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Highlights & Insights on European Taxation

Please find below a selection of articles published this month (February 2024) in Highlights & Insights on European Taxation, plus one freely accessible article.

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(comments by **Vassilis Dafnomilis**) (*H&I* 2024/41)

In the subject *BA* case, a dispute arose regarding the compatibility of a special valuation rule, the 10% rule outlined in German inheritance tax laws, with EU law. According to this rule, a 10% reduction in the value of the inherited immovable property was granted for properties let for residential purposes within the borders of Germany, the European Union (EU), or the European Economic Area (EEA). However, such a reduction was not granted for inherited immovable properties located in third countries. Consequently, Mr. A's beneficiary faced a higher inheritance tax burden in Germany concerning the bequeathed property in Canada compared to what would have been the case if the property were located in Germany, the EU, or the EEA. By applying the 10% rule, Germany aimed to reduce the tax burden on immovable property let for residential purposes which may compel heirs to sell such immovable property as a result of the inheritance tax for which they are liable, unlike institutional investors which are not subject to that tax (*BA*, para. 60).

From the very beginning I observe that it is not the first time where the compatibility of EU Member States' valuation rules has been subject to scrutiny by the Court of Justice of the European Union (CJ). Similar scrutiny occurred in previous cases such as *Jäger* (CJ 17 January 2008, C-256/06 *Theodor Jäger v Finanzamt Kusel-Landstuhl*, ECLI:EU:C:2008:20) and *Halley* (CJ 15 September 2011, C-132/10 *Olivier Halley, Julie Halley, Marie Halley v Belgische Staat*, ECLI:EU:C:2011:586). In these cases, as in the current *BA* case, Germany and Belgium were exercising worldwide taxing rights in their capacity as the state of the personal nexus. In addition, I observe that the 10% rule yields effect akin to an objective tax exemption. The CJ has previously scrutinized objective inheritance tax exemptions of various EU Member States, three times, including the Netherlands (CJ 18 December 2014, C-133/113 *Staatssecretaris van Economische Zaken, Staatssecretaris van Financiën v Q*, ECLI:EU:C:2014:2460 (*Q*, C-133/13), Greece (CJ 27 May 2015, C-244/15 *European Commission v Hellenic Republic*, ECLI:EU:C:2016:359 (*Commission v Greece*, C-244/15), and Belgium (CJ 22 November 2018, C-679/17 *Vlaams Gewest (2) v Johannes Huijbrechts* (*Huijbrechts*, C-679/17). (For more on objective tax exemptions and EU law, see Dafnomilis in Douma, Marres, Vermeulen & Weber, European Tax Law 2022, p. 374-375). In general, I observe that inheritance tax laws across EU Member States feature numerous objective exemptions, which stem from diverse policy rationales such as social, environmental, and cultural considerations (See Dafnomilis, *Taxation of Cross-border Inheritances and Donations: Suggestions for Improvement*, Wolters Kluwer, 2021, p. 14.)

This case mirrored the previously decided case in *Jäger* (C-256/06), where Germany applied different valuation methods to German agricultural and forestry land (valued only at 10% of the market price) compared to similar land located elsewhere (valued at full market price). In *Jäger*,

the CJ ruled that such a rule was not in line with EU law when the most favourable valuation method was not applied to inheritances of agricultural and forestry land in another EU Member State. The German tax office in the *BA* case was well aware of *Jäger* and took the view that the findings in *Jäger* could not apply by analogy to cases involving an estate situated in a third country (*BA*, para. 26).

For scholars following the jurisprudential evolvement of CJ case law on EU inheritance and gift taxation, it becomes evident that the *BA* case is in line with CJ precedents concerning the EU applicable freedom and the existence of a restriction. The imposition of a higher inheritance tax burden to the cross-border inheritance at hand signals to the Court that the rule not only dissuades the deceased – during his/her lifetime – from investing in real estate in a third country but also discourages beneficiaries from maintaining ownership of such property (*BA*, para. 45). The location of the property in Canada, rather than an EU Member State (as in *Jäger*), is immaterial at this stage. This is because the free movement of capital encompasses situations involving third countries, and the concept of restriction does not differentiate between EU and third country situations.

