whereas for non-nationals, IHT only applies to Italian *situs* assets. The applicable rates depend on the relationship between the deceased (or donor) and the beneficiary:

- Spouse, or descendant or ascendant, 4% only on asset value exceeding €1,000,000 for each beneficiary
- Brother or sister, 6% only on asset value exceeding €100,000 for each beneficiary
- Other relatives, including in-laws, 6%, but no thresholds
- Others, 8%, and no thresholds
- Where the Estate or part of the Estate devolves to one or more disabled children, the exempt amount is increased to €1,500,000
- Where the Estate includes a business or a substantial shareholding in a company, whatever the amount, these are not taxed if they pass to the children of the deceased and if the children undertake to continue the business or control the company for at least five years.

It has been noted[20] that the tax authorities view that gift tax was payable on settlement of a trust, rather than when the trust vests the property on beneficiaries, has not found favour with the courts in a number of recent cases. The most relevant for present purposes, was a decision of the Commissione Tributaria Provinciale of Florence n.30 on 12 Feb 2009.

Compared to the UK, the rates in Italy are sufficiently low, that only the most motivated would renounce Italian citizenship for IHT reasons alone. However, combined with forced heirship and taxation issues[21], the picture may change.

ASIA

In contrast to the US, UK, France, Germany & Italy, estate, inheritance & gift taxes are now relatively uncommon in Asia, having been abolished in countries which formerly had them. For instance, there are currently no such taxes in India, China, Hong Kong SAR[22], Malaysia[23] & Singapore[24].

RISK OF THE DUTIES' APPLICATION

[20] Emiliano Rossi, "The application of inheritance and gift tax to trusts: the Italian tax courts rule against the opinion of the tax authorities", Vol 8, Issue 3 TQR (2010).

[21] STEP Directory and Yearbook 2012 says: "For tax purposes, individuals are deemed to be resident in Italy if, for the greater part of the fiscal year (183 days, 184 in leap years), they are registered as resident or are domiciled in Italy. Pursuant to the *Civil Code*, domicile is the place where individuals establish the centre of their affairs and interests, while residence is the place where one usually lives. Italian nationals who change their residence to tax-friendly countries are treated as tax-residents for tax purposes, unless they prove that they have effectively emigrated to the tax-friendly country."

[22] abolished 11 Feb 2006.

[23] abolished 1 Nov 1991.

[24] abolished 15 Feb 2008.

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DOMICILE, NATIONALITY & FORCED HEIRSHIP

In most common law countries, such as Australia, it is the domicile[25] of a deceased that determines the testamentary law to apply to that deceased estate.

Most civil law countries have since Napoleonic times, adopted nationality as a test to determine the testamentary law to apply to a deceased estate of a national of a civil law country. States of the USA, have adopted a form of domicile more akin to "habitual abode".

In most civil law countries and Islamic countries the testator is not entirely free to exercise testamentary power as he sees fit i.e. "forced heirship"[26].

The Ango-Australian concept of domicile is still largely governed by the common law (e,g. *Udny v Udny* (1869) LR 1 HL 441; [L. R.] 1 Sc.&Div. 441), although in both Australia, and the UK (*Domicile and Matrimonial Proceedings Act 1973*), there are statutory amendments dealing with the domicile of married women and the domicile of dependent children[27]. Section 10 of the Australian *Domicile Act 1982* codifies the common law to a certain extent, in that it provides:

> "The intention that a person must have in order to acquire a domicile of choice in a country is the intention to make his home indefinitely in that country."

Of course, in order to change one's domicile of choice to Australia, it would be generally necessary to have the legal capacity through visa status to "make his home indefinitely" or "ends one's days"[28] in Australia[29]. This would require the taxpayer to convert to permanent resident status, in the case of a UK domicile, at least 3 years before the date of death in order to avoid UK Inheritance Tax (IHT) on world-wide assets: s267(1)(a) *Inheritance Tax Act 1984*.

[25] Dicey Morris, and Collins "The Conflict of Laws" 14th ed Sweet & Maxwell, London (2006) Ch 6 Also see generally Nygh and Davies, "Conflict of Laws in Australia", 7th ed. Lexis Nexis Butterworths (2002)

[26] as an example, for Italian force heirship, see pp5-6: http://www.robertgordontax.com/documents/AILA-Cross Border-Estate-Planning-16-11-10.doc

[27] In the UK, there has been since 1964, various law reform reports in relation to the concept of domicile, but they have largely only been implemented to deal with the most inappropriate of outcomes from the use of the test.

[28] Or "until the end of his days unless and until something happens to make him change his mind": *IRC v Bullock* [1976] STC 409 at 415.

