THE DUTCH CORPORATE EXIT TAX PROVISIONS IN THE LIGHT OF THE FREEDOM OF ESTABLISHMENT

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1 Introduction

The main objective of the European Union is the establishment of a European internal market without internal frontiers in which the free movement of goods, persons, services and capital is ensured.[2] The creation of the European Community and the establishment of the European internal market have generated significant interaction with direct tax systems of Member States. In general, direct tax matters still fall within the competence of the Member States. Tax measures at Community level can only be established by unanimity. However, that direct tax competence must be exercised consistently with Community law. This interaction can create tensions between on the one hand the interests of Member States and on the other hand the objectives of the European Union.

One of the tensions is seen in the field of exit tax legislation of Member States. In the last decades the mobility of individuals and corporate entities has increased significantly. Corporate entities are established in several jurisdictions and move to other countries in order to optimise their profits and capital efficiency. Countries impose exit taxes in order to protect the taxing rights on profits which accrued on their territory.

However, these exit taxes affect the effectiveness and competitiveness of the European internal market. In general, the exit tax legislation of Member States levies a tax when a company transfers its seat or assets to another Member State. The tax serves to recapture tax deferrals such as capital gains, goodwill and hidden reserves which would otherwise escape taxation. The tax is not levied if the company

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2 See article 14 (2) EC Treaty

maintains its seat in the same Member State. Consequently, an exit tax dissuades companies to move its seat or assets to other Member States.

The European Court of Justice (ECJ) and the Commission have both put increasing pressure on the exit tax legislation of Member States. In *De lasteyrie*[3] and *N*[4] the ECJ scrutinised the exit tax legislation of Member States on individuals. In 2006 the Commission published a Communication to coordinate the exit tax policies of Member States.[5] Recently, the Commission formally requested several Member States to amend their exit tax legislation in order to make it compatible with EU law.[6] The foregoing clearly shows the importance and present interest of the subject. The Commission also formally requested the Netherlands to amend articles 3.60 and 3.61 of the Income Tax Act 2001 (ITA) and articles 15c and 15d of the Corporate Income Tax Act 1969 (CITA).[7] The purpose of this essay is to examine the question whether the Dutch corporate exit tax provisions are compatible with the freedom of establishment as enshrined in the Treaty on the Functioning of the European Union (TFEU).

The scope of my dissertation is limited to exit taxes levied when corporate entities migrate to another Member States within the European Union. The exit tax provisions in respect of individuals and issues arising in respect of third countries will not be addressed.

At the time of writing, the importance of the question this essay seeks to answer became even more apparent in a preliminary ruling procedure. On the 15th of July 2010, the Court of Appeal of Amsterdam requested a preliminary ruling from the ECJ concerning the exit tax levied upon the transfer of the seat of a company to another Member State. This essay will complement existing literature by analysing the implications and possible outcome of the preliminary question. Given the diverging opinions in the academic literature, the outcome of the preliminary ruling will most likely clarify the discussion on exit taxes. The analysis in this essay of the possible outcome of the preliminary is therefore an interesting addition to the existing literature.

3 Case C-9/02 *Lasteyrie du Saillant v Ministere de l'Economie, des Finances et de l'Industrie* (ECJ 11 March 2004) (De lasteyrie).

4 Case C-470/04 *N v Inspecteur van de Belastingdienst Oost* (ECJ 7 September 2006) (N)

5 Commission (EC), 'Exit taxation and the need for co-ordination of Member States' tax policies' (Communication) COM (2006) 825 final, 19 December

6 See Press Report of the Commission, 18 September 2008, IP/08/1362 and 27 November 2008, IP/08/1813

7 Press Report of the Commission IP/08/1362 and 27 November 2008, IP/08/1813

This essay is divided in 6 chapters. The first and last chapter are the introduction and conclusion. The second chapter will set out the Dutch exit tax legislation. The parliamentary history, objectives and relevant principles of the CITA in general and article 15c and 15d CITA will be described. The third chapter examines the case law of the ECJ on migration of companies. The main question that will be answered is whether migrating companies have access to the freedom of establishment. When it has been established that the freedom of establishment can be invoked, the fourth chapter investigates whether the Dutch exit tax legislation actually constitutes an infringement of the freedom of establishment. The fifth chapter analyses the potential justification and the question whether the exit tax provisions are proportional.

2 Overview Dutch Domestic Exit Tax Legislation

2.1 General remarks

The Dutch exit tax legislation will be analysed in the following paragraphs. The exit tax provisions which are under scrutiny of the Commission can be divided into exit charges when a company transfers its residence/seat and exit charges when an entrepreneur moves with its company to another country. The first situation is covered by articles 15c and 15d CITA while the latter is dealt with by articles 3.60 and 3.61 ITA.

The scope of my dissertation is limited to the compatibility of the Dutch exit tax legislation in relation to corporate entities in the European Union. The focus of the following paragraphs will be on article 15 c and 15 d of the CITA. Article 15 c states the following;

> In the event that a taxpayer is no longer considered to be established in the Netherlands for the purposes of this Act or pursuant to a treaty for the prevention of double taxation or the Tax Regulation for the Kingdom of the Netherlands, its assets the benefits ensuing from which are no longer included in the taxable profit will be deemed to have been disposed of at their fair market value at the time immediately preceding the termination of the said residence.[8]

Article 15 d CITA acts as a residuary provision. All benefits that have not been taxed fall under the scope of article 15 d. Article 15 d states the following;

> Benefits that have not yet been taken into account on another basis will be allocated to the profits of the year in which the taxpayer ceases to enjoy profits taxable in the Netherlands. In that event, for purposes of the

8 Article 15 c CITA

disinvestment addition, its assets will be deemed to have been disposed of at their market value.[9]

In the following paragraph the objective and reasoning of the Dutch government behind the exit tax legislation will be set out. In the second part the subject, i.e. the entities which are covered by the legislation, and the object, i.e. the tax base, will be analysed. The last part will discuss the situations which trigger the exit tax legislation.

2.2 Objective and principles of the Dutch exit tax provisions

Articles 15c-15d of the CITA originates from article 16 ITA 1964. Article 16 imposes a tax on hidden reserves, tax reserves and capital gains of an entity when it transfers its seat abroad. The taxable event is the moment when an entity 'ceases to enjoy profits taxable in the Netherlands'. The reasoning behind the amendment of article 16 is that the provision did not cover all situations in which entities migrate to another country. When an entity, incorporated in the Netherlands, transfers its seat abroad, while part of the business was continued in the Netherlands after the transfer, the entity did not 'cease to enjoy profits in the Netherlands'. Consequently, a literal interpretation of article 16 would result in no exit tax charge. Entities which transfer the remaining assets after the migration would only be taxed on the remaining assets.[10] In order to overcome the shortcomings, the legislator amended article 16 and replaced it by article 15 c and 15 d. Article 15 c makes it possible to charge a partial exit tax and article 15 d is of similar wording as the old article 16.

The main objective of the articles is to include profit components such as fiscal reserves, goodwill and hidden reserves which are not taxed in the Netherlands during the period the company is resident in the Netherlands. The Dutch tax system provides for depreciation for tax purposes which differs from the actual economic loss or gain of the economic value of the assets. In order to tax all income that has its origin in the Netherlands, article 15c and 15d of the CITA levy an exit tax when a company moves to another state.[11] In other words, the objective of the laws is to avoid that accumulated untaxed profits will escape taxation in the Netherlands by immigrating to another country.

Another objective of the exit tax legislation is to counter tax avoidance. Without exit tax provisions companies can migrate without paying tax on profits accrued on the territory. Further justifications that are seen in the Dutch parliamentary documents

9 Article 15 d CITA

10 *Kamerstukken II* 1998/99, 26 727, nr. 3 P. 116

11 *Kammerstukken II* 1958/59, 5080, nr. 3, p. 38

are that the exit tax legislation counters potential loss of revenue and the legislation contributes to a balanced tax burden.[12]

2.3 Subject of the Corporate Income Tax Act

Corporate income tax is levied on entities listed in the CITA. Article 2 of the CITA includes public companies (NV), private companies (BV), open and limited partnerships, mutual funds and other societies and entities under public law not mentioned above, in the event that they run an enterprise. The exit tax provisions 15 c and 15 d apply to these entities.

A distinction can be made between entities which are resident in the Netherlands and non-resident entities of similar description which are subject to tax only insofar as they derive certain types of the Netherlands-source income. Article 3 CITA determines that entities that are not established in the Netherlands and receive Dutch income are considered non-resident taxpayers. These include companies and other legal entities, open limited partnerships and other companies not having legal personality whose capital is wholly or partially divided into shares.

The distinction between resident and non-resident taxpayers is of crucial importance for the exit tax provisions. Article 15 c states that 'when a taxpayer is no longer considered to be established in the Netherlands for the purposes of this Act'. A non-resident taxpayer has never been established in the Netherlands. Therefore article 15 c does not apply to non-resident taxpayers.

The question whether an entity is resident in the Netherlands, or has left the Dutch tax base is determined on the basis of national legislation and international tax treaties.

To determine residency for Dutch corporate income tax purposes the place of incorporation and the actual management are relevant. An entity incorporated in accordance with Dutch corporate law requirements will be considered to be established in the Netherlands for the purpose of the Corporate Income Tax Act.[13] Moreover, an incorporated entity is deemed to be resident in the Netherlands. When the central management and control moves to another country, the entity is still considered Dutch resident for corporate income tax act purposes. By reason of the 'deemed resident' fiction article 15 c does not apply.

