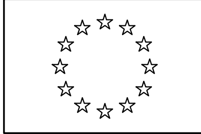

EUROPEAN COMMISSION
DIRECTORATE-GENERAL TAXATION AND CUSTOMS UNION
Analyses and tax policies
Analysis and Coordination of tax policies

Brussels, 28 July 2006
Taxud E1, FF/FV

CCCTB\WP\039\doc\en
Orig. EN

COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

Issues related to business reorganisations

Meeting to be held on 12th September 2006

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WORKING DOCUMENT

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I Introduction and purpose of the paper

1. An important element of any tax system is the body of rules governing business reorganisations, i.e. the tax consequences of restructuring operations such as mergers, divisions, etc. Tax legislators try to find a good balance between favouring a commercially straightforward organisation of companies' activity (by means of business-friendly tax rules) and countering tax avoidance.

2. From an accounting point of view, the international accounting standards specify the financial reporting rules to be applied by an entity undertaking a 'business combination'. In particular, IFRS 3[1] illustrates the accounting method (called the 'purchase' method) for recognising the fair values of assets, liabilities and equity involved in the transaction and any emerging goodwill (or negative goodwill). The main consequence of a business combination under IFRS is that the transferred assets are measured at their fair value at the date of exchange. Unless the cost of the business combination matches perfectly the fair values of the transferred assets, any difference is recognised, respectively, as goodwill or negative goodwill. Goodwill represents a payment in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised[2]. If the cost of the business combination exceeds the fair value of the transferred assets, the acquirer recognises goodwill. If, on the contrary, the fair value of the transferred assets exceeds the cost of the business combination, the acquirer recognises negative goodwill.

3. From a tax point of view, it is often the case that any emerging capital gain is temporarily exempted (tax deferral), provided that – for tax purposes – the historical value of the assets transferred remains unmodified despite the reorganisation. Thus, taxation will occur at a later stage, once the assets have been actually alienated and the capital gains have been realised. As a consequence, any goodwill is not depreciable. This is the solution chosen by the existing Community instrument covering some tax aspects of cross-border business restructuring, the 'Merger' directive[3].

4. The CCCTB as a comprehensive solution to tax obstacles faced by companies in the internal market will have to deal with business re-organisations. Business reorganisations may affect: (i) entities all covered by CCCTB rules and included in a consolidated group; (ii) entities all covered by CCCTB rules but not included in a consolidated group; (iii) some entities covered by CCCTB rules and other entities which are not; and (iv) none of them covered by CCCTB. This document deals with the first two situations. The Merger directive will continue to apply in a non-CCCTB context.

5. The CCCTB will have to define the general treatment for all transactions and possibly special arrangements for some of them. Therefore, the purpose of this document is to identify the main issues that need to be addressed in a CCCTB context as regards business reorganisations, and notably: (i) the scope of the 'business reorganisations', and

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[1] IFSR 3 'business combinations' can be found in all linguistic versions at the following web-site: http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2004:392:SOM:EN:HTML

[2] IFRS 3, paragraph 52.

[3] Council Directive 90/434/EEC (OJ L 225, 20.8.1990, p.1), as lastly amended by Council Directive 2005/19/EC of 17 February 2005 (OJ L 58, 4.3.2005, p. 19).

(ii) the main tax issues arising from business reorganisations. The document includes a series of questions for Member States' experts.

II. Scope of the 'business reorganisations'

6. The scope of the business reorganisations concerns both the entities and the transactions. As regards the entities, the Merger directive lists the entities to which it applies[4], not necessarily coinciding with all entities subject to corporate income tax. A separate document (**CCCTB\WP\040**) deals with the scope of entities covered by CCCTB. Once decided which entities can apply the CCCTB, it seems sensible that all (and only those) entities which are eligible for the CCCTB and actually apply it can undertake a business combination in accordance with the CCCTB rules. This will mean that, for those companies outside the CCCTB, existing rules will continue to apply.

7. In addition, specific rules may be necessary for business re-organisations involving entities that, after undertaking a business combination, opt out or are forced to leave the CCCTB regime, for example because they no longer meet the requirements to be eligible for CCCTB. When the range of entities which are eligible to opt for the CCCTB has been finalised, the issue of whether special business-reorganisation rules should be available for certain types of entities could also be analysed.

