On March 22, 2018, the Court of Justice of the European Union (CJEU) rendered its decision in the joined cases, Jacob (C-327/16) and Lassus (C-421/16), concerning the compatibility with the Merger Directive of French tax deferral rules in the case of an exchange of shares. The CJEU concluded that the French legislation is compatible with the Merger Directive, but constitutes an infringement to the freedom of establishment, insofar as capital losses occurring upon the subsequent transfer of the shares are not taken into account.

The first case (Jacob C-327/16) concerns a French taxpayer that exchanged shares held in a French corporation for rights in another French company. The capital gain arising from the exchange of shares was subject to an optional tax deferral, which meant that the gain was established at the moment of the exchange, while the related tax was only charged and collected upon the subsequent disposal of the shares received. Some years later, the taxpayer moved his tax residency from France to Belgium and sold the shares. As a consequence, the French tax authorities decided to collect the tax due on the capital gain resulting from the exchange of shares, considering as irrelevant that the taxpayer was no longer tax resident in France. On the contrary, the taxpayer argued that, according to the Merger Directive, the exchange of shares is not, in itself, a chargeable event and that the subsequent transfer of the shares is the event that gives rise to the capital gain. In addition, the sale of the shares should not be taxable in France since he was no longer resident there.

The second case (Lassus C-421/16) concerns a taxpayer who moved from France to the UK. Within two years after his relocation, he transferred securities in a French company to a Luxembourgish company receiving, in return, securities in the latter. In respect of the capital gain on the exchange, the taxpayer was subject to tax in France according to the France-UK Tax Convention, even though he had been a UK tax resident. The resulting capital gain was...
deferred pursuant to the French rules described above. Three years later, the taxpayer sold part of his holding in the Luxembourgish company, which, in the view of the French tax authorities, triggered the taxation of the corresponding proportion of the capital gain that was subject to the deferred taxation. The taxpayer incurred a loss on the transfer of the shares, which the French tax authorities refused to offset against the capital gain from the exchange of shares, arguing that France did not have powers of taxation over the subsequent transfer.

In both cases, the CJEU was asked if Article 8(1) of the Merger Directive (90/434/EEC) precludes a mechanism which allows for the deferral of taxation of the capital gain established upon an exchange of shares (within the scope of that Directive) until the subsequent disposal of those shares. The Court was further asked whether the Merger Directive prevents a Member State from charging the deferred tax if, at the time of the subsequent transfer, the assets exchanged fall outside its tax jurisdiction. In addition to these two common questions, the second case also deals with the question whether disallowing the offset of a loss arising on the subsequent disposal of the shares against the (deferred) capital gain determined upon the exchange, would constitute an obstacle to the freedom of establishment, as such offsetting would have been allowed in a purely domestic situation.

The CJEU decision

The CJEU first assesses the admissibility of the questions referred. With respect to the Jacob case (C-327/16), the Court observes that the French legislation at issue applies the same approach in a purely domestic exchange of securities, as provided for by the Merger Directive. As regards the Lassus case (C-421/16), the Court dismisses the view of the Austrian Government that the case does not fall within the scope of the Merger Directive, as the taxpayer was resident in another Member State than that of the acquired or the acquiring company. Since the Directive does not provide for such a limitation in scope, the Court concludes that the residence of the taxpayer holding those securities is irrelevant. As a consequence, the Court confirms the admissibility of the questions referred in both cases.

Turning to the question whether or not the French deferral mechanism is prohibited by the Merger Directive, the Court notes that, although the Directive provides for a fiscal neutrality requirement, it also aims at safeguarding the financial interests of the Member State of the acquired entity, including the power to tax the capital gain arising from the exchange of shares. In the Court’s view, the purpose of the fiscal neutrality requirement is not to avoid the taxation of such gain, but to prevent Member States from considering that exchange as a triggering event for taxation purposes. As a consequence, the French provisions in question respect the principal of fiscal neutrality and therefore comply with the Merger Directive.

Regarding France’s powers to tax the gain resulting from the exchange, even though the subsequent transfer of the shares falls outside its tax jurisdiction, the Court notes that the Merger Directive does not harmonize the criteria for allocating powers to tax between Member States. As a consequence, the latter have the right to tax any capital gain arising within their particular ambit of fiscal competence and it is therefore irrelevant that the subsequent transfer of the securities in question falls within the fiscal competence of another jurisdiction.

Finally, the Court examines whether or not the loss realized upon the subsequent transfer of the securities must be taken into account when assessing the capital gain resulting from the exchange. In this respect, the Court first notes that the question does not fall within the scope of the Merger Directive, before concluding that the issue must be assessed in light of the
freedom of establishment. The Court thus observes that a resident taxpayer would have been able to offset the loss incurred upon the transfer against the capital gain resulting from the exchange that was subject of a deferral, contrary to Mr. Lassus. This difference in treatment between a resident and a non-resident constitutes an obstacle to the freedom of establishment, which cannot be justified by the allocation of powers to tax between Member States.

Analyzing whether its former case law relating to the exit taxation of capital gain (e.g. the National Grid Indus case C-371/10) applies in the case at hand, the Court makes a distinction between cases where only the tax collection is deferred (exit taxation) and the case at hand where the capital gain - although being established at the time of the exchange - is taxed on the date of the subsequent transfer of securities (fiscal neutrality). This implies that France exercises its fiscal competence in respect of the capital gain at the time when the capital loss arises, and therefore has to take the latter into account.

As a consequence, the Court held that the French legislation in question infringes the freedom of establishment. Nevertheless, it is for the Member States to provide for rules relating to the offset and calculation of the capital loss in compliance with EU law.

EU Tax Centre comment

The CJEU decision does provide some clarity on the interpretation of the application of the Merger Directive. However, it is also interesting to note that the Court made a clear distinction between the exit taxation mechanism and the fiscal neutrality requirement when assessing the compatibility of the French legislation with EU law. Following the opinion of its Advocate General, the Court was thus of the view that the capital gain, which has been rolled over upon the exchange and which becomes taxable upon the sale of the exchanged shares, is capped at the actual capital gain economically achieved by the individual, notwithstanding the fact that he has changed his domicile.

Should you have any queries, please do not hesitate to contact KPMG’s EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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