

The Treatment of corporate tax attributes in Group Restructurings -

An analysis for corporations resident

in Austria, the United Kingdom and the Grand Duchy of Luxembourg in light of

recent ECJ judgements

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1 ABBREVIATIONS

AB	Swedish limited liability company (Aktiebolag)
AG	Austrian public limited liability company (Aktiengesellschaft)
AG	Advocate General
AktG	Austrian Corporate Law for public limited liability company
BMF	Austrian Ministry of Finance (Bundesministerium für Finanzen)
CA	The Companies Act
CTA	Corporation Taxes Act
ECJ	Court of Justice of the European Union (in European literature often abbreviated to CJEU)
EStG	Austrian Income Taxes Act (Einkommenssteuergesetz)
EU	European Union
EVL	Finnish Act on Business Taxation (Elinkeinoverolaki)
FSMA 2000	Financial Service and Markets Acts 2000
GAAR	General Anti-Abuse Rules
GmbH	Austrian private limited liability company (Gesellschaft mit beschränkter Haftung)
GmbHG	Austrian Corporate Law for private limited liability company
HMRC	Her Majesty's Revenue and Customs (UK)
IBFD	International Bureau of Fiscal Documentation
ICTA	UK Income and Corporations Taxes Act
KStG	Austrian Corporation Taxes Act (Körperschaftssteuergesetz)
LIR	Luxembourg Tax Rules (Loi de l'impôt sur le revenu)
LSC	Luxembourg law on commercial companies (loi sur les sociétés commerciales)
MS	Member State
PE	Permanent Establishment
SA	Luxembourg public limited liability company (Société Anonyme)
SarL	Luxembourg private limited liability company (Société à responsabilité limitée)
SCA	Luxembourg Partnership limited by shares (Société en commandite par actions)
StAnpG	Austrian Adjustment Taxes Act (Steueranpassungsgesetz)
StrukAnpG	Austrian Infrastructure Adjustment Taxes Act (Strukturanpassungsgesetz)

TAAR	Targeted Anti-Abuse Rules
TCGA	UK Taxation of Capital Gains Act
TFEU	Treaty for the Functioning of the European Union
TIOPA	UK Taxation (International and other Provisions) Act
TVL	Finnish Income Tax Act (Tuloverolaki)
UGB	Austrian Corporate Law (Unternehmensgesetzbuch)
UK	United Kingdom
UmgrStG	Austrian Corporate Restructuring Taxes Act (Umgründungssteuergesetz)

2 INTRODUCTION

2.1 Background

Corporate groups consist of a number of companies that are often independent legal entities, however despite this legal separation, in economic reality part of one unit. Each entity may be subject to separate corporate and tax rules in its country of incorporation. Optimizing the corporate legal entity structure by terminating loss-making activities and combining entities can achieve increased profitability and realize cost savings.

For domestic reorganizations, most jurisdictions provide favorable national treatment for groups of companies, by providing for tax neutral legal entity restructurings within a group. Crossborder reorganizations across multiple jurisdictions and tax systems are more complex and do not tend to award the same benefits for group mergers. They often result in unused losses or increased tax liabilities. In addition to the often lacking domestic rules for cross border mergers, these transactions are also often subject to European Union (“EU”) law. EU law does not explicitly harmonize direct Taxation, so the case law of the ECJ provides guidance in its judgments. The resulting uncertainty for corporates as to whether losses can be ‘merged’ makes decisions on legal entity restructurings difficult and may limit the ability to choose the most efficient corporate structure.

2.2 Aim and delimitations

The aim in this paper is to establish to what extent rules in domestic tax law provide for tax neutrality in mergers and whether they allow for internal and cross border loss set off. In this paper, an overview of the relevant rules for domestic and European

group mergers in three European countries - Austria, the Grand Duchy of Luxembourg and the United Kingdom – will be given, drawing out similarities and potential problematic areas. All three jurisdictions allow tax neutral restructurings of some kind, which raises the question as to what extent losses can be ‘mergable’.

ECJ case law is analysed with the aim to furthermore establish whether the ‘final losses doctrine’ and ‘valid commercial rationale’ discussion by the ECJ has been shaping the national laws on loss utilisation in Austria, Luxembourg and the United Kingdom. In the analysis of the case law, a natural area of focus will be on the recent emphasis for loss availability in a crossborder merger - the concepts of when losses are ‘*final losses*’ and when a restructuring is undertaken for a ‘*valid commercial rationale*’. These are important concepts in the ECJ’s jurisprudence as they ensure losses can no longer be used in the other Member State and no abuse is suspected, in which case an exceptional requirement for the host state to take losses into consideration exists.

The analysis is limited to the merger in groups of companies and their subsidiaries in the EU; rules on group consolidations and distributions will not be considered. The ECJ case law analysis will focus on cases with regard to final losses of subsidiaries, discussions of on-going losses or cases regarding foreign PEs will only be taken into consideration where they add an important aspect to the discussion.

2.3 Structure of Paper

Chapter 3 will review the three respective domestic corporate law framework for mergers, explore their definition of merger and give an overview of the national tax rules, including the approach to anti-abuse rules. The chapter ends with an overview of common themes and potential problems.

Chapter 4 gives an introduction to applicable EU laws, their mechanics and the fundamental freedoms. After an overview of the procedure of referring cases to the ECJ, it gives a summary of the increased role of the ECJ in defining the boundaries for harmonisation in the area of direct taxation in the EU.

Chapter 5 analyses how the line of ECJ case law on loss utilisation and anti-abuse scenarios has developed. The review here focuses on the ECJ judgement in *Marks & Spencer* and *A Oy* in the areas of loss utilisation and *Foggia* as an example of anti-abuse discussion as they constitute the most recent and most relevant decisions. The chapter concludes with summarising the requirements for cross-border loss utilisation in a group merger and potential open questions.

Chapter 6 contains a conclusion for the whole thesis by answering the questions raised at the outset and pointing to current developments.

3 DOMESTIC FRAMEWORKS FOR MERGERS

3.1 Introduction

To understand the different tax rules for mergers, a starting point will be the different concepts in the national corporate law of the three countries. For the purposes for this paper, the term ‘merger’ will be used to describe what is generally considered a legal merger¹. Essentially where a corporation (the transferring entity) is legally merged with another corporation (the receiving entity), the transferring entity’s assets and liabilities are taken over by the receiving entity and the transferring entity then ceases to exist without going into liquidation.²

One of the main challenges with this topic is that the definition of merger and its subsequent tax treatment depend entirely on the respective jurisdiction’s corporate law. Each of the jurisdictions has its own definition of merger. The corporate law in both Austria and Luxembourg provides specifically for a merger by absorption³, the UK however does not.

3.2 Corporate Laws on mergers

In Austria, corporates are subject to the general rules of the Unternehmensgesetz (“UGB”), which are then supplemented by specific rules depending on the type of corporation. For private limited companies (GmbHs), and public limited companies

¹ This understanding is in line with the definition of merger in Art.2 of the Merger Directive (Directive 90/434/EEC on a common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States).

² Also see the European Court of Justice’s (“ECJ”) decision in *Punch Graphix* (C-371/11), which confirmed that the dissolution of a company through a merger by acquisition cannot be equated to a liquidation.

³ In both countries, this in addition to a merger by incorporation, which is also explicitly stipulated in the corporate and tax laws.

(AG)⁴ the rules on mergers by absorption (“Verschmelzung durch Aufnahme”) are in § 96, Abs.1 GmbHG⁵ and § 219, Abs 1 AktG⁶. As a result of these rules, a merger by absorption leads to universal succession (‘Gesamtrechtsnachfolge’) by operation of law in exchange for shares, i.e. a full assignment of all assets, rights and liabilities from the transferring company to the receiving company.

In Luxembourg, the loi sur les sociétés commerciales⁷ (law on commercial companies, “LSC”) governs the legal aspects of domestic and cross border mergers for corporates⁸ (Section XIV – Des Fusions⁹). A merger by absorption is defined as *“an operation whereby one or more companies, dissolved but not liquidated, pass on all of their net assets (assets and liabilities included) to an existing or new company. Their contributions are remunerated by the allocation of shares in the pre-existing or new company and, where applicable, the payment of a balancing cash adjustment that does not exceed 10 % of the nominal value of the units or shares distributed.”*¹⁰

⁴ Applicable corporate and tax laws are driven by the legal form and seat (administrative centre, “Verwaltungssitz” - as per § 10 Bundesgesetz vom 15. Juni 1978 über das internationale Privatrecht (“IPR-Gesetz”), this will in most cases be the same as the place of effective management (“Ort der Geschäftsleitung”), which governs the jurisdiction to tax under § 27, Abs 2 Bundesabgabenordnung (“BAO”). See http://www.jusline.at/27_BAO.html on 20.5.2013.) of the company in question (See Steuerrichtlinien: Rz 28-30 UmgrStR. See <https://findok.bmf.gv.at/findok/link?gz=%22BMF-010203%2F0560-VI%2F6%2F2011%22&gueltig=20111115&bereich=rl> on 20.5.2013.)

