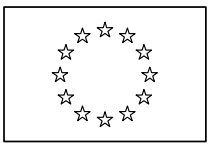

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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE EUROPEAN PARLIAMENT AND THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE

Exit taxation and the need for co-ordination of Member States' tax policies

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1. INTRODUCTION

The present Communication is presented within the framework of the Communication on co-ordinating Member States' direct tax systems in the Internal Market issued today. It analyses the legal requirements laid down in the EC Treaty as interpreted by the the European Court of Justice (ECJ) in the *de Lasteyrie*[1] case, and confirmed and developed in the *N* case[2], and considers how these affect exit taxes levied on individuals and on companies. It also examines how MSs' exit tax rules can be made compatible with the requirements of EC law and discusses the broad principles of possible co-ordinated solutions to the current mismatches between different national provisions. The Commission intends to develop more detailed guidance on these issues in close cooperation with MSs.

2. EXIT TAXES: LEGAL FRAMEWORK

2.1. The decision of the ECJ in *de Lasteyrie* and its implications for individuals

On 11 March 2004, the ECJ gave an important interpretation of the freedom of establishment in the context of French legislation taxing unrealised increases in value of securities where individual taxpayers move their tax residence outside France. When Mr. de Lasteyrie du Saillant in 1998 moved from France to Belgium, he was subject to immediate taxation on the unrealised increase in value of the shares which he held in a French company.

The ECJ held 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 MS, because they were subjected in the exit country, 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 a person maintaining his residence in France.

Although the ruling in *de Lasteyrie* relates to the facts and circumstances of the case at issue, the ECJ's interpretation of EC Law implies conclusions as regards exit taxes in general.

Taxing residents on a realisation basis and departing residents on an accruals basis is a difference in treatment which constitutes an obstacle to free movement. Where a MS decides to assert a right to tax gains accrued during a taxpayer's residence within its territory, it cannot take measures which present a restriction to free movement.

This rules out the possibility of immediate collection of the tax due on the unrealised gains when taxpayers move their tax residence to another MS. The ECJ ruled in *de Lasteyrie* and in *N* that the possible suspension of payment made subject, for example, to conditions that guarantees must be provided, constitutes a restrictive effect in that the taxpayer is deprived of enjoyment of the assets given as a guarantee. Similarly, it is clear from *de Lasteyrie* that suspension of payment cannot be made subject to the condition of designating a representative

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1 Case C-9/02 Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie, OJ C 94, 17.4.2004, p. 5.

2 Case C-470/04 N v Inspecteur van de Belastningsdienst Oost / kantoor Almelo, 7 September 2006.

in the MS of origin. 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.

As the ECJ confirmed in *N*[3], when a resident of a MS transfers his/her residence to another MS, the MS from which he/she departs is not prevented by EC law from assessing the amount of income on which it wishes to preserve its tax jurisdiction, provided this does not give rise to an immediate charge to tax and that there are no further conditions attached to the deferral. Such a practice is in line with the principle of fiscal territoriality, connected with a temporal component, namely residence within the territory during the period in which the taxable profit arises. A requirement, that the taxpayer submits a tax declaration at the time of the transfer of residence, necessary for the purpose of assessing the income, can be considered proportionate having regard to the legitimate objective of allocating the taxing powers, in particular so as to eliminate double taxation, between the MSs[4].

Most MSs which had exit tax rules on individual shareholders similar to those at issue in *de Lasteyrie* have since abolished or amended them in line with the ruling. This has enabled the Commission to suspend infringement proceedings against a number of MSs on this particular aspect. The Commission will, however, continue to monitor MSs' rules in this area with a view to ensuring their EC law compatibility.

2.2. Resolving mismatches and eliminating double taxation and double non-taxation

Although granting an unconditional deferral may resolve the immediate difference in treatment between taxpayers who move to another MS and those who remain in the same MS, it will not necessarily provide a solution for the existing mismatches between MSs' tax systems. According to the general rule of Article 13 of the OECD Model Tax Convention on Income and on Capital, it is the State of residence which has the exclusive taxing right on the alienation of shares. There are no specific rules in the Model Convention on how to treat individuals who have changed their tax residence. In practice, some MSs have included specific provisions in their bilateral tax conventions to ensure that the attribution of taxing rights matches an extended tax liability of taxpayers under national law. Others take the view that as the deemed disposal 'occurs' at the moment just before emigration, it is a domestic transaction to which the double tax convention does not apply.

