Exit Taxation of Cross-Border Mergers after *National Grid Indus*

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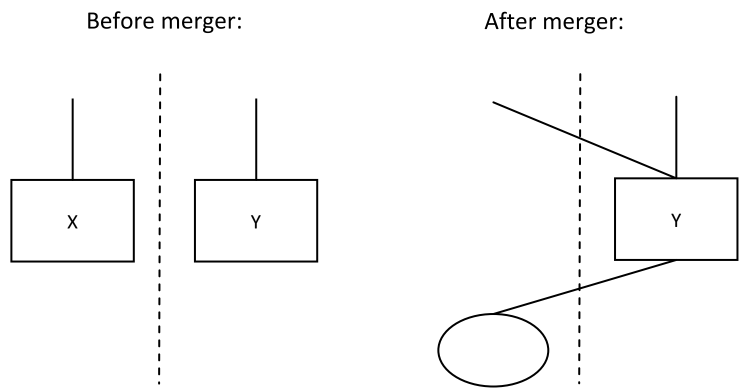
1. Introduction

In this paper I deal with the question to what extent exit taxation in the case of a cross-border merger infringes upon the freedom of establishment. By *mergers* the Tenth Council Directive, the SE Regulation and the Merger Directive mean operations in which one or more companies are wound up and transfer, under a universal title, all their assets and liabilities to another company which issues shares to the former shareholders of the dissolving companies. This can be illustrated as follows.



A merger leads to the winding up of one or more companies. Without fiscal facilities this would generally lead to the final taxation of the transferring companies as if these were liquidated. On that occasion corporate income

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tax is levied on the difference between the real value and the value for tax purposes of the assets and liabilities of the transferring company, in other words, on its latent capital gains. Taxation as a result of a cross-border merger results in an obstacle, in particular because a merger, by contrast to a sale of assets, does not lead to a cash flow to the transferring company out of which the taxes due can be paid. By means of the Merger Directive, the EU has adopted a system of tax deferral[2]. This system should safeguard Member States' tax claims and provide a tax-neutral solution. The Merger Directive does, however, not preclude exit taxation in the case of a cross-border merger. Therefore, the question rises to what extent merging companies can invoke the freedom of establishment.

In section 2 I discuss the system of tax deferral under the Merger Directive. In section 3 I discuss to what extent a transferring company exercises the freedom of establishment. And in section 4 I deal with the question to what extent exit taxation upon cross-border mergers is allowed. Section 5 contains the conclusions.

2. Exit Taxation and the Merger Directive

At the basis of the Merger Directive are two main objectives[3]. In the first place, fiscal obstacles to reorganizations must be removed. In the second place, taxing rights of Member States must be safeguarded. In that respect, deferral of capital gains taxation was considered a simple and adequate system.

In order to prevent tax avoidance or tax base erosion, deferral is only mandatory to the extent the assets transferred remain within the tax jurisdiction of the state of the transferring company. Under Article 4(1), mergers may not give rise to any taxation of capital gains:

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[2] B. Terra – P. Wattel, European Tax Law, Kluwer, Fiscale Handboeken, 2008, p. 549.

[3] Explanatory Memorandum to the 1969 Proposal for a Council Directive on the common system of taxation applicable to mergers, divisions and contributions of assets occurring between companies or firms of different Member States, 16 January 1969, COM(69)5, OJ C 39, 22.3.1969, pp. 3-5.

'A merger, division or partial division shall not give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes'.

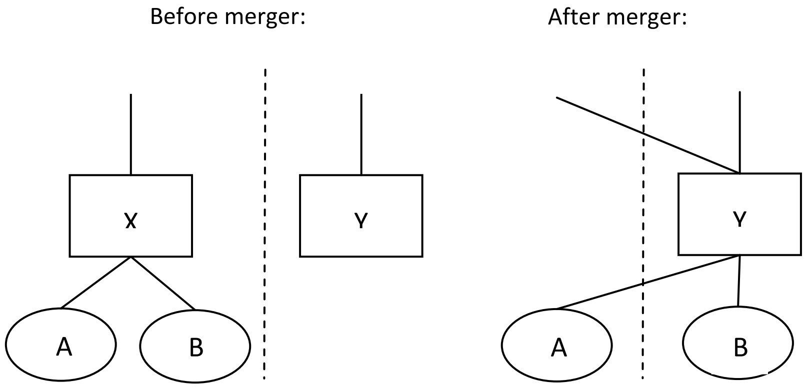
From this text it follows that the prohibition to levy tax only applies to the 'transferred assets and liabilities'. The term 'transferred assets and liabilities' is, however, confusing. Article 4(2)(b) provides for a definition:

''transferred assets and liabilities': those assets and liabilities of the transferring company which, in consequence of the merger (…) are effectively connected with a permanent establishment of the receiving company in the Member State of the transferring company and play a part in generating the profits or losses taken into account for tax purposes'.

Although, in the case of a merger, all assets and liabilities are legally transferred to the receiving company, the Directive considers to be 'transferred assets and liabilities' only those which remain connected to a permanent establishment in the state of the transferring company. Consequently, the system of tax deferral only applies to those assets and liabilities which remain behind in a permanent establishment.

Example

Company X has two activities, A and B. Company Y is established in another Member State. Company X merges with company Y and transfers, as a result of the merger, under general title all its assets and liabilities to Company Y. Company X is wound up. Activity A remains behind in a permanent establishment in the former state of residence of Company X. Activity B is transferred to the state in which Company Y is tax resident. Article 4 Merger Directive precludes Member State X to levy tax on the assets of activity A which remain behind in Member State X. Article 4 does not apply to the assets which are attributable to activity B and which are transferred to Member State Y. One of the assets of activity B is intellectual property with a book value of 400 and a market value of 500. Under the domestic legislation of Member State X, the merger is considered a taxable event, and the latent capital gain of 100 is taxed immediately. Article 4 does not preclude this form of exit taxation on assets which are transferred abroad, as Article 4 only applies to assets which remain behind in a permanent establishment in the state of the transferring company.



Capital gains in respect of assets and liabilities, including goodwill, which must be attributed to the new head office in the state of the receiving company may be taxed upon the merger. This applies for instance to assets which are carried abroad[4]. Also mergers of companies which do not result in a remaining permanent establishment, for instance holding companies, may be taxed[5].

The reason that Article 4 only applies to assets which remain behind in a permanent establishment is quite simple. If Member States X and Y have concluded a tax treaty which is in line with Article 7 OECD Model Convention, then the Member State of the transferring company X loses its tax jurisdiction in respect of the assets which are transferred abroad and which do not remain behind in a permanent establishment. In order to avoid the evaporation of tax claims, Article 4 does not apply to assets which are transferred abroad.

