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Looking Beyond *Cartesio*: Reconciliatory Interpretation as a Tool to Remove Tax Obstacles on the Exercise of the Primary Right of Establishment by Companies and Other Legal Entities

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Some had expected the *Cartesio* decision to mark a profound innovation in the protection of the right of establishment for companies (whether it is called primary establishment or a 'right to leave and enter' a territory of a Member State), whereas it in fact turned out to be the latest bastion in the defense of national sovereignty of European Union (EU) Member States on company law.¹ Two decades after *Daily Mail*, companies are back to square one. No matter where the right of establishment has meanwhile been taken, individuals and companies – being creatures of law – enjoy such right only to the extent that national law gives them access to the Internal Market. But to the extent that any areas fall within the competence of the Member States, they must nonetheless exercise it consistently with Community Law – so we thought that the Court claimed it unconditionally – and yet, the lack of harmonization in company law has successfully preserved national powers, thus giving rise to a diametrically opposed effect to tax law, where it may not even be regarded as a valid ground for justifying tax violation of fundamental freedoms.

We could say that the 'connecting factor' analyzed under *Cartesio* can be compared to the criteria on the allocation of taxing powers, which are also under the competence of the Member States. In fact, according to the Court in *Cartesio*, 'the company intends to reorganize itself in another Member State by moving its seat..., thereby breaking the connecting factor required under the national law of the Member State of incorporation'.² The Court missed, however, to analyze whether the connecting factor did not restrict the freedom of establishment. But

in contrast to *Cartesio*, in *N* case, the Court prohibited any restrictions to the freedom of establishment resulting from the connecting factors,³ in spite of recognizing that preserving the allocation of the power to tax between Member States is a legitimate objective.⁴ When the connecting factor is itself restrictive, it is incompatible with Community law, unless there is a relevant justification. As the Advocate General put it in *Cartesio*, 'the Court does not, *a priori*, exclude particular segments of the laws of Member States from the scope of the right of establishment... [it] rather concentrates on the *effects* that national rules or practices may have on the freedom of establishment and assesses the conformity of those effects with the right of establishment as guaranteed by the Treaty'.⁵ Contrary to the position of the Court in *Cartesio*, there is no nucleus of sovereignty that Member States can invoke against the Community, if they do not exercise it consistently with Community law.⁶ In *Cartesio*, the Court seems to go beyond *Daily Mail*, when it argues that although the Member State has the power to define the connecting factor (required for the company to be regarded as incorporated under the law of that Member State), it cannot prevent a company from converting itself into a company governed by the law of the other Member State without prior winding-up or liquidation, to the extent that this other Member State does not require that winding up or liquidation (page 113). However, if the Court is trying to argue that any disadvantage results from disparities in national legislations and does not constitute a restriction, that reasoning would only work as long as prior

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¹ See the article of H. Schneeweiss included in this issue of our review.

² ECJ 16 Dec. 2008, Case C-210/06, 110.

³ ECJ, 7 Sep. 2006, Case C-470/04, 31-39.

⁴ *Ibid.*, 42-47.

⁵ Opinion of Advocate General Poiares Maduro delivered on 22 May 2008, Case C-210/06, *Cartesio*, 30.

⁶ K. Lenaerts, 'Constitutionalism and the Many Faces of Federalism', *American Law Journal of Comparative Law* (1990): 220.

winding-up or liquidation of a company moving from one Member State to another Member State, before it is (again) incorporated, is not required by every Member State. *A contrario*, if every Member State required such winding-up or liquidation, the right of establishment could not be fully achieved without harmonization, and to the extent that such requirements are not necessary within a Member State, that regime would clearly prove to be discriminatory and restrictive. Thus, contrary to what the Court has argued, this is not a case of disparity but of discrimination, which needed relevant justification.⁷

This issue of our review contains some comments on the *Cartesio* decision and its implications in tax law. As co-editors, we felt the need to supplement these comments with an additional insight on the evolution of European tax law. Instead of passively letting the waves steer the rudder of the European tax ship, academic tax literature in Europe should constructively point out the direction in which European taxation should face the waves to reach the sheltered harbour of full neutrality in the exercise of the right of establishment within the internal market. European taxation today may not be confined to a mere matter of whether and how the existing obstacles should be removed but also of taking into account the policy implications that each change may have on international taxation. Of course, the perennial impasse of positive tax integration – due to the unanimity requirement for Council deliberations in this domain – reduces the chances of implementing a sound coordinated tax policy in Europe, which may not be based on mere limits to national jurisdictions arising from the correct interpretation of European law. However, we are confident that awareness of such problem is already an important element to let things change.

