

STUDY ON INHERITANCE TAXES IN EU MEMBER STATES AND POSSIBLE MECHANISMS TO RESOLVE PROBLEMS OF DOUBLE INHERITANCE TAXATION IN THE EU

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| PREFACE

The European Commission, Directorate General Taxation and Customs Union, has asked Copenhagen Economics to study two aspects of the Member States' domestic tax rules on inheritance.

First, the European Commission wishes to investigate if, and to what extent, Member States' domestic inheritance tax rules may lead to differences in treatment that are incompatible with Community law, *inter alia*, in the light of the recent case law from the European Court of Justice in this area.

Second, the European Commission wishes to investigate how much unrelieved double inheritance taxation exists in the European Union. At present, there is no comprehensive solution to this problem, due to the absence of inadequacy of unilateral methods of relieving double taxation as well as due to the limited number of existing bilateral conventions between Member States in the inheritance tax area. The European Commission, therefore, wants to consider possible solutions to this problem. But more information is needed to assess the size of the problem.

Chapter 1 MAIN FINDINGS

The domestic rules on inheritance tax vary substantially among the 27 Member States of the European Union. A majority of the 27 Member States (18) have an inheritance or an estate tax, which is respectively levied on the heirs or the estate of a deceased person. Out of these 18 Member States 15 have an inheritance tax and 4 have an estate tax. Denmark is the only Member States with both inheritance tax and estate tax. Nine Member States impose neither an inheritance tax nor an estate tax.

Inheritance taxation may create two potential internal market problems. First, cross-border discrimination may arise if non-domestic assets and/or liabilities are subjected to higher levels of inheritance taxes than equivalent domestic categories. Second, assets and liabilities may end up being taxed for inheritance purposes in more than one EU tax jurisdiction potentially leading to very high levels of taxation. Both problems arise from the fact that EU citizens own assets outside their home Member State and may have relatives as well in other EU Member States.

During recent years, the attention to both problems has increased. This study explores three key issues in this regard:

- The nature of the cross-border problems (discrimination and double taxation)
- The economic significance of the problems
- Possible policy solutions to the problems

1.1. THE NATURE OF THE CROSS-BORDER PROBLEMS

The domestic rules on inheritance taxes in the European Union give rise to two potential cross-border problems, namely discrimination and double taxation.

Discrimination

The first problem is of relatively straightforward nature: Domestic tax rules may contain provisions that conflict with the non-discrimination principle. Based upon a number of cases, the European Court of Justice has in recent years established an increasingly clear jurisprudence in the area. National tax rules that have been judged to be in breach of EU law are those that:

- Provide different and less favourable rules for the valuation of assets forming part of an inheritance if those assets are located in another Member State
- Restrict the deductibility of debts/liabilities related to assets that are part of the inheritance of testators who were non-resident at the time of death
- Apply higher inheritance or estate duties for legacies made to charities established in other Member States
- Grant tax exemptions from inheritance or estate tax only if the recipient is a domestic charity
- Provide for higher personal allowances in favour of resident taxpayers.

Our survey of the domestic tax rules provides good and bad news with respect to discrimination.¹ The good news is that rules of a discriminatory character seem to be declining over the last decade as a likely response to the increasing focus on the issues and the several rulings by the court of justice as referred to above. The bad news is that a large number of the Member States still (most likely) have such discriminatory rules in 2010. The survey reveals that the main discriminatory problems are linked to four areas:

- The scope of specific exemptions from the inheritance tax rules
- The deduction of debt in calculation of the tax base
- The design of valuation methods for foreign located assets
- Special exemption for certain domestically located assets

Double taxation

The second and more complicated problem is double taxation. The term ‘double taxation’ implies ‘over-taxation’ because the same inheritance or estate is taxed in more than one Member State.

The main cause of such double taxation is a conflict between the connecting factors of the tax rules of two or more Member States. Connecting factors are rules that determine if a particular inheritance or estate is connected to the tax jurisdiction of a given Member State. Most Member States have two connecting factors included in their domestic inheritance tax rules, namely:

- A personal nexus rule
- A source rule

A *personal nexus rule* is the main connecting factor in all Member States with inheritance tax rules. Member States using these connecting factors taxes on the basis of one or more nexus between the deceased/heir and the territory of the State. Three main principles are applied by the Member States, the residence principle, which is the most common, the domicile principle and the nationality principle. Some Member States apply a combination of the three principles, cf. Table 1.1.

¹ Maisto (2010) plus additional survey carried out for the purpose of this study.

Table 1.1: Three principles for determining the personal nexus of the deceased or heir(s)

Principle	Condition	Member States using principle
Residence principle	The estate or inheritance is taxed if the deceased or the heirs were residents of the Member State at the time of death. The number of days spent in a Member State is normally the main basis for determining the residence Member State.	Belgium, Czech Republic,* Denmark, Finland, Germany, Hungary, Ireland, Italy, Lithuania, Luxembourg, the Netherlands, Poland, Slovenia, Spain.
Domicile principle	A person is generally domiciled where his or her permanent home is situated. A 'domicile of origin' is acquired at birth, normally from one's father.	France, Germany, Greece, United Kingdom.
Nationality principle	A personal nexus is established if the deceased or the heir is a citizen of the Member State.	Bulgaria, Czech Republic, Greece, Hungary, the Netherlands, Poland.

Note: * Czech Republic refers to 'permanent address'. Details on the applied personal nexus rules are contained in the attachment to the report. Only Member States with an estate tax and/or inheritance tax are included in this table.

Source: Copenhagen Economics based on Global Property Guide and Maisto (2010).

A *source rule* (situs rule) is the second connecting factor. According to this rule, a Member State levies taxes upon death on assets that are located within its jurisdiction, but not covered by its personal nexus rule. The source rule mostly covers all assets, but is sometimes limited to a subset of assets, e.g. real estate. Among the 18 Member States with an inheritance or estate tax, only the Netherlands does not apply a source rule, cf. Table 1.2.

Table 1.2: Scope of source rules in the domestic tax rules on inheritance

Scope of taxations	Member States
All asset	Czech Republic, Germany,* Greece, Ireland, Italy, Lithuania, Slovenia, Spain, United Kingdom.
Real estate (immovable assets) only	Belgium, Bulgaria, Denmark*, Finland, France, Hungary, Luxembourg, Poland.
No source taxation	The Netherlands.

Note: * The German source rule does not apply to bank account in German banks. ** The Danish source rule also applies to 'movable assets pertaining to permanent establishments'. Details on the applied personal nexus rules are contained in the attachment to the report. Only Member States operating an estate tax and/or inheritance tax are included in this table.

Source: Copenhagen Economics based on Maisto (2010) and Global Property Guide.

The conflicts between the connecting factors that may create double taxation are of three types.

1. **'Residence-source conflict'**: This conflict is the most common conflict between connecting factors. It results from two levels of taxation. Firstly, the whole (world-wide) assets are subject to taxation in the Member State that establishes a personal nexus to the deceased/the heirs. This is typically in the Member State where the deceased or the heir is resident or domiciled. Secondly, the foreign assets, i.e. the assets located outside the Member State where the deceased or the heir is resident or domiciled, are subject to source taxation in the other Member State, cf. Table 1.3.
2. **'Residence-residence conflict'**: This conflict is less frequent, but in contrast has often the largest impact in terms of double taxation. It occurs when several tax authorities claim that the heir involved is to be taxed in their Member State through a

personal nexus connection. Most Member States apply a residence rule, but the definitions of residence may differ. Moreover, other Member States apply varying definitions of domicile and nationality. The result is that for example a person with Dutch passport, being brought up and having his/her main assets in UK but living for the moment in Spain may be seen by the tax authorities in all three Member States as being liable for inheritance tax, cf. Table 1.3.

3. **'Source-source conflict'**: This conflict appears if two or more Member States claim that an inheritance is sourced in their jurisdiction. For physical assets such as real estate, cases will almost by definition by rare: a villa in Southern France can hardly be claimed by UK authorities as being sourced in the UK. The problems relate typically to intangible assets such as copyrights, cf. Table 1.3.

Table 1.3: Types of conflicts that may result in double taxation

Type of conflict	Description of conflict
Residence-Source	The same income is taxed twice, first by the Member State where it is derived under its 'source rule', and then in the Member State where the taxpayer has his or her residence and personal nexus.
Residence-Residence	Differences in the residence rules imply that the same deceased or heir is regarded as a resident of two Member states.
Source-Source	Diverging rules for determining the location of an asset imply that the same asset is covered by the source rule of more than one Member State. Problem most likely for intangible assets such as patents, copyrights, trademarks, computer software and for shares.

Source: Rohatgi (2005).

As well as for other cross-border tax 'events', the EU Member States have means to deal with such double taxation problems. However, in many situations these means may fail to fully solve the double taxation problems. The failure is due to at least three reasons.

A small number of bilateral tax treaties: While the OECD has developed a bilateral tax treaty model to deal with inheritance and estate taxes, only a fraction of the 27 Member States have in fact concluded such treaties. In June 2010, only 33 bilateral treaties are in force and 351 would be required to secure a complete coverage for all Member States.

The scope of the unilateral relief is limited: In some Member States the unilateral relief for foreign paid taxes is limited to a subset of asset, typically real estate and/or other immovable assets, and all limit the scope of the relief to cover only inheritance and estate taxes and not other taxes levied on the deceased's assets. Furthermore, several Member States only grant a unilateral relief for taxes levied at a national level and not locally levied taxes as in Belgium.

Unilateral relief does not cover all cases of double taxation: Most Member States grants a unilateral relief for inheritance and estate taxes paid in another Member State, but it fails to cover a number of important cases.

- a. For Residence-Residence conflicts, where the worldwide inheritance or estate is double taxed, the unilateral relief only applies to the foreign sourced inheritance or estate. As residence-residence conflicts imply that the world-

- wide inheritance or estate is prone to double taxation, the domestic sourced inheritance or estate remains prone to double taxation in such cases.
- b. For Source-Source conflict problems the domestic unilateral relief may not apply because the relevant assets will not be regarded as a foreign-sourced inheritance under the domestic tax rules. The source-source conflicts arise when two or more Member States claim that the same inheritance or estate is sourced within their jurisdiction.
 - c. For Source-Residence conflicts problems, the domestic unilateral relief may not provide full relief because of narrow definitions of key concepts in relation to the tax rules. For example, in Germany a narrow definition of the concept of 'foreign located assets' implied that the German unilateral relief (tax credit) did not apply in the Block case, where a German resident inherited a bank deposit located in Spain.²

1.2. IMPORTANCE OF CROSS-BORDER INHERITANCE CASES

From a macro perspective, the existing evidence shows that the scale of double taxation problem in the field of inheritance is relatively small. In the European Union as a whole, the total revenue from inheritance and estate taxes, including purely domestic cases and cross-border cases, amounts to less than 0.5% of total tax revenue. As the cross-border cases count for only a fraction of the total number of inheritance cases, the revenues associated with cross-border cases amounts to far less.

However, for the individual EU citizens who are exposed to double taxation, the conclusion may be far different. To these EU citizens, it may have a major negative impact on their personal financial situation that their inheritance is taxed in more than one Member State. The Block case, which the European Court of Justice has recently dealt with, provides an example of the negative impact that double taxation may have on the financial situation of an individual.³ In this particular case, a German resident, Ms Block, was taxed in both Spain and Germany on a Spanish located inheritance. She consequently ended up with an extra tax bill of more than €63,500, which is equivalent to an increase in the taxes paid of more than 60%.

In addition, the macro indicators of the scale of the problem indicate an increase during the coming years. The indicators show that the number of intra EU migrants has increased significantly during recent years, and an identical trend has been seen with respect to foreign investments in both real estate and portfolio investments. All other things equal, this is a clear indication that more and more EU citizens are being exposed to the risk of double taxation on inheritance.

² Cf. European Court of Justice (ECJ) judgment in the Margarete Block case (C-67/08).

³ Cf. European Court of Justice (ECJ) judgment in the Margarete Block case (C-67/08).

Moreover, there are no signs that these trends will not continue in the coming years. The integration of the EU Member States goes on, and the framework conditions that cause double taxation on inheritance have more or less remained unchanged during the last ten years. Double taxation occurs due to the same conflicts between the connecting factors of the domestic inheritance tax rules. Furthermore, the bilateral tax treaties and unilateral relief that are aiming at resolving the double taxation problems are often not effectively doing so. It is obvious that the Member States have generally devoted very little attention to the problem of double taxation on inheritance.

We draw three overall conclusions on both the size and development in the impact of the double taxation problem.

The first conclusion is that at a national level the magnitude of double taxation following from cross-border inheritance cases is limited. The revenue in Member States from inheritance taxes amounts to less than 0.5% of total tax revenue – and the cross-border share will amount to far less. Furthermore, there is a tendency towards lower effective inheritance tax rates.

There is, however, a caveat to the conclusion that the problem is only limited. It cannot be ruled out that the low share of cross-border succession cases is to some extent a result of the expectation of double taxation on inheritance and that we are therefore underestimating the problem by looking at the current number of cross-border succession cases. Confronted with the double taxation problem, it may be that some EU investors prefer to liquidate the investments in good time before they die if they foresee a situation with risk of double taxation on cross-border inheritance.

The second conclusion is that despite the problem's limited national magnitude, double taxation can pose a significant problem for the individuals concerned. Many of the largest migration streams risk exposing themselves to large inheritance tax rates due to double taxation following from migration. The flows between the 'old' EU-15 Member States, and especially the large migrant streams from UK to Spain and Germany to Spain, appear particularly exposed to double taxation as these Member States typically have relatively high effective inheritance tax rates. In contrast, as noted above inheritance taxes are generally low in new Member States.

The third and final conclusion is that there are clear and robust indications that the problem will increase in magnitude over the coming years. More people migrate to other Member States and more real estate and other assets are purchased abroad. This will eventually lead to more and more cross-border inheritance cases in the future.

Our estimations predict that the annual number of potential cross-border inheritance cases to be between 290,000 and 370,000. We have estimated this number based on the sum of estimated cases arising from a foreign located deceased, cases arising from a foreign located

heir, and cases arising from foreign located assets, and corrected the subtotal from these three sources for possible double counting, cf. Table 1.4. There is however considerable uncertainty attached to especially the second source of cross-border inheritance cases, those arising from a foreign located heir.

Table 1.4: Estimated number of cross-border inheritance cases

	Number of potential cases
Cases due to foreign located deceased	74,900
Cases due to foreign located heir	200.000-300.000
Cases due to foreign located asset	32,500-44,000
Subtotal	300.000-400.000
Deduction due to possible double counting	Minus 9.000-27.000
Total	290,000-370,000

Source: *Copenhagen Economics*.

There are distinct differences in migration between the EU Member States and therefore differences in where cross-border inheritance cases may arise. The flows between the 'old' EU-15 Member States, and especially the large migrant streams from UK to Spain and Germany to Spain, are for two reasons particularly exposed to double taxation. First, these Member States have relatively high effective inheritance tax rates. In contrast, effective cross-border inheritance taxes are zero in many of the 12 'new' Member States implying that migration flows to and from many of these Member States are less likely to situations of double taxation. Second, the migrants from the UK and Germany to Spain are generally relatively wealthy migrants with asset ownership in both their Member State of origin and Spain.

The extent of double taxation must be expected to be relatively moderate in most cross-border cases. On the one hand, due to conflicting connecting factors, a small number of bilateral tax treaties and insufficient unilateral relief, the probability of double taxation in cross-border inheritance cases is relatively high. On the other hand, the degree of double taxation is most certainly relatively low in most of these cases. Most often, the double taxation is due to a 'residence-source' conflict, and in these cases it is only the foreign located inheritance that is prone to double taxation. There are not available statistics on the share of the foreign located inheritance, but despite the increased mobility of people and assets, it must be expected that in most cases the domestic located inheritance is larger than the foreign located inheritance.

However, when they occur they may create substantially additional tax burdens for the individuals concerned. We discuss pros and cons of various solutions in the following section.

1.3. SOLUTIONS AT EU AND NATIONAL LEVEL

The study examines a number of different instruments to solve the double taxation problem including pushing for adoption of bilateral tax treaties on gift and inheritance taxes, development of new OECD instruments or EU solutions. Essentially such instruments need to

deal with the three conflicts that are causing double taxation on inheritance, namely the source-residence conflict, the residence-residence conflict and the source-source conflict.

We suggest taking a pragmatic route. It is no co-incidence that there is no progress on bilateral tax treaties: there are large obstacles to agreeing on the large number of parameters necessary to get there, while the benefits of such exercise as seen by member states may be limited.

Our assessment is that from a macro perspective the scale of the double taxation problem on inheritance is rather limited. Therefore, the largest challenge and barrier to a more effective solution to the double taxation problem is probably that the current migration is to a large extent a one-way migration. From a taxation point of view, the fact that main migration traffic involves elderly migrants moving from Northern Europe to Southern Europe to gain a ‘sunny’ quality in their (pre)retirement age suggests that most solutions to be considered may have uneven impact on revenues in Member States unless carefully calibrated with this concern in mind. This implies that solutions where inheritance is taxed solely in the basis of one connecting factor, location of assets (*situs*), residence, domicile or nationality, can be expected to have different winners and losers depending on which connecting factor is chosen.

Rather than attempting to solve all double taxation cases, the European Union could aim to solve the most the cases affecting a very large number of citizens at relatively modest cost in the individual cases. The EU could consider developing a guideline eventually evolving into a directive with this aim in mind.

To address the most double taxation problems, the guideline should first of all target the situations, in which the current system with domestic unilateral relief and bilateral tax treaties is generally least effective. Our study has revealed that they include the following situations:

- *Situations where double taxation results from a residence-residence conflict:* The unilateral relief granted by the Member States is generally targeted at foreign taxes paid on foreign-sourced inheritance. In case of a residence-residence conflict, the domestically located inheritance is, however, also double taxed without the possibility of getting a unilateral relief.
- *Situations where double taxation results from a residence-source conflict:* The unilateral relief granted by the Member States is targeted the residence-source conflict, but in many Member States there are serious limitation:
 - a. The unilateral relief is in some Member States limited to a subset of foreign located asset, typically real estate and/or other immovable assets.
 - b. Due to no harmonisation concerning the meaning of ‘foreign assets’, not all foreign located assets always qualify for a unilateral relief for double taxation under the domestic rules. In the Block case, the German unilateral

relief has provided a clear example of the economic consequences of the latter problem.

- c. The effectiveness of the unilateral relief is also reduced by the fact that most Member States limit the scope of the relief to cover only inheritance and estate taxes and not other taxes levied on the deceased's assets.

The situations where the bilateral tax treaties are not effective include especially cases of double taxation due to the practice of extending the power of taxation to former residents who are no longer actually resident or domiciled in the Member States ('trailing tax'). The OECD Inheritance Model Tax Convention does not address situation where the taxation is based on the concept of 'deemed domicile' as applied by Germany, the Netherlands and the UK.⁴

The identified problems call for some kind of coordination of the domestic tax rules. This may be achieved through tax treaties and/or through harmonisation of the domestic tax rules. Irrespectively of the means, two areas seem to call most for attention. First, more coordination on the connecting factors could be a way of reducing the problem of double taxation. Second, more harmonised definitions of the key concepts of the inheritance tax rules could also be fruitful. The Block case has provided a clear example of the problems that lack of harmonisation of the concept of 'foreign assets' may create.

⁴ Cf. IFA (2002), page 32-33.

Chapter 2 DOMESTIC INHERITANCE TAX RULES IN THE EUROPEAN UNION

When a person dies his or her property has to be accounted for. Creditors must be paid, and the owned assets must be passed on to the heirs. This process is known as succession of property, or inheritance.

All over the world, it is a common practice to levy a specific tax on the transfer of wealth occurring upon the death of a person. This tax may variably apply to the deceased or his/her estate (estate tax) or to the heirs (inheritance tax), cf. Table 2.1.

Table 2.1: Definition of an estate and inheritance tax

Name of tax	Definition
Inheritance tax	An inheritance tax is levied on the recipient of the estate
Estate tax	An estate tax taxes is levied on the transferor or his/her estate

Source: Investopedia, www.investopedia.com.

The distinction between inheritance and estate taxes is, however, often not respected. For example, the ‘inheritance tax’ in the UK is practically a tax on property of the estate, and is therefore, strictly speaking, an estate tax. For that and for simplicity reasons, this report will mostly not distinguish between inheritance and estate taxes. If nothing else is mentioned, we will refer to both taxes as inheritance taxes.

Inheritance and estate taxes are often linked to gift taxes, i.e. gratuitously transfers of money or assets given without any value in return. Most Member States that charge inheritance taxes also charge gift taxes and generally the rules are coordinated so that gift-giving is not a method to circumvent effective taxation of inheritances. An example is France, where the value of gifts that the deceased has given to the heirs during the last six years is added to the value of the inheritance.

This chapter gives a brief description of some key aspects of the domestic inheritance tax rules in the EU. Section 2.1 gives a brief overview of the key characteristics of the rules on taxation of inheritance in the 27 Member States. The overview is based on more detailed survey of the domestic tax rules in the 27 Member States contained in the attachment to the report. Section 2.2 follows with a description of the most important differences in the domestic rules on inheritance taxes with respect to cross-border activity. Section 2.3 is about transfers of family-owned and closely held businesses. Finally, Section 2.4 summarises the main conclusions.

