TAXATION REGIME FOR COMPANIES AND EU LAW: 'SHOULD THE UK MIMIC ITS EX-COLONY?'

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Introduction

Competitiveness and efficiency are the driving forces of every economy. Governments are constantly trying to find ways to attract business in order to increase revenues of their countries. Chris Morgan, the Head of Tax Policy at KPMG in the UK claimed that 'Britain is open for business at least as far as corporate tax is concerned.' He then went on to say that due to reforms that have been made, UK's tax competitiveness appears to improve while he appreciates that due to complexity and compliance burden remaining too high, fewer companies were actively looking at moving.'[2] Taxes are the main source of income for each state thus it is of crucial importance to manage them in the most efficient way possible. This will not be beneficial only for the taxpayers who will probably enjoy lower taxation and increased benefits but it will also attract foreign investment in the country increasing the GDP levels which is of great importance especially in a time like the current one when a global economic downturn is taking place. While the UK is trying to increase its competitiveness, Cyprus is struggling to retain its reputation as a tax heaven and as a safe place for investment.

This paper aims to describe the obligations imposed by Community law on the EU Member States particularly in the field of corporate taxation. The practical application of these obligations shall be explained by looking at how Cyprus and the United Kingdom formulated their tax systems in order to comply with their Community obligations. Tax regimes of Cyprus and the UK were chosen to be the

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2 Andrew Goodall, 'KPMG survey suggests progress on UK tax competitiveness' (2011) Tax Journal 1103 < http://www.taxjournal.com/tj/articles/kpmg-survey-suggests-progress-uk-tax-competitiveness-36811 > accessed 20 July 2012

practical examples of this study because they allow us to make some interesting comparisons and at the same time suggest how the practices of one country could be used by the other in order to overcome certain difficulties or complexities in their fiscal systems. Fiscal transplantation is not what is being suggested but rather one Member State could mimic successful practices of the other Member State. Cyprus follows the British legal system and in many cases English statutes have been adopted per se after the necessary amendments were made to reflect the island's needs. This makes the two Member States even more 'comparable' in a way and proves that alterations are neither impossible nor catastrophic.

Part one of this paper focuses on exit taxation. The first section of part one is a very short introduction on Cyprus' accession in the European Union (EU) necessary to facilitate a better understanding and appreciation of its fiscal regime as well as the historical connection of the island with the United Kingdom. Section two focuses on describing freedom of establishment in an internal market environment in order to allow us to have a better understanding of how exit taxes can violate that freedom and hamper the objectives of the internal market.

Section three defines exit taxes and clearly demonstrates that the preservation of each Member State's taxing rights is permitted as long as this is pursued in a proportional way that does not preclude individuals and corporations of their rights guaranteed by the Treaty. It is shown that exit taxes are indeed legitimate as long as the option to choose for their repayment is provided. The risks of double taxation and double non-taxation are considered. Solutions based on 'mutual recognition and cooperation' are suggested to tackle such problems while the tremendous importance of existing mechanisms is stressed.

Section four, moves on to examine the development of exit taxation using the judgments of the European Court of Justice (ECJ). The *Daily Mail* case demonstrates that 'companies are creatures of national law'[3] while *Sevic*[4] clarifies that cross-border mergers fall under the umbrella of freedom of establishment. Moving on it is explained how *Cartesio*[5] made it possible for companies to re-domicile and become companies of other Member States. This section comes to an end by discussing how exit taxes can be legitimate and acceptable by the European Commission if the Member States manage to provide an option for their deferral.

3 Case 81/87 *The Queen v H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc,* paragraph 19

4 Case C-411/03, *SEVIC Systems AG, Judgment of the Grand Chamber of the Court of Justice* [2005] ECR I-10805.

5 Case C-210/06 *Cartesio Oktató és Szolgáltató bt* ECJ [2008]

The *National Grid Indus*[6] case is discussed in great detail to enable us to grasp these issues regarding exit taxation.

Section five discusses exit taxation in Cyprus and the UK and how each country amended its rules in order to comply with their Community obligations. Firstly the re-domiciliation process of companies in and out of Cyprus shall be described in order to demonstrate how Cyprus changed her previous restrictive provisions that regulated exit taxation. The UK's stance on the issue shall be explained, criticizing where necessary any anomalies and incompatibilities with EU suggestions and ECJ's judgments.

A final comparison between the rules of the two Member States governing re-domiciliation of companies shall be made in the end of this section.

The second part of this paper will focus on reorganizations of companies within the EU. Firstly a description of the Merger and Cross–Border Merger Directives will be provided in order to facilitate the comparison that follows in section two and three.

Section two focuses on Cyprus' reorganization rules and compares them with those set out in the Merger Directive. It will be observed how Cyprus 'synchronized' her pre-existing legislation in order to make it EU compatible. Following this, it will be pointed out which areas of the law need to be clarified and any omissions will be highlighted.

A discussion on the UK follows in section three. The approach adopted was by examining a practical example. This section focuses on an actual merger situation namely the one between Northern Foods Plc. and Greencore Group Plc. Despite the fact that the merger did not occur, it is still relevant since it gave commentators the opportunity to examine and point out omissions and ambiguities of the law in that field. Suggestions to overcome disparities and traps are also laid down. It shall then be concluded whether harmonization of the UK legislation with EU Directives is a myth or not.

PART ONE - EXIT TAXATION

Section One: Cyprus

Cyprus is a small island strategically located in the eastern Mediterranean linking Europe with Middle East, Africa and Asia. Its common law legal system is

6 C-371/10 *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterd* [2011] ECJ

essentially a replica of the British one, due to historical links with the British Empire. Nonetheless most of Cyprus laws, especially those governing business and financial sectors have been updated to reflect the 21^{st} century commercial needs. Also accession of Cyprus to the EU in 2004 led to the adoption of EU Regulations and Directives in order to harmonize the country's legal structure with the internal market. Cyprus tax system not only reflects the European union code of Conduct for business taxation but also shows the island's commitment to the OECD against harmful tax practices.

A significant indicator supporting the argument that Cyprus is a sound and reputable environment is as Deloitte's quote points out, that 'in April 2009 the OECD included Cyprus on its white list of 40 countries in the world that have substantially implemented internationally agreed tax standards, being the highest categorization possible". It is not surprising that 'Cyprus has been voted the most attractive European tax regime by major business organizations across Europe. Cyprus has been commended for the stability of its tax law, the consistency in interpreting its tax legislation and its low tax rate. Cyprus is proud to be the international business hub it is today'[7].

Section Two: Freedom of establishment

The Freedom of establishment set out in Article 49 of the Treaty on the Functioning of the European Union (TFEU) (ex Article 43 TEC) is one of the 'fundamental freedoms' and represents one of the cornerstones of the EU internal market. As Article 49 reads, "within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital."[8]

The aim behind this freedom is to ensure that a person or a company can 'establish' itself in any one of the Member States without having to face any

7 Deloitte, '*Cyprus International Tax and Business Environment'* http://www.deloitte.com/assets/Dcom-Cyprus/Local%20Assets/Documents/cy(en)_CyprusInternationalTaxAndBusinessEnvironment_060709.pdf> accessed 15 June 2012

8 *Article 49 TFEU*

restrictions or difficulties when attempting to do so. This follows the national treatment principle which as was laid down in *De Groot*[9] the origin Member State must 'respect the principle of national treatment of nationals of other Member States and of their own nationals who exercise the freedoms guaranteed by the Treaty.'[10] This principle ensures that individuals exercising the fundamental freedoms are not treated in a less favourable way than individuals in a comparable situation who are not affected by exercising the fundamental freedoms either by the 'origin' Member State rules, or by the 'host' Member State rules in question.[11] Member States must remove any restrictive national legislation since freedoms have a direct effect. As it was stated in the leading case of *Van Gend en Loos*[12] 'the Community constitutes a new legal order of international law for the benefit of which the states have limited their sovereign rights (...) and the subjects of which comprise not only Member States but also their nationals.'[13]This means that part of the Community law rules have immediate effect in domestic legal systems of the Member States and Nationals are granted with rights which they can invoke before national courts and tribunals.'[14] Any restrictions to the freedom will be considered incompatible and shall be amended unless they can be justified by overriding reasons of general interest[15] on grounds of public policy, public security or public health, provided that the principle of proportionality is met. It is settled case law that "all measures which prohibit, impede or render less attractive the exercise of that [freedom of establishment] freedom must be regarded as... restrictions"[16]

However as it is clearly portrayed in the case of *Schempp*[17], freedom of establishment does not guarantee that restructuring or establishment abroad will be to the company's interest. Member States are not obliged to make any tax provisions having in mind tax regimes of other Member States. The only obligation they have is to refrain from any restrictive measures. It is up to the taxpayer to decide whether and where to re-establish itself in such a way as to be beneficial.

