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AN EU PERSPECTIVE ON THE DANISH EXIT TAX RULES FOR INDIVIDUAL SHAREHOLDERS

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1 Introduction

For individuals as well as for companies and other taxable entities migrating from Denmark can have significant tax consequences. Individuals moving tax residence from Denmark triggers a capital gains tax if the taxpayer holds shares and certain other securities[2]. The tax authorities must under specific conditions grant individuals a suspension, but the system is administratively burdensome for the taxpayer, can result in cash flow disadvantages and is thus certainly worth taking into consideration if re-domiciling when holding shares. There is also notional capital gains tax on other assets, but the exit tax on shares is probably the one with the most significant impact.

Companies and other entities governed by the Corporation Tax Act[3] are to a wide extent subject to an immediate exit tax on accrued capital gains when ceasing to be resident in Denmark for tax purposes or when transferring assets outside Danish tax jurisdiction[4].

Especially since the Court of Justice of the EU (ECJ) rendered its decision in *Lasteyrie du Saillant*[5] there has been an ongoing debate in the Danish law journals concerning the compatibility of these different exit tax rules with the freedom rights

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2 Aktieavancebeskatningsloven, LBK nb 89 25/01/2010 §§ 38-39 B (Act on Capital Gains Tax on Shares).

3 Selskabsskatteloven, LBK nb 1376 07/12/2010 (Corporation Tax Act).

4 Selskabsskatteloven § 5, stk. 7 and § 7A.

5 ECJ, 11 March 2004, Case C-9/02, *Lasteyriedu Saillant v Ministére de l'Economie, des Finances et de l'Industrie ("De Lasteyrie du Saillant"),* [2004] ECR I-02409.

under EU law. Regarding the exit tax on businesses, the academics criticising it are now being supported by the Commission. In November 2010, the Commission referred Denmark, the Netherlands, Belgium, Spain and Portugal to the ECJ[6] over exit tax rules that the Commission alleges are incompatible with EU law, as it was interpreted in *Lasteyrie du Saillant*, the *N-case*[7] and the Commission's Communication on Exit Taxes from 2006[8]. The exit tax case against Sweden was closed when Sweden amended its rules to comply[9]. The Danish tax provision imposing capital gains tax on shares held by a re-domiciling individual has not yet been challenged, but is heavily debated in the literature[10] and there are indications that a complaint could be on its way[11].

This article endeavours to analyse the Danish exit tax rules for individual shareholders in the light of the jurisprudence of the ECJ in relation to exit tax cases. The thesis advanced in this article is that the Danish rules are another example of exit tax rules going beyond what is necessary to attain the objective they pursue.
In addition to this introduction and the concluding paragraph, the article will be divided into two parts, a descriptive and an analytical part.

2 Key elements of the new rules

In 2008 the Danish Parliament substantially amended the exit tax on individual taxpayer's shareholdings, an amendment that was debated and considered a step back compared to the amendment in 2004[12] where the provisions were changed to comply with the decision in the French case *De Lasteyrie du Saillant*. Whereas it is beyond the scope of this article to analyse the Danish rules from a historical perspective, a brief description of the scope and key elements of the currently applicable provisions is necessary.

6 http://ec.europa.eu/taxation_customs/resources/documents/common/infringements/factsheet /2010 /11/2010-11-1565-dk-tax-company_en.pdf (last visited 16 March 2011) and http://ec.europa.eu/taxation_customs/resources/documents/common/infringements/factsheet/ 2010/11/2010-11-1565-nl-tax-company_en.pdf (last visited 16 March 2011).

7 ECJ, 7 September 2006, Case C-470/04, *N v Inspecteur van de Belastingdienst Oost/kantoor Almeno("the N-case*"), [2006] ECR I-07409.

8 COM (2006) 825.

9 http://ec.europa.eu/taxation_customs/common/infringements/infringement_cases/bycountry/ index _en.htm(last visited 16 March 2011).

