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TAX ON INHERITANCES AND GIFTS IN THE SINGLE MARKET: PROPOSALS FOR ACTION

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According to the briefing of the EC Commission on 18th April 1996, its paper "Taxation in the European Union" was favourably received by the recent informal ECOFIN Council in Verona. It is not proposed to review the contents of the paper here but it identifies three main challenges facing tax policy. These are, first, the stabilisation of member states' tax revenues, second, the smooth functioning of the single market (which is seen as the "cornerstone" of EMU) and, third, the promotion of employment. The Commission sets out a line of action in response to these challenges. So far as direct taxation is concerned it notes that the functioning of the single market can be improved in relation to the taxation of non-resident individuals, cross-border interest payments, the taxation of permanent establishments and the adequacy of bilateral tax conventions. So far as inheritance and gift taxes are concerned the issue is not, of course, the adequacy of conventions so much as their existence.

From the perspective of individuals and families, inheritance and gift taxes often involve far larger sums than are at stake in relation to other areas which have attracted the Commission's attention: the deductibility of mortgage interest payments, for example, which were specifically referred to in the press release of 20th March 1996 issued on the presentation of the Commission's paper. Furthermore, there can be little doubt that inheritance and gift taxes have a significant impact on businesses and their owners and especially the small and medium-sized businesses which are likely to be so important in promoting employment. Indeed, the Commission has already recognised this and

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recommended that business assets be given 100%[2] relief from inheritance tax, as in the United Kingdom.[3] However, as the OECD observed in 1988, such reliefs are themselves not without disadvantages and the economic effects of inheritance and gift taxes do not concern just business assets.

In its report *Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals*,[4] which reviewed taxes on private capital, the OECD said:

> "Looking at the economic consequences in a broader perspective, governments must have regard to the possible adverse effect of capital taxes on saving and hence on capital accumulation. Any reduction in the rate of capital accumulation is likely to have corresponding effects on the rate of economic growth and (less important) will also react back on the revenue from capital taxes -- less capital accumulation implying less revenue. Governments may seek to reduce the possible harmful effects of capital taxation by exempting (or partially exempting by valuation concession) particular productive assets like agricultural land and private businesses; but in so far as the market reacts to these exemptions by pushing up the price of these assets so as to equalise net of tax returns on different forms of investment, the incidence of the tax is felt across the whole field of capital investment. In these circumstances the main effect of exemption is to give existing owners a once-and-for-all capital gain."

In a single market it is not just saving that is likely to be affected but the location in which the savings, or other capital assets, are kept. Furthermore, when considering where to live and work in the single market well-advised entrepreneurs and executives will often consider the taxation of their personal assets, such as their home. For the family the impact of inheritance and gift tax can be

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2 *Commission Recommendation of 7th December 1994 on the transfer of small and medium-sized enterprises*, OJ L385/14 (31.12.94); see especially Article 6. See also *Communication from the Commission on the Transfer of Businesses: Actions in favour of SMEs*, OJ C204/1 (23.7.94) at paragraphs 8-10, which foreshadows the *Recommendation* and suggests increasing the number inheritance and gift tax treaties or a multilateral convention, and *The Improvement of the Fiscal Environment of Small and Medium Sized Enterprises*, COM (94) 206 final Brussels 25th May 1994.

3 See the Inheritance Tax Act 1984 sections 104(1) and 116(2) dealing with business property and agricultural property respectively. The relevant reliefs were extended by the Finance Act 1996 sections 184 and 185.

4 OECD, Paris, 1988. The quotation below is at page 20 paragraph 0.29.

considerable although the tax revenue at stake is likely to be very small.[5] It is clear from the Commission's recent paper that it is conscious of the need to encourage the mobility of capital and labour. In view of this, the paper on direct taxation which the Commission is to produce later this year, should give some serious consideration to the problems surrounding multiple taxation of inheritance and gift taxes.

