Exit taxation of companies in Portugal

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1. Introduction

"*Should I stay or should I go...*"? The implementation of the EU's internal market, characterized in the Treaty on the functioning of the European Union (TFUE) as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured"[2], together with the persistence of considerable differences between the factual and normative conditions found by companies in the twenty-seven Member States of the Union converts the previous question from a well-known song refrain into an omnipresent sound bite, echoing in the minds of CEO's and CFO's all across Europe.

Under the European perspective, the transfer of an economic activity is not seen as a negative side effect of the internal market. From the very beginning, treaties recognized the need to protect the freedom of establishment, enclosing a "right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms"[3].

In order to achieve an effective internal market, obstacles to this freedom of establishment have to be abolished, which requires also changes in the

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2 See art. 26 (2) TFEU.

3 See § 2 of art. 49 TFEU. The aim is very broad and, in the words of the Court, encompasses the possibility of a "Community national to participate, on a stable and continuous basis, in the economic life of a Member State other than his State of origin and to profit therefrom, so contributing to economic and social interpenetration within the Community in the sphere of activities as self-employed persons". See ECJ, 30 November 1995, C-55/94, Gebhard, para. 25.

field of direct taxation. In this field, exit taxes is[4], certainly, one of the most discussed topics. These rules have an obvious impact in the internal market and all across Europe discussions are having place on whether these rules are compatible with EU Law.

This discussion is also taking place in Portugal. In November 2008 the EU Commission has sent a reasoned opinion concerning the exit tax rules on companies (reference no. 2007/2365). As Portugal hasn't introduced any changes or conveniently justified its rules, the case was referred to the Court of Justice of the EU (hereinafter CJEU) - case number 38/10. Several other countries have also cases pending before the court[5].

The purpose of this paper is to examine the compatibility of those Portuguese corporate exit taxes with EU Law. We will depart from a concise description of the rules targeted by the Commission and currently under the Court's review. Subsequently we will focus in applicability, to companies, of CJEU's case law on individuals. At a later stage we will focus again in the Portuguese system, in order to ascertain whether it can be said in line with the previously described EU law requirements.

2. The Portuguese normative framework

2.1 The adoption of the rules

In the above mentioned procedure it is questioned whether the rules of arts. 83º to 85º (formerly arts. 76-A, 76-B and 76-C) of the Portuguese Corporate Income Tax Code (hereinafter PCITC)[6] can be considered as

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[4] As the taxes levied by a domestic provision, based on the assumption that the transfer of residence of a company should be treated as a dissolution or alienation of its assets (with the taxation of the accrued gains). We will use this concept with a broad meaning as not only companies but also other entities (other than individuals), considered as "taxable persons", will be considered in this study.

[5] An updated list of this cases can be obtained by searching "exit tax" in the following list of ECJ cases. The EFTA Surveiling Authority has also initiated a procedure against Norway (Decision 70-10-COL, 10 March 2010, "to send a letter of formal notice to Norway regarding exit taxation of companies transferring to other EEA States").

[6] In Portuguese "Código do Imposto sobre as Pessoas Colectivas", Decree-Law no. 442-B/88, 30 November.

incompatible with EU Legal order. All these articles are gathered under the same section of the code, entitled “transfer of a company’s seat abroad and cease of non-resident activities”.

The rules, that establish forms of exit taxation for companies and shareholders, were introduced by the State Budget for 2006[7]. Till then, the transfer of a company’s seat was simply not recognized as a taxable event[8]. There were, however, some previous attempts. State Budget for 2004[9] had already authorized the government to introduce an “exit tax on companies”, but that “legislative authorization” expired before any measure was adopted[10]. Therefore, and till the end of 2005, if a company transferred its seat abroad without winding up, no corporate income tax would be levied.

It is somehow puzzling to understand the real motivation behind this set of rules. They were part of a “package”, aimed to implement the Directive 2005/19/EC[11], which modified the original merger directive’s regime[12]. Nevertheless, said diploma did not grant bases for the introduction of any new tax. It only set forth, and regarding the *Societas Europaea*[13] (SE) or the *Societas Cooperativa Europaea*[14] (SCE), that a transfer of residence would not give raise to any tax regarding the assets and liabilities that: i)

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7 Law no. 60-A/2005, 30 December (Portuguese State Budget for 2006).

8 See Câmara, F. S., “A Dupla Residência à luz das Convenções de Dupla Tributação”, *Ciência e Técnica Fiscal*, 403/2001, pp. 80 *et seq.*, Rodrigues, N. C., “A transferência de residência fiscal de sociedades em IRC”, *Fiscalidade* 15/2003, pp. 27 *et seq.*.

9 Law no. 107-B/2003, 31 December.

10 Its content was as follows (our translation): “a) in the assessment of the taxable income of the period in which the activity ceased, due to the transfer of the seat or the effective management of a company to other country, it shall be considered as positive or negative elements [of that income] the difference between the market value and the book value (for tax purposes) of the assets, except when those assets remain allocated to a Portuguese based permanent establishment of the said company (…); b) the aforesaid should also be applicable, with the needed adaptations, in the assessment of the taxable income of a permanent establishment of a non-resident regarding period in which the activity ceases completely or when the assets of the permanent establishment are transferred abroad; c) gains or losses registered by a company in its securities in the moment it transfers its seat of place of effective managements to other country should be considered as capital gains”.