[29] Although see most recently *Mark v Mark* [2005] 3 All ER 912, which casts some doubt on the status of *Solomon v Solomon* (1912) WNNSW 68, and *Puttick v A-G* [1979] 3 All ER 463.

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That a British person may find it easier to have evidence accepted of his acquisition of a domicile of choice in Australia rather than a country which is more alien in terms of language, culture, religion etc, although it is always a question of fact[30].

If the country of domicile of the deceased has an estate or inheritance tax, and/or lifetime gift duties, the determination of domicile will have significant tax implications, as most countries which have an inheritance tax, tax persons domiciled (or deemed domiciled) in their jurisdiction, to inheritance tax on their world-wide assets, but only tax non-domiciled persons on their assets within the jurisdiction.

Australia abolished State and Federal Death and Gift Duties in the around 1980. Australia is now one of only four or so OECD countries without death duties[31].

Whilst a person may be a resident of two (or even more) countries at the same time, a person can only have one domicile[32].

There are essentially three types of domicile - the domicile of origin, the domicile of choice and the domicile of dependency.

Basically, the domicile of origin of an individual is the domicile of the father at the date of birth (or the mother if the child is illegitimate). Once the individual turns 18, he or she is able to change his domicile to a domicile of choice, but the cases indicate that this is much more difficult that merely changing tax residence: see most recently, *Gains-Cooper v HMRC* [2006] UKSPC 00568 before the Special Commissioners in the UK.

In order for an individual to acquire a domicile of choice there must be both the act and the intention to select a new jurisdiction as that individual's permanent home. HMRC has shown continual resistance to claims of loss of UK domicile of origin[33].

Persons who will be the subject of forced heirship, may wish to avoid that result by making an *inter vivos* settlement in a country which has common law trusts. There is even forced heirship within the UK, in Scotland, in Canada in Quebec, and in the US, in Louisianna. There is also forced heirship in Japan. The case of *Abdel Rahman v. Chase Bank (CI) Trust Company Limited,* a decision of the Jersey Royal Court reported at [1991] JLR 103, involved the challenge to a Jersey trust by the wife of a Lebanese husband settlor. Civil law countries that are parties to the Hague Convention on the

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[30] As can be seen in *Casdagli v Casdagli* [1919] AC 145 at 156-157 and *Qureshi v Qureshi* [1971] 1 All ER 325 at 339-340.

[31] The Greens advocate the reintroduction of death duties for estates over $5M, item 23 economic policy (also see The Australian 11 Sept 2010), as do ACOSS.

[32] *Udny v Udny* [L. R.] 1 Sc.&Div. 441 at 448.

[33] see *IRC v Bullock*; *Re Clore (deceased)(No2), Official Solicitor v Clore & Ors* [1984] STC 609; *Anderson v IRC* [1998] STC (SCD) 43; *F v IRC* [2000] STC (SCD) 1; *Civil Engineer v IRC* [2002] STC (SCD) 72; *Moore's exec v IRC* [2002] STC (SCD) 463; *Surveyor v IRC* [2002] STC 501. For a case where there was a dispute between Australian and UK resident potential beneficiaries of the estate of the English born playwright, Anthony Shaffer, as to whether he had a domicile of choice in Queensland, see *Morgan & Anor v Cilento & Ors* [2004] EWHC 188 (Ch).

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recognition of trusts will then need to recognize such a trust, but there may be issues as to whether the distribution by the deceased during his or her life, can be "clawed back". Often the forced heirship laws will attempt to do so if the deceased has gifted the property within a specified period before death[34].

MINIMIZATION OF THE DUTIES – ESTATE PLANNING

Generally speaking, as only individuals die, estate & inheritance taxes are usually sought to be overcome by foreigners holding assets in "entities", such as companies and trusts[35], which may either exist in perpetuity as with companies, or for trusts, subject to a rule against perpetuities where the perpetuity period may span several or more generations[36].

Conversely, estate planning for residents of countries with estate or inheritance tax e.g. the UK, may involve wealthy Britons first becoming temporary tax residents of Australia, and eventually adopting a domicile of choice in Australia. This does not require them to renounce citizenship of the UK, unlike e.g. Italy, where inheritance tax is based on nationality.

Even though Australia currently imposes no estate or inheritance taxes, estate planning for some wealthy Australians may involve becoming a non-resident of Australia for tax purposes.

FRENCH FIGHTBACK

The concept of the trust has recently been addressed in relation to French tax, and is viewed with deep suspicion by the French authorities as a vehicle for tax avoidance. Trusts with a French connection must file disclosures with the authority, failing which there is a penalty of €10,000 or 5% of the trust assets, whichever is the greater.

