The Compatibility of Corporate Exit Taxation with European Law

Case C-371/10 *National Grid Indus BV v Inspecteur van de Belasting-dienstRijnmond/kantoor Rotterdam*, Judgment of the Court (Grand Chamber) of 29 November 2011, not yet reported

by

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In National Grid the CJEU confirmed that exit taxes on unrealised capital gains of corporations upon emigration to another Member State constitute a restriction on the freedom of establishment. The Court found that these exit taxes could be justified, however, and set out the conditions upon which this could be possible.

This article begins by briefly summarising the ambiguity that had surrounded this matter before this decision and then summarises the arguments of the Court, highlighting the circumstances under which such taxation might be compatible with EU law. Lastly, the commentary discusses the conformity of the Court's findings with international tax law and European internal market law as well as the implications of the judgement on the Commission Communication on Exit Taxation, on cross-border mergers and on company seat transfers.

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I. Introduction

On 29 November 2011, the Court of Justice of the European Union put

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forward its view on the permissibility of exit taxation on unrealised capital gains that result from a company's migration to another Member State. This ended the previous ambiguity regarding whether cross-border transactions of companies, particularly seat transfers, can trigger an exit tax on unrealised capital gains. Exit taxes levied on unrealised capital gains were considered one of the major obstacles to corporate mobility within the EU internal market. As such[1], the clarificatory judgment was highly anticipated.

The permissibility of this type of exit taxation had been ambiguous since the Court of Justice addressed the matter in *Lasteyrie du Saillant*[2] and *N*[3] in 2004 and 2006, respectively. In both cases, the Court determined that an immediate tax on the income of individuals which had not yet been realised hinders the freedom of establishment and, as such, violates Article 49 of the TFEU. However, these cases concerned natural persons rather than legal ones. In its 2006 Communication on exit taxation[4], the European Commission argued that these Court of Justice rulings must also be applied to exit taxes levied against migrating companies, a view that had been shared by many academics[5]. However, the CJEU had not yet confirmed this and, depending on the interpretation of the *Cartesio*[6] judgment in relation to the *Daily Mail*[7] judgment on corporate seat transfers, one could not be certain whether the matter indeed fell within the freedom of establishment[8].

1 See e.g. the Commission point of view in the infringement proceedings against Member States: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1565&type=HTML; G. Burwitz, 'Tax Consequences of the Migration of Companies: A Practitioner's Perspective', *European Business Organization Law Review* 7 (2006), p. 594.

2 C-9/02 *Hughes de Lasteyrie du Salliant* [2004] ECR I-2409, para. 47. See on this case for example G. Parleani, 'Relocation and Taxation: The European Court of Justice Disallows the French Rule of Direct Taxation of Unrealised Gains', 1 *ECFR* (2004), p. 379–389.

3 C-470/04 *N v Inspecteur van de BelastingdienstOost/kantoorAlmelo* [2006] ECR I-7409.

4 Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee – Exit taxation and the need for co-ordination of Member States' tax policies, COM(2006) 825 final.

5 See e.g. B. Angelette, 'The Revolution that Never Came and the Revolution Coming-De Lasteyrie Du Salliant, Marks & Spencer, Sevic Systems and the Changing Corporate Law in Europe', *Virginia law review* 92 (2006) p. 1198; C.Panayi, 'Corporate Mobility in the European Union and Exit Taxes', Bulletin *for International Taxation* (October 2009), p. 471; D. Zernova, Exit Taxes on Companies in the Context of the EU Internal Market, 39 *Intertax*10 (2011), p. 482; R. Kok, Compatibility of Exit Taxes and Community Law, 20 *EC Tax Review* 2 (2011).

6 C-210/06 *Cartesio* [2008] ECR I-09641.

7 Case 81/87 R *v HM Treasury and Commissioners of Inland Revenue, ex p Daily Mail and General Trust plc.*[1988] ECR 5483.

8 M. Szydlo, 'The Right of Companies to Cross-Border Conversion under the TFEU Rules on Freedom of Establishment', 7 *ECFR* 3 (2010), particularly p. 435–441; A. Wisniewski and A. Opalski, 'Companies' Freedom of Establishment after the ECJ Cartesio

Furthermore, provisions made a tax neutral transfer possible if the assets remained connected to a permanent establishment located in the home Member State[9] regarding cross-border transactions with regard to mergers or in the framework of the European Company (SE). However, it was unclear to what extent exit taxation remained permissible if the assets were no longer connected to a permanent establishment[10].

