Comment

# Please pay on your way out: UK exit charges and *Gallaher*


Speed read

**The judgment of the Court of Justice in *Gallaher v HMRC* was not only the last referral ever made by a UK court, it is also the latest chapter in the ongoing litigation concerning 'exit charges'. The UK may be relieved by the decision, particularly because of the court's confinement of the scope of free movement of capital, which arguably remains available in some form under domestic law by virtue of ss 4 and 5 of the European Union (Withdrawal) Act 2018. However, the CJEU's decision does not provide many answers in relation to other exit charge cases that are currently before the UK tribunals.**



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The background to *Gallaher* (Case C 707/20) is the EU treatment of 'exit charges'. In summary, an exit charge is a tax charge imposed by a member state on assets at the point when they leave its fiscal jurisdiction. At that point, many member states understandably want to impose a charge on any gains which have accrued whilst the assets are within their fiscal jurisdiction, notwithstanding that those gains have not yet been realised (i.e. the assets have not actually been sold for valuable consideration).

Two examples of exit charges which are presently the subject of litigation before UK tribunals are:

- TCGA 1992 s 80: Where the trustees of a settlement become non-UK resident, s 80 deems that the trustees have disposed of all of the trust's assets and immediately reacquired them at their market value. The effect of s 80 is therefore to impose an immediate capital gains tax charge in respect of any unrealised gains which have accrued on the trust's assets. This provision is the subject of the litigation in *Panayi* (Case C-646/15 and [2019] UKFTT 622).
- TCGA 1992 s 185: When a company ceases to be resident in the UK, this provision deems that it has disposed of and re-acquired all of its assets for market value, which gives rise to a corporation tax charge on any unrealised gains. Section 185 is the primary provision that is the subject of the litigation in *Redevco* [2022] UKFTT 102 (TC).

Exit charges have a legitimate basis because the point at which the taxpayer (or assets) leaves the fiscal territory of the member state is generally the last time that it has the power to tax gains which have accrued within that state. However, the obvious problem from the taxpayer's perspective is that they are being required to pay a tax liability even though they have received no consideration in respect of the assets on which the gains have accrued – so the taxpayer has no disposal proceeds with which to pay the charge.

## *NGI*

These competing perspectives are recognised in the EU law approach to exit taxes. For example, in *National Grid Indus BV* (Case C-371/10), the CJEU considered an exit charge arising on gains accruing to a company changing its place of effective management from the Netherlands to the UK. The court held that there was a restriction of NGI's freedom of establishment (provided for in TFEU article 49) because the company was being placed at a cashflow disadvantage to similar companies remaining in the Netherlands. In principle, the restriction could be justified by the objective of ensuring the balanced allocation of powers of taxation between member states, and it was proportionate for the Netherlands to establish the amount of tax definitively at the time that NGI left its fiscal jurisdiction. However, the immediate payment of the tax charge was disproportionate because the legitimate objective could still be protected if the taxpayer was given a choice to defer payment of the tax (i.e. there was a less restrictive alternative): 'it must be stated that only the determination of the amount of tax at the time of the transfer of a company's place of effective management, and not the immediate recovery of the tax, should be regarded as not going beyond what is necessary for achieving that objective.' Therefore, the national legislation was disproportionate overall because it did not contain a right to defer payment of the exit charge.

The analysis in *NGI* has been replicated and refined in a number of subsequent cases before the court concerning exit charges. In particular, what EU law requires in terms of a deferral has been confirmed in cases such as *DMC Beteiligungsgesellschaft mbH* (Case C-164/12) and *Verder LabTec GmbH & Co. KG* (Case C-657/13), with the CJEU confirming that a deferral of payment over a period of five years is proportionate. In addition, the case law was effectively codified in article 5 of Directive (EU) 2016/1164 in which the Council mandated that a taxpayer subject to certain types of exit charge (such as on a company migration) must be given the right to defer payment over five years. So the position under EU law is clear: exit charges can be justified and proportionate provided that the taxpayer is permitted to pay over a period of five years.

## *Gallaher*

Turning now to *Gallaher*, the company had made two transfers for full market value:

- a transfer of intellectual property rights (relating to tobacco brands) to its Swiss sister company, JT International SA in 2011 ('the Swiss transfer'); and
- a transfer of shares to its indirect Dutch parent company, JT International Holding BV, in 2014 ('the Dutch transfer').

