EXIT TAXES AND CORPORATE MOBILITY: THE '*DI.VI. FINANZIARIA*' CASE (C-380/11)

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The present article will focus on the analysis of the recent case *DI.VI. Finanziaria* (C-380/11)[2], which is included among other judgements that have been targeted by the European Court of Justice as dealing with the compatibility of restrictive measures on cross-border reorganisation of companies with the freedom of establishment within the Internal Market.

Background

DA.DV. Family Holding Sàrl ('DADV') was a company incorporated in 2000 in Luxembourg and having there its place of effective management. In the year 2004 DADV started allocating a Net Wealth Tax ('NWT') reserve and putting it in the balance sheet and, accordingly, it received a capital tax reduction, as it was permitted in the Luxembourg Net Wealth Tax Act (*Loi relative à l'impôt sur la fortune* - 'LIF'). According to its provisions, resident taxpayers are subject to taxation on worldwide net worth, regardless whether the property is located in Luxembourg or not. However, resident companies and other legal entities are entitled to limit their tax liability to capital tax by creating a reserve in the balance sheet and, for that sole purpose, by maintaining that reserve for an uninterrupted period of five years following its constitution[3].

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2 ECJ, 6 Sept. 2012, Case C-380/11, *DI.VI. Finanziaria di Diego della Valle & C. SapA v Administration des Contributions en matière d'impotes*.

3 Paragraph 8a of the '*Loi du 16 Octobre 1934 concernant l'impot sul la fortune'* as amended by the '*Loi du 21 Décembre 2001 portant réforme de certaines dispositions en matière d'impots directs et indirects'*, *Mémorial* A 2001, 157.

In 2006 DADV transferred its seat to Italy and after few months it merged with an Italian company and afterwards the newly created company DI. VI. Finanziaria ('DIVI') applied for the same capital tax credit that was due from the former company. Indeed, the Luxembourg law allowed the acquiring company to roll over the reserve as it resulted from the balance sheet of the acquired company, in order to meet the five years-length holding requirement.

Finally, in 2009, following an assessment of the income tax referred to the last couple of years prior to the transfer, the Luxembourg tax authority realised that the income had unduly been given too low a value regarding the reserve amount granted. In addition to that, they verified that DADV was not entitled to that benefit since it relocated to another country, thus ceasing to being liable to Luxembourg law. Accordingly, a claw back provision was applied to the fiscal advantage and the company was prevented from allocating a similar reserve for the future.

Thus, by reference of the Administrative Court, the European Court of Justice ('ECJ') had to determine whether the LIF constituted a restriction on the freedom of establishment, contrary to article 49 of the Treaty of the Functioning of the European Union ('TFEU').

Freedom of Establishment

The Court started by ascertaining whether the fundamental freedoms of the TFEU could find application in the case at stake. By referencing its previous jurisprudence[4], the ECJ observed that it was of no relevance in which State the requirements to apply for a tax credit were fulfilled, provided that they were met somewhere within the EU internal market.

More precisely the Court noted that:

> "The legislation at issue in the main proceedings is limited to attaching tax consequences, for companies incorporated under national law, to the situation in which those companies find themselves when they cease to be liable to Luxembourg capital tax, in particular following the transfer of their seat to another Member State"[5].

As a consequence, DADV could legitimately rely on the provisions enshrined in Article 49 of the TFEU to challenge the lawfulness of the refusal of the granting of

4 ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam,* para. 31.

5 *DI.VI. Finanziaria*, para. 30.

the tax benefit, the same that it would be allowed to claim if it had not relocated abroad.

Restriction on Freedom of Establishment

Next, the Court moved on to investigate whether the rules at issue could be regarded as a restriction on the freedom of establishment. The Court concluded that DADV had suffered less favourable treatment than that of a similar national company simply because it opted to move out of Luxembourg. If DADV had chosen to relocate elsewhere, yet remained within Luxembourg territory, it would not have been subject to the withdrawal of the corporation tax credit[6]. The Court came to this conclusion based on well-established case-law[7], according to which all measures that prohibit, impede or render less attractive the exercise of the freedom of establishment must be regarded as restrictive provisions[8]. In the light of the interpretation of article 49 TFEU, a fundamental freedom such as establishment must be recognised both from an origin State standpoint, i.e. the State of origin should not hamper the establishment of its nationals in another Member State, and from a host State perspective, in a way that foreign nationals and companies are treated equally to nationals of that host State[9].

