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European Commission Policy on Exit Taxation

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Introduction – the need for coordination of Member States' tax policies

Taxation lies at the heart of national sovereignty. It is an essential tool for governments to fund public expenditure and to execute the policies they consider important. It is, however, abundantly clear that there are still several aspects of national tax systems which impede the economic integration of the EU. As a result, economic operators continue to be faced with tax obstacles which prevent them from reaping the full benefits of the Internal Market. Also, Member States find it increasingly difficult to protect their tax bases in a manner which is compatible with the fundamental freedoms of the Treaty. More and more, they find that measures which they have adopted to protect their tax bases are held to be incompatible with EC law by the European Court of Justice (ECJ), which can have considerable budgetary consequences for the Member States concerned. Often such measures are also mismatched with the national tax rules of other Member States which can give rise to instances of double taxation or unintentional double non-taxation and make such measures increasingly vulnerable to tax avoidance and evasion.
The current institutional framework which provides for decision making by unanimity in the area of taxation is unlikely to change in the short to medium term. It is therefore important to explore new and creative approaches, that is to say, find pragmatic solutions to the main cross-border tax problems affecting Member States and market operators. It was with those challenges in mind that the Commission in 2006 launched an initiative for a new systematic approach

[1] European Commissioner for Taxation and Customs Union.

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based on a co-ordination of taxation policies[2]. The Commission believes that coordination of national tax policies at EU level can play a vital role in helping Member States to render their tax systems compatible with Community law and, at the same time, protect their tax bases from further eroding. It could significantly improve the performance of tax systems which can help to keep economic activity and 'mobile' assets in the EU.

It is important to acknowledge that there is not a single format for a coordinated approach. Different problems may require different solutions. Coordination of taxation policies can be achieved through a range of measures, including both legislative initiatives and non-legally binding instruments. In any event, unlike harmonisation which is characterised by the fact that national laws are substituted by a common body of legislation at Community level, coordination leaves the legislation at national level intact (provided that it complies with the EC Treaty requirements) but aims to render such laws compatible with each other. Rather than to encroach upon Member States' competencies in tax matters, coordination reinforces their ability to preserve their sovereignty through a collective effort.

In December 2006 the Commission issued a Communication on exit taxes[3] in which it set out its views on how a coordinated approach could prove useful in this field. The Communication is designed in part to provide guidance on the principles flowing from the case-law on exit taxes and prompting discussion on ways in which Member States can comply with their obligations. Member States are obliged to take action – the idea is to facilitate and coordinate such action. But the Communication also suggests that there is a need to address the mismatches between different national rules in order to ensure that they interact coherently with each other. In the following parts of this article I shall briefly recall the main findings of the Communication but also make an attempt to explain further how the Commission would like to see the mismatches being

[2] COM(2006)823 final, "Co-ordinating Member States' direct tax systems in the Internal Market", 19.12.2006.
[3] COM (2006) 825 final, "Exit taxation and the need for coordination of Member States' tax policies", 19.12.2006.

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removed through coordination.

What I have to say in the following text has to be seen in the context of the adoption by the Council of a Resolution on coordinated arrangements for exit taxation on 2 December 2008[4]. The Resolution is a non-binding instrument that does not create legal rights or obligations for Member States or taxpayers (as explicitly stated in the recitals).

The adoption of the Resolution is however a very welcome and important step forward in removing tax obstacles to the proper functioning of the Internal Market by ensuring the elimination of double taxation of transfers of business assets from one Member State to another. Although it does now depend on concrete action by individual Member States to implement their commitments, such tangible results prove that progress can be made in the area of direct taxation through coordination. It is true that the Resolution remains rather silent on an important requirement for the tax treatment of such asset transfers to be in keeping with the Member States' EC Treaty obligations, i.e. as to at which point in time can they collect exit charges. The Commission has been very clear about its views on this matter – the collection of exit charges may not take place any earlier than what would have been the case if the transferred assets had remained within the territory of the exit State and usually, this coincides with the moment when the transferred assets are actually disposed of. In this regard it may also be noted that the guiding principles attached to the Resolution explicitly invite the Member States at the receiving end of the asset transfers to provide administrative assistance to the exit State, in particular for the purposes of determining the date of disposal.

[4] Council Resolution of 2 December 2008 on coordinating exit taxation (2008/C 323/01).

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Exit taxation – a prime example of an area where coordination can prove useful

The raison d'être of exit taxes?