2.1. KEY CHARACTERISTIC OF INHERITANCE TAXES IN THE EUROPEAN UNION

Out of the 27 Member States, 18 currently have an inheritance or estate tax included in the tax system. The Danish tax is effectively both an estate and an inheritance tax, and the UK tax is called an inheritance tax, but is designed as an estate tax, cf. Table 2.2.

Table 2.2: Inheritance and estate taxes in the 27 Member States

	No. of Member States	Member States
Inheritance tax	15	Bulgaria, Czech Republic, Denmark,* Finland, Germany, Greece, Hungary, Ireland, Italy, Lithuania, Luxembourg, the Netherlands, Poland, Slovenia, Spain.
Estate tax	4	Belgium, Denmark,* France, United Kingdom.**
No inheritance or estate tax	9	Austria, Cyprus, Estonia, Latvia, Malta, Portugal, Romania, Slovakia, Sweden.

Note: * Denmark is double counted because the Danish tax is effectively both an estate and an inheritance tax.

** The United Kingdom tax on inheritance is called an 'inheritance tax', but is de facto an estate tax.

Source: Maisto (2010), AGN International (2010) and Global Property Guide.

Inheritance taxes are generally designed with the heirs as the tax subject. In contrast, estate taxes are in most cases designed with the deceased as the tax subject. And a few have both the heirs and the estate as tax subject. The tax base is in all Member States calculated as net value of the property transferred to the estate or the heirs.

The absence of inheritance and estate taxes does not imply that no tax is levied on transfers upon death. In all Member States with no inheritance or estate taxes, other more general taxes may apply to the transfer to the heirs. For example, in Portugal transmissions of assets caused by the death of an individual are subject to a flat rate stamp duty of 10%. There is, however, an exemption applicable to legitimate heirs, which in practice means that no taxation arises when such heirs are the beneficiaries of the estate.

Looking at the current level of inheritance tax rates, the striking point is a large diversity between the EU Member States. In some Member States, for example Denmark and France, transfers upon death to the spouse are exempted from taxation. In addition, there is usually a tax-free personal allowance. This is, for instance, the case in Germany, where the tax free allowance is €500,000, but inheritance above that value may be taxed as much as 30 per cent.

The tax rate is progressive in most Member States, and therefore there is often a large contrast between the average and the marginal tax rates. The progression is typically linked to two factors. First, progression is linked to the family relationships between the parties. The lowest tax rate generally applies to the spouse, but in some Member States the lowest rate is extended to cohabitants. As a rule, the nearer the family bond, the lower is the tax rate for any given level of inheritance. Second, progression is related to the value of the inheritance. The general trend is that the higher the value of the inheritance, the higher inheritance tax is due.

The progression implies that the marginal tax rates become very high under some circumstances. In some Member States, for example Germany, the marginal tax rate may be 100% or close to 100%. The German tax burden depends on, among other things, the relationship between the deceased and the heirs. There are three different tax classes and the closer the relationship to the deceased, the higher is the personal allowance and the lower are the tax

rates above the personal allowance. The formal tax rate varies between 7% and 50%, cf. Table 2.3.

Table 2.3: Tax Rate Percentage, Germany 2010

Taxable amount in €	Tax Class I	Tax Class II	Tax Class III
€ 75,000	7%	15%	30%
€ 300,000	11%	20%	30%
€ 600,000	15%	25%	30%
€6,000,000	19%	30%	30%
€13,000,000	23%	35%	50%
€26,000,000	27%	40%	50%
>€26,000,000	30%	43%	50%

Note: Spouses, children, stepchildren, grandchildren, great grandchildren, parents and grandparents form Class I. Tax Class II consists of brothers, sisters, nephews, nieces, stepparents, sons-in-law, daughters-in-law, parents-in law and divorced spouses and, in the case of gifts, parents and grandparents. All other persons, including legal entities and same sex partners, are in Tax Class III.

Source: Schweizer Kobas (2005).

The effective tax rates are generally much lower than the marginal tax rates. It is difficult to produce a proper comparison with regard to the effective tax burden in the Member States. The reason is that the progression makes the effective tax rate case-sensitive. Thus, it is not sufficient to compare the different tax rates which are applied for inheritance tax purposes. Comparisons will be misleading if they are not based on the same assumptions about both the family relationships between the parties and the values.

Such a comparison is performed on a yearly basis in a study published by AGN International. The study is based on the assumption that a married person dies on January 1, and that the deceased leaves a spouse and two children. Furthermore, a number of other assumptions are made, for example about the value and character of the assets owned at the death, Box 2.1.

Box 2.1: Assumptions in the AGN International comparison

The objective of the survey is to compare levels of inheritance tax payable and is based on a married individual who dies on January 1.

The deceased is assumed to leave a spouse and two children, and it is assumed that the deceased has left no will.

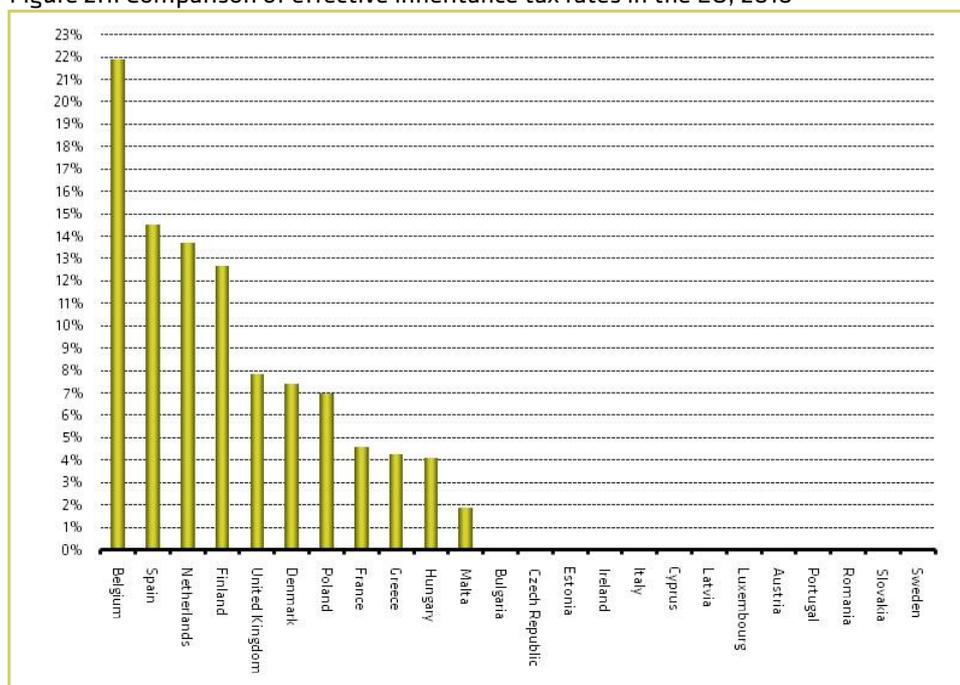
The assets owned at death have a total value of €2,600,000. The assets are:

- A house worth €600,000
- Cash of €1,000,000
- Quoted company shares valued at €300,000
- Unquoted company shares valued at €700,000

Source: AGN International (2009).

The results for 2010 show substantial differences in the effective tax rate on inheritance. The highest effective tax rate is 22%, which is the tax rate paid in Belgium. In contrast, the effective tax is zero for a large group of Member States, including Bulgaria, Czech Republic, Ireland, Italy, Luxembourg, Portugal and Slovenia, cf. Figure 2.1.

Figure 2.1: Comparison of effective inheritance tax rates in the EU, 2010



Note: The survey compares the levels of inheritance tax payable in the case of a married individual who dies on January 1, 2009, leaving a spouse and two children. The assets owned at death have a value of 2,600,000 euro and the deceased is assumed to have left no will, cf. Box 2.1. No data is available for Germany, Lithuania and Slovenia.

Source: AGN International (2010).

It is clear that other comparisons based on other assumptions will show a different picture. It is evident that in the nine Member States without inheritance taxes the effective tax rate will always be nil. However, for the Member States with inheritance taxes, it must be expected that the effective tax rates will generally be higher, if the comparison is performed for siblings or other recipients who are not as close to the deceased as a spouse. Furthermore, due to the progression in the tax rates, it can also be expected that the effective tax rates are higher if the same comparison was performed for an inheritance of a higher total value.

Recent developments

As a whole, effective taxation on inheritance seems to be declining. A number of Member States have lowered their tax rates on inheritance. Examples include Denmark in 1995, Italy in 2002, Finland and Greece in 2008, and the Netherlands in 2010, cf. Box 2.2.

Box 2.2: Amendment of the Dutch Inheritance Tax Act from 1 January 2010

As a part of a larger tax package, a new Dutch Inheritance Tax Act became applicable at 1 January 2010. The previous Inheritance Tax dated back to 1956.

The implication of the amendments is that the rates for inheritance (and gift) tax have been reduced substantially. For example, the top rate for inheritance by nephews and nieces has been lowered from 68% to 40%.

Besides the adjustments in tax rates, the magnitude of exemptions and the reduction in the number of groups of receivers, a couple of other provisions were changed. Under the old Inheritance Tax the change of partial ownership into full ownership was not taxed if the asset (real estate property) was purchased in a split manner: the partial ownership by the children and the by the parents. When parents die, the property is included in the assessment of inheritance tax with the children. Capital placed in an allocated fund will be directly attributable to the settler of the fund and to the settlers' heirs upon his death.

Source: *Copenhagen Economics based on Gomez (2010) and Van Oers International (2010).*

Another development has been that some Member States have reduced the tax base or broadened the scope of subjective exemptions to the spouse or descendants. For example, Poland reduced the tax base in 2007 and the UK has recently widened its exemption for agricultural property. Furthermore, several Member States have abolished the taxation of inheritance. During recent years, the Member States Austria, Portugal and Sweden have abolished their inheritance tax system.

2.2. MAIN DIFFERENCES IN INHERITANCE TAX SYSTEMS

It is not only the level of taxation that varies between the Member States, also the design of the domestic inheritance tax rules also vary. This section summarises some of the differences that may have relevance in inheritance cases with cross-border aspects.

Connecting factors

In a succession case, the heir or the estate incurs a liability for tax in a particular jurisdiction as a result of what are known as 'connecting factors'. Simply put, the connecting factor is the factor in a Member State's domestic tax law which links the taxpayer to a particular tax jurisdiction. In the case of inheritance taxes, the taxpayer is either the heir or the estate, and the connecting factors link the heir or the estate to a particular tax jurisdiction, typically a Member State.⁵ In levying inheritance taxes, a common rule among 18 Member States with inheritance or estate taxes is to use two connecting factors:

- **A personal nexus rule**, which establishes a link between an inheritance and the Member State where the deceased/heir is resident and/or domiciled and/or the Member State of which he/she is a national.
- **A source rule** (situs rule), which establishes a link between an inheritance and the Member State where this inheritance is located, in the absence of a personal nexus rule. The source rule may cover all assets that are part of an inheritance or a subset of assets, e.g. real estate.

⁵ An exception is Belgium, where the inheritance taxes are levied by the local governments.

Three main principles are applied to determine the personal nexus of the deceased or the heir. The three principles are the residence principle, the domicile principle and the nationality principle, cf. Table 2.4.

Table 2.4: Three principles for determining the personal nexus of a deceased or an heir

Principle	Condition
Residence principle	Under the residence principle, the estate or inheritance is taxed if the deceased or the heirs were residents of the Member State at the time of death. The number of days spent in a Member State is normally the main basis for determining the residence Member State of a person, for example you become a Spanish resident if you spend more than 183 days in Spain during one calendar year.
Domicile principle	A person is generally domiciled where his or her permanent home is situated. A 'domicile of origin' is acquired at birth, normally from one's father. The domicile of a minor normally follows that of the person on whom he or she is legally dependant (a 'domicile of dependency'). However, a 'domicile of choice' can be acquired from age 16. This broadly involves leaving the current Member State of domicile to settle in another Member State, and requires strong proof of having moved to the other Member State permanently or indefinitely. Living in another Member State is not conclusive evidence of an intention to change domicile.
Nationality principle	Under the nationality principle a personal nexus is established if the deceased or the heir is a citizen of the Member State.

Source: Maisto (2010).

A survey of the 18 Member States with inheritance or estate taxes reveals that the residence principle is the most commonly applied principle in the domestic tax rules on inheritance. Some Member States, Hungary, Germany, Greece, the Netherlands, use two criteria for the personal nexus, cf. Table 2.5.

Table 2.5: Overview of personal nexus rules in the domestic tax rules on inheritance

Principle	No. of Member States	Name of Member States
Residence principle	14	Belgium, Czech Republic,* Denmark, Finland, Germany, Hungary, Ireland, Italy, Lithuania, Luxembourg, the Netherlands, Poland, Slovenia, Spain.
Domicile principle	4	France, Germany, Greece, United Kingdom.
Nationality	6	Bulgaria, Czech Republic, Greece, Hungary, the Netherlands, Poland.
No inheritance or estate tax	9	Austria, Cyprus, Estonia, Latvia, Malta, Portugal, Romania, Slovakia, Sweden.

Note: *Czech Republic refers to 'permanent address'. Details on the applied personal nexus rules are contained in an attachment to the report. Only Member States operating an estate tax and/or inheritance tax are included in this table.

Source: Copenhagen Economics based on Maisto (2010) and Global Property Guide.

The survey of the 18 Member States with inheritance or estate taxes also reveals that only one Member State, the Netherlands does not have a source rule contained in its tax rules on inheritance. The scope of the source rule includes all domestically located assets, including bank account, shares, stocks and real estate, in nine Member States. In the remaining Member States with inheritance or estate taxes the scope of the source rule is limited to real estate or immovable assets, cf. Table 2.6.

Table 2.6: Scope of source rules in the domestic tax rules on inheritance

Scope of taxations	Member States
All asset	Czech Republic, Germany,* Greece, Ireland, Italy, Lithuania, Slovenia, Spain, United Kingdom.
Real estate (immovable assets) only	Belgium, Bulgaria, Denmark,** Finland, France, Hungary, Luxembourg, Poland.
No source taxation	The Netherlands.
No inheritance or estate tax	Austria, Cyprus, Estonia, Latvia, Malta, Portugal, Romania, Slovakia, Sweden.

*Note: * Bank accounts with German banks are not subject to taxation because of situs. ** The Danish source rule also applies to 'movable assets pertaining to permanent establishments'. Details on the applied personal nexus rules are contained in the report's Attachment. Only Member States operating an estate tax and/or inheritance tax are included in this table.*

Source: Copenhagen Economics based on Maisto (2010) and Global Property Guide.

The source taxation clearly opens a potential for cross-border double taxation. The potential for double taxation arises for all sorts of assets, including real estate, stock ownership and savings on bank accounts.

The Irish and the UK inheritance tax rules are typical examples of a set of connecting factors that determines whether assets/liabilities are subject to taxation. Under the Irish source rule, all assets located in Ireland are liable to inheritance tax in Ireland. In addition, under personal nexus rule all foreign located assets are liable to the Irish Inheritance Tax if the deceased or beneficiary is resident in Ireland, cf. Box 2.3. Under the UK rules, 'domicile' is used to establish the personal nexus, and if the domicile condition is fulfilled, the UK inheritance tax rules apply to all assets wherever they are located (worldwide taxation). In addition, for persons with a foreign domicile, all UK located assets will be subjected to the UK inheritance tax, except some 'excluded assets'.

Box 2.3 The connecting factors in the Irish and UK inheritance tax rules

Ireland:

An asset will be liable to Irish inheritance tax:

- a. If the asset is located in Ireland, or
- b. If the asset is located abroad, and the deceased or beneficiary is resident or ordinarily resident in Ireland.

UK

Generally, if you are domiciled, or deemed to be domiciled, in the UK, inheritance tax applies to your assets wherever they are situated.

If you are domiciled abroad, inheritance tax applies only to your UK assets. However, if you are domiciled abroad there is no charge on excluded assets and certain other types of UK assets may be exempted from the tax charge.

Source: *Irish rules: Revenue Irish Tax & Customs, 'Inheritance tax',*

www.revenue.ie/en/personal/circumstances/bereavement/inheritance-tax.html, *UK rules: HM Revenue & Customs, <http://www.hmrc.gov.uk/CTO/customerguide/page20.htm>.*

Tax exemptions and deductions

Another source of complexity is a number of differences in exemptions and deductions that the all Member States are granting. Most Member States grant exemptions under certain circumstances.

First of all, most Member States grant subjective exemptions from the general tax rules for the spouse. Full exemption applies, for example, in Czech Republic, Denmark, France, Luxembourg, Poland and the UK. Spouses are only partially exempted in, for example, Finland, Germany, Hungary, Italy, the Netherlands and Spain. The exemptions are sometimes subject to nationality, as is the case for Poland, where it applies solely to EU spouses. In some Member States, the scope of subjective exemptions is also extended to cohabitants. This is for example the case in Finland, Germany, Luxembourg, the Netherlands and France.

In addition, some Member States grant certain objective exemptions that apply if certain objective conditions are fulfilled. For example, some Member States have exemption for cultural assets.

Most Member States also allow some deductions in calculating the tax base. Most Member States allow deduction of the general liabilities of the deceased person, such as overdrafts on a bank account and specific liabilities which are directly attributable to assets falling under the taxable estate, such as a mortgage on immovable property.

Furthermore, costs incurred after the death of the testator are normally deductible insofar as they are related to the taxable estate (funeral expenses, probate or notaries fees associated with the inheritance proceedings, etc.). Several other deductions are allowed in certain Member States.

Asset valuations models

The applied valuation model is also an aspect where the tax rules vary considerably between the Member States. Most Member States apply a principle of market value, but the definition of market value varies and in addition several exceptions exist.

In some Member States, the cadastral value is used to value immoveable property. The cadastral value, which is determined by the government, is often much lower than the market value of the property. Germany, Italy and Greece are examples of Member States that use the cadastral value to determine the value of immovable property.

Value of listed shares is generally taxed. The tax value is normally based on listing values. There are, however, differences in the domestic rules as to the reference date. The reference day may be the date of the death of the testator or an average computed over a certain period of time.

Shares in non-listed companies are also taxed. The common valuation principle is the fair market value principle, but valuation rules differ considerably. In some Member States, fair value is the net asset value resulting from the last approved balance sheet of the company so that no goodwill is included.

Anti-avoidance provision

It would be tempting and easy to minimise the payment of estate and inheritance taxes if gifts were not taxed. Especially the older part of the population could be expected to give large presents to their heirs.

To avoid such tax optimisation, most Member States levy a gift tax in addition to the estate or inheritance tax. The gift tax normally has a level similar to the estate or inheritance tax so that it is not much more advantageous to the heirs to receive large gifts instead of an inheritance. For example, Denmark, Finland and Ireland have gift taxes.

In addition to gift taxes, a number of Member States employ broader and more general anti-avoidance provision to combat tax avoidance. A widely used method is to aggregate gifts made by the same donor to the same recipient during a certain period of time. Gifts made within that period are added to the estate or inheritance. However, the aggregation period varies between the Member States from one to several years prior to death of the deceased.

Most other special anti-avoidance rules provide that certain assets, not actually belonging to the deceased at the time of death, are nevertheless deemed to be part of the estate, thus making such assets subject to death duties. Some Member States, for example Germany and the UK, have also introduced an extended concept of residence or domicile in case of emigration of individuals.

Finally, tax avoidance on an international level, e.g. by emigrating from the Member State, is countered by introducing nationality as a criterion to levy a world-wide inheritance and gift tax.

2.3. TRANSFERS OF FAMILY-OWNED AND CLOSELY HELD BUSINESSES

Currently, 12 of the 18 Member States provide exemptions or special relief for transfers of family owned and closely held businesses upon death. The six Member States without such exemptions or special relief are Bulgaria, Denmark, Ireland, Lithuania, Luxembourg and Slovenia.

In some Member States, the exemption is limited to the transfer of a business conducted directly by the deceased as a sole entrepreneur. In other Member States, the scope of the exemption is extended to majority stakes in a company conducting an active business. Lower thresholds are laid down by internal laws of Finland, France and Germany.

