News and Commentary - ***Exit Tax: Comparative Analysis in a EU Perspective*** **(n. 1/2009)**

Revising the Portuguese exit tax
(Understanding the concept and dealing with the case)

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1. Introduction. General Remarks

Starting first January 2010 some changes were introduced to the IRC[2] (company taxation). Can we still see situations where the concept of exit tax – as ruled by ECJ - can be found? In an environment where exists freedom of movement for persons, capital and goods conducting to freedom of establishment can the act of changing residence determine taxation? The question was already answered in the ECJ Judgment of Court Case C-9/02[3] known as Lasteyrie du Saillant the name of the Author of the complaint against the French legislation that introduced in 1999 a disposition that would tax the latent increase in securities held but not sold by a taxpayer that transferred his residence for another Member State.

Although the French State argued that the taxpayer could avoid payment by suspending the taxation trough the setting up of guarantees and the aim of the measure was to avoid tax planning or avoidance the Court ruled that:

"The principle of freedom of establishment laid down by Article 52 of the EC Treaty[4] *(now, after amendment, Article 43 EC) must be interpreted as precluding a Member State from establishing, in order to prevent a risk of tax avoidance, a mechanism for taxing as yet unrealised increases in value such as that laid down by Article 167a of the French Code Général des Impôts, where a taxpayer transfers his tax residence outside that State."*

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[2] To understand the concept and basic features of IRC see, Manuel Pires, in European Tax Studies nº1/2009.
[3] European Court of Justice, Judgment of 11 March 2004, C-9/02, case *Lasteyrie du Saillant.*
[4] EC Treaty.

Situation was altered by the French law of 2005 (Loi de Finances rectificative pour 2005 – article 61). The Portuguese government that submitted written observations on the Case defended the Commission positions –point 22.

It is therefore interesting to understand how the Portuguese Government can be now in a position to be held in Court for a similar matter.

As the Court reminded Article 52 of the Treaty «constitutes one of the fundamental provisions of the Community law and has been directly applicable in the Member States since the end of the transitional period».

2. The taxation of increases in theory and in practice

In Portuguese legislation similar to many others in Europe and around the world only realised increases are taxed. This does not correspond to a generosity of the Portuguese government but to a basic principle of taxation that only existing accruals should be taxed. Underneath this practice there is the conviction that the latter the increase will be taxed the bigger it will be and this constitutes a way of increasing the tax revenue on a medium to longer term approach.

On the other hand to tax latent or non realised revenue is to force the taxpayer to pay the amount of something that he did not receive or collect. It becomes therefore unjust and determines planning reactions by the taxpayer that would jeopardize the detention of assets and the valuation of them. In the long term this would be economically wrong and would probably conduct to a lack of capital in the economy, induced by taxation.

The concept that the change of residence is a circumstance that determines taxation is based on the assumption that further selling of assets will not be controlled by the origin State and the fundamentals of increase taxation are jeopardised because the State did not tax in the moment of potential gain on the assumption that it would do so latter. As latter the Taxpayer is no longer resident he is no longer taxable by the origin State. In this approach

the existence of mechanisms that would avoid the residence status to be used as a form of fiscal avoidance or evasion is advisable and justified.
It is known that some European countries do not tax increases in stock market operations that are therefore exempted. This creates an inequality that tends to be used for treaty shopping or planning activities.

3. Exit tax Guiding Principles

The Council in their internal discussions approved some basic rules to deal with this matter since the taxation was no longer accepted and invited Member States to accept them – Resolution 16412/08.
The rules can be briefly summarised as follows:

A. The concept of «*transfer of economic activity*» can be defined as any operation by which a taxpayer that exercises an economic activity: i) stops being taxpayer of a direct tax revenue in one Member State (origin State) and at the same time starts being taxpayer in another Member State (destination State), or, ii) Transfers a set of elements of active and passive from a main office or permanent establishment in the origin State to a main office or permanent establishment in the destination State.
B. When by occasion of a transfer of economic activity, the origin State gives itself the right to tax the existing reserves (profits realised but not yet accounted for fiscal purposes) and recover, total or partially the provisions constituted (spending not yet incurred but already accounted for in fiscal terms), the State of destination may allow the constitution of reserves or provisions correspondent to similar amounts according to the rules applicable in that State to the tax base and authorize the respective deduction in the tax base in the year of its constitution.
C. When by occasion of a transfer of economic activities the origin State gives itself the right to tax the latent increases correspondent to the assets detained by the taxpayer, calculated

on the base of the difference between the market value of these assets at the date of transfer and their value in the balance sheet, the destination State takes the market value at the time of transfer to calculate the increase that will be generated in case of selling.

D. In case of disagreement between the State of origin and the State of destination, both States will solve the dispute according to competent procedure.
E. The destination State may demand the taxpayer that made the transfer of economic activities the proof that the origin State exercised or intends to exercise its rights in the conditions established above giving the relevant elements that prove the market value defined by the origin State.
F. The existing dispositions established at the Community level regarding mutual assistance constitute the framework of assistance to be given by the destination State to the origin State, namely to determine the date of selling.
G. Where the exit State applies an exit tax and the host State imposes a tax on gains, the two States will refer to a common value for calculating the tax: the market value on the date of transfer of economic activities.
H. In the event of disagreement on the value arrived at, the Member States will set up a procedure for settling their dispute.
I. The Directive on mutual assistance is the appropriate framework for the information exchanges required for proper application of the principle concerned.

This is the first time that the Commission's initiative on the coordination of Member States' direct taxation systems has taken tangible form, in a Council Resolution.

4. The Portuguese case

The Portuguese legislation establishes two situations where the change of status in residence may determine taxation.