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9 Case C-385/00, *F.W.L. De Groot v Staatssecetaris van Finanvien,* [2002]

10 ibid par 94

11 Tom O'Shea, *EU Tax Law and Double Tax Conventions, (*Avoir Fiscal Limited 2008) 47

12 Case C-26/62 *NV Algemene Transporten Expeditie Onderneming van Gend en Loos v Nederlandse Administratis der Belastingen*[1963]

13 ibid, Part II (B) of the judgment

14 O'Shea (n 10) 12-13

15 Article 52 TFEU

16 Case C-442/02 *CaixaBank France* [2004] ECR I-8961, paragraph 11, and Case C-55/94 *Gebhard* [1995] ECR I-4165, paragraph 37

17 Case C-403/03 *Schempp* [2005] ECR I-6421, paragraph 45

If any of the Member States fails to comply with Community Law, the Commission can commence 'infringement proceedings' against it.

Section Three: Exit Taxes

Member States can impose taxes on accrued capital gains when taxpayers (including individuals and corporations) move their residence or transfer individual assets to another Member State. These taxes are called "exit taxes" since they can only be triggered with the 'exit' from the Member State.

However the so called 'exit taxes' have to meet certain provisions in order to be compatible with EC law while there are additional provisions that need to be satisfied targeting double-taxation and tax avoidance.

The rationale behind exit taxes is that a country can tax on what was accrued on its territory. In other words when an individual or a company wishes to move or transfer to another Member State without disposing first any assets they might had, the origin Member State is entitled to tax the capital gains stemming from those assets. However when dealing with latent capital gains the principle of freedom of establishment enters into the picture. Member States, according to the European Court of Justice (ECJ) cannot require immediate taxation of latent capital gains since this will be considered as restricting freedom of establishment. In other words, if the Member State does not require immediate taxation when freedom of establishment is exercised domestically (which is usually the case) requiring immediate taxation when freedom of establishment is exercised cross border will be considered as discriminatory. Similarly, the origin Member State should not require any guarantees or fiscal guarantors for future realization of the assets. It should be stated however that slightly different treatment can take place when comparing exit taxation of individuals and corporations mainly because corporations can cease to exist since they can change their legal identity, while individuals can be tracked down despite moving to another Member State.[18]

European Commission in order to promote and coordinate a uniform approach in the field of direct taxation has urged member states to adapt their national rules on exit taxes in such a way as to comply and reflect internal market's aspirations such as freedom of establishment and free movement of capital. Looking at Commission's communication it is obvious that not only the legal framework is described but also it provides guidelines to overcome possible problems and disparities that might exist due to differences in national laws of the Member States.

18 Europa, '*Exit taxation and the need for co-ordination of Member States' tax policies*' <http://europa.eu/legislation_summaries/taxation/l31060_en.htm > accessed 15 June 2012

Under the European Company Statute, a Societas Europea[19] (SE) can transfer its registered office from one Member state to another without prior winding up or the formation of a new legal person. Transferring the registered office of an SE or of a European Co-operative Society[20] (SCE) from one Member State to another will not result in immediate taxation of unrealized gains on the assets remaining in the origin Member States. [21] It is accepted that there are no specific provisions regarding treatment of assets which are no longer connected to a PE in the origin state, however the Commission expects that the principles established in *De Lasteyrie*[22] will be applied in these situations as well.[23]

An exit charge may to arise in situations where the principal company transfers 'single assets or liabilities' to a permanent establishment in another Member State, but when it comes to analogous 'onshore' situations (i.e. transfer of assets from the head office to a branch both situated in the same Member State) there is no immediate tax consequence.[24]

Assume that the principal company is situated in Member State 'A' and the PE in Member State 'B'. In the first example (principal company to a foreign PE) it is possible that Member State 'A' calculates its taxing rights based on the gains of the assets and liabilities (i.e. value for tax purposes minus the market value at time of transfer).[25] The time to tax the difference is usually when gains are realized rather than when accrued. However the case seems to be somewhat different when the company's head office transfers assets and liabilities to its PE in Member State 'B'. In the later situation, assets and liabilities are considered to be 'alienated' and gains accumulated while in Member State 'A' are usually taxed immediately upon transfer of the assets.

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19 Council Regulation (EC) No 2157/2001on the Statute for a European Company (SE) OJ L294

20 Council Regulation (EC) No 1435/2003 on the Statute for a European Cooperative Society (SCE) OJ L207

21 Merger Directive (EC) 2005/19 amending Directive 90/434/EEC 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States OJ L58

22 Case C-9/02 *Hughes de Lasteyrie du Saillant v Ministere de l'Economie, des Finances et de l'Industrie,* (2004) ECR

23 Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Exit taxation and the need for co-ordination of Member States' tax policies, Com (2006) 825 final

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52006DC0825:EN:NOT > accessed 20 July 2012

24 ibid

25 ibid

Following *De Lasteyrie*[26], taxpayers exercising freedom of establishment cross border should not be treated any less favorably than those exercising the freedom internally. Thus when a Member State allows for tax deferrals for company transfers taking place in its territory then that Member State cannot deny the tax deferrals for company transfers taking place outside its territory. In both cases the companies are exercising freedom of establishment with the only difference that one is doing it internally and the other cross border. Requiring immediate taxation when the freedom is exercised cross border would normally be against the EC Treaty freedoms.

In the case where a Member State exercises her taxing right by calculating the difference between market value and book value of assets when the transfer takes place, must restrict herself to that calculation only. In other words she should only determine the amount reflecting the taxable income and allow for its deferred payment. No immediate taxation should be required nor the deferral should be made subject to any conditions.[27]

Such unconditional deferral does not prevent the tax authorities of the origin Member State from being informed about the state of assets even after the transfer of the company to a different Member State. Member State 'A' can insist on 'reasonable obligations' for her former taxpayers if they wish to benefit from a tax deferral. For example an annual declaration could be required reflecting the state of the assets for which the deferral has been given. The taxpayer would be responsible to inform Member State 'A' that the PE in Member State 'B' is in possession of the asset and in the case of disposal should inform accordingly.

Something like this will stimulate an 'administrative burden' for the taxpayer who could however choose when to pay the tax. In order to avoid such an administrative burden he could pay the tax on the date of transfer. The taxpayer should be given this option –which is indeed what makes the exit charge legitimate- without any kind of indirect coercion to choose any of the alternatives. The taxpayer should be able to decide himself/herself as to what he/she thinks is in his/hers best interest.

The Member States can and are encouraged to preserve the balance in the allocation of taxing rights while at the same time are required to do so without going beyond what is necessary to achieve this and without hampering the taxpayers' Treaty rights. Already there are a number of mechanisms that enable both exchange of information and assistance in collection of taxes between

26 *De Lasteyrie* (n 21)

27 Communication from the Commission to the Council (n 22)

Member State while time has shown that automatic exchange of information within the internal market is no longer an elusive aspiration.[28]

Double taxation and double non-taxation

Due to lack of a unilateral approach for tax valuation of assets between Member State double taxation and double non-taxation are very likely to occur especially in the absence of double tax conventions to regulate this. According to this Commission's communication, an asset which is transferred from a Member State that exercises its taxing rights at the moment of transfer to a Member State taxing the gain from date of transfer (i.e. market value – book value) until disposal of the asset, this could result in double taxation of the gains involved. If however the transfer is from a Member State allowing transfer at book value, to a Member State valuing the asset at market value, the difference between the book value and market value will be left untaxed, resulting to unintentional double non-taxation.[29]

Even in the case where two Member States exercise their taxing rights in a similar manner, they can still come to different outcomes regarding the value of the assets. If the host state attaches a greater value to the asset, a higher depreciation of the asset against the taxable profits of the PE will be allowed, and a lesser amount of gains will be taxed when the asset is disposed, leading to potential double non-taxation of part of the gains.[30] Potential double taxation could arise in the case where the host state attaches a lower value to the asset resulting to a lower depreciation and more gains on the date of disposal of the asset.[31]

The idea for creating an internal market was in order to facilitate greater economic performance by making it not only more efficient but also more beneficial for businesses to trade in such an environment and consequently the economy as a whole would benefit from this. One can expect that disparities like the ones just mentioned, are likely to dissuade companies from investing in other Member States, since it would be more expensive and thus there would be no rational for expanding or establishing their business in a foreign and unwelcoming environment. Double non-taxation on the other hand, despite the fact that it may appear beneficial and rather attractive when looked at from the individual perspective of companies, when looked at from a general public interest perspective, this would not be the case since companies would be basing their decisions on the wrong grounds. Not only full capacity of the internal market would not be at its optimum level but also implications of such malfunctioning

28 ibid

29 ibid

30 ibid

31 ibid

would be reflected in the economy as a whole. Therefore it is important each Member State to try and eliminate such disparities if the benefits of the internal market and the Treaty are to be enjoyed to the maximum possible extent. Cooperation between the Member States is essential.

