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Published by:
Kluwer Law International
PO Box 316
2400 AH Alphen aan den Rijn
The Netherlands
Website: www.kluwerlaw.com

Sold and distributed in North, Central and South America by:
Aspen Publishers, Inc.
7201 McKinney Circle
Frederick, MD 21704
United States of America
Email: customer.service@aspenpublishers.com

Only for Intertax
Sold and distributed in Germany, Austria and Switzerland by:
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***Intertax* is published in 12 monthly issues**

Print subscription prices 2014: EUR 1137/USD 1517/GBP 836
(12 issues, incl. binder)
Online subscription prices 2014: EUR 1053/USD 1404/GBP 774
(covers two concurrent users)

Intertax is indexed/abstracted in IBZ-CD-ROM; IBZ-Online

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Printed on acid-free paper.

ISSN: 0165-2826
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Printed and Bound by CPI Group (UK) Ltd, Croydon, CRO 4YY.

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PEER-REVIEWED ARTICLE

A Proposal to Expand and Improve Article 6 of the EU Merger Directive

G.F. Boulogne*

The European Court of Justice (ECJ's) judgment in A Oy (C-123/11) has created a rule for transferring losses cross-border, whereas the Merger Directive provides only for the takeover of losses in a domestic situation. This contribution contains a proposal for expanding and improving Article 6 of the Directive, not only to bridge the gap between what is possible under primary EU law and what is possible under secondary EU law, but also by providing solutions that are designed to attain the objectives of the Merger Directive as far as possible, irrespective of national law.

1 Introduction

On 21 February 2013 the European Court of Justice (ECJ) issued its judgment in *A Oy*,[1] a case concerning a cross-border merger between a Swedish company (B) and its Finnish parent (A Oy). B had got into difficulties in the years prior to the merger and had accrued substantial losses. If the merger had been purely between two Finnish companies, A Oy would have been able to deduct B's losses from its Finnish tax base, providing the transaction was not carried out for the sole purpose of obtaining a tax advantage.[2] This opportunity was not available, however, if B – as in this case – was resident in another Member State. No recourse could be sought to the provision to take over losses under Article 6 of the Merger Directive[3] as this allowed B's losses to be taken over only by a Swedish permanent establishment of A Oy. In the case of A Oy, however, nothing (or almost nothing)[4] was left in Sweden.

The ECJ ruled that this difference in treatment constituted a restriction on the freedom of establishment that was in principle 'justified by the need to safeguard the allocation of the power to impose taxes between the Member States and to avert the risks of the double use of losses and tax avoidance'.[5] According to the Court, the Finnish measure would go beyond what was necessary to attain the essential part of the objectives pursued if B had exhausted the possibilities available in Sweden to take account of the losses.[6] The ECJ ultimately left it to the national court to determine whether A Oy had proved that all the possibilities existing in Sweden for taking account of the losses had been exhausted.[7]

Whereas the Merger Directive provides only for the takeover of losses in a *domestic* situation, the ECJ's judgment in *A Oy* has created a rule for transferring losses *cross-border*. The question arising following this 'overtaking manoeuvre' is whether Article 6 of the Merger Directive continues to be compatible with primary EU law. In seeking to answer this question I discuss and comment on the judgment in *A Oy* in section 3 of this article. Section 4 examines Article 6 of the Merger Directive and its shortcomings. In section 5 I argue that primary EU law does not compel expansion of Article 6 of the Merger Directive, while section 6 explains why I personally believe such an expansion to be desirable. My proposal for expanding and improving Article 6 of the Directive set out in section 7 not only bridges the gap between what is possible under primary EU law and what is possible under

Notes

* PhD fellow, VU University Amsterdam and tax advisor, PwC (EU Direct Tax Group). The topic of his PhD research is 'Shortcomings in the EU Merger Directive'. The author can be contacted at g.f.boulogne@vu.nl. A Dutch version of this contribution ('Een voorstel tot uitbreiding en verduidelijking van artikel 6 van de EU-fusierichtlijn') was published in *Maandblad Belastingbeschouwingen* 2013/10, pp. 287–307.

1 ECJ 21 Feb. 2013, C-123/11 (*A Oy*).

2 ECJ 21 Feb. 2013, C-123/11 (*A Oy*), para. 17.

3 Council Directive 2009/133/EC of 19 Oct. 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.

4 It only remained bound by two long-term leases of business premises. ECJ 21 Feb. 2013, C-123/11 (*A Oy*), paras 11–12.

5 ECJ 21 Feb. 2013, C-123/11 (*A Oy*), para. 40.

6 ECJ 21 Feb. 2013, C-123/11 (*A Oy*), para. 49.

7 ECJ 21 Feb. 2013, C-123/11 (*A Oy*), para. 54.

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secondary EU law, but also goes further by providing solutions that are designed to attain the objectives of the Merger Directive as far as possible, irrespective of national law. I discuss the policy aspects of my proposal in section 8, followed by some closing comments in section 9.

2 Restriction on the Scope of this Contribution

As ECJ case law on cross-border loss relief (including *Futura*,[8] *Marks & Spencer*,[9] *Oy AA*,[10] *Lidl Belgium*,[11] *Krankenheim Wannsee*[12] and *X Holding*[13]) has already been widely discussed in tax literature,[14] I will refer to it here only briefly.

The Merger Directive contains two provisions for the transfer of losses, specifically Article 6 (covering mergers, divisions, partial divisions and transfers of assets) and Article 13 (covering the transfer of the registered office of an SE or an SCE). As the first of these two provisions covers the most frequently seen forms of restructuring I have limited myself here primarily to a discussion of Article 6 of the Directive.

For a more detailed discussion of loss relief on corporate restructurings in a Dutch context – under the Corporate Income Tax Act [*Wet Vpb*] 1969 and the Legal Merger Decree [*Besluit Juridische Fusie*][15] – reference is made to the literature.[16] The Dutch measure is discussed in section 7 of this article, albeit purely as one of the inspirations for my proposal to expand and improve Article 6 of the Merger Directive.

3 Judgment in *A Oy* (C-123/11)

3.1 *Facts and Preliminary Questions*

The Finnish company A Oy sold furniture in Sweden via its Swedish subsidiary B. The latter performed this loss-making activity from three leased retail premises. At a certain point B decided to end its trading activities, but continued to be tied to two of these retail premises under long-term lease contracts. Merging B into A Oy would allow the group to transfer these lease contracts to A Oy and to simplify its corporate structure. All the assets and liabilities of B would transfer to A Oy, with only the lease contracts remaining in Sweden.

Against this background, the Finnish central tax authorities were asked whether A Oy could be granted relief on the losses accrued by B, once the merger had been completed. The answer to this was negative as the Finnish tax measure allowed loss relief only in respect of losses incurred by a Finnish subsidiary or a permanent establishment of a Finnish company. After A Oy had unsuccessfully contested this decision at the highest court in Finland, the ECJ was asked for a preliminary ruling on whether the Finnish measure could be considered incompatible with the freedom of establishment laid down in (the current) Article 49 TFEU, and on how any losses on which relief was available should be determined (in other words, in accordance with the laws of the parent's Member State or the laws of the subsidiary's Member State).

3.2 *Can A Oy Invoke the Freedom of Establishment?*

The ECJ referred in its judgment to the *SEVIC* case, in which it had stated that cross-border mergers constitute 'particular methods of exercise of the freedom of establishment',[17] and that the merger fell within the scope of the freedom of establishment. The ECJ disagreed, therefore, with the four governments that claimed that the freedom of establishment was not relevant as B had discontinued its activities before the merger and the merger was in fact driven by the wish to deduct B's losses from the profits of A Oy.

3.3 *Is there a Restriction on the Freedom of Establishment?*

The ECJ was quick to conclude that this measure restricted the freedom of establishment in that the right to

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[8] ECJ 15 May 1997, C-250/95 (*Futura*).

[9] ECJ 13 Dec. 2005, C-446/03 (*Marks & Spencer*).

[10] ECJ 18 Jul. 2007, C-231/05 (*Oy AA*).

[11] ECJ 15 May 2008, C-414/06 (*Lidl Belgium*).

[12] ECJ 23 Oct. 2008, C-157/07 (*Krankenheim Wannsee*).

[13] ECJ 25 Feb. 2010, C-337/08 (*X Holding*).

[14] See, *inter alia*, S. van Thiel & M. Vascega, *X Holding: Why Ulysses Should Stop Listening to the Siren*, 50 Eur. Taxn. n. 8, 334–349 (2010); M. Isenbaert & C. Valjemark, *M&S Judgment: the ECJ Caught between a Rock and a Hard Place*, 15 EC Tax Rev. 10–17 (2006) and the literature cited in G.F. Boulogne & N. Sumrada Slavnic, *Cross-Border Restructuring and "Final Losses"*, 52 Eur. Taxn. 486–495.

[15] Toelichting en voorwaarden voor de fiscale begeleiding, verzoeken artikel 14b, derde lid, Wet Vpb, laatstelijk vastgesteld bij Besluit van 19 Dec. 2000, No. CPP2000/3131M, Infob 2001, 4.

[16] See, *inter alia*, G.C. van der Burgt & R.J. de Vries, 'Fusies, splitsingen en de verrekening van (voorfusie)verliezen: Voorstellen voor het wegnemen van enkele onduidelijkheden en knelpunten', *Weekblad voor fiscaal recht* 2012/1693 (6981).

[17] ECJ December 2005, C-411/03 (*SEVIC Systems*), para. 19.

take losses into account constituted a tax advantage for the parent company and the parent would be deterred from establishing subsidiaries in another Member State if this advantage were unavailable. The ECJ held that if the merger had been designed solely with a view to benefiting from the tax advantage, the right to deduct B's losses from taxable income would also have been refused if B had been a resident subsidiary. The ECJ therefore stated that if the national court were to decide that this was the case, A Oy would be unable to claim that non-resident subsidiaries were treated differently from resident subsidiaries.

If a situation is to constitute a restriction on the freedom of establishment, the cross-border situation must be comparable to the domestic situation. This comparability must be assessed from the perspective of what the national legislation is seeking to attain.[18] As the Finnish measure sought to grant the parent company an advantage, comprising the right to deduct a subsidiary's losses from tax, the ECJ concluded that the situation of a Finnish parent wishing to merge with its Swedish subsidiary was comparable to a situation in which a Finnish parent wanted to merge with its Finnish subsidiary.

3.4 *Can the Restriction on the Freedom of Establishment Be Justified?*

According to established ECJ case law, a restriction on the freedom of movement can be justified only by an overriding reason of general interest.[19]

3.4.1 *Overriding Reason of General Interest: Safeguarding the Balanced Allocation of the Power to Impose Taxes*

In determining whether a restriction on the freedom of establishment could be justified the ECJ specified three possible grounds for justification, with reference to its judgment in *Marks & Spencer*: 'the need to safeguard the allocation of the power to impose taxes between the Member States and to avert the risks of the double use of losses and tax avoidance'.[20] The ECJ elaborated on the first ground for justification, being the need to safeguard the allocation of the power to impose taxes, in paragraphs 41–43 of *A Oy*. In paragraph 41 it stated that failure to respect 'the right of a Member State to exercise its powers of taxation in relation to activities carried on in its territory' could undermine the *allocation* of this power, while in paragraph 43 it is suddenly the *balanced allocation* of this power between the Member States that is in jeopardy 'in that the taxable bases would be altered in both States to the extent of the losses transferred'. The ECJ would seem, therefore, to be applying two lines of reasoning. What is the actual issue at stake? Is it the *allocation* of the power to impose taxes, or the *balanced allocation* of this power? The fact that there is an essential difference between these two concepts was made very clear by the judgment in *X Holding*.[21] In *A Oy*, allowing the parent to deduct the Swedish losses of B from its taxable profit in Finland would incidentally have jeopardized both the *allocation* of the power to impose taxes and the *balanced allocation* of this power between Finland and Sweden as Finland would have to have accepted a loss from a Swedish activity, whereas it would not have been entitled to tax the profits of that Swedish activity.

