NON-EU CITIZENS DISCRIMINATION - JUDGMENT OF THE SPANISH SUPREME COURT, 19 FEBRUARY 2018[1]

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I. Preliminary Considerations

Although EU countries have the power to legislate on direct taxation, all legislation on this matter must respect the fundamental freedoms described in the Treaty on the Functioning of the European Union ("TFEU"). Several countries have had to review their internal legislation in order to make their Inheritance and Gift Tax (IGT) regimes compatible with EU Law. Given that IGT is not a harmonised tax, the case law of the ECJ has played a fundamental role on this point through that which has been termed "negative integration". Spain is one of the last countries to be affected by ECJ pronouncements on this subject.

The fact is that fiscal benefits could not be enjoyed by persons resident in other countries constitute a clear infringement of the principle of free movement of capital and this is derived from established case-law[2].

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2 Numerous examples are seen in the Court´s jurisprudence. See, for instance, the Judgment of 11 December 2003, *Barbier*, C-364/01, EU:C:2003:665; Judgment of 25 October 2007, *Geurts*, C-464/05, EU:C:2007:631; Judgment of 17 January 2008, *Jäger*, C-256/06, EU:C:2008:20; Judgment of 11 September 2008, *Eckelkamp*, C-11/07, EU:C:2008:489; Judgment of 11 September 2008, *Arens-Sikken*, C-43/07, EU:C:2008:490; Judgment of 12 February 2009, *Block*, C-67/08, EU:C:2009:92; Judgment of 22 April 2010, *Mattner*, C-510/08, EU:C:2010:216; Judgment of 10 February 2011, *Missionswerk*, C-25/10, EU:C:2011:65; Judgment of 31 March 2010, *Schröder*, C-450/09, EU:C:2011:198; Judgment of 15 September 2011, *Halley*, C-132/10, EU:C:2011:586; Judgment of 19 July 2012, *Scheunemann*, C-31/11, EU:C:2012:481; and Judgment of 17 October 2013, *Welte* EU:C:2013:662:446.

II. Reforming the Spanish IGT: A Matter of urgency since 2004

In Spain, Inheritance and Gift Tax (IGT) is governed by both the State and the 17 Autonomous Communities. Many of these Communities have amended the State rules to make them more beneficial but non-residents had to pay the national rate of tax, which was far less favorable.

The resulting situations may be so diverse as to lead to considerable territorial tax differences.

In 2004, the Commission sent a Communication to Spain requiring that it change its inheritance taxation regime for non-residents because it constituted an obstacle to the free movement of persons and capital[3].

The problem concerned the transfer of IGT powers to the Autonomous Communities. Spain´s inheritance tax system infringed articles 45 and 63 TFEU, given that non-residents of Spain and assets held abroad were being taxed at a higher rate without the Autonomous Communities approved fiscal benefits.

On May 5th, 2010, the Commission exercised its powers under article 258 TFEU and sent a reasoned opinion stating that Spain should make modifications to its IGT regime and was given two months to respond to the issues raised[4].

Spain did not comply with this requirement and on 16 February 2011, the Commission released an additional opinion. As the press release pointed out, the problem lay in applying State legislation to non-residents or to donations of assets held outside Spain, as this resulted in more tax being paid than by those residents in Spain, than by those who received gifted assets from within Spain[5].

Finally, the Commission decided –under article 258 TFEU- to refer the matter to the ECJ[6] alleging a violation of articles 21 and 63 TFEU[7]. A simple review of Spanish IGT should have been enough to solve the problem.

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3 Case citation: 2004/4090 Taxation. ES.

4 European Commission. Press Release: Taxation: Commission refers Belgium, Finland and France to the European Court of Justice and sends a reasoned opinion to Spain" IP/10/513, http://europa. eu/rapid/press-release_IP-10-513_en.htm/ .

5 European Commission. Pres Release: "Taxation: Commission requests Spain to change its discriminatory inheritance and gift tax provisions" IP/11/162, http://europa.eu/rapid/press-release_IP-11-162_en.htm .

6 (C-127/12). DO C 126 de 28.4.2012.

