AQ AND *DN* CASES: FRENCH RULES IMPLEMENTING THE MERGER DIRECTIVE CHALLENGED

Dr Tom O'Shea*

Introduction

In the *AQ* and *DN* cases, the Court stressed that, in the context of an exchange of shares which involved a deferral of taxation, on a subsequent transfer of the shares received in that exchange, the taxation of the deferred gain and the taxation of the gain in relation to the shares received should involve the same tax treatment as that which would have applied to the gain which would have been realised on the transfer of the securities existing before the exchange if the exchange had not taken place. Thus, if a holding period relief applied, it should also apply in relation to the *AQ* and *DN* situations, even though these both involved a deferral of taxation under the French regime that implemented the Merger Directive into French domestic law and as such, this relief was denied under French administrative practices to both AQ and DN.

Background

In the *AQ* case,[1] an exchange of shares took place in 2012 between two French companies. That exchange of shares did not confer on the acquiring company the majority of voting rights in the acquired company. When that exchange occurred, a capital gain at the date of the transfer was recorded and deferred for tax purposes in France. In 2015, the shares received in the exchange were transferred. This ended the deferral and the deferred capital gain was taxed. The capital gain resulting from the transfer of the acquired shares was also taxed at that time. However, the allowance for the length of time that the shares were held was granted only from the date of the exchange and not from the date that the shares were originally acquired. Following an appeal to the Constitutional Council in France, the deferred capital gain was

* Dr Tom O'Shea is a Chartered Tax Adviser and Director of the Academy of European and International Taxation, London. He may be contacted at tom@drtomoshea.com.

1 *AQ* and *DN*, Joined Cases C-662/18 and C-672/18, ECLI:EU:C:2019:750.

subsequently taxed at the rate of taxation in force at the time that the exchange occurred in 2012.

In the *DN* case, a merger took place in 1998 between two French companies involving an exchange of shares. On that occasion, a capital gain relating to the shares exchanged was recorded and deferred for tax purposes. In 2016, the shares received in the exchange were transferred. This ended the deferral of the 1998 capital gain which was taxed. The capital gain related to the 2016 transfer of shares was also taxed. The French tax authorities taxed the deferred capital gain at the rate applicable in 2016, but without application of the allowance for the length of time the shares were held, that was provided for in the national rules for capital gains realised after the 1 January 2013. Also, the French tax authorities calculated the allowance for the length of time the shares received in the exchange were held from the date of the exchange and not from the date that the shares were originally acquired.

The taxpayers AQ and DN submitted that such tax treatment was contrary to the Merger Directive 2009/133, in particular, Article 8. The Council of State (Conseil d'État) decided to refer the matter to the CJEU for a preliminary ruling.

Admissibility Issue

An issue concerning admissibility arose because the *AQ* and *DN* cases did not involve a cross-border situation, since both involved purely internal situations and French companies alone. However, the Court noted that France implemented the Merger Directive into its domestic law so that internal merger situations were treated in the same way as cross-border ones. In such circumstances, the Court pointed out, in paragraphs 30 and 31, that –

> "it is clearly in the interest of the European Union that, in order to forestall future differences of interpretation, provisions or concepts taken from EU law should be interpreted uniformly, irrespective of the circumstances in which they are to apply...
>
> the questions referred for a preliminary ruling concern the interpretation of provisions of EU law… the national legislation applicable in the cases in the main proceedings, adopted in order to implement Directive 90/434, replaced by Directive 2009/133, conforms, as regards the solutions applied to situations such as those at issue in those cases, to those provided for in those directives".

Consequently, the CJEU determined that the preliminary ruling was admissible.

The Merger Directive (as amended)

The Court noted that Directive 2009/133 (which replaced the Merger Directive) and Directive 90/434 (the Merger Directive) have the same objectives. The Court also accepted that its case law on one or the other applied to the other directive.