⁵ “Gesellschaften mit beschränkter Haftung können unter Ausschluß der Abwicklung verschmolzen werden. Die Verschmelzung kann erfolgen durch Übertragung des Vermögens einer Gesellschaft oder mehrerer Gesellschaften (übertragende Gesellschaften) im Wege der Gesamtrechtsnachfolge auf eine andere bestehende Gesellschaft (übernehmende Gesellschaft) gegen Gewährung von Geschäftsanteilen dieser Gesellschaft (Verschmelzung durch Aufnahme) [...]” at http://www.jusline.at/96_Begriff_der_Verschmelzung_GmbHG.html on 10.8.2013.

⁶ “Aktiengesellschaften können unter Ausschluß der Abwicklung verschmolzen werden. Die Verschmelzung kann erfolgen durch Übertragung des Vermögens einer Gesellschaft oder mehrerer Gesellschaften (übertragende Gesellschaften) im Wege der Gesamtrechtsnachfolge auf eine andere bestehende Gesellschaft (übernehmende Gesellschaft) gegen Gewährung von Aktien dieser Gesellschaft (Verschmelzung durch Aufnahme) [...]” at http://www.jusline.at/219_Begriff_der_Verschmelzung_AktG.html on 10.8.2013.

⁷ Initially dating from 10 August 1915 and as amended in 2011.

⁸ The corporate law applies to a range of commercial companies, including the S.A., S.a.r.L. and the SCA. All these companies limited by shares are also subject to corporate income tax.

⁹ See <http://eli.legilux.public.lu/eli/etat/leg/loi/1915/08/10/n1> on 10.8.2013.

¹⁰ See <http://www.guichet.public.lu/entreprises/en/fiscalite/developpement-restructuration/acquisition-societes/fusion/index.html>, on 14.5.2013.

In the UK, a very different approach is taken. Company law does not specifically provide for a ‘statutory’ merger or merger by fusion. Instead, a business combination can be achieved through a share exchange¹¹ combined with a subsequent group reorganization or by transferring the business to the receiving company in exchange for shares in that company (Scheme of reconstruction). These transactions do not automatically result in only one surviving company¹² and therefore require a subsequent liquidation of the transferring company.

Having three different corporate law approaches to the legal construct available for business reorganization, helps to understand the different national tax rules for mergers.

3.3 Tax Laws on mergers

3.3.1 Austria

In Austria, the process of legally and commercially combining the assets and liabilities of the transferring company and the receiving company is termed ‘Verschmelzung’ (amalgamation). In general, all transactions are subject to the main principle of Austrian taxation, the ‘Tauschgrundsatz’ § 6 Z 14 Einkommenssteuergesetz (“EStG”), whereby all exchanges should be valued at the common value of the asset. Austrian tax law, jurisprudence and case law differentiate

¹¹ See Harris (2013), p.542.

¹² The only form of universal succession in UK company law is achieved through schemes of arrangement, Companies Act 2006, Parts 26 and 27 (ss. 895-941). Also see <http://www.hmrc.gov.uk/manuals/insmanual/ins3101.htm>, on 16.5.2013. These are available either formally under both The Companies Act (Section 425 CA 1985 for preserving the business of a company to be carried on by substantially the same persons) and the Insolvency Act (Sections 110, 167 to 169 IA 1986 for companies in liquidation whose business is transferred to another company) or as informal schemes. They will result in the liquidation of the ceasing company post transfer of all or part of the undertaking. As the formal requirements are rather cumbersome, schemes of arrangements are seldom used.

combining entities, whilst maintaining essential business activities¹³, from a disposal of assets and liabilities. As a result, mergers of private and public limited companies are governed by the specific - and mandatory¹⁴ – rules of § 1 Abs 1 Z 1 Umgründungssteuergesetz¹⁵ (“UmgrStG”)¹⁶.

Tax neutrality is achieved by valuing the transferred assets and liabilities at their historic cost base in the receiving company (“Buchwertfortführung”). Consequently, unrealised gains and losses (“stille Reserven”, “stille Lasten”) are only triggered at a subsequent revaluation¹⁷ or disposal, provided the jurisdiction’s ability to tax subsequent gains is not diminished. These rules are limited by § 24 Abs 2 UmgrStG to a scenario where the ‘jurisdiction to tax’ is changing and a potential reduction of the Austrian tax base would occur.

The most significant exceptions to achieving tax neutrality occur in cases of abuse. Where substance and legal form differ, economic substance¹⁸ is taken as the basis for calculating the tax liability. Where the sole motivation of a transaction is found to be

¹³ This applies as long as the merger is indeed a reorganisation of business activities and assets under a new legal form and ownership. See later discussion of cases of abuse.

¹⁴ § 1 Abs 3 UmgrStG. The UmgrStG applies mandatorily but also exclusively to all cases of amalgamation with no ability to choose other, more general, tax rules. See Doralt/Ruppe I⁸ pp.382 *et seq.*

¹⁵ Applicable to mergers after 31.12.1991 (BGBl 1991/699). Prior to that the Strukturverbesserungsgesetz (BGBl 1969/69) allowed adjusting the legal form for commercially required reorganizations whilst avoiding the realization of profits as would have been triggered in a sale.

¹⁶ See § 20 Abs1 KStG, rather than applying the liquidation rules under § 19 Körperschaftssteuergesetz (“KStG”).

¹⁷ Under Austrian accounting rules (§ 202 Abs 2 Unternehmensgesetzbuch (“UGB”) (2013), amalgamations result in a) a choice whether to continue the cost base of the assets or apply current value, and b) in case of a continuation of the cost base, a limitation of backdating the merger by a maximum of 9 months prior to registration with the companies register (“Firmenbuch”). See Doralt/Ruppe I⁸ pp.385 *et seq.* Where the UmgrStG applies, the “Massgeblichkeitsprinzip”, a rule under which accounting results have to be carried into the tax accounts, does not apply and the tax accounts may diverge from the financial accounts. For a merger, final accounts of the ceasing company need to be prepared (“Schlussbilanz”) as well as combined accounts of the two companies after the merger (“Verschmelzungsbilanz”). The rules of the UmgrStG apply irrespective of whether there is an election to mark to market under the accounting rules.

¹⁸ See Rosenberger, Stürzlinger (2011), p.111 and § 21 Abs.1 BAO.

the reduction or elimination of a tax obligation¹⁹, § 44 UmgrStG negates the application of the UmgrStG for both domestic and cross border transactions. Cross border mergers are tested for abuse under the anti-abuse articles of the Merger Directive²⁰. In both cases the benefits of the UmgrStG are no longer available and the liquidation rules of § 20 iVm § 19 KStG 1988 apply, resulting in the realization of unrealized gains and losses.

In Austria, losses incurred by resident companies are generally available for indefinite²¹ carry forward²² (§ 18 Abs. 6 & 7 EStG 1988). For both domestic and cross border EU mergers, § 4 UmgrStG²³ provides that unutilised losses connected with either of the companies be transferred to the receiving company. They are subsequently available for future set off against profits as long as the assets relating to the losses are still in existence on the merger date (“objektbezogener Verlustvortrag”)²⁴.

The loss carry forward is limited by § 8 Abs 4 Z 2 KStG²⁵ in cases of trading loss companies (a circumstance considered abusive and termed ‘Mantelkauf’²⁶). The

¹⁹ As per the Austrian General Anti-Abuse Rule (‘GAAR’) of § 22 BAO. For a recent analysis see Kofler, Austria in IFA (ed.), *Tax treaties and tax avoidance: application of anti-avoidance provisions*, vol 95a, Cahiers de droit fiscal international, pp.100 *et seq.* (2010)

²⁰ Art. 15 of the EU Directive 2009/133/EG.

²¹ As introduced by the Strukturanpassungsgesetz 1996 (‘StrukAnpG’).

²² No provisions for loss carry back exist under Austrian tax law. See Achatz, p.294.

²³ Carrying forward the losses requires a) accounting for assets and liabilities at historic cost (§ 4 Z 1 lit a UmgrStG), b) assets relevant to losses being in existence at merger date (§ 4 Z 1 lit a UmgrStG), c) assets being transferred is comparable to assets at time of incurring losses (§ 4 Z 1 lit c UmgrStG), d) no limited for connected companies (§ 4 Z 1 lit d UmgrStG) and e) not abuse (‘Mantelkauf’ § 4 Z 2 UmgrStG).

