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Impact of marital property and forced heirship regimes on US/UK estate planning

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P.C.B. 98 *This article considers the impact of the Swiss marital property regime and Irish spousal succession rights on estate planning for US/UK couples with connections in these jurisdictions or in jurisdictions with similar regimes.*

In a complex and globalised world we have many different regimes for taxing wealth that passes gratuitously, whether by lifetime gift or by inheritance on death. Broadly, these regimes can be divided into donee-based regimes and donor-based regimes. The United States and the United Kingdom have donor-based regimes[1] whereby the domicile of the donor will determine whether a gift or inheritance is within the US federal estate tax/UK IHT charge. This is why US and UK estate planning very often involves the use of appropriately drafted trust structures, created both during lifetime and on death, that are designed to enable a US or UK domiciliary to enjoy assets during their lifetime without them being in their estate for US and/or UK purposes, as the case may be, on their deaths. However where the estate planner wishes assets to pass to a trust structure on death he (or she) needs to be sure that:

• the donor is capable of leaving these assets, having regard to any applicable marital property regimes affecting him; and

• where applicable, the surviving spouse and/or children do not have any absolute indefeasible succession rights that will treat a portion of the assets as being in the estate of the surviving spouse and/or children.

P.C.B. 99 The authors have come across these issues on a number of occasions when dealing with clients affected by the Swiss and Irish succession regimes, although the principles discussed in this article have general application for US and UK estate planning.

The Swiss marital property regime

Where spouses marry abroad and subsequently move their residence to Switzerland, they have to be careful as Swiss law is likely to be applicable to their marital property--with retroactive effect to the date of the marriage!

Under Swiss law, spouses may enter into a marriage agreement which provides that their marital property relationship will be governed either by the “separation of property” regime (*séparation de biens*) or by the “community of property” regime (*communauté de biens*). Such an agreement has to be made in the form of a notarised deed and may be entered into by the spouses either before the wedding or at any time during the marriage.

Under the “separation of property” regime, each spouse remains the owner of his or her assets (gifts, inheritance, salary, etc.) acquired before and during the marriage. At the end of the marriage, each spouse remains the owner of his or her assets. By contrast, under the community of property regime, the spouses' assets are divided into three parts: the common property and the own property of each spouse. The property held in common belongs to both spouses equally and in the case of death or divorce, each spouse has a right to half the common property.

In the absence of any marital or pre-nuptial agreement between the spouses, art.181 of the Swiss Civil Code (the SCC) provides that the “sharing of acquired property” regime (*participation aux acquets*) is to apply. This regime provides that each spouse owns the assets he or she acquired prior to the marriage as well as those received by way of gift or inheritance during the marriage. Upon termination of the marriage (by death or divorce), the net value of the assets acquired during the marriage will be split between them equally.

Spouses have the option to elect a law to govern their marital property under art.52 of the Swiss Private International Law Act (SPILA).

In short, therefore, a non-Swiss couple living in Switzerland has the following three options available to them:

1. adopt either the separation of property regime or community of property regime to apply to the distribution of their Swiss marital property by entering into a marriage agreement;

2. sign a written declaration in which they elect that the law of another country will apply to their marital property (their choice of which country to elect is limited as explained below); or

3. do nothing and automatically become subject to the “sharing of acquired property” regime.

Swiss forced heirship rules

On death, the marital property regime under which the spouses were married has to be dissolved first. Only then will the deceased spouse's assets form part of his or her estate to be distributed. A testator may freely dispose of his assets within the rules on forced heirship rights, protecting the so-called compulsory portion of close relatives. The compulsory portion is calculated as a specific percentage of the estate which the heir would have received under the Swiss intestacy rules. Any attempt by a testator to disregard these fixed rights can be met with claims by the disadvantaged heirs for their share.

**P.C.B. 100 Practical application*

The example below illustrates the practical application of the Swiss rules on US/UK estate planning.

Sarah is an Irish domiciled, UK deemed domiciled wealthy hedge fund manager. She and her husband Simon, a UK deemed domiciled US citizen, and their two US citizen children have moved to one of the Swiss cantons under a forfait agreement.[2] While UK resident, Sarah and Simon's income tax and estate planning strategy was based on avoiding the holding by Simon of any assets in his name in order to avoid a US income tax exposure and consequent reporting obligation. After completing four consecutive tax years outside the United Kingdom, Sarah and Simon will cease to be UK deemed domiciled.[3] Nonetheless, Sarah will continue to have an exposure to IHT as she has a substantial UK home in her name.[4] Absent Swiss and Irish issues, a sensible estate plan for Sarah would be to leave the residue of her estate on a life interest trust for Simon with an overriding power of appointment, with appropriate US restrictions included, so that the assets in the trust fund do not form part of Simon's estate (or the children's estates) for the purposes of US estate tax. The life interest trust would carry the UK spouse exemption to the extent that Sarah is deemed domiciled or has UK assets. If she dies after she has shed her UK deemed domicile the non-UK assets in the life interest trust should constitute excluded property for the purposes of IHT. As the trust fund is also outside the beneficiaries' estates for US estate tax purposes, the trust property can be passed down the generations and avoid estate taxes in both countries.

