Proposed German Exit Tax Revisions Are Subject of Controversy

by William Hoke

The German Cabinet's recent approval of legislation to bring domestic law into line with the EU's anti-tax-avoidance directive (ATAD) has led to concerns about the ramifications of a measure modifying the country's exit tax regime.

ATAD 1, which was approved by the EU Council in 2016, included five key measures that required all EU member states to implement rules for controlled foreign corporations, exit taxation, general tax antiavoidance, interest limitation, and switchovers. Germany failed to meet the EU's required implementation date of December 31, 2019. On March 24 the Cabinet approved proposed legislation to bring Germany into compliance.

In an April 13 client note, Philine Lindner and Luise Uhl-Ludäscher of CMS Hasche Sigle wrote that the proposed regulations on exit taxation go far beyond the adjustments required by the ATAD. "If the law is implemented on the basis of the current draft, entrepreneurs may face considerable strains on liquidity, not only when moving to a third country, but also when moving within the EU," they said.

Under current law, a departing German resident who owns at least 1 percent of a corporation's shares and has been subject to unlimited German tax liability for at least 10 years is deemed to have sold the stock and is subject to exit tax on any deemed gain. (In some situations, an owner of a stake in a partnership can also be subject to exit tax, as can a person making a gift of corporate shares.) If the move is to another EU country or a European Economic Area country, the gain is deferred with no interest due or collateral required for as long as the shares remain unsold. A change of residence to a non-EU/EEA country results in an exit tax liability that must be backed up with collateral and paid, with interest, after five years.

While the proposed legislation would do away with the deferral for changes of residence within the EU or EEA, it would allow a taxpayer to apply to pay the liability in installments over seven years without interest if collateral is provided. A change of residence outside the EU or EEA would be subject to the same rules, effective January 1, 2022, if the amendments are approved.

Uhl-Ludäscher told *Tax Notes* the justification for subjecting a departing resident who owns corporate stock to exit tax is that tax treaties generally grant the right to tax any subsequent gains to the country where the shareholder resides when they are sold, even if a significant part of the appreciation took place before the change of residence.

Maximilian Haag, an attorney with P+P Pöllath in Munich, said German tax authorities generally take the view that the country's exit tax is applied just before a taxpayer qualifies for treaty protection, which means that it cannot conflict with any existing treaty. "This has been contested by many tax practitioners," he said. "The only scenario in which there is a good chance for treaty protection against the German exit tax is [when] a taxpayer who, while having become a tax resident of Germany, has been under continuing treaty protection in Germany [because] his center of vital interests has never shifted from the other treaty country to Germany. Nevertheless, as German courts do not generally enjoin German lawmakers from applying German national treaty override provisions, even a conflict to a tax treaty would not bar the German revenue service from applying the exit tax, as the exit tax provisions would most likely be viewed as a valid treaty override."

Peter Happe, a CPA with SK-Berater in Frankfurt, said the exit tax law does not generally conflict with Germany's tax treaties because it is the last domestic tax act to apply before the person leaves the country. "Only in rare cases — for example, double residency and the person gives up German residency, or in case of shares in a real estate company holding foreign real estate — is there a conflict," Happe said. "However, the German supreme court has ruled that any German law can override a treaty provision, provided the wording openly indicates that it is a potential override and the [legislature] has taken the treaty override explicitly into account."

Gerd Kostrzewa of Heuking Kühn Lüer Wojtek in Dusseldorf said that while the German exit tax bill does not require a step-up in basis if the corporate shares were subject to exit tax in another EU member state, section 17, paragraph 2 of the

German Income Tax Act provides for a step-up if the assets were subject to a comparable exit tax in any country, even those that are not part of the EU.

Haag said many of Germany's tax treaties include similar provisions. He also said ATAD article 5(5) requires a member state to recognize asset values established by another member state for exit tax purposes. "However, the new country of residence is not bound to recognize the value determined by the exit state if the value determined by the exit state clearly deviates from fair market value," he said.

Two of the practitioners contacted by *Tax Notes* said Germany would not refund exit tax on appreciated shares paid by a resident who relocates to another EU country if the value of the assets had declined when they were sold later. Happe disagreed. "Germany would refund if the value decreases and the person has moved to an EU/EEA state," he said. "However, not in case the person moves to a third country. With the implementation of ATAD, the refund possibility will be given up due to alleged potential misuses — i.e., generally no refund in the future."

If a German resident pays exit tax on appreciated shares before moving to a non-EU country, the question whether the new jurisdiction can impose tax on the full amount of gain from a later sale of the assets depends on the provisions of Germany's tax treaty with that country, Uhl-Ludäscher said. Germany's tax treaty with the United States "provides for such a rule in article 13(6)," she said. "The profit, insofar as it has already been taxed in Germany, is then not taxed again abroad."

Happe said there is a similar provision in Germany's tax treaty with Switzerland. "If there is no step-up-in-basis provision in the treaty, it is a double taxation situation that might be solved in an arbitration procedure," he said. "If the treaty allows it, there is a bilateral solution. If it clearly violates the taxpayer's rights, the taxpayer has to go to the fiscal court in the new country of residence [for a] unilateral solution."

Haag said that under the proposed revision to the exit tax law, Germany would no longer distinguish between EU member states and non-EU countries. "Therefore . . . the new country of residence would have the right to tax the gain even though some or all of it was already subject to the German exit tax," he said. "Then, it depends on whether the other country recognizes the German exit tax as a step-up event."

Sten Günsel of Ebner Stolz in Stuttgart agreed. "The question needs to be addressed according to the other country's tax rules, which are normally not dependent on taxation in the original country," he said.

Freedom of Movement Under the TFEU

There have been arguments that the ATAD violates the freedom of movement under the Treaty on the Functioning of the European Union. "Since the implementation of ATAD as a directive is an obligation, Germany probably has to implement the directive, [but] the directive violates clearly the freedom of movement right," Happe said.

Happe said the Court of Justice of the European Union ruled in 2004 in *de Lasteyrie du Saillant* (C-9/02) that exit rules in France at the time violated the freedom of establishment. "The new rules implemented under ATAD are similar to the historic exit rules," he said. "The question will be in the end if the secondary right — a directive — can beat the primary right."

Kostrzewa said the German legislation cites two CJEU decisions — *National Grid Indus* (C-371/10), and *Commission v. Portugal* (C-503/14) — that support the position that the directive does not violate the TFEU.

Günsel said a TFEU challenge could prove problematic for the exit tax legislation. "But chances to successfully fight it remain [unclear], as Germany protects its right of taxation for unrealized capital gains and treats all taxpayers the same," he said.

Haag said the issue will likely end up before both German and EU courts. "There are strong arguments that Germany must not treat EU and non-EU countries alike," he said in an email. "While lawmakers argue that the right to pay the exit tax in seven annual installments sufficiently protects the fundamental freedoms under the [TFEU], many commentators question this. I personally think that litigation against the proposed law would likely be successful, even though it is completely unclear what the consequences then would be: Complete tax deferral? More than seven annual installments for EU cases? Other forms of protection for moves to other EU countries?" ■