The Court stressed that by virtue of Article 8(1) of Directive 2009/133, in an exchange of shares situation, the allotment of shares in the acquiring company to the shareholder of the acquired company in exchange for shares in the acquired company must not give rise to taxation of the income, profits or capital gains of that shareholder. However, the Court indicated that Article 8(6) of Directive 2009/133 provides that Article 8(1) does not prevent the Member States from taxing the gain arising from the subsequent transfer of the shares received in the same way as the gain arising out of the transfer of shares that existed before the acquisition.

The Court explained, in paragraphs 40 and 41 of the *AQ case,* that –

> "although Article 8(1) of the Merger Directive, by providing that an exchange of securities cannot by itself give rise to the taxation of the capital gain resulting from that transaction, ensures the tax neutrality of such a transaction, the purpose of that fiscal neutrality is not, however, to avoid such a capital gain being taxed by the Member States with fiscal competence in respect of that gain, but only to prohibit them from considering that exchange as the chargeable event for the purposes of taxation…
>
> since Directive 2009/133 does not contain provisions on the appropriate fiscal measures for the purposes of implementing Article 8 thereof, the Member States have, subject to compliance with EU law, a certain degree of latitude with regard to that implementation".

Therefore, the Court pointed out, in paragraph 43, that deferral of the chargeable event for the taxation of the capital gain relating to the exchanged shares means that –

> "the taxation of that capital gain follows the tax rules and the rate in force at the date on which that chargeable event occurs, in the present case on the date of the subsequent transfer of the securities received in exchange. It follows that, if, on that date, the tax legislation concerned provides for an allowance scheme for the length of time the securities were held, a capital gain deferred for taxation must also benefit from such an allowance scheme, under the same conditions as would have been applicable to the capital gain that would have been made on the transfer of securities existing before the exchange if the exchange had not taken place".

The Court explained, in paragraph 44, that –

> "Any other measure would go beyond a mere finding of the capital gain relating to the securities exchanged in the exchange of securities at the time it

> took place and could lead to real disadvantageous tax consequences on taxation of that gain at the date of the chargeable event for that taxation, in the present case on the date of the subsequent transfer of the securities received in exchange, which would be contrary to the principle of fiscal neutrality referred to in Article 8(1) of Directive 2009/133".

The Court concluded, in paragraph 45, in relation to the capital gain relating to the shares received in the exchange, that –

> "as is apparent from the wording of Article 8(6) of Directive 2009/133, those securities are simply substituted for the securities existing before the exchange. It is therefore appropriate to apply the same tax treatment and, in particular, the same tax relief to the capital gain resulting from the exchange and in respect of which taxation is deferred and to the capital gain relating to the transfer of the securities received in exchange as that which would have been applied to the capital gain that would have been realised on the transfer of the securities existing before the exchange if the exchange had not taken place".

The Court commented that the financial interests of the Member States are restricted to levying a tax equal to that which they would have been entitled to levy if the exchange of shares had not taken place.

The Court's Conclusion

The Court concluded that Article 8(1) and 8(6) of Directive 2009/133 and Article 8(1) and 8(2) of Directive 90/434, in the context of an exchange of shares, must be interpreted as requiring the application of the same tax treatment, to the capital gain relating to the shares exchanged and deferred for taxation and to the capital gain resulting from the transfer of the shares received, in the light of the tax rate and the application of a tax allowance that takes into account the length of time the shares were held, as that which would have been applied to the capital gain that would have been realised on the transfer of the shares existing before the exchange if the exchange had not taken place.

Analysis

The *AQ* and *DN* cases raise a number of questions concerning the interpretation of Article 8 of the Merger Directive, as amended. Although the situations in the two cases were purely internal to France, they involved an interpretation of the Merger Directive from the CJEU because France implemented the directives into French law that required similar rules to be applied in relation to a domestic exchange of shares as applied in relation to cross-border situations. Hence, in order to protect the uniformity of EU law, the Court was happy to provide some guidance to the French national court that referred the questions for preliminary ruling in relation to both cases.