²⁴ The requirement for transferred assets and liabilities to be connected with the losses is similar to the requirement of Article 4 (2) Merger Directive. See § 4 Abs Z lit d UmgrStG for rules regarding previous revaluations of group equity holdings.

²⁵ See Achatz p.299 *et seq.* for more background.

²⁶ See also SWK *Heft-Nr 9/1995*, 249 and SWK *Heft-Nr 9/1996*, 191. As the rules on ‘Mantelkaufgeschäfte’ are ambiguous, there are numerous discussion and cases on this topic debating what constitutes a continuation of comparable business assets and activities, for example SWK *Heft-Nr 23/2003*, 580 Norbert Schrottmeyer: *Umgründungssteuerrecht: Ein Fall aus der Praxis - Mantelkauf und Verschmelzungen, Zusammenspiel von § 8 Abs 4 Z 2 KStG und § 4 UmgrStG.*

circumstances of a ‘Mantelkauf’ transaction are suspected in cases of significantly changing a) the character of the business in a merger situation, b) substantial changes to the organizational structure and c) to the business scope of the company. As these facts would leave the business considerably changed they result in the non-transferability of the losses in a sale.²⁷

3.3.2 Luxembourg

In Luxembourg, specific tax rules cover legal entity restructurings including the combination of two entities through a merger by absorption. The rules of Art. 169-172bis Loi de l’impôt sur le revenu (“LIR”) provide for the universal transfer of the net assets²⁸ of the transferring entity to the receiving entity, the automatic dissolution²⁹ of the transferring entity and the remuneration for the transferring entity’s contributions. Roll over relief is provided for both domestic and cross border mergers. The benefit of tax neutral mergers are only available where the receiving a) company is a fully taxable Luxembourg resident taxpayer³⁰, b) the remuneration³¹ is limited to a small cash portion³² / exchange for shares and c) the receiving company continues to account³³ for assets and liabilities at historic cost base³⁴ to ensure any hidden reserves stemming from unrealised gains and losses will be taxed in the future.

²⁷ More on the likely circumstances constituting a ‘Mantelkauf’ in Petritz, Ressler p.193 *et seq.*

²⁸ Termed ‘transmission universelle de patrimoine’ and governed by art.171 al.I LIR, at http://www.impotsdirects.public.lu/legislation/LIR/Loi_modifie_du_4_d_cembre_1967_concernant_l_impot_sur_le_revenu_-_texte_coordonne_au_1er_janvier_20131.pdf on 14.5.2013.

²⁹ See art.170 al.I^{er} LIR.

³⁰ Art.170 al.2 LIR.

³¹ Art.170 al. 2 n° I LIR. A merger premium can be calculated by comparing the value of the net assets (‘la valeur nette comptable de l’actif social transféré’) to the total remuneration obtained (‘la rémunération obtenue pour l’actif social’), see Steichen (2004) pp. 446 *et seq.*

³² Not exceeding 10% of the nominal value of shares.

³³ Art.170 al.4 LIR.

³⁴ See also Steichen (2004) pp.446 *et seq.*

Tax-neutral mergers are possible for domestic or EU reorganisation if Luxembourg retains the right to tax any deferred gains at the time of realisation³⁵, usually implying some presence, i.e. a permanent establishment, remaining onshore in an outward merger. Where the receiving entity held a participating interest of 10% or more in the transferring entity, Luxembourg applies a preferential regime. The benefit provided from the Parent Subsidiary directive is extended to the capital gain from the share exchange and is treated as if it had been a dividend.³⁶

Only the entity that suffered the losses can carry them forward. Art.114 LIR provides that Luxembourg resident companies can carry forward losses without time limits and offset them against future profits, subject to certain conditions³⁷. In a merger, this means that the receiving entity cannot carry forward any losses incurred by the transferring company³⁸. By contrast, the same does not apply to a change in shareholder³⁹. In cases of suspected abuse, the tax authorities can refuse the carry forward of the losses and re-characterise⁴⁰ a transaction under § 6

³⁵ “L’article 170bis LIR nouvellement introduit en 2001 traite des opérations de fusion [.....] , impliquerait qu’il y aurait obligation que le bénéfice reste exposé à une imposition ultérieure au Luxembourg.” Winandy, (2003) p.12.

³⁶ Art.171 Al.3 LIR. See <http://www.guichet.public.lu/entreprises/en/fiscalite/developpement-restructuration/acquisition-societes/fusion/index.html#undefined>! on 10.8.2013.

³⁷ The conditions of indefinite loss carry forward und Art. 114 LIR are - the losses have not already been offset, - the company has maintained proper accounting during the loss making period and, - the losses are off-set by the company that incurred them.

³⁸ See Beltjens, p.436 regarding the options for fiscal unity utilization of losses for group companies. In addition, where the entity might have unrealized gains on assets, it could sell these to the receiving entity just before the merger and – as all transactions in Luxembourg are required to be conducted at arms length – realize the gain which could then be set off against its existing losses, see Beltjens p.438.

³⁹ The ability to continue using losses following a change in shareholder rather than a merger has been confirmed in 2010 by the Administrative Court of Luxembourg (CAA, 15 July 2010, no.25957c) which upheld a decision by the Administrative Tribunal (TA, 6 July 2009, no.23982) confirming that tax losses can not be carried over if the company has been solely bought for exploiting pre-existing tax losses . An administrative circular (Circular no. 114/2 LIR of 2 Sept 2010) confirmed the right to carry forward losses in case of changing shareholder as long as economic activities are continued or even extended.

⁴⁰ Transactions are analyzed based on their substance, rather than their chosen legal form, where there might be a divergence between the two. See IFA Cahiers 2011, vol.96a p. 476 referring to IFA Cahiers 2010, vol. 95a p.490.

Steueranpassungsgesetz (“StAnpG”)⁴¹. The ‘Mantelkauf’ theory is also applied in Luxembourg where the authorities suspect a new shareholder has simply bought an empty shell company with losses.

3.3.3 United Kingdom

A company will be subject to tax in the United Kingdom (“UK”), if it is resident⁴² there. Tax is levied on the company’s profits, which consist of its income and chargeable gains (i.e. the capital gains). This differentiation also drives the different sources of UK tax law most relevant to corporate restructurings - the Corporation Taxes Act (2009) (CTA 2009) and the Taxation of Capital Gains Act 1992 (TCGA 1992).⁴³

As established, the UK has no codified rules in corporate law for legal entity restructurings; hence the taxpayer must look to a number of provisions in tax law to understand the potential impact of a group merger. The Taxation of Capital Gains Act (TCGA) 1992 s.139 allows for the transfer of a business, or part of a business, from one company to another under a scheme of reconstruction at a tax value that results in neither a gain nor a loss.⁴⁴

Merger relief⁴⁵, a roll over deferral for Capital Gains Tax, is available for a merger by share exchange as long as certain holding thresholds⁴⁶ are met. Internal transfers of

⁴¹ In addition to the general tax provision of the Abgabenordnung (“AO”) dealing with procedural aspects of direct taxes, the StAnpG sets out particular principles of tax law. See Steichen (2013) pp.2 *et seq.*

⁴² The UK’s residency rules are twofold, either by the company being incorporated in the UK or by having it central management and control in the UK if it is incorporated elsewhere.

⁴³ Tax liabilities arising after the restructuring might be covered by Taxation (International and other Provisions) Act 2010 (TIOPA 2010) and Income and Corporation Taxes Act 1988 (ICTA 1988).

⁴⁴ See <http://www.hmrc.gov.uk/manuals/ctmanual/ctm47410.htm> on 15.5.2013. If the conditions are met, then the provision applies mandatory unless the main purpose is the avoidance of tax. If the assets are transferred in exchange for shares followed by liquidation, again a tax deferral is available until the ultimate sale of the assets under TCGA 1992 s. 140.

⁴⁵ See Harris (2013), p.538. Also see IBFD (2003), p.29 “*The tax legislation of the UK does not contain a provision providing for rollover relief for assets and liabilities transferred in the case of a merger by acquisition of a company resident in the United Kingdom and a company resident in another Member State.*”

assets within a capital gains group can also be achieved under the group relief rules resulting in the ‘porting’ of the historic book cost and any capital gain only being realized upon sale outside of the group as long as no exit from the UK tax system occurs.⁴⁷

Losses can not only be offset within the group, but also carried back or carried forward. A company can carry most losses forward with no time limitations, subject to a ‘quality’ limitation resulting from the UK schedular system of taxation - losses can only be offset against future profits of the same trade⁴⁸ by the same legal entity.