The ECJ would seem in *A Oy* to be adrift, not only on whether the issue at stake concerns the *allocation* or *balanced allocation* of power, but also on *when* allocation of the power to impose tax is jeopardized. On the one hand the ECJ states *in abstracto* in paragraph 43 that '[t]o give companies the right to elect to have their losses taken into account in the Member State in which they are established or in another Member State would seriously undermine a balanced allocation of the power to impose taxes between the Member States [. . .] in that the taxable bases would be altered in both States to the extent of the losses transferred.' The ECJ has come in for criticism for this comment in *Oy AA*, which is largely identical to a comment made in this respect in *X Holding*, given that the Court wrongly suggests that companies could 'play with losses' because the ability to reduce the taxable base in the parent's Member State would result in an increase in the taxable base in the subsidiary's Member State.[22] *In concreto* the ECJ ultimately established in paragraph 48 that this 'playing with losses' could not occur in *A Oy*:

> [w]ith respect to the proportionality of the obstacle to freedom of establishment, it must be observed, first, that granting the parent company the possibility of taking into account the losses of its non-resident subsidiary in connection with a cross-border merger is not a priori such as to allow the parent company to

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18 See, *inter alia*, ECJ 18 Jul. 2007 (*Oy AA*), C-231/05, paras 36–38.

19 See, *inter alia*, ECJ EU 12 Dec. 2006 (*Test Claimants in the FII Group Litigation*), C-446/04, para. 167.

20 ECJ 21 Feb. 2013, C-123/11 (*A Oy*), para. 40. See ECJ 13 Dec. 2005, C-446/03 (*Marks & Spencer plc*), para. 43: '[f]irst, in tax matters profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system in order to protect a balanced allocation of the power to impose taxes between the different Member States concerned. Second, if the losses were taken into consideration in the parent company's Member State they might well be taken into account twice. Third, and last, if the losses were not taken into account in the Member State in which the subsidiary is established there would be a risk of tax avoidance.'

21 See ECJ 25 Feb. 2010, C-337/08 (*X Holding*), para. 35.

22 See the annotation of D.M. Weber to the *X Holding* case in *Highlights and Insights on European Taxation* 7, pp. 66–74 (2010) and the further Opinion of Advocate General Wattel of 7 Jul. 2010, No. 43. 484*bis*, *NTFR* 2010/1918, para. 3.14.

choose freely from one year to the next the tax scheme applicable to its subsidiaries' losses (. . .).

The ECJ could have avoided this unnecessary confusion by limiting itself to elaborating on the grounds for justification used in *Philips Electronics* and *Lidl Belgium*,[23] being the objective to safeguard 'the symmetry between the right to tax profits and the right to deduct losses'.[24] As, in the case of A Oy, only Sweden was entitled to tax the profits of B, making Finland take account of losses suffered by B would disrupt the symmetry between the right to tax profits and the right to deduct losses.

3.4.2 *Averting the Risks of the Double Use of Losses*

The ECJ stated in paragraph 44 of *A Oy* that the risk of losses being used twice existed, in the event of a merger, if a parent company established in another Member State enjoyed the 'possibility of deducting from its taxable income the losses of the merged subsidiary'. In paragraph 49 the ECJ went on to state that the Finnish measure 'goes beyond what is necessary to attain the *essential part of the objectives pursued* in a situation in which the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account'. Although the ECJ does not explain what 'the essential part of the objectives pursued' is, it would seem obvious to me that double use of losses cannot occur if the opportunities to deduct losses in Sweden have been exhausted.

3.4.3 *Preventing Tax Avoidance*

In paragraph 45 the ECJ mentions the risk of tax avoidance if an intragroup restructuring is structured so that the losses are taken into account in the Member State that applies the highest rate of tax and in which the tax value of the losses is therefore the highest. This interpretation of the term 'tax avoidance' would seem to me to be somewhat wide, given that established ECJ case law allows companies to avail themselves of more favourable tax rates in other Member States (Member States are not allowed to neutralize advantages obtained in this way).[25] An additional issue in this case is the fact that the ground justifying the obstacle applies only if the transaction has not been carried out solely for the purpose of obtaining a tax advantage. Once that has been established, it would seem difficult, or at least less easy, to successfully invoke a need to prevent tax avoidance.

3.5 *Is the Finnish Measure Proportional?*

With regard to the proportionality of the Finnish measure, and as mentioned above, the ECJ states that it will not be possible, or at least not easy, to 'play with losses'. It then refers to the '*Marks & Spencer* exception', stating that the Finnish measure goes 'beyond what is necessary to attain the *essential part of the objectives pursued* in a situation in which the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account (. . .)'. The ECJ is not easily thrown off course in demonstrating that this is the case and states that A Oy's claim that 'once the merger operation has been carried out, B will be liquidated, and A will no longer have a subsidiary or a permanent establishment in Sweden' (paragraphs 50–52) is insufficient. As the ECJ points out, several Member States that have intervened in the case consider that the possibility of B's losses being taken into account in Sweden continues to exist. Ultimately, the ECJ states, it is for 'the national court to determine whether A has in fact proved that B has exhausted all the possibilities of taking account of the losses which exist in Sweden' (paragraph 54).

The ECJ regards the possibilities available to deduct losses from tax as being exhausted if three conditions are met: (i) the losses of the subsidiary cannot be set against profits in previous or future periods, (ii) the losses of the subsidiary cannot be utilized by being transferred to a third party, and (iii) the losses of the subsidiary cannot be used by a third party.[26] The ongoing *Marks & Spencer* litigation in the UK[27] and two judgments issued by the German *Bundesfinanzhof* on 9 June 2010[28] make it clear that national courts determine when losses are considered to be 'final' in different ways. One of the disputed issues is whether the possibility to take losses into account must have been exhausted *factually* or (only) *legally*. This aspect has been widely discussed in literature.[29] *Legal* exhaustion occurs upon expiry, for example, of the term during which losses can be carried over (as in the case of the one-year carry back and the nine-year carry forward periods

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[23] ECJ 6 Sep. 2012, C-18/11 (*Philips Electronics*), para. 24 and ECJ 15 May 2008, No. C-414/06 (*Lidl Belgium*), para. 33.

[24] See also W.W. Monteiro in his annotation to the *A Oy* case in *NTFR* 2013/649.

[25] See, *inter alia*, ECJ 26 Oct. 1999, C-294/97 (*Eurowings*), para. 44 en ECJ 12 Sep. 2006, C-196/04 (*Cadbury Schweppes*), para. 49.

[26] See ECJ 13 Dec. 2005, C-446/03 (*Marks & Spencer plc*), para. 55.

[27] See, *inter alia*, High Court, 11 Apr. 2006, *Marks & Spencer plc v. Halsey (Inspector of Taxes)*, [2006] EWHC 811 Ch; [2006] STC 1235; Court of Appeal, 20 Feb. 2007, *Marks & Spencer plc v. Halsey (Inspector of Taxes)*, [2007] EWCA Civ 117; [2008] STC 526; Court of Appeal, 14 Oct. 2011, *HMRC v. Marks & Spencer*, [2011] EWCA Civ 1156.

[28] *Bundesfinanzhof*, 9 Jun. 2010, I R 100/09 and I R 107/09.

[29] See, *inter alia*, G.F. Boulogne & N. Sumrada Slavnic, *Cross-Border Restructuring and "Final Losses"*, 52 Eur. Taxn. 489–491.

provided for in Article 20(2) of the Dutch Corporate Income Tax Act 1969), while *factual* exhaustion arises when, for instance, the subsidiary is liquidated and its activities discontinued.

In the post-*Marks & Spencer* litigation in the High Court in the UK, Park J held that the ECJ's references to 'possibilities available' meant 'recognised possibilities legally available given the objective facts of the company's situation at the relevant time',[30] while Chadwick LJ held in the Court of Appeal that the conditions for the '*Marks & Spencer* exception' were not met:[31]

> if the claimant did no more than demonstrate that it was improbable or unlikely, or that there was little or no real likelihood, or that the claimant (or the surrendering company) had no intention, that losses could or would be set against future profits. [. . .] Given the context, the phrase 'no possibility' in the second condition is to be read as 'no real possibility'; in the sense that a real possibility is one which cannot be dismissed as fanciful.

One of the questions considered by the Court of Appeal in London was whether the '*Marks & Spencer* exception' should be applied on the basis of the facts of an individual case, or whether this test should be applied more generally.[32] The UK tax authorities had argued that allowing a company to meet the conditions of the '*Marks & Spencer* exception' on the basis of the actual situation at the time of submitting the claim would give companies the opportunity to opt for where to set off the losses. The Court of Appeal concluded that the objective facts at the time of the claim being submitted should be used to determine whether there was a 'real' rather than merely 'fanciful' possibility that the losses would be set off against future profits.

As the two judgments by the German *Bundesfinanzhof* have already received considerable attention in literature,[33] I will limit myself on this occasion to a brief summary. The *I R 100/09* (2010) case involved a German-resident company that carried on its enterprise through a loss-making permanent establishment in France. The French losses from 1999 were no longer deductible after 2004 because the five-year period that French law allows for setting off losses had by then expired. Case *I R 107/09* (2010) concerned a company that was also resident in Germany and had a permanent establishment in France. The German company made losses in the years from 1998 to 2001 and decided in September 2001 to cease its French activities. The losses in 2000 and 2001 were not able to be carried forward or back in France, and in both cases the German company sought to deduct the French losses from its taxable base in Germany.

In *I R 100/09* the German *Bundesfinanzhof* rejected the claim that *legal* exhaustion was sufficient for compliance with the conditions of the '*Marks & Spencer* exception'. As a result, the French loss attributable to 1999 was not able to be deducted in Germany. Although the loss was also *factually* exhausted in 2005 because the French activities had ended, the *Bundesfinanzhof* was unrelenting and stated that the French loss was exhausted because of the five-year period having expired. The Court therefore regarded the impossibility of taking the French loss into account as a disparity. In the *I R 107/09* case, by contrast, the *Bundesfinanzhof* allowed the deduction of the French losses as these losses were *factually* exhausted in 2001 because of the ending of the French activities. In an obiter dictum the ECJ commented that exhaustion of losses could also be triggered by a permanent establishment being converted into a company, or if the assets and liabilities of a permanent establishment were transferred to a third party.[34]

In her Opinion on *A Oy* Advocate General Kokott stated that the '*Marks & Spencer* exception' could not be applied to mergers.[35] She had the same qualms as the UK tax authorities in the post-*Marks & Spencer* litigation; in other words, that merging companies could freely decide where to take the losses of the transferring subsidiary into account. AG Kokott was also concerned that the transferring subsidiary would consciously forgo possibilities to use its losses.

In my opinion, both *legal* and *factual* exhaustion of the possibilities to use losses should result in the subsidiary's losses becoming 'final'. The view of the *Bundesfinanzhof* that the '*Marks & Spencer* exception' should be limited to *factually* exhausted losses should be rejected. First, the outcome favoured by the *Bundesfinanzhof* creates an artificial incentive to cease foreign activities (if a group is concerned that it may otherwise lose the opportunities to offset losses against profits) rather than to continue these activities and aim for future profits. Second, not taking account of a subsidiary's losses that are exhausted only *legally* does not constitute a disparity, but instead a restriction on free movement that is caused by a discriminatory measure in the parent company's Member

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30 High Court, 11 Apr. 2006, *Marks & Spencer plc v. Halsey (Inspector of Taxes)*, [2006] EWHC 811 Ch; [2006] STC 1235.

31 Court of Appeal, 20 Feb. 2007, *Marks & Spencer plc v. Halsey (Inspector of Taxes)*, [2007] EWCA Civ 117.

32 Court of Appeal, 14 Oct. 2011, *HMRC v. Marks & Spencer*, [2011] EWCA Civ 1156.

33 See A. Bal, *New Case Law Developments in Germany: Finality of Foreign Permanent Establishment Losses*, 52 Eur. Taxn. 46.

