General Report

Luc de Broe*
(Belgium)

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* Partner, Stibbe (Brussels); Professor at Fiscale Hogeschool (Brussels)

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1. Introduction*

Because income taxes are always imposed as a function of the person producing the income, a transfer of residence by individuals and the resulting change of tax jurisdiction give rise to issues of allocation of taxing powers between the country of former residence (hereafter also the emigration country) and the country of new residence (hereafter also the immigration country).

Except for a few paragraphs in the OECD commentary on the model tax convention on income and capital[1] (hereafter the OECD commentary or the OECD model), neither the OECD model nor the UN model double taxation convention (hereafter the UN model) specifically deals with the tax consequences of an individual transferring his residence from one country to another. Nor do such materials address the more emotionally charged issue of the renunciation of citizenship.

If an individual moves from one tax jurisdiction to another, the country of former residence may lose a substantial portion of its tax base and thus tax revenues. Indeed, prior untaxed accrued income and appreciation in value of movable property which the taxpayer often takes with him to the other country (e.g. art; securities) may never be taxed if they are not included in the non-resident income tax liability, and future income from sources situated in the country of former residence may vanish because the source of the income simply disappears (e.g. employment in that country).

An increasing number of countries have taken measures with a view to protecting their taxing claims, either on latent gains inherent in movable property or on future income derived from sources in and/or outside the country of former residence. These measures can be divided into three main categories: (a) general and limited exit taxes; (b) unlimited and limited extended tax liabilities; and (c) recaptures of previously enjoyed deductions or deferrals. Throughout the general report and the branch reports such measures are referred to as emigration taxes. They are described in detail below in section 2.3.1.

Twenty-six branches have submitted reports on the subject.[2] From an EC perspective, the assessment of emigration taxes raises the question of whether such taxes are in accordance with the fundamental freedoms guaranteed by the EC Treaty. IFA is very pleased that Ms Kerstin Malmer, a principal administrator at the EC, has accepted the invitation to write a report expressing her personal opinion on the compatibility of emigration taxes with EC law. I wish to thank the IFA branch reporters and Ms Malmer for their cooperation in this undertaking and for the high quality of their work. This topic has recently been thoroughly examined by Mr R. Betten in his dissertation on *Income Tax Aspects of Emigration and Immigration of Individuals* (IBFD Publications, 1998). The outline of the IFA branch reports and

* Translations into French, German and Spanish are available on the CD-ROM of the *Cahiers.*

1 OECD commentary: in particular §§8–10 on art. 1 OECD model.

2 Argentina, Australia, Austria, Brazil, Canada, Denmark, Finland, France, Germany, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Mexico, New Zealand, Norway, the Netherlands, Spain, Sweden, Switzerland, United Kingdom, United States, and Ms K. Malmer.

this general report is based on the structure of this dissertation and the general reporter was fortunate that he could rely on Mr Betten's excellent study.

The focus of the IFA branch reports is not on the normal issues that arise when a resident or citizen of one country derives income from another country. The branch reports deal only with the tax problems resulting from a change of residence (or a loss of citizenship) and the desire by the country of former residence (or citizenship) to protect its taxing rights. The general reporter has asked the IFA branch reporters to discuss the relevant issues from the perspective of their country being first the emigration country and subsequently the immigration country.

From the perspective of the emigration country, the branch reporter discusses whether any of the three types of emigration taxes described above is levied and/or whether his/her country applies other protective measures to individuals giving up their tax residence or citizenship. Also the policy reasons behind these regulations or the absence of such regulations are dealt with. If such taxes are assessed, the branch reporter has been asked to discuss whether and to what extent his/her country, as emigration country, takes measures to give relief for the international double taxation that may arise from the levying of such emigration taxes.

From the perspective of the immigration country, the branch reports analyse in what circumstances the migrating individual may achieve full or partial international non-taxation as a result of transferring his residence from a country not levying an emigration tax to the country of the branch reporter. Where such emigration taxes have been assessed, the reporter discusses whether and to what extent his/her country is prepared to give relief under domestic law and tax treaties, if international double taxation arises.

Finally, the branch reporters have been invited to give their views on the issue of whether emigration taxes and other safeguarding measures applicable in the case of transfer of residence are in accordance with international law, and in particular with the international conventions on human and civil rights and with EC law.

Because the topic is wide and/or encroaches on other topics already addressed by IFA, the branch reports do not deal with the following issues:

(a) tax issues resulting from the migration of an individual owning an unincorporated business or exercising a liberal profession;
(b) the tax treatment of income from professional activities performed before emigration and the tax aspects of deferred or contingent compensation (including stock options);[3]
(c) taxes other than income taxes.[4]

The IFA branch reports thus mainly focus on the migrating individual who moves his private investments (e.g. shareholdings or other types of securities) to his country of new residence.

The general report compares the different national regulations that aim to protect the taxing rights of the emigration country, both under domestic laws and tax treaties, when an individual moves his residence abroad or renounces his citizen-

3 These topics have been dealt with during the 1999 IFA Congress on *International Tax Aspects of Deferred Compensation*, *Cahiers de Droit Fiscal International*, vol. 85 (b).

4 The estate and gift tax issues caused by a transfer of residence will be discussed in a seminar during the 2002 Oslo Congress.

ship, and identifies the typical tax issues connected therewith (e.g. enforcement, international double taxation and international non-taxation). Secondly, the general report aims to identify the policy considerations behind the various relevant domestic law and treaty provisions and to determine whether and to what extent international guidelines need to be worked out to avoid international double taxation and non-taxation. Finally, the general report gives a summary of the views expressed by the different branch reporters on the issue of the compatibility of emigration taxes with international law.

2. Income tax treatment of emigrants: general discussion

2.1. Taxation systems applied by the countries surveyed

Most countries use residence as the connecting factor for subjecting individuals to unlimited tax liability (i.e. tax on worldwide income), while non-residents are usually only taxed on a territorial basis, i.e. on income derived from sources within such countries (limited tax liability).

Not all countries, however, apply residence as a basis for their tax jurisdiction. The United States, for instance, subjects its citizens, wherever resident, to unlimited tax liability. Because the US also subjects resident aliens to tax on their worldwide income, the nationality criterion is used in parallel with the concept of residence. Non-resident aliens of the United States are only taxed on US source income.

The income tax system of Israel (and until 1998 of Argentina) is primarily based on the concept of territoriality. Residents and non-residents, regardless of their nationality, are subject to tax on income derived only from sources within (or deemed to be within) Israel. In countries applying territoriality as the connecting factor for income tax purposes, there is in principle no difference between the taxation of residents and non-residents. In recent years more and more features of taxation based on residence have been introduced in Israel's tax legislation (e.g. for capital gains tax purposes) and the Treasury recently announced its intention to subject Israeli residents to tax on their worldwide income.

In addition to residence, some countries also apply domicile as a connecting factor for income tax purposes. Domicile is a subjective and therefore difficult concept to deal with as it is concerned with a person's long-term nexus to a certain country. Each individual is born with a domicile of origin (generally the domicile of his father at birth). When he attains majority, the individual has the capacity to acquire a domicile of choice. In the United Kingdom and Ireland, for instance, a person who is resident but not domiciled there is typically only subject to tax on income from sources within that country. Foreign source income is only taxable if it is remitted into the country.

Countries using residence as a basis for their taxing jurisdiction give consideration to the taxpayer's personal attachment to the country concerned. To determine such attachment they apply various tests which are often not mutually exclusive: permanent residence under immigration laws (e.g. the United States, Argentina and Brazil); availability of a permanent home (e.g. Austria, Sweden, Finland, France, Mexico and Switzerland); presence for a certain period of time (e.g. United Kingdom, New Zealand, the United States, Norway, Spain, Finland and India); presence in the country for professional purposes for a certain period of time (e.g. Japan, France and Switzerland); situation of centre of economic or social interests (e.g. Netherlands, Italy, Spain and France) and, even in one case, nationality (Argentina). The application of some of these tests requires a facts and circumstances analysis.

2.2. Income tax revenue effects of emigration/taxpayer's perspective

2.2.1. Income tax revenue effects of emigration

The tax revenue effects differ according to whether the emigration country applies residence, nationality or territoriality as a basis for its tax jurisdiction.

2.2.1.1. Countries applying residence as a connecting factor

In countries applying residence as the connecting factor, the income tax revenue effects of emigration depend on the circumstances of each specific case.

Future income from sources within the emigration country may vanish because the source of income simply disappears, e.g. if employment in that country is terminated; deposits with a bank in that country are moved to a bank in the immigration country, etc. The emigration country normally maintains its tax jurisdiction on income derived from sources within that country. However, it may have forgone its right to tax income from such sources under a double taxation convention (hereafter DTC) (e.g. for private pensions under article 18 OECD model; article 18A UN model) or have agreed to reduce its taxing rights to a withholding tax (e.g. for dividends and interest under articles 10 and 11 OECD model and UN model). Usually, the foreign source income that has been included in the emigrated taxpayer's worldwide taxable income can no longer be taxed after emigration by the country of former residence because the necessary connection between the income and that country has disappeared.

Assets of which the market value exceeds their tax base (i.e. the historic cost or, in the case of depreciable assets, the net book value) carry an unrealized (accrued) capital gain in them. In this general report such assets are referred to as "appreciated property". The appreciation may result from an increase in the value of that property but also from a recapture of earlier depreciation allowances. Assets held by the taxpayer under a deferral regime that allows a taxpayer to defer, upon realization of certain assets, an otherwise taxable capital gain if he acquires qualifying assets or makes a qualifying reinvestment (e.g. exempt exchanges of shares as a result of corporate reorganizations) also carry an accrued gain in them. Upon a transfer of residence of the owner of the assets, the latent income tax claim of the emigration country on such assets will disappear if the taxpayer takes those assets with him to the country of new residence and the gain is not included in the non-resident income tax liability of the emigration country when the taxpayer realizes the assets. This may, e.g., be the case for gains on shares of a company not established in the emigration country or even for gains on shares of a company established in that country, when it has given up its taxing rights to the country of new residence under article 13(4) OECD model.

These discontinuities in taxation result also from the fact that countries usually apply the cash realization method for subjecting individuals to income tax. Income is to be recognized when cash or the equivalent is paid or received. Except for a few cases (see e.g. the Canada, New Zealand and US branch reports), countries do not allow or require taxpayers to recognize gains or losses under mark-to-market or accrual accounting methods[5] taking into consideration fluctuations in the value of privately held property on a yearly basis. Gains are taxed (and losses are deductible) only when the property is actually realized and cash or the equivalent thereof is received.

2.2.1.2. Countries applying nationality as a connecting factor

For a country that imposes tax on the worldwide income of its citizens, wherever they are resident, the change of residence of one of its citizens will not result in a loss of future tax revenues, even if the taxpayer moves appreciated property from the country to the country of new residence or if he no longer receives income from sources within the country of former residence. However, under unilateral relief measures or DTCs, the latter country may be obliged to grant foreign tax credits to its emigrated citizens who earn income that is also taxable in the country of new residence. Thus, emigration of its citizens could well have a negative impact on the tax revenues of the country of former residence.

Because countries applying nationality as a basis for their tax jurisdiction typically also subject resident aliens to unlimited tax liability, the tax revenues of such countries will be affected in the same way as explained in section 2.2.1.1 above when their nationals renounce their citizenship and at the same time transfer their residence abroad or when non-citizens emigrate.

2.2.1.3. Countries applying territoriality as a connecting factor

A country that applies a territorial taxation system will suffer from emigration if the sources of income within its jurisdiction are affected. For instance, if employment in the country is terminated or assets are moved out, the country will not be able to tax future income from such sources and its latent tax claim on the capital gain inherent in the assets will be lost. Even if the sources of income are kept

[5] There are many reasons why countries do not use the accrual method for determining taxable income of individuals: (a) both for tax authorities and taxpayers, annual valuation is difficult, expensive and risks being imprecise; (b) taxation of unrealized income causes problems for the taxpayer in paying the tax because no cash is received; (c) taxation of unrealized gains is considered to be premature and unfair, etc.

intact, that country may face a reduction in its tax revenues after emigration if e.g. non-residents are taxed at lower rates than residents or if the country's right to tax non-residents is prevented or reduced by a DTC with the country of new residence.

2.2.2. The taxpayer's perspective

A taxpayer who transfers his residence from a country applying the nationality principle to a country applying residence as the criterion for unlimited tax liability will be exposed to international double taxation if he maintains the nationality of the former country. To avoid such double taxation he will have to rely on the relief methods that are provided either unilaterally under the domestic laws of the emigration country or under a DTC between the emigration and immigration countries.

When a taxpayer moves his residence between two countries applying the residence principle, he will be subject to international double taxation if he maintains sources of income within the emigration country that enter into that country's limited tax liability and for which that country has not wholly or partly given up its taxing rights to the immigration country under a DTC (e.g. dividends, interest, salary, government remuneration and pensions). Again, to avoid such double taxation, the taxpayer will have to rely on relief methods. This time the relevant relief methods will be those unilaterally provided under the laws of the immigration country because he has established his residence there or those provided under a DTC between the two countries. Only if the taxpayer has no sources of income that are subject to non-resident income tax liability in the emigration country (or a third country) will he not face international double taxation.

However, it is a reality today that transfers of residence are also tax motivated. Upon transferring their residence to tax haven countries and no longer maintaining income from sources in their country of former residence (or third countries), taxpayers may achieve a definitive tax exemption. If a taxpayer owning a substantial shareholding or other securities that carry an accrued capital gain in them transfers his residence to a country that has entered into a DTC with the emigration country that allocates the right to tax capital gains to the country of new residence (cf. article 13(4) OECD model), a definitive and full exemption will also be obtained if he realizes the shares as a resident of the latter country and that country does not levy capital gains tax on shares and securities at all or on substantial shareholdings in companies that are not resident there (e.g. Switzerland and Belgium). This results from the combined effect of the use of the cash realization method for recognizing gains, the existing treaty network tailored to the OECD model and the fact that several countries do not apply a comprehensive capital gains tax. The OECD commentary has characterized such a transfer of residence as an artificial legal construction and a form of improper use of double tax treaties justifying the application of domestic anti-avoidance provisions.[6] While such emigration clearly exploits the lack of harmonization between countries' tax systems, it is believed that *bona fide* emigration is different from an artificial legal construction.

[6] OECD commentary §§8–10 on art. 1 OECD model.

2.2.3. Conclusion

It follows from the above that whatever concept a country uses as a basis for its tax jurisdiction, each country risks facing a reduction in its tax revenues when an individual transfers his residence abroad (for the United States eventually in combination with giving up US citizenship). It also becomes clear that emigration significantly affects the tax status of the taxpayer and that it may give rise to distortions in the income tax treatment of migrating individuals.

Not surprisingly, countries have addressed the negative tax revenue effects caused by emigration in several ways. These actions are discussed below in section 2.3.

2.3. Reactions by emigration countries

2.3.1. Introduction of emigration taxes

Most countries in the world and about a third of the countries discussed in this general report ignore emigration and do not treat it as a taxable event (Argentina, Brazil, Hungary, Israel, India, Indonesia, Japan, Korea, Mexico and Switzerland). These countries have not introduced any specific measures aimed at counteracting the loss of latent tax revenues. For a number of countries it is easily understandable that they have not considered the introduction of exit taxes because they do not levy a comprehensive capital gains tax or do not tax capital gains on privately held assets at all (e.g. Switzerland). Others that do levy some sort of capital gains tax on resident taxpayers (e.g. Brazil, Ireland, Finland, Japan and Korea) seem not to be concerned about the potential negative effects on their tax revenues caused by emigration and have not debated the issue publicly. Some countries, like Mexico, applied a type of emigration tax already in the 1930s but repealed it because it was considered ineffective, impractical and a poor source of tax revenue.

Several countries, however, do treat the act of emigration as a taxable event resulting in the deemed alienation of all (or some) items of property. Upon emigration all (or part of) accrued income is deemed to be realized for tax purposes and accrued but not yet realized capital gains on all (or some) items of appreciated property are to be valued and included in the taxable basis. For that purpose, exit taxes are levied upon emigration. They affect the latent income tax liability that exists at the time of emigration. General exit taxes are levied on accrued gains inherent in all items of appreciated property and are typically applied by countries that levy a comprehensive capital gains tax. General exit taxes have been applied in Canada since 1972 and in Australia since 1985. Limited exit taxes are levied on accrued gains included in certain items of appreciated property and are applied by countries that levy capital gains tax only on selective items of property, often substantial shareholdings. Germany introduced a limited exit tax in 1972 and since then the US has also done so; Austria, the Netherlands, Denmark, New Zealand and France have followed this example.

Extended tax liabilities or trailing taxes are another protective measure. Unlimited extended tax liability is based on the assumption that the emigrated taxpayer continues to qualify as a deemed resident of the country of former residence, despite the fact that he has established his residence for tax purposes in another country. Hence, the emigrant remains subject to tax on his worldwide income in the country of former residence, both on income derived from assets owned at the time of emigration and on income from assets acquired thereafter. In contrast to an exit tax, a trailing tax is not assessed at the time of the transfer of residence, but later when the income is actually realized. Unlimited extended tax liabilities amount to the extension of the residence concept and appear in the current tax systems of Sweden, Finland, Norway, Ireland, Spain and Italy, albeit that there are significant differences between the various jurisdictions, basically with respect to the persons captured by the tax and the events triggering the tax. A limited extended tax liability is restricted to income and gains from sources within the emigration country. Emigrants are then treated as non-residents by this country but not as ordinary non-residents because they are taxed for a number of years in a more burdensome way than the latter, often on the basis of expanded sourcing rules. Limited extended tax liabilities amount to an extension of the territoriality concept. They appear in different forms in the tax legislation of, among other countries, the US, Germany, Australia, Canada, Sweden, Norway, the United Kingdom and New Zealand. In countries that apply citizenship as a basic principle for the levy of income tax on worldwide income, extended tax liability may also be applied when the taxpayer has given up citizenship, whether for tax motives or not. The United States applies a limited extended tax liability to US citizens who renounce their citizenship for tax avoidance purposes.