11 Directive (EC) No 2005/19 of 17 February 2005 amending Directive (EC) No 90/434 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States.

12 Directive (EC) No 90/434 of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchange of shares concerning companies of different Member States.

13 Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE).

14 Council Regulation No 1435/2003 of 22 July 2003, on the Statute for a European Cooperative Society (SCE).

remained attached to a PE, located in Portugal and; ii) played a part in generating the profits of such a PE[15]. An *a contrario* interpretation of such regime, extended to the other types of companies, seems to be in the genesis of the regime.

The Portuguese corporate exit tax regime encompasses three sets of rules. The following segments will be devoted to them[16].

2.2 Rule 1: Exit taxes on companies

According with art. 83 (1) PITC, "in the taxable year when the activity ends, by virtue of the transfer of its seat or the place of effective management to another country, shall be considered as positive or negative elements [of the taxable income] the difference between the market value and the book value for tax purposes of the assets in the moment of the transfer".

The *rationale* is easy to understand and is shared with most of other European exit tax regimes: the need to safeguard a State's taxing rights over the hidden reserves in value of the company asset's obtained till the moment of the transfer. This is done because, according with tax treaty law, a Contracting State may only tax the gains of a non-resident if it is sourced in that State. If a company leaves, even if the profits accrued while it was a resident, those profits might no longer be taxed. Moreover when the transfer happens, tax authorities may no longer examine directly its activity.

The Portuguese rule was, however, drafted in a very broad manner. In fact, any entity considered as a tax subject (for the PICTC), including SE's and SCE's, transferring its seat or place of effective management to another country will be covered by this regime.

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[15] See, currently, art. 12 of Directive (EC) No 2009/133 of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States (codified version).

[16] For a broader description of the rules, concerning both individuals and companies, that might be considered as an "exit tax", see Pires, M., *Exit Taxes*, in European Tax Studies, no. 1/2009.

To trigger the rule it is necessary that both seat and place of effective management (effective seat) are transferred abroad. The maintenance of one of this connection factors in national territory will be sufficient to deem an entity as resident and, in such a case, the exit tax will not be applicable[17].

Despite the prolixity of the *formula* for the assessment of the liability, its content is easy to explain. To the taxable profit of a company that leaves Portugal should include, in the year it leaves the country (*i.e.*, the year when it transfers its seat and place of effective management abroad) the "hidden" or non-realized gains. This is done subtracting: i) to the market value of a company assets; ii) the book value for tax purposes of those assets. In simple terms, the gains obtained till the transfer.

2.3 Exception: the remaining PE requirement

If one understands the *rationale* behind the previously mentioned rule, it is not surprising to find an exception for the cases where the company leaves a permanent establishment (PE) - art. 83 (2) (3) and (4). Two conditions have, though, to be met: i) the assets have to "remain effectively connected to a permanent establishment of the same entity" located in Portugal; ii) those assets have to play a role in the production of the taxable profit of that PE". Being that the case, and despite the transfer, the exit tax will not be levied.

This exception is only granted because, under international tax law, gains on those assets (both the accrued till the transfer, and those latter on obtained) will still be submitted to Portuguese tax jurisdiction.

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17 A curious situation may happen if only the "place of effective management" is transferred. As Martin Jimenez and Calderón Carrero wisely point out, if a company only changes its place of effective management, becoming a double resident, and a tax treaty following the OECD MC applies (which is likely to be the case inside the EU), art. 4 (3)'s tie-break rule would deem the company to be tax resident in the new (host) country (to where the place of effective management was transferred). Even though this would not trigger the exit tax provisions, the company would escape the Home State tax jurisdiction. See Martín Jímenez, A. - Calderón Carrero, J. M., "Los Impuestos de Salida y el Derecho Comunitario Europeo a la Luz de la Legislación Española", Documentos de Instituto de Estudios Fiscales, 17/2007, p. 19.

For these cases, there is still an additional rule: the PE may deduct to its profits the losses that the transferred company had in the moment of the transfer[18]. This promotes the continuity of the activity held in national territory, when it is absorbed by the PE.
This exception also encloses an anti-abuse rule, of art. 83 (4). In practice, this works as an “exception of the exception” and is aimed to prevent the application of the “benefit” to abusive cases. The legislative technique was rather curious: instead of drafting a particular anti-abuse rule, the legislator has decided to refer this issue to art. 73 (10), implementing the anti-abuse clause of the merger directive[19]. Its wording is copied from the directive[20].
It is somehow puzzling to ascertain how this anti-abuse clause might be applied in cases of “remaining PE’s”, as it is clearly addressed to other cases. We believe that the aim was to deny the benefits to situations were the allocation of the assets to the PE was driven by tax purposes, is artificial or has no sound connection with its activity.

