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Frederik Boulogne

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Introduction

I BACKGROUND AND OVERVIEW OF THE MERGER DIRECTIVE

Cross-border restructuring operations, such as mergers, may produce various tax consequences. From a legal perspective, mergers entail a transfer of the rights and obligations of the transferring company to the receiving company. The provisions in the income tax acts of the Member States generally regard that transfer of rights and obligations, for tax purposes, as a deemed disposal of rights and obligations and, hence, ensure that there is a taxable event. Accordingly, mergers may result in a charge on the difference between the fair market values and the tax balance-sheet values of the assets and liabilities transferred. The taxation of these so-called hidden reserves may only be one of the many tax consequences. As a result of the merger, the shares held by the shareholders of the transferring company will be cancelled and, in consideration, they will acquire shares in the receiving company. If these newly issued shares have higher fair market values than the cancelled shares, the shareholders will realise a taxable gain. Furthermore, the transferring company may have tax losses available for carry forward. Ordinarily, the right to offset these losses will be linked to the company that incurred the losses. Accordingly, if the transferring company ceases to exist, its losses will disappear as well.

Historically, many Member States granted tax relief for restructuring operations concerning companies of the same Member State. These relief mechanisms usually did not extend to cross-border restructuring operations. One of the reasons was that there was no harmonised corporate law framework for cross-border mergers until the adoption of the Tenth Company Law Directive[1] and for cross-border transfers of seat there would not be a harmonised corporate law framework until the adoption of the SE[2]

1. Directive 2005/56/EC of the European Parliament and of the Council of 26 Oct. 2005 on cross-border mergers of limited liability companies, *Official Journal of the European Union* L 310/1, 25 Nov. 2005 ('Tenth Company Law Directive').
2. Council Regulation (EC) No 2157/2001 of 8 Oct. 2001 on the Statute for a European Company (SE), *Official Journal of the European Union* L 294, 10 Nov. 2001 ('SE Regulation').

and SCE[3] regulations.[4] It was, therefore, considered unnecessary to have a tax framework in place for operations that legally could not be effected. Nevertheless, even before the introduction of a harmonised corporate law framework for cross-border restructuring operations, there were directives, such as the Third Company Law Directive,[5] governing domestic mergers of public limited liability companies and the Sixth Company Law Directive,[6] governing domestic divisions of public limited liability companies. In the *SEVIC Systems AG* decision the ECJ held that cross-border mergers 'constitute particular methods of exercise of the freedom of establishment'[7] and that they should be treated equally to domestic mergers. This decision gave *cross-border* application to directives that initially only had a *domestic* scope. The *Leur-Bloem* decision, which will be discussed extensively in Chapter 4: section §4.03[E], had an equal effect.

Another reason why the relief mechanisms usually did not extend to cross-border restructuring operations was that Member States feared that facilitating cross-border mergers would lead to a leakage of taxing rights if the assets and liabilities of the transferring company would be transferred beyond the tax jurisdiction of the Member State of the transferring company. As a consequence, the Member State of the transferring company would not be able to effectuate its claim on the hidden reserves after the merger. In the absence of rules granting tax relief to cross-border restructuring operations, these operations were therefore treated disadvantageously compared to domestic restructuring operations.

The European Commission acknowledged that cross-border restructuring operations of the companies of different Member State are 'necessary to ensure the establishment and effective functioning of the common market'.[8] That goal would not be met if these operations were hindered with tax obstacles and for that reason, the Merger Directive was adopted on 23 July 1990, an event which coincided with the

3. Council Regulation (EC) No 1435/2003 of 22 Jun. 2003 on the Statute for a European Cooperative Society (SCE), *Official Journal of the European Union* L 207, 18 Aug. 2003 ('SCE Regulation').
4. It is submitted that, at the time of the finalisation of this dissertation, a proposal for a 14th Company Law Directive on the cross-border transfer of company seats is still pending. See, amongst others, European Parliament resolution of 2 Feb. 2012 with recommendation to the Commission on a 14th company law directive on the cross-border transfer of company seat (2011/2046(INI)).
5. Third Council Directive 78/855/EEC of 9 Oct. 1978 based on Art. 54 (3) (g) of the Treaty concerning mergers of public limited liability companies, *Official Journal of the European Communities* L 295, 20 Oct. 1978 ('Third Company Law Directive'). The Third Company Law Directive was replaced by Directive 2011/35/EU of the European Parliament and of the Council of 5 Apr. 2011 concerning mergers of public limited liability companies, *Official Journal of the European Union* L 110/1, 29 Apr. 2011 ('Directive 2011/35/EU').
6. Sixth Council Directive 82/891/EEC of 17 Dec. 1982 based on Art. 54 (3) (g) of the Treaty, concerning the division of public limited liability companies, *Official Journal of the European Communities* L 378, 31 Dec. 1982 ('Sixth Company Law Directive').
7. Case C-411/03, *SEVIC Systems AG* [13 Dec. 2005] ECR I-10805 (para. 19).
8. Preamble to Council Directive 90/434/EEC of 23 Jun. 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, *Official Journal of the European Communities* L225/1, 20 Aug. 1990 ('Merger Directive').

