European Union, Netherlands

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The ECJ's Judgement in the *N* Case against the Netherlands and its Consequences for Exit Taxes in the European Union

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1. Introduction

The European Court of Justice (ECJ) recently handed down its judgement in the *N* case[1] on the compatibility of the Netherlands exit tax legislation with EC law. A tax adviser predicted that, as a result of this decision, many Dutch residents living near the Belgian border and holding a substantial interest in a company would emigrate to Belgium in order to avoid the Netherlands tax that would be levied on the increase in value of their interest when they later transferred it.[2]

It is questionable whether this observation is correct. This article summarizes the ECJ's settled case law that finally resulted in the *N* case and discusses the consequences of this decision for exit taxes in the European Union. The article concludes with a summary and the authors' final remarks.

2. ECJ's Case Law

The *N* case was not the first case in which the ECJ ruled on the compatibility with EC law of a Member State's national legislation regarding cross-border transfers of shareholdings or companies. The discussion below therefore considers several cases decided by the ECJ which preceded the *N* case in this field of taxation, namely: *Daily Mail*,[3] *Überseering*,[4] *X and Y*,[5] and *Hughes de Lasteyrie du Saillant*.[6]

2.1. *Daily Mail* and *Überseering*

The ECJ's decisions in *Daily Mail* and *Überseering* dealt with company law. In *Daily Mail*, the ECJ ruled that the transfer of a company's seat (statutory seat or place of effective management) did not qualify for the freedom of establishment guaranteed by the EC Treaty. *Daily Mail* involved a UK company whose seat was transferred to the Netherlands; the UK company law requirements at issue made it less attractive to leave the UK. According to the ECJ, the mere transfer of a company's seat was insufficient to apply the freedom of establishment principles. There was no harmonization in the field of company law at the time of the case. Consequently, the UK legislation could remain effective. The ECJ said:

> 23. It must therefore be held that the Treaty regards the differences in national legislation concerning the required connecting factor and the question whether – and if so how – the registered office or real head office of a company incorporated under national law may be transferred from one Member State to another as problems which are not resolved by the rules concerning the right of establishment but must be dealt with by future legislation or conventions.

The ECJ also ruled on a company law provision in *Überseering*, which concerned Germany's refusal to accept the legal capacity of a company incorporated under the laws of another Member State whose real seat was in Germany. This restriction on company law was considered incompatible with EC law because it resulted in a different treatment depending on the Member State of incorporation of a company. According to the ECJ, Germany must also accept the legal capacity of foreign/EU-incorporated companies whose place of effective management is in Germany.

From *Überseering*, it can be concluded that, in principle, the freedom of establishment can apply in a case involving the transfer of a company's seat. After all, a company that is incorporated under the laws of one Member State but has its place of effective management and control in another Member State has, in effect, transferred its seat abroad. The ECJ explained the difference between the facts in *Daily Mail* and *Überseering*:

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1. Case C-470/04, [2006] ECR (not yet published).
2. The Dutch tax adviser made his remark in a regional newspaper. However, an article on the ECJ's judgement in the Dutch Financial Times (*Het Financieele Dagblad*) of 8 September 2006 took the position – correctly in the authors' opinion – that only a small group of persons would benefit from the outcome in the *N* case.
3. Case 87/81, [1988] ECR-5483.
4. Case C-208/00, [2002] ECR I-9919.
5. Case C-436/00, [2002] ECR I-10829.
6. Case C-9/02, [2004] ECR I-2409.

> 62. It must be stressed that, unlike *Daily Mail and General Trust*, which concerned relations between a company and the Member State under whose laws it had been incorporated in a situation where the company wished to transfer its actual centre of administration to another Member State whilst retaining its legal personality in the State of incorporation, the present case concerns the recognition by one Member State of a company incorporated under the law of another Member State, such a company being denied all legal capacity in the host Member State where it takes the view that the company has moved its actual centre of administration to its territory, irrespective of whether in that regard the company actually intended to transfer its seat.

Consequently, since the obstruction was made by one Member State with respect to a company established under the laws of another Member State, the ECJ ruled in *Überseering* that an appeal could be made to the freedom of establishment principles. The ECJ also indicated that the transfer of seat does not have to be without tax consequences. According to the ECJ, the overriding requirements relating to the general interest, such as the protection of the tax authorities' interests, could justify a restriction on a fundamental freedom. In *Überseering*, however, Germany could not rely on these objectives because the denial of legal capacity to a company infringes on the essence of the freedom of establishment principles.[7]

One could therefore suggest that a difference between *Daily Mail* and *Überseering* is the direction of the cross-border transaction. In *Daily Mail*, the company was hindered from leaving its residence state and could not invoke an EC Treaty freedom to combat the national law establishing the hindrance. In contrast, *Überseering* concerned a hindrance to get access to the market of another Member State.

If this were the actual difference in the approach taken by the ECJ, it could have, as a theoretical consequence, that the Member States may levy an exit tax at the time an individual or company leaves his/its Member State of residence. An exit tax, after all, obstructs a person from leaving his own Member State rather than obstructing him from entering another Member State; thus, following the *Daily Mail* judgement, it does not seem possible to invoke an EC Treaty freedom. On the other hand, since the *Bosman* judgement,[8] it has been clear that the EC Treaty freedoms prohibit all restrictions on both leaving and entering another Member State.[9] Consequently, the ECJ's different approach in *Daily Mail* and *Überseering* should be attributed to another cause. In the authors' view, the ECJ decided that rejecting the infringement of EC law in *Daily Mail* followed from the lack of harmonization in the field of company law.

