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## How Does the CJEU's Case Law on Cross-Border Loss Relief Apply to Cross-Border Mergers and Divisions?

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*The common system of taxation laid down in the Merger Directive does not require Member States to give cross-border loss relief further to a cross-border merger or division, and allows previously deducted permanent establishment losses to be recaptured upon a cross-border restructuring. This article analyses the CJEU's case law in A Oy and Commission v. UK, and attempts to define under which circumstances cross-border loss relief can be claimed on the basis of primary EU law. In addition, the author examines which conclusions can be drawn from the recent CJEU judgments in Nordea Bank and Timac Agro for cross-border mergers and divisions, i.e., if the recapture rule of Article 10(1) paragraph 2 of the Merger Directive is compatible with Article 49 TFEU.*

### 1 Loss relief and the merger directive

This article focuses on the consequences of a cross-border merger or (partial) division[1] between companies of different EU Member States for the (unrelieved) tax losses of the companies involved in such a transaction. Whereas the primary concern with cross-border reorganizations is obviously that roll-over relief applies at the level of assets transferred and shares exchanged as a result of the transaction, it is essential that the consequences for the available tax losses are considered as well, and that due regard is made to the fact that even 'tax-neutral' cross-border operations may result in adverse tax consequences at this level, either because the available carried-forward tax losses may not (entirely) 'survive' the restructuring operation (loss of carried-forward tax assets), or because previously deducted tax losses may have to be 'recaptured' as a consequence of the transaction (immediate tax charge).

The Merger Directive[2] deals only partly with the consequences of a cross-border merger or division for the tax losses, and does not guarantee a fully tax-neutral treatment at the level of the tax losses. The common system of taxation laid down in the Merger Directive contains two basic mechanisms regarding tax losses.

The *first mechanism* is laid down in Article 6 of the Merger Directive. This provision deals with the issue as to whether unrelieved tax losses incurred before the transaction by the transferring company in its Member State of residence must be taken over by (the post-transaction permanent establishment, if any, of) the receiving company in the Member State of the transferring company. This provision is limited in several respects.

One limitation is that it does not require an unconditional obligation for the Member State of the transferring company to allow the tax losses to be offset against future permanent establishment profits, but (merely) an obligation not to discriminate cross-border transactions against domestic reorganizations: to the extent that, in a domestic merger or division, the Member State of the transferring company allows the receiving company to take over the carried-forward tax losses of the transferring company, it must extend the respective provisions to cover the takeover of the tax losses by the receiving company's permanent establishment on its territory. As a result, the Member State of the transferring company is entitled under the Merger Directive to preclude or limit the takeover of the tax losses, and/or to provide limitations as to the effective utilization of the losses, as long as this limitation is made in a non-discriminatory way.

In addition, Article 6 of the Merger Directive's scope is limited to the issue of if (and to what extent) the carried-forward tax losses of the transferring company must be relieved in the Member State of the transferring company itself, i.e., in the Member State where these losses were incurred. The basic idea of the Merger Directive is therefore that the tax losses are relieved in the Member State in which they were initially incurred. As a result, the Member State of the receiving company has no obligation, at least not under the Merger Directive, to take into account any carried-forward tax losses incurred before the merger or division by the

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[1] All references in this article to 'division' also refer to partial divisions.

[2] 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, OJ L 310, 25 Nov. 2009.



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transferring company in its Member State (no 'cross-border' relief for losses).

Similar provisions apply for unrelieved tax losses incurred before the transaction by the transferring company in a permanent establishment situated in another Member State. For these permanent establishment losses, the same limitations apply as for the tax losses incurred by the transferring company in its residence Member State.

This means that the Merger Directive does not impose an unconditional obligation on the Member State of the permanent establishment to allow the losses to 'survive' the transaction, but only an obligation not to discriminate cross-border transactions. Under Article 10(1) paragraph 3 of the Merger Directive, the Member State of the permanent establishment must apply the provisions of the Directive as if it were the Member State of the transferring company. Read in conjunction with Article 6 of the Merger Directive, this means that any unrelieved tax losses incurred by the permanent establishment must 'survive' the transaction (only) to the extent that the tax legislation of the Member State of the permanent establishment allows tax losses to be taken over by the receiving company in a similar domestic reorganization.

It also means that the Merger Directive only deals with the relief for the tax losses in the Member State of the permanent establishment, i.e., in the Member State where the losses were incurred, without addressing the Member State of the receiving company (no 'cross-border' relief for losses).

The *second mechanism* laid down in the Merger Directive is the recapture rule: Article 10(1) paragraph 2 allows the tax losses that were incurred before the merger or division in a permanent establishment of the transferring company, and were previously offset against the head office's taxable profits (and not recovered prior to the transaction) to be recaptured.

These provisions of the Merger Directive interact both with the Member States' domestic tax legislation and with primary EU law.

The interaction with domestic legislation is due to the fact that the Merger Directive leaves a substantial degree of autonomy to the Member States. This autonomy reflects the remaining disparities in the Member States' respective tax legislation regarding domestic mergers and divisions (full or partial takeover of tax losses, or no takeover at all), and regarding the treatment of foreign permanent establishments (territorial system versus taxation of worldwide income; exemption versus credit system). In this respect, reference can be made to our in-depth study realized in 2012 on the tax and legal context for European cross-border reorganizations, including a country-by-country survey of the domestic tax legislations in thirteen EU jurisdictions.[3]

The other interaction, i.e., between the Merger Directive and primary EU law, is the subject of our current contribution. Since the *Sevic* case,[4] it is established case law that cross-border mergers, as well as '*other company transformation operations*' (thus including cross-border divisions[5]) '*constitute* particular methods of exercise of the freedom of *establishment, important for the proper functioning of the internal market, and are therefore amongst those economic activities in respect of which Member States are required to comply with the freedom of establishment laid down by Article 43 EC* [now Article 49 TFEU]' (author's emphasis). In addition, the merging companies may have exercised their freedom of establishment prior to the cross-border reorganization, e.g., by incorporating a subsidiary or creating a permanent establishment in another Member State, resulting in the subsequent cross-border merger or division having disadvantageous tax consequences compared to the tax regime that would have applied to the transaction if a domestic subsidiary or permanent establishment would have been incorporated/created. This raises the important question as to whether primary EU law can step-in in cases where secondary EU law (Merger Directive) is silent, or even overrule secondary EU law. These questions have already been analysed in relation to the 'permanent establishment' requirement of Article 4 of the Merger Directive.[6] Further to recent CJEU case law, similar questions arise in the area of cross-border loss relief and the recapture of tax losses, as will be discussed in this article.

## 2 Takeover of Tax Losses Incurred by the Transferring Company in Its Member State of Residence

### 2.1 Cross-Border Loss-Relief: Can Losses Be 'Imported'?

As mentioned above, the basic idea of the Merger Directive is that the tax losses that were incurred by the transferring company prior to the reorganization

[3] J. Vermeylen & I. Vande Velde, *European Cross-Border Mergers and Reorganizations* (Oxford University Press 2012).

[4] CJEU, 13 Dec. 2005, Case C-411/03, *Sevic Systems AG*.

[5] J. Vermeylen & I. Vande Velde, *European Cross-Border Mergers and Reorganizations*, para. 2.242 (Oxford University Press 2012).

[6] Under Art. 4 of the Merger Directive, the roll-over relief for capital gains at the level of the transferring company (only) applies for assets that, in consequence of the transaction, are effectively connected with a permanent establishment of the receiving company in the Member State of the transferring company. Further to the CJEU case law on exit taxation (particularly CJEU, 29 Nov. 2011, Case C-371/10, *National Grid Indus BV*), it could be argued that this 'permanent establishment' requirement is a disproportionate restriction on the freedom of establishment. See e.g., D.J. Jimenez-Valladolid de L'Hotellerie-Fallois, *The Permanent Establishment: Still a (Permanent) Requirement?* EC Tax Rev. 4–15 (2014).

