CJEU endorses former German exit tax rule spreading capital gains in transferred assets over 10 years under freedom of establishment

Executive summary

On 21 May 2015, the Court of Justice of the European Union (CJEU) rendered its decision in case C-657/13, Verder LabTec, upholding the former German practice to distribute the capital gains from a deemed realization of built-in-gains upon an “exit” of an asset over 10 years. According to the Court such taxation of capital gains in installments is in line with the “freedom of establishment” under Article 49 of the Treaty on the Functioning of the European Union (TFEU).

Detailed discussion

Facts

The case at hand concerns German tax rules establishing tax liability upon the loss of its taxing right caused by the transfer of an asset to a foreign permanent establishment. In the respective year the taxpayer was allowed, according to a longstanding administrative practice, to establish a compensatory item in its tax balance sheet neutralizing that profit. That item was, in the case of depreciable capital goods, to be written down proportionately over the remaining period of the asset’s useful life, or at the latest incorporated in profits 10 years after the transfer of the asset to abroad. These rules specifically apply when assets belonging to business property are transferred from a permanent establishment belonging to a German undertaking to its permanent establishment abroad. Verder LabTec, a limited partnership under German law, by contract transferred in 2005 various intellectual property rights from its permanent establishment in Germany, to its...
permanent establishment in the Netherlands. The tax authorities treated this event as a realization of the hidden reserves of the transferred assets and applied administrative practice and increased the tax base by 1/10 of the built-in-gains.

**CJEU reasoning**
The CJEU held that the exit tax rules did in fact establish a less beneficial treatment of a cross-border transfer of the IP as compared to a domestic transfer. The Court held, however, that this differential treatment could be justified as it was a measure to attain the objective of preserving the allocation of taxation powers between Member States. According to the Court, Member States may, in attempting to eliminate the discriminatory effects of (immediate) exit taxation, take into account the risk of non-recovery of the tax, which increases with the passage of time and therefore are allowed to distribute capital gains over a specific period of time resulting in levying the exit tax in installments. In the given case, the 10 year period was observed to be proportionate, particularly in light of the reasoning in the DMC decision, where the Court upheld a (former) rule providing for a five-year period in reorganization tax cases.¹

**Impact**
Although the administrative practice of spreading the profit from the deemed realization of the built-in-gains over 10 years was replaced in 2006 by a formal law shortening this period to only five years, the reasoning of the Court is still relevant. The Court endorsed the method that Germany applies to safeguard its taxing right in case of the transfer of an asset to a foreign permanent establishment, within the EU resulting in a loss of the German taxation right. It seems to follow that the Court’s reference to its decision in the DMC case (where the Court accepted a rule applying only in specific reorganization cases the taxation of built-in-gains over 5 years) means the Court would not challenge Germany’s current general approach to apply a five year period.

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**Endnote**

1. CJEU, C-164/12, see EY Global Tax Alert, *New CJEU decision does not fully provide clarity on exit taxation*, dated 30 January 2014.
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