2.2. *X and Y*

In the cases discussed above, the ECJ could limit its judgement to company law and avoid giving its opinion on the compatibility with EC law of tax issues in general and exit taxes in particular. Since more questions arose, however, the ECJ was asked to explain the applicability of the EC Treaty principles pertaining to taxation which could have an influence on exit taxes in later cases. One of these cases was *X and Y*. This case did not specifically deal with exit taxes, but the ECJ's wording could be relevant to them.

In *X and Y*, the ECJ ruled on the compatibility with EC law of a Swedish law that differentiated between three situations. For one (domestic) situation ("type C"), the law deferred taxation, but it did not defer taxation for the other two situations that had cross-border elements ("types A and B").[10] According to the ECJ, this difference in the treatment of domestic and cross-border situations constituted an infringement of the freedom of establishment.

Regarding the argument that the Swedish law could be justified on the basis that it prevented abusive behaviour, the ECJ said:

> 43. The national provision at issue, insofar as it excludes categorically and generally any type A or type B share transfer from the benefit of deferral of tax, does not allow the national courts to make such a case-by-case analysis taking account of the particular features of each case.
>
> 44. Furthermore, the criterion on the basis of which the national provision excludes type A and type B share transfers from that tax advantage – namely the fact that the transfer is to a company established under the legislation of another Member State or a branch set up in Sweden by such a company – relates to the exercise of the freedom of establishment guaranteed by the Treaty and cannot, therefore, in itself, constitute an abuse of the right of establishment (see, to that effect, *inter alia, Centros*, cited above, paragraph 27).
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> 45. Accordingly, refusal by a Member State of a tax advantage in respect of any transfer at undervalue of shares to a company established under the law of another Member State or to a branch of that company established on its territory (as provided for by the national provision at issue here) cannot be justified on the ground of abuse of freedom of establishment.

As mentioned above, in *X and Y*, the ECJ ruled that legislation that obstructs EC law by generally excluding situations with cross-border elements from tax advantages cannot be justified under EC law. Although in *X and Y* the interest in the Swedish company was transferred to another Swedish company, the disadvantageous treatment resulted from the fact that the parent of the Swedish receiving company was a Belgian company. Consequently, even though the situation concerned a domestic restructuring, the restructuring was treated differently than a "real" domestic transfer because of the Member State of establishment of the ultimate parent company. This treatment was considered incompatible with EC law.

This judgement of the ECJ could also be relevant to exit taxes. Although in *X and Y* the main focus was on the domestic transfer to a company whose ultimate parent

7. *Überseering*, supra note 4, Paras. 92 and 93.
8. Case C-415/93, [1995] ECR I-4921.
9. See Gammie, M., "EU Taxation and the *Societas Europaea* – Harmless Creature or Trojan Horse?", 44 *European Taxation* 1 (2004), at 35, 43.
10. A difference could be established between a transfer to a foreign company ("type A") and a transfer to a domestic company held by a foreign company ("type B").

was established abroad, "type A" transfers (to a foreign company) were also considered to be incompatible with EC law. Since an exit tax is also levied only in the case of a transfer of seat abroad, not in the case of a domestic transfer of seat, domestic and cross-border situations are treated differently. The ECJ therefore held that the freedom of establishment principles are applicable in this respect. It was not yet clear, however, whether exit taxes infringe on these principles.

2.3. *Hughes de Lasteyrie du Saillant*

Fortunately, the decision in *Hughes de Lasteyrie du Saillant* would provide further clarification.[11] In that case, the ECJ decided that an exit tax could be incompatible with EC law. The ECJ ruled:

> 45. In this case, even if Article 167a of the CGI does not prevent a French taxpayer from exercising his right of establishment, this provision is nevertheless of such a kind as to restrict the exercise of that right, having at the very least a dissuasive effect on taxpayers wishing to establish themselves in another Member State.
>
> 46. A taxpayer wishing to transfer his tax residence outside French territory, in exercise of the right guaranteed to him by Article 52 of the Treaty, is subjected to disadvantageous treatment in comparison with a person who maintains his residence in France. That taxpayer becomes liable, simply by reason of such a transfer, to tax on income which has not yet been realised and which he therefore does not have, whereas, if he remained in France, increases in value would become taxable only when, and to the extent that, they were actually realised. That difference in treatment concerning the taxation of increases in value, which is capable of having considerable repercussions on the assets of a taxpayer wishing to transfer his tax residence outside France, is likely to discourage a taxpayer from carrying out such a transfer.

From these considerations of the ECJ, it can be concluded that exit taxes can constitute an infringement on the freedom of establishment that cannot be justified. The ECJ pointed out that a taxpayer who stays in France is taxed on the realization of increases in value, whereas a taxpayer who leaves France is subject to tax on unrealized income.[12] It is not clear, however, whether the ECJ intended to forbid exit taxes in general. In *Hughes de Lasteyrie du Saillant*, Advocate-General Jean Mischo found that the French measure was *likely* to obstruct the freedom of establishment. In its final decision, the ECJ concluded that the French provision *did* infringe on the EC Treaty freedom, but a substantial part of the decision was based on the restrictions resulting from the conditional tax deferral.[13] It is possible to receive a deferral of the exit tax due on the transfer of seat abroad, but the deferral is not granted automatically. A deferral is granted only if, for instance, a guarantee is given to ensure payment of the tax. The ECJ held that, insofar as applying these conditions to a tax deferral involves restrictions on the exercise of the freedom of establishment, the justification based on preventing tax avoidance or any other justification cannot be relied upon.[14]

Thus, if France issued proportionate implementing rules, an exit tax could be justified. The ECJ did not explicitly say whether the automatic grant of a tax deferral could qualify as proportionate implementing rules.