Finally, countries may upon emigration recapture (claw back) previously granted deductions or tax deferrals. Recapture is typically applied in cases where a taxpayer, while a resident of a given country, has enjoyed a deduction or another tax advantage relating to some kind of deferred income scheme (e.g. a tax deduction for premiums paid under a private pension plan or life insurance) or a tax deferral of a realized capital gain (e.g. an exchange of shares under a tax exempt corporate reorganization) and subsequently transfers his residence to another country, which is entitled to tax the deferred income or gain often pursuant to a provision in a DTC with the country of former residence similar to articles 13, 18 or 21 OECD model. The tax systems of Finland, Germany, France, Sweden, Denmark, Australia, the Netherlands, Belgium and the United Kingdom provide for some sort of recapture mechanism.

These types of emigration taxes are not mutually exclusive. Nor do they prevent countries from introducing other specific measures to safeguard their taxing rights in the case of emigration of individuals. Such measures are addressed below in sections 2.3.2 and 2.3.3.

2.3.2. Rules on residence

Of course, one way for the emigration country to avoid the loss of its tax claims is to combat alleged transfers of residence that have not happened in reality. One observes a growing attention by tax authorities in this field, especially where the individual moves to a tax haven or a neighbouring country known for permitting the taxpayer to realize in a tax free manner income or gains which would not have been exempt absent the transfer of residence. For this purpose, tax authorities often use far-reaching investigation powers, thereby applying an "all facts and circumstances" test whereby substance largely prevails over form, as was recently demonstrated in the different *Pavarotti* findings in Italy.

Sometimes taxpayers speculate to realize tax free income while being resident for a few years in another country and remigrate shortly after such realization to their country of former residence. The Scandinavian countries have enacted legislation in order to deny non-residence status to temporary non-residents (short-term leavers) in the framework of their unlimited extended tax liabilities. The rules basically provide for a reversal of the burden of proof. In contrast to the general rules, the tax authorities of the alleged country of emigration do not have to demonstrate that the taxpayer has maintained his residence there, but the taxpayer is presumed to have kept his residence and must, during a certain period of time, give evidence that he has effectively cut off all substantial ties with the country of former residence. Only if he is successful in this proof will he be regarded as a non-resident. In Finland this rule applies to emigrating Finnish citizens for a three-year period. In Sweden it applies for a five-year period to emigrating Swedish citizens as well as to non-Swedish long-term residents (at least ten years). In both countries the proof involves in essence an analysis of all facts and circumstances of the case, albeit that in Sweden the statute prescribes which factors have to be considered to determine the termination of substantial links to the country. However, since the statute does not give any indication as to the number of factors to be upheld, several cases have been tried even before the Supreme Administrative Court of Sweden. It seems that in practice, however, Swedish tax authorities accept the non-resident status of a former resident if the person is regarded as a resident in the immigration country and if he is subject to unlimited tax liability there. Norway has a similar rule that applies for four years to former residents regardless of their nationality. However, a former Norwegian resident will be regarded as a non-resident if after an uninterrupted stay of one year abroad he is able to prove that he has established his residence in another country. The tax authorities limit the application of this rule to residence in DTC countries. This practice may, however, be questioned.

The Netherlands applies a less far-reaching rule that operates as a fiction. A person who returns to the Netherlands within one year after emigration without having established a tax residence in another country is presumed to have kept his residence in the Netherlands within the interim period. This rule does not apply if that person proves that he has established a tax residence in an EC Member State or a DTC country that provides for exchange of information with the Netherlands. In addition, the person needs to be taxed as a resident in that other country and his taxable income should be determined basically in the same way as in the Netherlands. The purpose of the rule is twofold: first, to frustrate attempts of tax avoidance by a person having no residence at all when realizing significant income and second, to remove uncertainty about residence in cases of temporary absence.

In several countries (e.g. Canada, the Netherlands, Sweden and the United States) taxpayers may apply for a binding advance ruling on the determination of their (non)-residence status.

2.3.3. Acceleration of payment of taxes other than emigration taxes

Surprisingly few countries have measures that aim at accelerating the payment of tax liabilities that the taxpayer incurred in the country from which he moves.

Because of its particular reporting and tax collection system, in 1999 France introduced specific rules to ascertain the collection of tax if an individual transferred his residence out of the country. Under the normal reporting and collection method, a taxpayer files his income tax return at the end of February of the year following the year in which the income was realized. Also in the year following realization of the income, the taxpayer makes provisional payments of tax (equal to a percentage of the tax due in the previous year). Near year-end the final tax for the previous year is assessed and due. This system no longer applies in cases of transfer of residence: the taxpayer should provisionally report all income accrued until emigration – even if it is not yet at his disposal – at the latest 30 days before emigration and pay all tax due thereon within the same period. Subsequently, final reporting is required under the normal rules and, if necessary, supplementary tax is assessed.

With a view to ensuring that an emigrant has no outstanding liabilities, several countries have introduced a "pay as you go" system. The United States, Australia, India, Korea, Norway, Japan (unless a Japanese tax agent is appointed) and Switzerland (e.g. the canton of Geneva) either *ex officio* or at the discretion of the tax authorities require a taxpayer who gives up his residence in the country to comply prior thereto with certain administrative formalities in view of imposing an advance assessment and to pay all taxes due for the year of departure. Upon payment thereof a tax clearance certificate is issued which the taxpayer may be requested to present at the point of departure. In some countries (e.g. Australia and New Zealand) the taxpayer himself may request an advance assessment.

No specific recovery methods for taxes owed by former residents are reported. This is remarkable because the emigration country is often left with little or no assets against which it can recover its outstanding tax claims. Also countries cannot rely on an expanded treaty network for the cross-border recovery of taxes. However, within the EC the entry into force of the amended Directive on mutual assistance on the recovery of claims (expanded to income taxes) on 1 July 2002 will partly remedy the lack of cooperation in this field.[7]

3. Taxation of emigrants: the levy of emigration taxes

3.1. General exit taxes in Canada and Australia

Canada and Australia, two countries that apply a comprehensive capital gains tax on personal property, have introduced a general exit tax. In 1996 the Clinton

[7] Directive 76/308, OJ L73, 19 March 1976, 18 (initially applicable to agricultural levies, customs and excise duties and VAT); Directive 2001/44, OJ L175, 28 June 2001, 17 (expanding Directive 76/308 to income taxes).

administration proposed the introduction of a broadly based exit tax on all assets that would have been subject to US estate tax if the individual had died immediately before emigration. The proposal was considered unworkable under US taxation principles and was finally rejected. However, in 2000 a new draft Bill was introduced to this effect if the aggregate value of the taxpayer's assets exceeded US $675,000.[8] In 2001 Germany announced that it was considering the introduction of a general exit tax.

In 1966 the Canadian Royal Commission on Taxation recommended in the so-called Carter Report, within the framework of the introduction of a capital gains tax in Canada, the enactment of a general exit tax in order to prevent wealthy Canadian residents escaping Canadian tax on gains that accrued during their residence by becoming residents of another country. In 1972 Canada abolished its inheritance tax and replaced it with a final income tax liability upon death. On the date of death an individual is considered to have disposed of his capital property at its fair market value so that all accrued gains therein are subject to final taxation, save for the application of certain deferrals. Also in 1972 a general exit tax on Canadian emigrants was introduced. From a methodological point of view the introduction of such an exit tax makes sense because of the obvious planning opportunities for taxpayers moving from Canada while they are still alive. The purpose of the exit tax is clearly to tax property gains that have accrued during the period of Canadian residence.

The general exit tax is due when the taxpayer becomes a resident of another country either for the purposes of Canadian domestic law or for the purposes of a Canadian DTC (eventually pursuant to the application of a tie-breaker rule included in the DTC), regardless of the tax system applicable in that other country and regardless of the taxpayer's motives for transferring his residence outside Canada. It applies to long-term Canadian residents, defined as individuals who were residents of Canada for more than five years in the ten years prior to departure.[9] Upon terminating Canadian residence the individual is deemed to have disposed of each item of property at its then fair market value. There is no need to apply the exit tax to assets that remain into a country's tax jurisdiction of non-residents. Therefore, several assets were initially excluded from the scope of the exit tax. One of the most notable exclusions was taxable Canadian property, generally speaking, property in respect of which Canada, in the absence of a DTC provision to the contrary, preserves its right to tax gains realized by non-residents of Canada. It includes, *inter alia*, real property situated in Canada; capital property used in a Canadian business; shares in a private Canadian corporation; certain Canadian partnership interests; a substantial shareholding in a public Canadian corporation, etc. However, in defining the exclusions from its exit tax a country cannot overlook the interaction between its domestic rules on tax jurisdiction and its DTCs. Canadian DTCs deviate from art-

8 S. Goldberg *et al*., "Taxation Caused by or After a Change in Residence", *Tax Notes International*, 7 and 14 August 2000, at 644–645; proposed law by Repr. Rangel (HR 3874) referred to Committee on 9 March 2000.

9 The exit tax applies to short-term residents but only with respect to property acquired other than by way of inheritance after becoming a Canadian resident.

icle 13(4) OECD model and provide for a clawback clause (see below, section 3.4.6). They allow Canada to impose on its former residents capital gains tax with respect to gains on the alienation of Canadian source assets (mainly shares) within a prescribed period of time following emigration (commonly six years).[10] The combined effect of the definition of taxable Canadian propertyand the application of the capital gains article of Canada's DTCs was that individuals owning e.g. shares in Canadian companies that carried an important accrued gain were able to avoid Canadian exit tax by giving up their Canadian residence and realizing their shares after the expiration of the clawback period of the relevant DTC. If they had moved to a country that exempted gains on the realization of the pertinent assets, they even achieved a full tax exemption, thereby defeating the goal of the Canadian provisions. As a result, in 1996 Canada limited the exclusions from the scope of the exit tax to assets for which Canada always remains entitled to tax capital gains under a DTC (i.e. basically Canadian real property and capital property and inventory of a Canadian permanent establishment).

The result of the levy of the general exit tax is that the emigrant should reflect upon departure all accrued gains and losses, recaptures of depreciation, etc. The combined net result is subject to capital gains tax according to the ordinary rules. An election is available to include in the tax base assets that would otherwise be excluded. This may be advantageous to the taxpayer if such assets carry accrued losses that as a result can be used to offset against gains accrued on non-excluded property.

In principle, the exit tax is payable on 30 April following the year of emigration. One of the main criticisms against the levy of exit taxes is that the taxpayer is required to pay tax on a "paper gain", i.e. a gain which he has not actually realized, and thus at a time when he does not have monies at his disposal from the alienation of the asset. Exit taxes not only accelerate the assessment of the tax, but also create liquidity problems for the migrating taxpayer. Canada has responded to this criticism by providing for an interest-free deferral of the payment of the exit tax until the actual alienation of the pertinent assets, provided that adequate security is posted with the tax authorities. Election for the deferral cannot be made selectively for certain assets, but should be made globally for all assets subject to exit tax. Hence, it is not possible to recognize losses on certain assets upon the date of emigration and defer recognition of the gains until their actual realization.

However, opting for the deferral may in certain instances be beneficial to the taxpayer. If the property is actually sold at a price lower than the fair market value retained upon emigration, the taxpayer can elect for a base adjustment for exit tax purposes by the amount of the subsequent loss. As a result, ultimately the tax is levied on the gain actually realized. However, such adjustment is only possible for taxable Canadian property. If, on the other hand, the gain actually realized exceeds the value upheld for exit tax purposes, the actual gain will be taxed in Canada even if the taxpayer resides in a DTC country.

10 The time period varies from five to fifteen years and some DTCs limit the application of the clawback to Canadian nationals or to long-term Canadian residents. See Canada's reservation in §34 on art. 13(4) OECD model.

With a view to avoiding double taxation a special accommodation is provided for re-migrants to Canada. If they have paid the exit tax upon departure, a step-up in basis is given at the fair market value of the assets still held upon re-establishing Canadian residence. If, on the other hand, they elected for the deferral, the exit tax is reversed, provided the assets have not been disposed of.

Together with the introduction of capital gains tax in 1985, Australia provided for a general exit tax. Australia closely follows the Canadian system. The Australian exit tax is also a "last chance tax" for gains that accrued while the taxpayer was an Australian resident. It is due when a long-term resident (resident more than five out of the last ten years before departure)[11] "stops being an Australian resident" under domestic law. The tax system applicable in the immigration country is not relevant; nor are the taxpayer's motives for emigrating. Unlike in Canada, the tax is not payable when an individual is treated as a resident of another country under a DTC tie-breaker rule. The exit tax applies to all property owned by the individual immediately before ceasing to be Australian resident, save for a few exceptions. The most notable exception is assets that have the "necessary connection with Australia" and that therefore remain within Australia's tax jurisdiction on non-residents. Such assets include Australian land and permanent establishments; shares in an Australian private company; a non-portfolio shareholding in an Australian public company, etc. Australia does not follow article 13(4) of the OECD model. It preserves its rights to tax capital gains on assets (other than Australian land and permanent establishments) unconditionally. Accordingly, Australia has not been faced with the tax avoidance issues encountered by Canada with respect to appreciated shares in Canadian companies. As is the case for Canada, the Australian emigrant is deemed to have disposed of all qualifying assets at their fair market value on the date of terminating his residence. For every asset he should reflect the accrued gains and losses. The net result is taxable under the normal capital gains tax rules. In principle the exit tax is payable upon termination of Australian residence under the normal assessment and collection rules.[12] If the asset to which the exit tax applies is subsequently alienated while the taxpayer is a non-resident of Australia, any gain is outside Australia's tax jurisdiction. Therefore, Australia does not apply a retrospective adjustment of the exit tax tax base by the amount of the subsequent gains or losses actually realized. However, instead of paying the exit tax upon emigration, the taxpayer may elect to have the rules on limited extended tax liability made applicable (see below, section 3.4.3). In this case, a deferral of payment of the exit tax is obtained until actual realization of the assets. This election should be made globally for all assets subject to exit tax. Unlike in Canada, no security should be given in order to be eligible for the deferral. Technically speaking, the election has the effect of characterizing the assets as owned by a non-resident but having the "necessary connection with Australia" and therefore remaining within Australia's tax jurisdiction. If the election has been

[11] For short-term residents the exit tax applies to assets acquired (other than by way of inheritance) after becoming Australian resident.

[12] Subject to advanced assessment and payment procedures determined at the discretion of the Commissioner.

made, any changes in value after emigration, whether up or downwards, affect the individual's Australian tax liability. As a result, the entire capital gain realized is subject to Australian tax, including that portion that accrued after the transfer of residence from Australia. This result is in accordance with Australia's policy of preserving its taxing rights under its DTCs. Re-migrants to Australia are given a step-up basis equal to the market value of the assets that were subject to exit tax and that are brought back into the country.

3.2. Limited exit taxes

3.2.1. Limited exit taxes on shares and securities

Whether a country introduces a limited exit tax on shares and securities depends to a large extent on whether it imposes tax on capital gains realized by its residents on shares and whether it preserves this right on gains realized by non-residents either under its domestic laws or under its DTCs by providing for a deviation from article 13(4) OECD model[13] or, with respect to substantial shareholdings, by providing for a clause such as article 13(5) UN model.[14] If a country does not preserve such taxing rights on non-residents it may well be tempted to protect its tax claims on appreciated shares and securities by levying an exit tax. It appears from the branch reports that several countries give up their tax claims on former residents holding securities and shares without taking any protective measures. Examples are Finland and Italy (residents in a DTC country), Ireland, Japan and Spain (residents of the EC or a DTC country).

Germany (1972), Denmark (1987), New Zealand (1988), the United States (1992),[15] Austria (1994), the Netherlands (1997) and France (1998) impose a limited exit tax on certain shareholdings and securities. In the early 1990s Norway discussed the desirability of introducing an exit tax on shares, but did not enact legislation to that effect.[16]

The German, Danish, Austrian, Dutch and French exit tax regimes all relate to substantial shareholdings[17] and contain many other similar aspects. They will therefore be discussed together (see below, section 3.2.1.1). The US and New Zealand exit tax, the scope of which is different, will be addressed subsequently (see below section 3.2.1.2).

13 According to art. 13(4) OECD model, capital gains from the alienation of property (other than real property, permanent establishment assets and ships and aircraft) are taxable only in the country of which the alienator is a resident.

14 According to art. 13(5) UN model 2001, gains from the alienation of substantial shareholdings in a company which is a resident of a contracting state may be taxed by that state.

15 Proposed Regulations of April 1992.

16 Several reasons were advanced: (a) unfairness of taxation of an unrealized gain with the possibility that the shares will actually be realized later at a lower value; (b) issues of solving the liquidity problem of the taxpayer who has to pay tax on a gain which he did not cash; (c) expected enforcement and valuation problems.

17 The Danish exit tax also applies to minority shares provided that they are held for at least three years and to certain debts, debt claims and financial instruments. The exit tax regime on debt claims does not allow a deferral of payment of the tax.

