CORPORATE EXIT TAXES AND THE FREEDOM OF ESTABLISHMENT

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1 Introduction

States are constrained to balance their taxing system carefully so taxpayers emigrating from one country to another are not subject to economic double taxation, on the one hand, but taxed accordingly on profits personally or economically linked to the state from which the taxpayer emigrates[2], on the other. In this respect exit taxes are often seen as necessary means.

In an international environment where not only individuals travel and reside in different states but also companies establish themselves in more than one jurisdiction, exit taxes are bound to affect companies' liquidity and capital efficiency. In order to protect the effectiveness and competitiveness of the internal market the European Commission has therefore kept a persistent focus on corporate exit taxes within the EU to ensure that companies are not deprived of their rights to pursue economic activities in other member states[3].

The Commission has called for co-ordinated solutions but Member States have in general retained their position on tax law being primarily an issue of domestic concern. As a result, the Commission has found it necessary to initiate infringement procedures against 5 member states.

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2 Henceforward designated the "origin state".

3 See the Commission Communication, *Exit taxes and the need for co-ordination on Member States' tax policies*, COM(2006) 825

Prompted by these infringement procedures this article seeks to examine the compatibility of corporate exit tax provisions with the freedom of establishment as enshrined by the Treaty on the Functioning of the European Union (TFEU).

Rather than projecting the outcome of each of the 5 cases, this article seeks to work from the general characteristics of corporate exit tax provisions as they recur in many jurisdictions.

The intention is to answer whether basic consequences of being subject to an exit tax interfere with a company's right to freedom of freedom of establishment. In the affirmative, it will be examined whether such restrictions constitute a violation of the Treaty or if reasons of public interests may be used as a justification.

The article examines exit taxation in relation to member states of the EU only. Issues arising in respect to third states will not be addressed.

1.1 Content of this article

This article consists of 6 sections including an introduction in section one (this section) and a final conclusion in section 6.

Following section two, which examines the basic concept of corporate exit taxes and recent development within the EU, the article is composed in line with the approach taken by the Court in its case law. Accordingly, section three examines the scope of the freedom of establishment and addresses the question of treaty violation. Section 4 explains the essential justifications used in case law and suggests the applicability of each justification in relation to corporate exit taxes. Finally, section 5 addresses the issue on proportionality.

2 Exit Taxes in an EU Context

The concept of corporate exit taxes in an EU context has been much discussed in literature. But what defines an exit tax and why has it attracted so much attention? The following section will by way of introduction pin down the fundamental elements of an exit tax and look at the major disadvantages. Focus is hereafter turned on case law from the European Court of Justice (ECJ) and recent development within the EU regarding exit taxes.

2.1 Characteristics of Exit Taxes

The concept of exit taxes varies significantly. Distinctive characteristics appear, however, to be the levy of tax on unrealized capital gains on assets and liabilities or a recapture of previous tax deductions, solely due to the transfer of residence of a tax *subject* or the transfer of a tax *object* between two tax jurisdictions[4]. The levy of exit taxes is also seen upon loss of profit potential when routine or high service functions are transferred even though assets are retained in the same state[5].

An exit tax is typically assessed at the time of the transfer and levied immediately even though the relevant assets and liabilities have not been disposed of. The immediate taxation will therefore constitute a cash flow disadvantage compared to taxation upon alienation, the latter being the preferred principle applied in many countries.

Secondly, determining the value at which capital gains is assessed may cause difficulties as the assets and liabilities have not been priced according to negotiations between independent parties. The risk of establishing prices different from market values is especially high in relation to intangible assets where market valuations often rely on several factors of uncertain and sensitive character. The origin state and the state to which the company has transferred its residence/assets and liabilities[6] may furthermore disagree on the assessment, which may result in double taxation or double non-taxation[7].

Lastly, in addition to the exit tax imposed by the origin state, the host state may upon disposal levy tax on a capital gain corresponding to the difference between the original acquisition amount and the sales price without providing for a step up in value at the time of the transfer. Without sufficient credit mechanisms the risk of economic double taxation will arise.

2.2 Case law and Recent Developments

Disadvantages as those described above may have severe impacts on the desirability for companies to engage in cross border activities. For the same reason, the European Commission has maintained focus on the subject and initiated infringement procedures against 5 member states.

Also the European Free Trade Association (EFTA) Surveillance Authority has drawn its attention to the subject and formally requested Norway to change rules

4 Also see Mattias Dahlberg, Tax Notes International 23 November 2009 (Doc 2009-25154)

5 The issue is often discussed in relation to transfer pricing aspects of restructurings, but seems not to be addressed by the Commission.

6 Henceforward designated the “host state”

7 See Prof. Dr. Hans Van den Hurk and Jasper Korving, *The ECJ’s Judgement in the N case against the Netherlands and its Consequences for Exit Taxes in the European Union*, Bulletin For International Taxation, (April 2007).

imposing an immediate exit tax when companies transfer their effective management or assets to another member state[8] of the EU or EFTA.

The infringement procedures initiated by the Commission and the EFTA are strongly inspired by two specific rulings from the ECJ explicitly dealing with exit taxes. However, both cases, of which the basics are summarised below, concerned individuals.

2.2.1 *Lasteyrie*[9]

The *Lasteyrie* case concerned French exit taxes imposed on a French individual shareholder upon transfer of his place of residence from France to Belgium. According to the Code Général des Impôts, Mr de Lasteyrie was subject to tax on the difference between the market value of his shares on the day of the transfer and the acquisition amount.

A suspension of tax payment was available but Mr de Lasteyrie had to fulfil three conditions: 1) declare the amount of the increase in value 2) designate a representative established in France authorised to receive communication and 3) provide guarantee sufficient to ensure recovery of the tax liability.

In addition the taxpayer had an annual obligation to send the tax authorities a statement of changes in the amount of unrealised capital gains[10].

The ECJ found that the French rules had at the very least a dissuasive effect on taxpayers wishing to establish themselves in another member state[11].

Since Mr de Lasteyrie was treated differently than French individuals retaining their residence in France the rules constituted a restriction on the freedom of establishment. The Court held that

> *"Although it is possible to benefit from suspension of payment, that is not automatic and it is subject to strict conditions…, including, in particular, conditions as to the setting up of guarantees. Those guarantees in themselves constitute a restrictive effect, in that they deprive the taxpayer of the enjoyment of the assets given as a guarantee"*[12].

8 Letter of formal notice dated 10 March 2010 (Event No 542580), available at www.regeringen.no.

9 C-9/02 *Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie* (Lasteyrie).

10 *Lasteyrie*, Paragraph 36, Advocate General's (AG) opinion.

11 *Lasteyrie*, Paragraph 45.

12 Id. paragraph 47.

2.2.2 *N*-case[13]

The second case was the *N*-case concerning a Dutch resident individual who transferred his place of residence to the United Kingdom. The taxpayer, N, was the sole shareholder in three companies and was consequently subject to Dutch tax on a notional disposal of shares.

Payment of the exit tax was deferred as N had provided sufficient security for the recovery of the claim. As a direct consequence of the Lasteyrie case, the Dutch tax authorities later informed N that the provided security was to be regarded as released. Nevertheless, N filed a complaint to the Gerechthof te Arnhem which decided to request a preliminary ruling from the ECJ.

The Court found that since N held a substantial shareholding in the companies he was exercising his free right of establishment in another member state[14]. Not surprisingly, the Dutch exit rules were therefore likely to hinder the exercise of that freedom.

The Court's conclusion was supported not only by the fact that a Dutch individual moving abroad was subject to disadvantageous rules compared to Dutch nationals who decided to stay in the Netherlands but also by the fact that the Dutch exit rules did not take into account decreases in value of the shares after the transfer of residence[15].

Last but not least the ECJ found that a required tax declaration in order to benefit from suspension of payment was an additional formality likely to hinder the freedom of establishment.

2.2.3 Recent Developments

To date the ECJ has not had the opportunity to rule explicitly on exit taxes in relation to companies[16]. A few company law cases concerning the determination of the relevant connection between a company and the legal system of a member state had an implicit exit tax effect and will be discussed later in a subsequent section.

A communication issued by the Commission in 2006 highlighted the Commission's interpretation of the Lasteyrie case and the N case in relation to exit taxes.

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13 C-470/04 *N v Inspecteur van de Belastingsdienst Oost/Kantoor Almelo*.

14 Id., paragraph 27

15 Id., paragraph 37

16 On July 15 2010 the Gerechtshof Amsterdam asked for a preliminary ruling concerning Dutch corporate exit taxes, cf. IBFD Tax News Service (TNS) 16 July 2010.

According to the Commission the principles laid down by the Court in these cases should have direct implications for companies as well[17].

The communication addressed both the transfer of residence and the cross border transfer of assets and liabilities between a company and its permanent establishment and a number of Member states levying an exit tax on these transactions were formally asked to amend their rules.

