Merger Directive: Conceptual Clarity of the Term "Branch of Activity" Needed

This note examines a recent Dutch Supreme Court decision wherein the Court interpreted the phrase "independent part of an enterprise", which is the Netherlands equivalent to the phrase "branch of activity" under the Merger Directive (2009/133) and highlights certain conceptual difficulties with the "branch of activity" test.

1. Introduction

In a recent decision, the Dutch Supreme Court interpreted the phrase "independent part of an enterprise". This phrase is the Netherlands equivalent of the phrase "branch of activity", defined in article 2(j) of the Merger Directive (2009/133), as "all the assets and liabilities of a division of a company which from an organisational point of view constitute an independent business, that is to say an entity capable of functioning by its own means".

The case concerned a Dutch limited liability company (A BV) that was engaged in real estate brokerage in two Dutch cities. A BV transferred, in exchange for securities, its activities and an office building in one city to the newly established B BV. According to the preconceived plan, B BV immediately transferred on, in exchange for securities, all the activities it had received, except for the office building, to the newly established C BV. A BV applied the Dutch "transfer of assets" facility (i.e. a rollover of tax balance sheet values), which requires that an "entire enterprise or an independent part thereof" be transferred.

The tax authorities argued that this requirement had not been met due to the immediate transferring on of the activities by B BV to C BV. The first instance courts and the Court of Appeal ruled in favour of the tax authorities and the Supreme Court (Hoge Raad) upheld their decision. It referred to paragraph 35 of the ECJ decision in Andersen vs Jensen (Case C-43/00), from which it inferred that the activities transferred to B BV should operate independently from an organizational and functional point of view, which should be assessed from B BV's perspective. Applying this test, the Supreme Court ruled that the activities transferred on to C BV should be disregarded when characterising the first transfer, as the latter transfer was already preconceived at that moment. Ultimately, the Supreme Court rejected the "transfer of assets" facility, as the office building remaining in B BV was not, in itself, an independent enterprise.

In light of the objective of the Merger Directive (2009/133), i.e. the removal of fiscal disadvantages to cross-border restructuring operations while safeguarding the financial interests of the Member States – the role of the "branch of activity requirement" is not self-explanatory. The authors, therefore, address the ECJ's decision in the Andersen vs. Jensen case (section 2.1.) and the ECJ's case law on the term "branch of activity" (and similar terms) in the Capital Duty Directive (2008/7/) and the VAT Directive (2006/112/) (sections 2.2. and 2.3.). It appears that conceptual clarity regarding the term "branch of activity" is needed. It is even questionable whether or not this requirement should be in the Merger Directive (2009/133) at all (section 3.). Section 4. contains some concluding remarks.

2. ECJ Case Law on the Term "Branch of Activity"

2.1. Merger Directive

In the Andersen vs. Jensen case, the ECJ interpreted the terms "transfer of assets" and "branch of activity". The shareholders of Randers Sport A/S, a Danish resident
company, sought to pass on the business of Randers Sport A/S to the next generation. In keeping with that aim, they set up a new company, Randers Sport Nyt A/S. Except for a minority shareholding in a third company, all assets and liabilities of Randers Sport A/S were transferred to Randers Sport Nyt A/S. In order to reduce the net value of the assets and liabilities transferred to Randers Sport Nyt A/S, Randers Sport A/S took out a significant loan. The proceeds of the loan remained with Randers Sport A/S, while the financial obligation was transferred to Randers Sport Nyt A/S. This enabled two associates of Randers Sport A/S to acquire, for little consideration, sizeable blocks of shares in Randers Sport Nyt A/S with low capitalization. In order to raise the funds necessary for its own business activity, Randers Sport Nyt A/S obtained working capital from a bank, which required that Randers Sport A/S grant a lien over the shares of Randers Sport Nyt A/S as a guarantee. Randers Sport A/S retained a small number of shares in a third company, which at that time was in receivership.

