tax notes international
Volume 67, Number 13 ■ September 24, 2012

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Reprinted from *Tax Notes Int'l*, September 24, 2012, p. 1173

HIGHLIGHTS

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The European Court of Justice on September 6 delivered its decision in *Commission v. Portugal* (C-38/10), holding that Portugal's exit tax violates the freedom of establishment. (For the ECJ judgment, see *Doc 2012-18664* or *2012 WTD 174-13*.)

This was the first judgment in four infringement proceedings related to so-called exit taxes — that is, the immediate taxation of unrealized gains on a transfer of assets out of the national tax jurisdiction. Infringement procedures against Spain (C-64/11), Denmark (C-261/11), and the Netherlands (C-301/11) are still pending. (For prior coverage, see *Tax Notes Int'l*, Jan. 2, 2012, p. 7, *Doc 2011-26317*, or *2011 WTD 244-2*; for the European Commission application in C-64/11, see *Doc 2011-6379* or *2011 WTD 59-22*; for the application in C-216/11, see *Doc 2011-16615* or *2011 WTD 147-29*; for the application in C-301/11, see *Doc 2011-17374* or *2011 WTD 156-15*.)

Portuguese exit tax rules apply in the following three cases:

- a Portuguese resident company transfers its corporate seat and its effective place of management to another jurisdiction (redomiciliation);
- a nonresident company transfers (legally or substantially) assets allocated to a Portuguese permanent establishment to another jurisdiction (transfer of PE assets); and
- a nonresident company ceases the business activities carried out through a PE in Portugal (cessation of PE activities).

The redomiciliation of a Portuguese company triggers immediate taxation of both the company and its shareholders, as follows:

- At the company level, the excess of the fair market value over the tax basis of the company's assets is subject to corporate income tax. This tax does not apply to the extent the company's assets remain allocated to a Portuguese PE.
- At the shareholder level, the excess of the company's net equity over the tax basis on the shareholders' stock is taxable for corporate or individual income tax. Note that this tax is triggered even if all the company's assets are allocated to a Portuguese PE and the shareholders are resident in Portugal.

The transfer of PE assets or the cessation of its activities triggers immediate taxation on the excess of the fair market value over the tax basis of the company's PE assets.

The obvious purpose of this regime is to tax all unrealized gains that will escape the Portuguese jurisdiction upon any of the above reorganizations.

Infringement Procedure

The European Commission challenged the Portuguese corporate exit tax regime on the basis that it constitutes a disproportionate restriction and, therefore, infringes the freedom of establishment provided under the EC Treaty. The commission argued that the regime makes establishment in another member state of companies incorporated under Portuguese legislation less attractive, since redomiciliation triggers taxation of unrealized gains that are not immediately taxed if the company migrates domestically. The same applies to foreign companies ceasing the activities of its PE in Portugal or transferring the assets of a Portuguese PE to another member state.

ECJ Judgment

The ECJ found disparities between domestic and cross-border treatment on the taxation of redomiciliations and the transfer of assets allocated to a Portuguese PE to another member state (it found no discrepancies in the case of the cessation of PE activities). The Court furthermore stated that such discrepancies restrict the freedom of establishment.

In its judgment, the Court followed closely the reasoning in the *National Grid Indus* case (C-371/10), where it held that although exit taxation may be justified by the balanced allocation of taxing powers between states, rules that provide for the immediate taxation upon transfer of effective management to another member state are not proportionate to their objective and therefore are in breach of EU law. The same conclusion is valid for the taxation of unrealized capital gains arising in the transfer of Portuguese PE assets to another member state. (For the ECJ decision in *National Grid Indus*, see *Doc 2011-24891* or *2011 WTD 230-22*.)

Referring to *National Grid Indus*, the Court stated that giving companies transferring their effective management an option to either settle their tax liabilities immediately or defer payment of such taxes to when the capital gains are realized would be less harmful to the freedom of establishment than the measure in the main proceedings (paragraph 32) and therefore may be admissible under EU law.

