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Miller's Tales V

Tax Cases

Implementation of EU Directives into domestic law

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Pete Miller writes about some more recent tax cases that have taken his interest

This time around, the cases are all about the implementation of EU Tax Directives into domestic law. Although none of the cases involves a UK company, they are still interesting demonstrations of the interaction of European and domestic rules.

At v Finanzamt Stuttgart-Körperschaften Case C-285/07

This is a case about Germany's implementation of the Mergers Directive (properly known as Council Directive 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States), as amended in 2005.

AT is a German public limited company which owned 89.5% of the shares of C-GmbH, a German private limited company. Those shares were sold to a French company, G-SA, in return for an issue of new shares in that company, amounting to 1.47% of the increased share capital. In other words, this was a share-for-share exchange, a very familiar transaction.

Under German domestic tax legislation, the value at which the transferee company shows the target company shares in its books will determine the taxable outcome of the transaction.

So there were two possible treatments for the transaction:

- if the transferee company, G-SA, had treated the C-GmbH shares as acquired at their original book value, AT would have been permitted to treat the G-SA shares issued to it as having been acquired at that same value, so that there would have been no gain under German tax legislation
- however, since G-SA had treated the C-GmbH shares as acquired at market value, AT was required to treat the G-SA shares issued to it as having been acquired at that same market value, so that there was a taxable capital gain under German tax legislation.

The first point to note is that the German tax rules apply equally to domestic and EU cross-border

transactions, so there was no obvious discrimination whereby the cross-border transaction was somehow less favourably treated because the purchaser was not German.

However, AT's primary challenge was that the German tax rules were incompatible with the clear and unambiguous terms of the Mergers Directive. Specifically, Article 8(1) states that:

'On a merger, division or exchange of shares, the allotment of securities representing the capital of the receiving or acquiring company to a shareholder of the transferring or acquired company in exchange for securities representing the capital of the latter company shall not, of itself, give rise to any taxation of the income, profits or capital gains of that shareholder.'

So there is a clear rule that a share-for-share exchange 'shall not ... give rise to any taxation' on the shareholder to which the shares were issued. In other words, the Directive should override German domestic legislation and did not permit Germany to tax a gain on the C-GmbH shares disposed of.

The German tax authorities, however, referred to Article 8(2), which says:

'The Member States shall make the application of paragraph 1 conditional upon the shareholder's not attributing to the securities received a value for tax purposes higher than the securities exchanged had immediately before the merger, division or exchange.'

German legislation only allowed AT to continue to use book value of the C-GmbH shares exchanged for the G-SA shares acquired if G-SA also valued the C-GmbH shares at book value. Since G-SA valued the shares at market value, German law required AT to value the C-SA shares similarly, hence the gain. So Germany argued that this position is compatible with Article 8(2). In other words, as AT valued the G-SA shares at market value, AT had 'attribute[d] to the securities received a value for tax purposes higher than the securities exchanged had immediately before the merger, division or exchange', so that Article 8(2) was in point and German legislation was compatible with the Mergers Directive in this respect.

The court found that Article 8(1) and (2), read together, clearly demonstrate that the Directive was intended to make cross-border share exchanges tax-free events and there was no discretion on Member States to impose further conditions. This was reinforced by title and preamble to the Directive, which clearly intended certain types of transaction -- mergers, divisions, transfers of assets and exchanges of shares -- to be free of tax between Member States. Therefore it was unacceptable for German law to add the condition that the transferor company must take on the accounting treatment used by the transferee company in order to determine the outcome for German tax purposes.

Germany also presented the argument that there was the potential for tax avoidance if AT was deemed to have acquired the G-SA shares at market value, while having disposed of the C-GmbH shares tax-free under the terms of the directive. This argument was dismissed by the court on the basis that domestic anti-avoidance rules are only acceptable if they are designed to look at transactions on a case-by-case basis.

A general rule that taxed a transaction that EU legislation clearly states should not be taxed could not stand, and the court therefore found that Germany's implementation of the mergers directive was defective in this respect.

Comments

This case is interesting on a number of levels. Firstly, the importance placed on the preamble (and, indeed, the title) of the Directive in this case, both by the court and by the Advocate-General's Opinion, shows how EU legislation is to be interpreted purposively.