Comparability

In assessing the existence of a restriction on the freedom of establishment, the Court had to determine whether the situations were comparable. More specifically, by contesting the argument of the Luxembourg Government, the Court held that from the standpoint of the legislation of the Member State which granted the tax benefit, there was no objective difference between the situation of companies willing to change their seat, yet remaining in their State of origin, and that of other companies desiring to leave their state origin in the five-year period from the allocation of the reserve. Indeed, in both cases the first Member State would be affected by a reduction in the collection of the wealth tax[10].

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6 *Id.* at para. 35.

7 See inter alia case C-250/95, *Futura Participations SA and Singer v Administration des contributions*; C-442/02 *CaixaBank France* (2004) ECR I-8961, para.11.

8 For a case of restriction see ECJ, C-8/74, *Procureur du Roi and Gustave Dassonville*, (1974), ECR 837, where the Court referred for first time to a '*measures having an effect equivalent to quantitive restrictions*'.

9 *Id.* at para. 32.

10 *Id.* at para. 37.

The Court also rejected the argument initially put forward by the tax authority, i.e. that DADV had failed to keep the reserve in the balance sheet for the five years as required by the legislation, since it was accepted that DIDV retained the reserve in its balance sheet and submitted evidence of same to the Court.

Balanced Allocation of Taxing Powers

In a number of previous cases,[11] the need to ensure a balance in the allocation of taxing rights between the Member States has been successfully invoked by the Member States as a general interest justification for maintaining restrictive rules contrary to the freedoms. Similarly, in the case at issue, the Court remarked on the legitimate objective pursued by this principle[12]. However, this was not an issue in present case since the capital tax reduction was withdrawn and the company immediately taxed upon its transfer outside the Luxembourg territory. The Court pointed out that such mechanism

> "[Did] not ensure either the power of taxation of the latter Member State of the balance allocation of the powers of taxation between the Member States concerned. The very nature of the mechanism of withdrawing an advantage implies that the Member State had agreed, in advance, to grant that advantage and, consequently, to reduce the capital tax of resident taxpayers if the conditions referred to in Paragraph 8a of the LIF were satisfied"[13].

Thus, a restrictive tax measure should work only in circumstances where a shifting of income between Member States is in jeopardy, contrary to the principles recognised by international tax practice, based on the distinction between resident and non-resident taxpayers.

Coherence of the national tax system

The second justification put forward by the Luxembourg government was based on grounds of preserving the coherence of the national tax system. The Court initially

11 Case C-446/03, *Marks & Spencer plc v David Halsey (Her Majesty Inspector of Taxes)*, para. 46; Case C-196/04, *Cadbury Schweppes*, para. 56; Case C-231/05, *Oy AA*, para 56; and Case C-337/08, *X Holding BV v Staatssecretaris van Financien*, paras 28-33; ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, para. 45.

12 *Id.* at para. 43.

13 *Id.* at para. 45.

accepted this justification in cases like *Bachmann*[14] where it accepted that a direct link existed between the deductibility of the pension contributions for the taxpayer and the subsequent taxation of the pension paid to that same taxpayer. However, in the case at hand, the ECJ highlighted that such a direct link could not be found -

> "Between, on one hand, the grant of a reduction in capital tax to a company that complies with the conditions referred to in subparagraph 1 of Paragraph 8a of the LIF and, on the other, the objectives pursued by that legislation, in particular offsetting that tax advantage with additional revenue from corporate income tax and trade tax on operating profit during the years when the reserve referred to in subparagraph 1 of Paragraph 8a of the LIF is maintained"[15].

The consequence was the cohesion of the fiscal system could not be accepted as a justification.

Reduction in Tax Revenue

Lastly, very few words were spent on the justification based on the reduction in tax revenue. The Court simply stated that this did not constitute an overriding reason in the public interest[16]. Also, in the instance at stake, the Court seemed to be aware that if mere revenue considerations were allowed as justification grounds for the refusal to grant a capital tax deduction, the Member States would be free to introduce any other restrictive tax measures and anti-abuse regulations as they saw fit.