3.2.1.1. Limited exit taxes in Germany, Denmark, Austria, the Netherlands and France

The justification given for the introduction of an exit tax on shareholdings is the same in all countries. Those countries have relinquished their taxing rights on capital gains on shareholdings to the country of residence of the shareholder either under domestic law (Denmark, for all shares regardless of whether in Danish or non-Danish corporations; the other countries, for shares in non-resident companies) or under their DTCs. Under a DTC taxing rights can be ceded to the residence state either unconditionally by accepting an article 13(4) OECD model clause or conditionally, as the Netherlands and Austria do (see below section 3.4.6),[18] by providing for a clawback clause pursuant to which the right to tax gains realized by former residents is retained during a number of years after emigration. Such countries perceive transfers of residence to a country that imposes little or no tax on gains realized on shareholdings as tax-motivated abuses. They consider it the right of the emigration country to protect its tax base if an individual transfers his residence to a country in favour of which the emigration country has relinquished its taxing rights (in particular if the immigration country imposes little or no tax on the gain) and to tax gains that accrued while a taxpayer was resident in the emigration country. The exit tax is seen as a “tax of last chance” (protective measure) but also as a tool to prevent tax-motivated emigration (anti-avoidance measure).

All countries apply the fiction that the shares are disposed of at their fair market value at the date of transfer of residence. The accrued capital gain (i.e. the difference between the tax base of the shares – which is generally the acquisition cost – and their fair market value) is subject to tax.

Termination of residence (sometimes technically defined as the passage from unlimited to limited tax liability) triggers the exit tax in the emigration country. The Netherlands, Germany and Denmark apply the exit tax also to individuals who have become non-residents by virtue of a tie-breaker rule included in a DTC (or for the Netherlands in the tax arrangement with the Netherlands Antilles). Austrian law has defined the taxable event in an original way. The exit tax is due where “Austria loses its taxing rights in favour of another country”. Obviously, this includes the transfer of residence from Austria under domestic law and DTCs. However, it also gives rise to a number of interesting issues regarding the occurrence of the taxable event. For instance, since under its domestic laws Austria preserves its taxing rights on non-residents if they hold shares in Austrian companies, the exit tax cannot become due if residence is transferred to a country with which Austria has not concluded a DTC. The result of the wording of the statute is that even if a taxpayer moves to a country with which Austria has concluded a DTC, Austria is not allowed to levy its exit tax if that DTC allows taxation by the emigration country because it provides for an article 13(5) UN model clause for sub-

[18] Dutch DTCs typically provide that the Netherlands retains its taxing rights on capital gains on substantial shareholdings in Dutch corporations within five years after emigration. In view of the period for which the Dutch exit tax applies, the new policy is to expand that rule to ten years (see e.g. 2001 DTC with Belgium).

stantial shareholdings or a clawback clause allowing the emigration country to tax its former residents for a number of years after emigration.[19] If Austria has retained a conditional right to tax the emigrant (e.g. the right to tax a former resident for five years after emigration), the Austrian tax authorities have accepted only making a preserving assessment at the time of transfer of residence. If the shares are not realized within five years, the exit tax becomes payable on the amount of the gain accrued while the taxpayer was an Austrian resident.

An exit tax on shareholdings should not apply to "accidental", i.e. short-term, residents. Such persons, who are usually foreigners, often reside in a country for a limited period of time (e.g. for professional purposes). They own substantial shareholdings in companies of their native country rather than shares of companies established in their country of residence. It is considered unfair that they should be liable to tax on gains accrued on such substantial shareholdings when they are returning to their native country. Accordingly, Germany, Denmark, the Netherlands and France only subject long-term residents (varying from five to ten years) to exit tax. The Netherlands does impose its exit tax on short-term residents (less than eight years), but only if they own a substantial shareholding in a Dutch company.

Normally non-residents of a country are not affected by its exit taxes. However, the Austrian rule has the remarkable consequence that a non-resident of Austria who lives in a country that has not entered into a DTC with Austria and owns shares in an Austrian company will become subject to exit tax if he transfers his residence to a country to which Austria has abandoned its taxing rights under a DTC. The Dutch exit tax may also be relevant to non-residents: they become liable if they hold a substantial shareholding in a Dutch company and transfer the seat of effective management of that company out of the Netherlands.

One observes a striking development in the definition of "substantial shareholding". Over the years several countries have significantly broadened the scope of the tax: Germany and Austria have reduced the qualifying shareholding from 25 per cent to 1 per cent. The Netherlands requires a 5 per cent stake together with the family group, while France requires 25 per cent. This gives rise to significant differences between the countries: an individual with a small but very valuable percentage in a large group of companies will be subject to exit tax if e.g. he moves from Austria or the Netherlands, but not from France. However, in France a minority shareholder will be subject to exit tax if his family group owns at least 25 per cent.

If the exit tax is meant to be an anti-avoidance and protective measure, it should cover shareholdings in companies not resident in the emigration country. Indeed, the emigration country will generally not be entitled to tax gains realized by a former resident on shares in a company not resident in the emigration country. Germany and France, however, limit the application of their exit taxes to German/French companies. Accordingly, French and German rules do not fully accomplish their purpose. However, if exit taxes are levied in cases where the emigration country has not abandoned its taxing rights to the immigration country (see below), the exit taxes have an overkill effect.

19 Austria entered into 19 DTCs containing such provisions.

As is the case for the general exit taxes, countries levying limited exit taxes face the fact that the taxpayer is liable to tax without having realized any cash income from the property. Countries have dealt with these issues in different ways. In Germany the tax is payable upon emigration, but the payment may be spread over five years. Interest is charged on the outstanding principal and security should be given. The tax is reimbursed if the emigrant reacquires German resident status within five years. Austria collects the tax under the normal rules. However, from the year 2000, a taxpayer may obtain a deferral until the actual realization of the shares if he transfers his residence within the EC or the European Economic Area.[20] As indicated above, the Austrian tax authorities are willing to impose a preserving assessment if Austria has conditionally retained its taxing right within a certain period after emigration. Denmark allows a deferral (with interest) until the realization of the shares or the death of the shareholder, whichever comes first, provided that proper security is posted. The pertinent shares qualify as security. The tax liability is waived if the taxpayer reacquires Danish residence and still holds the shares. The tax base of the shares is then restored to its pre-emigration status. On the condition that sufficient guarantee be provided, the Netherlands only imposes a preserving assessment for a ten-year period, without interest charge. The pertinent shares qualify as security. The preserving assessment becomes due if the shares are alienated or if another tainted transaction takes place (i.e. liquidation of the company; distribution of almost all retained earnings) within the ten-year period. Dutch withholding tax levied upon dividend distributions is credited against the preserving assessment. The assessment is waived after ten years if the shares are still held. The tax base of such shares is then restored to its pre-emigration status. Also in France a preserving assessment is applied, provided that sufficient guarantee is posted and a French tax agent is appointed. The pertinent shares do not qualify as security if they are not quoted on the stock exchange. The preserving assessment is imposed for five years. It is collected if the shares are sold or otherwise subject to a tainted transaction (e.g. stock redemption; liquidation) within the five-year term. The assessment is waived if the taxpayer still owns the shares at the expiration thereof or if the taxpayer reacquires French residency within the five-year period and still holds the shares.

An interesting issue is the relationship between the exit tax (if levied in the form of a preserving assessment) and the gains or losses realized upon the subsequent alienation of the shares. This issue is further complicated if, notwithstanding the fact that it has levied an exit tax, the emigration country has retained taxing rights on the gains either under domestic law (e.g. in the case of transfer of residence to a non-DTC country) or under a DTC (e.g. the Dutch and Austrian DTCs cited in footnotes 18 and 19). This is illustrated by means of an example under the Dutch regime.[21]

20 Under a private ruling the Austrian tax authorities have expanded this rule to Switzerland.

21 The example relates to a substantial shareholding in a Dutch company. As the Netherlands is not entitled to tax gains realized by a non-resident on non-Dutch shares, any alienation of such non-Dutch shares within ten years from emigration will trigger the payment of the preserving assessment. Any changes in value of the shares after emigration, whether up or downwards, are disregarded.

Upon emigration, the tax base of the shares is increased up to their fair market value that forms the basis of the exit tax. If, upon subsequent realization of the shares, the taxpayer resides in a DTC country and the Netherlands is still entitled to tax the gain under a clawback clause, the entire capital gain falls within the Dutch tax jurisdiction. This means that if the shares are ultimately sold at a higher price than the basis of the exit tax, the preserving assessment will become payable and a capital gains tax will be imposed on the further appreciation in value after emigration. If, on the other hand, they are sold at a price lower than the tax basis of the exit tax, the tax basis will be adjusted downwards and again the actually realized gain will be taxed so that finally a tax less than the preserving assessment will be due. The same rule applies if the taxpayer resides in a non-DTC country. If the taxpayer has taken up residence in a DTC country, but the Netherlands is no longer entitled to tax the gain under the clawback clause (e.g. sale after the five-year clawback period but within the ten-year term during which the preserving assessment is imposed), any appreciation or depreciation in value after emigration is no longer within the Dutch tax jurisdiction. As a result, only the preserving assessment will be effectively payable.

In the absence of contrary provisions in DTCs, France is unable to tax any appreciation in value after emigration if the individual resides in a DTC country. However, if the shares are realized within the five-year term during which the preserving assessment is imposed at a price lower than the tax basis of the exit tax, this basis will upon the request of the taxpayer be adjusted downwards and the preserving assessment will be fully or partially reimbursed. The basic difference between the Dutch and French rules with respect to the downwards adjustment is that in France the adjustment is obtained regardless of whether France has reserved taxing rights under a DTC, while under the Dutch rule the taxpayer residing in a DTC country will only be entitled to the adjustment if the realization is still within the Dutch tax jurisdiction as provided by the DTC.

Germany and Austria,[22] where the exit tax is due upon emigration (and payment is eventually spread over time or deferred), are not concerned with the above issues. Gains or losses on a subsequent realization do not affect the basis of the exit tax.

Notwithstanding the fact that shareholdings held by non-residents are no longer within its tax jurisdiction, Denmark allows a former resident to opt for the most beneficial treatment, regardless of whether the exit tax was paid or deferred. Accordingly, if the shares are sold at a price lower than the basis upheld for exit tax purposes, the shareholder may elect to pay Danish tax on the lower gain actually realized and the excess exit tax will be waived or, if paid, be reimbursed with interest. The rationale behind this accommodation is that the taxpayer should not be placed in a worse position than if he had remained a resident.

Although exit taxes are meant to prevent tax avoidance, they are applied generally. Countries imposing such taxes do not take the tax regime applicable to the relevant shareholding in the immigration country directly into consideration. The

[22] Unless Austria were allowed to tax under a DTC within x years after emigration: first, a preservatory assessment will be imposed. If the shares are not sold within that timeframe, the exit tax will be payable. If they are sold, the Austrian capital gains tax will be assessed according to ordinary rules.

immigration country may upon subsequent sale of the shares impose tax on the gain that accrued in the emigration country and that has been subject to exit tax there. To what extent countries eliminate such international double taxation is discussed below in section 4.2.2.1. As emigration countries, Denmark, the Netherlands and France do indirectly take the tax regime in the other country into account and grant a tax credit for the tax paid in the immigration country against their exit tax. Such credit is called a reverse credit because it is given by the country of non-residence. Germany and Austria do not provide for such a tax credit. The granting of such a reverse credit is the answer of the emigration country to the dilemma it faces: on the one hand, recognizing that the residence state has the sole right to tax the pertinent gain under article 13(4) OECD model and, on the other hand, not accepting international non-taxation.

By way of conclusion, it seems that the exit taxes discussed above serve different purposes, which may differ according to the circumstances in which they are imposed.

If the taxpayer has become a resident of a non-DTC country and he owns shares in a company resident in the emigration country, all countries (except Denmark) preserve the right to impose tax on capital gains subsequently realized. No exit tax is needed in such a case because the emigration country does not forgo a tax claim. Austria recognized this and does not levy its exit tax in that case. France and the Netherlands do levy their tax but the tax will, provided sufficient guarantee is given, take the form of a preserving assessment. Such an assessment is imposed for a number of years and is waived if no realization occurs within that timeframe. It rests on the assumption that the taxpayer has become a *bona fide* resident of the other country upon expiration of this time period. If he has not realized the shares within that period it is likely that he did not transfer his residence with the intention of realizing the shares in the immigration country. In essence, such an exit tax serves as a guarantee to recover tax from a non-resident living in a country for which no assistance for the recovery of taxes is available. The German exit tax is a protective measure that goes beyond the stated policy behind the legislation (protection of a latent tax claim that would otherwise be lost) because, first, it is levied in cases where Germany retains its tax jurisdiction and second – and this is even more subject to criticism – the tax is immediately due upon emigration, hence resulting in acceleration of the payment of tax on a gain that is not realized. Some have therefore characterized such exit taxes as disguised wealth taxes.[23] It is only to be hoped that in such circumstances the emigration country would allow a step-up in basis of the assets when the exit tax was assessed in order to avoid it imposing tax on the pre-emigration gain for a second time at the time of realization.

If the taxpayer has become a resident of a DTC country but the emigration country has preserved its taxing rights under the DTC (because it provides for an article 13(5) UN model clause or a clawback clause) again no exit tax is required to protect the tax claims of the emigration country. Eventually the exit tax needs only to be assessed if the right of the emigration country is effectively relinquished (e.g.

23 J. Hoogendoorn, “Verdragsbeleid en de ‘aanmerkelijk-belang’ wetgeving”, *FED*, 1996, no. 969.

at the expiration of the term of the clawback clause). With the exception of Austria, emigration countries disregard this in practice and impose the exit tax immediately upon emigration. The levy of the exit tax as a preserving assessment, as in France and the Netherlands, may in such a case be justified as a guarantee to recover a future tax from a non-resident. However, where such a preserving assessment is waived if the shares are not sold within the applicable time period the guarantee disappears, notwithstanding the fact that the emigration country may still be entitled to tax the emigrant pursuant to the DTC clause (e.g. French DTCs with an article 13(5) UN model clause).

If the taxpayer has become a resident of a DTC country and the emigration country has given up its taxing rights to the immigration country, French and Dutch exit taxes which take the form of a preserving assessment for a limited period of time and provide for a reverse tax credit are clearly to be catalogued as anti-avoidance measures. Indeed, if the shares are not sold within the given timeframe there is no tax-motivated transfer but the taxpayer is not harmed because the assessment is waived (except for encumbrances resulting from the posting of security). If the shares are sold and subject to tax in the immigration country there is again no tax-motivated transfer but the resulting double taxation is eliminated. However, if no or little tax is levied by the immigration country and the shares are alienated during the time period of the preserving assessment, the claims of the emigration country are protected against tax-motivated emigration. The same conclusion applies to the Danish exit tax that also provides for a reverse credit. German and Austrian exit taxes do not provide for a correction mechanism in the absence of tax avoidance: they are due upon emigration without the possibility of a preserving assessment and do not provide for a reverse tax credit if taxes are imposed by the immigration country on the gain actually realized. Such taxes cannot properly be called anti-avoidance measures. They are measures aiming at protecting the latent tax claims of those countries on pre-emigration gains. They also intend to impose income tax that would have been payable had the emigrant remained a resident of Germany or Austria and thus guarantee an equal treatment between residents and emigrants.

3.2.1.2. Limited exit taxes in the United States and New Zealand

The United States and New Zealand also have deemed disposition rules upon termination of residence that contain some similarities but also important differences.

The United States limited exit tax applies to shares in a passive foreign investment company (PFIC shares) upon transfer of residence out of the US. The PFIC rules do not require current taxation of the shareholder's portion of the PFIC income when such income is earned, unless an election is made in the first year the PFIC shares are held or, in the case of immigration into the US, in the first year of US residence. In the absence of such an election, the transfer of residence of the PFIC shareholder out of the US causes a deemed disposition of the PFIC shares at the then fair market value of the shares. Immigrants are not entitled to a step-up in basis in their PFIC shares upon becoming US resident. Consequently, the tax due upon emigration from the United States applies to pre- and post-residency income and appreciation. The tax on the deemed disposition must be included in the tax return of the year of emigration and is payable in that year (together with interest). There is no mechanism to recalculate the gain where the PFIC shares are sold in a later year and a lesser gain or loss is realized. The deemed disposition upon departure is especially onerous as the tax liability is incurred at the time no income is received from the PFIC shares to pay the tax bill and no payment concessions are provided for. Because of the election system and the absence of a step-up basis upon immigration in the US, the PFIC system is a trap for the unwary or the ill-advised immigrant. It is suggested that at least the law should be changed to capture only appreciation accrued and income accumulated during US residency.

The scope of the New Zealand limited exit tax is the foreign investment fund (FIF) investment.[24] The main thrust of this regime is to capture interests held by New Zealand residents in offshore portfolio investments.[25] Contrary to the basic rule of the US PFIC regime, the FIF investment requires current taxation on an annual basis of any value increase of the FIF investment by treating such unrealized gain as income. Upon cessation of New Zealand residence (including as a result of the application of a tie-breaker rule under a DTC), a disposition of the FIF investment is deemed to have occurred at fair market value and any accrued gains, not yet declared and taxed, are then subject to tax at ordinary rates. Tax is payable according to normal rules and no deferral or recovery mechanism in the case of a later sale at a lesser gain is available. However, the New Zealand exit tax is far less burdensome than the US one in two respects. First, while the PFIC regime does not in principle provide for current taxation, the FIF investment does. Hence, the tax basis on termination of residency of New Zealand will normally be much more limited (i.e. it includes accruals not previously taxed) than is the case under the US regime. Secondly, an immigrant of New Zealand gets a step-up in basis for the FIF investment up to its fair market value on the date he acquires New Zealand residency, while the US immigrant does not. Hence, the New Zealand exit tax only captures post-immigration accruals.

