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Taxation of deferred capital gains of company shares in case of transfer of residence of a natural person from a Member State to Switzerland – Martin Wächtler / Tax Office Konstanz

Judgement of the European Court of Justice, 26 February 2019 (Case C581/17)

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Anotácia

Európsky súdny dvor (ESD) vo svojom rozhodnutí z 26. februára 2019, Wuerttemberg (Finanzgericht Baden-Württemberg), rozhodol, že nemecké nariadenia o zdaňovaní pri odchode vo vzťahu k Švajčiarsku porušujú Dohodu o voľnom pohybe osôb medzi Švajčiarskom a EÚ. Nasledujúci článok skúma, čo presne toto rozhodnutie znamená a aké účinky a požiadavky na zmenu vyvoláva.

Annotation

In its ruling of 26th February 2019 (Case C-581/17) on the German taxation of company shares in the event of the transfer of residence of a natural person in the preliminary ruling procedure requested by the German Finance Court of Baden-Wuerttemberg (*Finanzgericht Baden-Württemberg)*, the European Court of Justice (ECJ) ruled that the German regulations of the Exit Taxation in relation to Switzerland violates the Agreement of the free Movement of Persons between Switzerland and the EU. The following article will examine what exactly this ruling means and what effects and reform requirements it causes.

Kľúčové slová

Dohoda o voľnom pohybe osôb, sloboda usadiť sa, zdaňovanie pri odchode, Nemecko, Švajčiarsko

Key Words

Agreement of the free Movement of Persons, Freedom of Establishment, Exit Taxation, Germany, Switzerland

Introduction

On 26 February 2019, the European Court of Justice (ECJ) ruled in the case *Wächtler* that the German exit tax in its current form in relation to Switzerland violates the Agreement on the Free Movement of Persons between Switzerland and the EU.[1] This means in particular that an unlimited, interest-free deferral must also be granted in relation to Switzerland. However, the ECJ allows the German tax authorities to make this deferral dependent on the provision of a security (such as a bank guarantee), in contrast to the EU/EEA situation (see § 6 para. 5 sentence 1 German Foreign Tax Act, *AStG*). This applies in any case to those taxpayers who settle in Switzerland in order to carry out self-employment there.

I. Legal situation under national law

According to current German national tax law, pursuant to section 6, para. 1, sentence 1 of the German Foreign Tax Act (*AStG*), a natural person who has been subject to unlimited tax liability for a total of at least ten years pursuant to section 1, para. 1, sentence 1 of the German Income Tax Law (*EStG*) is taxed in accordance with section 17 of the German Income Tax Law (*EstG*) in the event of a departure. In accordance with section 17 of the German Income Tax Law (*EstG*), the capital gain is taxed when shares in corporations are sold. In the case of the cessation of domicile or habitual residence, the sale of shares in corporations is therefore faked and the hidden reserves are taxed. This results in the creation of a – often considerable – tax burden without the taxpayer simultaneously receiving a corresponding liquidity to settle the tax claim. The tax authorities thus draw on the taxpayer's assets instead of simply skimming off any potential capacity to pay. This can also involve shares in a foreign company if the latter corresponds to a German corporation.[2]

According to section 17, para. 2, sentence 1 of the German Income Tax Law (*EStG),* capital gain is the difference between the selling price and the acquisition costs. In the absence of a sale, the sale price is replaced by the fair market value of the shares at the time of termination of the unlimited income tax liability pursuant to section 6, para. 1, sentence 4 of the German Foreign Tax Act (*AStG*). In addition, the partial income procedure in accordance with section 3 no. 40 c), 3c para. 2 of the German Income Tax Law (*EStG*) must be applied, i.e. only 60% of the profit is taxable. It is clear from section 6 of the German Foreign Tax Act (*AStG*) that only the increase in assets, i.e. a profit, can be realized. The realization of any loss is therefore excluded.[3]

In its ruling of 11 March 2004 in the „*Hughes de Lasteyrie du Saillant*" case, the European Court of Justice declared the exit tax regulated in French foreign tax law to be incompatible with the freedom of establishment under Article 49 TFEU. As a result, section 6 of the German Foreign Tax Act (*AStG*) was revised by the German legislation for fiscal measures of 7 December 2006.[4]

According to section 6, para. 5, sentence 1 of the German Foreign Tax Act (*AStG*), the tax owed is to be deferred without interest and without security deposit if the taxpayer is a citizen of an EU or EEA member state, moves to an EU or EEA state and is subject to a tax liability comparable to the German unlimited income tax liability there. A further prerequisite under section 6, para. 5, sentence 2 of the German Foreign Tax Act (*AStG*) is that administrative assistance and mutual support in the collection of the tax owed is guaranteed between the Federal Republic of Germany and the country of residence. The deferral is to be granted ex officio and without limitation until the actual sale of the company shares. However, the deferral is to be revoked upon the realization of certain circumstances, which are regulated in section 6, para. 5, sentence 4 of the German Foreign Tax Act (*AStG*). In addition, the taxpayer must comply with certain proof/notification obligations pursuant to section 6, para. 7 of the German Foreign Tax Act (*AStG*).[5]

Switzerland is not an EU/EEA state, so the deferral option was only permissible under the conditions of section 6, para. 4 of the German Foreign Tax Act (*AStG*). Up to now, deferral has only been permitted upon application, for a maximum period of five years from the first due date and against provision of security and only if their prompt collection was associated with considerable hardship for the taxpayer. Interest is also charged.

