EUROPEAN COMMISSION

Brussels, 15.12.2011
SEC(2011) 1488 final

COMMISSION STAFF WORKING PAPER

Non-discriminatory inheritance tax systems: principles drawn from EU case-law

Accompanying the document

COMMISSION RECOMMENDATION

regarding relief for double taxation of inheritances

{C(2011) 8819 final}
{SEC(2011) 1489 final}
{SEC(2011) 1490 final}

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1. INTRODUCTION AND BACKGROUND

Eighteen EU Member States levy taxes upon the death of a person while nine (Austria, Cyprus, Estonia, Latvia, Malta, Portugal, Romania, Slovakia and Sweden) have neither an estate tax nor an inheritance tax, although some tax inheritances under other tax laws.

Some Member States apply inheritance tax on the heirs, so that the taxable event is the enrichment of the beneficiary, while other Member States apply tax on the basis of the estate, in which case the taxable event is the transfer of property. The term inheritance tax is used in this document to mean taxes on both estates and beneficiaries on the occasion of the death of a person.

For reasons of simplicity, the term inheritance tax as used in this document also includes gift taxes. Gifts are often made in order to anticipate later inheritances and such gifts are in many Member States taxed under the same provisions as inheritances. Furthermore, the jurisprudence of the Court of Justice of the European Union (Court) treats inheritance and gift taxes according to the same criteria.

The Commission's Impact Assessment on solutions to cross-border inheritance tax problems[1] demonstrates that increasing numbers of EU citizens are moving from one country to another within the European Union during their lifetimes to live, work and retire, and are purchasing property and invest in assets in countries other than their home country.

The Commission's impact assessment also indicates that citizens and businesses may be exposed to two types of inheritance tax problems in cross-border situations, namely the discriminatory application of a Member State's inheritance tax rules, and unrelieved double or even multiple taxation of a single inheritance. These problems may hinder EU citizens from benefiting fully from their right to move and operate freely across borders within the European Union and may create difficulties for the transfer of small businesses on the death of owners.

The present paper examines the problem of discrimination. The double taxation problem is dealt with in a Recommendation that the Commission has adopted on the same day as the publication of the present document[2].

At the present stage of EU law, Member States and their political subdivisions have broad freedom to design their tax systems and allocate taxing powers between themselves.

Nevertheless, they must exercise that competence in accordance with EU law. That means that Member States' tax systems must respect the fundamental freedoms, notably the rules

[1] Impact Assessment on solutions to cross-border inheritance problems – *reference to be added when available*

[2] See Commission Recommendation regarding relief for double taxation of inheritances - *reference to be added when available*

relating to the free movement of persons, workers, services and capital and the freedom of establishment (Articles 21, 45, 56, 63 and 49, respectively, of the Treaty on the Functioning of the European Union - TFEU), as well as the general principle of non-discrimination on grounds of nationality (Article 18 TFEU).[3]

Under Article 21 TFEU, EU citizens have the right to move and reside freely within the territory of the Member States. Broadly defined, this freedom enables citizens of one Member State (irrespective of whether they are economically active or not) to travel to another Member State and reside there permanently or temporarily. Article 18 TFEU ensures that citizens who exercise this right to free movement cannot be discriminated against on the sole ground of their nationality.

The principle of the freedom of establishment has its basis in Articles 49-55 TFEU. These provisions enable an economic operator, whether a person or a company, to carry on an economic activity in a stable and continuous way in one or more Member States. The provisions also come into play where a holder owns significant amounts of shares giving the right to control the activity of the company.

The free movement of capital, as enshrined in Article 63 TFEU, is the most essential freedom in the area of inheritance taxation, as Court decisions in the inheritance tax area have been mainly based on this freedom. The Court has repeatedly confirmed that an inheritance involving a transfer to one or more persons of assets left by the deceased is a movement of capital within the meaning of Article 63 TFEU, except in cases where its constituent elements are confined within a single Member State.

It is of utmost importance in the Internal Market that Member States do not pose obstacles to the exercise of the fundamental freedoms by discriminating against cross-border inheritance cases compared to domestic situations. The principle of non-discrimination is a central element of the Treaty freedoms. According to well-established case-law, discrimination can result from treating differently situations which are comparable or treating different situations in the same way. In order for a national scheme providing for a difference in treatment to be compatible with the Treaty freedoms, it must concern situations which are not objectively comparable or it must be justified by an overriding reason in the general interest. Moreover, this national scheme may not in any event be more restrictive than is necessary in order to achieve the aim pursued; it must, in other words, be proportionate.

