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Exit Taxes: Where to Now? After ECJ Decision in *National Grid Indus* BV

Introduction

On 29 November 2011 the European Court of Justice issued its judgment in the case of *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond* C-371/10 (*NGI*). This case is important as it is the first time that the ECJ has specifically addressed the issue of exit taxes arising on a corporate migration of tax residence within the EU. Although the case related to Dutch tax law, it has potentially wider implications for other EU Member States, including Ireland, whose exit tax provisions have been subject to recent scrutiny by the European Commission.[1]

This article examines some of the problems associated with exit taxes on corporate migrations, focusing primarily on the existing Irish exit tax provisions under s627 TCA 1997. Consideration is also given to the implications of the *NGI* case for the current position on exit taxes in Ireland and the EU.

The Problems Associated with Exit Taxes

An exit tax is imposed on latent gains arising on assets that an individual, company or permanent establishment transfers to another jurisdiction on migration of tax residence. Generally, corporate tax residence is based on the place of central control

1 On 27 January 2011, the European Commission formally requested, by way of reasoned opinion, that Ireland amend its exit tax provisions on the basis that they were incompatible with the principle of freedom of establishment. The authors understand that a formal response to the reasoned opinion was submitted to the Commission on 30 March 2011, and the matter now rests with the Commission.

and management[2] of an entity. Factors that can determine the place of central control and management include where the board meetings are held, where the head office of the entity is located, where the directors are tax-resident etc. Therefore, where there is a change in the place of central control and management of an entity (for example, if the directors of an entity held board meetings in a different country), the entity might be considered to have become tax-resident in a new jurisdiction and therefore ceased to be tax-resident in its existing jurisdiction. This can result in an exit tax arising. Given the relative ease with which tax residence may be changed, entities may sometimes cease to be tax-resident in a jurisdiction unintentionally, possibly giving rise to an accidental but potentially expensive tax charge.

The imposition of an exit tax is based on the principle that a country is entitled to tax all income that arises in that country. However, the levying of this tax can give rise to a number of problems for the taxpayer:

› Cash-flow disadvantage – The tax arises at the date of emigration and not at the date of realisation of any capital gain on the company's assets.

› Double taxation – Given that there is currently no global or EU harmonisation of exit taxes, the migration of tax residence between countries does not automatically result in an uplift in base cost in the immigrant State.

› Tax base disadvantage – No consideration is given to future fluctuations in asset valuations after migration. This means that gains could increase or decrease between the date of departure and actual realisation of the asset, resulting in both the emigrant and the immigrant State taxing either more or less gains than they would ordinarily have done in the case of an actual realised gain.

Irish Exit Tax Provisions

An exit tax on the migration of the tax residence of a company out of Ireland has been in place since 21 April 1997. Section 627 TCA 1997 provides for a deemed disposal and reacquisition of all of the assets of a company that moves its place of residence outside of Ireland. While the charging provisions are broad, many companies are exempt from any exit tax if they are considered to be an "excluded company" (i.e. a company where at least 90% of its issued share capital is held by a company or persons controlled by a company that is tax-resident in a tax treaty State and not under the control of a person or persons tax-resident in Ireland).

If a company does not qualify for the excluded company relief, deferral of the exit tax may be possible. Under s628 TCA 1997, the exit tax may be postponed if the migrant company is a direct 75% subsidiary of an Irish-resident company and a joint election is made in writing to the Inspector of Taxes. However, the deferred gain will crystallise and be deemed to accrue to the parent company if, within ten years of the date of migration, any of the following occur:

› the assets on which the exit tax arose are actually disposed of,

› the parent company ceases to be Irish tax-resident or

› the subsidiary company ceases to be a direct 75% subsidiary of the parent company.

If a crystallised gain arises on the parent company as a result of one of the above occurring, it is possible for any capital losses in the subsidiary company to be surrendered to the parent company to shelter, as far as possible, any chargeable gain. This is one unusual example of where capital losses can be surrendered, and group relief is available between a resident and a non-resident company.

Where an Irish exit tax arises on migration, some of the problems highlighted above apply in an Irish context. Examples include:

› No uplift in base cost on inward migration and subsequent outward migration, meaning that companies are liable to CGT on the full appreciation of an asset, rather than the proportion of the appreciation that relates to the period when the company was tax-resident in Ireland. This can give rise to double taxation.

› Migration of a parent and a subsidiary at the same time. Any appreciated assets in the subsidiary will effectively be taxed twice – firstly, at the subsidiary level on the value of the appreciated asset and, secondly, at the parent level on the

2 For simplicity in this article, the term "place of central control and management" is deemed to be the same as place of effective management and similar terms that may be used in domestic tax legislation, double taxation treaties and case law throughout the world.

value of the shares in the subsidiary company, with no participation exemption available by virtue of s626B(3)(e) TCA 1997 (i.e. participation exemption does not apply to deemed disposals on migration).