Secondly, we see that the Directive is specifically designed to make certain transactions tax-free when carried out between Member States. This contrasts somewhat with the fundamental freedoms enshrined in the EC Treaty, which merely require that there is no discrimination or restriction that may prevent or impede cross-border transactions.

As it happens, the German rules did not differentiate between domestic and cross-border transactions. That said, AT also brought a second argument that the German rules were discriminatory and contrary to the freedoms of establishment and movement of capital (EC Treaty, Articles 43 and 56). But both the A-G and the court declined to answer this question, as they had found the terms of the Mergers Directive completely unambiguous in this area.

Finally, German law in this area has apparently been amended, presumably to ensure that it is now compatible with the Mergers Directive.

État Belge -- Service Public Fédéral Finances v Les Vergers Du Vieux Tauves SA Case C-48/07

This case, and the next, are about the Parent-Subsidiary Directive, properly known as Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States. One effect of this Directive is to restrict the right to tax dividends in the Member State of the parent, where they are received. Article 4(1) requires that the Member State of the parent company either exempts the dividends received or taxes them subject to an appropriate allowance for underlying tax suffered. Belgium follows an exemption method (see next case).

There are certain conditions, one of which was, at the time that this case arose, that the parent had at least 25% of the share capital or voting power of the subsidiary (the limit is now 10%).

A Belgian company (Les Vergers du Vieux Tauves SA, or VVT) acquired ten years of usufructuary rights over shares of another company. Belgian law provides that, 'Usufruct is the right to enjoy things owned by another, as the owner himself, but conditional on preserving the substance'. In other words, VVT had acquired the rights to the dividends on the shares for ten years but, under Belgian law, were not to be treated as owning the shares itself. On that basis, the Belgian tax authorities denied VVT any relief for the dividends received, as they were not covered by the parent-subsidiary directive.

The court compared the position of a person receiving dividends as a shareholder with that of a person receiving dividends under a right of usufruct. In particular, they referred to Article 3(1) of the Directive, which says that:

'[T]he status of parent company shall be attributed at least to any company of a Member State which fulfils the conditions set out in Article 2 and has a minimum holding of 25% in the capital of a company of another Member State fulfilling the same conditions.'

The court inferred that a 'holding in the capital' was restricted in meaning to the legal relationship between a parent company and its subsidiary. It did not mean that the Directive was intended to apply to other relationships, such as usufructs. The court concluded 'that the concept of a holding in the capital of a company, within the terms of that provision [Article 3 of the Directive], does not cover the right of usufruct held by a company over shares in the capital of another company'. This conclusion was also supported by the court's review of the preamble and of other provisions of the Directive, such as the reference in Article 4(1) to a parent receiving distributed profits 'by virtue of its association with its subsidiary', whereas VVT received dividends by virtue of the usufruct.

So the court concluded that 'in the light of the clear and unambiguous wording of the provisions of Directive 90/435, as confirmed by the purpose thereof, it is not possible to interpret the concept of a holding in the capital of a company of another Member State, set out in Article 3 of that Directive, as covering the holding, in usufruct, of shares in the capital of a company of another Member State'. So the Belgian implementation of the Directive was not defective in this respect.

Comments

This case was about the interpretation of the Parent-Subsidiary Directive, rather than about whether Belgium had correctly implemented it into Belgian law. But, once again, we see a purposive approach to the decision. The Directive is intended to reduce or eliminate the tax disadvantages suffered by groups of companies operating in several Member States, rather than in just one. It was not intended merely to reduce or eliminate taxation of distributed profits, so it did not reduce the taxation of dividends received under usufructuary rights.

The other point of interest is that both VVT and the company of whose shares it held a usufruct were Belgian-resident, so there were no cross-border dividends to which the Directive could apply. However, the court noted that its jurisdiction could extend to 'situations where the facts of the main proceedings are outside the scope of Community law but where those provisions have been rendered applicable by domestic law'. Since the applicable Belgian law was intended to enact the Parent-Subsidiary Directive, this was one of those situations.

Furthermore, the court pointed out that if Belgium were to grant relief in respect of usufruct situations domestically, it would be required to grant a similar tax advantage for cross-border usufruct dividends. To do otherwise would be discriminatory and thus non-compliant with the EC Treaty.

