Exit Taxation After *Commission v Denmark* C-261/11

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Introduction

The taxation of companies upon exit within the European Union has developed rapidly the past few years. New boundaries are being set by the European Court of Justice (hereafter "the ECJ") as illustrated by the latest ruling in *Commission v Denmark C-261/11.*

In *Commission v Denmark C-261/11,* the ECJ found that an exit tax levied on assets reallocated from Denmark to another Member State constitutes an obstacle to the freedom of establishment, due to the different treatment of comparable situations. Further, the ECJ stated that to justify such a restriction, it was already clear from case law that the immediate recovery of an exit tax goes beyond what is necessary to ensure the coherence of the national tax system.[1] Since the Danish rules required an immediate recovery of the exit tax, the rules were found to be disproportionate.[2]

The conclusion of the ECJ in *Commission v Denmark C-261/11* is not surprising in the light of previous case law. However, the ECJ did add a new vital element to case law in relation to the proportionality of exit tax regimes. This will be addressed below.

Exit Taxation And Proportionality

It is clear from case law that an exit tax does constitute an infringement of the freedom of establishment in art. 49 TFEU and art. 31 of the EEA Agreement. This was also addressed in *Commission v Denmark* 261/11 in which the ECJ explicitly stated that the freedom of establishment applies to movements of a company's activities from one Member State to another Member State, irrespective of whether the relevant company transfers its registered office and its place of effective management, or whether it transfers assets from a permanent establishment in the Member State to another Member State.[3] However, it is also clear from case law that an exit tax can be justified in ensuring the balanced allocation of powers of taxation between Member States in accordance with the principle of territoriality linked to a temporal component, since the Member State is merely exercising its power of taxation in relation to gains generated in its territory.[4]

The main issue in relation an exit tax regime is that it must not go beyond what is necessary to attain the objective it pursues, *i.e.* it must be proportionate. In order to assess whether an exit tax regime is proportionate, a distinction must be drawn between the establishment of the amount of exit tax and the recovery of the exit tax. It is proportionate to establish the amount at the time of exit and disregard changes in value after the exit.[5] It is, however, disproportionate to always recover the exit tax at the time of exit. Instead, it is proportionate if national legislation offers a company the choice between: (i) the immediate payment of the exit tax, which creates a disadvantage for that company in terms of cash flow, but frees it from administrative burdens, and (ii) the deferral of the payment of the exit tax, which necessarily involves an administrative burden for the company in connection with tracing the assets.[6] A company must therefore be able to defer the payment of the established exit tax for the exit tax regime to be proportionate.

However, it is not clear under which conditions such a deferral must be granted. Case law does not give any clear guidelines in regards to the period of deferral. Further, it is unclear to what extend interests can be levied on the deferred exit tax.

The Length Of Deferral

The purpose of the deferral is to avoid cash flow problems for the taxpayer by the immediate recovery of the exit tax.[7] The recovery of the tax at the time of the disposal of the asset as defined in national legislation is proportionate and must be the starting point and main rule.[8] However, exceptions do apply as it was addressed in *Commission v Denmark* 261/11.

In *Commission v Denmark* C-261/11, Denmark argued that the conclusions from *National Grid Indus* C-371/10 were limited to assets that would eventually be disposed of. Such a narrow interpretation was clearly rejected by the ECJ.[9] However, the ECJ stated that the fact that the assets are not disposed of does not preclude the Member State from recovering the tax.[10] The ECJ stated in Para. 37 that:

"The Member states, which are entitled to levy tax on the capital gains arisen while the assets in question were located within their territory, are thus entitled to provide an alternative criterion for the taxation than the actual disposal in order to ensure the taxation of assets, which are not intended to be disposed of, which is less restrictive of the freedom of establishment than the taxation at the time of the transfer."[11]

The ECJ clearly states that the conclusions from *National Grid Indus* C-371/10 apply to all assets, while Member States are entitled to provide an alternative criterion than the actual disposal of the asset, but only in relation to assets which are not intended to be disposed of.[12] Therefore, the predominant rule is that a deferral must be offered for all assets until the disposal of the asset. Only in relation to assets which are not intended to be disposed of are Member States entitled to provide an alternative criterion – not in relation to all assets. The ECJ did not in *Commission v Denmark* C-261/11 give any examples or details in relation to proportionate alternative criteria, which can limit the period of deferral for exit taxes on assets not intended to be disposed of.

