Past and perspectives of exit tax

Adriano Di Pietro[1]

1. The unstable equilibrium of present national systems

After having influenced the present of exit tax at a national level, EC case law is now mortgaging its perspectives. The uncertainty does not come from the absence of specific EC law provisions, but rather from the pervasive effectiveness of EC freedoms and prohibition of discrimination. Their primacy, also in the field of national income taxation, is affirmed and substantially consolidated, to such an extent that it has been generalized. As a consequence no field, even as specific as that of exit tax, could be left untouched.

The relevant national systems appeared steady and certain only on the surface. In fact, they relied on the sole national tax sovereignty on the territory, while such a sovereignty should have taken into account the EC system; they only considered effects on national market, while reference had to be made to the EC market; they regarded mobility as a limitation to national taxation – in order to reassert national powers of taxation – while such a mobility inspired and granted the implementation of the EC system as well as the full integration of common market. Also thanks to the Court of Justice, the unstable equilibrium of national systems has become a corollary of the integrated perspective of national tax systems within the framework of EC system. It stems from the compatibility judgment operated with respect to national options concerning exit taxes. ECJ case law has worked for the respect of both EC system and common market in the field of direct taxation, also in cases where national legislators had decided to maintain taxation on unrealized capital gains. This is the reason why, though limited to the two rulings which have been given on the

[1] The author is Professor of Tax Law at the University of Bologna – Alma Mater Studiorum. Translated by Cristiana Bottazzi, PhD student at the University of Bologna.

© Copyright Seast – All rights reserved

matter[2], sometimes leading to contradictory outcomes, it has played a systematic role. ECJ judgments, in fact, are characterized by such a systematic approach, which examines first of all reasons, grounds and effectiveness of latent capital gains taxation; then, once expressed a positive evaluation on exit taxes, the different exit tax regimes. So, up till now the focus has been on national characteristics, as revealed by case law as well as by grounds for recent infringement procedures against Spain, Portugal and Sweden. In fact, in ECJ's opinion, with a view to coherence of national systems, compatibility of national exit taxes depends on such characteristics. The aim is coherently stated and pursued. Both a compatibility check on the basis of EC principles – such as the one of proportionality – and an appreciation of possible national justifications are carried out.
On the other hand, outcomes are sometimes incoherent, though referring to similar regimes. As a matter of fact, the Court appreciated differently the anti-abuse justification as coherence of a national tax system. Thus, perspectives of national tax systems become increasingly precarious, although it is confirmed that taxation of latent capital gains as such is compatible with EC law.

2. EC compatibility of national systems: a difficult balance between national territoriality and EC coherence

2.1 Past experiences and the overcoming of territorial taxation unity

The past cannot come back. It relied upon national systems aiming at affirming – always and in any instance - their tax sovereignty on capital gains which, though not yet realized, were deemed as acquired by the system itself. As such, they could not escape the levy, even though the individual taxpayer had passed to another tax jurisdiction. As regards the internal system, national tax sovereignty served national

[2] Court of Justice 11 March 2004, *Huges de Lasteyrie du Saillant*, C-9/02; Court of Justice 7 September 2006, *N*, C-470/04.

© Copyright Seast – All rights reserved

financial interests; as regards EC system, it could only be justified with a view to prevent abusive utilizations.
Nowadays, national options are not absolutely free: they must comply with economical freedoms and, precisely, freedom of establishment, which have become a binding parameter for national options, by contributing to transform a merely internal solution into an EU issue. National regimes cannot alter, nor decrease, nor restrict the full achievement of EC Treaty. Territoriality, as their inspiring principle, has to be reconciled through coherence with the EC system and the common market.
A difficult balance which must take into account the dissociation, imposed by the EC framework, between the power of taxation and the relevant exercise. The first one being legitimate and compatible; the second one being compatible as well, but exclusively when the same conditions are met with reference to residents in a different territory and a different system. In the light of this, case law did not deem the principle of exit taxes incompatible, but rather it shared its ground and inspiration. In the name of EC law, the Court only put an end to the unity between powers of taxation and the relevant exercise, which had characterized national exit tax regimes since their introduction. Thus, it resulted in a dissociation, previously unknown in the purely domestic logic of taxation. The power of taxation – stating the national right to tax latent capital gains as ascertained at the time of the loss of residence – is kept intact and made consistent, also in the EC perspective, with its inspiring interest. The exercise of such a power – intended as the right to levy the tax relating to the amount of latent capital gains ascertained at the time of the loss of residence – is now relinquished in the light of the comparison between EC and national systems.