(whether in its residence state or in a permanent establishment) are to be relieved in the Member State where the losses were (initially) incurred. This means that the Member State of the receiving company has no obligation under the Merger Directive to take into account any carried-forward tax losses incurred before the merger or division by the transferring company. In this respect, there is a similarity between the Directive's approach and the idea (developed by CJEU case law) of a balanced allocation of taxing powers between the Member States, in that losses incurred in the tax framework of the Member State of the transferring company (or in the tax framework of the Member State of a permanent establishment) can only be relieved within the tax framework of that same Member State, and cannot, therefore, be 'imported into' the Member State of the receiving company.

This approach is the result of the fundamental option made in the Merger Directive that, to attain the objective of removing the tax restrictions on cross-border reorganizations, a common tax system should be put in place, as opposed to a requirement to extend the Member States' domestic tax regimes at EU level. The Merger Directive does not require such an extension, meaning that, if the Member State of the receiving company allows tax losses of the transferring company to be taken over by the receiving company in a domestic merger, the Merger Directive does not require this Member State to also allow such a tax loss takeover if the transferring company is not a resident company, but a company from another Member State. This fundamental option was made because such a system would have created an incentive for companies to establish themselves in an EU jurisdiction that would allow losses to be taken over in a domestic merger and, therefore, have produced distortions of competition.[7]

The conclusion that the Member State of the receiving company has no obligation under the Directive to 'import' the tax losses of the transferring company and to allow them to be deducted from 'domestic' profits, does not rule out, however, that such an obligation could, under certain circumstances, exist on the basis of primary EU law.

## 2.2 The A Oy Case

This issue was at stake in the *A Oy* case.[8] This case concerned a cross-border merger between a Finnish parent company and its Swedish subsidiary that had ceased trading, and had unrelieved tax losses in Sweden. From the description of the facts, it is clear that relief was claimed for carried-forward tax losses (as opposed to current year's losses), because the losses were apparently sustained in the years from 2001 to 2007, i.e., the years preceding the year when the last sales outlets of the subsidiary were closed (2008). In spite of the fact that the Swedish subsidiary's business was discontinued, the company took the position that the merger was justified from an economic perspective, because it allowed the existing lease contracts to be transferred to the parent company. However, this aspect was left to the national court to assess. The claim of *A Oy* that the losses of its Swedish subsidiary had to be offset against taxable income in Finland was rejected by the Finnish tax authorities on the basis that the losses were ascertained on the basis of Swedish tax legislation.

As a preliminary issue, the CJEU confirmed that Article 49 TFEU indeed applied. To this end, the Court referred to *Sevic*, confirming that a cross-border merger is amongst the transactions in respect of which the Member States are required to respect the freedom of establishment. Some governments had submitted that the *Sevic* ruling did not apply in the case at hand on the basis that the subsidiary had ceased all economic activities in Sweden and, therefore, the merger did not result in the Finnish company developing economic activities in Sweden. This argument was not accepted by the Court. In addition, the Court held that the application of Article 49 TFEU derived from the *former* exercise by the Finnish company of its freedom of establishment by establishing a subsidiary in Sweden.

The Court did not go into detail as far as the interaction is concerned between Article 49 TFEU and Article 6 of the Merger Directive, but merely restricted itself to the statement that the Directive does not address the issue of whether relief must be granted in the Member State of the receiving company. The Advocate General was more explicit in this respect: she admitted that, under the Merger Directive, the losses can only be used in the tax framework of the Member State of the transferring company, but at the same time confirmed that this does not rule out that the tax legislation of the Member State of the receiving company could be incompatible with the freedom of establishment in disallowing relief for losses incurred in the Member State of the transferring company. Interestingly, the Advocate General accepted the possibility that the Union legislator (Merger Directive) '*may not have done everything that is necessary to ensure the removal of tax disadvantages for cross-border mergers*', in which case the Member States need to take the necessary measures.[9] In other words, the fact that the common system of taxation laid down in the Merger Directive only regulates the relief to be granted in the Member State of the transferring company, and is silent on the relief (if any) to be granted

[7] Preamble to Council Directive 90/434/EEC, recital No. 4; Opinion of Advocate General Kokott, 19 Jul. 2012, Case C-123/11, *A Oy*, para. 65.

[8] CJEU, 21 Feb. 2013, Case C-123/11, *A Oy*. For a detailed analysis of this case, reference is made to M. Helminen, in *ECJ – Recent Developments in Direct Taxation 2011*, 80–92 (M. Lang et al. eds, Linde 2012).

[9] Opinion of Advocate General Kokott, 19 Jul. 2012, Case C-123/11, *A Oy*, para. 31.

in the Member State of the receiving company, cannot in itself justify restrictive legislation in the latter Member State.

The CJEU further ruled that the Finnish legislation was indeed restrictive in that it disallowed losses to be taken over in a cross-border merger with a subsidiary of another Member State, whereas a takeover of tax losses would have been allowed in a domestic merger with a Finnish subsidiary, but that such a restriction is in principle justified by the need to safeguard the allocation of the taxing powers between the Member States, and by the objective of avoiding the risk of double use of losses. However, the Court also ruled that the ban under Finnish legislation to 'import' the Swedish tax losses would be disproportionate in the event that these losses meet the criteria for being considered as 'final' losses within the meaning of its *Marks & Spencer* judgment, i.e., if all possibilities to utilize the losses in Sweden were exhausted ('no possibilities'-test).

Importantly, the CJEU thus confirmed that the '*Marks & Spencer* exception' still prevails, also in the context of a cross-border corporate restructuring. The CJEU confirmed its adherence to the *Marks & Spencer* doctrine despite the criticism from Advocate General Kokott, which was mainly situated on two levels. *First*, the Advocate General demanded that the '*Marks & Spencer* exception' be abandoned in cases where a restrictive piece of legislation is not (only) justified by reference to the objective of avoiding double use of tax losses, but (also) by reference to the objective of balanced allocation of taxing powers: if a Member State justifies its legislation on the basis of the objective of avoiding double dips, such a claim would obviously be disproportionate if, applied in practice, this legislation would result in the tax losses being relieved nowhere. In the context of a justification on the basis of the objective of a balanced allocation of taxing powers, however, the need for 'final' losses being relieved would be irrelevant, according to the Advocate General. *Second*, the Advocate General argued that tax losses can hardly be considered 'final' in the context of a merger, such an operation being the consequence of a deliberate decision by the respective companies' directors and shareholders: accepting that, after a cross-border merger, the losses of the subsidiary must be relieved at the level of the parent company would, in the Advocate General's view, be tantamount to accepting that the companies involved in the transaction have the right to freely choose where to claim relief for the tax losses (a right which, according to established CJEU case law,[10] companies do not have because such an option would be inconsistent with the idea of symmetry between the right to tax profits and the right to deduct losses).

Although, therefore, the '*Marks & Spencer* exception' continued to be accepted in principle by the Court, the question remained open under which circumstances, and if at all, losses can be characterized as 'final' in the context of a cross-border merger or division. The Court's judgment in *A Oy* did not provide any substantial guidance in this respect, because it ruled that '*it is for the national court to determine whether [the Finnish parent] has in fact proved that [the Swedish subsidiary] has exhausted all the possibilities of taking account of the losses which exist in Sweden*'.