A common measure in many countries is a time-limited length of deferral and/or annual installments. Such rules are in effect or proposed in Denmark, France, the Netherlands, Portugal, Sweden and the United Kingdom.[13] Whether the recovery of the exit tax in annual installments is proportionate must, on the basis of *Commission v Denmark* C-261/11, be evaluated on three considerations:

(1) Cash flow problems for the taxpayer
(2) Ensuring the Members States' actual taxation of the asset
(3) Be less restrictive than the immediate payment

The balancing of the considerations is the key issue. Annual installments will ensure the actual taxation of assets and are less restrictive than the immediate payment of the exit tax. Further, annual installments involve little or no administrative burdens and ensure certainty for both the taxpayer and the Member State, since a clear payment schedule is applied. However, the main outstanding issue is whether such a measure can take the taxpayer's cash flow problems sufficiently into account, *i.e.* are proportionate. Can a Member State just in general assume that cash flow is generated annually or can a Member State more specifically assume that cash flow is generated on the basis of the lifespan of the asset? This seems questionable.

The Commission repealed an infringement procedure against Sweden, after Sweden amended the exit tax regime in 2010. Under the new Swedish regime, a company can apply for a one-year deferral, which can be renewed until the disposal of the assets. However, exit taxes on machinery and equipment, hereunder intangible assets, must be paid annually up to a maximum of 5 or 10 years.[14] Accordingly, the Commission might find such measures proportionate, since the Commission repealed the infringement procedure against Sweden. The position of the ECJ is unknown but will hopefully be clarified in the pending case C-164/12. The ECJ has been asked by Finanzgericht Hamburg whether a national provision is compatible with the freedom of establishment, if the taxpayer is entitled to apply for a deferral of the tax with the effect that the tax is to be paid in annual installments.

Another measure, which is used in Denmark, is to recover the exit tax as the asset generates income. This applies to exit taxes on shares for individuals and is proposed to also apply for companies. Whether a recovery of the exit tax based on income generated by the asset is proportionate must also be evaluated on three considerations:

(1) Cash flow problems for the taxpayer
(2) Ensuring the Members States' actual taxation of the asset
(3) Be less restrictive than the immediate payment

Such a measure ensures the Member State's ability to actual tax an asset, which is not intended to be disposed of, and is less restrictive than the immediate payment of the exit tax in relation to cash flow problems for the taxpayer. However, the question is if the measure actually does take cash problems of the taxpayer sufficiently into account, when using revenue and not the company's net profit as the trigger point for the recovery of the exit tax. Revenue and other income from the asset is not a guarantee for a free cash flow in the company, since the company might have operating costs and other expenses exceeding the income from the assets. Further, such a measure increases the administrative burden in monitoring and assessing the income generated by the assets. It therefore seems questionable whether such a measure goes beyond what is necessary.

The Commission has delivered a reasoned opinion to the Danish Government, which indicates that the Commission does not consider the deferral of the exit taxes on individuals compatible with the freedom of establishment. However, it is unknown which part of the regime the Commission considers not to be compatible with the freedom of establishment. The position of the ECJ is unknown, but given the reasoned opinion from the Commission to Denmark regarding the deferral of exit taxes on individuals and that Denmark do not seem to agree with the Commission, it must be expected that the ECJ will have the opportunity to clarify the matter.

Interest Levied On Deferred Exit Taxes

Case law states that it is proportionate for national legislation to offer a choice between: (i) the immediate payment of the exit tax and (ii) the deferral of the payment of the exit tax, possibly together with interest in accordance with the applicable national legislation.[15] It should be noted that the issue of interest on deferred exit taxes is addressed by the ECJ in assessing whether the exit tax regime is proportionate. This means that it is not an assessment of whether or not interest is levied on other deferred taxes, but whether the exit tax regime goes beyond what is necessary to ensure the preservation of the allocation of powers of taxation between the Member States.[16]

Interest is usually paid by a borrower to the lender as compensation for the use of the asset, *e.g.* money. The interest is generally based on two elements: a risk-free interest rate to compensate the lender for forgone investments (opportunity costs) and a risk premium for the risk of non-recovery (credit risk).

The risk-free interest compensates the Member State for the lack of disposal of the money (tax) and the missed earnings thereof in the lending period and on the other hand offset the cash flow advantage the taxpayer would otherwise enjoy by postponing the payment of the tax. However, the Member State does not have opportunity costs and the taxpayer does not have a cash flow advantage – on the contrary. The deferral of the exit tax is exactly to offset the lack of neutrality (disadvantage) in exit situations within the EU. Further, levying interest on deferred exit taxes does not affect the amount of tax to be established or the allocation of powers of taxation. It is therefore hard to see the necessity of this type of interest.[17]

The risk premium element of interest relates to the risk of non-recovery (credit risk). A deferral of a tax will always involve a risk of non-recovery for the Member State and depends on the taxpayer's creditworthiness (risk of default) and guarantees. The risk of non-recovery has been approved by the ECJ to be taken into account by Member States in relation to deferred exit taxes and guarantee provisions.[18] It could be argued that this part of an interest charge is exactly what the ECJ refers to in case law.

