DMC – ECJ RULES 5-YEAR DEFERRAL OF EXIT TAX IS EU COMPATIBLE

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The list of exit tax cases ruled by Court of Justice of the European Union (hereafter 'the Court') has recently grown with a case that the literature has some difficulties understanding[2]. On the 23rd of January 2014, in the *DMC* case (C-164/12)[3], the Court determined that German exit tax rules may be justified by the objective of preserving the balanced allocation of taxing rights. As this seems to be in contradiction with the Court's former case law, it is necessary to analyse how the Court came to this conclusion without overriding its earlier exit tax jurisprudence[4]. More exactly, the Court found it justified and proportional to levy an exit tax before realisation only where the jurisdiction to tax from the country of "exit" disappears.

Background

Two Austrian resident corporations (K-GmbH and S-GmbH) were partners in a German limited partnership (DMC KG). In 2001, the group of companies carried out a reorganisation consisting of an exchange operation with a non-cash contribution of the KG's interests in return for shares in the German general partner (DMC GmbH). As a result of this operation, the partnership was dissolved, the capital of the German limited company increased and its new shares were distributed to the two Austrian companies. The German tax authorities considered that the transfer gave rise to a capital gain, based on the going concern

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2 R. Jackson, "*Assets may be taxed before gain realization, ECJ says*", Tax Notes International: New Stories, 2013, p. 311-312

3 ECJ, 23 January 2014, Case C-164/12, *DMC v Finanzamt* ("*DMC*"), [2014] ECR I-0000 (not yet published).

4 See, for earlier ECJ case law consistency on exit tax cases, Tom O'Shea, "*European Tax Controversies: A British-Dutch Debate: Back to Basics and Is the ECJ Consistent?*" World Tax Journal, February 2013, p 100-121.

value of the contributed assets, which was liable to tax in Germany due to the double tax convention between Germany and Austria. In those circumstances, the German tax legislation provided a choice between immediate collection and deferred payment of 20% of the tax every year over a 5-year period. Doubting the compatibility of that system with EU law, the German Court decided to stay proceedings and referred the matter to the ECJ by way of the preliminary ruling procedure.

Admissibility of the question

The German Government argued that the questions submitted to the Court were not admissible on the basis that they were hypothetical. In reply, the Court highlighted that the relevance of the questions referred was presumed and that the only situation where it will refuse to give an answer is where there is obviously 'no relation to the actual facts of the main action or its purpose, where the problem is hypothetical, or where the Court does not have before it the factual or legal material necessary to give a useful answer to the questions submitted to it'[5].

Applying this principle to the case, it appeared that the question did not fall into one of those exceptions and furthermore, since the national court considered that the legislation at issue could be in breach of the Treaty, 'the action [was] automatically admissible'[6]. Having decided to answer the question, the Court then had to assess whether the EU Treaties were infringed by the German legislation at issue.

Freedom at issue

Even though the main observations given to the Court indicated that the freedom of establishment was applicable, the Commission took the view that the legislation at stake involved the free movement of capital. In that regard, the Court recalled that only one freedom should be examined if the other freedom at issue was entirely secondary to the first one and that assessment should be done by taking into account the purpose of the national legislation in question.

The objective of the German legislation was to 'protect the fiscal interests of Germany in relation to capital gains generated in [its] territory where the international allocation of the right to impose taxes may undermine those interests'[7] and, in particular, was aimed at targeting 'capital gains on assets contributed by investors who are no longer subject to tax in Germany as a result of the transfer of

5 *DMC* para. 23

6 *DMC* para. 25

7 *DMC* para. 32

such assets from a limited partnership to a capital company'[8]. Furthermore, the German legislation did not differentiate between investors that had substantial holdings with a definite influence on the decision of the firm and those that did not. Thus, the Court stated that the challenged legislation should be examined solely under article 63 TFEU, which provides for the free movement of capital.

Next, the Court had to consider whether the free movement of capital was restricted by the German legislation at issue.