Recently, a GAAR rule has been introduced in the UK⁴⁹, which might significantly change the current position. To date no substance over form doctrine was enshrined in domestic legislation and only a range of targeted provisions (“TAAR”) and case law had developed a system where transactions could be recharacterised if found to be solely structured to obtain a tax advantage.⁵⁰ In general, genuine and commercially

⁴⁶ See Harris (2013), pp.542 *et seq.* Scenarios allowing for merger relief are a) the receiving entity holds in excess of 25% or ordinary share capital of the transferring entity, b) the receiving entity made a general offer to the shareholders of the transferring entity and c) post merger, the receiving entity holds ‘the greater part of the voting power’ in the transferring entity. See TCGA 1992 s.135 and 137, s.138 for clearance procedure available. However see Harris (2013), pp.547 *et seq.* for the potential issues in valuing the shares and assets appropriately.

⁴⁷ See TCGA 1992, s.171 allowing transfers between UK tax resident members of the capital gains group on a no gain/no loss basis and entitles the receiving entity to inherit the historic acquisition cost of the asset. There is an ongoing discussion whether the rules in s.171 conform with EU law due following the ECJ’s decision in *X and Y v Riksskatteverket* (C-436/00).

⁴⁸ CTA 2010, s.45 (1)-(6). See Green, Newby, Sarson (2011) p.737 for a review of circumstances and case law where losses cease to be available.

⁴⁹ On 17th July 2013, the Finance Bill 2013 received Royal Assent to become the Finance Act 2013 and introduced a GAAR into UK legislation. HMRC in its guidance note however make it very clear that its intention is to ‘change the game’ and deter taxpayers from entering into abusive arrangements, the guidance paper states as the fundamental approach “*It [the GAAR] therefore rejects the approach taken by the Courts in a number of old cases to the effect that taxpayers are free to use their ingenuity to reduce their tax bills by any lawful means, however contrived those means might be and however far the tax consequences might diverge from the real economic position.*” It is yet unproven how such this will influence what are perceived to be abusive arrangements and profit shifting activities and upcoming decisions by the courts.

⁵⁰ See line of argument from *Duke of Westminster v CIR* [1936] AC1 where the court refused to look a substance over form but respected the legal form chosen and its tax results (“*Every man is entitled if he can to order his affairs so that the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow tax payers may be of his ingenuity, he cannot be compelled to pay an increased tax.*”, Lord Tomlin) to Lord Wilberforce introducing the concept of ‘circular’ schemes of tax avoidance in *WT Ramsay Ltd v IRC* ([1981] STC 174) and establishing the ‘Ramsay principle’. The Ramsay principle got extended beyond circular transactions to a scheme of tax deferral in *Furniss v Dawson* ([1984] STC 153).

motivated cases of business restructuring should not be considered artificial. Anti-abuse provisions under TCGA 1992 s.137 mean that merger relief is not available if the transaction forms part of a so-called 'scheme' and one of its main purposes is to avoid tax⁵¹. Specific anti-abuse provisions are included in the corporation tax rules to prevent the utilization of losses incurred by an unconnected company, eliminating certain cases of trading in loss companies.⁵²

3.4 Common Themes and Potential Problems

The amalgamation of two corporations into one corporation is governed by different rules in each of the three countries, both under corporate and tax law. Where these rules foresee a legal merger scenario, one expects to see a coherent system and symmetry in the tax treatment.

Merging two companies and achieving tax neutrality in a domestic scenario can be achieved in all three jurisdictions, albeit through different mechanisms. In Austria and Luxembourg, corporate law recognizes the concept of a legal merger and tax rules allow tax neutrality for assets and liabilities under certain conditions where the merged company ceases to exist. By contrast, in the UK a business combination requires more complicated arrangements. Corporate law does not foresee a special procedure for a merger and hence the tax treatment depends on which surrogate is chosen. Roll over relief in Austria and Luxembourg for mergers and in the UK for

⁵¹ See HMRC Manual CG 52670, <http://www.hmrc.gov.uk/manuals/cgmanual/cg52670.htm> on 20.5.2013. HMRC as executive authority does neither write law nor does it generally issue binding rulings. Their current view can be deduced from publicly available HMRC manuals and handbooks and will give guidance as to interpretational freedom of the law. "As well as the legislation contained in the taxes Act and statutory instrument, the UK government also issues statements of practice (SPs) and extra-statutory concessions (ESCs), outlining the approach of HM revenue and Customs (HMRC) in relation to unclear or complex areas of legislation." See Green, Newby and Sarson, p.731.

⁵² CTA 2010, s.719 (2), (3), CTA 2010, s.673 (1)-(3) and HMRC Statement of Practice 10/91. Broadly, these require the original trade to be continued, losses to the original trade to be ring fenced as well as continuity in the ownership of the trade.

share exchanges is provided as long as the jurisdiction maintains the ability to tax any latent gains at a future point in time.

Over and beyond the transfer of assets at historic cost, the availability of losses becomes the most interesting subject for discussion. Looking at the wider context in the EU, only three countries (Denmark, Italy and Austria) allow crossborder offset of profit and losses⁵³. Nine EU members have no concept of group taxation and the remaining have a more or less generous concept of offsetting losses and profits like the UK and Luxembourg when taxing each entity separately under the concept of legal personality that are not in principle consolidated.

Austrian companies have the most generous tax group regime under § 9 KStG where even foreign losses can be offset. In Luxembourg, a tax consolidation regime allows for the offsetting of losses with profits within the same group as long as the parent company is fully taxable in Luxembourg and holds at least 95% of the share capital of its fully taxable Luxembourg consolidated subsidiaries⁵⁴. Austria and Luxembourg have “change of ownership” rules to limit the amount of losses transferred and trigger forfeiture if the subsidiaries losses in upon significant change in business activities or ownership. The UK has no system of group consolidation⁵⁵, it does however allow certain current year losses incurred by one company to be set off against the profits of

⁵³ See BMF, p.19. A recent report by the Federal Audit office (‘Bundesrechnungshof’) has highlighted that the generous crossborder group taxation regime resulted in EUR 3bn of foreign losses being offset in Austria and EUR 0.5bn foreign loss carry forwards being claimed against Austrian income. As Austria does not have any ability to tax foreign income, it is questionable whether any other countries would want to follow the example of the extended cross border tax grouping at such a high cost. The counter argument, and the argument the Ministry of Finance is putting forward, is that the generous group taxation rules in Austria have resulted in increased number of multinational companies relocating their headquarters and hence additional tax revenues. As no exact numbers are available this will remain an area for debate and political decisions.

⁵⁴ Art. 164 LIR, this tax consolidation only covers corporate and commercial income tax. Also see <http://www.guichet.public.lu/entreprises/en/fiscalite/developpement-restructuration/acquisition-societes/fusion/index.html#undefined>! on 10.8.2013.

⁵⁵ Each company is required to compute their profits and tax liability on a single entity basis.

a group company under certain conditions, known as group relief.⁵⁶ Members of a 75% owned group are able to offset trading losses⁵⁷ against profits in group companies in the same period avoiding the disadvantage of establishing group companies compared to setting up branches, which are automatically consolidated.⁵⁸

In crossborder settings, the ability to use losses of merged companies is often restricted. Losses can become 'stranded' in a country where they are inaccessible and no access to relief in the taxpayer's state of residence. This may put companies in an unfavourable position compared to a mere domestic setting by resulting in a total tax burden exceeding the actual profits and its economic capacity⁵⁹ to pay taxes. The shortcoming in domestic legislation only relieving losses from the state of origin constitutes a barrier to accessing other markets. As such these do not conform to the guiding principle of the European Union – the establishment of a functioning internal market.

At the same time, provisions too generous can also contravene EU law. The domestic rules allow for the Austrian parent to utilize foreign losses in the period in which they are incurred, if they cannot be offset abroad. Such loss utilization is subject to a claw back, if the losses can be used in the foreign state in the future then Austria retains the right to 'make up' payments. The ECJ's case law has shown in its decisions on final

⁵⁶ Also see *Marks & Spencer plc v. Halsey* (December 2005) for a successful challenge to the group relief rules and the subsequent extension of domestic group relief rules in 2006. A UK case, *Electronics v Inspector of Taxes* [2005] S.T.C. (S.C.D.) 512, discusses the issue of setting of terminal losses of two of its divisions against prior year profits, testing the question whether these were separate trades. Also, cross border loss surrender is not possible where the loss to be surrendered has been partially deducted from the non-residents tax liability, see *Philips Electronics* (C-18/11).

⁵⁷ Trading losses, excess capital allowances and non-trading deficits on loan relationships may be surrendered in full, irrespectively of whether the transferring company has other profits, which might have been offset. See <http://www.hmrc.gov.uk/manuals/ctmanual/CTM80110.htm> on 10.8.2013.