Furthermore, the CJ considered the situation of a bequest of real estate in Canada to be objectively comparable to that of a bequest of real estate in Germany, the EU, or the EEA. In arriving at this conclusion, the CJ departed from the arguments presented by the German government, which were grounded in the *Q* case (C-133/13) (*BA*, para. 58). In that case, the CJ ruled that, given the objective of the Dutch national legislation – the preservation of the integrity of certain properties forming part of Dutch cultural and historical heritage – a donation of a property in the Netherlands of historical and cultural value (in Dutch: '*landgoed*') was deemed not objectively comparable to that of a property of historical value situated in the UK (at the time, an EU Member State) (*BA*, para. 27).

In *BA*, the EU Court took another direction, and this is remarkable: the CJ observed that Germany applied its inheritance tax rules based on the value of the inherited property, and this value does not differentiate based on the location of the inherited property (*BA*, para. 62). This holds true given that Germany – being the EU Member State of the deceased and heir's personal nexus – exercises worldwide taxing rights. The comparison in *BA* takes place, therefore, *ratio personae* and not based on the objective of the rule introducing the difference in treatment (as in *Q*, para. 27 and *Huijlbrechts*, para. 28). In essence, the *ratio personae* comparison in *BA* is akin to that of *Jäger*, which was evidently not referenced by the German government on this point. However, in cases involving valuation rules, the CJ examines how the EU Member State determines inheritance taxes (comparison *ratio personae*), whereas in cases involving objective tax exemptions, the objective of the rule holds decisive weight. However, is it not so that the 10% rule ultimately results in a 10% objective tax exemption for inherited properties let for residential purposes? This contention warrants further examination, which will be addressed subsequently.

Germany brought forward two justifications but only one had the potential to fly. The presented justification of the need to guarantee the effectiveness of fiscal supervision was easily rejected by the Court. The income tax treaty between Canada and Germany allowed the exchange of information between the countries, even regarding inheritance taxes. This is because Article 26, para. 4 of the tax treaty applied to all taxes imposed by a Contracting State (*BA*, para. 82). This conclusion is in line with *Huijbrechts* (para. 41) Notably, and despite the scarcity of inheritance and gift tax treaties, the presence of a 'qualifying' income and capital tax treaty between the EU Member State and the third country effectively precludes any avenue for the EU Member State to

pursue such an argument. However, I note that the treaty should be a qualifying one, in the sense that it should provide for an exchange of information framework. This can include, for example, an inheritance and gift tax treaty with an exchange of information article, an income and capital tax treaty featuring an exchange of information article that extends beyond the covered taxes, or an exchange of information agreement. Consequently, the evaluation of the justification for the effectiveness of fiscal supervision concerning third countries remains consistent regardless of the type of direct tax in question, whether it is inheritance tax or corporate income tax (CJ 18 December 2007, C-101/05 *Skatteverket v A*, ECLI:EU:C:2007:804).

The analysis became particularly intriguing when considering the justification put forth by Germany regarding its public housing policy. Germany argued that the housing policy it pursued justified the 10% rule. It asserted that the 10% rule enabled the population to gain access to affordable rented accommodation in Germany/EU/EEA, which was also a task of a European nature (*BA*, para. 69). I observe that it is not unprecedented for an EU Member State to invoke a justification with a social background. This was exemplified in *Commission v Greece* (C-244/15). In that instance, Greece had implemented an objective exemption from inheritance tax concerning primary residences for beneficiaries who were Greek nationals or nationals of other EU Member States and were permanently residing in Greece. The exemption was designed within the framework of Greece's social policy and aimed to alleviate housing needs among the deceased's family members who acquired the family home as their primary residence, accompanied by tax relief measures.