The ECJ also ruled that exit taxes can be levied if they combat tax fraud. In *Hughes de Lasteyrie du Saillant*, however, the French provision was "not specifically designed to exclude from a tax advantage purely artificial arrangements aimed at circumventing French tax law, but [was] aimed generally at any situation in which a taxpayer with substantial holdings in a company subject to corporation tax transfers his tax residence outside France for any reason whatever".[15] With this line of reasoning, the ECJ implicitly referred to the *X and Y* case.

In *X and Y*, the justification ground submitted by Sweden was that the national legislation was enacted to prevent abuse. The ECJ did not accept Sweden's justification ground in this situation because the Swedish provision generally deemed all transactions with cross-border elements to be abusive. If, however, the provision aimed to prevent abuse in specific situations, the provision could possibly justify an infringement of EC law.[16]

The ECJ therefore seems to be of the opinion that exit taxes in general are not incompatible with EC law. Such taxes may continue to be levied under specific circumstances or subject to proportionate implementing rules. The conditional deferral of an exit tax, however, does not seem to qualify as a proportionate measure.[17] These conditions thus have to be abolished.

3. The *N* Case

The ECJ was recently in the position to clarify the issue of the compatibility of exit taxes with EC law in the *N* case, also referred to as the *van Dijk* case. In *N*, the ECJ was asked to examine the compatibility of a tax that is levied only when a Dutch resident changes his place of residence. The case involved N, a Dutch resident individual who had substantial interests in several Dutch companies. He decided to move to the United Kingdom and, at the same time, the companies' places of effective management were transferred to the Netherlands Antilles. The ECJ ruled:

> 35. In this case, analogously with what the Court has already found in relation to a similar system (*de Lasteyrie du Saillant*, paragraph 46), a taxpayer wishing to transfer his residence outside Netherlands territory, in exercise of the rights guaranteed to him by Article 43 EC, was subjected at the time of the facts to

11. *Hughes de Lasteyrie du Saillant* concerned the exit tax levied under France's domestic legislation. The other EU Member States followed the case because their domestic legislation contained comparable provisions. See the note by M. Lehner on the *Hughes de Lasteyrie du Saillant* case in 14 *Juristen Zeitung* 728 (2004).
12. Case Notes: "Out with an exit charge: *Hughes de Lasteyrie du Saillant*", [2004] *British Tax Review*, No. 6, at 590.
13. See d'Onorio, E., "L'exit tax a l'epreuve de la jurisprudence de la Cour de Justice des Communautés Européennes", in *Fiscalité Européenne et Droit International des Affaires* (2004), No. 136. See also Fischer, P., "Mobilität und (Steuer-)Gerechtigkeit in Europa", *Finanz-Rundschau Ertragsteuerrecht* 633 (2004).
14. *Hughes de Lasteyrie du Saillant*, supra note 6, Paras. 55 to 57.
15. "Out with an exit charge: *Hughes de Lasteyrie du Saillant*", supra note 12, at 592.
16. See also Case C-196/04, *Cadbury Schweppes*, [2006] ECR (not yet published).
17. See Kotanidis, S., "French Exit Tax Incompatible with the Freedom of Establishment", 44 *European Taxation* 8 (2004), at 375.

> disadvantageous treatment in comparison with a person who maintained his residence in the Netherlands. That taxpayer became liable, simply by reason of such a transfer, to tax on income which had not yet been realised and which he therefore did not have, whereas, if he had remained in the Netherlands, increases in value would have become taxable only when, and to the extent that, they were actually realised. That difference in treatment was likely to discourage the person concerned from transferring his residence outside the Netherlands.
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> ...
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> 39. In those circumstances, the tax system at issue in the main proceedings is likely to hinder the exercise of the freedom of establishment.

Consequently, a taxable event based on the fact that a person changes his Member State of residence in principle makes it less attractive to move abroad. That fact triggers the tax; in contrast, a comparable intra-Member State change of residence is not taxed. However, the less favourable treatment of cross-border movements constitutes an incompatible infringement of EC law only if it cannot be justified, and the restrictions must be of such a nature as to achieve the aim of the provision in question and may not go beyond what is necessary for that purpose. In *N*, therefore, several Member States submitted justification grounds.

With respect to the justification based on the allocation of taxing rights according to the principle of territoriality, the ECJ ruled as follows:

> 46. Thus, gains realised on the disposal of assets are taxed, in accordance with Article 13(5) of the OECD Model Tax Convention on Income and on Capital, and in particular in accordance with its 2005 version, in the contracting State of which the person making the disposal is a resident. As the Advocate General has observed in paragraphs 96 and 97 of her Opinion, it is in accordance with that principle of fiscal territoriality, connected with a temporal component, namely residence within the territory during the period in which the taxable profit arises, that the national provisions in question provide for the charging of tax on increases in value recorded in the Netherlands, the amount of which has been determined at the time the taxpayer concerned emigrated and payment of which has been suspended until the actual disposal of the securities.
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> 47. It follows, first, that the measure at issue in the main proceedings pursues an objective in the public interest, and, secondly, that it is appropriate for ensuring the attainment of that objective.