The Courts' Conclusion

By rejecting the justifications put forward by the Luxembourg government, the Court concluded that

> "Article 49 of the TFEU must be interpreted (...) as precluding legislation of a Member State which makes the grant of a reduction in capital tax conditional upon remaining liable to that tax for the next five tax years"[17].

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14 Case C-204/90, *Hanns-Martin Bachmann v Belgian State*, para. 28. See also case C-300/90, *Commission v Belgium*, para. 21.

15 *Id.* at para. 48.

16 *Id.* at para. 50.

17 *Id.* at para. 52.

Analysis

Exit Tax in the Regulatory Framework for Tax in the EU Internal Market

The present judgement falls within the framework of a number of other cases dealing with exit taxes. The concept of exit taxation of companies has become particularly topical in recent times as a consequence of corporate mobility within the European Internal Market. New business opportunities for individuals and companies have multiplied and, accordingly, migration has become a frequent instrument for economic traders to maximise the profitability of their commercial operations. As a result, many countries have started to feel challenged by the potential loss of tax revenue[18]. In addition, the possibility that a Member State would lose its powers to tax capital gains, reserves and other items of property that have accrued within its territory by way of restrictions posed by the principles of international practice as well as by tax treaties, make exit taxes an effective answer to the main risks related to migration.

However, from the taxpayer's standpoint, an exit tax can also have negative repercussions. More specifically, taxpayers could be subject to a cash flow disadvantage, since it is uncertain until the time of realisation of the asset whether they will have the cash available to discharge the tax liability. On the other hand, both the origin and host Member States are entitled to levy tax on that taxpayer, with the deleterious consequence of double taxation[19]. The latter occurs when the taxpayer's assets have not been granted a step-up to the market value in the host Member State, or when neither the origin nor the host Member State has granted any credit. There is no doubt that in this case an exit tax leads to the negative effect of hampering cross-border transactions and companies' operations.

Company Mobility and the Freedom of Establishment

Before going into a more detailed analysis of the issue of exit taxes and their compatibility with the fundamental freedoms embedded in the TFEU, it is worth illustrating the two major theories existing in international private law relating to companies: the incorporation and the real seat theory.

Member States that adhere to the first theory (also known as "*siège statutaire*" in France or "*Gründungstheorie*" in Germany) make the existence, internal affairs and extinction of a company dependent on the jurisdiction of the country of origin.

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18 Réka Világi, *Exit Taxes on Various Types of Corporate Reorganizations in Light of EU Law,* European Taxation, July 2012.

19 For an analysis see T. O'Shea, '*Dutch Exit Tax Rules Challenged in National Grid Indus'*, Tax Notes International, January 16, 2012.

Examples of countries following this doctrine are found mainly in common law systems, such as the United Kingdom, the United States of America, Ireland, Cyprus, Malta, etc.[20]. Being companies recognised as persons with legal capacity under the legislation of the place of their registered office, such theory bears the advantage that, in the event of migration, a company remains subject to the laws of the origin Member State without the need to go into liquidation and reincorporate under the law of the host State. The only burden suffered by the company is the exit taxation at the moment of exit. However, it might be argued that such entities would often abuse of the incorporation theory and accordingly chose to incorporate in a country with very lenient fiscal regulations, while conducting their economic activities elsewhere[21].

The alternative theory, i.e. the real seat theory, or "*siège réel*" or "*siege social*" in France, and "*Sitztheorie*" in Germany, sees the legal and fiscal regime of companies following the legislation of the place in which the real seat is situated, that is to say the place of the centre of administration. Countries like Germany, France, Italy, Spain, Portugal, Hungary and Greece have adopted this private international legislation. Thus, from the origin Member State standpoint, the company exercising its freedoms may not be recognised as a company under the laws of the host State, with the consequences of the loss of the shareholders' limited liability, and may be required to re-incorporate in the host State. Similarly, from an origin State perspective, the company may be obliged to first wind-up and liquidate before transferring its seat abroad. Thus, where migration, from a company law perspective, triggers liquidation first in the origin Member State and reincorporation in the host State, the same event, from an economic point of view, may trigger exit taxation of the capital gains. The corollary is that companies with their central management and control in a State which operates the real seat theory are discouraged from emigrating, having to face with the economic burden of the dissolution in the origin State and reincorporation in the host State.