Following the communication several member states were formally requested to amend their exit tax legislation. One of the countries addressed by the Commission[18] was Sweden. However, few month before the request, in a ruling delivered on the 24 April 2008, the Swedish Administrative Supreme Court had already found that while justified in breaching the freedom of establishment, the Swedish exit rules did not meet the proportionality test because less burdensome tax measures could have been applied meeting the same objectives[19]. The case concerned a Swedish company, which transferred its central management to Malta. Consequently, the company was subject to an immediate taxation on unrealised capital gains on assets and liabilities plus a recapture of contributions made to an equalisation reserve.

As a direct consequence new rules were enacted in Sweden that came into effect from 1 January 2010 and the Commission has recently decided to close the infringement procedure against Sweden[20].

Also Spain and Portugal were sent reasoned opinions and were formally requested to amend their tax legislation. According to both Spanish and Portuguese tax law unrealised capital gains on assets and liabilities are included in the taxable income and taxed immediately if a resident company transfers its residency to another member state. Similarly, this applies if a permanent establishment in Spain or Portugal ceases its activities in that country or if assets and liabilities located in Spain or Portugal are transferred to another member state[21]. Despite the Commission's request neither Spain nor Portugal amended their tax legislation and both member states were referred to the ECJ in October 2009[22].

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17 The communication was issued before the case C-210/06 *Cartesio Oktató és Szolgáltató bt* (*Cartesio*)

18 Commission press release IP/08/1363 of 18 September 2008

19 Mattias Dahlberg, *Sweden's Administrative Supreme Court Finds Fault With Exit Tax Regime*, Tax Analysts (2009), Doc-200814940.

20 Commission press release IP/10/299 of 18 March 2010

21 Commission press release IP/08/1813 of 27 November 2008

22 Commission press release IP/09/1460 of 8 October 2009

In March 2010 also Belgium, Denmark and the Netherlands were all formally requested to amend their exit tax rules for companies[23]. The cases against Denmark and the Netherlands were referred to the ECJ in November 2010[24].

Reasoned opinions by the Commission are not publicly disclosed and a thorough reproduction of the arguments presented by the Commission and the different member states is therefore not possible.

Also the Council of the European Union has made a resolution on coordinating exit taxation, inviting member states to adopt a line of guiding principles[25].

3 Freedom of Establishment

The Commission seeks to establish that corporate exit taxes breach the freedom of establishment. It is therefore necessary to start off with a brief examination of article 49 and 54 of the TFEU.

The link between the characteristics of corporate exit taxes and the freedom of establishment will be examined next in two sections: 1) transfers of residence and 2) transfers of assets and liabilities between a head office and a permanent establishment.

3.1 Article 49 and 54 TFEU

Freedom of establishment for individuals is provided for by article 49 TFEU, which forbids restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State.

Such restrictions are prohibited in case of both secondary establishments, by which is meant

> *"the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State"*,

and primary establishments, by which is meant

> *"the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within*

23 Commission press release IP/10/299 of 18 March 2010

24 Commission press release IP/10/1565 of 24 November 2010

25 Council Resolution of 2 December 2008 on coordinating exit taxation, Official Journal C 323, 18/12/2008 P. 0001 - 0002

> *the meaning of the second paragraph of Article 54"* [26].

The ECJ has in general applied a liberal interpretation to the scope of the freedom of establishment[27]. The freedom can be directly invoked by nationals of all other member states[28] and

> "*allows all types of self-employed activity to be taken up and pursued on the territory of any other Member State, undertakings to be formed and operated, and agencies, branches or subsidiaries to be set up*"[29].

Pursuant to article 54 TFEU, companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union are allotted the right to be treated in the same way as natural persons who are nationals of Member States.

The wording of article 49 entails a prohibition against restrictions imposed by the host state as for example seen in the case of Avoir Fiscal[30] where the Court held that

> "*it is the registered office in the above-mentioned sense that serves as the connecting factor with the legal system of a particular state like nationality in the case of natural persons. Acceptance of the proposition that the member state in which a company seeks to establish itself may freely apply to it a different treatment solely by reason of the fact that its registered office is situated in another member state would thus deprive that provision of all meaning"*[31].

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26 C-81/87 *The Queen v H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust Plc* (*Daily Mail*), paragraph 4 of AG opinion, 7 June 1989. Also see Anne Looijestijn-Clearie, *Centros LTD – A complete U-turn in the right of establishment for companies,* International & Comparative Law Quarterly, 49 (2000).

27 See for example Luca Cerioni, *The cross-border mobility within the European Community after the Cartesio ruling of the ECJ*, Journal of Business Law, (2010) or Andrew Johnston and Phil Syrpis, *Regulatory competition in the European community after Cartesio*, European Law review (2009).

28 Case C-2/74 *Jean Reyners v Belgian State*, paragraph 25.

29 C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano,* paragraph 23.

30 C-270/83 *Commission v France* (Avoir Fiscal).

31 Id., paragraph 18.

However, also restrictions imposed by the origin state are prohibited[32]. In the *Daily Mail* case the ECJ held that

> *"Even though those provisions are directed mainly to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation..[33]"*

Summing up, the freedom of establishment confers on both individuals and companies the right to establish themselves on the same conditions as laid down by the laws of the host state for its own nationals and companies having their registered office, central management or principal place of business in that state. On a similar basis, the freedom of establishments prohibits restrictions imposed by the state of origin[34].

3.2 Transfer of Residence

In both the Lasteyrie and the case *N* the court found that rules imposing an exit tax on individuals did not prevent a taxpayer from transferring his place of residence from one member state to another[35]. The tax rules at issue merely had a dissuasive effect on a taxpayer's wish to transfer his residence for tax purposes. Nevertheless, the negative effect was sufficient to conclude that the rules were likely to restrict the freedom of establishment.

Although closely linked, residence for tax purposes rather than residence for legal purposes is the focus for attention when exit taxes for companies are discussed. However, since member states apply different theories of conflict of law, residence for legal purposes may have a crucial role as well.

Before drawing the attention to case law, two major theories of conflict of law should therefore shortly be discussed.

Subsequently, case law on the freedom of establishment in regards to residence for companies will be examined. I will suggest that even though the Court in its ruling

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32 For a detailed presentation of the distinction between "origin" and "host" state obligations see Dr. Tom O'Shea, *EU Tax Law and Double Tax Conventions*, page 34, (Avoir Fiscal, London, 2008).

33 Daily Mail, paragraph 16.

34 C-374/04 *Test Claimants in the Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue* revealed that different obligations may be required from the host and origin state.

35 *Lasteyrie*, paragraph 45 and N-case paragraph 34.

of Cartesio[36] seems to have declined the Commission's interpretation of the consequences of Lasteyrie and N and upheld its Daily Mail decision, the case has nevertheless provided a different reasoning and patched some imperfection of the Daily Mail case which may affect the outcome of future cases.

3.2.1 Conflict of Law and Substantial Company Law

A company comes to existence by virtue of an agreement between its founders. A majority of countries apply a principle of freedom of contract providing several opportunities of designing the foundation under which the company may act. However, the respect of specific statutory provisions in substantial company law laying down certain minimum requirements is often required.

The agreement between the founders may have an international element, for example due to the different nationality of founders or multiple places of business activities. In order to decide which country's substantial law is applicable conflict of law theories are used.

Conflicts of laws relating to companies are most often decided by reference to either the *real seat theory* or the *incorporation theory*[37]. Both theories are applied in various versions.

The real seat theory requires a physical connection between the company and the legal system under which the company derives its legal personality[38]. The theory seeks to locate and attach the most important functions of a company to the legal system. Terms as "effective place of management", "the principle place of business" or "head office" are often used in that connection. Countries applying the real seat theory normally require a company, which has transferred its real seat to dissolve as the connecting factor will be considered broken. Foreign incorporated companies are similarly not recognised unless they incorporate in the state where they have their real seat.

The incorporation theory is regarded more liberal and focuses merely on the formal incorporation of a company regardless of where the effective management of the company takes place. Once incorporated the company may transfer its effective place of management elsewhere and still be considered a company subject to substantial law in the state of incorporation. Countries applying the incorporation

36 C-210/06 *Cartesio Oktató és Szolgáltató bt* (Cartesio).

37 For a more thorough examination see Christiana HJI Panayi, *Corporate Mobility in the European Union and Exit Taxes,* Bulletin for international Taxation, page 459 (October 2009) or Peter Dyrberg, *Full free movement of companies in the European Community at Last?*, European Law Review (2003).

38 Andrew Johnston and Phil Syrpis "*Regulatory competition in the European community after Cartesio*, European Law review (2009).

theory tend to recognise foreign incorporated companies even if the company is effectively management or has all of its activities within its jurisdiction.