In this respect, the ECJ's judgement seems to be inconsistent with *Hughes de Lasteyrie du Saillant*, in which the ECJ rejected the above-mentioned justification ground. Advocate-General Juliane Kokott was aware of this, and she specifically explained in her opinion why the situation in the *N* case differed from the situation that led to the case law cited. In her opinion, the analysis of the provisions concerning the tax on emigration appeared to be precluded by the judgement in *Hughes de Lasteyrie du Saillant*, in which the ECJ declined to find that maintaining the allocation of taxing rights could provide a justification. She referred to the French government which stated that the only purpose of the provisions then in dispute was to prevent tax evasion, and they were not 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 increases in value in question are acquired during the latter's stay on French territory". With respect to the Dutch system, she explained that, in contrast, the provisions were aimed not just at tax evasion, but also at enabling Dutch taxes to be levied in practice according to the allocation of taxing rights lawfully agreed between the Netherlands and the United Kingdom. If the tax was not assessed prior to emigration, the profit arising during the period of residence in the Netherlands would have to be calculated at a later date. Depending on the time of the disposal, this profit calculation might have to be made several years later and, as the German government submitted, this would cause significant practical difficulties.[18]

The justification grounds, however, can be accepted only if they are proportionate,[19] i.e. the measure may not go beyond what is necessary to attain its objective. According to the ECJ, most aspects of the Dutch "conservatory assessment" (i.e. an assessment made just prior to the transfer of seat which will be levied if capital gains are actually realized, but not after ten years) could be considered to be proportionate. On the other hand, the requirement to obtain a tax deferral and the fact that the reductions in value after the cross-border transfer were not taken into account did not meet the proportionality test. These aspects of the Dutch legislation therefore had to be changed.[20] Even before the ECJ's judgement in *N*, the Dutch legislation was amended to comply with EC law.[21] Another example of a disproportionate aspect of exit taxes given in Advocate-General Kokott's opinion in *N* was the failure to grant a step-up. This means that the new Member State of residence should take the fair market value of the shares in a company as their new book value. Consequently, at the time the person emigrates to another Member State, the Member State of residence could levy an exit only on the capital gains that accrued while the person was resident in that Member State. The ECJ did not mention the "step-up" argument because it was not necessary to decide the case.[22]

Both *Hughes de Lasteyrie du Saillant* and *N* concerned natural persons. But since the EC Treaty provides that the freedom of establishment applies equally to legal

18. Advocate-General's opinion in *N*, Paras. 100 and 101.
19. See Malmer, K., "Emigration taxes and EC law", pertaining to Subject II: The tax treatment of transfer of residence by individuals, in *Cahiers de droit fiscal international*, Vol. LXXXVIIb (2002), at 79, 87 (56th Congress of the International Fiscal Association, Oslo, 2002).
20. See e.g. Douma, S., "The Three Ds of Direct Tax Jurisdiction: Disparity, Discrimination and Double Taxation", 46 *European Taxation* 11 (2006), at 522, 530.
21. Before the ECJ's judgement in *N*, Austria and Switzerland amended their tax treaty to take account of Austria's exit tax legislation providing for the deferred taxation of capital gains. See Hasenauer, C. and J. Prinz, "Austria: Austria starts year with new double tax treaties", *International Tax Review*, March 2006, online at www.internationaltaxreview.com.
22. Advocate-General Kokott made the following observation in her opinion (Para. 107): "Moreover, the approach of the Netherlands tax system is coherent in that in the case of immigrating taxpayers taxation of profits on the disposal of substantial shareholdings is based on the value of the shareholding at the time of immigration ('step-up'). This method is consistent with the principle of territoriality because it takes account only of the profit which has arisen during the period of residence within the territory."

persons, the arguments mentioned above can also be made with respect to exit taxes on companies.[23]

4. Exit Taxes from an International Tax Law Perspective

As discussed above, exit taxes can be compatible with EC law if the provisions and requirements for them in the national legislation of the EU Member States are considered proportionate.[24] Exit taxes could, however, be incompatible with international tax law.

The OECD Model allocates the taxing rights between the signatory states. Regarding capital gains, the taxing rights are allocated by Art. 13. For some specifically mentioned capital gains, the taxing rights are attributed to the contracting state in which the alienator is established or the contracting state in which the underlying property is situated.

Art. 13 does not specifically refer to the taxing rights with respect to capital gains on shares. Consequently, those capital gains fall under the catch-all provision in Art. 13(5). According to Art. 13(5), capital gains on shares are taxable only in the contracting state of which the alienator is a resident. This situation is also acknowledged in Para. 30 of the Commentary on Art. 13 of the OECD Model.[25]

The OECD Model also does not contain a specific provision on exit taxes, whether on individuals or companies.[26] Exit taxes are levied based on the (unilateral) domestic legislation of several countries. By a legal fiction, the cross-border transfer of a shareholding (accompanying an individual) or company is qualified as an alienation; thus, the accrued capital gains thereon are taxed in the residence country of the shareholder or company just before the transfer, even though no actual alienation has occurred. As stated above, countries that levy exit taxes base their taxing rights on their domestic legislation; thus, international tax law in principle does not prohibit exit taxes. But there could be situations in which the levy of a tax on capital gains by a legislative fiction in one country infringes on a bilateral tax treaty.