10 Cf. eg. JansRavnskilde, SU 2009,158 , Jane Bolander, SU 2009,157 and Thomas Rønfeldt, INTERTAX, Volume 39, Issue 3 [insert pg ref].

11 http://www.inwema.com/article.172.html (last visited 25 March 2011).

12 L 119 17/12 2003.

These exit tax rules are only applicable when the taxpayer has been liable to capital gains tax on shares for minimum 7 out of the last 10 years preceding the tax year in which he ceases to be resident in Denmark for tax purposes, or if the shares have been obtained via succession . An additional requirement is that the market value of the shares is over a certain minimum threshold. Shares acquired at a negative price are however, always subject to exit taxation, regardless of the minimum threshold.
When a shareholding falls within the scope of the provisions, the tax is levied immediately on accrued capital gains as if the shares had been disposed of. This taxation is final in the sense that the access to recalculation of the gain when the shares are actually disposed of has been repealed. Furthermore, the exit tax is upheld under the current rules even if the taxpayer moves back to Denmark while still holding the shares. As described below, the taxpayer gets a credit for capital gains tax paid abroad and the tax value of losses occurring abroad is deducted.

Suspension of the notional capital gains tax is conditional upon the taxpayer submitting a tax return and an asset declaration at the time of relocation. For each year, where the balance for deferred tax remains positive, the taxpayer must continue to submit declarations. In the circumstance that the taxpayer fails to declare in a timely manner, the deferred tax falls due. If the taxpayer moves to a country governed by the Council Directive concerning mutual assistance for the recovery of claims relating to taxes[13] the tax deferral is not subject to a requirement for a financial guarantee.

A significant element of the new rules is that the deferred tax becomes due not only when the taxpayer sells the shares, but also if distributions are made, loans are obtained from the company or in any other comparable event where the value of the shares is reduced. However, tax free business reorganisations do not affect the balance for deferred capital gains tax.

If the shares are disposed of, the gain or loss on the specific share is calculated and the tax assessed. If this calculated tax exceeds the tax payable in the other country, the difference between the two amounts must be paid in Denmark and the balance is reduced correspondently. It is noticeable that this way of adjusting the balance may result in the taxpayer having to pay more tax at this stage than the deferred tax amount linked to the specific share, because the amount of exit tax that becomes due is calculated by reference to the actual sales price, whereas the deferred tax was based on market value at the time, when the taxpayer transferred his tax residence[14].
Should the disposal result in a loss, a negative amount of tax is calculated by which the balance is reduced. The result is thus, that this part of the suspended tax is waived. In the event that the taxpayer gets a reduction for the loss abroad, a

13 Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures *("MARD").*

14 Jane Bolander, SU 2009, 157, p. 297.

negative tax value is calculated in Denmark and that part of the balance becomes due.

Where the shareholder receives distributions of any kind, a distribution tax is calculated. In this calculation the taxpayer gets credit for distribution tax paid abroad and any withholding tax paid in Denmark. A part of the suspended exit tax corresponding to the calculated distribution tax becomes due. The balance is always only reduced by the part of the suspended tax that becomes due, not the distribution tax paid abroad.

If the shareholder obtains a loan in the company in which he hold shares, a part of the suspended tax corresponding to the loan must be paid immediately.

In the event that the taxpayer moves his tax residence back to Denmark, the shares are, for the purpose of future capital gains tax, deemed to be acquired at the actual acquiring date, but the value is based on the market value at the time where tax residence in Denmark is re-established. If the balance for deferred tax is positive at this point in time, the acquisition cost is reduced by the positive amount. The purpose of this element of the new Danish rules is obviously to ensure that the entire deferred amount of exit tax is taxed eventually.

When describing the key features of the Danish rules it should finally be mentioned, that they are extended to cover taxpayers that migrated from Denmark even before the amendment took effect[15]. If such taxpayers paid tax on accrued but unrealised capital gains on shares under the previously applicable rules they are given the possibility of opting into the new scheme and thereby being refunded the tax they have paid. A suspension granted under the previously applicable rules can be upheld, if the taxpayer submits the annual declaration required by the new rules.