Table 2.7: Main tax exemptions and reliefs granted for family owned and closely held businesses upon death

Member State	Key point
Belgium	Tax exemptions (full or partial) apply, given some conditions e.g. the deceased's participation in the business, capital requirements etc. The conditions vary between regions.
Czech Republic	Exemption from inheritance tax is provided for the first free-of-charge acquisition of a property share in a co-operative (housing or agricultural) between relatives in the direct line of descent, siblings or a spouse as well as other persons within family or similar relationship.
Finland	Partial exemption is under some condition granted for transfers of businesses and agricultural/forestry entities. If the form of legal entity is corporate, exemption requires that the heir receives at least 10%. As a further relief, the maximum of five years of interest-free payment time will be granted to the part of inheritance tax related to business or farm assets.
France	Heirs or legatees are exempt from estate taxes up to 75% of the enterprise's value (without any limitation applicable to the amount), given that they agree not to sell the enterprise's shares. Tax reduction is also given on a number of specific assets.
Germany	Business relief is applicable to all sole proprietorships, participation in partnerships and forestry/agricultural businesses. Shareholdings are subject to business relief if the deceased holds more than 25% of the corporation's share capital. Shareholders can form a share pool to achieve the threshold of 25%. There is no minimum participation for partnerships. The business relief requires that not more than 50% of the business property is invested in non-operating property. Furthermore, the aggregate wages for the next five years must be at least 400% of the average aggregate wages during the last five years before the transfer.
Greece	No favourable treatment applies for family-owned or closely held businesses per se. Instead, tax incentives rely on the degree of kinship between the transferor and the transferee rather than on the business characteristics.
Hungary	The inheritance of a number of business assets, such as business shares, is currently exempt. Special rules apply if agricultural land is inherited.
Italy	An exemption from inheritance tax applies to majority transfers of a business or of a participation in companies or partnerships to the spouse or descendants provided the spouse or descendants carry out an effective business activity.
The Netherlands	In case a family business is inherited, relief can be provided if the deceased possessed a qualifying business for one year and the recipient continues this business for a period of five years after the death of the deceased. The business succession facilities apply to both personal enterprises and enterprises run in the form of a limited liability company in which the deceased had an interest of at least 5% of the issued share capital.
Poland	Inheritance tax exemption applies to natural persons (in every tax group) acquiring an arable farm or its part provided that the acquiring person runs this farm for at least 5 years from its acquisition date. The exemption does not cover residential buildings, buildings used for breeding poultry or animals, greenhouses, and fruit storehouses.
Spain	A reduction of 95% of the value of the business may be made in addition to any other applicable reductions, provided that the acquisition is kept for at least ten years after the death of the deceased.
UK	Any transfer of value (under the inheritance tax rules) made by a close company shall be apportioned to its shareholders, and inheritance tax charged according to those individuals' particular circumstances, albeit that any tax due is primarily recoverable from the company.

Source: Copenhagen Economics based on Maisto (2010). More details on the specific conditions are contained in the Attachment on the domestic rules.

These rules express the clear legislative intent that taxes should not be adverse to the continuity of the business across generations. Within the European Union, this policy statement is well reflected in the EC Commission's Recommendations and Communications of 1994 and 2006 that recommend Member States to amend internal laws so as to eliminate tax obstacles to *mortis causa* transfers of a business within the same family.

It is generally desirable for the exemptions or other reliefs not to require the estate to comprise a majority shareholding as such a restriction might impair the continuity of the business. This is the case when the deceased person owned a minority stake and the remainder of

the share capital was already in the hands of his or her relatives, or when shareholders included third parties, so that the inability to obtain relief and concurrent obligation of the heirs to pay inheritance taxes would in any event reduce the capital available for reinvestment or force the relatives of the deceased to dispose of their participation therefore creating a barrier to the actual continuity of the conduct of the business by the heirs.

Provided that the right to such 'tax free' transfers are not conditioned upon the heir being resident in the Member State, then internal market principle are preserved which is the focus of this study. However, certain Member States have rules of 'ring fencing' whereby a change of residency of an owner of company leads to forced taxation of non-realised gains. Such ring fencing is typically put in place to prevent owners from moving out of a Member State with high taxation of capital gains/deferred profits and realise the gain in another Member State.

However, again this is more about taxation of capital gains and deferred profits than inheritance taxes per se. Thus, the only real connection between inheritance taxes, small and medium sized enterprises (SME's) and economic double taxation is that both discrimination and double taxation in the case of persons inheriting business from other Member States can create barriers to continuity precisely as capital gains taxes can.

The widespread use of source taxation of shares and stocks forming part of an estate may create financial problems for family owned and closely held businesses if such taxation effectively leads to double taxation as discussed particularly in chapter 3. The problems may arise if a significant shareowner dies and heavy taxation of the value of the share forces the heirs to sell and liquidate the shares in the business. Such liquidation may negatively influence the stock price and thus jeopardise the market value of a business.

2.4. CONCLUSIONS

Based on the information contained in this chapter, two main conclusions can be drawn concerning the domestic rules on inheritance taxation in the European Union.

The first conclusion is that the level of taxation on inheritance varies substantially both between cases and Member States. In 2010, 18 out the 27 Member States levy a tax on inheritance or estates, and the level of taxation is generally progressive. However, a recent development seems to be that the general level of taxation on inheritance decreases and that more and more Member States abolish taxes on inheritance.

The second conclusion is that the domestic rules on inheritance and estate taxes have the potential for having an impact on the cross-border mobility of people and assets within the European Union. The reason is that the design of the domestic rules on inheritance taxes varies between Member States in several ways that are relevant in inheritance cases with cross-border aspects. First of all, the Member States employ different 'connecting factors',

but in addition there are several differences with respect to issues such as valuation of assets, deductions and tax exemptions.

Chapter 3 CONFLICTS BETWEEN DOMESTIC TAX RULES AND THE INTERNAL MARKET

Under the assumption that the Member States respect the EU rules pertaining to the operation of the internal market, the Member States are allowed to choose the inheritance tax systems they consider most appropriate and according to their preferences. The main priority for the tax policy of the European Union is to secure that the differences in the domestic inheritance tax rules do not create significant obstacles to all forms of cross-border economic activity.

In this chapter, we explore the potential for two specific problems that the wide diversity of inheritance tax rules among the Member States of the European Union may cause in cross-border inheritance cases. The problems may occur irrespectively of whether the cross-border aspect is due to the fact that the asset of the deceased is located in another Member State; or to the fact that the heirs hold another nationality, domicile or residence than the deceased.

In section 3.1, we examine the existence of discriminatory provisions contained in the domestic rules on inheritance taxes. Discriminatory provisions are provisions that may result in difference in taxation based on location or nationality. Such provisions are in conflict with the Treaty on the Functioning of the European Union.

In section 3.2, we examine to which extent the domestic inheritance tax rules may result in situations where an inheritance is taxed under inheritance tax rules of more than one Member State.

3.1. THE DISCRIMINATION PROBLEM

Reducing impediments to the free movement of persons, businesses and capital is a key priority of the European Union. The relevant Treaty provisions governing the freedom of capital movements are enshrined in Articles 63 to 65 of the Treaty on the Functioning of the European Union.⁶ In particular, Article 63 of the Treaty on the Functioning of the European Union provides that:

'[...] all restrictions on the movement of capital [...] between Member States and third countries shall be prohibited [...].'

Source: European Commission, 'The EU Single Market', Treaty Provision, http://ec.europa.eu/internal_market/capital/framework/treaty_en.htm.

For many years, the consistency of the domestic inheritance tax rules with EC law was not called into question. A main reason was probably that a relatively small number of EU citizens established themselves in other EU Member States for longer periods of time or purchased assets in other EU Member States. Consequently, the number of cross-border succession cases also remained at a relatively low level.

⁶ In former EC Treaty, the same provisions were contained in Article 56 to 58.

During recent years, the attention to cross-border aspects of inheritance taxes has increased. Articles pointing to inconsistencies between domestic inheritance tax rules and the EC Treaty started to appear regularly in tax journals at the end of the 1990s.

In 2003, the European Court of Justice made its first decision in the field of inheritance taxes. In the following years, the European Court of Justice has on several occasions investigated whether specific provisions of Member States' inheritance tax provisions are compatible with the freedoms that the Member States have in the area of direct taxation.

In several cases, the European Court of Justice has ruled that specific domestic inheritance tax rules are covered by the EU rules on free movement of capital, once they contain cross-border elements. Moreover, the European Court of Justice has ruled that it is appropriate to investigate whether national provisions may entail a restriction of this freedom, cf. Table 3.1.

Table 3.1: Overview of the European Court of Justice case law in the field of inheritance taxes

Case	Year	Key point
Case C-364/01 Barbier	2002	The European Court of Justice made it clear that the freedoms of movement of capital and persons also apply to the field of inheritance tax.
Case C-513/03 Van Hilten-Van Der Heijden	2006	The European Court of Justice decided that the free movement of capital provisions of the Treaty on the Functioning of the European Union did not prevent a Member State from taxing the estate of a national of that Member State who lived abroad at the time of death, on the basis that she died within 10 years of ceasing to resident in that Member State, particularly if the legislation in question allowed relief for inheritance taxes levied by other States.
Case C-464/05 Maria Geurts and Dennis Vogten	2007	The European Court of Justice established that, under Article 43 of the Treaty on the Functioning of the European Union, Member States cannot deny an exemption to inheritances of family undertakings 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.
Case C-256/06 Jager	2008	The European Court of Justice ruled that the free movement of capital provisions of the Treaty prohibited Member States from applying for inheritance tax purposes a special favourable valuation system and partial exemption for assets located in that Member State while calculating the value of assets situated in other Member States according to normal fair market value rules.
Case C-11/07 Eckelkamp	2008	ECJ concluded Belgian inheritance tax provision on non-deductibility of charges on immovable property situated in Belgium by non-resident taxpayer incompatible with EC law
Case C-43/07 Arens-Sikken	2008	The European Court of Justice made it clear that the purposes of assessing the compatibility with EC law of domestic inheritance tax legislation, the existence of a tax advantage (i.e. tax credit) granted unilaterally by another Member State is not relevant.
Case C-67/08 Block	2009	The European Court of Justice concluded that Article 56 EC does not impose on Member States a legal obligation to avoid double taxation on inheritance which arises from the exercise in parallel by Member States of fiscal sovereignty.
Case C-510/08 Mattner	2010	The European Court of Justice ruled that a German gift tax provision according to which the tax allowance for non-residents is smaller than that for residents is in breach of the free movement of capital.

Source: European Commission, Taxation and Customs Union Directorate General (2010).

Based on this case law, it can be concluded that Member States' inheritance tax rules are in conflict with the rules on free movement of capital if they are designed as follows:

- They provide different and less favourable rules for the valuation of assets forming part of an inheritance if those assets are located in another Member State.
- They restrict the deductibility of debts/liabilities related to assets that are part of the inheritance of testators who were non-resident at the time of death.
- They apply higher inheritance duties for legacies made to charities established in other Member States.
- They grant tax exemptions from inheritance tax only if the recipient is a domestic charity.

- They provide for higher personal allowances in favour of resident taxpayers.⁷

The above list should not be seen as exhaustive. There are potentially several other conditions that are incompatible with the Treaty on the Functioning of the European Union, but where the European Court of Justice has not yet made a decision. With the current attention on discrimination due to differences in the domestic inheritance tax rules, it must be expected that more provisions will be judged as incompatible with the Treaty on the Functioning of the European Union in the coming years.

Progress in reducing discriminatory elements in national tax law

In 2000, a study on inheritance taxes in the EU⁸ concluded that the EC Treaty might have an impact on the domestic legislation on inheritance taxes and that discrimination was a barrier to cross-border activity.

The conclusion was based on a survey conducted by a group of national reporters in 15 EU Member States. The key message from the national reports was that several Member States' inheritance tax rules included discrimination on the basis of nationality that could be in conflict with the EC Treaty's provisions on free movement. Consequently, discrimination could potentially be a significant problem with respect to the functioning of the Internal Market.

The Member States have to some extent reacted and reduced the potential for discrimination in the area of inheritance taxes since the year 2000. This is clear by looking at the result of a more recent study, which surveys the domestic rules in 18 Member States,⁹ and a supplementary study of the domestic rules in the nine remaining Member States.

The main reason for the positive development is an increased attention to the issue and the fact that the new European Court of Justice case law has had a positive impact on the tax rules of several Member States. The positive development has materialised in the domestic inheritance tax rules as several Member States have amended their domestic laws to make them compatible with the current Treaty on the Functioning of the European Union.

The UK has recently extended its relief for agricultural property and woodland to cover not only domestic, but also property anywhere in the European Economic Area. Agricultural property relief operates to reduce the taxable value of certain farms, woodlands and similar assets. Originally, the UK relief was available only for agricultural property located in the United Kingdom, the Channel Islands or the Isle of Man. The Finance Act 2009 extended the availability of these reliefs to agricultural property and woodlands anywhere in the European Economic Area. The result is less risk of discrimination.

⁷ This last condition was added with the rules in the Mattner case (Case C-510/08), cf. Table 3.1.

⁸ Sonneveldt and Zwemmer (2000).

⁹ Maisto (2010).

Furthermore, the Member States Belgium, Czech Republic, Germany and the Netherlands have also reacted by extending their exemptions to foreign charities beginning from 2008.

Finally, Luxembourg has recently amended its inheritance tax rules related to the tax abatement provided for spouses and to exemptions between spouses and direct line heirs, in order to make it compatible with the Treaty on the Functioning of the European Union, cf. Box 3.1.

Box 3.1: Recent changes in the inheritance tax rules in Luxembourg

In December 2009, Luxembourg changed its legislation on inheritance taxes in a way that brought an end to several practices that the European Court of Justice had judged as discrimination in breach of the Treaty on the Functioning of the European Union.

Before December 2009, Luxembourg tax law provided for different inheritance duties depending on the domicile of the deceased person. Rules applying to the estate of Luxembourg residents (i.e. 'droits de succession') used to be more favourable than those applying to the estate of non-residents (i.e. 'droits de mutation à cause de mort').

For example, before December 2009 the persons domiciled outside Luxembourg were not granted the same exceptions or deductions and were not covered by the same thresholds as Luxembourg-domiciled persons.

In compliance with EU principles, the law of 18 December 2009 ends this discrimination, by granting the same deductions and exemptions in both situations.

Source: Copenhagen Economics based on PricewaterhouseCoopers (2009).

The same two studies show that despite this recent positive development and the reduced potential for discrimination, there is still room for progress on this issue. Despite the increased attention from the European Court of Justice, the domestic inheritance tax laws of several Member States still raise issues of compatibility with the Treaty on the Functioning of the European Union.

Among the 18 Member States under review in a recent study¹⁰, only five Member States have currently no known potential conflict between the domestic inheritance tax and the Treaty on the Functioning of the European Union. These five Member States are Denmark, Hungary, Poland, Portugal and Luxembourg.¹¹ The domestic rules of the nine remaining Member States have been surveyed in our complementary study. The results of this study show that the domestic rules of these nine Member States also contain provisions, which may potentially be in conflict with the Treaty on the Functioning of the European Union.

The potential discriminatory provisions are concentrated around the following four areas, cf. Table 3.2:

- The scope of specific exemptions from the inheritance tax rules
- The deduction of debt in calculation of the tax base

¹⁰ Cf. Maisto (2010).

¹¹ Goebel and Schaffner (2010) concludes that the Luxembourg inheritance tax legislation was widely incompatible with EU law before 2010, but the changes that have entered into force in 2010, has brought Luxembourg in line with decision of the European Court of Justice.

- The design of the valuation methods for foreign located assets
- Special exemption for certain domestically located assets

Table 3.2: Potential conflicts between domestic inheritance tax rules and the Treaty on the Functioning of the European Union

Area of concern	Member States with potentially illegal provisions
Objective exemption	<ul style="list-style-type: none"> ▪ Czech Republic: Tax-exemptions for private pension contributions do not cover contributions paid abroad. Also tax-exemption does not apply for foreigners in the third tax category regarding the acquisition of a property share in agricultural co-operatives. ▪ Germany: Grants to foreign charities are only tax exempt in the inheritance tax if the two governments have exchanged notes that reciprocity is guaranteed and, thereby, does not allow the taxpayer to bring the necessary information about the activities of the foreign charity. ▪ Greece: The favourable tax regime is denied to <i>mortis causa</i> transfers of shares in foreign companies, which are then taxed at regular rates. Also, the descendant's children or surviving spouse have to have lived in Greece for one full year to get the tax exemptions on house or land acquired by virtue of succession, in case they do not own real property that is sufficient for their dwelling needs. ▪ Italy: Transfers to EU public entities, associations and foundations from non-residents are denied exemption from inheritance tax. Also, no exemption is made for public debt securities from other EU Member States. ▪ Spain: Beneficiaries are subject to different tax systems (Autonomous Community or State law) in the Basque Country depending on when they resided in the area ▪ United Kingdom: UK does not make charities eligible for exemption granted to domestic entities.
Deduction of debt	<ul style="list-style-type: none"> ▪ Belgium: There is no provision for deductibility of over-endowment debts for non-residents. ▪ Bulgaria: It is not clear whether rights and receivables transferred to a foreign state are deductible. ▪ Finland: Restriction of deductions of debts pertaining to the estate of non-residents ▪ The Netherlands: The situs debts are incompatible with EC law and have to be extended on this point.
Valuation of foreign assets	<ul style="list-style-type: none"> ▪ Belgium: Belgian taxes on Belgian real estate in the estate of non-residents on the gross value have different time limitation rules for foreign and domestic moveable assets. ▪ Bulgaria: It is not clear how immovable property abroad, except from real estate, should be valued, which could create a potential for differential treatment, e.g. that it should be valued at market value. ▪ Ireland: A reduction in the valuation of business property require shares to be held in an Irish incorporated company and thereby excludes businesses not carried on mainly in Ireland ▪ Italy: Italy values foreign-situs assets differently than assets located in Italy. Also, the tax authorities cannot dispute the value of the Italian real estate if at least equal to the cadastral value. This rule does not apply to foreign real estate.
Exemption for domestically located assets	<ul style="list-style-type: none"> ▪ Bulgaria: Only domestic charities are exempt from the inheritance tax. However, charities established in an EU/EEA Member State are treated as local charities for inheritance tax purposes, so it is not clear if differential treatment exists under this provision. ▪ France: The preferential rule of exemption in favour of the reversion of life annuities between spouses or relatives in direct line do not apply to property located abroad. ▪ Italy: Foreign assets of cultural value cannot be exempt for the inheritance tax as can assets located in Italy.

Note: Details on the potential discriminatory provisions are shown in the attachment.

Source: Copenhagen Economics based on Maisto (2010) and EU Commission, 'Infringement cases - Press releases', http://ec.europa.eu/taxation_customs/common/infringements/infringement_cases/index_en.htm.

For discrimination to be a large impediment to the functioning of the Internal Market, it is not sufficient that the number of inheritance cases with cross-border aspects is large and increasing. To be a significant impediment to the functioning of the Internal Market, the relevant inheritance case is where at least one of the above four issues has a significant impact on the calculation of the inheritance tax. It is evident that there will be a minority of cross-border inheritance cases where this is indeed the case. However, in these specific cases, discrimination may be a significant problem leading to large economic losses to the individuals concerned.

3.2. THE DOUBLE TAXATION PROBLEM

The European Court of Justice has concluded that the Member States are not obliged to eliminate the double taxation of inheritances that may arise due to the parallel exercise of tax competence by two Member States.¹²

Nevertheless, from an Internal Market perspective, avoidance of international double taxation may still be important and have positive effects. It is clear that international double taxation may be an obstacle to cross-border activity and investment within the European Union.

In 2000, a study on inheritance taxes in the European Union¹³ concluded that the potential for double taxation on inheritance in the European Union was significant.

The conclusion was based on three observations:

1. The connecting factors in the domestic inheritance tax rules were often in conflict with each other which created a large potential for double taxation.
2. The Member States had only concluded few bilateral tax treaties for the avoidance of double taxation in the field of inheritance tax.
3. In many Member States, a full unilateral relief for double taxation is not available in all situations.

This study has assessed the current incidence of international double taxation on inheritance within the European Union. Our overall assessment is that the situation has not changed significantly during the last ten years, and that there is still a potential for double taxation in the majority of cross-border inheritance cases within the European Union.

Overall, there are clearly some trends that the importance of the problem has decreased because some Member States, including Sweden and Austria, have abolished their inheritance tax during recent years. However, besides that trend, the framework conditions that are the source of the potential for double taxation are more or less unchanged since 2000.

The potential for cross-border double taxation on inheritance

The term 'double taxation' implies 'over-taxation' due to overlapping taxing rights. Juridical double taxation of inheritance takes place when the same inheritance is taxed in two Member States due to differences in the applied connecting factors, cf. Box 3.2.

¹² The conclusion was drawn in the Block case (Case C-67/08).

¹³ Sonneveldt and Zwemmer (2000).

Box 3.2: Economic and juridical double taxation

Economic double taxation refers to a double tax on the same income in the hands of different persons, for example husband and wife, partnership and partners, company and shareholder, parent and subsidiary, etc.

Juridical double taxation deals with the same tax object and the same tax subject. It is the imposition of comparable taxes by two or more States on the same taxpayer in respect of the same subject matter and for identical periods ("legal identity of subject"). Juridical double taxation can arise, for example, where a resident of one Member State derives income from sources in the other Member State, and both countries' domestic tax legislation would tax that income. It can also arise where each Member State considers the taxpayer to be resident in that Member State under domestic tax laws.

Source: Rohatgi (2005).