As the Commission suggests[32], the host state can accept the market value attributed to the asset in question from the origin Member state at the moment of transfer as the starting its value for tax purposes. Such a straightforward approach benefits not only the taxpayers who might be ignorant of tax law, but also tax administrations who should find it simple to administer.

However the risk for tax-arbitrage will be eminent since some taxpayers might seek to exploit the valuation differences between Member States and arrange for the Member State with the lower taxing rates to tax majority of the gains. The Commission goes on to say that if Member States do not wish to alter the existing rules and continue to determine the value of the transferred assets according to their rules then there should be provisions aiming to resolve differences in valuation. Such provisions include a binding dispute resolution similar to the one for the EU Arbitration Convention,[33] or a more general mechanism to tackle double taxation within the EU. The Commission appreciating the serious consequences of such mismatches has launched a public consultation on the double non-taxation of cross-border companies that ran until 30th of May 2012. Based on the findings of the consultation, the Commission aims to develop the most appropriate policy reforms before the end of 2012.[34]

Another alternative could be for the host Member State to use the origin state's book value as the initial value for tax purposes despite that the normal practice of that country would be different (i.e. usually values the transferred assets at their market value). All the abovementioned practices are based on 'mutual recognition'[35] and cooperation.

32 ibid

33 90/436/EEC: Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:41990A0436:en:NOT> accessed 23 July 2012

34 European Commission, Press Release, Tackling double non-taxation for fairer and more robust tax systems

http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/201&> accessed 23 July 2012

35 Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Exit taxation and the need for co-ordination of Member States' tax policies, Com (2006) 825 final: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52006DC0825:EN:NOT > accessed 20 July 2012

As I understand it to be, the Commission views the existing mechanisms on exchange of information as very important and extremely effective when it comes to issues such as exit taxes. This can be inferred from the fact that in certain circumstances, such as when countries from the European Economic Area (EEA) are involved, the Commission is prepared to accept immediate collection of taxes if this can be justified by overriding reasons in the general interest such as effective fiscal supervision and prevention of tax evasion. According to the abovementioned communication from the Commission,

> 'what makes the two case scenarios different is the fact that EEA states do not have to implement secondary Community legislation in the area of taxation, such as the Mutual Assistance Directive and the Recovery Directive. Thus Member States do not necessarily have the same guarantees that deferred tax claims can be discharged at a later stage, as they would have within the community.'[36]

Immediate collection would not be acceptable if the countries involved were members of the European Union, simply because they would have the mechanisms to track down the company and recover any deferred tax the company might owed to them.

Section Four: ECJ Case Law

This section will consider how exit taxation has been developed and explained by the ECJ.

In the case of *Daily Mail*[37] a UK tax resident company wanted to transfer its central management and control to the Netherlands. Under UK Company law, there would be no loss of legal personality by transferring central management and control out of the UK. However the consent of the Treasury was needed in order for the company to cease to be considered a UK tax resident. One of the questions referred to the Court was whether origin Member states could make the right of a company incorporated there, to transfer its central management and control to another Member State, subject to the consent of national authorities. The Court in its judgment made it clear that 'companies are creatures of national law'[38] and it is

36 Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Exit taxation and the need for co-ordination of Member States' tax policies, Com (2006) 825 final http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52006DC0825:EN:NOT > accessed 20 July 2012

37 *Daily Mail (n 2)* par 1-5

38 ibid *Daily Mail,* par 19

up to each member state to define the connecting factor for incorporation of a company within the national territory.[39]

Daily Mail could not access freedom of establishment in this case as the UK provision at issue imposed no restriction on freedom of establishment as 'Treasury consent is required only where a company seeks to transfer its central management and control out of the United Kingdom while maintaining its legal personality and its status as a United Kingdom company.' [40] 'Treaty regards the differences in national legislation concerning the connecting factor and the transfer of the registered office or real head office of a company incorporated under national law from one Member State to another as problems which are not resolved by the rules concerning the right of establishment but must be dealt with by future legislation or conventions.'[41] This case demonstrates that 'the Treaty cannot be interpreted as conferring on companies incorporated under the law of a Member State a right to transfer their central management and control and their central administration to another Member State while retaining their status as companies incorporated under the legislation of the first Member State.'[42]

In *Überseering*[43] the Court held that Articles 43 EC and 48 EC preclude a Member State 'B' from denying to a company that moved its centre of administration there, legal capacity and the ability to ' bring legal proceedings before its national courts for the purpose of enforcing rights under a contract with a company established in Member State 'B'.[44] Also when a company wishes to exercise its freedom of establishment in Member State 'B' while the State of its incorporation and its registered office are in Member State 'A', Articles 43 EC and 48 EC 'require Member State B to recognize the legal capacity and, consequently the capacity to be a party to legal proceedings which the company enjoys under the law of its State of incorporation 'A'.[45]

In the case of *SEVIC Systems,*[46] the ECJ clarified that cross-border mergers where the national treatment principle applied, fell under the umbrella of freedom of

39 ibid *Daily Mail,* par 20

40 ibid*, Daily Mail,* par 18

41 *ibid, Daily Mail,* para 23

42 ibid, paragraph 24

43 Case C-208/00, *Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC)*

44 ibid, *Überseering,* para 94

45 ibid, *Überseering,* para 95

46 *SEVIC* (n 3)

establishment. In the named case, a company established in Luxembourg wished to merge with a German company but Germany refused to register the new company in the commercial register on the ground that German legislation allows only mergers between 'legal entities established in national territory.'[47] When it comes to mergers taking place within the national territory, there is no provision similar to cross-border thus there is a 'difference in treatment in Germany between internal and cross-border mergers.'[48] The Court applying Articles 43 and 48 EC, held that 'cross-border merger operations, (...) respond to the needs for cooperation and consolidation between companies' established in different Member States. It is one way of exercising freedom of establishment thus Member States must comply with freedom of establishment when considering cross-border mergers."[49]

Another important case is *Cartesio.*[50] As Dr. O'Shea shows in his article 'Exit Taxes Post-Cartesio *Cartesio Oktató és Szolgáltató',* the abovementioned case 'created the possibility for EU companies to re-domicile and become companies of other Member States.'[51] The author moves on to clarify the court's position on two different scenarios:

- when a company transfers its seat to another Member State while the company remains governed under the origin state's company law and
- when a company transfers its seat to another Member State with a change in the company law applicable.

In the first scenario freedom of establishment does not apply since Member States are free to determine the connecting factors required for company incorporation and also the consequences for modifying these factors. In the second scenario however freedom of establishment does apply since 'the company was converted into a form of company governed by the company law of the host Member State. (...)[I]f the origin Member State's rules required the company to wind up or liquidate in such circumstances, the company's freedom of establishment was in breach unless the rules could be justified on general interest grounds.'[52] The main tax issue, according to the author, regards the origin state's exit taxes on the latent

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47 ibid, *SEVIC,* para 12

48 ibid, *SEVIC para 13,14*

49 ibid, *SEVIC,* para 19

50 *Cartesio* (n 4)

51 Tom O'Shea, 'Exit Taxes Post-Cartesio *Cartesio Oktató és Szolgáltató'* [2009] The Tax Journal < http://www.ccls.qmul.ac.uk/docs/staff/oshea/52205.pdf> accessed 19 July 2012

52 ibid

gains in the company converting into a form of company governed by the laws of the host Member State at the date of emigration.[53] It seems that such exit taxes will amount to a restriction of freedom of establishment if the host state allows for conversion to be made but the origin state requires liquidation or winding up of the company prior to the conversion.[54] Unless the restriction can be justified to serve 'overriding requirements in the public interest' it shall be prohibited under Article 43 EC[55].

Next the issue of proportionality needs to be addressed. In other words it should be examined whether the origin Member State goes beyond what is necessary to achieve its public interest objective.

As O'Shea[56] argues, in the case of a company's re-domiciliation, a different person is created in the host state, thus the original company in origin Member State is now a different legal person in the host Member State –while in some situations the origin Member State will need to remove the company from the register of companies. It is rather clear that the origin Member State will not be able to benefit from the MARD in order to recover the exit taxes while the company is in the host Member State, 'as the re-domiciled company in the host Member State is totally a separate legal person from the origin Member State company which owes the taxes. (...) [O]rigin Member State's rules appear to be justified and proportionate and therefore do not constitute a breach of the freedom of establishment.'[57]

Therefore, exit taxes will not be regarded as a restriction if the origin state can justify their imposition, i.e. balance in the allocation of taxing rights. The origin state however must be careful in the way it requires the collection of such taxes since it must respect the principle of proportionality.

