3.3. EU Merger Directive

3.3.1. Background and force

3.3.1.1. Force

Original directive

The original form of the Merger Directive regulated the tax treatment of mergers, divisions, transfers of assets and exchanges of shares between companies of different EU Member States. [762] Member States had to bring into force the laws, regulations and administrative provisions necessary to comply with the directive no later than 1 January 1992. [763]

Amendment

In 2005, the scope of application of the Merger Directive was extended to cover partial divisions and the transfers of the registered office or a European Company (SE) or a European Cooperative Society (SCE). [764] The provisions concerning the transfers of the registered office had to be implemented under the domestic laws of the Member States no later than 1 January 2006 and the other provisions no later than 1 January 2007.

Codification

In 2009 the Merger Directive and its amendments were codified in Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States. This codified version of the Merger Directive repealed the original version of the Merger Directive with the amendments made to it. [765]

Transitional rules

The Merger Directive does not include transitional rules that would apply only to certain Member States. The directive has bound the old Member States since it entered into force and the new Member States from the date of their accession to the European Union.

3.3.1.2. Relevance of the directive

Objective

The objective of the Merger Directive is to abolish tax obstacles on cross-border company reorganizations in the European Union. The directive seeks to ensure that the Member States do not restrict the cross-border company reorganizations covered by the directive by tax restrictions, disadvantages or distortions. The company reorganizations covered by the directive should be tax neutral in the same way as pure domestic reorganizations usually are. [766]

Tax deferral

The company reorganizations covered by the directive must not cause immediate direct tax consequences to the companies and their shareholders participating in a company reorganization. The possible value increases related to a company reorganization may be taxed but only when they are realized. [767] A company reorganization covered by the directive does not trigger taxation of unrealized capital gains. The taxation is deferred to the moment at which the assets will be retransferred. [768] Taxes not covered by the directive, such as transfer taxes, however, may be levied already at the moment of a re-organization covered by the directive. [769]

3.3.2. Scope of application

3.3.2.1. Reorganizations covered

Possible reorganizations

Art. 1 of the Merger Directive lists the types of the reorganizations covered by the directive. These include mergers, divisions, partial divisions, transfers of assets and exchanges of shares in which companies from two or more Member States are involved. Also, the transfer of the registered office from one Member State to another Member State of European Companies and European Cooperative Societies is covered. The detailed requirements for these reorganizations to be covered by the directive are determined in Art. 2 of the directive.

Cross-border reorganizations

Only cross-border intra-EU company reorganizations come under the scope of application of the Merger Directive. Reorganizations between companies of one Member State do not come under the scope of the directive where one of the companies involved has a permanent establishment in another Member State and where one of the companies has shareholders in another Member State. The scope of application of the Merger Directive in this

respect is different, for example, from the scope of application of the Interest-Royalty Directive. [770] Several Member State, however, have extended the tax principles based on the Merger Directive to also cover purely domestic reorganizations under their domestic law. [771] Also, the basic freedoms of the TFEU may require that similar tax benefits be available in the case of domestic reorganizations if the companies involved have permanent establishments in other Member States. [772]

EEA States

The Merger Directive does not apply to reorganizations with a party from a non-Member State. The freedom of establishment principle of the EEA Agreement, however, may require that tax benefits similar to the benefits available in domestic situations are made available also to reorganizations between a company from a Member State and from an EEA State outside the European Union, provided that the states concerned have concluded a comprehensive tax information exchange agreement. [773]

General definitions

Art. 2 of the Merger Directive defines certain terms used in the Directive. The term “transferring company” means the company transferring its assets and liabilities or transferring all or one or more branches of its activity. [774] The term “receiving company” means the company receiving the assets and liabilities or all or one or more branches of the activity of the transferring company. [775] The term “acquired company” means the company in which a holding is acquired by another company by means of an exchange of securities. [776] The term “acquiring company” means the company that acquires a holding by means of exchange of securities. [777]

3.3.2.2. Company from a Member State

Definition

Art. 3 of the Merger Directive defines when an entity is considered to be a company from a Member State covered by the directive. The definition is identical to the definition included in Art. 2 of the Parent-Subsidiary Directive.

The entity must be a company which

– takes one of the forms listed in the Annex to the Merger Directive;

– is considered to be a resident of a Member State for tax purposes according to the national laws of that state and is not considered to be a resident for tax purposes outside the European Union under the terms of a tax treaty with a non-Member State; and

– is subject to one of the taxes listed in the Merger Directive or to any other tax which may be substituted for any of the expressly mentioned taxes, without the possibility of an option or of being exempt.

All three criteria mentioned above must be met simultaneously. It is sufficient, however, that each of the criteria is met in one Member State. It is not required that all the criteria are met in one Member State. [778]

Entity form

Typically, private and public companies limited by shares of different Member States come under the scope of application of the Merger Directive. [779] Also, European Companies (SEs) and European Cooperative Societies (SCEs) come under the scope of the directive; [780] otherwise, it depends on the Member State concerned which entity forms are covered.

In the case of some Member States, the Annex to the Merger Directive includes an expressive list of all the national entity forms covered. For example, national cooperative society forms may be included in the list of some Member States but not in the lists of all Member States. [781] National partnership forms are usually not included in the list and in most situations they would already fall outside the scope of the directive because they are not separately taxable entities.