3 Is the exit tax on individual shareholders contrary to EU law?

During the hearing process, before the adoption of these new exit tax rules for individual shareholders, concern was repeatedly expressed that the rules would amount to a breach of Denmark's obligations as an EU member state[16]. The criticism was to a certain extent taken into consideration and resulted in some changes before the new rules were adopted[17]. However, certain elements of the provisions are still questionable from an EU perspective.

15 The rules took effect from 30 May 2008.

16 The hearing responses are published on the official webpage for the Danish Parliament. http://www.ft.dk/samling/20072/lovforslag/L187/bilag.htm#dok (last visited 25 March 2011).

17 Cf. the report from the Tax Committee, which took part in the legislative process, http://www.ft.dk/samling/20072/lovforslag/l187/bilag/25/587017/index.htm (last visited 25 March 2011).

When analysing EU compliance a three step approach can be taken. First the national rules are examined to consider whether they constitute discriminatory treatment of individuals from other member states or a restriction on the exercise of any of the freedom rights. Secondly, whether such discrimination or restriction can be justified and finally, whether the principle of proportionality is fulfilled.

Since the exit tax is imposed by Denmark on Danish tax residents it cannot constitute discrimination on grounds of nationality. The comparator is in this case another individual shareholder maintaining tax residence in Denmark, so the analysis must instead be whether the rules have a deterrent effect on such a person leaving Denmark.

As established in *de Lasteyrie du Saillant* and confirmed and developed in the *N case*, an exit tax levied on an individual can constitute a restriction on the freedom rights. When making the above mentioned comparison it is clear that there is a disadvantageous treatment of the taxpayer moving out of Denmark. The restriction lies therein that the taxpayer must submit annual declarations as well as in the disadvantageous calculation methods when the deferred tax becomes due. Even restrictions of a limited nature are, as a starting point, contrary to EU law[18].

The second step in the evaluation of the Danish exit tax on individual taxpayers is to see whether the rules are justifiable because they pursue a *"legitimate aim compatible with the Treaty and are justified by pressing reasons of public interest*"[19].

The purpose for implementing these rules was to combat circumvention of the exit tax, where the taxpayer was granted a deferral of the capital gains tax on shares and then reduced the value of the shares by distributing the assets in the company after moving tax residence to a jurisdiction with no tax or a lower tax on distributions. This tax planning scheme was systematically used to avoid paying the exit tax, causing loss of revenue[20]. As will be elaborated in the following paragraph, the problem from an EU perspective is that the rules impose disproportional restrictions on all relocating taxpayers, including taxpayers who are legitimately exercising their freedom rights with no intention of tax avoidance. Amongst others Ravnkilde[21] insists that Denmark generally fails to recognise the difference between loss of

18 ECJ, 28 Jan. 1986, Case C-270/83, *Commission of the European Communities v French Republic("Avoir Fiscal")* [1986] ECR 00273, para 21.

19 ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v Administration des contributions, ("Futura"),* [1997] ECR I-024 71, para 26.

20 Cf. Answer from The Ministry of Taxation to question 2 from June 4 2008,http://www.ft.dk/samling/20072/lovforslag/l187/spm/2/svar/564800/584578/index.htm (last visited 25 March 2011).

21 SU 2009, 158.

revenue resulting from legitimate tax planning and loss of revenue in situations governed by ECJ's tax avoidance definition.

As the ECJ has clearly stated on a number of occasions, the mere loss of tax revenue cannot justify a restrictive measure[22] .

On the other hand, the ECJ has in some cases accepted restrictive tax rules that are adopted to prevent tax avoidance[23]. Whereas it was clear before introducing the Danish tax rules that the above mentioned tax planning scheme was used to avoid paying the exit tax, it is less clear whether such scheme can be categorised as tax avoidance under the ECJ terminology.