8. As regards the qualifying transactions, the CCCTB working group should analyse whether those covered by the Merger directive[5] describe all the possible business re-organisations which two or more CCCTB entities may undertake. To avoid the rigidity of a list of allowed reorganisation transactions (a list has to be updated, non-listed transactions are not covered, etc.) it could be envisaged in the CCCTB context that all restructuring operations involving transfer of business assets or shares may be covered[6], including any kind of transformations, liquidations - whether voluntary or compulsory (bankruptcy) – and transfers or the registered office, and regardless the fact that the transaction carried out foresees a cash payment exceeding a certain threshold, etc.

9. The common feature of the qualifying transactions described in the Merger directive is that the assets and liabilities transferred as a consequence of the reorganisation 'remain' connected with a permanent establishment located in the same country as the transferring entity, i.e. they do not leave the Member State that grant the tax deferral, so that exit taxes are not triggered. This requirement protects Member States' tax rights on capital gains accrued in their jurisdiction, thus countering tax planning techniques.

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[4] Annex to Directive 90/434/EEC as lastly amended by Directive 2005/19/EC.

[5] The Merger directive applies to mergers, divisions, transfers of assets and exchange of shares. The recent amendment to the Directive has extended the scope to partial divisions, incorporation (or 'subsidiarisation') of permanent establishment, transfers of the registered office of European companies (SE) and European Cooperative societies (SCE) and has eased the condition for upstream merger, in line with the changes in the Parent/Subsidiary directive

[6] This does not mean that a transfer of a single asset would be covered; restructuring operations should be represented by transfers of assets that from an organisational point of view constitute an independent business.

10. As regards entities all covered by CCCTB rules and included in a consolidated group (situation (i) referred to above), since the CCCTB will be a consolidated tax base[7], it could be questioned whether the requirement that the transferred assets continue to belong to a permanent establishment in the same country of the transferring company is still necessary. If such a condition is no longer required, the impact of the business reorganisations on the sharing out of the base (the formulary apportionment) should be carefully considered, given the existing differences in the level of taxation among Member States. Although discussions on the key factors of the formulary apportionment have not yet taken place within the CCCTB group, it is probable the location of assets in one Member State affects its share of the common tax base.

11. As regards entities all covered by CCCTB rules but not included in a consolidated group (situation (ii) referred to above), there is a less strong case for removing the condition that the transferred assets remain effectively connected to a permanent establishment in the Member State of the transferring company.

III. Main tax issues arising from business reorganisations

12. The basic accounting rules for business reorganisations have been briefly described in the introduction. Without specific tax rules, if the accounting values are relevant for tax purposes, the difference between the carrying amount of the transferred assets before the reorganisation and the fair value of the same assets after the reorganisation would represent capital gains, which would be taxed immediately. Logically, this would result in higher depreciation allowances for depreciable assets (step-up of depreciable basis) and lower capital gains (once such assets are alienated) at a later stage.

13. As this timing disadvantage (immediate taxation and higher depreciations) is seen as an important disincentive to the undertaking of business re-organisations, such transactions are usually tax neutral, and taxation is deferred to a later stage. As mentioned before, this is achieved by taking into account (for tax purposes) the book values of the transferred assets before the reorganisation. Neither do capital gains emerge from the re-organisation, nor are step-ups of the historical costs (and consequently higher depreciations or lower capital gains at a later stage) allowed. It should be recalled that similarly to other structural elements, it is not possible in the CCCTB to maintain the dependency from national (and diverging) accounting rules.

14. In the CCCTB context, the tax written down value of the transferred assets is to be understood as the CCCTB tax value as recognised before the business reorganisation takes place. For example, the tax written down value of an asset before a merger is the CCCTB tax value of that asset before the merger takes place. It seems sensible that the CCCTB maintains the tax neutrality principle and to create a business-friendly tax environment in line with the Lisbon goals. Therefore, business reorganisations carried out in a CCCTB context should guarantee that the transferred assets are recognised at their 'historical' CCCTB tax value (the CCCTB tax value prior to the reorganisation).