3.2.2. US limited exit tax on appreciated tangible property

After rejecting the 1996 Clinton proposal for introducing a general exit tax (see above section 3.1), the US enacted in 1997 a limited exit tax the purpose of which was to tax appreciated assets transferred by expatriating taxpayers (revised section 877 IRC). Expatriation refers to the US citizen surrendering his US citizenship and the lawful permanent resident (the so-called “green card holder”) who has been in

24 New Zealand also applies an exit tax to financial arrangements subject to the accrual rules. These rules require certain taxpayers to spread income/cost evenly over the term of the debt instrument. Upon termination of residency the taxpayer (except certain short-term residents) is required to apply a “base price adjustment” in order to determine the residual gain/loss in respect of the instrument.

25 In non-qualifying countries. The list of such countries being extremely short (Australia, Canada, Germany, Japan, the United Kingdom, the United States and Norway), the scope of the FIF regime is broad.

that status for eight of the previous fifteen years and gives up such residence status. The US Treasury Department believed that expatriation should not allow US citizens or residents to escape tax on income or wealth accrued while a citizen or resident and, hence, be treated more favourably than persons who did not expatriate.

The exit tax applies to the removal of appreciated tangible property from the United States on the occasion of expatriation and for ten years following expatriation.[26] Becoming resident under a DTC tie-breaker is assimilated to expatriation if the individual accepts the treaty benefits. The excess of the fair market value upon emigration over the historic cost base is taxed. Unlike the PFIC shares, an immigrant to the US qualifying as a long-term resident gets a step-up in basis to the fair market value on the date of establishing US residency. Accordingly, the expatriating long-term resident is only taxed on value increases while he was a US resident. The tax is due immediately, unless the taxpayer elects to defer it under a "gain recognition agreement". In such a case, the tax is deferred until the property is realized during the ten-year period following expatriation. Upon request by the IRS proper security may have to be furnished. If the property decreases in value after the transfer date, under the gain recognition agreement, a basis adjustment is permitted.

If the taxpayer has emigrated to a DTC country, the US has inserted a savings clause in its DTCs in order to be able to effectively enforce the exit tax with respect to removals of tangible property that occur after emigration at the time the individual is a resident of the other contracting state that may otherwise be entitled to tax income derived from that property. The effect of the savings clause is discussed below in section 3.4.1.

3.2.3. Dutch limited exit tax on tax exempt accumulated interest

In 2001 the Netherlands introduced an exit tax on accumulated tax exempt interest included in a so-called capital saving insurance. One of the conditions for the exemption is that premiums have been paid for at least 15 years. If such conditions are not fulfilled upon termination of residency (including under a tie-breaker rule in a DTC or in the tax arrangement with the Netherlands Antilles), the accumulated interest is taxed. Payment of tax may be deferred for two years. Meanwhile a preserving assessment is imposed (with no interest charge) provided proper guarantees are provided. The statute does not provide for relief for international double taxation.

3.3. Unlimited extended tax liability

3.3.1. Unlimited extended tax liability regardless of the tax regime of the immigration country

Sweden, Finland and Norway provide for an unlimited extended tax liability pursuant to which a former resident citizen (in Sweden and Norway also a non-

26 Extended by IRS under Notice 97-19 to fifteen years, beginning five years prior to and ten years after expatriation.

national) is deemed to remain resident regardless of the tax regime applicable in the country he moves to, unless he demonstrates that he has terminated all substantial links with the country from which he emigrates. The rule operates as a reversal of the burden of proof of residence. It applies for a certain limited period of time after emigration (varying from three to five years) and is more fully described in section 2.3.2 above. If the taxpayer fails in this proof he remains subject to unlimited tax liability in the country from which he emigrated. The rationale behind such extended tax liability is that non-residence status should not be made available to temporary non-residents who may have emigrated with the intention of realizing income or gains abroad in a tax advantageous way but also with the intention of returning to the country of former residence. Denmark also had such a rule from 1970 but repealed it in 1995.[27]

In Ireland an individual is regarded as “ordinarily resident” once he has had three consecutive years of residence. In case of emigration an unlimited extended tax liability applies because the individual remains ordinarily resident until he has had three consecutive years of non-Irish residence.

An unlimited extended tax liability under domestic law cannot effectively be imposed on emigrants established in a DTC country if the DTC between the emigration and immigration countries does not specifically allow the emigration country to do so. Indeed, application of the unlimited tax liability by the emigration country will very likely result in a conflict of residence with the immigration country, which will generally be solved in favour of the latter under the tie-breaker rule of the DTC. To this effect Finland has inserted a specific provision in some 30 DTCs allowing it to apply its unlimited tax liability to its citizens who have become residents of the other country. Sweden achieved the same result – albeit restricted to Swedish citizens – in a more limited number of DTCs, including those with some well-known immigration countries such as Switzerland and Spain. Absent specific DTC provisions, the unlimited extended tax liability will in practice only be relevant for individuals transferring their residence to non-DTC countries, mainly tax havens. The Irish unlimited extended tax liability will be overridden if the Irish DTC contains a tie-breaker rule, but also by the domestic rules on remittance. An individual who is resident but not domiciled in Ireland is subject to Irish tax on income arising in Ireland and the UK and capital gains on assets situated in Ireland and the UK. In respect of income or gains arising elsewhere, the individual is taxable in Ireland only to the extent that the income or gains are actually or constructively remitted into Ireland. If the emigrant was never domiciled before in Ireland or if he acquired a domicile of choice outside Ireland as a result of emigration, the extended tax liability is not of significance for non-Irish or UK-source income or gain because the emigrant is unlikely to make remittances into Ireland.

27 Several reasons were advanced: (a) difficult to manage in practice; (b) limited scope of application (i.e. only non-DTC countries); (c) protection of Danish tax base guaranteed by means of the limited exit tax discussed in section 3.2.1.1.

3.3.2. Unlimited extended tax liability in the case of emigration to a tax haven

Spain (1991) and Italy (1999) introduced an unlimited tax liability on citizens moving to tax haven countries under a "black list" approach. The Spanish rule applies for the year of emigration and the following four years. During that period a Spanish citizen is deemed to remain a resident of Spain and thus subject to tax on worldwide income there. It is an anti-avoidance measure that does not permit any proof to the contrary that effective residence is maintained in the other country. The Italian rule rather operates as a rebuttable presumption of non-residence in the tax haven. The Italian citizen is thus allowed to prove his effective residence in such country by means of the usual factual indications of residence abroad. Under Italian law, there is no time limit on the application of the unlimited tax liability.

3.4. Limited extended tax liability

3.4.1. United States: surrendering US citizenship or residency for tax avoidance purposes (section 877 IRC) (introduction 1966, significantly broadened in 1996)

A US citizen who surrenders his US citizenship and transfers his residence for tax avoidance purposes or a long-term permanent resident who gives up this status for such purposes is for the following ten years subject to US tax as a non-resident on income generated by US source assets under modified sourcing rules. These modified rules characterize income that would otherwise be foreign source income into US source. These rules basically provide that all gains from the sale of personal property located in the US or of stock of US corporations or debt obligations of a US person are US source. Certain income or gains derived from foreign corporations as well as certain income earned by controlled foreign corporations are equally turned into US source income. It is striking that the provision not only applies to income from property owned at the time of expatriation but also to income from property acquired during the ten years thereafter. This rule works as a disincentive for an expatriate to invest in his former country. This may not necessarily be to the advantage of the emigration country and its population.[28] Clearly, with respect to gains, all appreciation in value is taxed if the asset is disposed of within the ten-year period, regardless of whether it accrued prior to or after emigration. It is difficult to predict the actual tax revenues under a limited extended tax liability. A floor is therefore put on such tax liability: the taxpayer is always required to pay a minimum tax.

The statute includes two alternative mechanical tests (i.e. a net worth and a tax liability test)[29] that, if complied with, result in the irrebuttable presumption that

[28] Goldberg *et al*., *op. cit*., 649.

[29] Tax liability: average US tax of past years of US$115,000. Net worth: US$562,000 or more (2001 figures).

the taxpayer expatriated with tax avoidance motives. However, an individual who does not meet one of these tests can still be regarded as having expatriated for tax avoidance purposes if the IRS is able to make such determination on the basis of the facts. Given the insecurity resulting from the factual and essentially subjective nature of such determination a ruling can be requested. In many cases, the IRS could not make a determination of the taxpayer's intention. As a result, the ruling procedure was amended allowing the individual to report income as if he had no tax avoidance motives if he received confirmation from the IRS that the ruling request was complete and in good faith, subject, however, to a contrary finding during a later audit.[30] The ruling procedure is only available to certain (too narrowly defined) categories of expatriates;[31] it is overly complex and costly. For ten years burdensome reporting requirements and filings of annual tax returns are imposed on the relevant expatriates. None the less, the enforceability of the rule on taxpayers living overseas is difficult and revenue generation small. The US branch report suggests modifying the law at least to limit its application to high net worth US citizens because such persons enjoyed the benefits of their US citizenship. Long-term permanent residents, unlike US citizens, generally do not have significant vested interests in the US and should therefore not be targeted. In the general reporter's opinion, the fact that a long-term permanent resident who meets one of the two afore-mentioned tests transfers his residence out of the US is by no means an indication that such a transfer is tax motivated. Such an irrebuttable presumption has an overkill effect. At least consideration should be given to the country to which the individual returns (e.g. his native country) and what the tax regime of that country is (whether it is considerably more advantageous than the US or not).

In order to be able to tax its citizens, wherever resident, the US has included a saving clause in its DTCs. Otherwise the US would be precluded from taxing its non-resident citizens under the tie-breaker rule. According to article 1(4) of the US model tax treaty and the reservation made in §28 of the OECD commentary on article 1 OECD model, such a savings clause applies to former citizens and residents of the US.[32] Many US DTCs contain provisions that differ from this savings clause (e.g. because the clause does not apply to former residents since the latter have only been added in the 1996 model treaty). Under the US "later in time" doctrine the statute or DTC that came into existence most recently prevails and thus

30 From January 2000 until August 2001, 130 ruling requests were filed. In 50 rulings the IRS concluded that it was unable to make a determination. In 9 rulings tax avoidance intentions were found to be present.

31 A non-US citizen having been employed in the US for more than eight years who is relocated to another country, but not his country of birth, does not qualify because the transfer is not to the latter country.

32 Art. 1(4) 1996 US model tax treaty: "Notwithstanding any provision of the Convention except § 5 of this Article, a Contracting State may tax its residents (as determined under Article 4 (Residence)), and by reason of citizenship may tax its citizens, as if the Convention had not come into effect. For this purpose, the term 'citizen' shall include a former citizen or long-term resident whose loss of such status had as one of its principal purposes the avoidance of tax (as defined under the laws of the Contracting State of which the person was a citizen or long-term resident), but only for a period of 10 years following such loss."

provisions of a DTC may be overridden by a subsequent US tax statute that includes contrary provisions, provided that the statute has the unequivocal intention of overriding the provisions of a DTC. While according to certain case law the legislative history of the pre-1996 provisions of section 877 IRC does not permit a treaty override, with the 1996 revision of section 877 Congress expressly stated its intention to override conflicting provisions of existing DTCs. At the same time the US embarked on a programme of renegotiating its DTCs to avoid potential conflicts between the provisions of domestic law and DTCs (see e.g. article 1(6) of the 2001 DTC with the UK).

3.4.2. Germany: transfer of residence to low-tax countries (introduction 1972)

There are striking similarities between the German and the US systems. The German system also applies in the case of tax avoidance, more precisely where a German citizen who has been a long-term resident (for five out of ten years) transfers his residence to a low-tax country. However, while under the US system tax avoidance is defined with respect to the taxpayer and his intentions (but also by means of irrebuttable presumptions), the German system determines tax avoidance as a function of the tax system applicable in the immigration country. A low-tax country is defined by statute in an objective way, i.e. it is a country where the tax is more than one-third less than the German tax on a reference income or a country that has a special advantageous tax regime in addition to the ordinary regime. The mere fact of moving to a low-tax country is, as opposed to the Spanish and Italian regimes discussed in section 3.3.2, not sufficient for the extended tax liability to apply. It is further required that the taxpayer has retained substantial economic interests in Germany (e.g. entrepreneur in a German business; 25 per cent interest in a German partnership; owning a substantial shareholding in a German corporation). If those conditions are complied with, the German system again comes very close to the US system: the person is taxed in Germany for a period of ten years as a non-resident but on German source income defined under special sourcing rules that result in a broader concept of German income than that applicable to ordinary non-residents. So, like the US system, the German rule expands the tax liability of emigrants and all appreciation in value is taxed regardless of whether it accrued before or after emigration. Like the US system, the German system provides for a minimum amount of tax to be paid. It is also believed to be unnecessarily complex. In view of the limited number of taxpayers that are captured by the tax – but which are subject to a heavy compliance burden – and the poor revenues it generates, it has been questioned whether the system should be maintained. Comprehensive and watertight sourcing rules for the taxation of non-residents are preferred. Perhaps the main interest of such limited extended tax liabilities is their discouraging effect. If this presumption is correct, the systems protect the domestic tax revenues.

DTCs defining under what circumstances Germany is allowed to tax non-residents restrict the application of the limited tax liability. However, such tax liability typically applies in relation to low-tax countries with which Germany has not entered into a DTC. Given the proximity of a low-tax country such as Switzerland a specific provision allowing the application of the limited tax liability has, however, been provided in the German–Swiss DTC. It actually limits the application of the regime to five instead of the ordinary ten years.

3.4.3. Australia: alternative to the general exit tax (introduction 1985)

As described above (see section 3.1), Australia's limited extended tax liability is an alternative tax for those taxpayers who elect to opt out of the general exit tax. By making this election, the taxpayer is able to defer the recognition of gains under the general exit tax and thus the payment of such tax until actual realization of the relevant asset. As a result of the election the asset is characterized as "having the necessary connection with Australia" and therefore remains within Australia's tax jurisdiction of non-residents. The consequence of the application of the extended tax liability is that the entire gain, also the post-emigration appreciation, becomes subject to Australian tax. Of course, if the value goes down after emigration the taxpayer has avoided the payment of a tax otherwise due on an unrealized gain. As in the US and Germany, application of the extended tax liability does not require the posting of security and hence also the Australian Commissioner may face difficulties in collecting a tax due from an individual living overseas.

Australia's DTCs either contain a provision that allows Australia to apply its capital gains rules or they do not and in such a case capital gains are included in the "other income" article. The "other income" article in Australia's DTCs deviates from article 21 OECD model and permits a source-state tax. The result is that in both cases Australia can apply its limited extended tax liability in relation to DTC countries.

3.4.4. Sweden and Norway: capital gains on shareholdings (introduction in Sweden in 1983; in Norway in 1992)

Both Norway and Sweden have an extended tax liability on shares and related securities in Norwegian/Swedish companies. The rule aims at protecting the latent tax claims on gains that accrued while the shareholder was a resident and at preventing tax avoidance by means of transfers of residence. Instead of providing for a limited exit tax on shares in domestic corporations limiting their taxing rights to pre-emigration appreciation,[33] both countries preferred a limited extended tax liability. As a result, both countries are entitled to tax an emigrant for a number of years after termination of his unlimited tax liability (in Norway for five years, in Sweden for ten years).[34] This allows them to subject a former resident to tax on gains that accrued before and after emigration. This goes beyond the mere protec-

33 Norway debated the introduction of an exit tax but did not enact it; see above, section 3.2.1.

34 In combination with the four- or five-year rule under Norway's and Sweden's unlimited extended tax liability by virtue of which the taxpayer is deemed to remain resident, a taxpayer may be subject to limited extended tax liability on Norwegian or Swedish shares for a longer period than the stated term of such limited tax liability.

tion of a latent tax claim that exists upon emigration. A time period during which the country of former residence can subject an emigrant to tax has been provided because the country considers that if the shares have not been realized within that period there is no reason to believe that the taxpayer emigrated for the purposes of avoiding capital gains tax.

The liability applies regardless of the tax status of the immigration country and regardless of the nationality of the taxpayer. There is no requirement of long-term residency.

In both countries the practice is to impose the tax also on shares acquired after emigration.[35] It is difficult to see how this is in accordance with the underlying policy of protection of the tax base. It is a disincentive for emigrants to continue to invest in the country of former residence.

Such extended tax liabilities on shares are not in line with article 13(4) OECD model. In order to enable the application of their domestic rules, Norway and Sweden[36] have a very significant number of DTCs which deviate from the OECD model and allow the country of former residence to impose capital gains tax regardless of whether the immigration country taxes the relevant gain. Sometimes the right for the country of former residence to apply its capital gains tax is more limited than under domestic law (i.e. by providing for a shorter term during which the tax can be imposed or imposing a nationality requirement).

3.4.5. United Kingdom and New Zealand: the re-entry charge (introduction in the UK in 1998; in New Zealand in 1988)

Both the UK and New Zealand apply a tax to returning emigrants that have realized income abroad, on the assumption that they initially transferred their residence with a view to escaping UK/New Zealand tax. The tax liability arises in the year of return. The income captured by both rules is, however, entirely different. Both are straightforward anti-abuse measures.

The UK does not levy an exit tax, nor does it tax disposals by non-residents and those not ordinarily resident, even if the assets are in the UK. Capital gains tax was easily avoided if the taxpayer became a non-resident and spent three years of assessment outside the UK. To combat this tax avoidance, a former resident who realizes assets while away from the UK is now liable to UK capital gains tax if he returns within five years of departure. The tax is levied upon his reacquiring UK residency, hence its denomination. The re-entry charge applies to long-term residents (for four years out of seven) and as a rule only to assets owned upon emigration from the UK. It applies “without prejudice to any right to claim relief in accordance with any double taxation relief arrangement”. Accordingly, the UK recognizes that the immigration country may also tax the gain and that it may be able to rightfully and exclusively do so under a DTC containing an article 13(4) OECD model clause. It is accepted that such a DTC would override the re-entry charge. The UK already before the introduction of the re-entry charge in its domestic laws

35 Goldberg *et al*., *op. cit*., 649.

36 Swedish reservation on art. 13 (OECD model commentary on art. 13; §39).

in 1998 sought to include a provision in its DTCs permitting it to apply its capital gains tax to assets realized by its former residents for a number of years after emigration. Since 1998 all new DTCs confirm the UK's continuing right to impose capital gains tax on former residents. Accordingly, an important number of UK DTCs allow the application of the re-entry charge if the emigrant has taken up his residency in that DTC country.