2.2 Present experience and the role played by national tax systems

Therefore, the EC freedom of circulation and establishment of individuals served the purpose of censoring the previous liberty of national systems as to their options on exit taxes. In any case, such a freedom does not allow to define the current situation. The main interest of ECJ case law is thus turned to original characteristics of national systems, so as to prevent the onset of radical solutions, and especially to make any

© Copyright Seast – All rights reserved

compatibility judgment relative, as revealed by the French case relating to the issue of proportionality for required guarantees. In fact, the compatibility judgment is grounded on the analysis of terms, conditions and procedures provided by States for the taxation of latent capital gains. Furthermore, the chance of framing such a regime within the national tax system cannot be disregarded, nor, alternatively, considering it as a reaction to a misuse of the freedom of circulation and establishment within the European market, rather than a form of territorial taxation, as pointed out in *de Lasteyrie du Saillant* case law[3].

Therefore, the role played by national tax systems becomes increasingly important, in order to state and justify territoriality of taxation against coherence of EC system and unity of the relevant market, as well as useful, in order to define the balance between territoriality and coherence; but not anymore with a view to state the full territorial sovereignty – the power and the relevant exercise – on latent capital gains accrued by individuals changing their residence.

2.3 Coherence and discrimination of national systems providing for taxation of latent capital gains

Until now member States have reacted in a diversified way, also considering that, prior to the recent infringement procedures, only two of them had been directly involved in ECJ judgments. The Netherlands keeps relying on a national regime judged as compatible since justified in the light of the allocation of powers of taxation between two concerned States. France has chosen to dismantle its fiscal regime, even though the compatibility judgment had touched only the obligation to provide for a guarantee: it abdicated its power of taxation on latent capital gains, although its EC ground was acknowledged. The other States, although involved only indirectly, have modified domestic procedures concerning taxation or non-taxation in connection with the loss of residence. They have kept intact their powers of taxation, and have only intervened on some profiles of the relevant exercise, mainly in order to avoid the risk of proportionality incurred by the French system. However, they all shared the

[3] Court of Justice 11 March 2004, *Huges de Lasteyrie du Saillant*, C-9/02.

© Copyright Seast – All rights reserved

purpose of finding a solution on a domestic level, without any involvement of other States, thus showing distrust against the effectiveness of the model, suggested by ECJ, based on agreements aiming at the reconciliation between territoriality of taxation – for the State where capital gains are originated – and its exercise – to be agreed with the State where capital gains are realized.

Therefore, the present of national exit tax regimes is constantly changing, a sort of a work in progress. Following ECJ's guidance, States are entitled either to adapt their own systems to EC-compatible criteria, or to keep relying on their choices, by deeming them consistent with their own tax system and in line with objectives shared by the EC system, such as the adoption of anti-abuse measures. In this latter case, there is an appreciable interpretative effort: in fact, the aim was to systematize a fiscal regime apparently contingent – since finalized to avoid tax subtraction – or arbitrary – since it made the loss of residence equal to the domestic requirement for return from the onerous transfer of business assets.

In the Italian case, the current exit taxes regime could be regarded as consistent with the choice of the *Testo Unico delle Imposte sui Redditi* (General Income Tax Act) for a progressive enlargement of the number of events justifying taxation of latent capital gains. This way, taxation could be extended, by way of interpretation, to any case where the good leaves corporate assets, without indication of any further justification or fiscal effect. Under such a perspective, the loss of residence could be regarded as one of said cases, justified in consideration of the subtraction of assets concealing capital gains from national powers of taxation. Such an attempt would turn out to be useful in order to avoid doubts of discrimination; while making use of it would be more difficult with regard to restrictions of personal mobility and freedom of establishment. In fact, within the unitary framework of the European market, mobility joins together the permanence of the enterprise. Otherwise, it would be hard to justify the jurisprudential attempt to reconcile national power of taxation – recognized at the time of the loss of residence – and the exercise of said power – relating to the proceeds of assets concealing capital gains, although under a different tax jurisdiction. Proceeds and other assimilated hypothesis act as the moment of taxation, in line with a unitary corporate taxation taking into account EC mobility.