In recent years, the problems of tax discrimination related to cross-border inheritances have become increasingly evident; the Commission has, on the basis of complaints received and its own investigations, had cause to commence infringement proceedings against several Member States over aspects of their laws.

Furthermore, since 2003, the Court has examined the inheritance tax rules of Member States in ten cases referred by national courts. The Court of Justice decided in eight out of the ten cases that the national inheritance tax and gift tax rules of the Member States in question breached EU rules on the free movement of capital and/or freedom of establishment.

The Court also dealt with inheritance tax rules in another case which concerned higher succession duties for legacies made to charities in other Member States.

[3] Furthermore, any selective advantage, in the form of a differential tax treatment, for business assets that constitute part of an inheritance, should be in line with EU competition rules.

These Court judgments have brought a certain amount of clarity and certainty to this matter. However, in many instances, it may not be entirely clear what consequences a ruling involving legislation of one Member State should have on legislation of another Member State. Moreover, even where Member States introduce new tax rules as a result of a ruling, they may do so in vastly differing ways.

Furthermore, Court judgments in individual cases may not make clear to EU citizens which principles Member States must respect when taxing cross-border inheritances.

Therefore, it appears appropriate to set out the non-discrimination principles flowing from case-law that should inform inheritance taxation systems. This could improve the operation of the fundamental freedoms by making EU citizens aware of the rules which Member States must respect when taxing cross-border inheritances. It could also assist Member States in bringing their inheritance tax provisions into line with EU law..

The next chapters give an overview of the main judgments of relevance to inheritance and gift taxation and the principles flowing from this case-law.

As a starting point, it may be noted that while, as a rule, residents and non-residents may be treated differently in relation to direct taxes where this is warranted by a difference in circumstances, the Court has found in most of its rulings in inheritance tax cases that residents and non-residents should be treated equally.

2. GENERAL ANALYS OF THE RELEVANT CASE-LAW

2.1 Cases where the Court found Member States' inheritance and gift tax laws incompatible with EU law

2.1.1. The *Barbier* case (C-364/01)

The Court ruled in this case that a Member State cannot apply inheritance tax rules which would allow a certain deduction for tax purposes from the value of an estate if the deceased lived in that Member State at the time of death but would deny it if the deceased resided in another Member State prior to death.

In this case the Court ruled that "inheritance" comes within the compass of the provisions on free movement of capital once its constituent elements are cross-border. It may be noted that is not necessary to have regard to whether the persons actually themselves engage in cross-border economic activity for the applicability to inheritances of the free movement of capital provisions.

In this case the Court ruled that it is contrary to EU law if, in order to assess the value of an immovable property situated in the Member State concerned, there was a difference in tax treatment depending on whether the deceased was resident or not in that Member State at the time of death. In that case, the value of an obligation attached to the property should be taken into account for tax purposes irrespective of the Member State of residence of the deceased.

Moreover, the Court elaborated a key rule aimed at investigating whether national provisions may entail a restriction of the free movement of capital in the inheritance tax area. In this respect, a Member State is prohibited from applying a measure which has the effect of reducing the value of an estate belonging to a resident of another Member State to a greater extent than the value of an estate belonging to a resident of the same Member State The Court has followed this reasoning in all further judgments in the inheritance and gift tax area.

The Court also made clear that, for the purposes of assessing the compatibility with EU law of domestic inheritance tax legislation, the existence of a tax advantage granted unilaterally by a Member State other than the State of residence is not relevant. This reasoning was also followed in the consecutive judgments.

The Court did not specifically examine the case in the light of the right to free movement of persons enshrined in the Treaty. However it stated that inheritance taxes are among the considerations which a national of a Member State would reasonably take into account when deciding whether or not to make use of the freedom of movement provided for in the Treaty.

2.1.2. The *Maria Geurts* case C-464/05

In this case the Court found it discriminatory to treat the owner of a family undertaking and, after his death, his heirs, in a different way according to whether that undertaking employed workers in the Member State at issue or in another Member State.

The domestic legislation in question granted an inheritance tax exemption for shares in closely held family companies on the condition that such an undertaking employed a minimum number of workers in that Member State.

In this case, the Court examined the relevant legislation only from the point of view of the principle of freedom of establishment. This was because the legislation was applicable only where at least 50% of the share capital in the company concerned was held, in the three years preceding death, by the deceased, jointly or not with members of his close family. The Court found that a share of this size gave those persons influence over the decisions of the company concerned and made it possible for them to decide upon its activities. The Court also held that any restrictive effects of the said legislation on the free movement of capital would merely be an unavoidable consequence from its effects on cross-border establishment.