7 European Commission. Press Release: "Taxation: Commission refers Spain to the Court of Justice over discriminatory inheritance and gift tax rules", IP/11/1278, http://europa.eu/rapid/press-release_IP-11-1278_en.htm

III. ECJ Ruling of 3 September 2014, *Commission v. Spain*, C-127/12

Member States cannot treat non-resident heirs or deceased persons in a less favourable way since this would violate the free movement of capital, except in justified, objective situations. However, Article 63 of the TFEU[8] needs to be interpreted in light of the provisions contained in TFEU which acknowledges that Member States can differentiate on grounds of the place of residence and place of investment, provided that they "shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments". Regarding the free movement of capital, the possibility of establishing such limitations is included in Article 65 TFEU

In the Ruling of 3rd September 2014, European Commission v Kingdom of Spain, C-127/12, the Court determined that Spain was in breach of article 63 of the TFEU. However, the Court didn´t make reference to a breach of article 21 of the TFEU – the free movement of persons – which was also alleged by the Commission[9].

In Commission v Spain,[10] the Court determined that Spain was in breach of article 63 of the TFEU and article 40 of the European Economic Area Agreement, that prohibit restrictions on the free movement of capital. These differences in tax treatment are declared to be contrary to the principle of free movement of capital. The Court stated that:

> *"The Kingdom of Spain has breached its obligations under articles 63 TFEU and 40 of the EEA Agreement, by allowing differences in the tax treatment of donations and inheritances between heirs and donees who are resident or non-resident in Spain, between deceased residents and non-residents in Spain, and between donations and similar dispositions of immovable assets located in the Spanish territory and outside Spanish territory*"[11].

8 Article 63 TFEU: "1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited. 2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited".

9 The ECJ considered that the Commission had not shown how the Spanish legislation affected this freedom from being exercised, nor had it proved that there was a link between Spanish law and article 21 of the TFEU (Judgment in *European Commission v Kingdom of Spain*, EU: 2014:2130, paragraph 55).

10 Judgment of 3 September 2014, *European Commission v Kingdom of Spain*, C-127/12, EU:C:2014:2130.

11 This is the author's translation of Judgment of 3 September 2014, *European Commission v Kingdom of Spain*, C-127/12, EU:C:2014:2130, paragraph 84.

The Court´s judgment indicates that the only matter in question is the criterion of connection determined by Spanish legislation[12], which allows the application of fiscal reductions in cases where the taxable persons reside, or when property is physically located, in an Autonomous Community[13].

Also, of great relevance, is that when the ruling refers to the freedom affected, it generally alludes to non-residents. However, in our opinion, there is no requirement that those non-residents must reside in a European Union or European Economic Area Member State. Consequently, that is, because the free movement of capital also applies to third countries.

IV. Following the ECJ Ruling: Spain´s Amendment to its IGT Legal Regime

Implementing the Court´s ruling was extremely complex since the breach of the free movement of capital contained in Article 63 of the TFEU was a result of the tax system´s overall configuration in a decentralised country, and its effect on IGT.

Following the ECJ´s pronouncement, Spain acted almost immediately in order to ensure full compliance with the ECJ ruling. The reform attempted to put non-residents and residents of the Autonomous Communities on the same basis for tax purposes and a new provision was introduced into Law 29/1987, IGT, including five new points of connection.

These five new points of connection allow residents of the European Union or European Economic Area to apply the law of the Autonomous Community, with which they are most strongly connected.

1. *Mortis causa* acquisitions where the deceased was resident in a European Union or European Economic Area member State other than Spain: the appropriate Autonomous Community should be that the one where the greatest number of goods and rights in Spain are located. If none of the goods or rights are in Spain, the appropriate Autonomous Community should be the one in which the taxable person resides.
2. *Mortis causa* acquisitions where the deceased was resident in a Spanish Autonomous Community and the taxpayers reside in a European Economic Area Member State: in this case, the appropriate Autonomous Community should be the one in which the deceased resided.

12 The ECJ did not make direct reference to AC-approved regulations. Instead, it made reference to the State regulation (article 32, Law 22/2009) which contains the points of connection (Judgment in *European Commission v Kingdom of Spain*, EU: 2014:2130, paragraph 58).