In as much as it relates to a non-resident settlor, where the beneficiaries are also non-resident, the French inheritance, gift & wealth taxes can apply to such a trust with non-resident trustee holding French *situs* property, for instance, on the death of the settlor, inheritance tax would from 2011, be payable where the trustee is resident in a "non-cooperative State"[37]. Also, in relation to wealth tax, the non-resident trustee holding

[34] 10 years in Germany & France. In Latin America, the only country which does not have forced heirship is Panama, where it should be noted, the Panamanian private – interest foundation law rejects the enforcement of foreign order of forced heirship: see Nicolas Malumian, "Recognition of foreign trusts", STEP Journal, June 2010. Under Islam, there is no stipulation as to whom property may be gifted *inter vivos*, save that the gift must be outright, as gifts with reservation of rights to the donor may be treated as remaining within the deceased's estate. Subject to the donor's view, the donor may settle property on an *inter vivos* common law trust, with the only proviso from an Islamic perspective, that the donor has made the gift outright.

[35] Or civil law entities such as foundations, as to which see pp11-12: http://www.robertgordontax.com/documents/AILA-Cross Border-Estate-Planning-16-11-10.doc

[36] Note that the rule against perpetuities has only been abolished in South Australia. Several offshore jurisdictions have abolished the rule against perpetuities and accumulations e.g. Jersey, Cayman, and Labuan, Malaysia (from 11 Feb 2010).

[37] Being one which has not entered into an exchange information sharing treaty.

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French *situs* property will have an annual liability of 0.5% of the market value of the relevant assets.

COMPANIES

Shares in a company formed under the law of the country where the assets are to be situated is less likely to avoid the local IHT, as the shares are themselves likely to be treated as local *situs* property.

In recent times, due particularly to a high Australian dollar, and a slump in US real estate prices, a lot of Australian resident individuals have had marketing addressed to them for US real estate e.g. apartments in Florida. Agents often seem to suggest ownership through an US LLC, which seems to leave an Australian resident individual exposed to US inheritance tax on his membership interest in the LLC (if held personally), as the threshold for non-citizen non-domiciliaries is only US$60,000.

Ownership of US realty through an Australian resident unit trust might be preferred.

An Australian resident company might be used for investment in assets in countries with estate & inheritance tax, but this may not be possible due to local requirements, or it may not be ideal from an asset protection standpoint.

It may be that the foreign company should be formed and resident outside Australia and the investee country e.g a tax haven.

A non-resident company controlled directly or indirectly by five (5) or fewer Australian residents will be a "controlled foreign company" (CFC) for Australian anti-deferral tax purposes[38]. If the CFC only derives rent and capital gain, the Australian shareholder(s) will be assessable on the income as it is derived. However, if the CFC has only business (trading) income which is not "tainted", none of the income is attributable to the Australian shareholder(s), even if the foreign income has not been subject to tax (from 1 July, 2004).

This outcome does not change if all the shares in the offshore company are held by a transferor trust (TT), for asset protection reasons or otherwise[39].

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[38] Section 340 of Part X of the 1936 Act

[39] The use of an offshore company owned by a TT will often be administratively simpler, as the Australian resident principal can be a director of the company. The majority of directors will need to be resident where the company is to be resident If the company only has passive or "tainted" income, this will be attributed through the TT to the Australian resident transferor, but the capital of the company should be protected. The use of a tax haven company will usually allow more flexibility. If the Australian tax resident might cease to be an Australian tax resident for instance, if a sufficiently large capital gain was to be made on a tax haven trading company, it might have two (2) classes of shares. To enable tax free dividends to come back to Australia in the years before the sale, one class of share (with 10% of the voting rights) with discretionary dividend entitlement, would be owned by an Australian company in its own right (and entitled to s23AJ tax free dividends), while a TT might hold another class of shares which would also have discretionary dividend entitlement, which would only be used if the Australian (permanent) resident, ceased

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The island of Labuan is a Federal Territory of Malaysia, located close to Brunei. Labuan is an attractive tax haven for Australian purposes, as it has a common law system, with English as the business language, is in a more convenient time zone for Australia, and is also geographically much closer than European and Caribbean havens, and is also outside the EU Savings Tax Directive [40] and has not entered into agreements for Mutual Enforcement of tax judgments[41].

TRUSTS

It may be possible to use a trust with an Australian corporate trustee to invest into countries that have estate or inheritance tax[42].

However, some of the problems with onshore asset protection trusts referred to in the Appendix, are likely to see the emergence of the greater use of such trustees out of Australian jurisdictions[43].

