Exit Taxation in the European Union
Is there really a problem?

By

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# Table of Contents

Summary ........................................................................................................... 1

Preface ............................................................................................................. 2

Abbreviation list ............................................................................................. 3

1. Introduction .................................................................................................. 4
   1.1 Background .............................................................................................. 4
   1.2 Aim ........................................................................................................ 6
   1.3 Method and material .............................................................................. 6
   1.4 Outline .................................................................................................. 6

2. Explaining exit taxation .............................................................................. 7

3. ECJ solutions for exit taxation ................................................................. 9
   3.1 Company law cases ............................................................................... 9
   3.2 Individual Exit Taxation Cases ............................................................... 13
   3.3 Corporate Exit Taxation Cases ............................................................... 17

4. Bilateral treaties solution - OECD Model Tax Convention ...................... 21
   4.1 The concept of alienation .................................................................... 22
   4.2 Treaty override ..................................................................................... 25
   4.3 The right to tax ....................................................................................... 26
   4.4 Double Taxation .................................................................................... 27

5. Conclusions .................................................................................................. 28

Bibliography .................................................................................................... 32
Summary

Exit taxes represent an expression of state’s sovereignty by taxing value increases of assets, hidden reserves and any untaxed income that arose on its territory. These taxes are triggered before the state of emigration loses its power of taxation as a result of the transfer to the jurisdiction of another state when an individual or company changes residency. The purpose of exit taxes is to protect tax bases and to prevent the escaping of untaxed revenue.

As the EU is established on the principles of a single market, individuals and companies are guaranteed by TFEU a number of freedoms that cannot be restricted. Due to this fact, Member States cannot levy exit taxes in an unrestrained manner. According to the ECJ, exit taxes are split into two categories. Exit taxes for individuals have to be only in the form of a final tax assessment with an automatic deferral till the realization of the asset including consideration for future value decreases. On the other hand, in the case of exit taxes for companies, only an option between immediate taxation and deferral till realization must be provided. At the same time, Member States can request the payment of interest and guarantees until the tax is paid. Likewise, the tax can also be paid in yearly installment over a period of time without realization.

The levy of exit taxes can also be affected by bilateral tax treaties which are most commonly based on the OECD Model Tax Convention. Tax treaties have an important role in the allocation of taxing powers between Member States, yet unfortunately in the case of exit taxes a number of uncertainties create some difficulties. It is not clear if the OECD Model Convention prescribes the taxation of unrealized capital gains and at the same time the legal issue of treaty override can interfere in such situations. The OECD Commentaries provide contradicting statements in regards to these issues therefore the solution to these problems is a matter of interpretation.

Notwithstanding the aforementioned difficulties, there is nothing that would impede the Member States of the EU to levy exit taxes. The ECJ has acknowledged that Member States have the right to defend their tax base by taxing economic value generated by unrealized capital gains in their territory even if the gain concerned has not yet actually been realized. Additionally, tax treaties based on the OECD Model Convention do not forbid the levy of exit taxes, the state of emigration has the right to tax due to the fact that the tax liability is established when the taxpayer is still a resident. Taking into consideration the aforestated, it can be concluded that there is nothing wrong with the imposition of exit taxes as it is a fair manifestation of the Member States’ tax sovereignty.
Preface

I would like to express my outright gratitude to the Swedish Institute and the Swedish Government for offering me the chance to complete my studies in a state-of-the-art and one of the most competitive universities in the world. The knowledge and experience that I gained in Sweden will unquestionably mark me as a person and help me achieve my life goals.

I would also like to thank my coordinator Cécile Brokelind for guiding me through all this challenging process. Likewise, I would like to express my acknowledgement to all the professors at this master programme for the provided knowledge and guidance in a field that was effectively new for me.
# Abbreviation list

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<th>Abbreviation</th>
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<tr>
<td>TFEU</td>
<td>Treaty on the Functioning of the European Union</td>
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<td>ECJ</td>
<td>European Court of Justice</td>
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<td>EU</td>
<td>European Union</td>
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<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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</tr>
<tr>
<td>p.</td>
<td>page</td>
</tr>
<tr>
<td>pp.</td>
<td>pages</td>
</tr>
<tr>
<td>para.</td>
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</tr>
<tr>
<td>paras.</td>
<td>paragraphs</td>
</tr>
</tbody>
</table>
1. Introduction

1.1 Background

The EU is established on the principles of a single market. Article 26 of the TFEU states that the internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital are free to circulate. Albeit the fact that article 49 of the TFEU prohibits restrictions on the freedom of establishment and that the ECJ has already held that companies are to be treated in the same way as natural persons who are nationals of Member States\(^1\), restrictions that contradict the concept of a single market and the freedom of establishment still exist.

As Community law at this stage of harmonization does not have any compelling regulation in the matter of direct taxation, Member States have the power to determine the criteria for taxation of income and wealth.\(^2\) This means that they can establish what type of taxes to levy, the rate of the tax, the tax subject and tax object.\(^3\) At the same time, according to the ECJ although direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law.\(^4\) Taking into consideration the aforementioned, it can be concluded that one of the main reasons for the presence of restrictions in the EU is the conflict between the tax sovereignty of the Member States and the freedoms guaranteed by the TFEU.

One type of direct taxes that reflects the above mentioned situations are exit taxes. An exit tax represents an expression of the fiscal sovereignty of a state by taxing unrealized capital gains, hidden reserves and value increases of the assets of an individual or a company that leaves its jurisdiction.\(^5\) The ECJ finds exit taxation as a restriction on the fundamental freedoms guaranteed by the TFEU, mainly the freedom of establishment.\(^6\) The Court determined that exit taxation results in a disadvantageous treatment by comparing a taxpayer wishing to transfer his residence to the one who maintains his.\(^7\) A taxpayer that uses a right guaranteed by the TFEU is discouraged to do so by being taxed on income that has not yet been

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\(^7\) Case (C-470/04) N v. Inspecteur, [2006] ECR I-7409, para. 35.
realized and therefore creating a cash flow disadvantage.\textsuperscript{8} All measures that prohibit, impede or render less attractive the exercise of the freedom of movement must be regarded as restrictions on that freedom.\textsuperscript{9}

Despite the fact that the ECJ is rather clear that exit taxation represents a restriction on the basic freedoms, the Court’s case law also provides contradictions in connection to this subject. The ECJ has established that exit taxation is justified by the balance allocation of taxing powers between Member States.\textsuperscript{10} It has also held that for the purposes of the allocation of powers of taxation, it is not unreasonable for the Member States to find inspiration in international practice and, particularly, the model conventions drawn up by the OECD.\textsuperscript{11} Meanwhile, it has also been determined that Member States are at liberty, in the framework of bilateral agreements concluded in order to prevent double taxation, to determine the connecting factors for the purposes of allocating powers of taxation as between themselves.\textsuperscript{12}

If according to the ECJ exit taxation is justified and Member States can allocate taxing powers between themselves through bilateral treaties, then the question that arises is what is the issue that the Court has with exit taxation? An answer to this question can also be found in the case law. The ECJ has stated that as far as the exercise of the power of taxation so allocated is concerned, the Member States nevertheless may not disregard Community rules.\textsuperscript{13} If direct taxation is not in the competence of EU law and taking into consideration the present stage of harmonization, how far can the Court go in limiting the Member States’ tax sovereignty in order to eliminate restrictions caused by exit taxation through negative integration?

In spite of the fact that no statistics on business transfers in the European Union are available, a 2006 European Commission Communication\textsuperscript{14} estimated that one third of European entrepreneurs will be affected by a transfer in the following 10 years, influencing up to 690000 enterprises and 2, 8 million jobs every year. Taking into consideration the well-known globalization and the enhancing mobility in the European Union guaranteed by the founding treaties, it is easy to draw the conclusion that exit taxation influences a considerable number of companies and individuals as exit taxes can eminently impact a taxpayer’s decision to migrate.\textsuperscript{15} Therefore, the

\textsuperscript{9} Case (C-371/10) National Grid Indus BV, [2011] ECR I-0000, para. 36.
\textsuperscript{10} Case (C-470/04) N v. Inspecteur, [2006] ECR I-7409, para. 42.
\textsuperscript{12} Case (C-30797) Saint-Gobain, [1999], ECR I-6161, para. 56
\textsuperscript{13} Ibid., para. 57.
relevance of exit taxation in the EU and the solutions that Member States can apply for it are not to be neglected.

