*CFE ECJ Task Force**

Opinion Statement ECJ-TF 3/2014 of the CFE on the decision of the European Court of Justice of 23 January 2014 in *DMC* (Case C-164/12), concerning taxation of unrealized gains upon a reorganization within the European Union

This is an Opinion Statement prepared by the ECJ Task Force of the CFE on the ECJ decision in *DMC* (Case C-164/12), submitted to the European Court of Justice, the European Commission and the EU Council in December 2014.

1. Introduction

This is an Opinion Statement prepared by the CFE ECJ Task Force on *DMC* (Case C-164/12).[1] After illustrating the facts of the *DMC* case and the preliminary questions, this Opinion Statement focuses on selected critical points from this case by pointing out some differences between it and its most immediate relevant precedent, *National Grid Indus* (Case C-371/10),[2] which has been the subject of a previous CFE Opinion Statement.[3]

2. The Facts and the Preliminary Questions

(1) The case is a request for a preliminary ruling in tax proceedings made by the *Finanzgericht* Hamburg (Germany) in accordance with a decision of 26 January 2012.

(2) The case refers to the right of Germany to tax unrealized gains on interests in a German limited partnership (DMC KG) that were transferred to a German limited company (DMC GmbH) by non-resident Austrian limited partners (S GmbH and K GmbH). K GmbH and S GmbH made a non-cash contribution in the form of the interests held by them in DMC KG, receiving in consideration for the transfer of those interests shares in the capital of DMC GmbH as the acquiring company of the interests. All the interests in the limited partnership were transferred and, thus, the limited partnership was dissolved. All the contributions were shown in DMC GmbH's balance sheet at their historical book value.

(3) As a result of a tax inspection, the German tax administration concluded that the limited partners in DMC KG no longer had an establishment in Germany and, according to the Austria-Germany Income and Capital Tax Treaty (2000),[4] Germany had lost the right to tax the gains accruing to K GmbH and S GmbH as a result of the grant of the shares in DMC GmbH in consideration for the contribution of the interests held by those companies in DMC KG. Therefore, the interests contributed by the Austrian partners to DMC GmbH were to be valued *at their value as part of a going concern*, and not at their book value, giving rise to taxation of the unrealized capital gains on the interest in DMC KG. The applicant in the proceedings brought proceedings before the referring court against the notice of assessment, considering that it was incompatible with EU law.

(4) The applicant pleaded that both non-resident limited partners were subject to immediate taxation of unrealized capital gains generated in German territory, since the holder of the assets was no longer liable to tax in Germany on the gains accruing from the subsequent disposal of the assets received in consideration, leading to unequal treatment of limited partners having an establishment in Germany and those not maintaining such an establishment in Germany.

(5) In view of the proceedings, the *Finanzgericht* Hamburg decided to refer the following questions to the ECJ for a preliminary ruling:

1. Is it compatible with Article 43 EC ([now] Article 49 TFEU) for a national provision to provide that, in the

* **The members of the Task Force are: Alfredo Garcia Prats, Daniel Gutmann, Volker Heydt, Eric Kemmeren, Georg Kofler (Chair), Michael Lang, Franck Le Mentec, Pasquale Pistone, Albert Rädler†, Stella Raventos-Calvo, Isabelle Richelle, Friedrich Roedler and Kelly Stricklin-Coutinho. Although the Opinion Statement was drafted by the ECJ Task Force, its content does not necessarily reflect the position of all members of the group.**

1. The case was decided by the ECJ (First Chamber) on 23 January 2014: DE: ECJ, 23 Jan. 2014, Case C-164/12, *DMC Beteiligungsgesellschaft mbH v. Finanzamt Hamburg-Mitte*, ECJ Case Law IBFD.
2. NL: ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus BV v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, ECJ Case Law IBFD.
3. Opinion Statement of the CFE on the decision of the European Court of Justice of 29 November 2011 in *National Grid Indus* (C-371/10) and business exit taxes within the European Union.
4. *Agreement between the Federal Republic of Germany and the Republic of Austria Concerning the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, Taxes on Businesses and Land Taxes* (4 Oct. 1954), Treaties IBFD.

event of the contribution of partnership interests to a capital company, the business assets contributed must be assessed at their value as part of a going concern (and consequently, as a result of revealing undisclosed reserves, a capital gain arises for the transferor) where, at the time of the non-cash contribution, the Federal Republic of Germany has no right to tax the gain arising on the grant of the new company shares to the transferor in return for his contribution?