Some tax havens have special legislation designed to make it difficult to attack the assets of an offshore trust in their jurisdiction. A good example in our region is Labuan,

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to be so, in an Australian tax year before the offshore company made the sale. Whilst this is an oversimplification of the concept, it is a workable plan if implemented carefully. It will be observed that the use of the TT will also protect value in the non-resident trading company from potential creditors of the Australian resident principal. The Australian company that would hold the shares paying s23AJ dividends, would itself be owned by an Australian discretionary trust, also for asset protection and flexibility reasons.

[40] Council Directive 2003/48/EC has applied since 1 July 2005. It applies throughout the EU, in 5 other European countries, and in various tax haven dependencies of the UK and the Netherlands. It requires payers of interest to automatically report identity to the beneficial owner's country of residence tax authority, or during the transition phase, for Belgium, Austria, and Luxembourg to withhold at 20% up to 30 June 2011, and at 35% thereafter, instead of exchanging information. Council Directive 77/799/EEC has required wholesale exchange of information on a request basis, between member states since 1977. It now also provides for spontaneous exchange of information in specified circumstances.

[41] Unlike the position in Europe (Council Directive 2001/44/EC), Australia has so far only entered into a few treaties allowing Australia to collect tax on behalf of other countries revenue authorities i.e. New Zealand, Finland, Norway, South Africa and France

[42] As noted above, this is not possible for the UK, and a unit trust may work for the US.

[43] Australia was a signatory to the Hague Convention On The Law Applicable To Trusts And On Their Recognition (1989), and gave it force of law by the *Trusts (Hague Convention) Act 1991*. This is important even for Australia, as a common law country, as the Convention specifies that the law chosen for the trust doesn't have to have a direct connection with the trust (Dicey Morris and Collins *op cit* ¶ 29-016), contrary to the position at common law: *Augustus v Permanent Trust Co (Canberra) Ltd* (1971) 124 CLR 245. It was signed by 13 of the 72 member countries of the Hague Conference on Private International Law, but its scope is wider as it was ratified by the UK on behalf of: the Isle of Man, Bermuda, British Virgin Islands, & Gibraltar, amongst others Crown dependencies (excluding the Bahamas and Cayman Islands). It is particularly important for the civil law countries for which the Convention has entered into force: Italy, Luxembourg, Monaco, Netherlands & Switzerland: see Marco Giacomo Bonalanza, "The Swiss Confederation, the trust and the taxation of immigrants", Vol 7, Issue 3 TQR (2009). Apparently Panama has recently become a signatory.

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Malaysia[44]. It is also particularly noteworthy, that unlike Hong Kong and Singapore, there is no reciprocal enforcement of judgments with Malaysia.

An offshore trust may have nothing to do with Australian or other investor country tax planning[45], e.g. estate or inheritance tax planning in the investee country, with the principal "content" to pay the home country tax attributable to them as "settlor"[46], as long as the assets in the trust are protected, or not to be distributed according to forced heirship rules in their "home" country. *Abdel Rahman v. Chase Bank (CI) Trust Company Limited,* was a notable example of failure to implement correctly.

The so called Transferor Trust (TT) rules (contained in Div 6AAA of the 1936 Act) sought to prevent such deferral by attributing the offshore discretionary trust's income and gains to the party who had transferred property or services to the trust, unless the trust had borne tax at normal rates in one of seven (7) nominated high tax countries, or the transfer was to a trust under an arm's length dealing, and the transferor did not control the trust.

It is not having an interest in a TT which is proscribed, it is the failure to declare the existence of the TT, and the income and gains from the TT. If the taxpayer's concern is asset protection and they are happy to pay Australian tax on the earning of the trust, but want to protect its capital from potential creditors, a trust formed under the *Labuan Trusts Act* (Malaysia), or similar regime, would fit the bill. Based on *Ross v Dwyer* (1992) 34 FCR 463 and *Re Burton; Wily v Burton* (1994) 126 ALR 557, an Australian court should not allow the substitution of the Australian resident controller's trustee in bankruptcy, for the appointor, to vest the trust in favour of the bankrupt's creditors[47].

Also, for family planning purposes, assets which may not produce income but potentially large capital gains, can be held in a TT without any attribution, as it is only realised gains which are attributable. It may be that when the gain is to be realised, that one or more of the mere discretionary objects is living in one of the seven (7) high tax countries which are excluded from the TT regime, but whose tax rate may be substantially lower than Australia. Indeed, the TT may produce some income, but as long as it is declared as attributable, the fact that it flows from a significantly appreciating asset does not cause any issue in relation to that appreciation unless and until the gain is realised.