1.2 Aim

Having in mind the aforestated circumstances, the purpose of this paper is to establish the essence of exit taxation and to examine the connected legal issues on the EU and international level, such as the interaction of exit taxes with the fundamental freedoms, the problem of double taxation or the issue of a tax treaty override. In addition, the aim is to assess the solutions provided by the ECJ and the OECD Model Tax Convention for the issues in question. The hypothesis that this paper attempts to prove, is that there is nothing wrong with the imposition of exit taxes as it is a fair manifestation of the Member States’ tax sovereignty.

1.3 Method and material

The topic and purpose of this paper delineates the materials that have been used during the research. As this paper examines the aspects of exit taxation in the EU, the main materials used as a source is the ECJ case law. Due to the fact that direct taxes do not fall into the competence of EU law, the only way that exit taxes can be harmonized to comply with the principles enshrined in the TFEU is through the decisions of the ECJ. As a result, the main chapter of the paper is dedicated to studying and interpreting the relevant case law in a chronological manner. For a better understanding of the discovered solutions provided by the ECJ, a number of doctrinal articles and studies by different authors have also been used. Considering the fact that the levy of exit taxes does not only depend on EU law but also on the international agreements through which Member States bind themselves, the relevant articles of the OECD Model Convention have also been examined, along with the OECD Commentaries which have a crucial role in the interpretation of these kind of bilateral tax treaties.

1.4 Outline

The first chapter of this paper outlines the background and the purpose on which the research is based. The second chapter is one of the core chapters in which the essence of exit taxation is explained. It provides the definition and types of exit taxes, the reason behind them and all the important factors that influence the levy of the tax. The third chapter illustrates the ECJ case law, which essentially regulates the way exit taxes are applied in the EU. The first subchapter deals with the development and identification of the company law legal issues examined in the initial exit taxation cases. Although they do not involve exit taxation per se, these cases determined the relevant legal issues such as the matter of legal personality on which the
ECJ could further develop its judgments. The second and third subchapter deals with exit taxation of individuals and companies. The effect of these cases on those two categories of taxpayers is quite different. Finally, the last chapter of the paper describes the solutions that the OECD Model Convention provides for exit taxation, along with the relevant legal issues, such as double taxation or treaty override.

2. Explaining exit taxation

Generally speaking a taxpayer has to pay a tax whenever he is entitled to an income in a certain jurisdiction during a taxable period. In the case of an exit tax the situation is quite different. An exit tax represents an expression of the tax sovereignty of a state by taxing unrealized capital gains, hidden reserves and value increases of the assets of an individual or a company that leaves its jurisdiction. Although it is also a possible situation, the taxable base is not established by determining real income that was obtained, but most commonly it represents untaxed value increases of an asset belonging to a company or an individual.

Typically, value increases or capital gains are not taxed until they are actually realized (sold). In the case of exit taxes, these value increases are deemed to be realized when the taxpayer leaves a jurisdiction. The tax base for an exit tax does not only include value increases but also hidden reserves with regards to assets of which the book value is lower than the market value because an accelerated depreciation was allowed, or the tax authority can decide to claw back previously allowed deductions from which it expected to get back taxable income in the future.

To sum up, ‘the concept of exit taxation boils down to the principle of territoriality’. Governments wish to protect their tax sovereignty by deeming the exit of a taxpayer or an asset as taxable events. The objective of the tax is to preserve the tax base, therefore at the moment of exit, income over which a state loses power of taxation and that was accrued during the period the taxpayer was a resident is assessed and taxed. For the most part,
the tax authority calculates this tax as a ‘difference between the market value of the asset and its book value’. 25

Although some scholars are of the opinion that in order for a tax to be qualified as an exit tax ‘the tax base must represent the value of the unrealized capital gains at the moment the person leaves the emigration state’ 26, in the opinion of the author other situations are also possible, hence exit taxes can be separated into 4 general categories:

**Immediate exit taxes on unrealized gains** – which represent the taxation of gains that have not yet been realized but the change of jurisdiction however triggers the taxable event. 27

**Immediate exit taxes on realized gains** – in this situation, the gains have been realized prior to the date of the exit, yet the taxation has been deferred until a particular time later, the emigration triggers the tax. 28

**Deferred exit taxes on realized and unrealized gains** – the only difference between these two categories and the previous ones is that at the moment of exit, an extended tax liability is established and the collection of the tax is deferred until the assets are sold or until a different point in time. 29

As mentioned before, an exit tax is triggered when an individual or a company changes residency. 30 While in the case of individuals, the residence is rather simple to determine, in the case of companies it depends on the type of connecting factors that a state uses to determine residence, either the place of incorporation and registration, (incorporation theory) or the effective management of the company (real seat theory). 31

Countries that use the incorporation theory determine the place of residence by taking into account the place of registration of the company and if it satisfies all the formation requirements. 32 On the other hand, countries that use the real seat theory require a more significant connection to its territory in order to determine residence. 33 A company must not only be registered there but also have its effective management and central administration situated in that jurisdiction. 34

Depending on what type of connecting factor a country uses, it can have different consequences upon the migration of a company and therefore on

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25 Daria Zernova, Supra n. 5 at p. 472.
26 Fernando de Man & Tiitu Albin, Supra n. 15 at p. 615.
28 Ibid., p 383.
29 Fernando de Man & Tiitu Albin, Supra n. 15 at p. 616.
30 Ibid., p. 615.
31 Daria Zernova, Supra n. 5 at p. 471.
33 Ibid., p. 460.
34 Ibid., p. 460.
the levy of the exit tax. Real seat jurisdictions impose the liquidation of a legal entity if it transfers its effective management, such a movement does not have any repercussions in incorporation jurisdictions.\(^{35}\) This is why incorporation states are considered to have a more favorable internal market company law system.\(^{36}\) Companies that migrate from real seat states are effectively obliged to liquidate and at that moment exit, taxation is triggered on all the untaxed gains.\(^{37}\) The consequence under real seat countries according to EU law, is that when a company decides to exit it does not have access anymore to the fundamental freedoms guaranteed by the TFEU because ‘it no longer meets the criteria for existence under the domestic law of the Member State, thus it can no longer benefit from the freedom of establishment’.\(^{38}\)

The fact that countries using the incorporation theory do not require the dissolution of the company at the moment of the exit does not mean that they cannot impose exit taxes. According to the ECJ\(^{39}\) Member States can still tax all unrealized gains acquired during the company’s existence before the transfer based on the principle of fiscal territoriality.

### 3. ECJ solutions for exit taxation

The sequential cases in this chapter elucidate in details the problems a taxpayer faces in the EU when he leaves one jurisdiction for another and the solutions that the ECJ established.

#### 3.1 Company law cases

The first case in which the ECJ dealt with exit taxation was the *Daily Mail* case\(^{40}\). The case concerned a company established in the United Kingdom wishing to transfer its central management and control to the Netherlands but it was required under the national tax law to obtain a consent from the Treasury. The consent was conditioned on the partial sales of the company’s shares therefore triggering an exit tax.

The first legal issue upon which the ECJ pronounced itself was the legal personality of the exiting entity. The Court held that unlike natural persons, companies are creatures of the law and, in the present state of Community law, they exist only by virtue of the varying national legislation which

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\(^{35}\) Christiana HJI Panayi, Supra n. 32 at pp. 459 – 460.


\(^{38}\) Réka Világi, Supra n. 20 at p. 347.


determines their incorporation and functioning.\(^{41}\) It stated that it is up to the national legislation of each member state to determine the connecting factor with its territory (registered office, real head office, or the central administration of the company).\(^{42}\) Accordingly, the consequences on the legal personality of a company upon the removal of the central administration (winding-up of the company or retention) depends on the national legislation.