2. In the event that the first question must be answered in the negative: is the national provision compatible with Article 43 EC … if the transferor is entitled to apply for the deferment, on an interest-free basis, of the tax arising as a consequence of revealing the undisclosed reserves, with the effect that the tax due on the gain may be paid in annual instalments, each of at least a fifth of the tax due, provided that the payment of the instalments is secured?

3. The Decision of the Court

(6) The Court (First Chamber) gave its decision without an Opinion of Advocate General Wahl, after the hearing. This is surprising given that the decision appears to depart from previous case law of the ECJ. It is also noteworthy that no other Member State intervened in the proceedings.

(7) The Court supported the right of Germany to tax unrealized gains on interests in a German limited partnership as a result of their transfer to a German limited company, thus resulting in the dissolution of the limited partnership, if Germany actually loses taxing rights. In such a scenario, the Court considered that legislation that defers the payment in annual instalments of one fifth of the tax due if the payment of the instalments is secured, is proportionate.

(8) The Court decided as follows in paragraphs 58 and 69 respectively:

1. 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.

2. 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.

(9) Before answering the questions, the ECJ stated that it had jurisdiction in this case in respect of all questions. It was not apparent that the problem arising in the main proceedings was hypothetical. The *Finanzgericht* had argued that, in the event that the domestic law applicable were to be deemed incompatible with EU law, the action would automatically be admissible,[5] but with some limitations.

(10) The Court first decided that, despite the German Court raising a question regarding the implications of the freedom of establishment, the case needed to be decided on the basis of the free movement of capital. The Court, in this case, considered the purpose of the legislation concerned and not the facts in the main proceedings.[6]

(11) German legislation established a restriction on the free movement of capital. The restriction derives from a different treatment of the transferring taxpayer of an interest in a limited partnership. If Germany cannot tax the *unrealized* capital gains that will be realized by the transferring company/entity upon a future disposal of the shares exchanged, the capital gain is determined at the point at which the interests in the limited partnership were transferred and collected in accordance with the domestic rules. In contrast, if the transferring company remains liable to tax in Germany, the transfer of such an interest in a limited partnership is not taxed at that moment, but is deferred until the disposal of the shares granted in exchange for the interest in the limited partnership.[7]

(12) Immediate taxation of the capital gains arising as a result of the transfer puts the investors no longer liable to tax in Germany at a cash flow disadvantage by comparison with investors who remain liable to tax there: investors who do not remain liable there are taxed immediately, while investors that remain liable are taxed when the gains are "actually realized". That difference in treatment as regards the taxation of capital gains is liable to deter investors who are not resident in Germany for tax purposes from contributing capital to a limited partnership governed by German law, since the conversion of an interest in that partnership into shares in a capital company will give rise to the tax disadvantage.[8]

(13) Moreover, that difference in treatment cannot be explained by an objective difference of situation. From the point of view of the legislation of a Member State aiming to tax capital gains generated in its territory, the situation of an investor who transfers his interest in a limited partnership established in that territory in return for shares in a capital company also established in that territory and who, as a result, is no longer subject to tax on any profit he may receive from the sale of those shares is similar to that of an investor who carries out the same transaction but remains subject to tax on any profit he may receive as regards the capital gains relating to the interest in the limited company that were generated in that Member state before the interest was exchanged. Therefore, this dif-

5. *See DMC* (C-164/12), paras. 22-26.
6. *See DMC* (C-164/12), para. 29.
7. *See DMC* (C-164/12), para. 39.
8. *See DMC* (C-164/12), para. 40.

ference in tax treatment constitutes a restriction that is, in principle, prohibited by the provisions of the Treaty on the Functioning of the European Union (TFEU) (2007)[9] on free movement of capital.[10]

(14) The Court considered that the difference in treatment may be justified by the objective of preserving the balanced allocation of the power to impose taxes between Member States. The balanced allocation of the power to impose taxes between Member States may justify legislation of a Member State that 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 taxation of the capital gains relating to those assets generated in that territory before they are actually realized, 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 realized, which is a matter for the national court to determine.

