Taxation of cross-border inheritances and donations: suggestions for improvement

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CHAPTER 4

Separate solutions at the OECD level

It was previously argued that it could hardly be denied that an updated and watertight OECD IHTMTC would serve as a useful tool in dealing with some or most of the aspects of the problems of cross-border death and gift taxation. I observe, however, that the update work requires a benchmark. In my view, a model that is in line with (some of) the elements of this benchmark seems to address the problems of cross-border inheritances and donations in a more comprehensible manner (considering the objectives of the OECD IHTMTC) than a model that is not in line with (some of) these elements.

4.1 Introduction

In dealing with the suggested improvements to certain provisions of the model for the addressing of the problems of cross-border inheritances and donations, a benchmark is necessary. In that regard, I observe that the OECD IHTMTC does not have a concrete benchmark. However, if one reads between the lines of OECD IHTMTC and its Commentary, it could be argued that certain principles of death and gift tax laws can be identified. More specifically, as the OECD IHTMTC reflects the principles of death and gift tax laws of the majority of the OECD member countries, I argue that such a benchmark can be found only within the system that the OECD has introduced, namely the OECD IHTMTC and its Commentary. *This is the reason why the justifications of death and gift taxation (section 2.4), cannot operate as a whole as a benchmark*; they are *exogenous* to the system which the OECD IHTMTC has introduced. More specifically, they refer to existing inheritance and gift tax laws whereas the model applies, in my view, to one concept of an inheritance and gift tax. I decide to call this concept "the proposed inheritance and gift tax" which is the result of compromises among the OECD member countries.

Furthermore, I argue that the proposed inheritance and gift tax does not oblige the states to introduce a death and gift tax liability as this would be contrary to their fiscal sovereignty. The proposed inheritance and gift tax is merely a concept that consists of elements collectively assessed by those who drafted the OECD IHTMTC.

It is also important to note that the fact that a model does not meet (some of) the elements of the benchmark does not automatically mean that it becomes ineffective or a "bad model". However, a model that is in line with the elements of this benchmark seems to address, in my view, the problems of cross-border inheritances and donations in a more comprehensible manner (considering the objectives of the OECD IHTMTC) than a model that is not in line with (some of) these elements.

In the course of my research, I discovered that the proposed inheritance and gift tax consists of the following elements: a) *mortis causa* or *inter vivos* taxation, b) the windfall

justification, c) the definition of critical terms in accordance with civil law and d) the ability-to-pay-taxes justification.

4.2 The four elements of the proposed inheritance and gift tax

4.2.1 Mortis causa or *inter vivos* taxation

The first element of the proposed inheritance and gift tax is its *mortis causa* or *inter vivos* imposition. More specifically, the proposed inheritance and gift tax is levied *by reason of (the event of) death or a donation* to the exclusion of other events that may trigger taxation.

The importance of the *mortis causa* or *inter vivos* imposition as an element of the proposed inheritance and gift tax is first derived from Article 2 of the OECD IHTMTC. This Article defines the taxes to which the model applies. Under Article 2(1), "[t]his Convention shall apply to taxes on estates and inheritances and on gifts imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied." Paragraph 2 defines the term "taxes on estates and inheritances and on gifts". More specifically, "there shall be regarded as taxes on estates and inheritances taxes *imposed by reason of death* in the form of taxes on the corpus of the estate, of taxes on inheritances, of transfer duties, or of taxes on donationes *mortis causa*. There shall be regarded as taxes on gifts taxes imposed on transfers *inter vivos* only because such transfers are made for no, or less than full, consideration." (Italics, VD).

By using the phrase "by reason of death", Article 2 draws, in my view, a distinction between the event of death and the taxable event of death, for example, the enrichment of the beneficiary upon the person's death or the mere *mortis causa* transfer of property. The latter event seems to be immaterial for a tax to fall under Article 2 and therefore, also for the benchmark of the proposed inheritance and gift tax. Similar considerations apply to gift taxes.