Holding Period Relief

Under French law, a holding period relief for shares that were exchanged before 1 January 2013 and on which tax has been deferred, did not apply to the situations in the *AQ* and *DN* cases. In addition, the holding period relief for the length of time that the shares received in the exchange were held was calculated from the date of the exchange and not from the date of acquisition of the shares exchanged. Therefore, the holding period relief allowance applied only to a fraction of the gain resulting from the transfer of the shares received in the exchange "by discounting the length of time that they have been held since the date of the exchange of securities and not since the date of the acquisition of the securities exchanged" (paragraph 35).

The Court determined that the deferral of the chargeable event for the taxation of the chargeable gain related to the exchange of shares means that the taxation of that capital gain follows the tax rules and the rate in force at the date of the subsequent transfer of the shares received in the exchange. Therefore, a capital gain which was deferred must also benefit from the holding period relief allowance "under the same conditions as would have been applicable to the capital gain that would have been made on the transfer of securities existing before the exchange if the exchange had not taken place" (paragraph 43), otherwise the principle of fiscal neutrality contained in Article 8(1) of Directive 2009/133 would be breached.

The Court also held, in relation to the capital gain relating to the shares received in the exchange, that those shares were simply substituted for the shares that existed before the exchange took place. Therefore, it was appropriate to apply the same tax treatment and tax relief (holding period relief allowance) to the capital gain relating to the transfer of the shares received in the exchange "as that which would have been applied to the capital gain that would have been realised on the transfer of the securities existing before the exchange if the exchange had not taken place" (paragraph 45).

Principle of Fiscal Neutrality

The Court acknowledged the two-fold objective of the Merger Directive – first, the legislation ought to avoid the imposition of tax in connection with a merger or an exchange of shares etc. and second, the financial interests of the Member State of the transferring or acquired company had to be safeguarded. Therefore, Article 8(1) of the directive provides that the allotment of shares to the shareholder of the acquired company, in relation to an exchange of shares operation, does not, of itself, give rise to any taxation of the income profits or gains of the recipient at the time of the deferral provided the conditions set out in Article 8(4) are respected.

However, Article 8(6) makes it perfectly clear that the capital gain arising out of the subsequent transfer of the shares received in the exchange may be taxed "in the same way as the gain arising out of the transfer of securities existing before the acquisition". Therefore, the purpose of the fiscal neutrality contained in the Merger Directive (as amended) is not to avoid the capital gain resulting from the exchange of shares from being taxed, but simply to prevent the Member States from making the exchange of shares a chargeable event for tax purposes provided the conditions, noted above, in Article 8(4) are respected.

Outside the Scope of EU Law

One final comment needs to be made on the situations in the *AQ* and *DN* cases which involved purely internal French situations relating to an exchange of shares. It is settled case law that the Court can deliver preliminary rulings in these environments as long as the Member State has implemented an EU directive into national legislation where cross-border and domestic situations are to be treated in a similar way.

In paragraph 29, the Court also made it clear that –

> "such requests are admissible also in cases where the provision of EU law of which an interpretation is requested is to apply, in the context of national law, in situations different from those provided for by the corresponding EU law provision".

Thus, even though the exchange of shares in the *AQ* case did not result in the acquiring company obtaining the majority of voting rights in the acquired company, the Court could still respond to the preliminary ruling questions in that case. The Court confirmed (in paragraph 30) that uniformity of EU law prevailed in such an instance. This was in line with its earlier jurisprudence whereby the Court held that –

> "it is clearly in the interest of the European Union that, in order to forestall future differences of interpretation, provisions or concepts taken from EU law should be interpreted uniformly, irrespective of the circumstances in which they are to apply".[2]

2 See *Marc Jacob* C-327/16 ECLI:EU:C:2018:210, para. 34.