The Extent of the Problem

The possibilities for multiple taxation of gifts and inheritances can be demonstrated by the following example. An individual domiciled in State A (Ireland/UK) marries a national of State B (Sweden) and becomes resident there in, say, 1988. Subsequently, the individual moves to State C of which he is a national (Netherlands) and resides there before returning to the country of his birth and taking up residence in State A in the last few months of his life. By his will he makes a gift of a home and certain of its contents situated in State D (Denmark) for the benefit of a son. The son is resident in state E (Spain) and a national of State F (Greece).

The precise tax liability to be imposed by each affected state will no doubt be a matter for specialist lawyers in each of the member states concerned. The example purports to do no more than illustrate the potential for multiple taxation. It appears that as the donor had been married to a Swedish national and resided in Sweden within 10 years of death the property is subject to Swedish Inheritance Tax.[6] Irish Capital Acquisitions Tax[7] or UK Inheritance Tax[8] would be payable as the deceased died domiciled in one of these two states. At the outset, therefore, States A and B are in conflict. As the donor had been a resident of State C (the Netherlands) before returning to Ireland or the UK (State A) then, if the appropriate conditions are met, he will be deemed to be resident in the

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5 See Table 0.2 at p 27 of *Taxation of Net Wealth* etc, which shows that the total revenue from death and gift taxes as a percentage of tax revenues for EC member states ranged at that time from 0.17% for Austria to 0.94% for Greece.

6 'Sweden: Inheritance and Gift Tax' 34 *European Taxation* [1994] 10/11 p 410, Helena Rempler.

7 'Ireland: Inheritance and Gift Tax' 34 *European Taxation* [1994] 10/11 p 374 Lynda A M Carroll.

8 Inheritance Tax Act 1984 sections 4, 5 and 6.

Netherlands.[9] State C may, therefore, seek tax. State D (Denmark), in accordance with the approach of many states, will wish to charge tax in respect of gifts of realty situated within its borders.[10] State E (Spain) will probably charge tax because the recipient is resident there. If the son lives in Navarra or the Basque Country he may be liable to local inheritance and gift taxes which apparently exclude analogous central state taxes.[11] If the son is a Greek national and has lived in Spain for less than 10 years then Greece (State F) will seek tax, at least in respect of the movables.[12]

The threat of multiple taxation in the above example is not removed by double taxation conventions. Ireland does not, apparently, have an inheritance or gift tax treaty with any EC state except the UK. The UK has treaties with the Netherlands and Sweden. Sweden has, in addition to its treaty with the UK, treaties with Denmark, the Netherlands and Spain. Neither the Netherlands, Denmark nor Sweden have treaties to apply other than those already mentioned, and Greece has no treaty to apply at all. To avoid completely all double taxation in relation to the six States A to F referred to above, 15 bilateral double tax treaties would be necessary. In fact only 5 exist between the seven states named.

Unilateral relief will not resolve the difficulties either. For example, UK unilateral relief is restricted in respect of tax charges made by states which are attributable to property in third countries.[13] In Denmark a credit for foreign tax is limited

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9 The deemed residence rules apply to nationals for ten years after they have left the Netherlands: see 'Netherlands: Inheritance and Gift Tax' 34 *European Taxation* [1994] 10/11 p 391, Paul J te Boekhorst.

10 On 1st July 1995 Denmark abolished its Inheritance and Gift Tax Act 1991 and introduced an estate duty on inheritance and a gift tax on certain lifetime gifts by Act No.426 of 14th June 1995. By virtue of section 9(2) estate duty is levied on non-residents in respect of land located in Denmark or assets related thereto: see *Capital Taxes and Estate Planning in Europe* (Ed Timothy Lyons) *Denmark*, Christian Emmeluth and Eric Overgaard, paragraph 52.

11 See 'Spain: Inheritance and Gift Tax' *European Taxation* [1994] 10/11 p 404 notes 1 to 3 and p 405, Miguel-Angel Garcia Caballero.

