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Retroactive Effect of Mergers under Luxembourg Tax Law: Is Time Travel Actually Possible?

In this note, the authors discuss the circumstances in which a merger between domestic companies in Luxembourg might be given retroactive effect. To the extent this occurs, operations carried out by the absorbed company during the intervening period may be taken into account, for tax purposes, at the level of the absorbing company. Expenses incurred or losses realized by the absorbed companies may, therefore, be deducted from the taxable profit of the acquiring company.

1. Introduction

Pursuant to the Luxembourg Income Tax Law (LITL),[1] mergers constitute, in principle, tax neutral transactions that should not trigger adverse tax consequences. Nevertheless, a tax impact might apply to mergers in certain circumstances. This would, for instance, be the case where the merger is given retroactive tax effect by deeming the date of the merger to be the effective accounting date of the merger instead of the date of its legal completion. This would allow for operations carried out by the absorbed company during that time frame (i.e., from the effective accounting date of the merger to the date of the merger's legal completion) to be taken into account, for tax purposes, at the level of the absorbing company. In this scenario, expenses incurred or losses realized by the absorbed companies may be deducted from the taxable profit of the acquiring company.

The possibility for a taxpayer to carry forward losses incurred in the course of their business, including in the context of a merger, is strictly regulated under Luxembourg tax law, as confirmed by Luxembourg administrative tribunals and courts. In particular, carry-forwards and the deduction of past losses are limited to the taxpayer who actually incurred the losses, thus preventing the losses from being set off against the profits of, for example, an absorbing company.

It remains, however, unclear whether there is a possibility of transferring, to the absorbing company, the losses incurred by the absorbed company during the period between the effective accounting date and the date of legal completion of the merger. This possibility would only exist to the extent that a retroactive tax effect of such a transaction is accepted.

Since this issue has not been settled by tax law nor by company law (*see* section 2.1.), the possibility of a retroactive merger for tax purposes has been clarified by several decisions of the Luxembourg administrative tribunals and courts (*see* section 2.2.).

Even though, in practice, mergers are more frequently carried out by way of the formation of a new company than a takeover, only the second case is dealt with here, insofar as mergers by way of the formation of a new company have not, to the authors' knowledge, given rise to any tax litigation to date. In the authors' view, however, the following developments should, in principle, be equally applicable to mergers by way of incorporation of a new company. Moreover, this note solely addresses mergers between Luxembourg companies, as cross-border mergers are excluded from the present analysis.

2. Analysis

2.1. The current state of the law

In order to understand how a retroactive tax effect of a merger might be envisaged under Luxembourg tax law, it is necessary to delineate the concepts of "date of legal effect" (*date de prise d'effet*) and "effective accounting date" (*date de prise d'effet comptable*) of a merger.

The term "date of legal effect" is not defined under Luxembourg tax law or under Luxembourg company law[2] (Company Law). The Company Law provides, however, that once the concurring decisions (*decisions concordantes* – as explained further below) within the merging companies have been made, the merger is completed. In turn, parliamentary documents leading to the Company Law explicitly indicate that the date of completion of a merger corresponds to the date of its legal effect. It can, therefore, be assumed that the date on which the concurring decisions are made within the relevant companies is equivalent to the date on which it takes effect between those companies.[2]

The term "concurring decisions" refers to the various formalities the merging companies must comply with in order for the merger to be completed. In practice, these formalities can take three different forms:

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1. LU: Income Tax Law [*Loi modifiée du 4 décembre 1967 concernant l'impôt sur le revenu*].

2. LU: Law of 10 August 1915 on commercial companies, as amended [*Loi modifiée du 10 août 1915 concernant les sociétés commerciales*].

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(i) In principle, such concurring decisions would take the form of an approval by the general meeting(s) of shareholders of the merging companies.