Under New Zealand law residents are taxable on distributions from a foreign trust. A person who reacquires New Zealand residency within five years after emigration and who received a distribution from a foreign trust in the interim is deemed to have received the distribution on the date on which he re-established his residence in the country.

3.4.6. Limited extended tax liability achieved under DTCs

Several countries provide for a quite comprehensive non-resident tax liability but are unable to effectively enforce such taxes because they have ceded their taxing rights to the country of residence under a DTC with that country. While this can occur in many areas, for the purposes of this report it is extremely relevant in the field of capital gains on personal property and pensions. If the emigration country includes article 13(4) OECD model (capital gains) and/or article 18 OECD model (private pensions) in its DTCs it is precluded from exercising its tax jurisdiction on a non-resident who realizes gains on shares (even in a company resident in the emigration country) or receives a pension sourced in the emigration country as it has agreed that only the residence state should tax such items of income.

Accordingly, several countries deviate from the OECD model and preserve their domestic taxing rights on capital gains on personal property and/or pensions under their DTCs.

For capital gains there are many ways in which countries achieve this goal.[37] First, countries may insert a clawback clause in their DTCs. Such a clause allows the emigration country to tax former residents on gains on certain items of property if the gains are realized within a number of years after emigration. Almost all Canadian and Dutch DTCs and an important number of Austrian, Swedish, UK, German and Norwegian DTCs provide for such clawback clauses. It is suggested that in doing so, countries extend the tax liability of non-residents because they tax a category of non-residents (i.e. emigrants) which they would never have taxed had such persons not been residents before (i.e. ordinary non-residents).

While only such a clawback provision can properly be called a limited extended tax liability since it results in an extension of the territoriality concept, the three other measures discussed hereafter cannot be left unmentioned in the framework of this report. None of them intentionally focuses on emigrants, but in the case of emigration each method clearly has the effect of protecting the taxing rights of the country of former residence. Under a first approach countries give effect to the recommendation of §13 of the OECD commentary on article 13 and abandon their taxing rights only if the residence state actually imposes tax on the gains (subject

[37] See reservations in §§33 *et seq*. OECD commentary on art. 13 OECD model.

to tax condition, e.g. several UK and Mexican DTCs). Another approach is to give effect to article 13(5) UN model and allocate the taxing rights on gains realized on substantial shareholdings to the country of residence of the company, rather than to the country of residence of the shareholder (e.g. several DTCs of France, India, Austria, Norway, Argentina and Sweden). Finally, countries may simply not accept that capital gains be taxed in the residence state, but provide that gains from the alienation of personal property will be taxed by both countries under their domestic law provisions. A typical example is Australia since the introduction of the capital gains tax in 1985.

While the specific measures included in DTCs in the area of pensions cannot be qualified as limited extended tax liabilities within the meaning of this general report, their purpose is also to avoid tax base erosion. Countries safeguard their domestic taxing rights on non-residents either by providing for source-state taxation rather than residence-state taxation (e.g. Australian and Canadian DTCs, the Nordic Treaty, many Swedish, Danish and Finnish DTCs, recent Dutch DTCs), or by preserving the rights of the source state if the pension is not actually subject to tax in the residence state (e.g. many UK DTCs).[38]

3.5. Recapture of previously enjoyed deferrals and deductions

3.5.1. Exemptions and deferrals on capital gains

In initial public offerings (IPOs) and corporate restructurings whereby shares are issued or exchanged, countries often do not impose tax on the gains realized in order not to hinder the reorganization and/or because the shareholder does not receive cash under the transaction by means of which he is able to pay the tax otherwise due. This can be achieved by treating the share transaction either as a non-taxable event and providing for a carryover of basis to the shares received, or by treating it as a taxable event but allowing the shareholder to defer the payment of tax on the gain until realization of the newly issued shares.[39] Hence, the exemption or deferral is temporary. It is given on the assumption that the country will be able to collect the tax on the subsequent alienation of the shares received. At that time the exemption or deferral is cancelled. This assumption is incorrect if the shareholder emigrates before alienation of the shares and the emigration country has not preserved its taxing rights on non-residents under domestic law or DTCs. Finland, Sweden, Germany, the Netherlands and France therefore repeal the exemption or deferral when the taxpayer becomes subject to limited tax liability.[40] Logically, this

38 See reservations in §§39 *et seq.* OECD commentary on art. 18 and in §§13 *et seq.* on art. 21 OECD model.

39 Until 1 January 2000 France had a deferral system. On that date it was replaced by a temporary exemption.

40 Technically, in Germany and France the recapture operates as a limited exit tax and is thus governed by the rules described under section 3.2.1.1. The branch reporters have therefore discussed the system in the context of the exit tax. In view of the definitions used in this general report it is believed that for purposes of this report both systems are more appropriately characterized as recaptures.

occurs regardless of the tax status of the immigration country or the residence status of the emigrant (long- or short-term resident). No relief from double taxation should be provided since the emigration country is only claiming a tax on a transaction that took place when it was permitted to impose the tax and, if the tax liability in the emigration country is settled, the immigration country will probably accept the higher tax base. However, upon emigration the taxpayer does not have at his disposal the necessary cash to pay the tax. However, only Germany and France provide for payment accommodation. Payment of the German tax can be spread over five years without interest charge if a proper guarantee is provided. France imposes a preserving assessment if security is posted and a French tax agent is appointed. Such assessment is imposed as long as the relevant shares are not alienated. As a result, the French emigrant becomes subject to ongoing reporting obligations in France. The assessment is waived if the taxpayer returns to France and still owns the shares, but if he paid the tax upon emigration he cannot obtain a refund. Since in Germany and Finland the tax is in any event due on emigration, no refund can be obtained in case of return. Logically the returning taxpayer should in such a case benefit from a step-up in basis.

The United Kingdom has two recaptures of deferrals, albeit outside the field of corporate restructurings. They serve, however, the same purpose: to ascertain the collection of a deferred tax liability upon emigration. The first one involves the deferral of a chargeable gain if a qualifying re-investment is made; the second one relates to gifts and other non-arm's length disposals where gain recognition can be deferred until a subsequent alienation by the transferee. The latter deferral is available only if the recipient is a UK resident.

3.5.2. Pensions and life insurance

Denmark (1987), Belgium (1993) and the Netherlands (1992/2001) have enacted recapture legislation in this field.

The rationale behind the introduction of recapture is identical in all relevant countries. Future income generated at the expense of the tax revenues of the emigration country by means of deductions of contributions and/or tax-free accumulations of earnings should not be enjoyed in the immigration country without the emigration country having been able to tax it. Indeed, this is the consequence of articles 18 and 21 OECD model pursuant to which the emigration country waived its taxing rights in favour of the residence state. Giving up such taxing rights is particularly hard to accept for the emigration country if the immigration country has a favourable tax regime for foreign-source pensions and life insurance. A particularly well-known example is the case of the Dutch resident moving to Belgium to take advantage of Belgium's favourable tax regime for lump-sum payments in lieu of pensions.

The Danish rule seems to be the least far-reaching as it only applies to excessive pension premiums paid some years before emigration. If the immigration country belongs to the group of DTCs for which Denmark has provided for the source state to tax pensions, obviously the rule does not apply.

The Netherlands taxes the value of pension rights, as well as premiums deducted under life insurance contracts and earnings accumulated under such contracts, at the time of transfer of residence.[41] Upon providing proper security[42] a preserving assessment may be imposed for a ten-year period. If no tainted transaction occurs within that period the assessment is waived. Tainted transactions are e.g. the receipt of a lump-sum payment in lieu of a periodic pension or the transfer of the pension claims to a non-resident insurer. The paying out of a periodic pension does not, however, trigger the collection of the preserving assessment.

Although Belgium has not prepared a report, the general reporter wishes to point out that Belgium, notwithstanding that it typically includes article 18 OECD model in its DTCs, taxes former residents on the value of their pension rights. For that purpose the pension is deemed to be collected the day immediately preceding the transfer of residence. The rule has been heavily criticized because of the resulting double taxation. In response the tax authorities announced that they will refrain from applying it in situations involving article 18 OECD model if the immigration country effectively imposes tax on the pension. In addition, Belgium imposes a tax on the accrued value of a life insurance contract when the policyholder reaches the age of 60, irrespective of whether the value is paid out. According to the statute such tax is an indirect tax and imposed on the insurance company (that deducts it from the value of the contract). The tax rate and base, however, are those that apply for income tax purposes. The indirect tax is meant to be a substitute tax for the income tax that is no longer due upon receipt of the income. The result is double taxation if the contract is paid out when the policyholder lives in a country that is entitled to tax under article 21 OECD model. It remains to be seen whether such double taxation violates the DTC since Belgium subtly called it an indirect tax so that prima facie the tax is not covered by article 2 OECD model.

3.5.3. Other recaptures

Denmark claims back the depreciation allowances on non-Danish assets that have been admitted as a deduction in calculating the unlimited tax liability in Denmark when the owner emigrates. This is justified by the fact that in such a case Denmark no longer has the right to tax the gain on the assets (including that portion corresponding to the earlier depreciation).

Some countries report recaptures in the area of stock options (e.g. Australia,[43] Denmark and Sweden). Where stock options would in the domestic context be taxed e.g. only when exercised, the options are deemed to be exercised when the employee transfers his residence abroad if the options were vested at that time.

41 Including becoming non-resident under a tie-breaker rule of a DTC or the tax arrangement with the Netherlands Antilles.

42 Not required if the pension obligation is with a qualified insurance company. Such a company is liable for the tax.

43 Complex issues arise as a result of the simultaneous application of Australia's general exit tax and the recapture rules. These may lead to double taxation of the same income within Australia, which can only be avoided if the migrating employee elects for the extended tax liability.

4. Taxation of immigrants

4.1. The discontinuities caused by transfer of residence: international double taxation and non-taxation

If a person moves from a country that does not levy an emigration tax to a country that imposes tax on income or gains that accrued while he was a resident of the other country, no double taxation occurs. All that happens is that the immigration country taxes income that accrued prior to immigration but – in view of the fact that there is no internationally agreed principle of apportioning taxing rights on accrued income between states – that is not necessarily an unsatisfactory result.

However, if a person moves from a country that imposes an emigration tax to a country that subjects the relevant income or gain to tax upon receipt or realization, there is potential double taxation. If the tax levied by the emigration country is in the nature of an exit tax or a recapture of deductions and accumulated earnings in the area of pensions and the like, the income or gain accrued prior to emigration will be taxed twice. The same is true if the emigration country levies an unlimited or limited extended tax liability, but the result is worse: pre- and post-emigration income or gain will be subject to double taxation. Theoretically, there are three solutions to avoiding such double taxation: (a) the immigration country could accept as a tax base of the immigrant's property and pension rights the value that was taken into account for purposes of the emigration tax by the country of former residence (step-up in basis); (b) the immigration country could grant a foreign tax credit against its taxes for the emigration taxes paid abroad on the same items of income; (c) the emigration country could give a foreign tax credit (reverse credit) against its emigration taxes for the taxes paid in the immigration country on the same income.

If a person moves from a country that has not levied an emigration tax to a country that either does not tax the relevant gain or income or that allows a step-up in basis, a partial or full international non-taxation occurs.

Potential international double taxation and non-taxation in the area of pension and life insurance schemes needs some further consideration. If the emigration country does not allow a deduction for the contributions and/or subjects the accumulated earnings of the plan to current taxation (as in Australia), international double taxation results if the immigration country taxes the pension upon payment. On the other hand, international non-taxation is achieved if the emigration country allows a deduction and/or does not subject the earnings to current taxation and the immigration country exempts the pension in some way (e.g. via a step-up in basis).

In order to facilitate the consideration of these issues a few possible factual patterns are set forth in the following charts. The examples assume the levy (or non-levy as the case may be) of an exit tax and a limited extended tax liability (hereafter ETL) on a gain on shares in a company resident in the emigration country.

Table 1

1998	Country A	2000	Country B	2002
Acquisition 100		Emigration 200		Sale 300

1.1 A applies exit tax/ B gives no step-up

Economic gain:	300 – 100 =	200
A: Exit tax:	200 – 100 =	100
B: CGT:	300 – 100 =	200
Taxed gain:	300 → **DT:**	**100**

(pre-emigration accrual)

2.1 A applies ETL/ B gives no step-up

Economic gain:	300 – 100 =	200
A: ETL:	300 – 100 =	200
B: CGT:	300 – 100 =	200
Taxed gain:	400 → **DT:**	**200**

(pre and post-emigration accrual)

1.2 A applies exit tax/ B gives step-up

Economic gain:	300 – 100 =	200
A: Exit tax:	200 – 100 =	100
B: CGT:	300 – 200 =	100
Taxed gain:	200 → **no DT**	

2.2 A applies ETL/ B gives step-up

Economic gain:	300 – 100 =	200
A: ETL:	300 – 100 =	200
B: CGT:	300 – 200 =	100
Taxed gain:	300 → **DT:**	**100**

(post-emigration accrual)

1.3 A applies no exit tax/ B gives step-up

Economic gain:	300 – 100 =	200
A: Exit tax:	=	0
B: CGT:	300 – 200 =	100
Taxed gain:	100 → **partial non-taxation (pre-emigration accrual)**	

Table 2

1998	Country A	2000	Country B	2002
Acquisition 100		Emigration 200		Sale 150

1.1 A applies exit tax/ B gives no step-up

Economic gain:	150 – 100 =	50
A: Exit tax:	200 – 100 =	100[a]
B: CGT:	150 – 100 =	50
Taxed gain:	150 → **DT:**	**100**

(pre-emigration accrual)

2.1 A applies ETL/ B gives no step-up

Economic gain:	150 – 100 =	50
A: ETL:	150 – 100 =	50
B: CGT:	150 – 100 =	50
Taxed gain:	100 → **DT:**	**50**

(pre-emigration accrual)

1.2 A applies exit tax/ B gives step-up

Economic gain:	150 – 100 =	50
A: Exit tax:	200 – 100 =	100
B: CGT:	150 – 200 =	<50>[b]
Taxed gain:	**100**	

2.2 A applies ETL/ B gives step-up

Economic gain:	150 – 100 =	50
A: ETL:	150 – 100 =	50
B: CGT:	150 – 200 =	<50>
Taxed gain:	**50**	

[a] Some countries will under certain circumstances account for that depreciation in value in the framework of their exit tax: e.g. Australia, Canada, the Netherlands, France, Denmark (see sections 3.1 and 3.2.1.1).

[b] Some countries may account for that depreciation in value and allow a capital loss: e.g. Australia.

4.2. Measures taken to avoid discontinuities

4.2.1. Step-up in basis in the immigration country

Consistent with their policy of levying a general exit tax upon departure, Australia and Canada allow immigrants a step-up in the cost base of all their assets that will be subject to capital gains tax. Denmark does the same. This is surprising as Denmark only imposes a limited exit tax on shares and securities. The step-up is intended to exclude from capital gains tax any gain that accrued on an individual's assets while he was a non-resident of the immigration country and thus applies irrespective of whether the emigration country levied an exit tax. Logically, Australia and Canada do not apply the step-up to assets that were already within their tax jurisdiction before the individual took up residence, i.e. assets held by a non-resident that have the "necessary connection with Australia" and "taxable Canadian property". If a step-up were given to such assets, such countries would waive a tax claim that they already had before immigration. The new tax basis is equal to the fair market value of the property at the time of becoming a resident (sometimes by applying the fiction of a deemed acquisition) determined only under the domestic laws of the relevant immigration countries.[44] No account is taken of the value retained for exit tax purposes in the emigration country, if any, nor is there any provision for consultation with such a country. There may be different reasons for this non-automatic acceptance of the value upheld by the emigration country. One of them is that if the immigration country has a higher rate than the emigration country the taxpayer may be tempted to overvalue the basis for the exit tax, a manoeuvre the emigration country is not likely to contest. As an exception to the main rule, Denmark deems depreciable assets to be acquired upon immigration at their actual acquisition price but subject to a maximum depreciation under Danish law. If, however, such a net value is lower than the depreciated value under Danish law, the assets are deemed acquired at fair market value upon immigration. The rationale behind this exception is that immigration should not permit a taxpayer to depreciate an asset twice.

Austria and the Netherlands (both for substantial shareholdings) and New Zealand (for FIF and financial arrangements) also allow a step-up in basis, generally regardless of whether an exit tax was levied in the emigration country. These are mirror provisions of their exit tax on the same type of assets. The Netherlands applies this rule only to immigrants owning a substantial shareholding in a non-Dutch company. For immigrants with such a shareholding in a Dutch company and re-migrants the step-up will only be available in limited circumstances. One of the conditions is that a reasonable amount of exit tax was paid in the emigration country. In the absence of a foreign exit tax, the taxpayer will not be able to claim a step-up. For immigrants with Dutch shares this seems justified because before immigration such

[44] The reader should be aware of the fact that retaining the fair market value of the assets does not necessarily result in a step-up in basis. If the value upon immigration is lower than the historic cost of the asset, the new basis in the immigration country will actually lead to a step-down. This is, however, fully consistent with the policy of the relevant countries of taxing the gain that accrued while the taxpayer is a resident there. It is also correct if the taxpayer has been able to set off the loss abroad.

shareholding was within the ambit of the Dutch tax jurisdiction of non-residents, except for DTC provisions to the contrary (cf. the Australian and Canadian exclusions). For re-migrants the exclusion also seems to be justified, provided that they are still covered by the preserving assessment upon returning to the Netherlands.[45]

The US does not grant a step-up in basis except in the limited circumstance where the exit tax has been applied to emigrants under section 877 IRC, which is relevant if the assets become later again subject to US tax (e.g. in the case of re-migration). Also Israel will, in limited circumstances, not tax pre-immigration accruals under its exemption rules for Jewish immigrants owning property situated abroad at the time of immigration.