A similar breakdown of an interest charge is found in *Communication from the Commission on the revision of the method for setting the reference and discount rates* (2008/C 14/02) in which the interest is to restore the situation before unlawful state aid was granted. The interest consists of a base rate and a margin. The margin is used as a simplified criteria taking into account firms' creditworthiness and is calculated as follows:

Loan margins in basis points

Rating category	Collateralization		
	High	Normal	Low
Strong (AAA-A)	60	75	100
Good (BBB)	75	100	220
Satisfactory (BB)	100	220	400
Weak (B)	220	400	650
Bad/Financial difficulties (CCC and below)	400	650	1,000 [(a)]

[(a)] Subject to the application of the specific provisions for rescue and restructuring aid, as currently laid down in the Community guidelines on State aid for rescuing and restructuring firms in difficulty (OJ C 244, 1.10.2004, p. 2) and in particular point 25(a), which refers to "a rate at least comparable with the rates observed for loans to healthy companies, and in particular at the reference rates adopted by the Commission." Hence, for rescue aid cases, the 1-year IBOR increased by at least 100 basis points shall be applied.

An interest charge on exit taxes is to restore a situation without a deferral, but as argued in this article, to take the risk of non-recovery into account. The margin used in calculating the interest in unlawful state aid situations therefore seems a proportionate interest to be used on exit taxes, since it does take the risk of non-recovery into account in relation to both the creditworthiness of the debtor and collateral.

In conclusion, interest on deferred exit taxes must include an assessment of the risk of non-recovery to be proportionate and cannot be randomly set or include compensation to the Member State for opportunity costs. Otherwise the levied interest could create a situation for the taxpayer and the tax authorities, as if the exit tax had been paid immediately and thereby neutralize the deferral and bringing back the status quo.[19] Furthermore, a deferral with such an interest charge would actually put the taxpayer in an even worse situation, since the deferral also involves administrative burdens.

Exit Taxation In Denmark After *Commission v Denmark* C-261/11

The Minister of Tax has, due to *Commission v Denmark* C-261/11, presented a legislative proposal, which, if enacted, would provide companies the option to defer the payment of the exit tax within the EU and EEA. However, the deferral is subject to conditions.

The company must, in due time, file tax returns in the year of migration and the following years in which the deferral is maintained. Alongside the tax returns, the company must notify the tax authority of the decision to defer the payment and further about the location (country) of the assets on which the exit tax was levied on.

Case law states that it is proportionate for national legislation to offer a company the choice between the immediate payment of the amount of tax, which creates a disadvantage for that company in terms of cash flow, but frees it from administrative burdens, and the deferral of the payment of the exit tax, which necessarily involves an administrative burden for the company in connection with tracing the assets.[20] It therefore seems proportionate to require notification of the exit alongside the tax return as in the Danish proposal as well as to require a yearly notification of the location of the assets.

Further, the deferral is limited to a maximum of 7 years and the exit tax must be paid in annual installments. Every year at least 1/7 of the established amount of exit tax must be paid, but can be even higher, if the tax value of income from the assets exceeds 1/7 of the established exit tax.

Case law states that, as a main rule, the deferral must be granted until the disposal of the asset. However, in *Commission v Denmark* C-261/11 the ECJ approved the use of an alternative criterion, but only in relation to assets not intended to be disposed of. The Danish proposal does not contain such a distinction. In relation to assets intended to be disposed of, both the maximum 7 year deferral with annual payment and the recovery as income is generated certainly seems disproportionate. In relation to assets not intended to be disposed of, it is not clear whether the 7 year deferral with annual payments and the recovery as income is generated constitute proportionate measures. Hopefully, it will be clarified in relation to a time limited deferral with annual payment by the ECJ in the pending case C-164/12 and also in relation to recovery as income is generated if the Commission initiates an infringement procedure against Denmark.

