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CJEU Decision in the A Oy Case (C-292/16)

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 November 23, 2017, the Court of Justice of the European Union (CJEU) rendered its decision 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 was transferred to a domestic company.

The CJEU concluded that the Finnish legislation is contrary to the freedom of establishment, as it does not allow for the deferral of taxation of the unrealized capital gains upon the transfer of a permanent establishment to another Member State.

Background

Article 10 of the 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 of directly taxing the assets of that permanent establishment in the future. However, that State is required to provide 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 concerned 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 tax credit 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 was asked whether the Finnish rules that allow deferred taxation only in a domestic situation are compatible with the freedom of establishment. If incompatible, the Court was asked whether the restrictions are justified and, if so, whether the disputed legislation complies with the principle of proportionality.

The CJEU's Decision

The Court first examined the applicability of the Merger Directive in the case at hand and observed that the Finnish provision under review is merely implementing the possibility given to Member States under Article 10(2) of that Directive to tax the capital gains established upon the transfer of a permanent establishment outside its territory. The Court noted however that the Directive does not provide further details about the timing of the tax recovery and concluded that it is for the Member States to implement the corresponding provisions in accordance with EU law. Recalling its previous case law that transactions falling within the scope of the Merger Directive constitutes a particular method of exercising the freedom of establishment, the Court went on to address the compatibility of the disputed provisions with this freedom.

The Court considered that the difference in treatment between a cross-border transfer of assets subject to immediate taxation in Finland, and a domestic transfer, which is taxed only upon realization, is liable to deter Finnish companies from operating in other Member States through a permanent establishment. In this respect, Finnish companies transferring a foreign permanent establishment to a Finnish company on one hand and to a foreign company on the other are in a comparable situation.

As regards the justification of an overriding reason in the public interest, the Court held that a Member State is entitled to protect its taxing rights on unrealized capital gains that arise in its national territory. When a taxpayer transfers assets abroad (causing that Member State to lose the right to tax those gains after the transfer), those rights are protected by taxing such gains upon exit. However, on the issue of proportionality, the Court followed its settled case law and ruled that, by not allowing taxpayers the option to defer payment of the exit tax due upon the transfer, the disputed legislation goes beyond what is necessary to achieve the objective of preserving Finland's taxing rights and therefore does not comply with the principle of proportionality. In this respect, taxpayers should be given the choice between immediate or deferred payment of this amount. It is irrelevant that a tax credit is granted corresponding to the tax that would have been charged in the Member State of the permanent establishment.

The Court therefore concluded that the Finnish legislation is contrary to the freedom of establishment, as it does not allow for the deferral of taxation of the unrealized capital gains established upon the transfer of a permanent establishment to another Member State.

EU Tax Centre comment

The CJEU decision is in line with its previous case law on exit taxation, i.e. that taxpayers should be given the right to defer taxation over a period of several years. In line with the Opinion issued by Advocate General Kokott in this case, the Court reaffirmed the principle that the provisions of secondary EU law, such as the 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 queries, please do not hesitate to contact [KPMG's EU Tax Centre](#), or, as appropriate, your local KPMG tax advisor.



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