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Recent ECJ Judgment Regarding Portuguese Exit Tax Provisions

The European Court of Justice has ruled that Portuguese exit tax provisions infringe the freedom of establishment. This article presents details surrounding the case and considers its ramifications.

1. Introduction

Recently, the Court of Justice of the European Union (ECJ or the Court) has taken one important step as far as exit taxation of unrealized gains of companies is concerned.[1] The decision in *Commission v. Portugal* (Case C-38/10) is the most recent judgment, following the doctrine of the Court in previous case law concerning this subject,[2] and this is the first case to be decided in a series of infringement procedures against several Member States.[3]

In a nutshell, the decision in *Commission v. Portugal* declares that the Portuguese tax law applicable in the case of a transfer, by a Portuguese company, of its registered office and its effective management to another Member State or in the case of a transfer, by a company not resident in Portugal, of some or all of the assets attached to a Portuguese permanent establishment from Portugal to another Member State, and which prescribes the immediate taxation of unrealized capital gains relating to the assets concerned but not of unrealized capital gains resulting from purely national operations, infringes the freedom of establishment.[4]

2. The Infraction and the Decision of the Court Regarding Portuguese Legal Provisions

Article 83 (previous articles 76-A and 76-B) of the Portuguese Corporate Income Tax Code provides that in determining the taxable profit for the accounting period where an entity ceases its activity in Portugal, it must include in taxable profit the positive or negative differences between the market value and book value of the assets relevant for tax purposes at the date of termination. From this provision it may be inferred *a contrario* that if a resident company moves its head office and place of effective management within Portuguese borders, it will not be subject to tax on unrealized gains.

As drafted, the Portuguese exit tax regime is very similar to the Portuguese regime on the liquidation of resident companies.[5]

The ECJ has rightly decided that the Portuguese exit tax regime was incompatible with EU law because of its restrictive effects on the freedom of establishment of companies to which this regime would be applicable (residents and non-residents with a permanent establishment located in Portugal). The Court found that the basic question to be answered was whether it was proportional for the exit Member State to immediately tax companies because they move to another Member State based on a mere legal fiction, assuming that an unrealized gain (for tax purposes) had in fact occurred.

The first cases on this matter decided by the Court arose in relation to natural persons,[6] and were subsequently followed by the *National Grid Indus* case (C-371/10) in relation to companies.

This second corporate exit tax case may have a variety of different legal consequences for the development of EU law and in the balance with Member States' sovereignty, namely as regards the criteria chosen by Member States to determine what is and is not subject to tax.

Contrary to what the ECJ did in the *N.* case (C-470/04), in *Commission v. Portugal* the ECJ seems to adopt a per country approach,[7] i.e.in the Court's view the balancing of the taxing rights and the freedom of establishment is to be accomplished simply by analysing the home state's

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1. *See* PT: ECJ, 6 Sept. 2012, Case C-38/10, *European Commission v. Portuguese Republic*, ECJ Case Law IBFD.
2. *See* NL: ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, ECJ Case Law IBFD; HU: ECJ, 16 Dec. 2008, Case C-210/06, *Cartesio Oktató és Szolgáltató bt*, ECJ Case Law IBFD; NL: ECJ, 7 Sep. 2006, Case C-470/04, *N. v. Inspecteur van de Belastingdienst Oost/kantoor Almelo*, ECJ Case Law IBFD; FR: ECJ, 11 Mar. 2004, Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, ECJ Case Law IBFD; UK: ECJ, 27 Sep. 1988, Case 81/87, *The Queen v. H. M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc.*, ECJ Case Law IBFD.
3. The Commission has already initiated infringement procedures against Spain (C-64/11), Denmark (C-261/11) and the Netherlands (C-301/11). The United Kingdom and Ireland have been referred to the Court for the same subject (IP/12/1147, IP/11/78), Germany has also been referred for a similar topic, i.e. hidden reserves (IP/12/1019). Sweden, Belgium, France and Italy procedures were closed because the law has been changed.
4. *See Commission v. Portugal* (C-38/10), para. 26; *National Grid Indus* (C-371/10), para. 36.
5. B. Terra and P. Wattel, *European Tax Law* (6th eds., Wolters Kluwer Law & Business, 2012), at 968.
6. *See N.* (C-470/04) and *Lasteyrie du Saillant* (C-9/02).
7. *See* Katia Cejie, *Emigration Taxes – Several Questions, Few Answers: From Lasteyrie to National Grid Indus and Beyond*, 40 Intertax 6/7 (2012), at 394; Dennis Weber, *In Search of a (new) Equilibrium between Tax Sovereignty* (Kluwer – Deventer, 2006)

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tax regime and not by taking into consideration the host state's tax regime.

As stated, the core aspect of this regime is the proportional exercise of taxing rights by the exit Member State. The authors found it odd that there was no discussion of possible justifications for the restriction on the freedom of establishment identified by the ECJ. After omitting an analysis of possible justifications, the Court went on to mention that a deferral of the payment together with interest payment would constitute a less restrictive measure. In this regard, the authors tend to agree more with Advocate-General Mengozzi's opinion when he reasons that the deferral of the payment is not necessarily a less restrictive measure,[8] i.e. it is necessary to take into consideration the nature and extent of the asset portfolio, the administrative burden of tracking the assets, the payment of interest or the necessity to constitute a bank guarantee.

