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Estate Tax Conflicts Resulting from a Change in Residence

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The focus in my presentation is on estate, gift, generation skipping, inheritance, and capital transfer tax problems resulting from a change in residence or a change in domicile of an individual and is limited to a discussion of common law countries using Australia, Canada, England and the United States as paradigms.[1] The focus of this paper is not on the normal issues that arise when a domiciliary, citizen, or resident of one country owns assets in another country; nor is it on the income tax problems of the emigrating or expatriate taxpayer that have been discussed in Subject II of this Congress.

As an overview, the conflicts result from the following: (1) a conflict over the facts or the different definitions of the crucial status of "domicile"; (2) the retention by the former country of domicile of its power to tax an individual who is no longer a domiciliary; (3) a difference in the transfer tax regimes of two countries; and (4) a difference in the mechanisms for determining an estate tax credit for the other country's tax.

A. ***Conflicts Based Upon Domicile***. The definition and determination of domicile is not uniform, although it is similar throughout the common law countries. Under the laws of the United Kingdom and Canada, it is more difficult to change an individual's domicile that arises at birth. See Civil Engineer v. Inland Revenue Commission (2002) STC (SCD) 72, where, notwithstanding that an individual spent 30 years in Hong Kong, the court held him to be a U.K. domiciliary. When it does change, it reverts back to the domicile of birth until the new domicile is obtained. Under the laws of the United States, it is much easier for an individual to change his place of domicile, and his last place of domicile continues until he adopts a new domicile. Perhaps this is because of the mobility of individuals within the various states of the United States. In any event, conflicting rules can lead to a potential double domicile, i.e., two jurisdictions claiming an individual is domiciled within their country. There are a number of famous U.S. cases where two different states have claimed that the individual was domiciled within their jurisdiction. In In re Dorrance's Estate, 309 Pennsylvania 151 (1932), 115 NJ Eq. 268 (1934), aff'd 15 NJ Misc. 168, aff'd 116 NJL 362 (1936), both Pennsylvania and New Jersey successfully asserted that the decedent, owner of Campbell's Soup Company, was domiciled in each of their states. The Supreme Court of the United States denied certiorari in both cases. 288 U.S. 617 (1933); 298 U.S. 678 (1936). A similar result involved the Estate of Howard Hughes.

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[1] For a broader discussion on both income tax and transfer tax issues caused by a change in residence, see S.H. Goldberg, et al., "Taxation Caused by a Change in Residence," Tax Notes International, 7 August 2000, pages 643 - 659 (Part I); Tax Notes International, 14 August 2000, pages 741 -766 (Part II).

Another source of domicile conflicts arises when an individual changes his residence for purposes of a "temporary" assignment to a new job and the new state of residence treats him as a domiciliary immediately.

In the absence of a treaty between the two countries that claim that a decedent was domiciled within their jurisdiction, there is no recourse for the taxpayer.

Treaty Solutions. The general solution to the problem adopted by common law countries is by treaty. The OECD Model Double Taxation Convention on Estates and Inheritances (1982) ("OECD Model Estate Tax Treaty") provides a pecking order for assigning the priorities to the two jurisdictions in determining the domicile of the decedent. The priorities, in the following order, are: (1) permanent home, (2) closest personal and economic interests (center of vital interest), (3) habitual abode, and (4) citizenship. If the two countries can't agree, the competent authorities can, but need not, reach an agreement. OECD Model Estate Tax Treaty, Art. 4. It should be noted that estate tax conventions may not cover state and local taxes in all situations. For example, the U.S.-German estate tax convention requires both countries to give credit for federal and state taxes that the other country is permitted to impose on listed property, e.g., real estate, business assets. When a subdivision, in this case the State of Maryland, imposed an inheritance tax on intangible property, which by treaty only Germany the domiciliary state could tax, the court ruled that the treaty did not apply to taxation by the states and the heirs could not recover the state inheritance tax. The proper procedure may have been to request competent authority assistance. Register of Wills for Baltimore County v. Arrowsmith, 2001-2 USTC 90,266 (Ct. App. Md. 2001). Similar authority exists under the U.S.-U.K. and the old U.S.-Canada treaties.