13 Judgment in *European Commission v Kingdom of Spain*, EU: 2014:2130, paragraph 63.

3. Gratuitous transfers *inter vivos* of property located in Spain by taxpayers who are resident in a European Union or European Economic Area Member State: the appropriate Autonomous Community is that in which the asset is located.

4. Gratuitous transfers *inter vivos* of property located in a European Union or European Economic Area Member State made by taxpayers who are resident in Spain: in this case, the appropriate Autonomous Community should be the one in which the taxpayer resides.

5. Gratuitous transfers *inter vivos* of movable goods located in Spain made by taxpayers who are resident in a European Union or European Economic Area Member State: the appropriate Autonomous Community is that in which the movable goods have been located for the highest number of days during the previous five years.

As can be deduced from the previous comments, the new legislation for points of connection is complex and presents ample opportunities for case studies. Following the ECJ´s ruling, it must be questioned whether the amendment made to the IGT regime still fails to respect the free movement of capital. The new supplementary provision addressed only residents in Spain and in the EU but not residents of third countries.

It is clear that the new IGT legislation makes a distinction between non-residents and residents of third countries, so the Spanish legislation in this area need to be reconsidered.

The different situations that fall within the scope of the new points of connections expressed by the IGT legislation, following the ECJ Spain ruling, discussed above, have been exposed. However, these provisions seem incompatible with the free movement of capital (article 63 TFEU) and with established case-law on inheritance tax.

V. Judgment of the Spanish Supreme Court, 19 February 2018

As the previous discussion has shown, there continues to be many cases where the only option is to apply State legislation, without the taxpayer being able to benefit from Autonomous Communities approved fiscal benefits.

The difference of treatment between Spanish and EU citizens was eliminated as a consequence of the ECJ ruling. Though, Spain considered that this ruling affected only situations where discrimination was considered to involve EU Member States. However, residents of third countries were consequently outside the scope of this ECJ ruling.

However, the Spanish Supreme Court has reconsidered the interpretation given to this ECJ ruling in a pronouncement dated 19 th of February 2018[14] where a resident of Canada appealed to the Spanish Supreme Court for compensation in respect of state liability.

The Spanish Supreme Court based its interpretation on Articles 63 and 65 TFEU and on a solid jurisprudence from the ECJ.

In this pronouncement the Spanish Supreme Court highlighted the judgment of ECJ in *Welte*:

> *"articles 56 EC and 58 EC must be interpreted as precluding legislation of a Member State relating to the calculation of inheritance tax which provides that, in the event of inheritance of immovable property in that State, in a case where, as in the main proceedings, the deceased and the heir had a permanent residence in a third country, such as the Swiss Confederation, at the time of the death, the tax-free allowance which would have been applied if at least one of them had been resident in that member State at that time"* [15].

On this point, the case-law of the ECJ has played a fundamental role through so-called "negative integration", given that IGT is not a harmonised tax. The Spanish Supreme Court, on the basis of these cases found for the appellant and made some important statements.

In the Legal Basis 1º the Spanish Supreme Court stated in reference to *Scheunemann* case [16]:

> *"It is also clear from the case-law of the Court that the tax treatment of inheritances falls, in principle, under article 63 TFEU on the free movement of capital". Also, "Inheritances consisting in the transfer to one or more persons of assets by a deceased person, falling under heading XI of Annex I to Directive 88/361, which is entitled "personal capital movements", are movements of capital for the purposes of Article 63 TFEU"*[17].

14 Spanish Supreme Court 19 th February 2018, núm. 62/2017. In subsequent rulings, the Supreme Court has maintained the same interpretation: 21 March 2018 (núm. 488/2018) and 22 March 2018 (núm. 493/2018).

15 Judgment of 17 October 2013, *Welte*, C-181/12, EU:C:2013:662:446.

16 The ECJ has already made this comparison: "the cost of acquisition is directly linked to the payment made on the occasion of a share repurchase so that, in this regard, residents and non-residents are in a comparable situation. There is no objective difference between the two situations such us to justify different treatment on this point as between the two categories of taxpayers" (Judgment of 19 January 2006, *Bouanich*, C-265/04, EU: C:2006:51, paragraph 40).