In this respect, the Netherlands Supreme Court and several lower courts in the Netherlands have ruled that the tax on a fictitious alienation in specific circumstances can be incompatible with treaty law.[27] If a taxable event was allocated for tax purposes to one state, the other state cannot by a later legal fiction attribute taxing rights to itself regarding a purchase or alienation that did not actually occur. In this situation, the first-mentioned state could not know that the Netherlands would also levy an additional tax just before the taxpayer left the Netherlands (because the Netherlands enacted that provision after the treaty negotiations had ended).[28]

Thus, an exit tax could violate not only the tax treaty as agreed upon, but also the principles and methods of interpretation in the Vienna Convention on the Law of Treaties. Art. 31 of the Vienna Convention provides that a treaty should be interpreted in good faith.[29] Therefore, if one contracting state is granted taxing rights under a bilateral treaty, the treaty provisions should not be eroded or eluded by the taxing rights provided in the domestic legislation of the other contracting state. This means that, although exit taxes seem to be compatible with EC law, they can infringe on international tax treaties and international law in general.

5. Some Remaining Issues

The ECJ has not yet decided the issue of exit taxes. The *N* case against the Netherlands is not principally an exit tax case, although it has a great impact on the discussion on exit taxes. Regarding the compatibility of exit taxes with EC law, two cases are extremely important – *Daily Mail*, discussed above (and also extensively in the relevant literature), and *Bosman*. In addition, the European Commission recently announced some initiatives to regulate exit taxes in such a way that they do not restrict companies which move to another Member State.[30] One final remark on *Daily Mail*: it cannot be concluded from Para. 23 of the ECJ's judgement that an exit tax is prohibited because, as the ECJ decided in 1988, new legislation (harmonization) is necessary to resolve this issue.

Bosman also included an argument that would prohibit the Member States from levying an exit tax. *Bosman* dealt with soccer. Jean-Marc Bosman was a professional soccer player, although he was not extraordinarily gifted. One day he was placed on the transfer list of his Belgian

23. A possible difference between exit taxes on individuals and on companies was observed in "Out with an exit charge: *Hughes de Lasteyrie du Saillant*", supra note 12, at 594.
24. In its reasoning in *N* on the proportionality of exit taxes, the ECJ also referred to the OECD Model Tax Convention (Para. 46, quoted in 3.). See also the summary of the *N* case in 46 *European Taxation* 11 (2006), at EC-42.
25. Para. 30 of the Commentary on Art. 13 provides: "The Article does not contain special rules for gains from the alienation of shares in a company (other than shares of a company dealt with in paragraph 4 [real estate companies]) or of securities, bonds, debentures and the like. Such gains are, therefore, taxable only in the State of which the alienator is a resident."
26. It should be noted, however, that Art. 13(5) of the UN Model Convention provides that capital gains on shares can be taxed in the state in which the company is resident. Referring to that provision, several OECD Member countries have reserved the right to insert a provision comparable to Art. 13(5) of the UN Model. See Daiber, C. and R. Offermanns, "German Exit Tax Provisions, Substantial Shareholdings and Incompatibility with EC Law", 45 *European Taxation* 12 (2005), at 579.
27. See e.g. Netherlands Supreme Court, 5 September 2003, No. 37,651. The Court considered it important whether, by a legal fiction, the taxing rights were transferred from one country to the other. If this happened without the other treaty partner's knowledge, the legal fiction would be considered incompatible with international tax law. See also Tax Court of Den Bosch, 15 September 2005, *V-N* 2005/47.11.
28. If, however, a bilateral tax treaty was concluded *after* the enactment of a taxable event based on a fictitious transfer, the position could be taken that the exit tax could remain effective because the other contracting state could know of the other state's domestic legislation. Consequently, the compatibility of the exit tax depends on when the tax treaty in question was concluded. See e.g. Wattel, P.J. and O. Marres, "Characterization of Fictitious Income under OECD-Patterned Tax Treaties", 43 *European Taxation* 3 (2003), at 66.
29. On the interpretation of the "good faith" principle in a European context, see Pijl, H., "The OECD Commentary as a Source of International Law and the Role of the Judiciary", 46 *European Taxation* 5 (2006), at 216, in which the author disputes the interpretation of the "good faith" principle in Engelen, F., *Interpretation of Tax Treaties under International Law: A study of Articles 31, 32 and 33 of the Vienna Convention on the Law of Treaties and their application to tax treaties* (Amsterdam: IBFD Publications, 2004).
30. See Commission Communication (COM/2006/825) on exit taxation and the need for co-ordination of Member States' tax policies.

club because he refused to sign a new contract. When he wanted to leave his Belgian club to play in France, he was informed that, before he could go, his (new) French employer would have to pay a lump sum to his Belgium club. This was based on a rule of the Belgian soccer association elaborating on the UEFA rules. The French employer refused to pay the lump sum because Bosman was not good enough on the field. Bosman took his case to the ECJ, which decided that the lump sum restricted Bosman's right to leave Belgium and work in France. The ECJ found an infringement of Art. 39 of the EC Treaty (2007 text).

On the other hand, it has been concluded from *Werner*[31] that, because an exit tax is levied on resident taxpayers, the situation does not involve EC law. In the opinion of some commentators, the Member States are in principle allowed to discriminate against their own residents.[32] The authors disagree with this interpretation. From *Werner*, it can be inferred only that the ECJ is competent only if taxpayers qualify under the substantive scope of the EC Treaty. The ECJ is simply not competent in purely domestic situations.