## 2.3 Commission v. UK

More specific guidance was provided by the CJEU's later judgment in *Commission v. UK*.[11] This judgment was not reached as a result of a request for a preliminary ruling, but further to an infringement proceeding initiated by the Commission against the UK for allegedly not having correctly implemented '*Marks & Spencer*' in its domestic legislation. This judgment is therefore commonly referred to as *Marks & Spencer II*.

Although *Marks & Spencer II* did not concern a case of a cross-border merger or division, it is important for our analysis, because it provided the CJEU the opportunity to further clarify its view on the 'final loss' concept. It must be said, however, that substantial uncertainties remain, to the point that scholars and practitioners are probably left even more puzzled than before about the exact meaning of the 'final loss' concept, also and perhaps particularly in the area of cross-border restructurings.

The importance of *Marks & Spencer II* lies, first of all, in the fact that the CJEU took a position in the extensively debated issue as to whether the impossibility to utilize the tax losses of the subsidiary (or permanent establishment) ('no possibilities'-test) must be analysed from a legal or a factual perspective.

In this respect, the Court confirmed that '*losses sustained by a non-resident subsidiary cannot be characterized as definitive (. . .) by dint of the fact that the Member State in which the subsidiary is resident precludes all possibility of losses being carried forward*'. This is probably the 'easy case' where losses cannot be considered 'final': in the event that the tax legislation of the Member State of the subsidiary does not allow tax losses to be carried-forward in general, or that the possibility to utilize the losses is barred due to prescription of the time limitation, no relief can be claimed in the Member State of the parent company. In such a case, the Member State of the parent company cannot be required to step in for the negative consequences resulting from 'particularities' of the legislation of the Member State of the subsidiary[12] by

[10] CJEU, 15 May 2008, Case C-414/06, *Lidl Belgium*, para. 32. For private individuals, see CJEU, 7 Nov. 2013, Case C-322/11, *K*, para. 54.

[11] CJEU, 3 Feb. 2015, Case C-172/13, *Commission v. United Kingdom*.

[12] CJEU, 23 Oct. 2008, Case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH*, para. 49.

allowing the losses to be 'imported into' its tax system subsequently to a cross-border merger.

In addition, the Court ruled that '*losses sustained by a non-resident subsidiary may be characterized as definitive (. . .) only if that subsidiary no longer has any income in its Member State of residence*' (author's emphasis). This affirmation is in fact an extension of the CJEU's earlier finding in the *K* case[13] (in the private sphere) to the business context. In addition, this view has recently been re-affirmed in *Timac Agro.*[14] It seems therefore that it is now settled CJEU case law that the 'no possibility' criterion to be used to characterize a loss as 'final' must be checked on the basis of (only) the company's *factual* situation, rather than of its *legal* position. As will be discussed in more detail below, this position is not obvious in the context of a cross-border corporate reorganization. The factual test is moreover applied in a very strict manner because, in the Court's view, a company claiming a deduction for 'final losses' must demonstrate that no – not even minimal – income is to be expected in the future due to all its activities being discontinued and the disposal of all income-producing assets.

In addition to this very factual and strict position on the 'finality' of tax losses, the CJEU has further limited the scope of final losses in terms of the reference date when proof must be delivered that a foreign loss is to be regarded as final. Whereas, before *Marks & Spencer II*, the common understanding was that this proof could be delivered *ex post* (i.e., once the subsidiary or permanent establishment has ceased all activities and disposed of all assets), the CJEU now takes the view that the much stricter approach under UK legislation was compliant with the freedom of establishment. Under UK legislation, the reference date for determining whether a loss can be viewed as 'final' must be made '*as at the time immediately after the end of the accounting period in which the losses were sustained*'. Unlike the Commission, the CJEU did not consider that this timing requirement makes it virtually impossible for a UK parent company to deliver proof of the 'final' nature of its subsidiary's losses and to obtain cross-border loss relief accordingly. The UK legislation's *ex ante*' approach implies that relief must be claimed on a year-by-year basis. If, for instance, a subsidiary sustains losses during a period of several consecutive years, and subsequently ceases all activities, then the parent company will only be able to obtain relief for the losses of the last year(s). As the CJEU considered this UK rule complied with the freedom of establishment, the question must be raised whether it can be concluded from *Marks & Spencer II* that Member States are not required under EU law to grant relief for carried-forward tax losses (as opposed to current year's tax losses).[15]

As discussed in literature, however, it is far from certain that the CJEU indeed intended to narrow the scope of 'final losses' to current year's losses, and to deprive carried-forward tax losses from having a legal basis under EU law for being relieved.[16] If *Marks & Spencer II* were understood as meaning that carried-forward tax losses cannot qualify as 'final losses', then it would constitute a break with its previous *A Oy* judgment: in that case, where the tax losses sustained by the Swedish subsidiary in the years from 2001 through 2007 were at issue, the Court ruled '*in respect of the tax years* [plural] *prior to the merger*' that they must be considered 'final' and be relieved at the level of the Finnish parent company if the Swedish subsidiary has exhausted the possibilities of taking '*those losses*' (the losses sustained in the years preceding the merger, i.e., during the period from 2001 up to 2007) into account in its Member State of residence. In our view, the reference to '*those losses*' can hardly be interpreted differently from a reference to the Swedish subsidiary's *carried-forward* tax losses sustained in the years from 2001 to 2007.

We do not think that this discrepancy could be explained by the fact that the CJEU in *Marks & Spencer II* had intended to overrule its *A Oy* judgment. This can in our opinion be concluded from the recent CJEU judgment in the *Timac Agro* case[17] (which came after *Marks & Spencer II*). The question submitted to the Court in *Timac Agro* was whether the German recapture rule, which was triggered upon the transfer by the German company, *Timac Agro*, of its Austrian permanent establishment was consistent with the freedom of establishment. The recapture at issue was clearly related to *prior years'* tax losses, taking into account that the losses previously deducted from taxable profits in Germany were sustained in the years 1997 and 1998, and were recaptured further to a transfer of the Austrian permanent establishment in 2005. Nevertheless, the Court confirmed (referring to *Marks & Spencer II*) that the recapture mechanism would be contrary to Article 49 TFEU if the German transferring company could demonstrate that the recaptured losses were 'final'. On that basis, we conclude that there is no ground for

[13] CJEU, 7 Nov. 2013, Case C-322/11, *K*.

[14] CJEU, 17 Dec. 2015, Case C-388/14, *Timac Agro Deutschland GmbH*, para. 55.

[15] E. Pinetz & K. Spies, *Final Losses after the Decision in Commission v. UK ('Marks & Spencer II')*, EC Tax Rev. 309–319 (2015); CFE ECJ Task Force, *Opinion Statement ECJ-TF 2/2015 on the European Court of Justice in European Commission v. United Kingdom ('Final Losses'), Concerning the 'Marks & Spencer Exception'*, 56 Eur. Taxn. 2/3 (2016), Journals IBFD.

[16] E. Pinetz & K. Spies, *Final Losses after the Decision in Commission v. UK 'Marks & Spencer II'*, EC Tax Rev. 309–319, at 316 *et seq.* (2015).

[17] CJEU, 17 Dec. 2015, Case C-388/14, *Timac Agro Deutschland GmbH*, paras 52 et seq., where recapture of prior years' losses were at issue, and the CJEU nevertheless refers to the *Marks & Spencer* exception.

denying the 'final loss' relief in relation to carried-forward tax losses.

A more plausible explanation for the restrictive view on final losses developed in *Marks & Spencer II* could be that the Commission had built its case mainly on the alleged requirement to liquidate the foreign subsidiary before the end of the tax year, which could be countered by the UK government giving examples where losses did meet the requirement under UK law without liquidating the subsidiary before year end.