In defining the terms "transfer or assets" and "branch of activity", the ECJ referred to the wording of articles 2(d) and 2(j) of the Merger Directive (2009/133). The ECJ decided that a "transfer of assets", must encompass all the assets and liabilities relating to a branch of activity.9 With regard to the required independence of the branch of activity ("an entity capable of functioning by its own means"), the ECJ reiterated the definition of "transfer of assets" and held that:10

"[i]t follows that the independent operation of the business must be assessed primarily from a functional point of view – the assets transferred must be able to operate as an independent business undertaking without needing to have recourse, for that purpose, to additional investments or transfers of assets – and only secondarily from a financial point of view."

According to the ECJ, the operation of a business is not independent, from a financial point of view, when the receiving company’s income is insufficient to cover its financial obligations. As a permanently loss-making activity lacks the required financial independence, such an activity does not qualify as a "branch of activity".11

It is hard to reconcile the ECJ’s reasoning in Andersen og Jensen with the wording, scheme, and objective of the Merger Directive. At one point, the ECJ even contradicted its own settled case law. First, the finding that a transfer of assets "must encompass all the assets and liabilities relating to a branch of activity" does not ensue from the wording of article 2(j) of the Merger Directive. Article 2(j) does not require that all assets and liabilities that may be attributed to a certain branch of activity be actually transferred.

Article 2(j) only stipulates that the assets and liabilities that are actually transferred collectively constitute a branch of activity. Whether or not certain assets and liabilities remain behind should not matter. The authors’ approach is reflected in decisions of the French Supreme Administrative Court (Conseil d'État) and Supreme Court (Court de Cassation) on the concept of "complete branch of activity" as mentioned in Article 238 quaerdecies of the French General Tax Code,12 the French equivalent to the branch of activity requirement in the Merger Directive (2009/133). In a decision of 27 July 2005, the Supreme Administrative Court13 decided that to qualify as a "branch of activity", a transfer of "essential" elements suffices.14 Similarly, in a decision of 15 May 2012, the Supreme Court considered that the fact that receivables were not part of the transferred assets did not prevent the transferred assets from qualifying as a "complete branch of activity".15 Finally, through a legal notice of 13 July 2012, the Supreme Administrative Court announced that to qualify as a "complete branch of activity", the transfer of key staff is essential.16 In specific cases, however, the courts are allowed to deviate from this main rule, and may conclude that a "complete branch of activity" has been transferred despite the fact that key staff were not part of the transfer.

As an aside, the authors note that the ECJ has failed to clarify in what circumstances assets and liabilities are actually "related". In Andersen og Jensen, it held very sweepingly that the requirements of article 2(j) are not met when the proceeds of a large loan and the obligations deriving from that loan are dissociated.17 Although the finding that assets and liabilities are related may be straightforward in some situations, for example, in regard to the pension provisions for transferred employees,18 this process is more cumbersome when it concerns financial proceeds and obligations.19 It is possible that the proceeds of a loan will not continue to be bound to the obligation to repay the debt. An example is when an entity is able to service the interest payments on a debt, while the proceeds remain with the transferring company. If the loan obligation does not affect the entity’s capability of functioning by its own means, that entity should still qualify as a "branch of activity".20 Also, when debt is unsecured or when it was taken out a long time ago, it becomes difficult to identify the "proceeds" relating to it.

Second, the reference to the financial position of the receiving company is not logical in the light of the scheme of the Merger Directive (2009/133). Pursuant to article 4, in conjunction with article 9, the transferring company

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9. Andersen og Jensen (C-43/00), para. 24. From this, the ECJ inferred that all intrinsically linked elements should be transferred.