2.4 Rule 2: Exit taxes on Permanent Establishment

Another situation that triggers the exit tax is the cease of the activity of a permanent establishment. In fact, art. 84º PCITC extends the exit tax provisions to two types of situations concerning PE’s: a) when it ceases its activity in national territory; b) when it transfers, by any juridical or material act, to another country, assets connected with that PE.
This provision is essentially addressed to avoid that the gains on some assets were left untaxed when the PE ceases its activity in national territory. This would be the case when a PE would be left out with a substantial

18 See art. 83 (4) of the PITC.
19 Currently, art. 15 (1) (a) of the merger directive (Directive EC No 2009/133).
20 Therefore carves out the cases that “had as its principal objective or as one of its principal objectives tax avoidance [evasão fiscal], what can be considered verified, namely, in cases where the participating companies don’t have the global amount of its income submitted to the same of the regimes set forth by the Code or if the operations haven’t been carried out for valid economic reasons such as the restructuring or rationalization of the activities of the companies participating in the operations, cases where an additional levy of taxes may occur”Art. 73 (10) PCITC. Unofficial translation.

amount of assets following a business restructuring operation with the transfer of the seat of the main company to another Member-State.

2.5 Rules applicable to the shareholders

Under art. 85º, the transfer has also effects at the level of the transferring company's shareholders (individuals or not). For them, tax is levied on the difference between the company's net assets (valued at the time of the transfer at market prices) and the acquisition costs of the participation. The rules for the assessment of the value and for other procedures were simply remitted to the regime in force for companies' wind-up (which is illustrative of the real aim beneath regime)[21]. There is also a specific set of rules for cases where the transferring company is treated as a transparent one[22].
This article includes a "safeguard clause", aimed to carve out cases where the transferred company is a SE or a SCE. The wording used is, basically, a copy of current art. 14º of the merger Directive and provides that the transfer of one of those companies "does not imply, as such, the application" of the regime (immediate taxation of the shareholders)[23]. As no further guidance is given, hermeneutical problems may arise.

3. Exit taxes on individuals and EU Law

It is clear that any tax triggered by the transfer of a person (regardless of its status) from one Member State to another creates a hindrance to the internal market.

[21] Art. 81 (2-4), according with art. 85 (1) *in fine*.
[22] Art. 75 (4), according to art. 85 (1) *in fine.* For a description of all those rules see Pires, M., *Exit Taxes*, in European Tax Studies, no. 1/2009, p. 16.
[23] See art. 14 of the Directive (EC) No 2009/133, already mentioned.

The court has already scrutinized tax rules with this profile, in *de Lasteyrie du Saillant* and *N* (although some of guidance could already been inferred from the decision in *Biehl*[24]).

In the first, it was considered inadmissible to levy a tax on unrealized capital gains, whose taxable event was the mere transfer of the individuals' residence to another Member State even when the collection was deferred to the moment of realization, essentially because the deferral was conditioned to burdensome guarantees. In *N*, the court stated that the exit taxation would not become admissible simply by lifting a burdensome guarantee without further measures. Moreover, decreases in value of the assets after the moment of the transfer should nevertheless be taken in consideration[25].

This was, in short, the output given by the court in these cases. Notwithstanding, those decisions provide no guidance to a series of connected questions. The CJEU has only provided that the taxation of unrealized gains at the moment of the transfer had to be considered a restriction[26] but that, in some cases, it could be justified, namely by the fight against tax avoidance and evasion or by the need to maintain balanced allocation of taxing rights between Member States, according to the principle of territoriality, connected with a temporal element[27].

Therefore, there is no *a priori* or absolute ban to an "exit tax", as such[28], or to the request of certain administrative formalities at the moment of the transfer[29]. It might be considered admissible as long as it pursues a valid

[24] ECJ 8 May 1990, C-175/88 Biehl. In this case the court had already considered incompatible with EU Law to refuse the refund of excess tax levied on income from employment subject to progressive individual income tax, when the taxpayer transferred his residence abroad before the end of the tax year.

[25] For a comprehensive discussion of this cases see De Pietro, C., *Exit Tax: Fiscal Territoriality and Company Transfer*, in European Tax Studies no. 1/2009, p. 3 *et seq*.

[26] The court could had also framed this tax under the "discrimination" label as the individual that transferred his residence to another country (in the exercise of his fundamental freedoms) would be placed in a less favorable position than an individual that (even moving his residence) never left that Member State.

[27] ECJ 7 September 2006, C-470/04, N, paras. 45-46.

[28] ECJ, C-470/04, N, paras. 45-46. As Di Pietro correctly points out, what happened was a "dissociation, previously unknown in the purely domestic logic of taxation" between, "the power of taxation" and the "exercise of such a power" – See Di Pietro, A., *Past and Perspectives of Exit Tax,* in European Tax Studies, no. 1/2009, p. 3.

[29] ECJ, C-470/04, N, para. 49.

justification and its proportional to that aim[30]. In both previously mentioned cases, the measures went beyond what was needed to pursue the alleged goals[31].

