Client Information

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Drastic Tightening of Exit Tax planned – Draft of ATAD-Implementation Act –

On 10 December 2019, the Federal Ministry of Finance published a draft bill for a law to implement the Anti Tax Avoidance Directive (*ATAD-Umsetzungsgesetz - ATADUmsG*). This represents the first step in the implementation of the EU's ATAD-I Directive as part of the BEPS project (Base Erosion and Profit Shifting) of the OECD into national law.

In addition to the implementation of Art. 9 and 9b of the Directive (hybrid structures) and a reform of the controlled foreign corporation (CFC) rules, the draft bill provides for drastic tightening of the so-called exit tax (sec. 6 AStG - German Foreign Tax Act) in EU/EEA matters, although this is not affected by the ATAD I Directive. After the legislative procedure has been completed, the stricter requirements are to take effect with retroactive effect from 1 January 2020. However, the draft is still in the process of coordination within the government and a cabinet decision to start the official legislative procedure is still pending.

1. General Information on German Exit Tax

When a shareholder moves abroad, sec. 6 AStG subjects hidden reserves of an investment of at least 1% of a corporation's capital (sec. 17 EStG – German Income Tax Act) to German taxation, deeming a sale of the share. Thus, Germany secures the right to tax the hidden reserves in privately held shares generated in corporations while the taxpayer is resident in Germany at the moment he moves abroad. This is because under most double taxation treaties (DTT), the state of residence has the right of taxation on the capital gain from the sale of privately held shares in a corporation (Art. 13 para. 5 OECD-MC), so that Germany loses the right of taxation in principle, when the taxpayer moves abroad. However, the provisions of sec. 6 AStG go beyond the purpose of a final taxation of the hidden reserves generated in Germany and display an excessive taxation tendency.

2. Personal Applicability of the Exit Tax

Legacy System

According to the current law, the taxpayer must have been subject to unlimited tax liability in Germany for at least 10 years – in the course of his entire life up to his exit – in order to be subject to the exit tax at all. The first time this 10-year period is exceeded, a "general" obligation to pay exit tax on any future departure is triggered.

Future System according to the Draft Bill

The draft bill provides for a reduction of the period of unlimited tax liability required before the exit from 10 to 7 years. This means that taxpayers moving to Germany will in the future be subject to exit tax three years earlier. On the other hand, not all times of German tax residency during the entire life are necessarily taken into account any more: In the future, only the last 12 years are being looked at, of which the taxpayer must have been resident in Germany for at least 7 years. Time years are decisive, not calendar years.

3. Abolition of unlimited Deferment when moving to another EU/EEA Country

Legacy System

When moving to another member state of the EU or EEA, under current law, an unlimited, interest-free and unsecured deferment of the exit tax triggered by the move is granted automatically, as long as the taxpayer continued to hold his shares.

Future System according to the Draft Bill

The draft bill no longer provides for a permanent deferment of the exit tax. Instead, the exit tax will be payable in 7 equal annual installments when moving within or outside the EU or EEA. Even the payment in installments will only be granted upon application; however, no interest will have to be paid on the installments.

Considering the ECJ ruling in the *Wächtler* case on 26 February 2019, we do not consider the abolition of the deferral in EU/EEA cases to be consistent with European law. The legislator also explicitly addresses tis contradiction in the explanatory statement to the law, but refers to other, older ECJ rulings ("should ... nevertheless be compatible with EU law").

As a positive development, it should be noted that, for the first time, the possibility of extending the payment to 7 equal, non-interest-bearing annual instalments without any preconditions in the case of departures to non-EU/EEA countries is introduced.

4. Temporary Abscence („Returnee Provision“)

Legacy System

The exit tax is omitted with retroactive effect if the taxpayer is only temporarily absent (with well documented intention to return at the time of departure!) and re-establishes unlimited tax liability in Germany within 5 years after the exit. An extension of this period to a total of 10 years is possible if the taxpayer can plausibly demonstrate that his absence has professional reasons and his intention to return remains unchanged.