The importance of the above distinction can also be derived from Article 9B(1) (credit method) of the OECD IHTMTC which reads as follows: "[t]he Contracting State in which the deceased was domiciled at his death, or the donor was domiciled at the time of the gift, shall allow as a deduction from the tax calculated according to its law an amount equal to the tax paid in the other Contracting State on any property which, *in relation to the same event* and in accordance with the provisions of this Convention, may be taxed in that other State." (Italics, VD). It follows that, since the tax credit shall be granted for taxes levied "in relation to the same event", the mere imposition of a tax in the event of death or donation suffices, in principle, for such a credit to be granted.

Furthermore, the *property* on which the proposed inheritance and gift tax is levied would seem to be immaterial as derived from Article 2 of the OECD IHTMTC. More specifically, it seems to be irrelevant whether the tax is levied on the corpus of the estate as a whole or parts of the estate as devolved on the different beneficiaries. The proposed inheritance and gift tax thus incorporates any death and gift tax regardless of its name or the property on which it is levied on the condition that the other three elements of the benchmark are present. Consequently, the proposed inheritance and gift tax includes, in principle, death taxes such as inheritance taxes, estate taxes, *mortis causa* income taxes, capital gains taxes and taxes on donations *mortis causa*. Likewise, the proposed gift tax includes gift taxes, income taxes on gifts or any other tax that is imposed on *inter vivos* transfers.

Furthermore, both *donor-based and donee-based taxes* seem to fall under the scope of the benchmark of the proposed inheritance and gift tax.[1] This seems to be contradictory to Article 1 of the OECD IHTMTC that reads as follows: "This Convention shall apply: a) to estates and inheritances where the deceased was domiciled, at the time of his death, in one or both of the Contracting States, and b) to gifts where the *donor* was domiciled, at the time of the gift, in one or both of the Contracting States." (Italics, VD). Nevertheless, the suggestion of a subsidiary taxing right provision as laid down in paragraphs 70-72 of the Commentary on Articles 9A and 9B in conjunction with paragraphs 5-7 of the Commentary on Article 7 of the model confirms, in my view, that both types of taxes fall under the scope of the benchmark. However, I note that it follows from Article 1 of the model and the subsidiary taxing right provision that donor-based taxes take priority over donee-based taxes.

Finally, I note that the *starting point of taxation* seems to be immaterial for the application of the proposed inheritance and gift tax.[2] Nevertheless, I observe that starting points of taxation that reflect a degree of integration of the person with the community of a state take priority over starting points of taxation that do not (always) reflect such degree of integration. This is reflected in paragraph 1 of the Commentary on Article 1 of the OECD IHTMTC that reads as follows: "[M]ost Member countries take the view that it is preferable to limit the scope of a double taxation convention by reference to the property of persons who are either domiciled in or are residents of, one or both of the Contracting States. It is considered that, by taking part in the economic life of the State where he has settled, *although not possessing its nationality*, and by contributing to the public expenditure there like a citizen of the country, the deceased will normally have become sufficiently integrated in the community for it to be proper for him and his heirs to benefit from any international conventions for the avoidance of double taxation which may be concluded by his State of domicile." (Italics, VD). It can be derived from the above section of the Commentary that those who drafted the OECD IHTMTC considered that residence and domicile indicate a degree of integration with the community of the state while nationality not (or at least, not in all cases). Therefore, nationality does not form a *primary* criterion for the establishment of the term "fiscal domicile".