The Court established that a Member State could not deny an exemption for an inheritance of a family undertaking which employed at least five workers in another Member State when it would allow such an exemption from inheritance tax if the five workers had been employed in the same Member State.

2.1.3. The *Jäger* case (C-256/06)

The Court ruled in this case that foreign located estates should not be evaluated in a less favourable way than domestic located estates.

The *Jäger* case concerned a less favourable tax treatment applied by the Member State of residence with respect to assets situated in another Member State.

The Court ruled that the free movement of capital provisions prohibited Member States' legislation whereby a specially favourable valuation system and partial exemption is applicable to assets located in that Member State, as opposed to assets situated in other Member States, which are evaluated according to normal fair market value rules. As the calculation of the tax was directly linked to the value of the assets, there was objectively no difference in situation such as to justify unequal tax treatment.

2.1.4. The *Eckelkamp* case (C-11/07) and the *Arens-Sikken* case (C-43/07)

In these cases the Court found incompatible with EU law the application of different tax rules for the assessment of inheritance and transfer taxes payable in respect of assets, depending on whether the deceased resided in that Member State or abroad at the time of his/her death.

The Court decided in the *Eckelkamp* case that it is illegal for a Member State not to allow mortgage-related charges to be deducted from the value of property only because, at the time of death, the person whose estate was being administered was residing in another Member State.

The Court ruled in the *Arens-Sikken* case that it is contrary to EU law if an heir is allowed to deduct debts relating to the property inherited only where the person whose estate is being administered was residing, at the time of death, in the Member State in which the property is situated

Both of these cases dealt with the method of assessment of inheritance duties; and they concerned situations similar to the one obtaining in the *Barbier* case.

In the *Eckelkamp* case, the Court ruled that the denial of deductions for debts and liabilities was a breach of the provisions on the free movement of capital. The Member State concerned refused to take debts and liabilities relating to the inheritance into account for the purpose of assessing the inheritance tax due where the testator, at the time of death, did not reside in that Member State. However, it would have allowed the deduction of these debts and liabilities if the testator had been resident at the time of death. The Court stated that since the assessment of inheritance and transfer taxes was, under the legislation at issue, directly linked to the value of the immovable property, there was no difference in situation such as to justify unequal tax treatment with regard to immovable property situated in the Member State at issue, depending on the place where the deceased resided at the time of his death.

In the Arens-Sikken case, a property was left to a surviving spouse who was, however, by virtue of a testamentary parental partition *inter vivos*, obliged to pay each of the children the cash equivalent of their share of the estate. These “over-endowment debts” of the surviving spouse towards her children were not taken into account for the purposes of determining her transfer duty liability. If the testator had been resident in the Member State concerned at the time of his death, such a deduction would have been possible. The Court ruled that such a difference in treatment is incompatible with the free movement of capital.

2.1.5. The *Mattner* case (C-510/08)

The Court declared incompatible with free movement of capital a gift (and inheritance) tax provision according to which the tax allowance for children of the donor, in a case where all parties are non-resident, is lower than where one of them is resident.

In this case, the Court extended the jurisprudence it had developed in the area of inheritance taxes to national gift tax legislation.

The case at hand concerned the donation of a piece of land located in the taxing Member State. Both the donor and the donee, the donor's child, were resident in another Member State.

The national legislation at issue distinguished between cases in which the taxpayer was considered subject to *limited* liability to the tax, i.e. where both the donor and the donee were resident in another Member State at the time when the gift was made, and cases in which the taxpayer was considered subject to *unlimited* tax liability, i.e. where at least one of them was resident in the taxing Member State. In the latter situation, the legislation provided for a relatively high tax free allowance in the case of donations between parent and child, whereas the allowance was much lower in the former situation.

The Court found no objective difference between the two situations that could justify the difference in treatment. Moreover, the Court discussed a number of justifications presented, namely the need to prevent the same tax advantage being received twice by the same taxpayer and to prevent the circumvention of the limits through multiple donations, as well as the coherence of the national tax system. However, the Court accepted none of these justifications.

2.1.6. The *Halley* case (C-132/10)

In this case the Court found it discriminatory to set different limitation periods for the valuation of registered shares for inheritance tax purposes depending on whether the centre of effective management of the issuing company, in which the deceased was a stakeholder, was situated in the taxing Member State or in another State.

In this case the estate included registered shares in a company which had its centre of effective management in a Member State other than the taxing State and which were transferred by way of inheritance to a heir in the taxing State.