34 The transactions were mentioned in Art. 2a(4) of the German *Einkommensteuergesetz*.

35 Opinion of Advocate General Kokott of 19 Jul. 2012, C-123/11 (*A Oy*), points 55–60.

State. The judgment in *Krankenheim Wannsee*[36] adds an additional dimension. That case concerned a German-resident company that conducted its business through an Austrian permanent establishment. Initially the Austrian permanent establishment was loss-making and, under the rules then applying in Germany, its losses could be taken into account at the level of the German head office. In Austria, loss relief was available only if the losses could not be taken into account in Germany. When the Austrian permanent establishment became profitable, the previously deducted losses were recaptured in Germany. German legislation did not require this recapture if the taxpayer was able to demonstrate that the Austrian rules offered absolutely no opportunity for relief of the Austrian losses (*quod non*). As recapture would not have occurred in the case of a German permanent establishment, the tax treatment of a German company with an Austrian permanent establishment was less favourable than if this permanent establishment had been established in Germany. The ECJ held that the 'logical symmetry' of recapturing the previously deducted losses was necessary to safeguard the coherence of the German tax system and hence regarded the restriction that followed from the recapture as justified. The fact that the possibility to set off the losses under the Austrian rules could not be put into effect in the specific case, and that the taxpayer ended up with a 'final loss', was treated by the ECJ as a disparity. To summarize, the ECJ held in *Krankenheim Wannsee* that a Member State may treat loss relief in a cross-border situation less favourably than in a domestic situation, providing 'final losses' are in theory deductible. The Member State of the parent company does not need to harmonize its rules with those applying in the subsidiary's Member State. From this I conclude that the parent's Member State does not have to allow deduction of a loss that is *legally* exhausted according to that State's standards if relief on this loss is still available in the Member State of the subsidiary.

3.6 *How Should We Determine Losses to Be Transferred?*

The ECJ states that the freedom of establishment does not as a matter of principle prescribe which particular law has to be applied to calculate the losses that are being taken over (paragraph 58). This is hardly surprising since there has not, as yet, been any positive harmonization in this field and the parent's Member State is therefore free, in principle, to decide how to determine such losses. Obviously the method used to determine losses taken over from a *non-resident* subsidiary should not be less favourable than the calculation that would have been applied to losses taken over from a *resident* subsidiary (paragraph 59). The ECJ ultimately leaves the calculation to the Finnish court as '[t]hat question cannot, however, be addressed in an abstract and hypothetical manner, but must be analysed where necessary on a case-by-case basis' (paragraph 60).

The calculation of the losses to be taken into account becomes more complicated if, as is normally the case, the tax rules in the parent's Member State differ from those in the Member State of the subsidiary.[37] At one end of the scale there may be *temporary* differences due, for instance, to different rules on the depreciation of immovable assets. At the other end of the scale, there may also be *permanent* differences created, for example, by these Member States applying varying rules on thin capitalization. A subsidiary may even be loss-making according to the tax rules of its Member State of residence, but profitable according to the tax rules applying in the parent's Member State. Given that it is the parent's Member State that applies a restrictive measure, it could be argued, as the Court of Appeal ruled in the on-going *Marks & Spencer* litigation in the UK,[38] that the losses to be taken into account should also be calculated in accordance with the tax rules of that Member State. AG Kokott inclined towards a similar view in her Opinion on *A Oy*, albeit with some reservations. She held that the losses to be taken into account should *in principle* be calculated according to the tax laws of the parent's Member State as that was the only way to ensure equal treatment between domestic and cross-border situations.[39] Kokott dismissed the submissions – by the Commission and the Finnish government – that the losses to be taken into account should be maximized at the amount calculated under the tax laws of the subsidiary's Member State as such a limitation, she stated, would obstruct the desired attainment of equal treatment.[40] In some cases, however, Kokott saw scope for adjusting (i.e., reducing) the losses to be taken into account '(. . .) for example, for fiscal promotion measures of the receiving company's State of residence, such as higher depreciation, which result in a bigger loss.' The tenability of that latter claim, however, can be queried since in the judgment in *Tankreederei*, for example, the ECJ held that the free movement of capital should be interpreted as precluding a tax measure, such as a tax credit for investment in ships,

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36 ECJ 23 Oct. 2008, C-157/07 (*Krankenheim Wannsee*).

37 See also G.F. Boulogne & N. Sumrada Slavnic, *Cross-Border Restructuring and "Final Losses"*, 52 Eur. Taxn. 490–491.

38 Court of Appeal, 14 Oct. 2011, *HMRC v. Marks & Spencer*, [2011] EWCA Civ 1156, paras 87–88.

39 Opinion of Advocate General Kokott of 19 Jul. 2012, C-123/11 (*A Oy*), point 73.

40 Opinion of Advocate General Kokott of 19 Jul. 2012, C-123/11 (*A Oy*), point 74.

being denied to an enterprise established in that Member State on the sole ground that the capital goods, for which the credit was claimed, were physically used in the territory of another Member State.[41] In other words, a tax measure cannot be restricted to domestic situations purely on the grounds that extending it to cross-border situations would have adverse budgetary consequences.

The point of departure when determining the losses to be taken into account is that the objective of the freedom of establishment is to remove disproportionate obstacles to the freedom of movement. Given that, under established ECJ case law, Member States are not allowed, on the one hand, to 'neutralize' the tax advantages arising through cross-border establishment[42] and, on the other hand, are also not obliged to bring their systems into line with those of other Member States in order to remove any tax disadvantage that may arise through cross-border establishment,[43] the question of whether there is a 'final loss' and, if so, what this loss amounts to should, in my view, be determined in accordance with the tax rules of the parent's Member State. It follows from *Krankenheim Wannsee*, as I see it and as explained in section 3.5, that a loss considered final under the tax rules of the parent's Member State, but not under the tax rules of the subsidiary's Member State should not have to be taken into account in the parent's Member State.

3.7 *Application of the 'Marks & Spencer Exception'*

3.7.1 *Back from the Past, or Did It Never Actually Go Away?*

In *A Oy* the ECJ referred on no fewer than ten occasions to the judgment in *Marks & Spencer*, which had been delivered more than seven years previously. Most of these references concerned the 'final loss exception' in the latter judgment, whereby a measure that prohibits deduction of a non-resident subsidiary's losses in a situation in which the subsidiary has exhausted all the possibilities for loss relief in its own Member State goes beyond what is necessary to safeguard the power to impose taxes. This multitude of references prompts the question as to whether the ECJ considered it necessary to give this exception a new lease of life, or whether the '*Marks & Spencer* exception' has remained alive and well over the past seven years and the ECJ simply wanted to reconfirm its application.

3.7.2 *AG Kokott in A Oy: The 'Marks & Spencer Exception' Can No Longer Be Applied*

In her Opinion on *A Oy* AG Kokott stated, somewhat exasperatedly, in respect of the '*Marks & Spencer* exception' that '[i]n spite of so many words, it is not clear how far that exception extends and whether – in view of the Court's subsequent case-law – it still exists at all.' She nevertheless went on to conclude firmly in point 52 that '[i]f, on the other hand, the justification is based on the allocation of taxation powers among the Member States alone, the development of the case-law means that the '*Marks & Spencer* exception' can no longer be applied.'

AG Kokott's views can be explained as follows. In *Marks & Spencer* the ECJ established three grounds that could justify restrictions on the freedom of establishment. These included the objective to safeguard the allocation of the power to impose taxes between Member States and to avoid the double use of losses. There is no risk of losses being used twice if a subsidiary's losses can no longer be used in its Member State of residence, and refusing a request for group relief in such circumstances would be disproportional. Later case law, however, reduced this threefold justification (allocation of the power to impose taxes, double use of losses and tax avoidance) into a single justification ground: the need to safeguard the allocation of the power to impose taxes. This single justification ground is sufficient in itself to justify a restriction on the freedom of movement.

AG Kokott consequently asked, rhetorically, why the possibilities in the subsidiary's Member State were relevant for allocating the power to impose taxes. If the possibilities for loss relief were exhausted in the subsidiary's Member State, taking losses into account at the level of the parent was not a less restrictive measure for safeguarding the power to impose taxes: in such a case, the objective of allocating taxation powers was not maintained. She concluded that insofar as preventing the double use of losses was not recognized as independent justification, and justification derived solely from the need to allocate taxation powers among the Member States, the '*Marks & Spencer* exception' could no longer be applied.

3.7.3 *AG Mengozzi in K: the 'Marks & Spencer Exception' is Back from the Past*

As explained above, the ECJ did not follow AG Kokott's Opinion in *A Oy*. One month after the judgment in *A Oy*, however, AG Mengozzi expressed clear support for AG

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[41] ECJ 22 Dec. 2010, C-287/10 (*Tankreederei*), para. 34.

[42] ECJ 26 Oct. 1999, C-294/97 (*Eurowings*), para. 46.

[43] ECJ 29 Nov. 2011, C-371/10 (*National Grid Indus*), para. 62.

Kokott in his Opinion on the case of *K*.[44] This concerned the question of whether a resident of Finland was allowed to deduct a capital loss incurred on disposal of immovable property located in France from his Finnish taxable base. Normally a loss on the sale of immovable property would be deductible in Finland. Under the tax treaty between Finland and France, however, capital gains on disposals of immovable property were taxable only in the State in which they were located. Based on the principle of symmetry, losses on disposals of immovable property located in France were also not deductible from tax in Finland.[45] The loss was not deductible from tax in France and was therefore 'final'. In paragraphs 58–90 of his Opinion AG Mengozzi discussed the proportionality of the refusal to allow loss relief in Finland and specifically considered whether this situation was covered by the 'final loss exception' arising from *Marks & Spencer*. Like AG Kokott, AG Mengozzi stated that the ECJ explicitly recognized the safeguarding of the allocation of the power to impose tax between the Member States as an independent justification ground. According to AG Mengozzi, the ECJ was 'gradually wishing to distance itself from the *Marks & Spencer* exception'[46] [*as AG Mengozzi's Opinion on K had not been translated into English at the time of writing, all translations relating to this case are by the author*]. To illustrate his point AG Mengozzi referred to the examples of the judgments in *Lidl Belgium* and *X Holding*, in which the ECJ attached so much importance to the need to safeguard the allocation of the power to impose tax that the role of the 'final loss exception' could no longer be applied.

According to AG Mengozzi, the ECJ had 'reactivated' the '*Marks & Spencer* exception' in *A Oy*, but had failed to establish clear criteria for determining whether this exception was applicable. AG Mengozzi himself took up the gauntlet in an effort to identity 'a possible key to greater understanding'. In paragraphs 74–76 he stated that the number and nature of justification grounds mentioned should not influence application of the '*Marks & Spencer* exception': the judgments in *Marks & Spencer* and *A Oy* would be exactly the same, even if only the allocation of the power to impose tax had been at stake. As AG Mengozzi sees it, an 'absolutely more convincing explanation' for application of the '*Marks & Spencer* exception' can be found in 'the bilateral or unilateral origins of the objective sought to be attained by the Member State and the restrictive measure adopted to achieve this':

78. Thus, if the tax measure arises directly from the allocation of the power to impose tax agreed by the Member States in a convention, no consideration need be given as to whether the possibilities to take losses into account in the relevant Member State have been exhausted, given that the restriction is the direct consequent of an allocation agreed in the tax convention and not the application of a single tax regime.
79. This is incidentally also the solution for which the Court opted in paragraphs 47–52 of the judgment in *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt* mentioned by the referring court, the outlines of which were set out in the judgment in the *Lidl Belgium* case.
80. In those cases in which the objective and the restrictive measure conceived in order to attain it rely exclusively on a single tax regime (i.e., unilateral determination), application of the '*Marks & Spencer* exception' could, however, be considered.
81. If such an approach were to be opted for in the case at hand, it would have to be concluded that the refusal, which was based directly on the tax convention between France and Finland, to grant K's request was proportional to the objective of allocating the power to impose tax agreed by the Member States, without any requirement to consider the final nature of the loss incurred by K upon disposal of the immovable property in France [*translation*].