It was concluded that at that stage there was no harmonization at EU level concerning the transfer of a business, also no convention in this area has yet come into force.\(^{43}\) In consequence, the problems, which are not resolved by the rules concerning the right of establishment under the Treaty, must be dealt with by future legislation or conventions.\(^{44}\) Therefore, the ECJ recognized that it has no solutions for the problems related with the legal personality of a company, upon its transfer, and this issue remains within the sovereign powers of Member States.

To sum up, it could be said that the ECJ in this initial case gave Member States the freedom to deal with the exit of a company as they see fit. It stated that the legislation of some states permits companies to transfer their central administration to a foreign country but certain of them, such as the United Kingdom, make that right subject to certain restrictions, and the legal consequences of a transfer, particularly in regard to taxation, vary from one Member State to another.\(^{45}\)

It is difficult to challenge why the ECJ did not pronounce itself in this case on the issue of exit taxation. The matter of company law was not at stake because the United Kingdom and the Netherlands were both using the incorporation system; hence the problem of legal personality of the company was not in question.\(^{46}\) It can only be presumed that the Court did not want to impose its jurisdiction at that stage, this case only laid down the foundation for its future judgments on exit taxation.

The next noteworthy case with regards to company law legal issues upon the exit of a company was *Überseering*\(^{47}\). Due to the acquisition by German nationals of all its shares, a company incorporated in the Netherlands (incorporation system), effectively transferred its place of central management and control to Germany (real seat system). The company was denied legal capacity in a dispute before a German court because under German law it was required to reincorporate as a consequence of the


\(^{42}\) Ibid., para. 20.

\(^{43}\) Ibid., paras. 21, 22.

\(^{44}\) Ibid., para. 23.

\(^{45}\) Ibid., paras. 20, 21.

\(^{46}\) Peter J. Wattel, Supra n. 36 at p. 372.

transfer of central management. The ECJ found the requirement of reincorporation of the same company in Germany to be a negation of freedom of establishment.\footnote{Case (C-208/00) Überseering, [2002] ECR I-9919, para. 81.}

In comparison with \textit{Daily Mail}, this case added a new perspective in support of the transfer of a business and the freedom of establishment. The ECJ stated that a Member State cannot subject validly incorporated companies in other Member States that transferred their seat to its territory to compliance with its domestic company law.\footnote{Ibid., para. 72.} To put it in other words, even though Member States are free to point the connecting factor with their territory, they have to recognize the legal personality of an immigrating company if it does not cease to exist in the state of incorporation. Another conclusion according to Peter J. Wattel is that after this case ‘Member States may resist emigration of their own legal forms, but may not restrict immigration of other Member States’ legal forms if those other Member States allow a seat transfer without loss of legal personality’.\footnote{Peter J. Wattel, \textit{Supra n.} 36 at p. 372.}

The ‘breakthrough’ in company law legal issues was in the \textit{Cartesio} case\footnote{Case (C-210/06) Cartesio, [2008] ECR I-9641.}. A company established in Hungary (real seat jurisdiction) wished to transfer its real seat to Italy. The application was denied on the ground that under Hungarian legislation such a transfer would require, first, that the company cease to exist and, then, that the company reincorporate itself in compliance with the law of the country where it wishes to establish its new seat.

As in previous cases the Court established that Member States have the power to forbid a company governed under their law to retain its legal status if it intends to reorganize itself in another Member State.\footnote{Ibid., para. 110.} If a company moves its seat to the territory of another state, thereby breaking the connecting factor required under the national law, that state has the power to order its liquidation. Following this logic, under real seat systems, the dissolution of the company results in the termination of the rights guaranteed by the TFEU. Accordingly, an exit tax does not infringe any EU law.\footnote{Olga Sendetska, \textit{Supra n.} 37 at p. 231; Peter J. Wattel, \textit{Supra n.} 36, at pp. 372-373.}

It can be interpreted, that the groundbreaking part of this judgment was that the ECJ introduced a loophole and therefore a solution for companies to use when they exit a real seat jurisdiction. The Court introduced the notion of ‘cross-border conversion’. A company can be converted into a legal form, which is governed by the law of the Member State to which it has relocated.\footnote{Marek Szydło, ‘Case C–210/06, CARTESIO Oktató és Szolgáltató bt, Judgment of the Grand Chamber of the Court of Justice of 16 December 2008’, Common Market Law Review 46, Issue 2, (2009), Kluwer Law International BV, The Netherlands, p. 709.} Therefore, to the extent the legislation of the state of
immigration permits so and recognizes the legal personality of the immigrating company, the state of departure cannot order its dissolution.\textsuperscript{55} The possibility of cross-border conversion introduced in the \textit{Cartesio} case displayed the Court’s aspiration towards the removal of restrictions that constrains the right to freedom of establishment of company transfers in the EU.

The solutions for company law legal issues connected with exit taxation culminate with the \textit{VALE Építési}\textsuperscript{56} case. VALE Costruzione SRL moving its seat to Hungary was denied registration by the relevant authorities as legal predecessor of the Italian company due to fact that under Hungarian law conversion was possible only for domestic companies. The case in question elucidated in detail the legal issues of the cross-border conversion aforementioned in the \textit{Cartesio} case.

The starting point of this judgment was that the obligation to permit cross-border conversion neither infringes the power to define the connecting factor required of a company to be regarded as incorporated under its national law of the host state, nor that state’s determination of the rules governing the incorporation and functioning of the company resulting from a cross-border conversion.\textsuperscript{57} The ECJ settled that legislation that treats companies differently according to whether the conversion is domestic or of a cross-border nature amounts to a restriction within the meaning of Articles 49 TFEU and 54 TFEU. Furthermore, the wording ‘to the extent that it is permitted under that law to do so’ from the previous case, does not preclude the legislation of the host Member State on company conversions from the scope of the provisions of the TFEU on the freedom of establishment.\textsuperscript{58}

Due to fact that Hungarian legislation provided requirements of drawing up lists of assets and liabilities and property inventories before conversion, this operation implied to take account of documents issued by the authorities of the Member State of origin. The ECJ settled that in the absence of relevant EU rules cross-border conversion are governed by the law of both Member States in question.\textsuperscript{59} It further declared that the Hungarian requirements are in accordance with the principle of effectiveness and equivalence. Also, pursuant to the principle of effectiveness, the Hungarian authorities are obliged to take due account, when examining a company’s application for registration, of documents obtained from the authorities of the state of origin.\textsuperscript{60}

The \textit{VALE Építési} case consolidated the right to cross-border conversion of companies established in the EU. One important limitation to this right is

\begin{itemize}
  \item Peter J. Wattel, Supra n. 36 at p. 373.
  \item Case (C-378/10) \textit{VALE Építési}, [2012].
  \item Ibid., paras. 29-30.
  \item Ibid., para. 32.
  \item Ibid., para. 48.
  \item Ibid., para. 61.
\end{itemize}
that companies have access to it only ‘if they seek economic integration in the host Member State’. The ECJ referenced this limitation to the judgment in *Cadbury Schweppes*, in which it stated that the concept of establishment implies the pursuit of genuine economic activity.

In conclusion, it must be said that company law cases proved to be of high relevance to the future case law in exit taxation. The cleared up legal issues related to the transfer of a company from one jurisdiction to another laid down the foundation for the forthcoming cases in which the ECJ could concentrate on the exit tax itself and its consequences on the freedoms guaranteed by the founding treaties.

### 3.2 Individual Exit Taxation Cases

*De Lasteyrie de Saillant* was the initial case in which the ECJ addressed in detail the legal issues of an exit tax. The case involved a French national that transferred his fiscal residence to Belgium, taking along a significant shareholding in a French company. He was taxed on the unrealized capital gains.

The Court followed the opinion of Advocate-General Mischo and declared the French immediate exit taxation a restriction to the freedom of establishment. Although a suspension of payment was available, it was conditioned upon setting up guarantees sufficient to ensure recovery of the tax, along with the designation of a representative established in France. The strict conditions were found to be a disadvantage in comparison with taxpayers that maintain their residence, as in domestic situations, increases in value would be taxed only when they are realized. The ECJ also disapproved the fact that the suspension is not automatic and concluded that the rules under French law are likely to discourage a taxpayer from carrying out such a transfer.