Significant changes were made possible over the past years in European company law with the issuing of the *Societas Europaea* (SE) and SCE regulations, thus giving multinational enterprise an acceptable legal framework for removing the traditional national barriers on the primary right of establishment set by the existence of different national rules on the legal personality of companies. The 2005 update to the EU Tax Merger Directive extended the common regime also to such legal entities and removed the existing tax obstacles on the right of establishment that would have otherwise arisen because of the immediate tax liability on capital gains arising in such context. This improvement, however, does not remove the true problem. How should EU nationals fully exercise their right of establishment, namely, the right to leave and the right to enter a national territory, if they do not meet the conditions for setting up an SE or SCE or find it economically not convenient to do so? An international tax planner

would have a fairly easy answer to such question: whenever the cross-border transfer of seat of company implies the loss of its legal personality (such as in the case of EU Member States not following the criterion of incorporation), they should set up another company in the target (immigration) State and then make use of the operations (such as, for instance, a merger or a transfer of assets) that claim the benefits of the EU Tax Merger Directive. This answer could, however, be unsatisfactory from at least two points of view. First, although some countries – such as Lithuania and the United Kingdom – included all of their companies in the Annex to the EC Tax Merger Directive, others still follow a list-based approach and could therefore give rise to a non-neutral situation whenever a legal entity is not included in their list. The lists have a rationale structure, been updated and expanded, but they are still lists.

Second, why should EU nationals subject the exercise of rights granted by the EC Treaty to conditions that could perhaps result into an additional economic burden? Why should not a mere limited liability partnership – as in *Cartesio* – be allowed to do so? Even if we accepted that the decision of the Court in *Cartesio* is sound from the perspective of company law (independently of the reasoning), if we see it from a tax perspective, we should wonder whether the effectiveness of our rights should fully depend on the solution of problems involving the harmonization of company law. Traditionally, the answer to such question has so far been in the affirmative. We submit that it should not, especially if we more closely consider that the evolution of direct tax case law by the European Court of Justice (ECJ) on fundamental freedoms has meanwhile reached important results with respect to individuals. An individual can transfer his residence without being obliged to make an immediate payment of taxes due in the State of emigration on latent capital gains, thus deferring such payment – without any need for guarantees – until the actual moment of their realization, based on case law orbiting around the *De Lasteyrie*⁸ and *N* decisions. Equivalent results have to be reached in respect of all persons in tax law on the basis of reconciliatory interpretation and regardless of the harmonization of company law or the actual possibility to exercise the right of establishment by transferring the seat of the company.

Exit taxes are tax obstacles on the exercise of the right of establishment both when levied upon individuals and other persons, including when company law indirectly seems to make it still possible for a Member State to immediately claim its rights on a primary right made conditional upon a forced liquidation of a company. The *Cartesio* decision tells us that we must accept that forced liquidation from a company

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⁷ If we applied the internal consistency test as used by US Supreme Court, we would also come to the same conclusion: See Ruth Mason, 'Made in America for European Tax: The Internal consistency Test', *Boston College Law Review* 49, no. 4 (2008). Available at SSRN: <<http://ssrn.com/abstract=1025531>>.

⁸ ECJ 11 Mar. 2004, Case C-9/02.

law perspective. However, we cannot accept that such event may trigger an anticipated tax liability because the indirect taxable event of such liability would be the intention to exercise the right of establishment that at present is not fully recognized for companies. One could argue that we cannot claim a right that does not exist. Even if we cannot claim it from a company law perspective, exit taxes have been considered restrictions to the freedom of establishment and that assessment can neither depend on the form that tax restriction assumes nor on whether the taxpayer is an individual or not: Exit taxes are prohibited on the whole territory of the EU with respect to all persons.

Thus, should a company not be allowed to transfer its residence because of domestic company law rules, we submit that reconciliatory interpretation would require the Member State in which this company has its seat to freeze the liability to tax on the capital gains that shareholders would be technically obliged to realize when liquidating it and to keep track of such gains in the other EU Member State in which the new legal entity is set up in compliance with the applicable company law rules. Gains would then trigger the payment of tax at the time of the actual alienation of the shareholding, giving right to the State of emigration to collect its tax through the assistance of the State of immigration. From a tax perspective, this interpretation would reach equivalent effects to the ones currently applicable under the EU Tax Merger Directive and ensure tax neutrality to all EU nationals who wish to exercise in substance the primary right of establishment. It would not be in strict terms an extension of the EU Tax Merger Directive by means of interpretation but rather be a consistent interpretation based on the direct tax decisions on the primary right of establishment. Besides, we can legitimately use the example of a Directive as a parallel argument, as the Court already did it in *Advance Corporation Tax (ACT) Group Litigation*⁹ cross-referring to the Parent-Subsidiary Directive. We also have to consider the case where a company moves its tax residence (the place of effective management) without moving its residence under company law. In this case, an exit tax would likewise be prohibited.

Had the Court considered in *Cartesio* that there was a restriction and searched for relevant justifications, it would be much easier to reconcile the case law. In any case, that reconciliation is possible as suggested, and the solution of the aforementioned tax problems can neither be made subject to harmonization of company law nor depend on whether national law of the Member States allow for an actual transfer of residence; otherwise, the homogeneous protection of taxpayers' rights would be undermined.