The national legislation of the taxing Member State provided that its tax authority may require an expert valuation of certain assets located in that Member State in order to establish whether they have been undervalued in the inheritance tax declaration. The limitation period for the tax authority to introduce claims for such an expert valuation and possible consequent upward adjustment in the amount of inheritance tax due was set at 2 years from the date on which the inheritance tax declaration is made.

However, in the case of shares held in a company whose centre of effective management was situated outside the territory of the taxing Member State, no expert valuation was possible and the tax authorities could file a claim regarding undervaluation with a consequent increase in inheritance tax as well as interest and fines for a much longer period i.e. up to 10 years.

The Court stated that such legislation is contrary to the provisions on free movement of capital, because the application of a longer limitation period to heirs holding shares in a company which has centre of effective management abroad may have the effect of deterring residents of the taxing Member State from investing or maintaining investments in assets situated outside that Member State. Heirs of such residents will experience a longer period of uncertainty regarding the possibility of being subject to a tax adjustment.

The Court did not find any justification for such restriction on the free movement of capital, in particular because the period of 10 years was not based on the time needed to have effective recourse to mechanisms of mutual assistance between tax administrations or other alternative means of investigating the value of the shares in question.

2.2 Cases where the Court found Member States' inheritance tax laws compatible with EU law

2.2.1. The *Van Hilten-van Der Heijden* case (C-513/03)

The Court decided in this case that the provisions on free movement of capital did not forbid a rule whereby the estate of a national of a Member State who dies within 10 years of ceasing to reside in that Member State is to be taxed as if that national had continued to reside in that Member State. The important element was that the said rule did not distinguish between residents and non-residents.

In accordance with the double taxation convention between the two States concerned, the estate of a national of a Member State who dies within 10 years of ceasing to reside in that Member State was to be taxed as if that national had continued to reside in that Member State. The double taxation convention also stipulated that the taxing State would reduce the tax so due by the amount of tax due in the other State by reason of residence there.

The provisions at issue were not considered discriminatory because, unlike in the *Barbier* case, they did not distinguish between taxpayers according to their residence. Rather, they provided for identical treatment for the estates of nationals who had transferred their residence abroad and of those who had remained in the Member State concerned.

According to the Court, such legislation would neither discourage a national who had transferred his residence abroad from making investments in the taxing Member State nor a national who remained in the taxing State from investing in another Member State. Nor would such legislation diminish the value of the estate of a national who had transferred his residence abroad. As the Court pointed out, as long as there is no harmonisation in this area, Member States are free to determine the criteria for allocating their powers of taxation. In this respect, as an anti-abuse measure, they can also provide for an extended concept of residence, such as in the case at hand.

2.2.2. The *Block* case (C-67/08)

In this case the Court concluded that a Member State is not obliged to avoid double taxation on an inheritance which arises from the exercise in parallel by Member States of fiscal sovereignty, for example by crediting inheritance tax paid abroad against its own inheritance tax.

In the *Block* case the Court had to rule on the compatibility with the provisions on free movement of capital of national legislation which does not provide for inheritance tax paid in another Member State to be credited against inheritance tax payable by an heir in his Member State of residence.

This case differs from the cases already examined in that it does not concern the inheritance tax system of a single Member State but the consequence of the parallel exercise of the taxation powers of two Member States.

Both the heir and the deceased were resident in one Member State but movable assets of the estate were located in another Member State and taxed there as well as in the country of residence of the heir.

The Court ruled that the use of different connecting criteria for levying inheritance tax on capital claims is not contrary to EU law because at the current stage of EU law, there are no general criteria at EU level for the attribution of competence between the Member States in relation to the elimination of double taxation within the European Union.

Member States are therefore free to decide their own rules on direct taxation, including the connecting factors according to which a person or an income is taxable in its territory.

Furthermore, they are not obliged to adapt their own tax systems to the different systems of tax of the other Member States in order to eliminate the double taxation arising from the exercise in parallel by those Member States of their fiscal sovereignty. In particular, they do not need to credit inheritance tax paid abroad against their own inheritance tax.

2.3. Other relevant cases - Tax treatment of foreign charities

In *Missionswerk Werner Heukelbach* (C-25/10) the Court decided that a Member State granting certain inheritance tax advantages to domestic charities has to apply the same tax treatment to foreign charities if the foreign charities satisfy the conditions laid down in that Member State for the grant of tax advantages.

The Court had previously examined the tax treatment by Member States of charities established in other Member States as well as of donations to such entities. The *Stauffer* case (C-386/04) dealt with the first hypothesis whereas the *Persche* case (C-318/07) dealt with the second. In both cases, the Court ruled that domestic tax provisions that discriminate against foreign charities are incompatible with the provisions on free movement of capital.