At the level of Personal Income (IRS) - article 10º, nº 8 and 9 a) the loose of the status of residence may determine taxation in the following conditions:

- Whenever there was a previous exchange of shares or participations of the capital of a company and there was no previous taxation of this operation.
- In case, the increase will be taxed by the difference between the real value of the acquired shares/participations and the value of acquisition of the previous shares/participations.

As it can be seen the case only applies in specific cases where there was no previous taxation although there is a change in the possession of shares/titles that could – in principle – determine the existence of taxation.

Before the mentioned change in legislation and at the level of company tax (IRC) – article 74º rules - the neutrality principle was applicable trough two methods: exemption and imputation. This last method is used in the case of transfer of a p.e. situated outside the Portuguese territory that was controlled by a resident company.

The established situations of neutrality were as follows:

- Transfer of assets made by a resident company to another beneficiary resident in Portugal or being resident in a Member State these elements are allocated to a p.e. of the non resident company situated in Portuguese territory and concur to the taxable income of that p.e.;
- Transfer of assets of a p.e. belonging to a company sieging in a Member State to a resident company extinguishing therefore the p.e. (incorporation);
- Transfer of a p.e. situated in the portuguese territory belonging to a company situated in a Member State to that or another Member

State, provided that the assets transferred concur to the calculation of the taxable income imputable to the p.e.;

- Transfer of p.e. ´s situated in the territories of other Member States made by resident companies in favour of companies resident in Portuguese territory;

  The application of this regime determines that the beneficiary company keeps for tax purposes the transferred assets accounted at the same value that they had before the transfer.

This set of rules regulates the transfer of assets and the neutrality that presides the economic operation therefore respecting apparently the freedom of movements and establishment enshrined in the fundamental freedoms that preside the EU.

What were the changes and in what aspect do they change the Portuguese State position?

Actual article 83º of IRC under the title of «transfer of residence of a company abroad and ending of activity of non resident companies» rules the following:

- The ending of activity by the extinction of entity with main office or effective management in Portuguese territory, including European company and European Cooperative company, due to the fact of change of main office or effective management are no longer in Portuguese territory determines the taxation of capital gains, if any, calculated on basis of the difference between the market and the company books accounted value at the date of termination of activity,
- This rule does not apply to the assets that stay connected with a p.e. of the same entity and may contribute to a taxable profit according to the rule set in article 74º that are previously explained in this paper,
- The rule does not apply also if the objective of the operations were tax evasion.

Does this solution resist the test of proportionality that has been used by ECJ in the cases of non discrimination[5]?

The Portuguese solution is identical to the one applied for Portuguese nationals that end activity meaning that the liquidation of a company or a partnership implies taxation of capital gains. This means that the possibility of non taxation for non residents would create an inequality between residents and non residents benefiting the non residents. This would be against constitutional principles of non discrimination and equality.

- The other situation that determined taxation according to previous Portuguese law was the specific case of transfer of non resident assets controlled by a Portuguese resident when there was a previous exchange of stocks/participations that was not taxed and could have been according to the Portuguese legislation.

This last situation looks like a provision that was enacted for equity and prudential reasons and made in order to avoid inequality between resident and non resident capital. In this case we would be facing a situation where the use of the Treaty principles would determine a discriminatory treatment of similar situations by a double non taxation situation.

Could this be addressed by means of exchange of information with the concerned State therefore avoiding this kind of disposition? If so, does it mean that this provision was a violation of a fundamental Treaty freedom?

Question seems no longer valid because the existing drafting of article 77º of the IRC clearly states that the exchange of participations or shares made with residents of member States of the EU does not determine taxation as long as the evaluation and book value of these assets remains unchanged after the change of the participations/shares and the owners are in the conditions of Directive n. 90/434/CEE, of 23 July[6].

The solution is similar to the one used to Portuguese residents.

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[5] An extensive and deep analysis can be found in Andrea Mondini, *Coerenza Fiscale e principio di proporzionalità: crisi del sistema o dell´armonizzazione? Estratto,* Anno LXVI Fasc.3 – 2007, Milano Giuffrè Editore.

[6] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

5. Conclusions

There is no similar legal provision in the Portuguese legislation as we could find in the French legislation until 2005.

Can the pointed situations be considered as a limitation to the freedom of establishment? This question will be answered during the Case that has been announced by the Commission against Portugal but we must signal that some major differences seem to arise from these situations compared to the ones that were ruled by the ECJ in the Lasteyrie du Saillant Case.

The major differences are:

- The Portuguese legislation specifically establishes the neutrality of the transfer of assets operations provided that no money is paid and the accounted value stays the same after the change of residence;
- We know not of any particular case of dispute in the Portuguese Courts about this legislation.

5.1 The European Court Case

The Commission started an infringement procedure against Portugal after a formal and detailed advise numbered IP/08/1813 that gave recently way to a procedure sent to the ECJ number 2007/2365. In these documents it is argued that by taxing a resident that ceases to be on latent capital gains the Portuguese legislation creates an unnecessary discrimination against the freedom of movements and creates a condition that it is not applicable to a resident taxpayer therefore infringing the fundamental freedoms of the Treaty.

The existing rules seem to address the issue and are therefore enacted for prudential reasons that aim at avoiding the abuse of Community rules and principles and keep the coherence of the fiscal system.

Can it be insight the Bachmann Case – C-204/90[7] - as ruled by the European Court of Justice? As Andrea Mondini pointed out Bachmann Case is the only case where the Court has recognised in particular a justified limitation to the fundamental freedoms.

Does the Portuguese legislation still have unfounded limitations that hamper the fundamental freedoms?

We will have to wait for the Commission next move and Court decision.

[7] Judgment of the Court, 28 January 1992, *Hanns-Martin Bachmann v Belgian State*, case C-204/90.