The situation where the taxpayer in fact moves tax residence to another member state while holding shares and then reduces the value of the shares by distributing all the assets in the company in a member state with low or no tax on distributions cannot in itself constitute a *"wholly artificial arrangement.."*[24], and cannot under this reasoning be categorised as tax avoidance. Even if all parts of the tax planning scheme takes place within a limited period of time that temporal link does not in itself prove tax avoidance[25].

Another possible justification is the need to ensure a "*balanced allocation of the taxing rights*". It could be argued that because the value of the shares increased while the shareholder was still resident in Denmark, the gain should be taxed in that member state in accordance with e.g. OECD Model tax convention art 13(5).

The argument was brought forward by the German Government in *Lasteyrie du Sailliant*[26], but it was not accepted as a justification in that specific case.

Some authors have argued that the ECJ has since then changed its mind and started accepting balance in the allocation of taxing powers as a stand alone justification[27] after the decision in the *Marks and Spencer case*[28]. The justification was accepted in

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22 Cf. eg. ECJ, 16 July 1998, Case C-264/96, *Imperial Chemical Industries plc vK. Hall Colmer [Her Majesty's Inspector of Taxes], ("ICI")*, [1998] ECR I-04695., para 28 and ECJ, 21 Sept. 1999, Case C-307/97, *Compagnie de Saint-Gobain v Finanzamt Aachen-Innenstadt, ("Saint-Gobain"),* [1999] ECR I-06161, para 60.

23 Cf. eg. ECJ, 12 Sept. 2006, Case C-196/04 , *Cadbury Schweppes plc Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, ("Cadbury Schweppes*").

24 *ICI*, para 26.

25 ECJ, 5 July 2007, Case C-321/05, *Hans Markus Kofoed v Skatteministeriet, ("Kofoed").*

26 Para 68.

27 Cf. eg. Jane Bolander, SU 2009, 157.

28 C-9/02.

connection with the Dutch exit tax in the *N-case*[29], which leads to at least two questions relevant to the evaluation of the Danish exit tax on individual shareholders. First of all, why balanced allocation of the taxing right was accepted as a justification in the *N-case* when the court did not find the justification relevant in *Lasteyrie du Saillant*. And secondly, whether it is a standalone justification in exit tax cases or must be combined with other types of justification.

In Advocate General Kokott's Opinion it was mentioned, that the difference between *Lasteyrie du Saillant* and *the N-case* was that the French rules were only based on the prevention of tax abuse whereas the Dutch rules were also based on the allocation of taxing powers[30]. This particular part of the AG opinion was however not repeated in the court's decision and the meaning is thus not clear directly from the *N-case*. The Court does not explicitly state why balanced allocation of the taxing right was accepted in only the latter of the two cases and whether it is a justification in its own right.

One possible explanation to how *Lasteyrie du Saillant* and *the N-case* can be reconciled on this first specific issue is that the national exit tax rules examined in the two cases were not exactly the same. It can be argued that since the French rules contained an automatic exoneration after 5 years[31] the balanced allocation of taxing rights was not protected by the French rules. As long as the shares were not disposed of in this short timeframe France accepted not taxing the capital gain. Were the shares sold shortly after transferring the tax residence to another member state, France taxed the capital gains arguing that such a situation constituted tax avoidance[32]. On the other hand, the Dutch rules, examined in the *N-case*, did not provide for the same exoneration and could thus be linked more generally to the allocation of taxing rights.

Since the Danish rules equally have no time limit there is no apparent reason why the court should not accept protection of the balanced allocation of taxing rights as a justification for the Danish rules.

Regarding the second question aired above, it can be difficult to determine whether balanced allocation of the taxing rights is accepted as a standalone justification in the ECJ's jurisprudence.

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29 Paras 1-42.