17 Judgment of 19 July 2012, *Scheunemann*, C-31/11, EU:C:2012:481, paragraph 22.

As the ECJ indicated in *Barbier* and the Spanish Supreme Court has mentioned "a Community national cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force Member State other than his State of residence"[18]. Relations between Member States take place against a common legal background, characterised by the existence of Community legislation. Regarding the free movement of capital, the possibility of establishing limitations is included in Article 65 TFEU[19].

The Spanish Supreme Court also mentioned the *Rimbaud* case[20] and *Elisa* case[21]. Obviously, the free movement of capital with third countries has different justifications but there are no objective situations justifying the non-application of Autonomous Community-approved fiscal advantages to gratuitous transfers between third countries and a Member State.

Whereas Spanish Law continues to consider heirs and beneficiaries as taxable persons subject to IGT whether they are resident or not, there is no objective difference in situation justifying the different tax treatment of a resident and a non-resident.

The Spanish Supreme Court highlighted that the provisions of the new amendment discriminate against non-EU residents and, therefore, infringe EU principles because the free movement of capital may also be infringed in situations involving third countries and not only EU Member States. In various rulings throughout 2018, the Spanish Supreme Court declared that the free movement of capital went beyond the borders of the EU and the European Economic Are Member States[22].

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18 Judgment of 11 December 2003, *Barbier*, C-364/01, EU:C:2003:665, paragraph 71.

19 See, Judgment of 18 December 2007, *A Case*, C-101/05, EU:C2007:804: "that case-law, which relates to restrictions on the exercise of freedom of movement within the Community, cannot be transposed in its entirety to movements of capital between Member States and third countries, since such movements take place in a different legal context". One such example is the *Persche* case, where in relation to charitable bodies established in non-member countries, the Court noted that the taxing Member State was authorised to deny the granting of the tax advantage if it were not possible to obtain the necessary data from that country, in cases where the third country has not entered into any contracted treaty obligation to provide information (Judgment of 27 July 2009, *Persche*, C-318/07, EU:C:2009:33, paragraph 70).

20 The ECJ made clear that "where the legislation of a Member State makes the grant of a tax advantage dependent on satisfying requirements, compliance with which can be verified only by obtaining information from the competent authorities of a third country, it is, in principle, legitimate for that Member State to refuse to grant that advantage if, in particular, because the third country is not under any contractual obligation to provide information, it proves impossible to obtain that information from that country" (Judgment of 28 October 2010, *Rimbaud*, C-72/09, EU:C:2010:645, paragraph 41).

21 Judgment of 11 October 2007, *ELISA*, C-451/05, EU:C:2007:594, paragraph 96.

22 See Judgments of the Spanish Supreme Court, 21 March and 22 March 2019, cited above.

This Supreme Court judgment has had a huge impact on the current Spanish IGT rules.

VI. Consequences

Law 22/2009 is not modified in accordance with the new jurisprudence of the Spanish Supreme Court and there are different interpretations made by the legislator and the Spanish Supreme Court. The points of connection therefore need to be urgently reconsidered.

Having reviewed the recent Jurisprudence, the Spanish legislation in this area must be considered. When configuring the points of connection, it is important to bear in mind the difference between unequal treatment on the grounds of residence permitted by article 65 of the TFEU, and arbitrary discrimination, which is prohibited by Article 65(3) TFEU. Whereas that Spanish Law continues to consider heirs and beneficiaries as taxable persons subject to IGT whether they are resident or not, there is no objective difference in situation justifying the different tax treatment of a resident and a non-resident.

The main consequences from these rulings, especially for individuals who have already been taxed in Spain, are the following:

1. Non-EU residents who have paid taxes contrary to EU law are now entitled to appeal against the return filed at the time if they are still covered by the 4-year statute of limitations period.
2. Non-EU residents are entitled to benefit from the legislation of the Spanish Autonomous Communities where they have received the inheritance or gift, based on the ruling of the Spanish Supreme Court, in situations in which it would be more favourable for them than the State Law.