The National Grid Indus Case: A Pyrrhic Victory?

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1. Introduction

On 29 November 2011, the Court of Justice of the European Union (CJEU) handed down its decision in the National Grid Indus case. In this case, the key question was whether the Dutch exit tax upon the transfer of seat of a company from the Netherlands to the United Kingdom contradicts the freedom of establishment. The CJEU has answered this question in the affirmative. In this contribution, the decision of the CJEU is critically discussed[2].

2. European framework

2.1. Freedom of establishment

The freedom of establishment is laid down in Article 49 TFEU. Under this provision, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State are prohibited. In

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[2] The case has also been discussed by, *inter alia*, T. O'Shea, Dutch Exit Tax Rules Challenged in National Grid Indus, *Tax Notes International*, Volume 65, No. 3 (2012), pp. 201-205; E.C.C.M. Kemmeren, The Netherlands: Infringement Procedure on Exit Taxes on Business(C-301/11), in: M. Lang, P. Pistone, J. Schuch, C. Staringer & A. Storck, ECJ-Recent Developments in Direct Taxation 2011, *Series on International Tax Law*, Vienna: Linde Verlag Wien, 2012, pp. 183-212, D. Gutmann, Liberté d'établissement et transfert de siège, A propos de CJUE, 29 nov. 2011, *National Grid Indus*, Feuillet Rapide Francis Lefebvre 48/11, pp. 9 *et seq.*, P.J. Wattel, Exit Taxation in the EU/EEA Before And After *National Grid Indus*, *Tax Notes International*, Volume 65, No. 5 (2012), pp. 371-379; and C. HJI Panayi, Exit Taxation following the *National Grid Indus* case, *British Tax Review*, forthcoming.

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addition, Article 49 TFEU prohibits the imposition of restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State. According to Article 54 TFEU, not only individuals, but also companies or firms, can rely on the freedom of establishment, provided that they are formed in accordance with the law of a Member State and have their registered office, central administration or principal place of business within the Union[3]. The concept of establishment involves the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period, according to constant case law of the ECJ[4]. The concept therefore involves two, closely connected, factors: the exercise of an economic activity and a physical location, both on a permanent basis or at least on a durable one[5].
The freedom of establishment basically entails a right of national treatment. According to Article 49 TFEU, the freedom of establishment includes the right to set up and manage undertakings, in particular companies or firms, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the chapter relating to capital. It follows that not only the right to access, *i.e.* the right to take up an activity, but also the right to exercise, *i.e.* the right to pursue an activity, may not be restricted[6]. Furthermore, Article 49 TFEU not only requires the host state to treat establishment by foreign nationals and companies in the same way as nationals of that state. According to constant case law of the CJEU, this provision also requires the Member State of origin to refrain from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation[7]. In other words, both inward and outward

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[3] *Cf.* Article 54 of the TFEU. According to this provision, the term "companies or firms" means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.

[4] *Cf., inter alia,* ECJ 25 July 1991, C-221/89, *Factortame Ltd and others* [1991] ECR I-3905, para. 20; ECJ 11 December 2007, C-438/05, *International Transport Workers' Federation* [2007] ECR I-10779, para. 70.

[5] *Cf.* Opinion of Advocate General Darmon delivered on 7 June 1988, 81/87, *Daily Mail and General Trust PLC* [1988] ECR 5483, point 5.

[6] Barnard, *The substantive law of the EU*, 2nd ed., Oxford University Press, 2004, p. 293.

[7] *Cf., inter alia,* ECJ 13 December 2005, C-446/03, *Marks & Spencer* [2005] ECR I-10837,

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establishment is governed by the Treaty provisions relating to the freedom of establishment.