› Unfavourable treatment of non-trading assets because no exemption from exit tax applies to assets that are not used in or held for the purposes of a trade that continues to be carried on in the State after migration of the company. This means that double taxation can arise: firstly, on migration of tax residence and, secondly, on the later realisation of the assets, with no relief available, as the event giving rise to double taxation effectively took place before the company was resident in the new country.

Exit Taxes Within the EU[3] and Related Case Law

It is in the context of the above issues that exit taxes on migration of tax residence have been subject to closer scrutiny within the EU in recent years. Specifically, the European Commission has taken action against a number of Member States on the basis that their existing exit tax provisions are incompatible with the freedom of establishment as laid down in Article 49 of the Treaty on the Functioning of the European Union (TFEU).[4]

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The *Lasteyrie* case

The issue of exit taxes in the context of the freedom of establishment was first considered in the case of *Lasteyrie*.[5] This case related to a French individual who moved his place of tax residence from France to Belgium. On migration of tax residence, an exit charge arose on the unrealised gain attributable to shares held in a French company. It was possible to defer the payment of the tax on condition that the taxpayer filed a tax declaration make a sufficient guarantee to ensure that the French authorities could recover any tax due on migration. Ultimately, the ECJ held that the exit tax constituted a restriction on the freedom of establishment on the basis that the taxpayer was treated less favourably than an individual who maintained his or her French tax residence.

The *N* case

The ruling in *Lasteyrie* was refined in the *N* case.[6] In this case, a Dutch individual migrated to the UK in 1997 and at that time held shares in three Dutch companies. An exit tax arose on his migration of residence, although the taxpayer provided a guarantee to the Dutch authorities to defer the charge. However, following on from the *Lasteyrie* case, the guarantee was released by the Dutch authorities. The taxpayer sought damages from the Dutch authorities on the imposition of the security, and the case was ultimately referred to the ECJ. In considering the case, the ECJ confirmed that there was a restriction on the freedom of establishment. Unlike in *Lasteyrie*, it was held that an exit tax could be justified on the basis of territoriality, as the exit tax was an exercise of the Netherlands' power to define the criteria for tax allocation. However, the requirement for a guarantee to ensure the payment of any tax relating to the migration that may arise on an actual realisation of the asset was not proportionate to the aim of preserving the taxing powers. It was stated that proportionality could be achieved by a less far-reaching system of protective assessment, provided that such a system is not conditional on the provision of guarantees and takes full account of the changes in values of assets after any change in tax residence.

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3 The authors note that exit charges arise on migration of tax residence to non-EU countries. However, this article focuses on intra-EU migrations, given that much of the recent commentary and case law has dealt specifically with this aspect of exit charges. One point to note on non-EU migrations is that the European Commission has stated in its 2006 Communication that it recognises that, while such a restriction may represent a restriction on the free movement of capital, it may be justified on the basis of a lack of administrative co-operation.

4 Portugal, Denmark, the Netherlands and Spain have been referred to the ECJ, with reasoned opinions having been issued to Belgium, Ireland and the UK.

5 C-9/02.

6 C-470/04.

Although the *Lasteyrie* and *N* cases dealt with the migration of an individual, the decision in these cases applies also to companies by virtue of Article 54 of the TFEU, which states that companies formed in accordance with the law of a Member State and having the shall place of business within the EU shall be treated in the same way as individuals who are nationals of Member States.

The European Commission has issued a Communication[7] outlining its view of exit taxes, which has been supported by the European Council.[8] The Commission's Communication states that there are problems with exit tax provisions adopted by Member States, such as the mismatches in tax bases of the relevant assets in the origin and host States and the need for administrative co-operation. However, importantly, the Commission believes that, in principle, an exit tax is permitted provided that it does "not give rise to an immediate charge to tax and that there are no conditions attached to the deferral". While accepting that the unlimited deferral can itself give rise to the opportunity for companies to exploit the different valuation methods used by Member States in order to maximise the amount of the gain that arises in the lowest-tax jurisdiction available, the Commission offers no solution to how this would be overcome.

Recent Developments in the Area of Exit Taxes – *National Grid Indus*

The ECJ issued its judgment in this case on 29 November 2011. It is the first case before the ECJ that specifically considered exit taxes in the context of companies and is therefore a very important precedent.

The main findings of this case are:

› A Member State is allowed to impose an exit tax on migration of tax residence to another Member State.

› An exit tax does not need to take into account future falls in asset values up to the date of realisation in calculating any exit tax.

› The immediate collection of an exit tax breaches the freedom of establishment, and therefore there must be an option to defer payment of the exit tax.