3.7.4 *My View: The 'Marks & Spencer Exception' Never Went Away*

The objective of safeguarding the allocation of the power to impose tax is not achieved by requiring a Member State to grant loss relief on an activity if it is not allowed to tax the profits of such activity. This is no reason, however, to reject application of the '*Marks & Spencer* exception'. On the contrary, recognition of the need to safeguard allocation of the power to impose tax is the result of a tightrope walk between free movement on the one hand and Member States' fiscal sovereignty on the other hand. If a measure constitutes too great an infringement of the freedom of movement, the restrictive national measure

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[44] Opinion of Advocate General Mengozzi of 21 Mar. 2013, C-322/11 (*K*).

[45] Advocate General Mengozzi refers to Art. 6 of the tax treaty between France and Finland for the determination that the loss incurred with the disposal of the French immovable property is not deductible in Finland. In my view, this should be Art. 13(1) of that tax treaty, which stipulates that capital gains realized with the alienation of immovable property are only taxable in the State in which the immovable property is situated. I understand that the Finnish reference for a preliminary ruling refers to both provisions. In its decision (para. 42) the ECJ made a rectification by referring to both Art. 6(1) and Art. 13(1) of the tax treaty between France and Finland.

[46] Opinion of Advocate General Mengozzi of 21 Mar. 2013, C-322/11 (*K*), point 63.

will have to be abandoned, however legitimate the objective it seeks to attain may be.

I do not agree with AG Mengozzi that *Lidl Belgium* and *X Holding* can be seen as a death sentence for the '*Marks & Spencer* exception'. The issue in *Lidl Belgium* concerned whether a German-resident company was allowed to recapture and deduct losses incurred by its Luxemburg permanent establishment (that would have constituted less of a restriction on the freedom of establishment than the existing exemption allowed under German tax law for a permanent establishment in Germany). The ECJ explicitly considered the 'final loss exception' provided for in *Marks & Spencer* and stated that Lidl Belgium had not satisfied the essential condition (i.e., the inability to take the losses into account in the source state) as the losses of the permanent establishment were eligible for (and indeed were granted) relief in a subsequent year.[47] AG Mengozzi explained, however, that the ECJ wished to qualify its explicit reference to the '*Marks & Spencer* exception' by adding that:

> where a double taxation convention has given the Member State in which the permanent establishment is situated the power to tax the profits of that establishment, to give the principal company the right to elect to have the losses of that permanent establishment taken into account in the Member State in which it has its seat or in another Member State would seriously undermine a balanced allocation of the power to impose taxes between the Member States concerned.[48]

My inference from this quotation from *Lidl Belgium* differs, however, from that of AG Mengozzi. First, the idea that a taxpayer can choose where to take losses is based on a misconception. Second, the fact that losses are 'final' means there is no question of choice, given that the losses can no longer be set off in the source state. The 'qualification' in *Lidl Belgium* would not seem, therefore, to detract from the validity of the '*Marks & Spencer* exception' in any way. Similarly, the absence of references to the '*Marks & Spencer* exception' in *X Holding* cannot, in my opinion, be seen as indicating that the '*Marks & Spencer* exception' is no longer relevant as that case did not concern final losses (and their deductibility).

AG Mengozzi's suggestion that the '*Marks & Spencer* exception' does not apply if a restriction is 'the direct consequence of an allocation agreed in the tax convention and not the application of a single tax regime' [*translation*] is unconvincing as there is nothing in ECJ case law to suggest that the cause of a restriction (whether unilateral or bilateral) is of relevance when applying the test of proportionality. On the contrary, the ECJ treats restrictions arising from national law in exactly the same way as those arising from a tax treaty. And this is logical, given that Member States are free to define the boundaries of their powers to impose tax, either unilaterally or through tax treaties.[49]

It does not surprise me, therefore, that AG Mengozzi immediately sought to distance himself from the explanation that he had only slightly earlier seen as 'absolutely more convincing' and stated that this explanation relied heavily on procedural coincidences (did the referring court mention the tax treaty in the request for a preliminary ruling?) and – here it comes – that *it was not in line with established ECJ case law*. However creative AG Mengozzi may be, his suggestion is simply untenable.

I consequently regard *A Oy* as a re*confirmation* rather than a re*introduction* of the '*Marks & Spencer* exception'. *Marks & Spencer's* stores may have been absent from the Dutch high street for the past twelve years (although a press release of 16 April 2013 announced the chain's imminent return to Amsterdam under the heading of '*Marks & Spencer* returns to The Netherlands with a "Clicks & Bricks" Strategy'),[50] but the *Marks & Spencer* doctrine itself has maintained its presence throughout.

On 7 November 2013, the ECJ handed down its decision in *K*. In a similar way as AG Mengozzi, it found the existence of a restriction of the free movement of capital. Then, the ECJ held that the possibility of deducting losses sustained on the sale of immovable property could not be justified by a difference in situation related to the place where the property concerned as (i) Article 23(2)(c) of the tax treaty between France and Finland allows income that is taxable in France to be taken into account in the calculation of the tax on income that is taxable in Finland in order to apply progressive taxation (although Finland does not exercise this option as regards income from capital assets, which are taxed at a fixed rate) and (ii) the non-deductibility of the losses in Finland did not depend on their (non-)deductibility in France and the tax treaty does not preclude such losses from being taken into account.[51] Logically, the ECJ held that the restriction could be justified by the need to safeguard the balanced allocation of the power to impose taxes between Finland and France ('the refusal to allow deduction of losses arising from the sale of immovable property situated in France

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47 ECJ 15 May 2008, C-414/06 (*Lidl Belgium*), paras 50–51.

48 ECJ 15 May 2008, C-414/06 (*Lidl Belgium*), para. 52.

49 See, *inter alia*, ECJ 21 Sep. 1999, C-307/97 (*Saint-Gobain*), para. 58.

50 Http://corporate.marksandspencer.com/page.aspx?pointerid=a77e5cf0a54b41b5b23893464c49c201.

51 ECJ 7 Nov. 2013, C-322/11 (*K*), paras 36–48.

permits the symmetry between the right to tax profits and the right to deduct losses to be safeguarded'[52]). Clearly, there was no danger of a taxpayer deducting the same losses twice as the losses could not be deducted in France at all and the Finnish tax legislation was not specifically intended to prevent tax avoidance. The ECJ also considered that the refusal to allow the deduction of the losses could be justified by the need to ensure the cohesion of the Finnish tax system, but its interpretation of that justification ground seemed completely identical to the need to safeguard the balanced allocation of taxing powers, namely the logic of symmetry between the taking into account of losses generated by a capital investment and the taxation of returns (i.e., capital gains) on that investment. Finally, the ECJ confirmed that the '*Marks & Spencer* exception' is still alive, but it found an easy way out to having to apply it in the case at hand:[53]

> 76. However, in a situation such as that in issue in the main proceedings, a taxpayer such as K cannot be regarded, irrespective of the considerations of fact set out by the referring court, to have exhausted the possibilities available in the Member State in which the property is situated of having the losses taken into account.
>
> 77. Since the Member State in which the property is situated does not provide for the possibility of losses incurred on the sale of the property being taken into account, such a possibility has never existed.
>
> 78. In such circumstances, if it were accepted that the Member State in which the taxpayer resides must nevertheless allow losses on immovable property to be deducted from taxable profits in that Member State, that would effectively oblige the latter to bear the adverse consequences arising from the application of the tax legislation adopted by the Member State in which the property is situated.

The ECJ thus took a very literal approach in dismissing the application of the '*Marks & Spencer* exception' (plainly put: there cannot be an *exhaustion* of the possibility to take losses into account if such a possibility has never existed), but it cared little about the rationale of that exception. If the '*Marks & Spencer* exception' serves to strike a (delicate) balance between, on the one hand, respecting the need to safeguard the balanced allocation of taxing powers and, on the other hand, making way for free movement, it does not matter from the perspective of the Member State of residence (which causes the restriction) if the losses were never deductible at all, or if they were in principle deductible, but the possibilities to take them into account have become exhausted. In both cases, the end result is the same. In other words, this is not a matter of removing disparities, but a matter of weighing whether or not the end result created by the Finnish restriction (losses from alienation of the French immovable property are not deductible anywhere) is acceptable in the light of the free movement of capital.

4 Where does Article 6 of the Merger Directive fall short?

4.1 *Background to Article 6 of the Merger Directive*[54]

The aim of the Merger Directive is to establish a common system of taxation in order to eliminate tax obstacles to cross-border restructuring operations, while ensuring that the financial interests of the Member State of the transferring or acquired company are safeguarded. Article 1 of the Merger Directive lists the qualifying operations, one of which is a 'merger', whereby, according to the definition in Article 2(a)(ii), two or more companies are dissolved. In view of their link to the taxable subject, any non-exhausted losses of a transferring company will not normally be transferred in such an operation. This could deter companies from restructuring as:[55]

> [t]he fact that deferrable losses cannot be transferred from the acquired company to the acquiring company is clearly an impediment to restructuring operations. It means companies are more likely to abandon or defer any restructuring operations they might have planned and thus negatively influences the competitive situation of EU businesses.

Fortunately, Article 6 of the Merger Directive allows tax losses that have not yet been exhausted to be taken over by the receiving company's permanent establishment(s) situated in the territory of the transferring company:

> [t]o the extent that, if the operations referred to in Article 1, paragraph a, were effected between companies from the Member State of the transferring company, the Member State would apply provisions allowing the

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[52] ECJ 7 Nov. 2013, C-322/11 (*K*), para. 55.

[53] ECJ 7 Nov. 2013, C-322/11 (*K*), paras 76–78.

[54] For a discussion of Art. 6 of the Merger Directive, see J. Bezzina, *The Treatment of Losses under the EC Merger Directive 1990*, 42 Eur. Taxn. 57–71 (2002) and J. Calleja Borg, *Non-exhausted Losses and the Merger Directive: What It Fails to Say*, 39 Intertax 557–563 (2011).

[55] Commission of the European Communities, Commission Staff Working Paper *Company Taxation in the Internal Market*, COM(2001)582 final, 239, 23 Oct. 2001.

receiving company to take over the losses of the transferring company which had not yet been exhausted for tax purposes, it shall extend those provisions to cover the take-over of such losses by the receiving company's permanent establishments situated within its territory.

4.2 *Scope and Interpretation of Article 6 of the Merger Directive*

Article 6 of the Merger Directive applies to the operations referred to in Article 1(a), being 'mergers, divisions, partial divisions, transfers of assets and exchanges of shares involving companies from two or more Member States'. Provision for relief on losses incurred by an SE or an SCE that is transferring its registered office is made in Article 13(2) of the Merger Directive:

> [t]o the extent that a company transferring its registered office within the territory of a Member State would be allowed to carry forward or carry back losses which had not been exhausted for tax purposes, that Member State shall allow the permanent establishment, situated within its territory, of the SE or of the SCE transferring its registered office, to take over those losses of the SE or SCE which have not been exhausted for tax purposes, provided that the loss carry forward or carry back would have been available in comparable circumstances to a company which continued to have its registered office or which continued to be tax resident in that Member State.

Losses of the transferring company are transferred to the receiving company in the case of all the operations referred to in Article 6 of the Merger Directive, with the exception of exchanges of shares. In the case, however, of the operations referred to in Article 13(2) of the Merger Directive, the losses remain with the same company, but the liability to tax changes from a *domestic* to a *foreign* or *limited* liability.

As its reference to Article 1(a) of the Merger Directive shows, Article 6 of the Merger Directive also extends to 'partial divisions' and 'transfers of assets'. This means that dissolution of the transferring company is not a *conditio sine qua non* for taking over the losses, given that the transferring company will continue to exist in both of these situations. Article 6 of the Merger Directive would consequently seem to create a link between the assets and liabilities transferred and the losses to be taken over rather than serving as a remedy for the disappearance of the transferring company's losses.