3.2.2 Case Law on Freedom of Establishment

3.2.2.1 *Daily Mail*

In the Daily Mail case it became obvious that a transfer of residence for companies is not necessarily comparable to the transfer of residence for individuals. A British resident company, Daily Mail and General Trust Plc (DM), wished to transfer its central management and control to the Netherlands before selling a major part of its foreign located assets in order to repurchase its shares without having to pay capital gain tax in the United Kingdom (UK). The transfer would entail a transfer of residence for tax purposes and provide for at step up in value on transferred assets corresponding to market value at the time of transfer. A later disposal would therefore minimize the taxable capital gain on the assets and liabilities.

UK company law provided for such a transfer without the company losing its legal personality in the UK[39]. However, according to UK tax law the transfer was conditioned upon preapproval from the Treasury[40] who declined the request.

DM therefore filed a complaint arguing that the required consent from the Treasury violated the freedom of establishment[41].

The Court stated that for companies the right of establishment is generally exercised by the setting-up of agencies, branches or subsidiaries or by taking part in the incorporation of a company in another member state[42]. The UK legislation at issue did not impose a restriction on any of those transactions[43].

Arguing further for the reason why no restriction on the freedom of establishment could be established, the Court held that the Treasury consent was only required if the company wished to retain its legal personality in the UK and

39 *Daily Mail*, paragraph 3.

40 Id., paragraph 5.

41 From Confédération Fiscale Européenne, *Opinion Statement of the CFE ECJ Task Force on the Judgment in the Case of Cartesio Oktató és Szolgáltató bt (Case C-210/06) Judgment of16 December 2008*” it appears that it would have been a criminal offence if company resident in the United Kingdom moved its central management and control without such consent.

42 *Daily Mail*, paragraph 17.

43 Id., paragraph 18.

> "*in that regard it should be borne in mind that, unlike natural persons, companies are creatures of the law and, in the present state of Community law, creatures of national law*"[44].

The Court emphasised that legislation defining the connection between a company and a member state and the requirements for maintaining that connecting factor varies among the different jurisdictions. In defining the companies which enjoy the right of establishment the Treaty has taken account of that variety by placing on the same footing, as connecting factors, the registered office, central administration and principal place of business of a company[45].

A potential dissuasive effect resulting from the UK rules had therefore no impact because

> "*Article 52 and 58 of the Treaty cannot be interpreted as conferring on companies incorporated under the law of a Member State a right to transfer their central management and control and their central administration to another Member State while retaining their status as companies incorporated under the legislation of the first Member State*".

Hence, the reorganisation intended by Daily Mail was not covered by the freedom of establishment.

Analysis

Daily Mail triggers some thoughts about primary and secondary establishment and the coherence between article 49 and 54. Establishing that companies generally exercise the freedom of establishment by setting up agencies, branches or subsidiaries etc. the ECJ seemed to establish that companies enjoy the right of secondary establishment only. A conclusion that hardly observe the wording of article 49 and the reference in 54 and which therefore should be addressed.

The Court did not use the distinction between primary and secondary establishment even though the Advocate General in his opinion expressly explained the difference[46] and suggested that the question whether transfer of central management constituted "establishment" should be determined based on a range of factors relating to the business activity[47].

44 Id., paragraph 19.

45 Id., paragraph 21.

46 *Daily Mail*, paragraph 4, AG opinion.

47 Id., paragraph 8.

Admittedly, the second paragraph of article 49 concerning primary establishment seems to be written exclusively with individuals in mind and to apply this directly for companies is rather complicated[48].

As discussed in literature and by the ECJ in *Daily Mail*, companies, unlike natural persons, do not live *per se*[49] but exist only by virtue of the varying national legislation, which determines their incorporation and functioning. Is the reference to substantial law what explains why companies cannot refer from the Treaty a right of primary establishment?

In order for a company to enjoy the freedom of establishment a connecting factor has to be established. Whereas nationality applies for all member states in regards to individuals, the connecting factor may vary for companies. Since no common rules have been enacted member states are free to define the connecting factor and the necessary requirements to maintain that connecting factor.

The reasoning in *Daily Mail* appears incoherent because in an attempt to answer why companies cannot refer from the Treaty a right of primary establishment, the ECJ starts by referring not to conflict of law theories but to companies being creatures of national law which is a reference to the various substantial law provisions applicable in different member states.

Deviating from its starting point the Court then discusses different approaches to defining the connecting factor, which is a matter of theories regarding conflict of law.

As a result, a comparison between companies and *natural persons* is made instead of the more straightforward comparison between companies and *nationals*, the latter terms actually being the wording used in art. 49 and also the comparison made in Avoir Fiscal[50] cited above.

EU law does not govern nationality and rules therefore vary from one member state to another[51]. In the case of Chen[52] for example, the UK was obliged to accept the

48 See Anne Looijestijn-Clearie, supra 625.

49 See Federico M. Mucciarelli, *Company emigration and EC freedom of establishment- Daily Mail revisited*, page 294, European Business Organization Law Review (2008).

50 *Avoir Fiscal*, paragraph18

51 According to Article 20 TFEU every person holding the nationality of a Member State is EU citizen. However, citizenship of the Union shall be additional to and not replace national citizenship.

52 C-200/02 *Kunqian Catherine Zhu, Man Lavette Chen v Secretary of State for the Home Department* (Chen). See paragraph 37.

nationality of a young minor that was born in Ireland and because of the place of birth was granted Irish nationality. Under UK law, birth within UK territory did not automatically confer UK nationality[53].

The term "national" just as well as the term "company" is therefore a question of law and, in the present state of Community law, a question of national law.
In short, the reference to the different characteristics of companies compared to individuals leaves no further explanation to the issues. Instead the Court failed to elaborate on the most important question of what would have been the consequences if DM had transferred its residence without the consent.

UK applied the incorporation theory which initially suggests that legal personality would have been maintained. Consequently, it is difficult to see why the connecting factor was broken with the effect that DM could not invoke the freedom of establishment against UK administrative provisions[54].

3.2.2.2 Important Distinctions in Case Law

Many scholars have scrutinized daily Mail in an attempt to answer the above-mentioned questions and to reconcile the case with other cases concerning secondary establishments, which seem much more liberal[55].
Especially three distinctions have been employed in order to explain the coherence of the case law. Those are primary versus secondary establishment, inbound versus outbound establishment and application of the real seat theory versus application of the incorporation theory. In the following I shall examine the relevant case law from the ECJ with the aim of deciding on the importance of these theories in regards to the freedom of establishment.

3.2.2.2.1 Inbound versus Outbound Establishment

Segers[56]

In Segers a UK incorporated company carried on all of its activities through a Dutch subsidiary. The Dutch court was asked to decide on a Dutch sickness insurance

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53 *Chen*, paragraph 10.

54 Also se Carsten Gerner-Beuerle and Michael Schillig, *The mysteries of freedom of establishment after Cartesio,* International & Comparative Law Quarterly (2010), page 4.

55 See for an example Case comment to *Daily Mail, Daily Mail losses in European Court,* Journal of Business Law (1988) or Luca Cerioni, *The barriers to the international mobility of companies within the European Community; a re-reading of case law*, Journal of Business Law (1999), page 9 and Federico M. Mucciarelli, supra at 296.

56 C-79/85 *D. H. M. Segers v Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen* (*Segers*).

scheme and denied the director of the company access to the scheme because the company was incorporated in the UK.

The ECJ held that the freedom of establishment requires only that the company be formed in accordance with the law of a member state and has its registered office, place of management or principle place of business in the community. If those requirements were satisfied it was immaterial whether the company conducted its business through a subsidiary[57].

Requiring the company to be incorporated in the Netherlands therefore violated the Treaty as case no genuine business link with the state of incorporation could be required[58]. The Court, in two subsequent cases, has applied this approach consistently. These are the cases of Centros[59] and Inspire Arts[60], both concerning secondary establishments.

Centros

In the case of *Centros*, the Danish Commerce and Companies Agency (DCCA) refused to register a Danish branch of a UK company for reasons that the UK company did not trade in the UK and therefore was set up to circumvent Danish company rules, in particular, requirements for minimum paid up capital. Centros filed a complaint stating the company was lawfully incorporated in the UK and should therefore be entitled to set up a branch in Denmark.

The Court confirmed its findings in *Segers* and held that

> *"it is immaterial that the company was formed in the first Member State only for the purpose of establishing itself in the second, where its main, or indeed entire, business is to be conducted"*[61].

Inspire Art

In *Inspire Art* a company incorporated under UK law fell within the definition of a formally foreign company according to Dutch law because the company's activities

57 Id., paragraph 16.

58 Also see Luca Cerioni, *The barriers to the international mobility of companies within the European Community; a re-reading of case law*, Journal of Business Law (1999), page 3.

59 C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* (Centros).

60 C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam and Inspire Art Ltd,* (Inspire Art).

61 *Centros*, paragraph 17.

were entirely or almost entirely carried on in the Netherlands and the company had no real connection with England or Wales.

According to Dutch law several conditions concerning the disclosure of information in order for the company's registration in the Dutch commercial register were required plus in case of non-compliance penalties would be issued of which the director and the company would be jointly liable.

Inspire Art filed a complaint saying the company was not a formally foreign company[62] and therefore did not have to amend its registration.

