International estate planning

By Terry Dwyer,
Dwyer Lawyers, Canberra,
Australia

Of death and taxes, heaven and havens

Death may be inevitable, but for a religiously-inclined person, it may be seen as an escape from a vale of tears to heaven. It is curious, therefore, that there is a secular parallel in that death is not only an escape from taxation for the deceased but his estate can create a tax haven for those left behind.

To understand this paradox, we must recall that all tax systems work on having a taxpayer. Death rather defeats this objective. In place of the deceased taxpayer, there are his executors, his trustees, his estate and his beneficiaries. Naturally, in a simple situation in one country, the executors are treated as a continuation of the deceased and the estate becomes a notional taxpayer.

However, this changes if the deceased resided in country A but left assets in country B and appointed separate executors there. What if there are not sufficient assets in country A to satisfy debts against the estate there? Can those creditors claim against the executors in country B? Can the executor of a testamentary trust in country B be forced to pay the debts of the executor in home country A?

This must depend on the laws of country B. For example, as a rule of private international law, the Courts of many countries will not enforce certain debts such as tax debts from other countries (this being a surrender of sovereignty). Generally the answer is "No" as regards fiscal debts but "Yes" as regards normal debts. The basic rule is that a sovereign does not enforce another country's tax debts – the rule in *Government of India v Taylor* [1955] AC 491. Even indirect enforcement through an appointment of administrator may be rejected *Bath v British and Malayan Trustees Ltd* (1969) 90 WN (NSW) (Pt 1) 44. The rule may even be applied within a Federal system to prevent one state undermining the legislative policy of another state.

In some countries this policy of the law may also be confirmed by statute. In other cases, such as some OECD countries, there may be treaties for tax co-operation which over-ride the normal rule.

The rule against enforcement of foreign tax debts has a long and respectable lineage in jurisprudence, legal history and logic but is under attack by OECD tax authorities and has been weakened in some countries. One method of attack has been not to assert the tax debt directly in a foreign court but to bankrupt the taxpayer or his estate in his home country and then seek mutual legal assistance in the administration of a bankrupt estate on the basis this is a normal debt recovery. However, foreign courts and governments may see through this stratagem and strike out the tax debts in order to prevent circumvention of the rule in *Government of India v Taylor.*

Going past the death of the deceased, the next question is whether country A can tax the income or assets or capital gains arising to the executors in the estate in country B. Usually, country A cannot do so directly as any taxing nexus with country A in respect of those assets died with the deceased. However, country A may try to deem any income, or gains or assets as belonging to and taxable in the hands of the beneficiaries in country A. But what if the will made for country B did not leave anything outright to beneficiaries in country A? What if there was a discretionary testamentary trust created by the will in country B and the executors have set up the trust with themselves or some other person in country B designated by the deceased as trustee?

One sees that it becomes very difficult to tax anyone in country A because the logic is not there to do it. Most legislators, treasury officials and tax administrators are rational people who would regard it as a senseless exercise to try to tax someone on what is not his. Until and unless someone in country A becomes entitled to income or gain or an asset from the estate in country B, there is nothing to tax in country A. There is only something in country B (and country B might expect that, if anyone is to levy tax, it should be country B). Indeed, country B might take strong offence at extra-territorial tax claims by country A against income, assets or gains arising in country B.

To sum up the story thus far, death means that the deceased's assets and income may end up in more than one estate in more than one jurisdiction – rather like an amoeba splitting.

But tax may not be the big issue

So far, the example has been of tax claims as these are a well known example of potentially unenforceable claims in another country. But it is only one example and not necessarily the most important. There are other, often more significant, claims which may concern prospective testators.

Forced heirship, claims under family provision or testator's family maintenance legislation are examples of other liabilities which might be enforceable against the estate in country A but not against the estate in country B. In particular it may be noted that, in some jurisdictions, claimants under family provision legislation may include former spouses or domestic partners (even though there may have been a divorce settlement).

As with the refusal to enforce foreign tax judgments, so the domestic policy of a jurisdiction will generally refuse to enforce claims arising out of different legislative policies. In matters of positive, rather than natural, law each country is free to frame its own policies. These conflicts of law problems are resolved by Courts or Parliaments in country B deciding how far country B will go in recognising and enforcing claims brought in country B's Courts but arising under country A's different legislative policy. For example, a New South Wales mistress failed in her claim against the estate of a deceased Victorian billionaire in relation to his "notional estate" (assets gifted away prior to death) because Victoria did not include "notional estate" in its family provision legislation. (Viewers of the film "The Duchess" and students of 18th century social history will find it interesting that mistresses in this post-modern age are now considered part of the "family".)

A theoretical perspective

Stepping back, as a way of thinking about international estate and tax planning, we see that, on the death of a person, what he owned or enjoyed may be affected by four phenomena.

- Evaporation
- Disconnection
- Division
- Liability creation

Each of these factors may have consequences for both inheritance and the advantaging or disadvantaging of various possible or actual creditors. Some obligations may become unenforceable while others (such as inheritance tax or income tax on bequests) may both spring up and be quite enforceable because the taxpayer subject to the tax is within the jurisdiction.

Evaporation

Evaporation occurs where rights which the taxpayer previously enjoyed cease to exist on death. Properties held in joint tenancy pass outside the estate to the surviving joint tenant. Interests in partnerships or shares in private companies may be subject to pre-emptive rights in favour of family or business co-owners.

