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**Opinion Statement ECJ-TF 3/2014 of the CFE
on the judgment of the European Court of Justice
of 23 January 2014 in case C-164/12, *DMC*,
concerning taxation of unrealized gains upon a reorganisation
within the EU**

**Prepared by the ECJ Task Force of the CFE
Submitted to the European Court of Justice, the European Commission and the EU Council
in December 2014**

The CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 32 professional organisations from 25 European countries (22 EU member states) with 180,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe. The CFE is registered in the EU Transparency Register (no. 3543183647-05).

This is an Opinion Statement prepared by the CFE ECJ Task Force¹ on Case C-164/12, DMC.² After illustrating the facts of the DMC case and the preliminary questions, this document will focus on selected critical points from this case by pointing out some differences between it and its most immediate relevant precedent, National Grid Indus,³ which has been the subject of a previous Opinion Statement by the CFE.⁴

I. 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) made by 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 interest held by them in DMC KG, receiving in consideration of 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 double tax treaty between Germany and Austria, Germany 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 of 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 unrealised 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 European Union Law.
4. The applicant pleaded that both non-resident limited partners were subject to immediate taxation of unrealised capital gains generated in German territory, since the holder of the assets is 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 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*

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² The case was decided by the ECJ (First Chamber) on 23 January 2014.

³ C-371/10, National Grid Indus BV.

⁴ Opinion Statement of the CFE on the decision of the European Court of Justice of 29 November 2011 on case C-371/10, *National Grid Indus BV* and business exit taxes within the EU.

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?'*

II. The judgment of the Court

6. The Court (First Chamber) gave judgment without an Opinion of the Advocate General *N. Wahl*, after the hearing. This is surprising given that the judgment appears to depart from previous jurisprudence 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 its transfer to a German limited company, thus resulting in the dissolution of the limited partnership, if it actually loses taxing rights. In such case, the Court considered proportionate a legislation that defers the payment in annual instalments of one fifth of the tax due if the payment of the instalments is secured.
8. The Court decided as follows:
 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 to all questions. It was not apparent that the problem arisen in the main proceedings was hypothetical. The Finanzgericht had argued that, in the event that the domestic law applicable were 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 asking for 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 followed the consideration of the purpose of the legislation concerned and not the facts in the main proceedings.⁶

⁵ See paras 22-26 of the judgment.

⁶ See para. 29 of the judgment.

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 *unrealised* capital gains made by transferring company/entity at the 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 is collected in accordance with the domestic rules. On the contrary, if the transferring company remains liable to tax in Germany, the transfer of such interest in a limited partnership is not taxed at that moment and is deferred until the disposal of the shares granted in exchange of the interest in the limited partnership⁷.
12. Immediate taxation of the capital gains arisen 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 don't remain liable there are taxed immediately, while investors that remain liable are taxed when the gains are 'actually realised'. That different 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 which were generated in that Member state before the interest was exchanged. Therefore, this difference in tax treatment constitutes a restriction that is, in principle, prohibited by the provisions of the TFEU on free movement of capital.⁹
14. The Court considered that the difference of 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 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 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.
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 recognised 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 tax jurisdiction before the conversion, on the ground that the capi-

⁷ See para. 39 of the judgment.

⁸ See para. 40 of the judgment.

⁹ See paras 42-43 of the judgment.

tal gain has not in fact been realized. The Court recognizes that the former State is entitled to tax the gains obtained by a resident during the time it was resident, at the time the tax payer leaves the country.

- The fact that the legislation at issue in the main proceedings entails the taxation of unrealised 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 state concerned, because the Member States are entitled to tax economic value generated by an unrealised capital gain in its territory, even in the lack of a realization event. The Court again takes the view that was raised in *Commission v. Denmark* to recognize the power of Member States to make provision for a chargeable event other than the actual realisation of those gains in order to ensure taxation of [the capital gain generated by] those assets.¹⁰
 - 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 on the condition (only where, if) the Member State in whose territory the income was generated is actually prevented from exercising its power of taxation in respect of such income.¹¹ The justification will not be applicable if the State could take into account such capital gains in determining the corporation tax payable in Germany by the acquiring company. The ECJ considered 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 establishes, 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, despite the fact that the German legislation requires that both requirements need to be met jointly in order to defer the payment in instalments during five years.
19. As regards the possibility to spread payment of the tax due for 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 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.
 - It is appropriate to give the taxable person a choice between immediate payment of the amount of tax due on the unrealised capital 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 realised 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 tax-

¹⁰ Case C-261/11 *Commission v Denmark*, para 37.

