European Commission challenges Danish, Dutch and Spanish business exit taxes before the European Court

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1. Introduction

On 24 November 2010, the European Commission announced its decision to refer the Netherlands, Spain and Denmark to the ECJ for provisions that impose an exit tax on businesses[2]. Under national tax law in Denmark, The Netherlands and Spain, a business is taxed on its unrealised capital gains if it i) changes its residence; ii) moves its permanent establishment or iii) transfers its assets to another Member State. However, comparable domestic operations are not taxed for unrealised capital gains that may arise. The Commission is arguing that immediate taxation in these cases, although justified, is not proportionate. The Commission is of the view that the said Member States must defer the collection of their taxes until the moment of actual realisation of the capital gains, rather than upon the transfer of assets and liabilities (the Commission has presented its view on exit taxes within the Union elaborately in its Communication dated 19 December 2006[3]). In this contribution, the author analyzes the relevant case law of the ECJ and its impact on the possible final outcome in the above infringement procedures.

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[2] Press release of November 24th 2010, IP/10/1565.

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

2. Is there a restriction?

2.1 Taxation upon transfer of assets

To the extent the transfer of assets and liabilities results in a taxable event both in domestic and cross-border situations, no discrimination arises in the author's view. On the other hand, deferral of capital gains taxation upon the transfer of assets by a domestic company under the condition that the transferee company is a resident company as well, does constitute a discrimination in the meaning of the Treaty freedoms as follows from *X AB and Y AB* and *X and Y*[4]. By analogy to this case law, it is safe to assume that the immediate taxation upon the transfer of assets or liabilities by a company from its head office in one Member State to its permanent establishment abroad or *vice versa* constitutes a discriminatory restriction as well if no taxation takes place in a purely domestic situation[5].

2.2 Taxation upon transferring corporate tax residence

As concerns exit taxes in the field of company income taxation, matters appear to be a bit more complicated. At first sight, one could infer from *Daily Mail* that exit taxes do not constitute a discriminatory restriction in the meaning of the Treaty freedoms. This 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,

[4] ECJ 18 November 1999, Case C-200/98, *X AB and Y XB* [1999] ECR I-8261, para 36; ECJ 21 November 2002, Case C-436/00, *X and Y* [2002] ECR I-10829, para 36.

[5] A hint for this conclusion can be derived from ECJ 23 February 2006, Case C-253/03, *CLT-UFA SA* [2006] ECR I-1831, paras 22 *et seq*., in which case the ECJ rejected the argument raised by the German Government that there is a fundamental difference between the distribution of profits by a subsidiary to its parent company and the transfer of profits within a company. In the same vein: M. Tenore, *The transfer of assets from a permanent establishment to its general enterprise in the light of European tax law*, Intertax 2006/8-9, pp. 391-392.

companies resident for tax purposes in the United Kingdom were prohibited 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. Advocate General Darmon in his Opinion in this case clearly answered this question in the negative. The A-G firstly established that it is generally accepted that the winding-up required by national legislation as a condition for the emigration of a company is not contrary to Union law. He then went on by concluding that it would be paradoxical if a Member State not requiring winding-up were to find itself placed by Union law in a less favourable fiscal position precisely because its legislation on companies is more consistent with Union objectives in regard to establishment[6]. The ECJ rejected the taxpayer's claim as well. 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"[7]. From this judgment, read in the light of the Opinion of Advocate General Darmon, one could conclude that exit taxes in the field of company taxation do not infringe the Treaty freedoms[8]. Unfortunately, the ECJ itself casted doubts as to whether this conclusion is correct. The reason is that the ECJ based its judgment, at least partially, on the lack of harmonization in the field of company law[9]. In addition, the ECJ 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

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6 Opinion of Advocate General Darmon delivered on 7 June 1988, Case 81/87, *Daily Mail* [1988] ECR 5483, para 13.

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

8 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.*

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

of civil law rather than an issue of tax law[10]. This position is defended by several scholars as well[11] and was also endorsed by the High Court of Amsterdam in its decision in a recent Netherlands exit tax case dated 15 July 2010, although the Court did not consider this issue an *acte clair*[12]. Therefore, the decision *Daily Mail* is not fully conclusive.