12 See 'Greece: Inheritance and Gift Tax' 34 *European Taxation* [1994] 10/11 p 369, H Anagnostopoulos.

13 See Inheritance Tax Act 1984 section 159(3)(4)(5).

to certain classes of assets, such as foreign immovable property.[14] Whilst in states such as Sweden, unilateral relief is apparently discretionary.[15]

The Obligation to Act

Problems of this nature within the EC deserve attention. Indeed, the EC Treaty requires them to be resolved. If the Commission is to attend to the fiscal problems faced by frontier or mobile workers and entrepreneurs the capital as well as the income of the individual ought to be borne in mind. The Opinion on direct and indirect taxation of the Economic and Social Committee adopted on 31st December 1995 recommended a study of the major differences in taxation on highly-skilled workers in relation to taxes on income and noted that in relation to both income and wealth taxes tax competition was likely to occur.[16] If a study is to be undertaken then it ought to encompass the effect of taxes on gifts and inheritances as well. Whether a study is really necessary is surely open to question. There is no doubt that highly mobile individuals take into account the entire tax regime of states in making decisions about where to locate themselves and their businesses. There is also no question that member states are obliged to take steps to avoid double taxation and implement the single market fully.

The most basic obligation of the member states is to implement the internal market pursuant to Article 7a of the EC Treaty and approximate laws to achieve this aim, although in fiscal matters the Council must be unanimous. It is also essential that the fundamental freedoms are established. There is no reason why all four freedoms, of workers, establishment, services and capital, should not have some impact on the taxation of gifts and inheritances. The freedom of movement of capital may be particularly important in this context. Council Directive 88/361/EEC[17] (passed, of course, before the Maastricht Treaty introduced the new Article 73b into the EC Treaty) shows that taxation of inheritances is a matter that the EC considers of some importance in the context of these freedoms.

Article 1 of the Directive states that:

> "...Member States shall abolish restrictions on movements of capital taking place between persons resident in Member States."

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14 'Denmark: Inheritance and Gift Tax' 34 *European Taxation* [1994] 10/11 p 350 at p 353 B P Dik.

15 'Sweden: Inheritance and Gift Tax' 34 *European Taxation* [1994] 10/11 at p 410, H Rempler.

16 96/C 82/11 paragraphs 5.1 and 5.2. See OJ No C82/49 (19.3.96).

17 OJ 1988 L178/5 (8.7.88).

Capital movements are classified in accordance with the Nomenclature in Annex 1 to the Directive. The list contained there is expressly stated not to be exhaustive. However, it includes investments in real estate (paragraph II), personal capital movements (paragraph XI) and death duties (under the heading "Other Capital Movements" in paragraph XIII). Under personal capital movements are listed: loans, gifts, endowments, dowries, inheritances, legacies and transfers by immigrants and emigrants.

Council Directive 88/361/EEC could be relied upon by individuals by virtue of the doctrine of direct effectiveness. Of course, this doctrine can only be relied upon to the extent that the provisions of the Directive are not correctly transposed into domestic law. With the ratification of the Maastricht Treaty and consequent amendment of the EC Treaty to include Articles 73b-g individuals have a treaty provision upon which to rely. The correct transposition of EC law into domestic law is irrelevant and one of the justifications for EC intervention on the taxation of inheritances and gifts has been given a firmer foundation.[18]

Article 73b, it will be recalled, states that:

> "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."[19]

The subsequent provisions of the Treaty do affect the scope of this Article, and the Declaration on Article 73(1)((d) is also of importance. It is not proposed to discuss these here. What is important is to emphasise the potential impact of the fundamental freedoms, and this provision in particular, upon inheritance and gift tax. It may well be, for example, that the deemed residence or domicile rules

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18 A useful discussion of the development of the freedom of movement of capital is provided in Chapter 2 of *The Law of Money and Financial Services in the European Community*, John A Usher, Clarendon Press Oxford, 1994.