Although confirming that Inspire Art Ltd was a formally foreign company the Dutch court asked whether the freedom of establishment prevented Dutch legislation from attaching additional conditions to an establishment in the Netherlands of a branch of a UK registered company when that company was set up in the UK with the sole aim of securing the advantages provided by UK law.

Whereas *Segers* and *Centros* prevented establishment the Dutch rules in *Inspire Art* only imposed disadvantageous conditions. Nevertheless, the Court reiterated its findings saying that it was without importance that the entire activity of Inspire Art was conducted in the Netherlands and added that the additional administrative obligations could therefore not be accepted[63].

One of the arguments in Inspire Art was that Member States, because of Daily Mail, retained the right to take action against brass-plate companies. However, the Court stressed that whereas *Daily Mail* concerned an outbound primary establishment, *Inspire Art* concerned and inbound secondary establishment[64].

To summarise, *Segers*, *Centros* and *Inspire Art* all concern inbound secondary establishments and identify a vital difference in the Court's approach to freedom of establishment in relation to immigration and emigration[65]. However, it is important to keep in mind that the Court in *Daily Mail* also stressed that freedom of establishment prohibits the state of origin of hindering its own nationals of establishing themselves abroad.

62 The Eleventh Council Directive 89/666/EEC of 21 December 1989 included some of the information required.

63 *Inspire Art*, paragraph 99.

64 *Inspire Art*, paragraph 103.

65 See otherwise Federico M. Mucciarelli supra at 281.

3.2.2.2.2 Primary versus Secondary Establishment

Überseering[66]

In *Überseering* a Dutch company engaged a German company, Nordic Construction Company (NCC) to refurbish a garage and a motel. Due to defective work by NCC Überseering sought compensation by bringing the case before a German court. However, the case was dismissed because the shares in *Überseering* in the meantime were acquired by two German resident shareholders and the company therefore, despite being incorporated in the Netherlands, was effectively managed from Düsseldorf. Überseering was considered in non-compliance with German law requiring it to re-incorporate in Germany. Consequently, Überseering did not have legal capacity to bring proceedings in Germany.

It was argued that due to the Court's ruling in the Daily Mail case, the freedom of primary establishment for companies was not protected by the Treaty[67]. Germany should therefore be allowed to require Überseering to reincorporate.

The Court denied these arguments and distinguished Überseering from the Daily Mail case based on the fact that Daily Mail did not concern the way in which a member state treats a company which is validly incorporated in another member state and which is exercising its freedom of establishment[68].

Instead, from the *Centros* case it followed that a necessary precondition for the exercise of freedom of establishment is the recognition by one member state of a company with its registered office, central administration or principle place of management in another member state[69].

Besides confirming the importance of inbound versus outbound establishment, the *Überseering* case seems to add less importance to the distinction between primary and secondary establishment for companies. Despite what could be read from the Daily Mail case, both are protected by the freedom of establishment.

SEVIC[70]

The *SEVIC* case concerning a cross border merger between a German and a Luxemburg company confirmed these findings. German law provided for mergers

66 C-208/00 *Überseering BV v Nordic Construction Company*.

67 Id., paragraph 29-31.

68 Id., paragraph 66.

69 Id., paragraph 59, cf. paragraph 56-58.

70 C-411/03 *SEVIC Systems AG* (*SEVIC*).

between two German companies but not for cross-border mergers. Consequently, the German Authorities refused to register a cross border merger with a German company as the continuing company.

The ECJ held that cross border mergers

> *"constitute particular methods of exercise of the freedom of establishment, important for the proper functioning of the internal market, and are therefore amongst those economic activities in respect of which Member States are required to comply with the freedom of establishment laid down by Article 43 EC"*[71].

Because of the different treatment between domestic mergers and cross border mergers Germany breached the freedom of primary establishment.

3.2.2.3 Conclusion

From the case law examined above it appears that whereas inbound establishments seem to be protected both in case of primary and secondary establishments, the case of outbound primary establishments still seem to fall out from the freedom of establishment.

The outcome of the *Cartesio* case was therefore long awaited, not least because the Advocate General (AG) in his opinion had suggested a deviation from the *Daily Mail* case. The Cartesio case also spread some light on the last distinction, namely the incorporation theory versus the real seat theory.

3.2.2.4 *Cartesio*

Cartesio, a company established and incorporated in Hungary filed an application to move its effective place of management to Italy while remaining its status as a company governed by Hungarian law. The application was denied, as according to Hungarian law a company incorporated in Hungary could not transfer its seat abroad while continuing to be subject to Hungarian law governing its articles of association[72].

AG opinion

The AG started by noticing that Hungary applied the real seat theory and taking this theory to its full extent, Hungarian company law prohibited the 'export' of a Hungarian legal person to the territory of another Member State even though such a

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71 Id., paragraph 19.

72 *Cartesio*, paragraph 24.

transfer was permitted for domestic purposes[73]. In the AG's opinion the purpose of the transfer of seat answered to an actual pursuit of an economic activity the reason why the right of establishment should apply[74].

The AG referred to the outcome of the *Daily Mail* case but suggested that case law had developed since and that the Court's approach had become more refined. The AG noted in particular that, as a result of the judgment in Centros, Überseering, and Inspire Art the case law appeared to be moving in precisely the opposite direction and thereby rejecting the argument that

> *"rules of national company law should fall outside the scope of the Treaty provisions on the right of establishment"*[75].

The AG mentioned the several attempts made to distinguish the case law between primary opposed to secondary establishment and outbound versus inbound establishment. However, the AG found that these distinctions were never entirely convincing[76], not least because the Daily Mail case itself held that restrictions imposed by the origin state is prohibited as well[77].

Admitting that member states are free to choose to apply both the real seat theory and the incorporation theory the AG held that

> *"the effective exercise of the right of establishment implies that neither theory can be applied to its fullest logical extension – the best example to date perhaps being the case of Überseering"*[78].

Consequently, the AG concluded that member states do not enjoy the absolute freedom to determine the life and death of a company[79].

ECJ decision

The Court disagreed with the AG and reiterated its previous findings in the Daily Mail case that member states can make the rights for companies to retain their legal

73 *Cartesio*, AG Opinion, paragraph 23.

74 Id., paragraph 25.

75 Id., paragraph 27.

76 Id., paragraph 28.

77 Same conclusion was reached by some scholars before opinion, e.g. Federico M. Mucciarelli, supra at 296-298.

78 *Cartesio*, paragraph 30, AG Opinion.

79 Id., paragraph 31. For criticism of the AG opinion see Dr. Tom O'Shea, "*Hungarian Tax Rule Violates EC Treaty, Advocate General says*", Tax Notes International, (August 2008).

personality subject to certain condition concerning the place of effective management[80].

The Court stated that

> *" the question whether Article 43 EC applies to a company which seeks to rely on the fundamental freedom enshrined in that article – like the question whether a natural person is a national of a Member State, hence entitled to enjoy that freedom – is a preliminary matter which, as Community law now stands, can only be resolved by the applicable national law"*[81].

A company can therefore only enjoy freedom of establishment if that company actually has the right to that freedom, which is for the Member states to address by defining the necessary connecting factor.

However, as an obiter dictum the ECJ made an interesting distinction between the situation where the seat of a company incorporated under the law of one Member State is transferred to another Member State with no change in the law governing that company and the situation where the move is conducted with an attendant change as regards the national law applicable. The ECJ held that

> *"in the latter situation the company is converted into a form of company which is governed by the law of the Member State to which it has moved"*[82].

The distinction is important because if the laws of the host state allows for a conversion, the origin state cannot require the company to dissolve or liquidate if the company wishes to convert itself into a company covered by the laws of the host state.

Unfortunately, the Court provided only a negative interpretation of the word "conversion", by defining the merger in the SEVIC case as

> *"a situation fundamentally different from the circumstances at issue in the case which gave rise to the judgment in Daily Mail and General Trust"*[83].

The Court also declined an application (mutatis mutandis) of the European

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80 *Cartesio*, paragraph 107.

81 Id., paragraph 109.

82 Id., paragraph 111.

83 Id., paragraph 122.

Company Statute[84] as, according to the statute, a transfer of the registered seat would entail a change as in the national law applicable to the entity making the transfer[85].

Analysis

Cartesio may be said to introduce light and shade into the *Daily Mail* case by including a comparison to *nationals* instead of *individuals* only[86]. The comparison highlights that the question of a connecting factor is a preliminary question that accordingly should be applied equally for individuals and companies.

Hence, if a connecting factor can be established and maintained despite the transfer of effective place of management there should be no reason why companies should not enjoy the freedom of outbound primary establishment.

Consequently, it becomes vital whether the member state applies the incorporation theory which in general terms allows a company to maintain its legal personality or the real seat theory which does not allow the company to maintain its legal personality.

Despite many arguing that the Court in *Cartesio* upheld its case in *Daily Mail* a modification may therefore have come under way for the benefit of companies wishing to emigrate.