The French government justified the exit tax by stating the necessity to combat tax avoidance. This argument was disregarded, as it was found that these rules were not specifically designed to exclude from a tax advantage purely artificial arrangements aimed at circumventing French tax law, but were aimed generally at any situation in which a taxpayer changes his residence.

64 Ibid., para. 47.
65 Ibid., para. 46.
66 Ibid., para. 46.
67 Ibid., para. 50.
*De Lasteyrie de Saillant* is the only case in which a Member State tried to justify exit taxation based on the aim of preventing tax avoidance. The ECJ did not allow such a justification because the French tax provisions were not designed to counteract specifically abusive practices. The Court has already held that the concept of establishment within the meaning of the Treaty provisions on the freedom of establishment involves the actual pursuit of genuine economic activity in the host state for an indefinite period. Therefore, if the French exit tax would have been directed only at purely artificial arrangements, the provisions in question would be found compatible.

The question that arises here is whether or not it is in the interest of Member States to use exit taxation only as a measure to prevent purely artificial arrangements. As stated before the purpose of exit taxation is to protect the tax base of a country. Member States wish to capture untaxed valued increases, previously allowed deductions and hidden reserves. If Member States would only tax purely artificial migrations most of the value increases and untaxed gains would escape taxation. In consequence it is clear that exit taxation is not about counteracting abusive practices but about raising tax revenues and protecting tax bases.

The subsequent case in individual taxation was *N v. Inspecteur*. The circumstances in this case were similar to *De Lasteyrie de Saillant*, as it implicated a Dutch resident transferring along with his residence a shareholding in three limited liability companies. In this case the Court further clarified its views on individual exit taxation.

In contrast to *De Lasteyrie de Saillant*, the ECJ also analyzed the obligation to submit a tax declaration. Despite the fact that the ECJ agreed with Advocate-General Kokott’s Opinion that it is an additional formality that can restrict emigration, having regard to the legitimate objective of allocating the power of taxation, it was found to be proportional. A future tax assessment was considered to be not less burdensome for the taxpayer. The ECJ also dismissed the obligation to provide collateral and instructed Member States to use the Mutual Assistance Directives in order to recover claims that result from exit taxation.

Another noticeable part of this case was the fact that an exit tax can be justified by the balance allocation of taxing powers between Member States and by the principle of fiscal territoriality. This allegation was of course conditioned upon ensuring the proportionality of the measures adopted. Finally, the most distinct part of this judgment was that ECJ suggested that a
pertinent exit tax system would have to take full account of reductions in value of the assets after the transfer of residence by the taxpayer unless such reductions have already been taken into account in the host Member State.\textsuperscript{74}

After De Lasteyrie de Saillant and N v. Inspecteur, it could be ascertained that an exit tax is in compliance with EU law only if it is in the form of a tax assessment at the moment of the exit. There must be an automatic deferral of tax and it should be due only upon the realization of the assets. Furthermore, there can be no requirements to provide guarantees and the exit state should take into consideration future reductions in the value of the asset.

The latter can be found to be controversial. An exit tax is connected with a temporal component, namely residence within the territory during the period in which the taxable profit arises.\textsuperscript{75} After an exit, the host state should provide a step up in value and deduction to any consequent losses or reductions; therefore such a requirement should not be the responsibility of the state of departure.\textsuperscript{76} Applying this judgment can result to excessive administrative burden. Keeping track of the assets until the realization would involve considerable resources both for the taxpayers and for the tax authority.\textsuperscript{77}

The next relevant case for this paper is Commission v. Spain\textsuperscript{78}. The importance of this case is reflected by its circumstances, as it exemplifies one type of exit taxation that is not very common, exit taxes on realized gains. The case concerns an infringement procedure by the Commission against the Kingdom of Spain. The national tax provision stipulated the obligation for an individual taxpayer to immediately pay taxes on all income which has not yet been charged before the transfer of residence by including it in the tax base corresponding to the last tax period. The Spanish legislation at issue concerned only the taxation of income which has already been realized and of which the tax authorities have knowledge.

The first noteworthy part of this judgment was how the ECJ found the exit tax to be a restriction on the fundamental freedoms. The national tax provisions at issue implied the taxation of income that has already been realized and the person liable for the tax debt is not subject to an additional tax at the time of transferring his residence. Despite that fact, the difference in treatment in comparison with a person that maintains his residence was found to result in the withdrawal of an advantage that exists in the domestic situation.\textsuperscript{79} Taxpayers that retain their residence are not required to pay the tax while the ones that transfer their residence in Spanish territory are under

\textsuperscript{74}Case (C-470/04) N v. Inspecteur, [2006] ECR I-7409, para. 54.
\textsuperscript{75}Ibid., para. 46.
\textsuperscript{76}Peter J. Wattel, Supra n. 36 at p. 375.
\textsuperscript{77}Ibid., pp. 375, 377.
\textsuperscript{78}Case (C-269/09) Commission v. Spain, [2012].
\textsuperscript{79}Ibid., para. 59.
such an obligation, therefore for the exiting taxpayer, such treatment created a disadvantage in terms of cash flow and it was found to be a restriction to the freedom of establishment.\textsuperscript{80}

The other prominent part of this case was that an exit tax on realized income cannot be justified by the balance allocation of taxing powers. The ECJ stated that the income is taxed in the state in which it was realized, and the income obtained after the transfer of the taxpayer, is in principle going to be taxed exclusively in the host State.\textsuperscript{81} As a result, the Court established that there is an absence of conflict between the powers of taxation of the state of exit and those of the host state. Likewise, the Kingdom of Spain has failed to prove that it would be faced with a problem of double taxation or a situation in which the taxpayers concerned would completely escape paying tax, which could justify the application of a measure such as that at issue in the present case with the aim of pursuing the objective of preserving the balanced allocation of the powers of taxation.\textsuperscript{82}

The Kingdom of Spain also tried to justify the exit tax by the need to ensure effective recovery of the tax debt and the need to preserve the coherence of the national tax system.\textsuperscript{83} The first one was rejected due to the fact that the Mutual Assistance Directives are sufficient cooperation mechanisms in order to recover the tax debt in another Member State. The second, was denied on the grounds that there was no direct link in the national legislation between, on one hand, the tax advantage represented by the possibility of charging income to a number of tax periods and, on the other, the offsetting of that advantage by some kind of tax charge.\textsuperscript{84}

The conclusion from this case is that the ECJ does not accept an immediate exit tax even in the case of realized income. The exit tax cannot be justified by the balance allocation of taxing powers because there is no risk that could jeopardize the right of a Member State to exercise its powers of taxation in relation to activities carried on in its territory.

There are also ambiguities after this judgment, the ECJ only declared the national tax provisions as an infringement to the fundamental freedoms but it did not state a clear solution for such a tax. Judging from the context of the case, the Commission and the Court referred to the decisions provided in previous individual cases. It can only be presumed that the previous solutions for an exit tax on unrealized gains are to be applied for this case. An automatic deferral of the tax liability should be provided until the tax can be attributed to the corresponding tax period, future decreases in value are not at issue because the exit tax is on realized income.

\textsuperscript{80} Case (C-269/09) Commission v. Spain, [2012], para. 59.
\textsuperscript{81} Ibid., para. 80.
\textsuperscript{82} Ibid., para. 81.
\textsuperscript{83} Ibid., paras. 64, 83.
\textsuperscript{84} Ibid., paras. 68, 87.
### 3.3 Corporate Exit Taxation Cases

The benchmark case in corporate exit taxation is *National Grid Indus*[^85]. The case was about a company established in the Netherlands, which intended to transfer its place of effective management to the United Kingdom. As a result of the applicable treaty and the Dutch legislation, an exit tax on an unrealized exchange currency gain was triggered.