Potential problems

In the absence of any action taken by Sarah and Simon in respect of their Swiss marital property, the “sharing of acquired property” regime, as explained above, is deemed to apply under art.181 of the SCC. In addition, as Sarah is domiciled in Ireland, the Irish Succession Act 1965 s.111 needs to be considered. This provides that where an Irish domiciled testator leaves a spouse and children, the surviving spouse has a right to elect to receive one-third of the testator's estate (known as the “legal right share”).

The effects of both of these statutory provisions are potentially disastrous because they could prevent property from ever passing into the tax sheltered life interest trust. Moreover, if Simon predeceased Sarah, Swiss forced heirship rules could operate to pass the compulsory portions into the estates of the children for US tax purposes.

Solution

As mentioned above, SPILA art.52 provides that the marital property regime shall in principle be governed by the law chosen by the spouses. However, their choice is limited to the country of their common residence, the law of the country of their future residence after the marriage, or the law of the country of nationality of one of the spouses. Under SPILA art.53 such a declaration must be made in writing (or it must result "with certainty" from the provisions of a marital property agreement). Simon and Sarah are advised to make an election under SPILA art.52 for Irish law to apply to the distribution of their Swiss marital property. As Sarah is an Irish national, Irish law can apply to govern the distribution of their Swiss marital property in the event of death or divorce.

P.C.B. 101 Although the election under SPILA art.52 deals with the distribution of marital property, it does not apply to the entirety of Sarah's estate on her death. Under SPILA art.90, the estate of a person who had his or her last residence in Switzerland is governed by Swiss law. However, pursuant to art.90 II, a foreign national living in Switzerland can make a Will and elect the law of his nationality to apply to his estate. Therefore Sarah can, by Will, submit her estate to Irish law provided the following conditions are fulfilled at the time of her death: (a) she is still an Irish national; (b) she has not acquired Swiss nationality; and (c) she is still resident in Switzerland.

The issue of Simon's legal right share under Irish law would have arisen anyway but it is even more evident since Sarah has submitted her estate to Irish law. The question that then arises is does Simon's absolute and indefeasible legal right share under Irish law mean that this is an asset of his estate or that his failure to elect for it after Sarah's death makes him a partial settlor of the life interest trust in Sarah's Will? The answer depends on the legal analysis of the spousal legal right share under Irish law and is beyond the scope of this article.[5] To avoid any doubt on the issue, Simon should renounce his rights to elect for his legal right share by executing a Deed of Renunciation. In order for this to be recognised, he will need to receive independent legal advice.

Finally the question arises as to whether Simon's renunciation of his legal right share amounts to a gift to a non-citizen spouse[6] for US tax purposes. The authors are not US tax attorneys but they have received an opinion from a US tax attorney to the effect that the renunciation should not amount to a gift provided that it is given for adequate consideration--the consideration in this case being the agreement by Sarah to leave the residue of her estate on life interest trusts for Simon.

Conclusion

Depending on the combination of residence, domicile, citizenship and situs, trusts can be a powerful tool for keeping assets outside beneficiaries' estates while permitting enjoyment during their lifetimes. In order for trust planning to be effective, it is an essential preliminary step to ensure that, having regard to any applicable forced heirship or marital property regimes, the intended assets actually make it into the desired trusts. Local advice should always be sought in any jurisdiction to which there are relevant connecting factors.

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1. Of course both countries also levy estate/IHT based on situs subject to possible treaty relief. It is nonetheless possible to circumvent the situs rules through holding companies incorporated in suitable third jurisdictions although the impact of this on other taxes would need to be considered. Accordingly whereas situs can be blocked, the impact of domicile always needs to be planned for.

2. Broadly, a forfait agreement is a forward tax agreement whereby the taxpayer pays a fixed amount of tax calculated by reference to the rental value of their Swiss home. Gainful activity in Switzerland is not permitted.

3. Although if Sarah died after completing three consecutive years of non-UK residence and was non-UK resident in the year of her death, then she would be non-UK deemed domiciled at the date of death. The relevance of the completion of four consecutive years of non-UK residence is that Sarah would be free to return to the United Kingdom and be treated as a new arriver with the clock re-started for the purposes of the 17 out of 20 year test in IHTA 1984 s.267. Naturally in such circumstances Sarah would still need to take care not to become UK domiciled under common law.

4. Assuming the non-US spouse has the money to purchase the property, it is generally preferable for UK resident US/UK couples to hold the family home in the name of the non-US spouse. This is because the principal private residence exemption from CGT is potentially available in the United Kingdom but a US person only receives a limited US $250,000 exemption on the sale of a principal private residence. The gain in excess of that is subject to US income tax at 15 per cent assuming the long term capital gains rate applies.

5. It is suggested that the legal right share should not be as asset of the estate until such time as an election is made to exercise it.

6. To make gifts to a non-citizen spouse, a US citizen would either need to use up his annual exclusion amount to a non-citizen spouse (US $139,000 in 2012) and/or use his gift tax exemption (US $5,120,000 in 2012 but due to revert to US $1,000,000 on January 1, 2013 in the absence of Congressional intervention). Once the available thresholds are used up the gift is taxable.