The temporary assignment problem is mentioned in the commentaries to the OECD Model Estate Tax Treaty.

> "Special problems may arise when a person is domiciled in one of the States and is resident, and therefore domiciled for purposes of Article 4, in the other State, but who does intend to remain permanently in that other State. Such a case would arise where an executive of an international company is assigned to work for a certain period outside his own country. Some conventions provide a minimum period of residence before the individual is treated as "domiciled" in the State. The aim of Article 4 is to avoid assessing the merits of national rules of law governing the circumstances in which a person is treated as domiciled in a Contracting State. Member countries, especially those with domestic laws determining a liability to tax are significantly different, may deal with this special case by including such a provision in their bilateral conventions." (Commentaries, Art. 4, para. 13.)

The U.S. has such a special provision in its Treasury Department's Model Estate and Gift Tax Treaty of November 20, 1980 ("U.S. Model Estate and Gift Tax Treaty"). The provision states:

Where an individual was:

(a) a citizen of one Contracting State, but not the other Contracting State,

(b) within the meaning of paragraph 1 domiciled in both Contracting States, and

(c) within the meaning of paragraph 1 domiciled in the other Contracting State in the aggregate less than 7 years (including periods of temporary absence) during the preceding ten-year period,

> then the domicile shall be deemed, notwithstanding the provisions of paragraph 2, to have been in the Contracting State of which he was a citizen.

The provision is limited to citizens, perhaps because citizenship is a practical substitute for permanent residency. Notwithstanding the OECD Model Estate Tax Treaty and the U.S. Model Estate and Gift Tax Treaty, the provision appears in only 4 of the United States' estate tax treaties: the treaty with Austria, in which the test is 5 out of the preceding 10 years; the treaty with France, in which the test is 5 out of the preceding 7 years; the treaty with the Netherlands, in which the test is 7 out of the preceding 10 years, if the presence was attributed to employment; and the treaty with the United Kingdom, in which domicile is required for 7 out of the preceding 10 years.[2] The United Kingdom uses a similar provision in all of its recent estate tax treaties.[3]

B. ***Conflicts Based Upon Statutory Domicile Retention***. The second major problem is retention of the power to tax by the former country of domicile, notwithstanding that an actual change of domicile has occurred. Countries that have extended their power to tax former residents who are no longer domiciled in their countries include Germany, the Netherlands, the United Kingdom,[4] and the United States.[5]

Treaty Solutions. The OECD Model Estate Tax Treaty does not address this issue. Its scope is limited to estates of, or gifts made by, persons domiciled in one or both countries, disregarding any other criteria that under domestic law of a member country may lead to comprehensive tax liability. Thus, under the OECD Model Estate Tax Treaty, the potential for multiple taxation arises where a country taxes a decedent on a basis other than domicile or the situs of assets. Such potential clash between domicile and a "deemed domicile" is not covered by the normal tie-breaking rules of the tax treaties.

The U.S. extends its power of taxation to former citizens who lost their U.S. citizenship for purposes of avoidance of tax.[6] Comparable treatment is applicable to long-term, lawful, permanent residents who ceased to be taxed as residents.[7] The United States, under its normal rules, taxes the U.S. situs property of nonresidents of the U.S., including stock of U.S. corporations. Shares in certain foreign corporations are also included in the expatriate's estate when he has attempted to change the situs of the U.S. assets by investing through a foreign corporation. In that case, for purposes of imposing its estate tax, the U.S. taxes the portion of the fair market value of the stock of a foreign corporation owned by the decedent at the time of death that is attributable to U.S. situs assets. The provision is applicable only to a foreign corporation in which the decedent owned at the time of death (i) directly or through other non-U.S. entities, 10 percent or more of the total combined voting power of all classes of stock entitled to vote, and (ii) directly, indirectly, and by applying certain broad attribution rules, more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of such corporation. To avoid multiple taxation, which otherwise would be likely in this situation, the United

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[2] United States-United Kingdom Estate and Gift Tax Treaty, Article 4.