Future System according to the Draft Bill

These rules regarding the return of taxpayers are planned to be upheld in principle, but the period will be extended from 5 to 7 years. An extension by an additional 5 years up to a total of 12 years will also be possible, whereby only the continued intention to return is required; the existence of professional reasons will no longer be necessary. Upon application of the returnee, annual installments will not be levied.

According to the explanatory statement to the law, it will not be necessary in the future to substantiate the intention to return. However, considering the unchanged wording of the bill and the partly contradictory explanatory statement, it seems likely that the tax authorities will continue to demand for the intention to return to be existent at the time of departure. Therefore, it is urgently recommended that people who have left the country continue to document such an intention in the future if they wish to benefit from the retrospective omission of the exit tax when they return later.

If a deferment is applied for at the same time under which these returnee provisions apply, no installments are due for the entire deferral period until the taxpayer returns to Germany. This combination is therefore recommended.

5. Abolition of Deferment

The draft law includes stricter rules with regard to those cases that trigger the elimination of the deferment of the exit tax. Already under current law, the gift of the taxpayer's shares in a corporation to a non-resident person could lead to the revocation of the tax deferment (sec. 6 para. 5 sentence 4 no. 2 AStG). According to the draft bill, however, any "transfer" that is not made by reason of death is to be detrimental to the deferment, regardless of whether the recipient of the gift is resident in Germany or abroad. However, it cannot be right, that even a gift to a person resident in Germany should lead to the revocation of the deferment. Another planned tightening is a regulation according to which in future profit distributions or deposit repayments from the corporation with a volume of at least 25% of the value of the taxpayer's shares will trigger an immediate due date of the tax. This can lead to a (partial) "lock-up" of assets in the company, which should definitely be taken into account when planning to move away.

6. Collateral Security

Legacy System

According to current law, collateral security for the deferred exit tax only has to be provided to the tax office by a taxpayer who is moving to a country outside the EU/EEA.

Future System according to the Draft Bill

The new draft bill law no longer differentiates between moves to third countries and moves to EU/EEA countries - to the detriment of taxpayers who wish to move within the EU/EEA. In the future, for all relocations - also within the EU/EEA – collateral security must, as a general rule, be provided for a deferment, normally for seven years, but for a maximum of 12 years in cases of a temporary abscence. This will be an impossible obstacle for many taxpayers when applying for the seven-year installment payment, even when moving within the EU/EEA. This is because in the opinion of the tax authorities, at least in some federal states, the shares of the corporation subject to the exit tax cannot be accepted as collateral security for said tax. If the taxpayer does not have valuable German real estate or federal treasury bonds at his disposal, the exit tax could become due immediately in the future, even in the case of EU/EEA movers.

There are good reasons, however, to take the view that in the future, tax authorities will have to exercise their discretion in demanding a collateral security ("as a general rule") in accordance to the freedom of capital movement and freedom of establishment in a way that no such security can be demanded within the EU/EEA. This is because the EU Recovery Directive applies in this respect, so there is no risk to German tax revenue. Nevertheless, in the majority of future cases this will probably only be enforceable in remedy proceedings.

7. Conclusion

Many of the regulations proposed in the draft bill, especially the conditions for deferment and the circumstances for its revocation, are excessively restrictive. The free movement of capital and the freedom of establishment within the EU and the EEA would be significantly more restricted by the planned new regulations than it is currently the case. Furthermore, the question arises as to whether the planned new regulations on tax deferment are consistent with the constitutional requirement of taxation according to financial ability. Hopefully, the legislator will improve the draft bill in this respect. Since, according to the draft bill, the implementation act will take effect retroactively as of January 1st 2020, taxpayers with specific plans to leave the country in 2020 or 2021 should seek legal advice on this matter as soon as possible.

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