Member States have different reasons for levying exit taxes. Some levy them to counteract specific types of tax avoidance and tax-induced (temporary) emigrations. For others exit taxes are a means of ensuring that they are able to tax any income which has accrued while taxpayers were resident in their territory. Frequently, national exit tax provisions are also based on a combination of these reasons.

Most countries seek to tax their resident taxpayers (individuals and/or companies) on the capital gains they make on their assets. In domestic situations, such capital gains will usually be taxed when they are *realised*, that is when the assets are sold or otherwise disposed of. However, if an individual taxpayer moves to another state *before* disposing of his or her assets, the exit state risks losing the taxing rights on the capital gains which have accrued on those assets, as these rights will generally pass to the new state of residence. Similarly, if a company transfers its residence to another Member State in another Member State, the original state of residence risks the (partial) loss of its taxing rights on the gains which have accrued while the company was resident in its territory[5]. The same risk could be present where a company transfers individual assets to its branch (permanent establishment) situated in another Member State. Many EU Member States have attempted to deal with this issue by taxing such accrued but as yet unrealised capital gains at the moment of transfer of the residence by the taxpayer or of the individual assets.

[5] This is because in such situations the double tax conventions concluded between the Member States do not generally attribute the taxing rights over future disposals of transferred assets to the exit state.

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General principles flowing from the relevant case law – are exit taxes EC Treaty compatible?

In *De Lasteyrie du Saillant*[6], a case concerning French legislation on taxation of unrealised increases in value of securities upon emigration of individual taxpayers, the issue before the ECJ was whether or not a mechanism for the immediate taxation of latent capital gains on the transfer of tax residence is compatible with the principle of freedom of establishment (Article 43 EC Treaty). The ECJ took the view that the French provision in question was likely to restrict the exercise of the freedom of establishment, having at the very least a dissuasive effect on taxpayers wishing to establish themselves in another Member State, because they were subjected in France, by the mere fact of transferring their tax residence outside France, to tax on a form of income that had not yet been realised, and thus to disadvantageous treatment by comparison with persons maintaining their residence in France (who were not taxed on such latent gains).

Although the judgment obviously relates to the facts and circumstances of the case at issue, it would appear that certain conclusions of a more general nature can be drawn: taxing residents on a realisation basis and departing residents on an accrual basis is a difference in treatment which constitutes an obstacle to free movement.

Where an EU Member State decides to assert a right to tax revenue from capital gains accrued during a taxpayer's residence within its territory, it cannot take measures which present a disproportionate obstacle to free movement. The ECJ has confirmed that an obligation to provide guarantees is disproportionate as less restrictive methods are available, such as the measures on administrative assistance of the Mutual Assistance Directive (77/799/EEC) and the Tax Recovery Directive (76/308/EEC). This clearly rules out the possibility of any immediate collection of the tax due at the time of transfer of residence and, implies that Member States will increasingly have to rely on co-operation with

[6] ECJ C-9/02 *Hugues De Lasteyrie du Saillant* [2004] ECR I-2409.

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other Member States to ensure that they can effectively exercise their taxing rights. Similarly, suspension of payment cannot be made subject to the condition of designating a fiscal representative. In general, any means of preserving the tax claim must be strictly proportional to that aim and must not entail disproportionate costs for the taxpayer. The Commission encourages Member States to make better use of the means already at their disposal and is prepared to assist them in examining the scope for improvements in this area.

In the *N* case[7] which concerns a Dutch exit charge on emigrating substantial shareholders the ECJ confirmed that preserving the allocation of the power to tax between Member States is a legitimate objective and that the principle of fiscal territoriality can form the basis for such an allocation. At the same time, the Court has underlined that the allocation of Member States' powers of taxation is closely linked with the purpose of eliminating double taxation within the Community. Thus, a Member State may tax income, which arose during the period that a taxpayer was a resident of that State, but it should also ensure that any decrease in value after the transfer of residence to another Member State is taken into account.

The Commission takes the view that in order to attain the objective of allocating taxing powers, a Member State may demand a tax declaration at the time of transfer of residence in order to establish the amount of income which has accrued while the taxpayer was a resident of a Member State, provided this does not give rise to an immediate charge to tax and that there are no further conditions attached to the deferral of the tax charge. Some commentators have suggested that a Member State should also refrain from assessing the tax due at that time as a more proportionate response would be to defer such assessment until the moment of actual disposal. This would avoid a difference in timing with comparable domestic situations and allow the exit state to take full account of the personal circumstances of the taxpayer and the tax rates applicable at the time of disposal.

[7] ECJ C-470/04 *N. v. inspecteur van de Belastingdienst Oost/Kantoor Almelo*.