Nevertheless, nationality forms part of the *subsidiary* taxing rights provision. Concerning these rights, paragraphs 70-72 of the Commentary on Articles 9A and 9B in conjunction with paragraphs 5-7 of the Commentary on Article 7 of the model, allow states to depart from the rules of the OECD IHTMTC where there is a "compelling reason" to do so. Such a compelling reason can be the establishment of taxing rights under different rules and concepts than those endorsed in the model or addressing of tax avoidance where the deceased, in contemplation of death, or the donor, in contemplation of making a gift, moves his domicile to the other state with the intention of escaping taxation by his former state of domicile. In such a case, states can maintain their subsidiary taxing right on the grounds of the nationality/secondary domicile of the deceased or donor or the domicile/nationality of the heir, legatee, or donee for a limited period only, and in any event, not longer than ten years after the deceased or the donor has ceased to be domiciled in their territory."

1 On the distinction between donor-based and donee-based taxes, I refer to section 3.1.1.2 of this study.

2 I refer to section 3.1.1.1 in which I explain the concept of the starting point of taxation.

The *mortis causa* and *inter vivos* imposition is an important element of the proposed inheritance tax given the possible overlaps between the OECD IHTMTC and the OECD ICTMTC and the application of the OECD IHTMTC to different types of death taxes.

4.2.2 The levying of the tax on windfalls

The second element of the proposed inheritance and gift tax benchmark is the windfall justification. More specifically, the proposed inheritance and gift tax is levied on the unearned advantage, the "windfall" which the recipient receives without contributing to it. Furthermore, the proposed inheritance and gift tax applies at a progressive rate based on both the size of the *mortis causa* or *inter vivos* transferred property and the kinship between the parties involved. As noted in section 2.4.2, progression based on the kinship between the parties involved shows that it considered it fair if states tax incidental and unexpected receipts of wealth and at the same time protect the family property when received by family members. Therefore, the windfall justification dictates that states should tax a *mortis causa* transfer of property (because it is unexpected) but they should also take into account possible family property considerations (that make a *mortis causa* transfer of property less unexpected when received by family members who apparently have contributed to the accumulation of this property). In that regard, I noted that the granting of subjective tax exemptions/deductions to close relatives and the determination of the applicable inheritance and gift tax rates based, *inter alia*, on the kinship between the deceased/donor and the beneficiaries/donees serve as two important indications that confirm the windfall justification.

The recognition of the windfall justification as an element of the proposed inheritance and gift tax can be derived from several Articles of the model and its Commentary. The definition of the "taxes on gifts" in Article 2(2) of the OECD IHTMTC is illustrative: "there shall be regarded as taxes on gifts taxes imposed on transfers *inter vivos* only because such transfers are made for no, or less than full, consideration." In other words, gift taxes are taxes that are levied on the *inter vivos* received windfalls, for which the recipients have made no, or less than full, consideration. In the same vein and although the Commentary on Article 2(2) does not define the terms "estate" and "inheritance", one can easily observe that taxes on estates and inheritances are imposed on transfers *mortis causa* for which no, or less than full, consideration was paid.

Furthermore, the Commentary on Article 9A (exemption method) implicitly refers to the windfall justification concerning the treatment of special deductions granted by the Contracting States. Under paragraph 26 of the Commentary on Article 9A of the model, "[d]ifficulties may arise because the laws of most States provide for special deductions from the net amount of the estate or gift, or from specific items of the estate or gift, on the *relationship* between the deceased or the donor and the heir, legatee, or donee." (Italics, VD). The reference of the Commentary to these deductions shows, in my view, that the windfall justification is an important element of the proposed inheritance and gift tax on which the OECD member countries agreed. On the other hand, the OECD IHTMTC does not make direct reference to the determination of the death and gift tax rates based on the kinship between the parties involved, which often serves as another indication of the application of the windfall justification. Yet, the example of paragraph 79 of the Commentary on Articles 9A and 9B on the application of the credit method by Contracting States applying different

forms of death duties is built on the premise that different rates apply to the acquisition by each beneficiary: "the rates of tax in the State which levies the inheritance tax are 5% for the wife, 10% for the son and 15% for the mother."