The reason for international double taxation on inheritance to occur is that the same inheritance is caught by connecting factors of two or more Member States. For this to occur there must be a cross-border conflict between the connecting factors of the relevant Member States.¹⁴

Cross-border conflicts between connecting factors may result in cross-border double taxation under several circumstances. Since the Member States apply a combination of personal nexus rules (residence, domicile or nationality) implying worldwide taxation and source rules implying taxation of all domestically located assets. Therefore, it is hardly surprising that the potential for double taxation is large.

In practice, double taxation may occur due to three types of conflict:

- Residence-source conflict
- Residence-residence conflict
- Source-source conflict

The **residence-source conflict** is the most common conflict between connecting factors. Such a conflict occurs when the deceased (estate tax) or the heir (inheritance tax) has a personal nexus to one Member States (based on residence, domicile or nationality), and the deceased or the heir was in possession of assets that are covered by a source rule in another Member State. In most cases, such a residence-source conflict will result in the double taxation of the foreign-located assets. The Member State that has established the personal nexus will levy its inheritance tax on all worldwide assets and the other Member State will tax the assets located in its territory, cf. Table 3.3.

The **residence-residence conflict** is less common. A **residence-residence conflict** occurs in a situation where more than one Member State (based on residence, domicile or nationality) establishes a personal nexus to the deceased (estate tax) or the heir (inheritance tax). A residence-residence conflict will typically imply worldwide taxation in both Member States and, therefore, also double taxation of the whole (worldwide) inheritance, cf. Table 3.3.

¹⁴ A remark is that zero taxation may also be result of two Member States applying different connecting factors. In some cases, an inheritance will not be covered by any of the connecting factors, which will create a situation where an inheritance is not taxable in either of the two Member States.

The least common conflict is a *source-source conflict*. A source-source conflict occurs if an asset is covered by the source rule in more than one Member State. A likely reason for source-source conflict to occur is that the location of an asset is ambiguous, for example because the asset is not a physical asset with a visible physical location. This is the case for virtual assets such as copyright, shares, bonds and other securities, where it is a legal question where a particular asset is located. Here the conflict concerns may imply double taxation of the worldwide inheritance or only a subset of the assets depending on which assets the conflict concerns,¹⁵ cf. Table 3.3.

Table 3.3: Types of conflicts that may result in double taxation

Type of conflict	Description of conflict	Extent of double taxation
Residence-Source	The same income is taxed twice, first by the Member State where it is derived under its 'source rule', and then in the Member State where the taxpayer has his or her residence and personal nexus.	Foreign located inheritance
Residence-Residence	Differences in the residence rules imply that the same deceased or heir is regarded as a resident of two Member states.	Worldwide inheritance
Source-Source	Diverging rules for determining the location of an asset imply that the same asset is covered by the source rule of more than one Member State. Problem most likely for intangible assets such as patents, copyrights, trademarks, computer software and for shares.	Worldwide or a subset of the inheritance

Source: Rohatgi (2005).

The potential for double taxation due to 'residence-residence' conflicts is increased by some Member States' practice of extending the power of taxation to former residents who are no longer actually resident or domiciled in the Member States ('trailing tax'). Member States with such practice include Germany, the Netherlands and the UK. For example, in the UK, an individual who has abandoned his domicile under the general rules of law retains a 'deemed UK domicile' for the following three years.¹⁶

An important remark is that the differences in connecting factors may also lead to the opposite problem, namely zero taxation problems instead of double taxation. Zero taxation may occur if no Member States are able to establish a personal nexus with the deceased (or the heirs when relevant), for example because of differences in the definition of residence, and the asset is also not covered by the source rules of any Member State.

A few examples may illustrate how the three potential conflicts may result in full or partial international double taxation on inheritance. The examples focus at a hypothetical situation, where the cross-border aspects arise because of property being located in both the UK and

¹⁵ The key point here is that the Member States disagree where the assets are located implying that one Member State claims that an asset is located within its jurisdiction and therefore levies a tax upon these assets, and another Member State simultaneously claims that the same assets are located within its jurisdiction and levies a tax upon the same assets. If this tax conflict concerns all assets of an estate, the worldwide assets are double taxed, whereas if the conflict only concerns a subset of the assets, only a subset of the assets are double taxed.

¹⁶ Cf. IFA (2002), page 32-33.

Spain. Specifically, the case studies assume that a British domiciled widow dies leaving property in both Spain and the UK for her only child, a 22 year old British-domiciled daughter, cf. Box 3.3.

Box 3.3: Examples of double taxation: UK and Spain before considering effects of unilateral relief

Inheritance may be prone to double taxation in the case of a Residence-source conflict, a Residence-residence conflict or a Source-source conflict and no relief for double taxation. The following are hypothetical examples.

Example 1: A residence-source conflict between the UK and Spain

Assume that a UK domiciled widow owns a home in the UK, where her 22 year old daughter is also domiciled. Also assume that the widow owns a holiday home in Spain, and that the market value of the British home and the Spanish holiday home is €300,000 each. The Spanish holiday home is located outside the Autonomous Communities that have adopted their own tax rates.

When the widow dies, the daughter will be the only heir. Without any relief for double taxation, the Spanish part of her inheritance will be subject to double taxation. Since the widow was British-domiciled, the UK will apply its domicile rule and apply the British inheritance tax rules to both the British home and the Spanish holiday home. With a total value of €600,000 and a £/€ rate of 1.2, the British tax will be €82,742. The tax amount is a result of a personal allowance of €393,125 (£ 325,000) and a tax rate of 40% above this limit, and all taxes are levied on the value of the Spanish property, cf. the table below.

Double taxation occurs because Spain will simultaneously apply its source rule to the Spanish holiday home. With a value of €300,000, the personal allowance in Spain will be €15,957 and the Spanish tax rate will be 25.5%. This implies that Spain will levy an extra tax of €72,431 on top of the UK tax, cf. table below.

Table 3.4: Taxation of UK and Spanish property, residence-source conflict, and no relief for double taxation

	UK	Spain
Tax base (euro)	€600,000	€300,000
Allowance	€393,125 (£ 325,000)	€15,957
Tax rate	40%	25.5%
Total tax	€82,742	€72,431

Note: Continues overleaf.

Box 3.3: Continued

Example 2: A residence-residence conflict between the UK and Spain

Next, assume that a British-domiciled widow from example 1 takes up residence in Spain and dies there after two years of stay. Without any relief for double taxation, the whole inheritance will be subject to double taxation. After two years, according to UK rules, the widow will still be regarded as domiciled in the UK. Therefore the widow's world-wide estate will be liable to inheritance tax in the UK. With a total value of €600,000, the British tax will be €82,742, cf. the table below.

From a Spanish point of view, the widow will at the same time be considered a Spanish resident. Therefore her worldwide inheritance will also be subject to Spanish inheritance taxation. With a total value of €600,000, the personal allowance in Spain will remain unchanged at 15,957 euro, but the tax rate will increase to 29.75%. The result is that Spanish tax will be calculated to 173,753 euro, cf. table below.

Table 3.5: Taxation of UK and Spanish property, residence-residence conflict, and no relief for double taxation

	UK	Spain
Tax base (euro)	€600,000	€600,000
Allowance	€393,125 (£ 325,000)	€15,957
Tax rate	40%	29.5%
Tax amount	€82,742	€173,753

Example 3: A source-source conflict between the UK and Spain

A source-source conflict requires an asset for which it is not always evident where the asset is located. Such an asset may be a patent belonging to the UK domiciled widow from example 1 and 2 who takes up residence in Spain and dies there after two years of stay. If the same patent is registered in both the UK and Spain, both the UK and Spain may regard the value of this patent as an inheritance that is sourced in their territory, which will eventually result in double taxation.

Note: In Spain, both the tax rate and the personal allowance depend on the kinship. The tax rate also varies with the taxable amount. The UK and Spanish tax rules are described in the attachment.

Source: Copenhagen Economics based on Global Property Guide.

Generally, the type of assets, for example real estate, shares, bonds and bank deposits, does not matter when it comes to double taxation cases. The key question is whether the specific asset is taxed under the domestic rules of both Member States.

If this is the case, the value of the asset will generally be double taxed irrespective of the type. For example, in a cross border inheritance case the value of a share in a company located in one Member States will generally be taxed in both Member States, provided that the share is not covered by the specific rules on transfer of family-owned and closely held businesses (these rules are covered in section 2.3).

In contrast, there will be no double taxation if the specific asset is exempted from taxation in one of the Member States. A specific example is an asset in the form of bank deposits in cases involving Germany as one of the Member States. Under the German tax rules, bank deposits in German banks are exempted from inheritance taxes in Germany (cf. the Attachment with description on the domestic tax rules). Under its source rule, other Member States may levy taxes on bank deposits in German banks, but the German exemption implies that double taxation on bank deposits in German banks does not occur.

3.3. UNILATERAL RELIEF FOR DOUBLE TAXATION

The problem of double taxation is sometimes reduced by the domestic provisions granting unilateral relief for double taxation. This finding is based on an assessment of the effectiveness of the domestic provisions on unilateral relief.

There are two main methods that the Member States apply when granting unilateral relief for international double taxation:¹⁷

- The credit method
- The exemption method

The application of each of the two methods is typically based on the common international understanding that the source Member State has the primary right of taxation and that it is generally the Member State with the personal nexus (based on residence, domicile or nationality) that is providing the unilateral relief for double taxation.¹⁸

Under the *credit method*, the Member State with the personal nexus, taxes domestically *and* foreign-based inheritance, but gives a credit for foreign-paid taxes on foreign-based inheritance. The tax credit may be a full credit, implying that a full reduction of the foreign paid tax is given when calculating the domestic tax. However, the credit is in practice always limited to an ordinary credit so that the domestic tax credit is limited to the amount of domestic tax that would be due on the foreign-sourced inheritance. The effect of such an ordinary credit is that the total tax paid on the foreign-sourced inheritance is the higher of the domestic and the foreign tax rates. For example, if the foreign tax is 20,000 euro and the domestic tax is 10,000 euro the tax credit is limited to 10,000 euro.

The *exemption method* implies that the Member State with the personal nexus only taxes domestically-sourced inheritance. Foreign-sourced inheritance is exempted from taxation. The principle of exemption may be applied by two main methods:

- The property which may be taxed in the Member State of situs is not taken into account at all by the Member State of domicile for the purposes of its tax. The Member State of domicile is not entitled to take the property so exempted into consideration when determining the rate of tax to be imposed on the rest of the estate. This method is called ‘full exemption’.
- The property which may be taxed in the Member State of situs is not taxed in the State of domicile, but the Member State of domicile retains the right to take it into consideration when determining the rate of tax to be imposed on the rest of the estate. This method is called ‘exemption with progression’ or a ‘partial exemption’.

¹⁷ Cf. for example, Rohatgi (2005).

¹⁸ Cf. for example, Umling (2010).

All Member States with inheritance taxes but one have a provision on unilateral relief included in their inheritance tax rules. The domestic rules of the Czech Republic do not provide for a tax credit or exemption, but allow the deduction of foreign taxes paid. Poland is the only Member State that does not provide any unilateral relief from double taxation of inheritances. The Polish Minister of Finance does have a general competence to decide to refrain from collecting taxes for a specified group of taxpayers. However, this competence has not been widely used in the field of inheritance.¹⁹

The credit method, and more specifically a credit in the form of an ordinary credit, is adopted by most Member States. These Member States include Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Lithuania, the Netherlands, Spain and UK. The rest, i.e. Bulgaria, Czech Republic, Hungary, Luxemburg and Slovenia, apply the exemption method to give unilateral relief for double taxation, cf. Table 3.6.

Table 3.6: Unilateral relief for international double taxation on inheritance

Method	No. of Member States	Member States
Credit method	12	Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Lithuania,* the Netherlands, Spain, UK.
Exemption method	5	Bulgaria, Czech Republic,** Hungary, Luxemburg, Slovenia.
No unilateral relief	1	Poland***

Note: * Lithuania does not give unilateral relief for taxed paid in Bulgaria, Cyprus and Malta. ** The Czech Republic does not have a formal unilateral relief, but the domestic rules provide the possibility to deduct foreign taxes in the domestic tax. *** The Polish Minister of Finance does have a general competence to decide to refrain from collecting taxes for a specified group of taxpayers.

Source: Rohatgi (2005).

The unilateral reliefs provided by the Member States are sometimes, but not always effectively resolving the problem of international double taxation on inheritance.

The unilateral relief is most effective when international double taxation is due to the most common residence-source conflict where only the foreign-sourced inheritance is prone to double taxation.

The exemption method normally resolves all problems with inheritance giving rise to international double taxation due to the presence of a residence-source conflict. The exemption method implies that the foreign-sourced inheritance is only taxed in the other Member State, and domestic-sourced inheritance is only taxed domestically.

Under the credit method, the problem of international double taxation is also resolved. Here, the domestic tax is due and the foreign-sourced inheritance is only taxed in the other Member State. In contrast, when the domestic tax is highest, the foreign inheritance tax will still be paid in the other Member State, but the foreign-sourced inheritance will, to some ex-

¹⁹ Cf. Attachment to the report containing a survey of the domestic tax rules.

tent, also be taxed domestically. The domestic tax will equal the difference between the domestic and the foreign tax on the foreign-sourced inheritance. The total tax will, therefore, never exceed the tax paid in the Member State with the highest tax rate.

A specific example focussing on an inheritance consisting of assets located in Spain and the UK may be used to illustrate the effectiveness of the different types of unilateral relief. The specific example concentrate on a residence-source conflict, where the unilateral relief is generally most effective, cf. Box 3.4.

Box 3.4 Examples of unilateral relief for double taxation: Residence-source conflict

The fact that unilateral relief may resolve the problem of international double taxation may be illustrated by focussing on the example with a hypothetical residence-source conflict in Box 3.3, i.e. Example 1. It should be remembered that the unilateral relief is generally less effective in the case of a residence-residence conflict. This is illustrated later in Box 3.5.

It should be recalled that the example assumed that a UK domiciled widow owns a home in the UK, where her 22 year old child is also domiciled. In addition, the widow owns a holiday home in Spain. The market value of the British home and the Spanish holiday home is 300,000 euro each. The Spanish holiday home is located outside the Autonomous Communities.

When the widow dies, the child will be the only heir, and without any relief for double taxation, the Spanish part of her inheritance will be subject to double taxation. The British tax will be €82,742 and the Spanish tax will be an additional €72,431, cf. Table 3.7. The following illustrates how different types of unilateral relief may resolve the problem of double taxation on the Spanish located property.

Example 1: Credit method

The UK inheritance tax rules include a unilateral relief for tax paid in other Member States on foreign located assets. The relief is granted in form of an ordinary credit, i.e. the deduction given by the UK for the tax paid in Spain is restricted to that part of its own tax which is attributable to the property which may be taxed in Spain, in other words, the credit for the Spanish tax is applied against the UK tax referable to the house located in Spain only. In this specific example, the UK unilateral relief implies that the UK gives a credit for the amount of €72,431 paid in Spain. However, this amount will not be credited against the whole amount of the UK tax but only to the part which relates to the house in Spain. Given that the value of both the UK and the Spanish house is equal, the proportionate part of the UK tax relating to the Spanish house should be the half of the UK tax, i.e. $82.742/2=41.371$. This implies that the UK tax on the Spanish property is reduced from € 41.371 to € 0. However, the remaining part of the UK tax remains intact, cf. Table 3.7.

Table 3.7: Impact of the credit method: UK and Spain

	UK	Spain	Total tax
Without tax credit:			
Total tax	€82,742	€72,431	€155,173
With tax credit:			
Total tax	€41,371	€72,431	€113,802

Note: Continues overleaf.

Box 3.4: Continued

Example 2: Exemption method

The full exemption method would fully resolve problem of double taxation. If the UK granted a unilateral relief in the form of an exemption for foreign-sourced inheritance, the UK would not include the Spanish property in the tax base. Consequently, the UK tax base would only amount to 300,000 euro, which would result in no taxation in the UK because this tax base is lower than the personal allowance. The Spanish tax would remain unchanged at 72,431 euro, cf. Table 3.8

Table 3.8: Impact of the exemption method: UK and Spain

	UK	Spain	Total tax
Without exemption:			
Total tax	€82,742	€72,431	€155,173
With exemption:			
Total tax	€0	€72,431	€72,431

However, the exemption with progression, which is much more frequent method of eliminating double taxation, would trigger the right of the UK to take it into consideration the value of the Spanish property when determining the rate of tax to be imposed on the rest of the inheritance.

Note: In Spain, both the tax rate and the personal allowance depend on the kinship. The tax rate also varies with the taxable amount. The UK and Spanish tax rules are described in the attachment.

Source: Copenhagen Economics based on Rohatgi (2005).

However, the effectiveness of the unilateral reliefs provided by the Member States is not always as high as in the above situations.

The methods for unilateral relief (both credit and exemption) for international double taxation are generally ineffective when international double taxation is due to a residence-residence conflict.

In the case of a residence-residence conflict, the problem is that the domestically-sourced inheritance will still be prone to double taxation. The unilateral relief granted by the Member States is generally targeted at foreign taxes paid on foreign-sourced inheritance. In case of a residence-residence conflict, the domestically located inheritance is, however, also double taxed without the possibility of getting a unilateral relief. The economic consequences of the unresolved double taxation in the case of a residence-residence conflict may be very significant to the affected individuals, cf. Box 3.5.

Box 3.5: Example of the ineffectiveness of the unilateral relief in the case of a 'residence-residence' conflict

The fact that unilateral relief is not effectively resolving the problem of international double taxation in the case of a 'residence-residence' conflict may be illustrated by focussing at the example with a hypothetical residence-source conflict in Example 2. In the example, we will concentrate on the credit method, which is actually applied by the UK, but the same conclusion would appear with the exemption method as the method for unilateral relief.

It should be recalled that the example assumed that a British-domiciled widow takes up residence in Spain and dies there after two years of stay. At the time of death, the widow owns a home in the UK, where her 22 year old child is also domiciled. In addition, the widow owns a holiday home in Spain. The market value of the British home and the Spanish holiday home is €300,000 each. The Spanish holiday home is located outside the Autonomous Communities. When the widow dies, the daughter will be the only heir. The following illustrates how the UK located property will be prone to double taxation even though the UK inheritance rules include a unilateral relief for tax paid in other Member States on foreign located assets.

Without relief for double taxation, the worldwide inheritance, i.e. both the Spanish and the UK located inheritance, will be double taxed. After two years, according to UK rules, the widow will still be regarded as domiciled in the UK. Therefore the widow's world-wide estate will be liable to inheritance tax in the UK. From a Spanish point of view, the widow is also a Spanish resident. Thus, her worldwide inheritance will also be subject to Spanish inheritance taxation.

Because the double taxation is due to a residence-residence conflict, the UK unilateral relief will not be effective in resolving the double taxation problem.

The daughter can expect that the UK allows a credit for the taxes paid in Spain on the Spanish located asset. However, as the unilateral relief does not allow a credit for the foreign taxes on the foreign located assets. Therefore, despite the UK unilateral relief, the daughter will still be prone to double taxation. With a tax rate of 29.75% in Spain, the amount of additional tax is significant.

Source: Copenhagen Economics based on Rohatgi (2005).

With a source-source conflict, the inheritance in question will typically not qualify for the domestic unilateral relief. The reason is that the home Member State will regard the inheritance as being located within its jurisdiction and it will not qualify for a unilateral relief under the domestic tax rules. This will simply imply an even higher double taxation than in Box 3.5.

The effectiveness of the unilateral relief may also be depressed if the unilateral relief is subject to limitations. We provide three types of limitations.

First, the unilateral relief is in some Member States limited to a subset of foreign located asset, typically real estate and/or other immovable assets. This is the case in Belgium, Greece, Luxembourg and Bulgaria, cf. Table 3.9.

Table 3.9: The scope of the domestic unilateral relief for double taxation

Restriction of relief	All foreign located assets*	Subset of foreign located assets**
Credit method	Denmark, Finland, France, Germany, Greece, Ireland, Italy, Lithuania,*** the Netherlands, Spain, UK.	Belgium (real estate), Greece (movable assets).
Exemption method	Hungary, Slovenia.	Bulgaria (real estate), Luxembourg (movable property).

*Note: * The definitions of foreign located assets differ. The unilateral relief are not given in case the assets are not taxed under the domestic rules. ** The brackets indicate which assets are covered by unilateral relief. *** Lithuania does not give relief for taxes paid in Bulgaria, Cyprus and Malta.*

Source: Copenhagen Economics based on Maisto (2010).

Second, because there is no harmonisation concerning the meaning of ‘foreign assets’, not all foreign located assets always qualify for a unilateral relief for double taxation under the domestic rules. The German unilateral relief has provided a clear example of the economic consequences of this problem. In the Block case, a German resident was taxed in both Germany and Spain and received an extra tax bill of €63,655 equivalent to more the 60% of the tax bill without double taxation. The reason was that according to the German tax rules, capital claims against financial institutions in Spain do not constitute ‘foreign assets’, cf. Box 3.6.

Box 3.6: Ineffectiveness of the German unilateral relief: The Block case

The Block case (Case C-67/08) provides an example that illustrates that not all foreign located investments are always included in the definition of 'foreign located assets' contained in the domestic rules. In the Block case, the economic impact was significant as Ms Block, a German resident, was bound with an extra tax bill of €63,655.