19 These provisions have already been the subject of cases before the Court of Justice, although not in the context of the taxation of gifts and inheritances. See *Criminal Proceedings against Lucas and Others* Joined Cases C-163/94, C-165/94 and C-205/94 (unreported). See also *Criminal Proceedings against Aldo Bordessa and Others* Joined Cases C-358/93 and C-416/93 [1995] I ECR 361 in relation to Article 67. Article 73b was also referred to by the Advocate General in his Opinion in *Schumacker* (cited above) at p 233, paragraph 32.

which some member states, such as the UK[20] and the Netherlands, employ in relation to inheritance and gift taxes will, in certain circumstances, be vulnerable to attack as infringing the fundamental freedoms. Indeed, it is understood that the deemed residence rules in the Netherlands have already been the subject of litigation (in which there was no reference to the Court of Justice).[21]

Finally, attention ought to be paid to the provisions of Article 220 of the EC Treaty. This states that:

> "Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals:...
>
> - the abolition of double taxation within the Community..."

In this context it is worth noting that the Ruding Committee, having urged the conclusion of a full network of income tax treaties amongst the member states, went on to say:

> "... it was also pointed out that very few Member States have concluded bilateral tax treaties between each other that deal with taxes on estates, gifts and inheritances. The Committee considers that such treaties should also be concluded as soon as possible."[22]

Since then, as was noted above, the Commission has called for the avoidance of double taxation in this area either bilaterally or multilaterally.

Is Action Possible?

Notwithstanding the secure legal foundation for action it is sometimes suggested that any significant proposals by the EC would face formidable difficulties. The activities of certain member states suggest that the difficulties are by no means insuperable. Although the number of double tax treaties in relation to inheritance and gift tax is much lower than those relating to taxes on income and capital, there has in recent years been an increase in the number of treaties concluded by EC member states.

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20 See the Inheritance Tax Act 1984 section 267.

21 See 'Inheritance Tax Solely on the Basis of Nationality' 33 *European Taxation* [1993] 11, 384, Rijkele Betten.

22 Report of the Committee of Independent Experts on Company Taxation at p 206.

In the last six years France has been particularly active in this area, making treaties with Italy (20th December 1990), the Netherlands (28th November 1991),[23] Austria (26th March 1993) and Sweden (8th June 1994) whilst a treaty with Germany was initialled in May 1995. Sweden has, of course, always had a significant number of treaties on inheritance and gift tax and has nine treaties with EC member states if one includes the Nordic Multilateral Convention on Inheritance and Gift Tax (12th September 1989). In the last six years it has entered into two new treaties, one with France, noted above, and one with Germany (14th July 1992).

This progress by member states, whilst welcome, does not remove the need for activity at an EC level. The number of treaties on inheritance and gift tax is still small in comparison to those in relation to taxes on income. The recent increase in their number does show, however, that progress in eliminating double taxation can be made where the will exists.

It has been said that harmonisation is indispensable to progress in this area[24] but this would seem an unduly pessimistic view. Of course, it is true that taxes on gifts and inheritance use more widely differing concepts than taxes on income. Nationality, domicile and residence all have their part to play in linking an individual with a tax system. The person liable for the tax also varies. Sometimes it is the donor, sometimes the donee and sometimes both. This variety is one of the reasons why multiple taxation arises so easily in this area. Nevertheless, the Nordic Convention should show that this diversity can be overcome since the tax systems of the Nordic countries vary considerably.

Perhaps more difficulty would be encountered in dealing with the problems produced by the acceptance by the UK and Ireland of the trust but the existence of this one concept cannot reasonably be regarded as a reason to do nothing in contexts in which the trust is insignificant. In any event the EC states are becoming much more familiar with the concept of the trust by reason of international conventions such as the Brussels Convention 1968[25] and the Hague Convention on the Law Applicable to Trusts and on their Recognition 1985 (which the civil law member states of Italy and the Netherlands have ratified).

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[23] It is understood that this treaty is not yet in force.

[24] 'Harmonisation of Inheritance, Estate and Gift Taxes within the EU', *EC Tax Review* 1995/2, 88 at pages 95-96, F Sonneveldt and J Zuiderwijk.