Though, the Court did not explicitly establish that an effective distinction should be made between the real seat theory and the incorporation theory and it is therefore highly uncertain whether the ECJ modified the *Daily Mail* case deliberately.

As concerns the obiter dictum made by the Court, there seems to be much confusion about what exactly is meant by the term "conversion".

Andrew Johnston and Phil Syrpis write that

> *"in the continuing absence of a Fourteenth Directive on Seat Transfer, conversion is dependent on the new home Member State unilaterally putting in place specific rules providing for direct conversions. At present, no Member State has such rules in place"*[87].

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

85 Cartesio, paragrah 117.

86 The court also made a reference to its finding in Daily Mail that companies are creatures of law, cf. paragraph 104.

87 Andrew Johnston and Phil Syrpis, supra at 6.

On the contrary, Hermann Schneeweiss has taken the position that Portuguese company law allow for a conversion[88]. Also Peter J. Wattel is of the opinion that Belgium, Luxembourg and Italy allow for inbound conversion[89].

It is noteworthy that the Court found reasons explicitly to exclude mergers as SEVIC as one would obviously have thought of a merger as being a transaction enabling a foreign company to convert into a domestic company governed by domestic law. The reason is, however, understandable as article 4 (1b) in the merger directive[90] requiring for a permanent establishment in the member state of the transferring company would be rendered meaningless if companies could rely on article 49 and 54 in order to merge and at the same time transfer assets from one member state to another without being taxed.

3.2.3 Impact of Secondary Legislation

Two secondary legislative instruments provide for a transfer of a company's registered seat for legal purpose.

The merger directive provides for a company formed in accordance with the laws of a member state to establish a foreign EU subsidiary and subsequently carry out a downstream merger effectively transferring its registered seat abroad without having to dissolve. The merger will not have any tax consequences for the transferring company (also being the shareholder in this example) but assets and liabilities previously located in the member state of the transferring company must effectively be connected to a permanent establishment in that member state, cf. article 4 (1b). The merger directive therefore does not solve the questions of corporate exit taxes on cross border transfer of assets and liabilities.

The European Company Statute[91] provides for a company organised in the form of a SE (Societas Europaea) to transfer its seat to another member state without having to dissolve and reincorporate. The merger directive was amended in 2005 to include the transfer of the registered office of a SE[92]. However, similar to a merger, article 4 (1b) of the merger directive applies (cf. article 10b) and the company is not assured tax neutrality on capital gains on assets and liabilities not effectively connected to a permanent establishment.

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88 Hermann Schneeweiss, "*Exit taxation after Cartesio: The European Fundamental Freedom's impact on Taxing Migrating companies*, Intertax, volume 37 (2009), issue 6/7, page 372.

89 Peter J. Wattel, *Exit exitheffing?,* Nederlands Juristenblad, 540 (2009), page 663.

90 Council Directive 90/434/EEC of 23 July 1990.

91 Council Regulation (EC) No 2157/200.

92 Council Directive 2005/19/EC.

3.2.4 Concluding section 3.2

Despite the fact that the Treaty prohibits restriction imposed by the origin state, the ECJ has continuingly repeated its *Daily Mail* case and upheld the vital distinction between inbound establishments as in *Segers*, *Centros*, *Überseering*, *Inspire Art* and *SEVIC* and outbound establishments as in *Daily Mail* and *Cartesio*.

The distinction between primary and secondary establishment seems to be of less importance as the ECJ held that a necessary precondition for the exercise of freedom of establishment is the recognition by one member state of a company with its registered office, central administration or principle place of management in another member state.

In *Cartesio* the Court may have modified the reasoning behind the *Daily Mail* case by focusing on the comparison between companies and the nationality of individuals. This could lead to a line of arguments concluding that the distinction between applying the incorporation theory and the real seat theory is vital.

The argument would be that if a connecting factor can be established and maintained despite the transfer of effective place of management, there should be no reason why companies should not enjoy the freedom of outbound primary establishment.

However, to conclude that companies confer from the Treaty a right to transfer the central management abroad while retaining its legal personality in the origin state if the latter applies the incorporation theory would contradict the Daily Mail case because the UK actually provided for a transfer according to UK company law.
In my opinion it is therefore highly uncertain that the Commission will be able to succeed in convincing the Court that *Daily Mail* should no longer be applied and that member states are prevented from making the transfer of residence for tax purposes subject to exit taxes if the company maintains its legal personality in the origin state.

The Commission may instead resort to the comments made by the Court in *Cartesio* regarding companies wishing to transfer with a change in applicable law. It is, however, uncertain what the Court meant by “conversion” and the Commission will have to establish a detailed analysis hereof in order to convince the Court that the freedom of establishment is applicable in situations of outbound primary establishment.

This approach entail great difficulties as legislation of more than one member state will have to be scrutinized.

3.3 Transfer of Assets and Liabilities

Apart from the transfer of residence the Commission also targets exit taxes levied on the cross border transfer of single assets or liabilities between a head office and its permanent establishment.

A transfer of assets and liabilities can be an entirely intentional allocation to group entities in connection with a business restructuring in order to take full advantage of existing capacity. However, the transfer may also take place more or less unintentionally as part of a change in the business structure and the way functions are performed, assets employed and risks assumed. Especially identifying intangible assets before and after the restructuring may entail great difficulties[93].

A transfer of single assets and liabilities between a head office and its permanent establishment is normally not recognised for legal purposes as the transfer takes places within the same legal entity. For tax purposes, however, the transaction is often recognised because member states risk restricting their rights to tax capital gains and future income streams from the assets and liabilities.

A majority of member states taxes resident companies on their world wide income and will consequently retain their tax jurisdiction on capital gains and income streams even though the assets and liabilities are being transferred to a permanent establishment in another member state. If the host state taxes the same gain or income, taxing rights are often allocated according to a double tax convention (DTC) and, in case the DTC is drafted according to the OECD model convention, capital gains and income will most likely be attributed to the income of the permanent establishment in accordance with article 7 and taxed accordingly in the state hosting the permanent establishment.

A minority of member states taxes companies according to a territoriality principle that often entails that the origin state loses its taxing right[94].

3.3.1 Transfer of Assets and Liabilities and Freedom of Establishment

The case of Factortame II[95] concerned rules providing for the UK registration of vessels if certain conditions concerning nationality or residence were met. The conditions were tested in a case brought before the ECJ in which the Court held that

93 See paragraph 78 of the OECD Transfer Pricing Aspect of Business Restructuring, Discussion Draft for public comments 19 September 2008 to 19 February 2009.

94 Denmark is an example of a state applying the territoriality principle for companies.

95 C-221/89 *The Queen v Secretary of State for Transport, ex parte Factortame Ltd and others* (Factortame II). The *Factortame* litigation led to a series of decisions of which the two most important judgements were delivered in 1990 (C-213/89) and 1991 (C-221/89) and generally referred to as *Factortame* I and *Factortame* II respectively.

> *"where the vessel constitutes an instrument for pursuing an economic activity which involves a fixed establishment in the Member State concerned, the registration of that vessel cannot be dissociated from the exercise of the freedom of establishment"*[96].

The case of Factortame II shows that even though the establishment of a fixed place of business was not prohibited, companies cannot be deprived the advantages of national treatment if the asset in question is necessary to pursue an economic activity.

Therefore, it should equally be held that the transfer of assets and liabilities between a head office and its permanent establishment cannot be dissociated from the exercise of the freedom of establishment as long as the transfer is necessary to pursue an economic activity.

This conclusion seems also to be in line with a number of cases concerning thin capitalization and arm's length rules restricting cross border loan transactions between parent companies and their subsidiaries[97]. These cases fell under the scope of freedom of establishment despite the loans agreements were made to existing subsidiaries.

Especially the case of *SGI*[98] seems comparable as the lack of interests paid to SGI by its Belgium subsidiary was merely treated as an unusual or gratuitous advantage and added to the taxable income of SGI. No re-characterisation of interests into dividend was made and the loan agreement was therefore in no way aligned with an additional equity stake in the Belgium subsidiary.

The thin cap and arm's length cases furthermore established that national provisions which, according to their purpose, apply to holdings giving a decisive influence come within the substantive scope of the freedom of establishment rather than freedoms to provide services or the free movement of capital[99].

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96 *Factortame*, paragraph 22.

97 See C-324/00 *Lankhorst-Hohorst v Finanzamt Steinfurt* (Lankhorst-Hohorst), C-524/04 *Test Claimant in the Thin Cap Group Litigation v Commissioners of Inland Revenue* (Thin Cap GLO), C-192/04 *Lasertec v FA Salzburg-Land* and C- 311/08 *Société de Gestion Industrielle SA v Éstat belge* (SGI).

98 C- 311/08 *Société de Gestion Industrielle SA v Éstat belge* (SGI).

99 See Thin Cap GLO paragraph 27, Lasertec paragraph 19, SGI paragraph 25 and 28. The court normally also refers to C-251/98 *C. Baars v Inspecteur der Belastingsdienst Particulieren/Ondernemingen Gorinchem* (Baars) in which the court held that holding a definite influence in a company is covered by freedom of establishment.