Some Member States have not included an express list of all possible national entity forms in the Annex to the directive but they have determined broadly that all national company forms incorporated under the law of the state concerned come under the scope of the directive, provided that the other two criteria set forth in Art. 3 of the directive are met. This type of broad formulation is practical because it is less probable that this formulation leads to a treatment in conflict with the freedom of establishment principle than does the formulation including a list of the different national entity forms covered. It is possible that an express list of national entity forms covered excludes an entity that is to an extent similar to the entity forms covered that the entity must be subject to the tax benefits similar to the benefits of the directive in order for its tax treatment not to be in conflict with the freedom of

establishment principle. [782] However, a broad and general determination of the entities covered may be problematic in the way that it may lead to a conflict, if the states concerned interpret the term company differently.

Tax liability

Even if a company would take one of the entity forms covered by the Merger Directive it comes under the scope of the directive only if it is subject to one of the taxes listed in the directive (or to any other tax which may be substituted for any of the expressly mentioned taxes) without the possibility of an option or of being exempt. The taxes listed cover different income taxes and corporate taxes of the Member States. Transfer taxes, however, are not covered by the Merger Directive. [783]

Tax-exempt entities do not come under the scope of the directive even if they would take a form covered by the directive. Also, entities that can choose whether to be treated as an exempt entity or not fall outside of the scope of the directive.

Different partnership forms that are not treated as separately taxable entities also fall outside of the scope of the directive. However, hybrid entity forms that are treated as a separately taxable entity in one Member State but as a transparent entity in another Member State may come under the scope of the directive.

Because the directive does not set any limit for the required tax, also companies established in low-tax states come under the scope of the directive. It is, however, somewhat unclear as to what extent partially tax-exempt entities may come under the scope of application of the directive. [784]

Tax residence

The application of the Merger Directive requires that the tax residence of the company is in a Member State according to the tax laws of that state.The tax residence of the company must not be outside the European Union according to a tax treaty concluded with a non-Member State. Such a dual-residence conflict situation may emerge, for example, if the place of management of a company established and registered under the laws of a Member State is situated in a non-Member State that treats the company as a tax resident because of the place of management. These types of dual-residence companies are left outside the scope of the directive for anti-avoidance reasons.

Dual-resident companies with their tax residence in two different EU Member States come under the scope of the directive even if there would be a tax treaty between the two states concerned. Also, dual-resident companies with their tax residence in a Member State and in a non-Member State come under the scope of the directive if there is no tax treaty between the states concerned. These types of dual-residence companies are not problematic from anti-avoidance reasons because there is no tax treaty that would prevent an EU Member State from taxing the profits of the company.

From the tax treatment perspective, the scope of application of the Merger Directive also covers dual-resident companies with the state of residence in one of the EU Member States and in a non-Member tax treaty state, if the tax treaty resolves the dual-residence conflict in favour of the EU Member State. In many cases, this type of conflict may emerge if the place of management of the company is in the EU Member State and the company is established and registered under the law of the other state. In such a situation, the company, however, falls outside of the scope of application of the directive because the foreign entity form is not covered by the directive.

3.3.2.3. Merger

Company law

Cross-border mergers have been possible since 8 October 2004, when it became possible to form a European Company by a merger of companies from different Member States. [785] From the mentioned date the Merger Directive tax provisions concerning cross-border mergers have had practical relevance. [786] Cross-border mergers involving other types of companies of different Member States became possible on 15 December 2007. Until this date the Member States had to implement the requirements of the EU company law directive on cross-border mergers into their domestic laws. [787] A merger can be used, for example, to change a subsidiary structure to a branch structure or to transfer a company's residence to another Member State.

Definition

Art. 2a of the Merger Directive defines the mergers covered by the directive. The term "merger" covers three types of company reorganizations. A company may merge into an existing company or into a new company established in connection with the merger or a subsidiary may merge into its parent company.

Merger with an existing company

The provisions of the Merger Directive concerning a merger apply to an operation whereby one or more companies covered by the directive (merging company) on being dissolved without going into liquidation transfers all their assets and liabilities to another existing company (receiving company).

The merging company must give to its shareholders securities representing the capital of the receiving company in exchange. The consideration may also include a cash payment not exceeding 10% of the nominal value of the securities or, in the absence of a nominal value, 10% of the accounting par value of the securities. Other consideration, except the securities and cash payment, must not be used.

Merger into a new company

The types of mergers covered by the Merger Directive include an operation whereby two or more companies covered by the directive (merging companies), on being dissolved without going into liquidation, transfer all their assets and liabilities to a company that they form (receiving company). This operation may be used, for example, in order to establish a new European Company.

The merging company must give to its shareholders securities representing the capital of the receiving company in exchange. The consideration may include a cash payment not exceeding 10% of the nominal value of the securities or, in the absence of a nominal value, 10% of the accounting par value of the securities. Other consideration, except the securities and cash payment, must not be used.

Consideration

The Merger Directive does not require that the securities used as consideration be new but they may be securities that existed before the operation. Under domestic law it is possible to extend the scope of the directive benefits to also cover arrangements in which no consideration is paid. [788] The Merger Directive is not clear on the question whether the cash consideration should be given pro rata to the shareholdings. [789]

Subsidiary merger

The third type of merger covered by the Merger Directive concerns an operation whereby a subsidiary merges into its parent company. This is an operation whereby a company covered by the directive (merging company), on being dissolved without going into liquidation, transfers all its assets and liabilities to the company holding all the securities representing its capital (receiving company).

Consideration

No consideration is required in the case of a subsidiary merging into its parent company. No consideration is needed because the receiving company holds 100% of the shares in the merging company.