The Block case concerns Ms Block, a German resident, who was the sole heir of a person who died in 1999 in Germany, where the deceased was last resident. The estate essentially consisted of capital assets with a total value of €582,233, of which €73,756 was invested in Germany and the rest €508,477 with financial institutions in Spain.

The German tax authorities, the Finanzamt, initially applied its personal nexus rule and claimed worldwide taxation of the value of both the German and the Spanish assets, i.e. €582,233. In addition, Spain applied its source rule and claimed source taxation of the value of the Spanish assets, i.e. €508,477.

Ms Block filed a complaint to the Finanzamt applying for a unilateral relief so that the inheritance tax paid in Spain would be credited against the inheritance tax to be paid in Germany. The German inheritance tax rules include a unilateral relief for double taxation in the form of a tax credit. According to the German rules the tax credit applies 'where the foreign property of acquirors is subject, in a foreign country, to a foreign tax corresponding to German inheritance tax, the foreign tax set and payable by the acquiror, paid and not eligible for reduction, shall, in the cases referred to in the first point of Paragraph 2(1) and, in so far as the provisions of a double-taxation agreement do not apply, be offset, if an application is made for that purpose, against the German inheritance tax in so far as the foreign assets are also subject to German inheritance tax. ...

However, the Finanzamt found that the Spanish assets did not qualify for a unilateral relief under the German rules. In response to complaint from Ms Block, the Finanzamt allowed the deduction of the Spanish tax liability as a liability of the estate, meaning the deduction of inheritance tax paid in Spain from the basis of assessment of inheritance tax payable in Germany. According to that decision, the taxable acquisition, after deduction of liabilities from legacies and a personal allowance, amounted to €296,038, and the amount of inheritance tax to which that acquisition was subject was fixed at €63,655.

Ms Block took the case to the Finanzgericht (Finance Court). The Finance Court supported the decision made by the Finanzamt. The Finance Court took the view that it was not possible to credit Spanish inheritance tax when calculating the German inheritance tax, because capital claims against financial institutions in Spain do not constitute 'foreign assets' under the German tax rules. The Finance Court was aware that its decision would imply double taxation on the Spanish capital claims, but found that it was not for the German tax authorities to subsidise other Member States (Spain).

The economic cost of the double taxation was significant to Ms Block. If she had been granted a tax credit for the inheritance taxes paid in Spain, the German inheritance tax would have been reduced from the actual €63,655 to €0. As the Spanish tax would have remained unchanged, Ms Block's total costs of double taxation amounts to the actual German tax, i.e. €63,655, cf. Table 3.10.

Table 3.10: Overview of Ms Block's cost of double taxation on Spanish located assets

	Germany	Spain	Total tax
Tax base	€582,233	€508,477	-
Actual tax	€63,655	€106,126	€169,781
Tax with German tax credit	€0	€106,126	€106,126
Cost of double taxation	€63,655	€0	€63,655

Source: Judgement in the Block Case (Case C-67/08) and Romani (2010).

Third, the effectiveness of the unilateral relief is also reduced by the fact that most Member States limit the scope of the relief to cover only inheritance and estate taxes and not other taxes levied on the deceased's assets.

For example, the unilateral relief granted in Member States such as the UK, Germany and Denmark does not apply to the stamp duty in Portugal. In a number of cases, EU citizens,

therefore, experience that they pay inheritance tax in more than one Member State despite the fact that their domestic tax rules contain unilateral relief for double taxation. It should, however, be remarked that in several cases these other taxes are not only levied in inheritance cases, but more generally on transfers of real estate.

3.4. DOUBLE TAXATION TREATIES

A double taxation treaty is an agreement between two Member States. The treaties contain specific rules on how to divide the tax rights between the two Member States in situations where an inheritance is covered by the inheritance tax rules of both Member States, cf. Box 3.7.

Box 3.7: What is a double taxation treaty?

Double taxation treaties are conventions between two countries that aim to eliminate the juridical double taxation of income, profit or inheritance arising in one Member State and paid to residents of another Member State. They work by dividing the taxing rights each Member State claims by its domestic laws over the same income, profit or inheritance.

Many countries have entered into bilateral agreements (treaties) with respect to taxes (tax treaties). Tax treaties commonly include the following provisions:

- Define which taxes are covered and who is a resident and eligible for benefits,
- Reduce the amounts of tax withheld from interest, dividends, and royalties paid by a resident of one Member State to residents of the other country,
- Limit tax of one country on business income of a resident of the other country to that income from a permanent establishment in the first country,
- Define circumstances in which income of individuals resident in one country will be taxed in the other country, including salary, self employment, pension, and other income,
- Provide for exemption of certain types of organizations or individuals, and
- Provide procedural frameworks for enforcement and dispute resolution.

Source: *OECD Tax Treaties*.

Several governments and organisations have proposed model treaties to use as starting points in negotiations. The Organization for Economic Cooperation and Development (OECD) model treaty is often used as such a starting point. The OECD members have from time to time agreed on various provisions of the model treaty and the official commentary and the comments they made thereon provide excellent guidance on the interpretation by each member country.

The 1982 OECD Model Tax Convention

In the case of inheritance taxes, the OECD has approved the Estate and Inheritance Draft Model Convention in 1966. This model was subsequently revisited in 1982 to consider recent trends in Member States' legislations and to extend it to gift taxes (Model Double Taxation Convention on Estates and Inheritances and on Gifts).²⁰ We refer to it below as the OECD Model Tax Convention.

²⁰ Cf. for example, Sonneveldt and Zwemmer (2000).

The 1982 Model Convention consists of six chapters. Chapter I is devoted to the scope of the convention, while Chapter II defines a number of terms. Chapter III deals with the allocation of taxing rights between the Contracting States and Chapter IV discusses the methods for eliminating double taxation. Finally, Chapters V and VI contain the special and final provisions, cf. Box 3.8.

Box 3.8: The six chapters of the 1982 OECD Model Tax Convention on inheritance taxes

Chapter I: Scope of agreement

The scope of the agreement is defined in Article 1 and Article 2. According to Article 1, the general rule is that the agreement applies to situations where the deceased was domiciled in one or both of the contracting states. Article 2 states which taxes are covered by the agreement.

Chapter II: Definitions

Articles 3 and 4 contain the definitions that are relevant for the agreement. Article 3 contains the general definitions that are required for the agreement, for example which are the competent authorities. Article 4 specifically addresses the question of 'domicile'. First, paragraph 1 states that the question of whether the deceased was domiciled in one of the contracting states at the time of death shall be determined according to the law of these states. Second, paragraph 2 explains how to deal with cases where the deceased was domiciled in both states, i.e. how to solve a conflict of the 'residence-residence type'.

Chapter III: Taxing rules

The allocation of taxing rights is described in the articles 5, 6, 7 and 8. Article 5 states that immovable property may be taxed in the contracting state that the property is located, and that the term 'immovable property' shall be defined in accordance to the law of the contracting state in which the relevant property is located. Article 6 deals with the taxation rights for business property of a permanent establishment and assets pertaining to a fixed base used for the performance of independent personal services. Article 7 explains how property not mentioned explicitly shall be taxed. Article 8 finally concerns that deduction rights and the exemptions that are in force.

Chapter IV: Methods for eliminating double taxation

Article 9 explains how to deal with cases of double taxation where both contracting states impose tax by reason of an individual's domicile or citizenship. Articles 9A and 9B deal with possible methods to avoid double taxation using either the exemption method or credit method.

Chapters V: Special provisions

Article 10 deals with non-discrimination, where it is stated that the contracting states must not favour their own residents. Article 11 contain the Mutual Agreement Procedure, which allows designated representatives (the "competent authorities") from the governments of the contracting states to interact with the intent to resolve international tax disputes. Article 12 states the competent authorities of the contracting states shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the contracting states. Article 13 contains special rules for diplomatic agents and consular officers.

Chapter VI: Final provisions

Article 14 states when the agreement enters into force, and article 15 specifies when and how the agreement can be terminated by one or both parties.

Source: Copenhagen Economics based on Sonneveldt and Zwemmer (2000).

The key elements of the 1982 OECD Model Tax Convention are the provisions contained in chapter 2, 3 and 4, i.e. the definition of "fiscal domicile", the taxing rules and the methods for eliminating double taxation.

The scope of the 1982 Model Convention is restricted in that it only deals with deceased that were domiciled or resident in one or both contracting states at the time of death. Therefore, it does not solve cases where individuals are domiciled or resident in more than two contracting states. Furthermore, the term 'domiciled' is defined relatively broad implying that a deceased may very well be regarded as domiciled in both contracting states. To deal

with such ‘residence-residence’ conflicts, article 4 provides a number of tie-breaker rules so that in the end the dual domicile will always be decided in favour of only one of the contracting states.

In allocating the taxing rights between the contracting states the 1982 Model Convention gives priority to the contracting state where the assets are located (state of situs) in two cases. This state is given the right to tax immovable property (Article 5) and movable property of a permanent establishment or a fixed base (Article 6). All other property shall be taxable only in the contracting state in which the deceased or donor was domiciled at the relevant moment.

With respect to the methods for eliminating double taxation, Chapter 4 of the 1982 Model Convention provides that the contracting state in which the deceased was domiciled at his death shall either apply the exemption method (Article 9A) or the credit method (Article 9B) with respect to those properties which, in relation to the same event and in accordance with the provisions of the Convention, may be taxed in the state of situs.

The rules of the convention are in principle to be followed by the OECD Members. Nevertheless, there may be examples where it is motivated to deviate from these rules. One such example is when a deceased, planning for his demise, previously has moved his domicile to the other state with the intention of avoiding taxation by his former state of domicile. In such cases, states may retain a subsidiary right to impose tax, but only for a limited period of time (maximum 10 years). An example of such subsidiary taxing right is the treaty concluded between the UK and the Netherlands.

The current stock of bilateral tax treaties for the avoidance of double taxation on inheritance is inefficient in avoiding double taxation within the EU. There are two reasons behind this conclusion.

First, the number of treaties, and thus the coverage of the bilateral treaties, is very low and not increasing. On a worldwide basis, the number of tax treaties that are currently in force in the field of inheritance tax is less than 100. Between the 27 Member States, currently 33 bilateral treaties are in force and 351²¹ would be required to secure a complete coverage for all citizens.

In practice, many Member States have almost no treaties in force, and during the last ten years the 27 Member States have only managed to complete and get three new bilateral into force. During the same period, one existing bilateral tax treaty between the 27 Member States has been terminated, cf. Figure 3.1.

²¹ If any double taxation should be avoided, in a world with n states $(n^2-n)/2$ bilateral tax treaties would be necessary; if $n = 2$, one bilateral tax treaty is necessary; for $n=3$, three bilateral tax treaties; for $n=4$, six bilateral tax treaties; for $n=5$, ten bilateral tax treaties are necessary; and for $n=27$, 351 tax treaties are necessary.

Figure 3.1: Overview of bilateral tax treaties on inheritance in the European Union

	BE	BG	CZ	DK	DE	EE	IE	EL	ES	FR	IT	CY	LV	LT	LU	HU	MT	NL	AT	PL	PT	RO	SI	SK	FI	SE	UK	
BE									√																	√		
BG																												
CZ																			√*									
DK					√					√															√	√		
DE				√				√		√*																√	√	
EE																												
IE																											√	
EL					√				√	√															√			
ES								√	√	√																		
FR	√				√*				√	√									√		√				√	√	√	
IT				√				√	√	√																√	√	√
CY																												
LV																												
LT																												
LU																												
HU																				√						√		
MT																												
NL																				√*						√	√	√
AT				√*					√						√			√*								√		
PL																												
PT									√																			
RO																												
SI																												
SK																												
FI				√				√	√											√						√		
SE	√			√	√				√	√					√			√	√	√					√		√	
UK							√		√	√								√								√		

Note: √ means in force since before 1 January 2000; √* means new since 1 January 2000. The treaties between the Nordic countries are part of multilateral agreement signed by the Nordic countries in 1983: Nordiska skatteavtalet (Nordic convention), signed in Helsinki on 22 March 1983. In the matrix each treaty is shown twice, i.e. a treaty between UK and SE is marked for both SE-UK and UK-SE.

Source: Copenhagen Economics based on IBF, Tax treaties database.

Of the many reasons behind the meagre number of bilateral treaties, one stands out: the limited revenue compared to the efforts required to conclude a tax treaty. Also, tax administrations commonly have a keener interest towards periodic taxes.

Second, the few treaties that are in force are not always efficient in avoiding double taxation on inheritance. A number of problematic issues have been identified. For example, in Maisto (2010), the following conclusion is drawn about the effectiveness of the OECD Inheritance Model Tax Convention (OECD IHTMC): *As it stands, the OECD IHTMC is largely unable to cope with discrepancies among domestic laws and avoidance of international avoidance of double taxation.*

The problems arise because many actual situations are not covered by the outdated model. It is noteworthy that it has remained unchanged since 1982. Therefore, it is fairly inapt at handling the many discrepancies that arise because of domestic laws in the Member States. Examples of such discrepancies are mentioned below.

The notion of ‘taxes covered’ in Article 2 is not entirely clear given that the interpretation of such taxes that are imposed ‘by reason’ of death is more narrow than those taxes that are im-

posed ‘on the occasion of death’. The latter example opens up the possibility of levying taxes even when the death of the person is not the only reason for the tax.

Another controversy that is likely to emerge is the concept of domicile, as is defined in Article 4. Two states may have different opinions on ‘domicile’ in the individual case. Some states also provide for the possibility of having domicile in more than one state. In the latter case, some states have retained taxing rights under the concept of extended domicile. Thus, there are a number of examples where double inheritance and gift taxation would not be avoided.

In Article 8, the Member State, in which the asset are located (the state of situs), is obliged to deduct debt from the value of property, even if this is not allowed under domestic law. This is an apparent conflict between domestic tax laws and the OECD Model Tax Convention, which is rooted in differences in how property should be valued.

Moreover, the OECD Inheritance Model Tax Convention does not address double taxation due to the practice of extending the power of taxation to former residents who are no longer actually resident or domiciled in the Member States (‘trailing tax’). The OECD Inheritance Model Tax Convention does not address situation where the taxation is based on the concept of ‘deemed domicile’ as applied by Germany, the Netherlands and the UK.²²

3.5. CONCLUSIONS

The analysis presented in this chapter leads to three conclusions concerning the cross-border differences in the domestic inheritance tax rules.

Firstly, as far as the discrimination problem is concerned, it has been revealed that *a number of discrimination elements have been eliminated from certain Member States' jurisdictions*. Since 2000, the European Court of Justice has developed new case law in the area of inheritance taxation, and in several cases this new case law has materialised in amendments of the domestic inheritance laws to make them compatible with the Treaty on the Functioning of the European Union.

There is still room left for progress in this area, but it is not obvious that the remaining discrimination from the inheritance tax rules has a large impact on the functioning of the Internal Market. However, in the specific cases the impact of the problems may be very significant to the individuals involved.

Secondly, with respect to the double taxation problem, it has been revealed that the *potential for double taxation is large and almost unchanged compared with ten years ago*. Compared

²² Cf. IFA (2002), page 32-33.

to ten years ago the fact that some Member States, for example Sweden, Austria and Portugal, have ceased levying tax on inheritance has reduced the potential for double taxation.

However, besides from that, framework conditions that create double taxation are unchanged. Double taxation occurs in cross-border inheritance cases when there is a conflict between the connecting factors of the relevant Member States' domestic inheritance tax systems. This is the case in most cross-border cases because most Member States still apply a combination of a personal nexus rules (residence, domicile or nationality), implying taxation of worldwide assets, and source rule, implying taxation of all domestically located assets.

Furthermore, the general trend is that the Member States have not managed to secure relief for double taxation. The number of bilateral tax treaties has remained at a very low level since 2000. Many Member States grant unilateral relief for double taxation and it is effective in many cases. However, there are several limitations in the scope of the granted unilateral relief, which reduce the effectiveness of the unilateral relief.

Thirdly, the report has documented that the economic consequences of unresolved double taxation on inheritance may be very severe to the individual affected. For example, in the Block case (C-67/08), double taxation of assets located in Spain by Germany and Spain resulted in an extra tax bill of more than €63,000, which was an increase of more than 60%.

Chapter 4 THE SCALE OF THE PROBLEM WITH DOUBLE TAXATION ON INHERITANCE

This chapter considers the current scale of the double taxation problem as well as the trends in the scale of the problem.

Ideally, a full dataset of all cross-border inheritance cases on the micro level would allow precisely estimating the importance of cross-border inheritance cases on national tax revenue as well as the impact of the unsolved problems of double taxation on households. However, such data are currently not available.

Given the absence of the ideal dataset on cross-border inheritance cases, we will throughout this chapter investigate the scale of the problem by looking at three types of indicators. First, statutory and effective inheritance tax rates and revenues will serve as an indicator for the role of inheritance taxes in Member States. Second, migration serves as an indicator of the volume of cases as the migration of a deceased or an heir can also give rise to a cross-border inheritance case. Third, cross-border ownership of assets serves as a volume indicator as a deceased's ownership of foreign property abroad may give rise to a cross-border inheritance case.

We will first consider the scale of the problem and the recent trends in the scale of the problem at a macro level in section 4.1 and 4.2. The scale of the problem at a micro level will be considered in section 4.3 and the annual number of cross-border inheritance cases will be estimated in section 4.4. Section 4.5 concludes on our findings.

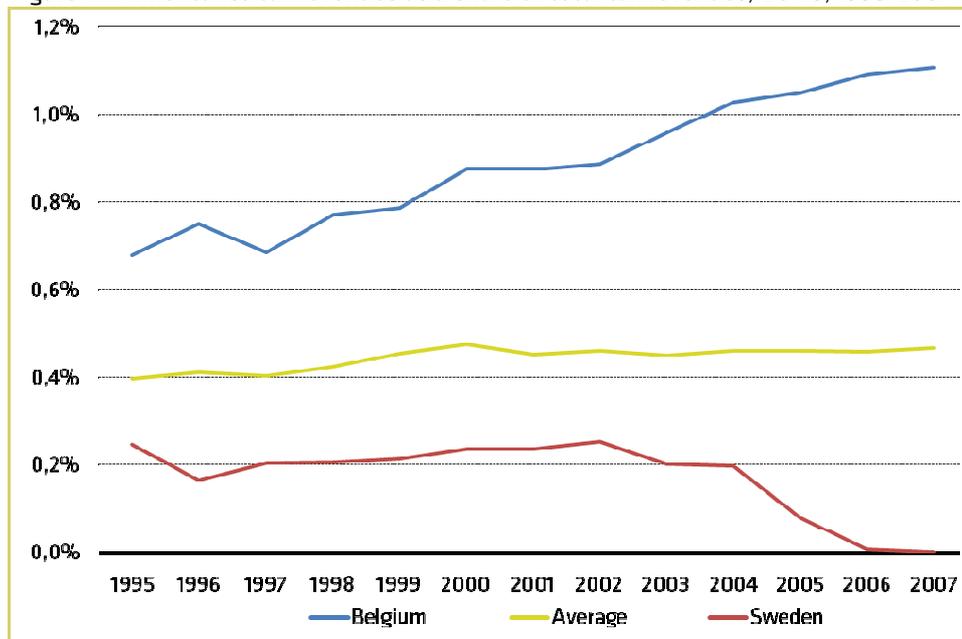
4.1. SCALE OF THE DOUBLE TAXATION PROBLEM AT A MACRO LEVEL

To investigate the scale of the double taxation problem at a macro level, two set of indicators are the most relevant. The first set of indicators consists of indicators of the total tax revenue generated from inheritance taxes in the Member States, and the second set indicator includes indicators on migration within the EU.

Inheritance taxes

Inheritance taxes are, and historically have been, a very modest contributor to national tax revenues. In 2007, the average 'old' EU-15 Member State generated only around 0.5% of their total tax revenues from the taxation of inheritance, cf. Figure 4.1.

Figure 4.1: Inheritance tax revenues as a share of total tax revenues, EU-15, 1995-2007



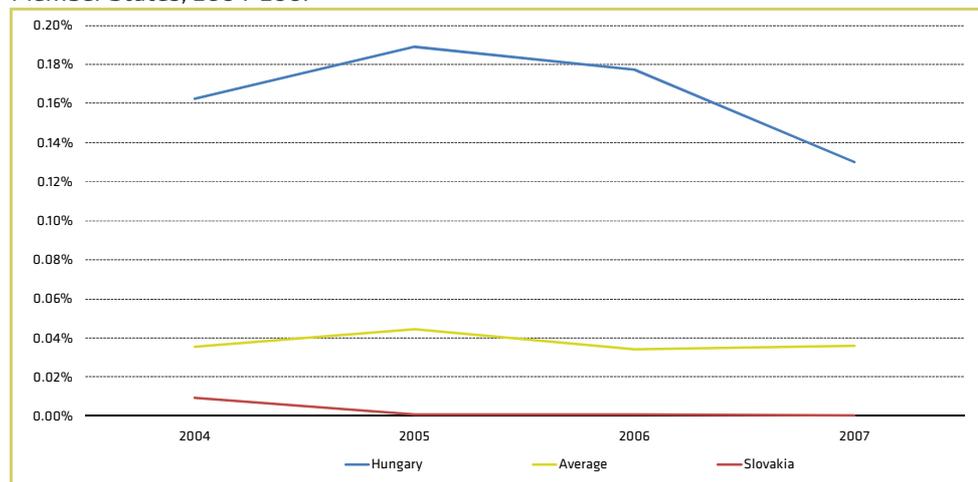
Source: Copenhagen Economics based on National Tax List,

http://ec.europa.eu/taxation_customs/taxation/gen_info/economic_analysis/tax_structures/article_5985_en.htm.