The issue of exit taxation in the case of mergers is similar to the issue of exit taxation in the case of transfers of seat of companies.

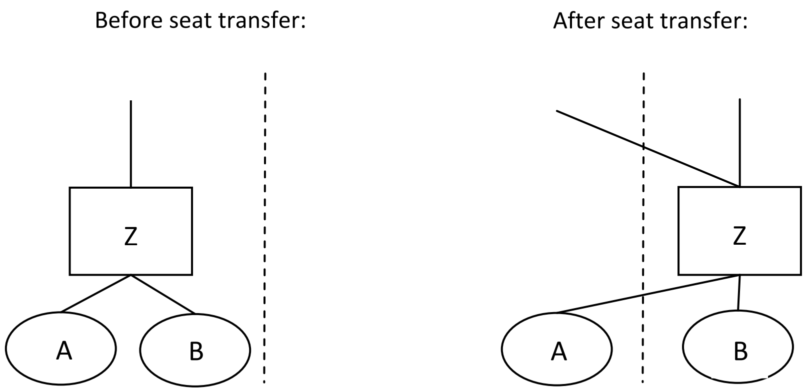
Example

Z is a European Company (SE) and has two activities, A and B. Company Z transfers its seat to another Member State. Activity A remains behind in a

[4] O. Thömmes, Merger Directive, EC Corporate Tax Law, IBFD, 2004, Article 4, para. 162.

[5] Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Towards an Internal Market without Obstacles, COM(2001)582 final, s. 3.2.3, p. 236.

permanent establishment in its former state of residence. Activity B is transferred to the new state of residence. Article 12(1) Merger Directive precludes Member State Z to levy tax on the assets of activity A which remain behind in that state. Article 12(1) does not apply to the assets which are attributable to activity B and which are transferred abroad. One of the assets of activity B is goodwill with a book value of 200 and a market value of 250. Under the domestic legislation of Member State Z, the transfer of seat is considered a taxable event, and the latent capital gain of 50 is taxed immediately. Article 12(1) does not preclude this form of exit taxation on assets which are transferred abroad.



Therefore, both in the case of mergers and of transfers of seat, the Merger Directive does not preclude exit taxation.[6] This does not mean that the Merger Directive infringes the freedom of establishment[7], for example in respect of transfers of seat. The Merger Directive does not either justify that Member States levy exit taxes[8]. The Merger Directive does not oblige Member States to levy exit taxes[9]. Only Member States have the autonomy to decide when and how to levy direct taxes. And only Member States have

[6] Cfr. Opinion of Advocate General Kokott, delivered on 8 September 2011, C-371/10, National Grid Indus, paragraph 50.

[7] Others, by contrast, hold that the permanent establishment requirement contravenes the fundamental freedoms, M. Hoffstätter and D. Hohenwarter-Mayr, The Merger Directive, in: M. Lang e.a. (ed.), Introduction to European Tax Law: Direct Taxation, 2nd ed., Spiramus, 2010, pp. 140-141, with reference to W. Schön, TNI, 2004, pp. 202 et seq.

[8] H. van den Broek, Cross-Border Mergers within the EU. Proposals to Remove the Remaining Tax Obstacles, Kluwer Law International, 2012, s. 7.3.4.2.

[9] H. van den Broek, Cross-Border Mergers within the EU, cited above, s. 7.3.4.2. Cfr. R.P.C.W.M. Brandsma e.a., Europees Belastingrecht, Cursus Belastingrecht, Kluwer, 2011, p. 252 with regard to transfers of seat.

the responsibility to make sure that their tax laws are in line with the fundamental Treaty freedoms and the relevant case law of the ECJ[10].

The Merger Directive does not preclude exit taxation. Therefore, in 2001 the Commission considered the requirement of a remaining permanent establishment a tax obstacle which hampers reorganizations. The Commission audaciously proposed to defer taxation also if no permanent establishment remains behind.[11] Until now, this proposal was not adopted.

In addition, where Articles 4 and 12(1) Merger Directive only apply to assets which remain behind in a permanent establishment, the Directive lacks a definition of 'permanent establishment'[12]. This raises the question which definition must be applied[13]. The Directive also requires that the assets and liabilities transferred must 'play a part in generating the profits or losses taken into account for tax purposes.' These profits must be subject to corporate income tax in the state of the transferring company[14]. Under Article 8(1) OECD Model Convention, earnings of international shipping and airline activities[15] are taxable only in the state where the effective management of the undertaking is situated. Therefore, in the case of a transferring shipping or airline company, there is no remaining permanent establishment to which these assets can be attributed. In 1990, the Council

[10] Cfr. Opinion of Advocate General Kokott, delivered on 8 September 2011, C-371/10, National Grid Indus, paragraph 50. Cfr. M. Helminen, EU Tax Law. Direct Taxation, IBFD, 2009, p. 196, 207, who holds that the freedom of establishment may prevent a Member State from exit taxation upon mergers and transfers of seat if similar domestic reorganizations would be tax exempt.

[11] Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Towards an Internal Market without Obstacles, COM(2001)582 final, s. 3.2.3, p. 6.3.1, pp. 331-332.

[12] H. van den Broek, Cross-Border Mergers within the EU, cited above, s. 6.1.2.5 regarding interpretation of the Directive in general.

[13] R.A. van der Laan, *De fusierichtlijn: beleidsvrijheid en richtlijnpolitiek*, Maandblad Belasting Beschouwingen, 1992, p. 194, s. 4. O. Thömmes, Merger Directive, cited above, Article 4, p. 163, states that Member States may apply their domestic rules regarding permanent establishment taxation and the provisions of their tax treaties. Cfr. Terra - Wattel, European Tax Law, cited above, p. 261. B. Larking, *Permanent Confusion? The Role of the Permanent Establishment in the Merger Directive*, European Taxation, 1992, pp. 305-307.

[14] B. Larking, *Permanent Confusion?*, cited above, p. 304.

[15] Council documents 5884/90, 11 April 1990, p. 2 and 6260/90, 8 May 1990, pp. 1-8.

adopted Council statement[16] number 3 allowing the state of the transferring air company to levy exit taxes in the case of mergers:
'3. Re Article 4
The Council and the Commission are agreed that in the case of a merger between international shipping companies or airlines, the Member State of the transferring company shall at the time of the merger be entitled to tax capital gain on the ships of aeroplanes which as a consequence of the merger will be excluded from this State's right of taxation'.
The benefits of Article 4 only apply to assets and liabilities which remain effectively connected to a permanent establishment in the state of the transferring company, if they continue, under both domestic law and the applicable tax treaties, to be subject to tax in that state[17].

