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Editorial

Exit Taxes: Separation of Powers?

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The subject of exit taxes has become something of a hot issue in recent years, with all the three institutions that comprise the *trias politica* in the European Union contributing to discussions. The European Commission has set out its vision in its Communication of 19 December 2006 (COM (2006)825 final), while the ECOFIN Council passed a resolution on 2 December 2008 on coordinating exit taxes (OJEU 2008 C323/1-2) and the European Court of Justice (ECJ) has also issued rulings in various cases. Subsequent developments, however, show that it is still insufficiently clear as to how Community law is to be applied in this field. And that not only creates great uncertainty for Member States, but also for citizens and businesses wanting to exercise their right to the freedom of movement.

There certainly seems to be some sort of power struggle going on between the European Commission and the Council in particular, but with a not insignificant role also being played by the ECJ. In the *Hughes de Lasteyrie* and *N* cases the Court specified the conditions in which action taken by a Member State seeking to retain its taxation rights on emigration would be compatible with Community law.

The method of the exit tax assessment is used primarily by states seeking to retain their rights, upon emigration, to tax claims relating to major shareholdings in companies and to rights under pension and life insurance policies. It is not used, however, in situations involving the emigration of entrepreneurs or transfers of corporate seats. In these situations Member States normally impose tax immediately prior to emigration on the hidden reserves that have been accrued. The host state in turn will grant a step-up so that taxes on profits in that state will be based on the market value of the assets and liabilities calculated at the time of emigration. It should be emphasized that the disadvantage for an enterprise in such situations is purely a liquidity or interest disadvantage. Obviously the tax rates applied by the two states may differ, but, as the Court has previously ruled, this constitutes a disparity, and that is a competence of the Member States themselves.

It is no secret that the European Commission does not really see exit taxes as appropriate in a single market. Indeed in its Communication of 19 December 2006 the Commission states that the ruling in *Hughes de Lasteyrie* should also apply to exit taxes imposed on entrepreneurs and companies, thereby taking no account of the ECJ's ruling in the *Daily Mail* case. International practice in this respect is very different, and the question is whether the ECJ is of the same opinion as the Commission?

In its ruling in the *Daily Mail* case of 27 September 1988 (C81/87), the Court stated that provisions regarding the life and death of a legal entity were determined solely by the Member State under whose laws the entity was established and that, in the absence of harmonisation or agreement in this field, Member States were entitled to impose obstacles on transfers of seats from a Member State. In this case, the company *Daily Mail* was resident in the United Kingdom, but wanted to move its effective seat of management to the Netherlands for tax reasons, while retaining its status as a company incorporated under UK law. Both the Netherlands and the United Kingdom apply the place of incorporation doctrine, and the requirement for UK Treasury consent that the United Kingdom imposed on the transfer of the company's effective seat of management was consequently permitted. Even though the Court did not make any direct pronouncements on the acceptability of exit taxes, the considerations expressed in its ruling imply that these taxes must be permitted.

After the *Daily Mail* case it was a long time before another similar case came before the Court. In the years from 1988 onwards the European Commission could have been expected to devote considerable attention to agreeing rules for transfers of seats. But that did not happen. In recent years the Commission had been working on a draft directive on transfers of seats, which would have been the Fourteenth Directive on company law. Matters need not actually have been made so complex, given that the Regulation on the European Company includes provision for transfers of seats. In late 2007, the Commission then announced that work on the Fourteenth Directive would be discontinued. However, even if the above Directive had materialized, we would still not have known what was actually permitted from a tax law perspective. The Commission would now appear to believe, following the Cross-Border Merger Directive and the still-to-materialize Council Regulation on the Statute for a European Private Company, along with the decision in the *Cartesio* case, that a directive on transfers of seats is not so vital.