Alternatively, a sole transferor with respect to the TT may cease to be a resident in the tax year immediately proceeding the tax year in which the TT makes the capital gain, so that he is not an attributable taxpayer with respect to the TT in the year of realization, and his

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[44] As to the advantages of the Labuan Trusts Act 1996, see pp15-17: http://www.robertgordontax.com/documents/AILA-Cross Border-Estate-Planning-16-11-10.doc

[45] Almost all common law jurisdictions treat the place of residence of the trustees as a test for tax residence of the trust, however, the Supreme Court of Canada in *Fundy Settlement v The Queen* [2012] SCC 14 has focused on the place of "central management & control" of the trust, without any statutory direction to do so, such as s95(2)(a) of the 1936 Act.

[46] s102AAZD of the 1936 Act.

[47] In any event, the deed should be drafted to provide for successor appointors in the case of bankruptcy or other incapacity.

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status as a “mere discretionary object” means that he isn’t deemed to have a CGT event at market value on becoming a non-resident[48].

USE OF DEBT

As noted above, in the UK, debt secured over assets other than Excluded Assets is taken into account in calculating the value of the net estate: s5(3) & 162(5) IHTA. The debt can either be from financial institutions or related non-resident individuals or entities, to reduce the value of the UK *situs* estate subject to IHT.

Also as noted above, unlike the UK, US non-domiciliaries can only deduct debt in determining the value of their net US *situs* estate, limited in proportion of their US assets to their world-wide assets.

MIGRATION TO AUSTRALIA

One long standing positive about Australian tax was the absence since 1980 of any State or Federal death or gift duty, so that retirees or other wealthy migrants from countries with inheritance tax may have sought to adopt an Australian domicile of choice, to escape the clutches of their country of origin inheritance tax[49].

However, it is perhaps the abolition of Australian taxation on the foreign source investment income of “temporary residents” that is going to excite the imagination of many prospective potential wealthy migrants[50].

The disposal of a permanent house in the UK and the acquisition of one in Australia would be one of the steps that could be taken by a UK domicile, firstly, to ensure that dual residence is resolved in favor of Australia under the ‘tie breaker” in the UK / Australia double tax agreement (DTA), and secondly, as an assistance on the path to acquiring an Australian domicile of choice for UK IHT purposes.

Ironically, non-domiciles of the United Kingdom, find it an attractive to reside but not adopt a domicile of choice in the UK, in order to make use of the remittance basis of taxation applicable to non-UK domiciles. The *Finance Act 2008* makes reliance on the

[48] Even if he was, based on *Chief Comm. of Stamp Duties v Buckle* (1995) 32 ATR 75, the market value of the asset would not be great.
[49] This topic was explored by the author in some detail for a paper “Protecting Family Wealth: Retiring In Australia” presented at Legal Week “Private Client Legal Forum” Villa d’Este, Lake Como, Italy 9-11 November, 2006 ", which can be found at http://www.robertgordontax.com/documents/articles/Protecting-Family-Wealth4-Retirement-Aus.doc. Also see in relation to income tax: Rijkele Betten, “Income Tax Aspects of Emigration and Immigration of Individuals”, IBFD (1998)
[50] from 6 April, 2006 (Div 768-R of the 1997 Act)

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remittance basis of taxation less attractive, after seven years of residence in any nine year period, by requiring the payment of £30,000 tax just for the privilege[51].

CEASING AUSTRALIAN TAX RESIDENCE

Estate planning for some wealthy Australians may involve ceasing to be a tax resident of Australia[52].

Firstly, it should be noted that on ceasing to be an Australian tax resident, the taxpayer triggers CGT event I1 on all his CGT assets other than "taxable Australian property", unless he elects to pay tax on realization. Holding assets in discretionary trusts or companies owned by discretionary trusts usually overcomes that issue. Secondly, a non-resident individual has a starting tax rate on Australian source income of 32.5% (if it is not subject to withholding tax, commonly at 10%) i.e. no tax free threshold or graduated rate up to 32.5%.

There is a wide-spread myth that leaving Australia for as short a period as two years, will necessarily suffice to become a non-resident for tax purposes. This has arisen due to para 25 of IT 2650 which actually only says that an absence of 2 years "would generally be regarded by this Office as a substantial period for the purpose of a taxpayer's stay in another country"[53]. IT 2650 discusses *Applegate*'s case[54], where the taxpayer was only out of Australia for two years. However, in that case he left the country indefinitely[55], and only returned from Vila, in two years, due to ill health.

More certainty of outcome can be achieved for tax planning, by the use of a suitable double tax treaty (DTA)[56], which contains a dual residence "tie-breaker".

For such a person, there is no point going to be resident in another high tax country, and so a country with a territorial system of taxation which also has a DTA with a "tie-breaker" fits the bill.