(ii) Since, however, approval of the merger by the general meeting of the acquiring company is not necessary in certain cases expressly provided for by Luxembourg corporate law (subject to specific requirements being satisfied), the concept of "concurring decisions" cannot refer solely to approval by a general meeting of all the merging companies. In this respect, the parliamentary works specify that, whenever a decision within the acquiring company is not required, the term "concurring decisions" shall refer to the moment at which both the date of (i) the common draft terms of the merger (a document mandatorily established between the merging companies, as explained further below) and (ii) the approval of the merger by the general meeting of the acquired company converge. In reality, in such a situation, the merger will only be effective once (i) it has been approved by the general meeting of the absorbed company and (ii) the conditions for not holding a general meeting at the level of the acquiring company, as specified under Company Law, have been met.

(iii) Furthermore, with regard to a "simplified merger", i.e., where the acquiring company holds all the shares of the absorbed company, often, no general meeting is held. The effective date of the merger will then generally be the date indicated by the parties in the common draft terms of merger, which must be set no earlier than one month after the date of publication of said terms in the register of companies and associations (*Recueil électronique des sociétés et associations* – RESA).

Thus, the date of legal effect of a merger and, consequently, the date to be used for the transfer of the assets and liabilities of the absorbed company to the acquiring company is, depending on the case, either (i) the date on which the last of the general meetings of the merging companies approved the merger, or (ii) the date on which (a) the merger was approved by the general meeting of the absorbed company and (b) the conditions allowing for the absence of a general meeting at the level of the acquiring company were satisfied, or (iii) the date indicated in the terms of the merger and fixed at the earliest one month after the date of publication of the latter in the RESA.

While the date of legal effect of the merger only applies to the parties to the merger, third parties shall be bound by the merger upon completion of certain publication formalities, which will not be further analysed herein to the extent that they are not relevant from a tax perspective.

In addition to the date on which the merger takes legal effect, as explicitly determined based on Company Law, Company Law recognizes the possibility for the parties to the merger to determine the date on which the merger takes effect for accounting purposes. Indeed, Company Law provides that the common draft terms of merger, a document that must be drawn up between the merging companies prior to the merger, must include "the date from which the operations of the company being acquired shall be treated for accounting purposes as being carried out on behalf of the acquiring company",[3] notwithstanding any other date of effect of the merger applicable to the parties to the merger or to third parties.

Insofar as the LITL does not provide a rule determining the effective date of a merger, reference should be made to the provisions of Company Law, i.e., the "tax follows accounting" principle, which consists in linking the tax balance sheet to the commercial balance sheet. While the "tax follows accounting" principle, as enshrined in the LITL, initially seemed to be limited to the valuation of assets and liabilities, the Luxembourg administrative tribunal, in a decision of 3 December 2007,[4] extended the principle in order to determine the tax treatment of all transactions carried out by a person, a view widely shared by practitioners.

In light of this principle, it should be noted that the effective accounting date of a merger may, therefore, be different from its effective legal date, the latter being determined by the applicable rules provided for by Company Law. Insofar as no legal provision specifies how the effective accounting date should be determined, some authors consider that the effective accounting date of a merger should necessarily satisfy the "annuality of accounts" principle (pursuant to which commercial accounts must reflect the revenue and expenses of a single financial year), in that the merger cannot (i) be earlier than the start date of the current financial year of a party to the merger, nor (ii) be earlier than the closing date of the last financial year of a party to the merger, whenever the publication of the decisions approving the merger did not take place before the said closing date of the last financial year.

Assuming that the "tax follows accounting" principle remains fully applicable in respect of mergers, an effective accounting date prior to the completion of the merger should logically be possible from a tax point of view. Moreover, in the absence of rules in the LITL and Company Law diverging, there should, a priori, be no reason to make a distinction between the effective accounting and tax dates. The tax administration has traditionally taken the view that it is a third party and, therefore, a retroactive merger is not enforceable against it. This analysis seems to be correct if the tax administration is considered a creditor of the parties involved in a merger, but not necessarily when acting as the taxing authority. As a result, it should be possible to recognize the retroactive effect of a merger not only from an accounting perspective, but also from a tax perspective.