› Interest may be applied to any deferred exit tax, and the taxing authorities may require a guarantee to ensure future payment of any tax.

Background to the case

National Grid Indus was a Dutch-incorporated and tax-resident company that migrated its place of effective management to the UK in December 2000. Under the provisions of the UK–Netherlands double taxation treaty, the company was deemed to be UK tax-resident from this point. Under Dutch tax rules, the migration of tax residence triggered an exit tax on an unrealised gain relating to a UK-denominated receivable owed to the UK parent company. The company challenged the tax assessment on the basis that the imposition of this exit tax was a restriction of the freedom of establishment under Article 43 of the TFEU because of the cash-flow disadvantage that it placed on the company in comparison with non-migrating Dutch entities and that the immediate imposition of an exit tax without deferral or regard for any future fall in the value of the asset was not justified or proportionate.

Restriction

Although a number of Member States argued that the migration of companies falls outside the scope of the freedom of establishment, the ECJ ultimately held that, as NGI retained its legal personality in the Netherlands, it was being unfairly treated in comparison to other Dutch-incorporated entities that retained their Dutch tax residence, and therefore the differing treatment between a Dutch-incorporated non-resident entity and a Dutch-incorporated resident entity was in principle a breach of the freedom of establishment.

Justification and proportionality

According to the ECJ, a restriction of the freedom of establishment can be justified only for "overriding reasons in the public interest", and a restriction could not go beyond what was necessary to attain that objective. The imposition of an exit tax was considered to be a preservation of allocation of taxing powers available to a Member State and therefore a legitimate objective of any Member State. On this basis, it was held that the Dutch domestic legislation was appropriate for ensuring the preservation of allocation of taxing

7 Commission of the European Communities, "Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Exit Taxes and the Need for Co-ordination of Member States' Tax Policies", 19 December 2006.
8 Council Resolution on Coordinating Exit Taxation, 2911th Economic and Financial Affairs, 2 December 2008.

rights, and the taxing of unrealised gains in the Member State in which they arose was justified.

Regarding proportionality, the ECJ made a specific distinction between establishing the amount of tax due and the recovery of that tax. In relation to the amount of tax due, the ECJ agreed with the view put forward by the Advocate-General that establishing the amount of tax due at the date of the migration was proportionate and it was not necessary to take into account a subsequent decrease in asset value in calculating the exit tax at the date of migration or to revise the exit tax downward on actual realisation of the asset, on the basis that allowing such a revision would call into question the balanced allocation of powers of Member States and also lead to possible double taxation or double deduction of losses.

In relation to the recovery of tax, the ECJ stated that the immediate collection of the exit tax placed a company at a cash-flow disadvantage compared with non-migrating entities. However, it also accepted the argument put forward by ten Member States that the deferral of an exit tax would require some form of tracing of assets and that this could in certain circumstances become onerous and itself be considered a restriction on freedom of establishment. Ultimately, the ECJ held that national legislation should offer a choice between:

› immediate payment of tax (although subject to cash-flow disadvantage, but without the administrative tracing exercise) or

› deferral of tax (with tracing of gains/losses on the asset but no upfront cash cost).

It should also be noted that the ECJ also stated that the tax due under a deferral provision could be subject to interest imposed under national legislation. Furthermore, to ensure payment of tax at a later date, the Member State could also require security from the migrating company.

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Conclusion

The judgment in *National Grid Indus* represents a significant refinement of the position of exit taxes in the EU. While of importance, this ruling would appear to have some shortcomings. For example, the ruling does not clarify when a gain is considered to be realised; this could be relevant, for example, for internal goodwill, which, although an asset on migration, may never be realised, and therefore no exit charge ever paid on it. Also, the imposition of a guarantee to avail of any potential deferral contrasts with the ruling in *Lasteyrie*, where it was held that a guarantee was in itself a restriction. Notwithstanding these shortcomings, the Dutch authorities implemented the ruling of the ECJ in full in their domestic tax law on 22 December 2011, applying retrospectively from the date of the ruling. The Italian authorities have also taken steps to amend their exit tax provisions on foot of this decision.

In the context of Ireland, in light of the *NGI* decision, the application of our exit tax would seem justifiable in the context of preserving taxing rights, although the immediate recovery of the tax would appear to be disproportionate to this objective and contrary to EU law. Although there is currently provision for deferral of the exit tax under s628 TCA 1997, the *NGI* decision would indicate that Ireland may need to extend this deferral to be in line with the ECJ decision in this case and to ensure that our provisions are proportionate. It is possible that this ruling may give the Commission the impetus to act further against Member States whose exit tax provisions it considers to be in breach of the freedom of establishment, notwithstanding some of the shortcomings identified above.