Lastly, an annual interest charge is levied on the deferred exit tax. The interest is calculated on the basis of the Danish Nationalbank's discount rate plus 1 percentage point, but in total at least 3 percent. As argued in this article, an interest charge can be levied, but in this author's opinion only to the extent that the interest is related to the risk of non-recovery and not to offset the cash flow "advantage" of the taxpayer or to compensate the Member State for the lack of disposal of the money (tax). The proposed Danish interest charge is based on the Danish Nationalbank's discount rate. The discount rate is not an actual rate of return for banks or any others, but most Danish banks adjust their interest rates in accordance with changes in the discount rate. The discount rate is therefore only a "signal" rate.[21] Since the discount rate and the added 1 percentage point seems unrelated to the risk of non-recovery and rather randomly selected, the interest charge laid down in the Danish proposal seems disproportionate. There is no or little connection to a general or specific assessment of the risk of non-recovery.

The purpose of the Danish proposal is to make the Danish exit tax regime compatible with art. 49

TFEU by enacting a proportionate deferral of the payment of the exit tax. In this author's opinion, the proposal does not succeed.

Endnotes

1 *See* Para. 32.

2 *See* Para. 40.

3 *See Commission v Denmark* C-261/11 Para. 28. The legal existence of the company is of course a prerequisite for the application of the freedom of establishment.

4 *National Grid Indus* C-371/10 Para. 45-47, *Commission v Portugal* C-38/10 Para. 31, *Commission v Spain* C-64/11 Para. 31, *Commission v Denmark* C-261/11 Para. 32 and *Arcade Drilling* E-15/11, Para. 93.

5 *National Grid Indus* C-371/10 Para. 86, *Commission v the Netherlands* C-301/11 Para. 16, *Commission v Spain* C-64/11 Para. 31, *Commission v Denmark* C-261/11 Para. 32 and *Arcade Drilling* E-15/11, Para. 93

6 *National Grid Indus* C-371/10 Para. 86, *Commission v the Netherlands* C-301/11 Para. 16, *Commission v Portugal* C-38/10 Para. 32 and *Arcade Drilling* E-15/11, Para. 99-105.

7 *See National Grid Indus* C-371/10, Para. 68.

8 *National Grid Indus* C-371/10 Para. 86, *Commission v the Netherlands* C-301/11 Para. 16, *Commission v Portugal* C-38/10 Para. 32 and *Arcade Drilling* E-15/11, Para. 99-105.

9 *See* Para. 35.

10 *See* Para. 36.

11 Author's own translation of the Danish and French version.

12 *See* Para. 35-37.

13 The Netherlands also offers the option to defer the payment until the disposal of the asset, while the UK for some assets offers a deferral of up to 10 years. See Uceda and Dechsakulthorn, *Key Changes in EU Member State Exit Tax Regimes*, Global Tax Weekly Issue 35 2013, p. 6.

14 *See* Világi, *Exit Taxes on Various Types of Corporate Reorganizations in Light of EU Law,* European Taxation (Vol. 52) no. 7 2012, p. 352.

15 *National Grid Indus* C-371/10 Para. 73 and *Arcade Drilling* E-15/11 Para. 103.

16 *See* Thömmes and Linn*, Deferment of Exit Taxes after National Grid Indus: Is the Requirement to Provide a Bank Guarantee and the Charge of Interest Proportionate?*, Intertax, Volume 40, Issue 8/9 2012, p. 490. *See other position* Kok, *Exit Taxes for Companies in the European Union after National Grid Indus*, EC Tax Review 2012-4, p. 204 and van den Broek and Meussen, *National Grid Indus Case: Re-Thinking Exit Taxation,* European Taxation (Vol. 52) no. 4 2012, p. 195.

17 *See also* Thömmes and Linn*, Deferment of Exit Taxes after National Grid Indus: Is the Requirement to Provide a Bank Guarantee and the Charge of Interest Proportionate?*, Intertax, Volume 40, Issue 8/9 2012, p. 490.

18 *See National Grid Indus* C-371/10 Para 74, *Commission v Portugal* C-38/10 Para. 32 and *Arcade Drilling* E-15/11 Para. 105.

19 *See* Thömmes and Linn*, Deferment of Exit Taxes after National Grid Indus: Is the Requirement to Provide a Bank Guarantee and the Charge of Interest Proportionate?*, Intertax, Volume 40, Issue 8/9 2012, p. 490.

20 *National Grid Indus* C-371/10 Para. 86, *Commission v the Netherlands* C-301/11 Para. 16, *Commission v Portugal* C-38/10 Para. 32 and *Arcade Drilling* E-15/11, Para. 99-105.

21 *See* publication from the Danish Nationalbank, *Pengepolitik i Danmark,* 3rd edition (2009), pp. 22-23.