© Copyright Seast – All rights reserved

2.4 The role played by national Courts

Focus on qualifying features of national exit tax regimes not only characterizes EC judges, but also national ones. The latter cannot ignore any longer neither case law nor outcomes of pending infringement procedures. However, courts cannot take the place of the legislator and innovate existing national regimes. Courts have an uncertain attitude toward national systems which, as to their nature and operational conditions, might appear in contrast with EC law – in accordance with Commission's or ECJ's statement of incompatibility about other similar systems – or might not be justified in the light of coherence with both national and EC systems.
Although national judges are not the direct recipients of infringement procedures, they maintain in any case their role as communitarian judges. They would not be entitled to apply an incompatible regime, even though such a decision would require a delicate and difficult check. In fact, they choose an EC interpretation, but they must apply it in consideration of features of national systems and within national systems which, evidently, are not correspondent to cases deemed as incompatible. Therefore, they must take into account terms of application according to the interpretative method followed by EC case law. However, the effect is not equally positive. While, at EC level, the aim is to verify the compatibility of the exercise of national power of taxation, at a national level, with regard to the role of judges, it is more difficult to make a comparison between incompatible regimes and national regimes not yet examined by the Commission or ECJ. Such a comparison being essential in order to legitimize the intervention of the national judge as a communitarian judge, as well as to state the effectiveness of case law as *ius receptum*. Thus, the widespread uncertainty risks endangering a full affirmation of the EC role of national judges.

2.5 Exit taxes regime and allocation of competences

According to EC case law, in order to grant freedom of circulation and establishment within the Common Market, the source State is not entitled to exercise its power of taxation on latent capital gains, as regulated by national exit taxes regimes, at the

© Copyright Seast – All rights reserved

time of transfer to another tax jurisdiction. So as to allow the State where latent capital gains accrued to exercise a power recognized by EC system, another State has to be involved, precisely the one to which the taxpayer has transferred his/her residence. Then, according to EC case law, mobility seems to become a corollary of a new allocation of competences within the European market; it differs from the traditional approach, which intends safeguarding the right to mobility, by eliminating any obstacles coming from domestic tax law.
On the contrary, the EC issue concerning exit taxes arises from the effects of mobility, namely the loss of residence. In brief, with a view to avoid restrictions to free circulation and establishment of individuals, the EC case law has raised another issue – the allocation of powers of taxation –, directly involving not only the State which had registered capital gains, but also the State where the proceeds would be subsequently realized. Anyway in this case, the allocation does not stem from a conflict of powers, but rather from irreconcilability of the relevant exercises: the State where capital gains accrued is not entitled to exercise its power of taxation; the other State, which could exercise it at the time of actual realization, has to share it with the first State. A conflict takes place between the exercise of the power by the source State on the taxpayer who lost his/her residence and the same exercise by the State of residence with reference to capital gains accrued prior to the transfer to its tax jurisdiction.

3. The ECJ's way to compatibility of national exit taxes regimes: weakness of the EC model

EC case law did not only examine national regimes in the light of the direct applicability and consolidated interpretation of personal mobility and freedom of establishment. It also pointed out a solution aimed at reconciling national power of taxation, taxation territoriality, and freedoms of circulation and establishment, by keeping the power of taxation of the source State. Said State, in order to levy taxes on latent capital gains, should accept to postpone the exercise of its power of taxation

© Copyright Seast – All rights reserved

at the time of actual realization within the State of residence. Then, it would be required to check and follow the evolution of latent capital gains also beyond national borders.

This way, ECJ would be entitled to keep stating the primacy of European market without any sacrifice for powers of taxation of the source State. Powers would remain intact, while their exercise would be regulated in consideration of European freedom of circulation and establishment. Therefore, in the name of said freedoms, ECJ's proposal leans towards a dissociation between power of taxation and territoriality. As a consequence, the State of residence waives its right to levy taxes on capital gains accrued prior to the residence transfer, while the source State does not lose its power of taxation on the taxpayer also after his/her residence transfer.

Such a jurisprudential solution gives rise to a difficult balance. In fact, it is not sufficiently supported by a consistent EC effectiveness. The latter gives way to powers of taxation of the State of residence, since EC law cannot prevent said State from exercising its powers nor force it to waive such powers to the advantage of the source State.

Furthermore, effectiveness of this EC model exclusively relies on bilateral agreements subject to the autonomous discretion of concerned States with respect to the free establishment and circulation of latent capital gains. Case law turns to non-EC sources in order to reach EC-compatible outcomes. But said sources are grounded on national systems, rather than on the EC system.

The weakness of the EC model suggested by the ECJ risks bearing on the national power of taxation of the source State as such. While, in case law, it appeared strong in front of the EC system, it now risks growing increasingly weaker, since the relevant exercise at the time of the realization of capital gains is not supported by EC instruments as to its effectiveness, but only by bilateral agreements. In fact, the power of taxation of the source State is not exercised in the absence of consent from the State of residence. On the other hand, the source State could hardly respect Common Market freedoms, and then hardly exercise its power of taxation, though recognized by EC system. Indeed, it would be largely weakened because of difficulties met in the consistent application to realized capital gains.

