



Euro Tax Flash from KPMG's EU Tax Centre



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Advocate General's Opinion on French Mechanism for deferred Taxation of Capital Gains

[Exchange of shares – Taxation of Capital Gains – Merger Directive](#)

On November 15, 2017, Advocate General (AG) Wathelet of the Court of Justice of the European Union (CJEU) published his Opinion in two individual income tax cases referred to the CJEU by the French Supreme Court ([C-327/16](#) and [C-421/16](#)). In both cases – which were dealt with jointly – the questions referred to the CJEU deal with the compatibility of Article 8 of Directive [90/434/EEC of July 23, 1990](#) ('Merger Directive') with a national rule providing for the deferral of taxation of capital gains in the case of an exchange of shares falling within the scope of the Merger Directive.

In both cases, the Court was asked if Article 8(1) of the Merger Directive 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 situation where the Member State disallows the offset of a loss arising on the subsequent disposal of the shares against the (deferred) capital gain determined upon the exchange of shares, where such an offset is permitted in a domestic situation.

Background

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. Pursuant to French provisions in force in the year at issue, the capital gain arising from the exchange of shares was subject to an optional tax deferral, which meant that the gain was established and settled at the moment of the contribution, while the related tax was charged and collected at the moment when the event putting an end to the deferral occurs, i.e. upon the disposal of the shares received as a

consequence of the exchange. Some years later, the taxpayer moved his tax residency from France to Belgium and subsequently sold the shares. The French tax authorities take the view that the sale of the shares triggers the end of the deferral and therefore the taxation of the capital gain resulting from the exchange of shares. Furthermore, they conclude that the fact that the taxpayer is no longer tax resident in France was irrelevant as the French taxation right was established at the moment of the exchange of shares.

On the other hand, 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. He also takes the view that the sale of the shares is not taxable in France since the sale of the shares occurred after he had already given up his French tax residence.

The second case (*Lassus C-421/16*) concerns a UK tax resident, who transferred securities in a French company to a Luxembourgish company receiving, in return, securities in the latter. The resulting capital gain was deferred pursuant to the French rules described above. Three years later, the taxpayer sold 45 percent 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 it did not have powers of taxation over the subsequent transfer.

In addition to the question that arises in the *Jacob* case, in *Lassus* the taxpayer also argues that the refusal to offset the capital loss would constitute an obstacle to the freedom of establishment guaranteed by the EU freedom of establishment, since the offsetting of the subsequent loss would have been allowed in a purely domestic situation.

The AG's Opinion

The AG firstly noted that Article 8 of the Merger Directive provides that an exchange of shares or securities does not, *in itself*, give rise to any taxation – any increases in the value of the securities are only taxed when realized. This is aimed at ensuring fiscal neutrality while at the same time safeguarding the taxation rights of the Member State in which the capital gain arises. The AG also noted that Article 8(2) of that Directive allows Member States to tax capital gains from the subsequent disposal of the shares obtained through an exchange in the same way as the gain arising out of the disposal of shares existing before the acquisition. He concludes that the deferral mechanism in question does not create a cash flow disadvantage, which would arise if the tax were due before the gains were realized and is therefore not precluded by Article 8 of the Merger Directive. In answer to the second question, the AG concluded that it is irrelevant that the subsequent transfer of the securities falls within the fiscal competence of another Member State. Changes in the fiscal competence of the Member State subsequent to the exchange of shares does not affect that state's right to tax a capital gain that was within its taxing jurisdiction at the time of the exchange.

With respect to possibility to offset the capital loss resulting from the subsequent transfer against the deferred capital gain, the AG is of the opinion that refusing to allow such an offset to a taxpayer who has exercised his freedom of establishment while granting it in a comparable

domestic situation is precluded by EU legislation. The AG states that the preservation of the allocation of powers of taxation does not justify the restriction.

EU Tax Centre comment

The AG's Opinion provides some clarity on the interpretation of the application of the Merger Directive. It is interesting to note that, when assessing the possibility to take into account losses arising on the subsequent disposal of the exchange shares, the AG found irrelevant the fact that the transfer did not fall within the jurisdiction of the same Member State. In such a case, the capital gain which has been rolled over upon the exchange and which becomes taxable upon the sale of the exchanged shares has to be decreased in order to reflect the actual gain made by the individual at that time. In other words, the Court seems to be of the view that the rolled over capital gains is capped at the actual capital gain economically achieved by the individual notwithstanding the fact that he has changed his domicile.

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Robert van der Jagt

Chairman, KPMG's EU Tax Centre and
Partner,
Meijburg & Co

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KPMG's EU Tax Centre, Laan van Langerhuize 9, 1186 DS Amstelveen, Netherlands

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