The figure indicates large differences between the Member States. The two most extreme Member States regarding developments in inheritance tax revenues are Belgium and Sweden. Belgium was the Member State with highest inheritance tax rate in 2007, and in contrast Sweden was the Member State with the lowest rate in 2007. In Belgium, the inheritance tax as share of total tax revenues have increased from 0.7% to 1.1% during the period 1995-2007, while it went from 0.25% in 1995 to 0.0% in 2007 in Sweden. The latter reflects that Sweden has ceased to collect inheritance taxes all together. But even for Belgium, the inheritance tax contributes only modestly to the overall tax revenue.

In the 12 'new' Member States, inheritance taxes play an even smaller role. The Member State with the highest average rate is Hungary and the Member State with the lowest rate is Slovakia (together with Latvia and Estonia). The share of inheritance taxes in total tax revenues averages less than 0.04% in the 12 'new' Member States for 2006 and 2007, cf. Figure 4.2.

Figure 4.2: Inheritance tax revenues as a share of total tax revenues in eight 'new' Member States, 2004-2007



Note: The eight Member States in the sample are Cyprus, Czech Republic, Estonia, Hungary, Lithuania, Malta, Slovakia, and Slovenia.

Source: Copenhagen Economics based on National Tax List,

http://ec.europa.eu/taxation_customs/taxation/gen_info/economic_analysis/tax_structures/article_5985_en.htm.

The finding that inheritance is generally not a very important tax source in today's tax system is confirmed by other studies. A study from 2010 finds that inheritance taxes account for less than 1% of the overall tax revenue in most OECD countries.²³

The modest inheritance revenues suggest, at this point, that the magnitude of revenues associated with double taxation should be very limited. After all, if the revenue from domestic and cross-border inheritance taxes together account for less than 0.5% of total tax revenues (and that it is close to 0% in the 12 'new' Member States), the cross-border cases alone must account for far less than 0.5% of total tax revenues.

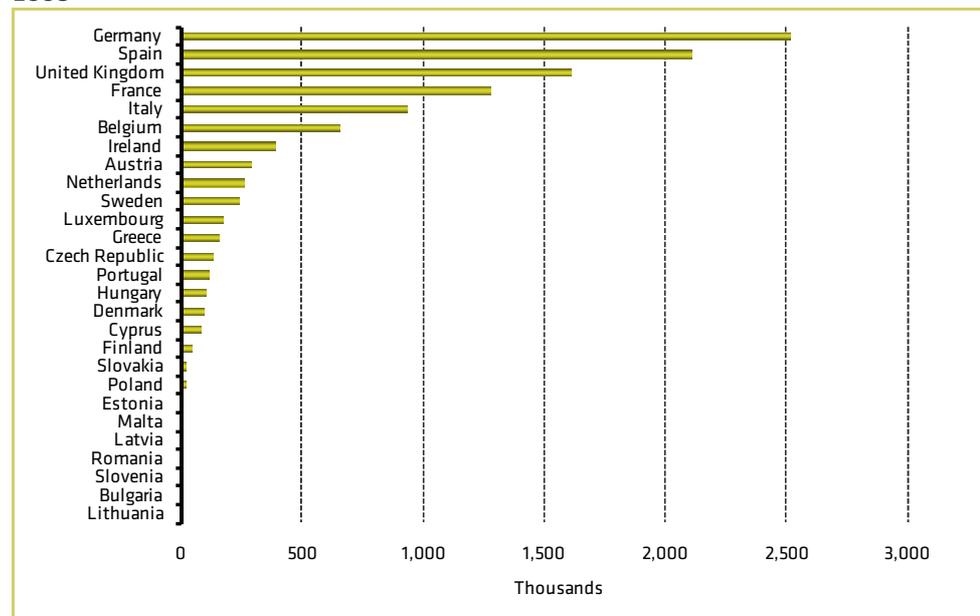
Migration

Migration of people is an important indicator of cross-border inheritance cases. Migration creates a cross-border element that can make an inheritance case trans-national when decease strikes.

A closer look at the distribution of intra-EU migrants across the EU shows that most of the intra-EU migrants come from the 12 'new' Member States and that most of them settle in the 15 'old' Member States. Taken together, the 12 'new' Member States attract an insignificant amount of migrants, but they are the main contributors to immigration into the 15 'old' EU Member States. The largest number of migrants has chosen to settle in the largest EU economies: Germany, Spain, UK, France and Italy, cf. Figure 4.3.

²³ Cf. Maisto (2010).

Figure 4.3: Number of non-nationals but citizens of other EU-27 Member States in 2008



Note: Composition of usually resident population by country of birth. Population is the number of people with a place of legal or registered residence.

Source: Copenhagen Economics based on statistics from Eurostat.

This migration pattern from the 12 ‘new’ Member States to the 15 ‘old’ Member States, gives an initial indication of importance of the double taxation problem. In addition, three other factors are important for an assessment of the magnitude of the double taxation problem caused by migration.

First, it is not only of importance where the migrant is settling, but also where he is migrating from. If the Member State from which the migrants travel to and from has adopted a double taxation treaty, the migration is less likely to result in a double taxation problem. On the contrary, if no treaty is present, the existence of a double taxation problem is more likely.

Second, the age profile of the migrant streams is important. From the perspective of probability of the migrant dying, and then creating a potential cross-border case, people aged above the working age (i.e. 65+) are of special importance. For these old migrants, it is likely that their heirs are living in the native Member State. In contrast, from an heir perspective, persons in the age group 30-65 are more important as this is typically the age in which their parents die in the native Member State.

Third, the duration of the stay is of interest because a longer stay in another Member State will make it more likely that ties are made to the host Member State, e.g. marriage or property purchase, which can ultimately result in a double taxation case. On the other hand, the

longer duration might also reduce the probability of double taxation cases since it is more likely that spouse and children are also residents of the host Member State.

The intra EU migrant population turns out to be dominated by a few large populations. Of the 702²⁴ possible intra EU migrant streams, the 10 largest intra EU migrant populations account for no less than 39.7% of the total intra EU migrant population. Looking at the 10 largest migrant populations, we see four patterns determining migration.

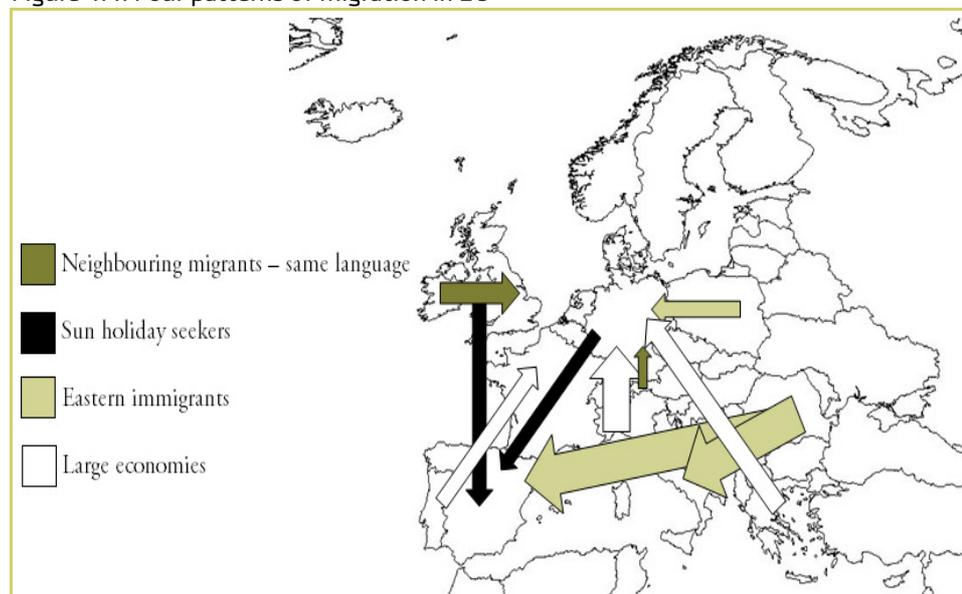
First, there are migrants that move to a neighbouring Member State with same language – as the Irish moving to United Kingdom, cf. Figure 4.4.

Second, from northern Europe, people are migrating south towards Member States with a better climate, e.g. British moving to reside in Spain, cf. Figure 4.4.

Third, there are the large amounts of immigrants arriving from Eastern Europe as the Romanians migrating to Italy and Spain, cf. Figure 4.4.

Finally, there is a significant amount of immigrants moving to one of the large economies, such as Greek nationals migrating to Germany, cf. Figure 4.4.

Figure 4.4: Four patterns of migration in EU



Note: The arrows indicate direction and size of migration.

Source: Copenhagen Economics and Eurostat.

²⁴ From the 27 EU countries people can migrate to 26 other EU countries, i.e. there are $26 \times 27 = 702$ possible intra EU migrant streams.

The exact volumes of these main movements are displayed in Table 4.1. It must be noted that the expected annual deaths in each of the migrant streams differ markedly due to differences in age structure of the 10 migrant streams. For example, the mortality rate is markedly lower for Romanians migrating to Spain than for British citizens migrating to Spain. This reflects the fact that the Romanians are younger, probably there to work or study, while the British citizens are older and more likely to be retired.

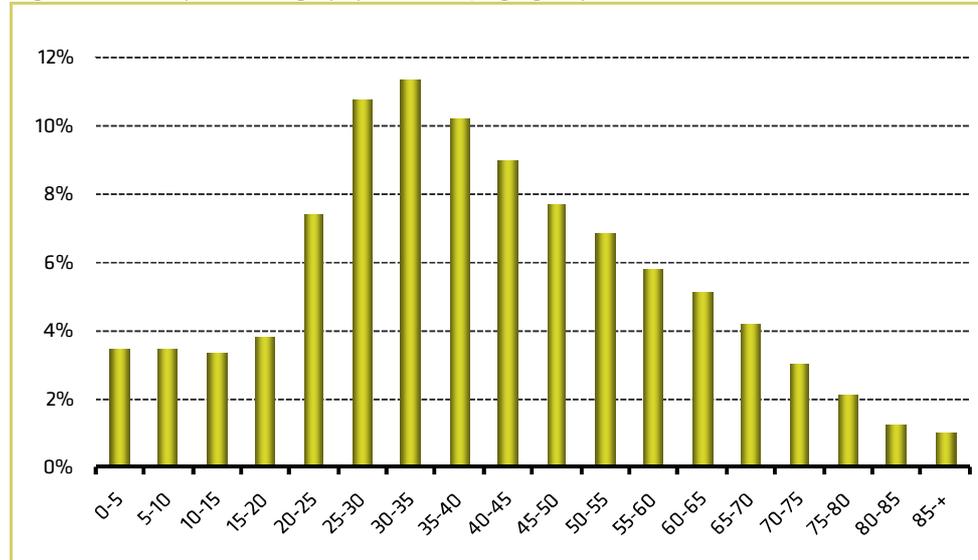
Table 4.1: Top 10 migration streams in the EU-27.

Case#	Citizenship of migrant	Member State of residence	Double taxation treaty present	No. of migrants
1	Romania	Spain	No	799,225
2	Romania	Italy	No	796,477
3	Italy	Germany	No	560,364
4	Portugal	France	Yes	491,983
5	Poland	Germany	No	419,555
6	UK	Spain	No	375,856
7	Ireland	UK	Yes	369,47
8	Greece	Germany	No	306,402
9	Germany	Spain	No	191,08
10	Austria	Germany	No	190,15
Total				4,513,095

Source: Eurostat and Copenhagen Economics.

The intra EU migrant population is generally dominated by working age (25-65) migrants. Of the entire intra EU migrant population, 67% are in the working age. Almost a third of the EU migrants are between 25 and 40 years of age. Younger (age 0-25) and older (age 65+) citizens account for smaller fractions with 22% and 12% respectively, cf. Figure 4.5.

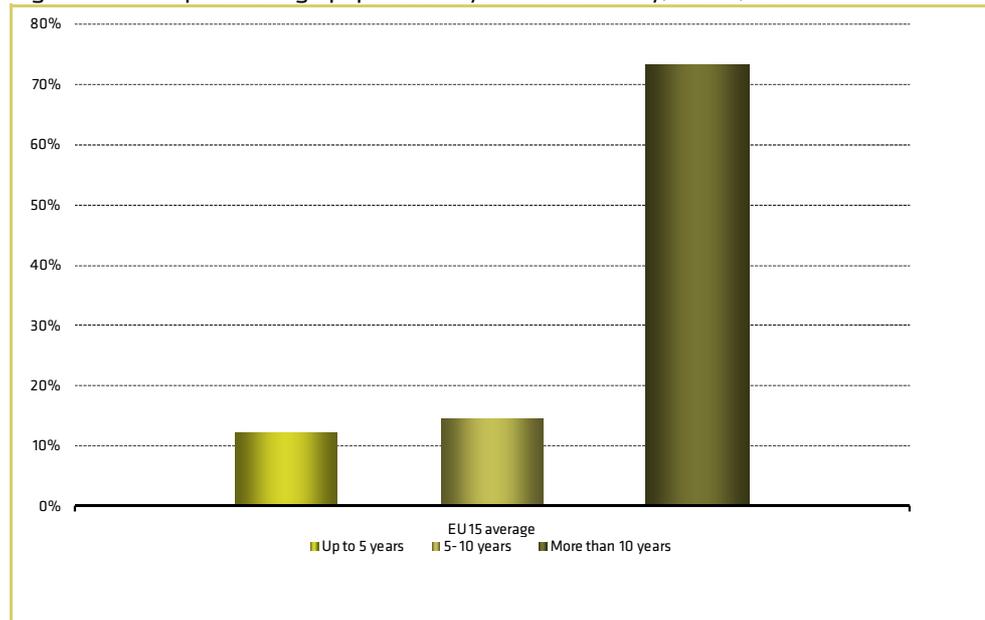
Figure 4.5: European foreign population by age group, EU-27, 2008



Source: Copenhagen Economics based on data from Eurostat.

The OECD has investigated the length of stay of migrants. The main finding is that migrants predominantly remain abroad for long periods of time. Statistics from 2000 show that nearly 75% of the migrants had been living outside their Member State of citizenship for more than 10 years, cf. Figure 4.6.

Figure 4.6: European foreign population by duration of stay, EU-15, 2000



Source: OECD Statistics.

There are no indicators of the probability of return after a stay abroad of more than 10 years. However, given that the duration of the stay is mostly more than 10 years, it appears reasonable to assume that such migrants achieve a high level of social and economic integration with their new Member State of residence, meaning that it will be difficult to cut off all ties easily in the short run.²⁵ This of course points in the direction of more cross-border inheritance cases compared to a situation where most stays had a rather short duration.

4.2. TRENDS IN THE PROBLEM AT A MACRO LEVEL

To investigate the trends in the double taxation problem at a macro level, the same two sets of indicators are relevant, i.e. indicators of the total tax revenue generated from inheritance taxes in the Member States and indicators on migration within the EU. In addition, indicators of trends in cross-border ownership of assets in the EU are also present and relevant.

Inheritance taxes

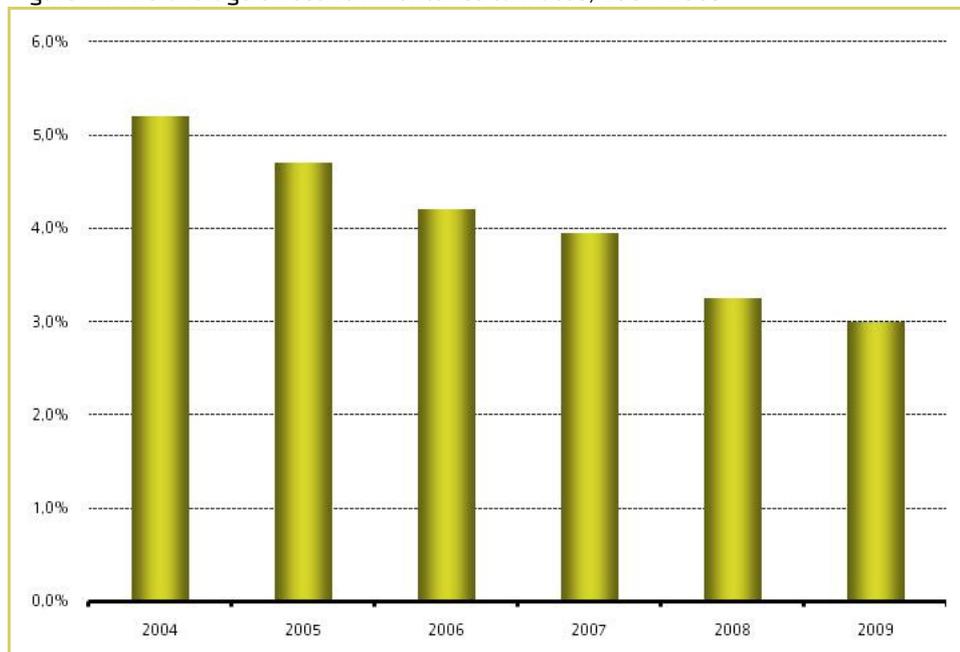
The development in the effective tax rate on inheritance is an indicator of the development in the tax revenues from cross-border inheritance taxation and thus the importance of the double taxation problem.

During the last decades, there has been a clear trend for lower inheritance taxes in Europe. The yearly studies performed and published by AGN International reveal that the average effective inheritance tax rate in Europe has dropped since 2004. The studies have looked at the same case of a married individual who dies on January 1, leaving a spouse and two children and assets with a total value of €2,600,000 and no will.²⁶ The effective tax rate has decreased from around 5% in 2004 to around 3% in 2009, cf. Figure 4.7.

²⁵ For example, migrants that are married, with children, owning an apartment, or having a pension or insurance scheme, may be less likely to change residence. Even if they did change residence, they are likely to retain significant cross-border ties, e.g. leaving behind their children as heirs, renting the owned apartment, receiving payouts from a pension fund, etc.

²⁶ The precise definition is further explained in chapter 2, Box 2.1.

Figure 4.7: EU average effective inheritance tax rates, 2004-2009



Note: The survey compares the levels of inheritance tax payable in the case of a married individual who dies on January 1, 2009, leaving a spouse and two children. The assets owned at death have a value of 2,600,000 euro and the deceased is assumed to have left no will, cf. Box 2.1 in chapter 2.

Source: Svenskt Näringsliv (2010).

The declining trend in the average tax rate is a result of three trends in the taxation of inheritance during the last decades.²⁷

The first trend is that several Member States have lowered their tax rates on inheritance. Examples include Denmark in 1995, Italy in 2002, Finland and Greece in 2008, and the Netherlands in 2010.

The second trend is that some Member States have reduced the tax base or broadened the scope of subjective exemptions to the spouse or descendants. For example, Poland reduced the tax base in 2007. Furthermore, the UK has recently widened its exemption for agricultural property.

The third trend is that several Member States have abolished the taxation of inheritance. In 2010, the Member States Austria, Cyprus, Estonia, Latvia, Slovakia and Sweden have all abolished their inheritance tax system.

The presented evidence of inheritance taxes provides ambiguous indications regarding the trend in the magnitude of the problem of double taxation.

²⁷ Cf. Maisto (2010).

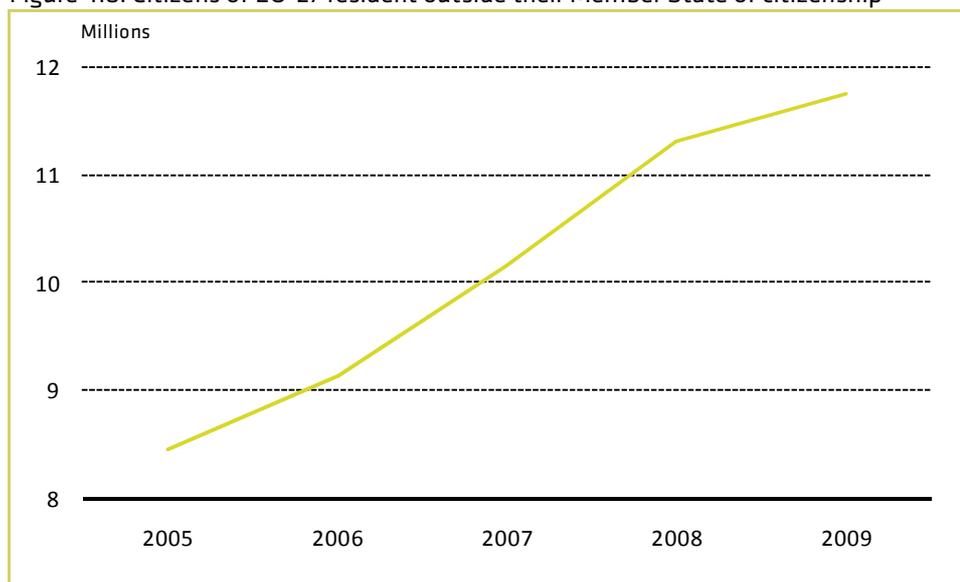
On the one hand, provided that the cross-border cases are representative of all inheritance cases, a decline in the effective tax rate indicates that the double taxation problem has become less important.

