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Landmark Supreme Court case: state's civil liability for discrimination against third-country residents in inheritance taxation

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The Spanish Supreme Court recently issued (February 19, Spanish version here) a long awaited judgment confirming that the Spanish inheritance tax legal framework breaches the free movement of capital when taxing non-EU residents on Spanish assets received through inheritance.

The origin of this discrimination is the Spanish regional inheritance taxation system, under which Spanish regions (autonomous communities) are entitled to apply tax breaks and reductions when the deceased person lived in their region. Most regions in Spain have approved substantial reductions for inheritances received in the vertical line of kinship (e.g., Madrid region has a 99% tax credit).

However, when either the deceased person or the heir does not reside in Spain, the inheritance tax is calculated under the central state rules, where no tax breaks are available. A similar situation occurs when a non-resident receives a donation of an asset located in Spain.

This situation is blatantly unjust; for instance, two brothers receiving the same inheritance from their deceased father could be taxed differently, depending on their tax residency: the Spanish resident would benefit from the vertical line tax reductions, and the non-resident would be charged full tax with no reductions.

Several years ago, this unfair tax treatment attracted the attention of the EU Commission, which opened an infringement procedure against Spain based on the free movement of capital. This procedure ended with the EU Court of Justice judgment dated September 3, 2014 (C-127/12). The court was clear in declaring that these regional tax differences caused an unjustified breach of articles 63 of the TFEU and 40 of the EEA.

The EU Court of Justice did not refer expressly to its application to residents of third countries, and it barely touched on the fact that Spain had not justified why there was no mutual assistance procedure between EU and EEA states supporting a restriction on the free movement of capital.

The Spanish government understood the judgment referred only to situations within the EEA, and it promoted a change of law that, since January 2015, has extended the regional inheritance and gift family tax breaks to residents in the EEA. However, the law did not remedy the unequal treatment non-EEA residents received when subject to Spanish inheritance or gift taxation. They had to

continue calculating their inheritance and gift tax under the central state rules, without being allowed to benefit from the regional tax breaks.

In its landmark case, the Supreme Court states that the judgment of the Court of Justice on Spanish inheritance tax was founded on the free movement of capital without any express limitations on extending its effects to third-country residents.

When justifying its position, the Supreme Court reminds us that the Court of Justice had already considered the German inheritance tax rules illegal. Under the German rules, an inheritance from a Swiss deceased person was taxed more heavily than an inheritance from an EU deceased person (Judgment of October 17, 2013, c-181/12, Welte). Therefore, Spain should have interpreted the judgment on its inheritance rules by following the clear statements in the judgment on the German provisions.

In the eyes of the Supreme Court, the case is so clear that it justifies declaring the civil liability of the Spanish state under the principles established in *Brasserie Du Pêcheur & Factortame* (EUCJ judgment March 5, 1996, C-46/93 and C-48/93). In other words, the breach of the Spanish provisions was serious enough to justify recognition of damages for taxpayers.

This Supreme Court judgment will have a huge impact on the current Spanish inheritance and gift tax rules. It not only forces the Ministry to amend the current provisions, but it also opens the door for taxpayers to claim refunds of all taxes paid under the discriminative rules in the past four years, the standard term of the statute of limitations for taxes.

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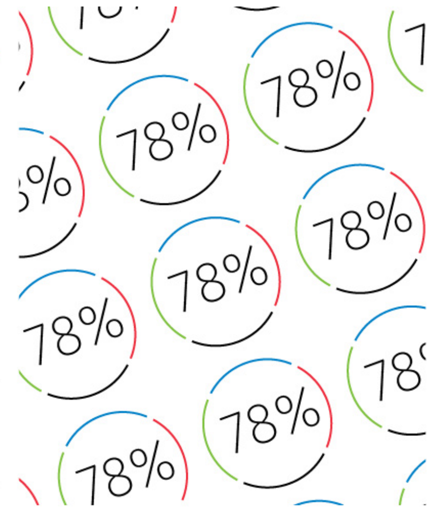

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