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<u>Object</u> : Exit tax : inventory of a disputed mechanism affecting French residents who are candidates for departure

1 - The present study focuses on the exit tax system. Known in many legal systems, including in France, it is marked by an obvious technicality. It envisages the taxation of unrealized gains on social rights in the event of a transfer by the taxpayer of his fiscal domicile to another State. Regarding the French exit tax, it is necessary to distinguish whether the transfer takes place to another EU country, to Iceland or Norway, in which case a deferment of taxation (*"sursis d'imposition"*) can be obtained by right, or to another State.

According to recent studies, tax exile has attractions whose vigor does not weaken. Among the factors to be taken into account for candidates at departure, the transfer of the tax domicile of natural persons outside France entails the taxation of unrealized capital gains (*"plus-values latentes"*) on certain of their holdings. The related mechanism, known as the "exit tax", is found, in varying modalities, in foreign legal systems (1). In general, the exit tax is a very technical mechanism, as the French case illustrates (2).

1. <u>The exit tax, a widespread mechanism in State legislations</u>

2 - One of the objectives pursued by the tax legislator is to combat certain forms of tax evasion, in particular when they result in the relocation of the most important incomes and assets. This explains why many countries, like France (A), have set up exit tax systems, showing a contrasting international tax landscape (B).

A. <u>The exit tax, a mechanism known from French law</u>

3 - Mechanism initially set up. - A first mechanism, repealed in positive law, was introduced by the Finance Act for 1999 (French General Tax Code, *"Code General des impôts"* hereinafter *"GTC"*, art. 167 bis).

It provided for the taxation of unrealized capital gains on the substantial investments held by natural persons transferring their tax domicile outside France.

At the date of transfer of domicile, were taxable the following assets:

- the unrealized capital gains realized on the substantial participations held by the French tax resident taxpayer in respect of at least 6 of the 10 years preceding his departure from France;
- and capital gains placed on deferral of taxation (*"report d'imposition"*) without condition of duration of tax residence.

In both cases, the taxpayer could benefit from a deferment of payment allowing deferring the effective taxation of capital gains on the transfer, redemption, redemption or cancellation of the securities concerned, on condition to provide sufficient guarantees for the recovery of the debt to the Treasury.

This system was sanctioned by the Court of Justice of the European Communities (CJEC) in 2004[1] and was repealed by the 2005 Amending Finance Law (*"Loi de Finances rectificative pour 2005"*) because of the incompatibility of some of its provisions with Community law, concerning the need to systematically provide sufficient guarantees to benefit from the derferment of payment.

4 - New system introduced in 2011. - A new exit tax system was introduced by the Amending finance law for 2011 for transfers since March 3, 2011 appears in Article 167 bis of the GTC. In its version of 2011, it provides that taxpayers who are taxpayers domiciled in France for at least 6 of the 10 years preceding the transfer of their domicile abroad are taxable on the unrealized gains on social rights, securities, Rights held in companies, hold, on the date of the transfer, one or more direct or indirect participations:

- granting them at least 1% of the profits of a company;
- or whose cumulative value exceeds € 1,300,000.

In order to be compatible with European Union law, this new arrangement no longer determines the suspension of payment for the provision of adequate guarantees only in the event of a transfer of residence in a third State to the economic area (EEA) or Liechtenstein.

5 - Modulation of capital quotas in 2013. - The Amending finance law for 2013 modulated the capital quotas concerned by departures since January 1, 2014: the exit tax is now applicable to the holdings of more than 50% of the profits or of a cumulative value exceeding 800,000 €.

6 - Alignment of the exit tax rules with the internal tax regime for capital gains carried forward. - The Amending Finance Law for 2016 aligned the rules for determining the rate of taxation of

[1] CJEC, March 11 2004, C-9/02.

capital gains placed under deferral pursuant to Article 150-0 B ter of the GTC, prior to the transfer of residence, On the rules governing the taxation of such capital gains under national law (GTC, Article 200a, 2b).

7 - Transfer of corporate headquarters. - The exit tax also concerns the transfer of company headquarters.

The Court of Justice of the European Union (CJEU) has transposed the principles set out in its case-law relating to the mechanisms of the exit tax of natural persons, in particular in the judgment "National Grid Indus BV" where it sanctioned the mechanism of taxation of unrealized capital gains during the transfer of business seats provided for by Dutch law, for infringement of freedom of establishment since the immediate recovery of taxation was disproportionate to the objective of preservation of the distribution of the tax burden between Member States[2].

