U.S. Expatriates and The World of Estate Planning

R. Scott Jones, Esq.*

None of us is immune to the challenge of trying to understand the ever-changing tax picture that confronts U.S. Citizens living, working and investing domestically. The nuances and burdens of Alternative Minimum Tax, evolving State tax laws and the estate tax landscape in flux are all but examples of this phenomenon. U.S. expatriates, however, remain subject to all such basic rules while abroad (based upon the principle of taxability founded on U.S. Citizenship), but are also impacted by rules specific to their status as expatriates, in addition to being subject to foreign tax laws. In this way, an already complex tax profile can become thoroughly confusing! Understanding the interaction of these various tax rules, however, is critical to managing tax exposure and to avoiding double taxation.

But, let us step back for a moment. Where does (or should) tax planning fit in the overall scheme of concerns for a long-term U.S. expatriate or U.S. investor in foreign markets?
In this author's long-held view, an area that is often overlooked by U.S. expatriates and their advisers – in part due to the ever-pressing needs of dual-country, complex income tax compliance requirements – is the wider, and potentially much more significant issue of estate planning in the cross-border context. In a sense, one can see income and estate tax issues as a sub-set of a far broader spectrum of estate planning concerns. Unfortunately, many find themselves bogged down in the annual (and growing) thicket of income tax compliance, while missing the bigger picture.

Unquestionably, this can be a major mistake, as understandable as it may be. Since the notion of estate planning in the international context embraces an even greater number of important legal issues beyond simply taxation, this outline is intended to provide merely an overview of the key considerations at hand.

International Legal Systems

Perhaps the most fundamental issue to recognize is that very often a U.S. expatriate may become impacted by the legal system of a jurisdiction that operates very differently from that which applies in the majority of States within the United States. And so the first principle of estate planning reveals itself – it is generally State law that governs legal entitlement in the United States. Federal taxation will first take its cue from State principles as to ownership and beneficial entitlement.**1**

So, what about the international dimension?

The United States as a whole is generally a "common law" jurisdiction founded on legal principles originally developed in the United Kingdom and, today, still enshrined in legal systems of many other countries such as Australia and Canada, among others. Common law refers to the law and corresponding legal system developed through decisions of courts and similar tribunals (called case law), rather than through legislative statutes or executive action.

In contrast, many countries adopt a “civil law” system, more given to codification of their laws in legislation, and, in this context, often do not recognize some of the legal constructs that inform *our* system. Examples are France, Italy, the Netherlands, Spain and various Latin American countries. There are also further variants on this model in Germany, Japan and the Nordic countries. To further complicate matters, there are elements of the “civil” system in some of the United States also! For example, the principle of community property – the notion that most property acquired during marriage (except for gifts or inheritances) is presumptively owned jointly by both spouses and is divided upon divorce, annulment or death - is a civil law notion and applies in a number of U.S. States, such as California and Texas, as well as in many civil law countries. These are not the only international systems. Sharia law (the Islamic law system) has its own distinct characteristics and is arguably more akin to the common law system in its reliance on the application of legal interpretation.

One might reasonably ask, what is the significance of all of this?

The answer, broadly speaking, is that the possible divergence between legal systems affecting a U.S. expatriate in the estate planning arena can very often cause complications when planning for international moves and, at a minimum, needs to be carefully considered based upon the particular fact pattern.

Succession Law

Ultimately, estate planning centers on the conservation and devolution of assets to successive generations and other beneficiaries. Whether one can ensure that such beneficiaries are those intended is a question of control and which, as a principle, tends to carry more weight in common law jurisdictions than civil law regimes.

Those originating from common law States in the United States, for example New York, may be unpleasantly surprised to find that their accustomed freedom to pass assets with relatively few restrictions – including by Will and in *trust* – may not be recognized in the local jurisdiction on a number of fronts.

We have mentioned community property already. Community property principles may impact marital entitlement both in life and death. Equally importantly, however, forced heirship (succession) rules determining automatic entitlements of children of the deceased, for example, in Italy, and the general lack of recognition of trust vehicles as a whole in civil law jurisdictions (with some variants), represent significant departures from common law principles.