Legal clarity was not only necessary for corporate actors, but also for national authorities, who were uncertain as to what extent their domestic legislation violated EU law. As both the Commission and the EFTA Surveillance Authority have begun infringement proceedings against several Member States on exit tax legislation, the outcome of this judgment is decisive for the respective litigation strategies[11].

Although *National Grind* relates chiefly to European tax law, it does involve the transfer of the company's place of effective management and therefore, allows some preliminary conclusions as to the uncertainty regarding the interpretation and the scope of *Cartesio*, the 2008 judgment on company seat transfers. It thus adds to the recently published Opinion of the Advocate General Jääskinen in *Vale*, which concerns the seat transfer saga of the Court of Justice[12].

As a consequence, having summarised the facts and the reasoning of the Court,

Judgment', *European Business Organization Law Review* 10 (2009), pp. 595–625; A. De Sousa, 'Company's Cross-border Transfer of Seat in the EU after Cartesio', *Jean Monnet Working Paper* No. 7(2009); see also a comment by the legal counsel in the cases *Cartesio* and *Vale*: V. Korom, P. Metzinger, 'Freedom of Establishment for Companies: The European Court of Justice Confirms and Refines its Daily Mail Decision in the Cartesio Case C-210/06', 6 *ECFR* 1 (2009), p. 125–160.

9 See Articles 10b, 10c and 10d of Council Directive 2005/19/EC of 17 February 2005, [2005] OJ L 58/19, amending Directive 90/434/EEC of August 1990 (Merger Directive), OJ L 225/1.

10 Though, one has to state that in such a case an exit tax seems in any event incomprehensible. The objective of an exit tax is to tax unrealised capital gains before they become un-taxable. If the assets remain within the Permanent Establishment as defined under the respective law and the double taxation conventions of the respective Member States, they also remain taxable in that Member State.

11 The Commission started proceedings against Sweden in 2008, against Portugal and Spain in 2009 and against Belgium, Denmark and the Netherlands in 2010. The EFTA Surveillance Authority gave a final warning on this matter to Norway in 2011.

12 Opinion of Advocate General Jääskinen in Case C-378/10 *VALE*, delivered on 15 December 2011. See on the seat transfer cases for example H.J. de Kluiver, Inspiring a New European Company Law, 1 *ECFR* (2004), p. 121–134; W. Schön, 'The Mobility of Compromise in Europe and the Organizational Freedom of Company Founders', 3 *ECFR* 2 (2006), p. 122–146.

a comment will be given on the issue of exit taxation followed by a short remark regarding the topic of seat transfers within the EU.

II. Facts

National Grid Indus ('NGI') was a Dutch incorporated and tax-resident company that since June 1996 has had a claim of GBP 33,113,00 against National Grid Company plc., a company established in the United Kingdom. On 15 December 2000 NGI transferred its place of effective management to the United Kingdom.Due to the rise of the pound sterling against the Dutch guilder an unrealised exchange rate gain was generated on that claim. In accordance with the applicable double-tax treaty, NGI became a UK tax resident and ceased to exist for taxation purposes in the Netherlands as a consequence of the transfer of place of effective management. The national law of the Netherlands required final settlement of tax on unrealised capital gains at the time and the Dutch Inspector decided that NGI should be taxed on the exchange rate gain. NGI appealed this decision and following a second appeal the Gerechtshof Amsterdam (Regional Court of Appeal, Amsterdam) made a preliminary reference to the Court of Justice of the European Union asking-whether final settlement without possibility of deferment or taking into account subsequent decreases in value was contrary to Article 49 TFEU.

III. Findings of the court

The Court approached the case in the following way: It first answered whether a company transferring its place of effective management to another Member State can rely on Article 49 TFEU against that Member State. Following that, it analysed whether the exit tax is in violation of the freedom of establishment and last it examined whether the Dutch legislation can be justified.

Regarding the first point the Court explained that it was stipulated in *Cartesio* that a Member State can determine the connecting factors required of a company to be incorporated under its national law. It can thus place restrictions on the transfer of such a connecting factor if the company seeks to remain incorporated under the Member State's company law. However, in *National Grid* the transfer of the place of effective management to the United Kingdom did not affect the status of the company and consequently the transfer did not affect the possibility of relying via Article 54 TFEU on Article 49 TFEU[13].

Next the Court examined whether the exit tax restricts the freedom of estab-

13 See paragraphs 22–33 of the judgment.

lishment and reasoned that such an exit tax puts a company at a disadvantage in terms of cash flow compared to a company retaining its place of effective management in the Netherlands. The difference in treatment is liable to deter a Dutch company from transferring its place of effective management to another Member State[14]. The difference of treatment can also not be explained by objective differences in situation[15]. As a consequence, according to the Court, the exit tax constitutes a restriction on the free movement of establishment[16].