On that basis, we still believe that carried-forward tax losses can be qualified as 'final losses' in the context of a cross-border merger or division. Based on that assumption, we will analyse below if and under which conditions cross-border loss relief is possible under current EU law in the event of a cross-border merger or division.

## 2.4 Cross-Border Reorganizations and Final Losses

As mentioned above, particularly after *Marks & Spencer II*, it seems settled CJEU case law that the 'finality' of tax losses must be analysed from a factual perspective (existence or absence of income). However, *Marks & Spencer II* was not related to a case of a cross-border merger or division. For such cross-border restructuring operations, the factual approach to 'final losses' whereby the sole criterion is whether income continues to be earned in the Member State of the transferring company, and the legal position of the receiving or 'surviving' company to claim relief for the losses is entirely disregarded, raises some serious issues.

*First*, it must be noted that this approach can have adverse consequences in terms of double non-relief for tax losses.

Consider for instance the case of a German subsidiary being merged into its Belgian parent company. Even if all the assets and liabilities of the former German subsidiary remain invested in a German permanent establishment of the Belgian company (and, therefore, the latter receives income in Germany after the merger), the unrelieved German tax losses of the subsidiary cannot be offset against the permanent establishment's future profits. This is because, under the German *Umwandlungssteuergesetz*, the receiving company in a domestic merger is not entitled to utilize any carried-forward tax losses incurred by the transferring company and, as a result, in a cross-border merger, no tax loss takeover by the permanent establishment is required under Article 6 of the Merger Directive.[18]

If the factual circumstances only are considered to determine whether the German tax losses are 'final', then the conclusion would clearly be that, in this case, these losses are not (because the post-merger permanent establishment in Germany will continue the existing German business and realize profits), despite the fact that, due to legal restrictions, the permanent establishment is permanently deprived of the possibility of utilizing these losses. In such a case, narrowing down the issue of the 'finality' of the tax losses to a mere factual issue results in the losses being relieved nowhere (not in the Member State of the transferring company due to legal restrictions on the transferability of tax losses in a (cross-border) restructuring context, and not in the Member State of the receiving company either because the loss could not be characterized as 'final'). This example shows that a merely 'factual' approach to the 'final loss' issue may constitute a serious hurdle for obtaining cross-border loss relief in a restructuring context.

Admittedly, the factual approach can be argued on the basis of the reasoning developed by the CJEU in *Krankenheim*. In that case, the Court validated the recapture in Germany of previously deducted losses of the Austrian permanent establishment (despite the fact that such losses could not be offset against later permanent establishment profits realized in Austria) on the basis that '*a Member State [Germany] cannot be required to take account (. . .) of the possible negative results arising from particularities of legislation of another Member State [Austria] applicable to a permanent establishment situated in the territory of the said State (. . .)*'.[19] On that basis, the Court decided that the 'responsibility' for eliminating double non-relief for losses resulting from '*disparities, arising from national tax rules*'[20] did not lie with the Member State of the head office (Germany).

If it is accepted that this is the correct approach in a cross-border restructuring context as well, then it would mean that, in the above example, the impossibility under German tax law for a receiving company in a cross-border merger to take over the unrelieved tax losses of the transferring company would have to be viewed as a '*particularity*' of German tax law, for which the Member State of the receiving company (Belgium) would not have to step in. It would mean that the receiving Belgian company must 'live with' a double non-relief of its losses in the EU, and accept that, under the current status of EU law, this outcome is the inevitable result of '*disparities arising from national tax rules*' applying in the Member States.

[18] S. Simon et al., in *European Cross-Border Mergers and Reorganizations*, para. 8.221 (J. Vermeylen & I. Vande Velde eds., Oxford University Press 2012).

[19] CJEU, 23 Oct. 2008, Case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH*, para. 49.

[20] CJEU, 23 Oct. 2008, Case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH*, para. 50.

It has been suggested,[21] however, that the outcome in *Krankenheim* (i.e., that Germany was not required to avoid a double non-relief for the losses) was due to the fact that the German recapture rule was not discriminatory in the first place (because a similar tax effect would have applied, had the establishment been in Germany instead of Austria).[22] Arguably, this fact distinguishes the *Krankenheim* case from the cross-border merger case considered here: in the cross-border merger case, the tax legislation of the Member State of the receiving company (Belgium) is discriminatory if it does not allow losses of a transferring company established in another Member State to be taken over, whereas such a takeover would (wholly or partly) apply in a domestic merger.[23] From that perspective, the double non-relief arising in the cross-border merger case is not the result of a mere disparity. It may be argued therefore that, because its legislation is discriminatory, the Member State of the receiving company cannot justify its refusal to grant relief for final losses on the basis that the double non-relief is the result of a mere disparity (also taking into account that the 'particularity' of the legislation in the Member State of the transferring company (Germany) is *not* discriminatory, because the German rule equally applies to cross-border and domestic transactions). Although this appears to be a justifiable approach, it does not seem in line with the CJEU's strictly factual interpretation of 'final losses' in *Marks & Spencer II*, and is, therefore, not very likely to be upheld, leaving merging entities with a potentially serious tax restriction to their cross-border merger transaction.

*Second,* the CJEU's refusal to look at other reasons for the unavailability of tax losses than merely factual ones, raises other issues for cross-border mergers, because for such transactions, the legislation of the Member State of the transferring company must inevitably be taken into account as well (in addition to the factual circumstances) in determining whether the losses have become permanently unavailable as a result of the termination of the business activities in that state. In a cross-border restructuring context, therefore, the point made by M. Lang, that the possibility to utilize the losses in the source state will never depend on factual circumstances alone, but also on that state's tax legislation,[24] is particularly relevant.

Consider for instance the case of a cross-border parent/subsidiary merger in which the business of the transferring subsidiary is discontinued in consequence of the merger and, therefore, the receiving company does not maintain a permanent establishment in the Member State of the transferring company immediately after the merger. If the legislation of the transferring company's Member State provides that the losses become permanently unavailable if no permanent establishment remains after the merger, then these losses are clearly 'final' both from a factual and a legal perspective. As a result, the Member State of the receiving company would have to grant relief for the (final) losses. Alternatively, however, the legislation of the transferring company's Member State may provide that, even if no permanent establishment remains after the merger, the losses remain available for being carried forward and offset against future permanent establishment profits should, some years after the merger, the receiving company start permanent establishment activities in the Member State of the transferring company. The latter approach seems in line with Article 6 of the Merger Directive, which requires that the loss takeover rule provided for domestic transactions must be extended to cover the takeover of the losses '*by the receiving company's permanent establishments*', without requiring that such permanent establishment should exist '*in consequence of the merger*'.[25] In the latter case, the losses are not permanently unavailable in the Member State of the transferring company, despite the fact that, immediately after the merger, there are no activities or income-producing assets anymore in the Member State of the transferring company. In such a case, the losses would be 'semi-final' at best. For the factual approach to the issue of the 'finality' of tax losses to be satisfactory in such a case, a 'conditional' relief should be available in the Member State of the receiving company, i.e., a relief that is subject to recapture when the permanent establishment in the Member State of the transferring company becomes profitable. If the loss relief in the Member State of the receiving company would not be subject to recapture, then a double use of tax losses could arise as a result of the exclusively factual approach to final losses. Taking these effects into consideration, we tend to agree with those authors who have called the test relating to the existence of activities/income an

[21] W.C. Haslehner, *Cross-Border Loss Relief for Permanent Establishments under EC Law*, 64 Bull. Intrl. Taxation, 33–44, at 42 (2010).