In this judgment, a company had transferred its place of effective management from the Netherlands to the United Kingdom and had been taxed for an unrealized exchange gain (*"gain de change latent"*) on a receivable in connection with that transfer, whereas this tax did not exist in the event of a transfer of a seat within that State.

It should, however, be pointed out that the Court seems to have accepted the obligation for taxpayers wishing to benefit from a deferred tax, to provide guarantees, contrary to its previous position concerning the exit tax of natural persons[3]. The position adopted in that judgment has been confirmed several times[4].

Accordingly, Article 221 §2 of the GTC has been amended in order to bring French legislation into conformity with European regulations and to allow companies to opt for the split payment over 5 years of the tax due on account of the unrealized capital gains on the assets of the company, when its head office is transferred to the European Union, Iceland or Norway.

It may be noted that the capital gains tax does not take place, in this case, if the transfer of the registered office is not accompanied by the transfer of the assets, that is to say if the latter remain on the balance sheet of a French permanent establishment of the company.

8 - ATA Directive. - The further development comes from the European Union. On January 26 2016, the European Commission published a "package on the fight against tax evasion", including a proposal for a Directive, including a clause providing for an exit tax mechanism, which codifies the principles of the "National Grid Indus"[5], which was approved by the Member States on 21 June 2016 and adopted by the Council of the European Union on 12 July 2016. The Directive introduces an exit tax mechanism for companies which transfer their head offices in order to reserve for the State of origin the taxation of any unrealized capital

[2] CJEU, November 29 2011, C-371/10.

[3] CJEC, March 11 2004, C-9/02.

[4] The CJEU confirmed this position concerning mechanisms that are in Portuguese legislation, (CJEU, Sept. 6 2012, C38/10), Dutch legislation (CJEU, January 31 2013, C301/11), Spanish (CJEU, April 25 2013, C64/11) and Danish (CJEU, July 18 2013, C261/01).

[5] CJEU, November 29 2011, C-371/10.

gains in its territory. Member States have until December 31 2018, to transpose the Directive into their national law.

9 - Challenges. - In addition, it should be noted that the terms of the exit tax arrangements continue to be regularly challenged.

The French State Council (*"Conseil d'Etat"*) recently referred three questions to the CJEU for a preliminary ruling on the compatibility of the exit tax with the freedom of movement of persons under the Luxembourg Agreement of 21 June 1999, signed between the European Community and its Member States, on the one hand, and the Swiss Confederation, on the other hand, in the case of a taxpayer who has been taxed in respect of the exit tax (in the version prior to January 1 2005) his domicile for tax purposes in Switzerland.

In this case, the taxpayer claims that he moved to Switzerland in order to continue to engage in self-employment as part of the management of his holdings under conditions characterizing the pursuit of an economic activity

He was already practicing in France before his departure and therefore requests the discharge of the additional charges which have been charged to him in accordance with Article 167a of the GTC[6].

B. The exit tax, a mechanism which is in other legislations

10 - Some States sanction the transfer of residence of natural persons more heavily than France does. - Some States link the taxation of natural persons unlimitedly (United States) or limited in time (Germany: taxpayers continue to be taxed in Germany for the ten years following the transfer of their domicile in a State with lower taxation when they maintain economic links with Germany).

• **United States**. - This taxation of ordinary income according to nationality is sometimes cumulated with a mechanism similar to the exit tax. For example, the United States have introduced a system known as the "mark to market tax", which affects American citizens renouncing their US citizenship and long-term residents who terminate their residence in the United States. Taxation applies to contributors of which:

- the average taxation of income over the 5 years preceding the transfer of tax residence exceeds a certain amount ($ 160,000 per year in 2015);
- or whose asset value exceeds $ 2 million at the date of the transfer of residence for tax purposes;
- or who have not filed the form n° 8854 certifying that they have fulfilled all their tax obligations during the 5 years preceding the transfer of their domicile.

Under this plan, the taxpayer is deemed to sell all assets at market value at the date of transfer of his or her domicile. The taxpayer is then taxed on unrealized capital gains after deduction of an allowance of $ 690,000 (for a transfer in 2015).

[6] CJEU, June 23 2016, n° 378008.

• **Germany.** - Germany provides that a taxpayer who has been subject to German income tax on the basis of all his income during the 10 years preceding the transfer of his tax domicile to another State and who, after the transfer of its tax residence, is no longer subject to German income tax, is taxed, during this transfer, on account of unrealized capital gains on its shareholdings in German companies, when he has held, directly or indirectly, at least 1% of the capital of the company at any time during the 5 years preceding the transfer of domicile.