Companies which are not incorporated in the Netherlands can still be resident in the Netherlands for CITA purposes if the place of the actual management is located in the Netherlands. The place of the actual management is defined in the case law of

12 *Kamerstukken II* 1998-1999, 26727, nr. 3, p. 116-117

13 Article 2 sub 4 CITA

the Dutch Supreme Court.[14] The place of actual management has to be determined on a case by case basis. In general, it can be assumed that the actual management lies with the board of directors and an entity's place of business is where the board of directors exercises management and control. When there is reason to believe on the facts of the case that the actual control is exercised by another person, the entity's place of business lies there.[15] When a company has its actual management in the Netherlands, article 15 c and 15 d applies.

However, residency for CITA purposes has to be distinguished from residency for tax treaty purposes. Although incorporated entities are deemed to be resident in the Netherlands, a transfer of central management and control often result in a change in residency for tax treaty purposes. The entity is still considered resident in the Netherlands according to article 2 (4) CITA. When the domestic legislation of the country of immigration applies the actual management as the connecting factor, the entity is dual resident. When there is a double tax convention between the countries, the tie-breaker rule will determine which country has the taxing rights. Most double tax conventions are based on article 4 OECD model, which determines that the entity is resident in the country where the place of effective management is located. In the foregoing situation the Netherlands will lose its taxing rights. Articles 15c and 15 d CITA levy an exit tax in order to avoid profits leaving the Dutch tax base without being taxed.

2.4 Object of the Corporate Income Tax Act

The object of the exit tax provisions can be described as the profit elements which are relevant for the exit charges. The tax object of the CITA is linked by article 8 sub 1 to the provisions in the ITA. The Dutch CITA can be divided in two tax systems which are important to explain how the object of the exit tax legislation is formed; the total profits calculation and the annual profits.

The total profit from business activities is the amount of the total benefits which, under whatever name, are earned from a business. The total business profits are calculated by deducting the initial value from the total value of the company. The total business profits are the total profits earned by the entity. The total profits are taxed when a company ceases to exist. [16]

In order to tax companies during their business, profits are calculated annually. Article 3.25 ITA states that 'the profits generated in one calendar year are calculated in accordance with good commercial practice, taking into account a stable line of

14 Hoge Raad 23 September 1992, nr 27293, *BNB 1993/193*

15 Hoge Raad 23 September 1992, nr 27293, *BNB 1993/193*

16 Article 3.8 ITA

action that is independent of the suspected outcome. The stable line of action can only be changed if justified by good commercial practice'.[17]

Hidden reserves

The calculation of the annual profits is based on 'good commercial practice' which can be divided into two principles which are relevant for the object of the exit tax legislation; the realisation and prudence principle. The realisation principle means that profit and losses can be taken into account when they are actually realised. The prudence principle specifies that losses can be deducted before they are incurred and profits have to be taken into account when they are actually realised. [18]

The prudence principle makes it possible that there are hidden reserves at the moment of migration of a company. The direct deduction of losses and the deferment of taking profits into account till they actually realise, can result in a difference between the actual value of assets and the book value. Hidden reserves are for example the depreciation of movable and immovable property, the increase in value of the inventory and assets which are not taken into account in previous accounting periods.

Goodwill

Another important hidden reserve which is taxed when an entity migrates is goodwill. Goodwill is the surplus between the value of the assets and the total value of the company.[19] Goodwill is often a large part of the value of a company. The exit tax legislation levies a tax on the increase of the value of the goodwill which accrued in the period the company was resident in the Netherlands.

Tax reserves

The CITA contains several provisions to defer taxation. Examples of tax reserves are the equalisation reserve and the reinvestment reserve.[20] The equalisation reserve makes it possible to evenly spread costs and expenses. Expected costs can be set off against profits. The reinvestment reserve defers taxation when the proceeds from selling a business asset exceed the book value of the business asset. The difference can be reserved and later

17 Article 3.25 ITA

18 E.J.W. Heithuis and R.P. van den Dool, *Compendium van de vennootschapsbelasting*, (Kluwer: Deventer 2009) p. 59

19 Ibid p. 67-68

20 Article 3.53 ITA

reduce the applicable acquisition costs for business assets that are acquired in the year of selling or in the subsequent three years.[21] Article 15 c and 15 d prevents that the tax reserves are not taxed when a company migrates.

2.5 Exit tax provisions companies in the corporate income tax act

2.5.1 Article 15 c Corporate Income Tax Act

Article 15 c sub 1 determines that an exit tax is levied when an entity is no longer established in the Netherlands for the purpose of the Corporate Income tax act, a tax treaty or the Tax Regulation for the Kingdom of the Netherlands. The exit tax is levied on assets which are transferred when the entity emigrates. Furthermore, assets which were transferred before the emigration of the entity are taken into account and taxed. In other words, a partial settlement on the assets which were transferred before emigration is possible under article 15 c. The taxable event of article 15 c consists of two cumulative criteria;

1. There are assets transferred abroad

2. The actual management is transferred to the country concerned

The exit tax is effectuated by the assumption of a fictitious disposal of the assets in respect to assets which were transferred before or during the transfer of the actual management to another country. The difference between the actual value and the book value of the assets, i.e. the hidden reserve, tax reserves and goodwill, are taxed. The exit tax is levied immediately preceding the termination of the said residence. There is no possibility for deferred payment of the tax claim.[22] In the following the different scenarios which can result in an exit tax charge will be set out.

Entity incorporated in the Netherlands

When an entity, incorporated in the Netherlands, transfers the actual management to a state which has a double tax convention with the Netherlands, the application of the treaty will often result in a change of residence to the country where the management is located. Although article 2 sub 4 CITA determines that the entity is ‘deemed to be resident’ for CITA purposes, the connecting factor for tax treaty purposes is often the country where the actual management is located. The Netherlands loses the taxing rights over the profits of the entity. Article 15 c applies in this situation and

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21 Article 3.54 ITA

22 S.A.W.J. Strik and N.H. de Vries, *Cursus Belastingrecht (Vennootschapsbelasting)*, (Kluwer: Deventer, 2010) Paragraph 2.10.3.B

an exit tax will be levied on the hidden reserves and goodwill when assets are moved abroad.

When assets are transferred abroad and the actual management is still in the Netherlands, there are no exit tax implications in relation to the unrealised profits. Moreover, when assets are transferred to a permanent establishment (PE) in another country, the transfer is initially not taxed. However, hidden reserves and goodwill will indirectly be taxed by reducing the deductibility of profits of the PE, which is allowed in order to avoid double taxation.[23]

When, at a later date, the actual management moves to another country, article 15 c determines that the remaining difference in actual value and book value of the exempted profits of the PE are taxed at the moment the management is transferred to the other country.[24]

Article 15 c does not apply to the circumstances in which the Netherlands has no double tax convention with the country of immigration. The entity, incorporated in the Netherlands is 'deemed to be resident' in the Netherlands. The Netherlands can still tax the world wide profits. Therefore article 15 c does not charge an exit tax.[25]

Foreign incorporated entity

An entity, incorporated in a foreign jurisdiction, with the actual management in the Netherlands is considered resident under the CITA. When the actual management is transferred to another jurisdiction and the entity becomes non-resident, article 15 c applies regardless whether the Netherlands has a tax treaty with the country of immigration since the entity cannot be 'deemed resident' due to the fact that it is not incorporated in the Netherlands.

2.5.2 Article 15 d Corporate Income Tax Act

Article15 d of the CITA is drafted as a residuary provision. All benefits that have not yet been taken into account, e.g. under article 15 c, fall under the scope of article 15 d. The taxable event of article 15 d is the moment that an entity ceases to earn taxable profits in the Netherlands.

Although most of the situations in which the actual management moves to another country are covered by article 15 c, there are circumstances in which

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23 Ibid Paragraph 2.10.3.B

24 Ibid Paragraph 2.10.3 B

25 Ibid Paragraph 2.10.3 B

article 15 d is still relevant. When an entity transfers its seat and some of the assets remain in a PE in the Netherlands, the assets are still taxable in the Netherlands. Article 15 c does not apply. When the assets are transferred on a later date in a way that the PE ceases to earn taxable profits in the Netherlands, article 15 d makes it possible to tax the assets and reserves.[26]

Moreover, article 15 d is relevant in situations not directly related to the emigration of entities. For example entities which are exempt from taxation or in the situation of a cross-border merger, the assets can be taxed on the ground of article 15 d CITA. Although article 15 d CITA might cause discrimination in breach of EU law, a comprehensive analysis of the potential issues and compatibility with EU law is outside the scope of my dissertation.