Belgische Staat v Cobelfret NV Case C-138/07

This is another case involving the Parent-Subsidiary Directive. Article 4(2) provides that:

'... each Member State shall retain the option of providing that any charges relating to the holding and any losses resulting from the distribution of the profits of the subsidiary may not be deducted from the taxable profits of the parent company. Where the management costs relating to the holding in such a case are fixed as a flat rate, the fixed amount may not exceed 5% of the profits distributed by the subsidiary.'

Under the Belgian dividend exemption rules a company was entitled to deduct from its profits 95% of the distributions received from its EU subsidiaries, so leaving a 5% fixed charge in place. However, the deduction of 95% of dividends could not create or augment a loss, nor could 'unused' dividends be carried

forward for deduction in future years.

Cobelfret made losses for a number of years and consequently was not permitted to deduct the dividends in ascertaining the losses for tax purposes. Cobelfret therefore argued that the dividends were not being properly exempted from tax, as required by the Directive. Belgium argued that the dividends were not taxed, which complied with its obligations under Article 4(1) of the Directive, which does not expressly provide that an impact on the losses of the parent company is prohibited.

The court noted that no conditions could be imposed by domestic legislation implementing the directive, other than those conditions that are expressed in the directive. So it was not open to the Belgian authorities to implicitly add a condition that a Belgian parent company can only benefit from the Directive if it is profitable.

Furthermore, the effect of the Belgian rule was to reduce the loss carried forward to the next year, so that more of that later year's profits would be taxable. As the court noted, this is effectively taxing the dividends from subsidiaries in the later year. But one of the stated purposes of the Directive is to prevent double taxation of the profits of subsidiaries, either by exemption or by tax credit.

This purpose would clearly be overridden if the dividends are merely taxed in a later year.

On this basis, the court decided that the Belgian legislation had not correctly implemented the Directive into domestic tax law.

Comments

Cobelfret was able to demonstrate that Belgium's implementation of the Parent-Subsidiary Directive was defective, as there were circumstances where dividends from subsidiaries were not exempt from taxation. In particular, the court also held that the terms of Article 4 were 'unconditional and sufficiently precise' for the company to be able to rely on the rule in the Directive over the defective implementation in domestic law.

Conclusions

These cases give rise to a number of interesting points. We clearly see the primacy of EU legislation over domestic law. Once a Directive is in force Member States have to implement it into national law within a specified period. If they do not, or if implementation is defective, nationals of the Member State can rely on the Directive, so long as it is 'unconditional and sufficiently precise' in its terms.

ECJ cases also differ from UK domestic cases in terms of procedure. We are more used to cases where the taxpayer and the tax authorities are in dispute, with the dispute being arbitrated by the courts. But ECJ decisions are generally under the preliminary ruling procedure, where the ECJ is merely advising on its interpretation of Community law and whether specific aspects of domestic legislation are compatible with it. In the cases we have seen, both Germany and Belgium (in *Cobelfret*) had rules that were incompatible with EU directives.

Once the ECJ has decided on the validity of the domestic rules, the case returns to the Member State courts for a final decision on the actual tax liabilities at stake.

Where the domestic implementation of a rule is inadequate, the courts would have to rule on the basis of the underlying EU legislation instead. So it seems likely that AT should not have to pay tax on the disposal of C-GmbH to G-SA, and Cobelfret should be allowed to augment its losses by deduction of 95% of the dividends received in the relevant years.

Finally, some words about the interpretation of EU legislation. It is very interesting that EU legislation is interpreted purposively, and is specifically written to facilitate this approach. Thus each Directive is preceded

by a detailed (sometimes very detailed) preamble explaining the reasons behind the directive and also explaining what it is intended to achieve. Indeed, in *AT* we see the court reviewing not only the recitals but also the title of the Directive, in order to give context to the question in hand. As a result, it is relatively straightforward to determine what the directive is there for and how it should be interpreted.

This is the first foray of Miller's Tales into the realms of European jurisprudence but it is unlikely to be the last. EU legislation is having an increasing impact on UK taxation and we are likely to see an ever greater number and range of challenges to UK domestic legislation.