From *Bosman*, it can be deduced that an exit tax could infringe on the four EC Treaty freedoms. If the basics of the case are examined, however, the only point that counts is that the Member States may not impose restrictions on persons who want to exercise their right to work in another Member State. What does this mean for exit taxes? In principle, a rule that restricts a person (company or individual) from moving to another Member State by levying a tax at the time of emigration seems to constitute a restriction. Art. 43 of the EC Treaty can in principle help companies to resist the consequences of exit taxes.[33]

Does this mean that exit taxes may not be levied at all, as some commentators have written in the past few years?[34] The authors do not think so. We first go back to the principles of taxation.

5.1. Exit taxes and the principles of taxation

One major principle of taxation is that a country may tax all income that has its origin in that country. In this respect, a distinction should be made between a company incorporated and resident in Member State A ("type 1" company) and a company resident in Member State A that was incorporated under the laws of Member State B ("type 2" company).[35]

For a "type 1" company, the income generated in the Member State of residence is taxed from the time of the company's incorporation. Since the company did not emigrate, all increases in value of its assets and capital gains can be attributed to the total period of the company's existence.

The situation is different for a "type 2" company, which was incorporated under the laws of one Member State, but transferred its residence abroad. If the transfer takes place after a few years of residence in the Member State of incorporation, goodwill and capital gains could have arisen. When the company's residence is subsequently transferred to another Member State and the gains are realized, not all the gains can be attributed to the period of the company's residence in its new Member State. Consequently, in order not to tax the company on the gains attributable to its prior residence in another Member State, several countries (e.g. the Netherlands) provide for a step-up in their domestic legislation. In order to calculate the tax due on the gains arising during the period of residence, the company should prepare a new balance sheet based on the fair market value of all its assets. If the company emigrates again or realizes gains or reserves, only the increase in value during the period of residence is taxed. If a step-up is not granted, the historically generated capital gains and goodwill would also be taken into account for tax purposes. Consequently, the tax base includes the gains and goodwill during the period of non-residence.[36] It is questionable whether this is compatible with EC law if the tax in the Member State in which the increase in value was generated is not taken into account.

The difficulty with this system is that successful companies also derive unrealized income – partly because goodwill and other intangible assets are created and partly due to potential capital gains on assets. The unrealized income arises because the depreciation rules of many tax systems allow depreciation for tax purposes which differs from the actual loss of economic value. In most situations, these potential capital gains are unrealized when the company emigrates to another Member State. If the Member State of departure levies an exit tax, the following problems can arise:[37]

(1) the potential capital gains at the time of taxation are not fixed. In principle, the gains can still decrease, which means that the Member State of departure

31. Case C-112/91, [1993] ECR I-429.
32. Most recently, this point was mentioned in De Broe, L., General Report on Subject II: The tax treatment of transfer of residence by individuals, in *Cahiers de droit fiscal international*, supra note 19, at 73 (footnote 75): "It has been inferred from the *Werner* decision that a Member State may discriminate against its own nationals."
33. According to T. Franz, however, Germany's exit tax legislation pertaining to companies complies with EC law because Germany treats the exit of the company as a liquidation – as the "*natürlichem Ende*" of the company; Franz, T., "Berührt '*Hughes de Lasteyrie du Saillant*' die durch den Wegzug veranlasste Besteuerung von Kapitalgesellschaften in Deutschland?", *EuZW* 2004, at 272.
34. See e.g. the annotation to *Hughes de Lasteyrie du Saillant* by G.T.K. Meussen, *BNB* 2004/258, point 4. A more modest position was taken in Weber, D., "Vpb 2007. Opruimen van EG-rechtelijke knelpunten", *WFR* 2004/1251 (under the reference to the taxation possibilities in the Merger Directive).
35. The possible different consequences for the compatibility of exit taxes with EC law based on the applicable seat theory were also acknowledged in Weber, D., "Exit Taxes on the Transfer of Seat and the Applicability of the Freedom of Establishment after *Überseering*", 43 *European Taxation* 10 (2003), at 350, 352.
36. This situation can occur in the United Kingdom because the UK does not seem to grant a step-up for capital gains that can be attributed to the period before UK residence. A problem can arise in the United States because, although the US in principle does not levy an exit tax, the exit tax paid before migration to the US cannot be deducted for US income tax purposes. See Armstrong, C., "Management of investment asset basis for arriving and departing aliens – time to re-examine the assumption that the U.S. is the 'high tax' jurisdiction?" (2003), online at www.rmstrnglaw.com.
37. For individuals, see De Broe, supra note 32, at 77.

taxes more gains than were actually realized later (tax base disadvantage);
(2) taxation takes place at the time of emigration, not at the time the capital gains are actually realized (cash flow disadvantage); and
(3) because no harmonization has taken place within the European Union, an exit tax does not automatically mean that the Member State of immigration grants a step-up in order to prevent double taxation (double taxation disadvantage).