None of the other countries surveyed in this general report, including those countries that apply an exit tax (Germany, France) or a limited extended tax liability on shares (Norway, Sweden) allows, in the absence of a DTC, for a new tax basis for immigrants.[46] Such inconsistency is hard to justify, in particular if the emigration country itself imposes an exit tax, but it has been explicitly confirmed on two occasions by the German BundesFinanzHof. The refusal to grant a step-up is, however, not an unsatisfactory result if the immigration country is willing to avoid double taxation by means of a foreign tax credit.

One expects a country that has levied an emigration tax to make sure that its former resident is not subject to tax again on the accrued value of the property on which the emigration tax was assessed once he became a resident of the other country and thus that the emigration country takes the necessary actions in its DTCs with the immigration country to achieve this goal. This is not the day-to-day reality. It seems that countries are very much concerned with the protection of their own tax base but not with the avoidance of the double taxation suffered by the taxpayer. In fact, only four countries (i.e. Canada, Germany, Denmark and Australia) seem to have developed a treaty practice in this sense, albeit that such practice is very limited. Canada has in recent years sought to renegotiate its DTCs to enable its former residents to obtain a step-up in basis in the immigration country. Twelve new DTCs now have a provision to this effect. In addition, changes to the Canada–US DTC are expected for transfers of residence after 18 September 2000 in both directions.[47] Both Germany[48] and Denmark[49] have entered into six recent DTCs providing for a step-up in basis. There is no provision in such DTCs requiring the immigration country to accept the value retained by the other country for the

45 Which is waived upon return with the shares within the ten-year period or cancelled after this period.

46 The Norwegian report seems to suggest that if evidence of payment of an exit tax is submitted, the Norwegian authorities would normally allow a step-up.

47 DTCs with Luxembourg, Germany, Chile, Algeria, Austria, Portugal, Czech Republic, Slovak Republic, Ecuador, Peru, Venezuela and Senegal. The existing Canada–US DTC already provides that a US citizen who is subject to Canadian exit tax may for US tax purposes elect for a deemed disposition at fair market value. The result is that he obtains a step-up in basis in the US and can credit the Canadian exit tax against the US tax on the deemed disposition.

48 German DTCs with Canada, Finland, Italy, New Zealand, Switzerland and the USA. Note that where the step-up under the DTC is on a reciprocal basis (e.g. DTC with Canada) Germany is, notwithstanding its domestic laws, required to grant a step-up.

49 Danish DTCs with the three Baltic states, Italy, Ukraine and South Africa.

assessment of the exit tax, nor is there a provision requiring the two countries to agree on a common value at the time of emigration. It is believed that the DTC provisions on exchange of information and on the mutual agreement procedure offer the necessary basis for exchanging the information on valuation and for consultation between the competent authorities. Australia's treaty policy in this area is brand new. In fact, the only provision so far appears in the DTC with the United States (not yet in force): if Australia has applied its exit tax, the taxpayer may elect to treat the change of residence similarly for US tax purposes, a provision comparable to that of the Canada–US DTC. As a result, the taxpayer also recognizes the gain in the US and thus obtains a US tax basis equal to the fair market value. Double taxation is avoided by way of a tax credit. If the Australian former resident has opted out of the exit tax (see section 3.4.3) the US and no longer Australia is entitled to tax the gains upon actual realization. Thus, in the case of emigration to the US, such election eliminates the Australian extended tax liability.

Very few countries have taken measures in the area of pensions and life insurance to avoid double taxation of the pre-emigration contributions and/or accumulations.[50] Australia does not tax benefits that have accumulated in a non-resident pension fund before the individual acquired Australian residence. If lump-sum payments are made within six months after arrival a full exemption is available; if not, only the post-emigration accumulation is taxed. To avoid double taxation a tax credit is given, but only for the proportion of the foreign tax that relates to the payment subject to Australian tax so that the taxpayer may easily end up in an excess credit situation. In 1998 the Netherlands introduced a similar regime. However, in order to avoid double non-taxation the step-up only applies if the immigrant has been subject to a foreign tax on the accumulations that is comparable to the Dutch tax or if he did not enjoy a deduction for the contributions. In the case of immigration to Canada the individual is deemed to acquire his life insurance or annuity contract at its then fair market value. In addition, certain contracts may qualify as exempt policies. In New Zealand certain life insurance contracts owned by immigrants fall under the FIF regime and thus benefit from a step-up in basis. The United Kingdom also exempts certain life insurance policyholders from UK tax on that part of the income that arose prior to immigration.

All the above-mentioned measures are included in the domestic laws of the various countries. DTCs do not deal with this issue.

4.2.2. Foreign tax credit by the immigration country for taxes of the emigration country

4.2.2.1. For exit taxes

Obviously, immigration countries that allow a step-up in basis should not give a tax credit for the emigration taxes imposed by the other country since the pre-immigration appreciation will as a result not be taxed in the immigration country.

50 To a certain extent this can be explained by the fact that some countries do not tax foreign source pensions (e.g. Korea) or proceeds from life insurance (e.g. Australia).

The following countries surveyed in this general report have indicated that very probably they would not give credit under their domestic laws: Germany, United States, New Zealand, Sweden, Norway, Finland, Ireland, Spain, Italy, Mexico, India, Japan, Korea and Hungary. Various justifications are given for the absence of such a tax credit. First, exit taxes are not considered as "real" income taxes since they are not imposed on an income realization event but on unrealized appreciation, i.e. on a notional income. Secondly, value that accrued abroad is not income to be included in the notion of "taxable income" in the immigration country, so no double taxation occurs upon emigration. Thirdly, exit taxes are levied while the individual was a non-resident of the immigration country. Generally, only residents can claim a foreign tax credit. Finally, the most cited reason for the refusal to grant credit is the time lag between the two taxable events (i.e. in the emigration country, transfer of residence; in the immigration country, realization of the asset). Indeed, many countries provide that in order for a foreign tax to qualify for credit the foreign and the domestic tax should have become due in the same year of assessment. Accordingly, for all these reasons an immigrant will be unable to claim credit in the year of immigration, and also in the year of actual realization of the asset. However, in countries where the exit tax is imposed as a preserving assessment it could be argued that the taxable events in the two countries coincide since in this case the preserving assessment will only be effectively collected upon realization of the asset. Some countries are willing to mitigate the unfortunate effect of the absence of a tax credit by allowing a deductible expense for the amount of the exit tax (e.g. Germany, Sweden and Norway).

Only the United Kingdom and Brazil grant a tax credit. The United Kingdom has very generous foreign tax credit provisions in the Inland Revenue's Statement of Practice 6/88. Under that Statement the principal requirement is that the foreign tax is computed by reference to the same gain that is chargeable with UK tax. There is no requirement that the asset is disposed of and the gain realized in the same year as the year in which the UK tax charge arises. Nor is there a requirement that realization occur within a fixed time period after emigration. Normally, Australia should not give credit because it allows a step-up in basis of the assets upon acquiring Australian residency, except, however, for assets "having the necessary Australian connection" (see above, section 4.2.1). If double taxation occurs with respect to such assets because of the levy of a foreign exit tax, a credit may be available if the income can be characterized as being of foreign source.[51] In Austria, which grants a step-up on substantial shareholdings, the tax authorities have agreed to eliminate double taxation by way of credit if they are not able to accept the value retained for exit tax purposes by the emigration country as a basis for the step-up.

DTCs do not alter the above conclusion. Indeed, it seems that only Denmark has developed a treaty practice of including in its recent DTCs a provision pursuant to

[51] This may be difficult to achieve as the assets have per definition a connection with Australia. Gains on sales of shares in an Australian private company will probably not be of foreign source. A foreign exit tax on such shares will thus not qualify for credit, although there is authority to say that the source is foreign if the sales contract is not signed in Australia.

which the immigration country will avoid double taxation on the pre-emigration appreciation by way of credit or exemption. A similar provision is included on a reciprocal basis in the German DTCs with Sweden and Denmark.

4.2.2.2. For extended tax liabilities

Application of an unlimited extended tax liability (Finland, Norway, Sweden and Ireland) gives rise to international double taxation since both the emigration and the immigration country consider the individual as resident and subject him to tax on his worldwide income. The double taxation issues in this field are complex. Three types of income could theoretically be subject to such international double taxation: income from sources in the emigration country; income from sources in the immigration country and income from sources in third countries. If capital gains are taxed within the scope of the unlimited extended tax liability, typically all appreciation in value, i.e. both the pre- and post-emigration appreciation, will be taxed. The immigration country (if it does not give a step-up in basis for the assets upon entrance) will probably do the same.

Since both the emigration and the immigration country treat the taxpayer as their resident, they will probably give relief (by means of credit or exemption) for the taxes levied by the other country on income arising in the other country that has been subject to tax there.[52] If Finland has applied its extended unlimited tax liability, it gives credit under its domestic law and DTCs for the tax paid in the immigration country on income arising there. Sweden does the same under domestic law and its DTC with Switzerland. For income from third countries, the emigration and immigration country will probably give relief for the tax levied by the third country. However, it is less clear whether the emigration country will give relief for the tax imposed on that third-country income by the immigration country. This basically depends on the sourcing rules of the country giving relief. From a limited review of the Finnish DTCs, it seems that Finland may give credit also for the taxes imposed by the immigration country on income arising in a third country.[53] Sweden, however, does not grant a credit for such taxes against its unlimited extended tax liability. If the United States is the immigration country a tax credit will probably be available to the Finnish national/US resident for the tax paid in the third country and the Finnish tax on that third country income, subject to the foreign tax credit limitation rules. If Australia is the immigration country it is arguable that it will give credit for both the taxes levied by the third country and the emigration country on that third country income,[54] but if Canada, the UK, the

52 Although some countries refuse to give credit for a foreign extended tax liability. Examples are New Zealand (because it does not impose a similar tax) and India.

53 See e.g. art. 23(1)(c) DTC with the United States: “Finland shall allow any US tax paid on income or capital as a deduction from Finnish tax in accordance with the provisions of sub-paragraph (a).”

54 Assets subject to capital gains tax will first be allowed a step-up in basis. The Australian tax credit is not restricted to the emigration country’s tax that is confined to the pre-emigration appreciation. The combination of these credit rules may result in the taxpayer being in an excess credit situation (five years’ carryforward).

Netherlands or Sweden were the immigration country the taxpayer resident in such countries would not be permitted a credit for the emigration country's tax on the third country income. Because income must be of foreign source to qualify for the foreign tax credit, no credit may be available in some immigration countries (e.g. Australia and the UK) for taxes levied by the emigration country on income or gain sourced in the immigration country.

Australia, which has preserved the application of its domestic rules on capital gains in several of its DTCs and hence also the levy of its limited extended tax liability, and countries that have provided for a limited extended tax liability in their DTCs (see above sections 3.4.3 and 3.4.6) address the elimination of the resulting double taxation in the relief article of the DTC. If the emigration country has imposed a limited extended tax liability on items of income derived by a resident of the immigration country, the latter is required to give relief for the double taxation by way of credit or exemption.[55] In order to ascertain that the immigration country regards the income that the emigration country has taxed as foreign source income for purposes of its foreign tax credit rules, several countries applying a limited extended tax liability pursuant to a DTC (e.g. Canada and the UK) include a provision in their DTCs according to which income taxed in accordance with the DTC is deemed to be sourced in the country that levied the tax.

An interesting issue arises with respect to the double taxation caused as a result of the UK applying its re-entry charge. Since the country of temporary residence imposes its capital gains tax upon actual realization of the asset and the UK upon reacquiring UK residency, typically a number of years have elapsed between the two taxable events. If the country of temporary residence is a country that eliminates double taxation by way of credit the taxpayer may well be precluded from claiming foreign tax credit in that country because double taxation arises at the time he is no longer resident in that country.

4.2.2.3. For recaptures

None of the countries surveyed in this general report will give a foreign tax credit for the double taxation resulting from the emigration country applying a recapture in the area of pensions. The two main reasons justifying such refusal are: (a) the recapture is not a taxable event according to the taxation principles of the immigration country; thus the taxpayer is not required to recognize income in such a country upon recapture and no double taxation occurs at that time; and (b) a foreign tax credit is only granted if the foreign and the domestic tax are payable in the same year of assessment: in the case of recapture several years may lapse between the taxable event in the emigration country (transfer of residence) and the one in the immigration country (paying out of the pension). It further appears that none of the DTCs entered into by the countries surveyed deals with the issue of recaptures and the resulting double taxation.

[55] One exception is the Canada–US DTC that provided that gains taxed in Canada are deemed to be of US source. As a result, Canada should grant a reverse credit.

4.2.3. Foreign tax credit by the emigration country for taxes of the immigration country (reverse credit)

4.2.3.1. Against own exit tax

The ordinary rules on foreign tax credit usually do not allow an emigrant to claim a reverse credit in his country of former residence. Specific legislation to that effect might be required. However, countries may be reluctant to do so since they typically consider that it is the obligation of the residence state (i.e. the immigration country) to remove double taxation. For instance, Australia has not enacted specific foreign tax credit rules in this area. It is therefore unlikely that Australia will grant a reverse tax credit against its general exit tax. There may be various reasons. First, a foreign tax credit is only available for foreign source income. This implies that the exit tax has been imposed on non-Australian assets, which is likely to be the exception. Even if such a condition were met, it is uncertain that a tax credit would be granted because of the lack of identity between the income taxable in Australia (the notional income/accrual) and abroad (the gain actually realized). Finally, credit will only be available upon realization of the asset. The taxpayer may in practice be time barred from claiming the credit since generally a credit should be claimed within four years from the date on which the Australian tax becomes payable.

Canada, on the other hand, under its domestic law provides for a foreign tax credit against its general exit tax, provided that the foreign tax was paid to a country with which Canada had entered into a DTC and the taxpayer was a resident of that country. The credit is limited to the foreign tax paid in respect of the pre-emigration appreciation. The amount of the credit is further reduced by any credit that the taxpayer can claim in the immigration country under domestic law or the DTC with Canada. There is no time limit imposed on the claiming of the credit. This foreign tax credit is designed as an interim measure pending the renegotiation of Canada's DTCs in order to provide for the immigration country to allow a step-up in basis (see above section 4.2.1).

The domestic laws of some countries levying a limited exit tax on shareholdings provide for a reverse credit. This is the case in Denmark, France and the Netherlands. The credit operates as an ordinary credit: it is limited to the amount of income tax imposed by the immigration country with respect to that part of the gain that was subject to the exit tax and can never exceed such tax. Although they impose a limited exit tax on substantial shareholdings, Germany and Austria do not provide for such a reverse credit either in their domestic laws or in their DTCs since they consider it the task of the immigration country to give relief from double taxation.

The US provides under its domestic laws for a foreign tax credit against its limited exit tax on appreciated property provided that the foreign tax is incurred in the same year. The US tax liability is incurred in the year of expatriation or of removal of the property from the US, while the foreign tax liability arises upon actual realization. These two taxable events do not necessarily coincide. If they do not, the taxpayer may be precluded from claiming the credit (unless he deferred the payment of the US tax under a gain recognition agreement). Any excess credit is lost. The credit is granted for the foreign taxes relating to the property on which the exit tax was imposed and cannot offset any other US tax liability.

The availability of a reverse credit in the emigration country can give rise to complex issues if the immigration country also gives credit for the exit tax levied by the former. The issue is in essence which of the two countries grants the credit first. The Canadian policy seems to be that first the immigration country should give relief. Canada applies a “three-stage” calculation: first, the Canadian exit tax is assessed on the accrued gain; second, any foreign tax levied on the same gain is reduced by a tax credit for the Canadian tax; and finally, any remaining tax imposed by the immigration country is credited against the Canadian tax.

4.2.3.2. Against own extended tax liabilities

Whether any of the countries applying an unlimited extended tax liability will give a reverse credit for taxes imposed by the immigration country has been discussed under section 4.2.2.2.

The savings clause included in DTCs allowing the US to apply its limited extended tax liability to former citizens and residents does not deny such persons the benefit of the relief from double taxation provided for by the DTCs. As a result of the combined application of the savings clause and the domestic tax credit provisions regarding US emigration taxes discussed under section 4.4.1, a US expatriate will be entitled to a foreign tax credit for tax imposed by the immigration country on income or gains subject to the US limited extended tax liability.

Australia will not give credit for foreign taxes paid by a former resident against its limited extended tax liability since the taxpayer, at the time of realizing the gain and becoming liable to Australian tax, is a non-resident and under Australian law foreign tax credit is only available to residents.

In a limited number of DTCs Germany, Sweden and Canada have agreed to give credit to residents of the other country for the tax paid in the immigration country on items of income that are also subject to the limited extended tax liability in Germany, Sweden or Canada.[56]

Where under the relevant DTC the UK is permitted to apply its re-entry charge upon the taxpayer reacquiring UK residency, this taxing right is not exclusive since the country of temporary residence is also entitled to tax the gain. Because of a provision typically included in UK DTCs deeming income which may be taxed by the other country in accordance with the DTC as sourced in that country, the gain is deemed to arise in the country of temporary residence, regardless of where the assets are situated. The UK will grant a foreign tax credit to the re-migrant even if the tax levied by the country of temporary residence was paid in an earlier year upon actual realization of the asset.