Restriction

In order to assess whether the German legislation was a restriction on the free movement of capital, as the issue falls into the category of an origin Member State situation, the Court applied its usual national treatment test. The Court compared the tax treatment of a company not resident for tax purposes in Germany, involved in a partnership there, proceeding to an exchange transaction such as giving interests of the partnership in return for shares in the German limited company, and a company resident for tax purposes in Germany in the same situation. In the first scenario, the tax due on the gains is calculated at the time of the transfer and is collected in accordance with national law, i.e. whether immediately or spread over five years, whereas in the second situation, the tax is calculated and collected when the gains are actually realised. As a consequence, the investor who is no longer liable to tax in Germany is placed at a disadvantage in terms of cash flow compared to an investor still liable to tax in Germany. The Court determined that this difference in treatment which was not based on an objective difference of situation between the domestic and the cross-border investor, infringed the free movement of capital. However, that restriction still might be justified.

Justification

The Court recalled that 'a restriction of free movement of capital is permissible only if it is justified by overriding reasons in the public interest'[9]. The justification put forward by the German Government was the need to ensure the balanced allocation of the power to impose taxes between the Member States in accordance

with the principle of territoriality. The Court stated that such a justification was 'a legitimate objective recognized by the Court'[10] and that 'in the absence of any unifying or harmonising measures of the EU, the Member States retain the power to

8 *DMC* para. 33

9 *DMC* para. 44

10 *DMC* para. 46

define, by treaty or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation'[11].

Focusing then on the facts at issue, the Court highlighted that an operation such as the one at stake cannot have the effect of making a Member State give up its right to tax a capital gain that was generated in its territory and fell within its tax jurisdiction before the conversion of the assets. The Court emphasised that the Member State who had jurisdiction to tax the capital gains was entitled to tax those profits at the time the taxable person disappeared from its tax jurisdiction. Under cover of this justification, two facts become irrelevant. The first one is the fact that the taxation is based on unrealised gains as a 'Member State is entitled to tax the economic value generated by an unrealised capital gain in its territory even if the gain concerned has not yet actually been realised'[12] and is 'entitled to make provision for a chargeable event other than the actual realisation of those gains, in order ensure that those assets are taxed'[13]. The second irrelevant fact is the different nature of the assets which generated the capital gains as the capital gains reside in the shares emanating from the exchange of the interests in the partnership. Consequently, the Court held that 'the simple fact that the conversion of an interest in a limited partnership into shares in a capital company has the effect of removing income from the exercise of the powers of taxation of the Member State on whose territory the income was generated is sufficient justification for a provision such as that at issue in the main proceedings, in so far as it provides that the amount of tax payable on that income is to be established at the time of the conversion.'[14] However, this justification is strictly limited and '<u>can especially only</u>* justify legislation such as that at issue in the main proceedings where, in particular, the Member State in whose territory the income was generated is actually prevented from exercising its power of taxation in respect of such income.'[15]

Finally, the Court pointed out that the relevant facts were not clear enough to give more specific guidance on the issue of the actual inability of Germany to exercise its jurisdiction to tax when the assets are materially realized. This is a matter for the national court. Once the Court has accepted a justification argued by a Member State, the next matter to be determined is whether the restriction meets the principle of proportionality.

Proportionality

11 *DMC* para. 47

12 *DMC* para. 52

13 *DMC* para. 53

14 *DMC* para. 55

15 *DMC* para. 56 * translation by the author regarding the German formulation:'insbesondere nur dann rechtfertigen'(emphasis is added).

The proportionality test focused, first, on the time when the exit tax has to be determined. The Court referred to *National Grid Indus ("NGI")*[16] and recalled that 'it is proportionate for a Member State, for the purpose of safeguarding the exercise of its powers of taxation, to determine the tax due on the unrealised capital gains that have arisen in its territory at the time when its powers of taxation in respect of the investor in question cease to exist'[17]. Second, the Court focused on the proportionate recovery method for the tax in question. The Court noted that the *NGI* judgment gave a clue regarding the proportionality test, saying that, giving the taxpayer the choice between immediate and deferred payment of the tax would be proportionate. However, in *DMC*, the Court balanced this with the fact that the risk of non-recovery increases with the passing of time, thus leading to the conclusion that 'by giving the taxpayer the choice between immediate recovery or recovery spread over a period of five years (without interest), the legislation at issue in the main action does not go beyond what is necessary to attain the objective of the preservation of the balanced allocation of the power to impose taxes between Member States.'[18]

One final point concerned bank guarantees which the German legislation imposed in cases of deferred payments. On that issue, the Court held that, as such a requirement is restrictive, it must be strictly correlated to the risk of non-recovery otherwise it would be considered disproportionate.