Therefore, it may be concluded that the restriction to the freedom of establishment derives from the immediate recovery of the tax claim over the unrealized capital gains. The immediate assessment of the tax, upon migration, is compatible with EU law.

Additional Issues

Two crucial exit tax issues were not properly addressed by the Court. The first relates to the risk of tax recovery by the origin member state. The second relates to late payment interest charges on the deferred tax amount.

Recovery Risk

In *National Grid Indus*, the Court stated that ''account should also be taken of the risk of nonrecovery of the tax, which increases with the passage of time. That risk may be taken into account by the Member State in question, in its national legislation applicable to deferred payments of tax debts, by measures such as the provision of a bank guarantee'' (paragraph 74). (For a related analysis, see *Tax Notes Int'l*, Jan. 30, 2012, p. 371, *Doc 2012-1269*, or *2012 WTD 19-18*.)

Several authors have argued that the Court is referring to special situations when high-value assets are transferred and special circumstances justify a particular guarantee. Advocate General Paolo Mengozzi supported this idea in paragraph 82 of his June 28 opinion in *Commission v. Portugal*:

> I essentially share the view taken by the Commission and the Danish Government to the effect that such a guarantee can be required only if there is a genuine and serious risk of nonrecovery of the tax claim. Furthermore, contrary to the claims made by the French Government in its response to the written question asked by the Court and at the hearing, I consider that the amount of the required bank guarantee cannot correspond to the amount of the tax claim the payment of which is deferred, otherwise a measure which is as restrictive as immediate payment of the tax when the place of management is transferred will be reintroduced. That guarantee must nevertheless be sufficient having regard to the circumstances of each specific case.

Unfortunately, in *Commission v. Portugal*, the Court has not taken any position on this matter. It is unclear whether the Court: (i) agrees with the advocate general's opinion that a guarantee may be requested in high-risk or highly complex situations; or (ii) believes that member states may subject the tax deferral to any guarantees, on the basis that existing European legislation provides the authorities of the origin member state with a framework of cooperation and assistance that allows them to actually recover the tax debt in the host member state.

Late Payment Interest

In his opinion, Mengozzi draws attention to the fact that only the immediate recovery of the tax claim, not the immediate assessment, is at stake. Based on this, the advocate general attempted to clarify the issue of late payment interest on the deferred tax, raised in *National Grid Indus*, by suggesting that it is in accordance with the principle of equivalence for member states to request late payment interest in the situation of a cross-border transfer only if this requirement is generally applicable for cases of domestic deferred payment. (For Mengozzi's opinion, see *Doc 2012-13834* or *2012 WTD 126-20*.)

It is disappointing that the Court did not address this and simply restated its view, inconclusively and drafted in light terms, that member states would possibly be permitted to charge interest on the deferred tax payment ''in accordance with the applicable national legislation'' (paragraph 32).

Comments

During the proceedings, Portugal has acknowledged that should the ECJ find that its legislation restricts the freedom of establishment, it will amend the exit tax regime in order to allow for the possibility to defer the amount of the tax on unrealized capital gains. Portugal has traditionally been quite quick to amend tax legislation that the ECJ ruled to be restrictive. However, in this particular case, several crucial matters still need further clarification by the Court.

It is not clear what period of deferral will be acceptable under EU law. Also, it is unclear in what circumstances late payment interest may be imposed on the deferred tax. It is also undefined in which circumstances Portugal may require guarantees in order to grant the tax deferral, particularly where the migrating company has a complex asset structure that is impossible to track upon migration. Finally, the Court did not deal with the alleged restriction of the freedom of establishment at the shareholder level of taxation, on the grounds that the European Commission's complaint was inadmissible because of a failure to provide sufficient evidence on this issue. This is a very relevant issue in the area of Portuguese exit taxation.

It remains to be seen whether the three remaining pending cases on exit taxation will clarify these issues and provide much needed guidance for the amendments in the Portuguese legislation. ◆

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