INTERNATIONAL TAX REVIEW

Portugal’s exchange of shares under the Merger Directive

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Portugal's Merger Directive has remained ambiguous on whether a company ought to exist prior to an exchange of shares, leading rise to a number of questions regarding domestic and cross border transactions.

The Merger Directive of October 19 2009 (Council Directive 2009/133/EC) implemented a tax deferral (neutrality) regime applicable to corporate re-organisations within the European Union. While the directive is aimed at cross-border re-organisations, most EU member states have extended its application to domestic transactions, which has led the European Court of Justice (ECJ) to clarify the need for member states to apply such regimes equally to cross-border and domestic transactions in a coherent way, pursuant to the object and purpose of the Merger Directive.

One of the re-organisations covered by the directive is the "exchange of shares", which consists of a share-for-share deal where a shareholder contributes shares of a subsidiary (the "acquired company") into an acquiring company in return for the shares of the later. In practice, the shareholder converts a direct stake into an indirect one, held through the acquiring company.

The fact that the Directive is silent on whether the acquiring company should exist prior to the re-organising transaction (or be set up in the context of the transaction in order to receive the shares of the acquired company), has been the basis for some EU tax authorities denying application of the tax neutrality regime, arguing that the acquiring company should in all cases be incorporated prior to the transaction. Such a position can lead to the immediate taxation of gains in the shares of the acquired company, but may also cause the expiry of tax losses, provisions, reserves and other relevant tax credits.

A Portuguese legal perspective to the exchange of shares

Portugal's exchange of shares is specifically foreseen in the corporate income tax (CIT) code (which virtually reproduces the definition set out in the Merger Directive), and qualifies as a form of "in-kind contribution" and/or capital increase for corporate law purposes. While neither the Merger Directive or the CIT code clarify whether the acquiring company should be incorporated prior to the transaction, the answer may, in our opinion, result from a coherent interpretation of the object and purpose of the Merger Directive, and a combined interpretation of tax and corporate law provisions.

Notably, the Merger Directive clearly indicates that other transactions (where a branch of activity should be transferred) should qualify for tax neutrality, even if the newly incorporated companies are involved. In fact, the wording of the Merger Directive has been improved over time to clarify that the tax neutrality regime does not depend on the incorporation of the companies involved. In the case of converting a permanent establishment into a subsidiary, the European Commission clarified that the formation of a new company should not prevent the application of the Merger Directive.

The position of tax authorities and courts

In Portugal, this subject was addressed in a tax litigation procedure where tax authorities decided not to question whether the acquiring company should be incorporated in the course of an exchange of shares, challenging such a transaction, pursuant to the anti-avoidance provision (accepting the newly-incorporated acquiring company as eligible under the Merger Directive).

Portuguese case law confirms that the transactions defined in the CIT code should be interpreted in light of the purpose of the Merger Directive, even if they are not detailed in the CIT code. The fact that the incorporation of the company upon an exchange of shares is lawful under company law is an additional argument to support the eligibility of the transaction. We are confident that the Portuguese experience may contribute to an extension of this interpretation throughout the European Union.

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