[3] United Kingdom inheritance tax treaties with South Africa, the United States, the Netherlands, Sweden, and Switzerland (no time limit, but limited to residence for employment purposes only).

[4] Inheritance Tax Act 1984, section 267.

[5] IRC '2107.

[6] IRC section 2107.

[7] IRC section 877.

States grants a credit for the taxes imposed by a foreign country under its estate, inheritance, legacy, or succession taxes on the corporation to the extent of the proportion of its U.S. situs assets.

In addition, lifetime transfers of intangible property by an expatriate, which are not generally taxed where the transferor is a nonresident, are subject to the gift tax if the intangible property has a U.S. situs. In order to avoid multiple taxation, the U.S. gives a credit for taxes paid to any foreign country with respect to those transfers.

In the United Kingdom, an individual who has abandoned his domicile under the general rules of law retains a deemed U.K. domicile for the following three years.[8] The definition of domicile in the U.K. also includes any person who has been resident in the U.K. during 17 of the preceding 20 tax years. The effect of these provisions is that the U.K. continues to tax under internal law the deceased's (or donor's) worldwide assets during the period of deemed domicile. Under its estate tax treaties, the U.K. treats this extended tax as taxation on account of actual domicile so that the dual domicile provision applies, which may result in the other country being the country of domicile for treaty purposes. In other cases, a partial credit is available to reduce double taxation in this situation.[9] This credit is determined by the following formula:

$$\frac{\text{United Kingdom Tax}}{\text{United Kingdom Tax + Foreign Tax}} \quad \text{X} \quad \text{Lower of United Kingdom Tax and Foreign tax}$$

The effect of this formula is that if the country imposing the foreign tax grants a credit using the same formula, then the total tax will be equal to the greater of the two taxes. No country, other than Germany and the United Kingdom, provides a credit for foreign taxes on property located in a third country paid by a former domiciliary to a country where the taxpayer is not actually domiciled. To preserve its right to tax, both in the case of being the loser under a dual domicile provision and on the basis of situs of assets other than those on which the treaty permits taxation, the U.K. includes in its treaties a provision to protect its taxing rights for a period of years[10] so that the new state of residency does not retain the sole taxing right and the U.K. will give relief for the other state's tax.

Neither Australia nor Canada has an estate or inheritance tax. An income tax is due when the individual changes his residence to another country or dies, which might be considered a change of residence. When an individual immigrates into Australia or Canada, his assets are revalued, thus reducing (in the case of appreciated assets) the income tax on death. The tax on emigration may be deferred until death or disposition of the property by posting security. Also, there is no exit tax on property that remains subject to a future Australian or Canadian tax. Thus, upon death, one country may impose an income tax on death while the other county may impose an estate tax. In Estate of Ballard, 85 T.C. 300 (1985), the decedent, a U.S. citizen and domiciliary, died owning real estate in Canada. The estate paid an income tax to Canada on the unrealized appreciation and claimed a credit against its U.S. estate tax. The U.S. Tax Court held that the tax paid to Canada was not an estate tax for which a credit is allowable under IRC '2014(a) and also was not a tax of substantially similar character to the estate tax that was imposed by

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[8] Inheritance Tax Act 1984, section 267.

[9] Ibid., section 159.

[10] United States (10 years); Ireland (10 years); South Africa (10 years); Netherlands (10 years); Sweden (10 years); Switzerland (five years for dual domicile).

Canada at the time the United States-Canada Estate Tax Convention was adopted. Therefore the Canadian income tax on death was not creditable.

The Canadian treaty with the United States and the Canadian treaty with France attempt to coordinate the two different tax regimes. The Canada-U.S. income tax treaty provides for reciprocal concessions by both countries. Canadian residents receive a credit for U.S. estate taxes and state inheritance taxes imposed with respect to U.S. situs property and the U.S. grants a credit against its estate tax to its citizens and residents for Canadian and provincial taxes on property located outside of the United States. Art. XXIX.B.6 and 7. The French treaty provides for reciprocal concessions also. Both countries give a credit for the other's tax. Canada gives its residents a credit against its income tax for French inheritance taxes on property situated in France and France gives its residents a credit against its inheritance tax for the Canadian income tax on Canadian property. Art. 23. Australia does not have any treaty that deals with this issue.