In conclusion, a Member State is allowed to levy a tax on the accrued gains obtained by the taxpayer till the transfer whenever: i) the subsequent decreases in value of the securities are taken in account; ii) the effective taxation is deferred to the moment when the gains are obtained (disposal of the assets); iii) no disproportionate administrative or financial burdens are attached to the deferral. Similar conclusions are reached and discussed in the Commission's Communication on exit taxes[32] and in the Council of the European Union "Resolution on coordinating exit taxation"[33].

4. Exit taxes and companies

The admissibility of any form of exit taxation on companies is, still, an open discussion[34]. Even if the court used consistently the term "taxpayer" in its

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[30] The rationale is sharply explained by De Pietro, "The Court's solution, in respect to the principle of proportionality, aims at preserving the origin state's taxing power, guaranteeing the taxation of capital gains accrued during the whole period of residence for tax purposes. Nevertheless, tax can be levied only when those capital gains are actually realized, so that emigrant taxpayers are in the same position as taxpayers who remain within the country" – See De Pietro, C., *Exit Tax: Fiscal Territoriality and Company Transfer*, in European Tax Studies no. 1/2009, p. 20.

[31] In the court's words, "tax avoidance or evasion cannot be inferred generally from the fact that the tax residence of a physical person has been transferred to another Member State". "The objective envisaged, namely preventing a taxpayer from temporarily transferring his tax residence before selling securities with the sole aim of avoiding payment of the tax on increases in value due in France, may be achieved by measures that are less coercive or less restrictive of the freedom of establishment". Moreover "the obligation to provide guarantees, necessary for the granting of a deferment of the tax normally due, whilst doubtless facilitating the collection of that tax from a foreign resident, goes beyond what is strictly necessary in order to ensure the functioning and effectiveness of such a tax system" ECJ 11 March 2004, C-9/02 de Lasteyrie du Sailant, para. 51 and 54.

[32] Communication COM(2006) 825 final of 19 of December 2006, from the Commission to the Council, the European Parliament and the European and Social Committee, entitled "Exit taxation and the need for co-ordination of Member States' tax policies".

[33] Adopted by the Council of the European Union, 2911th economic and financial affairs in Brussels of 2 December 2008. This resolution isn't more than a political commitment, not being juridical binding. Anyway, it points out that individuals and companies should not face a less favorable treatment (as double taxation steaming from the concurrence of exit taxes with host State regular capital gains taxes) when they move their residence from one Member State to another.

[34] See Greggi, M., *Tax Mobility within the EU: the quest for a new European Nomos*, in European Tax Studies, no. 1/2009, p. 9-10. As much as several authors consider them

previous case law, it is not quite clear if those findings can be immediately applied in the field of companies. Two objections can be found: i) the legal personality question, at a civil/commercial level, and; ii) the substance over form approach.

Let's start with the first: unlike individuals, whose legal personality is determined by pre-legal and natural events (such as birth and death)[35], companies are created and extinguished by a juridical act[36]. Therefore, one has to start by ascertaining if the specific legal order allows a company to maintain its legal personality when it transfers to another country. This is due to the fact that, in the EU, the question is still not harmonized and Member States are free to create their own rules, which are still modelled following two archetypes (although, in practice, most countries use elements from the both): the incorporation theory and the real seat theory[37]. Only in the first the transfer is admissible.

Cartesio[38] drawn a certain parallel between nationality and incorporation of a company[39] and stated that a Member State has still the power to define

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incompatible, Boers gives us notice that in the Netherlands the legislator has been repeating for several times that exit taxes on corporations are compatible with EU Law – See Boers, S. *Influence of EC Law in Dutch exit tax provision*, in European Tax Studies, no. 1/2009.

35 Although, as we see in ECJ 2.03.2010, C-135/08 Rottmann, it is even possible for a Member State to withdraw from a citizen of the Union the nationality of that state, acquired by naturalization, when that nationality was obtained by deception, on the condition that the decision to withdraw observes the principle of proportionality.

36 Its existence is not an *a priori*, imposed itself to the legal system; but a *constructo*, the consequence of the rules of a given legal system. In other terms, it is up for civil and commercial law to determine in which terms a company can be created and which circumstances make her cease to exist (with the known exceptions of the SE and the SCE). About their regime see González Sánchez, Elena, Franch Fluxa, Juan, "La transferencia de la residencia fiscal de las sociedades y libre establecimiento. Reflexiones a la luz de la jurisprudencia del TJCE y del Reglamento de la Societas Europaea", Quincena Fiscal, 17/2005, pp. 35-47.

37 For a detailed discussion of those two systems, beyond the scope of this article, see Panayi, C., "Corporate Mobility in the European Union and Exit Taxes", Bulletin for International Taxation 10/2009, pp. 459-473 (in particular, section 2 – Conflict of Laws Theories and Companies) as well as, from the same author, "Corporate Mobility under Private International Law and European Community Law: Debunking Some Myths", Yearbook of European Law, 2009, pp. 124-176.

38 See ECJ 16 December 2008, C-210/06 Cartesio, (which, in this regard, develops a line of reasoning already present in ECJ 27 September 1988, C-81/87 Daily Mail).