A possible unjustified restriction could arise if the exit State calculated the capital gain at the moment of deemed disposal, and collected the tax at the moment of actual disposal, and the new State of residence taxed the whole capital gain from acquisition up to the actual disposal. This would cause double taxation of the value increase from acquisition to deemed disposal, if the residence State considered that it had the exclusive taxing right on the disposal, and neither MS granted a credit for the tax levied by the other. The Commission considers that where two MSs choose to exercise their taxing rights on the same income, they must ensure that this does not result in double taxation. This view also finds implicit support in the ECJ's decision in *N*[5].

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3 Paras 42-46.
4 Para 49.
5 Para 49.

The Commission sees different options for MSs to resolve these mismatches:

– In practice, a number of MSs 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 gains.

– MSs could also agree to divide the taxing rights on the gains, e.g. by splitting up the taxing rights according to the period that the shareholder was resident in the respective MSs. This may require changes to existing double tax conventions. As confirmed by the ECJ in *N*, any solution would need to take account of a possible decrease in value of the shares[6] by either the host MS or that of origin. The fact that a taxpayer has exercised his or her right of free movement may not result in taxation of a higher amount of gains than would have been taxable had he/she not changed residence.

Irrespective of which method MSs use to resolve the mismatches between their tax systems, effective administrative co-operation will be key to ensuring the success of such measures. 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 occurs. Similarly, if the emigrated taxpayer refuses to pay his/her taxes, the exit State will have to rely on the new State of residence to collect the taxes on its behalf[7]. MSs should therefore make full use of the possibilities offered by the Mutual Assistance Directive and the Recovery Directive[8].

3. EXIT TAXES ON COMPANIES

3.1. Implications of *de Lasteyrie* for companies

The Commission is of the opinion that the interpretation of the freedom of establishment given by the ECJ in *de Lasteyrie* in respect of exit tax rules on individuals also has direct implications for MSs' exit tax rules on companies[9].

The European Company Statute became available for use on 8 October 2004, making it possible for a company organised in the form of an SE (*Societas Europaea*[10]) to transfer its registered office to another MS, without this resulting in the winding up of the company or the creation of a new legal person. The 2005 amendments[11] to the Merger Directive (90/434/EEC) ensure that, provided certain conditions are met, the transfer of the registered office of an SE or of a European Co-operative Society[12] from one MS to another will not result in immediate taxation of unrealised gains on assets remaining in the MS from which the office is transferred. The amendments are silent on those assets which do not remain connected to a PE in the MS from which the registered office is transferred. However, the Commission considers that the principles of *de Lasteyrie* apply to such 'transferred' assets.

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6 Para 54.

7 As the ECJ observed in *N*, see paras 52-53.

8 Council Directive 77/799/EEC of 19.12.1977 and Council Directive 76/308/EEC of 15.3.1976 as last amended by Council Directive 2001/44/EC of 15.6.2001.

9 Some commentators have observed that with the exception of one paragraph, the entirety of the judgement was written in terms of "taxpayer", rather than referring merely to taxation on individuals. It may be noted that the ECJ itself cites *de Lasteyrie* in its judgment of 13.12.2005 in Case C-411/03 *Sevic Systems AG* concerning the cross-border merger of companies.

10 Council Regulation (EC) No 2157/2001 of 8.10.2001.

11 Council Directive 2005/19/EC of 17.2.2005.

12 Council Regulation (EC) No 1435/2003 of 22.7.2003.

There is also a type of exit charge in most MSs when a company transfers single assets or liabilities to a permanent establishment (PE) situated in another MS, whereas a similar transfer of assets from a head office to a branch in the same MS would not attract any immediate tax consequences[13].

When a company transfers assets to a PE in another MS, the MS of residence of the company may want to assert its taxing rights on the difference between the market value of assets and liabilities at the time of transfer and their value for tax purposes (gains). This difference is usually taxed upon realisation, and not on an accruals basis. However, assets and liabilities which are transferred by a company's head office to its PE situated in another MS are, under the current tax rules of most MSs, considered as 'alienated' and gains accrued while the assets were effectively connected with the company resident in their territory are usually taxed immediately upon transfer of the assets.

It follows from *de Lasteyrie* that taxpayers who exercise their right to freedom of establishment by moving to another MS may not be subject to an earlier or higher tax charge than taxpayers who remain in one and the same MS. If a MS allows tax deferral for transfers of assets between locations of a company resident in that MS, then any immediate taxation in respect of a transfer of assets to another MS is likely to be contrary to the EC Treaty freedoms.

A MS wishing to exercise its taxing rights on the difference between the book value and the market value of the asset at the moment of transfer, may establish the amount of income on which it wishes to preserve its tax jurisdiction, provided this does not give rise to an immediate charge to tax and that there are no further conditions attached to the deferral. However, such an unconditional deferral will not necessarily provide a solution for the existing mismatches between MSs' tax systems (see under 3.2).