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[7] The consolidation implies the neutralisation of intra-group transactions and the sharing out of the consolidated base among participants according to a given apportionment mechanism and not on a 'arm's length' basis

15. The tax neutrality principle should also allow for the carry-over - at their CCCTB tax values - of pre-existing exempted provisions or reserves and the take-over of pre-existing losses by the acquiring entity (the latter possibility is admitted in the Merger directive insofar as it would be possible at the domestic level[8]). The general tax treatment of losses has been briefly touched upon during the discussions concerning the group taxation and will be dealt with in more detail by Subgroup 5.

16. The current tax rules covering business reorganisation can lead to economic double taxation[9]. In case of transfer of assets or exchange of shares, if both the assets which are transferred and the shares which are received in exchange are recognised at their book value, the subsequent sale of assets and of shares would give raise to two capital gains in the hands of two different taxpayers but for the same item. Such a double taxation would not occur if the capital gains on the sale of qualified financial assets are tax exempt (participation exemption rules). On the other hand, if the shares are recognised at the fair value of the assets received in exchange there is a risk of double non-taxation.

17. In a CCCTB context, a possible solution could be to record for the shares received in exchange for the transferred assets at their fair value, but to introduce a minimum period of possession for the shares (for example two years). A disposal within the period would trigger taxation of capital gains calculated on the basis of the CCCTB tax value of the transferred assets and not on the basis of the fair value of the share received.

18. As regards entities joining or leaving the CCCTB jurisdiction, a possible anti-avoidance solution could be the setting up of a **recapture mechanism** whereby any tax deferral granted by the CCCTB legislation would be reversed if the beneficiary entity stops applying the CCCTB within a given time-frame.

19. With reference to anti-avoidance rules, it should be noted that some Member States have implemented the Merger directive in a particularly restrictive way to counter possible tax avoidance, on the basis of the general anti-abuse provision contained in the Directive[10]. However, it follows from the case-law of the European Court of Justice[11] that a general rule automatically excluding certain categories of operations from the tax advantages, without a case-by-case examination (open to judicial review) on whether the operation has as its principal or one of the principal objectives tax evasion or tax avoidance would not be admissible.

20. Tax avoidance provisions should be compatible with the Community *acquis* and at the same time effective enough to protect Member States' legitimate interest in terms of revenue collection. As far as business reorganisations are concerned, such measures should prevent, for instance, exploitation of loss-making entities, (more or less) fictitious transfer of assets to low-tax jurisdictions, etc. This could be achieved, for instance, by introducing targeted anti-abuse clauses such as 'continuity of business' or 'continuity of ownership' tests in order for business reorganisations to benefit from tax neutrality; a 'vitality test' clause for the recognition of a company's previous losses in the hands of the receiving company, etc.. However, this is not the only area where anti-avoidance

[8] Article 6 of the Directive.
[9] See company tax study, part III, paragraph 3.3.2
[10] Article 11 of the Directive.
[11] In particular the Leur-Bloem case, C-28/95.

provisions are necessary. Members of the CCCTB Group may wish to discuss anti-avoidance provisions separately and at a later stage. Finally, if it is accepted that the scope of the transactions covered by business reorganisations is extended to any restructuring operations, including for instance those carried out in the context of liquidation or bankruptcy etc., it should be analysed whether any **distribution of liquidation proceeds to shareholders** should benefit from the tax neutrality principle. Generally, such proceeds are to be considered as dividends distribution.

IV Points for discussion

As a follow-up to the present Working Document, MS experts are invited to comment on the following open questions relating to business combinations:

- Do Member States experts agree that the CCCTB should provide for the tax neutrality of business reorganisations? If so, should the tax neutrality apply to a close list of transactions or to any transaction? Should the tax neutrality apply also to other elements of the tax base (reserves, provisions, losses, etc.)?What could be the approach as regards liquidation (included or not, special rules, etc.)?
- Do Member States experts think that the neutrality principle should apply only insofar as a permanent establishment (to which the transferred assets remain effectively connected) is maintained in the Member State of the transferring entity? Would it be possible to differentiate between business reorganisations among entities that consolidate and business combination between entities that do not consolidate?
- Do Member States experts agree that any double taxation arising from business reorganisations should be avoided? If so, which solutions do they envisage to this purpose?
- Do Member States experts consider that anti-avoidance rules should be dealt with in this context or should it be discussed at a later stage? In the first case which anti-avoidance rules do Members of the Group envisage for the CCCTB.