(See figure above right.)

Those disposals gave rise to corporation tax charges under national law on the accrued gains. However, the basis of the taxpayer's case was that, had the transferees been resident in the UK or carrying on a trade from a UK PE, then it would have benefited from group relief (under TCGA 1992 s 171 and CTA 2009 ss 775–776 – referred to collectively as 'the group transfer rules'), which would have rendered the transactions tax neutral. The taxpayer effectively argued that this was analogous to an exit charge because it was being taxed on the assets at the point that they left the UK's fiscal jurisdiction in circumstances in which the same transfer to a UK company would not have given rise to a charge. The fact that the alleged restriction was the limited effect of a relief rather than the charge itself was not seen as material, but there were two points which were potentially problematic from Gallaher's point of view:

- the Swiss transfer was to a third country: therefore, it was not obvious that Gallaher could invoke freedom of establishment; and
- in both cases, the gains were realised gains because the transfers were for full market consideration.

The First-tier Tribunal heard the case in 2019 ([2019] UKFTT 207) and held (in summary) that there was no restriction in relation to the Swiss transfer, but there was a restriction in relation to the Dutch transfer and, since the national legislation at the time did not allow for any deferral of payment, it was incompatible with EU law. The tribunal went on to disapply the national legislation in relation to the Dutch transfer.

The case came before the Upper Tribunal at the end of October 2020, just over two months before the final deadline for UK courts to make referrals to the CJEU. The Upper Tribunal ([2020] UKUT 354 (TCC)) identified a number of issues which it referred to the court on 30 December 2020 (the day before the deadline). The three main issues which the court actually decided were as follows:

1. Can free movement of capital (within TFEU article 63) be relied upon in relation to the group transfer rules?
2. In relation to the Swiss transfer, is there a restriction of freedom of establishment where UK company transfers assets to Swiss sister company, both of which are subsidiaries of a common parent company resident in a member state?
3. Is the restriction justified and proportionate where the disposals were made for full market value?

## The CJEU confirmed that 'national legislation intended to apply only to those shareholdings which enable the holder to exert a definite influence on a company's decisions and to determine its activities falls within the scope of Article 49'

The above issues reflected the main arguments of the taxpayer, particularly in relation to the Swiss transfer. In order to establish that there was a restriction in relation to that transfer, the taxpayer had two main options: firstly, it could seek to argue that it was the freedom of establishment of the parent company (which was resident in a member state) that was being restricted because, in essence, the parent of a multi-national group was being treated less favourably than the parent of a UK group.

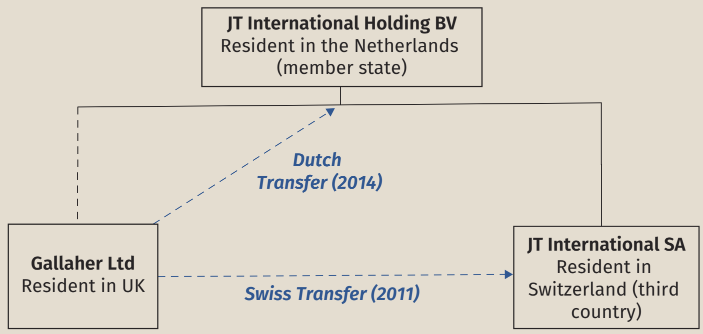
Secondly, it could persuade the court to analyse that transfer by reference to free movement of capital (article 63), which prohibits restrictions between member states and third countries. On this issue, the taxpayer sought to argue that if freedom of establishment did not apply then, even though the group transfer rules applied only to groups, the court could still consider the national legislation in the light of article 63. It further argued that the transfers in the present case were movements of capital which (in themselves) did not fall within the scope of freedom of establishment.

Pausing there, the implications of the second argument were potentially significant: Gallaher was arguing that, even in relation to national legislation which applied solely to corporate groups (i.e. a situation which primarily fell to be examined by reference to freedom of establishment), if the court held that no other freedom applied then it should examine the national legislation by reference to free movement of capital. That argument could have important ongoing consequences for the UK: since exit day, freedom of establishment is no longer recognised in UK domestic law (by virtue of the Freedom of Establishment and Free Movement of Services (EU Exit) Regulations, SI 2019/1401). However, free movement of capital may continue to be available under UK law in some form (pursuant to ss 4 and 5 of the European Union (Withdrawal) Act 2018). So, if Gallaher was right that, in any situation in which no other freedom applied, a taxpayer could seek to rely on free movement of capital then that might significantly expand the application of EU law in the UK post-Brexit.