Since *Daily Mail*,[22] followed by *Cartesio*[23], the ECJ has pointed out that the transfer of a company's real seat to a Member State applying the real seat doctrine could not be covered by article 49 of the TFEU. Since a company which is liquidated can no longer rely on the freedom of establishment because it ceases to

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20 But also Switzerland, Denmark and the Netherlands. For a more detailed analysis see S. Rammeloo, *Corporations in Private International Law: A European Perspective*, Oxford University Press, 2001, Chap. 4, Part. II.

21 E. Vaccaro, *Transfer of Seat and Freedom of Establishment in European Company law,* European Business Law Review, 2005, pp. 1348-1365.

22 ECJ, 27 Sept. 1988, Case 81/87, *The Queen v. H.M. Treasury and Commissioners of Inland Revenue*, ex parte *Daily Mail and General Trust plc*, paras. 21-23.

23 ECJ, 16 Dec. 2008, Case C-210/06, *Cartesio Oktató és Szolgáltató bt*, paras. 108-110.

exist under its domestic law. In addition, it has to bear the fiscal consequences and other restrictive measures connected with migration. On the contrary, only companies incorporated in Member States that adopt an incorporation approach can retain their legal personality and invoke the protection of the fundamental freedom of establishment. However, in *Cartesio* the ECJ, where a limited liability partnership incorporated under Hungarian law wished to transfer its real seat to Italy, while maintaining its status as an entity subject to Hungarian company law, decided not to follow the exhortation of the Advocate General to move away from the principles laid down in *Daily Mail*[24]. On the contrary, recalling the general principle by which companies are 'creatures of national law', the Court highlighted that

> "The power [to define both the connecting factor to be regarded as incorporated under the law of a Member State and that required to maintain that status], *far from implying that national legislation on the incorporation and winding-up of companies enjoys any form of immunity from the rules of the EC Treaty on freedom of establishment*, cannot, in particular, justify the Member State of incorporation, by requiring the winding-up or liquidation of the company, in preventing that company from converting itself into a company governed by the law of the other Member State, to the extent that it is permitted under that law to do so"[25] (emphasis added).

But the Court did distinguish the "conversion" situation and highlighted that national legislation like the Hungarian rules at issue in *Cartesio* constituted a restriction on the freedom of establishment[26] when the rules of the host Member State allow the company or limited partnership to convert into an entity of the host Member State.

Essentially, whether engaged in a case involving a conversion (*Cartesio*), a merger (*SEVIC)*[27] or a transfer of effective management of a company (*National Grid Indus*), the Court has always tackled the issue of exit taxes on migration of corporations from the viewpoint of a possible restriction of the freedom of establishment.[28].

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24 Advocate General's Opinion, *Cartesio*.

25 *Cartesio*, para. 112.

26 T. O'Shea, '*Exit Taxes Post Cartesio*", The Tax Journal, 31 August 2009, 1-2.

27 ECJ, 13 Dec. 2005, Case C-441/03, Landgericht Koblenz v Sevic System AG.

28 T. O'Shea, *Dutch Exit Tax Rules Challenged in* National Grid Indus, *Tax Notes International*, January 16, 2012.

National Grid Indus

In *National Grid Indus*[29], the Court held that a company which moves its place of effective management to another country and which is allowed to maintain its legal personality under the legislation of the origin Member State can invoke the protection of the freedom of establishment set out in articles 49 and 54 of the TFEU when it is faced with a restriction caused by the immediate taxation of unrealized capital gains. However, this case represents an innovation in the panorama of exit taxes for the application of the proportionality test. In line with its previous case-law, the ECJ accepted the justification of the need to prevent the balanced allocation of taxing powers between the Member States. However, in ascertaining whether such measure would go beyond what was necessary to attain the purposes of the national legislation, the Court noted that the definite quantification of the unrealised capital gains at the time of the transfer by the origin State was proportionate and that only the host State had to take into consideration any subsequent changes in value of the assets in question. Asking the origin State to do so would have meant disrupting the balanced allocation of taxing powers, and would have led to double taxation or possibly, double non-taxation[30]. Conversely, with regard to the collection of taxes, the Court found the exit charge was proportionate only where the taxpayer was given the option of choosing between the immediate payment of taxes and the deferral of such a payment until the time of realisation, with the chance for the origin Member State to ask for a security, for instance in the form of a bank guarantee[31].