After the judgment in *N v. Inspecteur* one could have expected from the ECJ to transpose it to corporate exit taxation, reality proved that this was not the case. The only similarity between these two cases is the establishment of a final tax assessment before the transfer and the accepted justifications for an exit tax. The ECJ upheld that it is proportionate for Member States, for the purpose of safeguarding the exercise of its powers of taxation to establish the amount of tax at the time of the transfer of a company’s place of effective management.[^86] At the same time, the principle of fiscal territoriality linked to a temporal component and the balance allocation of taxing powers were identified to be valid justifications for an exit tax.[^87]

The first legal issue in which the Court distances itself from the previous case is the decreases in value that occur after the transfer of the company. The ECJ held that the state of departure is not obliged to take account of any future losses as it could call into question not only the balanced allocation of powers of taxation between Member States but also lead to double taxation or double deduction of losses.[^88] Moreover, since the profits of the company are, after the transfer, taxed exclusively in the host state, it is the duty of that state to take account, at the time when the assets of the undertaking in question are realized, of capital gains and losses in relation to those assets.[^89]

Furthermore, a possible omission by the host state to take account of decreases in value does not impose any obligation on the exit state to revalue. It was stated that the TFEU offers no guarantee to a company covered by Article 54 that the transfer of its place of effective management to another Member State will be neutral as regards taxation.[^90]

The next disparity with previous case law was with regards to the deferment of the tax. The Court did not consider that the deferment has to be automatic anymore. It must only be provided as an option. Surprisingly though, the ECJ decided that interest should be paid in the case of deferral.[^91] After it analyzed the cash flow disadvantage resulting from an immediate taxation and the administrative burden of both parties connected with the tracing of

[^86]: Ibid., para. 52.
[^87]: Ibid., para. 46.
[^88]: Ibid., para. 59.
[^89]: Ibid., para. 61.
[^90]: Ibid., para. 62.
[^91]: Ibid., para. 73.
the assets in the case of deferment, the ECJ even took account of the risk of non-recovery of the tax. Hence, if the applicable national legislation to deferred payments of tax debts, has a provision of a bank guarantee, that measure is acceptable.92

Perhaps the most important part of this judgment was the fact that the ECJ settled in an unquestionable manner the right of Member States to levy an exit tax. The Court held that the transfer of the place of effective management of a company of one state to another cannot mean that the state of origin has to abandon its right to tax a capital gain which arose within the ambit of its powers of taxation before the transfer.93 A Member State is entitled to charge tax on those gains at the time when the taxpayer leaves the country and such a measure is intended to prevent situations capable of jeopardizing the right of the Member State of origin to exercise its powers of taxation in relation to activities carried on in its territory.94

Last but not least, it is important to mention that the ECJ also examined the issue of legal personality of the exiting company. The Court restated that Member States have the power to define the connecting factor required of a company if it is to be regarded as incorporated under its national law and as such capable of enjoying the right of establishment. Contrary to the Daily Mail case, it held that the issue of legal personality of the company was not in question because both countries are using incorporation system, therefore the transfer did not affect that company’s possibility of relying on Article 49 TFEU.95

It could be concluded that ‘National Grid Indus reversed the Daily Mail case and amended the N v. Inspecteur’.96 A company exiting an incorporation system has the option between immediate taxation and the deferral of the exit tax.97 If the deferral option is chosen, the state of departure is entitled to receive interest and may require a bank guarantee from the exiting company due to the risk of non-recovery. However, in the author’s opinion this does not mean that the former cases in individual exit taxation are obsolete. Those cases still apply to individuals as the ECJ has made a clear difference in this judgment between an individual and a company’s assets and its taxable profits.98 Therefore the solutions provided in individual exit taxation cases are still relevant.

The sequential infringement procedures of the European Commission against Portugal, Spain, the Netherlands and Denmark concerning their national exit taxation systems have shed some new light in corporate exit

93 Ibid., para. 46.
94 Ibid., para. 46.
95 Ibid., paras. 27-32.
96 Peter J. Wattel, Supra n. 36 at p. 377.
97 Ibid., p. 378.
taxation and also reaffirmed some of its previous decisions. The ECJ confirmed that immediate taxation of unrealized capital gains on the transfer of the place of residence or of the assets of a company to another Member State represents an infringement of Article 49 TFEU.\textsuperscript{99} It therefore maintained its former views that deferment represents a less harmful measure and should be provided as an alternative.\textsuperscript{100} Another reaffirmed issue was the fact that a final assessment of the tax due is proportional to the objective of safeguarding the exercise of its tax jurisdiction.\textsuperscript{101} In Commission v. Portugal the ECJ also confirmed the lawfulness of requiring interest upon deferral. However, this was not mentioned in the other infringement procedures.

In Commission v. Denmark, a case concerning exit taxation on the transfer of assets of a company to another Member State, we can witness a shift in the Court’s view with regards to the moment of taxation. The representatives of Denmark and other Member States convinced the ECJ that in the case of depreciable non-financial assets, the exiting state can tax unrealized gains at different point of time than the actual realization. The value of these kind of assets is limited in time, therefore if companies could defer taxation of assets until their disposal, they could avoid paying the tax.\textsuperscript{102} In these circumstances, the Court decided that Member States are entitled to tax capital gains at another event than the actual disposal in order to ensure taxation.\textsuperscript{103}

The new legal issue tackled in Commission v. Denmark concerning the collection of the exit tax was further developed by the ECJ in the DMC\textsuperscript{104} case. The conversion of an interest in a limited partnership into shares of a capital company had the effect of removal of the income from the exercise of the taxing powers of Germany, consequently triggering an exit tax. The provisions of the German law enabled a taxable person to spread the exit tax over a period of five years, without being required to pay interest.\textsuperscript{105}

The Court approved the German deferral system, motivating its decision to the fact that the risk of non-recovery of the tax in such circumstances increases with the passing of time. Thus, in contrast to the previous case, the ECJ did not only confirm the right of Member States to collect the tax at a different point in time than the actual realization, but also approved an existing mechanism for it. Another innovative part of this judgment was the

\textsuperscript{99} Case (C-38/10) Commission v. Portugal, [2012], para. 31; Case (C-64/11) Commission v. Spain, [2013], para. 32; Case (C-301/11) Commission v. Netherlands, [2013], para. 16.
\textsuperscript{100} Case (C-38/10) Commission v. Portugal, [2012], para. 32; Case (C-64/11) Commission v. Spain, [2013], para. 34.
\textsuperscript{101} Case (C-64/11) Commission v. Spain, [2013], para. 31; Case (C-301/11) Commission v. Netherlands, [2013], para. 16.
\textsuperscript{102} Case (C-261/11) Commission v. Denmark, [2013], paras. 12-13.
\textsuperscript{103} Ibid., paras. 36-37.
\textsuperscript{104} Case (C-164/12) DMC, [2014].
\textsuperscript{105} Ibid., paras. 62-63.
fact that the provision of guarantees was conditioned upon prior assessment of a risk of non-recovery. It can be assumed that without a considerable risk of non-recovery the requirement of bank guarantees would be a disproportionate measure.

The same result can be expected from the new pending case Verder LabTec v. Finanzamt Hilden, which also concerns the German tax rules that establishes tax liability to be paid in yearly instalments over a period of 10 years in the case of an exit tax on hidden reserves. The Advocate-General Jääskinen made a retrospective of all the noteworthy exit tax cases and came to the conclusion that since Commission v. Denmark and DMC the ECJ does not impose an obligation on Member States to allow payment of the exit tax to be deferred until actual realization of the assets, as it is not the only permissible chargeable event. Ergo, an alternative method of recovery of the tax is also possible, supplying the tax subject with a choice between immediate payment and recovery of the tax in installments is proportionate.

The last case worthy of being mentioned for this paper is Nordea Bank. A restructuring process resulted in the partial sale of some foreign PEs over which the Kingdom of Denmark exercised its powers of taxation. As a consequence the previously deducted losses of those foreign PEs were reincorporated into Nordea Bank’s taxable profit.

Once again the ECJ found a disadvantageous treatment in comparison to the domestic situation in which the transfer does not entail the reincorporation of deducted losses, a restriction to the freedom of establishment. The ECJ recalled that the balanced allocation of the power to impose taxes has the objective to safeguard the symmetry between the right to tax profits and the right to deduct losses. As a consequence, the right to deduct losses cannot be denied if Member States tax the profits made in respect of that establishment before its transfer, including those resulting from the gain made upon the transfer.