3 Case Law European Court Of Justice On Migration Of Companies: Does The Freedom Of Establishment Apply?

3.1 General remarks

The case law of the ECJ has not explicitly dealt with the compatibility of corporate exit taxes of Member States with the freedom of establishment. However, the case-law on the migration of companies may have tax implication. A Member State can prevent a company from conducting a substantial amount of their activities abroad or transferring their centre of administration to another Member State by requiring the company to dissolve and liquidate in the state from which the company moves. The mandatory dissolution and liquidation inherently induce taxation on the migrating company. The rules of Member States which restrict the ability of companies to establish itself in another Member State might be incompatible with the freedom of establishment. Moreover, mandatory dissolution and consequently the exit tax implications could also restrict the freedom of establishment.[27]

The importance of the case law on migration of companies is further seen in the literature and parliamentary debate. Although the *Cartesio*-case was not yet decided, the Minister of Finance announced in several official statements, with reference to the *Daily Mail*-case, that the Dutch exit tax provisions are not incompatible with EU law.[28] Furthermore, several authors advocate the opinion that *Daily Mail* precludes

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26 N. Bouwman, *Wegwijs in de vennootschapsbelasting*, (Sdu Uitgevers: Amersfoort 2009) p. 757

27 C. HJI Panayi, 'European community tax law and companies: principles of the European court of justice' in *Gore-Browne on EU company law* (Jordan Publishing 2009) paragraph 19-90

28 See for example Brief van de Staatssecretaris van Financiën, 9 februari 2005, nr. WDB 2005/77U, *V-N* 2005/11.7

an assessment of the compatibility of the Dutch exit tax provisions with EU law.[29]

In the following paragraphs the case law of the ECJ concerning the migration of companies will be analysed. The main question that will be answered is whether article 15 c and d fall under the scope of the freedom of establishment. The limitations to a company's ability to migrate evolve from international private law of companies. The first paragraphs will set out the principles of private international law which are of importance. The latter paragraphs discuss the case law of the ECJ and its exit tax implications.

3.2 Conflict of law theory and companies

National corporate laws of countries determine the legal status, relationship between companies, rules on corporate governance, dissolution and liquidation of companies. The question which domestic corporate laws apply to an entity is governed by private international company law and the conflict of law theories.

In practice there are two main theories: the incorporation theory and the real seat theory. The application of the different theories can affect corporate mobility when there is a transfer of registered office or a transfer of administrative seat.

3.2.1 Incorporation theory

The incorporation theory connects a company to the jurisdiction in which it has been incorporated. The place of incorporation is in principle the 'place of registration' of the company, since legal personality is attributed upon registration. The 'place of registration' is normally determined by the 'registered office' or 'legal seat', as defined in the memorandum, article of association or statutes of the company.[30] Countries such as the UK, United States, Ireland, Denmark, Switzerland and the Netherlands subscribe the incorporation theory.

The existence and internal affairs of the company are regulated by the law of the state of incorporation. In other words, the rules in relation to dissolution, liquidation and consequently exit tax implication are determined by the state of incorporation, irrespective of any activities pursued in other states. Once

29 See for example D.S. Smit, 'Verslag van het EFS-seminar "Exitheffingen in Europa"' (2006) 6679 WFR, 'Verslag van het EFS seminar exitheffing in europa, WFR 2006/835 or M. J.C. Merkus 'Emigratieheffingen in de vennootschapsbelasting. Art. 15c en 15d Wet VPB 1969 getoetst aan het EG-verdrag' (2006) 1293 WFR

30 G.Maisto (ed.), *Residence of Companies under Tax Treaties and EC Law*, (International tax law series vol. 5, Amsterdam: IBFD 2009) p 11-12 (Maisto)

company has satisfied the formation requirements in its state of incorporation, it is recognised everywhere.[31]

The main implication of the incorporation theory in relation to migrating companies is that as long as the registered office remains in the state of incorporation, a company can transfer its actual centre of administration to another state without losing its legal personality. The company remains subject to the laws of the state of incorporation. No mandatory dissolution and liquidation is required to transfer the actual centre of administration to another Member State.[32]

3.2.2 Real seat theory

The real seat theory connects a company to the jurisdiction where the real seat is located. The real seat relies either on the internal governance and decision-making structure or on the business activities of the company to determine where the 'real seat' is located.[33] Although there is no universally accepted definition of the real seat, the place where the central management decisions are being implemented on a day to day basis is the most commonly used factor.[34] The real seat theory is seen in France, Portugal, Belgium, France and Germany.

The main exit tax consequences of the real seat doctrine is that a company formed in a real seat state cannot transfer its actual centre of administration to another state without mandatory dissolution and a change in the applicable laws. Moreover, when a company, formed in another state, immigrates to a real seat state by transferring its actual centre of administration, the real seat state will only allow the immigration if the company dissolves in the home state and reincorporates in the host state.[35] The mandatory dissolution can trigger exit taxes in the country of emigration. The requirement of dissolution seriously inhibits corporate mobility which is undesirable in a European market.[36]

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31 C.HJI Panayi, *'Corporate Mobility under Private International Law and European Community Law: Debunking Some Myths'* [2009] 28 YEL p 6 (Panayi)

32 Ibid, p. 6

33 Maisto, supra at 12

34 N. Kubak Erk, 'The Cross-Border Transfer of Seat in European Company Law: A Deliberation about the Status Quo and the Fate of the Real Seat Doctrine' (2010) 21 (3) E.B.L.R., p. 416

35 This is often mitigated by the doctrine of renvoi. The doctrine of Renvoi allows a company to have its registered office in another state as long as that home state adopts the incorporation theory.

36 Panayi supra at 11

3.3 Case law of the European Court of Justice

3.3.1. Daily Mail

The *Daily Mail*-case concerned a UK incorporated company, Daily Mail, which wanted to transfer its central management and control to the Netherlands without losing legal personality. The UK company legislation allowed such a transfer. However, section 481 (1) (a) of the Income and Corporation Taxes Act 1970 required Treasury consent when a company ceased to be a resident for tax purposes.[37]

The HMRC would only give its consent if Daily Mail would at least sell parts of the assets before transferring its central management and control. The case was referred to the ECJ for preliminary ruling. The main question in the dispute was whether Daily Mail could rely on the freedom of establishment and if so, whether the UK could make the right subject to Treasure consent.[38]

First, the ECJ stressed that the freedom of establishment does not only ensure equal treatment of foreign nationals and companies in the host Member State, it also prohibits origin Member States from hindering the establishment in another Member State.[39]

Next, the court emphasised that the freedom of establishment generally covers the setting up of agencies, branches or subsidiaries and that none of those transactions are hindered by the UK legislation. Moreover, the UK legislation did not hinder a partial or total transfer to a newly formed company in another Member State.[40] In other words, the UK legislation did not hinder primary or secondary establishment.

The ECJ continues its deliberations by recalling that 'unlike natural persons, companies are creatures of the law and in the present state of Community law, creatures of national law. They exist only by virtue of the varying national legislation which determines their incorporation and functioning.'[41] The national legislation varies widely in both the connecting factors which provide a connection to the national territory required for the incorporation

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37 Case 81/87 *The Queen v H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc* (ECJ 27 September 1998), paragraph 1-5 (Daily Mail)

38 Ibid paragraph 9

39 Ibid, paragraph 16

40 Ibid paragraph 17-18

41 Ibid paragraph 19

of a company and how a company incorporated under the legislation of a Member State may subsequently modify that connecting factor.[42] With reference to article 58 (49 TFEU) the ECJ concludes that the Treaty has taken account of the varying connecting factors in national legislation.[43] In other words, Member States can determine the connecting factor and how a company can maintain its connection and legal personality. In the case at hand Daily Mail could maintain connected if it required Treasury consent.
The ECJ continues that there is no convention or secondary community law in place to deal with the differences. The differences in national legislation are problems which are not resolved by the rules of the freedom of establishment. It must be dealt with by future legislation.[44]

The ECJ concludes that 'under those circumstances, article 52 (49 TFEU) and 58 (54 TFEU) 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.'

3.3.2 Überseering

Whereas *Daily Mail* involved the rules of the Member State of origin, the *Überseering*-case is of importance because it involved a host Member State scenario. Moreover, the ECJ confirmed the reasoning of the *Daily Mail*-case.

Überseering, a company incorporated in the Netherlands, acquired a piece of land in Germany. The garage and motel on the site were refurbished by a German company. When the contractual obligations were performed, Überseering claimed that the paintwork was defective. Meanwhile the shares in Überseering were acquired by two German nationals. Überseering brought an action before the German Court in order to claim damages.[45]

The German High Court dismissed the action. It found that Überseering had transferred its actual centre of administration to Germany once the shares were acquired by the two Germans. The German High Court held that Überseering did not have legal capacity in Germany since the company was

42 Ibid paragraph 20

43 Ibid paragraph 21

44 Ibid paragraph 23

45 Case C-208/00 *Überseering BV v Nordic Constructions Company Baumanagement GmbH (NCC)* (ECJ 5 November 2002) paragraph 6-9

incorporated in the Netherlands. Consequently, Überseering was not able to bring legal proceedings in Germany.[46] The German High Court referred the question whether the refusal to recognise the legal capacity was a restriction on the freedom of establishment for preliminary ruling to the ECJ.

The ECJ started its reasoning by determining whether the Treaty provisions on freedom of establishment apply to the situation. First, the ECJ reiterated its reasoning of the *Daily Mail*-case, thereby approving that *Daily Mail* still constitutes good law. However, the court explicitly distinguished *Überseering* from *Daily Mail* on the ground that *Daily Mail* 'did not concern the way in which one Member State treats a company which is validly incorporated in another Member State and which is exercising its freedom of establishment in the first state.'

With reference to the *Centros*-case, the Court held that article 58 (54 TFEU) grant the right of establishment to companies formed in accordance with the law of a Member State and having their registered office, central administration, or principle place of business within the community.[47] Consequently, Überseering could rely on the freedom of establishment.