In *Missionswerk Werner Heukelbach*, the Court extended the non-discrimination principles set out in those earlier judgments to Member States' inheritance tax legislation. The case concerned the applicability of a reduced rate of succession duty to a legacy in favour of a non-profit-making association. The national legislation in point provided that the reduced rate was applicable only where the association had its centre of operations either in the taxing Member State or in the Member State in which, at the time of death, the deceased actually resided or had his place of work, or in which he had previously actually resided or had his place of work.

The Court ruled that Article 63 precludes such legislation where a non-profit organisation recognised as such in its Member State of establishment fulfils also the conditions governing analogous organisations imposed by the taxing Member State. The fact that a foreign charity does not have its centre of operations in that Member State or in the Member State where the deceased had worked or resided was considered immaterial.

3. PRINCIPLES FOLLOWING FROM THE CASE-LAW

Principles may be identified from the relevant case-law that can be grouped under the following headings:

<u>Geographical links of the assets forming part of cross-border inheritances</u>

1. Member States' inheritance tax provisions are in breach of the provisions on free movement of capital if they provide for different tax treatment for assets that are part of the inheritance, depending on whether these assets have a given link to the national territory, notably whether they are located there. This means, *inter alia*, that:

    a. Valuation methods cannot be less favourable for assets located abroad.

    b. There should be no restrictions on deductibility of debts/liabilities related to assets located abroad if there are no restrictions for local assets.

    c. Member States' inheritance tax provisions cannot provide for a higher inheritance tax rate with regard to inherited assets located abroad.

    d. Member States cannot set different limitation periods for the reevaluation of registered shares for inheritance tax purposes depending on the location of the issuing company's centre of effective management.

2. The underlying principles could equally prohibit, *inter alia,* inheritance tax treatment that:

    a. is less favourable in the case of inherited shares registered on foreign exchanges or held in a company located abroad, than in the case of shares registered on domestic exchanges or held in domestic companies;

    b. privileges payments made by domestic pension insurances as part of the inheritance over payments made in the same situation by foreign insurances;

    c. is less favourable in the case of public debt securities issued by other Member States than in the case of similar securities issued by the taxing Member State.

<u>Residence of persons concerned in cross-border inheritances</u>

2. Member States' inheritance tax provisions are contrary to EU law if they provide for higher tax free allowances for residents than for non-residents in relation to gifts or inheritances, where residents and non-residents are in a comparable situation.

   Depending on the case, this could mean, *inter alia*, that Member States cannot provide for lower inheritance tax allowances on the sole basis that the deceased and the heir were/are not resident of the Member State granting such an allowance.

3. Regarding the determination of the value of inherited assets, it is contrary to EU law to allow deductions only if the deceased resided in the taxing Member State.

   This could also mean, *inter alia*, that Member States' inheritance tax provisions are not in line with EU law if they restrict the deductibility of debts and liabilities related to assets inherited by a non-resident but do not apply any such restriction to assets inherited by residents.

4. More generally and in the absence of objective justifications, Member States' provisions are incompatible with free movement of capital if they provide for less favourable inheritance tax treatment with regard to non-resident heirs or deceased.

<u>Inheritance tax treatment of businesses such as SMEs</u>

5. Member States cannot provide for preferential tax treatment for an inheritance of a business that is conditional on the business being carried on/continued domestically.

6. Member States cannot provide for a less favourable tax treatment of an inherited business merely because its employees are located abroad.

7. Inheritance tax relief for businesses, such as exemptions or special relief for transfers of family-owned and closely-held businesses upon death should be provided in the same way for heirs who are not resident in the Member State providing the relief as for resident heirs.

<u>Inheritance tax treatment of charities</u>

8. Member States' inheritance tax provisions cannot apply less favourable inheritance tax treatment for legacies made to a charity on the sole basis that the charity is established in another Member State rather than in the taxing Member State.

4. CONCLUSIONS

Many principles relating to non-discrimination in the field of inheritance taxation have already been fixed by jurisprudence. The Court may in the future be requested to examine other situations not so far addressed, in which the applicable legislation distinguishes between purely national situations and situations with a cross-border element. However it is already clear that distinctions between purely national and cross-border situations are not compatible with EU law in the absence of any objectively relevant difference between these situations or a justification linked to overriding requirements of general interest.

EU citizens are entitled to seek redress if they detect any incompatibility between the inheritance tax rules of a Member State and EU law.

For its part, the Commission is entitled, as guardian of the EU Treaties, to take appropriate steps when it detects violations of EU law in the inheritance and gift tax area.