To put it differently, the ECJ decided that not all type of exit taxes can be justified by the balance allocation of taxing powers and that essentially Member States cannot tax absolutely everything when a company leaves its jurisdiction. As long as Member States have the power to tax the profits and other gains, the right to deduct losses can be compared to the right to deduct costs and expenses used to obtain those profits, it cannot be denied.

106 Case (C-164/12) DMC, [2014], para. 67.
107 Case (C-657/13) Verder LabTec.
109 Ibid., paras. 67,73.
110 Case (C-48/13) Nordea Bank Danmark, [2014].
111 Ibid., para. 22.
112 Ibid., para. 32.
113 Ibid., para. 36.
Consequently, in its latest judgments on exit taxation, while the ECJ helped clarify the characteristics of an acceptable exit tax system for companies it also tried to limit as much as possible the restrictions on the basic freedoms that these taxes imply by consenting another alternative taxation system and limiting the applicability of guarantees.

4. Bilateral treaties solution - OECD Model Tax Convention

According to the ECJ case law for the purposes of the allocation of powers of taxation, Member States are free to find inspiration in international practice and, particularly, the model conventions drawn up by the OECD. Hence, the relevant articles of the OECD Model Convention need to be examined in order to determine if they provide any solutions for exit taxation. Before proceeding to that, a number of issues that arise in the applicability of the Model Convention in the case of exit taxes must be clarified and some general remarks should be made for their better comprehension.

The main purpose of the OECD Model Convention is to prevent double taxation. This objective is realized through the allocation of taxing powers between the Contracting States. It is imperative to understand that the way the Model Convention works is not by giving or enhancing taxing rights, but on the contrary, countries come to an agreement to actually restrict their right in taxing certain types of income.

As a result of the aforementioned, Contracting States allocate their taxing powers by bilateral treaties through 3 approaches:

1. Taxing income and capital without limitation at source, such as employment income, profits of a PE or income from immovable property.
2. Taxing income and capital with limitation (sharing taxation) at source such as dividends and interest.
3. Taxing income and capital based on the state of residence of the taxpayer such as royalties, gains from the alienation of shares or securities.

Article 1 of the OECD Model Convention states that it shall apply to persons who are residents of one or both of the Contracting States. In consequence, the effect of the provisions of the Convention on a Contracting State’s right to tax income arising on its territory depends on

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116 Fernando de Man & Tiia Albin, Supra n. 15 at p. 617.
117 Ibid., p. 617.
119 Ibid., para. 22.
120 Ibid., para. 23.
the taxable person’s residency. On the other hand, the principle of territoriality on which an exit tax is based envisages that the tax is levied by virtue of the fact that the taxable income arose on its territory.\textsuperscript{121} The change of residency in most cases according to the Model Convention can restrict a state’s right to tax, while in the case of exit taxes the change of residency is what actually triggers the taxable event. Therefore, there is a conflict between the general principles based on which the OECD Model Convention and exit taxes work.

As exit taxes commonly represent taxes on value increases of an asset belonging to a company or an individual, the appropriate article that would apply to such taxes is article 13 – capital gains.\textsuperscript{122} According to the Commentary on the OECD Model Convention, this article does not specify to what kind of tax it applies, it is understood that the article must apply to all kinds of taxes levied by a Contracting State on capital gains, it is left to the domestic law of each Contracting State to decide whether capital gains should be taxed and, if they are taxable, how they are to be taxed.\textsuperscript{123} However, as exit taxes are usually levied in the case of unrealized capital gains, it is not clear if the Convention applies to these kind of taxes.

4.1 The concept of alienation

Article 13(5) which is suitable for exit taxes on capital appreciation states that ‘gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident’. The words ‘alienation of any property’ would seemingly indicate that it refers only to realized capital gains. Meanwhile, the taxable event for exit taxes generally represents a deemed disposal of an asset that occurs at the moment of emigration, therefore a fiction and not a real alienation.\textsuperscript{124} This would mean that this article is not applicable, or if it were to be applied in the case of exit taxes it might raise the question of treaty override. As there are considerable debates concerning the concept of ‘alienation’, this issue must also be analyzed.\textsuperscript{125}

The Commentary on article 13 of the Model Convention provides contradicting statements with regards to this aspect. On one hand, it formulates a definition for ‘alienation’ that indicates that there must be a sale or exchange of property and therefore a transfer of ownership.\textsuperscript{126} On the other hand, it states that taxes on capital gains vary from one country to

\textsuperscript{121} Katia Cejie, Supra n. 27 at p. 390.
\textsuperscript{122} Bruno Macorin Carramaschi, Supra n. 18 at p. 284.
\textsuperscript{124} Katia Cejie, Supra n. 27 at pp. 382, 386.
\textsuperscript{125} Fernando de Man & Tiiu Albin, Supra n. 15, at p. 617; Katia Cejie, Supra n. 27 at pp. 387-388; Bruno Macorin Carramaschi, Supra n. 18 at pp. 284-288.
\textsuperscript{126} Commentary on Article 13 on the OECD Model Tax Convention on Income and on Capital 2014: Condensed Version, para. 5; Katia Cejie, Supra n. 27 at p. 388.
another, in most cases appreciation in value not associated with the alienation of a capital asset is not taxed, however, it specifies a number of situations when the taxation of the capital appreciation without alienation is possible.127

The first described situation is the taxation of capital appreciation in the case of reevaluation of business assets. It is depicted, that a number of states levy special taxes on book profits; such revaluations may result from the fact that the value of the asset has increased in a manner that the owner proceeds to the reevaluation of this asset in his book.128 This may happen due to a number of reasons, like depreciation of national currency, an increase in the paid-up capital or amounts put into reserve.129 The fact is that the Commentary points out explicitly that such taxes on capital appreciation are levied even if there is no alienation, and they are covered by Article 2 of the Convention.130

The second situation outlines the taxation of capital appreciation in the case of transfer of an asset from a PE situated in the territory of a state to a PE or the head office of the same enterprise situated in another state.131 The Commentary states that these kind of transfers are treated as alienations and that the article does not prevent these states from taxing profits or gains deemed to arise in connection with such a transfer.132

Taking into consideration the described situations, it is in the opinion of the author that article 13(5) can be applied in the case of exit taxes where most commonly they are levied in circumstances in which there is no real alienation. The second example (transfer of an asset from a PE to another state) provided by the Commentary is particularly convincing. The taxation of value increases of an asset, over which a state loses its power of taxation as a result of transfer to the jurisdiction of another state fits perfectly into the definition of exit taxation.

This line of reasoning was also supported in the exit taxation cases133 on substantial shareholding at the Netherlands Supreme Court. The Netherlands’ Income Tax Act construes the term alienation with the time a taxpayer changes residency and deems the moment of realization at the time before the taxpayer loses residency.134 The Supreme Court ruled upon the compliance of the Netherlands exit tax on the increase in the value of the

128 Ibid., para. 8.
129 Ibid., para. 8, 11.
130 Ibid., paras. 7, 8.
131 Ibid., para. 10.
132 Ibid., para. 10.
133 Cases 07/12314; 42.701; 43.760; 20 february 2009, Tax Treaty Case Law, IBFD Tax Research Platform, (accessed, 6 may 2015).
shares upon the emigration of the shareholders with the provisions on capital gains in the tax treaties between the Netherlands and the United Kingdom, Belgium and the United States.\textsuperscript{135}

The Supreme Court settled upon the term ‘alienation’ and concluded that it has a broad meaning which also includes deemed realization.\textsuperscript{136} The Court referred its decision to the OECD Commentary on article 13, especially to paragraph 8 in which it is stated that special circumstances may lead to the taxation of the capital appreciation of an asset that has not been alienated.\textsuperscript{137} The Court also reiterated the special situation described above, concerning the taxation of capital appreciation in the case of asset reevaluation. Hence, it was concluded that the Netherlands has the right to tax accrued and not yet realized capital gains under article 13(4) (corresponding to article 13(5) of the OECD Model), and that the notion of alienation also included the notion of deemed alienation.\textsuperscript{138}

Another case that supports the same reasoning concerning the term ‘alienation’ is the South African exit taxation case \textit{C:SARS v. Tradehold Limited}\textsuperscript{139}. The South African tax provision also deems the disposal of assets upon the change of residency. Due to the fact that Tradehold Limited changed its effective management to Luxembourg an exit tax on its shareholding in another company followed.

