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The Court of Justice of the European Union’s Overruling of Danish Exit Taxation

18 July 2013, the Court of Justice of the European Union (“the CJEU”) delivered its decision in the case of the European Commission (“the Commission”) vs. Denmark, C-261/11, (“the Decision”). The case concerned whether the Danish provision on exit taxation of companies was in violation of the European principle of freedom of establishment provided in article 49 of the Treaty on the Functioning of the European Union and in article 31 of the Agreement of the European Economic Area (“Freedom of Establishment”).

The Danish Provision on Exit Taxation

The provision in Section 8 (4) of the Danish Corporate Tax Act (”The Provision”) orders companies subject to full tax liability in Denmark to immediately pay tax on unrealised capital gains on assets transferred from Denmark to a permanent establishment in a foreign country, the Faroe Islands or Greenland. Thus, the exit taxation only affects companies transferring assets to a permanent establishment outside of Denmark, while companies making a similar transfer of assets between different establishments within Denmark are not subject to any immediate tax payment.

The Case in brief

September 2008, the Commission sent a letter of formal notice to Denmark stating that the Provision was in violation of the Freedom of Establishment. As Denmark denied this violation, the Commission brought the dispute to the CJEU 26 May 2011.

The parties agreed that the Provision constituted a restriction on the Freedom of Establishment. Further, the parties agreed that the reasons behind ensuring the maintenance of Danish taxation powers and to prevent an arbitrary reallocation of the Danish tax base to other countries were compatible with the European Law.

However, the Commission claimed that the Provision was not proportionate to the objective pursued since it excluded any possibility of deferred taxation.

Denmark justified the immediate taxation on two counts. It was stated that deferring taxation to the time of the actual transfer made no sense with regards to operating assets, since such assets are either never sold or would be without value at the time of sale, as the operating asset’s value will typically decrease as it is used to generate commercial revenue. Finally, Denmark stated that if an operating asset is purchased in Denmark with right to tax deduction of the expenses incurred in this connection, the Danish tax base would arbitrarily be reallocated to other countries if the asset concerned could be transferred without taxation while the income generated by the asset will not be subject to Danish taxation.

The Decision

Initially, the CJEU ruled that the Provision constituted a restriction on the Freedom of Establishment. In relation to the question of whether the Provision was proportionate with the objective pursued, the CJEU overruled the Provision, having regard to the fact that an immediate taxation was disproportionate in relation to ensuring the Danish national right of taxation. However, at the same time, the CJEU ruled that member states are entitled to provide another less restrictive criterion for initiating taxation of assets transferred to a permanent establishment or a headquarters in another member state than taxation at the time of the transfer.

Our Assessment of the Decision

The Decision confirms that immediate taxation of capital gains on assets transferred to a permanent establishment in another member state or relocation of headquarters to another member state is incompatible with the Freedom of Establishment. This applies regardless of whether the assets are intended for realisation.

The CJEU confirms that exit taxation of cross-border asset transfers is compatible with European Law if the rules allow companies to choose between immediate taxation and deferred taxation. The deferral may, in such a case, be extended to the time of the actual transfer.

The impact of the Decision for future taxation of companies transferring assets and liabilities to a permanent establishment in another member state cannot be finally established before the Danish Ministry of Taxation has reacted to the Decision. However, it is certain that the Decision will necessitate amendments to the Danish Corporate Tax Act. It must be noted that European law regarding freedom of establishment is directly applicable in Denmark and that the Danish courts therefore cannot maintain the current legal position. Companies that have been subject to taxation incompatible with the Decision should consider claiming repayment of such taxes, provided that the Danish Ministry of Taxation grants access to reopening of cases.

The expected Reaction of the Danish Ministry of Taxation

16 August 2013, the Danish Minister of Taxation addressed the Decision delivered by the CJEU[1]. The Minister of Taxation stated that a bill will be introduced in response to the Decision as soon as possible. The content of the bill has not been finally determined, but it is expected to be generally in accordance with the Decision. Thus, a company transferring assets and liabilities to a permanent establishment or headquarters located in another EU/EEA country may choose deferred taxation.

The Danish Ministry of Taxation has not yet stated whether access to reopening of cases will be granted for companies that paid taxes under the rules which violated the EU law.

Consequences for taxpayers when deferring taxation

How the specific content of the bill, namely ensuring payment of taxes, will be formulated is still

[1] The Danish Minister of Taxation's reply to question no. 90 of 19 July 2013 of the Danish Parliament's European Affairs Committee.

unclear. During the legal proceedings, Denmark claimed that member states are entitled to demand payment of interests on the determined tax on capital gains as well as a bank guarantee at the time of the transfer[2]. The Commission contested the claims on the grounds that interests and a bank guarantee are not proportionate to the objective of ensuring effective taxation powers. The CJEU did not concretely address the issue. However, in a previous Decision, the CJEU stated that if a company chooses to defer the time of taxation, member states may claim interests in accordance with national legislation[3].

On that basis, it is to be expected that the bill will contain an opportunity for companies that transfer assets and liabilities to a permanent establishment or headquarters located in another EU/EEA country to choose between immediate taxation and deferred taxation with the addition of interest in accordance with the Danish Interests Act.

With regards to the question of whether the requirement that companies that choose deferred taxation must provide a bank guarantee is compatible with the European Law and is therefore likely to be included in the bill, the proportionality in relation to the objective of ensuring effective taxation powers is essential. In a previous case, the CJEU referred to the requirement of a bank guarantee as a measure to reduce the risk of not being able to collect a tax[4]. Since the CJEU has not addressed the matter further, it must be assumed, until stated otherwise, that the bill, in agreement with European law, may contain a requirement for a bank guarantee in case of deferred taxation.