(15) The Court finds that the purpose of the legislation at issue is to ensure the balanced allocation of the power to impose taxes between the Member States, in accordance with the principle of territoriality. The Court recognizes that the preservation of the balanced allocation of the power to impose taxes between Member States is a legitimate objective recognized by the Court, and that Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation.

- The Court considers that the conversion of an interest in a limited partnership into shares in a capital company cannot have the effect of requiring the Member State in which those entities are established to relinquish its right to tax a capital gain that was generated in its territory and fell within its taxing jurisdiction before the conversion, on the ground that the capital gain has not in fact been realized. The Court recognizes that the former state is entitled to tax the gains accruing to a resident during the time it is resident, at the time the taxpayer leaves the country.
- The fact that the legislation at issue in the main proceedings entails the taxation of unrealized capital gains is not, in itself, capable of calling into question the legitimacy of the objective of preserving the balanced allocation of the powers to impose taxes between the Member states concerned, because the Member States are entitled to tax economic value generated by an unrealized capital gain in their territory, even in the absence of a realization event occurring. The Court again takes the view that was raised in *Commission v. Denmark* (Case C-261/11), which is to recognize the power of Member States to make provision for a chargeable event other than the actual realization of those gains in order to ensure taxation of [the capital gain generated by] those assets.[11]
- The conversion of an interest in a limited partnership into shares in a capital company removes income from the exercise of the powers of taxation of the Member State and, therefore, is sufficient justification for a provision such as that at issue.

(16) The ECJ, however, justifies the restrictive German measure only on the condition that the Member State in whose territory the income was generated is actually prevented from exercising its power of taxation in respect of such income.[12] The justification will not be applicable if the State could take into account such capital gains in determining the corporate tax payable in Germany by the acquiring company. The ECJ considers it irrelevant whether the capital gain could be taxed in the hands of the transferor or in the acquiring company, leaving the matter for the national court to establish.

(17) The Court decides, furthermore, that the legislation at issue is proportionate, as the restriction does not go beyond what is necessary to attain the objective of preserving the balanced allocation of the power to impose taxes between Member States. In that regard, the relevant German legislation establishes that:

> […] the income tax or corporation tax due in respect of a capital gain may be paid in annual instalments, each of at least one fifth of the tax due, on condition that the payment of the instalments is secured. No interest shall be charged where payment is deferred. Any disposal of shares during the deferral period shall put an immediate end to that arrangement […].

(18) In respect of the proportionality of the measure, the ECJ deals separately with the option to spread payment over a period of five years, on the one hand, and the need to secure the payment with a bank guarantee, on the other, despite the fact that the German legislation requires that both requirements be met jointly in order to defer the payment in instalments over five years.

(19) As regards the possibility to spread payment of the tax due on the capital gain over a period of five years, the Court considers it proportionate based on the following arguments:

- It is proportionate for a Member State to determine the tax due on the unrealized 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.
- It is appropriate to give the taxable person a choice between immediate payment of the amount of tax due on the unrealized capital

9. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), EU Law IBFD.
10. *See DMC* (C-164/12), paras. 42-43.
11. DK: ECJ, 18 July 2013, Case C-261/11, *European Commission v. Kingdom of Denmark*, para. 37, ECJ Case Law IBFD.
12. *See DMC* (C-164/12), para. 56.

gains and deferred payment of that tax, possibly together with interest in accordance with the applicable national legislation.

– The ability to spread payment of the tax owing before the capital gains are actually realized over a period of five years constitutes a satisfactory and proportionate measure for the attainment of the objective of preserving the balanced allocation of the power to impose taxes between Member States, considering that the risk of non-recovery increases with the passage of time.