The Court concluded that 'the very existence is inseparable from its status as a company incorporated in the Netherlands and the requirement of reincorporation of the same company in Germany is therefore tantamount outright negation of the freedom of establishment.'

3.3.3 Cartesio

The latest case on migration of companies in an origin state environment is the *Cartesio*-case. Cartesio, a limited partnership formed under Hungarian law, requested for registration of the transfer of its seat to Italy, while remaining subject to Hungarian law. The application was rejected on the ground that Hungarian law in force did not allow a company incorporated in Hungary to transfer its seat abroad while maintaining to be subject to Hungarian law. Under Hungarian law, a company who wants to transfer its real seat or operating headquarters to Italy would have to wind up in Hungary and re-incorporate itself in the country it wishes to establish.[48]

Among other questions, the main question referred to the ECJ for preliminary ruling is whether the Hungarian rules which prevented a transfer

46 Ibid paragraph 9

47 Ibid paragraph 56-59

48 Case C-210/06 *CARTESIO oktató és Szolgáltató bt* (ECJ 16 December 2008) paragraphs 100-104 (Cartesio)

of seat to another Member State are incompatible with the freedom of establishment.

Advocate General Maduro argued that the above situation is covered by the freedom of establishment. In a very critical opinion AG Maduro first noted that the case law has departed from the *Daily Mail*-case. With reference to *Centros*, *Überseering* and specifically *Inspire Art*, Maduro argued that 'the ECJ has consistently rejected the argument that the rules of national company law should fall outside the scope of the Treaty provisions on the right of establishment.'[49]

According to AG Maduro 'It is impossible for Member States to enjoy an absolute freedom to determine the life and death of companies constituted under their domestic law, irrespective of the consequences for the freedom of establishment. Otherwise, Member States would have *carte blanche* to impose a death sentence on a company just because it had decided to exercise the freedom of establishment.'

As some authors expected,[50] the ECJ did not follow the opinion of AG Maduro. As set out by O'Shea, AG Maduro appears to miss the point that the freedom of establishment covers the right to set up subsidiary, branches or agencies. The Hungarian rules do not restrict Cartesio to establish a branch, subsidiary or agency in Italy or to establish a new company. Instead, Cartesio was seeking to move its central management and control while it wanted to maintain governed by Hungarian law. As already set out in *Daily Mail*, in the present state of community law the freedom of establishment does not confer a right to transfer the central management and control while maintaining its registered office in the country of origin.

The ECJ reiterated its *Daily Mail* reasoning. Companies are creatures of national law and exist only by virtue of the national legislation which determines its incorporation. The Member State of origin can define the connecting factor and how to maintain that status. That power includes the possibility not to permit a company to retain its states, if the company reorganises itself in another Member State by moving its central management and control, thereby breaking the connecting factor.[51] However, the court makes an important distinction.

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49 Opinion AG Poiares Maduro in Cartesio C-210/06, paragraph 26-27

50 See T. O'Shea, 'Hungarian Tax Rule Violates EC Treaty, Advocate General says' (2008) 51 (5) Tax Notes international and J.L. van de Streek, 'Omzetting van rechtspersonen in fiscaal perspectief' (2009) 102 TFO

51 *Cartesio* paragraph 110

> '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 as regards the law which governs that company falls to be distinguished from the situation where a company governed by the law of one Member State moves to another Member State with an attendant change as regards the national law applicable, since 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.'

In the latter case a company can actually rely on the freedom of establishment. A mandatory winding up or liquidation of the company is a barrier for the company to actually convert to a legal entity governed by the law of the other Member State and constitutes a restriction on the freedom of establishment.[52]

3.4 Conclusion case law migration of companies: access to the fundamental freedoms?

As can be concluded from the *Daily Mail*-case, a transfer of the actual management does not necessarily fall under the scope of the freedom of establishment. Moreover, the *Cartesio*-case specified that when an entity converts into a foreign entity, the transfer is covered by the freedom of establishment. In order to answer the question whether the Dutch exit tax provisions are incompatible with Community Law, the provisions have to fall under the scope of the freedom of establishment. In this paragraph the foregoing question will be analysed.

In the literature the consequences in relation to exit taxes are valued differently. The large amount of diverging opinions underlines the difficulty to predict whether exit taxes are compatible with EU law. There are two approaches which can be distinguished in the literature. In the following sub-paragraphs the two approaches will be analysed. The last sub-paragraphs discuss the recent preliminary question of the Dutch Court of Appeal and the implications for the Dutch exit tax legislation.

3.4.1 Case law migration of companies cannot by analogy be applied to exit taxes

In the literature[53] there are several academics who advocate that article 54

52 Ibid paragraph 112-113

53 See for example G.J Vossestein, 'Grensoverschreidende zetelverplaatsing en omzetting van rechtspresonen'(2009) 5 NTER, p. 186 (Vossestein) also J.N. Schutte-Veenstra, 'De implicaties van het Cartesio-arrest voor het vestigingsrecht van vennootschappen' (2009) 9 MMB p. 305 (Schutte-Veenstra) and R. Szudoczky, 'How Does the European Court of Justice Treat Precedents in Its Case Law? Cartesio and Damseaux from a Different Perspective: Part 1' (2009) 37 (6/7) Intertax, p 356 (Szudockzy)

TFEU concerns company law connecting factors. The connecting factors for tax purposes do not fall under the scope of article 54 TFEU. The exit tax provisions do not concern the question whether a company may remain a national of its origin state after a transfer of the actual management. Therefore, they should not remain outside the scope of the freedom of establishment and be subjected to the scrutiny of the ECJ as other origin state restrictions.[54]

The reasoning behind the argument is the following. The ECJ explicitly mentions in paragraph 20 of the *Daily Mail*-case that a transfer of the central administration can be made subject to certain restrictions and legal consequences, in particular in regard to taxation. In *Cartesio* the court reiterates *Daily mail* in paragraph 105. However, the ECJ only refers to 'the consequences that winding-up entails under *company law*.' The court does not refer to tax consequences in *Cartesio*. From the foregoing it is concluded that tax provisions do not fall under the scope of article 54 TFEU and *Daily Mail* is superseded by *Cartesio* and is no longer good law.[55]

The author partially supports the reasoning as set out above. The main question in the case law on migration of companies is whether the connecting factor of a company is broken for company law purposes. However, the reasoning that *Daily Mail* is no longer good law is in my opinion not correct. In *Daily Mail*, Treasury consent was required in order to maintain legal personality and status as a UK company after the transfer of the central management and control to the Netherlands. Without the Treasure consent Daily Mail would lose its legal personality in the UK. Consequently the connecting factor would not only be broken for tax purposes. The legal entity would lose its legal personality for tax law and company law purposes. The situation in which prior authorisation for a transfer of the registered seat, central management and control or the real head office has to be distinguished from the settlement of a company's tax position. Therefore, *Daily Mail* can still be considered good law.

3.4.2 Case law migration of companies applied by analogy to exit tax legislation

Other academics have argued that the ECJ does not want to distinguish between company law based on the incorporation theory and the real seat theory. Article 54 TFEU places the connecting factors on the same footing. It would be in breach with the Treaty if the connecting factors would be treated differently. Accordingly, where the dissolution and liquidation of an entity is inherent in a Member State which applies the real seat theory,

54 Szudoczky, supra at 356

55 Vossestein supra at 186

Member States which subscribe the incorporation theory should be able to impose less restrictive measures such as an exit tax levied upon a transfer of the central management and control.[56] The freedom of establishment cannot be invoked to assess whether the exit tax is compatible with EU law.

In my opinion the foregoing does not lead to the conclusion that exit taxes in general cannot be assessed on the compatibility with the freedom of establishment. The ECJ does not make a distinction between the incorporation theory and the real seat theory. However, in the authors view the theories should be interpreted as two recognised systems of company law which do not influence the reasoning on whether exit taxes are compatible with EU law.

The *Daily Mail*-case can be reconciled with the foregoing reasoning in the following way. In *Daily Mail* the Treasury consent was needed in order to transfer the central management and control. The Treasury consent would be given under the condition that certain assets would be taxed upon the transfer. It was a condition in order to maintain legal personality and to stay connected to the UK territory. Whereas exit taxes do not influence the question whether a company is connected to the territory, the Treasury consent does. Consequently, the denial of Daily Mail to conform to the condition of HMRC, broke the connecting factor. Accordingly, the freedom of establishment cannot be invoked.

However, exit taxes in general do not concern the question whether the company can maintain legal personality; it concerns taxation of hidden reserves and unrealised gains upon migration. Therefore exit taxes fall under the scope of the freedom of establishment.

3.4.3 Analysis of the case law

In the authors view a company can invoke the freedom of establishment when it is connected to a Member State in accordance with article 54 TFEU, regardless which connecting factor is used. The ECJ does not distinguish between the incorporation theory and the real seat theory.