Indeed, in many civil law countries, it is unusual to form a Will at all since succession is generally determined based upon legal principle as opposed to individual choice, and, at best, there is very limited application for arrangements in trust.

Trusts In Focus

Broadly stated, a trust is an arrangement wherein a legal entity holds title to property for the benefit of one or more other persons or entities. Trusts are a creation of English law and its derivation, the common law system throughout the world, is replete with various forms. Trusts can be extremely useful tools to achieve one's intended purpose and, in the area of estate planning, also carry advantages of flexibility, privacy and incontestability since, unlike Wills, they are not required to be probated – or "proven" – in court upon death. As stated, however, civil law jurisdictions generally do *not* recognize these arrangements.

Some civil law countries are signatories to the 1985 Hague Convention on the Law Applicable to Trusts and Their Recognition. This does not necessarily mean, however, that, beyond recognition of the existence of trust arrangements, that such a country embraces the concept as part of its own domestic law! Certain countries may partially embrace the trust concept (or a variant thereof), but as a general proposition the legal effect of such an arrangement at minimum requires validation. Clients with trust arrangements already in place may find them wholly ineffective as regards the laws applicable in the host country. Transfers to and from trust arrangements may cause titling issues and costly transfer taxes that will likely not apply at home. Moreover, there may also be unintended income tax consequences to those gifting assets to such trusts – whether revocable or not - as a result of their non-recognition. Indeed, such issues may not be restricted to civil law jurisdictions either. For example, Australia, Canada and Ireland may present tax problems with respect to such trust planning. The time-honored adage of "best-laid laid plans of mice …." comes to mind.

But is it *all* problematic? Not necessarily. In fact, the relevance of the difference in approach in the host country, for example with respect to the trust concept, first springs from the threshold question as to which jurisdiction's law even applies to the U.S. expatriate or assets involved.

This is particularly relevant in the context of either moving one's permanent home (known as "domicile") or citizenship to such a legal jurisdiction, or otherwise purchasing real estate or business assets in such a host country. However, the adjudication as to which laws apply is known as the concept of private international law – or the "choice of law".

<u>Choice of Law</u>

Navigating one's way through choice of law provisions is not an exercise for the faint-hearted. It can be a complex matter depending upon the approaches taken by the respective jurisdictions, the types of assets involved and how they are titled.

Under United States law, whether one dies with a valid Will in place or not (i.e. dies intestate or not), regarding *real estate* matters, in general the law of the jurisdiction in which land is located will determine how the entitlement to the land is passed. On the other hand, the disposition of *personal* property will be determined by the law of the state of the individual's *domicile* (i.e. permanent home) on his or her death.**2**

Many civil law countries, however, base their choice of law rules in succession law matters on the decedent's *citizenship* as opposed to the decedent's domicile.

For example, if such a person owns real property in Spain, the U.S. choice of law rules would generally provide that Spanish law should apply to succession law matters related to that real property. Spanish conflicts law, however, generally provides that the law of a decedent's nationality controls all succession law matters.

Somewhat paradoxically in this context, although France is, in fact, the source of much of the world's modern civil law, this country relies on "domicile" in its choice of law on succession law matters, as does Belgium. France and Belgium also follow the common law system's choice of law paradigm that the law of the location of real estate property governs succession law matters related to such assets.

Naturally, given that the world is neither flat nor uniform, *conflicts* between choice of law rules can also occasionally arise. A U.S. citizen and domiciled individual who owns real property located in a civil law country that follows a nationality principle in choice of law rules comes to mind…..

So, what happens in the case of such a conflict of laws?

Conflicts between jurisdictions at to which laws apply and the substance of their respective laws can often trigger a referral mechanism called *renvoi* (from the French, meaning "send back"). In the United States, r*envoi* arises when the conflict rules of a U.S. State direct that a U.S. court shall consider a matter by reference to the "law" of another jurisdiction. While the complex mechanics of *renvoi* are beyond the scope of this article, essentially the purpose of the rule is to prevent "forum shopping" (i.e. to prevent laws being selected simply by reference based upon the most desirable outcome).

As a general matter, the United States does *not* follow the doctrine of *renvoi* as it can lead to yet further unpredictable results!