While the reluctance of the tax authorities to recognize retroactive taxation has usually been followed by the administrative tribunals and courts, two recent decisions now seem to admit this possibility, subject to the fulfilment of certain conditions.

3. Id., art. 1021-1 5°.
4. LU: Administrative Tribunal, 3 Dec. 2007, No. 22678.

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2.2. Clarifications from the administrative tribunals and courts

In a decision of 2 June 1999,[5] the administrative tribunal had to rule, for the first time, on the possibility of a retroactive merger for tax purposes. In effect, and in line with the possibility offered by Company Law, the parties to the merger specified, in their merger plan, a date of effect that preceded that of the completion of the merger. In this decision, the judges considered that the rationale of the Company Law provision allowing for a retroactive accounting date of effect was to "set the time reference point for determining the accounting situation of the absorbed company with a view to establishing the exchange ratio and to determine the values at which the assets will be entered in the accounts of the absorbing company".

The judges went on to state that the determination of the date indicated in the common draft terms of the merger cannot result, legally speaking, in the transfer of assets and liabilities from the absorbed company to the absorbing company taking place before such assets and liabilities were effectively transferred. According to the judges, the possibility of a retroactive merger for tax purposes, which would result in the completion of the operations of the absorbed company on behalf of the absorbing company, is only conceivable in the event of a delay in the transfer of assets and liabilities. With this decision, the Administrative Court refused, for the first time, to recognize a retroactive tax mechanism for mergers, perhaps due to the application of the principle of the annuality of tax. In this instance, it was relevant that the retroactive date was prior to the closing of the last financial year.

The same conclusion was reached in several separate cases before the administrative tribunal, wherein the judges considered that the retroactivity of a merger was only possible from an accounting point of view, but not from a tax perspective. In doing so, the judges referred to parliamentary works, marking an improvement in the reasoning behind such decisions compared to the ruling of the administrative tribunal of 2 June 1999.

A decision of the Administrative Court of 28 May 2020,[6] however, confirming a decision of the administrative tribunal of 25 September 2019,[7] seems to open the way to the tax recognition of a retroactive merger.

In the case at hand, the taxpayer had requested that the merger have retroactive tax effect on the basis, inter alia, of the fact that "any discrepancies between the tax and commercial balance sheets could only be inferred from different mandatory tax and commercial rules".[8] The taxpayer noted that no such discrepancy existed with respect to the retroactive effect of mergers. The taxpayer also supported his position by referring to German, French and Belgian tax laws, which Luxembourg tax legislation partly follows. According to the taxpayer, these laws allow for retroactive effect of mergers in tax matters, which is why the application of this principle cannot be ruled out under Luxembourg tax law in the absence of any provision to the contrary.

The Court recalled, however, that an item of income and an expense must be attributed, for tax purposes, to the person who has effectively realized such income or incurred the said expense, a principle necessarily deriving from the LITL. The fact that the allocation of an item of income or expense may be influenced by another taxpayer through certain facts or legal situations (for example, due to a majority shareholding) cannot, however, impact the taxpayer to which such income or expense is attributable.

Based on German doctrine, the Court went on to state that, even if retroactive taxation of a merger were conceivable because of a parallel between the accounting and tax law rules, such retroactivity would only be possible if the transaction corresponded to "the underlying economic reality of the transaction in question",[9] due, inter alia, to the principle of autonomy of tax law.

In the case in question, however, the Court found that the retroactive tax treatment did not correspond to economic reality. Indeed, while the date of legal effect was determined by the Court to be 26 September 2016, the common draft terms of merger between the merging companies provided for an accounting effective date of 1 January 2016. The acquiring company, however, only acquired a majority shareholding (more than 90%) in the acquiring company on 12 August 2016. Therefore, the Court held that the merger could not be backdated (at least for tax purposes) to a date prior to this acquisition, i.e., 12 August 2016, as this would not correspond to the economic reality of the transaction.