When the connecting factor is broken by the transfer of the registered office, central management and control or the real head office to another Member State, the company cannot invoke the freedom of establishment. Consequently, when a Member State applies the real seat theory, a transfer

56 See for example H.P.A.M. van Arendonk, 'Cartesio: zijn we dichter bij een oplossing?' (2009) 9 MMB, p 4 (Arendonk) and also P.J. Wattel, 'Exit exitheffing' (2009) 11 NJB 549 (Wattel) and B.J.M. Terra & P.J Wattel, *European Tax Law*, (Kluwer: Deventer 2008) p. 788 (Terra & Wattel)

of the central management and control or head office will inherently mean that the connecting factor is broken. The entity cannot invoke the freedom of establishment, as is seen in *Cartesio*. When a Member State applies the incorporation theory, a transfer of the central management does not break the connecting factor. The entity can invoke the freedom of establishment.[57]

In order to ground my reasoning, the question must be asked whether the connecting factor was broken in the *Daily Mail*-case. The ECJ held that Daily Mail could not invoke the freedom of establishment. It could be argued that for company law purposes the connecting factor was not broken since the UK subscribes the incorporation theory and the central management and control was transferred.

As briefly described in the foregoing paragraph, it can be explained as follows. As set out in Daily Mail, national legislation of Member States can determine the connecting factor of a company and how the connecting factor is subsequently modified. In *Überseering* the court clarified that a Member State is able, in the case of a company incorporated under its laws, to make the company's right to retain its legal personality under the law of that Member State subject to restrictions on the transfer to a foreign country of the company's actual centre of administration. In *Daily Mail* the transfer was made subject to treasury consent. Without the consent it is still possible for Daily Mail to transfer the actual management, but it would lose its legal personality and status as a UK company. Consequently the connecting factor is not only broken for tax purposes, but the connection with the UK is broken in its totality, for tax and company law purposes. Therefore, the freedom of establishment could not be invoked. On first sight it seems that the connecting factor is not broken. However a deeper analysis gives compelling reasons to believe that the connecting factor was broken in *Daily Mail*.

In the *Cartesio*-case the ECJ reiterates *Daily Mail*, thereby confirming that the same reasoning is applied when the connecting factor is broken by a company established in a real seat country. By transferring the central management and control to Italy, the connecting factor was broken. Consequently Cartesio could not invoke the freedom of establishment.

When the foregoing reasoning is applied to the Dutch exit tax legislation, it can be concluded that article 15 c and d CITA fall under the scope of the freedom of establishment. The exit tax is not a condition imposed on the transfer of the central management and control in order to maintain legal personality and its status as a Dutch company. In other words, a company can transfer its central management and control without losing its legal

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57 See also Schutte-Veenstra, supra at 309

personality in the Netherlands. The incorporation theory, applied by the Netherlands, means that the connecting factor is not broken for company law purposes. Consequently the freedom of establishment can be invoked.

3.4.4 Preliminary question Dutch Court of Appeal

On 15 July 2010, the Court of Appeal Amsterdam requested a preliminary ruling from the ECJ in relation to an exit tax levied upon the transfer of the seat of a company to another Member State. The case concerned a Dutch limited liability company (BV) which transferred its actual management and all activities to the UK. The Dutch board of management was replaced by three UK managers, the office in Rotterdam was closed, the Dutch bank accounts terminated and new accounts were opened in England. After the transfer HMRC regarded the company as a UK resident for tax purposes.[58]

The Dutch company had provided a substantial loan in British pounds to a group company. Pursuant to the transfer of the actual place of business the loan contained a positive hidden reserve of 22 million Guilders, based on the currency difference between the initial historic book value and the actual value of the loan.

In accordance with article 16 ITA, which is now replaced by article 15 c and d CITA, the Dutch tax authorities levied an exit tax on the hidden reserves immediately prior to the migration of the company to the UK, without any possibility of deferred payment of the tax.

The Court of Appeal of Amsterdam referred three questions to the ECJ:

1. Can a company invoke the freedom of establishment against a Member State, if that Member State imposes an exit tax on a company established under the laws of that state which transfers its actual place of business to another Member State?

2. If the question is answered in the affirmative, is an exit tax which taxes all capital gains on the assets of a company which is transferred from the state of emigration to the state of immigration, as existing at the time of transfer of its actual place of business, without deferral and without the possibility to take future value decreases into account, incompatible with the freedom of establishment because such an exit tax cannot be justified by the need for a balanced allocation of taxing rights between Member States?

58 Gerechtshof Amsterdam 15 juli 2010, nr P08/00135 paragraph 4.7.9

3. Does the answer on the previous question also depend on the circumstance that the exit tax at issue is imposed on a currency gain, which arose under the Dutch jurisdiction and which will not be recognised under the tax regime existing in the country of immigration?

In my opinion the analysis set out in paragraph 3.4.3 can be applied to the above facts. The company transferred its actual place of business to the UK. The connecting factor for company law purposes is not broken since the Netherlands and the UK apply the incorporation theory.

As can be concluded from *Daily Mail*, the origin Member State can make the right to transfer central management and control subject to certain requirements in order to maintain legal personality and status as a company of the Member State of emigration. However, the Dutch exit tax provisions do not concern requirements in order to maintain legal personality. Consequently, the company can invoke the freedom of establishment. The question whether the exit tax provisions constitute an infringement and can be justified by overriding reasons in the public interest will be analysed in the next chapter.

3.4.5 Exit taxes which fall under the scope of the freedom of establishment

Although in my opinion the analysis in the previous paragraphs showed that the Dutch exit tax legislation fall under the scope of the freedom of establishment, there are several academics that draw other conclusions from the *Daily Mail*-case. Regardless of the interpretation of the *Daily Mail*-case, the Court made an important distinction in the *Cartesio*-case. Where a company governed by the law of one Member State transfers the seat to another Member State with an attendant change in company law applicable, the freedom of establishment can be invoked.[59] In this paragraph the consequences for the article 15 c and d CITA will be analysed.

Transfer of the actual management to a real seat country

A common used structure for Dutch limited companies, often motivated for tax purposes, is to transfer the actual management to Luxembourg. After the transfer the entity holds two sets of articles of association which are required in both countries. The Dutch limited company is still resident in the Netherlands since the Netherlands applies the incorporation theory. Under Luxembourg law such an inbound transfer is allowed. The company is both

59 *Cartesio* paragraph 111

governed by Luxembourg and Dutch law, a so called hybrid SARL/BV.[60] The hybrid Sarl/BV can benefit from paragraph 111-113 of the *Cartesio*-case and move to Luxembourg with the protection of the freedom of establishment.

For example when the actual management is transferred to Luxembourg the entity is under the legal fiction of article 2 (4) CITA still taxable on its worldwide profits for domestic tax purposes. However, for tax treaty purposes the residency changes to Luxembourg. The assets will form a PE in the Netherlands. Accordingly, as described in chapter 2, article 15 c CITA does not apply. There is still a PE in the Netherlands which can be taxed in accordance with the treaty. However, when the assets of the PE are transferred on a later date to Luxembourg, article 15 c-d CITA levy an exit tax.

When the *Cartesio*-case is applied to this situation, the entity can choose to be governed only by Luxembourg law. The Netherlands cannot set any additional requirements. When the assets are moved to Luxembourg, the Netherlands cannot levy the exit tax of article 15 c-d CITA while the company ceases to earn taxable profits in the Netherlands. The exit tax of article 15 c-d CITA is incompatible with the freedom of establishment unless it can be justified by overriding requirements in the public interest.

Transfer of a Dutch entity to an incorporation country

Similar reasoning is possible when a Dutch entity moves to an incorporation country. For example Italy applies the incorporation theory for domestic entities. When a foreign company moves its actual management to Italy, it is mandatory according to Italian law to convert into an Italian entity.[61] A Dutch limited company, incorporated in the Netherlands, which transfers the actual management to Italy and converts into an Italian Srl, can benefit from the freedom of establishment and dispose the Dutch legal form without any hindrance.

The foregoing example is covered by the freedom of establishment. The Netherlands will charge an exit tax which is incompatible with the freedom of establishment unless justified by a reason of public interest.

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60 Schutte-Veenstra, supra at 306

61 J.W. Bellingwout, 'Cartesio: mijlpaal en doorbraak na Daily Mail' (2009) 6800 WFR, p. 123 (Bellingwout)

Emigration of a foreign company

Another scenario is the transfer of the actual management of a foreign company, for example a UK company, from the Netherlands to another Member State, for example Germany. The company is incorporated in the UK and transferred its management to the Netherlands. For company law purposes the company does not have to dissolve or liquidate since the UK applies the incorporation theory. Moreover, the Netherlands will recognise the foreign entity and the company remains to be governed by the law of its incorporation state. The transfer of its central administration does not affect its status as a national of the UK.

However, for tax treaty and Dutch CITA purposes, the company will be resident in the Netherlands and taxable on its profits. When the same company transfers the actual management to Germany, article 15 c CITA will immediately levy an exit tax on the unrealised gains which accrued on the Dutch territory.

In the *Daily Mail*-case the ECJ held that the country of incorporation may impose additional requirements on the transfer of the actual management to another Member State. In the described scenario the company is incorporated in the UK while the Netherlands impose the exit tax. As a result, the exit tax levied when the actual management is transferred is covered by the freedom of establishment.[62] It is a different scenario than the *Daily Mail*-case. The restriction is precluded by the freedom of establishment.

4 Dutch exit tax legislation in the light of the exit tax case law of the European Court of Justice

4.1 Preliminary comments

In the previous chapter it has been established that article 15 c and d CITA can be assessed on the compatibility with the freedom of establishment. The access to the freedom of establishment makes it possible to draw parallels with the case law on exit taxes levied on individuals.