[22] For the arguments why the German rules were not discriminatory, see P. Wattel, *Non-discrimination à la Cour: The ECJ's (Lack of) Comparability Analysis in Direct Tax Cases*, 55 Eur. Taxn. 12 542-553, at 552 (2015), Journals IBFD.

[23] For the same reason, the Finnish legislation that was at issue in *A Oy* was discriminatory; see M. Helminen, in *ECJ – Recent Developments in Direct Taxation 2011* 80–92, at 84 (M. Lang et al. eds, Linde 2012); M. Helminen, *Must the Losses of a Merging Company be Deductible in the State of Residence of the Receiving Company in EU?*, EC Tax Rev. 172–178, at 174–175 (2011).

[24] M. Lang, *Has the Case Law of the ECJ on Final Losses Reached the End of the Line?*, 54(12) Eur. Taxn. 530–540, at 536 (2014).

[25] Article 4 of the Merger Directive requires a permanent establishment to exist '*in consequence of the merger*' in order for the roll-over relief in respect of assets transferred as a result of the merger to be available. A similar requirement is not provided for in Art. 6 for the takeover of tax losses.

'arbitrary distinction',[26] particularly if applied in cases of cross-border restructurings. At the least, it should be accepted that tax rules must be considered as well in order to determine if a given fact pattern (absence of activities/income) results in the losses being permanently unavailable.

*Third*, it should be noted that the CJEU's 'factual' criterion of whether any income is still earned in the source state means, if applied in a cross-border restructuring context, that the tax losses of the transferring company can only be considered 'final' if that company has ceased all activities and has disposed of all income-generating assets before or shortly after the merger. This is precisely the fact pattern in which national tax authorities would take the position that the restructuring is not driven by valid commercial reasons, but by the (exclusive) tax motive to offset the losses of the transferring company against post-merger profits of the receiving company. If that is the case, then the Member State of the receiving company would probably not allow the losses to be taken over in a domestic merger either, meaning that that Member State's refusal to relieve the losses in a cross-border transaction could not be challenged for being a restrictive measure. This point was argued by some governments in *A Oy*, but the Court merely decided that it was for the national court to assess whether the anticipated merger was abusive.

*To summarize*, although the CJEU, in its *A Oy* judgment, has left the door open for relief for final losses in cases of cross-border mergers or divisions, the merely factual approach to final losses, as adopted in *Marks & Spencer II* is far from obvious in a cross-border merger context.

*First*, even if the business activities of the transferring company continue in a permanent establishment, the transaction could result in double non-relief for the tax losses. Even if, from a practitioner's perspective, this is obviously an undesired effect, it would be understandable from a theoretical perspective, to the extent that this is the result only of '*disparities arising from national tax rules*'. The question remains, however, whether the double non-relief is indeed only an issue of disparity if it is triggered by a discriminatory tax rule in the Member State of the receiving company.

*Second,* in cases where no permanent establishment remains in the Member State of the transferring company, the factual approach is unsatisfactory from a theoretical perspective (because the legal context cannot be fully disregarded in determining when losses become permanently unavailable), and may in some cases be ineffective in practice (because a merger after termination of all activities in the transferring company often does not qualify for tax-neutral treatment in a domestic merger either).

## 3 Recapture of Previously Deducted Tax Losses Incurred by the Transferring Company in a Permanent Establishment

### 3.1 Cross-Border Reorganizations and the Recapture Rule

Article 10 of the Merger Directive deals with the specific case where the assets transferred in a merger or division include a permanent establishment in another Member State (than the Member State of the transferring company). This provision would, for example, apply in a triangular case in which a Belgian company with a German permanent establishment is merged into a Dutch company.

If the tax legislation of the Member State of the transferring company provides that permanent establishment losses can be offset against taxable profits of the head office, then Article 10(1) paragraph 2 of the Merger Directive allows such previously deducted and unrecovered losses to be recaptured (i.e., reinstated in the taxable profits of the transferring company). The recapture rule of the Directive allows a one-off claw-back of the tax losses upon the merger or division.

The *rationale* behind this one-off recapture rule is that, as a result of the merger or division, the 'normal' recapture mechanism (i.e., recapture of losses in a going-concern situation applying to the extent that the permanent establishment generates profits) is 'blocked', because the transaction results in the permanent establishment being 'disconnected' from the entity in the Member State of the transferring company. In the example above of a 'triangular' merger, for instance, the activities conducted in Belgium would be 'converted' into a permanent establishment of the Dutch (receiving) company, and the former German permanent establishment of the Belgian (transferring) company would become a permanent establishment of the Dutch company as well.

Although, therefore, the recapture rule is intended to safeguard the financial interests of the Member State of the transferring company (avoiding a temporary deduction to become 'final'), it can result in an effective tax charge that could form a serious restriction to the transaction. This raises the legitimate question whether the Merger Directive's primary and secondary objectives (i.e., respectively 'elimination of tax restrictions' and 'safeguarding the financial interests of the Member States') have been adequately balanced.

In addition, it must be noted that, under the Merger Directive, the Member State of the transferring company is allowed to apply an 'unconditional' recapture mechanism, involving a reinstatement of the permanent establishment losses irrespective of whether the Member

[26] M. Danish, *What Remains of the Marks & Spencer Exception of Final Losses? – Examining the Impact of Commission v. United Kingdom (Case C-172/13)*, 55(9) Eur. Taxn. 417–422, at 419 (2015), Journals IBFD.

State of the permanent establishment allows the tax losses to be taken over by (the permanent establishment of) the receiving company, and thus 'survive' the transaction. As mentioned above, such 'loss survival' is not guaranteed, and will, in principle, only be the case to the extent that the tax legislation of the Member State of the permanent establishment allows tax losses to be taken over by the receiving company in a similar domestic reorganization. If, in the above 'triangular' case, German tax legislation does not allow the unrelieved tax losses of the permanent establishment to be taken over by (the permanent establishment of) the receiving Dutch company, whereas Belgian tax legislation requires a full and automatic recapture of such losses, then the merger results in no relief being granted for the losses.

As the recapture mechanism allowed under the Merger Directive results in an effective tax charge at the level of the transferring company, and thus hinders the restructuring, and potentially results in double non-relief for the tax losses, it has an obvious restrictive effect. Therefore, the question arises on whether the loss recapture could, albeit permitted under the Merger Directive, successfully be challenged on the basis of Article 49 TFEU. Interestingly, the CJEU has recently examined the compatibility of the Danish and German recapture rules with primary EU law. Although these cases concerned the recapture of losses further to a straightforward sale of the permanent establishment (i.e., a taxable disposal, as opposed to a tax-neutral restructuring), we will analyse below which conclusions can be drawn from this case law in the context of cross-border mergers and divisions. The analysis differs depending on whether the Member State of the transferring company applies a credit or an exemption system.

### 3.2 Justification in a Credit System: The Nordea Bank Case

In the recent *Nordea Bank* case, the CJEU held the Danish recapture system to be incompatible with the freedom of establishment under the TFEU and the EEA Agreement.[27] The Danish bank *Nordea* had sold its loss-making branches in Finland, Sweden and Norway to local affiliated companies. According to Danish domestic tax law, the balance of losses previously deducted at the level of the Danish head office (i.e., losses not covered by subsequent permanent establishment profits) had to be fully reincorporated into the taxable profits in Denmark.

The Court acknowledged that the recapture mechanism could, in principle, be justified by the objective of countering tax avoidance. Such tax avoidance could indeed exist if, once an initially loss-making permanent establishment becomes profitable, it is transferred to a separate legal entity that, unlike the permanent establishment, is not taxable in Denmark.