Some forms of income may cease upon death, such as annuities, life interests or discretionary trust distributions. Superannuation, pension or annuity rights may revert directly to spouse or children.

Some assets over which the deceased may have had control during his life can be realised without ever becoming part of his estate. Life insurance policies will be paid to beneficiaries who may not be executors and who have no liability to pay the proceeds into the estate. Nor can a life insurance company be compelled to pay the estate when it gets a good discharge by paying the third-party beneficiary.

Disconnection

Upon death, the taxpayer's estate becomes disconnected from him personally. Therefore legislative provisions which operated against the taxpayer cease to operate. For example, there can be a cessation of the operation of tax laws attributing income to the taxpayer in respect of assets the taxpayer may have transferred abroad, or attribution of income in respect of interests in companies.

An estate can become disconnected in another way. If a taxpayer has assets in a foreign country, he can make a separate will in that country and on his death a new "entity" (loosely described) may come into being which has no connection to his country of residence or domicile.

Division

A testator may make more than one will. As noted above, he may make separate wills and appoint separate executors or trustees for different assets in each jurisdiction. For example, he may separate wills for assets in different states or territories of a country. He may make different wills for different assets in different countries.

If the taxpayer has assets in a "foreign" jurisdiction (which may be another state in his own country) and has made a separate will for those assets in that jurisdiction, those assets come to be owned by a separate "entity".

Thus on the death of the taxpayer what was one taxpayer can be replaced by several taxpayers in the form of executors or testamentary trustees in several countries.

But division also involves liabilities which are also split across counties but may be allocated disproportionately to assets. For example, a testator may have borrowed in the UK to buy Australian shares. It is possible that one estate may be insolvent while another is solvent. The difficult question then emerges as to what extent one executor can call upon another executor elsewhere to pay debts in another administration of assets. For example, an executor in one country may be able to claim a homestead exemption or an exemption from creditors in bankruptcy for proceeds of life insurance policies and may not be able to be compelled to meet debts in another jurisdiction.

Liability creation

Death duties are the most obvious examples of liability creation on death. But there are others. Some contracts may require an executor to elect whether to put in more money or leave a venture.

Not all estate liabilities or obligations created against an estate may be unwelcome to the objects of a testator's bounty. Some may be desired and planned for. A testator may deliberately enter into disadvantageous transactions whereby, for example, an option to purchase his land becomes exercisable against his executors in favour of a person whom he wishes to benefit.

Testamentary trusts in international estate planning

Long-term post-mortem estate planning for beneficiaries usually involves a testamentary trust (though a civil law foundation may also be used). The fundamental reason for having trusts, including testamentary trusts, is to look after property – for infants, married women and descendants, basically to provide asset protection. That is to say, to prevent the property being seized, stolen or attacked by various ne'er-do-wells such as unfaithful spouses, opportunistic creditors or what the Bible calls publicans, otherwise known as tax collectors.

Where an estate crosses national boundaries into a common law jurisdiction, a testator may provide for his family by creating a testamentary trust under his will. The position of trustee of a testamentary trust is different to that of an executor, though often or usually the executor is also the testamentary trustee (but need not be).

Testators wanting family privacy may choose to create a secret or semi-secret trust. If an ostensible beneficiary is apparently given property under a will on the agreement that he will hold it on certain trusts he will be held to those trusts whether such a trust is not referred to at all in the will (a secret trust) or there is reference such as "to hold on the trusts I have communicated to him" (a semi-secret trust).

Such secret and semi-secret trusts are no less legally enforceable than any other testamentary trust. Of course, a prudent testator needs to ensure there is clear documentary evidence placed in the hands of the real beneficiaries to enable them to enforce the trust.

Funding a testamentary trust in another jurisdiction

Using the conceptual framework set out above, suppose a testator wishes to forestall a family provision claim. He may shift the situs of key assets to a jurisdiction which does not have family provision legislation (or which has narrower legislation) and make a separate will for that jurisdiction. A family company may, for example, set up a branch register in another jurisdiction (which may even be another state) and the testator may transfer the registration of his shares to that register so that the shares may only be dealt with in that jurisdiction (for which he then makes a separate will).

He may also be able to change the place of incorporation of a family company (though that may raise adverse tax consequences, if it results in a change of tax jurisdiction – this might not be the case where a country, such as the UK, uses the "central management and control" test of company residence).

Another method of funding an overseas testamentary trust may be to transfer assets to an overseas trustee on bare trust and dispose of the equitable interest in the assets through a will for that overseas jurisdiction.

As a result of disconnection, an advantage of such an overseas testamentary trust is that it may earn income free of domestic tax consequences for the beneficiaries until distributions are made.

A potential disadvantage is that there may be adverse tax consequences on disconnection in transferring assets to such an overseas testamentary trust – the testator's home country may impose exit charges, such as capital gains tax, on appreciated property being transferred to an overseas trust. It may be possible to manage such exposure by transferring assets gradually as they are realised.

Pre-mortem estate planning

While there is life there is indeed hope and, if a testator moves assets across borders and makes wills properly, he may be able to move on to a better place while leaving his intended heirs (loosely speaking) without a legacy of claims. (Incidentally, Australia has no death duties and is thus a tax haven in this respect.)

But he may well ask what's in it for him? Without going into specifics, it is sometimes the case that evaporation and disconnection strategies can be started upon during the testator's life and provide him with some of the asset protection and other benefits he wishes to bequeath to his family.