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Exit taxes on companies

Until to date the ECJ has only pronounced itself on exit tax rules in respect of individuals. The Commission is however of the opinion that there can be little doubt that the case-law also has direct implications for Member States' exit tax rules on companies[8]. This does not just affect exit taxes levied on the transfer of a company's seat to another Member State, but also any type of exit charge on the transfer of single assets or liabilities from a company's head office to its permanent establishment in another Member State (or vice versa). It follows from *De Lasteyrie* that such cross-border transfers should not be treated less favourably than comparable domestic transfers. If a Member State allows tax deferral for transfers of assets between locations of a company resident in that Member State, then any immediate taxation in respect of a comparable transfer of assets to another Member State is likely to be contrary to the EC Treaty freedoms.

While granting an unconditional deferral may resolve the immediate difference in treatment between domestic and cross-border situations and thus render Member States' rules compatible with the EC Treaty, it will not by itself ensure that the exit state is able to collect the tax due at the moment of actual realisation of the income. This may require reasonable reporting obligations on taxpayers and/or appropriate exchange of information and, if necessary, assistance in collection of taxes, between tax authorities. The exit state will only be able to exercise its taxing rights at the moment of disposal, if it is aware that such a disposal has occurred. Similarly, if a taxpayer who has transferred his residence refuses to pay his taxes, the exit state may have to rely on the new state of residence to collect the taxes on its behalf.

[8] It may be noted that the ECJ itself cites *De Lasteyrie* in its judgment in Case C-411/03 *Sevic Systems AG* concerning the cross-border merger of companies established in different Member States.

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Mismatches

Deferral measures alone will not necessarily provide a solution for the existing mismatches between national tax systems. With respect to corporate taxpayers mismatches *inter alia* arise from differences in valuation methods as regards transferred assets. A number of Member States allow assets to be transferred to a permanent establishment in another Member State at book value. These Member States choose not to exercise their taxing rights on the difference between the book value and the market value of the assets at the time of transfer. Generally, these Member States also value assets transferred to a permanent establishment in their country at book value. Other Member States seek to exercise their taxing rights on the difference between the book value and the market value of the assets at the moment of transfer. In practice, these differences can result in double taxation or inadvertent non-taxation of capital gains. Mismatches also occur when two Member States apply the same basic approach but in practice reach different conclusions on the value of the specific assets involved.

Such mismatches affect the proper functioning of the Internal Market as they may dissuade companies from investing in other Member States when they risk being faced with double taxation. The scope for double non-taxation may also encourage them to structure their cross-border activities in such a way as to exploit the gaps between the different national tax systems rather than to make their business decisions on sound economic grounds. The Commission is of the opinion that such instances of double taxation and double non-taxation are equally undesirable and therefore encourages Member States to examine the scope for coordinated solutions. Such coordinated solutions could e.g. include mutual recognition of the valuation method applied by the transferring state or binding dispute resolution that would result in a single agreed value at the moment of transfer.

A deferral until the moment of actual disposal of the assets is also not the only possible approach and certain types of assets may require a different treatment.

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As acknowledged in the Exit tax Communication, certain types of assets (intangibles, wasting assets) used in or created by companies are, by their nature, not meant to be disposed of, but are used up by the company or expire over time. In practice, Member States often use other taxable events than actual disposal to ensure appropriate taxation of such assets in domestic situations. The Commission believes that Member States should be able to apply economically equivalent solutions in cross-border situations, provided these do not result in a worse treatment compared to domestic situations and do not give rise to double taxation. The possible contours of such equivalent solutions should be pragmatic and minimise the administrative and compliance burdens for tax administrations and taxpayers. They should also limit the need for administrative co-operation between Member States to a minimum.

Possible coordinated solutions

Coordinated solutions would allow the different national systems to work together seamlessly. The Commission sees different general and specific options for resolving the mismatches.

General approaches

A number of Member States which either assume a deemed disposal just before emigration or apply a system of extended tax liability already provide for a mechanism to *credit* any tax levied by the new residence state on the same capital gains. Such practices may or may not be confirmed in the tax treaty between the countries concerned. The Commission is of the opinion that where two Member States knowingly choose to exercise their taxing rights on the same income, they must ensure that this does not result in double taxation for the taxpayer.

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Another possibility to resolve the existing mismatches would be for Member States to agree to *divide* the taxing rights on the capital gains, e.g. by splitting up the taxing rights according to the period that the shareholder was resident in the respective Member States. This may require changes to existing tax treaties in order to reflect such a division. Any solution would need to take account of a possible decrease in value between the moment of exit/entry and the actual disposal. The fact that a taxpayer has exercised his or her right of free movement may not result in taxation of a higher amount of capital gains than would have been taxable had he or she not changed residence.