However, the CJEU finally held that the Danish recapture rule was disproportionate because it did not function in a manner respecting the symmetry between the right to tax profits and the right to deduct losses. Earlier, the Court had ruled in *Krankenheim* that the recapture rule applied in the German exemption system operated in a perfectly symmetrical manner, '*only deducted losses being reintegrated*'.[28] In a system of worldwide taxation (such as the Danish system), the symmetry requirement means, according to the *Nordea Bank* judgment, that the deducted permanent establishment losses must be capable of being offset by taxation of permanent establishment profits made throughout the period when the permanent establishment belongs to the company, i.e., both the profits made as going concern until the transfer of the permanent establishment, and the profits or gains made as a result of the transfer. In other words, the symmetry requirement is met if both the profits and the losses of the permanent establishment are taken into account. The Danish recapture mechanism disrupts this symmetry, because it leads to the situation that, finally, the losses are not deducted (the initial deduction being recaptured), whereas the profits of the permanent establishment (including the gains realized upon the transfer) are taxed (be it with a credit for the tax in the jurisdiction of the permanent establishment, which may however be low or nil due to the losses being utilized in the jurisdiction of the permanent establishment).

In our view, the same conclusion should apply if the permanent establishment is transferred further to a cross-border merger or division. If the Member State of the transferring company in a cross-border merger applies a credit system, then it is allowed, under Article 10(2) of the Merger Directive, not to exempt the gains on the permanent establishment's assets, but to tax these gains and grant a 'notional' tax credit instead, i.e., a credit for the tax that, but for the relief in respect of those gains granted in the Member State of the permanent establishment, would have been charged in the Member State of the permanent establishment. As in the case of a sales transaction (*Nordea Bank*), the combined effect of the recapture of the tax losses and the taxation of the capital gains results in the symmetry between the treatment of gains and losses being disrupted. As a result, the recapture seems to infringe the freedom of establishment if the Member State of the transferring company has a credit system.[29]

[27] CJEU, 17 Jul. 2014, Case C-48/13, *Nordea Bank Danmark A/S*.

[28] CJEU, 23 Oct. 2008, Case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH*, para. 44.

[29] H. van den Broek, *Cross-Border Mergers within the EU. Proposals to Remove the Remaining Tax Obstacles*, 397–398 (Wolters Kluwer 2012).

### 3.3 Justification in an Exemption System: The Timac Agro Case

The analysis is different if the transferring company is established in a Member State that applies an exemption system. In its recent *Timac Agro* judgment, the CJEU (again) examined the compatibility of the German recapture rule with the freedom of establishment. In *Krankenheim*, the Court had found the German recapture rule to comply with primary EU law in a 'going concern' situation in which the permanent establishment was not transferred/converted. In *Timac Agro*, a full recapture of the total amount of the previously deducted permanent establishment losses was at issue. This recapture was triggered pursuant to the sale by the German company *Timac Agro* of its Austrian permanent establishment to an Austrian affiliated company.

The CJEU considered that the recapture resulted in a disadvantageous treatment of the non-resident permanent establishment (compared to a German establishment), and that such a disadvantageous treatment could not be justified on the basis that both situations would not be objectively comparable (because, by allowing the deduction of losses of a non-resident permanent establishment, German tax legislation had equated a non-resident permanent establishment with a German establishment from the perspective of deduction of losses). As a result, the CJEU examined whether the recapture could be justified by overriding reasons in the public interest. The Court concluded that such justification was indeed available, based on the following considerations.

*First*, the CJEU acknowledged that the recapture mechanism was in principle justified by the need to safeguard a balanced allocation of the taxing powers between the Member States, and in particular a symmetry between the right to tax profits and the right to deduct losses: since Germany applies an exemption system and, therefore, cannot tax the profits of the permanent establishment, it should be entitled to recapture the losses upon a transfer or conversion of the permanent establishment. If not, the company could, by transferring the permanent establishment, avoid the 'normal' loss recapture up to the amount of future permanent establishment profits, which would have the effect of 'electing' to claim relief for the losses in the Member State of the head office (Germany). This outcome would be contrary to established case law that companies do not have the right to choose freely in which Member State losses are deducted.

*Second*, the CJEU accepted the justification based on the need to preserve the coherence of the tax system, on the basis that the recapture is an inextricable complement of the deduction initially granted.

*Third,* the CJEU accepted the objective of preventing tax avoidance as a justification because the recapture rule's aim was to avoid that the 'normal' loss recapture (applying in a going-concern situation) would be made ineffective by transferring the permanent establishment to a company outside the German tax jurisdiction once the permanent establishment becomes profitable.

*Finally*, the Court found the German recapture rule to be proportionate on the basis that, unlike under the credit system that was at issue in *Nordea Bank*, the initial deduction of the losses could not be offset by taxation of later profits made by the permanent establishment '*under the tax jurisdiction of the Member State in question*' (because both the permanent establishment profits realized prior to the transfer and those recognized at the time of the transfer were treaty-exempt). Therefore, the reincorporation of the initially deducted losses into the German taxable profit resulted in a symmetrical treatment of profits and losses, with none of them being taken into account for German tax purposes.

What lessons can be learnt from the *Timac Agro* judgment for the case where a permanent establishment is transferred in a cross-border merger or division, assuming that the transferring company is established in an exemption state?

*First*, the recapture rule of Article 10(1) paragraph 2 of the Merger Directive seems justified by the need to safeguard a balanced allocation of the taxing powers between the Member States and the symmetry between the right to tax profits and the right to deduct losses. If the losses would not be recaptured, companies could 'elect' to claim relief in the Member State of the transferring company by transferring the permanent establishment in a cross-border merger transaction. *Second,* the recapture rule of the Merger Directive preserves the coherence of the tax system, because it cannot be dissociated from the fact that the losses have been deducted earlier. *Third,* in a merger scenario, the tax avoidance effect (or motive) could in principle even go beyond the potential effect (motive) in a sales transaction (i.e., making the initial deduction in the Member State of the transferring company 'final' through transferring the permanent establishment once it becomes profitable): if the tax legislation of the Member State of the permanent establishment allows the permanent establishment losses to 'survive' the merger, then the transaction results in a 'double-dip' of losses, unless the initial deduction in the Member State of the transferring company is recaptured.

Arguably, however, the proportionality requirement calls for a different analysis in the case of a cross-border merger than the CJEU's analysis in *Timac Agro* regarding a sale of a permanent establishment. In the latter case, the CJEU held that the symmetry requirement means that the initial deduction of the permanent establishment losses must be '*capable of being offset by taxation of the profits made by it* [i.e., by the permanent establishment] *under the tax jurisdiction of the Member State in question*'. In a sales transaction, in which the transferring company is established in a Member State

with an exemption system, later permanent establishment profits realized before or at the time of the transaction cannot, in principle, be taxed under the tax jurisdiction of the Member State of the transferring company. If adequate provisions are made in the double tax treaty, the initial loss deduction can be 'reversed' up to the amount of permanent establishment profits made before the transfer and gains recognized upon the transfer. The excess loss exceeding these profits and gains cannot, however, be offset by taxation of profits realized after the transfer of the permanent establishment, due to the fact that the permanent establishment does not exist anymore, and any future profits will be realized by another entity that does not fall under the tax jurisdiction of the Member State of the transferring company. Under such circumstances, the requirement for the 'excess loss' (i.e., the loss not yet offset by profits or gains) to be recaptured is a proportionate measure.