Decision

The Court concluded that Article 63 TFEU must be interpreted as meaning that the objective of preserving the balanced allocation of the power to impose taxes between Member States may justify the legislation of a Member State which requires assets in a limited partnership contributed to the capital of a capital company with its registered office in the territory of that Member State to be

assessed at their value as part of a going concern, thus giving rise to the taxation, before they are actually realised, of the capital gains relating to those assets generated in that territory, if it will in fact be impossible for that Member State to exercise its powers of taxation in relation to those gains when they are in fact realised, which is a matter for the national court to determine.

Further, the national legislation of a Member State which provides for the immediate taxation of unrealised capital gains generated in its territory does not go beyond what is necessary to attain the objective of the preservation of the balanced allocation of the power to impose taxes between Member States, provided that,

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16 ECJ, 29 November 2011, Case C-371/10 *National Grid Indus v Inspector van de Belastingdienst* ("*NGI*"), [2011] ECR I-12273.

17 *DMC* para. 60

18 *DMC* para. 63

where the taxable person elects for deferred payment, the requirement to provide a bank guarantee is imposed on the basis of the actual risk of non-recovery of the tax.

Analysis

My first remark would go to the particularity of this exit tax case. It involves companies but it is not a classical cross-border seat or effective place of management transfer (*Cartesio*[19], *NGI*[20]). Here, we have a transfer of assets from a limited partnership to a capital company in exchange for shares. Actually this is a transformation from an LLP to a limited company in Germany. Even if the operation conducted by the group led to a change in the legal ownership of the assets, as the Austrian companies received shares in the capital of the German capital company, the effective owners remained unchanged, remaining resident in Austria. However, the effects for the German tax authorities are the same: the taxpayer was not liable to tax in Germany anymore so it needed to pay any tax due in that jurisdiction. As a consequence, even if the facts do not fit clearly with previous cases, some parallel analyses can still be done.

The justification part of the exit tax judgments is now considered a straightforward one: the balanced allocation of taxing rights between Member States is accepted as covering national legislation enabling a Member State to tax a capital gain that arose in its territory even if that gain actually has not been realised.

The second comment, and the major one, consists in a confirmation of the proportionality test from earlier cases dealing with exit taxes. There are three components to be looked at in the test: the time of definitive establishment of the tax, the time of recovery of this tax, and the requirements of the national legislation if the tax due is postponed.

Concerning the proportionality of the definitive establishment of the amount of tax at the time the company ceases to be liable to tax in the Member State in question, there are actually two issues: the establishment of the amount of tax and the fact that this amount is definitive. The Court already answered those two issues in *NGI*, where it stated that “it is proportionate for that Member State, for the purpose of safeguarding the exercise of its powers of taxation, to determine the tax due on the unrealised capital gains that have arisen in its territory at the time when its power of taxation in respect of the company in question ceases to exist”[21]. As regards the “definitive issue”, the Court did not discuss this in its *DMC* judgment since the

19 ECJ, 16 December 2008, Case C-210/06, *Cartesio Oktató és Szolgáltató bt* (“*Cartesio*”) [2008] ECR I-09641.

20 Ibid 15 (“*NGI*”)

21 *DMC* para. 60 referring to *NGI,* para 52

explanation in paragraphs 54 to 59 of *NGI* is clear. The Court ruled that the establishment could be not definitive in cases such as in *N*[22] because the assets at issue were shares that were liable to increase or decrease in value whereas when the assets are part of a business, the amount is definitive since the State of origin no longer maintains a taxing right over the future profits of the business[23]. As a consequence, the amount of tax is to be regarded as definitive at the time of departure even if those assets appreciate/ depreciate after the transaction that takes them out of the origin Member State's jurisdiction.

Regarding the time of recovery of the tax, the Court ruled in *NGI* that the freedom of establishment was to be interpreted as 'precluding legislation of a Member State which prescribes the immediate recovery of tax on unrealised capital gains relating to assets of a company transferring its place of effective management to another Member State at the very time of that transfer'[24]. This seems to be in contradiction with the ruling in *DMC* where the Court determined that: 'The national legislation of a Member State which provides for the immediate taxation of unrealised capital gains generated in its territory does not go beyond what is necessary to attain the objective of the preservation of the balanced allocation of the power to impose taxes between Member States, provided that, where the taxable person elects for deferred payment, the requirement to provide a bank guarantee is imposed on the basis of the actual risk of non-recovery of the tax'[25].