When a wholly owned subsidiary of a parent company merges into the parent company, the receiving parent company receives all assets of the merging subsidiary and the merging subsidiary ceases to exist.

Shareholders

The Merger Directive does not set any requirements as to the shareholders of the merging company. The shareholders may be natural or legal persons and they may be residents in any state.

3.3.2.4. Division

Background

Originally, the Merger Directive covered only complete divisions but not partial divisions. A partial division, in which the transferring company is not dissolved, was not possible without immediate tax consequences unless a tax-neutral partial division was made possible under domestic law. This deficiency was removed by Directive 2005/19/EC, according to which a new provision on tax-neutral partial divisions had to be implemented under the domestic laws of Member States no later than 1 January 2007.

Company law

Despite the tax provisions of the Merger Directive, the lack of Union-level company law on divisions has meant an obstacle to cross-border divisions. The basic freedoms of the TFEU, however, may be interpreted to require that

intra-EU cross-border divisions are allowed in Member States to the same extent as pure domestic divisions are allowed. [790]

Definition

Art. 2(b) and (c) of the Merger Directive defines what is meant by the terms “division” and “partial division” used in the directive. The directive covers both partial and complete divisions.

Complete division

A complete division is an operation whereby a company covered by the directive (transferring company), on being dissolved without going into liquidation, transfers all its assets and liabilities to two or more existing or new companies covered by the directive (receiving company).

In exchange, the transferring company issues securities representing the capital of the receiving companies pro rata to its shareholders. Also, a cash payment may be used, provided that it does not exceed 10% of the nominal value of the securities or, in the absence of a nominal value, of the accounting par value of the securities.

Partial division

Partial division means an operation whereby a company covered by the directive (transferring company) transfers, without being dissolved, one or more branch of activity to one or more existing or new companies covered by the directive (receiving company). The transferring company must leave at least one branch of activity in the transferring company.

The transferring company must give pro rata to its shareholders securities representing the capital of the receiving companies in exchange. The consideration may include a cash payment not exceeding 10% of the nominal value of the securities or, in the absence of a nominal value, 10% of the accounting par value of the securities. Other consideration, except the securities and cash, may not be used.

Recipient of the consideration

The Merger Directive provisions on partial divisions do not apply to a situation in which the receiving company issues its new shares to the transferring company. The partial divisions covered by the directive are an operation where the consideration is given to the shareholders of the transferring company. The situation in which the consideration is paid to the company transferring its branch of activity instead falls under the scope of the Merger Directive provisions on a transfer of assets.

The Merger Directive does not set any requirements as to the shareholders of the transferring company falling under the scope of the directive. The shareholders may be natural persons or entities taking any entity form and the shareholders may be residents in any state.

Consideration

The Merger Directive does not require that the shares issued in consideration should be new but shares which already existed before the reorganization also qualify as consideration. Even though the Merger Directive requires a pro rata issue of the shares to the shareholders, it seems to be in accordance with the directive to make agreements on the division of the voting powers. [791] The Merger Directive is not completely clear on whether a cash consideration must also be given pro rata to the shareholders. [792]

Branch of activity

According to Art. 2(j) of the Merger Directive, the term “branch of activity” means all the assets and liabilities of a division of a company which from an organizational point of view constitute an independent business, i.e. an entity capable of functioning by its own means. [793]

In addition to tangible assets, the assets included in a branch of activity also include intangible assets that are necessary for the functioning of the branch of activity. Also, for example, a foreign subsidiary may be a part of the assets of the transferred branch of activity. [794] The Merger Directive provisions on a division do not apply to a reorganization in which only assets are transferred without a transfer of the business.

Permanent establishments

The provisions of the Merger Directive on a division may apply even if the parties to the operation had permanent establishments in other states, provided that the parties are companies covered by the Merger Directive.

3.3.2.5. Transfer of assets

Company law

The company law prerequisites of a cross-border transfer of assets depend on the law of the state of the receiving company.

Definition

The term “transfer of assets” is defined in Art. 2(d) of the Merger Directive. The term means an operation whereby a company covered by the directive (transferring company) transfers, without being dissolved, all or one or more branches of its activity to another company covered by the directive (receiving company). The transferring company must receive in exchange for the transfer securities representing the capital of the company receiving the transfer. As a consequence of the transfer, the transferring company becomes a shareholder of the receiving company.

The transfer includes all the assets and liabilities connected with the branch of activity transferred and the reserves connected with the transferred business. The receiving company may be a new or existing company continuing the transferred business. The transfer of assets may be used, for example, in order to transfer a branch of activity to a company of another Member State.

Branch of activity

The assets and liabilities transferred in a transfer of assets must form a branch of activity. [795] The term “branch of activity” is defined in Art. 2(j) of the Merger Directive both for the purposes of transfers of assets and for the purposes of partial divisions. [796] The Merger Directive does not cover an operation in which only assets are transferred without a transfer of the business.

Often, the transferred branch of activity is in the state of residence of the transferring company but it may also be in the state of residence of the receiving company or in a third state. If the branch of activity is not situated in the state of residence of the receiving company, the transferred branch of activity will usually form a permanent establishment to the receiving company in the state in which the branch of activity is situated.

Consideration

The recipient of the consideration in a transfer of assets is the transferring company and not its shareholders as in a partial division. The transferring company becomes a shareholder of the receiving company. The Merger Directive does not require that the securities issued in consideration are new but also securities that existed before the operation qualify as consideration. Cash consideration cannot be used in the case of transfer of assets. [797] The directive is unclear on whether the securities used as a consideration must be valued at book value or at current value.

