

Restructures of Companies in Swedish Income Tax Law – What is a Branch of Activity?

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This article deals with the interpretation of the concept *branch of activity*. This concept is of significant importance for tax relief by the two methods of restructuring a company called *transfer of assets* (Sw: *verksamhetsavyttring*) and *under-price transaction* (Sw: *underprisöverlåtelse*). The ECJ has in a recent case defined the concept *branch of activity* relating to the EC harmonised transfers of assets. The main question in this article is whether the EC case law on transfers of assets has to be applied to the national phenomenon under-price transactions. The conclusion of the article is that it probably has to, not due to EC Law but because of the principles of interpretation in national law as well as the principle of equal treatment in the Swedish Constitution.

1 Introduction

In Swedish income tax law concerning restructures of companies, the concept *branch of activity* (Sw: *verksamhetsgren*), sometimes also called a part of a business, is of great importance. There are two main methods to transfer a branch of activity to another party without triggering any tax. One method is a so-called *under-price transaction* (Sw: *underprisöverlåtelse*)¹ and the other method is a *transfer of assets* (Sw: *verksamhetsavyttring*) according to the European Merger Directive.²

The concept *branch of activity* is defined in Chapter 2 § 25 of the Swedish Income Tax Code³ (hereafter: SITC). Accordingly, a branch of activity shall

¹ In English, an *under-price transaction* is often called a transfer of assets for a consideration under the fair market value. Since I come back to this restructure method several times in this article, I have chosen to use the term under-price transaction, which might be less common but which is much shorter.

² Directive 90/434/EEC.

³ Sw: *Inkomstskattelagen* (1999:1229).

mean such a part of a business that is feasible to separate into an independent business. The definition in Chapter 2 § 25 SITC is used both for under-price transactions and for transfers of assets. However, as the provisions regarding *transfer of assets* derive from the European Merger Directive, the concept *branch of activity* in Chapter 2 § 25 SITC in this sense has to be interpreted and applied in accordance with Community Law. The provisions about under-price transactions are national, without EC Law implications. One important question in this article is therefore if the concept *branch of activity* in Chapter 2 § 25 SITC may be interpreted and applied in one – EC Law conforming – way regarding transfers of assets and in another way concerning under-price transactions. This question appears relevant, since the concept *branch of activity* in the sense of under-price transactions has been discussed and to some extent clarified in different Swedish legal sources. This is not the case with the same concept regarding transfers of assets, which, on the other hand, has been clarified by the European Court of Justice (ECJ).

In a transfer of assets a company transfers without being dissolved all or one or more branches of its activity to another company in exchange for the transfer of securities representing the capital of the company receiving the transfer.⁴ The result of a transfer of assets is so-called *double continuity*, which means that the acquisition value of the shares will be equal to the tax basis of the assets.⁵

An under-price transaction means an operation when assets or shares are sold for a consideration lower than fair market value.⁶ Normally, such a transaction is taxed as if it were carried out for fair market value.⁷ If certain conditions are met, e.g. a branch of activity is transferred, the transaction is tax-free and the acquisition value of the assets or shares will be equal to the tax basis of the vendor.⁸ The result of an under-price transaction is therefore *ordinary continuity*. For obvious reasons, under-price transactions are only carried out between related parties.⁹

This article is arranged as follows. First, in section 2, the concept *branch of activity* in the Merger Directive is analysed. After that, in section 3, the concept in Swedish income tax law is dealt with. In section 4 the influence of EC Law on the concept in Swedish income tax law is discussed. Finally, in section 5, I give some concluding remarks.

⁴ Article 2.c of the Merger Directive. *See also* Chapter 38 SITC.

⁵ *See* Alhager, Eleonor och Magnus, *Omstruktureringar och moms*, Stockholm 2002 at 141.

⁶ *See* Chapter 23 SITC.

⁷ *See* Chapter 22 SITC.