Apart from certain joint ventures[100] permanent establishments are usually subject to decisive influence from the head office and exit tax rules treating a transfer of assets and liabilities between a head office and a foreign permanent establishment differently than domestic transfers may restrict the freedom of establishment unless justified.

3.4 Conclusion to section 3

The freedom of establishment is most likely to be restricted in two cases: 1) where member states levy exit taxes on the transfer of residence to a tax jurisdiction that allows for a conversion and 2) where member states levy exit taxes on the transfer of single assets and liabilities between a head office and its permanent establishment. Restrictions in both scenarios depend on the cross border transaction being subject to less advantageous rules than similar domestic transactions.

4 Justifications

Article 52 TFEU explicitly provides for justifications on grounds of public policy, public security or public health. These justifications, however, provide member states a narrow opportunity to limit the access to certain types of activities only, not to apply discriminatory tax rules once the access has been given[101]. The subject for this section is therefore to examine the grounds of justifications previously recognised by case law as being of overriding public interest.

In the *Gebhard* case[102] the Court held that

> *"National measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it[103]".*

100 These should be examined in light of the free movement of capital, see Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty.

101 See Servaas van Thiel, *Justifications in Community Law for Income Tax Restrictions on Free Movement: Acte Clair Rules That Can Be Readily Applied by National Courts – Part 1*, European Taxation (June 2008), page 279.

102 C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* (*Gebhard*)

103 *Gebhard*, paragraph 39.

Various reasons for justifications have been argued by member states, some of which have been accepted and developed by the Court whereas others have continually been declined[104]. The 4 most commonly discussed justifications are risks of tax avoidance, effectiveness of fiscal supervision, balanced allocation of taxing rights and cohesion of the tax system.

Each of these justifications have gradually been developed over years and used on either a standalone basis or together with other types of justifications[105]. The purpose of the following section is to examine only the key elements of the 4 types of justifications in relation to corporate exit taxes. The intent is not to provide a thorough analysis of each justification.

4.1 Risk of Tax Avoidance

Member states as a justification for unequal treatments, see for an example *Segers*, *Centros* and *Inspire Art*, all cited above, has repeatedly used the argument on risk of abuse of rights.

Recurring in phrases as "tax avoidance" or "tax evasion" this justification has also been reiterated in the area of direct tax law. Yet, in *Avoir Fiscal* the court held that

> *"the risks of tax avoidance cannot be relied upon in this context. Article 52 of the EEC Treaty does not permit any derogation from the fundamental principle of freedom of establishment on such ground"*[106].

ICI[107]

In *ICI*, the Court took a more detailed approach to the risk of tax avoidance. Through a consortium, ICI owned 49% of a holding company. By way of a tax deduction ICI wished to set off 49% of trading losses incurred by a UK subsidiary held by the holding company.

Surrender of losses within a consortium was allowed under UK tax law provided ICI qualified as a trading company. However, since the majority of subsidiaries in the

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104 E.g. loss of revenue, see C264/96 *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer*, paragraph 28 or C-307/97 *Compagnie Saint-Gobain v Finanzamt Aachen-Innenstadt paragraph 50*.

105 In C-446/03 *Marks & Spencer plc v David Halsey (her Majesty's Inspector of Taxes)* the preservation of the allocation of power to impose taxes, the risk of losses being used twice and the risk of tax avoidance constituted a combined justification.

106 *Avoir Fiscal*, paragraph 25.

107 C264/96 *Imperial Chemical Industries plc v Kenneth Hall Colmer (her Majesty's Inspector of taxes)* (*ICI*).

consortium (19 out of 23) were resident outside the UK (mostly in third countries but 6 in other Member States) ICI did not qualify as a trading company.

The UK government argued that the rules were designed to reduce the risk of tax avoidance arising from the possibility for members of a consortium to channel deductible losses to UK resident subsidiaries and to have profits attributed to non-resident subsidiaries[108].

However, the rules applied to all situations in which the majority of subsidiaries were established outside the UK and the ECJ therefore held that the rules were not designed to prevent wholly artificial arrangement from attracting tax benefits which circumvented UK tax law[109]. The existence of only one subsidiary would potentially give rise to tax avoidance and the term "majority" had therefore no bearing[110].

Lasteyrie

In the *Lasteyrie* case, cited above, the exit tax sought to prevent French resident taxpayers from escaping French capital gains tax by moving their residence for tax purposes shortly before selling the securities and soon after returning to France.
The French Government used the ICI case and argued that in the case of Mr. de Lasteyrie the French rules sought in fact to prevent abusive exercise of a right conferred by the community law[111]. Provided the securities were not disposed of within five years after the transfer of residence the taxpayer would be released from any obligation towards the French authorities[112].

The ECJ took a different view and held that the rules were aimed generally at any situation in which a taxpayer with substantial holdings in a company transferred his tax residence outside France for any reason whatever[113]. The mere transfer of residence to another member state could not in itself imply tax avoidance[114] and the rules did not take into account taxpayers with no intention of returning to France.
Thus, the rules were not specifically designed to exclude from a tax advantage purely artificial arrangements aimed at circumventing French tax law.

108 *ICI*, paragraph 25.

109 Id., paragraph 26.

110 Id., paragraph 27.

111 *Lasteyrie*, paragraph 24.

112 Id., paragraph 27.

113 Id., parapraph 50.

114 *Lasteyrie*, paragraph 51.

Cadbury Schweppes[115]

In the case of *Cadbury Schweppes* significant guidance was giving by the ECJ on how to establish what constitutes a wholly artificial arrangement.

The case concerned Cadbury Schweppes (CS), a UK resident company and parent company of two companies in Ireland, Cadbury Schweppes Treasury Services (CSTS) and its subsidiary Cadbury Schweppes Treasury International (CSTI). CSTS was owed indirectly through a chain of subsidiaries at the head of which were Cadbury Schweppes Oversea Ltd (CSO).

Profits made by CSTI were subject to a lower level of taxation within the meaning of UK controlled foreign company (CFC) legislation and consequently included in the taxable income of CSO as none of the conditions for exemption from CFC taxation were applicable.

The Court held that the UK CFC rules constituted a restriction on the freedom of establishment and that only legislation specifically aimed at conduct involving the creation of wholly artificial arrangements without economic reality and with a view to escaping the tax normally due on the profits generated by activities carried out on national territory could justify such a restriction on grounds of prevention of abusive practices[116].

Furthermore, the court said

> *"In order to find that there is such an arrangement there must be, in addition to a subjective element consisting in the intention to obtain a tax advantage, objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment,…,has not been achieved"*[117].

Legislation preventing abusive practice must be based on objective factors which are ascertainable by third parties. If an establishment is intended to carry on genuine economic activity, legislation hindering that exercise must be excluded even though the establishment has been pushed forward for tax reason[118].

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115 C-196/04 *Cadbury Schweppes plc Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* (Cadbury Schweppes).

116 Id., paragraph 55.

117 Id., paragraph 64.

118 Id., paragraph 65-67.

Accordingly, the ECJ referred the case back to the national courts to decide whether the legislation in questions lent itself to be interpreted as being restricted to wholly artificial arrangements[119].

4.1.1 Risk of Tax Avoidance and Corporate Exit Taxes

Cases like *ICI*, *Lasteyrie* and *Cadbury Schweppes* demonstrate that the risk of tax avoidance is a justification incapable of justifying a breach of community rights unless the scope of application is strictly limited to abusive conduct.

Applying risk of tax avoidance as a standalone justification to exit tax rules necessitate that domestic exit tax rules, based on objective factors which are ascertainable by third parties, are capable of excluding companies transferring their residence or assets/liabilities for reasons of genuine economic activities.

However, in *OY AA*[120] and *SGI*[121] the Court held that even though national rules are not aimed at wholly artificial arrangement, they may be taken together with other justifications and used as a combined justification despite the rules apply beyond wholly artificial arrangements.

4.2 Effectiveness of Fiscal Supervision

A correct assessment of corporate income tax depends on access to a long list of information such as accounts and bookkeeping, tax depreciations, internal transactions etc. Extended cooperation from taxpayers and other authorities holding the information is therefore needed.

Within a domestic tax system legislators have a variety of opportunities to secure access to information and sanction tax payers' non-compliance. In a gross border setting, however, member states are faced with certain restrictions in order to respect other jurisdictions. Meanwhile, authorities of one state cannot in general be expected to assist in the collection of another state's taxes. Cross border transactions may therefore under certain circumstances be subject to different treatment compared to domestic transactions in order for a state to ensure the effectiveness of fiscal supervision.

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119 Id., paragraph 72. Conformity of UK CFC legislation was decided in *Vodafone 2* v *Commissioners for Her Majesty's Revenue and Customs* [2008] EWHC 1569. The Court of Appeal decided that the CFC rules as a whole could be interpreted in a way so they were compatible with freedom of establishment.

