**Analysis of the Proposed Directive on Cross-Border Conversions, Mergers and Divisions**
**Artificial Arrangements**

***Briefing paper series on the Company Law Package***

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***What problems are the proposed Directive addressing?***

- The stated aim is to facilitate cross-border operations whilst protecting the rights of employees, shareholders and creditors, and preventing tax evasion.
- Member States are entitled to block cross-border restructuring processes where they amount to artificial arrangements: "A crucial element of the procedure is that it would prevent a cross-border conversion where it is determined that it constitutes an abuse, namely in cases where it constitutes an artificial arrangement aimed at obtaining undue tax advantages or at unduly prejudicing the legal or contractual rights of employees, creditors or minority members."[1]

***What is in the proposed Directive (main provisions)?***

- MS **required to establish a procedure** for cross-border conversions (Art 86a(2)) and divisions (Art 160a(2)
- Conversion or division is **not to be permitted** if it 'constitutes an artificial arrangement aimed at obtaining undue tax advantages or at unduly prejudicing the legal or contractual rights of employees, creditors or minority members', to be assessed by departure Member State (Art 86c(3) and Art 160d(3) (omitting word 'minority'))
- National competent authority to examine documentation and issue **pre-conversion certificate** (Art 86m) or **pre-division certificate** (Art 160o). Where 'serious concerns' that the restructuring constitutes an **artificial arrangement** (Art 86m(7)(c) and 160o(7)(c)), national authority may conduct an in-depth assessment before deciding whether to issue certificate (Art 86n and 160p), drawing on report prepared by independent experts (Art 86g and 160i)
- At the **hearing**, the national competent authority should hear the company and 'interested third parties in accordance with national law' (Art 86n(2) and 160p(2))
- During the **in-depth assessment**, national competent authority 'shall take into account at a minimum the following: the characteristics of the establishment in the destination Member State, including the intent, the sector, the investment, the net turnover and profit or loss, number of employees, the composition of the balance sheet, the tax residence, the assets and their location, the habitual place of work of the employees and of specific groups of employees, the place where social contributions are due and the commercial risks assumed by the converted company in the destination Member State and the departure Member State'. Each of these factors is 'indicative' in the overall assessment and should not be considered in isolation. (Art 86n(1) and Art 160p(1)
- The decision to issue or not issue a certificate 'is subject to judicial review in accordance with national law' (Art 86o(1) and 160q(1))

**What are the shortcomings and what could be done to fix them?**

- The rules on certification and possible denial of restructuring where it amounts to an artificial arrangement **do not apply to cross-border mergers**. Since a conversion can be effected

[1] Explanatory Memorandum

(albeit at more cost) by merger into a shell company, this means the procedure can be bypassed. Whilst Member States could probably, under the case law of the CJEU, restrict cross-border mergers they consider to be artificial arrangements on a case-by-case basis, it would be desirable from the perspective of legal certainty for cross-border mergers to be subject to similar scrutiny.

**Distinction between 'artificial arrangements' and letterbox companies**

- The directive's proposed rules in relation to 'artificial arrangements' will supersede the CJEU's *Cadbury Schweppes* decision regarding when MS are allowed to restrict the establishment of letterbox companies and allow MS to restrict conversions and divisions where these are being carried out with the intention of reducing the company's tax obligations to the origin MS.
- The directive attempts to prevent circumvention of future mandatory BLER by providing for negotiation where the company converting or dividing is at four fifths of the threshold for triggering employee representation in the departure MS, and the destination MS does not provide for the same level of participation (Art 86l(2) and 160n(2). We welcome this anti-avoidance provision but have some concerns. In particular, it may have the effect of simply bringing forward in time the decision to restructure. The preamble should clarify that the intention is to allow MS to block restructuring where it is purely aimed at tax advantages or evading future BLER.