In case of deferral, MSs may impose reasonable obligations on taxpayers to keep the tax authorities regularly informed of their continued holding or indeed disposal of the transferred assets, provided such obligations do not go beyond what is necessary to achieve their objective and do not prevent taxpayers from exercising their Treaty rights. A MS could for example require its taxpayers to file a declaration when they transfer assets to another MS confirming that they have not disposed of the assets. A simple annual statement from the taxpayer that its PE in the other MS continues to hold possession of the transferred asset combined with a declaration at the moment of actual disposal or of a subsequent transfer of the asset to a third state would also appear to be acceptable and sufficient.

The Commission also encourages MSs to make better use of the means already at their disposal to improve the exchange of information and assistance in collection between the tax administrations concerned. The Commission is prepared to assist MSs in examining the scope for automatic exchange of information in this area.

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[13] Similar issues may arise in respect of the transfer of assets from a PE to a head office in another MS, or indeed for transfers between two PEs of the same company situated in different MSs. For the sake of simplicity, only the transfer of assets from head office to PE is discussed in this Communication, but the analysis is equally applicable to those other types of transfer. It may however be noted that the practical implications may vary for the different scenarios depending on the method used by the MS of the head office to avoid international double taxation.

If a MS wishes to minimise the administrative burden, it could offer its taxpayers the *option* to renounce the deferred collection of tax and to choose to pay the tax at the moment of transfer. Such an option must however be truly voluntary and even-handed. A MS may not coerce its taxpayers into opting for immediate payment of the tax by imposing an undue burden on them in case of deferral of collection until the actual disposal of the assets.

3.2. Resolving mismatches and eliminating double taxation and double non-taxation

MSs apply different valuation methods in respect of the cross-border transfer of assets. A number of MSs allow assets to be transferred to a PE in another MS at book value. These MSs 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, they also value assets transferred to a PE in their territory at book value. Other MSs seek to exercise their taxing rights on the difference between the book value and the market value at the moment of transfer.

If an asset is transferred from a MS which chooses to exercise its taxing rights at the moment of transfer to a MS which values the transferred asset at book value and taxes any subsequent increase in value upon disposal of the asset, this can result in double taxation of the gains involved. If, on the other hand, an asset is transferred from a MS which allows transfer at book value to a MS which values the transferred asset at market value, there will be no taxation of the difference between the book value and the market value of the asset in either MS, i.e. unintentional double non-taxation.

Mismatches also occur when two MSs apply the same basic approach but in practice reach different conclusions on the value of the specific assets involved. If the MS to which the asset is transferred attributes a higher value to the asset, thus allowing for a higher depreciation of the asset against the taxable profits of the PE and taxing a lower amount of gains on any possible subsequent disposal of the asset, this can lead to double non-taxation of part of the gains. If, on the other hand, the MS to which the asset is transferred attributes a lower value to the asset, depreciation will be lower and gains on an eventual later disposal higher, resulting in double taxation of part of the gains.

Such mismatches hamper the proper functioning of the Internal Market as they may dissuade companies from investing in other MSs. 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.

Where a MS chooses to exercise its taxing rights at the moment of transfer of the asset to another MS, the taxpayer should not suffer any double taxation as a result. The MSs concerned should therefore ensure that measures are taken to avoid such double taxation.

One way to do this would be for the MS to which the asset is transferred to accept the market value established by the other MS at the moment of transfer as the starting value of the asset for tax purposes. 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 MSs to maximise the amount of gains taxed in the MS with the lower corporate tax rate. Alternatively, MSs could continue to value the assets according to their own rules, but provide for a procedure to resolve possible differences in valuation, e.g. a binding dispute resolution mechanism such as that provided for in the EU Arbitration Convention

(90/436/EEC) or a generalised mechanism to overcome double taxation within the EU (as stated in the Coordination Communication the Commission intends to explore the scope and feasibility of such a mechanism in due course).

Where an asset is transferred from a MS which allows transfer at book value to a MS which would usually value the transferred asset at market value, MSs should take appropriate measures to avoid double non-taxation of the difference between the book value of the asset and its market value at the moment of transfer. One way to do this would be for the MS to which the asset is transferred to use the other MS's book value as the starting value for tax purposes. In these circumstances, an approach based on mutual recognition would appear the obvious solution.

The above approaches are generally premised on the idea that the exit State should grant tax deferral until the actual disposal of the assets by the PE or the transfer of those assets to a third country (see Chapter 4). It must, however, be acknowledged that certain types of 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 (e.g. certain intangibles). In practice, MSs frequently use other taxable events than actual disposal to ensure appropriate taxation of such assets in purely domestic situations, e.g. national tax systems generally compensate for accelerated depreciation in the first year(s) after purchase by a corresponding reduced depreciation in subsequent years Another example is the current taxation of the income stream from a self-developed patent (no capitalisation of research and development expenditure) during the patent protection period.