However, the CJEU rejected that analysis confirming that, 'national legislation intended to apply only to those shareholdings which enable the holder to exert a definite influence on a company's decisions and to determine its activities falls within the scope of Article 49' and therefore falls to be examined exclusively by reference to freedom of establishment. No independent examination under article 63 is justified because: 'Should the said rules have restrictive effects on the free movement of capital, those effects would be the unavoidable consequence of such an obstacle to freedom of establishment as there might be, and do not therefore justify an independent examination of those rules from the point of view of Article 63 TFEU'. The fact that Gallaher might not be able to establish a restriction of article 49 is immaterial if the situation is one which engages that freedom alone. This aspect of the decision is likely to be a relief for the UK as it means that, even though post-Brexit no one can rely on freedom of establishment, that does not extend the scope of free movement of capital and allow taxpayers to argue that they can rely on that freedom merely because none of the other freedoms continue to apply.

The CJEU went on to hold that in fact there was no restriction at all in relation to the Swiss transfer because, considering the position of the parent company by reference to freedom of establishment, there had been no difference in treatment based on the location of that company. In other words, the group transfer rules would still not have applied had the parent company been resident in the UK, so the legislation did not discriminate in any relevant respect. Moreover, even though there was a restriction in relation to the Dutch transfer, the CJEU re-confirmed that the problematic aspect of exit charges is that they apply to unrealised gains – but Gallaher had realised the gains in relation to its transfers and therefore there were no grounds upon which it was necessary for the UK

### Group structure and transactions in *Gallaher*



to defer payment of the charges: 'In the case of a capital gain realised as a result of a disposal of assets, however, the taxpayer does not, in principle, face a liquidity problem and can pay the capital gains tax with the proceeds of that disposal of assets.' There was therefore no breach of EU law in relation to either of Gallaher's transfers.

### Where does *Gallaher* leave the other exit charge cases that are presently before the UK tribunals?

The decision in *Gallaher* is of limited direct assistance to tribunals considering other UK exit charges because it was focused on the specific facts and legislation in issue in that case, in particular the fact that one of the transactions was a transfer to a third country and therefore could not engage freedom on establishment in a conventional manner (whereas the outstanding cases concern movements between member states), and the fact that the gains being taxed in that case were fully realised (whereas the outstanding cases concern deemed disposals and therefore unrealised gains).

> The litigation on UK exit charges seems set to continue with the outcome uncertain, but one enduring potential implication for the UK of the decision in *Gallaher* is that the court confined the scope of free movement of capital

The remaining exit charge cases will therefore derive little assistance from *Gallaher* and much of the argument is likely to focus on a question which the CJEU declined to consider, being the appropriate remedy if there is a breach of EU law. In that regard, it is worth noting that the two tribunals that have thus far considered the question of conforming construction in relation to UK exit charges have come to opposite conclusions: in both *Gallaher* and *Panayi*, the First-tier Tribunal was faced with the question of whether it could adopt a conforming construction which permitted a deferral of payment of an exit charge as required by EU law. The tribunal in *Gallaher* (which had found that there was a disproportionate restriction in relation to the Dutch transfer) considered that the various options for implementing such a deferral made a conforming construction impossible, and therefore felt compelled to disapply the legislation. However, the tribunal in *Panayi* disagreed with that decision and concluded that it could apply an interpretation which entitled the taxpayer to pay the exit charge in five equal annual instalments – being the approach expressly endorsed by the CJEU.

The litigation on UK exit charges therefore seems set to continue with the outcome uncertain, but one enduring potential implication for the UK of the decision in *Gallaher* is that the court confined the scope of free movement of capital. As that is the only freedom which might continue to apply in some form after Brexit (subject to the implications of the Retained EU Law (Revocation and Reform) Bill), from the UK's perspective that is likely to be a significant relief as it seeks to disentangle itself from the structure of EU law. ■

*The author acted with Rupert Baldry KC for the UK government in this case.*

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