11 - Other European states apply a similar scheme to the French exit tax.

• **Norway. -** Norway provides that the transfer by a taxpayer of his residence for tax purposes outside Norway makes him taxable on unrealized capital gains on certain of its financial assets (in particular shares and interests in Norwegian companies), with the possibility To apply for a deferral of tax under certain conditions. It is also provided that its liability to tax ends at the end of a period of 5 years following the date of his transfer if his has retained its assets.

• **Denmark. -** Denmark provides that the taxpayer who transfers his domicile outside Denmark shall be subject to an exit tax on account of his assets which are not subject to Danish tax (movable or immovable assets). More specifically, the exit tax applies to unrealized capital gains on all shares held by the taxpayer transferring his domicile when their cumulative value exceeds DKK 100 000, provided that he has been a Danish resident for at least 7 of the 10 years preceding the transfer of his residence Its fiscal domicile.

The taxpayer may benefit from a tax deferral under certain conditions, in particular on condition that he files a tax return with the Danish tax authorities each year following the transfer of the domicile. This option ends when the asset generates income or when it is sold, and in principle each year the contributor must pay 1/7 of the amount of the deferred tax.

• **Netherlands. -** The exit tax regime set up in the Netherlands and amended since September 15 2015 provides that a tax assessment formalizes the amount of the exit tax relating to the unrealized capital gains realized on the substantial participations Held by a Dutch taxpayer transferring its tax domicile outside the Netherlands, with a mechanism for deferral under guarantee. It is expected that the Dutch exit tax will have to be paid in the event of the distribution of reserves or the sale of shares. It should be noted that there is no longer a time limit allowing the taxpayer not to be taxed on the capital gain realized before the transfer of his residence.

12 - Other States have introduced different systems of taxation to penalize the transfer of residence.

• **Ireland. -** Ireland taxes taxpayers who are considered to be ordinary tax residents for three tax years and transfer their domicile outside Ireland, considering that they remain resident until the end of the third tax year following the transfer of their tax domicile: they will therefore be liable to pay Irish tax on some of their income.

• **United Kingdom. -** The United Kingdom does not have an exit tax as such but reserves the right to tax foreign income not taxed in the UK at the return of the taxpayer to UK, if this transfer of the domicile outside the UK took place less than 5 years before his return (socalled “temporary non-resident regime”). This system concerns all repatriated incomes and not exclusively capital gains.

13 - The issue of exit tax is now introduced in certain tax treaties.
An amendment to the Franco-German tax convention[7] signed in 2015 introduced a specific clause to the exit tax in the Convention: Article 7 of the Convention now provides for a taxation shared between the two States in the event of the transfer of securities by a individual resident who has discharged an exit tax in the other State during the transfer of his domicile.

2. The French exit tax, a highly technical mechanism

14 - The technicality of exit tax devices can be illustrated from French law.

We will see the substantive aspects (A) and the declarative aspects (B), as well as the modalities of the suspension of payment and the events leading to the tax relief or refund (C).

Unrealized capital gains concerned	• Unrealized gains on social rights, securities and rights mentioned in article 150-0 A, I of the GTC; • Claims that come out of a price supplement clause; • Deferred capital gains (*“plus-values en report”)* on application of one of the following: - Capital gains on a company's share of a receivable arising from an earn-out clause (GTC, article 150-0 B bis); - Transfer capital gains *(“plus-value de cession”)* made before January 1st 2006 by certain employees or directors of companies in accordance with Articles 150-0 C and 92 B of the GTC; - Capital gains realized before 1 January 2000 resulting from certain restructuring operations (GTC, former articles 92 B and 160, I ter); - Capital gains on a company subject to the corporate tax *(“impôt sur les sociétés”)* controlled by the contributor (GTC, article 150-0 B ter). • It was recently decided by the Montreuil Administrative Court *(“Tribunal administratif de Montreuil”)* that the exit tax applied to capital gains on securities held in a young innovative company[8]. On the other hand, this mechanism concerns only **capital gains taxable under the provisions of Art. 150-0 A of the GTC**. • It was thus confirmed that the unrealized capital gains on the shares of

[7] Franco-German tax convention, amendment, July 21st 1959 signed on March 31st 2015, Official Journal January 24th 2016.
[8] Montreuil Administrative Court, April 19 2016, n° 1411447. This decision has been subjected to an appeal, which is not published yet.