3. Transferring Companies and the Freedom of Establishment

3.1. Introduction

Where the Merger Directive does not preclude exit taxation, the question rises whether the fundamental Treaty freedoms do. Can the transferring company invoke the freedom of establishment against exit taxation?

3.2. The SEVIC Case

The ECJ ruled in Case C-411/03 *SEVIC*[18] that the general refusal in Germany to register a merger of a German receiving parent company with a Luxembourg transferring subsidiary company is contrary to Community law. SEVIC Systems AG ('SEVIC') applied for registration in the national

[16] Council document 7046/90, 12 June 1990, p. 4. See for the text of all Council Statements: H. van den Broek, Cross-Border Mergers within the EU, cited above, pp. 705-707.
[17] Cfr. P.H. Simonis, *Fusierichtlijn: Wetsvoorstel tot wijziging van de Wet op de Vennootschapsbelasting 1969*, Weekblad voor Fiscaal Recht, 1991, s. 6.2, p. 1654. E. van den Brande-Boomsluiter, De bedrijfsfusiefaciliteit in de vennootschapsbelasting, 2nd ed., Kluwer, 2004, pp. 54-58.
[18] ECJ 13 December 2005, C-411/03, SEVIC Systems AG, [2005] ECR I-10805.

commercial register of the merger between itself and Security Vision Concept SA ('Security Vision'), a company established in Luxembourg. SEVIC was the parent company of Security Vision[19]. The *Amtsgericht* Neuwied rejected the application for registration of the merger, on the ground that the German law on company reorganizations (Umwandlungsgesetz) provided only for mergers between companies established in Germany. The ECJ, however, ruled that Articles 43, particularly paragraph 2, and 48 EC applied to the cross-border merger at hand (now Articles 49 and 54 TFEU). The ECJ held that the freedom of establishment includes in particular the formation and management of (foreign) companies under the conditions legally defined for its own companies. It covers all measures which permit or even merely facilitate access to another Member State and the pursuit of an economic activity in that state. The ECJ held that cross-border merger operations constitute particular methods of exercise of the freedom of establishment[20]. German law established a difference in treatment between companies according to the internal or cross-border nature of the merger, which was likely to deter the exercise of the freedom of establishment of the receiving company. This restriction could not be justified[21]. The Court acknowledged that it is not possible to exclude the possibility that imperative reasons in the public interest such as protection of the interests of creditors, minority shareholders and employees, and the preservation of the effectiveness of fiscal supervision and the fairness of commercial transactions may, in certain circumstances and under certain conditions, justify a measure restricting the freedom of establishment[22]. But such a restrictive measure would also have to be appropriate for ensuring the attainment of the objectives pursued and not go beyond what is necessary to attain them[23].

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[19] ECJ 13 December 2005, C-411/03, SEVIC Systems AG, [2005] ECR I-10805, Report for the hearing, para. 17.

[20] ECJ 13 December 2005, C-411/03, SEVIC Systems AG, [2005] ECR I-10805, paras 16-19.

[21] ECJ 13 December 2005, C-411/03, SEVIC Systems AG, [2005] ECR I-10805, paras 20-23.

[22] ECJ 13 December 2005, C-411/03, SEVIC Systems AG, [2005] ECR I-10805, paras 26-28.

[23] ECJ 13 December 2005, C-411/03, SEVIC Systems AG, [2005] ECR I-10805, paras 29-30.

3.3. Does the Freedom of Establishment apply to the *Transferring* Company?

The question arises whether the freedom of establishment grants companies also the right to be involved as *transferring* company in a cross-border merger. For example, if in *SEVIC*, instead of Germany, Luxembourg would have prohibited the merger of the Luxembourg transferring company. Do transferring companies also exercise their freedom of establishment and may they rely on it?

Many authors assume from *SEVIC* that the freedom of establishment also applies to outbound mergers[24]. Others acknowledge that this may be problematic. Schön and Schindler hold that, as a result of its auto-extinction, the transferring company which ceases to exist, might be no longer subject to the freedom of establishment[25]. Together with others, however, they consider the arguments for the application of the freedom of establishment stronger[26]. They emphasize that the shareholders of the merging companies exercise their freedom of establishment, and that it is irrelevant whether the transferring company continues to exist[27]. Furthermore, otherwise foreign receiving companies would be discriminated compared to domestic receiving companies. Foreign parent companies would not be able to convert their subsidiaries into permanent establishments[28]. Some authors, by contrast, hold that the freedom of establishment does not apply to the transferring company[29].

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[24] H. Kuβmaul - L. Richter - S. Heyd, *Ausgewählte Problemfelder der Hinausverschmelzung von Kapitalgesellschaften aus Deutschland*, Internationales Steuerrecht, 3/2010, p. 76; R. Eismayr - A. Linn, *8. Thema: Steuerliche Aspekte des Wegzugs von Kapitalgesellschaften*, in Handbuch der internationalen Steuerplanung, Teil 3: C. Konzernreorganisationen, ed. Siegfried Grotherr, NWB Verlag, 2010, par. B III.

[25] W. Schön - C.P. Schindler, Die SE im Steuerrecht, Verlag Dr. Otto Schmidt, 2008, p. 72, referring to further literature.

[26] W. Schön - C.P. Schindler, Die SE im Steuerrecht, cited above, p. 72; D. Aβmann, Steuerrechtliche Aspekte der Gründung und Sitzverlegung einer Europäischen Gesellschaft (Societas Europaea) – Die Behandlung stiller Reserven, Verlag Dr. Kovač, 2006, p. 186.

[27] W. Schön - C.P. Schindler, Die SE im Steuerrecht, cited above, p. 72, referring to further literature. R. Eismayr - A. Linn, *Steuerliche Aspekte des Wegzugs von Kapitalgesellschaften*, cited above, par. C.I.3.bc.

[28] W. Schön - C.P. Schindler, Die SE im Steuerrecht, cited above, p. 72.

[29] H. van den Broek, Cross-Border Mergers within the EU, cited above, pp. 113-117.

Where in *SEVIC* the ECJ allowed the *receiving* company to participate in a cross-border merger, in paragraph 122 of Case C-210/06 *Cartesio* the ECJ clarified in an *obiter dictum*:

'SEVIC Systems concerned the recognition, in the Member State of incorporation of a company, of an establishment operation carried out by that company in another Member State by means of a cross-border merger (…) similar to the situations considered in (…) Centros (…) Überseering; and (…) Inspire Art'.