International tax planning is not the best solution to guarantee rights, either. For the tax community, the issue is not which company law regulates the life of an entity but rather to avoid the payment of tax on accrued gains emerging from the lack of EU-wide harmonization in company law. After all, the whole progress of European (tax) integration concerns giving immediate rights with no additional cost, thus removing the need to set up complex superstructures and tools of international tax planning designed to circumvent the problem. Removing the obstacles will reduce the need to exclusively rely on international tax planning to exercise a right within the internal market, possibly also reducing borderline cases that could in some instances be tainted of tax avoidance. This is one of the unquestionable merits of European tax law – showing how beneficial its impact on international tax law may be.

From a tax policy perspective, we believe that removing exit taxes is a sound practice, whereas from the perspective of ensuring an effective supremacy of European law in the field of direct taxation, we submit that it is an indispensable goal to achieve, taking into account that the tax authorities within the internal market avail themselves of enhanced mechanism for cooperation.¹⁰ Our suggestion is also addressed to the European Commission, which may encounter some relevant difficulties after the *Cartesio* decision in countries such as The Netherlands, Portugal, Spain, and Sweden against which it had previously launched infringement procedures for exit taxes levied upon the transfer of seat of companies. The EU Commission was probably right in equating from a tax perspective all types of levies upon emigration, no matter whether triggered on the right of establishment of individuals or other persons. However, taking into account the *Cartesio* decision, if taxes upon liquidation of a company before converting itself in a company governed by the law of another Member State will not be considered prohibited hidden exit taxes by the Court, filing infringement procedures against countries that at least allow companies to emigrate may have some undesirable unfair effects. In fact, Member States that keep hiding their exit taxes behind their company law compliant systems would be unduly protected. Accidents can, however, turn into advantages, and one could thus support that such evolution shows the need for positive tax integration, such as, for instance, the issuing of a proposal for a directive that achieves the consistent regulation of all exit taxes at the level of the internal market. But perhaps also, other routes for European tax integration could work,¹¹ as our editorial suggests. There is one more important reason

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⁹ ECJ 12 Dec. 2006, Case C-374/04.

¹⁰ Hopefully, a further upgrade of such instruments will be possible as soon as the recently announced amendments to the directives on exchange of information and mutual assistance in recovery of taxes – see COM 2009 28 and 29 of 2 Feb. 2009 – will be approved by the Council.

¹¹ This issue will be object of the conference 'The Road to European Tax Integration', organized by the GREIT (Group of Research on European International Taxation) and to be held in Amsterdam (The Netherlands) on 24-25 Sep. 2009.

for transforming exit taxes into a coordinated system, and that is Article 2.2 of the Fourth Protocol to the European Covenant on Human Rights, according to which everyone – thus also other persons than individuals – has the right to move freely across countries. Some years ago, after the *Ferrazzini v. Italy* decision,¹² many were persuaded that the European Court of Human Rights would have kept taxes simply out of the scope of the European Covenant on Human Rights. Furthermore, authors have supported the view that this Court is simply not fit to deal with tax technicalities and ought to be left out of the arena where national jurisdictions clash with each other. However, the recent judicial trend of the European Court on Human Rights – which decided a number of direct tax cases in the past three years – seems to show some degree of openness to taxes, or at least with respect to some problems arising in our field. For our purposes, one could consider for instance the *Riener v. Bulgaria* decision.¹³ Although in that case Bulgaria was condemned for infringing the right to ensure an effective remedy (Article 13 ECHR), the case dealt with an Austrian-Bulgarian

national, director of a Bulgarian company, who could not leave Bulgaria – being a kind of tax hostage in the hands of that country – until such taxes had actually been paid. The case showed that taxes are no secluded sphere of law but rather one of the domains in which the rights of persons can be violated and require an effective protection. Meanwhile, also outside Europe, authors have started to support a holistic view of human rights, no longer disconnected from trade, social security levies (having a fairly strong common component with taxes), and the economic freedoms in a globalized world.¹⁴ Taxes are not different from other domains, and their effects should be taken into account when ascertaining the protection of human rights, if we want to achieve an actual and effective protection throughout in Europe.

If we look back at the *Daily Mail* case,¹⁵ we will find out that tax authorities would have given their consent to emigration if only taxes on accrued gains had been paid. In our view, *Cartesio* has not given new life to *Daily Mail*: EU Member States have thus no *carte blanche* to shift exit taxes from individuals to companies over the next decades.

Notes

¹² European Court of Human Rights; decision, 12 Jul. 2001, application No. 44,759/98, *Ferrazzini v. Italy*.

¹³ European Court of Human Rights; decision, 23 May 2006, application No. 46,343/99, *Riener v. Bulgaria*.

¹⁴ B.E. Hernandez-Truyol & S. Powell, *Just Trade* (New York: New York University Press, 2009).

¹⁵ ECJ decision of 27 Sep. 1988, Case 81/87, *Daily Mail*.