⁵⁸ See ICTA88/S403 (1), (2) and (3). The group relief rules are different for income and capital gains tax and some important limitations apply, in particular re capital losses.

⁵⁹ See also Cohrs (2013).

losses that it does not consider the Austrian loss utilization rules in § 9 Abs.6 Z6 KStG compliant with EU law.

4 EU LEGAL FRAMEWORK FOR MERGERS

4.1 EU Law

Under the Treaty on the Functioning of the European Union (“TFEU”)⁶⁰ national rules must comply with EU law to support the internal market. EU Directives provide a framework and the desired outcome but leave form and method of achieving these to the member state.

In tax law, generally only indirect taxes are harmonized⁶¹ as they impact the free movement of goods and the freedom to provide services. Direct tax laws remain the sole responsibility of the Member State⁶², a reserved but not unlimited competence, which only applies within the boundaries set by EU law⁶³. National rules create a restriction, when they implement measures that “[...] *prohibit, impede or render less attractive the exercise of that freedom*”⁶⁴. The TFEU articles concerning the free movement of goods, persons, services and capital (the four ‘fundamental freedoms’)⁶⁵ have direct effect for national law. The questions referred to the ECJ ordinarily

⁶⁰ C 83/51 as updated in 2010, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:en:PDF> on 11.8.2013.

⁶¹ Under Art. 113 TFEU “*The Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition.*” See also Council Directive [2008/7/EC](#) of 12 February 2008 concerning indirect taxes on the raising of capital and Council Directive [2006/112/EC](#) of 28 November 2006 on the common system of value added tax, as amended over time.

⁶² In the absence of a specific provisions, Art. 115 TFEU is seen to be the most appropriate legal basis for possible EU wide harmonization in the area of direct tax.

⁶³ See AG Maduro’s opinion on *Mark & Spencer* at para. 4 for the role of the ECJ and the statement of the ECJ in its Schumacher (C-279/93) judgement at para. 21.

⁶⁴ See AG Maduro’s opinion on *Mark & Spencer* at para. 35.

⁶⁵ The fundamental freedoms are: 1. Free movement of workers Art. 45 TFEU, 2. Freedom of establishment Art. 49-55 TFEU, 3. Freedom to provide services Art. 56 TFEU, and 4. Free movement of capital Art. 63 TFEU.

concern discussions whether a restriction imposed by the Member State engaged any of the fundamental freedoms. Following an array of case law⁶⁶, it is now a generally accepted doctrine of Community Law that cross-border mergers in Europe⁶⁷ are protected by the fundamental freedom of establishment⁶⁸. Alternatively to switching on the fundamental freedoms, group mergers across jurisdictions also might fall under the Merger Directive and invoke EU law through that route.

As established earlier in this paper, domestic tax rules often lack with respect to crossborder mergers. This creates uncertainty and leads to cross border reorganizations being frequently discussed in the European courts and referred to the ECJ. In the functioning internal market, a company should have the choice as to whether it incorporates a subsidiary domestically or in another member state. When merging a subsidiary⁶⁹, often it will be in a loss making position or have historic losses and hence be considered for closure. The ability to use such losses is critical to the surviving group companies.

⁶⁶ See Cohrs 2013 for a formidable review of the case law.

⁶⁷ See *Mindpearl AG v HMRC* [2011] UKFTT 555 (TC) for a decision, where a Swiss company which had claimed loss relief under the Income and Corporation Taxes Act 1988 s.343 based on the trading losses of its predecessor could not argue that the 75 per cent requirement under s.343(1)(a) was contrary to EC Treaty (Nice) art.43, now Article 49 TFEU, as that provision only applied to transactions between nationals of Member States.

⁶⁸ Under Art. 49 TFEU, as extended to companies by Art. 54 TFEU. See discussion in Chapter 5 for analysis of recent case law.

⁶⁹ This also applies to the establishment of a domestic branch versus a cross border Permanent Establishment. For relevant case laws see *Deutsche Shell GmbH v. Finanzamt für Grossunternehmen in Hamburg* (C-293/06) and *Krankenheim Ruhesitz* (C-157/07) which both concerns final losses of a foreign PE, whereas *Lidl Belgium* (C-414/06) concerns ongoing losses of PE.

4.2 The Merger Directive

National Rules on group restructurings have been shaped by the Merger Directive⁷⁰, which aims⁷¹ to abolish tax obstacles on cross-border reorganisations. The scope⁷² of the Merger Directive is very prescriptive – it applies to cross border mergers between companies resident in European Union member states⁷³ (“Member States”). The Merger Directive allows the merger of business operations without triggering immediate capital gains tax and puts cross border mergers on an equal footing to most domestic systems of tax neutral reorganisations⁷⁴. The Merger Directive also aims to protect the financial interests of the Member States and sets out to protect the taxing rights through the requirement for a permanent establishment to remain (Art.4 Merger Directive)⁷⁵.

Loss transfers are stipulated in Art. 6 Merger Directive. The rules only apply if the member state has domestic rules providing loss transfer for unutilized losses connected to the transferring branches/activities to the receiving company⁷⁶. The loss offset rules of the receiving company’s country are not covered in the Merger Directive. This light touch, together with requirement of Art.4, results in the loss

⁷⁰ See Lang, Pistone, Schuch, Staringer p.24.

⁷¹ See Preamble (2) and (3) of the Merger Directive.

⁷² See Art. 2 (a) Merger Directive, also Lang/Pistone/Schuch/Staringer p.136.

⁷³ As of August 2013, 28 states have joined the EU, for up to date information see <http://europa.eu/about-eu/countries/member-countries/>.

⁷⁴ Basically this is achieved by granting a roll-over of the balance sheet values under Art.4 Merger Directive. Also Helminen (2011) at p.172 gives a good overview of the Merger Directive and its goals.

⁷⁵ See Lang/Pistone/Schuch/Staringer p.140 regarding this requirement seen as ‘claim saver’ for the future realization of any capital gains and the continued right of the member state to tax such gain. The usefulness of this requirement and the ECJ’s discussion on exit taxes are outside the scope of this paper.

⁷⁶ Note discussion in Helminen (2011), p.173 “*In conclusion, the Merger Directive requires the deferral of capital gains taxation if a permanent establishment is left in the state of residence of the merging company. The Merger Directive, however, does not require the state of residence of the receiving company to deduct losses of the merging company even if a permanent establishment would be left in the state of residence of the merging company. It then depends on the basic freedoms of the TFEU to what extent the state of residence of the receiving company is required to allow a deduction for the losses of the merging company.*”

transfer rule being considered only a non-discriminatory rule, which is not often triggered on its own, and hence rendering it, in the eyes of some academics, obsolete.⁷⁷

Anti-abuse provisions are included in the Merger Directive in Art.15 (1) (a)⁷⁸ and allow the Member States to withdraw the benefits of the Directive where tax evasion or abuse is present.

As no definition of tax evasion or avoidance is given in the text of the Directive, Member States when implementing the Directive into national law are able to translate these concepts as they see fit. The ECJ had to consider a number of cases on the interpretation of Art. 15 (1) (a) Merger Directive⁷⁹.

4.3 The Procedure

Where national rules do not comply with the TFEU, the view of the ECJ can be sought⁸⁰ by a national court or a Member State or indeed referred by the Commission

⁷⁷See Lang/Pistone/Schuch/Staringer p.142.

⁷⁸ Art. 15 Merger Directive: “1. A Member State may refuse to apply or withdraw the benefit of all or any part of the provisions of Articles 4 to 14 where it appears that one of the operations referred to in Article 1:

(a) Has as its principal objective or as one of its principal objectives tax evasion or tax avoidance; the fact that the operation is not carried out for valid commercial reasons such as the restructuring or rationalization of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives.”

⁷⁹ See *Leur-Bloem* (C-28/95) and *Kofoed* (C-321/05). In *Zwijenburg* (C-352/08) the ECJ clarified that only taxes to which the benefit of the Merger Directive relate are considered when looking at the motivation of a transaction and tax avoidance.

⁸⁰ Under the preliminary ruling procedure, a national court requests a ruling on an actual case to clarify the interpretation of the TFEU, whereas in an infringement procedure, a community institution or a member state bring proceedings against another Member State. Member State rights in Art. 265 TFEU. Commission rights in Art. 258 TFEU see *Avoir Fiscal* (C270/83) for an example where the Commission investigated member state rules. Art. 267 TFEU, for the entitlement and the requirement for submission by national court, also *Lutz GmbH and Others* (C-182/00) para. 13 for more insight. Requests for preliminary rulings are subject to the ‘Acte Clair’ Doctrine, under which question should not be asked if the interpretation is unambiguous, see *CILFIT* (C-283-81) para. 21 “unless it has established that [...] the community provision in question has already been interpreted by the court so that the correct application of Community Law is so obvious as to leave no scope for any reasonable doubt”.

itself as a proxy for direct harmonization⁸¹. The taxpayer has no right to refer to the ECJ directly. In analyzing any case, the ECJ will firstly identify which of the four ‘fundamental freedoms’ is at stake and then proceed to test whether there was discrimination⁸² on grounds of nationality or a restriction⁸³. Before reaching a conclusion, the ECJ needs to take into account whether the restriction pursues an objective compatible with EU law. Member states have the opportunity to present justifications⁸⁴ and finally the rules are reviewed for proportionality⁸⁵. If a justification is not accepted and rules are not found to be proportional, then they are in conflict with EC law.