Assuming that the ECJ essentially decided the *Daily Mail* case as a matter of civil law rather than as a matter of tax law, one could subsequently infer from *Lasteyrie du Saillant* that an exit tax upon transfer of seat must be regarded as a discriminatory restriction. In this case, the ECJ had to consider the French exit taxes upon emigration of individuals which became liable, simply by reason of a transfer of residence, to tax on income which had not yet been realised and which the respective taxpayer therefore did not have. If on the other hand the taxpayer had stayed in France, increases in value would become taxable only when they were actually realised, for instance by means of an actual disposal. This difference in treatment concerning the taxation of increases in value was, according to the ECJ, contrary to the freedom of establishment[13]. On the basis of the above assumption, it is safe to conclude that the interpretation of the freedom of establishment given by the ECJ in *Lasteyrie* regarding exit tax rules on individuals is also valid for exit tax rules on companies applied by Member States. The reason is that Article 54 TFEU stipulates that companies established under the laws of a member state and having their central management within the EU will be treated in the same way as individuals. In addition, in *avoir fiscal* the ECJ made it clear that regarding the principle of nondiscrimination there is no objective difference between a corporate entity and an individual[14].

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

[11] In the same vein, amongst others, E.C.C.M. Kemmeren, 'Nederlandse exitheffingen anno 2005 zijn onhoudbaar, maar een passend alternatief is denkbaar', WFR 2005/6650, pp. 1613-1628, under para 6.2; Netherlands Advocate General Wattel in his opinion delivered in Dutch Supreme Court 13 May 2005, no. 39 613, *BNB* 2005/234, para. 6.14.

[12] This case is currently pending before the ECJ under Case C-371/10, *National Grid Indus BV*.

[13] ECJ 11 March 2004, Case C-9/02, *Lasteyrie du Saillant*, [2004] ECR I-2409, para 46.

[14] ECJ 28 January 1986, Case C-270/83, *Avoir Fiscal*, [1986] ECR 00273, para 18.

3. Is there a justification?

3.1 Need to combat tax abuse

The subsequent question arises to which extent the above identified discriminations can be justified. From *X and Y* it follows that the denial to defer capital gains taxation upon the transfer of assets by a domestic company by reason that the transferee company is established in another Member State can be justified by the need to combat tax evasion. A categorical and general exclusion of transnational transactions, however, is disproportionate[15]. The charge of an exit tax would in the author's view be justified on the basis of anti-abuse considerations where it would appear that the company qualifies as a fictitious establishment which does not carry out any genuine economic activity in the territory of the host Member State[16].

3.2 Need to preserve the fiscal coherence of the tax system / territoriality

From *X and Y* and *N.* it furthermore follows that the denial to defer capital gains taxation upon the transfer of assets by a domestic company by reason that the transferee company is established in another Member State can be justified by the need to preserve the coherence of the tax system respectively the principle of territoriality[17]. This is under the condition that the disputed legislation actually aims at ensuring that increases in value accrued during the period that the company was established in the Member State concerned are to be taxed[18].

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[15] ECJ 21 November 2002, Case C-436/00, *X and Y*, [2002] ECR I-10829, paras 42-43.

[16] ECJ 12 September 2006, Case C-196/04, *Cadbury Schweppes*, [2006] ECR I-7995, para. 68. See also ECJ 8 November 2007, Case C-251/06, *Firma ING. AUER*, [2007] ECR I-9689, paras 41 *et seq*.

[17] ECJ 21 November 2002, Case C-436/00, *X and Y* [2002] ECR I-10829, paras 57 *et seq.*; ECJ 7 September 2006, Case C-470/04, *N.*, [2006] ECR I-7409, para 46.