[56] E.g. DTC Germany–Switzerland; DTC Canada–USA; DTC Sweden–USA.

4.2.3.3. Against own recaptures

No country surveyed in this general report will give a reverse credit to avoid double taxation. The fact that some countries allow a reverse credit against their exit taxes but not against their recaptures may probably be explained by the fact that with respect to recaptures countries believe that they are in any event entitled to tax the pertinent income, while in the case of exit taxes the main purpose is to prevent tax avoidance. Tax avoidance is not present if the other country has sufficiently taxed the capital gain.

4.3. Evaluation and recommendations

4.3.1. Exit taxes

Legislators of the emigration countries believe that the introduction of exit taxes is not prohibited by the DTCs and thus does not constitute a treaty override. Several arguments are advanced.[57] Because exit taxes are assessed just before the tax liability based on residence ceases, the main argument is that at the time of imposition of the exit tax the taxpayer is a resident of the country imposing the tax, not of the other contracting state. So the levy of an exit tax cannot be in conflict with a DTC. It is further argued that DTCs allocate taxing rights in the case of alienation of assets, while exit taxes are not imposed on the occasion of the alienation. It is also claimed that no double taxation occurs since double taxation implies that two different countries tax the same income at the same time. Together with some branch reporters, the general reporter believes that it is permissible to question this point of view. The OECD and UN models, two bodies of tax law the provisions of which are recognized worldwide, allocate the taxing rights on capital gains on assets (other than real property, permanent establishment assets and ships and aircraft) in a clear way. The exclusive right to tax gains on items of personal property is granted to the state of residence of the alienator, except, under the UN model, where the right to tax gains on substantial shareholdings is allocated to the country where the company is established. It is at least permitted to presume that countries that have accepted the provisions of such models without any reservation[58] were aware that taxpayers could one day transfer their residence and thus that such countries could lose their taxing rights by virtue of such provisions. In the general reporter's perception §§6–10 of the OECD commentary on article 13 OECD model do not support the view that countries are entitled to tax unrealized gains that accrued prior to emigration. On the contrary, §21 of the commentary on article 13 and §6 of the commentary on article 23 OECD model confirm the sole taxing rights of the residence state. Finally, it may be questioned whether the notion of double

57 The arguments and counterarguments developed at the time of introduction of the Danish exit tax are discussed in detail by L. Weizman, "Departure Taxation – Treaty Override? Extraterritorial Tax Law?", *European Taxation*, 1994, 73.

58 Only Canada has formulated a reservation with respect to the preservation of taxing rights on former residents (§34 OECD commentary on art. 13).

taxation as defined above is not too narrow: what matters is not that two taxes are imposed in the same year, but that such taxes relate to income that accrued during identical periods.[59] Accordingly, in view of the *pacta sunt servanda* principle laid down in articles 26 and 27 of the 1969 Vienna Convention on the Law of Treaties, it is not unreasonable to question whether the unilateral introduction of exit taxes by such countries does not violate their treaty obligations.

One of the goals of an exit tax is the prevention of tax avoidance. According to §§8 and 9 of the OECD commentary on article 1 OECD model, emigration with a view to realizing capital gains tax free in another country of residence is an abuse of a treaty. §23 of the same OECD commentary goes on to say that the large majority of OECD member countries consider domestic anti-abuse measures as part of the basic national tax law that determines which facts give rise to a tax liability and that such rules are not addressed in DTCs and therefore not affected by them. However, §10 recommends in this respect that it may be appropriate for the contracting states to agree in their DTCs that the DTC does not affect the application of domestic anti-abuse provisions. Yet it appears that exit taxes are introduced unilaterally without regard to the tax regime applicable abroad and that very few DTCs explicitly authorize their assessment on a bilateral basis.[60]

Further consideration should be given to §§25 and 26 of the same OECD commentary:

> "Member Countries should carefully observe the specific obligations enshrined in tax treaties, as long as there is no clear evidence that the treaties are being improperly used. Furthermore, it seems desirable that counteracting measures comply with the spirit of tax treaties with a view to avoiding double taxation. Where a taxpayer complies with such counteracting measures, it might furthermore be appropriate to grant him protection of the treaty network … Counteracting measures should not be applied to countries in which taxation is comparable to that of the country of residence of the taxpayer."

Yet exit taxes are introduced without regard to the tax system applicable in the immigration country. Furthermore, if that country imposes a capital gains tax, the accrued gain may be taxed twice. It appears that such double taxation is eliminated in a still too limited number of cases.[61] As recommended by the Council of the OECD, member countries should conform to the OECD model as interpreted by the commentary and they should follow the commentaries when applying and interpreting provisions of a DTC that is based on the OECD model.[62]

The number of countries introducing exit taxes is likely to increase. The internationalization of business, economic conditions and retirement stimulate the mobility of individuals. On the other hand, the freedom to move should be ham-

59 Weizman, *op. cit.*, 79.

60 Only some 15 Danish and 3 German DTCs (Denmark, Sweden and Austria) expressly allow such countries to apply their exit tax. Two of the German DTCs are with countries that levy an exit tax themselves.

61 See sections 4.2.1, 4.2.2.1 and 4.2.3.1.

62 Recommendation of the OECD Council of 23 October 1997.

pered as little as possible (see section 5.2 for EC law considerations in this respect).

Accordingly, a policy needs to be worked out and agreed upon at least between OECD member countries to deal with the taxation of accrued gains in the case of transfer of residence and with the avoidance of double taxation and non-taxation.

First, it has to be decided how the taxation powers between the two countries are to be allocated with respect to such gains. As Betten has pointed out in his dissertation, theoretically there are two approaches:[63] either the right to tax is confined solely to the immigration country or it is divided between the countries where the taxpayer was a resident when the gain accrued. The first approach – which seems to be the one currently favoured by the OECD commentary – has the undisputed advantage of avoiding all international double taxation. However, in the absence of tax harmonization, it has the disadvantage of not excluding international double non-taxation. Consequently, in view of the number of countries levying exit taxes today it is believed that this approach may no longer be internationally accepted. Allocating the taxing rights between countries on the basis of the accrual principle has the advantage of avoiding non-taxation and of fairness.[64] The crucial element of such a system is the determination of a common value of the relevant property items upon transfer of residence. Therefore, the system needs to be introduced bilaterally or multilaterally (in the EC probably by means of a directive) and it needs to include a procedure for the determination of such a common value between the competent authorities of the two countries involved and the taxpayer, eventually with an appeal or arbitration procedure. Other issues that should be resolved are the determination of each country's pertinent share of tax revenues; the assistance with the cross-border recovery of the tax; the subsequent emigration to third countries and the cash problem of the taxpayer who upon emigration is liable to pay tax on an unrealized gain. Ideally, the latter problem should be resolved by the emigration country agreeing to defer the collection of its pertinent share of tax until the actual realization of the assets. Upon emigration a preserving assessment could eventually be imposed to guarantee the future payment of tax due upon realization (see section 5.2 for the EC law considerations). The Dutch branch report contains suggested language for an appropriate treaty article. The OECD commentary on article 13 should make it clear whether the OECD believes that it is still appropriate to grant the exclusive taxing right to the residence state and/or under which conditions countries can impose exit taxes.

[63] R. Betten, *Income Tax Aspects of Emigration and Immigration of Individuals*, IBFD Publications, 1998, at 101 *et seq*.

[64] While business income is taxed on an accruals basis and non-business income dealt with in this report is generally taxed on a cash basis, it cannot be left unmentioned that for business income such allocation seems to be accepted. See §10 OECD commentary on art. 13 (transfers of assets carrying a latent gain from permanent establishment to head office) and §101 of the OECD discussion draft on the attribution of profits to permanent establishments. Both the OECD commentary and the discussion draft recognize the risk of double taxation. According to §15 and 15.1 of the OECD commentary on art. 7 it is up to the in-bound country to resolve such double taxation on a bilateral basis.

Second, with respect to the situation today, the current practice of countries introducing exit taxes without taking any measure to avoid international double taxation and leaving it up to the immigration country to do so either unilaterally – from a revenue perspective this country has no interest in doing so – or at best via a mutual agreement procedure under a DTC is not acceptable. If countries introduce exit taxes they should provide for a reverse credit in their domestic tax laws. While it is admitted that such a credit would not be in line with the apportionment of taxes on the accrued gain discussed above – the emigration country may as a result of the credit receive little or no tax – it is believed that such a credit should be made available in order to give effect to the recommendations of §§25 and 26 of the OECD commentary on article 1. Subsequently, such countries should revise all their existing DTCs with a view to negotiating with their treaty partners relief from the double taxation risk by introducing a step-up in basis and a procedure to determine a common value upon emigration as discussed above. Of course, new DTCs should be concluded along the same pattern. The reverse credit should be seen as an interim measure: it should only be made available as long as the DTCs have not been amended (cf. the current Canadian practice). If countries enter into DTCs with countries imposing little or no capital gains tax and they want to exclude an abuse of the treaty, they can still preserve their taxing rights after emigration by providing for a subject to tax clause or a clawback clause for former residents. The latter clause should, however, be restricted to a reasonable time period (say a maximum of ten years) since the expiration of this period would be an indication of the absence of tax-motivated emigration.

4.3.2. Extended tax liabilities

Unlimited extended tax liabilities are only effective if the taxpayer has transferred his residence to a low-tax country or to a DTC country provided that the emigration country has preserved its rights to apply such extended tax liability in the relevant DTC. Imposing an unlimited extended tax liability on emigrants gives rise to complex international double and triple taxation issues if the immigration country is not a low-tax country and the taxpayer also derives income from third countries. It seems that if double taxation remains in such a case it generally relates to the third country income.

The US and German limited extended tax liabilities in the case of tax avoidance are very complex. The effect of such tax systems is difficult to predict for the emigration country and it seems that such systems generate poor revenues. Moreover, they are difficult to enforce on taxpayers living abroad. The effects of limited extended tax liabilities should not be overestimated. Emigrants who are residents of a country that has entered into a DTC with the emigration country usually benefit from the relief from double taxation clause provided for by that DTC or, as is the case in the US and UK, benefit from a reverse credit.

4.3.3. Recaptures

Recaptures of previously enjoyed exemptions in the area of capital gains on shares and the like are measures necessary to ascertain the collection of a tax liability that arose while the taxpayer was a resident but the payment of which was deferred. Such measures are needed to avoid that the tax claim of the emigration country would be definitively lost.

The huge differences in the taxation systems of pensions and life insurance between the various countries significantly restrict the mobility of employees. In view of the substantial number of employees that have built up pension rights, the impact of recapture measures in this field is an even further obstacle to their freedom to move (see section 5.2 for the EC law considerations). The lack of harmonization between the tax regimes in this area makes it very difficult to avoid international double taxation and non-taxation. The unilateral introduction of step-ups in basis without regard to the tax system underlying the building up of the pension rights in the emigration country (e.g. Australia) may result in double non-taxation. Unilateral recaptures without regard to the taxation regime of the receipts under the pension plan or life insurance scheme in the immigration country (e.g. Belgium) may easily cause double taxation. While it can be understood that countries introduce anti-avoidance measures to protect their tax base in this area – also in view of the fact that no consensus on the introduction of new rules can be reached within the EC and the OECD – countries should do so in full respect of their treaty obligations and the recommendations laid down in §§25 and 26 of the OECD commentary on article 1. Recaptures should not be unilaterally introduced if there is no clear evidence of tax avoidance and abuse of treaty. No counteracting measures can be taken if there is comparable taxation in the other country and if such measures result in double taxation, the taxpayer should benefit from the relief provisions of the relevant DTC. One may seriously question whether the recaptures reported here comply with these principles.

Amending a complete treaty network is admittedly a time consuming effort, but a change of the provisions of articles 18 and 21 OECD model seems necessary. The following suggestion is made. The right to tax is in principle conferred to the residence state. However, this state should refrain from taxing if the taxpayer has built up pension rights in another state that allowed him a deduction for the contributions to the pension fund and/or that did not currently tax the accumulations in the fund. In that case the source state has the right to tax because it facilitated the building up of the pension rights. The residence state should also not tax if the taxpayer was subject to a normal income tax regime abroad but was not able to claim a deduction for the contributions in that country and/or such country taxed the accumulations currently. Taxation then occurred upon the building up of the pension rights. This reflects the current Dutch position.

5. Compatibility of emigration taxes with international and EC law

5.1. International law

The International Covenant on Civil and Political Rights; the Universal Declaration of Human Rights and the Fourth Protocol to the European Convention on

Human Rights all guarantee the freedom of movement and the free choice of residence in a country and forbid discrimination on several grounds, such as nationality.[65] While the right to emigrate is recognized as a fundamental human right, it is, however, not unrestricted. Countries may impose limits on this right in well-defined circumstances such as the protection of national security and public order.

There is no unanimity between the reporters about whether emigration taxes may infringe those provisions of international law. In the absence of any specific case law, one can only speculate on the outcome of court decisions. Very few cases are reported where taxpayers in the area of transfers of residence claimed that the tax imposed violated the above-mentioned provisions of international law. In most decisions the courts held against the taxpayer.[66] One notable exception, however, is a 1992 ruling of the French Administrative Supreme Court with respect to a lump-sum tax due by every resident of French Polynesia who wanted to leave the territory. Such tax was deemed to constitute an infringement on the mobility rights as guaranteed by the French Constitution, the Fourth Protocol to the ECHR and article 12 of the ICCPR, which was not justified by the exceptions laid down in these agreements.[67] In view of this decision, it cannot be ruled out that the recently introduced French limited exit tax will be regarded as conflicting with the quoted provisions.

5.2. EC law

Whether emigration taxes are compatible with EC law cannot be answered in general. A case-by-case analysis is needed. Such is not the purpose of this report. Based on the various branch reports, the report from Ms Malmer and the case law of the ECJ, the general report only wants to explore how courts in EC Member States and the ECJ may handle a case involving emigration taxes imposed on individuals. However, we will soon know the ECJ's views on this issue. Just before the finalization of the general report it was announced that for the first time the ECJ had been asked to issue a preliminary ruling on the compatibility of an emigration tax, i.e. the French limited exit tax on substantial shareholdings, with EC law.[68]

Against the background of the EC law framework in direct tax matters (as outlined in the report by Ms Malmer) the report addresses the following issues: (a) do emigration taxes restrict the freedoms enshrined in the EC Treaty? (b) If so, do they fulfil a legitimate aim that justifies such a restriction? (c) If so, is the restriction proportionate to that aim?

65 Arts. 12 and 26 International Covenant on Civil and Political Rights (ICCPR); art. 13 Universal Declaration of Human Rights; art. 2 Fourth Protocol to the European Convention on Human Rights (ECHR).

66 European Commission on Human Rights, Application no. 10653/83; Dutch Supreme Court, 13 November 1996, no. 30316; *Di Portanova* v. *US*, 690 F2d 169 (1982).

67 *Conseil d'Etat*, 9 November 1992, RFDA May–June 1993, 570.

68 *Conseil d'Etat*, 14 December 2001 (request on compatibility with art. 43 EC Treaty).

5.2.1. Do emigration taxes restrict the freedoms enshrined in the EC Treaty?

Articles 39, 43, 49 and 56 of the EC Treaty provide for the four fundamental economic freedoms, i.e. the free movement of workers, the freedom of establishment giving self-employed persons the right to establish a business in another Member State, the free rendering of services and the free movement of capital, all of which are to be guaranteed by the EC Member States without discrimination on the basis of nationality. As a result of the entering into force of the Agreement on the European Economic Area, all freedoms apply within the EC and the European Economic Area (for purposes of this report, in particular relevant to Norway). According to the settled case law of the ECJ, the non-discrimination principle in the field of direct taxation covers not only overt discrimination on the basis of nationality but also covert discrimination. Different treatment on the basis of other criteria than nationality (e.g. residency) causes covert discrimination if the application of such criteria results in a different tax treatment of a category of persons that mainly comprises foreign nationals. The ECJ has also construed the four freedoms as being so fundamental for the realization of the common market that they forbid the enactment of regulations that impede or render unattractive the exercise of any of such freedoms, even if such rules apply without regard to nationality. This prohibition is in practice of great importance to the Member State of origin of a resident of a Member State since it prevents this state from introducing measures, including tax regulations, that could restrict the individual in making use of e.g. his freedom to work as an employed person or to establish himself as a self-employed person in another Member State or could dissuade him from doing so.[69]

As the ECJ Attorney General pointed out, tax regulations imposed by a Member State that restrict the exit of taxpayers from that state enter into the scope of this prohibition.[70] It is clear that the imposition of emigration taxes by a Member State may significantly hamper the free movement of an individual resident in that Member State in connection with the use of his fundamental economic freedoms in another state and even cause the individual not to exercise such freedoms. Take the case of the promising young son/daughter of the manager of a French company owning him/herself a small stake in that company, but together with the family at least 25 per cent. It may be impossible for this child to be assigned to a managing function in the UK subsidiary because of the levy of the French exit tax or the costs involved in providing the necessary guarantees to obtain a preserving assessment. Is the French economy served by such a measure?