4.4 Conclusion

Direct taxation is neither specifically regulated under EU law nor harmonized across Member States. This uncertainty combined with the requirement for national rules to comply with the TFEU creates an area requiring guidance both for the taxpayer as well as the domestic legislator. The case law of the ECJ is helping to establish the

⁸¹ See Art. 115 TFEU, which provides a proxy for a EU provision for legislative competence in the area of direct taxation. “Without prejudice to Article 114, the Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.”

⁸² Art. 16d TFEU. Both direct and indirect discrimination on grounds of nationality are prohibited. See *Schumacker* (C-279/93) para. 30 for a definition of discrimination. The ECJ states in *Imperial Chemical Industries Plc v Cromer* (C264/96), para. 16, “[...] the legislation at issue limits, or at least discourages, the exercise by British companies of the right to create corporate structures in other Member States [...]”.

⁸³ See *Dassonville* (C8/74) for development of the definition started in *Avoir Fiscal* (C270/83), that can be paraphrased as “hinders, deters, makes less attractive the exercise of fundamental rights”. In *Dassonville* the Court held that trading rules that could hinder intra-EC trading contradict the then Art. 28 ECT, Art. 34 TFEU. Also *Futura* (C-250/95) and *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* (C-157/07). Helminen (2011) discusses the circumstances constituting restrictions, p.174, and gives a brilliant overview of the possible justifications, pp.175 *et seq.*

⁸⁴ Treaty Justifications under TFEU are limited to public policy, security and health for the freedom of establishment, Art. 52 TFEU, and public policy & security for the free movement of capital, Art. 66 TFEU. See *Cassis de Dijon* (Case 120/78) para. 8, *Keck and Mithouard* (C267 and C-268/91) para. 15. Justifications that have been accepted in case law include a) coherence of tax system (in *Danner* (C-136/00), also accepted in *Bachmann* (C-204/90) but has since been mainly rejected by the ECJ), b) prevention of tax avoidance (in *Cadbury Schweppes* (C-196/04)), c) balancing allocation of taxing rights (in *Marks & Spencer*) and d) ensuring effective fiscal supervision (in *Marks & Spencer*). Discussion in O’Shea 2006 pp.70-81. Economic reasons including protection of tax revenues have not been accepted by the ECJ, see *Vestergaard* (C-55/98), also Gammie p.23. The so called ‘rule of reason’ or ‘Gebhard formula’ requires national rules to be a) non-discriminatory, b) meet the public interest requirement in its legitimate ECT-compatible objectives, c) be appropriate for meeting the objective and d) are proportional and do not go beyond what is necessary to achieve the stated objectives, i.e. no less-restrictive means could be utilized to protect the public interest. See also O’Shea 2006 p.69 *et seq.* and Kofler p.27 *et seq.*

⁸⁵ *Gebhard* (C-55/94) para. 37, see *Futura* for ECJ finding national rule disproportionate. Also O’Shea 2006 p.81 *et seq.*

boundaries of domestic rules to ensure they remain within what is required to ensure the functioning of the internal market. This allows companies to remain competitive and adapt to the requirements of the common market. The ability of the Court to provide general guidance in specific circumstance is very important. This is further illustrated by certain cases becoming landmark decisions that are referred backwards and forwards by the national courts to extract the most precise answer possible.

5 ECJ CASE LAW ON LOSS UTILISATION

To understand the effect of EU rules on national merger laws, relevant EU case law needs to be considered to see how the ECJ applies the rules of the TFEU and the Merger Directive.

5.1 ECJ cases on cross border loss utilization in group mergers

The ECJ's view on cross border losses has evolved from its 2005 landmark decision in *Marks & Spencer* (C-446/03)⁸⁶ when it held that cross-border group relief should be possible under certain - very specific – conditions in cases of liquidating foreign subsidiaries. Subsequent cases have shed additional light on the system national legislators and court should act within. In no other cases until *A Oy* (C-123/11) has the ECJ accepted cross border loss consolidation in its judgement.

⁸⁶ This case had been decided in the UK Courts on 17 December 2002 (*Marks and Spencer plc v Halsey* [2003] STC (SCD 70), was appealed to Park J, referred without judgement to the ECJ where it became case C-446/03. On its return to the UK court, Park J provided his view on the ECJ judgement 2006 ([2006] STC 1235). Again this was appealed and cross-appealed to the Court of Appeal, its judgement obtained in 2007 ([2008] STC 526) and returned to First Tribunal under John F. Avery Jones and Macolm Gammie in February 2009 ([2009] UKFTT 64 (TC)) to find the facts in accordance with the Order of Park J as varied by the Court of Appeal. The First-tier Tribunal substantially confirmed the claims by Marks & Spencer for EU group relief claim to be valid.

5.1.1 Marks & Spencer

5.1.1.1 *The facts of the case*

Marks & Spencer plc., the parent company of the Mark & Spencer group and itself resident in the UK, had a number of non-resident subsidiaries across the EU. Following several years of unsuccessful trading, it decided in March 2001 to terminate loss-making activities and liquidate its subsidiaries in Germany and Belgium. As these subsidiaries were not resident in the UK and did not maintain a permanent establishment in the UK, they were not in scope for the UK group relief rules. The UK national provision for its group relief system was only available to UK resident companies or UK permanent establishments of non-resident companies. Between 2000 and 2008, Mark & Spencer applied for group tax relief for losses incurred by its non-resident subsidiaries in line with what would have been granted for resident entities⁸⁷. After being refused such relief by the Revenue (“HMRC”), Marks & Spencer argued that by denying its subsidiaries in EU member state the right to surrender trading losses, the UK rules infringed its freedom of establishment⁸⁸.

5.1.1.2 *The ECJ judgment*

The ECJ found that the right of freedom of establishment also requires the Member State of Origin to not hinder the establishment in another Member State⁸⁹. *“The exclusion of such an advantage in respect of the losses incurred by a subsidiary established in another Member State which does not conduct any trading activities in the parent company’s Member State is of such a kind as to hinder the exercise by that parent company of its freedom of establishment by deterring it from setting up*

⁸⁷ See *Marks & Spencer* (C-446/03) at para. 24. The amounts were substantial, with the losses in the German and Belgian entities – at the time- amounting to £99m, or a £30m reduction in tax.

⁸⁸ Under Arts. 43 and 48 of the EC Treaty.

⁸⁹ See *Marks & Spencer* (C-446/03) at para. 31.

subsidiaries in other Member States.”⁹⁰ UK Group relief rules were limited to companies resident in the UK and hence made it less attractive to establish subsidiaries outside of the UK, an exit restriction for UK resident companies entailing unfavourable treatment for companies setting up subsidiaries abroad⁹¹.

The UK submitted a number of justifications for its restrictive national rules⁹². The ECJ’s analysis of the justifications in its judgement extends the justification of the coherence of the tax system established in *Bachmann* (C-204/90). AG Maduro in his opinion on *Marks & Spencer* emphasizes the protection of the integrity of national rules, only for so long though as they do not create an impediment to the integration to the internal market⁹³. The ECJ did, for the first time, accept a threefold justification⁹⁴ put forward by UK - the prevention of double counting of losses⁹⁵ and tax avoidance⁹⁶ was accepted ‘taken together’ with the preservation of the taxing powers as justification. The decision in *Marks & Spencer* introduces the argument of ‘preserving the balanced allocation of taxing powers between Member States’ to the ECJ vocabulary. This was the first time that the Court accepted that the aggregate of these justifications weights more than the sum of its parts and found the restriction to be justified.

However, all national rules need to be proportional and any restriction should not go beyond what is necessary to achieve a desired outcome. The ECJ regarded the UK’s

⁹⁰ See *Marks & Spencer* (C-446/03) at para. 33.

⁹¹ See AG Maduro in *Marks & Spencer* (C-446/03) at para. 53.

⁹² See *Mark & Spencer* (C-446/03) at para. 42 *et seq.*

⁹³ See AG Maduro in his opinion on See *Mark & Spencer* (C-446/03) at para. 66.