Permanent establishments

The Merger Directive may apply even if the parties of the operation had permanent establishments in other states, provided that the parties of the operation are companies covered by the directive. The transfer of assets may be used, for example, in order to transform a permanent establishment situated in another Member State to a subsidiary.

3.3.2.6. Exchange of shares

Definition

The type of exchange of shares that comes under the scope of application of the Merger Directive is defined in Art. 2(e) of the Merger Directive. Exchange of shares is an operation whereby a company covered by the directive (acquiring company) acquires a holding in the capital of another company covered by the directive (target company) such that it obtains a majority of the voting rights in that company. The directive also covers an operation whereby a company holding such a majority acquires a further holding. The acquiring company becomes a shareholder of the target company.

The acquiring company issues to the shareholders of the target company securities representing the capital of the acquiring company in exchange for their securities. A cash payment can also be used, provided that it does not exceed 10% of the nominal value or, in the absence of a nominal value, the accounting par value of the securities issued in exchange. The Merger Directive does not mention whether the consideration must be paid pro rata to the shareholding. [798]

Consideration

The Merger Directive does not require that the securities given to the shareholders should be newly issued but securities that existed before the operation can also be used as consideration. The Merger Directive does not mention the value that the acquiring company should give to the shares acquired.

Cash consideration

The concept of cash payment covers monetary payments having the characteristics of genuine consideration for the acquisition. These payments include payments agreed upon in a binding manner in addition to the allotment of securities representing the share capital of the acquiring company, irrespective of any reasons underlying the acquisition. [799]

A monetary payment made by an acquiring company to the shareholders of the acquired company cannot be classified as a cash payment merely because of a certain temporal or other type of link to the acquisition, or possible fraudulent intent. It is necessary to ascertain in each case, having regard to the circumstances as a whole, whether the payment concerned has the characteristics of binding consideration for the acquisition. [800]

Parties

The Merger Directive applies provided that the parties to the operation are companies of two different Member States that qualify as companies for the purposes of the directive. It is irrelevant whether or not the companies conduct business. [801] The directive may apply even though the parties to the operation would have permanent establishments in other states as long as the parties are companies covered by the directive.

Under domestic law or practice, Member States may also apply the provisions based on the Merger Directive in a situation in which both the acquiring company and the target company are from the same Member State, if the shareholder of the target company is from another state. [802]

Shareholders

The Merger Directive does not set any requirements for the shareholders that exchange their shares to come under the scope of the directive. The shareholders may be individuals or legal persons taking any form. The shareholders may be residents in any state. The Merger Directive provisions on exchanges of shares apply no matter if the shareholder is a resident of another Member State or of a non-Member State. Only a resident of a Member State, however, benefits from the directive's tax benefits. [803]

3.3.3. Tax treatment of mergers, divisions and transfers of assets

3.3.3.1. Applicable provisions

Minimum requirements

The Merger Directive sets the minimum requirements for the tax treatment of the operations covered by the directive. The detailed provisions on the tax treatment of the operations covered by the directive depend on the domestic law implementation provisions of each Member State.

Basic principles

The same taxation principles apply to the mergers, divisions and exchanges of shares covered by the Merger Directive. These principles are expressed in Arts. 4-8 of the Merger Directive. Because of its nature, Art. 4 of the Merger Directive, however, does not apply to exchanges of shares in which no assets are transferred but only the ownership of the securities is changed.

Transfer of assets

Only the principles expressed in Arts. 4, 5 and 6 apply to transfers of assets. [804] This limitation is due to the fact that a transfer of assets is an operation between two companies and not an operation between a company and its shareholders, for which the operation does not have direct tax effects on the shareholders.

Transfer of a permanent establishment

Art. 10 of the Merger Directive concerns the tax consequences related to the transfer of a permanent establishment in connection with a merger, division or a transfer of assets. Because of its nature, the provision does not apply to exchanges of shares in which assets are not transferred but only the ownership is changed.

Transfer of registered office

Arts. 12-14 of the Merger Directive concern the transfer of the registered office of a European Company or a European Cooperative Society.

3.3.3.2. Deferral of capital gains taxation

Prohibition to tax capital gains

According to Art. 4(1) of the Merger Directive, a merger, division or transfer of assets [805] must not give rise to any taxation of capital gains calculated by reference to the difference between the real value of the assets and liabilities transferred and their values for tax purposes. Capital gains taxation is deferred to the moment of a subsequent transfer of the assets.

The value for tax purposes means the value on the basis of which any gain or loss would have been computed for the purposes of tax upon the income, profits or capital gains of the transferring company if such assets or liabilities had been sold at the time of the merger or division but independently of it. [806]

Permanent establishment required

The transferred assets and liabilities referred to in Art. 4(1) of the Merger Directive mean the assets and liabilities of the transferring company that, in consequence of the merger, division or transfer of assets, are effectively connected with a permanent establishment of the receiving company in the Member State of the transferring company. The assets and liabilities must play a part in generating the profits or losses taken into account for tax purposes. [807]

The deferral of capital gains taxation does not need to concern situations in which the transferred assets and liabilities do not remain in a permanent establishment in the state of residence of the transferring company. The requirement of a permanent establishment is based on the fact that the state of residence of the transferring company will have taxing rights in relation to income connected with the transferred assets only if the income is connected with a permanent establishment in that state. The freedom of establishment principle of the TFEU, however, may prevent a Member State from taxing the transfer even if no permanent establishment were left in the state of residence of the transferring company, if similar domestic transfers are tax exempt. [808]

No mention is made in the Merger Directive about the possible tax consequences if the assets connected with a permanent establishment are later transferred from the permanent establishment after the operation covered by the directive. The tax consequences on the subsequent transfer depend on the Member State concerned, which usually means tax consequences. The requirements of the freedom of establishment principle of the TFEU, however, must be taken into account.