Various Exit Tax Scenarios

The different scenarios of transnational migration which are liable to trigger exit taxes may be better understood by analysing two infringement cases, *Commission v Spain ("*C-269/09*")* and *Commission v Portugal ("*C-38/10*")*[32].

Commission v Spain ("Exit Taxes")

In *Commission v Spain* ("C-269/09"), the Commission targeted Spanish rules according to which natural persons who transferred their residence outside Spain were required to include in the tax base of the tax year before exit any income not

29 ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam.*

30 *National Grid Indus*, para. 59.

31 *Id,* para. 85.

32 ECJ, 12 July 2012, Case C-269/09, *European Commission v Kingdom of Spain;* ECJ, 6 Sep. 2012, Case C-38/10, *European Commission v Portuguese Republic*; ECJ, 31 Jan 2013, Case C-301/11, *European Commission v Kingdom of the Netherlands*.

yet charged to tax, whereas a same obligation was not provided for taxpayers who moved their residence within Spanish territory. The Court argued that such a difference in treatment was capable of putting nationals who exercised their freedom of movement in the EU Internal Market at a financial disadvantage, especially when the withdrawal of the advantage was available only in cross-border situations and not also in domestic situations[33].

Also relevant in this regard is the comparability test carried out by the Court, when it noted that

> "[The] difference in treatment cannot be explained, in the present case, by an objective difference of situation. From the point of view of legislation of a Member State designed to tax realized income, the situation of a person transferring his residence to another Member State is similar to that of a person maintaining his residence in the former Member State, as regards the taxation of the income already realized in that Member State before the transfer of residence"[34].

However, it should also be noted that contrary to its previous case-law, the ECJ dismissed the justification based on the balanced allocation of taxing powers. The Court pointed out that -

"Since, in the present case, it is not the determination of the tax debt at the time of the transfer of residence which is at issue but the immediate recovery of that tax debt, the Kingdom of Spain has not proved that, in the absence of conflict between the powers of taxation of the State of exit and those of the host Member State, it would be faced with a problem of double taxation or a situation in which the taxpayers concerned would completely escape paying tax, which could justify the application of a measure such as that at issue in the present case with the aim of pursuing the objective of preserving the balanced allocation of the powers of taxation".[35]

Commission v Portugal ("Exit Taxes")

In *Commission v Portugal ("Exit Taxes"),* the Commission challenged a Portuguese law, which provided for an exit tax on unrealised gains when a company transferred its seat and place of effective management to another Member State. The unrealised gains in the company's assets had to be included in the taxable base of the final financial year. The Court noted that the Portuguese

33 *European Commission v Kingdom of Spain*, para. 59.

34 *Id*. para. 60.

35 *Id*. para 81.

legislation was liable to deter a company from emigrating from one Member State to another[36], in other words it was liable penalise those companies wishing to migrate or to transfer their assets abroad, by dissuading them from exercising their freedom of establishment[37].

Referring to *National Grid Indus* case, the Court held that although exit taxes may be justified by the need to protect the balance in the allocation of taxing powers, nonetheless giving companies an option between the immediate of deferred payment of their taxes would be a less restrictive measure in relation to freedom of establishment[38].

Conclusion

In the analysis of the recent *DI.VI. Finanziaria* judgment, followed by a brief review of other cases, this article has examined how exit tax issues come before the ECJ on a regular basis, as a consequence of the interplay between company mobility and corporate re-organisation schemes.

The Commission, under the clear guidance of the ECJ and its consistent jurisprudence, has proven to be persistent in the task of loosening the tight reins on corporate mobility deriving from national substantive law and conflict of law rules, with a view to eliminate double taxation or, more in general, all the obstacles that may deter from emigration within the Internal Market.

36 *European Commission v Portuguese Republic*, para. 28.

37 See A. Patrakeev, *European Commission requests Portugal and Spain to change restrictive exit tax provisions for companies* (27 Nov. 2008), News, IBFD.

38 *Id.*, para. 32.