© Copyright Seast – All rights reserved

4. The weakness of a case law model and the role played by EC policy

4.1 Equalization of exit tax regimes for companies

The weakness of the EC case law model highlighted the difficulty to reconcile national regimes and the EC system. Obviously, the primacy of freedom of establishment, which directly influences national systems, was out of the question. Said primacy involved exit tax regimes concerning individuals, but, acting as a principle, would not limit its scope to the one defined by previous case law. It was the Commission[4] which took charge of clarifying the general scope implied in such a principle. The freedom of establishment calls for compliance also by exit tax regimes concerning companies as well, not only individuals, as in the previous ECJ's case law. As explained hereinafter, such a juridical awareness borders on political responsibility. The aim of the Commission is sustainable in its attempt to overcome apparent subjective limitations of freedom of establishment, as defined by ECJ case law, in order to justify them in the light of peculiarities of national regimes submitted to the attention of the Court. The Commission has worked to enlarge the effectiveness of the principle according to which freedom of establishment becomes a parameter for EC compatibility of national income tax system.

At least apparently, the juridical solution was as simple as the political benefit was great. The Commission could extend its competences by limiting States' sovereign autonomy without having to present complex argumentations. The juridical cost of the political benefit was limited, almost inconsistent. In the Commission's opinion, it was sufficient to emphasize the effectiveness of a jurisprudential principle, by recognizing its largest applicability, so as to overcome potential subjective limitations which would question the effectiveness of the ECJ principle as such. Under a juridical perspective, said solution could not be suitable to assure the general effectiveness of the principle; moreover it did not correspond to a mere unification under the EC control of regimes for both individuals and companies. In fact, fiscal criteria to determine national

---

[4] Communication from the Commission of 19.12.2006, *Exit taxation and the need for coordination of Member States' tax policies*, COM(2006) 825 def.

© Copyright Seast – All rights reserved

territoriality of companies make reference to the registered office or to the administrative office or seat of the activity. Therefore, companies are exposed to fiscal consequences coming from the application of either the rule of incorporation or the rule of administrative seat, from which they would derive their juridical survival in case of transfer of the actual seat.

4.2 The difficult coexistence with the national principle of territoriality

National principles of territoriality hardly reconcile with the EC control of compatibility relating to national exit tax regimes for companies. Once examined and recognized as EC-compatible by ECJ case law itself, their effects at EC level have to be accepted as well. They impact on the source State and the State of residence, they determine either the juridical survival or the extinction of companies. Such profiles evidently influence fiscal effects on companies' mobility and freedom of establishment, as well as the exercise of powers of taxation by the source States and State of residence, which, in the ECJ's view, represents a necessary allocation of jurisdiction in order to safeguard the powers of taxation of the source State and the relevant postponed exercise.

The solution can be only juridical, since it pertains to relationships between national and EC systems, although it has not yet been defined for territoriality and EC coherence. In the light of this, the Commission's proposal to rely upon bilateral or conventional agreements has to be regarded as juridically unsatisfactory. In fact, said instruments are not endowed with grounds, nor with the EC effectiveness which would allow them to prevail on national systems in any case, by virtue of the primacy of EC system.

The same approach should be envisaged for the Conventions set forth by the Treaty, notwithstanding their consideration by EC case law as convenient juridical instruments in the lack of EC solutions, suitable to avoid a direct comparison between economic freedoms and national tax systems, unlike national exit tax regimes. The Commission's attitude to regard such solutions as definitive does not mean that an

© Copyright Seast – All rights reserved

innovative outcome is reached on a EC level. In other words, an unsolved juridical issue is shifted to the political level.
In brief, as an effect of the Commission's solution, companies' exit tax regimes have been included in the unstable equilibrium of national tax regimes which had previously concerned individuals.

5. Conclusions

The Past corresponds to the loss of identity between power of taxation and its exercise.
The Present is a work in progress where the weak EC model copes with the difficult compatibility between exercise of powers and EC freedoms, as revealed by the great variety of national solutions submitted at the same time to the ECJ's examination.
The Future envisages a situation where weakness of the taxation of realized capital gains by source States makes the safeguarding of their power of taxation increasingly difficult, or demands from them to stipulate bilateral agreements or conventions. In any case, these instruments - proposed by ECJ and requested by the Commission - confirm the difficulty to reach an EC solution which would also correspond to an institutional model. Should it concern also regimes applicable to companies, such a solution would become even more difficult. To this day, in fact, the outcome depends on the EC issue of reconciling national criteria of territoriality with direct effectiveness of freedom of establishment. As long as it is an open issue, also exit tax regimes for companies will suffer from the same unstable equilibrium as national regimes do with respect to individuals. Thus, uncertainty on the national future of exit taxes is stressed, as well as the uncertainty on the development of the European market, and not only on its regulations.

© Copyright Seast – All rights reserved