In order for an individual to claim protection under the EC Treaty, he should encounter a restrictive measure when making use of one of the four freedoms enshrined in the Treaty. There can be little doubt that the enactment of recaptures

[69] Case 81/87 (*Daily Mail & General Trust plc*), 1988, ECR I, 5483, §16. Confirmed in Case 415/93 (*Bosman*), 1995, ECR I, 4921, §§96–97; Case 264/96 (*ICI plc*), 1998, ECR I, 4695, §21; Case 18/95 (*Terhoeve*), 1999, ECR I, §§37–40; Case 200/98 (*XAB & YAB*), 1999, ECR I, 8261, §26; Case 251/98 (*Baars*), §28; Case 141/99 (*AMID*), §21.

[70] Case 264/96 (*ICI plc*), Opinion of A.G. Tesauro, §§15–18.

in the field of pension and group insurance schemes or of stock options will restrict the individual in the exercise of his freedom to work either as an employed or a self-employed person. The situation may be less clear in the case of the levy of an exit tax on shares. Although in the majority of Member States an exit tax is imposed on a substantial shareholder, the threshold for being subject to tax is extremely low (1 per cent to 5 per cent) and even a small shareholder can be regarded as a substantial shareholder if the shares owned by his family group are taken into account (e.g. France and the Netherlands). Moreover, exit taxes may be imposed on non-active shareholders, i.e. shareholders not performing managerial duties in or not employed by the company. The freedom of establishment laid down in article 43 EC Treaty requires the actual performance of a cross-border activity by means of a permanent establishment in another Member State. In a recent case the ECJ held that the mere ownership of a substantial shareholding in the meaning of Dutch tax law does not as such enter into the ambit of article 43, but where the shareholding entitles the shareholder to control or manage a company resident of another Member State, the shareholder is protected by article 43.[71] In another case the ECJ held that an active director living in one Member State and who was the sole shareholder of a company established in another Member State is a self-employed person who makes use of his freedom of establishment.[72] It seems to result from that case law that, even in the absence of the exercise of management and control functions or employment in the company, the ECJ has not ruled out the possible application of other freedoms and in particular the free movement of capital. However, it is questionable whether the assessment of an exit tax on shareholdings, even in a company not resident in the Member State where the shareholder resides, restricts the free movement of capital. It is believed that not the capital movement, but rather the shareholder himself, is hampered. Although the ECJ has not rendered an opinion on this issue in a tax case, a lot of the remaining uncertainty as to whether the individual is protected by the EC Treaty if it is not clear whether he transfers his residence in connection with the exercise of one of the fundamental economic freedoms now seems to be removed by the introduction of the notion of citizenship of the European Union by article 17 of the EC Treaty. Citizens of the Union enjoy the right to move and reside freely within the territory of the Member States, subject to limitations and conditions laid down in the Treaty and by measures adopted to give it effect (article 18 EC Treaty). Accordingly, it is suggested that one can reasonably expect that the ECJ will accord Treaty protection to a citizen of the Union transferring his residency from one Member State to another without making use of one of the four economic freedoms.[73] The question then arises as to whether the ECJ will allow such protection only in the case of discrimination on the basis of nationality – as it did in a recent case[74] – or also where

[71] Case 251/98 (*Baars*), §§20–22, quoted in footnote 71.

[72] Case 107/94 (*Asscher*), 1996, ECR I, 3089, §§24–29.

[73] Indirectly confirmed in the joint Cases 64 and 65/96 (*Uecker & Jacquet*), 1997, ECR I, 3171, §§17 and 23 where the ECJ denied Treaty protection in a case not involving the use of the fundamental economic freedoms, nor a transfer of residence.

[74] Case 85/96 (*Martinez Sala*), 1998, ECR I, 2691, §63 (discrimination on basis of nationality). The subsequent Case 135/99 (*Elsen*), §34, however, seems to suggest that discrimination of per-

the right to move and reside freely within the EU is restricted as such. This question is relevant since in many instances emigration taxes are imposed regardless of the nationality of the taxpayer.

Based on the ECJ decision in the *Werner* case and a holding of the Dutch Supreme Court according to which EC law is not applicable in a purely domestic tax case all relevant aspects of which take place in one Member State,[75] the Dutch branch reporter has expressed his concern that courts in Member States and the ECJ itself may decide that emigration taxes do not fall within the scope of the EC Treaty because they are imposed while the taxpayer is still resident in that Member State and they capture in the majority of cases nationals of such Member State holding shares in companies resident in the same state. It is for a number of reasons not certain whether this concern is still justified. Since the *Werner* decision ECJ case law has further developed: the decisions according to which the EC Treaty articles on fundamental freedoms not only prohibit discrimination, but also the application of restrictive tax regulations that could impede the use of such freedoms illustrate this evolution. Meanwhile, the freedom of moving and taking up residence within the EU has been enshrined in the EC Treaty. Emigration taxes are by their very nature measures that impede the right to move freely within the European Union or Economic Area.

5.2.2. Do emigration taxes fulfil a legitimate aim able to justify such restrictions?

Exit taxes on substantial shareholdings are usually justified as measures that prevent tax avoidance. They also constitute tools for the protection of a latent tax claim on gains that have accrued up to the transfer of residence. Except in Austria, they are imposed without regard to whether the emigration country loses its taxing rights after emigration and they apply generally, i.e. to all taxpayers moving out of a Member State, regardless of their underlying motives. As a result, exit taxes rest on the presumption of tax avoidance or evasion and do not allow for counterproof by the taxpayer. Do the purposes behind such taxes justify the restrictions to the Treaty freedoms?

A limited number of justifications are codified in the EC Treaty itself. A second set of justifications has been developed by the ECJ case law.

The Treaty only allows impediments to the four fundamental economic freedoms through discriminatory provisions on the basis of nationality if they are justified on grounds of public policy, public security or public health. Because exceptions need to be construed restrictively, it is unlikely that measures against tax avoidance are captured by these justifications. If a taxpayer faces the levy of an exit tax in connection with the exercise of the free movement of capital, the two

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sons having moved from one Member State to another against those who have not moved is as such sufficient.

75 Case 112/91 (*Werner*), 1993, ECR I, 429; *Hoge Raad*, 13 November 1996, BNB 1997/54. It has been inferred from the *Werner* decision that a Member State may discriminate against its own nationals.

justifications laid down in article 58 §1 of the Treaty become relevant. First, the free movement of capital does not preclude a Member State from treating taxpayers differently on the basis of their residence or the place where they invest their capital. This may be important for French and German exit taxes that are imposed only on shareholdings in domestic corporations. However, the ECJ has made it clear that such different treatment cannot be a wildcard for arbitrary discriminations or disguised restrictions on the movement of capital and that any justification for such a different treatment should be proportionate to the goal to be achieved.[76] This "proportionality" test is discussed in section 5.2.3. Secondly, the free movement of capital does not limit the right of the Member States to take all necessary measures to avoid tax fraud. Again, such measures may not lead to arbitrary discriminations or disguised restrictions and should also be proportionate. It is in the current state of the ECJ case law unclear whether restrictions to the free movement based merely on EU citizenship can be justified at all.[77]

Further, the ECJ developed its so-called "rule of reason" according to which non-discriminatory obstacles to the freedoms may be justified on grounds not referred to in the Treaty termed as "overriding reasons of general interest". In tax cases Member States have advanced various general justifications that allegedly enter into this definition. However, the ECJ appears to be very reluctant to accept such justifications. It has e.g. rejected the following justifications: the need, in the absence of tax harmonization, to take account of differences between the national tax rules; the fact that the discrimination or restriction could have been avoided by undertaking another action; the protection of tax revenues and other budgetary reasons requiring the introduction of compensatory tax arrangements; the risk of tax avoidance or fraud. With respect to the latter, the Court has emphasized that Member States cannot enact general anti-avoidance measures whereby predetermined criteria are applied, but that they must subject each case to a general examination that must be open to judicial review.[78] This leads to the conclusion that many of the likely justifications for the assessment of exit taxes may not hold. Hence, a decision of the BundesFinanzHof according to which the German exit tax does not contravene the EC Treaty freedoms because it is the only way in which Germany can protect the tax claims that it has forgone under its DTCs is highly questionable.[79]

In direct tax matters so far the ECJ has only been prepared to include two justifications within its "rule of reason" doctrine, i.e. (a) ensuring the efficiency of tax audits and (b) the coherence of the tax system (fiscal cohesion).[80] Coherence of the tax system has been accepted in the *Bachmann* case if the purpose of tax regulations is to ensure in relation to the same taxpayer the symmetry between, on the

[76] Case 35/98 (*Verkooijen*), 2000, ECR I, 4071, §44.

[77] Case 85/96 (*Martinez Sala*), 1998, ECR I, 2641, §64 seems to suggest that no justification based on the "rule of reason" is acceptable.

[78] Case 28/95 (*Leur-Bloem*), 1997, ECR I, 4161, §§41–44; Case 264/96 (*ICI plc*), §26, quoted in footnote 69.

[79] BFH, 17 December 1997, I B 108/97, BStBl. II 1998, S. 558.

[80] Case 250/95 (*Futura*), 1997, ECR I, 2471, §§26 and 31; Case 204/90 (*Bachmann*), 1992, ECR I, 249, §§21–23.

one hand, taxing rights exercised over certain payments and, on the other hand, deductions and reliefs granted during the period of residence.

Upon closer analysis of the ECJ case law, it is difficult to see how a Member State can rely on either of these two justifications in the case of exit taxes. First, the levy of such taxes is by no means a measure that aims at ensuring that tax audits are carried out in an efficient way. Secondly, in the *Wielockx* case the ECJ held that a Member State could not rely on the principle of fiscal cohesion where pursuant to a DTC the country of former residence, which had once granted tax relief for pension contributions, had given up its taxing rights in favour of the immigration country at the time the pension was paid out. In such circumstances, as the ECJ put it, fiscal cohesion is not established in relation to one and the same person by a strict correlation between deduction and taxation – as was the case where it upheld the coherence – but shifted to another level, i.e. that of reciprocity of the rules applicable between the two contracting states under a DTC.[81] In the case of capital gains taxation, there is no stated principle of international tax law that Member States are entitled to tax those gains that accrued while the individual was resident there. Under the majority of DTCs (i.e. those including an article 13(4) OECD model clause) Member States have given up their taxing rights on gains, including those that accrued until the date of emigration, to the country of new residence and the right given up is not a certain and established right. On the other hand, Member States are compensated because they can tax all gains, including pre-immigration gains, if a person takes up residence in such states. An argument on the basis of fiscal cohesion could, however, be more successful if the capital gains tax system is symmetric and the Member State levying the exit tax on an emigrant taxpayer also grants a step-up in basis to the relevant assets of an immigrant. This is only the case under the Danish, Austrian and (conditional) Dutch regimes.

The unlimited extended tax liability in e.g. Finland, Sweden, Spain and Italy and the limited extended tax liability in Germany capture essentially nationals of that country. As such tax liabilities are based on an extension of the residence or territoriality principle they result in nationals/emigrants of those countries being taxed more heavily than non-nationals/emigrants. They are justified as being anti-avoidance measures that also aim at compensating for the low tax paid abroad. The compatibility of such rules with the Treaty freedoms may be questioned under the ECJ case law.[82] The discussion is, however, probably rather academic. The German, Spanish and Italian rules apply only in the case of emigration to low-tax countries. Only very few low-tax countries (e.g. Gibraltar) formally fall within the EU territorial scope for income taxes. The Finnish and Swedish rules are only applicable if permitted by DTC. Both countries have entered into very few DTCs with Member States allowing such taxation (e.g. Finland three DTCs).

Recaptures in the area of pensions and group insurance seem to serve the double goal of functioning as an anti-avoidance measure in the case of emigration to a country that has a favourable tax regime for the pertinent income and making up

81 Case 80/94 (*Wielockx*), 1995, ECR I, 2493, §§25 and 26.

82 E.g. Case 107/94 (*Asscher*), 1996, ECR I, 3089; Case 294/97 (*Eurowings*), 1999, ECR I, 7447, §§43–44.

for the earlier deductions granted by a Member State on the understanding that this state would be allowed to tax the future receipts. As to the first justification reference is made to our comments on exit taxes. Whether the second purpose will be sufficient to justify a restriction of the Treaty freedoms is uncertain. It is true that it reflects the coherence principle accepted by the ECJ in its *Bachmann* decision. However, as mentioned above, the ECJ considerably limited the importance of that principle in its subsequent *Wielockx* decision. Two out of three Member States applying Recaptures (i.e. Belgium and the Netherlands) have in the majority of their DTCs agreed that the country of residence imposes tax on the receipts under pension and group insurance schemes. It cannot be excluded that the ECJ would hold that in such circumstances the fiscal cohesion was shifted to that of the reciprocity of the rules applicable between the Treaty partners. It remains to be seen whether the recent introduction of the step-up in basis for certain non-Dutch pension schemes will constitute a sufficient argument to underscore the coherence of the Dutch tax system.

5.2.3. If emigration taxes fulfil a legitimate aim, is the resulting restriction proportionate to that aim?

In the area of tax avoidance the ECJ takes a very strict look at the proportionality of the anti-avoidance measures. Such measures may not go beyond what is necessary for preventing the tax avoidance or fraud that they aim to combat.[83]

All countries (except Austria) levy an exit tax also in cases where they have retained their taxing rights (e.g. under a DTC with Member States containing a clawback clause, which is typical for Dutch DTCs, or an article 13(5) UN model clause in some French DTCs). Such an overkill effect makes the exit tax vulnerable under EC law. This risk of conflict is further increased if no measures have been taken to avoid the resulting double taxation (e.g. Germany and Austria). In the EC, exit taxes take the form of either a charge payable upon departure (Germany), a preserving assessment during a certain time period provided proper security is offered (the Netherlands and France) or a deferral until actual realization of the shares (Denmark and Austria). It is clear that the first type of exit tax may not pass the proportionality test. They may even force the taxpayer to sell the shares in order to pay the tax bill. Whether preserving assessments will pass that test is less clear. The *Denkavit* case seems to leave room for such arrangements. However, upon closer analysis there seems to be a significant difference between the facts underlying the *Denkavit* case[84] and those underlying the Dutch and French exit tax. Indeed, the situation of an individual taxpayer subject to exit tax cannot be com-

[83] See cases quoted in footnote 78.

[84] Joined Cases 283, 291 and 292/94 (*Denkavit et al.*), 1996, ECR I, 5063, §§33–35. The case involved the payment of a dividend by a subsidiary to its parent at the time the two-year holding period for obtaining the exemption of withholding tax was not yet met. At stake was the appropriate security arrangement for ensuring that the exemption was not unduly granted. The ECJ did not rule out an immediate exemption guaranteed by the posting of adequate security by the subsidiary.

pared to the multinational group of companies that is required to provide a guarantee when a dividend is actually distributed. Providing proper security at a time when an individual has not realized income from the assets that are subject to exit tax may be very cumbersome and costly and thus restrict free mobility, in particular if the shares themselves do not qualify as security (as is sometimes the case in France) because monies or other assets will be frozen for five/ten years and, in the case of the French recapture on shares (see section 3.5.1), even during the entire life of the emigrated taxpayer. If one of the purposes of the preserving assessment is to guarantee the payment of a potential future tax (as e.g. in France and the Netherlands) it may be difficult to defend these measures. In this respect special consideration should be given to the fact that Member States have at their disposal two sets of rules designed to permit them to levy the correct amount of taxes, to combat tax avoidance and evasion across the geographical borders and to recover income taxes within the EC.[85] The ECJ has repeatedly referred to such secondary bodies of Community law where Member States have advanced the risk of fraud as a justification for discriminatory or restrictive measures.

However, in determining whether a measure is proportionate in each case an "all facts and circumstances" test should be undertaken. Therefore the following issues need to be addressed. (a) Does the emigration country give appropriate relief for double taxation via reverse credit (such as under the Dutch, French and Danish exit tax)? (b) Do its DTCs provide that the immigration country shall give such relief by way of a step-up or credit (for exit tax: certain Danish and German DTCs)? (c) Does the emigration country allow a postponement of payment of the exit tax until actual realization of the assets (Denmark and Austria)? (d) Does it provide for an offsetting of accrued losses against accrued gains on emigration? (e) Does it take into account a decrease in value after emigration (Denmark, France and the Netherlands)? (f) Does it provide for a reduction of the preserving assessment with the amount of the withholding tax on dividends distributed during the period for which the assessment is imposed (the Netherlands)? (g) Is the exit tax system symmetric via a step-up in basis for immigrants (Austria, Denmark and, conditionally, the Netherlands)?

It results from the above that it is not possible to give a clear answer as to whether in general the emigration taxes are compatible with EC law. However, it seems that certain emigration taxes, or at least certain features of them, may have difficulties in passing the legitimacy and proportionality tests. Finally, if such taxes meet those tests it should further be analysed whether they comply with other secondary EC tax law. For instance, the question arises of whether the tax deferral provided for by the EC Merger Directive for shares received in a tax-free merger or division can be recaptured upon emigration of the shareholder (such as e.g. in Sweden, Finland and France) without violating the directive and in particular the provision according to which the shareholder may only be taxed upon subsequent alienation of the shares.[86]

[85] Directive 77/799 on mutual assistance in the field of direct taxation; Directive 2001/44 on mutual assistance for the recovery of tax claims (applicable as of mid-2002).

[86] Compare art. 8(2) with the Sixth Recital of the Merger Directive 90/434.

5.3. Conclusion

The threshold for impermissible incursions on mobility rights is much lower in the EC context than in the area of the above-mentioned international agreements. Hence, it is much more likely that emigration taxes may be held to infringe EC law rather than the international agreements. This is to be explained by the different purposes of these legal regimes. The international agreements aim at the harmonization of the domestic laws of the member states around a minimum standard of protection of human rights. The EC Treaty aims at the creation of a common market through mobility. The EU cannot afford to leave wide margins of discretion to its Member States to achieve real economic integration.