Following this the Court analysed whether there is justification for this restriction. It noted that the legislation is justified by the objective of ensuring the balanced allocation of powers of taxation of Member States since that legislation intends to prevent circumstances capable of jeopardising the right of that Member State to exercise its power of taxation regarding activities carried out on its territory. Furthermore, the Court found that the legislation is appropriate to do so[17],as the CJEU put it, '[u]nrealised capital gains relating to an economic asset are thus taxed in the Member State in which they arose.'[18]

Finally, the question arose whether the legislation went beyond what was necessary to attain the objective. The Court split this question into two parts: First, it looked at the issue of the definitive establishment of the amount of tax at the time when the company transferred its place of effective management without taking into account losses that may occur after the transfer. Second, it addressed whether an immediate recovery of the tax at the time of the transfer goes beyond what is necessary to attain the objective.

Regarding the first issue, the Court agreed with the Advocate General that establishing the amount of tax at the moment of transfer can be in conformity with the principle of proportionality. In order to safeguard the exercise of its powers of taxation, the Member Statecan determine the tax due at the moment that its power of taxation ceases to exist. In accordance with the principle of fiscal territoriality, it is for the host Member State to monitorin its tax system fluctuations in the value of the company assets which arise after the home Member State loses its fiscal connection with the company. Consideration of the gains or losses by the home Member State could call into question the balanced allocation of powers of taxation between the Member States and lead to double taxation or double losses[19].

Regarding the second matter, whether the immediate recovery of the tax goes

14 Paragraph 37 of the judgment.
15 Paragraph 38 of the judgment.
16 Paragraph 41 of the judgment.
17 Paragraphs 46–48 of the judgment.
18 Paragraph 48 of the judgment.
19 Paragraphs 52 to 59 of the judgment.

beyond what is necessary, the focus is on the question of whether the alternative, a deferred recovery,would involve an excessive burden both for the company and for the tax authority. The Court stated that a deferred recovery may avoid cash-flow problems which could otherwise arise for the company. However, it also acknowledged that corporate asset situations can be so complex that tracing these assets may lead to an excessive burden for the company which could be as harmful to the freedom of establishment as an immediate exit tax[20].

The conclusion that the Court reached was that less restrictive legislation would be possible for examplelegislation that gives companies the choice between an immediate payment of the tax and a deferred payment, the latter 'possibly together with interest in accordance with the applicable national legislation'. Furthermore, it was stated that account should be taken of the risk of non-recovery and this could be areason why a Member State might be allowed to ask for the provision of a bank guarantee[21]. Finally, the Court noted that a deferred payment would not be an excessive burden for the Member States. Based on the Mutual Assistance Directive[22] Member States can obtain information on whether or not the company has realised certain assets in the host Member State[23].

IV. Comments

After this judgment it is clear to Member States that domestic legislation requiring companies to pay an immediate exit tax on unrealised capital gains in the event of corporate migration is in violation of European law. In that respectthe judgment confirms the case law in *Lasteyrie du Saillant* and *N.*

However, the essence of the judgment is not that exit taxation is prohibited. Whilst such legislation may well be in violation of the freedom of establishment[24]provisions imposing such taxes can be justified based on the basis of the preservation of the allocation of powers of taxation between Member States[25].

The importance of the judgment lies in its definition of a proportionate exit tax. First, Member States may calculate the taxable capital gain atthe moment of emigration and do not have to take – in contrast to the case law in *N.* – later

20 Paragraphs 68–70 of the judgment.
21 Paragraph 74 of the judgment.
22 Directive 2008/55 EC on the mutual assistance for the recovery of claims relating to certain levies, duties, taxes and other measures, [2008] OJ L 150/28.
23 Paragraph 78 of the judgment.
24 Paragraph 41 of the judgment.
25 Paragraph 48 of the judgment.

losses into account[26]. Second, Member States must allow deferred payment tothe moment of actual realisation of the capital but can raise fees for the additional administrative burden and interests for the durationof the delayed payment.

With regards to both aspects the judgment reflects conformity with both European internal market law and international tax law. Whilst freedom of establishment is one of the mechanisms to ensure an internal market without unjustified barriersit is at the same time a principle that the common market freedoms do not guarantee tax neutral corporate emigration[27]. As both the Advocate General in the case and the Court reasoned, the objective of the internal market has to be balanced against domestic considerations such asa Member State's power of taxation in relation tocapital gains within that Member State. Therefore, it is proportionate to determine the tax due when the state loses its power of taxation[28].