In S-E Asia, the more predictable results may follow in Singapore or Malaysia, which countries will also allow reasonable business infrastructure. As Hong Kong does not have

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[51] Increasing to £50,000 tax when resident in at least 12 of the previous 14 years (for 2012-3); now s809H Income Tax Act 2007

[52] See material in the Appendix on the definition of Australian tax resident.

[53] The importance of establishing residence in a particular foreign country can be seen from the case of the physiotherapist on a working holiday for 5 years, who was found to have remained a tax resident of Australia throughout that period: *AAT Case 12,511* (1998) 37 ATR 1263.

[54] 79 ATC 4307, followed by a statement about an absence of anything less than two years being "transitory" in IT2650 at ¶ 27.

[55] Whilst *Applegate*'s case was said to be applied in *FC of T v Jenkins* 82 ATC 4098 at 4101, Mr Jenkins did not leave Australia with the intention to be out of Australia indefinitely, but for three years, which was enough on the facts of that case, to mean that he had a "permanent place of abode" in Vila, as his presence there was not "temporary".

[56] This will help avoid the result that occurred for the taxpayer in the UK case of *Gains-Cooper v HMRC*, who unsuccessfully argued that he had established tax residence in the Seychelles, to the exclusion of the UK. The UK does not have a DTA with the Seychelles.

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a DTA with Australia, it is not suitable. Singapore is well known as an expensive place to live, although the tax position is quite positive[57]. Malaysia is a lot cheaper, and on closer examination, may well be the best choice on the tax front as well[58].

Dual residence is resolved in the Article 4 "tie-breaker" of the Australia/Malaysia DTA, extracted in the Appendix.

If the taxpayer can use the first tier of the tie-breaker i.e. "permanent home" in Malaysia and no "permanent home" in Australia, then together with the fact that he doesn't need to be in Malaysia for all of the 183 days in the first calendar year he moves there, as he can travel on business (in the employ of his own Labuan company), so as to be "temporarily absent"[59] and count those days as "in" Malaysia for the 183 day test[60], there is a lot more flexibility in moving to Malaysia to achieve the overall objectives than available with other countries[61].

APPENDIX

RESIDENCE

Australian residence at the time of death, or for a period before death, and citizenship (or dual citizenship), may be relevant to the question of the deceased's domicile at the time of death, but only domicile in an Australian jurisdiction, determines the proper law to be applied to the estate.

Australian Tax Residence

Section 6(1) of the 1936 Act defines Australian residents as it relates to individuals as follows:

'"resident" or "resident of Australia" means -

(a) a person ... who resides in Australia and includes a person -

[57] For instance, the top marginal rate of tax for a Singapore resident individual is 20%, and is not incurred until the individual's taxable income reaches S$320,000, compared to 45% in Australia, once taxable income reaches A$180,000. Singapore does not have a CGT but speculative profits are treated as income.
[58] There is no CGT in Malaysia, but speculative profits are taxed as income. Whilst a Malaysian resident individual will pay a top marginal rate of 26% once taxable income reaches RM100,000, directors fees from a Labuan company are currently not taxed, and there is currently a 65% exemption from tax on managerial salaries from a Labuan company. Further, if the individual controls the Labuan company, there is nothing to compel them to pay themselves a taxable salary.
[59] *Re Young* (1875) 1 TC 57, *Rogers v Inland Revenue* (1879) 1 TC 225, *Reed v Clark* (1985) 58 TC 528, *Shepherd v IRC* [2006] STC 1821, *Barrett v Revenue & Customs* (2007) UKSPC SPC00639, *Revenue & Customs v Grace* [2008] EWHC 2708 (Ch). Also see the Australian case previously referred to: *FC of T v Jenkins* 82 ATC 4098 at 4101
[60] s7(1)(b)(i) of the Income Tax Act 1967
[61] For more detail see: http://www.ectrustco.com/documents/AUSTRALIANS-2.doc. For seriously wealthy Australians who are not UK domiciled, the UK represents a tax haven for unremitted foreign source investment income.

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(i) whose domicile is in Australia, unless the Commissioner is satisfied that his permanent place of abode is outside Australia;

(ii) who has actually been in Australia, continuously or intermittently, during more than one-half of the year of income, unless the Commissioner is satisfied that his usual place of abode is outside Australia and that he does not intend to take up residence in Australia; or

(iii) who is [a member, spouse or child under 18 of a member of certain Commonwealth public service superannuation funds]' (underlining added)

As the specific tests widen the concept of "residence" beyond whether a person "resides" in Australia in a particular year of income, it only becomes necessary to consider the specific tests if the individual does not "reside" in Australia in the ordinary meaning of that word, in a particular year of income.

It will be observed that whether a person's residence will be taken into account in deciding their domicile, the reverse is also true. That is, a person's domicile is taken into account in the first specific test of tax residency.