Regrettably, for procedural reasons the Court did not address the compatibility with EU law of the Portuguese tax regime on shareholders of the migrating company.

3. The Response

In one of the earlier versions of the proposal of the Portuguese State Budget for 2013 presented by the government, new wording for the exit tax regime was already included. In this earlier version, that was not ultimately adopted, it was maintained that the migrating company should include in its taxable profit the positive or negative differences between the market value and book value of the assets relevant for tax purposes at the date of migration. However, in the case of migration of a company resident in Portugal to another Member State of the EEA, the migrating company could opt to be taxed immediately; to be taxed only when there is a realization triggering event (e.g. a sale) or to pay the tax due in ten annual instalments. Under the latter two options, interest would be due and was dependent on the issuance of a guarantee to the tax authorities. Furthermore, the company would be required to complete a specific form indicating the title to the assets and submitting this form annually to the tax authorities. Finally, it was anticipated that postponement or payment in instalments would immediately cease to apply in the case of a second migration of the company to outside the EEA.

For unknown reasons, this wording was not adopted in the final Proposal for the State Budget for 2013 presented by the government to the parliament. Instead, it was replaced with an authorization granted by the parliament to the government to change the exit tax regime at a later stage during 2013.[9] After analysing the terms under which the authorization was granted,[10] the authors believe that the final wording will not deviate much from the wording of the first draft described above.

Arguably, the changes anticipated to the Portuguese regime will render it compatible with the fundamental freedoms as interpreted by the ECJ. At least the option to be taxed only upon the sale of the asset (or other realization triggering event) represents a more suitable step towards rendering the exit tax regime more compatible with the principle under the Portuguese Constitution, as companies are fundamentally taxed according to their real profit. However, under this option, the taxable profit will still be measured by the positive or negative differences between the market value and book value of the assets at the date of migration, and not the positive or negative difference between the realization value and the book value.

In any case, it remains to be evaluated whether the requirement to postpone the exit tax to the realization triggering event (i.e. the presentation of a guarantee to the tax authorities, the payment of interest and the formal requirement to submit annually a form to the Portuguese tax authorities) will be considered excessively cumbersome and disproportionate.

4. Difficult Cases

In the authors' opinion, the path that is being followed by the Portuguese legislature in order to render the law compatible with EU law may continue to create unjust situations. For instance, for how long is it reasonable for a corporation to continue filing the annual form declaring the current status of its assets? Moreover, the migrating company – facing the option between immediate payment on the one hand, and deferral or payment in 10 annual instalments on the other hand, where, in the two latter cases, it will have to pay interest and provide some sort of guarantee – will most certainly opt for immediate payment. This means that, in practice, the new regime will be equivalent to the existing regime that was rendered incompatible with EU law by the ECJ.

Finally, the exit tax may create situations of unrelieved international juridical double taxation where an unrealized gain is recorded upon exit and also upon realization that may be taxed in the host state. Also, in the cases where upon exit an unrealized gain is recorded, while when the realization event takes place a loss is recorded, ultimately, the company will pay tax on unrealized profits which, under the actual framework of the tax systems, should be avoided.

5. Conclusion

In the authors' opinion the fundamentals of exit tax regimes remain unclear. Ultimately, it seems that the justification for taxing a migrating company is that the exit state will not be able to tax that company in the future. However, this is not a sound basis of taxation. Therefore, these regimes should be avoided because they merely create restrictions on the freedom of establishment within EU borders, except

8. *See* Opinion of AG Mengozzi, Case C-38/10, para. 117.
9. An initial question that immediately arises concerns what regime will be applicable for companies that migrate during the period between the ECJ judgment and the entry into force of the new regime, as the Portuguese Constitution forbids laws with retroactive effect.
10. Under Portuguese law, the terms of the authorizations granted by the parliament to the government to legislate in tax matters must be given with a certain degree of detail.

for cases where the migration takes place exclusively for tax reasons, i.e. to avoid a tax that would be due (or would be due at a higher rate) if the company did not migrate.

In this light, it seems that the regime recently introduced in France (for individuals) is following the right path. Under the French regime, the exit tax will not apply if the individual does not sell the asset within eight years after migrating.[11] In the authors' understanding, a similar path should be followed by the Portuguese legislature, i.e. drafting the regime as an anti-avoidance rule which, in addition to the need for proportionality requirements, would apply only in the case of perceived abuse. Moreover, the taxation of shareholders should in any case be avoided because it is difficult to assess the income obtained by the shareholders as a result of the migration of the company. Such taxation may cause some troublesome results in the case of foreign shareholders (e.g. if the shareholders' income is considered investment income that is subject to withholding tax it is difficult to assess who will be responsible for the withholding).

11. *See* Bruno Gouthière, *New Exit Tax for Individuals*, 52 Eur. Taxn. 1 (2012), Journals IBFD.

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