In a cross-border merger, the permanent establishment profits realized at the time of the transaction are exempt based on Article 10(1) paragraph 1 of the Merger Directive. The essential difference with a sales transaction is that, in principle, the permanent establishment remains in existence after the merger and can realize future profits that can be offset against the carried-forward tax losses of the permanent establishment. Arguably, therefore, it should be possible to provide that the initial deduction of the permanent establishment losses must be reversed up to the amount of the post-merger permanent establishment profits. Under such a system, the symmetry requirement would be perfectly met (because the initially deducted losses would be '*capable of being offset by profits made by the permanent establishment*'). Arguably, therefore, the one-off recapture mechanism allowed under the Merger Directive (entailing a disadvantageous timing difference) is disproportionately restrictive.[30]

Admittedly, subsequently to the merger, the permanent establishment no longer belongs to the transferring company and, therefore, its future profits do not fall under the tax jurisdiction of the transferring company's Member State. As a result, a deferred recapture that would apply when and to the extent that the permanent establishment makes profits would not, technically, take the form of '*a taxation of profits made by the permanent establishment under the tax jurisdiction of the Member State of the transferring company*', as mentioned in the *Timac Agro* judgment. However, a similar recapture effect could technically be achieved by recognizing a deferred tax liability at the level of the post-merger permanent establishment in the Member State of the transferring company. Arguably, the way the recapture of the losses would be technically achieved is secondary to the requirement that the recapture must not apply in a disproportionately restrictive manner. In addition, the existing instruments for mutual assistance[31] should, in principle, enable the Member State of the transferring company to obtain information from the Member State of the permanent establishment concerning the existence and the amount of post-merger profits realized in the latter Member State.

Reference can be made to the CJEU's case law on exit taxation,[32] which held that an immediate recovery of the tax on unrealized gains at the time when the place of effective management of a company is transferred to another Member State is disproportionately restrictive. The CJEU confirmed that a less restrictive system whereby the recovery of the tax is deferred until the actual realization of the assets in the host Member State is acceptable (although, under the applicable treaty or domestic law, the assets will no longer '*fall under the tax jurisdiction*' of the exit Member State at the time of actual realization).

As a result, the recapture rule can (and, arguably, must) be applied in a less restrictive manner. If the actual recovery of the tax triggered by the recapture were to be deferred until the moment and to the extent that the permanent establishment actually makes profits, then it would clearly be proportionate, taking into account that, in *Krankenheim*, the CJEU approved the German recapture rule that applied in a going-concern situation on the basis that '*the restriction is entirely proportionate to the objective pursued, since the reintegrated losses are reintegrated only up to the amount of the profits made*' (author's emphasis).[33]

Alternatively, and by analogy with CJEU case law on 'exit taxation',[34] the recapture rule could be made less restrictive by granting the transferring company the option to defer (the payment of the tax resulting from the) reintegration of the losses into its taxable profits to another point in time (other than the moment when the permanent establishment actually makes profits) or by offering the company the possibility to stagger the payments of the tax charge resulting from the recapture.[35] The benefit of such alternative approach would be that the disproportionate effect is reduced (compared to a one-off recapture system), while at the same time the compliance burden intrinsic to a system of recapture proportionate to profits made, is avoided.

[30] H. van den Broek, *Cross-Border Mergers within the EU. Proposals to Remove the Remaining Tax Obstacles*, 395–397 (Wolters Kluwer 2012).

[31] Council Directive 2011/16/EU of 15 Feb. 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC.

[32] See e.g., CJEU, 29 Nov. 2011, Case C-371/10, *National Grid Indus BV*.

[33] CJEU, 23 Oct. 2008, Case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH*, para. 45.

[34] CJEU, 18 Jul. 2013, Case C-261/11, *Commission v. Denmark*; CJEU, 23 Jan. 2014, Case C-164/12, *DMC*; CJEU, 21 May 2015, Case C-657/13, *Verder LabTec GmbH & Co. KG*.

[35] The solution of staggered payments has been suggested by H. van den Broek, *Cross-Border Mergers within the EU. Proposals to Remove the Remaining Tax Obstacles*, 276–277 (Wolters Kluwer 2012).

However, the alternative approach would not exclude the risk that losses are recaptured although no future permanent establishment profits are realized at all.

A further question is whether a recapture of the losses (whether one-off or deferred) would be allowed at all if the tax legislation of the Member State of the permanent establishment does not allow the (remaining) losses to 'survive' the merger. Such a scenario is possible due to the fact that, under the Merger Directive, pre-merger unrelieved tax losses of the permanent establishment must 'survive' the merger only to the extent that the tax legislation of the Member State of the permanent establishment allows tax losses to be taken over in a similar domestic reorganization. If this is not the case, then there is no obligation under the Directive to allow the losses to be offset against profits realized after the merger in the permanent establishment. If, in addition, the losses must be recaptured in the Member State of the transferring company, a 'double non-relief' situation arises.

At first sight, the recapture applying under those circumstances may be justified by reference to *Krankenheim,* i.e., on the basis that the double non-relief is the result of a mere disparity, for which the Member State of the transferring company does not have to step in. It has been suggested,[36] however, that the outcome in *Krankenheim* (that the German recapture rule could apply) was due to the fact that this rule was not discriminatory (because a similar tax effect would have applied had the establishment been in Germany instead of Austria). Arguably, this distinguishes the *Krankenheim* case from the envisaged case of a recapture following a cross-border merger: as the latter recapture mechanism applies if the loss-making activities are conducted in a permanent establishment in another Member State, whereas no similar effect arises if these activities are conducted in the Member State of the transferring company, it has a discriminatory effect. From that perspective, the double non-relief is not the result of a mere disparity. It may be argued therefore that, because its legislation is discriminatory, the Member State of the transferring company cannot justify its recapture rule on the basis that the double non-relief is the result of a mere disparity (also taking into account that the 'particularity' of the legislation in the Member State of the permanent establishment is *not* discriminatory, because the losses do not 'survive' in a domestic transaction either).

Nevertheless, it is not to be expected that the CJEU would characterize the pre-merger tax losses in this case as 'final' (and hold the recapture rule contrary to Article 49 TFEU accordingly): as discussed above, the CJEU seems to consider factual circumstances only with a view to determine if losses could be considered as 'final', the (only) test being whether or not the permanent establishment still receives any income.[37]

Based on the above arguments, we believe caution is required in drawing final conclusions from the *Timac Agro* judgment for cross-border mergers and divisions. In our view, legitimate questions remain as to the proportionality of the recapture rule of Article 10(1) paragraph 2 of the Merger Directive and, therefore, its compatibility with Article 49 TFEU, also in transactions where the transferring company is established in an exemption state (at least if the recapture rule under the Directive is interpreted as allowing an *immediate* recapture and an *immediate* recovery of the tax upon the merger or division).

### 3.4 Merger Directive versus Freedom of Establishment

If the reasoning above is correct, then it implies that a provision of the Merger Directive can be in breach of primary EU law laid down in the TFEU and must, in such a case, be overruled by the TFEU.

This outcome clearly goes a step further than what was accepted by the CJEU and the Advocate General in *A Oy* regarding the relief (if any) to be granted subsequently to a cross-border merger by the Member State of the receiving company for tax losses incurred in the Member State of the transferring company: the Merger Directive only provides under which circumstances such losses must remain available to be offset against permanent establishment profits, assuming that a permanent establishment remains in the Member State of the transferring company, but does not address the issue as to whether the Member State of the receiving company must step in and grant relief, should no permanent establishment remain in the Member State of the transferring company. Therefore, the CJEU has had no difficulty in ascertaining that this 'unaddressed issue' must be dealt with in compliance with the fundamental freedoms of the TFEU.