The Merger Directive does not include a definition of the term “permanent establishment”. It is thus possible that sometimes it is not clear whether or not a permanent establishment as required by the Merger Directive exists. The permanent establishment concepts included in the Parent-Subsidiary Directive and in the OECD Model Convention may be looked at as interpretative guidance in such a situation. There are, however, no EU Court judgments from which it can be deduced whether the permanent establishment concept of the Merger Directive has the same meaning as the Parent-Subsidiary Directive concept or the OECD Model concept.

Hybrid companies

According to Art. 4(3) of the Merger Directive, the prohibition of capital gains taxation applies also in the case of hybrid entities. The provision covers situations in which a Member State considers a non-resident transferring company as fiscally transparent on the basis of that state’s assessment of the legal characteristics of that company arising from the law under which it is constituted and therefore taxes the shareholders on their share of the profits of the transferring company as and when the profits arise. That state must not tax any income, profits or capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes. [809]

Art. 11 of the Merger Directive, however, allows taxation of the shareholders of the hybrid entity for the income, profits and capital gains of the hybrid entity. If a Member State does not consider a foreign transferring or acquired company as a separately taxable entity, the state does not need to follow the Merger Directive principles when it taxes the hybrid entity’s direct or indirect shareholders. [810]

If a Member State taxes the shareholders as and when the profits arise, the Member State must give a relief for the tax which would have been charged on the transparent company on its income, profits or capital gains if the Merger Directive had not applied. The relief must be given in the same way and in the same amount as that state would have done if that tax had actually been charged and paid. [811]

Rollover basis

According to Art. 4(4) of the Merger Directive, the tax exemption based on Art. 4 of the directive, both in the case of normal companies and in the case of hybrid companies, only applies if the continuity principle is applied. The receiving company must compute any new depreciation and any gains or losses in respect of the assets and

liabilities transferred according to the rules that would have applied to the transferring company or companies if the merger, division or transfer of assets had not taken place (rollover basis).

Art. 4(5) of the Merger Directive concerns situations in which, under laws of the Member State of the transferring company, the receiving company is entitled to have any new depreciation or any gains or losses in respect of the assets and liabilities transferred, computed on a basis different from the basis that would apply if the reorganization had not taken place. In such a situation, the prohibition to tax does not apply to the assets and liabilities in respect of which that option is exercised.

Value of the received shares

The Merger Directive does not establish the conditions which govern the transferring company's ability to benefit from deferral of taxation of the capital gains relating to the securities representing the capital of the receiving company and issued in exchange for the transfer. The Directive does not address the question as to what value the transferring company must attribute to those securities. The Directive leaves it to the Member States' discretion as to whether or not the fiscal neutrality from which the transferring company benefits is to be made subject to obligations to valuate the securities received in exchange (e.g. maintaining the continuity of values for tax purposes). It is possible to set such obligations provided that those obligations do not have the consequence that the issue of the securities during the transfer itself gives rise to taxation of the capital gains relating to the assets. [812]

3.3.3.3. Carry-over of provisions and reserves

Primary rule

Art. 5 of the Merger Directive concerns a carry-over of provisions and reserves. [813] The Member States must ensure that where provisions or reserves properly constituted by the transferring company are partly or wholly exempt from tax, the provisions or reserves may be carried over, with the same tax exemption, by the permanent establishment of the receiving company that are situated in the Member State of the transferring company. The transfer must be carried out in a way that the receiving company thereby assumes the rights and obligations of the transferring company.

Exception

The requirement that the provisions and reserves are carried over to the permanent establishment does not concern provisions and reserves that are derived from permanent establishments abroad. The Member State of the transferring company may recapture and tax these provisions and reserves at the moment of the reorganization concerned; otherwise, the Member State of the transferring company would lose its taxing right over the foreign permanent establishment. The immediate taxation, however, may not be in accordance with the TFEU if a similar pure domestic reorganization does not cause tax consequences in a similar situation.

3.3.3.4. Takeover of losses

Permanent establishment state

Art. 6 of the Merger Directive concerns takeovers of losses. [814] The basic principle is that cross-border company reorganizations must be subject to a beneficial treatment as applies to pure domestic operations.

To the extent that the Member State of the transferring company would in pure domestic situations apply provisions allowing the receiving company to take over the losses of the transferring company which had not yet been exhausted for tax purposes, those provisions must be extended to also cover takeovers of such losses by the receiving company's permanent establishment situated in that Member State. [815]

If the takeover of losses is not possible in the case of pure domestic arrangements, it is not required in the case of cross-border arrangements.