It is striking that, in this case concerning conversions of companies, the ECJ gives a characterization of its *SEVIC* ruling. Apparently the ECJ considered it necessary to clarify the *SEVIC* ruling, to make sure that the implications of *SEVIC* are not overestimated. *SEVIC* and *Centros* are cases of recognition which only impose obligations on the *host* state in the field of company law. By contrast, *Daily Mail* and (perhaps?) transferring companies in outbound mergers are cases which do *not* impose obligations on the state of origin in the field of company law.

In my opinion, in *SEVIC* the ECJ did not hold that the freedom of establishment grants companies the right to participate as transferring company in an outbound merger. The case only regarded the rights of a receiving company in an inbound merger. This difference is similar to the difference between the cases *Daily Mail* and *Cartesio* vs. *Überseering*, *Centros* and *Inspire Art*.

In the second place, in *SEVIC*, the ECJ ruled that the freedom of establishment includes the formation and management of foreign companies and covers all measures which permit or even merely facilitate access to another Member State. But, by contrast with a receiving parent company, a transferring company does not as such manage foreign companies nor does it seek access to another state. A transferring company does not establish itself in another Member State. Therefore, the participation in a cross-border merger does not constitute an act of establishment of the transferring company. Instead, in the course of a merger, the transferring company quits its economic activities and transfers them all to the receiving company. The transferring company even ceases to exist. Therefore, a transferring company as such does not exercise its freedom of establishment and may not rely on this freedom[30].

In the third place, in *Cartesio*[31], the ECJ makes a clear distinction between the preliminary question whether a company exists and has Treaty freedoms (Article 54 TFEU) and the subsequent question whether national legislation infringes the right of establishment (Article 49 TFEU)[32]. The preliminary question regards the issue whether a company which transfers its real seat abroad continues to exist as a legal entity or whether it must be liquidated. Only if a company continues to exist in the course of a reorganization does it continue to be a company of a Member State for the purpose of Article 54 TFEU. Only in that case is the company entitled to the freedom of establishment.

In settled case-law, among which the cases Case 81/87 *Daily Mail* and Case C-210/06 *Cartesio*, the ECJ held that Member States have the *autonomy* to determine under which conditions their companies can be established and under which conditions they continue to exist. The freedom of establishment does not grant companies the right to transfer their seat abroad. Member States may liquidate such companies and they may not rely on the freedom of establishment. Member States enjoy autonomy in respect of the choice of their company law systems. Only if Member States allow their companies to transfer their real seat abroad *and these companies continue to exist*[33], then they exercise their freedom of establishment and they must be *recognized* by the host Member State[34].

In my opinion, this line of thinking of the ECJ must also be applied to outbound mergers. Mergers result in the winding up of the transferring

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[30] This also applies in the case of an outbound contribution of assets in which the transferring company continues to exist: that company does not establish itself in another Member State.

[31] ECJ 16 December 2008, C-210/06, Cartesio Oktató és Szolgáltató bt, [2008] ECR I-9641, para. 110.

[32] ECJ 16 December 2008, C-210/06, Cartesio Oktató és Szolgáltató bt, [2008] ECR I-9641, para. 109.

[33] ECJ 8 March 1999, C-212/97, Centros Ltd, [1999] ECR I-1459; ECJ 5 November 2002, C-208/00, Überseering BV, [2002] ECR I-9919, and ECJ 30 September 2003, C-167/01, Inspire Art Ltd, [2003] ECR I-10155, and recently ECJ 29 November 2011, C-371/10, National Grid Indus BV [not yet published].

[34] H. van den Broek – G. Meussen, *National Grid Indus case, re-thinking exit taxation*, European Taxation, 2012, [not yet published].

company. Where the transferring company ceases to exist, the preliminary conditions of Article 54 TFEU stop being met. The freedom of establishment no longer applies to such a transferring company. Its position is similar to a company which transfers its real seat from a real seat state and ceases to exist. Furthermore, the concept of autonomy means that a Member State may determine when a company is wound up, but also when it is *not* wound up. For instance that a company is not wound up if it transfers its real seat abroad. Or that a company may not be wound up in an outbound merger with a foreign company.

Therefore, a transferring company does not establish itself in another Member State. It also ceases to be a company of a Member State which is entitled to the freedom of establishment. Consequently, the freedom of establishment does not oblige Member States to allow their companies to participate in cross-border mergers as *transferring* company[35].

4. Exit Taxation and the Freedom of Establishment

4.1. Is Exit Taxation Immune to the Freedom of Establishment?

Different from the question whether a company can rely on its freedom of establishment in order to act as dissolving company in a cross-border merger is the question of the extent to which exit taxation must be in line with the freedom of establishment in case the company law of both companies allows cross-border mergers. This second question does not affect the autonomy of Member States in the field of company law. But also where company law allows cross-border mergers, the transferring company does not exercise its freedom of establishment. Therefore, the transferring company cannot rely on its freedom of establishment in order to object to exit taxation as a result of the merger.

Notwithstanding this, in my opinion, final taxation of the transferring company must be in line with the freedom of establishment. In *SEVIC*, the ECJ ruled that in the case of a cross-border merger, the *receiving* company

[35] H. van den Broek, Cross-Border Mergers within the EU, cited above, pp. 113-117.

takes over the economic activities connected to the assets and liabilities of the transferring company and gets access to the economy of the state of the transferring company. By means of the cross-border merger, the receiving company opens a secondary establishment. The *receiving* company exercises its freedom of establishment. Therefore, in a cross-border merger it is not the transferring company but the receiving company that exercises its freedom of establishment.

The question arises whether the *receiving* company may invoke its freedom of establishment against the exit tax imposed by the state of the *transferring* company. In the first place, it is settled case law that, as a rule, also the *host state* where a company starts an establishment may not restrict the access of a foreign legal entity to its market and must refrain from discriminatory taxation. Therefore, the state of the transferring company may not levy tax in a way that restricts the freedom of establishment of the receiving company.

In the second place, it is important to acknowledge that, in fact, exit taxation in the state of the transferring company restricts the freedom of establishment of the receiving company. To the extent that domestic mergers in the state of the transferring company enjoy merger benefits, it is less attractive to merge with a foreign receiving company. Exit taxation in the hands of the *transferring* company therefore hampers the freedom of establishment of the *receiving* company (indirect discrimination of the receiving company).