Establishing the latent capital gains at the moment of transfer of the assets

Ideally, the exit state should only establish the amount of latent capital gains where it would risk losing the taxing right on the transferred assets and defer the taxation of those gains in accordance with the Merger Directive (90/434/EC). Hence, latent capital gains would only be established in respect of transferred assets which, due to a transfer or a cross-border restructuring operation, do not 'remain effectively connected with a permanent establishment' in that State and do not 'play a part in generating the profits or losses taken into account for tax purposes'.

Tax deferral in case of tangible and intangible assets by creating a provision equal to the amount of the latent capital gains

The established latent capital gains in respect of the transferred tangible and intangible assets would not be taxed immediately by the exit state, but gradually over the period of time that such gains would have been taxed had the assets not been transferred. To this end, provision(s) could be created within or outside the commercial or tax balance sheet. Such provisions in respect of transferred tangible assets would be released and taxed over a fixed period of time. To ensure the greatest possible degree of economic equivalence, this period should

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ideally be based on the expected remaining useful life of the individual assets at the moment of transfer. For the sake of administrative simplicity for both tax administrations and taxpayers, one could however also consider an approach based on fixed release periods based on the average useful life of the different categories of assets.

Pro rata release of the provision(s) in respect of tangible assets over a fixed period of time

In case of ordinary tangible assets, if one were to consider an approach based on a fixed release period, a period of 5 to 10 years would appear reasonable (based on the average depreciation period for such assets in domestic situations). A shorter period than 5 years would not normally amount to equivalent tax treatment compared to purely domestic situations.

Pro rata release of the provision(s) in respect of intangible assets (including goodwill which is transferred together with (part of) the company) over a fixed period of time

Provisions in respect of intangible assets including (internally generated or acquired) goodwill could also be released and taxed over a fixed period of time. This period could also be based on the expected remaining useful life of the individual assets at the moment of transfer and/or, for practical reasons, on the normal depreciation period for intangible assets in the exit state. In case of the latter, one could consider a statutory period of 10 to 15 years. A shorter period would not normally amount to equivalent tax treatment compared to purely domestic situations and should therefore only be considered in exceptional cases. Even if a Member State did not normally allow a write-down of acquired goodwill in domestic situations, it may nevertheless be appropriate for purely pragmatic reasons to accept gradual release of a provision over a fixed period. From a business perspective the expenditure incurred in the host state after the transfer

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will over time replace the elements which contributed to the generation of goodwill in the exit state. Thus, it is reasonable to allow release of the transferred goodwill over a given period of time, in order not to maintain this provision *ad infinitum*.

Immediate release of the provision in case of disposal of the asset or transfer of the asset to a third state

If an asset is transferred within the above discussed period to a permanent establishment situated in a third state or sold to another company or otherwise disposed of (i.e. any event which would in domestic situations trigger a tax charge), the provision in respect of the latent capital gains of the relevant asset would be immediately and fully released and taxed.

In the *N* case, the ECJ held in respect of an exit tax on individuals that in order to be regarded as proportionate the tax system at issue would have to take full account of any reductions in value after the transfer of residence.

In respect of the transfer of assets by companies, assets which are used in the production process or for rendering services or which expire over time (intangibles) will generally incur a drop in value over time. Consequently, the market value of the assets at the moment of disposal will generally be lower than the market value at the moment of transfer. As such decreases in value are due to the wear and tear of those assets in the host state, they should be taken into consideration in that state. If anything, there should only be a residual obligation for the exit state to recognise such reductions, e.g. when there is a dispute over the valuation at the moment of transfer (i.e. overvaluation of transferred assets).

Option for immediate taxation of latent capital gains in respect of transferred assets

In order to avoid unnecessary administrative costs and minimise the compliance burden, companies should be able to renounce the deferred collection of tax and

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opt for immediate taxation at the moment of transfer of the assets. An option for immediate taxation would be particularly helpful in those situations where the amount of latent capital gains is limited or where the assets are due to be sold shortly after the transfer. As this option does not entail a financial gain for the company and it simplifies the application of the provision method, it would be unlikely to create any risk of abuse.
A point for discussion is whether the option should be based on an 'all or nothing' approach. If e.g. 10% of the transferred assets in case of a cross-border restructuring operation represent 90% of the transferred latent capital gains, it may be in the interest of both the taxpayer and the tax administration to limit the deferral and any related reporting obligations to those specific assets and to opt for immediate taxation of the 90% of the assets which only represent 10% of latent capital gains. This would appear a more proportionate and pragmatic solution than to only give taxpayers a choice between immediate taxation and deferral of <u>all</u> latent capital gains. On the other hand, an 'all or nothing' approach has the merit of simplicity.