Residence state

The Merger Directive does not say whether the losses of the merging company should be tax deductible by the receiving company in its state of residence. The treatment depends on the domestic law of the state concerned. [816] As a consequence many Member States do not allow deductions of losses of the merging company in the state of residence of the receiving company. This treatment is problematic especially in regard to those member countries that apply the credit method instead of the exemption method in relation to permanent establishments. [817]

The TFEU freedom of establishment principle, however, may require that the losses be deductible in the state of the receiving company. According to case C-123/11 *A Oy2* the loss deduction possibility cannot be limited to concern only domestic mergers in situations in which the foreign merging company can prove that it has

exhausted all the possibilities of taking account of the losses [818] In the case of such final losses it goes beyond what is necessary to deny the deductibility which would be available for domestic mergers. [819] The EU law does not say whether the deductible amount of the loss has to be determined in accordance with the laws of the state of the merging company or the state of the receiving company, but the calculation must not lead to unequal treatment compared with a domestic situation. [820]

3.3.3.5. Holdings of the receiving company in the transferring company

Tax exemption

Art. 7 of the Merger Directive concerns situations in which the receiving company had a holding in the capital of the transferring company before the reorganization. In such a situation any gains accruing to the receiving company on the cancellation of its holdings must not be liable to taxation.

Exceptions

Member States may derogate from the main principle based on Art. 7 of the Merger Directive if the receiving company has a holding of less than 10% in the capital of the transferring company. The limit of 10% corresponds to the holding requirement in the Parent-Subsidiary Directive. If a profit distribution made between companies of two different Member States would be tax exempt on the basis of the Parent-Subsidiary Directive, the cancellation of the shareholding is also tax exempt. The tax consequences on the cancellation could in any case be avoided by making a tax-exempt profit distribution. Under domestic laws of the Member States, the tax exemption may even be given a broader scope.

3.3.3.6. Tax exemption of the shareholders

3.3.3.6.1. Situations covered

Merger, complete division and exchange of shares

Art. 8(1) of the Merger Directive concerns the tax treatment of the shareholders in connection with a merger, a complete division or an exchange of shares. The allotment of securities representing the capital of the receiving or acquiring company to a shareholder of the transferring or acquired company in exchange for securities representing the capital of the latter company must not, of itself, give rise to any taxation of the income, profits or capital gains of the shareholders.

Partial division

According to Art. 8(2) of the Merger Directive, the same principle applies in connection with a partial division. The allotment to a shareholder of the transferring company of securities representing the capital of the receiving company must not, of itself, give rise to any taxation of the income, profits or capital gains of the shareholder.

Transparent shareholders

Art. 8(3) of the Merger Directive concerns shareholders that are treated as transparent for tax purposes. The provision applies if a Member State considers a shareholder as a fiscally transparent entity on the basis of the state's assessment of the legal characteristics of that shareholder arising from the law under which it is constituted. The provision applies, if the state therefore taxes the persons having an interest in the shareholder on their share of the profits of the shareholder as and when the profits arise. According to the provision, the state taxing the shareholder as a transparent entity must not tax the persons having an interest in the transparent shareholder on income, profits or capital gains from the allotment of securities representing the capital of the receiving or acquiring company to the shareholder.

Valuation

According to Arts. 8(4) and 8(5), the tax exemption of the shareholders needs to be made available only if the shareholder does not attribute to the received securities (and those held in the transferring company in the case of a partial division) a tax value (value for tax purposes) that is higher than the value the exchanged securities or the securities held in the transferring company had immediately before the merger, division, partial division or exchange of shares. [821] However, Member States are not allowed to require that the acquiring company also applies the book value. Member States are not allowed to make the tax neutral based on the Merger Directive dependent on some extra requirements not mentioned in the directive. [822]

The expression "value for tax purposes" means the value on the basis of which any gain or loss would be computed for the purposes of tax upon the income, profits or capital gains of a shareholder of the company. [823]

3.3.3.6.2. Situations not covered by the tax exemption

Later transfer

According to Art. 8(6) of the Merger Directive, the prohibition to tax the shareholders does not prevent Member States from taxing gain arising out of the subsequent transfer of securities received in the same way as the gain arising out of the transfer of securities existing before the acquisition.

Different valuation

If, under the law of the Member State of residence of the shareholder, shareholders may opt for tax treatment that is different from the valuation and tax treatment leading to tax deferral, the prohibition to tax the shareholders does not apply to the securities in respect of which the option is exercised. [824]

Shareholders of hybrid entities

Paras. 3 and 4 of Art. 11 of the Merger Directive include an exception applying to the shareholders of a hybrid entity. If a Member State considers a non-resident receiving or acquiring company to be fiscally transparent on the basis of that state's assessment of the legal characteristics of that company arising from the law under which it is constituted, the Member State has the right to tax the shareholders. The tax treatment must be the same that would apply if the companies were resident in that Member State. The tax treatment applied to the shareholders must not be more beneficial in the case of shareholders of domestic companies than in the case of shareholders of foreign companies.

Cash consideration

The prohibition to tax the shareholders does not apply in the case of a cash consideration. The Member States may take the cash payment made on a merger, division or exchange of shares into account when taxing the shareholders. [825] The prohibition to tax applies only the part of the consideration paid in securities.

3.3.3.7. Transfer of a permanent establishment

Applicable provision

Art. 10 of the Merger Directive concerns situations in which the assets transferred in a merger, partial division or a transfer of assets include a permanent establishment of the transferring company that is situated in a Member State other than that of the transferring company. The permanent establishment may be situated in the state of the receiving company or in a third Member State. [826]

State of the transferring company

According to Art. 10 of the Merger Directive, the Member State of the transferring company must renounce any right to tax the permanent establishment. The Member State of the transferring company, however, may reinstate in the taxable profits of that company such losses of the permanent establishment as may previously have been set off against the taxable profits of the company in that state and which have not been recovered. [827]

State of the permanent establishment of the receiving company

The Member State in which the permanent establishment is situated and the Member State of the receiving company must apply the provisions of the Merger Directive to a transfer of a permanent establishment in accordance with Art. 10 as if the Member State where the permanent establishment is situated were the Member State of the transferring company. The operation must not lead to capital gains taxation and provisions and reserves must be transferred provided that the roll-over basis is applied. These provisions also apply in the case where the permanent establishment is situated in the same Member State as that in which the receiving company is a resident. [828]

Credit system states

Irrespective of the tax exemption based on Art. 10 of the Merger Directive, the Member State of the transferring company may tax all profits and capital gains of the permanent establishment resulting from the merger, division or transfer of assets if that state applies a system of taxing worldwide profits. [829] This exception applies to the Member States that apply the credit system instead of the exemption system to eliminate international double taxation.