However, an exception to the general rule of no *renvoi* in U.S. courts involves succession law matters related to foreign real estate owned by US nationals. Under the U.S.

approach, when a succession law matter related to foreign real property owned by a U.S. decedent is litigated in a U.S. court, the court is likely to apply what scholars refer to as "*double renvoi*." As such, the U.S. court would attempt to decide the case in the same manner as a court in the other country, applying both the *actual law* and the *choice of law* rules of that country – but this is, in part, reliant upon the jurisdiction accepting *renvoi* from the United States.**3**

Germany, for example, will accept *renvoi*. Therefore, if a U.S. citizen domiciled in Germany owns real estate assets in Germany, German law initially refers to U.S. law with respect to succession law issues related to the property on principles of citizenship. A U.S. court, however, would refer to German law under U.S. choice of law rules. A German court should accept this reference and apply its own law with respect to the real property. Thus, a transfer of German real estate at death would be subject to German forced heirship (succession) rules.

Formal Validity of Wills

A further very basic issue to consider is whether another jurisdiction considers one's Will to have been validly executed, and so respects it as being valid (to the extent it has a bearing in the first instance). This is an issue familiar to lawyers who practice in the United States because each state has similar, but not identical, requirements for the execution of a Will and how to prove the due execution of the Will in a probate proceeding. If a Will is considered formally invalid, a U.S. court will not allow the Will to be probated – and so it is true for foreign jurisdictions also.

Fortunately, such questions can often be resolved in this area because of two multilateral conventions: The Convention Providing a Uniform Law on the Form of an International Will (known as "The Washington Convention") and the Hague Convention Relating to the Form of Testamentary Dispositions.

These conventions stipulate certain elements as to the form and formation of Wills in other jurisdictions in order for them to be considered valid in the local jurisdiction. As such, these conventions can provide for the automatic recognition of the formal validity of an "International Will." It is, of course, important to ensure this issue is reviewed.

Multiple Wills

Even if one already has a Will, a further question arises when purchasing assets (particularly real estate) in a foreign jurisdiction, or making an indefinite move to the jurisdiction, as to whether to form an *additional* local Will. It may be advisable, for example, to effect a foreign Will that would govern ONLY real estate in the host country, while one's Will at home in the United States applies to all other assets and governs other issues such as guardianship. Such an arrangement may be respected under the choice of law rules for a U.S. expatriate to the United Kingdom, for example.

A local Will of this kind is often referred to as a “situs” Will. One advantage of such a dual arrangement is the removal of any concern that the home country Will may not be admitted into probate in the local jurisdiction (i.e. the introduction of a local Will introduces more certainty).

However, it is clearly somewhat more expensive in terms of professional fees to take such a dual-Will approach and is extremely important that effective co-ordination occurs between the home and host country Will provisions. Of particular note, it is imperative to ensure that effecting a local Will does not revoke home country arrangements if this is not the intent of the person forming the Will (testator). Even silence in the text on this issue may be deemed sufficient to revoke pre-existing Will arrangements. Care should also be taken as to how multiple Wills impact any apportionment of tax liabilities among beneficiaries. Lastly, since Wills are required to be probated upon death, consideration should be given as to whether the Wills are intended to be standalone with respect to separate assets or, rather, as inter-dependent documents and, as such, possibly both required to be probated in the same jurisdiction (this may defeat the purpose).

In-Life Planning Documents

There are two key planning documents, besides Wills, that are must-haves in one’s toolkit for effective planning.

The first is a power of attorney to be granted in favor of another individual to permit action on one’s behalf in a legal or financial matter. Generally, a power of attorney becomes ineffective if the grantor of the power dies or becomes incapacitated because of physical injury or mental illness. However, it is possible to specify that the power of attorney will continue to be effective even if the grantor becomes incapacitated (but then ends when the grantor dies). This is referred to as a *durable* power of attorney.

In addition, a health care directive empowers an appointed agent (proxy) of an individual to take health-care actions for the grantor who is no longer able to make such decisions, up to and including terminating care and "pulling the plug" on machines that may be keeping a critically and terminally-ill patient alive.

Both these documents can clearly be extremely important in their own right. Even in circumstances where such documents (if in place at home) are not legally binding in the host country, they may still be very persuasive as to intent. Otherwise, similar host country arrangements may be recommended and, at minimum, existing arrangements should be reviewed.