[25] The Brussels Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters contains specific provisions relating to trusts. The Convention on Bankruptcy, Winding Up, Arrangements, Compositions and Analogous Procedures, initialled on 25th September 1995, will require recognition of the actions of trustee in bankruptcy.

The EC may, therefore, approach the problems of double taxation in this area in the knowledge that member states can improve the position regarding double taxation on inheritances and gifts if they so wish and that some of them, in accordance with their legal obligations under the EC Treaty, are doing so. Nevertheless, without action at the EC level many of the problems presented by double taxation of inheritances and gifts are likely to be around for a very considerable time.

Proposals for Action

Dr Rädler put forward some proposals in the 6th Annex to the Ruding Report. He said:

> "Within the Community, all taxes on capital, estate and inheritances must be covered by a tax treaty. Therefore, these taxes should be included in Article 2 of the OECD Model Treaty (taxes covered). They are of particular importance for small and medium-sized enterprises."

This statement is useful in that it clearly links the legal obligation to avoid double taxation with the practical necessity for doing so. As we have seen, the Commission has subsequently borne in mind the importance of small and medium-sized businesses and emphasised the economic justifications for action. It is important, though, to keep in mind the legal obligations imposed by the EC Treaty since it is these which give the EC its authority to act in this area. It would not, however, be easy to add inheritance and gift taxes to the taxes covered by treaties governing double taxation of income and capital. To give one example of the difficulties which may arise, questions of property situs, often so important where double taxation of gifts and inheritances is concerned, would not be specifically covered.

The Commission has undoubtedly learnt from its experience with the so-called "French package"[26] that progress in relation to taxation is more likely to be achieved incrementally. It is also essential to ensure full respect for the principle of subsidiarity (and the introduction to the Commission's paper expressly refers to the need to do this). Against this background one can see the attraction of encouraging the member states to emulate the UK's decision to exempt business assets from Inheritance Tax altogether, as was done in the 1994 Recommendation.[27] Such action does not require agreement between the member

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26 Directive 90/434 (OJ 1990 L225/1) the Merger Directive, Directive 90/435 (OJ 1990 L255/6) the Parent/Subsidiary Directive, and the Arbitration Convention (OJ 1990 L225/10).

27 See note 2 above.

states, unanimously or even bilaterally, and it leaves action to the member states themselves. However, even if the implementation of the proposals of the Recommendation can be guaranteed, the problems in this area would be very far from solved as is shown by the example of multiple taxation given above. More needs to be achieved if individuals and their families are not to be penalised for exercising their fundamental freedoms.

It is suggested, therefore, that the Commission should put forward a proposal to limit double taxation of inheritances and gifts on personal as well as business assets. One possible form for this would be a draft Directive establishing that inheritance and gift tax on the value attributable to immovable property, used otherwise than for the purposes of business, is paid only in the state in which the immovable property is situated.

The 1983 Model Double Taxation Convention on Estates Inheritances and Gifts provides, in Article 5, that immovable property which forms part of an estate of or gift made by a person who is domiciled in the Contracting State other than that in which the immovable property is situated may be taxed in the state of situs of the property. As the Commentary on Article 5 recognises,[28] the provision does not apply where land is situated in the Contracting State in which the deceased or donor is domiciled, nor where the land is situated in a third country. The provisions of Article 7 apply to such property and they provide that the state of domicile of the donor or deceased is to have taxing rights.

The proposal that the value attributable to immovable property is taxed only in the state in which the land is situated would leave unchanged the position where land is situated in the state of the domicile of the deceased or donor, since the effect of Article 7 is to ensure that the state of situs of the land has taxing rights. There would, however, be a change in relation to land situated in a third country (as it would be called in the context of a bilateral treaty). This would be taxed in the state of situs and not in the state of domicile of the deceased or the donor. Such a provision would be likely to be acceptable in the context of a Directive which all member states must implement. The scope for dispute between member states would also be reduced by reason of the fact that only property used for residential purposes would be affected. The more valuable and therefore more contentious issues concerning immovable property of businesses and permanent establishments would be unaffected. In view of this, the unanimity which would be required under Article 100 of the Treaty should be more easily attainable. Accordingly, valuable as Recommendations are, there would seem little reason to prefer a Recommendation to a draft Directive on grounds of political expediency.