ECJ's judgment in *National Grid Indus*[58], has been the subject of many discussions among scholars and professionals. The court in its judgment made it clear that companies incorporated in Member State 'A' wishing to transfer their place of effective management to Member State 'B', while retaining their status as a company of Member State 'A', can rely on Article 49 TFEU in order to challenge

53 ibid

54 *Cartesio* (n 4) para 113

55 ibid

56 O'Shea (n 50) 2

57 ibid

58 *NGI* (n 5)

the lawfulness of a tax imposed by 'A' because of the transfer. More importantly the Court made it abundantly clear that Article 49 TFEU, does:[59]

- Not preclude national legislation of a Member State from determining the definite amount of tax on unrealized capital gains relating to the company's assets the moment when the place of effective management is transferred to Member State 'B'. Member State 'A' is not obliged to take into consideration future increases or decreases in the value of the assets. It is irrelevant that the unrealized capital gains that are being taxed relate to exchange rate gains that subsequently cannot be reflected under the tax system of the host Member State (B).

- Preclude national legislation of a Member State from requiring immediate recovery of tax on unrealized capital gains of the transferring company on the very time of that transfer.

Anderson S., senior manager of KPMG EU Taxes Group, when discussing the NGI decision on exit taxes, correctly points out that 'The amount would be fixed- the timing could differ.'[60] She also distinguishes *NGI* from the abovementioned exit tax cases by pointing out that in *NGI,* the status of the company did not change. Despite the transfer of its effective management to the UK, the company was still registered in the Netherlands. As the author writes, 'The Dutch legislation did not result in a change to the company's legal status and thus did not affect whether the company could rely on Article 43, it merely applied a tax charge on the transfer of the effective management of that company.'[61]

In other words Dutch legislation did not provide for any conditions to be fulfilled prior to the transfer of effective management to a different Member State. Despite being able to legislate that companies wishing to transfer their effective management out of the Netherlands should first cease to exist as Dutch companies - i.e. 'A Member State is therefore able, in the case of a company incorporated under its law, to make the company's right to retain its legal personality under the law of that State subject to restrictions on the transfer abroad of the company's place of effective management'[62] - it did not. 'Since the transfer by National Grid Indus of its place of effective management to the United Kingdom did not affect its

59 ibid para.87

60 Sarah Anderson, 'The decision of the ECJ in National Grid Indus: is the UK migration charge contrary to EU law?' (2011) <http://www.kpmg.co.uk/email/12Dec11/263937/TJ_1104_Comment_Anderson_accessible.pdf> accessed 10 July 2011

61 ibid

62 *NGI* (n 5) para 27

status of a company incorporated under Netherlands law, the transfer did not affect that company's possibility of relying on Article 49 TFEU'[63]. The company was still considered a Dutch company, thus Netherlands was to be accountable for any kind of restrictions having a knock on effect on that company. The Netherlands charged the company for transferring its effective management out of the country, while if a similar transfer was to be performed internally the company's unrealized capital gains relating to the assets transferred would not be taxed until and if they were realized. The Netherlands, according to Anderson S.[64], merely charged the transfer – if the transfer had not been performed, no charge would arise. This could be seen as an obstacle that potentially could deter a company from exercising cross-border establishment thus hindering in this way the freedom of establishment.

The Court in this case went on to assess the issue of proportionality by distinguishing a) the establishment of the amount of tax and b) the recovery of the tax. The Court emphasized that it is proportional for a Member State to establish the amount due on unrealized gains at the time of transfer, as the power to tax ceases to exist. Also, Member State of origin should not worry about exchange rate gains or losses accruing after transfer, because this would question the balanced allocation of powers between the Member States and also could lead to double taxation or double deduction of losses.[65] The Court went on to explain that the TFEU offers no guarantee of 'neutral taxation' upon transfer of effective management, as it can be beneficial or not.[66] As far as the recovery of the tax is concerned, the Court held that what makes it proportional is 'choice'. A choice should be given to companies of either immediate payment of tax or for deferred payment. The companies can then weight the advantages and disadvantages of each of the options and decide themselves what suits them best.

It is rather clear that the court does not consider the immediate imposition and calculation of the tax to be a disproportionate restriction but rather the immediate recovery of the tax given the existence of machinery for mutual assistance[67]

63 ibid, para 32

64 Anderson (n 59)

65 *NGI* (n 5) 58

66 *NGI* (n 5) 62

67 Article 4(1) of Council Directive 2008/55/EC of 26 May 2008 on mutual assistance for the recovery of claims relating to certain levies, duties, taxes and other measures (OJ 2008 L 150, p. 28) provides that '[a]t the request of the applicant authority, the requested authority shall provide any information which would be useful to the applicant authority in the recovery of its claim'. That directive thus enables the Member State of origin to obtain information from the competent authority of the host Member State on whether or not certain assets of a company which has transferred its place of effective management to the latter Member State have been realised, in so far as the information is necessary to enable

between the authorities of Member States which enables the safe deferment of such taxes.[68]

In case of deferred exit taxes for companies, the origin Member State can require interest or security, as its taxing right is crystalized on the company's date of exit. Therefore the origin Member State has no possibility to consider future fluctuations because of its crystalized power to tax. Thus it needs to be determined whether the emigrating company retains any activity in the origin Member State.

A new question enters the picture now, namely whether the host state should give a step-up in value for the assets on date of arrival.[69] However as it was noted in *Kerckhaert-Morres*[70] 'maybe such double taxation must be accepted (…) due to the parallel exercise of fiscal sovereignty by two Member States.' What is more, the Court reminded us once again that the Treaty does not guarantee neutral tax outcomes upon the transfer of effective management.[71]

As O'Shea concludes, case law proves that EU law is constantly evolving. In *National Grid Indus* it was concluded that 'the transfer of the place of effective management of a company incorporated in an EU member state, whose national law allows the company to remain in existence after the transfer of the place of effective management, also falls within the scope of the freedom of establishment.'[72]

Section Five

In this section I will discuss how and to which extent the rules of the chosen examples of Member States are compatible with ECJ's rulings.

Cyprus

With the entry of Cyprus into the EU, all Directives and Regulations had to be adopted. Complying with the EC legislation, made it possible for companies to

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the Member State of origin to recover a tax debt which arose at the time of that transfer. Moreover, Directive 2008/55, in particular Articles 5 to 9, provides the authorities of the Member State of origin with a framework of cooperation and assistance allowing them actually to recover the tax debt in the host Member State. *NGI* (n 5) 78

68 *NGI* (n 5) 78

69 Tom O'Shea, 'Featured Perspectives Dutch Exit Tax Rules Challenged In National Grid Indus' (2012) 65 Tax Notes International 205

70 Case C-513/04, *Mark Kerckhaert, Bernadette Morres v Belgische Staat ('Kerckhaert Morres'),* [2006] paragraph 20

71 *NGI* (n 5) 62

72 O'Shea (n 68) 205

transfer their registered offices into and out of Cyprus without being subject to any exit taxes.

Cyprus' legislation allows the transfer of the registered office of a company initially registered in another Member State to Cyprus, after its de-registration from its former jurisdiction of incorporation and after obtaining a certificate of continuation in Cyprus. Equally this applies for companies registered in Cyprus, which can transfer their registered offices from Cyprus to another Member State, enabling in this way corporate transfers and continuations.

Prior to accession to the European Union and compliance with EC law, transferring a company out of the island, involved major tax consequences since it had to be liquidated first in the country of incorporation and taxable disclosure of its hidden reserves could not be avoided. Such provisions would be considered to deter cross-border corporate emigration (freedom of establishment) and would not be in line the objectives of the internal market.

The procedure that needs to be followed in order for a Cyprus company to re-domicile out of its jurisdiction is found in Cyprus Companies Law Cap. 113 (hereinafter 'the law' section 354. The company after obtaining the consent of the Registrar of Cyprus companies, must apply to the competent authority of the host state it wishes to become registered [in order to continue under its legal regime] provided that the chosen host state permits to do so.[73] In order for the Cyprus Registrar to give its consent to the legal entity to continue its existence under a host regime, the application must be accompanied by a statement signed by at least two of the company's directors -who have been authorized by the board of the company- stating according to section 354 K of the Law the following information:[74]

- The name of the company under which it requests to be registered in the approved country

- The place of the proposed registration, the name and address of the Competent authority in the approved country
- The proposed date of establishment of the company to the new jurisdiction

In order for the Cyprus Registrar to approve re-domiciliation of the company the conditions laid out in section 354L of 'the law' must be satisfied. Among other requirements, the conditions provide that the shareholders of the company must approve the application for re-domiciliation via a special resolution; the market

73 The Companies Law, Chapter 113, September 2006, 354J

74 The Companies Law (n 72) 354 K

value of the company's assets must be determined in the general meeting and documents confirming that the company does not owe any taxes and customs duties must also be presented. Collection of the tax is due on the normal date for collection of that tax as if the re-domiciliation was not to take place. Unless all the conditions laid down in section 354L are satisfied, the application for re-domiciliation cannot be finalized.