**Recommendations**

- The Directive should be amended so that the 'artificial arrangements' procedure also applies to cross-border mergers
- The preamble should clarify that the directive is not intended to put downward pressure on national corporate tax rates, undermine national systems of taxation or the viability of mandatory BLER, which is fundamental to many MS systems of corporate governance. It is intended to facilitate freedom of establishment, which presupposes genuine economic activity in the destination MS. Where there is no such genuine economic activity, or where the intention is to reduce tax or evade BLER, MS may rule that the restructuring is an artificial arrangement and block it.
- The preamble should make it clear that the 'artificial arrangements' procedure is intended to protect the capacity of MS to impose tax and employee participation obligations on companies in the future. Member States should be allowed to block conversions, mergers and divisions where these amount to artificial arrangements entered into by businesses with the intention of undermining national rules relating to tax or employee participation by evading future obligations
- The preamble should state that the directive does not prejudice the rights of MS to impose BLER on companies which are incorporated in another MS but do not conduct genuine economic activity there.
- The Directive should guarantee specific third parties (including tax authorities, employee representatives, pension funds) input into in-depth assessments and the right to challenge certification decisions. These matters should not be left to national law.

**Annex**

Extending the AA procedure to cross-border mergers will be opposed by business, which is already opposed to the procedure for examining conversions and divisions. However, it is essential that the framework for controlling AAs be extended to cross-border mergers:

- **Close a potential loophole:** companies can change their applicable law (or avoid the imposition of codetermination by going through a merger with a shell company in another Member State) without going through the scrutiny process for artificial arrangements
- **Greater clarity:** the case law of the CJEU has not considered the possibility of scrutinising cross-border mergers as artificial arrangements, and Member States (and trade unions) may not be aware that there is a possibility of challenging corporate restructures on this basis.

**Distinguishing letterbox companies from artificial arrangements**

- EU law protecting free movement rights has previously been highly tolerant of, and arguably encouraged, the establishment of letterbox/shell companies. Now, there is greater understanding and willingness to put in place restrictions (e.g. Posted Workers Dirctive).
- *Centros* and *Cadbury Schweppes* are not easy to reconcile, not least because *Centros* states that a decision to incorporate in the MS 'whose rules of company law seem to him the least restrictive… cannot, in itself, constitute an abuse of the right of establishment' (*Centros*, para 27).
- The *Centros* case law deals with establishment of a new company, and third parties are free to decide whether to deal with it or not. *Polbud* goes further, because it deals with the conversion of an existing company, and the MS of origin can justify restricting the exercise of the right in order to protect overriding requirements relating to the public interest (paras 54 and 58). As noted in the briefing paper on corporate governance implications, the Directive presumably supersedes the possibility of justifying blanket restrictions on the grounds of protecting existing shareholder, creditor and employee rights.
- However, CJEU case law is clear that MS are permitted to adopt measures to prevent nationals from evading domestic legislation (*Polbud* at para. 39, citing to *Centros, Inspire Art*).The provisions relating to 'artificial arrangements' allow MS to take account of the effect of the restructuring on the future imposition of regulatory obligations on the company. This is most relevant to future tax obligations and future employee participation obligations. They will supersede the existing case law, which allows MS to justify such measures, replacing it with the procedures set out in the Directive.
- In terms of the existing case law, *Cadbury Schweppes* allows MS to restrict freedom of establishment on a case-by-case basis to prevent the use of EU rights to create 'wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory' (CS, para 55). The MS should establish 'a subjective element consisting in the intention to obtain a tax advantage' and 'objective circumstances showing that… the objective pursued by freedom of establishment [pursuit of genuine economic activity in the host Member State]… has not been achieved' (CS, para 64). In assessing whether there is genuine economic activity, the MS should base their finding on 'objective factors which are ascertainable by third parties with regard, in particular, to the extent to which [the company] physically exists in terms of premises, staff and equipment'. Where the MS concludes that [the company] is 'a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, [the company]… must be regarded as having the characteristics of a wholly

artificial arrangement. That could be so in particular in the case of a 'letterbox' or 'front' subsidiary' (CS, para 67-8)

- The AA procedure for in-depth review is in line with the CJEU *Cadbury Schweppes* case law, namely the requirement of subjective intention and objective lack of genuine economic activity.
- It would arguably also be open to MS to restrict conversions and divisions on the grounds of 'artificial arrangements' where the intention is to evade **future employee participation**. However, there are no cases which establish this (the *Cadbury Schweppes* line of cases is concerned with tax obligations), and it is not clear on the face of the directive.[2]