(20) In relation to the requirement to provide a bank guarantee, the Court considers that this requirement cannot be imposed without prior assessment of the risk of non-recovery. According to the Court, the risk needs to be assessed in light of the fact that the unrealized gains relate solely to one form of asset, namely shares held by only two companies with their registered office in Austria and, secondly, the fact that those shares are held in a capital company with its registered office in Germany.

4. Comments

(21) *Change in settled case law?DMC* raises similar problems as *National Grid Indus*,[13] in that it concerns the taxation of unrealized gains. From that perspective, the Court in *DMC* has relaxed its previous standards of proportionality, departing from previous settled case law. In the view of the Task Force, its new approach is inconsistent with such case law. This change in parameters was made without clear reasoning, without justification for the change and, more surprisingly, without an Opinion of the Advocate General that could clarify the reasons for such a change. In particular, the Court missed the opportunity to reconsider its case law on "safeguarding the *balanced* allocation of powers of taxation *between* the Member States", which leads to a lot of uncertainty. The rights of taxpayers recognized under EU law according to previous settled case law may suffer an unreasoned limitation and it appears unclear whether or not the outcome of *DMC* is now applicable, for instance, to private individuals in a typical exit tax case or, on the contrary, the approach in *Lasteyrie du Saillant* (Case C-9/02)[14] and *N* (Case C-470/04)[15] is still valid.

(22) *Freedom involved*. In line with its most recent case law,[16] the Court identifies the applicable freedom based on the scope of the applicable domestic provision. Since the application of the German provision does not depend on the extent of an investor's interest in the limited partnership, the free movement of capital is applicable. Thus investors from third countries could also, in principle, benefit from the ECJ's decision in *DMC*.

(23) *Analysis of the difference in treatment*. Largely referring to *National Grid Indus*,[17] the ECJ focuses the difference in treatment between established and non-established investors having an interest in a partnership based on the requirement of immediate taxation of *unrealized capital gains generated in German territory*. It did not matter for the ECJ whether the general rule in Germany was taxation of the transfer, as a result of the reorganization, or deferral of hidden reserves.

(24) *Unclear relevance of the justification on grounds of balanced allocation of powers between Member States*. Referring, inter alia, to *Marks & Spencer* (Case C-446/03),[18] *N* (Case C-470/04)[19] and *National Grid Indus*,[20] the Court reiterates, in this case, the justification based on the need to safeguard the balanced allocation of powers between Member States. In essence, the Court only allows for the use of this justification when the Member State is actually prevented from exercising its taxing powers. If the hidden reserves can be taxed by Germany under applicable domestic law in the hands of another person, the justification is not accepted.[21] If, however, Germany is actually prevented from exercising its taxing powers, the Court accepts this justification, hereby granting Member States *carte blanche* to define and protect the tax base. Hence, more than safeguarding *the balanced allocation* of taxing powers *between* the Member States, the Court – and the Member States – are concerned about securing the Member State's *unilateral exercise*, regardless of the proper and balanced allocation of the other Member State in the case at stake, and despite the fact that the lack of exercise of such tax power derives from a voluntary abandonment of such exercise as a result of the tax treaty signed between them.

(25) *Proportionality of the measure*. The Court's assessment of the proportionality of the German measure is questionable. Indeed, for the first time, the Court accepts taxation of unrealized capital gains over five annual instalments. The court case law on exit tax would have implied the option for taxpayers to defer taxation until realization.[22] However, and without providing any explanation, the Court in *DMC* merely states that, "by giving the tax payer the choice between immediate recovery or recovery spread over a period of five years, 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".[23]

13. *See National Grid Indus* (C-371/10).
14. FR: ECJ, 11 Mar. 2004, Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, ECJ Case Law IBFD.
15. NL: ECJ, 7 Sept. 2006, Case C-470/04, *N. v. Inspecteur van de Belastingdienst Oost/kantoor Almelo*, ECJ Case Law IBFD.
16. UK: ECJ, 13 Nov. 2012, Case C-35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue, Commissioners for her Majesty's Revenue & Customs,* ECJ Case Law IBFD.
17. *See National Grid Indus* (C-371/10).
18. UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. Halsey (Her Majesty's Inspector of Taxes),* para. 45, ECJ Case Law IBFD.
19. *See N* (C-470/04), para. 42.
20. *See National Grid Indus* (C-371/10), para. 45.
21. *See DMC* (C-164/12), paras. 56-57.
22. *See*, for example, *National Grid Indus* (C-371/10).
23. *See DMC* (C-164/12), para. 64.