The compatibility of exit taxes with the freedom of establishment is dealt with by the ECJ in the *De Lasteyrie*-case and the *N*-case. The Commission is of the opinion that the interpretation of the freedom of establishment given by the ECJ in respect of exit taxes rules on individuals has direct implications for Member States exit tax

62 H. Schneeweiss, ‘Exit taxation after Cartesio: The European Fundamental Freedom Impact on Taxing Migrating Companies’ (2009) 37 (6/7) Intertax, p. 371 (Schneeweiss)

rules on companies.[63] Moreover, the ECJ consistently applied to corporations the principles it developed in relation to individuals. Article 54 TFEU further underlines the foregoing by stating that companies formed in accordance with the law of a Member State shall be treated in the same way as natural persons.[64]

In the following paragraphs the implications of the exit tax case law on individuals in regard to the Dutch corporate exit tax provisions will be set out. The question whether article 15 c and d CITA constitute a restriction on the freedom of establishment will be analysed.

4.2 Case law exit tax individuals

4.2.1 De Lasteyrie

The De *Lasteyrie*-case concerned a French resident who moved to settle in Belgium. Mr De Lasteyrie held shares in a French company. A tax was levied on the unrealised increase in value of the shares immediately before Mr. De Lasteyrie moved its residence to Belgium. The taxation could be deferred until realisation under the condition that the taxpayer provided an appropriate guarantee. The French Court referred the question whether the French legislation restricts the freedom of establishment to the ECJ for preliminary ruling.[65]

The ECJ held that the French exit tax provisions restrict the freedom of establishment. A French resident wishing to transfer his tax residence to another Member State is subject to disadvantageous treatment in comparison with a person who maintains his residence in France. Simply by reason of the transfer, the taxpayer becomes liable to tax on income which has not yet been realised while if he remained in France, the increase in value would only be taxed when the increase is actually realised. The ECJ concludes that the disadvantageous treatment is likely to discourage a taxpayer from transferring its residency to another Member State.[66] In regard to the guarantee the ECJ determined that ‘the guarantees in themselves constitute a restrictive effect in that they deprive the taxpayer of the enjoyment of the assets given as a guarantee.’

63 Commission (EC), ‘Exit taxation and the need for co-ordination of Member States' tax policies’ (Communication) COM (2006) 825 final, 19 December, p. 5

64 Schneeweiss, supra at 371

65 De lasteyrie paragraph 18

66 Ibid, paragraph 46

4.2.2 N

In the *N*-case a Dutch national, sole shareholder of three limited liability companies, transferred his residence to the UK. The Dutch legislation imposed a tax on the increase in shareholdings at the moment an individual transfers its residence to another country. A deferment of payment could be granted if the taxpayer provides security. The question whether the Dutch legislation is contrary to the freedom of establishment was referred to the ECJ.

As could be expected after the *De Lasteyrie*-case, the ECJ concluded that the migrant is treated less favourable in comparison to a Dutch resident who stayed in the Netherlands. In addition to the reasoning in *De lasteyrie* the Court supported its argument by the fact that the Dutch exit tax rules did not take account for potential decreases in value after the transfer.[67]

The ECJ continues with the question whether the restriction can be justified by a legitimate objective in the public interest, which is appropriate to ensure the attainment of the objective and does not go beyond what is necessary. The ECJ held that preserving the allocation of the power to tax between Member States, on the basis of the territoriality principle, is a legitimate objective, recognised by the court in *Marks and Spencer*. However, the obligation to provide a guarantee went beyond what is strictly necessary. The council directive on mutual assistance[68] (MAD) and the directive on the mutual assistance in the recovery of tax[69] (MARD) make it possible for a Member State to ascertain information and collection of tax in the Member State of immigration.[70]

4.3 Infringement freedom of establishment

When the reasoning of *De Lasteyrie* and *N* is applied *mutatis mutandis* to migrating companies, article 15 c and d CITA restrict the freedom of establishment. As described in chapter 2, article 15 c and d CITA levy an exit tax on hidden reserves, tax reserves and goodwill immediately prior to the termination of the residency of a Dutch entity. The entity which transfers its residence is immediately taxed on gains which are not yet realised. The company is subject to disadvantageous treatment in comparison with a company which remains in the Netherlands, which would only be

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67 N paragraph 37

68 Council directive 77/799/EEC of 19 December 1977

69 Council directive 76/308/EEC of15 March 1976 as amended Council directive 2001/44/EC of 15 June 2001

70 N paragraph 52-53

taxed when the profits are actually realised. That difference in treatment is likely to discourage the entity concerned from transferring his residence outside the Netherlands.[71]

Moreover, as described in chapter 3 there are several scenarios possible in which a company converts into a legal entity of another Member State. The ECJ concluded in *Cartesio* that requiring the liquidation or mandatory winding up which prevent a company to convert into a foreign legal entity constitutes a restriction on the freedom of establishment.[72]

The restriction can be divided in a tax base disadvantage, a cash flow disadvantage and it can result in double taxation.

4.3.1 Tax base disadvantage

The capital gains and goodwill are immediately taxed on the actual market value. The market value is determined at the moment of emigration. In principle, the gains can still decrease after the migration which means that the country of emigration could tax more gains then were actually realised. The previous results in a tax base disadvantage compared to entities which do not migrate. In the *N*-case the ECJ stressed that the migrant is treated less favourable by not taking into account potential decreases in value in comparison with a taxpayer who does not transfers its residency.[73]

Moreover, the taxing rights should be limited to the period in which an entity is resident in the Netherlands. When an entity immigrates to the Netherlands and later moves its seat to another country, the tax base must be precisely determined, taking into account the gains attributable to the period of non-residence, in order to avoid a potential tax base disadvantage. If the tax base is not determined precisely, the country could tax more than it is entitled.[74]

Furthermore, tax rates can change over time. The immediate taxation is based on the tax rates which are in use at the time of migration. A company

71 See also M. Koerts, 'Houdbaarheid van exitheffingen bij zetelverplaatsing in Europeesrechtelijk perspectief' (2009) 6810 WFR p.532 (Koerts) and A.C. van Ede, 'De eindafrekening is nog (steeds) niet EU-proof' (2002) 6482 WFR (Van Ede) and Schneeweiss, supra at 371

72 *Cartesio* paragraph 112-113

73 *N* paragraph 36

74 See also H. Van den Hurk and J. Korving, 'The ECJ's judgement in the N case against the Netherlands and its consequences for Exit Taxes in the European Union' (2007) 61 (4) B.F.I.T, p. 156 (Van den Hurks & Korving)

which does not migrate is taxed at the rate which is used at the time of the actual disposal of the assets while the migrating company is taxed at the rates which are used at the time of migration.

4.3.2 Cash flow disadvantage

As described by Van Den Hurk, Korving and Van Ede, the Dutch exit tax constitutes a cash flow disadvantage. The goodwill and hidden reserves are taxed at the moment the entity migrates while the gains will probably be realised a long period after the migration. The goodwill and hidden reserves of an entity which maintains its seat in the Netherlands will only be taxed when they are actually realised. As decided in for example *Oce van de Grinten*, *Metallgesellschaft* and later confirmed in the *N-case*, a cash flow disadvantage in itself can constitute an infringement of EU law.[75]

4.3.3 Double taxation disadvantage

The difference in exit tax systems which are used by EU Member States can result in double taxation. As described in paragraph 2.4 of chapter 2, the Netherlands applies a system of 'total profits'. In order to collect taxes in an effective manner, profits are calculated and taxed annually. The starting point of the calculation of the total profits of an immigrating company is the net equity value based on the actual value of the assets, liabilities and also items which are not yet on the balance sheet such as goodwill. In other words, the Netherlands grants a so called 'step up' and applies a new book value which takes into account increases in value of assets that were realised before the entity moved to the Netherlands.

The double tax disadvantage is caused by other countries, for example the United Kingdom, which do not grant a step up on the balance sheet. When a company migrates from the Netherlands to the UK, the Netherlands charge an exit tax over hidden reserves, tax reserves and unrealised gains. When the company migrates from the UK to another country, the UK will charge an exit tax over the total amount of gains without taking into account any gains realised before the entity moved to the UK. Since the company was already taxed in the Netherlands and later taxed in the UK, there is double taxation.[76]

4.3.4 Reasoning applied to the preliminary question

In my opinion the immediate taxation of the hidden reserves of the Dutch BV constitute a restriction of the freedom of establishment. Under Dutch

75 See also Van den Hurk & Korving, supra at 156 and Van Ede, supra at 737

76 Van den Hurk & Korving, supra at 156

legislation it is possible for Dutch companies to have the historic Guilder-British Pound currency rate of the loan on the balance sheet. In a domestic situation the currency gains will only be taxed when the loan is redeemed or the loan is alienated. However, when the company transfers its actual place of business to another Member State, article 16 ITA levies an exit tax on the unrealised currency gains immediately prior to the transfer. The immediate taxation constitutes a cash flow disadvantage. Moreover, the exchange rate between the Guilder and the British Pound can change after the transfer. The potential decrease in value is not taken into account. Consequently, a company which migrates is treated less favourable in comparison to a company which does not transfer its seat. The foregoing constitutes a restriction on the freedom of establishment.

5 General Interest Justifications

5.1 Background

It has been established in the previous chapter that the Dutch exit tax legislation constitutes a restriction on the freedom of establishment. However, the Dutch exit tax legislation may be allowed if they are justified by overriding requirements in the public interest which are suitable to attain the object and do not go beyond what is necessary.[77] The next paragraph analyses the relevant justifications recognised by the ECJ. The second paragraph will examine whether the justification is proportionate.

