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Cross Border Legacies and Charities

For an ever increasing number of UK nationals holding property abroad, a bequest of the foreign immovables to a charity would seem a simple and convenient solution to deal with the property on their death. The reality is somewhat different.

Aside from the standard advice surrounding issues of the charitable beneficiary's identity and status, an owner of foreign property having formed this intention has to contend with possible local restrictions as to the choice of beneficiary (reserved heirship) as well as the potentially restrictive domestic law definition of what constitutes a charity. The tax treatment of the legacy in the country where the property is situated, the country where the beneficiary is resident and potentially the countries where the Testator is domiciled or resident all require careful consideration.

Reserved heirship

Under the principle of scission, succession to immovables is governed by the lex situs. Accordingly, where the owner of immovable property situated abroad dies, domiciled in England and Wales, the distribution will generally be governed by the lex situs*, (*although *renvoi* has been applied in this area).

In many civil law jurisdictions, the relevant connecting factor is that of nationality, so that the same issues may apply in relation to distribution of movable property held by a foreign national or domiciliary.

In either case, this will involve a measure of reserved heirship where a part of the Estate is reserved for the heirs (spouse / children / parents). France[1] prohibits gifts or legacies which exceed one half of the Deceased's assets when there is one child, one third where there are two children or one quarter if the Deceased had three children or more (the reserved heirs). If the legal reserve is exceeded, the children may have the legacy reduced so that their rights to inherit are preserved.[2]

Italy, by contrast, reserves one third each for the spouse and one child; if there are more children, the reserves are one quarter for the spouse and one half between the children.

A move towards the introduction of an element of flexibility can be observed in some civil law jurisdictions which is obviously good news for charities. France has recently introduced the concept of the "*pacte successoral*[3]*"* (inheritance contract). The legislation was motivated by the need to loosen the rules whilst still preserving the principle of the reserved heirs. The

[1] Art.913 Civil Code
[2] Art.920 Civil Code
[3] La loi no 2006-728 du 23 juin 2006

law permits (within strict conditions) a reserved heir to renounce in advance his right to require the reduction of a gift made by a person, e.g. parent in respect of whom the reserved heir obtain his rights which would otherwise affect the reserve.

The new rules will have an important impact in relation to lifetime giving to charities: the beneficiary of the gift will no longer be exposed to the risk of having to return part or all of the gift, possibly many years after the event, in the event that that reserve is found to have been infringed at the donor's death.

By the same law, the right for the ascendants (parents / grandparents) in the absence of children to a legal reserve was abolished except in very specific circumstances.[4]

A similar "inheritance contract" already exists in Germany and some other states.

Definition of qualifying charity

The rules relating to gifts to charities qualifying for tax relief differ from country to country. Nearly all EC Member States provide for unequal tax treatment between giving to a domestic charity and a foreign based charity. For instance, under UK law, tax relief for gifts to charities is allowed but limited to those charities established in the UK. Charities in other countries are excluded from relief.

In France, the exemptions and reductions allowed for inheritance tax (*droits de mutation à titre gratuit)* are usually limited to organisations having their registered office in France. They must be recognised as being a not-for-profit organisation in the public interest or within certain other restrictive criteria. However, exemption may be granted on the basis of an ad-hoc provision in the relevant double tax treaty, e.g. France-Belgium Treaty of 20 January 1959 relating to taxes on successions. In the absence of specific provision, exemption may still be obtained on the basis of legislative reciprocity where this exists. In addition, legacies or donations to foreign charities have to be authorised by the Minister of the Interior.

In the US gift and estate tax deductions for US citizens and domiciliaries are not subject to territorial restrictions and a gift tax charitable deduction for gifts to European charities that meet certain criteria may be obtained.

For those who are not US citizens or domiciled there, estate and gift tax will be due on gifts or legacies of US situs property, unless there is protection given by a specific Double Tax Treaty.