For the company to be completely de-registered from the Cyprus Registrar, a notice of the special resolution regarding its re-domiciliation must be published in two daily Cyprus newspapers.[75] A period of three months will have to pass for the company to be deleted from the Cyprus Registrar. This will give enough time to any creditors of the company to submit an objection to the court for the company's continuation cross-border. It is up to the discretion of the Court to approve company's continuation or forbid it. After the three months period, the Registrar will consent to the company's re-domiciliation. In order for the company to be removed from the register, it has to provide a document of continuation from the host state and file it to the Cyprus Registrar of companies. The company will cease to be a company registered in the Republic from the date that its continuation is set in force in the other approved country.[76] According to section 354P, the Cyprus Registrar retains a copy of all the companies that choose to continue their existence in another jurisdiction, the name of the continuing company in the host state and all relevant details for that company.

United Kingdom

UK was one of the seven countries to form the European Free Trade Association (EFTA) in 1960 and has been a member of the European Economic Community since 1973. Since then many steps have been taken in order to coordinate its national legislation with EU Regulations and Directives.

UK exit charges appear to be one of the latest nuisances of HMRC since they seem to restrict freedom of establishment. Since the decision in *National Grid Indus* it could be said that there is little room for UK to maneuver and justify her current exit tax regime. However the UK is not alone in this since the development of exit taxation showed that in fact many Member States had restrictive exit taxes and had to amend their rules.

The UK law governing exit taxes is the Taxation of Chargeable Gains Act (TCGA) 1992. Sections 185 and 187 of TCGA apply to a company when it ceases to be resident in the UK and a charge is imposed to Corporation Tax on the company's

75 The Companies Law (n 72) 354M

76 The Companies Law (n 72) 354 O

unrealized gains. Immediately before the so-called 'relevant time'[77] a charge is generated by creating a scenario where the company disposes all of its assets at their market value (just before the relevant time) and right afterwards reacquires them at that value again (at the relevant time).[78] [79]

The charge on Corporation Tax is what is known as 'exit charge'. What is more, roll-over relief does not apply if the company acquires a new asset after cessation of its UK residency while 'any gain arising on its immediate disposal would be outside the charge to UK tax.'[80]

However in the event of the company having a permanent establishment in the UK through which it continues trading, then despite not being a UK resident, Corporation Tax will be charged on the profits arising from the permanent establishment.[81] Section 185(4) of the TCGA 1992, exempts UK based assets which are 'used or held for the purposes of the trade or permanent establishment' from the exit charge.

The said exit charge can be postponed under section 187 of the TCGA 1992 in cases where a subsidiary company (which is owned by at least 75% by a UK principal company) migrates but the principal company remains a UK resident and the two companies 'so elect, by notice given to the inspector within 2 years after that time, [immediately after the relevant time]'[82]. In such case, the gain will become a chargeable gain of the principal company:

- 'If a relevant asset is disposed of within six (6) years of the relevant time and a gain would have accrued on the deemed disposal of the relevant asset at the relevant time, or
- if at any time,
    - the company ceases to be a 75% subsidiary of the principal company due to the principal company disposing any of the ordinary shares

77 when the company ceases to be resident in the United Kingdom, s185 (1)

78 Taxation of Chargeable Gains Act 1992, s 185(2)

79 HM Revenue & Customs, CG42370 - Migration of companies: exit charges, <http://www.hmrc.gov.uk/manuals/cgmanual/cg42370.htm> accessed 25 July 2012

80 ibid

81 Corporation Tax Act (CTA) 2009, s 5(2) and Taxation of Chargeable Gains Act 1992, s 10(b)

82 Taxation of Chargeable Gains Act 1992 (n 77) s. 187(1)

- the principal company ceases to be resident in the United Kingdom'[83]

The 75% subsidiary of the principal company could come to an end if the subsidiary issued additional ordinary shares and disposed them to a third party. In any of the cases, the whole amount of the unrealized gain which was postponed, will become chargeable gain of the principal company. It is irrelevant that only part of the principal company's holding of ordinary shares in the subsidiary is disposed. The case will still be that the entire postponed amount will become chargeable.

It could be said that section 185 of the TCGA 1992 treats the companies that wish to transfer their business out of the UK in a less favorable way than UK companies remaining in the UK, since it makes it more burdensome for the first group of companies to make such transfer. The fact that the company's assets are treated in a way that are deemed to have been disposed at their market value and then reacquired at that value creating in this way an exit charge puts the company's financial position in an inferior position than what it would be if the company remained a UK resident. Making it more difficult for companies to leave the country could be said to deter potential migrating companies from exercising their freedom of establishment.

Of course it is settled case law that freedom of establishment does not guarantee that a transfer from one member state to another will be beneficial to the company. The freedom rather makes the transfer possible and prohibits any kind of restriction that create an additional hurdle for companies who wish to establish their business cross border when compared to companies establishing their business within the national territory.

In the case of the UK, section 185 of the TCGA 1992 treats the assets of the company as if they have been disposed and then reacquired creating in this way a corporation tax (exit charge). Although it is legitimate for the UK to have such exit charges in order to be able to tax the companies for gains acquired on its territory, s185 allows deferral of the exit tax only in limited circumstances. Such a constraint leaves a significant number of companies unable to meet the specific requirements creating arguably indirect discrimination.

A further restriction, similar to the one noted in the case of *National Grid Indus* by the Dutch legislation, occurs in the event where the exit charge cannot be postponed under section 187 of the TCGA 1992 since the taxpayer is left with no option to decide when to pay the charge. According to the ECJ lack of such an

83 ibid s. 187(4)

option for future repayment of a legitimate exit charge goes beyond the principle of proportionality and thus should be amended accordingly. As Anderson argues in her article an additional point where the UK rules fall short of EU law is 'where the postponed tax is triggered by the migrated subsidiary ceasing to be a 75% subsidiary of a UK company rather than a disposal by that company of the assets held at the date of the migration'[84] under section 187.[85]

As a result of the abovementioned exit tax rules, KPMG submitted a confidential complaint and the Commission on the 22nd of March 2012 sent a reasoned opinion (the second stage of an infringement procedure) to the UK requesting amendment of its corporate tax legislation providing for exit taxes on companies. According to European Commission's press release:

> 'The UK legislation at stake results in immediate taxation of unrealized capital gains in respect of certain assets when the seat or place of effective management of a company is transferred to another EU/EEA State. However, a similar transfer within the UK would not generate any such immediate taxation and the relevant capital gains would only be taxed once they had been realized.
>
> The Commission considers that the United Kingdom has failed to fulfill its obligations under EU rules by maintaining these restrictive provisions. Exit taxes may be in breach of the freedom of establishment as they make it more expensive to transfer a company seat or place of effective management to another Member State than to another location in the UK.'[86]

If the UK fails to provide a satisfactory response within two months (i.e. 22nd May 2012), the Commission may refer the matter to the European Court of Justice. Until today (15th July 2012) however there is no evidence that a reply has been given by the UK or that the Commission proceeded to further measures.

Comparing corporate tax legislation of the UK and Cyprus, it is rather clear that the former colony managed to amend its previous restrictive rules and aligned them to the objectives pursued by the EU and the internal market. Cyprus' competitive tax regime encourages exercise of freedom of establishment by abstaining from use of exit taxes and by offering the chance for a number of exemptions when it comes to company reorganizations. UK in order to comply

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84 Anderson (n 59)

85 Taxation of Chargeable Gains Act 1992 (n 77) s 187

86 European Commission, *Taxation: Commission requests the UK to amend its corporate tax legislation providing for exit taxes on companies* (Press Release, 22 March 2012) http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/285&format=HTML&aged=0&language=en&guiLanguage=en accessed 20 July 2012

with ECJ's case law should mimic Cyprus in this field and alter its domestic rules accordingly. Unless this is done, UK exit rules will be considered to be a restriction of freedom of establishment.