4.3 *Article 6 of the Merger Directive Does Not Allow Unrestricted Loss Relief on the Exchange of Shares*

Article 6 of the Merger Directive refers to 'the operations referred to in Article 1, paragraph a', which also include an exchange of shares.[56] Although an exchange of shares is stated to involve both an 'acquired company' and an 'acquiring company',[57] Article 6 refers to the 'transferring' and 'receiving company'. Furthermore, an exchange of shares involves only the transfer of the shares in the acquired company, and not the transfer of any other assets and liabilities. Both the text and system provided for in Article 6 of the Merger Directive would seem incompatible with application of this Article to an exchange of shares.

In the case of a merger, the dissolution of the company could be the reason for a transferring company's losses being ineligible for relief. The reason in the event of a transfer of the registered office of an SE of SCE could be the switch from a *domestic* to a *foreign* or *limited* liability to tax, while the reason in the case of an exchange of shares could relate to the change in ownership of the acquired company. In order to combat trading in loss-making entities, legislation in many Member States contains provisions that restrict the right to set off losses incurred by subsidiaries.[58]

In my view, losses should be fully eligible for relief in the event of an exchange of shares, just as they are in the case of the operations covered by Article 6. If such an exchange has 'trading in a loss-making entity' as its principal objective or as one of its principal objectives, the appropriate provision for combating such action is Article 15(1)(a) of the Merger Directive, insofar as this objective would qualify as 'tax evasion or tax avoidance' (which, incidentally, I doubt).

4.4 *Article 6 of the Merger Directive Provides for Losses to Be Carried Forward, but Not Carried Back*

Based on a literal reading of the text ('to takeover the losses of the transferring company which had not yet been exhausted for tax purposes') Article 6 of the Merger

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56 See Art. 2(e) of the Merger Directive.

57 See Art. 2(h) and 2(i) of the Merger Directive.

58 See W. Kessler & R. Eicke, *Losing the Losses – The New German Change-of-Ownership Rule*, 48 Tax Notes Intl. 1045–1048 (10 Dec. 2007) and D. Post & K.P.E. Stals, *The Tax Treatment of Corporate Losses: A Comparative Study*, 40 Intertax 236–237 (2012).

Directive provides for losses only to be carried forward. Article 6 differs from Article 13(2) of the Directive in this respect as the latter also refers to the possibility of losses being carried back ('the loss carry forward or carry *back*').

A possible explanation for this difference between the two Articles is that losses being carried back relate specifically to the taxable subject and so can be set off only against profits attributable to that company. If, for example, an SE were to transfer its registered office from one Member State to another, while leaving a permanent establishment in the original Member State, the losses of the SE (or the permanent establishment) could be set against the profits the SE generated prior to its migration. This would be different in the case of a cross-border merger as, in that situation, it would be the losses of the *receiving* company (or permanent establishment) that would be set against the pre-merger profits of the *transferring company*. I am not convinced, however, by the claim that changing the taxable subject frustrates the ability to carry back losses because this issue also arises if losses are carried forward. If assets, for example, are transferred, it is the losses of the *transferring company* that are set off against the profits of the *receiving* company. I consequently see no dogmatic objections to extending Article 6 of the Merger Directive to include the carrying back of losses.

It is currently up to the Member States to determine the periods during which they wish to allow losses to be carried back or forward. In practice this means differences between the various Member States; these would seem to me to be unwelcome, given that the Merger Directive is specifically seeking to achieve a common system of taxation. These differences are particularly relevant when it has to be determined whether a loss is 'final'; a loss can conceivably be 'exhausted' in the subsidiary's Member State, but not yet in the parent's Member State and so not (or at least not yet) eligible for relief in the latter. In order to avoid such discrepancies, the Merger Directive ought to specify periods during which losses can be taken into account, with a one-year period for carry back and an unlimited period for carry forward seeming to me to be reasonable. It should be noted that the draft CCCTB Directive (see section 4.6 of this article) allows an unlimited period during which losses can be carried forward, but makes no provision for carry back,[59] with the reason for this stated to be that '[l]oss carry back is relatively rare in the practice of the Member States, and leads to excessive complexity.'

4.5 *Article 6 of the Merger Directive Requires Member States to Treat 'Cross-Border' Operations Only in the Same Way as 'Domestic' Operations*

Under Article 6 of the Merger Directive the Member State of the transferring company has to allow losses to be taken over by the receiving company (or its permanent establishment) only if it would also allow such treatment in a domestic situation. This represents a shortcoming in the provision as not all Member States' tax laws allow such treatment. In Germany, for example, a German receiving company cannot take over the losses of a German transferring company. The opportunity to do this was ended in response to the judgment in *Marks & Spencer* because of fears that German receiving companies could use cross-border mergers to import foreign losses.[60]

If the receiving company cannot take over the losses of the transferring company, it may be deterred from embarking upon a cross-border restructuring. Given the objective of the Merger Directive, an unconditional right to take over losses would be welcome. The question, however, is whether such an expansion would be seen as adversely affecting the 'financial interests' of the Member States that are supposed to be protected. The answer to this question can, in my view, be found in the judgment in *3D I Srl*.[61] This case concerned an Italian company (3D I Srl) that transferred a branch of its business to a Luxemburg company and received shares in the Luxemburg company in return. The branch that had been transferred became the Italian permanent establishment of the Luxemburg company. Instead of applying the transfer of assets facility provided for in Italian law to the book profit generated on the transferred assets and liabilities (as this would have required 3D I Srl to create a provision in its balance sheet if it attributed a higher tax value to the shares received in its books than the value for the tax purposes of the assets and liabilities transferred), 3D I Srl chose to exercise the option available in Italian law to pay a substitution tax for the capital gain on the asset transferred at that time. After subsequently becoming aware of a possibly favourable ECJ judgment,[62] the company requested reimbursement of the substitution tax paid, claiming that the Italian accounting requirements were incompatible with the Merger Directive as they deviated from the principle of fiscal neutrality that this Directive sought to attain. In a clearly worded Opinion,

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[59] See the fifteenth recital in the preamble of the draft CCCTB Directive and Art. 43(1) of the draft CCCTB Directive.

[60] See J. Englisch, *Reform of the Reorganization Tax Act and Related Changes*, 47 Eur. Taxn. 342–343 (2007).

[61] ECJ 19 Dec. 2012, C-207/11 (*3D I Srl*).

[62] Particularly the case ECJ 21 Nov. 2002, C-436/00 (*X and Y*).

AG Jääskinen held from the preamble to the Merger Directive that the 'so-called principle of fiscal neutrality relates solely to the tax treatment *at the time of a cross-border merger, division, transfer of assets, or share exchange, and at no other stage*'. AG Jääskinen concluded that 3D I Srl could not invoke the Merger Directive because this Directive did not contain any rules on how a transferring company had to value a transfer of assets (proposals on this were rejected) and because Italian legislation did not give rise to taxation at the time of the 'transfer of assets', but instead at a later stage (i.e., upon distribution to the *3D I Srl* shareholders). The ECJ agreed with the Advocate General, stating that the Merger 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, such as maintaining the continuity of values for tax purposes, provided that those obligations do not have the consequence that the issue of those securities during the transfer of assets itself gives rise to taxation of the capital gains relating to those assets'. The ECJ ultimately held that the Italian rules were not incompatible with the Merger Directive, thus making it clear that, in situations on which the Merger Directive does not pronounce, Member States continue to be allowed to make the Directive's benefits dependent on compliance with additional conditions, unless these conditions result in *immediate* taxation at the time of the transfer of assets. The reverse of the *3D I Srl* coin, in my view, would be that Member States that see their tax revenues fall because of having to extend the opportunities to take over losses at the time of a merger will also be unable to demand protection of their financial interests, given that their right to tax any capital gains on the transferred assets and liabilities will be unaffected.

There would seem to be sufficient support for the idea of extending Article 6 of the Merger Directive to include the unconditional takeover of losses. In its Company Taxation Study, the European Commission, for example, described the limited opportunities for losses to be taken over as one of the 'problems not resolved by the Directive'.[63] It was therefore proposed, under the heading of the 'Desirable changes to the Directive', to amend the Directive so as 'to oblige Member States – in the event of mergers, divisions or transfers of assets – to transfer the transferring company's unused losses to the company receiving the assets'. An Opinion from the European Economic and Social Committee also expressed a wish to extend the opportunities provided by the Directive for losses to be taken over: '[f]inally, the Committee insists that the fiscal neutrality of cross-border restructuring should be fully guaranteed, particularly as regards the take-over of losses and the immunisation of provisions and reserves.'[64]

4.6 *Article 6 of the Merger Directive Fails to Clarify How Non-exhausted Tax Losses of the Transferring Company Should Be Apportioned to Assets and Liabilities Transferred*

Disputes can arise between taxpayers and tax authorities when apportioning non-exhausted tax losses of the transferring company to the assets and liabilities transferred. The dispute in the case of a *transfer of assets* may concern the share of the losses to be transferred to the receiving company and the share to remain with the transferring company, while the dispute in the case of a *division* could concern which share of the transferring company's losses to transfer to which receiving company. Leaving the allocation of non-exhausted losses solely to the discretion of the relevant companies could result in arbitrary outcomes. From a liquidity perspective, for example, companies would clearly have an incentive to allocate as many non-exhausted losses as possible to profitable activities, while tax authorities may also opportunistically seek to apportion such losses to loss-making activities.

The Merger Directive fails to clarify this aspect. The 1969 proposal for a Merger Directive provided a start in Article 10(2), which stated that – in order to avoid abuse – provisions, reserves or losses should be able to be taken over by the receiving company only if it could be demonstrated that these provisions and so on related to the transferred 'branches of activity'.[65] This anti-abuse provision was to apply only in the event of a transfer of assets. The Council's report of 27 February 1984 shows that the French delegation wanted to impose (even) stricter rules on the transfer of losses from the transferring company and so added a proviso to the proposal on the grounds that it would be difficult to establish whether losses were genuinely attributable to the transferred branch of activity. The majority of the delegations,

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[63] See Commission of the European Communities, Commission Staff Working Paper 'Company Taxation in the Internal Market', COM(2001)582 final, 238–239, 23 Oct. 2001.

[64] See the Opinion of the European Economic and Social Committee on the proposal for a Council Directive amending Directive 90/434/EEC of 23 Jul. 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(2003) 613 final, para. 5.4, O.J. of the EU C 110/30, 30 Apr. 2004.

[65] See the Proposal for a Directive on the common system of taxation applicable to mergers, divisions and contributions of assets occurring between companies of different Member States of 15 Jan. 1969 COM (69) 5 final., 12 and 23.

however, did not foresee any particular problems in the original provision.[66]

How can we now bring some structure to the apportionment of these losses? On the one hand, we could seek alignment with the closing balance sheet or final income statement, with the obvious charm of this solution being that it is simple and practical. It would not always, however, result in a balanced outcome. If, say, a transferring company performed two equally profitable activities, one of which was loss-making in the past, and each of the two receiving companies received one of the activities in a division, a decision to apportion non-exhausted tax losses on the basis of the closing balance sheet would mean a 'fifty-fifty' split, even though these losses had been incurred by only one of the two activities. A technically purer way of allocating the losses would be to conduct a functional analysis so as to determine exactly which assets and liabilities gave rise to the non-exhausted tax losses. The disadvantage of this method is that it may be administratively difficult to implement because it requires profits and losses to be broken down more precisely than in the income statement.