3. The Court's decision in National Grid Indus

3.1. Facts of the case

The facts of the National Grid Indus case can essentially be described as follows. National Grid Indus BV is a company which is incorporated under the laws of the Netherlands and which has its place of effective management in the Netherlands. As a result, it is treated as a Netherlands resident corporate taxpayer and liable to tax for its worldwide income accordingly. In December 2000, the company transferred its effective place of management from the Netherlands to the United Kingdom. At the time of transfer, the company owned a substantial group receivable, denominated in British pounds. As the British pound had strengthened against the Dutch currency (at that time: the Dutch guilder), the value of the receivable had increased and a substantial unrealized currency gain rested on the loan receivable. On the date of the transfer, the unrealized currency gain was assessed, based on the exit tax provisions incorporated in the Dutch Corporate Income Tax Act 1969. National Grid Indus BV lodged an appeal against the tax levied on this unrealized currency gain, inter alia arguing that the Dutch corporate exit taxation provision infringed the freedom of establishment under Article 49 TFEU. The Dutch Court of Appeal of Amsterdam was uncertain as to the compatibility of the Dutch corporate exit tax provisions with the freedom of establishment and therefore referred the case to the CJEU.

para. 31; ECJ 16 July 1998, C-264/96, *Imperial Chemical Industries / Colmer* [1998] ECR I-4695, para. 21.

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3.2. Decision of the CJEU

The decision of the CJEU essentially boils down to the following. Firstly, the CJEU holds that National Grid Indus BV can invoke the freedom of establishment. The reason is that the transfer of the place of effective management to the United Kingdom did not, under the incorporation theory as applied under Netherlands company law, affect the status of National Grid Indus BV as a company incorporated under Netherlands law. In other words, under the civil law incorporation theory, National Grid Indus BV did not cease to exist as a result of its transfer of seat. As a consequence, National Grid Indus BV could rely on the freedom of establishment.

Secondly, the CJEU rules that the Netherlands exit tax provision creates a cash-flow disadvantage for companies moving their place of effective management abroad. This is because a company transferring its place of management within the Netherlands is taxed on its hidden reserves no earlier than when they are actually realised. The CJEU consequently rules that the Dutch exit tax provision constitutes a restriction of the freedom of establishment.

The subsequent question is whether this restriction can be justified. The CJEU establishes in this regard that the contested exit taxation is intended to tax unrealised capital gains relating to an economic asset in the Member State in which they arose. Capital gains realised after the transfer of the company's place of management, by contrast, are taxed exclusively in the host Member State in which they have arisen. Based on this, the CJEU consequently rules that the restriction is justified by the need to preserve a balanced allocation of taxation powers between Member States. The final question is, however, whether an immediate taxation is nonetheless proportionate. In other words, is there a measure available which is less restrictive for the taxpayer and under which the balanced allocation of taxation powers would equally be ensured? The CJEU answers this latter question in the affirmative. On the one hand, it rules that the tax assessment as such is proportionate. This means that the Netherlands is allowed to definitively establish the amount of tax at the time when the

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company transfers its place of effective management to another Member State. The CJEU decides in that regard that the Netherlands is not obliged to take account of any exchange rate losses that may occur after the transfer by National Grid Indus of its place of effective management to the United Kingdom. On the other hand, immediate collection of the taxes due upon the transfer of the company's place of effective management is not proportionate. The CJEU rules that the Netherlands should provide the taxpayer the choice between either i) immediate payment of tax or ii) deferred payment of the amount of tax, possibly together with interest, until the moment of actual realization of the accrued currency gain. In the latter case, however, the administrative burden that could be occasioned by the deferred recovery of tax should be accepted by the taxpayer. Finally, Member States are allowed to take into account the risk of non-recovery of the tax in the latter case, for example by requiring a bank guarantee from the taxpayer.

4. Appraisal

The CJEU's decision raises many interesting questions. Below, I will briefly touch upon several of them.

4.1. Is Daily Mail overruled?

First of all, one could question how the CJEU's decision relates to the Daily Mail case. The Daily Mail case concerned an investment company established in the United Kingdom that wished to transfer its actual management to the Netherlands. At the time of the proceedings, UK company law provided that a company could relocate its place of central management and control to another country without being liquidated or dissolved. However, under the UK Income and Corporation Taxes Act, companies resident for tax purposes in the United Kingdom were prohibited

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from ceasing to be so resident without the consent of the Treasury. In the case at hand, the Treasury proposed that Daily Mail should sell at least part of its assets before transferring its corporate tax residence. The question was whether the requirement of prior approval infringed the freedom of establishment. The CJEU rejected the taxpayer's claim. It held that "the Treaty regards the differences in national legislation concerning the required connecting factor and the question whether - and if so how - the registered office or real head office of a company incorporated under national law may be transferred from one Member State to another as problems which are not resolved by the rules concerning the right of establishment but must be dealt with by future legislation or conventions"[8].