Europe steps in

Within a European context, the domestic restrictions imposed may be discriminatory and contrary to the Treaty of Rome. The United Kingdom received a formal request from the European Commission to end discrimination of foreign charities dated 10 July 2006.[5] The Commission's position is that charities established in other member states are the subject of discrimination contrary to the EC Treaty if tax relief is restricted to gifts to UK charities.

The various forms of tax relief for gifts to domestic charities should apply to gifts to bona fide charities established in other member states and the difference in treatment constitutes an obstacle to the free movement of capital. Cross border gifts / legacies are specifically

[4] Art.914 and 916 Civil Code
[5] Commission case ref 2005/2281

mentioned in Council Directive 88/361/EEC. The discrimination is also contrary to the free movement of persons. This might arise in the case of an EU national moving to the United Kingdom for work purposes and wishing to make gifts to charities established in his or her home country.

In addition, the rules are contrary to the freedom of establishment if a foreign charity is compelled to set up a branch in the UK in order to benefit from the tax advantages.

Commentators have highlighted this as the first time that the Commission has focused on Income tax incentives being denied for lifetime gifts to foreign charities in an infringement procedure.

The request to the United Kingdom is in the form of a "reasoned opinion" under Article 226 of the EC Treaty. The procedure, if the United Kingdom does not reply satisfactorily within the timeframe, would be for the Commission to refer the matter to the European Court of Justice.

Previously in July 2005[6], the European Commission had referred Belgium to the European Court of Justice because the Commission believed the Walloon inheritance and gifts tax laws discriminated against foreign charities.

Briefly, the three Belgian regions had extended the inheritance and gift tax reductions to charities established in other EU Member States further to a notification from the EC in October 2002[7]. However, the Commission took the view that the restrictions imposed by the Walloon legislation were such as still to constitute discrimination. As a result, the EC referred the case to the European Court of Justice, but proceedings were suspended in July 2006.

The judgement of the European Court of Justice in the Stauffer Case[8] in September 2006 concerned a reference for a preliminary ruling from the Bundesfinanzhof (Germany) on the exemption for charitable foundations to taxation on the rental income from a letting property on the condition that the foundations were resident. The European Court held that a member state was precluded from refusing to grant the same exemption as was allowed to charitable foundations in respect of similar income to a foreign-established charitable foundation on the sole grounds that the foundation has only limited tax liability in its territory.

As a result, in October 2006 the Commission also began similar proceedings against Ireland[9] and Poland[10] and on 21 December 2006 recommenced the case against Belgium[11] taking into account the Stauffer decision.

Turning now to the perspective of the charity, in receipt of a bequest of foreign property: the potential infringement of the legal reserve and tax treatment of the gift will not be its only concern. Trustees who become owners of foreign property may find themselves having to defend their position in a civil law jurisdiction where the concept of a trust does not exist. In France rules have been adopted which have led to the recognition of trusts but there is no domestic equivalent. The Fiducie concept, if adopted into French law, may provide limited assistance to Trustees in the future.

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[6] Commission case ref IP/05/936
[7] Commission case ref IP/02/1527
[8] Judgement of the Court (Third Chamber) of 14 September 2006 (Case C-386/04 Bundesfinanzhof – Centro di Musialogia Walter Stauffer V Finanzamt München für Körperschaften).
[9] Case 2005/2430
[10] Case 2005/2410
[11] Case 2005/5062

Similarly, a company owning foreign property will have to ensure the local filing requirements are respected. In both cases, clarification on the domestic tax treatment of the property owning charity will also need to be obtained. In the interim, the charity's representatives should avoid any action which might constitute acceptance of the bequest under the local law.

Conclusion

As will be apparent, a Testator or Donor will continue to need to take expert advice prior to effecting a gift or legacy across national borders but it is to be hoped the unequal taxation treatment to be found in the majority of member states will now soon be reduced.

For more information please contact:

Dawn Alderson
Partner
020 8394 6373
Dawn.Alderson@russell-cooke.co.uk

Patrick Delas
Solicitor
020 8394 6387
Patrick.Delas@russell-cooke.co.uk

Veronique Cardon
Solicitor
020 8394 6355
Veronique.Cardon@russell-cooke.co.uk

May 2008