**Recommendations**

- The Directive should be amended so that the 'artificial arrangements' procedure also applies to cross-border mergers
- The preamble should clarify that the directive is not intended to put downward pressure on national corporate tax rates, undermine national systems of taxation or the viability of mandatory BLER, which is fundamental to many MS systems of corporate governance. It is intended to facilitate freedom of establishment, which presupposes genuine economic activity in the destination MS. Where there is no such genuine economic activity, or where the intention is to reduce tax or evade BLER, MS may rule that the restructuring is an artificial arrangement and block it.
- The preamble should state that the directive sets out the process by which exercises of rights should be evaluated in order to ascertain whether they amount to artificial arrangements, and supersedes the possibility of MS justifying restrictions on freedom of establishment on the grounds of abuse of rights
- The preamble should make it clear that the 'artificial arrangements' procedure is intended to protect the capacity of MS to impose tax and employee participation obligations on companies in the future. Member States should be allowed to block conversions, mergers and divisions where these amount to artificial arrangements entered into by businesses with the intention of undermining national rules relating to tax or employee participation by evading future obligations
- The preamble should state that the directive does not prejudice the rights of MS to impose BLER on companies which are incorporated in another MS but do not conduct genuine economic activity there. [**We need to consider whether this should be included in the main body of the directive and/or offer some definitions of how much activity is required. In this note we have tried to steer clear of the real seat rule debate for the purposes of brevity, but the essence of this suggestion is to allow MS to regulate companies' whose economic and operational centre of gravity is within their jurisdiction]
- The Commission should publish additional guidance or secondary legislation detailing how the various matters listed in the Directive should be weighted by the Member States, and ideally giving examples.

[2] Para 1.4.5 of the Impact Assessment expresses concern that procedure does 'not lead to abuse, including a proliferation of "letter-box" companies for abusive purposes such as for avoiding labour standards or social security payments as well as aggressive tax planning. Therefore, the connection that the converting company's business activity has with the new MS is crucial.' At 1.14.5.2, the IA states that conversion should not be blocked if 'company planning to move to another MS for genuine business reasons.'

- The Directive should guarantee specific third parties (including tax authorities, employee representatives, pension funds) input into in-depth assessments and the right to challenge certification decisions. These matters should not be left to national law.
- A more radical solution would be to revise the directive to state that, where a company moves after it has reached the four fifths threshold for mandatory BLER, then, rather than trigger a negotiation process, it should create a **rebuttable presumption that the intention is to carry out an artificial arrangement intended unduly to prejudice worker rights.** The business should then be required to show a genuine business case for the move before the certificate can be issued. Below the 4/5 threshold, it would still be open to MS to argue that the change of jurisdiction was an artificial arrangement intended to prejudice employee rights. This change would be in addition to retaining the rule requiring negotiation at 4/5 of the threshold, and would give MS the option either to block the restructuring or to allow it to go ahead subject to negotiations on BLER. [**We would appreciate TU feedback on this suggestion]
- Suggested draft clause to add to Art 86n(1):
  'As regards the number of employees, where the company carrying out the conversion has, in the six months prior to the publication of the draft terms of the cross-border conversion as referred to in Article 86d of this Directive, an average number of employees equivalent to four fifths of the applicable threshold, laid down in the law of the departure Member State, which triggers the participation of employees within the meaning of point (k) of Article 2 of Directive 2001/86/EC, the competent authority shall apply a rebuttable presumption that the conversion constitutes an artificial arrangement within the meaning of Article 86c(3). If this presumption is rebutted, the provisions of Art 86l still apply'.
- Suggested draft clause to add to Art 160p(1):
  'As regards the number of employees, where the company carrying out the cross-border division has, in the six months prior to the publication of the draft terms of the cross-border conversion as referred to in Article 86d of this Directive, an average number of employees equivalent to four fifths of the applicable threshold, laid down in the law of the departure Member State, which triggers the participation of employees within the meaning of point (k) of Article 2 of Directive 2001/86/EC, the competent authority shall apply a rebuttable presumption that the conversion constitutes an artificial arrangement within the meaning of Article 86c(3). If this presumption is rebutted, the provisions of Art 160n still apply.'