At first sight, one could infer from this judgment that exit taxes in the field of company taxation do not infringe the Treaty freedoms[9]. Unfortunately, the CJEU itself casted doubts as to whether this conclusion is correct. The reason is that the CJEU based its judgment, at least partially, on the lack of harmonization in the field of company law[10]. In addition, the CJEU has reinterpreted its judgment in *Daily Mail* in the civil law case *Überseering* and suggested that it had addressed the issue in *Daily Mail* only as a matter of civil law rather than an issue of tax law[11]. In brief, it seems that the CJEU essentially has decided the Daily Mail case as a matter of civil law (despite the fact that the case in substance was a matter of tax law), thereby deciding that the real seat theory is not contrary to the freedom of establishment (despite the fact that the United Kingdom actually adhered to the civil law incorporation theory). If the CJEU would now be asked to decide again on the same set of rules as those under scrutiny in the Daily Mail case, one could legitimately wonder whether the decision would still be the same, given the CJEU's decision in National Grid Indus.

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[8] ECJ 27 September 1988, Case 81/87, Daily Mail and General Trust PLC [1988] ECR 5483, para 23.

[9] In the same vein, for instance, P. te Boekhorst, as cited by: D.S. Smit, Verslag van het EFS-seminar "Exitheffingen in Europa", WFR 2006/6679, pp. 835 *et seq*. Te Boekhorst acknowledges that this conclusion may be different in the case of transfer of seat of a *Societas Europaea.*

[10] ECJ 27 September 1988, Case 81/87, Daily Mail and General Trust PLC [1988] ECR 5483, paras 20-22.

[11] ECJ 5 November 2002, Case C-208/00, Überseering [2002] ECR I-9919, para 70.

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In the meantime, the CJEU's decision creates a remarkable distinction between exit taxes under the civil law real seat theory and those under the civil law incorporation theory. Corporate exit taxes applied in those Member States that adhere to the internal market-friendly incorporation theory can be scrutinized under the freedom of establishment whereas corporate exit taxes applied in those Member States that adhere to the internal market-unsympathetic real seat theory cannot. This is a rather paradoxical result[12].

4.2. Post-emigration losses and securities

A second question is how the CJEU's decision relates to the decision in the N. case[13]. In the N. case, the CJEU held the Netherlands exit taxation upon the emigration of an individual substantial shareholder from the Netherlands to the United Kingdom to be contrary to the freedom of establishment under Article 49 TFEU, even although the shareholder could opt for deferral of payment of the tax debt. This was because the granting of deferment of the payment of that tax was conditional on the provision of guarantees by the taxpayer. The CJEU held that the Mutual Assistance Directive and the Recovery Directive constituted less restrictive measures that would equally ensure the effectiveness of the Netherlands tax system. In addition, reductions in value of the shareholding arising after emigration were not taken into account by the Netherlands. The CJEU held that the Netherlands should take these reductions into account if they were not already taken into account by the United Kingdom.

If one compares this ruling to the CJEU's decision in National Grid, the contradictions are striking. In National Grid Indus, the CJEU allows the Netherlands, contrary to the decision in the N.-case, to take into account the risk of non-recovery of the tax by requiring, for example, a bank guarantee from the taxpayer. The CJEU does not clearly explain why it chooses to diverge from its decision in the N.-case in this respect. Perhaps,

[12] In the same vein: Opinion of Advocate General Darmon delivered on 7 June 1988, Case 81/87, Daily Mail [1988] ECR 5483, para 13.

[13] ECJ 7 September 2006, C-470/04, *N.* [2006] ECR I-7409.