Hence, according to this decision fixed instalment payments spread over five years are now acceptable. There are only the briefest of legal arguments why this measure might be proportionate and it is unclear why the cash flow disadvantage to the taxpayer is no longer taken into consideration whereas it was in earlier case law. Moreover, the Court gives no indication if an even shorter instalment period (for example, three years) might be acceptable. Additionally, there does not appear to be an increased risk of tax avoidance that would justify a measure that does not give the taxpayer an option to defer taxation until realization and hence depart from economic reality. Finally, the ECJ does not consider the effect of the combination of the option to defer and the requirement of a guarantee.

(26) *Requirement of an additional guarantee.* In *National Grid Indus* the Grand Chamber of the Court had briefly stated that "the risk of non-recovery of the tax, which increases with the passage of time" may be taken into account by a Member State, in its national legislation applicable to deferred payments of tax debts, "by measures such as the provision of a bank guarantee".[24] It was, however, unclear if that statement gave *carte blanche* to Member States to establish such a requirement and, since such requirement is in itself a restriction, how it relates to the Court's previous case law, for example, *Lasteyrie du Saillant*[25] and *N*.[26] Indeed, the EFTA Court in *Arcade Drilling* (Case E-15/11) rejected the idea that Member States may require a bank guarantee as they please, noting that there has to be a "genuine and proven risk of non-recovery" and that such risk is essentially dependent upon the nature and extent of a taxpayer's tax position, "and the sources of information available to the national authorities regarding these tax positions, *inter alia*, through cooperation with and the exchange of information with the authorities of other EEA States".[27] The Court in *DMC* took a similar approach: it first confirmed that "such guarantees in themselves constitute a restrictive effect, in that they deprive the taxpayer of the enjoyment of the assets given as guarantee",[28] and that "[t]herefore, such a requirement cannot, as a matter of principle, be imposed without prior assessment of the risk of non-recovery".[29] In assessing this risk the Court pointed out that the unrealized gains solely relate to one form of assets (shares) that were held by two Austrian companies.[30] Unfortunately, the Court did not address the question of how the Mutual Assistance Directive [on administrative cooperation in the field of taxation] (2011/16)[31] and the Recovery Directive (2010/24)[32] relate to such risk assessment.

5. The Statement

(27) The Confédération Fiscale Européenne is concerned that by accepting discriminatory taxation of unrealized capital gains in a reorganization, where such taxation is spread out over five annual instalments, the Court in *DMC* has relaxed its standard of proportionality and thereby may have departed from settled case law that gave taxpayers an option to defer taxation until a real economic event, i.e. realization in the market, takes place.

(28) The Confédération Fiscale Européenne welcomes the fact that the Court has clarified that a Member State may require an additional guarantee in the event of deferred taxation only if there is a genuine and proven risk of non-recovery, but invites the Court to also consider the Mutual Assistance Directive (2011/16) and the Recovery Directive (2010/24) when making such a risk assessment.

24. *National Grid Indus* (C-371/10), para. 74.
25. *Lasteyrie du Saillant* (C-9/02), para. 47.
26. *N* (C-470/04), para. 36.
27. NO: EFTA Court, 3 Oct. 2012, Case E-15/11, *Arcade Drilling AS v. Staten v/Skatt Vest*, paras. 101-102.
28. *See DMC* (C-164/12), para. 66.
29. *See DMC* (C-164/12), para. 67.
30. *See DMC* (C-164/12), para. 68.
31. EU Mutual Assistance Directive (2011): Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ L 64 (2011), EU Law IBFD.
32. EU Recovery Directive (2010): Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures, OJ L84 (2010), EU Law IBFD.