A method falling somewhere between a completely arbitrary allocation of losses, an allocation based on the closing balance sheet or final income statement, and an allocation based on a functional analysis would be to allocate losses on the basis of the criteria for 'formulary apportionment' contained in the draft CCCTB Directive.[67] This Directive sets out the European Commission's proposal for a common consolidated tax base for companies active within the EU. As stated in point 6 of the preamble, 'consolidation is an essential element' of such a tax base. Under the proposal, the results of the members of a group[68] will be consolidated and apportioned to the Member States in which the group members are resident, in accordance with Articles 86–102 of the draft CCCTB Directive. The apportionment formula provided for in Article 86(1) of the draft CCCTB Directive essentially attributes equal weight to the factors of sales, labour and assets. Groups and members of groups can merge through business reorganizations, a concept that the draft CCCTB Directive does not define. Article 71 of the draft CCCTB Directive contains specific rules for dealing with losses in the event of a business reorganization between two or more groups:

1. Where, as a result of a business reorganisation, one or more groups, or two or more members of a group, become part of another group, any unrelieved losses of the previously existing group or groups shall be allocated to each of the members of the latter in accordance with Articles 86 to 102, on the basis of the factors applicable to the tax year in which the business reorganisation takes place, and shall be carried forward for future years.
2. Where two or more principal taxpayers merge within the meaning of Article 2(a)(i) and (ii) of Council Directive 2009/133/EC[19], any unrelieved loss of a group shall be allocated to its members in accordance with Articles 86 to 102, on the basis of the factors applicable to the tax year in which the merger takes place, and shall be carried forward for future years.

For the purposes of allocating non-exhausted tax losses to group members, both of the above paragraphs refer to the factors specified in Articles 86–102 in the year in which the business reorganization or merger took place. The Merger Directive could opt for the same solution: in other words, non-exhausted tax losses of the transferring company should be apportioned to the transferred assets and liabilities in proportion to the factors of sales, labour and assets in the transferred assets and liabilities are in relation to the sales, labour and assets in the transferring company.

4.7 *Article 6 of the Merger Directive Does Not Specify the Profits against Which the Transferring Company's Losses Can Be Set Off*

Although both the *travaux préparatoires* of the Merger Directive[69] and the European Commission's 2001 Company Taxation Study[70] allude to the possibility of avoidance if a transferring company's non-exhausted tax losses are able to be taken over by the receiving company upon merger, these suggestions are not made explicit. Apart from a completely arbitrary allocation of the transferring company's losses (see section 4.6), the only possible form of avoidance that I see would be if a restructuring operation were to take place solely for the

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[66] See European Commission, the Council, 27 Feb. 1984, 5270/84 ECOFIN 24 FISC 15 Introductory Note – General Secretariat of the Council ECOFIN Council on 12 Mar. 1984.

[67] See the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4 – 2011/0058 (CNS), *European Commission*, 16 Mar. 2011.

[68] See Arts 54 and 55 of the draft CCCTB Directive.

[69] See the Proposal for a Directive on the common system of taxation applicable to mergers, divisions and contributions of assets occurring between companies of different Member States of 15 Jan. 1969 COM (69) 5 final., 12 and 23.
European Communities, the Council, 27 Feb. 1984, 5270/84 ECOFIN 24 FISC 15 Introductory Note – General Secretariat of the Council ECOFIN Council on 12 Mar. 1984.

[70] Commission of the European Communities, Commission Staff Working Paper *Company Taxation in the Internal Market*, COM(2001)582 final, 330, 23 Oct. 2001.

purpose of offsetting losses of a transferring company against profits of a receiving company that are not attributable to the assets and liabilities transferred. In that case, a receiving company carrying on a profitable enterprise through a permanent establishment in the transferring company's Member State could absorb a company with non-exhausted tax losses purely in order to offset these losses against the profits from the other activities. The next question then is whether 'vertically' offsetting the losses against the profits of the receiving company in this way can be regarded as 'avoidance'.

The OECD would seem to hold this view, at least if base erosion and profit shifting can be regarded as avoidance. The OECD's report on *Addressing Base Erosion and Profit Shifting*, which was published on 12 February 2013, refers on page 46 to the earlier OECD report of 12 August 2011 on *Corporate Loss Utilisation through Aggressive Tax Planning*. Chapter 3 of this latter report contained a list of 'Schemes Involving Tax Losses', and while the situation referred to above is not mentioned in so many words, other similar 'structures' involving cross-border reorganizations are listed.

Dutch Acts and Decrees also regard the offsetting of losses between different taxable subjects in a merger as something that needs to be prevented. The Legal Merger Decree, which sets out the conditions for a merger under Article 14b(3) of the Corporate Income Tax Act 1969, states that it is undesirable for losses taken over from the transferring company to be offset against profits of the receiving company that are not attributable to the transferred assets and liabilities. It is also considered undesirable for non-exhausted tax losses of the receiving company to be offset against profits that are attributable to the transferred assets and liabilities. In short, 'vertical' loss relief must remain restricted to the taxable subject. In order to ensure that this is the case, paragraph 3 of the Decree prescribes that the profits of the receiving company should be divided:

> [t]he acquiring company shall apportion the profit in order to prevent these losses being set against profits that are not attributable to the assets and liabilities acquired as part of the legal merger. The profit shall be apportioned in accordance with the method applied in respect of the fiscal unity. The profit shall also be apportioned if the acquiring company has tax losses that are eligible for relief, such in order to prevent these losses being set against profits earned on assets and liabilities transferred as part of the legal merger. An explanation of the profit apportionment is set out in paragraph 5. Sufficient information for apportioning the profit will normally be available within the business in the form, for example, of branch accounting records or budgets. If the apportionment of profits nevertheless leads to substantial problems, a company may seek to agree a notional apportionment formula with the tax inspectorate. When assessing the apportionment of profits in practice, the approach adopted by inspectors should contain a degree of flexibility [*translation*].

This solution is not without foundation, as the reference to the method used for apportioning profits under the fiscal unity regime in Article 15 of the Corporate Income Tax Act 1969 demonstrates. Although the specific purpose of the fiscal unity regime is to allow companies in the fiscal unity to set off their profits and losses 'horizontally', losses incurred by one of the companies prior to the fiscal unity can be offset against the fiscal unity's taxable profits 'vertically' only insofar as this profit is attributable to that company (see Article 15ae, paragraph 1, Corporate Income Tax Act 1969). Hofman clearly explains that the legislator had wanted to prevent the fiscal unity having an influence outside the period of its existence (i.e., transactions entered into within a new fiscal unity having an effect on the relief available on previously arising losses).[71] Article 20a of the Corporate Income Tax Act 1969, which seeks to prevent trading in loss-making entities,[72] also illustrates how the legislator sought to block opportunities for 'vertical' setting-off of losses incurred by one company against profits generated by another company. Both the Legal Merger Decree and the Corporate Income Tax Act consequently ensure that the various ways in which 'vertical' loss relief could become cross-subject have been carefully closed. It is doubtful, however, whether this amounts to the combating of avoidance, or whether the legislator simply wanted not or no longer to accept the budgetary consequences of loss-making entities being traded in this way. There is no question of 'trading' or an 'artificial construction' in the event of a merger between two 'active' group members; instead, the problem there is of losses being used that may otherwise not be taken into account, or only at a later date.

The ECJ adopted a milder tone on losses of the transferring company being set against profits of the receiving company in the *Foggia* case, in which the Court sought to interpret [the current] Article 15(1)(a) of the Merger Directive.[73] *Foggia* concerned a purely Portuguese group, in which a holding company, Foggia – SGPS, acquired three other holding companies through a merger. Foggia – SGPS requested the Portuguese *Secretário de*

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[71] See A.W. Hofman, 'Verliezen meegeven bij ontvoeging: vraagtekens bij HR 13 mei 2011', *Weekblad voor fiscaal recht* 2013/553, §2. Hofman refers, *inter alia*, to *Kamerstukken II* 1999/2000, 26 854, No. 3, p. 42.

[72] On Art. 20a Wet of the Dutch Corporate Income Tax Act 1969, see S.J. Smalbrugge, *Het labyrint van de regels over de handel in verlieslichamen 2012*, NOB/LOF serie, Deventer: Kluwer 2012.

[73] ECJ 10 Nov. 2011, C-126/10 (*Foggia*).

Estado to allow it to take over non-exhausted losses of these three companies. This request was granted in respect of two of the companies, but not for the third company, which no longer performed any management activities and no longer had any financial holdings. The (reformulated) question on which the ECJ was asked to rule was whether the merger with this third company could be considered to be carried out for 'valid commercial reasons' within the meaning of Article 15(1)(a) of the Merger Directive 'where it has a positive effect in terms of the cost structure of that group, even where the acquired company does not pursue any activity, has no financial holdings and transfers only substantial losses to the acquiring company'.[74] The ECJ qualified its response by stating that a merger carried out with the aim of reducing administrative and management costs could have valid commercial reasons, but that this would not be the case if the cost savings would be only marginal compared to the magnitude of the tax benefit anticipated. The critical consideration in my view is that valid commercial reasons for a merger can be regarded as existing even if the transferring company no longer performs any activities at the time of the merger and the receiving company wants to set off the non-exhausted tax losses of the transferring company:

40. Indeed, a merger or restructuring carried out in the form of the acquisition of a company that does not carry on activity and that does not contribute assets to the acquiring company may, nevertheless, be considered by the latter to have been carried out for valid commercial reasons.

41. Likewise, it cannot be ruled out that a merger by acquisition of a company holding such losses may have valid commercial reasons since Article 6 of Directive 90/434 makes express reference to the legislative provisions that authorise taking over an acquired company's losses which have not yet been exhausted for tax purposes.

The fact that the Merger Directive is silent on which profits of the receiving company (or its permanent establishment) may be offset against the transferring company's losses means there is a risk that Member States will continue, purely for budgetary reasons, to apply restrictive rules on profit allocations, even when no avoidance occurs. Given that established ECJ case law assigns a wide interpretation to the material scope of the Merger Directive and avoidance can be combated by the anti-avoidance provision in Article 15(1)(a) of the Merger Directive,[75] an obvious choice would be in principle to allow unlimited loss relief (i.e., allowing losses of the transferring company to be offset against *all* profits of the receiving company that arise in the Member State of the transferring company). Any deduction of losses that is considered to constitute avoidance can then be dealt with under Article 15(1)(a) of the Merger Directive.

4.8 *Article 6 of the Merger Directive Covers 'Domestic' but Not 'Cross-Border' Takeover of Losses*

Article 6 of the Merger Directive allows a 'domestic' takeover of losses (i.e., where the permanent establishment of the receiving company takes over the losses of the transferring company), but is silent on whether the Member State of the transferring company has to take account of the losses of the receiving company, and also on whether the Member State of the receiving company has to take account of the losses of the transferring company. In short, therefore, the Merger Directive fails to provide for situations involving the takeover of losses in cross-border situations.

The judgment in *Futura* is relevant for answering the first question; in other words, whether the Member State of the transferring company has to take account of the losses of the receiving company. The ECJ ruled in this case that it was 'in conformity with the fiscal principle of territoriality' for Luxemburg to tax a French taxpayer with a permanent establishment in Luxemburg only for the profits and losses arising from its Luxemburg activities and to refuse to allow its 'French' losses to be deducted.[76] Similarly, the Member State of the transferring company did not have to take account of the losses of the receiving company.

The ECJ provides its answer to the second question in *A Oy*, when it states that the Member State of the receiving company does not in principle have to take account of the transferring company's losses, unless these losses are 'final'.

5 Primary EU Law Does Not Compel Expansion of Article 6 of the Merger Directive

Insofar as Member States' national laws implement secondary EU law, those national laws must be in compliance with secondary EU law. It follows from the judgment in *A.T.* that Member States may not make the tax advantage provided for under the Merger Directive in respect of exchanges of shares conditional on compliance

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[74] See ECJ EU 10 Nov. 2011, C-126/10 (*Foggia*), para. 30.

[75] See, *inter alia*, ECJ 17 Jul. 1997, No. C-28/95 (*Leur-Bloem*), para. 35 and ECJ 20 May 2010, C-352/08 (*Zwijnenburg*), para. 41.

