Foundation for
Family Businesses

# The reformed exit tax

## Economic, behavioural, constitutional and EU law aspects

# Summary of main results

## I. Reason for the reformed exit taxation

*The study in German language is available here:*

The most recent reform of exit taxation initiated by the Act Implementing the Anti-Tax Avoidance Directive (ATAD Implementation Act)[1] of 25 June 2021 was an extremely controversial political issue. It introduces a paradigm shift based on the elimination of the so-called perpetual deferral and treats all exit cases within the European Union in the same way as exit cases to so-called third countries.

There was no obligation under secondary law for a paradigm shift in exit taxation, as occurred with the exit tax reform as part of the ATAD implementation. The fact that the explanatory memorandum in the legislative documents suggests such an obligation is unacceptable on the basis of the rule of law.

## II. Overview of the reformed exit taxation

The reformed exit tax has considerably tightened the legal situation to the detriment of owners of shares in corporations. In many cases, exit taxation leads to dramatic restrictions on the mobility of shareholders, particularly those of owner-managed and family corporations.

Conceptually, legislators have equated the actual departure of a natural person (termination of residency) with two substitute facts. Systematically, the circumstances covered by exit taxation as a whole are a termination circumstance (Section 6, paragraph 1, sentence 1, no. 1 of the German External Tax Relations Act (ETRA), a transfer circumstance (Section 6, paragraph 1, sentence 1, no. 2 of the ETRA) and a restriction or exclusion circumstance (Section 6, paragraph 1, sentence 1, no. 3 of ETRA). In addition to the departure of a domestic taxable person, the gift or inheritance of shares in a company to a person living abroad is the most practically relevant case. In addition, there are substitute circumstances that were only partially expressly regulated in the past and that are now covered by a general catch-all provision "Exclusion or restriction of the right of taxation of the Federal Republic of Germany".

Even if the material scope of application of the reformed exit tax has not changed significantly compared with the previous legal situation, notable changes can be identified with regard to the personal scope of application of the exit tax. In the past, exit taxation applied if a shareholder had been subject to unlimited tax liability in Germany for a total of 10 years. This 10-year period could be added together over any length of time and with any number

1 Cf. BGBl. I 2021, 2056.

of interruptions. Under the reformed legal situation, it is sufficient to have had unlimited tax liability in Germany for at least seven years within the last 12 years. This is sometimes vividly and formulaically described as "7 out of 12". Depending on the situation, this material change can have both a favourable and an adverse effect in individual cases.

## III. Mitigation of legal consequences

The core component of the reformed exit taxation is the attempt to mitigate the legal impact of the statutory measures by means of an instalment payment concept and the so-called returnee regulation.

In contrast to the previous legal situation, the new regulation no longer differentiates between the country of destination when an individual relocates. In essence, the deferral rules that were previously applied only in third-country cases will be uniformly extended to EU/EEA cases. Under the reformed legal framework, the full amount of tax is generally due immediately upon departure or the triggering of one of the statutory substitute circumstances for all cases of departure. Taxpayers can apply for an instalment payment plan under which the total amount of tax due is divided into seven equal annual instalments. No interest is paid on the tax claim during this seven-year period. Under the new regulation, a security deposit is generally required for this. In the case of high hidden reserves and the resulting high deferred exit tax, this represents a considerable financial burden that can make the relocation appear to be unfeasible due to a lack of financing.

With the slightly modified returnee regulation regarding time periods, the exit tax is to be waived for a maximum of 12 years if the taxpayer is only "temporarily absent". If the intention to return is sufficiently substantiated, an initial seven-year period is granted. This period can also be extended by an additional five years. The continued existence of the intention to return is a prerequisite and should be substantiated by the temporarily absent taxpayer. At the request of the returnee, no annual instalments will be charged. A significant tightening of the situation is reflected by the fact that the previously de facto indefinite return regulation for EU/EEA migrants has been eliminated.

## IV. Compatibility of the reformed exit tax with higher-ranking law

It seems to be highly doubtful that the massive tightening of the rules introduced as part of the reformed exit tax will be permanent when these regulations are measured against higher-ranking law. First, from an EU law perspective, numerous new regulations introduced by the exit tax reform are hardly covered by the case law of the European Court of Justice. This is exemplified by the fact that, under ECJ case law, the provision of a security deposit is always a less harsh approach than instalment payments. However, legislators have simply ignored this aspect of European case law and are therefore wilfully facilitating the violation of EU law. The legislative documents themselves point out that, according to the ECJ, the pro rata deferral is "more costly" than a deferral until the company shares are sold.

On the other hand, certain case settlement effects of the reformed exit taxation in the area of the instalment payment concept and the returnee regulation can hardly be reconciled with the principle of proportionality guaranteed by EU law.

In addition, the reformed exit tax also raises considerable constitutional questions. Concerns have been expressed that violations of the ability-to-pay principle, the general principle of equality and the fundamental right to freedom of movement derived from the general freedom of action could occur.

## V. Proposals for lawmakers to consider

The current rules on exit taxation should be brought back into conformity with EU law and constitutionally and commercially sound conditions sooner rather than later. To this end, it would be necessary to restore the basic legal structures that were in place until 31 December 2021. Obvious evasive arrangements such as tax-free distributions abroad, so-called "devaluation models" or gift tax-free share donations, which in the past have facilitated tax losses that are contrary to the system and which, according to reports, have also initiated the reform of exit taxation, could be countered in a minimally invasive legislative manner. Regulations that are highly questionable in terms of EU and constitutional law would then be just as unnecessary as regulations that limit the economic freedom of the shareholder to an excessive extent.

Specifically, the reintroduction of the perpetual deferral in EU/EEA cases and in constellations in which a so-called "major information clause" is relevant on the basis of a double taxation agreement (DTA) is required. In DTA cases with a so-called "small information clause", deferral with a security deposit is a less harsh option. Stricter regulations could be justified only in DTA situations without any information clause and in non-DTA situations, for example in the form of the instalment payment concept with a security deposit that has now become law.

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