If a Directive were to be implemented to give effect to these provisions it would avoid much of the double taxation which arises in the example given above. It

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28 See paragraph 1.1.

would also give individual taxpayers in the EC immediately enforceable rights by virtue of the doctrine of direct effect. If the property in respect of which the proposed Directive were to operate were set out in an annex, then it would be possible to extend the scope of the Directive simply by amending the annex.

Once a limited Directive has been passed it may be easier to make more general advances in the reduction of double taxation of inheritances and gifts. Such general advances, of the kind that the Commission has said it wants, could be achieved in a number of ways. Apart from making Recommendations, the Commission could propose legislation under Article 100 of the EC Treaty or it could propose a treaty for implementation pursuant to Article 220.

Recommendations do have a positive role in raising the level of awareness of member states in relation to a particular issue. In construing the EC Treaty the Court of Justice will take them into account. One area in which this was particularly true was in relation to the taxation of frontier workers.[29] Recommendations should not, therefore, be regarded as pointless. They are, perhaps, particularly useful in relation to narrowly defined areas, but the more complex or general the issue the less likely they are to achieve results.

If it is accepted that it would be difficult to achieve the necessary unanimity pursuant to Article 100 for legislation of a general nature, or a multilateral treaty we are left with the option of reliance on Article 220. Instead of simply encouraging member states to enter into bilateral treaties, it is suggested that the Commission could put forward a multilateral Convention to avoid double taxation of inheritances and gifts to come into force on the occasion of the third state to ratify it.[30] This would be preferable to waiting for ratification by all member-states of the EC, as was necessary for the Arbitration Convention, since it allows those states which wish to make progress to do so. It would be important to ensure that the Convention was subject to the interpretation of the Court of Justice and gave taxpayers directly effective rights. As a Convention under Article 220 of the EC Treaty is proposed, a special protocol giving the Court of Justice jurisdiction would be required. (The absence of such a protocol is a well-known disadvantage of the Arbitration Convention.)[31]

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29 See *Schumacker supra*, and the opinion of Advocate General Léger at paragraph 73.

30 This formulation is not uncommon in international conventions; see, e.g., the Hague Convention on the Recognition of Trusts 1985.

31 See for further comment *EC Tax Law*, P Farmer and R Lyal, Clarendon Press Oxford, at p 308.

Conclusion

It is time to recognise the scale of double taxation of inheritances and gifts in the EC and the practical need as well as the legal obligation to avoid it. All tax advisers know just how important gift and inheritance tax can be to individuals, and the economic impact of these taxes on individuals' decisions is out of all proportion to their benefit to member states' revenues. A single market in which member states compete to tax the capital assets of individual voters is bound to be viewed with some scepticism by those whose assets are in issue.

Should the ECSC's suggested study of personal taxation take place it ought to cover taxes on inheritances and gifts, but further study ought not to be allowed to delay action which is justified both legally and practically. Without an initiative from the Commission the problems of multiple taxation in relation to inheritance and gift taxes in the EC will persist for a long time to come.

A proposal for a Directive that the value of immovable property used otherwise than for business purposes be taxed in the state in which the property is situated would be worthwhile and would complement the proposal to relieve business assets from taxation. Once in place it may make further progress that much easier to achieve.

As a way of increasing the awareness of the scale of double taxation of inheritances and gifts, maybe the member states could, in the course of their discussions on the future of the EC, find room for a short declaration in the following form:

> "Having regard to the need to enable individuals to exercise their fundamental freedoms so as to facilitate the creation and distribution of wealth within the EC and having regard to the importance of small and medium-sized enterprises in achieving this objective, the Member States hereby commit themselves to avoid double taxation of inheritances and gifts."

At least a declaration in that form would put the issue of double taxation of gifts and inheritances on the EC's agenda, which is surely where it belongs.