⁹⁴ The concept of territoriality was rejected by the Court in *Marks & Spencer* (C-446/03) at para. 40. The loss of tax revenue was not accepted as overriding public interest justification (para. 44), the preservation of taxing power power however was (para. 45).

⁹⁵ See *Marks & Spencer* (C-446/03) at paras. 47-48.

⁹⁶ See *Marks & Spencer* (C-446/03) at para. 49.

domestic rules to go beyond what is necessary to attain the objective pursued⁹⁷ with regards to final losses only. The Court provides a first set of criteria⁹⁸ what final losses are; losses are thus exhausted where the following cumulative requirements are met⁹⁹:

- the possibilities for foreign loss set off have been exhausted, including carry back to previous periods
- no further utilization can be expected in the foreign jurisdiction at any point in the future, either by the subsidiary or a third party,

Where these conditions are met, the ECJ ruled that the freedom of establishment prevails over any potential justifications and the state of origin must allow the deduction of final losses for non-resident subsidiaries where it has comparable rules for resident entities.

5.1.1.3 The Marks & Spencer legacy - The final losses doctrine

The landmark decision in *Marks & Spencer* has for the first time given guidance to Member States as to what extent non-resident losses may impact the domestic result for taxes. Numerous countries commented in the judgment and were very concerned by the potential requirement to amend their legislation and accept potential reduced tax revenues. The ECJ's judgement has clarified that in general Member States are not required to take non-resident losses into account unless there are final and comparable rules allow resident losses to be taken into account. This 'final losses' doctrine results then in an obligation for Member States to take into consideration

⁹⁷ The principle of proportionality, see *Marks & Spencer* (C-446/03) at para. 35, the conclusion that the UK group relief rules are not proportionate are in para. 55 of the judgement.

⁹⁸ In its *X Holdings* judgement, the ECJ has evoked increased doubt as to whether even final losses need to be considered. See AG Kokott's Opinion on *A Oy* (C-123/11), para. 47-54.

⁹⁹ See *Marks & Spencer* (C-446/03) at paras. 55-56. The 'no possibilities test'.

losses of foreign subsidiaries, where any possibility for deducting the loss in the host state has been exhausted and no potential future use by the foreign subsidiary appears possible.

The debate remains open as to the difference between a factual impossibility and a judicial impossibility. The difference between factual and legal impossibility could be where technically the tax rules allow a future offset however no entities remain in the jurisdiction or the one remaining are themselves This continues to be discussed in the national courts¹⁰⁰. The assessment whether losses are final is ultimately a question for the national courts to decide. The ECJ has explicitly stated the Member States right to introduce specific anti-abuse provisions targeted at avoiding the national rules¹⁰¹. Already, the ECJ's decision has resulted in a significant change to the UK rules. Also, the decision has been seminal for subsequent case law¹⁰² and remains one of the most prominent judgements of the ECJ in the area of direct taxation.

5.1.2 A Oy

The ECJ decided for the taxpayer in in *A Oy* (C-123/11) and examined cross border relief of final losses in a group merger with a foreign subsidiary. As the Merger Directive is silent on “*the question to which extent the state of residence of the receiving company must allow a deduction of the losses of a merging company in an*

¹⁰⁰ See decision of 16 June 2011 (6-K-445/09) of the Lower Court of Niedersachsen, requiring a factual impossibility in determining the final nature of losses. The focus in UK jurisprudence has been on the legal possibility of using the losses not on the factual possibility. See *Bologne/Slavnic* at p.7 “*In the authors' view, it follows from *Krankenheim Wamsee* that M/S P [Member State of Parent, addition by author] should only be obliged to allow for a deduction of the losses incurred in M/S S [Member State of Subsidiary, addition by author] if these losses also qualify as “final losses” according to the tax rules of M/S P.*”

¹⁰¹ See *Marks & Spencer* (C-446/03) at para. 57.

¹⁰² *Oy AA* (C-231/05) and *X Holdings* (C-331/08) are cases dealing with on-going losses of foreign subsidiaries.

intra-EU cross-border merger.”¹⁰³, the ECJ’s decision in *A Oy* has been ground breaking in its potential requirement for Member States to adapt its taxation laws and apply the *Marks & Spencer* “final losses” doctrine in a merger scenario.

5.1.2.1 *The facts of the case*

On March 7th 2011, the Supreme Administrative Court of Finland referred case KHO 2011/547 (21) to the ECJ for a preliminary ruling. The case concerns an appeal from a Finnish parent company limited by shares, A Oy, regarding a binding advance ruling of the Central Tax Board of Finland (‘Keskusverolautakuna’ (KVL)) regarding the upstream merger of B Ab, a Swedish subsidiary of A Oy. The national Finnish rules provided for the right of the acquiring company in a domestic merger to deduct losses if it owned more than 50% in the subsidiary at the beginning of the year in which the losses were incurred. Under Finnish rules (the Finnish Act on Business Taxation (Elinkeinoverolaki), “EVL”, and the Finnish Income Tax Act (Tuloverolaki), “TVL”), losses could only be deducted in Finland, if they were determined in accordance with the EVL, the losses of B Abs however had been calculated in line with the Swedish tax rules and amounted to 44.8m SEK (approx. 5.2m EUR) from the years 2001-7. As the loss was not based on EVL and TVL, it was not taken into account for the Finnish tax calculation. There was no indication that the merger was solely motivated by tax¹⁰⁴.

5.1.2.2 *The ECJ judgment*

The ECJ held in favour of the taxpayer and confirmed that the *Marks & Spencer* doctrine of “final losses” can be invoked to offset losses of a non-resident transferring

¹⁰³ See Helminen 2011, p.172.

¹⁰⁴ See *A Oy* (C-123/11), para. 17.

company in a merger. The national rules stipulated a loss transfer for the receiving company¹⁰⁵ in a domestic merger but not for a cross border merger, the freedom of establishment was invoked and a restriction found. The losses were considered to be ‘final’ as the only other group companies in Sweden were themselves loss making¹⁰⁶. No possibility of loss set-off was to be expected¹⁰⁷ and no indication of tax avoidance was given.

AG Kokott found that the restriction could be justified by the balanced allocation of taxing powers¹⁰⁸ and found the Finnish rules ‘reasonable proportionate’¹⁰⁹. The ECJ disagreed and found the restriction not justified. As a result, the Finnish parent company (A Oy) could deduct the unutilized pre-existing operating losses in Sweden through an upstream merger of its fully owned Swedish subsidiary (B Ab).¹¹⁰ The Merger Directive was deemed not to be applicable by both the Advocate General Kokott¹¹¹ and the ECJ¹¹² as no permanent establishment of A Oy remained in Sweden¹¹³, the judgement confirmed that the freedom of establishment can go further

¹⁰⁵ See *A Oy* (C-123/11), para. 30. See *X Holdings* (C-337/08), para. 17 for the applicability of the freedom of establishment also to companies, “Freedom of establishment, which Article 43 EC grants to Community nationals and which includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, under the same conditions as those laid down for its own nationals by the law of the Member State in which such establishment is effected, entails, in accordance with Article 48 EC, for companies formed pursuant to the law of a Member State and having their registered office, central administration or principal place of business within the European Community, the right to exercise their activity in the Member State concerned through a subsidiary, a branch or an agency (see, inter alia, Case C-307/97 *Saint Gobain ZN* [1999] ECR I6161, paragraph 35, and *Marks & Spencer*, paragraph 30)”

¹⁰⁶ See *A Oy* (C-123/11), para. 11.

¹⁰⁷ No signs of using losses twice were obvious, see *A Oy* (C-123/11), para. 44.

¹⁰⁸ See AG Kokott’s Opinion on *A Oy* (C-123/11), para. 54.

¹⁰⁹ See AG Kokott’s Opinion on *A Oy* (C-123/11), para. 68.

¹¹⁰ See *A Oy* (C-123/11), para. 9.

¹¹¹ In her opinion as published on 19/07/2012, see <http://curia.europa.eu/juris/document/document.jsf?docid=125201&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&cid=83515> on 11.8.2013.

¹¹² See judgement at <http://curia.europa.eu/juris/document/document.jsf?text=&docid=134107&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=5684992> on 10.8.2013

¹¹³ The remaining group companies, Y AB and Z AB, were subsidiaries of another group company, X Oy and not directly owned by A Oy. See Art.4 & 6 Merger Directive and *A Oy* (C-123/11), para. 10.

than the Directive. With respect to the rules for determining the amount of the tax reduction, the ECJ has given limited guidance in *A Oy*, as it stipulates that the calculation should reflect equal treatment compared to that of the equivalent entity in a domestic situation, the resident subsidiary¹¹⁴, which indicated that the rules of the origin state where the receiving entity is resident should be applied. This judgement will require national courts to determine the relevant losses on a case-by-case basis.