Conflicts Based Upon Different Taxpayers

Another potential source of conflict is because of different regimes, e.g., when one country taxes on the basis of the residence of the transferor, an estate tax, and the other country taxes on the residence of the transferee, an inheritance tax. This could arise, for example, when an individual changes his domicile and desires to leave his assets to those of his family that have remained behind. Both countries have the power to tax the full amount of the transferred property. Where the domicile of the decedent is in the U.S. and the domicile of the transferee is in another country, the U.S. will grant a credit for the taxes paid to the other country, provided that the property subject to tax is situated in that country. IRC '2014. If the property is not situated there, no credit is allowed and double taxation may result. Double taxation in this situation can only be avoided by treaty. These usually give the primary taxation right to the country of the transferor's domicile but requires a credit for any tax paid to the country where the property is located. See U.S. Model Estate and Gift Tax Treaty, Art. 9; OECD Model Estate Tax Treaty, Art. 9.

Problems Caused by Timing Differences

Death is finite and definite. Death occurs at an instant of time, although because of the variation in time zones it may not occur at precisely the same time in different countries. However, taxation because of death may not occur at the same time, resulting in a potentially serious mismatch in taxation in different countries. The primary cause of this incongruity is the ability in many common law countries to postpone taxation on death where property is transferred to the decedent's spouse. All of the common law countries, whether imposing an income tax or an estate tax on death, permit the postponement of a tax on property passing to a surviving spouse. As a result, the tax on death may be imposed on the death of the decedent, the death of the surviving spouse or some time in between. A typical scenario for a migrating individual might be the death of a husband followed by the surviving spouse returning to their native country. Where a credit is permitted for foreign taxes, and all of the countries allow a credit, the time of the imposition of the tax becomes crucial.

Canada and the U.S. have settled some of these problems by treaty. A matrix of that settlement assuming a resident of the United States who owned at his death Canadian real property shows that the relief of double taxation is not complete.

	CANADA			
	Facts	***Death of first Spouse***	***Sale of Assets***	***Death of Second Spouse***
UNITED STATES	Tax on death of first spouse	U.S. credit for Canadian tax 1	No credit unless competent authority 2	U.S. - credit for Canadian tax and refund 3
	Death; QDOT; and later distribution	Canada - no credit for U.S. tax unless competent authority 4	Canada - no credit unless competent authority 5	Canada - no credit unless competent authority 6
	Death; QDOT; and death of second spouse	U.S. gives credit for Canadian tax 7	No credit unless competent authority 8	U.S. credit for Canadian tax 9

Problems of Prior Gift Taxes

The U.S. death tax regime is fully integrated. Transfers during life are subject to a gift tax. Upon death, the donated property is included in the decedent's taxable estate and credit is given for the gift tax paid. Prior to the adoption of a unified estate and gift tax in 1976, it was possible for a gift to be subject to a gift tax and also a later estate tax. If the property transferred is subsequently included in the decedent's estate because under the U.S. estate tax the decedent did not completely transfer all his rights, e.g., a power to determine the timing of the income of the property, the retention of an interest that did not terminate before death, the gift tax paid would be credited against the estate tax otherwise payable.

If a decedent had made gifts that were subject to a gift tax in one jurisdiction and later moves to a jurisdiction that imposes an estate tax on death, double taxation may arise. The U.S. has considered this problem but has decided that it appears too difficult to cover comprehensively in a model estate tax treaty. See discussion of Article 9 in the Technical Explanation of the United States Model Estate and Gift Tax Treaty. The OECD, on the other hand, attempts to deal with the problem by requiring the decedent's state of domicile to give credit for the gift tax paid to the former state of domicile. The issue is very complicated and any attempt to resolve it must deal with credit versus exemption systems, countries do not tax gifts, timing of the gift and the change in domicile. Art. 9, OECD Model Estate Tax Treaty and Commentaries, paragraphs 40-69.