10. Andersen og Jensen (C-43/00), para. 3.5.


14. In the case at hand the Supreme Administrative Court considered a trademark an essential element.


17. Andersen og Jensen (C-43/00), para. 25.

18. See Aigner, supra n 4, at p. 384.

19. See Vintner et al., supra n 4, at p. 444.

20. See Aigner, supra n 4, at p. 382.
is granted carry-over relief. It is not always possible for that company, however, to assess whether the transferred assets and liabilities operate in a financially independent manner at the level of the receiving company. Based on a more restrictive reading of the decision, one could counter that the ECJ was only referring to the receiving company in concreto (Randers Sport Nyt A/S). That company was newly established and the financial (in)dependence of that company could, therefore, be equated with the financial (in)dependence of the branch of activity itself. If the ECJ, instead, meant to say that the financial (in)dependence of the branch of activity should be assessed at the level of the receiving company, even if that company is already operative, that would lead to arbitrary results from the transferring company's perspective. Its entitlement to carry-over relief in regard to a transfer of assets would then be dependent on the financial position of the receiving company. The ECJ's decision in Leer Bloem (Case C-28/95) supports the view that the receiving company's position is not relevant. In that case, the ECJ rejected Dutch legislation that made relief under the "exchange of shares" facility dependent upon conditions that do not exist under the current article 2(c) of the Merger Directive (2009/133), such as a condition referring to the nature of activities performed by the acquiring company. By analogy, as neither article 2(c) nor article 2(d) of the Merger Directive impose any conditions regarding the activities performed by the receiving company, it is odd that financial difficulties of that company would jeopardize its qualification as a "branch of activity". The same logic applies to intentions of the receiving company's management regarding the further use and exploitation of the assets and liabilities received. Whether management intends to carry on the business or sell it directly after acquisition (as in the Dutch Supreme Court case) is of no relevance for the qualification of the transferred assets and liabilities as a "branch of activity". Obviously, such an intention could be conceived as an indication of tax evasion or tax avoidance, but this may be prevented through article 15(1)(a) of the Merger Directive.

Third, in disqualifying the operation, the ECJ considered it relevant that the companies involved could have achieved the same result by engaging in another transaction that would not have constituted a transfer of assets. In interpreting the scope of article 2 of the Merger Directive (2009/133), the ECJ thus interwove a subjective element into the objective facts. This seems to contradict settled case law, such as Leer Bloem, in which the ECJ stated that:

"[It is clear [...] from the general scheme of the Directive that the common tax rules which it lays down, which cover different tax advantages, apply without distinction to all mergers, divisions, transfers of assets or exchanges of shares irrespective of the reasons, whether financial, economic or simply fiscal, for those operations. [emphasis added]]"

2.2. Capital Duty Directive

Article 4(1)(a) of the Capital Duty Directive (2008/7) defines restructuring operations that shall not be considered to be contributions of capital as:

[...] the transfer by one or more capital companies of all their assets and liabilities, or one or more branches of activity to one or more capital companies which are in the process of being formed or which are already in existence, provided that the consideration for the transfer consists at least in part of securities representing the capital of the acquiring company.

Aside from the general observation that "[the economic effects of capital duty are detrimental to the regrouping and development of undertakings", the rationale behind the "branch of activity exemption" does not emerge clearly from the preamble to the Capital Duty Directive (2008/7). In Commerz-Credit-Bank AG (Case C-50/91), the ECJ nevertheless considered it "apparent" from the preamble to the 1969 and 1985 Capital Duty Directives that the purpose of this fiscal derogation:

[...] is to avoid transfers of assets between companies being impeded by tax obstacles, in order to facilitate the reorganization of undertakings, in particular within one undertaking of various entities carrying on identical or complimentary activities.

To give effect to that objective through a teleological interpretation of article 7(1)(b), the ECJ defined the phrase "part of a business" as embracing "any part of an undertaking which constitutes an organized aggregate of assets and persons capable of contributing to the performance of a specified activity." The ECJ stressed that:

[...] in deciding whether a part of an undertaking is a part of a business, it is only the performance of that activity which is to be taken into consideration, even if the activity is financed with funds provided by the head office or is carried on by the entity in question in accordance with instructions from the head office.