We need, therefore, to look at the ruling in *Cartesio* (C-210/06). This case involved Cartesio, a Hungarian-resident entity (Hungary applies the real seat doctrine), which wanted to transfer its effective seat of management to Italy, while retaining its status as an entity listed in the Hungarian trade register. The objective in this respect was to avoid having to dissolve and liquidate the entity and, therefore, to avoid being liable for the resultant exit taxes. Advocate General Maduro announced his opinion on this case on 22 May 2008. He believed that, following recent ECJ case law on the freedom of establishment, the ruling in *Daily Mail* could no longer apply and that a Member State was no longer entitled to decide on the life and death of legal persons established under its national laws. According to Maduro, Article 43 EC (now Article 49, TFEU) also applied to transfers of seats, which would mean that the ECJ 'barrier' doctrine rules also applied. The justification grounds and the requirement for proportionality would then also become important. However, there has been no recent ECJ case law on transfers of seats, which means that the analysis and opinion expressed by Maduro were based on quicksand. The ECJ was consequently correct in *Cartesio* not to follow the opinion of Advocate General Maduro. In essence the Court reiterated, almost literally, the reasoning expressed in the *Daily Mail* case. From this, too, we can conclude that transfers of seats from a state applying the real state doctrine are not governed by Article 43 EC (now Article 49 TFEU) and that Member States are consequently entitled to apply their own rules to such transfers.

The *Cartesio* case concerned civil law aspects of a transfer of seat and tax issues did not arise. If, however, a state applying the real seat doctrine is permitted to demand dissolution and liquidation of an entity transferring its effective seat of management abroad, tax settlement will be an inherent part of the process. Even if this settlement is not referred to as an exit tax, the situation from an economic perspective will be identical to the tax imposed on a company that is resident in a place of incorporation state and moves its effective seat of management abroad.

Following the ruling in *Cartesio* the Commission could have been expected, based on the information and views now available to it, to have withdrawn its Communication of 19 December 2006 or to have revised it. This, however, has not happened. It would seem that the Commission is not satisfied with the decisions taken by the ECJ. Indeed the European Commission believes that the exit taxes imposed on companies by Spain and Portugal are incompatible with Article 43 EC (now Article 49 TFEU) because domestic and cross-border situations are treated differently. As a result, it has started infringement procedures against these states (European Commission press release of 8 October 2009, No. IP/09/1460).

I do not believe the reasoning that domestic and cross-border situations are treated differently to be incorrect. In the specific cases in question, however, the comparison is not valid as the entrepreneur/company is emigrating from a Member State and so is changing its tax jurisdiction, whereas there is no change of tax jurisdiction in a purely domestic situation. Or maybe the Commission no longer recognizes the concept of tax jurisdictions? If that, however, is the case, the Commission would be out of line with reality. What is important is to avoid imposing double taxation, but that is primarily a matter for the Member States themselves.

The ECOFIN Council resolution of 2 December 2008, which was adopted unanimously, takes the view that Member States are entitled to impose exit taxes on emigrating entrepreneurs/companies. The host state, however, should grant a step-up and so, when calculating profit taxes due, should accept the market value of the assets and liabilities applied by the exit state. All the Member States are required to incorporate these principles into their national tax regulations to the extent that this has not yet been done.

The Council's stance in this respect is significantly different from the views expressed by the Commission, and so it is therefore not so surprising that countries such as Spain and Portugal are refusing to amend their tax legislation to bring it into line with the Commission's wishes.

The above means that the Commission has refused to accept the ECOFIN Council Resolution and actually believes it to be incompatible with Community law. What then is the value in law of the Commission's Communication and the ECOFIN Council Resolution? The Communication can be classified as 'soft law' and, given that the Commission does not have exclusive competence in this field, I believe the legal value of the Communication to be minimal. Similarly, the Council Resolution is also not legally binding. As this Resolution, however, was approved unanimously, I would consider it to be of higher legal value than the Communication. If Member States structure their tax systems in accordance with the Resolution, they will avoid double taxation being imposed, and it is this that constitutes the principal fiscal obstacle to the emigration of entrepreneurs and companies. It is now up to the Court to decide who is the best guardian of Community law and thus bring this power struggle to an end.