¹¹ See para. 56 of the judgment.

es between Member States, considering that the risk of non-recovery increases with the passing 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 assessment of the risk needs to be done in the light of the fact that the unrealised gains 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.

III. Comments

21. *Change in settled case law?* *DMC* raises similar problems as *National Grid Indus*,¹² in that it concerns the taxation of unrealised gains. From that perspective, the Court in *DMC* relaxes from previous standards of proportionality and hereby departs from the previous settled case law and, in the view of the Task Force, is inconsistent with it. This change in parameters is 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 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*¹³ and *N*¹⁴ is still valid.
22. *Freedom involved.* In line with its most recent case law¹⁵ 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 also investors from third countries could, in principle, benefit from the ECJ’s decision in *DMC*.
23. *Analysis of the difference in treatment.* Largely referring to *National Grid Indus*,¹⁶ 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 *unrealised 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*,¹⁷ *N*¹⁸ and *National Grid Indus*,¹⁹ 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 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.²⁰ If, however, Germany is actually prevented from

¹² Case C-371/10 *National Grid Indus* [2011] ECR I-12273

¹³ Case C-9/02 *Lasteyrie du Saillant* [2004] ECR I-2409.

¹⁴ Case C-470/04 *N* [2006] ECR I-7409.

¹⁵ Case C-35/11 *Test Claimants in the FII Group Litigation*, EU:C:2012:707; see most recently Case C-47/12, *Kronos International Inc.*, ECLI:EU:C:2014:2200.

¹⁶ Case C-371/10 *National Grid Indus* [2011] ECR I-12273.

¹⁷ Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, para. 45.

¹⁸ Case C-470/04 *N* [2006] ECR I-7409, para. 42.

¹⁹ Case C-371/10 *National Grid Indus* [2011] ECR I-12273, para. 45.

²⁰ Paras 56-57 of the judgment.

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 its *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 of 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 unrealised capital gains in five annual instalments. The court case law on exit tax cases would have implied the option for taxpayers to defer taxation until realization.²¹ 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”.²² Hence, according to this judgment 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 where it was in earlier case law. Moreover, the Court gives no indication if an even shorter instalment period (e.g., 3 years) might be acceptable. Additionally, there does not appear to be an increased risk of tax avoidance which would justify a measure that does not give the taxpayer an option to defer taxation until realisation 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” and 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”.²³ It was, however, unclear if that statement gave *carte blanche* to Member States to establish such requirement and, since such requirement is in itself a restriction, how it relates to the Court’s previous case law, e.g., in *Lasteyrie du Saillant*²⁴ and *N*.²⁵ Indeed, the EFTA-Court in *Arcade Drilling* has rejected the idea that Member States may require a bank guarantee as they please in that it noted 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 positions, “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”.²⁶ 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,”²⁷ and that “[t]herefore, such a requirement cannot, as a matter of principle, be imposed without prior assessment of the risk of non-recovery”.²⁸ In assessing this risk the Court pointed out that the unrealized gains solely relate to one form of assets (shares) which are held by two Austrian companies.²⁹ Unfortunately, the Court did not address

²¹ See, e.g., Case C-371/10 *National Grid Indus* [2011] ECR I-12273.

²² Para. 64 of the judgment.

²³ Case C-371/10 *National Grid Indus* [2011] ECR I-12273, para. 74.

²⁴ Case C-9/02 *Lasteyrie du Saillant* [2004] ECR I-2409, para. 47.

²⁵ Case C-470/04 *N* [2006] ECR I-7409, para. 36.

²⁶ EFTA Court of 3 October 2012, Case E-15/11, *Arcade Drilling AS*, paras 101-102.

²⁷ Para. 66 of the judgment.

²⁸ Para. 67 of the judgment.

²⁹ Para. 68 of the judgment.

the question how the Mutual Assistance Directive and the Recovery Directive relate to such risk assessment.

IV. The Statement

- 27 The *Confédération Fiscale Européenne* is concerned that by accepting discriminatory taxation of unrealised capital gains in a reorganisation, if such taxation is spread 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., realisation on the market, takes place.
28. The *Confédération Fiscale Européenne* welcomes that the Court has clarified that a Member State may require an additional guarantee in case 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 and the Recovery Directive when making such risk assessment.