39 As correctly pointed out by the CFE ECJ Task Force on Cartesio, the court draft "a parallel between the incorporation of companies and the nationality of individuals. An individual must have the nationality of a Member State to enjoy freedoms as such as the freedom of establishment: it is clearly for the national law of each Member State to determine which individuals enjoy its nationality. Similarly, a company incorporated in a Member State enjoys the fundamental freedoms: it is for the domestic law of each Member State to define what conditions have to be satisfied for a company to be incorporated, may

the criteria that allow a company to maintain its legal personality[40]. If the legal order requires that a company has to maintain its real seat inside the country of incorporation, the unavoidable consequence of its transfer – accepted by EU Law[41] – is the loss of legal personality. In practice, the company is forced to wind-up before moving to another Member State, which: i) forces the disposal or realization of the gains, and; ii) the attached taxation of such gains. Only when the company is able to transfer abroad without losing its legal personality as a consequence of the emigration, we can move further in the legal analysis.

On should note, however, that in the current state of affairs, Member States are able to circumvent the CJEU's orientation on exit taxation: this is done by simply introducing some changes in their civil and commercial law in order to disallow a company to maintain its legal personality when transferring abroad[42].

When the discussion is taken to the tax dimension, it is still possible to have an objection: to argue that the exit tax is not more than a requalification, for tax purposes, of the transfer. Applying a "substance over form" approach one can sustain that moving abroad is the same as liquidating a company. This requires the application of the normal tax consequence

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shift any of those conditions to another Member State and yet still remain incorporated under the law of the first state" – see "Opinion Statement of the CFE Task Force in the Judgement in the Case of Cartesio Oktató é Szolgáltató bt (Case C-210/06), Judgment of 16.12.2008", § 9.

[40] In the courts words "a Member State has the power to define both the connecting factor required of a company if it is to be regarded as incorporated under the law of that Member State and, as such, capable of enjoying the right of establishment, and that required if the company is to be able subsequently to maintain its status. That power included the possibility for that Member State not to permit a company governed by its law to retain that status if the company intends to reorganize itself in another Member State by moving its seat to the territory of the latter, thereby breaking the connecting factor required under the national law of the Member State of incorporation" - See Cartesio, para. 110.

[41] In the light of ECJ 19.10.2004, C-200/02 Zhu and Chen and also Cartesio, already mentioned.

[42] This is the unavoidable consequence of still not having harmonized in that field. Whenever the transfer is possible, we have to necessarily shift the discussion from international private law to the field of direct taxation. Here, the framework of analysis will be different and very similar to those already set for individuals. According with settled case law, it is for each Member State, having due regard to EU Law, to lay down the conditions for the acquisition and loss of nationality – See ECJ 11.11.1999, C-179/98, Micheletti and Zhu and Chen, already quoted. And, as stated by the CFE Task Force "the decision in Cartesio provides no support to those who consider that corporate exit taxes are compatible with Community Law. Rather, it gives some indications that the court will follow its jurisprudence with regard to individuals, and will find such corporate exit taxes to be incompatible with Community Law" – See the mentioned "Opinion Statement", para. 13.

attached to the liquidation, *i.e.*, the levy of a tax on the (accrued) gains obtained till the moment of the transfer. Notwithstanding, this would lead to a discriminatory and unacceptable treatment as, in this case, no realization takes place and the shareholders also don't receive any real flow of income[43].

If one overcomes these two discussions, then it is possible to start questioning the compatibility of exit taxes with EU Law. And in the field of direct taxation, the settled position of the court is that a national measure cannot introduce an unjustified and disproportionate infringement of the fundamental freedoms[44].

The Court's case law also suggests that a company transferring to another EU Member State (or EEA State[45]) cannot be submitted to any tax burden higher or anticipated, comparing with the burden that a taxpayer making a similar domestic transfer would face[46]. Of course, the domestic and the cross-border cases are not entirely comparable, and some specific rules for cross-border cases may be enacted[47].

The analysis has to be focused on the effects of the particular levy. In this sense it seems irrelevant to ascertain if tax is levied when the gains are realized (taking in consideration only those who accrued while the company was resident) or, instead, if the tax is levied at the time of the transfer, on

[43] As Dourado correctly points out "taxations does not occur exactly in the same terms as in respect of profits regarding the fiscal year / period of the liquidation, since in this case tax gains are determined and taxed when the assets are distributed to the shareholders and this distribution is legally equivalent to a market sale, the taxable value being the market value of the assets" – see Dourado, A. P., "Portugal: Pending Cases" in: Lang, M., Pistone, P., Such, J. and Staringer, C. (eds.), ECJ-Recent Developments in Direct Taxation 2009, Linde, 2009, p. 228.

[44] In the same way notes Schneeweiss, H., "Exit Taxation after Cartesio: The European Fundamental Freedom's Impact on Taxing Migrating Companies, Intertax, 6-7/2009, p. 363: "at first sight the European Court of Justice (ECJ)'s Judgements in *Cartesio* looks like a victory for the European Union Member States collecting exit taxes from migrating companies. A closer look reveals that *Cartesio* is applicable only to a small portion of possible migration scenarios".

[45] Iceland, Liechtenstein and Norway.