22 ECJ, 7 September 2006, Case C-470/04, *N v Inspecteur van de Belastingdiens*, ("*N*") [2006] ECR I-07409

23 See, Tom O'Shea, "*Dutch Exit Tax Rules Challenged in National Grid Indus"*, Tax Notes International, Jan. 16, 2012, p. 201-205 and ibid 3

24 *NGI* paragraph 87.

25 *DMC* paragraph 70.

Explanations are several but overall the Court's objective is to balance the taxpayer's right to freedom of establishment or free movement of capital and the right of a Member State to tax capital gains associated with its territory. Doing so, it is obvious that as the legislation challenged will vary depending on the Member State concerned, the decisions are going to be different regarding the facts at issue. In individual cases, the Court clearly prohibited immediate taxation of unrealized gains, likewise the requirement to provide security after the taxpayer leaves the Member State, in situations where it was apparent that directives coordinating exchange of information and tax recovery between Member States[26] were applicable (*de Lasteyrie*[27] and *N*[28]).

The situations faced in corporate cases seem to be much more problematic. Indeed, the complexity of the assets in a company situation led the Court to acknowledge that in some situations, deferral of payment of the exit tax can be more constraining as companies need to trace the assets that were taxable under the jurisdiction of the origin Member State. This can be perceived as an excessive administrative burden, which can be more harmful than immediate payment of the exit tax. Thus, in the *NGI* case, while prohibiting immediate recovery of the tax, the Court gave guidance that giving the choice to a company between immediate taxation and deferred payment 'while being appropriate for ensuring the balanced allocation of powers of taxation between the Member States, would be less harmful to freedom of establishment'[29]. As a consequence, many Member States changed their legislation on that point, implementing systems of deferred payments as in Germany and in the *DMC* case, the Court was once again given the opportunity to explain its interpretation of the Treaties: 'Member States entitled to tax capital gains generated when the assets in question were in their territory have the power, for the purposes of such taxation, to make provision for a chargeable event other than the actual realisation of those gains, in order ensure that those assets are taxed'[30]. Reference is made to *Commission* v *Denmark*[31], where the Court already ruled that the fact that the assets at issue could stay unrealised after the transfer

26 See, for example, Council Directive 77/799/CE of 19 December 1977, modernised in 2011 with Council Directive 2011/16/EU of 15 February 2011 and Council Directive 2010/24/EU of 16 March 2010 , Commission Implementing Regulation (EU) No 1189/2011 of 18 November 2011

27 ECJ, 11 March 2004, Case C-9/02 *Hughes de Lasteyrie du Saillant v Ministère de l'Économie* ("*de Lasteyrie*"), [2004] ECR I-02409

28 Ibid 21

29 *NGI*, para. 73

30 *DMC* para. 61

31 ECJ, 18 July 2013, Case C-261/11, *European Commission v Kingdom of Denmark* ("*Commission v Denmark*") [2014] ECR I-0000 (not yet published), case read in French.

does not prevent a Member State from recovering the tax that is due[32] as it could settle a reasonable period of deferred payment linked to the risk of non-recovery which would be less harmful to freedom of establishment than immediate payment[33]. Member States are thus encouraged to define a reasonable and proportionate date where the exit tax can actually be due and recovered in order to ensure that the tax is effective and not subject to high risk of non-recovery. This is to be linked with the "conversion issue"[34] in *Cartesio*[35] where the Court stated that when a taxpayer disappears from the jurisdiction of a Member State, the latter has a right to recover taxes due when the taxpayers leaves. In *DMC*, the conversion from a partnership into a capital company might make the taxpayer disappear for German tax authorities and affect the German right to tax (this is a matter for the German courts to determine). This is the reason why the recovery of tax could happen before actual realisation of the capital gains.

In an EU context, the Directive on Administrative Cooperation and the Recovery of Taxes Directive[36] apply and the protection of effective taxing rights is generally protected. Consequently, it is arguable that the recovery of tax is impossible if the taxpayer no longer exists from an origin Member State perspective. One has to wait for decision of the national courts to be enlightened on that point.