	predominantly real estate companies *(sociétés à prépondérance immobilière")* not subject to corporate tax referred to in Article 150 UB of the GTC which are subject to the real estate gains regime are therefore excluded from this regime, since the disposal of these shares in companies would still be subject in France to the levy provided for in Art. 244 bis A of the GTC. This reply does not refer to securities of predominantly real estate companies subject to corporate tax, which had however been excluded from the scope of the exit tax by the tax authorities in its doctrine explaining the scope of the system introduced by the Amending Finance Law of 2011. This position has not been confirmed after the amendments made to the scope of the exit tax by the Amending Finance Law for 2013. However, the comments of the Administration contained in the Memorandum Declaration of exit tax always exclude the securities listed in Article 244 bis A, I, 3 of the GTC, which include the securities of predominantly real estate companies to corporate tax. A previous confirmation of the doctrine made by the tax administration on this subject would therefore be welcome, all the more so the capital gains realized on these securities by a French resident fall within the scope of Article 150-0 A of the GTC. • On the contrary, **regarding the securities held in an Equity Saving Plan** *("Plan d'Epargne en Action, hereinafter "PEA")*, the combined reading of the notice which excludes securities held in PEA from the exit tax base and the administrative doctrine relating to the management of PEA in the event of a departure abroad specifying that the loss of resident status does not result in the automatic closure of the plan unless it is transferred to an non-cooperative State or territory (ETNC) within the meaning of s. 238-0 A of the GTC[9], suggests that the transfer of the tax domicile of the holder of the plan outside France can not lead to the taxation of the unrealized capital gains on the securities listed in the PEA that would result from the immediate closure of the PEA. However, it is regrettable that the Administration has not yet confirmed its position regarding the exclusion of securities held in PEA from the scope of the exit tax since the legislative modification of the scope of the exit tax.
Condition of domiciliation	The taxpayer has been domiciled in France for at least 6 of the last 10 years preceding the transfer of his tax domicile outside France.
Threshold of the implementation of the regime	• The value of the social rights, securities, securities or rights held by the taxpayer with the members of his tax household, represents at least 50% of the profits of a company; • Or their total value exceeds € 800,000.
Basis	• **Unrealized capital gains** are determined by the difference between their

[9] French State Council *(« Conseil d'Etat »)*, June 2nd 2006 : JurisData n° 2006-080908.

	actual value *("valeur réelle")* at the date of transfer of the domicile outside France and their purchase price or value by the taxpayer. • **For listed securities** *("titres cotés")*: the actual value is determined by reference to the last known price on the date of departure outside France or the average of the last 30 days preceding that date. • **For unlisted securities** *("titres non cotés)*: the actual value is estimated by the taxpayer. The potential unrealized capital losses are not offset against capital gains calculated on other securities. Similarly, the taxpayer cannot reduce his tax base by the imputation of capital losses recorded in a period prior to his departure and placed under deferral. It should be noted that the valuation of securities proposed by the taxpayer as part of his statement of exit tax does not bind the tax authorities on the past.
Potential application of deductions for ordinary ownership period *("abattements pour durée de détention")*	Unrealized capital gain is reduced if necessary for income tax (*"impôt sur le revenu", hereinafter "IR"*) taxation, by the deduction for ownership period, or the enhanced deduction for executives going on retirement *("abattement renforcé pour les dirigeants partant à la retraite")*. For the latter, the transfer of the domicile outside France shall be treated as a transfer against payment if the following conditions are cumulatively fulfilled: - The taxpayer has asserted his pension rights before the transfer of his tax domicile; - The taxpayer resident in France sells his securities within two years after his retirement (CGI, Articles 167 bis, I, 2 bis and 3). It should be noted that the deduction for any ownership period applicable does not apply to social security contributions but only to income tax.
Operative event	**In principle:** the operative event for taxation is the transfer of the tax domicile outside France, which is deemed to take place on the day before the day on which the taxpayer ceases to be subject in France to a tax liability on all his income. **Are therefore concerned:** taxpayers who remain French tax residents within the meaning of domestic law (GTC criteria, Article 4 B) but who would be regarded as non-residents within the meaning of international conventions. This applies in particular to taxpayers who have the center of their economic interests in France and would therefore be considered to be French tax residents within the meaning of national law but whose center of vital interests is situated in another State and would be taxed in that other State by application of the applicable Convention.

	Clarification on transfers to overseas collectivities (*"collectivités d'outre-mer, hereinafter COM*): the transfer of domicile does not intervene during the physical transfer of the residential home to the COMs, but at the end of the 5 year of residence in the COM. This period is assessed from date to date.

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