PART TWO - REORGANIZATIONS OF COMPANIES

Section One

(A) Council Directive 2005/19/EC[87] (amending Directive 90/434/EEC 1990)

The 90/434/EEC[88] launched rules regulating business restructuring. Its principal objective was that 'taxation of income, profits and capital gains from business reorganizations should be deferred and Member States taxing rights safeguarded,'[89] while one of its principal aims was the 'elimination of obstacles to the functioning of the internal market, such as double taxation'.[90]

The Directive[91] now applies to mergers, divisions, partial divisions, transfers of assets and exchanges of shares in which companies from two or more Member States are involved, transfers of the registered office from one Member State to another Member State of European companies (Societas Europaea or SE), as established in Council Regulation (EC) No 2157/2001 of 8 October 2001, on the statute for a European Company (SE)[92], and European Cooperative Societies (SCE).[93] Under the amended Article 4, 'a merger, division or partial division shall not give rise to any taxation of capital gains calculated by reference to the

87 Council Directive 2005/19/EC amending Directive 90/434/EEC 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member [2005] OJ L 225 (Merger Directive) <http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l_058/l_05820050304en00190027.pdf> accessed 25 July 2012

88 Merger Directive, art 1

89 ibid article 2

90 ibid article 3

91 Merger Directive

92 Regulation as amended by Regulation (EC) No 885/2004 (OJ L 168, 1.5.2004, p. 1). OJ L 294, (2001) p. 1

93 Regulation as amended by Decision of the EEA Joint Committee No 15/2004 (OJ L 116, 22.4.2004, p. 68) OJ L 207 (2003) p 1

difference between the real values of the 'assets and liabilities transferred'[94] and their 'values for tax purposes'[95]'.[96] If the transferring company is a 'fiscally transparent'[97] entity, then the transferring Member State once again will abstain from taxing income, profits or capital gains calculated on the abovementioned difference between real values and tax values of the assets.[98] Paragraph three (3) of Article four (4) clarifies that the aforementioned Paragraphs one (1) and two (2), will only apply in cases where the receiving Member State calculates a 'new'[99] depreciation and gain of the assets.

The amended Article 6, extends the scope of the Directive to apply also in cases where the receiving company can take–over losses arising from mergers, divisions, partial divisions, transfers of assets and exchanges of shares to also cover the take-over of such losses by the receiving company's permanent establishment situated within the territory of a single Member State.

The Merger Directive is extremely useful in cases of mergers and divisions where it is likely that assets and liabilities will be transferred from one company (the so called transferring company) to other company or companies (the so called receiving companies). In such transfers, normally tax authorities will charge on the difference between the 'the real value' and the tax value of the transferred assets but the Merger Directive provides for deferral of these charges. The provision shall apply only if the receiving company continues with the tax values of the assets and 'effectively connects them to its own permanent establishment in the Member State of the transferring company or to a permanent establishment in another Member State (often described as a triangular example). The said assets need to form a branch of activity.[100]The amended Directive extends its scope to

94 'transferred assets and liabilities': those assets and liabilities of the transferring company which, in consequence of the merger, division or partial division, are effectively connected with a permanent establishment of the receiving company in the Market State of the transferring company and play a part in generating the profits or losses taken into account for tax purposes.' Merger Directive Article 4(a)

95'Value for tax purposes': the value on the basis of which any gain or loss would have been computed for the purposes of tax upon the income, profits or capital gains of the transferring company if such assets or liabilities had been sold at the time of the merger, division or partial division but independently of it.'

96 Merger Directive, art 4(2)

97 fiscally transparent entities are the entities that their income goes directly to its investors (shareholders), thus most countries do not apply any dividend tax on the entities but rather tax the investors on their revenues.

98 Merger Directive, art 4(2)

99 Merger Directive, art 4(3)

100 European Commission-Taxation and Customs Union, 'Merger Directive' <http://ec.europa.eu/taxation_customs/taxation/company_tax/mergers_directive/index_en.htm> accessed 15 July 2012

cover 'fiscally transparent' companies[101] and 'fiscally transparent shareholders'[102]

Article 10(a) provides for certain exceptions related to the new Articles 4(2) and 8(3). Namely a Member State shall have the right not to follow the provisions of this Directive when taxing a direct or indirect shareholder of the company in respect of the income, profits or capital gains of that company, provided that the company is the transferring company and it is fiscally transparent.[103] In this case the Member State must give relief for the tax that would have been charged.[104]

Article 2(b)(a) of the Directive also covers a new type of transaction, namely the 'partial division'. The transferring company is not dissolved and continues to exist. Certain parts of its assets and liabilities are transferred to another company, which in exchange issues securities representing its capital. The securities are then transferred to the shareholders of the transferring company.

Under Article 7(2) of the Directive, there is a capital gains exemption when the receiving company holds 10%[105] of the shares in the transferring company while Article 10 provides for relief when converting a branch into a subsidiary. What is more, guidelines have been added governing the transfer of the registered office of SE or an SCE from one Member State to another. In such cases, there will be tax deferral on the capital gains of the transferring SE or SCE if their assets remain connected to a permanent establishment situated in the Member State from where they moved (Title IVb, Articles 10b to 10d). The shareholders concerned in this case should not be taxed for the transaction.

Article 8 has also been amended and now provides that in the case of 'merger, division or exchange of shares, the shares that represent the capital of the receiving company to a shareholder of the transferring company (...) shall not give rise to any taxation of the income, profits or capital gains of that shareholder.'[106] This provision is extended to exempt the relevant allotment on the income of 'fiscally transparent shareholders'. [107] The Member States are not prevented from taxing any gain arising after any subsequent transfer of the securities.[108]

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101 Merger Directive, art 4(2)

102 Merger Directive, art 8(3)

103 Merger Directive, art 10(a)(1)

104 Merger Directive, art 10(a)(2)

105 it used to be 25% but it was altered to align with the *Parent Subsidiary Directive 2003/123/EC*

106 Merger Directive, art 8

107 Merger Directive, art 8(3)

108 Merger Directive, art 8(6)

Amendments reflect a greater range of cases where the Directive can be applied, enhancing freedom of establishment within the internal market by removing any latent obstacles. Member States had to comply with the amended Directive by 1 January 2007.

(B) Council Directive 2005/56/EC[109] on cross-border mergers of limited liability companies

The new Directive 2005/56/EC on cross-border mergers of limited liability companies aims at removal of fiscal obstacles to cross-border mergers of limited liability companies governed by national laws of different Member States.

In the Directive (2005/56/EC) it is clearly stated that cross-border mergers between limited liability companies are to be allowed if the national laws of the respective Member States allow mergers between such types of companies. National provisions and formalities will apply as they would have been applied in the case of a national merger. It is expressly provided that national provisions and formalities should not restrict freedom of establishment or free movement of capital unless such restriction can be justified for general interest and are the necessary and proportionate means to do so.

The Directive applies to mergers between limited liability companies which have their 'registered office, central administration or principal place of business within the Community' given that at least two of the merging companies are governed by different Member States' laws (ie cross-border mergers).

Section Two

Cyprus

Reorganization of companies was another field in which Cyprus had to introduce new rules in order to harmonize the Cyprus Tax Law and fulfill her obligations vis-à-vis the European Union. Not only this has been achieved, but Cyprus took it a step further, increasing the scope and benefits of the relevant Directive, namely the Merger Directive[110]. The new reorganization rules for Cyprus have been into force since 1st of January 2003.

This section will begin by outlining the pre-existing rules governing reorganizations as set out in Cyprus Company law and then it will move on to

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109 Directive 2005/56/EC on cross-border mergers of limited liability companies [2005] (Cross-Border Merger Directive)

110 Merger Directive

examine the scope of the new rules and point out the cases where tax exemption is provided. Finally it will be explained how Cyprus furthered the provisions of the Merger Directive. Any ambiguities and room for improvement of the current Cyprus legislation will then follow.

Companies Law Chapter 113

Capital structure of a company can be reorganized under Section 198 and 270 of the Companies Law.

Section 198 provides for compromise or arrangement between a company and its creditors or/and its members[111] provided that the Court sanctions this. When the Court is satisfied that the proposed compromise or arrangement's purpose is the 'reconstruction or amalgamation' of the whole or any part of the involved companies it may sanction the scheme under section 198.[112] The Court may also provide for 'the transfer to the transferee company of the whole or any part of the undertaking and of the property or liabilities of any transferor company.'[113]

Section 201 provides for takeovers. It gives the power to the transferee company that made 'a scheme or contract involving the transfer of shares or any class of shares in the transferor company'[114] the power to acquire shares of shareholders dissenting from the scheme or contract approved by the majority (no less than 90%). The mechanism provided by section 201 must be followed precisely when compulsory acquisition of shares is the case. The sanction of the Court is required applying mutatis mutandis section 200.

Section 270 gives the liquidator the 'power to accept share as consideration for sale of property of company.'[115] This section applies only in cases of 'members' voluntary winding up.' The liquidator of the transferor company may, provided that a special resolution authorized it, sell or transfer the whole or part of the business or assets of the transferor company, in exchange for shares or other securities of the transferee company. The acquired shares or securities are then distributed to the shareholders of the transferor company who will now be holders of the transferee company. In this way the transferee company absorbs assets and property of the transferor company and an amalgamation has occurred.[116]

111 The Companies Law (n 72) s198(1)

112 The Companies Law (n 72) s200

113 The Companies Law (n 72) s200(a)

114 The Companies Law, Chapter 113, s 201

115 The Companies Law, Chapter 113, s270

116 Andreas Neocleous & Co < http://www.neocleous.biz/cz/index.php?contentid=177 > accessed 25 July 2012

New Reorganization Rules

The majority of the new reorganization rules are reflected in Part VI on Company Reorganizations of the Income Tax Law.[117] In addition to this, Capital Gains Tax Law[118] and Stamp Law[119] have been amended to enable better enforcement of the EU legislation and objectives of the internal market. The said legislation came into force on 1st January 2003 and remain good law to date.

