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German Tax Deferral Rules Infringe EU Law

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German tax law allows deferring the tax on certain disposal gains by transferring the hidden reserves in the disposed assets to similar newly acquired or newly produced assets ("Replacement Assets"). The tax deferral requires an allocation of the Replacement Assets to a German permanent establishment. The ECJ has recently ruled that this restriction infringes the right of freedom of establishment enshrined in article 49 TFEU and article 31 of the EEA Agreement (ECJ C-591/13); the decision was based on the prohibition on the deferral if the replacement assets formed part of the assets of a permanent establishment located outside Germany. It is questionable how the national legislators will react to this decision.

I. Germany

A. Abolition

Under its double taxation treaties Germany is not allowed to impose a tax on gains from non-German permanent establishments. In the court proceedings Germany argued that a similar treatment for German and non-German Replacement Assets would create unreasonable administrative burdens for the tax administration and the taxpayer. To ensure a corresponding treatment for all investments in Replacement Assets (i.e. irrespective of their allocation to a German or a non-German permanent establishment) Germany could therefore abolish the challenged provision.

B. Widening

Alternatively Germany could extend the scope of the provision to all investments in Replacement Assets. Economically the widening of the challenged tax rule could result in a relocation of economic activities from Germany to foreign countries. At first glance this is contrary to the original intention of the German lawmakers, which is to enable the taxpayer to replace outdated business assets with up-to-date assets tax neutrally, to adjust its activities to amended economic conditions, and to strengthen the German economy. However, considering that the taxpayer's non-German activities are also linked to its German activities, the economic growth outside of Germany should strengthen not only the German taxpayer, but also the German economy – at least indirectly.

II. UK

The UK has similar rules for rollover relief where UK business assets are involved (rather than non-UK assets). The ECJ decision has raised the possibility of these rules being changed.

Taxpayers should, therefore, start to prepare for changes in this area.

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