On the other hand, the combination of the findings that the effective tax rate has declined and that the total tax revenue has increased slightly in EU-15 (cf. section 4.1) indicates either more cross-border inheritance cases or higher-valued average inheritances. The latter could be driven by increasing real estate prices from late 1990's to 2008 where the economic crisis erupted.

Migration

During the last couple of years, the tendency in intra EU migration has been clear and persistent. The number of EU-27 citizens that reside in another EU Member State has increased steadily reaching approximately 12 million in 2009, cf. Figure 4.8.

Figure 4.8: Citizens of EU-27 resident outside their Member State of citizenship



Source: Eurostat.

From 2005 to 2009 the population of migrants grew by approximately 3 million. The largest rate of growth was observed from 2006 to 2008.

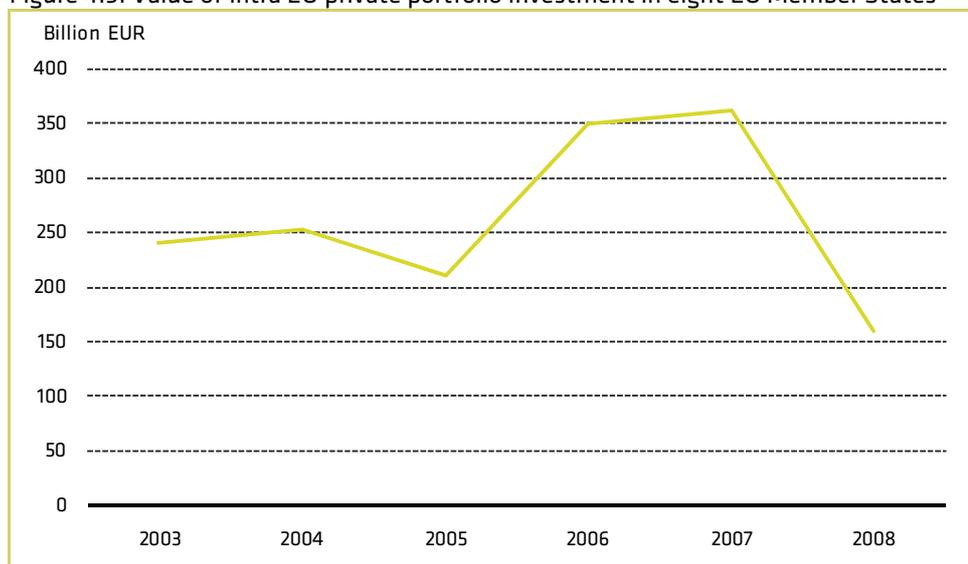
A contributing factor to the growth has probably been the EU expansions in 2004 and 2007. The increased intra EU migration points towards an increase in the potential for cross-border cases.

Cross-border ownership of assets

Cross-border ownership of assets can result in double taxation on inheritance, for example due to the source rule that most Member States apply to tax assets that are within their jurisdiction although the deceased is not. Below we briefly consider the trends for two of such cross-border asset groups, namely portfolio investments and real estate.

Between 2003 and 2007, the value of intra EU private portfolio investment has increased by approximately 50%, although the value of private portfolio holdings has sharply declined in 2008, cf. Figure 4.9.

Figure 4.9: Value of intra EU private portfolio investment in eight EU Member States



Note: Reported portfolio investment assets held by the household sector and issued in another EU Member State. Data on the stock of cross-border holdings of securities- equity securities and long- and short-term debt securities - valued at market prices (excluding securities held as reserve assets). The eight Member States included in the sample are Cyprus, Denmark, Finland, France, Hungary, Italy, Spain and Sweden. The rest are omitted due to lack of data.

Source: Coordinated Portfolio Investment Survey (CPIS) Data by IMF, Copenhagen Economics.

Much of the development seems to be caused by fluctuations in asset prices during the period. Most European stock markets saw impressive growth rates until 2007, but suffered great losses with the influx of the financial crisis in 2008. This underlying driver makes it difficult to draw firm conclusions on the tendency in intra EU private portfolio investments from the data at hand.

Regarding foreign home ownership, several sources have examined the trend in foreign real estate ownership. The general conclusion is that the tendency of foreign home ownership is increasing.

Paris (2006) used data on transnational second home ownership and reported an increase in this indicator in the period of study, cf. Table 4.2.

A study by Direct Line (2005) explored data on British owners of second homes overseas. It predicted that the number of British owners of overseas second homes would increase from 178,000 in 2005 to 249,000 in 2015, with the largest shares located in Spain (35%) and France (24%), cf. Table 4.2.

Similar findings were presented in Savills (2004) and Grant Thornton (2006). The Grant Thornton-study predicted that up to 2 million households in the UK will own a property abroad in 2025, cf. Table 4.2.

Table 4.2: Tendencies in foreign home ownership

Type of ownership	Study	Source	Main findings	Comparative data available for the EU
Transnational second home ownership	Paris (2006)	Forrest,(2005) Smith, (2005)	<i>"growth in the ownership of 'second' and more 'homes' across the EU and beyond"</i> <i>"Changing relations between countries, EU expansion and the democratisation and development of free markets in former communist countries have made it easier for citizens of one country to purchase homes elsewhere"</i> <i>"Greater levels of mobility, both personal and of financial assets, are resulting in massive expansion of leisure-related investment and consumption"</i>	No
British owners of overseas second homes	Direct Line (2005)	Authors' estimates	<i>"Number of British owners of overseas second homes would increase from 178,000 in 2005 to 249,000 in 2015, with the largest shares located in Spain (35%) and France (24%)"</i>	No
	Savills (2004)	Authors' estimates	<i>"..the expansion in these English markets has been relatively limited in numerical terms. The real growth story is being seen in much sunnier locations. This has been for both high value and more affordable stock, in coastal and rural parts of southern France, Italy and southern Spain as well as locations further afield."</i>	No
	Grant Thornton (2006)	Authors' estimates	<i>"...thousands of UK nationals have been attracted by the lure of a warm climate, a cheap cost of living and easy access to a second home overseas. The number of households in the UK owning property abroad has almost trebled from 102,000 in 1995 to an estimated 300,000 in 2006."</i> <i>"The result, by 2025, could be that some 1.5million to 2million households in the UK will own a property abroad"</i>	No

Source: Copenhagen Economics based on the studies displayed in the table.

Thus, there are indications of a tendency towards increased foreign home ownership which should increase the potential for cross-border inheritance cases.

4.3. SCALE OF THE PROBLEM AT A MICRO LEVEL

In section 4.1, we considered the scale of the problem at a macro level and concluded that inheritance taxes, and thus double taxation, constitute a rather modest revenue source for

Member States. However, at a micro level the double taxation problem could severely affect the individuals that become subject to it. This section will briefly consider the individual effects of double taxation in inheritance cases by regarding estimates of the effective tax rates for the 10 largest intra EU migrant streams.

For each of the 10 largest intra EU migrant streams, we have listed the estimates of the effective tax rates in the migrant and the resident Member State displayed in Figure 2.1. The tax rates for the migrant flows are presented below in Table 4.3.

Table 4.3: Effective inheritance tax rates for top 10 migration streams in the EU-27

Case#	Citizenship of migrant	Member State of residence	Double taxation treaty present	Effective tax rate in migrant Member State	Effective tax rate in resident Member State*
1	Romania	Spain	No	0%	15%
2	Romania	Italy	No	0%	0%
3	Italy	Germany	No	0%	5%
4	Portugal	France	Yes	0%	5%
5	Poland	Germany	No	7%	5%
6	UK	Spain	No	8%	15%
7	Ireland	UK	Yes	0%	8%
8	Greece	Germany	No	4%	5%
9	Germany	Spain	No	5%	15%
10	Austria	Germany	No	0%	5%
Average				2%	8%

Note: The survey compares the levels of inheritance tax payable in the case of a married individual who dies on January 1, 2009, leaving a spouse and two children. The assets owned at death have a value of 2,600,000 euro and the deceased is assumed to have left no will, cf. Box 2.1. Not data available for Lithuania and Slovenia. * Germany has been calculated with information on taxation from the attachment to this report; Survey of the domestic rules on taxes levied upon death.

Source: AGN International (2010) and Copenhagen Economics.

From the table it is apparent that:

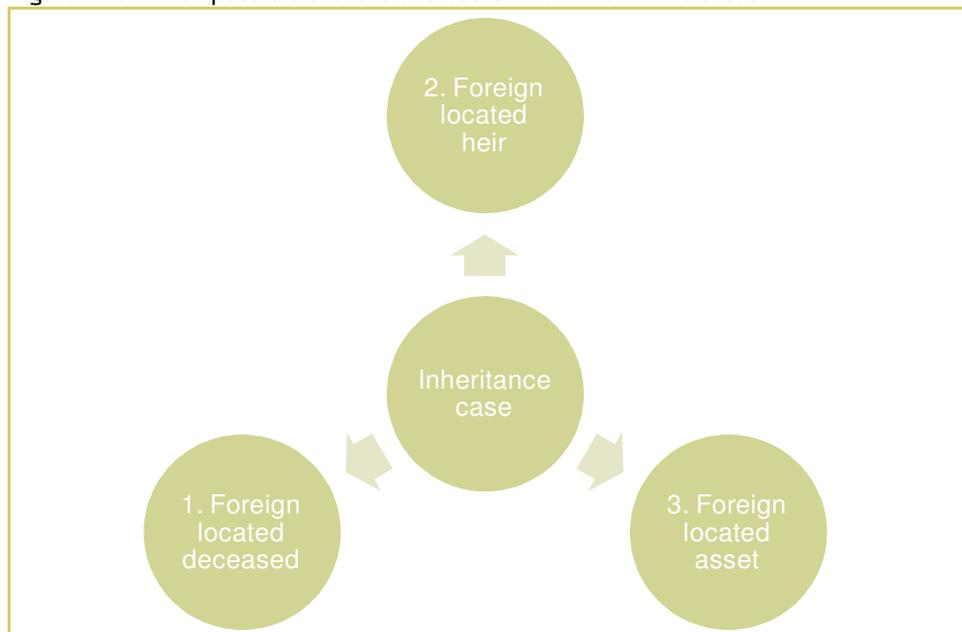
- The Member States of destination typically have larger effective tax rates than the migrants' Member States of origination: nine out of ten destination Member States have higher effective tax rates than the corresponding origination Member States.
- Flows between EU-15 Member States are most relevant for double taxation issues because the new Member States typically have effective inheritance tax rates of 0% implying that double taxation is not an issue. Moving from one of the 12 'new' Member State to an 'old' EU-15 Member States will then typically imply that the migrant will have to pay inheritance taxes in the EU-15 Member State, but (still) not in the new Member State he migrated from.
- Especially the sun holiday migrant streams, from UK to Spain and from Germany to Spain, stand out in a double taxation context as the migrants become exposed to two relatively high effective inheritance tax rates.

These indications align both with the cases in Box 3.3, Box 3.4 and Box 3.5 and the more general findings of section 3.2. Therefore, we are left to conclude that the consequences for individuals of double taxation can be very significant. In particular, attention should be directed to the individuals that migrate between two EU-15 Member States.

4.4. ASSESSMENT OF THE NUMBER OF CROSS-BORDER INHERITANCE CASES

For a cross-border inheritance case to arise, an inheritance case must have some cross-border element. Intuitively, there are three ways that this can occur: Either, the deceased, the asset or the heir can be located in another Member State, cf. Figure 4.10.²⁸

Figure 4.10: Three possible sources of cross-border inheritance cases



Source: *Copenhagen Economics*.

In the following, we will estimate the magnitude of the problem by assessing the size of these three sources of cross-border inheritance cases.

We will proceed in four steps. First, we will estimate the significant streams of migration and use these to measure the annual magnitude of foreign located deceases. Second, we will estimate the likely magnitude of cases arising from foreign located heirs from assessing the annual amount of intra EU immigrants' parents passing away. Third, we will estimate the

²⁸ This is a simplistic way of presenting the sources of cross-border inheritance cases. It should be noted that 'location' for the heir or the deceased can be based on both residence and domicile. 'Foreign location' should be seen in connection with the nationality of the deceased: If the deceased/heir/asset is located in another country than the country of nationality of the deceased, it will be considered as 'foreign located'.

number of cases arising from foreign located assets by considering the magnitude of foreign home ownership. Finally, we will compare our estimate to other previous findings.

Since there is no flawless way to measure the number of cross-border cases from the data at hand, the estimate will necessarily be a crude one. Possible sources of error from the present approach include:

- Double counting (e.g. when both the deceased and the asset is located abroad)
- Foreign ownership of other assets than real estate (e.g. when the deceased owns a company abroad)
- Country-specific personal connecting factors (e.g. when personal connecting factors applies with respect to the deceased such that a cross-border cases does not arise despite the heir being located abroad)
- Other legal distinctions (e.g. when the deceased residences in another member State but a cross-border inheritance case does not arise because the inheritance taxation is based on domicile)

1. Foreign located deceased

In this section, we will estimate the annual amount of deceases that give rise to a cross-border inheritance case because the deceased is located in another Member State. Within the EU there are 11.3 million inhabitants living in other EU Member States. Based on expected mortality rates, we expect that out of those, 74,900 die annually, resulting in cross-border inheritance cases. At first, this may seem like a low mortality rate. However, it covers both older people moving to and maybe retiring in another EU Member State and younger people moving to study or work.

The expected number of deaths in the total EU migrant population is also dominated by the top ten migrant streams: They represent 34.6% of total expected annual migrant deaths. Yet, the top ten migrants streams' share of expected annual deaths is smaller than its share of the general migrant population reflecting that of the migrants, younger people account for a relatively large share of the annual deaths, cf. Table 4.4.

Table 4.4: Expected annual deaths in total EU migrant population

	Population of migrants	Expected annual deaths
Top 10 largest migrant population	4,513,095	25,960
Total migrant population	11,314,351	74,900
Share - top 10 migrant populations in % of total	39.7%	34.6%

Source: Eurostat and Copenhagen Economics.

The exact volumes of these top 10 movements are displayed in Table 4.5. Note that the expected annual deaths in each of the migrant streams differ markedly due to differences in age structure of the top ten migrant streams. For example, the mortality rate is markedly lower for Romanians migrating to Spain than for British citizens migrating to Spain. This reflects

the fact that the Romanians are younger, probably there to work or study, while the British citizens are older and more likely to be retired.

Table 4.5: Expected annual deaths for top ten migration streams, EU-27

Case#	Citizenship of migrant	Residence Member State	Double taxation treaty present	No. of migrants	Mortality rate	Expected annual deaths
1	Romania	Spain	No	799,225	0.17%	1,357
2	Romania	Italy	No	796,477	0.16%	1,242
3	Italy	Germany	No	560,364	0.76%	4,238
4	Portugal	France	Yes	491,983	0.57%	2,812
5	Poland	Germany	No	419,555	0.40%	1,693
6	UK	Spain	No	375,856	0.87%	3,266
7	Ireland	UK	Yes	369,470	1.34%	4,964
8	Greece	Germany	No	306,402	0.72%	2,200
9	Germany	Spain	No	191,080	1.00%	1,911
10	Austria	Germany	No	190,150	1.20%	2,277
Total				4,513,095		25,960

Source: Copenhagen Economics based on Eurostat.

The methodology applied to calculate the expected annual number of deaths is described in Box 4.1.

Box 4.1: Methodology for calculating the expected annual number of deaths

The methodology we have used to compute the expected annual deaths is the following:

Number of cross border inheritance cases due to deaths =
(no. of migrants in age groups) x (death rate for age group)

We have included age 25 and upwards. We have not included persons younger than 25 because we assume they do not own assets abroad in which case, their deaths would not result in a cross-border inheritance case.

We have applied Eurostat ("migr_pop1ctz") to obtain data on populations by citizenship and age structure and national statistics offices to obtain expected death rates.

A limitation of our method is that the Eurostat data does not account for foreign residents becoming citizens of the new Member State. When these naturalized citizens still possess wealth in their former Member States or inherit property from family still residing in their former Member State, this would lead to further cases. This error source thus suggests that our estimate underestimates the total amount of cases.

Source: Copenhagen Economics.

2. Foreign located heirs

The number of cross-border inheritance cases that arise from the heir being located abroad is probably the most difficult of the three sources to estimate. A cross-border inheritance case with the heirs located abroad arises if a relative of an immigrants die.

Calculation difficulties arise primarily from estimating the probability of an immigrant becoming an heir in a cross-border inheritance case. It requires assessing the answer to several questions, including:

- Who the heir can inherit from?
- What the probability is of these people passing away?
- Whether the inheritance to this heir will be large enough to create a cross-border inheritance tax case (the inheritance may be split between many heirs and there is typically a personal allowance)?

These are all characteristics of other persons (the relatives of the young immigrant) rather than the persons, who we are able to observe (the young immigrant). This clearly adds complexity and uncertainty to the estimation. On top of that come the problems that arise from legal issues and double counting.

Nonetheless, simple calculations suggest that the number of cross-border inheritance cases that arise from the heir being located abroad is substantial. Assuming that young immigrants can only inherit from their parents (clearly an assumption), one can use demographic figures to estimate the number of cases by calculating the amount of immigrants' parents dying annually.

Applying the total number of intra EU migrants and their age distribution, as displayed in Figure 4.5, in combination with the average age of the females giving birth in EU, one can conjecture the distribution of age of the immigrants' mothers (if they are alive). Further, one can then use average age-based mortality rates to calculate how many of them are expected to pass away in a given year. Doing so, one arrives at a striking number of approximately almost 170,000 immigrants' mothers dying annually. When assuming that their fathers follow the same pattern, one arrives at a rough estimate of 340,000 immigrants' parents dying annually.

However, in the estimation one needs to account for the fact that often, only the death of both parents gives rise to inheritance passing from parents to children. With this fact in mind, a reasonable estimate must lie above the expected amount of single parents dying (approximately 170,000) but below the total amount of parents dying (340,000). Therefore, we estimate the annual number of cross-border inheritance cases arising from a foreign located heir to be somewhere between 200,000 and 300,000 annually.

The primary driver of the result is one of the conclusions from section 4.1: The intra EU immigrant population is dominated by working age (25-65) citizens. Statistically, it is also within this age that the EU citizens are most likely to lose their parents – the crude calculations above show that 89% of EU citizens lose their parents while being in the working age.

In conclusion, the intra EU immigrants are dominated by the working age groups (25-65) that are most likely to lose their parents. This indicates a very large number of cross-border inheritance cases arising from a foreign located heir. There is considerable uncertainty attached to the estimation but a crude estimate is in the region of 200-300,000 cases per year.

3. Foreign located assets

In this section, we will estimate the annual amount of cross-border inheritance cases that arise from the deceased owning foreign located asset. Our approach will be limited to one of the most commonly foreign assets: Real estate. We have calculated the deaths among domestically residing Europeans owning foreign property (such as a holiday home) to be between 32,500 and 44,000 annually.

We have estimated the number by specifically looking at the amount of real estate, such as holiday homes. This number to a large extent represents the large amount of Germans and British citizens in France, Italy and Spain.

Our estimate of property owned by domestic owners is based on a conjecture from the German Notary Institute (2002). A 2002 estimate by the Deutsche Bundesbank assessed the German foreign property ownership within other EU Member States to be 1 million.²⁹ The German Notary Institute (2002) study uses this figure to conjecture the total intra EU foreign property ownership to be approximately 2.5 million. We use this last estimate in our calculation.

As the number was estimated in 2002, we have extrapolated it to bring it up to date. We have constructed an interval with increases in the volume of properties by respectively 10% and 50%. An increase of 50% since 2002 is supported by UK evidence.³⁰ This evidence suggests that the amount of UK second homes abroad increased by 55% in the period 2003-2008. Taking into account that the financial crisis has most likely dampened the growth, we believe that 50% is a realistic assumption.

From the population of owners of foreign property, we compute the expected annual number of deaths. We do so by multiplying the current number of house owners with the mortality rate of the house owners, which we estimate to be 1.18%. The estimate of mortality rate of house owners is based on the assumption that house owners are, on average, older than the average population. Therefore, we use the average of the three highest mortality rates among migrants from Table 4.5 (Ireland to UK, Austria to Germany and Germany to Spain).

Table 4.6: Cross-border cases due to property ownership in other EU Member States

Steps in computation	Estimated number
Number of domestic owners of foreign property within the EU	2,500,000
Updating the above number to 2010 level (10%-50% increase)	2,750,000-3,250,000
Annual deaths in the above population - with an annual mortality of 1.18%	32,500-44,000

Source: *Copenhagen Economics*.