The recognition of the windfall justification as the second element of the proposed inheritance and gift tax benchmark limits in a way the broad scope of the first element of the benchmark. More specifically, the proposed inheritance and gift tax includes all *mortis causa* or *inter vivos* levied taxes that are levied on the whole amount of the transferred windfall. Conversely, the proposed inheritance and gift tax does not include those taxes that are not levied on the whole *mortis causa* or *inter vivos* transferred or received windfall. As a matter of example, the *mortis causa* levied capital gains tax that is not levied on the whole amount of the gain received does not seem to be consistent with the suggested benchmark, as explained in section 6.1.4.

4.2.3 The definition of critical terms by civil law

The third element of the benchmark of the proposed inheritance and gift tax is the definition of some critical terms for its imposition in accordance with civil law (family law, matrimonial property law and the law of succession). The OECD IHTMTC Commentary already acknowledges the connection of the existing inheritance and gift tax laws with the applicable civil laws in several sections. For example, paragraph 1 of the Commentary on Article 4 of the OECD IHTMTC states that "[i]n some Member countries estate and gift taxes are based on "residence" and, for them, "residence" has virtually the same meaning as "domicile". In others, especially those whose legal system is based on English common law, these taxes are based on "domicile" which in those countries has a different meaning from residence, domicile denoting a more lasting connection with the country concerned." I also observe that the applicable civil laws often define the terms "residence" and "domicile". There are also other terms, which are defined by the applicable civil laws, such as "death", "estate", "heirs/beneficiaries", "surviving partner", "habitual abode", "permanent home", "movable property", "immovable property" and "receivable".

Furthermore, paragraphs 14-35 of the Commentary on Article 1 of the OECD IHTMTC refer to several legal arrangements, which may be employed in the law of succession: trusts in common law jurisdictions and foundations, fideicommissum and usufruct in civil law jurisdictions. These are the so-called "special features of the domestic law of the Contracting States". The application of the OECD IHTMTC to these arrangements is sometimes difficult, especially concerning property transfers from and to the legal arrangement at hand. Nevertheless, the mere reference of the Commentary to these arrangements shows, in my view, that the OECD member countries acknowledged the connection of death and gift taxes with civil law. Finally, under paragraph 29 of the Commentary on Article 1 of the OECD IHTMTC, "[d]ue to the differences in the civil and taxation laws of Member countries, it was not possible to insert in the Convention provisions which would be acceptable to all States." It can be concluded from the above that those who drafted the OECD IHTMTC and the OECD member countries acknowledged the connection of death and gift taxes with civil law. Such a connection, therefore, serves as the third element of the proposed inheritance and gift tax.

This element is particularly important with regard to problems arising from the special features of the domestic laws of the Contracting States and the conflicts of qualification with regard to rights or entities.

4.2.4 The ability-to-pay-taxes justification

The fourth element of the proposed inheritance and gift tax benchmark is the ability-to-pay-taxes justification. The *mortis causa* or *inter vivos* transfer of property increases the beneficiaries' financial capacity and, thus, their ability-to-pay-taxes. The ability-to-pay-taxes justification explains the imposition of the proposed inheritance and gift tax at progressive tax rates depending on the size of the acquisition. On the contrary, it does not justify progression based on the kinship between the parties involved that is explained by the windfall justification instead. For this reason, I argue that it should not be considered a primary justification of death taxation. Nevertheless, it seems that those who drafted the OECD IHTMTC considered the ability-to-pay-taxes justification when drafting the OECD IHTMTC.