The term 'Reorganizations' as used in Income Tax Law, Capital Gains Tax Law and Stamp Law, means 'a merger, division, transfer of assets or exchange of shares involving companies resident in the Republic and or companies not resident in the Republic.'[120] However it should be made clear that certain sections will apply to companies that are not resident in Cyprus only if they have a permanent establishment there.[121] For a company to be considered a Cyprus 'resident company' must have its management and control in Cyprus. A 'permanent establishment' is defined as 'a fixed place of business through which the business of an enterprise is wholly or partly carried on.[122]

Essentially Part VI of the Income Tax Law, provides for three types of 'company reorganizations' that can take place. These reorganizations can involve:

- Cyprus company 'resident' and a company from another Member State or a third country 'non-resident'. The Merger Directive provided for this situation since it specifically required Member States to apply it to reorganizations in which the companies from two or more Member States are involved.
- Resident companies only
- Non-resident companies given that tax implications arise in Cyprus. This will be the case if one of the non-resident companies earns income from sources in Cyprus.

Under section 26(1) 'assets and liabilities, including provisions and reserves, which are transferred under a reorganization, shall not give rise to taxable profits

117 Income Tax Law, No.118(I)/2002, Part VI Company Reorganizations

118 Capital Gains Tax (Amendment) Law, No.119 (I)/2002 (Capital Gains Tax)

119 Stamp (Amendment) Law, No.121 (I)/2002

120 Income Tax Law, No.118(I)/2002 (Income Tax Law), Part VI Company Reorganizations, s30

121 Income Tax Law, ss. 27-28

122 Income Tax Law, article 2

for the transferring company.'[123] The receiving company will carry on claiming capital allowances in respect of the transferred assets according to the conditions that would have applied to the transferring company if the reorganization had not taken place.'[124]

Section 27 provides that given that the transferring and the receiving companies are Cyprus residents, or if not they have a permanent establishment in Cyprus, 'any accumulated losses of the transferring company (…) shall be transferred to the receiving company (…) and provisions for set-off or carry forward of losses shall apply.'[125]

If 'the receiving company owns part of the transferring company's capital, any profits arising to the receiving company upon cancellation of the holding shall not be liable to tax'[126], provided that the receiving company is Cyprus resident or if not it has a permanent establishment in Cyprus.

Shares of the receiving company given to the shareholders of the transferring company in exchange for the transferring company's shares, 'shall not give rise to any profits or benefits liable to tax in respect of that shareholder.'[127] 'The shares of the receiving company shall have the same value for tax purposes as the shares exchanged had immediately before the reorganization. (…) Any subsequent profit arising from the shares shall be taxed.' [128]

Under the Capital Gains Tax Law[129], transactions amounting to a 'transfer of property' result to 20% tax rate for the arising profits. 'Transfer of property' concerns the transfer of immovable property. After amendments, in order to broaden the spectrum of those not constituting a 'transfer of property' two more situations were added that fall into this category.

The new categories not amounting to 'transfer of property' are governed by the new section 10(h) which concerns transfer of property in the case of reorganizations. Section 10(i) regulates 'the transfer of shares due to reorganization, representing the capital of the receiving or acquiring company by a

123 Income Tax Law, s26(1)

124 Income Tax Law, s26(2)

125 Income Tax Law, s27

126 Income Tax Law, s28

127 Income Tax Law, s29

128 Income Tax Law, s 29(2-3)

129 The Capital Gains Tax

shareholder of the transferring company in exchange of shares representing the capital of the latter company.[130]

Following the amendments, in the case where immovable property is transferred due to reorganization, there will be no capital gains tax for the transferred property until the new company disposes of it.[131]

Adding to these benefits, Cyprus exempts reorganization transactions from having to pay Stamp Duty.[132]

EU and National legislation

I shall now compare the Merger Directive with the Cyprus reorganization rules and point out in what ways Cyprus managed to extend the objectives of the Directive to cover even more situations than what was the original requirement.

Cypriot rules, unlike the Merger Directive, have provisions for domestic reorganizations as well as for reorganizations involving a third-country. The Merger Directive provides only for cross-border reorganizations leaving it to some extent on the discretion of each Member State how to treat domestic reorganizations. Italy is an example where domestic reorganizations are treated differently than cross-border ones, and are thus subject to tax.

The Merger Directive limits itself to providing relief from direct taxation while Cyprus extents its rules to give further exemption from all stamp duties. However land transfer fees and registration fees are not exempted in all cases and can be a significant burden for the new company.

Article 11 of the Merger Directive, gives the Member States the opportunity to abstain from any of the Directives' provisions in the case where 'reorganization':

- 'has as its principal objective tax evasion or tax avoidance, (...) the fact that one of the operations referred to in Article 1 [mergers, divisions, partial divisions etc.] is not carried out for valid commercial reasons (...) may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives,
- results in a company, whether participating in the operation or not, no longer fulfilling the necessary conditions for the representation of

130 Andreas Neocleous & Co (n115)

131 The Capital Gains Tax, section 10

132 The Stamp (Amendment) Law, No.121 (I)/2002 section 4A

> employees on company organs according to the arrangements which were in force prior to that operation.'[133]

Contrary to this, Cyprus legislation in this field contains no anti-abuse provisions per se while at the same time their implementation by implication is not excluded.

Suggestions for Improvements

Despite the fact that Cyprus seems to reflect its willingness and readiness to fulfill its obligations vis-à-vis the European Union, there is still room for improvement of its laws in this field. Evidently the Income Tax Law provisions governing reorganizations apply only when companies are involved while they remain silent on how to treat assets that are being transferred from partnerships or sole proprietorships to a company or vice versa.

Other than that, land transfer fees are haunted by uncertainty. In many cases companies involved in reorganizations, own property in Cyprus which as a direct consequence of the reorganization will have to transfer it from one company to another. As the law now stands, there is no provision for exemption of such land transfer fees and it is still uncertain whether the receiving company will have to pay for such a fee.

Under the current legislation, land transfer fees are to be paid by companies upon mergers and divisions but not for transfer of assets and exchanges of shares. In other words when there is an 'actual' land transfer then there is a land transfer fee, but in the case where only the ownership of the company is changed no such fee arises since in reality the land is still owned by the same legal person.

Thus if a company wishes to reorganize in a fiscally efficient way it would be suggested to avoid a merger or a division and exchange shares instead. In this way the company would not need to be dissolved and land transfer fees would be avoided.

Section Three

United Kingdom

In this section it shall be considered as to what extent the UK has made the required amendments to its laws in order to comply with the Merger Directive. The way to examine this shall be by examining a practical example of merger namely that of Northern Foods with Greencore. The relevant information will be mostly based on the analysis provided by Mr. Taussig A. and Mr. Zeller I. who

133 Merger Directive, art 11

had been advising Northern Foods in relation to the merger with Greencore. Despite the fact that the merger did not take place, it revealed certain limitations and practical problems of the new legislation that was introduced into the UK tax code.[134]

The merger was going to be carried out in the form of 'merger by absorption' where the transferor company (Northern Foods Plc.) would transfer its assets and liabilities to the transferee company (Greencore Group Plc), which in exchange would issue shares to the transferor shareholders. The transferor company would be dissolved when its shares were cancelled while no liquidation process would need to take place.

Section 140E of the Taxation of Chargeable Gains Act 1992 (TCGA) provides that assets transferred from the transferor to the transferee will occur on a 'no gain no loss'[135] basis while rollover treatment will be available to the shareholders involved if the merger can be defined as a 'scheme of reconstruction.'[136]

However as the authors point out, one should not be misled by these seemingly compliant rules since in practice they can be rather problematic and confusing.

Section 140E and 10B lay down that in order for the transferor to be granted a 'no gain no loss' treatment for any transferred assets to a non-UK tax resident transferee, the transferee must hold those assets through a permanent establishment that conducts its business in the United Kingdom. Thus it could be argued that when the transferee does not conduct its business within the UK then these provisions are of limited relevance. It is thus advisable that the transferor ensures in advance that the 'substantial shareholdings exemption (SSE)'[137] 'would be applicable in order to exempt any chargeable gain arising when shares in subsidiaries are transferred to the transferee.'[138] In the case where SSE or any other reliefs do not apply, then chargeable gains can and will arise. However it should be said that despite the transferor being dissolved right after the transfer is completed, the SSE would still be applicable.[139]

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134 Aurell Taussig, Isaac Zeller *'Analysis European cross-border mergers'* Tax Journal (2011) <http://www.herbertsmith.com/NR/rdonlyres/E9EE3471-EF5F-452C-93E6-D0533F5E4D95/17856/EuropeancrossbordermergersTaxJournalJanuary2011.pdf> accessed 26 July 2012

135 TCGA 1992, s140E

136 TCGA 1992, s136

137 Taxation of Chargeable Gains Act 1992, Schedule 7AC

138 Taussig, Zeller (n 133)

139 TCGA 1992,Sch 7AC para 3(3)(b)(i)

Taxes not expressly exempted in the Directives will have to be suffered by the transferee. Such taxes may include stamp duty reserve tax (SDRT), stamp duty land tax (SDLT) or VAT which can be treated as cash flow cost if it is recoverable.