The Commission believes that where MSs use other taxable events than disposal in domestic situations, they should also be able to apply similar mechanisms in cross-border situations, provided this does not result in a worse treatment of cross-border operations compared to domestic ones. MSs should however ensure that such alternative mechanisms do not give rise to double taxation and unintentional double non-taxation. They should therefore co-ordinate their application with the MSs to which the assets are being transferred. The Commission is prepared to assist MSs in developing detailed guidance on these issues.

4. EXIT TAXES IN RESPECT OF EMIGRATION OR TRANSFER OF ASSETS TO EEA/EFTA STATES

4.1. Freedoms applicable to EEA-states

The European Economic Area (EEA) Agreement provides for the same four basic freedoms as the EC Treaty (goods, persons, services and capital). It also includes horizontal provisions relevant to the four freedoms. Secondary Community legislation in the area of taxation, however, has not been incorporated in the EEA Agreement. The Mutual Assistance Directive and the Recovery Directive therefore do not apply to these states

4.2. Emigration of individuals / transfer of seat of companies – free movement of workers / freedom of establishment

Taxes levied in case of the emigration of individuals or the transfer of seat of companies would primarily appear to involve the free movement of workers (Article 39 EC / 28 EEA Agreement) and the freedom of establishment (Article 43 EC / 31 EEA Agreement) respectively. The exit taxes at issue in *de Lasteyrie* and *N* which applied to individuals with substantial shareholdings were found to contravene the freedom of establishment. As the same

basic freedoms apply to EEA states, the rulings in *de Lasteyrie* and *N* are of direct relevance to them. The question is whether there are significant differences in situation which could justify such restrictions in the case of EEA states. The Commission is of the opinion that an immediate collection of tax may be justified in certain circumstances by overriding reasons in the general interest, in particular the need to ensure the effectiveness of fiscal supervision and to prevent tax evasion.

EEA states are not obliged to implement secondary Community legislation in the area of taxation, such as the Mutual Assistance Directive and the Recovery Directive. As a consequence, MSs do not necessarily have the same guarantees that deferred tax claims can be discharged at a later stage as they would have within the Community. In many cases, MSs have, however, concluded bilateral or multilateral tax conventions with EEA states which include information exchange obligations that provide for an equivalent level of mutual assistance. The Commission believes that in situations where a lack of administrative co-operation prevents MSs from safeguarding their tax claims they should be entitled to take appropriate measures at the moment of emigration or transfer.

4.3. Transfer of assets – freedom of establishment, free movement of goods and capital

The transfer of assets from a company's head office in a MS to its PE situated in another MS could, depending on the circumstances and nature of the assets, involve the freedom of establishment, the free movement of goods or the free movement of capital.

In the case of EEA states, where the same freedoms apply, this would appear to raise issues similar to those discussed in 4.2. in respect of the emigration of individual taxpayers and the transfer of seat of companies. The Commission is of the opinion that MSs should be allowed to safeguard their tax claims at the moment of transfer of the assets if there is no adequate information exchange relationship with the EEA state concerned.

5. EXIT TAXES IN RESPECT OF THIRD COUNTRIES

Of the four basic freedoms, only the free movement of capital and payments (Article 56) applies to third countries.

In respect of the emigration or transfer of seat to other third countries[14] as such, the provisions on the free movement of persons do not apply and MSs remain free to assess and collect their taxes at the moment of departure. However, the emigration of an individual or the transfer of seat of a company may involve transactions which are covered by the provisions on the free movement of capital. The transfer of assets to a PE in a third country may also fall to be examined from the perspective of the free movement of capital.

Since the result of the application of the different freedoms should be the same, it would appear that an immediate collection of tax at the moment of transfer of such assets constitutes a restriction on the free movement of capital. However, as noted above, the Commission believes that a lack of administrative co-operation may justify a restriction in these circumstances. The Commission would encourage MSs, where appropriate, to enhance

[14] With the exception of Switzerland. Under the 1999 Agreement between the European Community, its MSs and the Swiss Confederation, the free movement of persons also applies in respect of Switzerland.

administrative co-operation with their non-EU partners, as this is the best means of ensuring tax compliance and preventing tax evasion.

6. CONCLUSION

Exit taxation is a prime example of an area where MSs could benefit from co-ordination at EU level. A co-ordinated approach can help MSs to make their exit tax rules compatible with the requirements of EC law and with each other.

The Commission is willing to assist MSs in developing the co-ordinated solutions set out in this Communication and intends to establish more detailed guidance on the above issues in close co-operation with MSs.

The Commission invites the Council, the European Parliament and the Economic and Social Committee to give their opinion on this Communication.