[46] See Commission's Communication COM(2006) 825 final, § 3.

[47] As the requirement of a declaration in the moment of the transfer, with an assessment of the accrued and non-realized gains.

the accrued gains (and, immediately, a deferral is granted till the realization of those assets)[48].

Perhaps even more important than the discussion around the compatibility is the one focused on the coordination between Member States' policies in this field. In our opinion, both Member States and the Commission (and neither of these parties should just rely in the other) can take active steps to coordinate Member States' tax systems in order to avoid any cases of double taxation. However, insofar as these situations flow from overlapping rules, they become simple disparities, remaining outside the scope of this study. We will also not deal with the different alternatives to levy those taxes, as it is currently discussed by some commentators or with the question of whether exit taxation may constitute an infringement to tax treaty law[49].

5. Corporate Exit Taxes in Portugal

5.1 Introduction

In terms of corporate taxation, there are essentially two situations in which Portuguese measures may rise concerns in terms of its compatibility with EU law. Those are the taxation on unrealized gains: i) when a company transfers its seat and place of effective management abroad; ii) when a PE is transferred to another member State or transfers abroad some of its assets. Problems may also arise due to the immediate taxation of

[48] For a critical view on the deferral mechanism see, Douma, S., "National Grid Indus. Request for preliminary ruling on exit tax on companies. Court of Appeals of Amsterdam", Insights and Highlights on European Taxation, 12/2010.

[49] See Hurk, H. - Korving, J., "The ECJ's Judgment in *N* Case against the Netherlands and its Consequences for Exit Taxes in the European Union", Bulletin for International Taxation, 4/2007, p. 154. As these authors note: "if a contracting state is granted taxing rights under a bilateral treaty, the treaty provision should not be eroded or eluded by the taxing rights provided in the domestic legislation of the other contracting state". Therefore "although exit taxes seem to be compatible with EC Law, they can infringe on international tax treaties and international law in general".

shareholders of the companies that move abroad. This paper will only deal with these specific forms of exit taxation.

In this segment we will: i) ascertain whether it is possible, according with Portuguese law, to transfer a society to another Member State, and; ii) verify if the measures currently in force are in line with EU Law. In the last section we will examine the regime applicable to shareholders of companies that transfer their residence.

5.1 Changing the seat or the place of effective management of company resident in Portugal

From *Cartesio*, the question of knowing whether a company maintains its legal personality when it moves abroad becomes a logical precursor of all the analysis. This encompasses two sets of issues: i) to ascertain whether the law of the Member State that governs the company allows it to move abroad and to continue its existence as such; ii) to know whether the Host Member State's law allows that company to continue to exist.

For the purposes of this paper, we will only focus on the first part of the discussion. Nonetheless one must bear in mind that even if we conclude that Portugal allows a company to move abroad, it is still necessary to check if the host Member State law (and this depends on the specific MS) allows that company to continue exist as such[50]. This two-pronged exam will only not be necessary, as already stated, facing SE's and SCE's[51].

The answer seems to be relatively straightforward: "a company with its seat in Portugal may transfer it to another country, maintaining its legal personality, if it is accepted by the law of the other country" - See art. 3 (4)

[50] The system is, therefore, in line the "Cartesio requirements".

[51] As Szudoczky sustains "The SE is a supranational company form, unlike companies incorporated under the laws of the Member States, it is created under and governed by common rules of EU Law. It can freely transfer its registered office by virtue of those common rules of EU law. Obstacles to that transfer stemming from the national laws of the Member States cannot be accepted." – Szudoczky, R., "Comments – Letter of formal notice – Norwegian rules on exit tax. EFTA Surveillance Authority", Insights and Highlights in European Taxation, 7/2010, p. 99.

of the Commercial Societies Code (CSC)[52]. Symmetrically, Portugal accepts the transfer of a company governed by the law of another country, provided that this other country's legal system also accepts that transfer. Nonetheless, said company has to adapt its statutes to domestic law.

Therefore, domestic company law creates no barriers to the transfer of a Portuguese company abroad[53]. It is possible to transfer the real seat, the effective seat or both. If that other country's domestic law also accepts the continuity of such a company (recognizing its legal personality) we can move forward[54] and ascertain the compatibility with EU law[55]. For the purposes of the following segments we will assume that, in the case of the transfer of a Portuguese governed company, the host state continues to recognize its legal personality.

5.2 Compatibility with EU Law of the exit taxes on companies

First of all one should note that despite all similarities, the Portuguese exit tax regime is not an implementation of the merger directive[56]. While the

[52] "Código das Sociedades Comerciais" in Portuguese. The decision to transfer shall meet the requirements for changes to the statutes and, in any case, can be taken by less than 75% of the votes. Members who have not voted in favor have the right to withdraw from the society and shall notify it of their decision in the 60 days after the publication of the deliberations – see art. 3 (5) of the CSC.