General Test – "resides"

The issue of common law residence[62] was considered in *Gains-Cooper v HMRC* [2006] UKSPC 00568 before the Special Commissioners in the UK, where the law was analyzed, and as the stakes were very high, the case was argued with considerable resources[63]. As the appeals were limited to errors or law, and the appeal courts found none, the Special Commissioners decisions stood. HMRC also had success in subsequent cases[64]. In recent years cases dealing with residence of individuals in Australia have not moved past the AAT[65].

[62] For a discussion of the relevant matters that the Commissioner will take into account in determining whether a person is resident according to ordinary concepts see Taxation Ruling TR98/17.

[63] Also see *Shepard v HMRC* [2005] UKSPC 00484

[64] *Barrett v HMRC* [2007] UKSPC 00639; *Grace v HMRC* [2009] EWCA Civ 1082; *Genovese v HMRC* [2009] STC (SCD) 373; *Hankinson v* HMRC [2009] UKFTT 284 (TC); *Tuczka v HMRC* [2010] UKFTT 52 (TC); *Turberville v HMRC* [2010] UKFTT 69 (TC); *Broome v HMRC* [2011] UKFTT 760 (TC); *Ogden v HMRC* [2011] UKFTT 212 (TC); *Kimber v HMRC* [2010] UKFTT 107 (TC)(8 Feb 2012).

[65] *Mynott and the Commissioner of Taxation* [2011] AATA 539; *Iyengar and the Commissioner of Taxation* [2011] AATA 856; and *Sneddon and the Commissioner of Taxation* [2012] AATA 516; *Murray and the Commissioner of Taxation (No 3)* [2012] AATA 557; *Boer and the Commissioner of Taxation* [2012] AATA 574; *Sully and the Commissioner of Taxation* [2012] AATA 582 (31 Aug 2012)

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Mr Gains-Cooper was found by the Special Commissioners to have remained a resident of the UK[66], whether or not he had become resident in the Seychelles, with which the UK does not have a DTA.

First Specific Test - domiciled but permanent place of abode outside Australia

Domicile

The first of the three specific tests refers to the domicile of the individual[67].

Permanent Place of Abode

The most relevant expression of opinion by the Commissioner of Taxation is contained in Income Taxation Ruling IT 2650, which is headed “Residency – Permanent Place of Abode Outside Australia” (underlining added). That ruling is essentially directed at the question of whether persons absent from Australia for particular periods may become non residents of Australia during the period of absence.

Second Specific Test – in more than 183-days but usual place of abode outside Australia

After the issue of IT 2650 and TR98/17, a further case was decided: *FC of T v Executors of The Estate of Subrahmanyam* 2002 ATC 4001 (Full Federal Court), and on remission to the AAT, 2002 ATC 2303. This case didn’t deal with domicile, and as it was fought on the basis of the second test. It appears that the evidence was always the taxpayer had intended to return to Singapore, and so it appears to have been conceded by the ATO that she was domiciled in Singapore.

In this case, the deceased, who was a citizen of Singapore, had been in Australia for almost 4 years, essentially for medical treatment, and her lifestyle had been severely restricted by the health problems. She had closed her medical practice in Singapore, sold her house and transferred the proceeds of sale to Australia. However, she had left valued possessions in Singapore and maintained her Singapore medical registration and travelled back there on a few occasions. Ultimately on remission to the AAT, she was found not to have a usual place of abode outside Australia.

Dual residence

Dual residence is often resolved in DTAs. For example, Article 4 “tie-breaker” of the Malaysia/Australia DTA provides:

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[66] His substantive appeals to the High Court [2007] EWHC 2617 (Ch), and the Court of Appeal were dismissed [2008] EWCA Civ 1502. His administrative appeal was dismissed by the Supreme Court of the UK, reported as *Davies & Anor v HMRC* [2011] UKSC 47.

[67] As to the question of domicile, see the discussion at ¶ 8-10 and ¶ 21 of IT 2650. Also see *Iyengar* at [87] -[101].

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"2. Where by reason of the preceding provisions an individual is a resident of both Contracting States, then his status shall be determined in accordance with the following rules:

> (a) he shall be deemed to be a resident solely of the Contracting State in which he has a permanent home available to him;
>
> (b) if he has a permanent home available to him in both Contracting States, or if he does not have a permanent home available to him in either of them, he shall be deemed to be a resident solely of the Contracting State in which he has an habitual abode;
>
> (c) if he has an habitual abode in both Contracting States, or if he does not have an habitual abode in either of them, he shall be deemed to be a resident solely of the Contracting State with which his personal and economic relations are the closer.