Degrouping charges might arise in the case where the transferor company dissolves and any previous reliefs can be recuperated. Quoting from the authors, 'failure to cater for the peculiarities of the cross-border merger regime across the range of taxes can create some perhaps surprising anomalies.'[140] It is also argued that because there is no winding up of the transferor company the provision[141] blocking the recapturing of SDLT group relief will not be applicable, since for that to apply the vendor would have to be wound up in case of degrouping. In this case scenario, if Northern Foods - in the period of three years before the merger was about to be completed - had transferred to any of its subsidiaries UK land and stamp duty land tax was claimed, now the recapturing provisions might apply.

The transferee's tax position is rather uncertain due to lack of specific provisions modulating tax liabilities of the transferor. As a result, one could only assume that the transferee would undertake transferor's tax liabilities in their entirety. It would be interesting to note that domestic provisions only provide for cross-border transfer of liabilities and had the merger taken place it would be the first time to see how these provisions would apply in a scenario where only UK tax payers were concerned.

Unlike Cyprus' position on the issue, the UK regulations remain silent on how to treat tax liabilities such as corporation tax that arise as a result of the merger itself. Nevertheless as the authors suggest, 'in the absence of specific language excluding the transfer of such liabilities, the safest course would be to assume that the transferee will inherit such liabilities.'[142]

In cases where the merger would not be considered to be a 'scheme of reconstruction'[143] section 140G of the TCGA 1992 provides for 'rollover relief' while 'its detailed operation may be problematic.'[144] In order for the said section to apply to a 'merger by absorption', 'the transferee must issue shares or debentures to each person holding shares or debentures in the transferor.'[145] Consequently, the

140 Taussig, Zeller (n 133)

141 Finance Act 2003, Schedule 7 para 4(4)

142 Taussig, Zeller (n 133) p13

143 TCGA 1992, s136

144 Taussig, Zeller (n 133) p14

145 ibid

transferor's shareholders do not have any rollover relief under section 140G if the transferee is in procession of any shares in the transferor company pre-merger.

Mr. Taussig and Mr.Zeller suggest two ways to overcome this 'trap.' One way would be for the 'transferee to dispose of any shares it holds in the transferor before the merger takes place'[146] (one should bear in mind that this course of action might be commercially undesirable or could even be impossible as a matter of law).[147] Otherwise, section 140G could be side-stepped if the merger is organized in such a way as to amount to 'a reconstruction scheme' [148] in this way, shareholders would benefit of the rollover relief under section 136 of the TCGA.

It could also be argued that section 140G is rather restrictive when compared to the Cross-Border Merger Directive and the Merger Directive since it suggests that consideration for the assets and liabilities transferred, should be in the form of shares and debentures. This wording infers that in the event where any cash is given to the shareholders then rollover would not apply. However this is not in line with the Directives since they 'allow for cash as well as shares to be distributed to shareholders of the transferor equal to10% of the nominal value of the shares issued, and for rollover relief to be available to the extent of the share-for-share-exchange.'[149] Once again the authors suggest avoiding section 140G in order to escape from its traps.

To sum up, UK new rules regulating reconstructions, might at first glance seem to comply with the EU guidelines and obligations, but when it comes to their practical use one can see that not only they are not straightforward but in many cases they provide uncertainty. Also the amendments do not go beyond the requirements of the Directives, and unlike Cyprus' do not extend their scope.

Conclusion

As it can be observed from the aforementioned discussion, EU competence is only limited to some fields and Member States can, to a great extent impose their own rules and regulations as long as they are in accordance with EU principles and objectives. Lack of specific legislation regulating the field of exit taxation and lack of a harmonized approach on the issue results to differences between the tactics incorporated by each Member State causing disparities and distortions in the

146 ibid

147 ibid

148 TCGA 1992, Sch5AA

149 Taussig, Zeller (n 133) p14

internal market. Disparities are accepted as long as they are not in breach of the fundamental freedoms or if they can be justified and meet the proportionality criteria. Examples of transfers of assets and liabilities from a principal company to a PE have been described both in an onshore and cross border environment. Difference in treatment between the two situations suggests discriminatory treatment impeding freedom of establishment and distortion of the internal market. The abovementioned discussion also sets out clearly the cases where freedom of establishment can be applied and when not. Namely, when a company remains governed under the origin state's company law after transferring its seat to another Member State, freedom of establishment does not apply since companies are creatures of national legislation and Member States are free to determine the connecting factors required for a company's incorporation or the implications that any future modification might have upon the company's status. However the case shall not be the same when there is a change in the company law that governs the company. In this case conversion takes place and freedom of establishment will apply. Any additional requirement imposed by the origin Member State preventing the conversion or making it more expensive compared to what it would have been if the company chose to remain within its national territory shall be regarded as restrictions preventing the exercise of freedom of establishment.

In addition to this it was shown when and how exit taxation can be an acceptable practice and when not. Member States in order to preserve their taxing rights are allowed to tax whatever was accrued on their territories. This however should be done having in mind that double taxation and double non-taxation should be prevented. Several suggestions to achieve this were presented while what all had in common was the need for mutual recognition and cooperation of the countries involved. As long as Member States provide for the option for the deferral of exit taxes, then there is no problem or infringement of the freedom of establishment. If however the Member State requires immediate repayment of the exit taxes it is very likely that it will be against freedom of establishment and the Member State will have to amend its rules accordingly. This is the case with the UK, where the Commission's actions are expected after sending a reasoned opinion requiring amendment of the UK rules regulating exit taxation.

One could say that the UK seems to hesitate when it comes to making changes in the legislation to reflect EU legislation. Despite that some alterations do take place, they do not result in radical change of the pre existing legislation, causing the speed of harmonization with the EU to slow down. This is also reflected in the field of reorganizations discussed in part two of this paper.

As it has been demonstrated, greater interaction among Member States and third countries is pursued by the European Union which constantly amends Regulations and Directives in order to extend their scope. The example of Merger Directive was used in order to demonstrate such an extension in scope. It has been discussed how the parameters of the Directive have been broaden to encompass its greater application. New kinds of transactions have been included such as the partial division, while SEs, SCEs, fiscally transparent companies and fiscally transparent shareholders are also covered.

Cross-border merger takes all these arguments and objectives a step further, by removing fiscal obstacles to cross –border mergers of limited liability companies which are situated in two different Member States. In this way, freedom of establishment is enhanced.

It was then demonstrated how the Member States adapted their rules to comply with their Community obligations. First was the example of Cyprus which one could safely support that not only her rules were harmonized but also the new fiscal regime covers much more than what was required by the Directives. Income Tax Law, Capital Gains and Stamp Duty Laws include provisions that cover situations not originally covered in the Directives (such as mergers between domestic companies) and also provide for more exemptions than those dictated in the Directives.

However uncertainties and room for improvement do exist. For instance rules regulating land transfer fees cause some uncertainty and confusion while it is observed that the rules remain silent on whether they cover partnerships and sole proprietorship.

As far as the UK is concerned, the research has revealed that despite attempts were made in order to harmonize the UK rules on corporate reorganizations the amendments that took place were not very radical while there are still many traps that someone will need to be aware.

For instance commentators draw their attention on rules that seem compatible but when looked at more carefully, they are rather problematic and confusing. Such is the section found in Taxation of Chargeable Gains Act regulating provisions for ‘no gain no loss’ basis and rollover treatment available to shareholders.

UK legislation despite making the necessary amendments to its rules, shows no willingness to extend the benefits any further then what is required to. For instance, the transferee, unlike similar Cyprus situations, will have to bare any taxes such as stamp duties that are not exempted in the Directive. Cyprus on the other hand, provides for such an extension.

Also, domestic provisions apply only for cross-border transfer of liabilities while they remain silent on what the situation would be when only UK taxpayers are involved.

Comparing Cyprus with the UK one could say that Cyprus tax reforms had as a result a more straightforward tax regime, with many exemptions that in many cases extend the scope of the EU Directives. The relevant UK tax regime on the other hand, is still rather complicate with many technicalities, and despite making the necessary amendments it does so in a rather moderate way extending no further the scope of the Directives.

Maybe Chris Morgan should think more before claiming that 'Britain is open for business at least as far as corporate tax is concerned.'[150]

150 Goodall (n1)