⁸ *See* Chapter 23 SITC.

⁹ Nobody wants to sell assets or shares for a consideration under fair market value to an independent party.

2 Branch of Activity in the Merger Directive

In the Merger Directive the concept *branch of activity*, which is used for transfers of assets,¹⁰ is defined in Article 2.i. Accordingly, a branch of activity shall mean 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 ECJ has dealt with the concept *branch of activity* in one judgment, C-43/00 *Andersen og Jensen*.¹¹ The judgment, which was a preliminary ruling under Article 234 EC, dealt with the passing of a business to the next generation.¹² In the restructure the owners of the original company, Randers Sport A/S, set up a new company, Randers Sport Nyt A/S.¹³ The business of Randers Sport A/S was to be transferred to Randers Sport Nyt A/S.¹⁴ Before the restructure, Randers Sport A/S took out a loan of DKK 10 million.¹⁵ The 10 million were supposed to remain in Randers Sport A/S, whilst the obligation arising from the loan was to be transferred to Randers Sport Nyt A/S.¹⁶ The cash-flow requirements of Randers Sport Nyt A/S would be covered by a line of credit granted by a financial institution.¹⁷ To grant the credit, the financial institution required all the shares representing the capital of Randers Sport Nyt A/S as a security.¹⁸ Randers Sport A/S would also keep a small number of shares in a third company.¹⁹ The main question in the preliminary ruling was whether all or one or more branches of activity in accordance with Article 2.c and 2.i of the Merger Directive could be considered to be transferred from the vendor to the acquirer.²⁰

The ECJ stated that a transfer of assets must encompass all the assets and liabilities relating to a branch of activity.²¹ Only an entity capable of functioning by its own means could constitute such a branch of activity.²² When the transferring company retained the proceeds of a large loan, and transferred the obligations deriving from the loan, all the assets and liabilities could not be considered to have been transferred.²³ On the other hand, the fact that the transferring company retained a small number of shares only excluded that all

¹⁰ Article 2.c of the Merger Directive.

¹¹ C-43/00 *Andersen og Jensen ApS v Skatteministeriet*. Judgement of the Court 15 January 2002.

¹² C-43/00 para. 8.

¹³ C-43/00 para. 8.

¹⁴ C-43/00 para. 8.

¹⁵ C-43/00 para. 8.

¹⁶ C-43/00 para. 8.

¹⁷ C-43/00 para. 8.

¹⁸ C-43/00 para. 8.

¹⁹ C-43/00 para. 8.

²⁰ See C-43/00 para. 20.

²¹ C-43/00 para. 24.

²² C-43/00 para. 24.

²³ C-43/00 para. 25 and 27.

the business had been transferred.²⁴ It could not exclude a transfer of a branch of activity unrelated to the shares.²⁵

As mentioned above, the cash flow requirements of Randers Sport Nyt A/S would be covered by a line of credit granted by a financial institution. One question was therefore, if Randers Sport Nyt A/S could be considered to carry out an independent business, that is to say, an entity *capable of functioning by its own means*.²⁶ The ECJ stated:

“It 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 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. The fact that a company receiving a transfer takes out a bank loan under normal market conditions cannot in itself mean that the transferred business is not independent, even where the loan is guaranteed by shareholders of the receiving company who provide their shares in that company as security for the loan granted. [...] That position may, however, be *different* where the financial situation of the receiving company, as a whole, makes inevitable the conclusion that it *will very probably not be able to survive by its own means*. That may be the case where the income of the company receiving the transfer does not appear sufficient to cover the payments of principal and interest due in respect of debts.”²⁷

The most important conclusions that may be drawn from case C-43/00, *Andersen og Jensen*, are, in my opinion, the following.