At first sight, it might seem curious that taxation of a legal entity can restrict the freedom of establishment of another legal entity. However, in various cases, the ECJ has recognized that this may occur. The ECJ has ruled that the freedom of establishment of a parent company is restricted if the subsidiary company is subject to discriminatory taxation[36]. And in the

[36] See for example Joined cases ECJ 8 March 2001, C-397/98 and C-410/98, Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd, [2001] ECR I-1727, paras 2, 43-44, 76; ECJ C-324/00 12 December 2002, Lankhorst-Hohorst GmbH, [2002] ECR I-11779, paras 2, 11, 21, 27-32; ECJ 10 May 2007, C-492/04, Lasertec Gesellschaft für Stanzformen mbH, [2007] ECR I-3775, paras 2, 13, 28; ECJ 18 July 2008, C-231/05, Oy AA, [2007] ECR I-06373, paras 2, 17, 25, 43; ECJ 17 January 2008, C-105/07, Lammers & Van Cleeff NV, [2008] ECR I-173, paras 2, 7-10, 19, 23.

field of individuals, the ECJ has ruled that the right granted by Article 18 EC to move and reside freely in the territory of another Member State was applicable when a man was taxed more heavily because of the fact that his former wife migrated to another Member State[37].

With regard to cross-border mergers this means that discriminatory taxation of the transferring company by its state of establishment infringes the freedom of establishment of the *receiving* company, which, moreover, is its legal successor[38]. In conclusion, the freedom of establishment of the *receiving* company requires that taxation by the state of residence of a *transferring* company may not be heavier than in the case of a domestic merger, unless it can be justified. If there is no such justification, the transferring company may appeal against these tax assessments on grounds of an infringement of the freedom of establishment of the receiving company.

4.2. *National Grid Indus* and Cross-Border Mergers

4.2.1. Introduction

To what extent do the fundamental freedoms preclude exit taxation in the case of outbound mergers[39]? What requirements must exit taxation meet?

The 2001 Bolkestein report acknowledges that cross-border restructuring operations are only partly covered by the Merger Directive[40]. The Commission concludes that capital gains taxes on cross-border mergers are often prohibitively high. Exit taxation is mentioned among the tax obstacles in the Internal Market which hamper reorganizations. The Commission suggests that a more radical change to the Directive would be to extend its scope so as to defer the triggering of tax charges where assets are moved

[37] In ECJ 12 July 2005, C-403/03, Egon Schempp, [2005] ECR I-06421, paras 22-26.

[38] H. van den Broek, Cross-Border Mergers within the EU, cited above, pp. 329-331.

[39] W. Schön - C.P. Schindler, Die SE im Steuerrecht, cited above, p. 72, notice that there are doubts whether immediate taxation is allowed.

[40] Commission Staff Working Paper, Company Taxation in the Internal Market, SEC(2001)1681, s. 3.2.3, 6.3.1, pp. 331-332.

to another Member State while preserving Member States' tax claims[41]. In 2006, the European Commission issued its communication on exit taxes[42]. It is a pity that the Commission did not address the issue of exit taxes levied on occasion of cross-border reorganizations. In 2008, the ECOFIN Council adopted a Council Resolution[43] on coordinating exit taxation. This resolution does not apply to cross-border mergers either.

Without any doubt exit taxes constitute a burden to cross-border mergers[44]. The main question is therefore whether this tax burden can be justified. It is settled case law of the ECJ that national laws which hinder the exercise of fundamental freedoms or make it less attractive may be justified if they pursue a legitimate objective in the general interest[45]. These measures must be appropriate to attain that objective, and may not go beyond what is necessary[46]. Apart from the means of justification laid down in the TFEU[47], the ECJ has also recognized a limited number of means of justification which are based upon the so-called rule of reason[48]. Member States may only rely on these grounds of justification to the extent that their national legislation is actually based upon those grounds[49]. The question is to what extent these requirements are met in the case of cross-border mergers.

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[41] Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Towards an Internal Market without Obstacles, COM(2001)582 final, s. 4, p. 10; para. 40, p. 38; para. 56, p. 42.

[42] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on Exit taxation and the need for co-ordination of Member States' tax policies, 19 December 2006, COM(2006)825 final, p. 6.

[43] Council Resolution on coordinating exit taxation, 2 December 2008, 16412/08, FISC 176.

[44] J.W. Bellingwout, *Fiscale aspecten van grensoverschrijdende fusie (en omzetting)*, Weekblad voor Privaatrecht, Notariaat en Registratie, 2007, p. 722, notes that in a domestic merger no tax is levied, while this occurs (or may occur) in a cross-border situation.

[45] ECJ 8 March 1999, C-212/97, Centros Ltd, [1999] ECR I-1459, para. 34.

[46] ECJ 30 November 1995, C-55/94, Case C-55/94, Reinhard Gebhard, [1995] ECR I-4165, para. 37; ECJ 8 March 1999, C-212/97, Centros Ltd, [1999] ECR I-1459, para. 34; ECJ 11 March 2004, C-9/02, de Lasteyrie du Saillant, [2004] ECR I-2409, para. 49; ECJ 7 September 2006, C-470/04 Case C-470/04, N., [2006] ECR I-7409, para. 40.

[47] Article 52 Treaty on the Functioning of the European Union (TFEU) allows special treatment for foreign nationals on grounds of public policy, public security or public health.

[48] ECJ 20 February 1978, 120/78, Rewe-Zentral AG, [1979] ECR 649.

[49] ECJ 11 March 2004, C-9/02, de Lasteyrie du Saillant, [2004] ECR I-2409, paras 83-87.

4.2.2. Failing Grounds for Justification

Although the financial interests of the state of origin cannot be safeguarded unless by imposing exit tax assessments, it is settled case law that the loss of tax revenues is not a qualifying ground of justification[50].

The necessity to prevent tax avoidance[51] requires that the national measures apply to 'wholly artificial arrangements set-up to circumvent [national] legislation'[52]. Such abuse may only be determined case by case[53]. Exit taxation upon outbound mergers is, by contrast, aimed generally at *any* situation in which a company transfers its assets abroad. International mergers cannot generally be considered abusive.

In *Marks & Spencer II*, tax avoidance was accepted as part of a three-fold ground of justification[54]. The ECJ took into account the *possibility* of tax avoidance[55], by the transfer, at will, of losses to high rate Member States, in combination with the risk that losses would be deducted twice and the risk of jeopardizing a balanced allocation of the power to tax by transferring losses at will to other states. Mergers, however, do not result in double loss deduction nor in the possibility to transfer losses abroad.