Estate and Gift Taxation

Last – but by no means least, what is “the bottom line”…..?

A U.S. citizen's worldwide estate is subject to U.S. gift tax in addition to estate tax upon his or her death. If the decedent's estate includes property located in or connected to a foreign country this will also be included.

If a decedent owned real estate located in a foreign country, for example, the decedent's executor should obtain an appraisal of the real estate value at death by an appraiser or other expert in that country.

Since the host country may impose estate tax similar to that in the United States (or other taxes, such as in inheritance or succession taxes, imposed on beneficiaries and which are typical of civil law systems), the estate of a U.S. citizen or resident decedent faces the possibility of double taxation. In many situations, however, U.S. tax law allows a credit for death taxes imposed in the foreign country that are substantially equivalent to an estate, inheritance, legacy or succession tax.

Not all estate and gift (transfer) taxation systems are created equal. Indeed, this tax map resembles somewhat of a patchwork quilt. For example, certain jurisdictions, such as Australia, Canada and China, do not impose estate taxes at all. Canada applies a deemed income tax on certain assets instead of an estate tax. New Zealand imposes a gift tax but has no estate tax. Certain countries may permit the tax-free transfer of assets between spouses, but such rules may not apply to non-citizens or persons not domiciled in the country and, as a result, may impact the overall tax burden on an estate. These are just some of the variations that can be encountered.

Moreover, civil law jurisdictions generally do not apply the concept of estate tax. In general, tax is not imposed on the estate itself as a function of its value at death but, rather, the beneficiaries pay some form of income or "succession" tax. In some cases, such as in Spain and Japan, tax is based upon the residency or citizenship of the beneficiary. In other instances, the status of the decedent may be relevant but with tax still imposed upon beneficiaries. In other words, the permutations can be endless…..

Estate Tax Treaties

In an effort to smooth the interaction of the respective countries' gift, estate and inheritance tax laws, the United States also has estate tax treaties with the following countries: Australia, Austria, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland, and the United Kingdom. This is actually a relatively small group – compare this to the 60 plus *income tax* treaties with the United States that are in existence.

Even these estate and gift tax treaties can vary considerably in their provisions as to the taxability of assets between treaty partners and the various deductions and exemptions available to taxpayers. However, between treaty partners, generally the newer treaties accord the taxing right of all assets of U.S. citizens to the United States with the exception of real estate and business interests located in the host country.

Conclusion

And so…let's take a break here!

While not the focus of this discussion, there are further issues such as the treatment of income from foreign estates and trusts and the related disclosure requirements. These provisions are also similarly complex even under U.S. domestic law provisions. Coordinating these rules with foreign provisions related to the same income, while utilizing the appropriate income tax treaty network, we'll leave as a challenge for another day….

1 Morgan v. Comr 309 U.S. 78, 80 (1940)

2 In a famous case, however, a New York court held that a New York choice of law provision actually made in a U.S. Will of a U.S. Citizen that had become a *French* domiciliary trumped French law that would have made the US Will inapplicable. In *In re Estate of Renard*, 437 N.Y.S.2d 860 (Surr. 1981) *aff'd.* 447 N.Y.S.2d 573 (App. Div. 1981) *aff'd.* 439 N.E.2d 341 (N.Y. 1982), the court felt that the French forced heirship laws conflicted too egregiously with New York's principle of testamentary freedom and determined that the deliberate selection by the testator of New York law should override French choice of law rules.

3 There is little legal authority concerning *renvoi* in this context in the United States. The principal U.S. case involving *renvoi* in succession law matters is *Accounting of Schneider*, 96 N.Y.S.2d 652 (Surr. 1950). The Surrogate's Court for New York County considered whether to apply Swiss or New York law with respect to a succession law matter related to the proceeds from the sale of a decedent's Swiss real estate. The court felt that it should apply the law that a Swiss court would apply. The court noted that Switzerland followed the nationality principle in succession law matters and would not accept the *renvoi* from New York, however. Accordingly, the court applied New York law to determine the parties' rights in the proceeds.

***** R. Scott Jones, Esq. is a partner with New York law firm Goldstein Jones LLP.