In terms of international tax lawthe country of residence has,under the OECD Model Convention,the exclusive right to tax capital gains[29].Under most double taxation treaties a state has no power to tax the income of a former resident after emigration. Consequently, a state is conflicting with the standards of international taxation if it takes into account post-emigration alterations of the capital gains for determining the tax basis of an exit tax as wassuggested in *N.National Grid* corrects this requirement and brings the case law of the CJEU into accordance with international tax treaties.

The risk that refusal to take post-emigration losses into account for the calculation of the deferred exit taxation would lead to disadvantageous results compared to regular taxation of capital gains is further negligible: Due to the taxation of unrealised capital gains upon emigration the assets can be re-valued and thus the opening balance sheet for tax purposes in thehoststate would enter the assets at this re-assessed market value.Subsequent losses on these assets couldbe set-off in the hoststate, which compensates for the disadvan-

26 One also has to note that in this respect, the case *N* is different. An essential difference is the possibility to set off post-emigrational losses. Whilst this is usually possible for companies individuals may not always be allowed to do so, particularly if their participation is not seen as business assets by the tax authorities of the host Member State, but as private investment. Therefore, the comparability is limited to situations where the emigrated person is able to deduct post-emigrational losses.

27 C-365/02 *Lindfors* [2004] ECR I-7183, para. 34; C-403/03 *Schemp* [2005] ECR I-6421, para. 45.

28 Paragraph 52 of the judgment; points 55 and 56 of the Opinion of the Advocate General.

29 Cf. the prospective Articles 7, 13 and 21 OECD Model Convention; in detail on the qualification of exit taxes under the OECD Model Convention Fernando de Man/ TiiuAlbin, Contradicting Views of Exit Taxation under OECD MC and TFEU: Are Exit Taxes Still Allowed in Europe?, *Intertax* 39/12 (2011), p. 618 et seq.

tages of taxation atthe higher unrealised value rather than the actual final value[30].In addition, the re-valuation of assets and liabilities leads to a higher depreciationbasisthat could correspondingly be used to lower the tax exposure in the host state[31].A disadvantage could only arise if further losses wereterminal, meaning that they could notbe taken into account in the hoststate. The Court heldin *Marks& Spencer* thatterminal losses have to be taken into account in order not to infringe the freedom of capital[32]. However, it referred to the non-comparable situation where the losses of a subsidiary have to be taken into account in the parent's state, whereas presently the losses would have to be taken into account for a company that ceased to exist for tax purposes and thus, could notclaim any tax benefits. Yet, such disadvantageswould arisefrom disparities between the national tax systems of Member States that are, as long as such rules are not discriminatory, not regarded as infringing the common market freedoms and couldlegitimately lead to disadvantageous taxation upon emigration[33].

In taking this stance on exit taxation, the judgment also clarified the position of the Commission Communication on exit taxation and the ambiguity surrounding exit taxation on cross-border mergers or in relation to SEs if the assets do not remain connected to the permanent establishment. As already stated, contrary to the Commission Communicationthe Court ruled that a deferred payment does not have to take into account any changes in value of the assets after emigration[34]. Furthermore, since the Court upholds the Member States' competence in defining such conditions, the present judgment does not help to resolve mismatches of the tax basis due to different valuation methods of assets in the emigrating and immigrating country that could lead to problems of double (non-)taxation[35].Concerning cross-border mergers and SEs, Directive 2005/19/EC grants tax neutrality in the form of a deferral only if the assets remain in a permanent establishment of the former home state. If

30 This possibility to set-off post-emigration losses is regarded as the central issue for the proportionality of a deferred exit taxation that does not take future losses into account (para. 58 of the Judgment; point. 88 of the Opinion of the Advocate General). Its conditions and limits are a Member States' competence (point 78 of the Opinion of the Advocate General).

31 Cf. B. Terra/P. Wattel, *European Tax Law*, 5th Ed., Alphen a/d Rijn Kluwer Law International, 2008, p. 789.

32 C-446/03 Marks & Spencer II [2005] ECR I-10837, para.55. See on this case also R. Seer, 'The ECJ on the Verge of a Member State Friendly Judicature', 3 *ECFR* 3 (2006), p. 237–247.

33 C-403/03 Schempp [2005] ECR I-6421, para. 45; in detail B. Terra/P. Wattel (op. cit.), p. 68 et seq.

34 Cf. Communication of 19 December 2006, Exit taxation and the need for co-ordination of Member States' tax policies, COM(2006) 825 final, p. 6.