[50] ECJ 16 July 1998, C-264/96, Imperial Chemical Industries plc (ICI), [1998] ECR I-4695, para. 28; ECJ 13 December 2005, C-446/03, Marks & Spencer plc, [2005] ECR I-10837, para. 44. Safeguarding the cohesion of a tax system may, by contrast, be a ground for justification.

[51] ECJ 16 July 1998, C-264/96, Imperial Chemical Industries plc (ICI), [1998] ECR I-4695, para. 26; ECJ 13 December 2005, C-446/03, Marks & Spencer plc, [2005] ECR I-10837, para. 57.

[52] ECJ 16 July 1998, C-264/96, Imperial Chemical Industries plc (ICI), [1998] ECR I-4695, para. 26; In ECJ 21 January 2010, C-311/08, Société de Gestion Industrielle (SGI), [2010] ECR I-00487, para. 67, the ECJ recognized the possibility of artificial constructions if no adequate transfer pricing rules are applied.

[53] ECJ 8 March 1999, C-212/97, Centros Ltd, [1999] ECR I-1459, para. 25.

[54] The ECJ used to require a case-by-case approach with regard to the anti-abuse justification. Cfr. ECJ 8 March 1999, C-212/97, Centros Ltd, [1999] ECR I-1459, para. 25, with regard to the freedom of establishment, and ECJ 17 July 1997, C-28/95, A. Leur-Bloem, [1997] ECR I-4161, para. 41, with regard to the Directive 434/90. It seems as if the ECJ abandoned its case-by-case approach in ECJ 13 December 2005, C-446/03, Marks & Spencer plc, [2005] ECR I-10837, para. 61, where it 'generally' allows specific anti-abuse legislation. Cfr. P. Wattel, *Note on ECJ 13 December 2005, C-446/03, Marks & Spencer plc*, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak, 2006/72c, para. 15.

[55] ECJ 13 December 2005, C-446/03, Marks & Spencer plc, [2005] ECR I-10837, para. 49.

The need to ensure the cohesion of the tax system of Member States[56] does not apply to mergers. The ECJ requires a direct link, in the case of a single taxpayer, between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy[57]. A symmetrical treatment (i.e. registration at fair market value) of assets in inbound and outbound mergers regards the tax treatment of different taxpayers and does not qualify as ground for justification.

4.2.3. The Division of Taxing Powers in line with Territoriality

A more successful ground for justification is the division of the power to tax[58] in combination with the territoriality principle as applied in Case C-470/04 *N.*[59] to exit taxes levied on individuals and in Case National Grid Indus[60] concerning exit taxation of migrating companies.

In Case C-470/04 *N.*, the Netherlands exit tax provisions at issue were historically designed to allocate between Member States, on the basis of territoriality, the power to tax increases of value in company holdings. The ECJ acknowledged that no unifying or harmonizing measures had been adopted, and Member States had not yet concluded any multilateral treaty to that effect.[61] Under those circumstances, Member States retained the power to define, by treaty or unilaterally, the criteria for allocating their

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[56] ECJ 28 January 1992, C-204/90, Hanns-Martin Bachmann, [1992] ECR I-249. ECJ 28 January 1992, C-300/90, Commission v. Kingdom of Belgium, [1992] ECR I-305. ECJ 23 October 2008, C-157/07, Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH, [2008] ECR I-8061.
[57] ECJ 6 June 2000, C-35/98, B.G.M. Verkooijen, [2000] ECR I-4071, para. 57; ECJ 13 April 2000, C-251/98, C. Baars, [2000] ECR I-2787, para. 40; ECJ 18 September 2003, C-168/01, Bosal Holding BV, [2003] ECR I-9409, paras 29-30.
[58] ECJ 12 May 1998, C-336/96, Mr and Mrs Robert Gilly, [1998] ECR I-2793, paras 30-31; R. Eismayr - A. Linn, *Steuerliche Aspekte des Wegzugs von Kapitalgesellschaften*, cited above, par. C.I.3.bc.
[59] ECJ 7 September 2006, C-470/04, N., [2006] ECR I-7409; R.E.C.M. Niessen, *Conserverende aanslag deels gered*, Fiscaal Tijdschrift Vermogen, 2006, pp. 9-10; Vakstudienieuws (ed.), *Note on Case C-470/04, N.*, Vakstudienieuws, 2006/46.4; I.J.J. Burgers, *Note on Case C-470/04, N.*, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak, 2007/22c.
[60] ECJ 29 November 2011, C-371/10, National Grid Indus BV, [not yet published].
[61] ECJ 7 September 2006, C-470/04, N., [2006] ECR I-7409, para. 43.

powers of taxation, particularly with a view to eliminating double taxation[62], while it was not unreasonable to find inspiration in international practice and, particularly, the OECD Model Tax Conventions[63].

In case C-371/10 National Grid Indus the ECJ ruled that when a company transfers its place of effective management to another Member State, in accordance with the principle of fiscal territoriality linked to a temporal component, the Member State of origin is entitled to charge tax on capital gains which arose within the ambit of its powers of taxation[64].

Also with regard to outbound mergers, the allocation of jurisdiction on the basis of the territoriality principle plays a crucial role. With regard to exit taxes, it can be argued that 'it is in accordance with that principle of fiscal territoriality, connected with a temporal component, namely residence within the territory during the period in which the taxable profit arises, that the national provisions in question provide for the charging of tax on increases in value recorded in the Netherlands'[65].

The territoriality, the temporal component, and the increases in value recorded in the state of origin, fit perfectly to outbound mergers. Exit taxes are levied on the gains accrued in the period in which the state of origin had the power to tax the assets of the transferring company. Outbound mergers equally fulfill the requirements of the *N.* case and of the *National Grid Indus* case. In order to be justified, exit taxes on of outbound mergers must be designed[66] to allocate between Member States, on the basis of the territoriality principle, the power to tax capital gains[67].

Cross-border mergers differ from exit taxes of migrating individuals in the sense that taxation of cross-border mergers has been harmonized by means

[62] ECJ 7 September 2006, C-470/04, N., [2006] ECR I-7409, para. 44; ECJ 12 May 1998, C-336/96, Mr and Mrs Robert Gilly, [1998] ECR I-2793, paras 24, 30; ECJ 21 September 1999, C-307/97, Compagnie de Saint-Gobain, [1999] ECR I-6161, para. 57; ECJ 12 December 2002, C-385/00, F.W.L. de Groot, [2002] ECR I-11819, para. 93; ECJ 23 February 2006, C-513/03, Heirs of M. E. A. van Hilten-van der Heijden, [2006] ECR I-1957, paras 47-48.