If the Member State of the transferring company taxes the profits or capital gains, it must give relief for the tax that would have been charged on the profits and capital gains in the Member State in which the permanent establishment is situated in the same way and in the same amount as it would have done if that tax had actually been charged and paid but because of the Merger Directive has not been. [830]

The relief based on the Merger Directive requires that the tax that would have been paid in the permanent establishment state if the Merger Directive would not have prohibited the tax is deducted from the tax that is levied in the state of residence of the transferring company on the same income. This is a tax-sparing credit type of an arrangement in which a tax that has actually not been paid is credited. Because of the credit, the

transferring company has to pay tax in its state of residence only if the tax in that state exceeds the tax that would have been paid in the permanent establishment state had the Merger Directive not existed. Also, the differences in the tax base have an effect on the tax.

3.3.4. Transfer of registered office of a European Company or European Cooperative Society

3.3.4.1. Background and relevance

Company law

Since 8 October 2004 it has been possible to establish European Companies (SEs) based on the Regulation 2157/2001 and since 18 August 2006 European Cooperative Societies (SCEs) based on the Regulation 1435/2003. The transfer of the registered office of an SE or an SCE may be carried out without a winding up of the company or the cooperative society.

Merger Directive

The transfer of the registered office of an SE or an SCE may be carried out following the continuity principle without direct tax consequences in accordance with Arts. 10b-10d of the Merger Directive. The direct tax consequences may be avoided provided that a permanent establishment is left in the Member State from which the registered office is transferred.

Implementation

Member States had to implement the provisions of the Merger Directive concerning the transfer of registered office of an SE or an SCE into their domestic laws no later than 1 January 2006. [831]

3.3.4.2. Transfer of registered office

Definition

Para. k of Art. 2 of the Merger Directive defines what is meant by a transfer of the registered office. A transfer of the registered office is an operation whereby an SE or an SCE, without winding up or creating a new legal person, transfers its registered office from one Member State to another Member State.

The definition covers both the transfer of the registered office and the cessation of the residence in the Member State from which the registered office is transferred. The directive covers an operation whereby an SE or an SCE transfers its registered office from a Member State to another Member State (transfer of the registered office). The directive also covers the consequences of the fact that the SE or the SCE transferring its registered office ceases to be a resident in the Member State from which the registered office is transferred and it becomes a resident of the Member State to which the registered office is transferred (cessation of residence). [832]

3.3.4.3. Tax consequences

Applicable articles

The tax principles applicable to the transfer of the registered office of a European Company or a European Cooperative Society and the change of tax residence are expressed in Arts. 12-14 of the Merger Directive. The details of the domestic law implementation provisions depend on the Member State concerned.

Prohibition to tax

According to Art. 12 of the Merger Directive, the transfer of the registered office or the cessation of residence must not give rise to any taxation of capital gains in the Member State from which the registered office has been transferred. The prohibition to tax applies in relation to those assets and liabilities that remain effectively connected with a permanent establishment of the SE or the SCE in the Member State from which the registered office has been transferred. The capital gains are calculated in accordance with the same principles that apply in the case of the other operations covered by the Merger Directive. [833]

Continuity principle

The prohibition to tax any capital gains applies only if the SE or the SCE computes any new depreciation and any gains or losses in respect of the assets and liabilities that remain effectively connected with that permanent establishment as though the transfer of the registered office had not taken place or the SE or the SCE had not ceased to be a resident. [834] The continuity principle must be followed.

Art. 12(3) concerns a situation in which the SE or the SCE, under the laws of the Member State concerned, is entitled to have any new depreciation or any gains or losses in respect of the assets and liabilities remaining in

that Member State computed on a basis different from the rollover basis. In such a situation the prohibition to tax does not apply to the assets and liabilities in respect of which that option is exercised. [835]

Transfer of reserves

Para. 1 of Art. 13 of the Merger Directive concerns the transfer of provisions and reserves. If provisions or reserves properly constituted by the SE or the SCE before the transfer of the registered office are partly or wholly exempt from tax, the Member State concerned must ensure that the provisions and reserves may be carried over with the same tax exemption by a permanent establishment of the company or the cooperative society in the Member State from which the registered office was transferred. This requirement applies provided that the provisions and reserves are not derived from permanent establishments abroad.

Transfer of losses

Para. 2 of Art. 13 of the Merger Directive prohibits discriminatory treatment in the transfer of losses. If a company transferring its registered office within a Member State would be allowed to carry forward or to carry back losses that had not been exhausted for tax purposes, the Member State must allow the permanent establishment situated in its territory to take over the losses of the SE or the SCE transferring its registered office in the same way. Equal treatment is required provided that the loss carry-forward or carry-back would have been available in comparable circumstances to a company that continued to have its registered office or which continued to be tax resident in the Member State concerned.