[53] The system is similar to the Spanish one, although not so debated. For the Spanish approach see Sanz Clavijo, A., The European Commission's Infringement Cases about Spanish Taxes Provisions for Individuals and Companies", Intertax, 6-7/2010, pp. 375-376, Herrera Molina, P., "Spain: Pending Cases": in: Lang, M., Pistone, P., Such, J. and Staringer, C. (eds.), ECJ-Recent Developments in Direct Taxation 2009, Linde, 2009, Martín Jímenez, A., Calderón Carrero, J. M., "Los impuestos de salida y el Derecho Comunitario europeo a la luz de la legislación española", Crónica Tributaria, 125/2007, pp. 49-76, and Calderón Carrero, J. M., "La compatibilidad comunitaria de los impuestos de salida y de las reglas para el reembolso de garantías exigidas con infracción del Derecho Comunitario: el caso N", Estudios Financieros. Revista de contabilidad y tributación, 286/2007, pp. 103-126.

[54] For an excellent discussion of the different systems in force in Europe See Frada de Sousa, A., "Company's Cross-Border Transfer of Seat in the EU after Cartesio", Jean Monnet Working Paper, 07/09, 2009.

[55] According with Szudoczky, "Exit tax provisions do not concern the question whether a company may remain a national of its home state after the transfer of its central administration. Therefore, they should not remain outside the scope of the freedom of establishment but be subjected to the scrutiny as other home state restrictions" – see Szudoczky, R., "How Does the European Court of Justice Treat Precedents in its Case Law? Cartesio and Damseaux from a Different Perspective: Part I", Intertax, 6-7/2009, p. 356.

[56] Or, more precisely, of the 2005 changes to the merger directive, already quoted.

latter addresses the benefits that some cross-border business reorganizations may obtain, exit taxes create a levy with is triggered by the transfer of tax residence of a company.

Second of all, and after detailing all the features of the Portuguese exit tax regime, we are now in a position to accurately assess its compatibility with primary EU Law. The answer seems to be quite straightforward: the Portuguese rules, when applicable, lead to an inacceptable infringement of the freedom of establishment. In other words, companies that decide to leave Portugal or to transfer their assets abroad are subject to an immediate taxation, whereas companies which remain in Portugal or transfer their assets domestically are not taxed.

Prima facie, this transfer seems to be under the protection of the freedom of establishment (art. 49 of the Treaty on the Functioning of the European Union - TFUE and art. 31º of the Agreement on the European Economic Area - AEEA[57]). As long as the legal personality issues are overcome, the transfer of the company corresponds directly to the exercise of the freedom of establishment. Moreover, the rules at stake constitute an infringement to that freedom, which can be characterized both as a restriction[58] and as a discrimination[59]. Decisive is the fact that this difference in treatment dissuades companies from exercising some features of their freedom of establishment, as transferring their residence outside Portuguese territory[60]. The *obiter dicta* present in *de Lasteyrie du Saillant* seem to apply perfectly to these cases[61].

[57] Published in the Official Journal No L 1, 3.1.1994, p. 3 *et seq.* and EFTA States' official gazettes.

[58] As it is triggered when a company "crosses a border", exercising its freedom of establishment.

[59] As those companies receive a less favorable treatment, comparing with those who stay in Portugal or move their assets within this jurisdiction.

[60] As stated in N, para. 35.

[61] In this case the court stated that "a taxpayer wishing to transfer his tax residence outside [of his State of origin]" in the exercise of [one of the fundamental freedoms], is subjected to disadvantageous treatment in comparison with a person who maintains his residence in [that State]. That taxpayer becomes liable, simply by reason of such a transfer, to tax on income which has not yet been realized and which he therefore does not have, whereas, if he remained in [the origin State], increases in value would become taxable only when, and to extent that, they were actually realized. That difference in treatment (...) is likely to discourage a taxpayer from carrying out such a transfer." – See ECJ, de Lasteyrie du Sailant, para. 46.

Obviously, fundamental freedoms are not absolute and one might wonder if the measure can still be considered admissible, *i.e.*, if it was enacted to ensure an acceptable justification and is proportional to that aim. In this situation, justifications could be as diverse as the fight against tax evasion and avoidance, the need for an effective fiscal supervision or the need to ensure a balanced allocation of taxation rights. Nevertheless, and regardless of the justifications invoked, one is almost immediately lead to the conclusion that the Portuguese regime would be considered disproportional.
In fact, the regime is even harsher than the one scrutinized in *de Lasteyrie du Saillant* as: i) there is no possibility of deferral; ii) it is not possible to take in consideration eventual decreases in value occurred after the exit. Therefore, the assessment moves upstream: we are not accessing if the declaration or the guarantees required at the moment of the deferral are proportional, but if the immediate taxation, as such, is admissible. And the answer is clearly negative.
All the previous mentioned objectives could be ensured with less restrictive measures, while keeping the taxation at the moment of the realization[62] (or, equivalently, allowing the taxation at the moment of the transfer and establishing a immediate deferral of the collection to the moment when the realization takes place, without imposing disproportionate administrative burdens). The balanced allocation goal would be achieved as Portugal would still be able to tax the gains accrued while the taxpayer was a resident (*i.e*. before the transfer); the fight against tax avoidance and evasion as well as the fiscal supervision would be guaranteed by the combination of a procedural burden (*e.g.* some declarations)[63] with the mechanisms set in force by the directives on mutual assistance in the exchange of information and on the recovery of (tax) claims.