[76] See ECJ 15 May 1997, C-250/95 (*Futura*), para. 22.

with additional requirements in national law (the 'double book value requirement') that do not appear in the Merger Directive.[77] If a directive offers Member States an option, Member States must also comply with primary EU law when exercising that option. This was made painfully clear to the Netherlands by the judgment in *Bosal*, when it was ruled that the option under Article 4(2) of the Parent-Subsidiary Directive not to allow the deductibility of costs relating to a parent's holdings could not be restricted only in respect of foreign-resident companies.[78]

Like national law, secondary EU legislation, too, has to comply with primary EU law.[79] This is illustrated by the judgment in *Gaz de France*, in which the ECJ considered whether the Parent-Subsidiary Directive was compatible with the freedom of establishment or the free movement of capital in that companies with a legal form that was not listed in the Directive were (and indeed continue to be) automatically excluded.[80] The ECJ held that Community institutions were 'free to introduce harmonisation gradually or in stages'. The Parent-Subsidiary Directive, which 'does not seek to introduce a common system for *all* companies of the Member States or for *all* holdings', can therefore be regarded as 'piecemeal legislation'. The above statement by the ECJ comes as little surprise, given that it is 'generally difficult to implement such measures because they require the competent Community institutions to draw up, on the basis of diverse and complex national provisions, common rules in harmony with the aims laid down by the EC Treaty and approved by a qualified majority of the Members of the Council, or even, as is the case in fiscal matters, their unanimous agreement'.[81] The ECJ avoided the precarious question of whether the unanimously adopted Parent-Subsidiary Directive was compatible with primary EU law and took the easy way out by stating that the Parent-Subsidiary Directive 'does not authorise a Member State to treat profits distributed to companies in other Member States which do not fall within the scope of the directive less favourably than profits distributed to comparable companies established in its territory'.[82] Interestingly, the ECJ concluded from this that the limited scope of the Parent-Subsidiary Directive consequently was 'not apt to create a restriction on the freedom of establishment'.[83]

The lesson to be learned from *Gaz de France* is that the ECJ attaches great importance to the Community institutions' powers to introduce harmonization in stages as this is already difficult enough in the field of direct taxation. The Merger Directive will not easily, therefore, be considered incompatible with the freedom of establishment. Furthermore, the ECJ has an easy escape route available in that – in many cases – the desired outcome can also be achieved by interpreting national law to be compliant with the freedom of establishment. Two points, however, should be noted in this respect. Firstly the Treaty of Lisbon, which came into force on 1 December 2009, provides various opportunities for 'enhanced cooperation' in direct taxation.[84] The need for unanimity is less readily available as an excuse now that a less constrained harmonization process allows the ECJ a narrower 'margin of appreciation' when assessing harmonization measures. Second the idea that all obstacles in the Merger Directive can be justified by the argument that 'harmonisation is already difficult enough' is open to question. Previously it has been argued that the Merger Directive's comprehensive exclusion of third-state companies[85] could not be justified under any circumstances because it is incompatible with the 'strict' prohibition of discrimination on grounds of nationality, arising from the unwritten principle of equality in the European legal order and as set down in Article 26 of the ICCPR[86] and Article 24(1) of the OECD Model Convention.[87]

The ECJ's cautious approach to testing secondary EU law for compatibility with primary EU law means Article 6 of the Merger Directive will stand up to the test of Article 49 TFEU. The fact that the Merger Directive negotiations took from 1969 to 1990 to complete shows how difficult it was (and is) to reach agreement on a common system

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77 See ECJ 11 Dec. 2008, C-285/07 (*A.T.*).

78 See ECJ 18 Sep. 2003, C-168/01 (*Bosal*).

79 On the relationship between national law, secondary EU law and primary EU law, see, *inter alia*, the contributions of A.P. Dourado (*The relationship between primary and secondary EU law in tax law: the legitimacy of different interpretation criteria applied to EU and national legal sources*) and R. Szudoczky (*The influence of primary law on the interpretation of secondary law in the field of EU citizenship and direct taxation: 'whatever works' …*) in D.M. Weber (red.), *Traditional and Alternative Routes to European Tax Integration* (Amsterdam: IBFD Publications BV, 2010) and K.J.M. Mortelmans, *The Relationship Between the Treaty Rules and Community Measures for the Establishment and Functioning of the Internal Market – Towards a Concordance Rule*, 39 Com. Mkt. L. Rev. 1303–1346 (2002).

80 See ECJ 1 Oct. 2009, C-247/08 (*Gaz de France*), para. 53. For a critical discussion of this case, see G.F. Boulogne & W.W. Geursen, Gaz de France*: Dividends to Companies Not Listed in the Parent-Subsidiary Directive Are Not Exempt*, 50 Eur. Taxn. 129–140 (2010).

81 See ECJ 1 Oct. 2009, C-247/08 (*Gaz de France*), para. 52.

82 See ECJ 1 Oct. 2009, C-247/08 (*Gaz de France*), para. 59.

83 See ECJ 1 Oct. 2009, C-247/08 (*Gaz de France*), para. 61.

84 See, *inter alia*, Arts 326–334 of the TFEU.

85 The 'legal form requirement' in Art. 3(a) of the Merger Directive in conjunction with Annex I, Part A, only covers qualifying EU legal forms.

86 International Covenant on Civil and Political Rights.

87 See G.F. Boulogne, 'De toepassing *ratione personae* van de reorganisatiefaciliteiten in de Wet IB 2001 en de Wet VPB 1969', in: G.F. Boulogne & L.J.A. Pieterse (eds.), *Aanbevelingen ter verbetering van het vestigingsklimaat voor ondernemingen. Tribuut aan Jaap Bellingwout* (ZIFO-reeks nr. 6), Deventer: Kluwer 2012, pp. 35–49.

in this field, while the image of 'chaos and despair'[88] conveyed by AG Kokott specifically in respect of loss relief makes it abundantly clear that Article 6 of the Merger Directive as agreed in 1990 probably represented the maximum achievable.

This brings me to another point, and that is that although the opportunity provided in Article 6 for loss takeover may perhaps be a half-hearted solution, it is certainly nothing more than that. In her Opinion on *A Oy* AG Kokott stated that 'by means of the Tax Merger Directive the Union legislature has made certain *fundamental decisions*, which I think must be respected, with regard to the allocation of taxation powers'.[89] The first 'fundamental decision' is alluded to in the preamble to the Merger Directive, in which the Union legislature expresses a preference for *positive* harmonization ('a common system of taxation') rather than *negative* harmonization ('an extension at Community level of the systems in force in the Member States') as a means of avoiding distortions. The second 'fundamental decision' is regarded as having been made in Article 6 of the Merger Directive, which provides for the 'accumulated loss to be used in the Member State in which the transferring company was resident'. AG Kokott held that cross-border extension of the Finnish measure would result in distortions as Swedish subsidiaries, for example, would be treated differently with regard to the transfer of an accumulated loss in the event of a merger, depending on the tax system of the Member State in which their parent company was resident, and this would conflict with the 'conscious choice' to limit Article 6 of the Merger Directive to the 'domestic' takeover of losses. AG Kokott overestimates the role of the Merger Directive, which, in my view, is no more than one of the cobblestones along the bumpy road to full harmonization of direct taxes. I refer once again to the judgment in *Gaz de France*, in which the ECJ regarded the exclusion of the types of companies not listed in the Directive as 'collateral damage' in a gradual process of harmonization rather than a consciously discriminatory choice that would be incompatible with higher EU law. On the other hand, the limited scope of Article 6 of the Merger Directive cannot suddenly serve as a wall blocking a national measure from applying beyond its borders. It is one or the other. My view is supported by the judgment in *Amurta*.[90] This case concerned the discriminatory withholding tax that was imposed on a dividend distributed by a Dutch company to one of its shareholders resident in Portugal. As the shareholder owned only 14% of the shares in the Dutch company, he was unable directly to invoke the exemption from withholding tax provided for in Article 5(1) of the Parent-Subsidiary Directive as this requires a shareholding of at least 25%. The Dutch and Italian governments argued that 'below the threshold for the minimum holding introduced by Directive 90/435, the fact of making a non-resident company [*but not a resident company*] liable to withholding tax on dividends cannot in itself be considered to be a breach of the fundamental freedoms'.[91] The ECJ gave short shrift to these views:[92]

> 24. In that regard, it must be pointed out that, in respect of shareholdings which are not covered by Directive 90/435, it is for the Member States to determine whether, and to what extent, economic double taxation of distributed profits is to be avoided and, for that purpose, to establish, either unilaterally or through double taxation conventions concluded with other Member States, procedures intended to prevent or mitigate such economic double taxation. However, this does not of itself mean that the Member States are entitled to impose measures that contravene the freedoms of movement guaranteed by the EC Treaty.

In her Opinion on *National Grid Indus*, however, which was delivered less than a year before *A Oy*, AG Kokott did assess the value of provisions in the Merger Directive correctly.[93] This case concerned the question of whether the exit taxation due immediately upon transfer of a Dutch private limited company's place of effective management to the UK was compatible with the freedom of establishment. Kokott referred to Article 12(1) of the Merger Directive, which states in essence that the Member State from which the company has been transferred must not tax any unrealized capital gains on assets that remained effectively connected with a taxable permanent establishment in that Member State. The referring court and some of the participating governments argued that, by inference, this meant that the Merger Directive did not prohibit exit taxes on unrealized capital gains on those assets that are transferred abroad. AG Kokott, however, interpreted Article 12(1) as follows: '(. . .) the question of how far an exit tax is in fact permissible in the cases covered by the directive need not be decided here and must ultimately be clarified on the basis of primary law.'[94] The Advocate General also attributed the correct value to

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[88] See the Opinion of Advocate General Kokott of 19 Jul. 2012, C-123/11 (*A Oy*), point 1.

[89] See the Opinion of Advocate General Kokott of 19 Jul. 2012, C-123/11 (*A Oy*), point 64.

[90] ECJ 8 Nov. 2007, C-379/05 (*Amurta*).

[91] ECJ 8 Nov. 2007, C-379/05 (*Amurta*), point 21.

[92] ECJ 8 Nov. 2007, C-379/05 (*Amurta*), point 24.

[93] Opinion of Advocate General Kokott of 8 Sep. 2011, C-371/10 (*National Grid Indus*), points 34–36.

[94] Opinion of Advocate General Kokott of 8 Sep. 2011, C-371/10 (*National Grid Indus*), point 50.

the role of the Merger Directive in her Opinion on *Zwijnenburg*:[95]

> 52. The essential characteristic of Directive 90/434 is that – despite the use of the expression 'common system of taxation' – it does not lead to a comprehensive harmonisation of taxation and levies that can be charged on a merger. It provides only for individual benefits by which tax disadvantages on the cross-border restructuring of undertakings are to be overcome.

6 However, expansion of article 6 of the merger directive is preferable

In section 5 of this article I argued that primary EU law does not compel expansion of the opportunities for loss relief in the Merger Directive. The fact, however, that a transferring company's losses cannot always be apportioned to the assets and liabilities that gave rise to them remains an aspect of concern. Furthermore, expanding the opportunities for losses to be taken over would not adversely affect the financial interests that the Merger Directive seeks to safeguard. These interests concern purely the safeguarding of the right to tax capital gains on transferred assets and liabilities, whereas that right is not affected by the takeover of 'final' losses from abroad. An expansion of the possibility to offset losses would consequently accord well with the system and objective of the Merger Directive.

Such an expansion would also align with the fourth point in the preamble to the Merger Directive, which states that the objective of eliminating tax obstacles cannot be attained by extending, at a Community level, the systems in force in the Member States since differences between these systems can produce distortions, and that only a common tax system can provide a satisfactory solution. Distortions do indeed occur at present, either because some Member States allow a receiving company to take over losses in a merger within their territories, while others do not, and only those Member States that allow this for a domestic merger also have to permit it in a cross-border situation. Expanding the Merger Directive would end this confusion and thus increase the legal certainty for taxpayers.