Shareholders

Art. 14 of the Merger Directive concerns the tax treatment of the shareholders in connection with a transfer of the registered office. The transfer of the registered office of an SE or an SCE must not, of itself, give rise to any taxation of the income, profits or capital gains of the shareholders.

The prohibition to tax does not prevent the Member States from taxing the gain arising out of the subsequent transfer of the securities representing the capital of the SE or the SCE that transfers its registered office.

Unclear situations

The Merger Directive makes no mention of the tax treatment of assets that do not remain effectively connected with the permanent establishment of the original state of residence of the company or cooperative society which transferred its registered office to another Member State. Under the domestic law of many Member States, such a transfer is treated as an operation realizing capital gains tax consequences. The tax treatment, however, must not be in conflict with the freedom of establishment principle of Art. 49 of the TFEU. Such a conflict may emerge if the Member State concerned does not tax a similar domestic transfer of different parts of a company. [836]

Change of tax residence

The Merger Directive regulates only the direct tax consequences of the transfer of a registered office and of the change of tax residence. It makes no mention of the tax treatment of the SE or the SCE after the change of the state of residence for tax purposes. Because of the lack of harmonization in the field of corporate taxation, the tax treatment in the new state of residence depends largely on the domestic tax law and the tax treaties of the state concerned.

3.3.5. Tax avoidance

3.3.5.1. Artificial tax-avoidance arrangements

Denial of benefits

In principle, the Merger Directive applies to all company reorganizations that fit under the scope of the directive without giving any regard to the motives behind the arrangements, no matter if the motives are business or tax driven. [837]

Art. 15 of the Merger Directive, however, includes an anti-avoidance provision based on which a Member State may refuse to apply or withdraw the directive benefits wholly or partly in exceptional cases. [838] The proportionality principle must be followed when deciding the consequences. [839] The tax consequences must be proportionate to the protected interest and the benefit of the tax-avoidance arrangement to the company.

Tax-avoidance purpose

The directive benefits may be denied if the operation otherwise covered by the directive has as its principal objective or as one of its principal objectives tax evasion or tax avoidance. Under these conditions, the directive benefits can be denied no matter what the most important objective for the operation was.

The fact that the operation is not carried out for valid commercial reasons such as restructuring or rationalization of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives. [840] Minimizing of taxes is not considered to be such a valid commercial reason. [841] Minimizing of such taxes that are not covered by the directive, however, does not entitle the Member States to deny the directive benefits. [842]

The anti-avoidance provision of the Merger Directive applies even if there would be some valid commercial reasons for the operation. If one of the primary motives for the operation is avoidance of such taxes covered by the directive, the anti-avoidance provision may be applied.

All relevant facts must be looked at when determining whether one of the primary motives is tax avoidance. For example the fact that the merging company has ended all its business and that a very large amount of losses is transferred from the merging company to the receiving company, may constitute a presumption that the operation has not been carried out for valid commercial reasons. [843] These type of aspects may indicate that tax avoidance is one of the primary motives. However, none of these aspects necessarily mean that tax avoidance is one of the primary motives. There may still be valid commercial reasons for the company reorganization. [844] If the relevance of the commercial reasons, however, is quite marginal compared to the magnitude of the anticipated tax benefit, tax avoidance may be the primary motive of the transaction. [845]

Directive benefits do not need to be made available in the case of abuse of EU law. [846] Normally, the application of any anti-avoidance provisions under EU tax law, however, requires that the operation is a wholly artificial tax-avoidance arrangement. [847]

Burden of proof

The burden of proof in relation to the application of the anti-avoidance provision of the Merger Directive falls primarily on the Member States and not on the taxpayer. The burden of proof of the existence of commercial reasons for an operation, however, lies on the taxpayer, who has better possibilities to provide the proof. Therefore, documentation of a company reorganization and its objectives is necessary. [848]

In practice, the anti-avoidance provision should not be applied too easily. Certain types of operations should not be left outside of the scope of application of the directive automatically, but the taxpayer should have the possibility to show the existence of adequate commercial reasons. [849] The anti-avoidance provision must also be applied in the same way to cross-border arrangements as to pure domestic arrangements.

Implementation

Even if the anti-avoidance provision of the Merger Directive would not be implemented as such into the domestic tax law of a Member State, the directive benefits may be denied in a tax-avoidance situation on the basis of other domestic provisions. [850]

Other tax-avoidance provisions

The wording of the anti-avoidance provision of the Merger Directive is different from the anti-avoidance provision of the Parent-Subsidiary Directive. In practice, the provisions, however, may be applied in the same type of situations. Even though there would be no special anti-avoidance provisions, the benefits of EU tax law could be denied in the case of a wholly artificial tax-avoidance arrangement. [851]

3.3.5.2. Other situations

Change of residence

It is not completely clear as to what extent the benefits of the Merger Directive may be denied in a situation that cannot be seen as a pure artificial tax-avoidance arrangement, with tax avoidance as one of the primary motives, but in which the taxing right of a Member State is in danger for some other reason.

The Merger Directive, for example, does not mention whether it is acceptable to deny directive benefits retroactively if the person that benefitted from the directive later changes residence with the consequence that the original state of residence loses its taxing right on a possible subsequent transfer. In practice, this type of exit tax treatment is common in the Member States.

EU law compatibility

Despite their common use, different exit provisions are problematic from the perspective of the basic freedoms of the TFEU. EU nationals should be free to move from a Member State to another without any tax treatment restricting this freedom. [852] The use of the right to free movement, as itself, should not lead to taxation of unrealized income or capital gains.