5.2 Balanced allocation of taxing rights

In the *N*-case the ECJ accepted the preservation to allocate the power to tax between Member states on the basis of the territoriality principle as a legitimate justification, recognised by the Court in the *Marks & Spenser*-case.[78] The Court distilled the territoriality principle from the OECD model. The Court held that

> ‘it is in accordance with that principle of fiscal territoriality, connected with a temporal component, namely residence within the territory during the period in which the taxable profits arise, 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.’

77 As first seen in Case C-55/94 *Gebhard* (ECJ 30 November 2005) paragraph 39

78 *N* paragraph 41-42

In my opinion article 15 c and d of the CITA can be justified by the need to ensure a balanced allocation of taxing rights on the basis of the territoriality principle.[79] The balanced allocation of the taxing rights is endangered because the Netherlands loses its taxing rights when an entity ceases to be a resident of the Netherlands while the entity has benefited from the deferred taxation and depreciation advantages offered by the Dutch CITA. When the Netherlands would not be able to levy the exit tax it is forced to accept a loss in tax revenue. Although it is questionable whether the immediate taxation prior to the said residence is proportionate, the justification applies in my opinion to article 15 c-d CITA.

However, in the literature it is advocated that in order to successfully invoke the justification balance in the allocation of taxing rights, it is necessary to identify the course of action which is capable of jeopardising the right of the Member State to exercise their taxing power.[80] In *Marks & Spencer*, the justification was put forward in combination with the double use of losses and the risk of tax avoidance. The ECJ concluded that the three justifications taken together pursue legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest.[81] The justification is further specified in *OyAA* and *Lidl Belgium*. In *OyAA* the justification was accepted in combination with tax avoidance. In *Lidl Belgium* the Court determined that the two justifications put forward, balance in the allocation of taxing rights and double use of losses, must each be considered capable of justifying a restriction of the freedom of establishment.[82] Consequently, although the *N*-case does not explicitly state what action actually jeopardises the balanced allocation of taxing power, it could be argued that this must be established in order to invoke the justification. Especially since the ECJ refers to *Marks & Spencer* in the N-case.

In regard to the foregoing the parallel can be drawn with the *SGI*-case[83]. The Dutch exit tax legislation does not specifically targets wholly artificial arrangements designed to circumvent the legislation of the Member State concerned. However, one of the objectives of the exit tax legislation is to

79 See also Koerts, supra at 532 and Arendonk, supra at 315

80 See T. O'Shea, *EU Tax Law and Double Tax Conventions*, (Avoir Fiscal Limited, London. 2008), p 139 (O'Shea)

81 Case C-446/03 *Marks & Spencer plc v David Haley* (ECJ 13 December 2005) paragraph 51

82 Case C-414/06 *Lidl BelgiumGmbH & Co. KG v Finanzamt Heilbronn* (ECJ 15 may 2008) Paragraph 37

83 Case C-311/08 *Société de Gestion Industrielle v Belgium* (ECJ 21 Januari 2010) paragraph 65-66 (SGI)

prevent Dutch entities from transferring its residency without paying tax.[84] In the *SGI*-case the Court held that when the legislation is not specifically designed to combat wholly artificial arrangements it can be justified by the objective of preventing tax avoidance, taken together with that of preserving the balanced allocation of the power to impose taxes between Member States.[85]

5.3 Coherence of the tax system

A tax measure of a Member State can be justified by the need to ensure coherence of the tax system. The justification is first recognised by the ECJ in the *Bachmann*-case[86] and recently approved in the *Krankenheim*-case[87].

In the *Bachmann*-case, Belgium allowed a deduction for contributions payable to insurers under pension and life assurance contracts on the basis that it will tax the future payments of the pension and life assurance fund to persons who paid the contribution. When contributions were paid to pension providers in other Member States, Belgium did not allow a deduction since it does not have the opportunity to tax the pensions paid out by such companies. The ECJ concluded that the Belgium legislation at issue was justified by the need to ensure cohesion of the tax system.[88] There was a direct link between the tax advantage, i.e. the deductibility, and the taxation of the sums paid out by the insurance funds.

In *Wielockx*[89] and *Danner*[90], the Court further specified that coherence could also be achieved at the level of double tax agreements between two Member State if both states tax only the pensions of its residents, irrespective of whether or not those residents obtained tax deductions of their pension contributions.[91] In those situations the coherence is secured by the double tax convention.[92]

84 *Kamerstukken II* 1998-1999, 26727, nr. 3, p. 116-117

85 SGI paragraph 65-66

86 Case C-204/90 *Bachmann v. Belgian State* (ECJ 28 January 1992)

87 Case C-157/07 *Finanzamt für körperschaften III in Berlin v Krankenheim ruhesitz am Wannsee-seniorenheimstatt GhmB* (ECJ 23 October 2008)

88 Ibid Paragraph 27-28

89 Case C-80/94 *Wielockx v Inspecteur der Directe Belastingen* (ECJ 11Augustus 1995) (wielockx)

90 Case C-136/00 *Danner* (ECJ 3 October 2002)

91 O'Shea, supra at 141

92 *Wielockx* paragraph 25

In regard to exit taxes, the need to ensure coherence of the tax system was put forward in *De Lasteyrie*. The court held that in order to assess the need to ensure coherence of the tax system, the aim pursued by provision must be considered. The French exit tax provision was designed to prevent temporary transfer of tax residence outside France for tax purposes.[93] Therefore, 'the provision appears not to be aimed at ensuring generally that increases in value are to be taxed, in the case where a taxpayer transfers his tax residence outside France, in so far as the increase in value in question are acquired during the latter's stay in France.'[94] Consequently, the ECJ did not accept the justification.

In subsequent cases the ECJ continuously rejected cohesion of the tax system. In the literature it was argued that justification lost its importance. In order to ensure a coherent system the tax authorities initially forgoes the collection of a revenue claim only on the clear understanding that the claim can be realised at a later stage. Otherwise a revenue leak would affect the budgetary position of the Member State. The fact that the ECJ does not accept justifications based on a loss in revenue render the justification meaningless.[95]

However, in 2008 the ECJ accepted the justification in *Krankenheim*. The ECJ held that German rules reintegrating losses of an Austrian PE which previously have been taken into account by the German company, reflects a logical symmetry which constitutes a direct, personal and material link.[96] The recent approval of coherence of the tax system shows that the justification can still be invoked as long as there is a logical symmetry which constitutes a direct personal and material link, regardless whether there is a loss of tax revenue.

In my opinion the Dutch exit tax legislation can be justified by the need to ensure coherence of the tax system.[97] The justification can in particular come in useful to justify the taxation of tax reserves upon migration.

First it can be concluded that there is a direct, personal and material link. The Netherlands initially forgoes taxation by granting a tax advantage. For example the equalization reserve and reinvestment reserves grant an

93 *De Lasteyrie* paragraph 64

94 Ibid paragraph 65

95 S. 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, (2008) 8 E.T. p 281

96 *Krankenheim* paragraph 42

97 See also Van Ede, supra at 737

advantage by deferring taxation. When the corporate entity migrates, the Member State wants to recapture the tax deferrals which otherwise escape taxation.[98]

Second, in regard to the denial of the justification in *De lasteyrie* it can be noted that the aim of the Dutch exit tax legislation is to include profit components such as fiscal reserves, goodwill and hidden reserves which are not taxed in the Netherlands during the period that the company is resident in the Netherlands. Contrary to *De lasteyrie* the aim of the Dutch exit tax legislation is in accordance with the cohesion justification.

Furthermore, cohesion is not achieved in double tax conventions which the Netherlands has concluded with other Member States.

5.4 Proportionality

The last question which has to be addressed is whether the justifications do not go beyond what is necessary to achieve their public interest objective. When the reasoning of the ECJ in the *N*-case is applied by analogy to the exit tax provisions in the CITA, it can be concluded that article 15 c-d are disproportionate measures.
First, the MAD and the MARD ensure the collection of tax in the other Member State. Therefore, immediate taxation is not necessary in order to achieve the objective, i.e. collection of tax. For example a deferment of payment until the gains actually realise without a guarantee is a less restrictive measure.[99] In other words, although the exit tax provisions can be justified, it may have to defer the collection of tax on the hidden reserves and goodwill in situations when the collection of taxes in the host Member State is ensured under the MAD and the MARD.[100]

Second, the system for the recovering of tax must take full account of reductions in value arising after the transfer of residency, unless such reductions have already been taken into account in the host Member State.[101] Article 15 c-d do not take account of potential decreases in value of for example goodwill.

However, there are differences between an exit tax levied on a migrating individual and legal entities. There is an administrative difference between monitoring the shareholdings of individuals on the one hand and the numerous assets of legal entities on the other hand. There is only one realisation moment for individual shareholdings; the moment when the shares are sold, while the numerous assets of a

98 Ibid p. 3

99 See also Van Ede, supra at 373 and Koerts, supra at 533

100 See fn 50 supra.

101 *N* paragraph 54

migrating company will be disposed at different moments. Therefore, it might be questionable whether the less restrictive measure of deferred taxation can be applied to migrating companies.[102]

In relation to the foregoing, Terra & Wattel argue that the exit tax levied on legal entities is less burdensome in comparison to the exit tax on individual shareholdings. Most host Member States will grant a step-up. The assets and liabilities will be on the fiscal balance sheet at market value in the state of immigration. The tax paid on the unrealised gains in the exit state is compensated by the advantage of a corresponding higher depreciation basis for tax purposes. The higher depreciation results in lower tax exposure in the state of immigration.[103] Although not all Member States grant a step-up, the Council of the European Union published a resolution in which it urges Member States to coordinate their exit tax. One of the guiding principles for the host Member State is to adopt the market value of assets when economic activities are transferred, i.e. to grant a step-up.[104] As a corollary, it can be expected that Member States will coordinate their exit tax legislation.