5.1.2.3 A Oy - The impact on future case law

The ECJ judgement in *A Oy* provides useful clarity for Member States as to their requirement to align merger loss utilisation rules for domestic and cross-border mergers. It also clarifies that Member States need to provide loss utilization rules for one-off losses stemming from mergers not only from liquidations and potentially similar circumstances. From its deliberations, it becomes evident that where internal mergers benefit from loss relief, cross-border mergers in a comparable situation need to have access to the same rules. Many questions though remain open - whether losses that only exist under the rules of the host state and are due to timing differences need to be taken into account into the state of origin, or whether the amount of the losses should be only be determined under the rules of the origin state. These questions are relevant as in the frequently used words of the ECJ: "*freedom of establishment cannot [...] be understood as meaning that a Member State is required to draw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, taxation which removes any disparities arising from national tax rules.*"¹¹⁵ Further ECJ cases are to be expected and will hopefully provide for continuing clarification, maybe already in the pending *K* case (C-322/11).

¹¹⁴ See *A Oy* (C-123/11), para. 59.

¹¹⁵ *Bologne/Slavnic* citing *Deutsche Shell* (C-293/06) at p.6.

5.2 ECJ on Tax Avoidance for loss utilization in mergers

5.2.1 Foggia

The ECJ delivered its judgment in the preliminary ruling request by the Portuguese Supremo Tribunal Administrativo (the court of final instance) in the *Foggia* (C-126/11) case. Before even answering the questions referred, it had to establish its competence to answer; the Portuguese Government had questioned the ECJ's remit, as the circumstances were purely internal¹¹⁶. The ECJ ruled that it had jurisdiction as the tax rules for mergers applied both domestically as well as cross-border. In particular where a term ("valid commercial reasons"), initially used in this context in the Merger Directive, was used in national legislation, the ECJ found it important to ensure a consistent interpretation.

5.2.1.1 *The facts of the case*

In 2003 Foggia, a Portuguese resident taxpayer and member of a corporate group, merged with three of its group companies in a merger by acquisition. The transferring entities, three holding companies, were also Portuguese resident. Portuguese tax law allows in a merger for the tax losses of the transferring entity to be offset against the taxable profits of the receiving entity as long as such merger was entered into for "valid commercial reasons"¹¹⁷. In order to deduct the unutilized losses of the transferring entities and in line with the domestic legislation, Foggia applied to the Ministry of Finance to set off losses by the three transferring companies incurred

¹¹⁶ See *Foggia* (C-126/11) at para. 16 *et seq.*

¹¹⁷ See Portuguese Corporation Tax Code (Código do Imposto sobre o Rendimento das Pessoas Colectivas, the "CIRC"), Art. 68-60 at *Foggia* (C-126/11) at paras. 6-7. Such restriction is in line with the requirements of the Merger Directive as the same conditions re put upon domestic and cross border transactions.

between 1997 and 2002. The taxpayer argued that the benefits from the group restructuring were mainly derived from administrative and management cost savings.

Such application was denied for one of the companies (Riguadiana – SGPS SA, “Riguadiana”)¹¹⁸ as no commercial interest was identified and abuse was suspected. The local authorities suspected abuse as Riguadiana did not effectively carry out any activities or generated any taxable income, but had invested in securities and no clear provenance of its tax losses could be provided¹¹⁹. In its refusal, the authorities explicitly stated that the reduction of administrative costs alone does not provide a sufficient commercial rationale for a merger.

5.2.1.2 The ECJ judgment

In the judgement on *Foggia* (C-126/10), the ECJ clarified that EU law would apply, in accordance with settled EU case law where a domestic legislator employs an EU law concept in internal law, such concepts should be interpreted uniformly by the ECJ.

When discussing the questions referred by the national courts, the ECJ follows its previous case law on “valid commercial rationale”¹²⁰ and gives further insight into its thinking on the then Art.11 (now Art.15) Merger Directive. Where tax avoidance is one of the main objectives, Member States are able to withhold the benefits of the Merger Directive¹²¹.

¹¹⁸ See *Foggia* (C-126/11) at para. 10. The request was approved for the other two companies.

¹¹⁹ See *Foggia* (C-126/11) at para. 11.

¹²⁰ The ECJ describes tax avoidance in *Cadbury Schweppes* (C-196/04) as ‘wholly artificial arrangements’. See *Zwijenburg* (C-352/08), also see Ionna Mitroyanni (2007), p.77 “*The scope of the anti-abuse provision of the EC Merger Directive 212 has been interpreted in Leur-Bloem. The Court gave a strict literal interpretation of the anti-abuse clause. It ruled that, if the operation was not carried out for ‘valid commercial reasons’, there is a presumption of tax evasion or avoidance.*” *Leur-Bloem* (C-28/95)).

¹²¹ See *Foggia* (C-126/11) at paras. 3-5.

The ECJ recognises that tax considerations might be one of the considerations in a group restructuring decisions, however clarifies that it should not be predominant.¹²²

Further, a positive effect from a merger on administrative and management cost is to be expected in a group simplification but in this case are too marginal to outweigh the tax advantage as the main driver. In particular, the absence of any commercial activities like actual holding activities rather than just investment in securities, combined with a relatively large tax loss of EUR 2m of undefined pedigree, let the ECJ conclude that the transaction had not been entered into for ‘valid commercial reasons’¹²³ and “*the form of the transaction was that of a merger, but the merger was not the real purpose of it, rather, the tax losses were*”¹²⁴.

After answering these questions, the ECJ referred back to the national courts’ remit to decide whether a particular group restructuring intends to avoid tax as no predetermined criteria can be relied upon.¹²⁵

5.3 Resulting trends in ECJ case law

The criteria for final loss utilization have been set very tightly and will limit the area of application to a specific set of circumstances as final losses can be considered one-off occurrences in contrast to general rules for loss utilization. Where those specific circumstances apply, Member States will have to review their tax rules carefully. The ECJ’s decisions on the freedom of establishment have significantly influenced the

¹²² See *Foggia* (C-126/11) at para 35.

¹²³ This has been developed already in a number of cases following *Cadbury Schweppes* (C-196/04) and *Halifax* (C-255/02), i.e. in *Leur-Bloem* (C-28/95) and *Zwijnenburg* (C-352/08).

¹²⁴ See Jimenez, p.11.

¹²⁵ See *Foggia* (C-126/11) at para. 37.

UK's rules on group and consortium relief and resulted in amendments to "*permit a non-UK-resident company in certain circumstances to surrender losses and other amounts by way of group relief that are not attributable to a permanent establishment it has in the UK.*"¹²⁶ The Austrian rules on loss carry over in merger situations require not only transfer at historic cost (i.e. following the rules the transferring entity was subject to) but also the assets and liabilities that incurred the losses to be present in the receiving entity, in cross border situations, this might be rather difficult and might either require further ECJ guidance or an adjustment of national rules.

The UK's introduction of a GAAR with the related overriding statutory limit as to what extent taxpayers can reduce their tax liabilities, mirrors the focus of the ECJ's jurisprudence and its focus on "valid commercial rationale". As *Foggia* shows, the ECJ's judgement lead to a more uniform interpretation of common concepts and might help to harmonize at least the small areas of direct taxation.

6 CONCLUSION

From the review in this paper, it can be concluded that all of the three jurisdictions allow some sort of tax neutral transfer. The analysis found a wide spectrum ranging from full domestic and EU group consolidation in Austria, a fiscal unity regime in Luxembourg and a system of group loss transfer rules in the UK. Specific merger taxation legislation exists in Austria and Luxembourg, whereas the UK has more specific rules depending on the kind of income and the transaction chosen.

¹²⁶ See Bramwell et al. at T5.1.1.1.

When reviewing the limited but very significant case law for intragroup mergers and loss transfers, it becomes clear very quickly how relevant these decisions are for national rules. Taking into account the main developments in EU case law to understand the “final losses doctrine” and the ECJ’s emphasis on “valid commercial reasons”, it can be demonstrated that there is a trend towards harmonization in the area of direct tax. One could put to the ECJ that any member state not wanting to be challenged for cross border merger issues, would best not have any rules for internal mergers. In such a scenario, where no permanent establishment remains and the Merger Directive does not apply, no requirement can be established under the freedom of establishment. Such a stance however would serve neither the internal market nor the domestic circumstances.

The underlying principles of the TFEU and the increasing connectivity of corporate groups across Europe, will also further fuel an on-going need for balancing the sovereignty of the Member States and the need for further harmonisation across the Union. For the time Member States will maintain their right to determine the laws for direct taxation in their territory and will have to find a way to do so that is compatible with EU law as well as ensuring they remain an attractive location for corporates to locate their headquarters.

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