5.1.1. Tax base disadvantage

This disadvantage illustrates that the result of exit tax is that one Member State may potentially tax more than it is allowed to tax based on the capital gains actually realized. Under EC law, a Member State is allowed to ensure that it gets the tax revenues to which it is entitled. But if one of its residents emigrates again, the Member State's right to tax is limited because the capital gains it wants to tax should be precisely determined, also taking into account the capital gains attributable to the period of non-residence. For example, if a company moves from State A to State B and, a few years later, to State C, State B is entitled to tax only the capital gains derived in State B and may not take into account the profits accrued in State A. If the tax base was not precisely determined, the Member State potentially taxes more than it was entitled to tax. This could lead to an unacceptable restriction. As stated in *N*, the only solution is to levy tax at the time the capital gains are actually realized even if, at that time, the company has been a non-resident of the Member State for many years. As long as the company stays within the European Union, the Member States can follow the company based on several Directives on exchange of information[38] and the Directive on assistance in recovery of claims,[39] which has been extended to tax claims. Therefore, the risk of loss of tax revenues in the Member State in which the unrealized capital gains arose is very limited.[40]

5.1.2. Cash flow disadvantage

There is no tax base disadvantage if the tax base was determined precisely because, for one reason or another, the potential capital gains are fixed. In this situation, however, one problem still needs to be resolved. The capital gains are taxed at the time the company emigrates to another Member State, but the gains are potentially realized only a long time after emigration.[41] As decided in *Océ van der Grinten*, a cash flow disadvantage in itself constitutes an infringement. This was confirmed by the ECJ in its decision in *N*.

5.1.3. Double taxation disadvantage

The ECJ has essentially settled the first two issues, but the third is still unresolved and a major problem in practice.[42] In many countries, exit taxes are the result of a system based on the principle that the country has a right to tax all profits and increases in value of resident companies and of shareholdings held by individuals. For example, the Netherlands has the "total profits" system, which means that the Netherlands levies tax on the difference between the company's net equity at the time it ceases to exist and the equity at the time it was formed. In order to avoid having to wait for decades or even centuries before levying tax, a system has been established which determines the actual profits each year. Based on these principles (sound business practice), the total profits are divided into pieces and allocated to a certain year. These pieces differ from the actual relative part of the total profits per year because sound business practice makes it possible to delay the time of taxation if required from a sensible business perspective. It should be noted that sound business practice only influences the annual profits, and any delay in taxation is only a temporary measure. In the end, the total profits are taxed.

From a systematic approach, this system is ideal. If a company moves to the Netherlands, its net equity is valued based not only on the actual assets and liabilities on the balance sheet but also on items not yet on the balance sheet such as intangible assets, e.g. goodwill.

What this means in practice can be illustrated by the example of a company that moved to the Netherlands and left the Netherlands three years later. The calculations in the example are based on the Netherlands Corporate Income Tax Act 2007; thus, goodwill is depreciated in ten annual parts. When the company moved to the Netherlands, its goodwill was valued at EUR 1 million. Three years later, when the company left the Netherlands, its goodwill was valued at EUR 2.5 million. At that time, in addition to a tax on the annual profits, an exit tax was levied on EUR 1.8 million, i.e. EUR 2.5 million minus EUR 1 million plus EUR 300,000.[43]

In other countries, the tax system's approach is less systematic.[44] For example, in the United Kingdom, a company that moves to the UK does not get a step-up for its goodwill or unrealized capital gains on the tax balance sheet. This does not hurt the company if these intangible assets are not taxed at all. In practice, however, if a company leaves the UK, the estimated capital gains (on the goodwill) are taxed without taking into account any

38. Directives 76/308, 2001/44 and 2002/94.
39. Directive 2001/44/EC of 15 June 2001.
40. The most important risk is probably the risk that the company will go bankrupt.
41. This possible non-compliance with EC law was also mentioned in Kotanidis, supra note 17, at 381; the author, however, did not take a position on whether the taxing rights with respect to a latent gain, and thus before actual realization, should be allocated to the Member State of origin or the Member State of the alienator. She addressed the issue whether taxing a latent capital gain could be incompatible with tax treaties and whether taxing a capital gain qualifies as taxing a realized gain.
42. See the Advocate-General's opinion in *N*.
43. Based on Art. 3.30 of the Individual Income Tax Act in connection with Art. 8 of the Corporate Income Tax Act 2007, goodwill can be depreciated, but in at least ten annual parts. In the example, the company was in the Netherlands for three years; thus, only three parts can be deducted from the tax base. From the original goodwill of EUR 1 million, EUR 700,000 remained after three years. Since the goodwill at the time of emigration was valued at EUR 2.5 million (disregarding the discussion in 5.1.1. and 5.1.2.), the exit tax is levied on EUR 1.8 million.
44. In the example, the UK would tax EUR 2.5 million of which EUR 1.5 million is based on the principle of territoriality.

step-up for the gains that were realized before the company moved to the UK. Thus, if a company moves from the Netherlands to the UK and later moves back to the Netherlands, double taxation can arise. In first instance, an exit tax is levied in the Netherlands on the capital gains arising while the company was in the Netherlands; later, an exit tax is levied in the UK on all capital gains, including those that arose in the non-UK period.[45]

5.2. Real seat and statutory seat

Could it be of relevance whether the compatibility with EC law of the exit tax levied by a Member State depends on the applicable theory of seat?[46] In international tax law, two seat theories can be distinguished:

- the real seat theory or *siège réel*; and
- the statutory seat theory or *siège statutaire*.