[62] Only in this moment emerges an effective ability to pay and a cash-flow movement that facilitates the collection of the tax. Moreover, as Carinci correctly points out, this would be the only way to allow an effective taxation of the goodwill – see Carinci, A., *EC law and exit tax: limits, future perspectives and contradictions*, in European Tax Studies, no. 1/2009, p. 8-9, "ste.seast.org/en".

[63] For instance: i) one at the moment of the transfer and one at the moment of the realization, as it is recommended by the Commission's soft law on this matter. This solution is also sustained by Pires, M., *Exit Taxes*, in European Tax Studies, no. 1/2009, p. 16, "ste.seast.org/en".

Therefore, a charge like the Portuguese one, which is collected immediately with no possibility of deferral goes way beyond what is necessary to pursue valid justifications and, as a result, is not in line with EU law.

5.3 Compatibility with EU of the tax levied on shareholders

The problems of compatibility with EU law arise also at the level of the shareholders. The reasons that we've explored in the previous segment are here, with minor adaptations, fully applicable.

It is not admissible to (indirectly) discriminate shareholders (and apply a less favourable tax treatment) on the grounds that the company in which they have a holding has exercised its freedom of establishment and moved abroad. One should take in consideration that the event that leads to the infringement is the transfer of the society – therefore an exercise of the freedom of establishment. It follows that it is not relevant to know if the holding provides is bearer a definite influence[64] in the *sub juditio* company.

Moreover, and in terms of tax policy, it seems hard to justify such a regime. If the taxpayer continues to be a resident, policy wise, it is irrelevant if the company transfers its assets or not: Portugal would still be entitled to tax eventual capital gains at the moment of its realization, as it happens for domestic situations[65]. The transfer of the residence and the eventual changes in the company's tax regime are irrelevant at the level of the shareholder; what should really matter is his real ability to pay, measured by the gain that he eventually obtains with the disposal of shares.

[64] That, according with *Baars* doctrine, would allow distinguishing between freedom of establishment and free movement of capital – See ECJ 13.04.2000, C-251/98 Baars.

[65] Reaching the same conclusion, but on cases regarding the EEA countries see Szudoczky, R., "Comments..." *cit.*, p. 100.

6. Conclusions

The taxation of unrealized gains of a company's assets due to the transfer of its seat and place of effective management to another country is very recent, and was only introduced by the Portuguese State Budget for 2006. Those rules are currently present in art. 83º to 85 of the PCITC (previously art. 76º-A, 76º-B and 76º-C). There is an undeniable innuendo that these rules come as an implementation of the directive 2005/19/CE, of 17 of February, which introduced some changes in the merger directive. The measures follow very closely, in its wording, the rules present in that instrument (as it is more than evident in the remission to the anti-abuse clause of for business restructuration, derived from the merger directive).

In the sense that this regime embraces clauses, concepts and other terms that are clearly taken out from secondary EU law, it is quite clear that national tax authorities and courts will have to interpret those provisions along the lines that are set forth by the CJEU. The *a contrario* interpretation of the directive (in which the regime seems to find grounds of legitimacy) is not to be admissible as: i) the directive only provides for partial harmonization and is not meant to be taken as a comprehensive instrument of legislation (from which an *a contrario* reasoning could be inferred); ii) even the non-harmonized part is already governed by the fundamental freedoms and, as the court as established as settled case law, domestic tax measures infringing those freedoms, triggered by the sole exercise of them, will most likely be considered incompatible with EU law.

Broadly speaking, what the domestic legislator introduced, in current arts. 83º to 85º of the PCITC, was a new tax. This restriction / discriminatory treatment could be assessed under different rule of reason justifications (as the fight against tax evasion and avoidance, the need to ensure effective fiscal supervision and the balanced allocation of taxing rights). But, in any case, the absence of a deferral feature converts it in a disproportionate measure to achieve any of those goals.

In conclusion, Portuguese rules requiring that unrealized capital gains in respect of a company's assets must be included in the taxable base of the year, when a Portuguese company transfers its seat and place of effective management to another Member State or, in case a PE of a non-resident entity ceases its activity in Portugal or transfers its assets located in Portugal to another State, whereas unrealized capital gains from purely domestic transactions are not included in the taxable base - is incompatible with EU law.

Besides all the warnings and proposals (namely of the Commission and the Council, through the mentioned Communication and Resolution) Portugal has still not adopted any changes and maintains rules that are, policy wise, difficult to understand, if not simply inadequate. It would be advisable not only to introduce the afore mentioned changes but also that the Commission, more than expecting a pro-active coordination among member States[66], took a step forward (following the subsidiarity principle) and proposed a binding legal instrument, in order to deter the unintended cases of double taxation that will inevitable persist while an harmonized system in this field is not adopted.

[66] This view is expressed by the former Commissioner for Taxation, expressed in Kovács, L., *European Commision Policy on Exit Taxation*, in European Tax Studies, no. 1/2009, p. 9 et seq.