It is doubtful whether any value should be assigned to the ECJ's interpretation of the term "part of a business" in Commerz-Credit-Bank AG when interpreting the term "branch of activity" in article 2(j) of the Merger Directive. In Commerz-Credit-Bank AG, the ECJ could only resort to a purposive reading of article 7(1)(b), as the term "part of a business" was not defined. If the aim of the Capital Duty Directive is to fiscally facilitate the reorganization of undertakings, only the ability of the entity to enhance the development of the receiving company is of significance. A degree of dependence, either financial (receiving funds from the head office) or functional (obeying instructions from the head office) is less relevant, provided that the performance of the activity by the entity remains unaffected. In Andersen og Jensen the ECJ had to interpret the definition of "branch of activity" in article 2(j) of the Merger Directive (2009/133). This definition is stricter, as it requires the entity to be functionally and factually autonomous.

21. NL: ECJ, Case C-28/95, 17 July 1997, A. Leer Bloem v. Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2, ECJ Case Law BH1D. 22. Andersen og Jensen (C-43/00), para. 26. 23. Leer Bloem (C-28/95), para. 36. 24. DE: ECJ, Case C-50/91, 13 Oct. 1992, Commerz Credit Bank AG – Europartner v. Finanzamt Saarbriücken, para. 11, ECJ Case Law BH1D. 25. Commerz Credit Bank (C-50/91), para. 12. 26. Commerz Credit Bank (C-50/91), para. 16. 27. As the ECJ held in Commerz Credit Bank (C-50/91), the objective of the 'transfer of assets' provisions only seems to indicate that a branch of activity must be able to contribute to the activity of the receiving company.
although this does not automatically ensue from the objective of articles 2(c) and 2(d) of the Merger Directive.

The ECJ decision in *Muwi Bouwgroep* (Case C-164/90)\(^{28}\) may be of more importance in interpreting "branch of activity" in article 2(j) of the Merger Directive. This case concerned the question as to whether or not shares that constituted a 100% shareholding in another capital company could be regarded as a "part of a business" within the meaning of article 7(1)(b) of the 1969 Capital Duty Directive. The ECJ noted that article 7 of this directive also contained a paragraph (1)(bb), which was added "to permit the extension of the reduced rate to regroupings of companies which, economically speaking, produce similar effects to the reconstruction operations referred to in Article 7(1)(b) but follow a different legal procedure."\(^{29}\) Article 7(1)(bb) applies to situations where a capital company which is in the process of being formed or which is already in existence acquires shares representing at least 75% of the issued shares of another capital company. In keeping with the *lex specialis derogat legi generali*, the ECJ held that, since transactions involving a transfer of shares are governed by article 7(1)(bb), they cannot be covered simultaneously by article 7(1)(b). Accordingly, shares representing 100% of the share capital of another capital company could not be regarded as a "part of a business".

The ECJ’s decision in *Muwi Bouwgroep* seems relevant to the scope of article 2(c) of the Merger Directive (2009/133). Article 2(e) of the Merger Directive essentially defines an "exchange of shares" as an exchange of securities, whereby the acquiring company obtains or expands a majority interest in the voting rights in the acquired company. A transfer of shares of such weight that the acquiring company obtains or expands a majority interest in the voting rights in the acquired company can, therefore, not qualify as a "branch of activity", as it is already covered by the more specific article 2(e) of the Merger Directive.

2.3. VAT Directive

The ECJ decision in *Zita Modes* (Case C-497/01)\(^{30}\) concerned the interpretation of the no-supply rule in article 5(8) of the Sixth VAT Directive (77/388/EEC)\(^{31}\) (currently article 19(1) of the VAT Directive (2006/112)), which reads as follows:

[i] in the event of a transfer, whether for consideration or not as a contribution to a company, of a totality of assets or part thereof, Member States may consider that no supply of goods has taken place and in that event the recipient shall be treated as the successor to the transferor.