[18] See, by analogy, ECJ 11 March 2004, Case C-9/02, *Lasteyrie du Saillant*, [2004] ECR I-2409, para 65; and ECJ 18 September 2003, Case C-168/01, *Bosal*, [2003] ECR I-9409, para 36. In the author's view, this implies that where a Member State does not grant a step-up in

A moot question, however, is whether the measures under consideration are also proportionate in that the goal to preserve the coherence of the tax system and territoriality can be achieved by a less far-reaching rule other than immediate taxation. At least as far as the transfer of single assets is concerned, one can infer from *X and Y* that this question must be answered in the negative. In this case, the ECJ held that the coherence of the tax system could be safeguarded by measures which are less restrictive or less prejudicial to freedom of establishment, relating specifically to the risk of a definitive departure of the taxpayer[19]. The decision in *N.* demonstrates by contrast that a system of deferral of payment of tax until the moment of actual disposal of the transferred asset is allowed under the Treaty freedoms, provided that such deferral is not conditional on the provision of guarantees. In addition, possible reductions in value of the transferred asset after emigration should be taken into account as well by the Member State of origin if these reductions are not taken into account by the host Member State[20].

As concerns exit taxation involving the transfer of an enterprise (or part thereof), less restrictive measures are conceivable as well. Notably, deferral of taxation until the moment of actual realization of the capital gains would be a less restrictive measure which would still preserve the fiscal cohesion of the tax system. Depending on the type and nature of asset, realization could subsequently been determined on the basis of the actual disposal of the transferred assets and on the basis of yearly depreciation of the transferred business assets. Such system would boil down to an (optional) system of extended full tax liability in the company's Member State of origin after its transfer seat to another Member State[21]. 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 permanent

the reverse case of immigration of companies, the fiscal coherence *c.q.* the territoriality argument can possibly not be relied on.

[19] ECJ 21 November 2002, Case C-436/00, *X and Y* [2002] ECR I-10829, para 59.

[20] ECJ 7 September 2006, Case C-470/04, *N.*, [2006] ECR I-7409, para 55.

[21] To the extent such system should be considered too burdensome from the perspective of the taxpayer, it is submitted that it is for the taxpayer to weigh out the advantage of deferral of taxation against additional administrative constraints. By analogy, in the context of the credit method, Advocate General Kokott in her Opinion delivered on 11 November 2010, Joined Cases C-436/08 and C 437/08 (Haribo and Österreichische Salinen AG), para. 57.

establishment based on the separate entity approach[22]. It can be argued, however, that the same system could be applied in the reverse case as well. The German Supreme Court in fact has adopted the same approach in a recent case where an entrepreneur transferred its place of residence and its business out of Germany[23]. The German Supreme Court held that when there is no explicit and sufficiently detailed legislation on the taxation upon the transfer of an asset available, there may not be tax or a tax assessment with suspension upon the transfer of assets. However, any later realization of unrealized reserves remains taxable in Germany if, and to the extent that, such reserves are attributable to the former permanent establishment in Germany. The Court explicitly decided that this interpretation did not contravene the applicable tax treaty.

4. Final remarks

It follows from the above that the case law of the ECJ substantially supports the position of the Commission. However, the position of the Commission is no decided case yet, especially given the ECJ's considerations in the *Daily Mail* case. In addition, it must be observed that in earlier cases, notably *Marks & Spencer* and *Lidl Belgium*, the EJC has demonstrated that the proportionality test also has its limits. In the former case, the ECJ explicitly held in the context of cross-border relief that in so far as it may be possible to identify other, less restrictive measures, such measures in any event require harmonisation rules adopted by the Community legislature[24]. Also the High Court of Amsterdam in its decision in the above said Dutch exit tax case dated 15 July 2010 wondered to which extent the Court should assess an exit tax against the benchmark of proportionality. The ECJ might therefore ultimately decide that less restrictive measures for exit taxes can only be achieved through coordination or harmonization measures. Should

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[22] *Cf*. Article 32(3) read on conjunction with Article 9(3) of the Netherlands unilateral Decree for the avoidance of double taxation 2001.

[23] Decision by the German Supreme Court dated 28 October 2009, I R 99/08, DStR 2010/1-2, pp. 40 *et seq.*

[24] ECJ 13 December 2005, Case C-446/03, *Marks & Spencer*, [2005] ECR I-10837, para 58 as confirmed by ECJ 15 May 2008, Case C-414/06, *Lidl Belgium*, [2008] I-3601.

that be the final outcome, it must be hoped that the Member States will take their responsibility and remove the restrictive effects of exit taxes within the Union by coordinated legislative action. For it is clear that national exit taxes on unrealised capital gains within the EU constitute in any event an anathema to the internal market.