Although the government representative (in charge of defending the interests of the Luxembourg tax authorities before the administrative tribunals and courts) sometimes raised the abuse of law argument in the above-mentioned cases, no judge ever took the opportunity to rule on that particular point. This changed with a decision of the administrative tribunal of 28 September 2020,[10] which analysed the abusive character of tax retroactivity in a merger context.

In this case, the taxpayer retroactively applied the accounting and tax date of its merger with another entity to 1 January 2011, whereas the legal effective date of the merger was 30 December 2011. This retroactivity had been approved by the tax authorities in an advance ruling of 7 September 2011, subject to the condition that the retroactive merger would not, ultimately, result in a reduction in the taxpayer's tax base. The key point concerned a value adjustment following a depreciation and a litigation provision recorded in the accounts of the absorbed company at a time between (i) the date of the advance ruling and (ii) the date of legal effect of the merger. As a result of the accounting and tax retroactivity of the merger, these

5. LU: Administrative Tribunal, 2 June 1999, No. 10788.
6. LU: Administrative Court, 28 May 2020, No. 43749C.
7. LU: Administrative Tribunal, 25 Sept. 2019, No. 41147.
8. No. 43749C (28 May 2020).
9. Id.
10. LU: Administrative Tribunal, 28 Sept. 2020, No. 42139.

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expenses were deducted from the taxable profit of the acquiring company. It is worth mentioning that, although the advance tax ruling procedure was not, at that time, enshrined in Luxembourg tax law (contrary to what is the case today), the Luxembourg tax authorities were nevertheless bound by the terms of the ruling, once accepted and subject to the taxpayer meeting certain conditions.

While the tax authorities had approved the tax treatment of the operations contemplated in the advance ruling as at 7 September 2011 and the conditions for the ruling to remain valid had been met, the government representative claimed that any operations occurring thereafter, namely the depreciation and the litigation provision, had not been formally approved, since not disclosed by the taxpayer. Therefore, according to the representative, the transactions effectively carried out departed from the fact pattern described in the request for an advance ruling, resulting in the said advance ruling no longer being binding upon the Luxembourg tax authorities. Further, the tax authorities qualified the operations, so carried out as an abuse of law. The Court, ruling in favour of the taxpayer, took a pragmatic approach, considering that the advance ruling did not extend to the future evolution of the absorbed company's taxable result. It, therefore, considered that the description of the facts in the advance ruling request was not incomplete, and that the ruling was thus binding on the tax authorities, before dismissing the abuse of law argument.

In terms of tax fairness, this decision is entirely correct; in the absence of tax retroactivity, losses arising from the provisions of the absorbed company would not have been transferred to the absorbing company, whereas the reversals of provisions would potentially have been taxed at its level.

Unlike in previous cases, however, the tribunal did not analyse whether retroactivity of a merger, for tax purposes, was possible, to the extent that such an analysis had already been performed and validated by the tax authorities in the advance ruling. It seems, however, that if the tribunal had not agreed with the principle of a retroactive merger, the advance ruling would probably have been dismissed.

3. Conclusion

In light of the above, it would seem that a merger may be retroactive for tax purposes, provided that (i) the effective date for tax purposes is in line with economic reality, i.e. it cannot, in any event, precede the date on which the acquiring company acquired a participation enabling it to influence the course of the business of the acquired company, and (ii) the effective accounting date is determined in compliance with the principle of annuality of the merging companies' accounts.

Care must be taken, however, not to fall within the scope of the abuse of law doctrine, insofar as the effects of a retroactive merger, from a tax point of view, could, in certain respects, resemble the effects of a reverse merger, which can be considered abusive if its purpose is, inter alia, to circumvent the principle that tax losses are not transferable. In this case, any retroactive merger, the main effect of which is to offset the profit of one merging company against the losses of another merging company, without any other valid economic motivation, would a priori risk attracting the attention of the tax authorities.

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