Facts of the Case

In its decision of 26 February 2019 in the *Wächtler* case, the ECJ dealt with this national regulation. The plaintiff, a German citizen, had been a partner and managing director (50 % shareholding) of a corporation based in Switzerland since 2007 and provided IT consulting services for this company. In 2011, the plaintiff moved his residence from Germany to Switzerland. As a result, the responsible tax office subjected the increases in value of his investment to German income tax in accordance with section 6, para. 1, sentence 1 of the German Foreign Tax Act (*AStG*). The tax office refused the (unlimited) tax deferral requested by the plaintiff pursuant to section 6, para. 5 of the German Foreign Tax Act (*AStG*), pointing out that this was only possible if the plaintiff moved to an EU/EEA Member State.[6]

The action brought against this decision was suspended by the competent Finance Court of Baden-Württemberg and the ECJ was asked to decide, pursuant to Art. 267 TFEU, whether the so-called Agreement on the Free Movement of Persons (FMPA) with Switzerland requires an unlimited tax deferral of the German exit tax.[7]

II. Judgement of the Court

The ECJ ruled that the FMPA precludes the taxation of a taxpayer who moves to Switzerland to work there from being taxed without the possibility of deferral.

A German citizen who is self-employed in Switzerland can, as a „self-employed person“ within the meaning of the FMPA, rely on its protection. The material scope of application was open in the case of a dispute because the plaintiff had established himself in Switzerland for the purpose of exercising his self-employed activity (Article 12, para. 1 of the Annex to the FMPA). He could invoke the principle of equal treatment vis-à-vis his country of origin. He argued that exit taxation in the case of a transfer of residence to Switzerland constituted unequal treatment compared with the purely domestic case, since the tax under section 17 of the Income Tax Act was only levied there at the time of the actual realization of the hidden reserves in the units. If the person moving away had to pay immediately, he or she would suffer a direct liquidity disadvantage compared with shareholders remaining in Germany. The FMPA's right of establishment was thus violated.[8]

Nevertheless, such unequal treatment under Art. 21, para. 3 FMPA could be justified on grounds of the public interest or for the purpose of allocating taxing powers if they appear appropriate and proportionate.[9] A tax assessment at the time of the transfer of residence may be appropriate to achieve the objective of preserving the division of taxing powers.

However, that objective does not justify the fact that a deferral of tax is impossible, since Germany does not waive its tax claims even in the case of a deferral.[10]

Nor does the objective of effective tax control justify the lack of a deferral option, as the exchange of tax information is guaranteed under the DTA-Switzerland.[11] Finally, the immediate collection of tax, even with reference to the objective of avoiding a reduction in tax revenue, was disproportionate, since, also in view of Switzerland's lack of recovery assistance, a demand for securities accompanying the deferral would constitute a milder means.

Against this background, the failure to grant a deferral of the exit tax in the event of a move to Switzerland would constitute an unjustified restriction of the right of establishment guaranteed by the FMPA and thus an undue hardship for the taxpayer. This finding applies notwithstanding the possibility of paying the tax in instalments as provided for under section 6, para. 4 of the German Foreign Tax Act (*AStG*), since this would not eliminate the liquidity disadvantage of the person moving away. As a result, the taxpayer must therefore be granted a permanent and interest-free deferral of the exit tax.[12]

III. Letter of the German Ministry of Finance

On 13 November 2019, the Federal Ministry of Finance issued a letter[13] in which it positioned itself on the implementation of the ECJ's ruling in the case *Wächtler.* The ECJ had ruled that people moving from Germany to Switzerland must be treated in the same way as people who are moving to the EU/EEA area if they fall within the scope of the EU-Swiss Agreement on the Free Movement of Persons.

However, the tax authorities do not fully implement this equal treatment: Within the scope of application of the Agreement on the Free Movement of Persons, a deferral of the exit tax on the basis of Section 6 para 4 sentence 1 of the German Foreign Tax Act (*AStG*) is to be granted as follows:

- The deferral shall be made in five equal annual instalments.
- Deferral interest (6 % p.a.) is payable.
- A considerable hardship in case of immediate collection is not important.
- The deferral is carried out without the provision of security, unless the tax claim appears to be at risk.