The EU Court concurred with Germany, citing Article 115 of the Treaty on the Functioning of the European Union (TFEU), which pertained to social policy in the EU (*BA*, para. 71) and the second recital of the EEA Agreement (*BA*, para. 72). This was done with the aim of emphasizing the significance of EU and EEA integration compared to non-integration with third countries. Consequently, the Court concluded that an objective of social policy could indeed rationalize the restrictive 10% rule's application, albeit limited to German/EU/EEA contexts (*BA*, para. 73), contingent, however, upon its proportionality to the intended objective (*BA*, para. 74). However, Germany encountered a stumbling block in the execution of its policy. The 10% rule, as implemented, exhibited inconsistencies with its intended purpose. Notably, this rule applied to all types of properties, irrespective of their location (be it in urban centres experiencing housing scarcity or rural areas presumed to have an abundance), their level of luxury (ranging from modest dwellings to opulent estates), and the actual utilization of the property by the heir for rental purposes. As a result, the CJ considered that the rule is disproportionate. On the element of the actual utilization of the property from the heirs, I observe that the *BA* judgment resembles the way that the CJ considered the justification brought forward by Greece in *Commission v Greece* (C-244/15) on the general social-interest objective of addressing housing needs in Greece. According to the CJ, the relevant provision was not appropriate for guaranteeing attainment, in a systematic and consistent manner, of the general social-interest objective of addressing housing needs in Greece since the exemption laid down by that provision is not subject to the obligation that the heir establish the inherited property as his primary residence or that he occupy that property at all (*Commission v Greece*, C-244/15, para. 40).

What captivates me about the present judgment is the Court's dual rulings. On the one hand, it affirmed that the promotion and provision of affordable rented accommodation in EU Member States and EEA countries could indeed justify a potential restriction on the free movement of capital concerning third countries (*BA*, para. 73). On the other, it found fault with Germany's application of the 10% rule, considering it inconsistent with its objective (*BA*, para. 74). From my

perspective, it is evident that the current legislation runs afoul of EU law due to its disproportionate nature. Consequently, Germany is obligated to extend the 10% exemption to inheritances involving real estate in Canada or any other third country with which it applies an exchange of information framework. Simultaneously, Germany has the opportunity to enact new legislation that aligns with the objective of social policy in a proportionate manner. For instance, this could involve making the 10% rule available in areas facing housing scarcity, whether in Berlin (Germany), Athens (EU), or Reykjavik (EEA), and perhaps with a cap on the value of inherited property. At the same time, such legislation would not necessarily need to extend the 10% rule to properties in third states.

Besides how Germany will need to amend its law, I am still faced with an apparent challenge in reconciling the *BA* case with *Q* case. In the *Q* case, the CJ emphasized the importance of considering the objective behind Dutch legislation, which aimed to protect Dutch culture and history. This objective led the Court to conclude that the donation of an estate (‘*landgoed*’) within the Netherlands was not objectively comparable to the donation of a foreign property of historic value, such as the Bean House in the UK. In contrast, in the *BA* case, the CJ focused on the establishment of taxing rights by Germany to determine the comparability of situations, while the objective of the legislation was considered during the justifications part of the EU law assessment. Despite the different legislative objectives between the Netherlands and Germany, in *Q* and in *BA* respectively, both countries were taxing in their capacity as the state of the personal nexus, exercising worldwide tax jurisdiction. So, either *Q* is revised (although the objective of the Dutch legislation would have probably validated the Dutch legislation at the justifications part in an analysis akin to the analysis found in CJ case law concerning non-profit entities, e.g., *Missionswerk Werner Heukelbach* (CJ 10 February 2011, C-25/10 *Missionswerk Werner Heukelbach eV v État belge*, ECLI:EU:C:2011:65) or the CJ should have initially determined the non-comparability of situations in *BA* without requiring recourse to justifications.

Dr. Vassilis Dafnomilis

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