The judgment in *A Oy* still leaves a number of unresolved issues in respect of cross-border loss relief. It remains unclear, for example, exactly when losses should be regarded as 'final', while how 'final losses' are to be calculated also continues to be disputed. In *A Oy* the ECJ left it up to the national courts to decide how to interpret these points. This gives cause to fear – in my view, at least – that these issues will continue to be contentious. The belief that this fear is justified is underpinned by, for example, the on-going *Marks & Spencer* litigation in the UK, and also by the request for a preliminary ruling that the referring UK court submitted to the ECJ in the *Felixstowe* case.[96]

A final important reason for prescribing that 'final losses' should be allowed to be taken into account in cross-border situations is to prevent Member States from using (or continuing to use) their group consolidation regimes to disguise efforts to avoid importing losses from abroad, while they allow losses to be taken over in purely domestic situations.[97] The judgment in *X Holding* makes it clear that the need to safeguard the allocation of the power to impose tax releases Member States from their obligation to allow non-resident companies to avail themselves of group consolidation regimes.[98] Member States can therefore consistently keep their front doors locked by never allowing losses to be taken over in mergers, while opening their back doors ('horizontal' loss relief under a group consolidation regime) to resident companies only. Another way to keep foreign losses out is, seemingly consistently, to apply profit allocation rules so that losses taken over can be set off only against the share of the receiving company's profits that is attributable to the transferred assets and liabilities. By the time the losses taken over are 'final', there is usually little profit left to be generated on the assets and liabilities transferred. In this way the profit allocation rules deter cross-border mergers (as cross-border losses cannot be taken over until they have become 'final'); losses compensated between groups within a Member State continue, therefore, to be treated differently from those in a cross-border setting.

7 Proposal to expand and improve article 6 of the merger directive

Based on the above, the following parameters can be drawn for a rejuvenated Article 6 of the Merger Directive:

- relief should be available on losses of the acquired company in the case of an exchange of shares;
- losses of the transferring company can be carried both forward and back;
- 'domestic' losses can always be taken over;

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[95] See the Opinion of Advocate General Kokott of 16 Jul. 2009, C-352/08 (*Zwijnenburg*), point 52.

[96] Reference for a preliminary ruling, submitted on 15 Feb. 2012, C-80/12 (*Felixstowe*). The order for reference can, *inter alia*, be found on www.minbuza.nl/ecer/. Advocate General Jääskinen's Opinion was delivered on 24 Oct. 2013.

[97] On this topic, see F.A. Engelen, 'De fiscale eenheid als dekmantel voor verboden beperkingen van de vrijheid van vestiging', *NTFR* 2012–102.

[98] ECJ 25 Feb. 2010, C-337/08 (*X Holding*).

- non-exhausted tax losses of the transferring company should be apportioned to the transferred assets and liabilities in proportion to the factors of sales, labour and assets in the transferred assets and liabilities are in relation to the sales, labour and assets in the transferring company;
- 'final' losses of the transferring company can be taken into account by the receiving company in the other Member State;
- losses of the transferring company are regarded as 'final' if the transferring company has factually or legally exhausted the opportunities for loss relief in the Member State of the transferring company;
- the losses to be taken over should be determined in accordance with the tax rules of the Member State of the receiving company, as if the operation had been carried out by companies resident within its territory.
- losses of the transferring company can be set off against all profits of the receiving company in the Member State of the receiving company.

Based on these parameters my proposal for expanding and improving Article 6 of the Merger Directive is as follows:

Article 6

1. On a merger, division, partial division and transfer of assets, the Member State of the transferring company allows the receiving company's permanent establishments situated within its territory to takeover the losses of the transferring company which had not yet been exhausted for tax purposes. Losses to be taken over will be able to be set off against all profits of the receiving company in the Member State of the transferring company.
2. In an operation as referred to in paragraph 1, the Member State of the receiving company allows the receiving company to takeover the losses of the transferring company, if the transferring company has factually or legally exhausted the existing possibilities for loss relief in the Member State of the transferring company. The losses to be taken over in that case will be determined in accordance with the rules of the Member State of the receiving company, as if the operations referred to in paragraph 1 were performed between companies resident in that Member State's territory. The losses to be taken over will be able to be set off against all profits of the receiving company in the Member State of the receiving company.
3. The relationship between the losses referred to in paragraphs 1 and 2 and the total losses of the transferring company will be in equal proportion to the weight that sales, labour and assets in the transferred assets and liabilities represent of the total sales, labour and assets of the transferring company.
4. The losses to be taken over as referred to in paragraph 1 will be eligible to be set off against the profits of the previous year and subsequent years. The losses to be taken over as referred to in paragraph 2 will be eligible to be set off only against profits attributable to subsequent years.
5. An exchange of shares does not in itself result in losses of the acquired company becoming ineligible for relief.

8 Policy aspects

Researchers are in a luxurious position compared to that of politicians. The former have no need to heed calls for higher or lower taxes in their publications, while the political feasibility of their proposals is also of little importance to them. What matters to researchers is the academic integrity of their proposals. Nevertheless they cannot entirely ignore the political and social reality in which they operate, certainly not if their research is publicly funded. I am very aware that my proposal is far-*reaching*, but it is certainly not far-*fetched*. The question, however, is whether the European Commission will have sufficient appetite to include it in a proposed amendment of the Merger Directive.

The wave of harmonization seen in 1990 (the Merger Directive, the Parent-Subsidiary Directive and the Arbitration Convention were all adopted that year), followed by the adoption of the Interest and Royalty Directive in 2003, the expansion of the Parent-Subsidiary Directive in 2003 and the expansion of the Merger Directive in 2005, achieved considerable progress in reducing the tax obstacles serving to deter cross-border business activity. Recent years, however, have seen a wind of change, and a wind that is less favourable to enterprises. Although the 2011 proposal to amend the Interest and Royalty Directive included some increases in personal scope, it also and primarily contained a series of stricter provisions (such as the tighter requirements for qualifying for an exemption set out in Article 1(1),[99] while the proposal to amend the Parent-Subsidiary Directive that is planned to be presented in late 2013 is expected mainly to

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[99] See the Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, (COM)2011 714 final – 2011/0314 (CNS), *European Commission*, 11 Nov. 2011.

seek to curb hybrid financing structures.[100] Most recent developments in the field of European taxation have focused on making it easier for Member States to exchange information[101] and to combat aggressive tax planning.[102] Not only do most of the common rules being devised focus primarily on combating tax excesses rather than on eliminating tax obstacles, but also more and more efforts to achieve harmonization seem to be becoming deadlocked. A good example of this is the proposal for a financial transaction tax,[103] which would require an enhanced cooperation procedure and which seems to be collapsing under the strain of disagreements about the structure and design of the transaction tax and the economic consequences it may have,[104] despite the high revenues (EUR57 billion) it is forecast to generate.[105]

There have been two significant developments specific to the field of cross-border loss relief in the past few years. Firstly, the publication on 19 December 2006 of the European Commission's Communication on the Tax Treatment of Losses in Cross-Border Situations,[106] which was published in response to the previous year's judgment in *Marks & Spencer* and in which the Commission emphasized the importance of having effective systems for cross-border loss relief within the EU. This latter aspect is seen as one of the major obstacles to cross-border business activities within the EU. The Communication covered both loss relief within companies (i.e., between permanent establishments and head offices) and within a group of companies, and set out three possible ways of structuring cross-border relief. Despite the Commission's expressed hope that Member States will review their existing tax systems and consider new systems that create wider scope for cross-border relief, the opposite seems, however, to be happening. Germany, for example, has discontinued its system of allowing relief on mergers because of fears that the judgment in *Marks & Spencer* would result in foreign losses being imported, while the ECJ's judgment in *X Holding* ends the opportunities for cross-border loss relief under group consolidation regimes. The second significant development, being the proposal for a Common Consolidated Corporate Tax Base (CCCTB) Directive, was discussed at length in section 4.6 of this article. As I understand it, the current status of this file is that the European Council approved the Council of Ministers for Economic affairs and Finance (ECOFIN) report of 6 December 2012[107] on 21 June 2013;[108] this report states little more than that the European Commission published a proposal for a CCCTB Directive in 2011 and that the technical aspects of this proposal were discussed at length during the Cyprus presidency.

In view of these developments, amendment of the Merger Directive would seem to be low on the European priority list, with the only reference to the Merger Directive that I have come across in recent years being the comment in the Action Plan to strengthen the fight against tax fraud and tax evasion of 6 December 2012 that '[t]he Commission will also review the anti-abuse provisions of the Directives on Interest and Royalties, Mergers and Parent-Subsidiary, with a view to implement the principles underlying its Recommendation on aggressive tax planning.' If developments in the past offer any indications for the future, I expect my proposal to await the same fate as that of the proposal for a CCCTB Directive. I comfort myself, however, with the belief that the proposal will have contributed both to the academic debate and, who knows, to better times in the future.

9 Closing comments

The ECJ confirmed the '*Marks & Spencer* exception' in its judgment in *A Oy*, with the outcome of this being that 'final' losses of the transferring company can be deducted in the Member State of the receiving company. Whether losses are regarded as 'final' and, if so, how these are to be determined is a matter, according to the ECJ, for the national courts. Given that the Merger Directive seeks to create a common tax system for cross-border

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100 The conclusions of the European Council of 22 May 2013 note the following: '[t]he Commission intends to present a proposal before the end of the year for the revision of the "parent/subsidiary" Directive, and is reviewing the anti-abuse provisions in relevant EU legislation.'

101 On 1 Jan. 2013 Council Directive 2011/16/EU of 15 Feb. 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC entered into force. On 12 Jun. 2013, the European Commission issued its Proposal for a Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, COM(2013) 348 final – 2013/0188 (CNS), *European Commission*, 12 Jun. 2013. During the European Council of 22 May 2013 the Council called for the adoption of the revised Directive on the taxation of savings income (see the Proposal for a Council Directive amending Directive 2003/48/EC on taxation of savings income in the form of interest payments, COM(2008) 727 final–2008/0215 CNS, *European Commission*, 13 Nov. 2008.

102 See the ambitious 'Communication from the Commission to the European Parliament and the Council – An Action Plan to strengthen the fight against tax fraud and tax evasion', COM(2012) 722 final, *European Commission*, 6 Dec. 2012.

103 See the Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final – CNS 2013/0045, *European Commission*, 14 Feb. 2013.

104 http://online.wsj.com/article/SB10001424127887323683504578567192034185964.html.

105 http://europa.eu/rapid/press-release_MEMO-12-799_en.htm.

106 See the Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee – Tax Treatment of Losses in Cross-Border Situations, COM(2006) 824 final, 19 Dec. 2006.

107 ECOFIN report to the European Council on Tax issues, 6 Dec. 2012, 17364/12.

108 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137573.pdf.

reorganizations, it would be desirable, in my view, for the Merger Directive to codify the '*Marks & Spencer* exception' and to resolve those aspects that are unclear. The proposal outlined in section 7 of this article provides a starting point in this respect.

As well as extending the *domestic* loss relief provided for in Article 6 of the Merger Directive to include *cross-border* relief, this proposal also removes a number of other shortcomings, including making provision for unlimited loss relief by the acquired company in the event of an exchange of shares. Article 15(1)(a) of the Merger Directive can be invoked if the primary objective or one of the primary objectives of the exchange of shares is 'tax evasion or tax avoidance'. In addition to creating opportunities for losses to be carried forward, my proposal also allows them to be carried back.

The proposal states that the right to loss relief in 'domestic' situations should be unconditional; this is in order to prevent Member States from keeping the door closed to foreign losses, even if they have been declared 'final', by prohibiting the receiving company from taking over losses in both domestic and cross-border situations and by allowing the horizontal transfer of losses within a group consolidation regime in domestic situations only. In order to clarify how the transferring company's losses should be apportioned to the transferred assets and liabilities, while seeking to maintain a balance between simplicity and practicality on the one hand and fiscal reality on the other hand, the proposal suggests basing the apportionment on the factors of sales, labour and assets, as in the draft CCCTB Directive. Given that rigid rules on profit allocation would create an unnecessary obstacle to loss relief, losses of the transferring company should in principle be able to be set off against all profits of the receiving company, with Article 15(1)(a) of the Merger Directive being applied (proportionally) to counter any avoidance.