The proportionality test raises two more questions in relation to the deferral of payment, one on the charging of interest and the other on the requirement of a guarantee. The first question is whether the Member State that grants the deferral is entitled to collect interest from the moment of exit. The Court states that 'deferred payments of that tax, possibly together with interest in accordance with the applicable national legislation'[37]. One wonders whether the mention of "applicable national law" refers to extensions of payment in general, to extensions of payment in the event of domestic transfers of real seats or in other cases where the freedom of the treaties impedes immediate recovery[38]. From the wording of *DMC* it is understandable that interest is related to the national legislation dealing with deferred tax payments in general as the Court mentioned 'spread over a period of five years, without being required to pay interest, payment of the tax due in respect of the transfer of the shares which that person holds'[39]. Consequently, if a

32 Ibid para. 36

33 Ibid para 37

34 Tom O'Shea, "*Exit Taxes Post-Cartesio*", The Tax Journal, 31 August 2009, p1-2

35 Ibid 18

36 Ibid 24

37 *DMC* para. 61

38 H. van den Hurk, H van den Brock and J. Kroving, "*Final settlement taxes for companies : transfer of seats, interest charges, guarantees and set-ups in value*", Bulletin for International Taxation, April/May 2013, p 257-267

39 *DMC* para. 63

Member State has a rule imposing interest if a tax is due but recovered later, this rule should be equally applicable to national and cross-border situations. On the contrary, a Member State would not be able to impose interest only on cross-border situations as this would breach the national treatment concept and this would, a priori, not be justified by overriding reasons of public interest.

The second question concerns bank guarantees. The Court is consistent in this respect: a bank guarantee constitutes a restriction, as pointed out in *de Lasteyrie*, it deprives the taxpayer of the enjoyment of the assets given as a guarantee[40]. In the latter judgment, the Court stated that a guarantee could not be requested automatically in order to benefit from deferral of the exit tax payment[41]. In *N*, the Court stated that if such a guarantee was needed but incurred costs for the taxpayer, it was for the national legislation to compensate as the mere release of the guarantee was not sufficient to cover the disadvantage of providing it[42]. The Court in *DMC* highlighted that such a requirement could only be proportionate if there was a genuine and serious risk of non-recovery of the claim[43]. In particular, it is highlighted that in the situation at issue, it should be assessed ‘in the light of the fact that, first, the unrealised gains, which are subject to the contested tax, relate solely to one form of assets, namely shares held by only two companies with their registered office in Austria and, second, that those shares are held in a capital company with its registered office in Germany’[44]. Furthermore, the General Advocate in the *Commission v. Portugal (C 38/10)* Opinion aptly pointed out that the guarantee could not cover the total amount of the claim, as it would have the same effect as an immediate payment of the tax[45].

Conclusion

After the *DMC* decision, the situation on exit taxes seems to be clear and may be summarised as follows. Member States have a right to tax capital gains that arose in their jurisdiction so the general concept of exit tax is compatible with EU law. However, the time of its recovery depends on the protection of the right to tax from the Origin Member State after the taxpayer leaves, (or after an operation such as the one undertaken in *DMC*). If the right to tax is protected, by the EU mutual assistance directives, the Member State will have to defer the payment until realisation of the assets concerned. This will be the case in the wide majority of

40 *De Lasteyrie* para 47

41 *De Lasteyrie* Para 52

42 *N* Para 57

43 *DMC* para 67

44 *DMC* para 68

45 Opinion Advocate General Mengozzio, 28 June 2012, ECJ case C-30/10, *European Commission v. Portuguese Republic*, para. 82

situations. Conversely, if the right to tax appears to be lost, then, giving the choice to the taxpayer between immediate recovery and reasonable deferral (in *DMC* spread over five years) is proportionate to the need for Member States to ensure balanced allocation of taxing rights. For any deferral, interest can be levied but up to the limit that it is a national requirement for every deferral without distinction between national and cross-border situations. In addition, a bank guarantee can be required only if justified by a high risk of non-recovery.

In order to know whether the German exit tax is EU compatible, the judgment of the national court is to be awaited, "Patience is bitter, but its fruit is sweet."