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By PwC Deutschland | 08 February 2022

Rules for limited inheritance tax liability only in part compatible with EU law

According to the decision of the European Court of Justice (ECJ), the different inheritance tax allowances in the case of unlimited and limited tax liability is in line with EU law, specifically it is not in breach of the free movement of capital. However, the refusal of the German tax office to deduct liabilities linked to the inheritance in the case of limited tax liability is not compatible with EU law.

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Background

In the case at hand, the plaintiff was an Austrian resident who had inherited real property located in Germany from her father in 2018. The German assets accounted for 43% of the total value of the estate. The plaintiff was the only person appointed as the heir in the will. Yet, other relatives were entitled to a compulsory share of the estate under Austrian inheritance law. Therefore, the plaintiff compensated them in cash, paying the sums of EUR 1 700 000 and EUR 2 850 000 respectively, to settle their claims.

Under German inheritance tax law, the plaintiff was liable to tax to the extent that the inherited assets were in Germany (limited tax liability), whilst a German resident would have been liable to tax in respect of the entire estate irrespective of the assets' location (unlimited tax liability).

Pursuant to Section 16 paragraph 2 of the German Inheritance Tax Act (ITA), the plaintiff was entitled to a tax-free allowance of EUR 172,000, which is 43% of the allowance available to a taxpayer in a case of unlimited tax liability (EUR 400,000) and thus corresponds to the fraction of the assets' value that was subject to tax in Germany.

Pursuant to Section 10 paragraph 6 ITA, liabilities linked to the inheritance are in case of limited tax liability only deductible if they are "economically linked to the taxable assets". The German tax authorities denied the deduction of the liabilities that the plaintiff owed to her relatives.

ECJ decision

In its decision the ECJ largely followed the Opinion of the Advocate General.

The CJEU held that the reduced allowance does not infringe the free movement of capital. Although the ECJ considers the different allowances to be a restriction on the free capital movement, it is - in his view - justified by an overriding reason in the general interest: The German tax system is coherent in not granting the full allowance as only the assets located in Germany are subjected to German taxation.

However, the non-deductibility of the liabilities owed to the relatives is not compatible with the principle of free movement of capital as the liabilities are partly caused by the German assets. Here, the restriction on the movement of capital cannot be justified either by the need to preserve the coherence of the German tax system or by the principle of territoriality and the need to ensure a balanced allocation of the Member States' powers to impose taxes. Germany must, therefore, treat at least part of the liabilities as deductible.

Source:

The ECJ case reference **C-394/20** *Finanzamt V* judgment of 21 December 2021.

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