The administrative regulation does not adequately implement the requirements of the ECJ. According to this, moving to Switzerland must be treated in the same way as moving to an EU/EEA country. This is because the Free Trade Agreement between the EU and Switzerland also guarantees the taxpayer freedom of establishment. In this respect, it would have been expected that the tax authorities would also allow unlimited and interest-free deferral of exit taxation in the event of a move to Switzerland (Section 6 para. 5 of the German Foreign Tax Act, *AStG*).[14]

IV. Draft of Implementation Act (*ATADUmsG*)

The draft of an implementation act regarding the anti tax avoidance in Germany („*ATADUmsG*") provides for a comprehensive reform of exit taxation. In particular, the required duration of the unlimited tax liability is to be reduced from currently ten years to seven years, while at the same time the relevant period of consideration is to be limited to twelve years. At the same time, the Federal Ministry of Finance also intends to make changes in other areas..[15]

In particular, the abolition of the deferral provisions of Section 6 of the German Foreign Tax Act (*AStG*), as provided for in the draft, is to be regarded as recognizable in the light of the *Wächtler* case law. Accordingly, section 6, para. 5 of the German Foreign Tax Act (*AStG*), and thus the unlimited and interest-free deferral without security deposit is to be completely abolished. Instead, section 6 para. 4 of the implementation of the new German Foreign Tax Act (*AStG-E*) newly regulates that an interest-free deferral in linear instalments over seven years is to be possible upon application, which, according to the wording, „as a rule“ requires a security deposit.[16]

A distinction between the EU and third countries is no longer made. Instead of accommodating the taxpayer as a result of the „*Wächtler*“ decision and improving the situation of default in third countries, the previous EU regulation is abolished and corresponding transfers of residence are reduced to the rank of cases of withdrawal to third countries. The abolition of the deferral option now leads to precisely the liquidity disadvantage that the ECJ criticised in the *Wächtler* ruling..[17]

Conclusion

As a result of the ECJ decision, it is now clear that an exit tax pursuant to section 6 of the German Foreign Tax Act (*AStG*) must also be deferred interest-free and for an unlimited period of time in relation to Switzerland by analogous application of section 6 para. 5 of the German Foreign Tax Act (*AStG*). However, this is subject to the applicability of the Agreement on the Free Movement of Persons, which requires gainful employment (employee, self-employed person or cross-border commuter). The European Court of Justice considers a temporary tax deferral under section 6, para. 4 of the German Foreign Tax Act (*AStG*) to be disproportionate, thereby expressing that a changeover to a temporary tax deferral under section 6, para. 5 of the German Foreign Tax Act (*AStG*) is not compatible with Union law.

However, in the absence of mutual assistance in the context of tax collection, the tax authorities may require a security to be provided in relation to Switzerland.

It will be exciting to see how the legislator reacts. At first glance, there appear to be various options:

- It is conceivable that Switzerland could be included in the existing regulation for EU/EEA matters (section 6, para. 5 of the German Foreign Tax Act, *AStG*). In this way, the legislator would go beyond the requirements of the ECJ, as in these cases deferral is granted without the provision of security.
- The creation of a separate deferral regime for Switzerland (unlimited and interest-free, but with security) is still conceivable.
- Finally, the legislator could even extend the deferral regime required by the ECJ to all third country cases. While this would appear desirable from a tax point of view, since the German tax base would thus remain protected (security line!), it would not make it unnecessarily difficult to move away. However, for this to happen, the legislator would have to jump over its shadow and accept certain fiscal disadvantages – namely the fact that the tax would not be levied until later.

Consequences

With the judgment in the *Picart*[18] case, the ECJ has laid a foundation for the interpretation and applicability of the Agreement on the Free Movement of Persons between the Member States of the European Union and Switzerland of 21 June 1999 with regard to the intervention of a Member State's exit tax arrangements. The *Wächtler* ruling is a further decision in this context, which also refers to the German provision of section 6 of the German Foreign Tax Act (*AStG*). The ECJ is thus extending its line of case law on the admissibility under Union law of exit taxation of natural persons, which it began with the rulings in the *Lasteyrie du Saillant*[19] and *N*[20] cases.

Although the present ruling is in principle very welcome from the point of view of the taxpayer, it must be noted that it is probably only applicable to certain tax cases and immediate taxation under section 6 of the German Foreign Tax Act (*AStG*) does not always violate the provisions of the Agreement on the Free Movement of Persons. Furthermore, even after the present ruling in the case *Wächtler*, there are still a number of unanswered questions regarding the interaction between the provisions of the Agreement on the Free Movement of Persons, Union law and the national law of the Member States, which probably also require interpretation by the ECJ.

The interest-free and unlimited deferment of payment can therefore probably only be achieved by legal action if the person concerned moves to Switzerland. This does not seem hopeless. It is true that out-of-court appeal proceedings will remain unsuccessful. On the other hand, the fiscal courts will take a close look at the case law of the European Court of Justice.

The letter from the Federal Ministry of Finance is expressly issued „pending a legal amendment", so it is probably only intended as a transitional arrangement. The decree thus reinforces the fear that the tax authorities are seeking a change in the law in order to abolish the unlimited and interest-free deferral of the exit tax even in the case of moves to other EU/EEA countries in favor of a deferred payment of the exit tax.

It remains to be seen whether the legislator will go down this path within the framework of the reform of the German Foreign Tax Act (*AStG*) already under discussion. It cannot be ruled out that the legislator could introduce a retroactive regulation. However, it seems doubtful whether such a regulation could also apply to moves that have already been implemented prior to a public announcement of a corresponding change in the law (e.g. by cabinet resolution).

For taxpayers who are currently planning to move to Switzerland, but also to EU/EEA countries, there will probably be a need for action in any case.

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