In this case, the tax authority contested Tradehold Limited’s right to rely on the protection of treaty between South Africa and Luxembourg for the reason that they considered that the term ‘alienation’ from article 13(4) (corresponding to article 13(5) of the OECD Model Convention) did not include a deemed disposal of property. As a consequence, the Supreme Court of South Africa analyzed the meaning of this term.

The Court reached the conclusion that article 13 is widely cast and it includes within its ambit capital gains derived from the alienation of all property.\textsuperscript{140} It was stated that that the term ‘alienation’ as it is used in the treaty is not restricted to actual alienation.\textsuperscript{141} It is a neutral term having a broader meaning, comprehending both actual and deemed disposals of assets giving rise to taxable capital gains. Therefore, article 13(4) of the treaty applies to capital gains that arise from both actual and deemed alienations or disposals of property.\textsuperscript{142}

The aforementioned cases demonstrate that both on the EU and international level it is not uncommon that the term ‘alienation’ from article 13(5) of the

\textsuperscript{135} Carla De Pietro, Supra n. 134 at p. 8.
\textsuperscript{136} Ibid., p. 9.
\textsuperscript{137} Ibid., p. 9.
\textsuperscript{138} Ibid., p. 9.
\textsuperscript{140} Ibid., para. 24.
\textsuperscript{141} Ibid., para. 25.
\textsuperscript{142} Ibid., para. 26.
OECD Model Convention to be interpreted to include the deemed disposal of unrealized gains. As a consequence, the article in question is appropriate to deal with exit taxation.

### 4.2 Treaty override

Regarding the legal issue of treaty override, the identification of such a breach in international law, is matter of interpretation, which depends on the wording of the treaties and the national legislation of the Contracting States. The term ‘treaty override’ according to the OECD Report means ‘a situation where the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that State’. The problem of this definition is that the structure and the functioning of the OECD Model Convention is very dependent on the domestic legislation of the Contracting States. As it was mentioned before, Contracting States come to an agreement to actually restrict their right in taxing certain types of income by the means of international norms enshrined in the OECD Convention. Therefore when analyzing the matter of a treaty override it is necessary to analyze if the national legislation based on which a tax is levied has been restricted or limited by the Convention.

The term ‘alienation’ is not defined in the OECD Model Convention, therefore for such situations article 3(2) plays a crucial role. It states that ‘…any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies…’. This article grants the right to a state to use the definition from domestic law on any term which is not defined in the Convention with one limitation, it must be in the context and the purpose of the treaty at the moment of application. The question that arises in these conditions is if the deeming of an alienation of assets without realization at the moment of emigration is against the context and purpose of the Convention?

In the opinion of the author, judging from the context of the OECD Commentary on article 13, a deemed realization cannot be interpreted as a treaty override. The Commentary as described above anticipates situations in which Contracting States can tax capital appreciations without any actual alienation. Moreover, some countries are already using these situations as justifications in Courts for defending their right in levying exit taxes. Given these facts, it can be concluded that there are sufficient arguments for

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143 Carla De Pietro, Supra n. 134 at pp. 3, 4.
145 Carla De Pietro, Supra n. 134 at p. 3.
146 Fernando de Man & Tiiu Albin, Supra n. 15 at p. 617
147 Carla De Pietro, Supra n. 134 at pp. 3, 4.
148 Ibid., p. 4.
149 Ibid., p. 6.
Contracting States to consider their national legislation on deeming alienation as in the context and purpose of the OECD Model Convention.

4.3 The right to tax

As it was established that article 13(5) is appropriate to use in the case of exit taxes, the next step is to determine what allocating solutions can be applied. Due to the fact that this paper examines the issues related to exit taxation at the EU level, the solutions that the OECD Model Convention can provide must be analyzed from this perspective.

According to the ECJ at the moment of exit the individual and corporate taxpayers have different choices. In the case of individuals Member States cannot levy immediate exit taxes, an automatic deferral till realization of the asset must be provided.\(^{150}\) On the other hand, corporate taxpayers have the choice between immediate taxation, deferral till realization and the payment of the tax in installments over a period of time depending on the national legislation of Member States and the type of assets.\(^{151}\) Hence, these options that the taxpayers have, must be analyzed.

The distributive rule from article 13(5) establishes the right to tax to the state in which the alienator is a resident. It follows that the residency of the taxpayers must be determined. Article 1 states that the Convention applies to the residents of one or both state, theoretically, there is not a moment when the taxpayer is not a resident of either of the Contracting States.\(^{152}\) Based on the definition of exit taxation and practical cases, it can be concluded that the deemed alienation is established to be right before the moment the taxpayer changes residency.\(^{153}\) Thus, the right to tax is accordingly within the ambit powers of the emigration state.

Despite the fact that immediate exit taxes are practically forbidden in the EU, they still can be applied at the request of corporate taxpayers.\(^{154}\) Therefore in such a situation, following the logic described above, there is nothing to forbid a Member State in levying them, article 13(5) allocates this right to the state of emigration. Hence, the OECD Model Convention does not prohibit immediate exit taxes.

In the case of deferred exit taxes the situation is a bit more complicated. The asset is effectively disposed when the taxpayer is a resident of the immigration state, therefore according to article 13(5) that state has the right to tax it. As a consequence, according to some scholars, the only way the emigration state could levy the exit tax is to modify the provisions of article


\(^{151}\) Case (C-371/10) National Grid Indus BV, [2011] ECR I-0000; Case (C-164/12) DMC, [2014].

\(^{152}\) Fernando de Man & Tiiu Albin, Supra n. 15 at p. 616.

\(^{153}\) Katia Cejie, Supra n. 27 at p. 386.

One country that does this is Sweden, it reserves its right to tax the gains if the assets are sold in a period of ten years after the migration.\textsuperscript{156} However, in the opinion of the author, the tax liability for deferred exit taxes is set in the form of a preserving assessment when the taxpayer is still a resident of the emigration state based on the principle of territoriality. As a result, the fact that the payment of the tax is deferred until realization is just a financial benefit for the taxpayer imposed by EU law, it is merely a debt that is due at the moment of realization of the asset. These circumstances do not change the right of the state of emigration to levy the tax. The tax liability corresponds to the value increases registered when the taxpayer was a resident in the state of exit.\textsuperscript{157} The only element that changes in this situation, is that the state of immigration has also the right to tax the asset in question. Respectively, even in the case of deferred exit taxes, the state of emigration can still levy the tax. The same line of reasoning also applies in the case of levying the exit tax in installments spread over a period of time when the taxpayer is a resident of the state of immigration.

### 4.4 Double Taxation

The sole problem that remains unsolved in the case of exit taxes is double taxation. If the emigration state levies the exit tax on unrealized gains before the exit (immediate exit taxes), or a preserving assessment in the case of deferred exit taxes, when the asset will be effectively sold in the immigration state, it will be taxed again.\textsuperscript{158} Both states apply the tax when the taxpayer is their resident, therefore the exemption or credit method enshrined in Article 23 A and B cannot solve the double taxation.\textsuperscript{159}

One way this issue could be settled if the state of immigration would provide a step-up in value of the assets for the immigrating taxpayer.\textsuperscript{160} Basically, this would mean that the tax base for state of immigration would be the market value at moment the taxpayer became a resident, therefore the increase in value registered in the state of emigration would not be taxed twice.\textsuperscript{161} In consequence, when the taxpayer will sell the asset in the state of immigration at a price higher than the original market value, only subsequent increases in value will be taxed.\textsuperscript{162} Such a solution can be introduced by states that apply exit taxes into their bilateral treaties or provided unilaterally by the immigration states in order to prevent double taxation.