Specifically, the question considered by the ECJ was whether this rule applies to any transfer of a totality of

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32. *Zita Modes* (C-497/01), paras. 39–41.
33. *Zita Modes* (C-497/01), para. 40.
34. See the Proposal for a Directive on the common system of taxation applicable to mergers, divisions and contributions of assets occurring between companies of different Member States of 15 January 1989 (1990 Merger Directive Proposal), COM (90) 561 final, at p. 11: "En matière d'apport direct, il est proposé que le régime commun applique aussi aux apports partiels, mais dans la mesure où ils portent sur une ou plusieurs branches d'activité... Aller au-delà risquerait d'inciter les sociétés à procéder sous forme d'apports partiels à des cessions déguisées".
35. See the second recital in the preamble to the Merger Directive (2009/133).
36. It has been observed that article 2(d) (transfer of assets) of the Merger Directive (2009/133) speaks of the "transfer" rather than the "insuse" of securities. This distinction also exists, for instance, in the French (la renonci à l'attribut) and the Dutch (verkrijging vs. uitreiking) language versions of the Merger Directive. A possible explanation for the use of different terms is that with a "transfer of assets", the transferring company receives the securities in the transferring company, whereas with the other restructuring operations, the shareholders of the transferring company are the recipients.
the Merger Directive (2009/133). This suggests that the "branch of activity requirement" serves a different purpose. Thirdly, as the "branch of activity requirement" is imposed at the company level, it is ill-equipped to combat disposals of assets disguised as partial divisions. In such cases, the transferring company's shareholders, and not the transferring company itself, would benefit from the disguise.

As Terra and Wattel (2012) observe, the definition of branch of activity does not clarify whether a branch must be carrying on an "active" business (for example, manufacturing) or whether it may also be of a more passive nature (for example, portfolio investment). Although the tax deferral at the company level in regard to a transfer of a merely passive branch of activity will, ultimately, fall through owing to the PE requirement (which requires that an active business be carried on), this question is relevant in so far as it concerns the availability of tax deferral at the shareholder level pursuant to article 8 of the Merger Directive. In regard to a "partial division", such carry-over relief will only be available where there is a transfer of at least one branch of activity.

What also adds to the systematic lack of clarity is that the "branch of activity requirement" is not imposed in respect of all operations covered by article 2 of the Merger Directive. Accordingly, the option to choose a division, which does not entail a "branch of activity requirement", as an alternative to a "partial division", will not add to that requirement's legitimacy. What would the relevant distinction be between these two operations that would justify the latter operation being classified as a transfer of a branch of activity? Certainly, as a result of a division, the transferring company is dissolved, whereas with a partial division, the transferring company is not dissolved. However, if there were any fear that a taxable capital gain (on assets) could be converted to a potentially exempt gain (on securities), the dissolution of the transferring company would be irrelevant, as it would be its shareholders who would profit from such conversion. Such a fear is more warranted in regard to a transfer of assets, as the transferring company would be receiving the securities. In any event, article 2 of the Merger Directive is not the right place to prevent such undesirable behaviour: if the conversion of potentially taxable hidden reserves to a potentially exempt gain is to be regarded as tax evasion or tax avoidance, this should be prevented through article 15(1)(a) of the Merger Directive. Alternatively, less restrictive means are available to prevent the (perceived) abuse of the "transfer of assets" facility. One option, in line with an amendment that was proposed by the European Parliament (but was never adopted) is to insert a requirement concerning a minimum period of ownership of the securities received.

The relationship between the branch of activity requirement and the PE requirement in article 4(2)(b) of the Merger Directive (2009/133) is not clear either. Article 4(2)(b) makes carry-over relief at the company level conditional upon the transferred assets and liabilities becoming connected with a PE. There is, however, no PE definition in the Merger Directive. Since the 1969 Proposal for the Merger Directive contained a definition of that term that was worded almost identically to the OECD definition and since the PE definitions in the Parent-Subsidiary Directive (2011/96) and the Interest and Royalties Directive (2003/49) also follow the OECD Model (2010), it is fair to assume that the ECJ will have recourse to that definition. The OECD definition ensures that only sustained restructuring operations qualify, as it imposes...