The recognition of the ability-to-pay taxes justification as the fourth element of the proposed inheritance and gift tax can be derived, for example, from paragraph 3 of the Commentary on Article 9A of the OECD IHTMTC that refers to the application of the progression with exemption method. More specifically, under paragraph 38 of the Commentary on Article 9A of the OECD IHTMTC (exemption method), "[t]he question of preserving the progressive tax rate may also arise for the State which is not the State of domicile even though the Convention limits the taxation right of that State to property falling under Articles 5 and 6. This may happen for a number of reasons: because the domestic law of that State provides for *a progressive tax rate by reference to the total value of all taxable property* situated in its territory, or even by reference to the total value of the estate or gift, or when, in the absence of the Convention, that State would have had the right to tax the total estate or gift and, consequently, at the *rate of tax appropriate to that total* (such a situation is most likely to occur in those States which have a comprehensive right to tax on the basis of the nationality of the deceased or donor or the domicile or nationality of the heir)."(Italics, VD)

Furthermore, under paragraph 43 of the Commentary on Article 9B of the OECD IHTMTC (credit method), "[i]t is not necessary to have a clause maintaining the right of the State of domicile to calculate its tax at a *progressive rate*. Article 9B implies, in fact, that this State may also, if its domestic law entitles it to do so, tax property falling under Articles 5 and 6. The Convention thus does not lead to any modification in the rate of the tax calculated on the total estate according to the law of the State of domicile." (Italics, VD)

4.3 Conclusion of Chapter 4

In this chapter, I presented the benchmark of the update work. As the OECD IHTMTC reflects the principles of death and gift tax laws of the majority of the OECD member countries, I argued that such a benchmark could be found only within the system that the OECD has introduced, namely the OECD IHTMTC and its Commentary. I called this benchmark "the proposed inheritance and gift tax" and observed that it consists of four elements: the *mortis causa* or *inter vivos* levying of the tax, the windfall justification, the definition

of critical terms in accordance with civil law and the ability-to-pay taxes justification. In that regard, it is important to note that the fact that a model does not meet (some of) the elements of the benchmark does not automatically mean that it becomes ineffective or a "bad model". However, in my view, a model that is in line with (some of) the elements of this benchmark does seem to address the problems of cross-border inheritances and donations in a more comprehensible manner (considering the objectives of the OECD IHTMTC) than a model that is not in line with (some of) these elements.

The first element of the proposed inheritance and gift tax is its *mortis causa* or *inter vivos* imposition. More specifically, the proposed inheritance and gift tax is levied *by reason of (the event of) death or a donation* to the exclusion of other events that may trigger taxation. On the contrary, the taxable event, the taxable property, the taxable person and the starting point of taxation seem to be immaterial as derived from Articles 2 and 9B (1) of the model. Nevertheless, I note that donor-based taxes seem to take priority over donee-based taxes. In the same vein, starting points of taxation that reflect a degree of integration of a person with the community of a state seem to take priority over starting points of taxation that do not reflect such a degree of integration.

The levying of the tax on the *mortis causa* or *inter vivos* transferred or received windfalls serves as the second element of the benchmark. More specifically, the proposed inheritance and gift tax is levied on the unearned advantage, the windfall that the recipient receives without contributing to it. This can be derived from Articles 2(2) and Commentary on Article 9A of the model.

The third element of the benchmark of the proposed inheritance and gift tax is the definition of some critical terms for its imposition in accordance with civil law (family law, matrimonial property law and the law of succession). The Commentary on Articles 1 and 4 of the OECD IHTMTC already acknowledges the connection of the existing inheritance and gift tax laws with the applicable civil laws in several sections.

Finally, the fourth element of the proposed inheritance and gift tax benchmark is the ability-to-pay-taxes justification. The *mortis causa* or *inter vivos* transfer of property increases the beneficiaries' financial capacity and, thus, their ability-to-pay-taxes. The recognition of the ability-to-pay taxes justification as the fourth element of the proposed inheritance and gift tax can mainly be derived from the Commentary on Article 9A of the OECD IHTMTC, which refers to the application of the progression with exemption method.

In the following chapter, I will discuss the provisions of the OECD IHTMTC and its Commentary that, in my view, can be improved having regard to the objectives of the OECD IHTMTC and the proposed inheritance and gift tax, concerning each separate problem of cross-border death and gift taxation.