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\textsuperscript{155} Fernando de Man & Tiiu Albin, Supra n. 15 at p. 618.
\textsuperscript{156} Katia Cejie, Supra n. 27 at p. 384.
\textsuperscript{157} Fernando de Man & Tiiu Albin, Supra n. 15 at p. 614.
\textsuperscript{158} Katia Cejie, Supra n. 27 at p. 389.
\textsuperscript{159} Ibid., p. 389.
\textsuperscript{160} Bruno Macorin Carramaschi, Supra n. 18 at p. 289.
\textsuperscript{162} Vikram Chand, ‘Exit Charges for Migrating Individuals and Companies: Comparative and Tax Treaty Analysis’, Bulletin for International Taxation, 2013 (Volume 67), No. 4/5, published online: 5 April 2013, IBFD, pdf version, p. 3.
taxation. Unfortunately, not many countries provide such a solution, it is mainly provided for individuals and in special circumstances, for example the Netherlands provides a step-up for substantial shareholdings.

A second solution is for the state of emigration to provide a reverse credit when the state of immigration taxes capital gains upon realization. In essence this represents a tax credit that is limited to the amount of the foreign tax paid by the taxpayer only in regard to the part of the gain that was subject to tax in the emigration state. This solution can also be introduced in the bilateral treaties or provided unilaterally. Likewise the step-up solution, few countries counteract double taxation with this method.

Last but not least, the third solution would be for the state of immigration to offer a foreign tax credit. This credit could be limited to the part of value that was taxed in the state of emigration. This solution is also not very common due to the fact that the ‘exit taxes are levied while the taxpayer was not a resident of the immigration state, and generally only residents can claim a foreign tax credit’.

Lamentably, the OECD Model Convention provides none of the described solutions for double taxation. Contracting States have to provide these solutions unilaterally or introduce them in their bilateral treaties at their own initiative. The only existing solution in the Model Convention is Article 25(3), which encourages Contracting States to resolve by mutual agreement the legal issue of double taxation in cases not provided for in the Convention. This solution regrettably is not the most expeditious and there is no guarantee that the problem will be solved in the interest of the taxpayer.

In summary, it can be stated that exit taxes are not forbidden under the OECD Model Convention. In the same time, in the matter of allocating taxing rights, the Convention does not provide all the necessary solutions for the problems that arise when these taxes are levied.

5. Conclusions

Exit taxes represent the expression of a state’s sovereignty by levying taxes on value increases that arose on its territory. The tax is applied as a result of the intention of the taxpayer to change residency which in consequence would remove a state’s power to tax income that was accrued during the

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163 Luc De Broe, Supra n. 161 at p. 12.
164 Luc De Broe, Supra n. 161 at pp. 57-58; Vikram Chand, Supra n. 162 at pp. 3, 13.
165 Luc De Broe, Supra n. 161 at p. 55.
166 Ibid., p. 63.
167 Ibid., p. 63.
168 Ibid., p. 55.
169 Ibid., p. 60.
period the taxpayer was a resident. In essence exit taxation is about territoriality and tax sovereignty. The purpose of the countries that apply exit taxes is to protect their tax base and to prevent the escaping of untaxed revenues from their jurisdiction.

The first legal issue that the ECJ dealt with in the case of exit taxation was the legal personality of the exiting entity. Albeit the fact that in the current state of affairs Member States still have the power to pinpoint the connecting factor with its territory and consequently decide the legal status of a company, the Court has introduced a loophole that taxpayers can use. Under a real seat system, the transfer of a company’s effective management would result in its liquidation without any access to the rights guaranteed by the TFEU. A company can escape this discrimination by converting itself at the moment of exit into a legal form of the host state. Provided that the legislation of the immigration state permits so, the end result is the change of applicable law and the reincorporation of the company.

The subsequent cases in individual exit taxation and corporate exit taxation proved to have a very different result. Due to the fact that the ECJ offers different solutions for these situations it can be practically considered that according to the ECJ exit taxes are split into two categories, exit taxes on individuals and exit taxes on companies. In essence, it can be ascertained that the ECJ contradicts itself by creating different rules for the exit of an individual and a company. Long before the exit taxation cases the ECJ has held that companies are to be treated in the same way as natural persons who are nationals of Member States. Likewise, in the opinion of the author this kind of treatment is in contradiction to the provisions of article 54 of the TFEU.

An exit tax system in the case of individuals must only represent a final tax assessment with an automatic deferral of the tax itself till the realization of the assets in question, also with future consideration to reductions in value. On the other hand, in the case of corporate exit taxation Member States do not have to take account of any future reductions in value and deferral may be conditioned upon the provision of guarantees and the payment of interest.

Additionally, the ECJ accepts that due to the risk of non-recovery of the tax increases with the passing of time, Member States can tax the unrealized gains at a different point than the actual realization. A deferral system that spreads the exit tax over a period of consecutive years was found to be a proportional measure for the attainment of the objective of preserving the balanced allocation of the power to impose taxes between Member States.

Another solution provided by the ECJ is for exit taxes that have the purpose to recapture previously deducted losses. Member States cannot tax absolutely everything when they lose the power to impose taxes over a legal entity. Some basic benefits that a company had in one country cannot be
reversed after its transfer to a different jurisdiction. The right to deduct losses cannot be denied if Member States tax the profits made in respect of that establishment before its transfer, including those resulting from the gain made upon the transfer.

The ECJ decisions on exit taxation conclusively support the hypothesis that this paper attempts to prove. The Court has held that a Member State is entitled to tax the economic value generated by an unrealized capital gain in its territory even if the gain concerned has not yet actually been realized. At the same time, it is in accordance with the principle of fiscal territoriality, connected with a temporal component, namely the fact that the taxable person is resident for tax purposes within national territory during the period in which the capital gains arise to levy exit taxes.

Moreover, the ECJ stated that the transfer of the place of effective management of a company of one Member State to another cannot mean that the state of origin has to abandon its right to tax a capital gain which arose within the ambit of its powers of taxation before the transfer. Exit taxes are intended to avoid situations capable of jeopardizing the right of the Member State of origin to exercise its powers of taxation in relation to activities carried on in its territory and may therefore be justified on grounds connected with the preservation of the balanced allocation of powers to impose taxes between Member States.

From an international perspective, the right to levy exit taxes can also be affected by bilateral tax treaties that are most commonly based on the OECD Model Convention. Unfortunately, the utilization of the Convention in the case of exit taxes does not prove to be without difficulties.

Due to the fact that the Commentary on article 13 of the Convention provides contradictory statements with regards to the concept of alienation, it is not yet settled if the term alienation from article 13(5) includes deemed realizations of assets. As a result, this subject is still open for debates and interpretation. Moreover, this issue opens up the matter of treaty override. A Contracting State by deeming a realization of the assets when the taxpayers leave its jurisdiction can be considered to be overriding the applicable treaty. However, in the opinion of the author, the Commentary provides for sufficient arguments on which Contracting States can rely when they levy exit taxes on unrealized gains.

Last but not least, a problem that remains unsolved is double taxation. The OECD Model Convention does not provide any solution for this legal issue in the case of exit taxation. The available solutions, such as a step-up mechanism or a reverse credit can only be provided unilaterally or negotiated at their own initiative by Contracting States.
Despite the described difficulties, it can be concluded that the Model Convention does not forbid exit taxation. The distribution rule from article 13(5) establishes the right to tax to the state in which the taxpayer is a resident. Based on the fact that the tax liability is established when the taxpayer is still a resident, the right to levy the tax remains within the ambit power of taxation of the state of emigration.

In conclusion, notwithstanding that there are a number of difficulties, both on the EU and international level there are no explicit obstacles that would impede a Member State to levy exit taxes. Even though exit taxes are found to be a restriction on the basic freedoms, the ECJ acknowledges the right of Member States to defend their tax base through these methods. It also forces them to develop exit tax systems that would put as fewer restrictions as possible for the access of individuals and companies to the freedoms enshrined by the TFEU. Judging by the development in exit taxation case law, it can be expected that the ECJ will further inflict its jurisdiction in direct taxation in order to solve the arising legal issues.
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