The Member States that adhere to the first theory levy tax on all companies having their effective place of management in that Member State. For tax purposes, it is of no importance whether the company's statutory seat is also in that Member State. According to the seat theory, the Member States applying the theory thus levy tax only on income arising during the period of residence. However, since capital gains are in principle taxed only at the time the underlying property is transferred, it follows from the real seat theory that capital gains arising during the period of residence can be taxed upon emigration. The capital gains can be attributed to the period during which the company was resident in the Member State. Thus, due to the direct link between the unrealized capital gains and the fact that tax is levied only during the period of residence, an exit tax can be acceptable from an international tax perspective.[47]

The Member States could also adhere to the statutory seat theory. Under that theory, a Member State taxes a company because it was initially incorporated under the laws of that Member State, irrespective of the company's current place of effective management. Therefore, even after the real seat is transferred abroad, the Member State of incorporation levies tax on the company's income. In principle, exit taxes do not fit in the tax system of these Member States because, for tax purposes, the company does not cease to exist in the Member State of incorporation if its place of effective management is transferred. Consequently, if due to a fictitious alienation, capital gains are taxed at the time the effective management is transferred, the exit tax should in principle be declared incompatible with EC law and international tax law because the company remains subject to tax in its Member State of incorporation. Some commentators are of the opinion that, since the UK applied the statutory seat theory at the time of *Daily Mail*, the ECJ should have taken into account these principles of international tax law.

A possible explanation for an exit tax levied by a Member State applying the statutory seat theory can also be found in international tax law. A company incorporated under the laws of a Member State applying the statutory seat theory could transfer its place of effective management to a Member State applying the real seat theory. In that case, the dual resident company could in principle be taxed in both Member States, depending on their domestic legislation. In many situations, the problem of double taxation is solved by a bilateral tax treaty. In those situations, a tie-breaker rule in the treaty could determine which Member State is competent to tax the company's income. If, under the treaty, in the case of a dual resident company, the Member State in which the company's effective management is located can levy tax, the Member State of incorporation is no longer competent. In these situations, the latter Member State would presumably want to tax the capital gains that accrued before that Member State lost its right to tax the company. Under current treaty law, this is possible if, for instance, a UK company transfers its place of effective management to the Netherlands – which is exactly what happened in *Daily Mail*. The authors think that this is outdated. They are of the opinion that, in the EU context, differences in the legal theory of seat will and should be overruled by one theory with respect to the transfer of a company's seat. This has as a consequence that a company emigrating from a Member State adhering to the statutory seat theory will also be subject to an exit tax. Unity in legal principles is, in the authors' opinion, key to the single European market.[48]

But even though there has been no harmonization in this field, it remains questionable whether an exit tax could be justified based on the choice of the applicable seat theory. In several cases, the ECJ found that a treaty is the result of negotiations between the contracting parties and ruled that individuals may not appeal to a single treaty provision without taking into account the treaty as a whole. If this line of reasoning is also followed by the contracting parties themselves, e.g. based on the principle of equality (that both parties will be treated equally under the bilateral treaty without one party being treated more favourably than the other) in international tax law, the outcome would be that the Member States applying the statutory seat theory could not infringe on the structure of their domestic tax legislation by levying an exit tax because they could lose their taxing rights under the tie-breaker rule in the treaty. This should also be considered the result of the treaty negotiations and should not lead to an infringement of the tax system of (e.g.) the UK by the introduction of an additional taxable event upon emigration. This time, the argument could be used to the taxpayer's advantage.

45. The European Commission called the situation in which double taxation can occur as being incompatible with EC law. See Commission Communication (COM/2006/825), supra note 30, and the accompanying press release (IP/06/1829).
46. According to Craig, P. and G. De Búrca, *EU Law* (Oxford, 2003), at 793 et seq., both the real seat and the statutory seat should be established in the EU in order to benefit from the freedom of establishment provisions, but the authors did not indicate which seat theory should prevail.
47. Weber, supra note 35, at 350.
48. Compare the old discussion on the implementation of EC law in the Member States with a monistic system (e.g. the Netherlands) or a dualistic system (e.g. Italy). See Case 26/62, *van Gend en Loos*, [1963] ECR-3.

6. Concluding Remarks

As a concluding remark on the compatibility of exit taxes with EC law, it is not yet entirely clear that exit taxes are in themselves incompatible with EC law. In principle, the authors' position is that capital gains could be taxed when a company leaves its Member State of residence, provided the Member State also taxes capital gains in a domestic situation. In a domestic situation, the taxable event occurs when the capital gains are realized, and the same should apply in a cross-border situation, i.e. the Member States should not treat cross-border transfers of seat less favourable than intra-Member State transfers of seat. Consequently, taxation after a cross-border transfer should be deferred until the capital gains are realized. If, at this time, the realized capital gains are less than at the time of emigration, the lesser amount should be taken into account. The Member State of the new seat should provide for a step-up with respect to the capital gains.

The position could also be taken that, based on *Hughes de Lasteyrie du Saillant*, exit taxes can no longer be levied because they make it less attractive to establish a company in another EU Member State. From the same judgement, however, it can be concluded that an exit tax can be considered compatible with EC law if the tax is proportionate. This means that, if the tax is deferred until the capital gains are realized and the deferral is granted automatically and unconditionally, an exit tax may possibly still be levied. In addition, the exit tax should be levied only on capital gains accruing during the period of residence.

In the end, however, harmonization seems to be the best solution to finish the discussions on exit taxes. If, in the EU context, the exit tax is deferred until the time of realization, no double taxation should occur. In addition, the Directives on exchange of information and the Directive on mutual assistance in recovery of claims are helpful in granting each Member State the tax revenues to which it is entitled and in avoiding double taxation within the EU. As mentioned above, the European Commission has started discussing the harmonization of exit taxes in the Member States. Hopefully, that will end the discussion on the compatibility of exit taxes with EC law..