30 AG Juliane Kokott, paras 100-101.

31 Lasteyrie du Saillant, para 3.

32 Para 24.

When reading the *Marks and Spencer*-case in combination with the recent *SGI case*[33] it appears that balanced allocation of the power to tax is not acceptable to the court as a stand alone justification[34]. The ECJ expressed in *Marks and Spencer*[35], that the mere fact that UK could not tax the profit of non-resident subsidiaries did not in itself justify restricting the group relief to national parent companies. Furthermore it was mentioned[36]that the court considered the three argued justifications *"taken together"* and based its decision thereon. In *SGI* the justification ground was further developed and it can be inferred[37], that the court accepts the objective of preventing tax avoidance, taken together with that of preserving the balanced allocation of taxing rights, even in situations where the tax planning scheme cannot be categorised as a wholly artificial arrangement.

The same reference to a combination on justification grounds cannot, however, be seen from *the N-case*. The national court argued that preservation of allocation of the power to tax could justify the Dutch rules[38], and the ECJ accepted the justification without mentioning tax avoidance or other separate justification grounds:

> *" Thus, gains realized on the disposal of assets are taxed, in particular with Article 13(5) of the OECD Model Tax Convention on Income and on Capital, and in particular in accordance with its 2005 version, in the contracting State of which the person making the disposal is a resident. As the Advocate General has observed in paragraph 96 and 97 of her Opinion, it is in accordance with that principle of fiscal territoriality, connected with a temporal component, namely residence within the territory during the period in which the taxable profit arises, that the national provisions in question provide for the charging of tax on increases in value recorded in the Netherlands, the amount of which has been determined at the time the taxpayer concerned emigrated and payment of which has been suspended until actual disposal of the securities.* "[39].

33 ECJ, 21 Jan. 2010, Case C-311/08 – *Société de Gestion Industrielle SA (SGI) v État belge ("SGI")*.

34 Cf. Tom O'Shea, European Tax Controversies – "Quis Custodiet Ipsos Custodes?" ECTJ (2011/12), 1, p. 92. .

35 Para 40.

36 Para 51.

37 Para 66 and 69.

38 Paras 41-42.

39 Para 46.

Since *the N-case* is the most recent exit tax case and the only one where the exit tax is not exonerated after a certain number of years it must be concluded that "balanced allocation of taxing rights" is accepted by the ECJ as a justification for restrictive exit taxes.

Finally, the Danish provisions must meet the proportionality test[40], which means that they must be appropriate for ensuring the attainment of the objective, namely the need to protect the balanced allocation of the taxing powers. The second limb of the test is that the provisions cannot go beyond what is necessary for that purpose.

In several of the cases where prevention of abusive practices has been argued as a justification for restrictive tax rules the problem has been that the rules had a broader scope than necessary[41]. The Danish exit tax rules for individual shareholders have been critisised by eg. Ravnkilde for their broad scope[42], leading to exit taxation even in situations where no tax avoidance purpose can be established. This is however not sufficient ground for automatically deeming the rules incompatible with EU law, since exit tax rules with a similar broad scope were approved as appropriate for ensuring the attainment of that objective in the *N-case*[43]. The more questionable part is, whether the Danish rules go beyond what is necessary to attain the objective.

From the *N-case* and *Lasteyrie du Saillant* it can be seen that exit taxation is generally only acceptable to the court if suspension is automatically granted without requirement for guarantee, if the suspension lasts until actual disposal and if full account is taken of later reductions in value of the shares.

Whereas the Danish rules in line with ECJ jurisprudence do not require guarantee as a precondition for obtaining the suspension, the system with forced payment of the suspended tax when distributions are made, loans are obtained in the company and in other similar situations, has arguably almost the same effect[44]. The system ensures priority for the Danish tax authorities when the taxpayer receives distributions etc. and can thus be compared to the cash flow disadvantages in connection with the guarantee requirements in the French and Dutch rules in *Lasteyrie du Saillant* and the *N-case* respectively.