However, the higher depreciation basis still constitutes a cash flow disadvantage. Although the step up mitigates the exit tax, the author is of the opinion that the immediate taxation is still disproportionate.

Another important difference, set out by O'Shea, is that migrating individuals will remain the same person while a converting company becomes a different legal entity. A different entity is created in the host Member State from that which existed in the origin Member State.[105] The foregoing difference has consequences when a company wants to invoke the freedom of establishment when it converts into a legal entity of another Member State.

5.3.1. Conversion in a host state legal entity

The ECJ explicitly stated in the *Cartesio*-case that the conversion of a company into a legal entity with a change in the applicable law is covered by the freedom of establishment. As described in Chapter 3.4 there are several scenarios in which a Dutch legal entity can convert into a legal entity of another Member State.

102 G. Führich, 'Exit taxation and ECJ case law' (2008) 48 (1) ET p. 13

103 Terra & Wattel, supra at 789

104 Council of the European Union (EC), 'Council Resolution on coordinating exit taxation', 2 December 2008, nr. 104449, p. 2

105 O'Shea in Tax J., Supra at 2

In the *N*-case the guarantee was disproportionate because the MAD and the MARD ensure that a Member State can acquire information and assistance in order to collect the tax. However, it is questionable whether a request for recovery is possible when a company is converted into a foreign legal entity.

O'Shea correctly analysed that the MARD directive only refers to the legal entity in the Member State making the request. In order to make a request for recovery, the name, address and other information in regards to the addressee or debtor must be indicated. The debtor of the tax claim is the legal entity which ceased to exist when it converted into the new legal entity in accordance with the laws of the host Member State. Moreover, article 9 (2) and 7 (2) (b) provide that 'the origin Member State tax authority cannot make the request for recovery unless it has applied the appropriate recovery procedures available to it in the origin Member State.' Again, it can only be concluded that is referred to the origin Member States legal entity.[106]
From the foregoing it can be concluded that the Member State of origin cannot rely on the MARD directive. Therefore, deferment of taxation cannot be seen as a less restrictive measure. Consequently the immediate taxation of hidden reserves and goodwill is a proportionate measure to achieve the public interest objective.

5.3.2. Preliminary Ruling of the Court of Appeal of Amsterdam

The case in question can be distinguished from the situation described in the previous paragraph. The Dutch limited liability company did not convert into a UK legal entity. The transfer of the actual place of business did not break the connecting factor for company law purposes. Accordingly, the Dutch BV maintained legal personality. Consequently, the Member State of origin can apply the MARD directive in order to ensure the collection of tax since it is still the same legal entity. The immediate taxation of the currency gain is disproportionate.

However, in my opinion it could be argued that immediate taxation is proportionate in the specific circumstances in the case in question. After the transfer of the actual place of business the Dutch company kept its accounts in British Pounds. Consequently, the difference in the exchange rate between the Guilder and the British Pound will no longer exist after the transfer. In other words, the currency gain is final after the transfer of the actual place of business.[107] When the parallel is drawn with the *Deutsche Shell*-case, which concerned terminal losses, it could be argued that the opposite situation, 'terminal profits', can be taxed in the Netherlands.

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106 O'Shea in Tax J., supra at 2

107 Gerechtshof Amsterdam 15 juli 2010, nr P08/00135 paragraph 4.15.3

The *Deutsch Schell*-case concerned a German Company with a PE in Italy. The German company injected start up capital in the Italian PE. When the PE was transferred to an Italian subsidiary of Deutsche Shell the start up capital was paid back to the German company. When the money was exchanged in German Marks, a currency loss was incurred. The German tax authorities refused to deduct the currency loss from the profits of Deutsche Shell.[108] The losses were terminal since the currency loss could not occur in Italy. The ECJ held that 'it is unacceptable for a Member State to exclude from the basis of assessment of the principle establishment currency losses which, by their nature, can never be suffered by the PE.'

When the reasoning is applied to the case at hand, the transfer of the actual business constitutes a PE in the UK. After the transfer, the accounts were held in British Pounds. Consequently, the currency gains of the loan are terminal. Furthermore, a potential decrease in value is no longer an issue since there is no longer an exchange difference after the transfer. The Dutch tax authorities could argue that if they have to take account for terminal losses, terminal profits can be taken into account in the origin Member State. Immediate taxation is therefore a proportionate way to tax the terminal profits.[109]

6 Conclusion

This article has examined the question whether the Dutch corporate exit tax provisions are compatible with the freedom of establishment. In several steps it has been established that article 15 c and 15 d CITA are not compatible with the freedom of establishment.

First it has been established that article 15c and 15d CITA fall under the scope of the freedom of establishment. The examination of the case law showed that a company can invoke the freedom of establishment when it is connected to a Member State in accordance with article 54 TFEU, regardless which connecting factor is used. Legal entities are creatures of national law and therefore exist only by virtue of the national legislation of Member States. The national legislation of Member States determines the connecting factors and how a company can maintain connected to the jurisdiction of the Member State. When, according to the national laws of a Member State, the connecting factor is broken, a company can no longer rely on the freedom of establishment.

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108 Case C-293/06 *Deutsche Shell GmhB v Finanzamt für Großunternehmen in Hamburg* (ECJ 28 February 2008) paragraph 9-17

109 See also Gerechtshof Amsterdam 15 juli 2010, nr P08/00135 paragraph 4.15.4-5

The Netherlands subscribe the incorporation theory. Consequently, a company incorporated in the Netherlands can transfer its seat while maintaining its legal personality as a Dutch company. The connecting factor is not broken for company law purposes. Contrary to the UK legislation in *Daily Mail*, the Netherlands do not impose requirements in order to maintain legal personality and status as a Dutch company. Therefore, the exit tax legislation can be assessed on their compatibility with the freedom of establishment.

Moreover, *Cartesio* extended the scope of the freedom of establishment to situations where a company moves to another Member State with an attendant change as regards the national law applicable. The author showed several possibilities for Dutch companies to convert into a legal entity of Member States which either apply the real seat theory or to the incorporation theory. Consequently, the exit tax levied in these scenarios can be assessed on their compatibility with the freedom of establishment.

Next, the examination of article 15c and 15d CITA confirms the conclusion that the rules constitute a restriction on the freedom of establishment. A company wishing to transfer its seat is taxed immediately on unrealised gains thereby being treated less favourable in comparison to a company which maintained its residence in the Netherlands, which is only taxable on the gains when they actually realise. Article 15 c and 15 d CITA constitute a cash flow disadvantage, a tax base disadvantage and is liable to potential double taxation.

The need to ensure a balanced allocation of taxing rights and coherence of the tax system are capable of justifying article 15c and 15d CITA.

The need to ensure a balanced allocation of taxing rights on the basis of the territoriality principle is best capable of justifying article 15c and 15 d CITA. The balanced allocation of taxing rights is endangered because the Netherlands loses its taxing rights when an entity ceases to be a resident of the Netherlands while the entity has benefited from the deferred taxation and depreciation advantages offered by the Dutch CITA.

Coherence of the tax system is in particular useful to justify exit taxes levied on tax reserves. There is a symmetrical direct link between the granting of a tax advantages such as a reinvestment reserve and equalisation reserve and the subsequent recapture of the tax deferrals upon migration.

However, article 15 c and 15 d CITA cannot be regarded as a proportionate measure to attain the objective. The MAD and MARD ensure the collection of tax after migration. Therefore the immediate taxation prior to the said residence goes beyond what is necessary to attain the objective. Less restrictive measures such as deferment of payment until the gains actually realise without a guarantee could be used in order to collect the tax. Moreover, article 15 c and 15 d CITA do not take account of reduction in value after the transfer of residence.

In regard to the foregoing it must be noted that there are relevant differences between individuals and legal entities. Deferment of taxation until the gains actually realise is administratively more burdensome for legal entities. It is likely that the ECJ will accept a certain degree of administrative requirements in order to successfully rely on the measure.

Furthermore, the MARD and the MAD do not apply when a legal entity converts into a foreign legal entity. Therefore, the immediate exit tax levied upon migration can be regarded as a proportionate measure in the scenario that a Dutch entity converts into a foreign legal entity.

Finally, this essay analysed the preliminary question of the Court of Appeal of Amsterdam. In my opinion it can be expected that the Dutch limited liability company can invoke the freedom of establishment against the exit tax levied upon the transfer of the actual business. However, the specific circumstances of the case justify the conclusion that an immediate taxation upon the transfer is proportionate. The currency gain is final after the transfer. Therefore immediate taxation is a proportionate measure.

Whatever the outcome will be, the decision will probably clarify and end the uncertainty in regard to the question whether the exit tax legislation of Member State can be assessed on the compatibility with the freedom of establishment.