Euro Tax Flash from KPMG's EU Tax Centre

Advocate General's Opinion in the *A OY* case

Freedom of establishment - Merger Directive – Transfer of a foreign permanent establishment – Immediate taxation – Unrealized gains – Assessment of secondary law with regards to primary law

On July 12, 2017 Advocate General (AG) Kokott of the Court of Justice of the European Union (CJEU) issued her opinion in the *A Oy* case (C-292/16). The case concerned the immediate taxation in Finland of the unrealized gains of a permanent establishment upon its transfer to a company, both being located in another Member State than Finland, by virtue of domestic legislation implementing the Merger Directive, whereas taxation would be deferred if a Finnish permanent establishment is transferred to a domestic company.

In the AG's view, the Finnish legislation is contrary to the freedom of establishment.

Background

Article 10 of the EU Merger Directive, provides for various types of tax relief, including on the transfer of a permanent establishment situated in another Member State. Under Article 10(2) of the Directive, if the Member State of the transferring company applies a system of taxing worldwide profits, that state may tax any profits or capital gains of the permanent establishment resulting from the transfer. This derogation is intended to account for the fact that, as a result of the transfer, the permanent establishment will be owned by the receiving company and therefore the Member State of the transferring company will lose the right to directly tax the assets of that permanent establishment in the future. However, that state is required to give relief for the tax that would have been charged in the absence of the Merger Directive on those profits or capital gains in the

Member State of the permanent establishment.

The *A Oy* case concerns a Finnish company that transferred its Austrian permanent establishment to an Austrian company in exchange for shares in the latter. Such transfers of assets are subject to immediate taxation in Finland, whereas the transfer of a domestic permanent establishment to a Finnish company is not taxed until realization. However, in the case of a foreign permanent establishment, the Finnish transferring company is entitled to a deemed foreign credit tax corresponding to the amount of tax that would have been due in the Member State of the permanent establishment, but for the provisions of the Merger Directive.

The CJEU is being asked whether the Finnish rules that allow deferred taxation only in a domestic scenario are compatible with the freedom of establishment. In the event of incompatibility, the Court is further asked whether the restriction can be justified and, if so, whether the disputed legislation complies with the principle of proportionality.

The AG's opinion

On the question whether the implementation of a directive can be reviewed under the freedom of establishment, the AG referred to existing CJEU case law, and noted that even exhaustive harmonization measures must be interpreted in conformity with primary EU law, i.e. the fundamental freedoms. Furthermore, the AG pointed out that the Merger Directive does not bring about such exhaustive harmonization, as Article 10(2) of that directive confers on the Member State of the transferring company only a right of taxation and not an obligation to tax, while not specifying the timing and amount of such tax. The national legislator is required to exercise that right and the resulting choices in light of the fundamental freedoms.

As regards the applicable freedom and whether this was restricted, the AG also noted that the freedom of establishment not only protects the setting up of a permanent establishment (PE), but also the cessation of its activity such as through the transfer to a company located in a Member State other than that of the transferring company. By taxing the unrealized gains of a foreign permanent establishment transferred to a non-resident company, while allowing for a deferral in the national case, the disputed Finnish legislation generates a cash-flow disadvantage in the first case and therefore makes it less attractive for domestic companies to set up permanent establishments in another Member State and also to transfer a foreign permanent establishment to a non-resident company, as opposed to the transfer of a domestic permanent establishment to a domestic recipient.

While recognizing that Finland will have the right to tax future gains from the disposal of the shares received in exchange for the permanent establishment, i.e. an indirect right to tax future PE hidden reserves, the AG concluded that this is not equivalent to having the right to directly tax the assets of the PE. The Member State therefore has a legitimate interest in the final taxation of unrealized gains of the PE.

As regards compliance with the principle of proportionality, the AG noted – by analogy with previous CJEU decisions in the area of exit taxation – that taxpayers should be given the option of paying the tax due over a period of several years. By not allowing for this possibility, the disputed Finnish legislation goes beyond what is necessary to achieve the objective pursued and is therefore disproportionate. The AG dismissed the argument put forward by the Swedish and Finnish governments according to which the transfer of a foreign PE is not an exit situation, but rather a sale whereby hidden reserves are realized and should therefore become taxable. Furthermore, the offsetting of a deemed foreign tax credit does not have the effect of reducing the inequality of treatment between the cross-border situation and the domestic situation, but simply prevents the double taxation of those unrealized gains.

The AG therefore concluded that the freedom of establishment precludes a national provision such as the disputed Finnish provision introduced to transpose Article 10(2) of the Merger Directive, which provides for immediate taxation in the state of the transferring company where the permanent establishment transferred and the receiving company are situated in a different Member State, whereas such taxation does not apply in a similar domestic case.

EU Tax Centre comment

The AG's opinion is in line with previous CJEU decisions in cases dealing with exit taxation, i.e. that taxpayers should be given the right to deferred taxation over a period of several years. The AG also reinforces the principle that the provisions of secondary EU law, such as the EU Merger Directive – and national legislation implementing such provisions, must be interpreted in light of primary EU law – more specifically, the fundamental freedoms.

Should you have any questions, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

Robert van der Jagt
Chairman, KPMG's EU Tax Centre and
Partner, Meijburg & Co

KPMG's EU Tax Centre, Laan van Langerhuize 9, 1186 DS Amstelveen, Netherlands