The cash flow disadvantages are disproportional when the taxpayer moves to another EU Member State, because the Directive concerning mutual assistance for

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40 ECJ, 30 November 1995, Case C-55/94, *Reinhard Gebhard v Consigliodell 'Ordinedegli Avvocati e Procuratori di Milano, ("Gebhard"), [1995], I-04165,*para 37.

41 Cf. eg. *ICI* para 26.

42 Ravnkilde, SU 2009, 158.

43 Para 47.

44 Jens Ravnkilde, SU 1009,158.

the recovery of claims relating to taxes[45] applies. The de facto priority right for the Danish tax authorities is especially not proportionate to the above mentioned aim in situations where the taxpayer does not receive any liquidity. An example of this is the situation, where the company loans money to another company in which relatives of the taxpayer holds minimum 10% of the shares. In such a situation a part of the taxpayers deferred capital gains tax corresponding to the full loan amount becomes due, even if the taxpayer only holds a small percentage of shares in the first mentioned company. Only loans to a wholly owned subsidiary are excluded, since the shares in the parent company do not decrease in that situation.

Closely connected with the cash flow disadvantages, the taxpayer may suffer disproportional planning disadvantages. Whereas it is possible for the taxpayer to plan when to dispose of the shares and thus when to bear the financial burden of the deferred tax in that situation, it is not always possible for the minority shareholder to decide when distributions are made.

As mentioned above, the Danish rules can furthermore have the effect that all the suspended tax is paid even though all shares are still held by the taxpayer. This is contrary to the second condition the ECJ has established for accepting exit taxation on shareholders.

Furthermore, and perhaps most significantly the third condition for accepting the exit taxation as compatible with EU law is not fulfilled. It is not always possible to take full account of later reductions in the value of the shares. Since the deferred capital gains tax becomes due in other situations than at the time of actual disposal, the balance for deferred tax may reach zero before the last share is disposed of. In this event it is not possible to take account of a loss connected to the last share. Additionally there is no possibility to take full account of later losses if the taxpayer moves back to Denmark before selling the shares, since the deferred capital gains tax becomes final in this situation.

When comparing the Danish exit tax rules to the Dutch rules, which the ECJ ruled on in the *N-case*, the declaration requirement is also more administratively burdensome in the Danish rules. The ECJ held that the Dutch requirement for a tax declaration at the time of the transfer of tax residence was proportionate. The taxpayer would have to make such a declaration at a later stage anyway had the Dutch rules provided for tax at the time of disposal instead of at the transfer time[46]. The Danish rules are however more restricting because the requirement is extended to annual declarations until all the deferred tax has been paid. The question is, whether this additional administrative burden would be acceptable to the ECJ or would be considered disproportionate to the aim of ensuring a balanced allocation of

45 Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures.

46 Para 50.

taxing powers? As suggested by Bolander[47], it must depend on the EU compatibility of the whole system in the Danish rules. If the system, where a part of the deferred tax becomes due in connection with distributions, is held to be compatible with EU law, this additional administrative burden must also be compatible.

4 Conclusion

There can be no doubt that the complicated Danish exit tax rules on individual shareholders constitute a restriction on the exercise of the freedom rights provided for in the EU treaty. Cash flow disadvantages and administratively burdensome rules can have a deterring effect and must pursue a legitimate objective in the public interest acceptable to the court and meet the proportionality test.

Even though the rules can possibly be justified by the need to protect the balanced allocation of taxing rights, the proportionality test is not fulfilled. In line with *the N-case* and *De Lasteyrie Du Saillant* the Danish rules do not have a precondition that a financial guarantee must be set up to gain the suspension, but as argued above the system entails de facto financial security for the tax authorities, because they get a priority right to a part of future dividends and loans, even where the shares are still held by the taxpayer.

The Danish exit tax provisions finally fail, in some situations, to take full account of later reductions in the value of the shares. This is contrary to what the ECJ held in *the N-case*[48].

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47 SU 2009,157.

48 Para 54.