Other Cases in which the Decision may be relevant

Cross-border relocation of the registered office or the management's seat to another EU/EEA country
If a company chooses to relocate its registered office or the management's seat (in the following only referred to as "the Management's Seat") to a foreign country, the company is still subject to full tax liability in Denmark, provided that it is registered at the Danish Business Authority[5]. However, if the company is regarded as being resident in the country where the Management's Seat is relocated to, the company will be subject to full tax liability in that country if there is a double taxation agreement between the country in question and Denmark, cf. article 4(3) of the OECD's model agreement and Section 5 of the Danish Corporate Tax Act (5). Unrealised capital gains are in Denmark subject to taxation at the time when the capital gains are moved out of Denmark, cf. Section 5 (7) of the Danish Corporate Tax Act. Assets and liabilities connected to a permanent establishment or a real property in Denmark will continue to be subject to Danish taxation, cf. article 6 and 7 of the OECD's model agreement and are consequently not subject to exit taxation in the case of relocation of the Management's Seat.

The provisions concerning relocation of the Management's Seat are generally similar to the Provision, which gives rise to the question of whether the Judgment of the CJEU will apply to cases in which a company relocates the Management's Seat to another EU/EEA country.

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[2] C-261/11 Denmark against the Commission, paragraph 18.
[3] C-371/10 National Grid Indus, paragraph 73.
[4] C-371/10 National Grid Indus, paragraph 74.
[5] TfS2007.264H.

In the Decision, the CJEU noted that when transferring assets and liabilities to a permanent establishment abroad, a company will still be subject to full tax liability in Denmark. Thus, the transfer will have no impact on the Danish possibility of collecting taxes[6]. However, the situation is different when relocating the Management's Seat abroad, as, according to OECD's model agreement, the company will become resident in and consequently fully tax liable in the country which the Management's Seat is relocated to, see the above analysis of Section 5 (5) of the Danish Corporate Tax Act.

In a previous decision, the CJEU determined that article 49 of the Treaty on the Functioning of the European Union precludes immediate taxation of unrealised capital gains on assets in companies which relocate the Management's Seat to another EU Member State[7]. The CJEU has not decided whether article 31 of the EEA Agreement prevents the same situation.

In a previous decision, the CJEU distinguished between article 49 of the Treaty on the Functioning of the European Union and article 31 of the EEA Agreement. The distinction was made due to the fact that the EU member states have entered into an agreement on exchange of information and mutual assistance regarding recovery of taxation claims[8]. This agreement has not been incorporated by the EEA Countries[9].

In the Decision's reasoning regarding article 31 of the EEA Agreement, the CJEU determined that a restriction of the Freedom of Establishment could not be regarded as proportionately reasoned in an effective power of taxation, as there was a Danish power of taxation. Thus, the taxation did not require an arrangement regarding tax assistance from the country which the Management's Seat was relocated to[10]. As mentioned above, a company choosing to relocate the Management's Seat out of Denmark is no longer subject to Danish taxation. Based on the CJEU's abovementioned reasons, it is therefore assumed that immediate taxation is compatible with European law if there are no arrangements for tax assistance from the country which the Management's Seat is relocated to.

Denmark has acceded to the OECD's convention on mutual administrative assistance in tax matters, which Norway and Iceland likewise have acceded to[11]. Furthermore, Denmark and Liechtenstein have entered into an agreement on exchange of information regarding tax matters[12]. Therefore, immediate exit taxation when a company relocates its Management's Seat to an EEA country is assumed to be incompatible with the freedom of establishment in article 31 of the EEA Agreement.

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[6] C-261/11 Denmark against the Commission, paragraph 47.
[7] C-371/10 National Grid Indus, paragraph 86.
[8] Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for recovery of claims relating to taxes, duties and other measures.
[9] Notice from the Commission to the Council of the European Union, the European Parliament and the European Economic and Social Committee on exit taxation and the need for coordination of the member states' tax policies, section 4.1, 19.12.2006.
[10] C-261/11 Denmark against the Commission, paragraph 47.
[11] The Danish legal guidance section G.A.3.6.2.2.3.3.
[12] The Danish International order no. 9 of 17 March 2012 concerning the agreement of 17 December 2010 between Denmark and Liechtenstein on exchange of information on tax matters.

Conclusion

Based on the above analysis, it is to be expected that the Danish Corporate Tax Act will also be amended in situations in which a company that decides to relocate its registered office or its Management's Seat to another EU/EEA country may choose between immediate taxation and deferred taxation of unrealised capital gains in Denmark. The law is not expected to be amended in situations where a company decides to relocate its registered office or its Management's Seat to a country outside of the EU/EEA, since the Freedom of Establishment does not apply to these situations.

The above should also apply in cases regarding European limited liability companies, since these companies are subject to the member states' national laws, among other things with regards to taxation[13].

The same is assumed to apply for cases involving cross-border mergers and divisions. With regards to tax treatment in case of termination of a Danish transferring company, reference is made to Section 5 of the Danish Corporate Tax Act[14].

Should you have any questions or wish any further information on the above, please contact partner Christian Bredtoft Guldmann (cbg@mwblaw.dk), attorney Henning Hedegaard Thomsen (hht@mwblaw.dk) or junior associate Henrik Rasmussen (hra@mwblaw.dk).

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[13] See the European Public Limited Companies Act, Annex 1, no. 20 and the European Private Limited Companies Act, Annex 1, no. 16.

[14] For cross-border mergers, the reference is in Section 15 (4) of the Danish Merger Tax Act. For cross-border divisions, the reference is in Section 15 b (2) of the Danish Merger Tax Act.

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