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39. A. Massimino, An Analysis of the 2005 Amendments to the Merger Directive, Interact 6-7, p. 334 (2006) writes that the requirement in article 2(c) of the Merger Directive that at least one branch of activity be left in the transferring company was inserted "to prevent the use of this operation to sell individual valuable goods deferring or avoiding the taxation of the capital gain".
40. The proposed article 8(1a) reads: "in order to avoid possible abuses related to the rapid exchange of shares, Member States shall apply an anti-abuse provision aimed at establishing a minimum holding period of 1 year, with the possibility to extend it to 2 years for each Member State in the event of extreme situations of tax avoidance."
41. See European Parliament, 26th plenary session 2003-2004: Final report on the proposal for a Council directive amending Directive 90/434/ EEC of 23 July 1990 on the common system of taxation applicable to mergers, divestitures, transfers of assets and exchanges of shares concerning companies of different Member States (COM(2003)265-1, COM (2003)265-2, 289). At p. 6. On the other hand, in the Commission Staff Working Paper, Commission Taxation in the Internal Market, minimum holding period requirements were regarded as impediments to cross-border economic activity, see Commission of the European Communities, Commission Staff Working Paper, Commission Taxation in the Internal Market, COM(2011)582 final (23 Oct. 2011), p. 261: "[T]he case most often cited is where a number of Member States require that shares received under a transfer of assets or an exchange of shares be kept for a certain period which varies from three to seven years. The rapid disposal of shares received as a result of a transfer of assets or exchange of shares could be an abuse within the meaning of Article 11 of the Directive. However, in its judgment [sic] in Case C-28/95, Last Bloom (1997), the European Court of Justice ruled that such abuse had to be assessed on a case-by-case basis. A blanket refusal to apply the Directive, where shares received are disposed of before a particular deadline without giving taxpayers an opportunity to prove that such disposals are not of an abusive nature is therefore unlikely to be be [sic] consistent with the Directive. Moreover, minimum holding periods that are particularly long - up to five or seven years after the initial investment - appear to be difficult to justify on the grounds of preventing abuse.
46. Terra & Wattel take the view that the ECJ may resort to the "OECD term" permanent establishment for purposes of interpretation of a PE under the Merger Directive. See Terra & Wattel, European Tax Law (1ED. fiscal studiesesec) 6th ed., p. 261 (Kluwer Fiscal en Financiële Uitgevers 2011).
amongst others, a “location test”, a “duration test” and a requirement that the activities not be of a merely auxiliary nature. Accordingly, as the PI requirement is capable of excluding restructuring operations that are not sustained, the branch of activity requirement appears to be superfluous.

4. Concluding Remarks

As argued in section 2.1., the ECI’s interpretation of the term “branch of activity” in Andersen og Jensen is hard to reconcile with the wording, scheme, and objective of the Merger Directive (2009/133). In the authors’ view, the definition in article 2(j) only requires that the transferred assets and liabilities collectively constitute a branch of activity. It should not matter whether or not certain assets and liabilities remain behind. The financial position of the receiving company and the intentions of the receiving company’s management also should not be of relevance.

In section 3., the authors demonstrated that the branch of activity requirement in the Merger Directive raises some questions from a conceptual angle. Firstly, the rationale behind the branch of activity requirement is unclear. Secondly, from a systematic point of view, it is questionable why the branch of activity requirement is not imposed for all operations covered by article 2 of the Merger Directive. Thirdly, given the existence of the PI requirement in article 4(2)(b) of the Merger Directive, the branch of activity requirement appears to be superfluous. As the option to transfer individual assets and liabilities in exchange for securities would give companies the flexibility “to adapt to the requirements of the internal market, to increase their productivity and to improve their competitive strength at the international level”, the authors advocate the abolition of the branch of activity requirement.

As a final point, the branch of activity requirement cannot be used to counteract tax evasion or tax avoidance. Such undesirable behaviour should not be combated through article 2, but through article 15(1) (a) of the Merger Directive.


47. See art. 5(4)(c) and (f) OECD Model (2010).