120 C-231/05 *Oy AA*, paragraph 63.

121 *SGI*, paragraph 66.

This justification has been widely used in combination with the risk of tax avoidance[122] but can also be traced back to the case of Cassis de Dijon[123] as a separate justification. In *Cassis de Dijon* the court held that German rules, requiring a minimum amount of alcohol in goods, sold as liqueur, constituted a restriction to the free movement of goods.

The Court held that

> *"obstacles to movement within the community… must be accepted in so far as those provisions may be recognised as being necessary in order to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision…"*[124]

Also in *Futura*, concerning the carryover of losses by branches of foreign companies [125] the Court held that

> *"effectiveness of fiscal supervision constitutes an overriding requirement of general interest capable of justifying a restriction"*[126].

However, the Court has also repeatedly declined the justification in areas where secondary legislation or national provisions have been capable of solving the issue. In the *Schumacker*[127] case Germany argued that German tax rules not allowing Mr. Schumacker, a Belgian tax resident working in Germany, the benefit from certain income splitting rules in order to mitigate progression in the tax rate, were justified by the administrative difficulties for Germany to obtain information on Mr. Schumacker's Belgian income[128].

The Court declined the argument referring to the Mutual Assistance Directive[129] (MAD) which provided Germany for ways of obtaining the necessary information.

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122 See for example C-451/05 *Européenne et Luxembourgeoise d'investissements SA (ELISA) v Directeur général des impôts, Ministère public* or C-540/07 *Commission of the European Communities v Italian Republic*.

123 C-120/78 *Rewe-Zentrale AG v Bundesmonopolverwaltung für Branntwein* (Cassis de Dijon).

124 *Cassis de Dijon*, Paragraph 8.

125 C-250/95 *Futura Participations SA and Singer v Administration des contributions* (Futura).

126 *Futura*, paragraph 31.

127 C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker* (Schumacker).

128 *Schumacker*, paragraph 43.

129 Council Directive 77/799/ECC of 19 December 1977

Thus, apart from situation where information cannot be obtained due to the specific exceptions in the MAD, the need to ensure the effectiveness of fiscal supervision is practically useless between member states.

Furthermore, in *Commission v. Denmark*[130] and *Skatteverket v A*[131] the court held that even though the directive does not impose on member states an obligation to exchange certain information there is nothing preventing the member state from obtaining the necessary information and documentation from the taxpayer involved[132].

4.2.1 Effectiveness of Fiscal Supervision and Corporate Exit Taxes

If member states retain the power to impose taxes after a transfer of residence/assets and liabilities they may argue that the necessary information to assess the taxable income correctly cannot be achieved or verified sufficiently when there has been a time span between the transfer and the transaction triggering the income.
However, the MAD impedes this argument and the need to ensure effectiveness of fiscal supervision as a justification on restrictive exit tax rules on transfers between member states must be regarded to have very limited use only.

4.3 Balanced Allocation of Taxing Rights

Marks and Spencer

In *Marks and Spencer* (MS) a UK parent company wanted to set off losses from (indirectly held) subsidiaries in the Netherlands and Belgium in its UK income. UK tax law provided for group reliefs but only if losses were recorded in the UK. The subsidiaries in the Netherlands and Belgium did not have activities in the UK and loss relief was therefore denied.

The ECJ held that not allowing for cross border group relief while providing for domestic group relief constituted a restriction on the freedom of establishment[133].
The UK was acting in accordance with the principle of territoriality enshrined in international tax law by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that the UK[134].

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130 C-150/04 *Commission of the European Community v. Kingdom of Denmark* (Commission v Denmark).

131 C-101/05 *Skatteverket v A*, paragraph 58.

132 Commission v Denmark, paragraph 54.

133 MS, paragraph 34.

134 Id., paragraph 39.

However, that argument in itself did not justify the restriction, as it was necessary to look at the consequences of allowing cross border relief as well[135].

To give companies the option to choose where losses should be taken into account would jeopardise a balanced allocation of the power to impose taxes between Member States[136]. Combined with the risk of losses being deducted twice and the risk of tax avoidance the restriction on the freedom of establishment was therefore justified[137].

Thus, the Court indicated that a balanced allocation of taxing rights between member states is not a justification that can be used without a further explanation of how the balance is jeopardised[138].

N-case

The Court's findings in MS were reiterated in the *N* case, cited above. When allocating between Member States, on the basis of a territoriality principle, the power to tax increases in value in company holdings[139] the Court did not find it unreasonable for the member states to find inspiration in international practice, in particular the OECD model convention.

The ECJ held that a principle of territoriality can be found in article 13 (5) of the model convention allocating taxing rights on capital gains from the alienation of any property other than those referred to in paragraph 1-4 to the state of residence. The ECJ held

> *"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, the amount of which has been determined at the time the taxpayer concerned emigrated and payment of which has been suspended until the actual disposal of the securities"*[140].

135 Id., paragraph 41.

136 Id., paragraph 46.

137 Id., paragraph 51.

138 Also se Dr. Tom O'Shea, supra at 139 and Servaas van Thiel, *Justifications in Community Law for Income Tax Restrictions on Free Movement: Acte Clair Rules That Can Be Readily Applied by National Courts – Part 2*, European Taxation (July 2008) page 346.

139 *N* case, paragraph 41.

140 *N* case, paragraph 46.

In the *N* case the balanced allocation of taxing rights was not taken together with other justifications. Instead the justification was further developed with a reference to the territoriality principle[141] and the suspension of the tax payment.

4.3.1 Balanced Allocation of Taxing Rights and Corporate Exit Taxes

It seems reasonable to apply the arguments made by the Court in MS and the N case to corporate exit tax cases as well as it would undermine the balanced allocation of taxing rights between member states if companies were allowed to transfer their residence or their assets and liabilities to jurisdictions with the lowest tax rate shortly before disposal. However, suspension of the tax payment until the actual disposal must to be an implicit condition.

The Court's argumentation in the N case is not without imperfections. Article 13 (5) of the model tax convention does not allocate the right to tax *a part of* a gain to the origin state based on the increase in value until the time of emigration. Neither does article 13 (5) preclude the host state to tax the entire difference between acquisition amount and sales price, even though a part of the increase arose while the tax payer was a resident of another state[142].

On the contrary, article 13 specifically applies upon "alienation" and exit taxes on unrealised capital gains levied by the origin state have consequently been discussed to breach article 13[143]. However, international tax law has in general accepted a concept of fictitious alienation used in domestic law[144].

4.4 Cohesion of the Tax System

Bachmann[145]

In the case of *Bachmann* the ECJ accepted that Belgium law, allowing for tax deductions for contributions made to life and sickness insurance, was conditioned upon the payment being made in Belgium.

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141 The ECJ refused the justification in the case of Lasteyrie, cf. paragraph 68.

142 Also see Bert Zuijdendorp, *The N case: the European Court of Justice sheds further light on the admissibility of exit taxes but still leaves some questions unanswered*, EC tax review (2007/1)

143 Luc De Broe and Katrien Willoqué, *Interpretation of Articles 13, 15 and 18 of the OECD Model Convention. The 2009 decisions of the Dutch Supreme Court on the Dutch exit taxes on substantial shareholdings and pension claims: Treaty override or not?*

144 See Prof. Dr Hans van den Hurk and Jasper Korving, *supra* 154.

145 C-204/90 *Bachmann v Belgian State* (Bachmann).

The Court saw a link between the granting of the deduction and the ability to tax the sums payable by the insurer[146] and at the stage of EC law it was not possible to

> *"ensure the cohesion of such a tax system by means of measures less restrictive than those at issues"*[147].

The Court did not place importance on tax treaties between member states that on a bilateral level governed the taxation of premiums paid by the insurer[148]. This was, however, addressed in the cases of *Wielockx*[149] and *Danner*[150]. In both cases the Court held that fiscal cohesion was not established in relation to one and the same person but was shifted to the level of the double tax convention[151].

Cohesion of the tax system was also refused as a justification in a large number of cases because the issue in question concerned different taxpayers or different taxes[152] and member states therefore failed to establish a direct link.

Krankenheim[153]

However, in 2008 in the case of *Krankenheim* the Court found that German rules reintegrating losses from an Austrian permanent establishment, which had previously been deducted in the taxable income of the German company, were "appropriate to achieve such an objective, in that it operates in a perfectly symmetrical manner, only deducted losses being reintegrated" [154].

Thus, the Court allowed the reintegration of losses to be justified by the cohesion of the tax system because there was a direct link between allowing for the offset of

146 Id., paragraph 21.

147 Id. paragraph 27.

148 Id. paragraph 26.

149 C-80/94 *G. H. E. J. Wielockx v Inspecteur der Directe Belastingen* (Wielockx).

150 C-136/00 *Rolf Dieter Danner* (Danner).

151 *Wielockx,* paragraph 24 and Danner, paragraph 41.