adoption of the Parent-Subsidiary Directive[9] and the Arbitration Convention on the same day.[10] In the *Punch Graphix* decision the ECJ emphasised the complementary nature of the Merger Directive and the Parent-Subsidiary Directive by referring to the equal dates of their proposals, adoptions and transposition deadlines and their similar objectives:[11]

> (...) the proposal for Directive 90/435 was submitted by the European Commission on the same day as that for Directive 90/434, (...) those two directives were adopted on the same day by the Council of the European Union and were also expected to be transposed simultaneously. Furthermore, materially, as is clear from the first recital in their preamble, those directives have the same objective to abolish restrictions, disadvantages or distortions arising in particular from the tax provisions of the Member States for the operations covered by those directives, namely, as regards Directive 90/435, cooperation between parent companies and subsidiaries of different Member States, and, as regards Directive 90/434, mergers, divisions, and transfers of assets concerning companies of different Member States. Accordingly, those directives, governing different types of transnational cooperation between companies, constitute, according to the legislature's plan, a whole, in that they complement each other.

If, as the saying goes, good things are worth waiting for, the Merger Directive would have to be a good thing as a proposal for a Merger Directive had already been launched in 1969. The available *travaux préparatoires* for the period 1969 to 1990 show that the then Member States of the European Union (EU) were unable to reach agreement on several topics, of which some had been actual deal-blockers, such as the fears by the German government that cross-border restructuring operations would lead to a reduction of employee representation rights.[12]

The objective of the Merger Directive is articulated in its preamble as the removal of tax obstacles to cross-border restructuring operations, while safeguarding the financial interests of the Member States.[13] This dualistic objective has to be achieved by a common framework through which the Member States are obliged to facilitate cross-border restructuring operations. In aligning the two apparently conflicting aims of granting tax relief and securing the financial interests of the Member States, a pivotal role is assigned to the notion that cross-border restructuring operations:

> normally result either in the transformation of the transferring company into a permanent establishment of the company receiving the assets or in the assets becoming connected with a permanent establishment of the latter company.[14]

9. Council Directive 90/435/EEC of 23 Jun. 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, *Official Journal of the European Communities* L225, 20 Aug. 1990 (Parent-Subsidiary Directive).
10. Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/436/EEC), *Official Journal of the European Communities* L225, 20 Aug. 1990 ('Arbitration Convention').
11. Case C-371/11, *Punch Graphix Prepress Belgium NV v. Belgische Staat* [18 Oct. 2012] ECLI:EU:C:2012:647 (para. 35).
12. See Ch. 4: s. §4.01 on Art. 11(1)(b), which was eventually inserted in the Merger Directive as a safeguard.
13. See the third, fourth and fifth recitals in the preamble to the Merger Directive.
14. See the fifth recital in the preamble to the Merger Directive.

Under its domestic tax laws, a Member State will ordinarily tax the profits of a non-resident company that carries on business on its territory through a permanent establishment. Pursuant to the applicable tax treaty, the right to tax the business profits attributable to a permanent establishment will be allocated to the Member State in which that permanent establishment is situated. In exercising the taxing rights under its domestic law, the Member State in which the permanent establishment is situated will, therefore, not be restricted by the applicable tax treaty, unless the concept of 'permanent establishment' under domestic law exceeds the concept of 'permanent establishment' in the tax treaty.

To the extent that the assets and liabilities of the transferring company become connected with a permanent establishment of the receiving company, the Member State of the transferring company can refrain from immediate taxation, but still safeguard its taxing rights by requiring the (permanent establishment of the) receiving company to continue with the balance-sheet values that the transferred assets and liabilities had at the level of the transferring company. Upon the actual realisation of the hidden reserves – for instance, if the assets and liabilities are disposed of – the Member State of the transferring company will still be able to tax. Relief by means of a carry-over of balance-sheet values is also the mechanism chosen in the Merger Directive to defer taxation at shareholder level: the balance-sheet values of the cancelled shares are carried over to the newly issued shares and, as a result, the Member State of the shareholder is able to tax the capital gains arising upon the actual disposal of these shares. Also the transferring company's losses can be taken over by the (permanent establishment of the) receiving company, but this is made conditional upon the transferability of these losses in a purely domestic situation. If the losses would not have been transferable in a restructuring operation involving companies from the same Member State, there is no obligation to allow the takeover of losses in the case of a cross-border restructuring operation.

Even though the Merger Directive's solutions have proven to be useful in eliminating major tax disadvantages to cross-border restructuring operations, its application has revealed a number of shortcomings. Already soon after its adoption in 1990, the European Commission saw the need to improve the Merger Directive and in 1993 it submitted a proposal for its amendment.[15] It would take until 2005, however, for the Merger Directive to be actually amended.[16] Amongst others, the 2005 Merger Directive increased the types of companies having access to the Merger Directive, it expanded its coverage to partial divisions, and it clarified that the conversion of branches to subsidiaries is within the scope of the Merger Directive. There have also been several minor amendments, which merely reflect the enlargement of the EU from

15. Proposal for a Council Directive amending Directive 90/434/EEC of 23 Jun. 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, COM(1993) 293 final, *Official Journal of the European Communities* C 225/3, 20 Aug. 1993.
16. Preamble to Council Directive 2005/19/EC of 17 Feb. 2005 amending Directive 90/434/EEC 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, *Official Journal of the European Union* L58/19, 4 Mar. 2005 ('2005 Merger Directive').

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