²⁹ A recent British estimate suggests that almost half a million UK nationals have second homes abroad, cf. Savills (2008).

³⁰ Savills (2008).

The above methodology does not take into account cross-border holdings of financial assets such as companies, bank accounts and large amount of stocks. Thus, our methodology is likely to underestimate the actual number of cross border inheritance cases.

Total estimate

In the above three sections we have estimated each of the three sources of cross-border inheritance cases. The three sources add up to 300,000-400,000 cross-border cases per year.

Adding up sources may lead to overestimation of potential cross-border cases, but we think that there is no need for large corrections. The reason is that double-counting is likely to be linked principally to situations where a citizen is living in another Member State while also owning real estate outside his country of residence or nationality. However, the latter category is the smallest fraction of the three sources because the double counting related to both heirs and deceased living outside their country of origin must be expected to be of a limited magnitude. A very substantial part of the foreign located heirs are by definition of working age population, often from new Member States, implying a substantial probability that their parents have remained in the country of origin.

Formally assessing the magnitude of double counting is very difficult given the large uncertainty already attached to the estimation of each of the sources as well as the specific bi- and trilateral configurations of tax systems in these cases. More as an illustration of its potential importance than as a reflection of real estimates, we have in the table below provided an example of double accounting effects, which would lead to a reduction of 9,000 to 27,000 persons per year. The correction for double counting results in a total estimate of 290,000-370,000 annual cross-border cases, cf. Table 4.7.

Table 4.7: Estimated number of cross-border inheritance cases

	Number of potential cases
Cases due to foreign located deceased	75.000
Cases due to foreign located heir	200.000-300.000
Cases due to foreign located asset	32.000-44.000
Subtotal	300.000-400.000
Deduction due to possible double counting:	
-- 10-30 per cent of foreign located assets (10-30 per cent of mid range estimate of 38.000)	Minus 4.000-12.000
-- 2-10 per cent of double counting heirs and deceased both living outside their own country (2 to 10 per cent of mid range estimate for heirs 250.000)	Minus 5.000-25.000
Subtotal for double counting	Minus 9.000-27.000
Total (rounded)	290.000-370.000

Source: *Copenhagen Economics*.

Comparison to similar studies

We have compared our estimate to similar studies performed by other authors.

In an impact assessment of a proposal for the introduction of a European Certificate of Inheritance from 2009,³¹ the EU Commission estimated the annual number of cross-border cases at around 450,000. This estimate is based on an estimate that in 2006 around 9-10% of all EU successions involved a cross-border element. The impact assessment contains an overview of estimated proportions of succession cases with a cross-border element from legal practitioners serving very wealthy clients in different EU countries where the average estimate is 12.5% (corresponding to 588,000 annual cross-border cases), but the report suggests that this figure of 588,000 overestimates the actual number of cases, cf. Table 4.8.

In the older study of German Notary Institute (2002) the amount of annual cross-border cases due to a foreign located asset or deceased was estimated to be between 50,000 and 100,000. The number was estimated by using some of the same sources as we have used, which is estimates from the Deutsche Bundesbank and Eurostat data. However, we have applied newer Eurostat data and we have matched the age distribution with the mortality rates. We have used the same Deutsche Bundesbank figure for foreign ownership, but we have assumed that the amount of ownership has increased in the past decade since the study, cf. Table 4.8.

³¹ See European Commission (2009c), COMMISSION STAFF WORKING DOCUMENT Accompanying the Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on jurisdiction, applicable law, recognition and enforcement of decisions and authentic instruments in matters of successions and on the introduction of a European Certificate of Inheritance Impact Assessment (COM(2009) 154 final) (SEC(2009) 411).

Table 4.8: Previous estimates of cross-border inheritance cases

Estimated Variable	Study	Source	Expected annual cases – their estimate	Comparison with our estimate
Total amount of cross-border cases	European Commission (2009a)	Various international lawyers	<i>Around 450,000</i>	<i>Based on selected statistics on the proportion of foreign citizens in Member States, the number of foreign wills and ownership of foreign property. The figure arises from an estimate of 9-10% of all EU succession cases having a cross-border element. A related estimate of 12.5% of all succession cases having a cross-border element is also presented, based on estimates from legal practitioners, but the report regards this as an overestimate due to the sample being dominated by rich countries and individuals.</i>
Cross-border cases due to foreign located deceased or asset	German Notary Institute (2002)	Eurostat and Bundesbank	<i>50,000-100,000</i>	<i>This number is based on some of the same sources as we use, but they do not take into account that heirs inheriting in another country also result in a cross-border inheritance case. The omission of migration of heirs leads to an underestimation of the total amount of cases compared to our numbers. For the calculation of migration for the deceased cases, we use newer Eurostat data where we match age distribution with mortality rates. We use the same number for foreign ownership, but we expect the amount of ownership to have increased in the past decade since the study in 2002.</i>
Cross-border cases due to foreign located deceased	European Commission (2009a)	Eurostat	<i>125,000</i>	<i>Their estimation of cross-border inheritance cases due to migration of the deceased is higher because it is based on the number of foreign migrants from third countries and not only the EU. The numbers do take into account the fact that countries without any inheritance tax cannot contribute to the amount of cases.</i>

Source: Copenhagen Economics based on the studies displayed in the table.

4.5. CONCLUSIONS

We draw three overall conclusions on both the size and development in the impact of the double taxation problem.

The first conclusion is that at a national level the magnitude of double taxation following from cross-border inheritance cases is limited. The revenue in Member States from inheritance taxes amounts to less than 0.5% of total tax revenue – and the cross-border share will amount to far less. Furthermore, there is a tendency towards lower effective inheritance tax rates.

There is, however, a caveat to the conclusion that the problem is only limited. It cannot be ruled out that the low share of cross-border succession cases is to some extent a result of the expectation of double taxation on inheritance and that we are therefore underestimating the problem by looking at the current number of cross-border succession cases. Confronted with the double taxation problem, it may be that some EU investors prefer to liquidate the investments in good time before they die if they foresee a situation with risk of double taxation on cross-border inheritance.

The second conclusion is that despite the problem's limited national magnitude, double taxation can pose a significant problem for the individuals concerned. Many of the largest migration streams risk expose themselves to large inheritance tax rates due to double taxation following from migration. The flows between the 'old' EU-15 Member States, and especially

the large migrant streams from UK to Spain and Germany to Spain, appear particularly exposed to double taxation as these Member States typically have relatively high effective inheritance tax rates. In contrast, as noted above inheritance taxes are generally low in new Member States.

The third and final conclusion is that there are clear and robust indications that the problem will increase in magnitude over the coming years. More people migrate to other Member States and more real estate and other assets are purchased abroad. This will eventually lead to more and more cross-border inheritance cases in the future.

With considerable uncertainty, we estimate the annual number of potential cross-border inheritance cases to be between 290,000 and 370,000. This estimate is comparable to earlier estimates by the EU Commission but is likely to underestimate the number of cases as only real estate is included among the types of cross-border assets that give rise to cross-border inheritance cases.

Chapter 5 POSSIBLE SOLUTIONS TO THE DOUBLE TAXATION PROBLEM

Chapter 3 concludes that the potential for double taxation on cross-border inheritance is significant, despite some progress reached in some Member States. In this section, we describe the most likely reasons why this problem of double taxation on cross-border inheritance has not been resolved.

The main reason for the limited progress on solving the problem of double taxation of cross-border inheritances may result from some cost-benefit analysis at national levels. On the one hand, the efforts required to negotiate and conclude a tax treaty within the area of inheritance is generally the same as other areas, for example the areas of income and capital taxation. On the other hand, with the limited revenue generated from the inheritance taxes in most Member States, the potential benefits from a tax treaty are much higher in the areas of income and capital taxation. Moreover, the gains and losses from such treaties may be quite unevenly distributed both within populations and between the contracting Member States.

In this chapter, we present our current assessment of the possible methods to the problem of double taxation on inheritance in the EU while baring in mind the constraints involved from such cost-benefit and stakeholder analysis.

In section 5.1, we make an assessment of the consequences for the different Member States if the problem of double taxation on inheritance is solved. By looking at the current situation, we identify who are the likely winners and losers of such a solution.

Section 5.2 presents two possible bilateral methods to resolve the current problem of double taxation on inheritance.

Likewise, section 5.3 presents two possible multilateral methods aimed at addressing this problem.

Finally, in section 5.4 the main conclusions are summarised.

5.1. ASSESSMENT OF THE NATIONAL IMPACT: REVENUES AND POLICIES

The obstacles to solving the double taxation problems are not simply of a technical nature, they reflect basic policy choices and constraints at the national level.

At the general level, the lack of bilateral treaties covering inheritance and estate taxes should not be seen as random outcome of history, but as a result of deliberate policy choices.³² A particular concern raised has been the interaction of OECD bilateral treaties on income and capital with bilateral treaties on estate, inheritance and gift taxes. Using Austrian tax law as an example, it is shown that application of the two treaties at the same time can lead to non-taxation of the beneficiary, i.e. non-taxation in both the source and the residence Member

³² Lang (2005), p. 223.

State.³³ This is not solved simply by ‘adding’ inheritance taxes to bilateral treaties on income and capital.

The lack of general progress in resolving the problems of double taxation on inheritance is to a large extent due to the fact that every solution has its winners and losers. No matter which solution is chosen, a group of Member States will lose tax revenues compared with today’s situation. Given that the main migration flows in the European Union currently go from East to West and from North to South (cf. Chapter 4), it is to a large extent obvious which Member States will be the main winners and losers if some of the most obvious solutions to the problem of double taxation are implemented at the EU level.

Two decisive factors

To identify who will be the winners and the losers if an effective solution to the problem of double taxation is implemented, two decisive factors must be taken into account.

The first factor is that currently, the main problem of double taxation on inheritance is connected to the migration flow from North to South. The migration flows from the East to the West are clearly significant with respect to the number of people, but with respect to wealth, assets ownership and thus inheritance taxes, the flow from North to South is much more important. In 25 years, the picture may look very different, but our analysis has revealed that currently, a substantial part of the problem stems from real estate assets owned by migrants from Northern Europe that have chosen to live in or invest in Southern Europe, not the least Spain and France. In the case of their death, these holdings will be subject to source taxes in these Member States, which may not be fully credited under inheritance tax rules in the Northern residence Member States.

The second factor is that an effective solution to the problem of double taxation must involve a coordination of the connecting factors that the Member States apply in cases that involve taxation of cross-border inheritance. Basically, there are two solutions that will solve all problems of double taxation, including the ‘source-residence’ conflicts, the ‘residence-residence’ conflicts and the ‘source-source’ conflicts. One solution is that inheritance is taxed solely in the basis of the personal nexus rule and that all Member States apply the same personal nexus rule, for example residence, domicile or nationality. The other solution is that inheritance is taxed solely in the basis of the source rule and that all Member States apply the same source rule.

Expected winners and losers from different solutions

Solutions where inheritance is taxed solely on the basis of the personal nexus rule can be expected to have different winners and losers depending on whether residence, domicile or nationality is the chosen criterion.

³³ Lang (2005), p. 223.

On the one hand, if the solution implies a common adoption of the nationality or the domicile principle, it is likely that the Northern Member States, especially UK and Germany, will be the winners and the Southern Member States, especially Spain and France will be the losers. Especially the UK and Germany are in a position where many of their nationals and domiciled citizens own primary or secondary homes in Southern Europe, especially in Spain and France. A solution where inheritance is taxed solely on the basis of domicile or nationality implies that the assets owned by these nationals and domiciled citizens will only be taxed in the UK and Germany, and not in Spain, cf. Table 5.1.

On the other hand, if the solution implies a common adoption of the residence principle, it is likely that the Southern Member States, especially Spain and France, will be the winners and the Northern Member States, especially the UK and Germany, will be the losers. A solution where inheritance is taxed solely on the basis of residence implies that the assets owned by Brits and Germans in Spain will be taxed in Spain and not in the UK and Germany, cf. Table 5.1.

Solutions where inheritance is taxed solely on the basis of source can be expected to favour the Member States in Southern Europe, especially Spain and France. Pure source taxation would imply that the primary or secondary homes in Southern Europe, especially in Spain (and France), which are owned by especially Brits and Germans, would be taxed solely in Spain. Such a solution would clearly turn the Southern Member States into winners and the Northern Member States into losers, cf. Table 5.1.

Table 5.1: Expected winners and losers if different tax principles are implemented

	Southern Member States	Northern Member States
Nationality rule	Losers	Winners
Domicile rule	Losers	Winners
Residence rule	Winners	Losers
Source rule	Winners	Losers

Source: *Copenhagen Economics*.

5.2. BILATERAL METHODS

The current relief for double taxation is two-stringed. First, it is based on bilateral tax treaties concluded between the Member States. Second, it is based on unilateral relief granted by the individual Member States under the domestic tax rules.

There are two obvious ways in which the current system could be improved. One is to include inheritance and estate taxes in the bilateral income tax treaties which are much more numerous³⁴. The second is to aim at developing an EU Model Tax Convention instead of the current OECD model.

³⁴ Cf. Maisto (2010).

Include inheritance in the income tax treaties

The first possible bilateral method is to include inheritance in the income tax treaties instead of having a parallel structure with separate treaties for inheritance tax and income tax.

There are two reasons why this could be a shortcut towards a broader and more comprehensive coverage of the bilateral tax treaties in the field of inheritance.

The first reason is that one of the most important barriers for the conclusion of more inheritance tax treaties could be the low yield compared to the effort required to negotiate and conclude an international convention.

The second reason is that the OECD IHTMC has many aspects in common with the OECD Model Tax Convention on Income and on Capital, which is used to avoid double taxation on income and capital.³⁵ Both include provisions on residence, exchange of information, non-discrimination, competent authority, taxes covered, and avoidance of double taxation.

It appears that few additions to the current OECD Model Tax Convention on Income and on Capital could lead to a situation where inheritance and estate taxes could be covered. Furthermore, with around 2,000 bilateral treaties in force for income and capital, a more complete coverage will be secured.

An interesting observation is that this model has already been applied in practice. The current bilateral tax treaty concluded between Denmark and Germany is a comprehensive tax treaty which applies to taxes on income, capital, estates, inheritances and on gifts.³⁶ In addition, some provisions of the French income tax and capital gains tax conventions may be applicable to inheritance.³⁷

An EU tax treaty model

The second possible bilateral method is to aim at developing an EU Tax Treaty Model which should be used by the 27 Member States as the outset when negotiating tax treaties instead of the current OECD model.

Such a model could be regarded as a replacement of the current OECD model or a competitor and alternative to the OECD model. If the last option is preferred, it could be regarded as an area of choice for the Member States.

³⁵ Cf. for example, OECD Model Tax Convention on Income and on Capital - an overview of available products, http://www.oecd.org/document/55/0,3343,en_2649_33747_1913957_1_1_1_1.00.html.

³⁶ Cf. Michelsen (2010).

³⁷ Cf. Monassier (2010).

It is realistic that an EU Tax Treaty Model would not be dramatically different from the current situation where the OECD model is the outset of most negotiations. It is obvious that many of provisions of the OECD model would be required in a new EU Tax Treaty Model. In the development of the EU Tax Treaty Model, the main focus should be at the specific European Union issues that are causing problems today when applying the current OECD model.

An advantage of an EU Tax Treaty Model would, on the one hand, be that the Member States would still be have the opportunity to address bilateral issues that are of particular interest to these two Member States in the tax treaties. Ideally, a new EU Tax Treaty Model would include a perfect mix of the issues that are common to all Member States and the bilateral issues that are of specific interest to the two specific Member States.

The most obvious disadvantage would, on the other hand, be that the model would maintain the bilateral type of solution. Therefore the problem which is probably the most important reason for the low number of bilateral treaties would still prevail, namely the fact that the efforts required to conclude the treaty are often larger than the expected benefits of the treaty.

5.3. MULTILATERAL METHODS

The current situation, with only 33 bilateral treaties in force between the 27 Member States of the European Union (cf. Section 3.2), demonstrates that the instrument of bilateral treaties is not effective for dealing with the complexity of the globalised world. This naturally gives rise to the question of whether the problem of double taxation on inheritance calls for a multilateral solution.

Two multilateral methods stand out as the most obvious options: Development of a multilateral tax treaty and harmonisation through new EU legislation.

Development of a multilateral EU tax treaty

The development of a multilateral EU tax treaty is one possible multilateral solution to the problem of double taxation on inheritance. With the Internal Market for labour and capital, more and more economic transactions have transnational aspects. Therefore, it seems obvious to aim for new multilateral instruments that are better suited to solve the problems that arise from these transnational transactions than the current bilateral treaties.

The idea of multilateral tax cooperation within the field of inheritance is not new. The Nordic Convention on tax issues is an existing multilateral treaty that is already in force between some Member States, of which many are also members of the European Union.

The Nordic Convention was signed in 1983 between Finland, Sweden and Denmark, who are all members of the European Union, and Iceland and Norway. The Nordic Convention

is a multilateral double taxation agreement which replaced the previous bilateral treaties between the five Member States and, which among other things, covers inheritance taxes. The Nordic countries also co-operates on other tax issues, such as coordination of the tax systems.³⁸

The OECD Committee on Fiscal Affairs has already considered the possibility of adopting a multilateral convention to replace the existing bilateral tax treaties.³⁹

It has, however, abandoned the idea for the time being in view of the difficulty of putting it into practice. It should be borne in mind that despite the fact that the tax systems of the Nordic countries are relatively similar, it is not a trivial task to secure an effective functioning of the Nordic Convention. With the domestic tax systems evolving gradually, a multilateral EU treaty must be updated frequently to remain effective over time.

In the ideal world, a multilateral EU treaty would make the entire network of bilateral treaties between Member States obsolete. This would be a major step forward compared with today's very complex system of bilateral treaties.

However, in practice, this is not realistic as domestic tax rules are so complex and different from each other, that all issues could not be handled by a single multilateral treaty. There would be a substantial risk that a multilateral treaty would merely cover a subset of the problems that must be addressed to avoid double taxation on cross-border inheritance.

Harmonisation of domestic rules

Harmonisation of the domestic tax rules is another possible multilateral method to mitigate the problem of double taxation on inheritance.

With conflicting connecting factors being the main reason for double taxation on cross-border inheritance to occur (cf. section 3.2), the most obvious place to start would be to harmonise the connecting factors of the domestic tax rules. Of course, other aspects could also be harmonised, but these will not be considered here.

To solve the double taxation problem through harmonisation of the connecting factors would require that all Member States agreed on a single connecting factor, for example domicile, residence, nationality or source. Furthermore, an effective harmonisation would require that all 27 Member States agreed upon a common definition of the chosen connecting factor.

The potential advantages of such a harmonisation are evident. All citizens of the European Union would avoid double taxation and it would be markedly easier for them to foresee the

³⁸ Cf. Norden, 'Official co-operation in the Nordic region', 'Nordic co-operation on taxation', www.norden.org/en/areas-of-co-operation/taxation/nordic-co-operation-on-taxation.

³⁹ The following is based on European Commission (2005).

level of taxation that their inheritance would be subject to. If for example “residence” – the most commonly applied principle – was chosen as the common connecting factor, all citizens would be attached to only one Member States’ tax rules.

However, the challenges are massive. Today, the Member States typically employ two connecting factors and these two connecting factors differ substantially (cf. Section 3.2). Furthermore, many Member States can be expected to be very reluctant to such tax harmonisation because under Union Law, Member States are largely free to design their direct tax systems so as to meet their domestic policy objectives and requirements.

Until now, only a minimum degree of harmonisation has been achieved within the EU in the direct tax area. The situation is different as far as indirect taxes are concerned (e.g. VAT).

5.4. CONCLUSIONS

The fact that very little progress has been made in addressing the issue of economic double taxation in this area suggests that pure revenue considerations is not the real issue and that proposed solutions should be tailored to the most obvious problems.

This chapter concludes that both multilateral and unilateral methods can be applied to resolve the problem of double taxation, but that all methods have their advantages and disadvantages. Generally, the multilateral methods are on the one hand the most effective, but on the other hand also the most difficult to apply and implement.

This chapter further concludes that the lack of general progress in resolving the problems of double taxation on inheritance to a large extent is due to the fact that every solution has its winners and losers. Currently, the problem of double taxation on inheritance is mainly connected to the migration flow from North to South. Our assessment is that the Northern Member States will be the winners and the Southern Member States will be the losers if domicile or nationality is adopted as the common tax principle. If the residence principle and the source principle are adopted instead, the situation will be reversed such that the Northern Member States will be losers and the Southern Member States will be winners.

The identified problems call for some kind of coordination of the domestic tax rules. This may be achieved through tax treaties and/or through harmonisation of the domestic tax rules. Irrespective of the means, two areas seem to call most for attention. First, more coordination on the connecting factors would be an effective way of reducing the problem of double taxation. Second, more harmonised definitions of the key concepts of the inheritance tax rules would also be fruitful. The Block case provides a clear example of the gains that could be achieved from the harmonisation of the concept of ‘foreign assets’.

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