[63] ECJ 7 September 2006, C-470/04, N., [2006] ECR I-7409, paras 46-47; ECJ 12 May 1998, C-336/96, Mr and Mrs Robert Gilly, [1998] ECR I-2793, para. 31; ECJ 23 February 2006, C-513/03, Heirs of M. E. A. van Hilten-van der Heijden, [2006] ECR I-1957, para. 48.

[64] ECJ 29 November 2011, C-371/10, National Grid Indus BV, [not yet published], paras 46-47.

[65] ECJ 7 September 2006, C-470/04 Case C-470/04, N., [2006] ECR I-7409, para. 46.

[66] ECJ 7 September 2006, C-470/04 Case C-470/04, N., [2006] ECR I-7409, para. 67.

[67] ECJ 11 March 2004, C-9/02, de Lasteyrie du Saillant, [2004] ECR I-2409, paras 83-87, with regard to increases in value of shareholdings in companies.

of the Merger Directive. The Merger Directive does, however, not preclude companies from appealing to the fundamental freedoms of the TFEU[68].

In the case of the transfer of seat of a company, it is possible to defer the imposition of exit taxes, while maintaining a latent tax claim on the same legal entity. By contrast, in the case of a merger, the transferring company ceases to exist, and the last opportunity to levy tax on that legal person is the moment of the merger. Is this a sound ground to justify immediate exit taxation in the case of mergers? In practice, Member States apply arrangements for domestic mergers in which the transferring companies may shift their tax obligations to the receiving company. The Merger Directive also provides for the transfer of tax claims. Apparently, there are alternative and adequate ways to levy tax on the transferred latent gains when these gains are realized by the receiving company. Therefore, this is not a justification to restrict the exercise of the freedom of establishment.

4.2.4. Is immediate exit taxation an appropriate and proportionate measure?

In Case C-470/04 *N*. and in Case C-371/10 *National Grid Indus* the Court considered it in accordance with the principle of fiscal territoriality that the national laws provide for the charging of tax on increases in value recorded in the state of origin, the amount of which is determined at the time the taxpayer emigrated and payment of which has been suspended until the actual disposal. 'It follows (…) that the measure (…) is appropriate for ensuring the attainment of that objective'[69]. This conclusion applies *mutatis mutandis* to exit taxation in occasion of outbound mergers: exit taxation is appropriate to divide the power to tax on the basis of territoriality.

[68] Cfr. ECJ 18 September 2003, C-168/01, Bosal Holding BV, [2003] ECR I-9409, paras 26, 43-44, in respect of the Parent-Subsidiary Directive.

[69] ECJ 7 September 2006, C-470/04, N., [2006] ECR I-7409, paras 46-47. Cfr. ECJ 29 November 2011, C-371/10, National Grid Indus BV, [not yet published], para. 48.

Do exit taxes on cross-border mergers go beyond what is necessary to attain this objective?[70] In Case C-470/04 *N*. and in Case C-371/10 *National Grid Indus*, the ECJ ruled that an exit tax on unrealized gains is as such not disproportionate[71]. Immediate collection of the exit tax would however be disproportionate[72]. In the case of migrating shareholders, deferral should be granted until the moment of realization. In the case of a migrating company with many types of assets, the situation can be complex and the monitoring of the relevant assets until the moment of realization might entail an excessive burden on the company[73]. In other cases of migrating companies monitoring may be easy[74]. Therefore, companies should be able to opt for deferred collection and consequent monitoring, while mandatory immediate tax collection is disproportionate[75].

By contrast with the *N.* case, which regarded tax deferral without interest payments, in *National Grid Indus* the ECJ referred to 'deferred payment of the amount of tax, possibly together with interest in accordance with the applicable national legislation'. Furthermore, in the *N.* case, the ECJ ruled that the obligation to provide guarantees, necessary for the granting of a deferral of the tax, went beyond what was strictly necessary, taking into account the Council Directives 77/799/EEC and 76/308/EEC on mutual assistance[76]. By contrast, in National Grid Indus, the ECJ held that 'account should also be taken of the risk of non-recovery of the tax, which increases with the passage of time. That risk may be taken into account by the Member State in question, in its national legislation applicable to deferred payments of tax debts, by measures such as the provision of a bank guarantee'[77].

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[70] H. Kuβmaul – L. Richter – S. Heyd, *Ausgewählte Problemfelder der Hinausverschmelzung*, cited above, p. 75, hold that the existing lack of tax deferral in case of outbound mergers does not meet the proportionality requirement and therefore infringes the freedom of establishment.

[71] ECJ 7 September 2006, C-470/04, N., [2006] ECR I-7409, paras 49-50; ECJ 29 November 2011, C-371/10, National Grid Indus BV, [not yet published], paras 46, 49.

[72] ECJ 29 November 2011, C-371/10, National Grid Indus BV, [not yet published], paras 73, 85.

[73] ECJ 29 November 2011, C-371/10, National Grid Indus BV, [not yet published], para. 70.

[74] ECJ 29 November 2011, C-371/10, National Grid Indus BV, [not yet published], para. 72.

[75] ECJ 29 November 2011, C-371/10, National Grid Indus BV, [not yet published], para. 73.

[76] ECJ 7 September 2006, C-470/04, N., [2006] ECR I-7409, paras 51-53.

[77] ECJ 29 November 2011, C-371/10, National Grid Indus BV, [not yet published], para. 73.

Curiously, the payment of interest and the granting of guarantees did not seem an issue of discussion before the ECJ, and the Advocate General and the Report of the Hearing do not treat these issues. One might wonder why the ECJ seemed to rule deviating from the N-case[78].

Meanwhile, on 14 December 2011, in reaction to National Grid Indus, the Netherlands State Secretary of Finance has issued a Decree providing for deferred collection of exit taxes, while allowing the tax inspector to charge corresponding interest payments and to require bank guarantees[79].

I, however, doubt whether the ECJ actually deviated from its *N.* ruling. In the first place because *National Grid Indus* did not regard a case concerning the conditions of tax deferral, but regarded a case without tax deferral. In the second place, the ECJ ruled that Member States could apply their 'applicable national legislation' concerning interest payments and guarantees. In my opinion, the ECJ intends to say that interest payments and guarantees may be required on a non-discriminatory basis, under the same conditions as purely national cases of domestic seat transfers. Member States are not allowed to require interest payments nor guarantees if they don't in domestic situations. Since the Netherlands does not charge interest payments with regard to unrealized capital gains in the case of domestic transfers of seat (or domestic situations without transfer of seat), it is not allowed to do so in the case of cross-borders transfers of seat. Therefore, in my opinion, the Netherlands Decree of 14 December 2011 which allows interest charges, is not in line with the National Grid Indus ruling and infringes upon the freedom of establishment.