Arguably, the discussion as to whether the recapture rule of the Directive can be overruled by Article 49 TFEU also goes a step further than the acceptance of the idea that the 'permanent establishment' requirement in Article 4 of the Merger Directive may be a disproportionate restriction. What the Merger Directive provides is that rollover relief must be available for those assets and liabilities that, after the merger, remain effectively connected with a post-merger permanent establishment. In our opinion, the position (based on an *a fortiori* reasoning) that gains on assets that do *not* remain connected to a permanent establishment, are subject to an immediate tax charge upon the merger, cannot be upheld, because such an immediate tax

[36] W.C. Haslehner, *Cross-Border Loss Relief for Permanent Establishments under EC Law*, 64 Bull. Intrl. Taxation, 33–44, at 42 (2010).

[37] CJEU, 3 Feb. 2015, Case C-172/13, *Commission v. United Kingdom*, para. 36; CJEU, 17 Dec. 2015, Case C-388/14, *Timac Agro Deutschland GmbH.*, para. 55.

charge without deferral option would be a disproportionate measure, as has been decided by the CJEU in its case law on 'exit taxation'.[38] Arguably, however, there is no 'conflict' between the 'permanent establishment' requirement of the Directive and the freedom of establishment. On the one hand, the Directive provides a 'safe harbour' for those assets that retain a territorial nexus with the Member State of the transferring company and therefore remain within the tax jurisdiction of that Member State. On the other hand, the Directive remains silent regarding the consequences of the reorganization for gains on assets that do not meet this requirement, which is different from an implicit justification of an immediate tax charge.[39]

The recapture rule of Article 10(1) paragraph 2 of the Merger Directive, however, provides that the Member State of the transferring company '*may reinstate*' the previously deducted permanent establishment losses in the taxable profits. This wording seems to suggest an explicit confirmation that such recapture is indeed allowed. However, since it follows from the CJEU ruling in *Nordea Bank* that the recapture is not justified in a credit system, it seems clear that credit states cannot rely on the Merger Directive to justify a recapture of permanent establishment losses. Applying the recapture rule would not be justified, because it would mean that restrictive legislation that has been found to be non-compliant with the freedom of establishment in a straightforward sales transaction would be allowable in the context of a 'tax-neutral' merger or division. This would make no sense, also taking into account that, in a cross-border merger, credit states are – '*by way of derogation from paragraph 1*' – entitled to tax the gains on permanent establishment assets (subject to a notional tax credit) under Article 10(2) of the Directive. Arguably, therefore, states using this option are '*by way of derogation from paragraph 1*' not entitled to require a recapture of the losses.

However, as discussed above, there are solid arguments for the view that the recapture mechanism applied by some exemption Member States may also, at least under certain circumstances, result in a disproportionate restriction that is contrary to the freedom of establishment (at least provided that the recapture rule under the Directive is to be interpreted as allowing an *immediate* recapture and an *immediate* recovery of the tax upon the merger or division). If that is correct, the freedom of establishment should, in our opinion, prevail on the basis that secondary EU legislation cannot limit the scope of the fundamental freedoms under the TFEU.[40]

## 4 Conclusions

The Merger Directive is not a comprehensive piece of Union legislation covering all implications of cross-border reorganizations for the available tax losses of the companies involved in the transaction, but a common system of taxation reflecting the consensus on some of these implications. 'Unaddressed issues' must be dealt with in compliance with the TFEU. In addition, for issues that *are* addressed, the solution provided by the Directive must be examined and (where possible) interpreted in the light of the fundamental freedoms under the TFEU and, if a contradiction exists, primary EU legislation must prevail. The main findings of our analysis can be summarized as follows.

*First*, in a cross-border merger case where the transferring company has sustained tax losses in its Member State prior to the transaction, the CJEU has in principle left the door open for these losses to be relieved in the Member State of the receiving company (*A Oy*). However, it is expected that the merely factual approach of the CJEU to the 'final loss' concept (*Marks & Spencer II*) will make it difficult to claim cross-border loss relief in a cross-border merger context. However, particularly for cross-border mergers and divisions, the merely factual approach may be an arbitrary test because tax rules must often be considered as well (in addition to factual circumstances) to determine whether the losses have become permanently unavailable after the merger or division. In addition, situations of double non-relief arising in a cross-border merger due to legal restrictions on the availability of tax losses cannot always be attributed (reduced) to a 'mere disparity' (*Krankenheim*), but can result from discriminatory provisions in the tax legislation of the receiving company's Member State. Particularly in such a case, both the result achieved (double non-relief) and the justification (i.e., that the losses are not 'final' from a narrow factual perspective) are unsatisfactory.

In addition, the Court has created even more uncertainty in *Marks & Spencer II*, to the point that some authors have questioned whether carried-forward tax losses can qualify at all as 'relievable' final losses. If not, then the relevance of *Marks & Spencer* for cross-border restructurings would have become very remote. On the basis of prior (*A Oy*) and later case law (*Timac Agro*), we think, however, that the 'final loss' doctrine is still relevant for carried-forward tax losses of companies engaged in a cross-border restructuring.

*Second,* the recapture rule of Article 10(1) paragraph 2 of the Merger Directive seems to be incompatible with

[38] CJEU, 29 Nov. 2011, Case C-371/10, *National Grid Indus BV*; CJEU, 18 Jul. 2013, Case C-261/11, *Commission v. Denmark*; CJEU, 23 Jan. 2014, Case C-164/12, *DMC*; CJEU, 21 May 2015, Case C-657/13, *Verder LabTec GmbH & Co. KG*.

[39] D.J. Jiménez-Valladolid de L'Hotellerie-Fallois, *The Permanent Establishment: Still a (Permanent) Requirement?,* 4–15 EC Tax Rev., at 13 (2014).

[40] D.J. Jiménez-Valladolid de L'Hotellerie-Fallois, *The Permanent Establishment: Still a (Permanent) Requirement?,* 4–15 EC Tax Rev., at 14 (2014).

Article 49 TFEU in cases where the transferring company is established in a credit state.

For cross-border mergers in which the transferring company is established in an exemption state, the analysis of whether the recapture rule is compatible with primary EU law is less obvious. Although, in *Timac Agro*, the CJEU has validated the German recapture rule in a case of a sale of the permanent establishment, caution is required, in our opinion, in drawing conclusions for cross-border merger cases. For cross-border mergers, arguably, a one-off recapture system (entailing a disadvantageous timing difference) is a disproportionate restriction. A more proportionate approach could be to defer the (recovery of the tax resulting from the) recapture until the moment and to the extent that the permanent establishment transferred in the merger actually makes profits. Such an approach would result in the initial deduction of the permanent establishment losses being '*capable of being offset by future permanent establishment profits*' as required by the CJEU in *Timac Agro* for the measure to be proportionate to its aims (including the symmetry between the right to tax profits and the right to deduct losses). Alternatively, the recapture mechanism could be made more proportionate by offering the possibility of staggered payments. In addition, the recapture rule for mergers can result in double non-relief for losses if the legislation of the Member State of the permanent establishment does not allow the (remaining) losses to 'survive' the merger. In the CJEU's merely factual approach to final losses, this is probably an effect that companies have to 'live with', although it is unsatisfactory because, arguably, it does not result from a 'mere disparity' (*Krankenheim*) of the respective Member States' tax legislations.

*Finally,* the Commission has recently announced[41] the re-launch of CCCTB.[42] The intention is to take a staged approach to implementing the CCCTB, and to introduce the proposal for the first phase this year. Importantly, this first phase (prior to actual consolidation) would include an element of cross-border loss relief. It is to be hoped that there will be more legal certainty under these legislative proposals than in the current case law-based environment.

[41] Communication from the Commission to the European Parliament and the Council: 'A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action', 17 Jun. 2015, COM(2015) 302 final.

[42] Proposal for a Council Directive on a Common Consolidated Tax Base (CCCTB), 16 Mar. 2011, COM(2011)121.