35 Cf. Communication of 19 December 2006 (op. cit.), p. 7 et seq.).

the Member State however loses its right of taxation, it now follows from *National Grid* that domestic direct taxation legislation regarding mergers and SEs has to comply with the conditions stipulated in this judgment.

As can be seen the Court managed to end the ambiguity regarding exit taxation on cross-border transactions of companies. Nevertheless, it will be interesting to see how national courts will approach the limitations to the conditions stipulated by the Court. In particular regarding the licit interest rate it is unclear ifthe interest rate of a Member Statethat exceeds the recovery of inflationwill be disproportionate.The additional costs could be a prohibitive barrier to opt for a deferred payment and a deferred payment should not be regarded as delayed payment, since without the emigration the taxes would not have been due earlier. Therefore, any penalty-interest rates for the delay seem inappropriate.

To close this case-note, a short comment on company seat transfers is required. After the *Cartesio* judgment in 2008, there has been considerable discussion about the interpretation of this case: whether, and if so in how far, the judgment overruled or confirmed the *Daily Mail* judgment from 1988 on outbound seat transfers in which it was stipulated that the freedom of establishment is not applicable on seat transfers[36]. The pending case *VALE* will hopefully clarify this matter completely[37]. However, seeing the Opinion of Advocate General Jääskinen in this case, the Court might well not be able to do so because it is possible that the CJEU finds that the company in this case will not be able to rely on the freedom of establishment[38].

Contrary to the arguments of the intervening Member States[39], the judgment at hand clarifies that *Daily Mail* has finally been brought to its grave.Outbound seat transfers do not *per se* fall outside of the scope of Article 49

36 See e.g. C. Gerner-Beuerle and M. Schillig, 'The Mysteries of Freedom of Establishment after Cartesio' (2010), 59 *International and Comparative Law Quarterly* 2 (2010), p. 303–323; V. Korom, P. Metzinger, 'Freedom of Establishment for Companies: The European Court of Justice Confirms and Refines its Daily Mail Decision in the Cartesio Case C-210/06', 6 *ECFR* 1 (2009), p. 147–152; J. Bohrenkämper, 'Corporate mobility across European Borders: Still no Freedom of Emigration for Companies?', in *European Law Reporter* 3 (2009); M. Szydlo, 'The Right of Companies to Cross-Border Conversion under the TFEU Rules on Freedom of Establishment', 7 *ECFR* 3 (2010), p. 424 et seq. See further Case C 81/87 *Daily Mail* [1988] ECR 05483, para. 24–25.

37 Case C-378/10 VALE, pending, lodged on July 28, 2010, not yet reported.

38 Opinion of Advocate General Jääskinen in Case C-378/10 *VALE*, delivered on 15 December 2011, points 43 to 52. Due to deregistration from the commercial register, the company did not exist anymore under the law of the Member State of origin (Italy) at the time of registration in Hungary.

39 Para. 29 of the judgment; point 19 of the Opinion of the Advocate General.

TFEU[40].Confirming *Cartesio,* Member States have the power to determine the conditions required by a company for it to be incorporated under its law. For example, for Member States following the incorporation theory it confirms that they can require companies incorporated on their territory to have the registered office within their territory[41].Outbound transfers of the registered office would therefore not fall within the scope of Article 49 TFEU if the company seeks to remain under the company law of this State[42].However, being incorporated under the national law of a Member State allows a companyto be able to rely, via Article 54 TFEU, on the right to freedom of establishment. Thus, any further conditions, such as legislation on winding up orimposing an exit tax, will potentially be in violation of Article 49 TFEU if it restricts the freedom of establishment of the company and is not justifiable.

Nevertheless, the outcome in the case *Vale*will be instrumentalin this discussion. *National Grid* did not clarify the *obiter dictum* of the *Cartesio* judgment dealing with the question of whether, and if so under which circumstances, a Member State has to allow an inbound company conversion, meaning a company transferring its seat into the territory of this Member State and incorporating under its law[43]. This part of the judgment is at hand in the *Vale* case and for reasons of legal certainty on the overall scope of the possibility of corporate migration, it is hoped that the Court of Justice will deal with this matter in the pending case.

40 Compare with para. 24–25 of Case C 81/87 *Daily Mail*.

41 See on this matter e.g. M. Szydlo, 'The Right of Companies to Cross-Border Conversion under the TFEU Rules on Freedom of Establishment', 7 *ECFR* 3 (2010), p. 425.

42 This would be the situation under scrutiny in the *Cartesio* case.

43 Case C-210/06 *Cartesio*, para. 111–112.