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the CJEU sees a difference between the collection of tax relating to one single asset in the case of emigration of an individual shareholder and the collection of tax relating to a complex of business assets in the case of the transfer or seat of a company. This explanation would find some support in the CJEU's decision in *X AB and Y AB*, which case was handed down some years before the N.-case[14]. *X AB and Y AB* concerned a Swedish tax rule for share-for-share mergers that provided that share transfers to a foreign company were liable to immediate taxation, whereas a deferment of tax liability was granted for share transfers to a Swedish company. The CJEU decided that an immediate final settlement in the case of emigration constituted a disproportionate restriction. The CJEU held that the cohesion of the tax Swedish tax rule could be guaranteed by less restrictive measures focused on the risk of a definitive emigration of the taxpayer. The CJEU suggested, in such an eventuality, that the member state create a system of securities or other necessary guarantees to ensure the payment of tax in case the transferor relocated permanently to another country. Hence, here too the CJEU apparently accepted securities as a proportionate measure as well.

Despite of this, one must remember that in the taxable year at stake in *X AB and Y AB* the Recovery Directive was not yet applicable in the field of direct taxation. In the *National Grid Indus* case, by contrast, it was. It is therefore unclear why the CJEU did not refer to the Recovery Directive (and the Mutual Assistance Directive) in *National Grid Indus* as well as suitable measures that would ensure the effective collection of tax in a less restrictive way compared to bank guarantees and the like. On balance, one gets the impression that the CJEU has loosened its constant case law entailing that Member States should make use of the Mutual Assistance and Recovery Directives when relying on the effectiveness of fiscal supervision and collection of tax as a justification ground.

A second contradiction is the fact that the CJEU decides that the Netherlands is *not* obliged to take account of any possible exchange rate losses that may occur after the transfer by National Grid Indus of its place

[14] ECJ 18 November 1999, C-200/98, *X AB and Y XB* [1999] ECR I-8261.

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of effective management, even although these possible currency losses on the British pound sterling can, by their very nature, not materialize in the United Kingdom. It appears that the CJEU gives full effect to the territoriality principle in this regard, and does not allow, like it did in the N.-case, for exceptions on this principle. The CJEU thus seems to introduce a distinction here between taxpayers that directly carry on enterprise (full territoriality) and taxpayers that indirectly carry on enterprise through a substantial shareholding (conditional territoriality). Furthermore, the CJEU identifies a risk of double taxation or double deduction of losses if the Netherlands should take into account future currency fluctuations. It is admitted that, in general, this could of course be true. The point is, however, that in the case at hand this risk did not occur at all. For unspecified reasons, however, the CJEU chooses for an "all or nothing"-approach here, meaning that future currency losses need not to be taken into account by the Netherlands *in concreto* since there is a risk of double loss deduction or double taxation *in abstracto*.

4.3. Step-up required by host state?

As was stated in the previous section, the CJEU decided in *National Grid Indus* that the Netherlands is not obliged to take account of any exchange rate losses that may occur after the transfer by National Grid Indus of its place of effective management to the United Kingdom. A related question is whether the host Member State should grant a tax base step-up accordingly upon immigration of the company. This position could be derived from paragraph 58 of the CJEU's decision. This paragraph reads as follows:
"58 Since, in a situation such as that at issue in the main proceedings, the profits of a company which transfers its place of effective management are, after the transfer, taxed exclusively in the host Member State, in accordance with the principle of fiscal territoriality linked to a temporal component, *it is also for that Member State*, in view of the above-mentioned connection between a company's assets and its taxable profits,

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and hence for reasons relating to the symmetry between the right to tax profits and the possibility of deducting losses, *to take account in its tax system of fluctuations in the value of the assets of that company which occur after the date on which the Member State of origin loses all fiscal connection with the company* [italics added]."

In my view, however, the above conclusion cannot be drawn from the above consideration. The only thing the CJEU is saying here is that the territoriality principle in any case does not require the Member State of departure to take account of deduction of fluctuations in value occurred after emigration but that, at most, such fluctuations could be taken into account in the host Member State. Perhaps, the CJEU was assuming that the host Member State would grants a tax base step-up (which would be in line with the territoriality principle), but we know that this is not always the case in reality. The CJEU did not, however, require the host Member State to grant a tax base step-up. It is hard to believe that in a case which concerns the issue of the compatibility of corporate exit taxes with EU law, the CJEU would have decided on another fundamental and controversial issue of a possible obligation to grant a tax base step-up, almost between brackets and without giving the Member States the opportunity to express their views in this matter and, thus, to defend themselves. In my view, it is therefore hard to believe that the CJEU has really decided on this issue which basically completely fell outside the scope of the preliminary reference.