152 The *Baars* case concerned different taxes (wealth tax and corporate tax) paid by different taxpayers (shareholder and company).

153 C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* (Krankenheim).

154 *Krankenheim*, paragraph 43.

foreign losses in the German income and the subsequent taxation of income when the permanent establishment later made a profit[155].

Papillon[156]

In *Papillon* French rules allowed companies to form an integrated group with the objective of setting off losses against profit in the group. However, a sub-subsidiary could not be included if held by a foreign intermediary subsidiary. Consequently, Papillon a French company holding shares in a French sub-subsidiary through a Dutch intermediary company, was precluded from including the sub-subsidiary in the group.

The National Court had observed that the coherence of the system for neutralising intra-group transactions would be affected if foreign intermediary companies were allowed in the group and could lead to cases of double deductions[157].

Whereas it took the Court one paragraph to establish a direct link in *Krankenheim*, it took the Court 6 paragraphs and a rather detailed analysis of depreciations of holdings before the Court succeeded in establishing a link between losses and intra group transactions affecting those losses and therefore enabling a group of companies to benefit twice.

Before the cases of *Krankenheim* and *Papillon* it was argued that the cohesion of the tax system is a question of compensation for giving a deduction. Since the Court does not accept justifications based on loss of revenue, this justification was in practical terms useless within the area of discriminatory tax measures[158].

Nevertheless, *Krankenheim* and *Papillon* proved otherwise and in *Papillon* the court seems to have accepted a more complex approach to defining a direct link.

4.4.1 Cohesion of the Tax System and Corporate Exit Taxes

The Court has required a direct link between a tax advantage and the offsetting of that advantage by a particular tax levy in order for cohesion of the tax system to succeed as a justification.

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155 According to Prof. Dr Gerard T.K. Meussen an application of German rules only did not treat the Austrian permanent establishment less advantageous compared to a domestic permanent establishment, cf. "*The ECJ's Judgment in Krankenheim –The Last Piece in the Cross-Border Loss Relief Puzzle?*" European Taxation, (July 2009).

156 C-418/07 *Société Papillon v Ministère du Budget, des Comptes publics et de la Fonction publique* (papillon).

157 *Papillon*, paragraph 42.

158 Servaas van Thiel Part 1, supra at 281.

Such a link may be established if an argument could be made that future rights to tax income streams from assets and liabilities are forfeited despite deductible expenses in the origin state have been used to build up the value of those assets and liabilities creating the basis for future income. In this regard, protecting rights to tax future income streams from intangible assets are of particular interest because intangible asset are often not disposed of but kept until they have lost their value.

The argument is in some way similar to the Swedish Administrative Supreme Court case cited above[159]. If there was no recapture of the equalisation reserve, the income would never be taxed in Sweden which would be against the objective of the provisions allowing for the deductions.

Therefore, justifying exit rules on the basis of cohesion of the tax system does not seem unreasonable if a particular type of deduction has been given with a certain purpose in mind. On the contrary, if the deduction is given as a general deduction for business expenses, it will likely be more difficult to convince the ECJ.

4.5 Conclusion on Justifications

The *N* case concerned exit taxes imposed on individuals and will necessarily have a great deal of impact on cases concerning corporate exit taxes as well. The need to preserve the balanced allocation of taxing rights seem to be the most practicable justification, either as a standalone justification or combined with the risk of tax avoidance.

The Court in article 13 of the OECD model convention has found inspiration to this justification. If, however, exit taxes are regarded as compensation for previous deductions combined with the loss of tax jurisdiction over future income streams a similar principle may hardly be found in international tax practice.

Instead, the cohesion justification could be invoked especially if deductions have been given with a specific purpose in mind as for an example the equalisation of timing differences in the taxation of specific assets.

In my opinion, the need to ensure effectiveness of fiscal supervision cannot be expected to play a significant role as a justification.

5 Proportionality

Rules justifying an infringement may not go beyond what is necessary in order to attain the purpose, cf. the *Gebhard* case cited above. Thus, member states always have to apply less restrictive measures if possible.

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159 Mattias Dahlberg, *Sweden's Administrative Supreme Court Finds Fault With Exit Tax Regime,* Tax Analysts (2009), Doc-200814940.

Despite the French rules in the *Lasteyrie* case being unjustified, the Court emphasised that the objective of preventing taxpayers from transferring their residence shortly before disposal in order to escape France tax could instead be achieved by levying a tax upon re-entrance to France[160].

In the *N* case, a suspension was granted automatically without being subject to strict conditions (after the security had been released) and the exit tax was consequently justified by the balanced allocation of taxing rights. In accordance, a tax declaration necessary for assessing the tax on income could not be regarded as a disproportionate formality even though the declaration was required at the time of transfer. Waiting until disposal would involve an obligation no less significant for the taxpayer[161].

From the *N* case it is uncertain whether the Court accepts that the origin state establishes its claim for a specific amount of tax, or only the amount of income on which it wishes to preserve its tax jurisdiction can be established. Applying the latter would enable subsequent decreases in tax rates and other timing differences to be taken into account and would therefore be less restrictive[162].

Even though the Dutch Government succeeded in convincing the ECJ that the Dutch rules could be justified, the ECJ held that the rules were not proportionate as reductions in value after the transfer of residence were not taken into account even if such losses were not accounted for according to the laws of the host state.

Consequently, a suspension of payment must be accompanied by a mechanism enabling subsequent changes in value of assets and liabilities to be taken into account.

If member states instead rely on cohesion of the tax system as a justification, the important issue will be to render probable proof that domestic exit taxes work in a “perfectly symmetrical manner” as stated in *Krankenheim*. If an exit taxes seeks to compensate for previous deductions, taxation of future income streams may not succeed previously deductions taken.

5.1 Proportionality in Cases of Conversion

The Dutch rules in the *N* case were only proportionate if combined with a suspension of payment and a mechanism enabling subsequent decreases to be taking into account.

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160 *Lasteyrie*, paragraph 54.

161 *N* case, paragraph 49 and 50.

162 Also see Bert Zuijdendorp, supra at 5.

If the suspension of payment is seen in respect to the proportionality aspect and the obiter dictum statement in Cartesio, a direct application of the N case to companies may not be entirely feasible.

In *Exit Taxes Post-Cartesio*[163], Dr. Tom O'Shea stresses the important difference between individuals and companies in respect of transfers of residence. When a company transfers its residence by converting, a new entity is established in the host state. Meanwhile, the old entity may be removed from the company register in the origin state.

The combined effects of these events are that the tax authorities of the origin state are prevented from relying on the Mutual Assistance to the Recovery of Taxes Directive (MARD) to require the host state to assist.

Consequently, it would be reasonable to suggest that an immediate taxation could be proportionate to secure the balanced allocation of taxing rights.

6 Conclusion

The *Daily Mail* case must be considered the single most important case in regards to corporate exit taxes. The Court's reasoning was, however, short and opened up for more questions than answers.

Subsequent case law has addressed some of these issues. While emphasising the vital distinction between an inbound and outbound transfer, the Court has in general shown an unwillingness to apply the freedom of establishment to outbound primary establishments. Only in case of a conversion into a company governed by the law of the host state will the Court allow for protection under the Treaty.

Nevertheless, the examination of case law has shown some discrepancies in the Court reasoning opening up for an interpretation that theories of conflict of law could have a decisive saying in future cases, unlike in the Daily Mail case. In my opinion, however, it is highly uncertain that the Court will depart from its Daily Mail ruling and argue for the use of the incorporation theory as a reason for retaining the connecting factor.

As is apparent from the examination in this article, the levy of an immediate corporate exit tax may therefore infringe the freedom of establishment in two scenarios only: 1) when a company transfers its residence by converting into a new company in the host state and 2) when assets and liabilities are transferred between head office and a permanent establishment.

163 Dr. Tom O'Shea, *Exit Taxes Post-Cartesio,* The Tax Journal, (31 August 2009).

The combined effect of a principle of territoriality and the need to ensure a balanced allocation of taxing rights between states is expected to be the most effective justification in regards to corporate exit taxes.

The allocation of taxing right may nevertheless be an insufficient tool especially as regards intangible assets because, unlike the Court’s findings on capital gains (i.e. the reference to article 13 in the OECD model convention) a similar principle of territoriality can hardly be found in connection to future income streams.

Cohesion of the tax system may therefore come in useful as another type of justification but only if a direct link between a tax advantages and the offsetting of that advantage by a particular tax levy can be established. A recapture of deductions taken for general business expenses may hardly satisfy as a direct link.

On the other hand, deductions given with a specific purpose in mind could justify a recapture, but establishing a symmetrical tax treatment between the advantages and the offsetting of that advantage will be crucial.

The only thing left to address is the question of proportionality. Except from cases of conversion, member states must refrain from imposing an immediate tax. A suspension must be provided for and subsequent decreases should be taken into account. In order for such a system to work, the Court will be expected to accept a certain level of administrative requirements.