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Dutch Exit Tax Rules Restrict Freedom of Establishment, ECJ Says

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Dutch Exit Tax Rules Restrict Freedom of Establishment, ECJ Says

Settling an infringement procedure initiated by the European Commission against the Netherlands in August 2011, the European Court of Justice on January 31 held in *Commission v. Netherlands* (C-301/11) that the Dutch rules on exit taxation restrict the freedom of establishment under article 49 of the Treaty on the Functioning of the European Union (TFEU). (Referral from the European Commission.)

Although an exit tax may be justified by the need to ensure a balanced allocation of taxing rights between member states, the ECJ considered the Dutch obligation to immediately pay the exit tax to be disproportional.

Under Dutch tax law, when a taxpayer operating a business moves its place of management to another country, including another EU or European Economic Area member state, the taxpayer becomes subject to a tax assessment for the (deemed) capital gain upon exit. The tax is imposed on the unrealized profits (for example, goodwill, hidden reserves, and tax reserves) attributable to that business.

The exit tax rules apply both to legal entities and to individuals that relocate their businesses' place of effective management from the Netherlands to another country. Because of their deemed Dutch tax residence for Dutch corporate income tax purposes, entities that are incorporated under Dutch corporate law are subject to the exit tax only if the relocation is to a country with which the Netherlands has a tax treaty in effect that attributes the right to tax to the state where the relevant entity is located. If, upon the taxpayer's relocation to another country, a permanent establishment remains in the Netherlands, the exit tax will not apply to the assets and liabilities attributable to that PE.

The European Commission was not satisfied by the responses it received from the Netherlands during the early stages of the infringement proceedings, which it initiated before the ECJ judgment in *National Grid Indus* (C-371/10).

As could be expected, in its January 31 decision, the ECJ referred to its previous decision in *National Grid Indus*. That case concerned Dutch exit tax imposed on a company that relocated its place of effective management from the Netherlands to the United Kingdom. The ECJ approved of the concept of exit taxes because of the need to ensure a balanced allocation of taxing rights between member states. However, a ''balanced allocation measure'' of this type must satisfy the proportionality test, and the ECJ found the immediate payment obligation disproportional. Because the cross-border relocation exposed the taxpayer to a cash flow disadvantage that would not have existed if the relocation had been domestic, the ECJ deemed the immediate taxation of the unrealized (foreign exchange) gains under some circumstances to be in violation of the TFEU principle of freedom of establishment.

After the *National Grid Indus* judgment, the Netherlands recognized the need to change its rules, and during the infringement proceedings it confirmed to the European Commission that the change to its exit tax rules will have retroactive effect.

In anticipation of the legislative measures, then-Minister of Finance Jan Kees de Jager on December 14, 2011, published a policy statement (BLKB 2011/2477M) that gives taxpayers the option to defer payment of the exit tax (under some conditions) if the relocation is to another EU or EEA member state.

In its January 31 decision, the ECJ said that the Netherlands' decision to change its law is irrelevant to the outcome of the infringement procedure; only the content of the law during the infringement proceedings is relevant. Even though a tax deferral is currently allowed under some circumstances by the policy statement, that does not suffice for purposes of the infringement procedure, the Court said. Hence, the ECJ found that the Netherlands has not met its obligations under EU law.

This judgment comes as no surprise, as both the state secretary of finance (through the above policy statement) and the lower house of the Dutch parliament (through a draft bill) had already recognized this restriction in domestic law. On December 4, 2012, the lower house approved a bill of law concerning the deferral of exit tax. That bill of law was sent to the upper house on May 15, 2012, following the judgment in *National Grid Indus*.

After the bill of law is approved by the upper house (which is expected soon), the new rules will take effect retroactively from November 29, 2011 (the date of the ECJ decision in *National Grid Indus*).

The European Commission has not withdrawn its infringement proceedings against the Netherlands, saying it expects member states to take legislative measures in a timely manner, which the Netherlands failed to do. The commission said Dutch taxpayers thus far have been able to rely only on the policy statement. (In most situations, that should make no difference to the taxpayer, although the draft bill does have a broader scope.)

It is hoped that the ECJ's January 31 judgment will encourage the upper house of the Dutch parliament to pass the bill quickly and that a lesson will have been learned in the Netherlands for future events. ◆

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