4.4.How to establish the realization moment?

As stated above, the CJEU held in *National Grid Indus* that the taxpayer should have the possibility to defer the payment of taxes until the moment of actual realization of the accrued currency gain. A question in this context is: how should one establish when the accrued gain is actually realized? Unfortunately, the CJEU remains silent on this matter. In the case of National Grid Indus, one could look at the moment when the group

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receivable is repaid or possibly waived. This could, however, raise new difficulties if the taxpayer were to simply decide not to repay the group receivable or at least to postpone repayment substantially.

Similar questions arise in the case of other assets. Depending on the type and nature of asset, realization could be determined on the basis of the actual disposal of the transferred assets or on the basis of yearly depreciation of the transferred business assets. This system is essentially already applied by the Netherlands but only in situations where assets are transferred from a Netherlands head office to a foreign branch. It can be argued, however, that the same system could be applied in the case of corporate migration as well. Again, it is quite unfortunate that the CJEU did not give any further clues in this regard.

4.5. The "interest"-element

A final question relates to the conditions under which a taxpayer is allowed to choose for deferral of payment of the amount of tax due. The CJEU accepts in paragraph 73 of its judgment that Member States should provide for deferred payment of the amount of tax, *possibly together with interest* in accordance with the applicable national legislation. Does this mean that the deferral of payment can be made subject to an obligation for the taxpayer to pay interest? Or does it mean that the tax assessment as such could include an interest element, but that the deferral of the amount of tax due, including this interest element, should be interest-free? Both readings are defendable. If the first reading is correct, one can establish that the CJEU has basically abolished one restriction (the cash-flow advantage) while introducing a new restriction at the very same time (the obligation to pay interesting during the period of the deferred payment). If this is true, the decision in the *National Grid Indus* case appears to be a Pyrrhic victory. On balance, the benefit of deferred taxation with the obligation to pay interest will probably be minimal or even absent compared to the cash-flow disadvantage following from immediate payment upon the moment of the

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corporate migration. Hence, by allowing Member States to charge interest during the period of deferral of the payment of tax, the decision of the CJEU would immediately have been made ineffective. In my view, it is hard to believe that this is what the CJEU really intended to say, also given the fact that the CJEU rather laconically refers to the possibility to charge interest. If this would be such a crucial issue, one would expect that the CJEU would have elaborated on the possibility to charge interest in more detail. The second reading is therefore, in my view, much more plausible. It is observed, however, that the Netherlands Government has indicated in a published Decree that it will follow the first reading when giving effect to the *National Grid Indus* case[15]. In my view, it remains to be seen whether this interpretation is in line with *National Grid Indus*.

5. Final remarks

The outcome in *National Grid Indus* has been long anticipated. Unfortunately, the CJEU's decision is not clear in all respects and, in addition, conflicts with some of the CJEU's earlier decisions in the field of exit taxes. Consequently, the judgment raises many new questions. Particularly more guidance is needed as to how one should determine the moment of actual realization of any accrued gain. The same holds true as concerns the accepted possibility for Member States to charge interest. It could be argued that the CJEU has accepted that the deferral of payment can be made subject to an obligation for the taxpayer to pay interest. This would mean, however, that the decision in *National Grid Indus* would turn out to be a Pyrrhic victory. It is hard to believe that this is what the CJEU really intended to say. Currently, several infringement procedures are pending before the CJEU in which exit tax regimes in several Member States (including the Netherlands) are combated by the European Commission. It must be hoped that the CJEU will clarify the uncertainties raised in *National Grid Indus* in its future decisions in these cases.

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[15] Decree of 14 December 2011, No. BLKB 2011/2477M, *Vakstudie Nieuws* 2012/4.16.

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