As a rule immediate taxation of current assets

As current assets would normally be expected to be used or sold within a short period of time, it would appear reasonable - if only for practical reasons - to accept, as a rule, immediate taxation at the moment of transfer. In those circumstances, the taxpayer should however have the possibility to demonstrate that the assets were not disposed of by the balance sheet day and to create a provision for such remaining assets.

Equal treatment of latent capital gains and latent capital losses

If the transferred assets and liabilities include latent capital gains as well as latent capital losses, it would be appropriate and necessary in view of the intended neutral effect of the provision method on the tax bases of Member

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States to treat such latent gains and losses equally for tax purposes. It would not be correct if latent gains were taxed in the exit state in subsequent years as the provisions were released, while latent losses would be transferred to the other state without recognition by the exit state. In practice, latent capital losses are only likely to occur in case of pension provisions and other similar liabilities.

The national rules and practices for recognition and valuation of companies' assets and liabilities and, in particular with respect to the establishment and valuation of provisions, can vary considerably between the EU Member States. In case of the transfer of registered office of an SE[9], an SCE[10] or - in the future - an SPE[11] from a Member State which offers rather limited possibilities for establishing provisions to a Member State which attaches more weight to the prudence principle (and, consequently, allows earlier recognition and/or higher valuation of such provisions for tax purposes), it may prove difficult to agree on the values for transferred provisions. It should however be possible to mitigate these different approaches by adjusting the values assigned to the transferred goodwill (the difference of the value of the company as a whole minus the market values of all the recognised assets and liabilities).

Reporting obligations for taxpayers and extent of administrative co-operation between Member States

In principle, the company itself will have to report, as part of the tax declaration for the permanent establishment or its own self-assessment, the release of the provisions over time or in case of disposal or alternative realisation within the release period the amount of capital gains to be taxed immediately. Administrative assistance should only be necessary in those cases where the

[9] *Societas Europaea* (SE); Council Regulation (EC) No 2157/2001 of 08.10.2001.
[10] *Societas Cooperativa Europaea* (SCE); Council Regulation (EC) No 1435/2003 of 22.07.2003.
[11] *Societas Privata Europaea* (SPE). The Commission services are currently working on a proposal for a European Private Company Statute (SPE), which inter alia should allow the transfer of registered office of an SPE from one Member State to another without liquidation. In July 2007 the services of the Internal Market Directorate General launched a public consultation on the SPE. The impact assessment report on the different options for a future SPE has been presented to the Impact Assessment Quality Board this spring. Further information: http://ec.europa.eu/internal_market/company/epc/index_en.htm

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taxpayer does not respect its reporting obligations (which often could by way of sanction result in the direct and full release of the provision) or when the exit state has doubts about the accuracy of the information. This type of assistance may in many cases already be covered by the existing arrangements and should, given its exceptional nature, not create an excessive burden for Member States' tax administrations.

Differences in valuation, dispute settlement and dispute resolution mechanisms

As the value of the transferred assets established by the exit state at the moment of transfer will form the basis of future taxation of latent capital gains, different approaches in Member States to the valuation of assets could result in double taxation or inadvertent double non-taxation. As suggested in the Exit tax Communication, one way to overcome this problem would be for the Member State to which the asset is transferred to accept the value established by the exit state at the moment of transfer as its starting value. Such an approach based on mutual recognition would be simple to administer for tax administrations and taxpayers. It may however offer scope for tax arbitrage in that taxpayers may seek to exploit differences in valuation practices between Member States to maximise the amount of gains taxed in the Member State with the lower corporate tax rate.

Concluding remarks

Exit taxation is an area where the Member States can benefit from coordination at EU level. A successful implementation of coordinated solutions in this field would prove that real progress can be made without harmonised measures or the need to resort to legal litigation. In this respect, the recent adoption of the Council Resolution on exit tax arrangements is an important first step which should hopefully lead to further coordinated action in this area. It also provides an encouraging example for similar efforts in other fields of direct taxation.

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Irrespective of which methods Member States would choose to resolve the mismatches between their tax systems, it is of utmost importance that these are as simple and effective as possible so as to allow the taxpayers to fully benefit from the Internal Market but without creating scope for abuse. The success of the initiative will depend on EU Member States' willingness to follow-up in their legislation and administrative practice on the commitment they have made in the Council Resolution.

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