3. In determining for the purposes of paragraph 2 the Contracting State with which an individual's personal and economic relations are the closer, the matters to which regard may be had shall include the citizenship of the individual." (underlining added)

It will be observed that whilst nationality (and indeed dual citizenship) is relevant to the "tie breaker", it is not directly relevant to the domestic definition of Australian tax residence.

ASSET PROTECTION CONCERNS

Asset protection concerns from the use of Australian discretionary trusts started with *Australian Securities and Investments Commission in the Matter of Richstar Enterprises Pty Ltd (ACN 099 071 968) v Carey (No 6)* [2006] FCA 814, a decision of French J (as he then was).

In that case a receiver was appointed over various trust assets on the basis that the defaulting debtor as a beneficiary and as in effective control of the trustee, had an interest in the assets, entitling the appointment of a receiver over them under the Corporations Act. This has caused considerable consternation[68], as the case didn't even refer to *Re Burton; Wily v Burton* or *Dwyer v Ross*. For a display of some restraint after *Richstar*, see *ASIC v Burnard* [2007] NSWSC 1217, particularly at ¶ 69-71 and 76-78. Also see *Public Trustees v* Smith [2008] NSWSC 397 and *Farr v Hardy* [2008] NSWSC 996. However, *Dwyer v Ross* was distinguished in *Rafferty v Time 2000 Waste Pty Ltd (No.9)* [2011] FCA 1483 at [58] to allow a freezing order to continue over trust property.

[68] See "Trust Practices under threat- Discretionary trust interests: the Westpoint Litigation" Ron Jorgensen & Renuk Somers, TIA Vic Div 13 Sept, 2006 and Halperin *op cit*. But apparently no consternation to Justice Branson "The Bankrupt, His or Her Spouse ant the Family Trust- A Consideration of Part VI Div 4A of the Bankruptcy Act", ITSA 2006 Bi-Annual Conv.

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However, the uneasiness is still there, as high profile insolvencies darken the public and judicial mood, when the blameworthy individuals seem to have "salted away" assets for themselves[69].

As to whether a family discretionary trust will be able to be attacked by a party to an Australian family law dispute, the position still depends on the circumstances, and is no less easier to decide following the High Court of Australia decision in *Kennon v Spry* [2008] HCA 56 in which Gummow & Hayne JJ observed (at ¶ 89):

> "the term 'property' is not a term of art with one specific an precise meaning. It is always necessary to pay close attention to any statutory context in which the term is used [and referred by way of footnote to *Richstar*]. In particular it is, of course, necessary to have regard to the subject matter, scope and purpose of the relevant statute".

The problem in *Kennon v Spry*, is that the majority differed as to how they reached their conclusion. It should first be observed that the dissenter, Heydon J reached the conclusion that neither the husband nor the wife had "property" in the trust as a matter of general law (referring to *Gartside v IRC* [1968] AC 553) at ¶ 56), and that the position was no different for family law purposes under s79 (at ¶ 187).

Of the majority, none mentioned *Gartside v IRC* directly, although French CJ noted that the husband's power as trustee to appoint assets or income to the wife "may not be property according to the general law" (at ¶ 79).

It should be noted that s90AE of the Family Law Act (which was introduced in 2006), and allows orders to be made against third parties, was not available to the wife, as in the proceedings at first instance, she did not lead evidence as required by s90AE(4).

If a party to a marriage in Australia has settled or gifted property on an *inter vivos* trust outside Australia, even if the Family Law Court made s90AE against the foreign trustee (without assets in Australia), then it will it be extremely difficult to enforce especially, an Australian non-money order judgment in that jurisdiction[70].

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[69] Also see "Trust me –I don't own anything!", Michael Lhuede, TIA Vic State Conv, Oct 2008. "Claims against the Estate (Warnings for Executors)", Craig McKie, TIA Estate & Succession Planning Intensive, WA Div 24 Sept, 2008 pp14-15. Also see other cases referred to in "Modern Day Trust Structures", Daniel Smedley, TIA Vic State Conv, Oct 2008 pp19-20 including *Kawaski (Australia) Pty Ltd v Arc Strang Pty Ltd* [2008] FCA 461 at ¶ 75, reference to *Lygon Nominees Pty Ltd v Commissioner of State Revenue* (2005) 60 ATR 135 at [58]. Also see "Wealth Preservation in a Sub-Prime World", Ken Schurgott, TIA WA State Conv. 2008 pp4-5 and "Trusts and Asset Protection Best Practice", Ken Schurgott, TIA National 24-25 September 2011.

[70] If it is a common law country and it does not have Reciprocal Enforcement of Judgment legislation which covers Australian judgments.

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DISCLAIMER

This paper does not constitute advice. It should not be relied on as such.

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