Finally, in order to be proportionate, in the *N.* case the ECJ ruled that the state of origin would have to take full account of reductions in value capable of arising after the transfer of residence, unless such reductions had already been taken into account in the host Member State[80]. By contrast, in *National Grid Indus*, the ECJ ruled that the state of origin is not obliged to take into account reductions in value arising after the transfer of residence

[78] Peter Wattel, Carry on Discriminating, Nederlands Juristenblad, 44-45/2011, p. 2248.

[79] Decree State Secretary of Finance, 14 December 2011, nr. BLKB 2011/2477M, V-N 2012/4.16.

[80] ECJ 7 September 2006, C-470/04, N., [2006] ECR I-7409, para. 54.

of companies. According to the ECJ, after emigration, also under international tax law, the host state taxes the profits and losses of the emigrating company[81], while the state of origin loses its tax jurisdiction. Furthermore, business assets by nature are depreciated, differently from shareholdings[82]. A different treatment is therefore justified.

What do these guidelines entail for cross-border mergers? Also on occasion of a domestic or cross-border merger, the transferring company must file a tax declaration. This formality cannot be regarded as disproportionate. The 2006 Commission paper on exit taxation states that it would be proportionate to require the filing of annual statements declaring whether the assets involved have been disposed of or not[83]. I fully agree with that conclusion, also with regard to mergers.

From the *N.* case[84] and *National Grid Indus* it follows that the imposition of deferred tax assessments on the occasion of a migration is proportionate. In practice, however, in the case of cross-border mergers, the payment of tax assessments can generally not be deferred under Member States legislation with regard to assets carried abroad. Exit taxes levied on companies which are absorbed in outbound mergers must be paid immediately. In my opinion, this is disproportionate and infringes the freedom of establishment[85].

In theory, there are distinctions between migrating companies and merging companies. The company which is absorbed in a merger ceases to exist as a legal subject. The deferred exit tax must be collected from its foreign legal successor. Furthermore, it would be consistent to collect the exit taxes levied on transferring company A when receiving company B, its legal

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[81] However, according to the ECJ it is irrelevant whether the host state is not obliged to take into account reductions in value.

[82] ECJ 29 November 2011, C-371/10, National Grid Indus BV, [not yet published], paras. 64 and 58.

[83] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on Exit taxation and the need for co-ordination of Member States' tax policies, 19 December 2006, COM(2006)825 final, p. 6. Unfortunately, the Commission did not address mergers. Certain authors consider the obligation for the taxpayer to provide annual statements after a merger as burdensome, D. Aβmann, Steuerrechtliche Aspekte einer Europäischen Gesellschaft, cited above, p. 192, with reference to further literature.

[84] R. Eismayr - A. Linn, *Steuerliche Aspekte des Wegzugs von Kapitalgesellschaften*, cited above, par. C.I.3.bc, with further literature references.

[85] H. van den Broek, Cross-Border Mergers within the EU, cited above, pp. 363-368.

successor, disposes of the former assets of company A. Both differences do, however, not seem to cause particular problems.

An interesting issue regards the assets which the receiving company does not dispose of. A migrating individual will sooner or later dispose of his shares, while it is not certain whether a migrating or receiving company will ever dispose of the assets, for instance goodwill. A company may continue to exist for centuries. It can hardly be expected of Member States that they defer the collection of exit taxes until the end of time, taking into account the yearly administrative efforts and the risk of frustrating the collection of taxes[86]. In *SEVIC* the ECJ refers to the effectiveness of fiscal supervision[87]. I consider it proportionate to put a certain time limit on the deferral, for example, not exceeding ten years[88]. In *National Grid Indus*, however the ECJ did not impose any time limits.

Finally, after the *N.* case, it was argued that, also in case of mergers, the state of origin must take into account post merger reductions in value[89]. This would, however, be in breach of the territoriality principle and in breach of international practice. From *National Grid Indus* it follows that in the case of companies, the state of origin does not have this obligation. Generally, on the occasion of a merger in which exit taxes are levied on the basis of the fair market value, the host state will record the assets transferred at fair market value[90] and take into account future decreases in value of these assets[91].

[86] See, for example, the judgment in ECJ 20 February 1978, 120/78, Rewe-Zentral AG, [1979] ECR 649, para. 8, and ECJ 15 May 1997, C-250/95, Futura Participations SA and Singer, [1997] ECR I-2471, para. 31.

[87] ECJ 13 December 2005, C-411/03, SEVIC Systems AG, [2005] ECR I-10805, para. 28.

[88] Terra - Wattel, European Tax Law, cited above, p. 788, refer to the same problem in the case of emigration of companies and propose a ten-year period as well. With regard to the emigration of non-incorporated entrepreneurs, H.P.A.M. van Arendonk, *Inkomstenbelasting en Europa: nationale folklore met een Europees sausje*, Maandblad Belasting Beschouwingen, 2008, s. 4.1, suggests a practicable system of immediate exit taxation with a deferred, phased collection, for instance during a five-year period.

[89] D. Aβmann, Steuerrechtliche Aspekte einer Europäischen Gesellschaft, cited above, pp. 187-188; R. Eismayr - A. Linn, *Steuerliche Aspekte des Wegzugs von Kapitalgesellschaften*, cited above, par. C.I.3.bc.

[90] This is different in the case of a tax-exempt merger. In that case many Member States do not grant a step-up.

[91] Should the host state record the assets at former book value, a post-merger decrease in value, from market value to former book value, is not taken into account by the host state. From the *N.* case it follows that the state of origin is not obliged to take into account those reductions.

5. Conclusions

The Merger Directive does not preclude exit taxes on outbound mergers, but this does not justify immediate exit taxation. Exit taxation hampers the freedom of establishment of the receiving company. In order to be justified, exit taxes levied on occasion of cross-border mergers must be, historically, designed to allocate the power to tax between Member States on the basis of territoriality, particularly concerning the assets that leave their fiscal jurisdiction. Member States must defer the collection of exit taxes until the assets involved are actually realized. Almost all Member States' exit taxes on cross-border mergers are collected immediately. They are disproportionate and infringe the freedom of establishment. Member States may require guarantees and interest payments as a condition to obtain deferral, but in my opinion, only if they also do so in the case of domestic mergers. The state of origin must not take into account future decreases in value. In my opinion, these conditions should be laid down in the Merger Directive. Where national merger provisions infringe the freedom of establishment immediate action by the national legislators is required. And the European Commission should require that Member States amend their legislation.