1. If all the business of a company is to be transferred, all the assets must be transferred.
2. The acquirer is not allowed to keep any assets of the branch of activity that is transferred – not even cash.
3. Whether a business will be deemed as *independent* must primarily be assessed from a functional point of view.
4. A business is independent when it can function by its own means, without additional investments or transfers of assets.
5. The functional assessment regards the transferred business as such, not the situation of the vendor or acquirer before the transaction.
6. Secondly, the independence of a business might be assessed from a financial point of view.
7. If the receiving company very probably will not be able to survive by its own means the financial situation might indicate a lack of independence.
8. A receiving company may not be able to survive by its own means when its income does not appear sufficient to cover the payments of principal and interest due in respect of debts.

²⁴ C-43/00 para. 28.

²⁵ C-43/00 para. 28.

²⁶ C-43/00 para. 30.

²⁷ C-43/00 para. 35-36 (my italics).

More generally it may be concluded that the case C-43/00, *Andersen og Jensen*, is very illuminating regarding the concept *branch of activity* in the Merger Directive. Before this judgment, EC Income Tax Law was silent regarding this concept. Since this judgment, the concept is, in my opinion, much easier to apply.

3 Branch of Activity in SITC

As mentioned above in the introduction, a branch of activity in SITC means such a part of a business that is feasible to separate into an independent business. There are very few cases on the concept *branch of activity* and there is only one case from the Supreme Administrative Court, RÅ 2000 not. 87. This judgement dealt with the concept in the context of under-price transactions. In the case a school was to be divided into two separate units. The restructure was to be carried out by forming a new company (NewCo) and thereafter transferring some assets and activities into the NewCo in an under-price transaction. The activities of the two units were carried out in geographically separated entities. The pupils and the staff were also transferred into the NewCo. One conclusion that might be drawn from the case is that a branch of activity might be a business carried out in separate localities. The business may, and in my opinion probably has to, include important staff and clients.

In Swedish VAT Law, a transfer of a business or a part of a business could be exempted from VAT. The concept business or part of a business has been defined in the judgment RÅ 2001 not. 99. A *business* is deemed to have been transferred when a going concern has been transferred. A *part of a business* shall, due to the same judgment, mean an asset or an aggregate of assets that is capable of functioning as a separate entity and to realise a specific business purpose.²⁸

In Sweden, preparatory works (*travaux préparatoires*) are considered to be a very important source of law.²⁹ In the government bill of the reform of the tax provisions in the field of restructures of companies,³⁰ the concept of *branch of activity* is discussed. For example, a branch of activity may consist of one ship, when the legal entity owns many ships.³¹ Furthermore, a building could, under certain provisions, form a branch of activity.³² As in the above mentioned case from the Supreme Administrative Court, RÅ 2000 not. 87, the preparatory works

²⁸ See also Alhager, Eleonor, *Mervärdesskatt vid omstruktureringar*, Uppsala 2001 at 527-532 (Summary in English regarding VAT and restructures of companies).

²⁹ See C-478/99 *Commission of the European Communities v Kingdom of Sweden*, judgement of the court 7 May 2002 para. 14. The ECJ stated: "According to a legal tradition well established in Sweden and common to the Nordic countries, the preparatory works is an important aid to interpreting legislation". Consequently, the ECJ accepted an implementation performed in the preparatory works.

³⁰ Prop 1998/99:15 *Omstrukturering och beskattning*.

³¹ Prop 1998/99:15 at 137.

³² Prop 1998/99:15 at 137.

tend to emphasise geographical factors. However, it should be underlined that a ship or a building does not automatically, by itself, constitute a branch of activity. The business activities also have to be transferred.

In Swedish tax literature; the general opinion seems to be that the branch of activity should be deemed at the *acquirer*.³³ In the literature, this is considered as a change made in the above mentioned restructure tax reform of 1999. In previous case law, the transfer of a branch of activity should be deemed at the transferor.³⁴

In my opinion, the discussion in the literature does not seem to be in line with the above mentioned case C-43/00 *Andersen og Jensen*. In that case, the ECJ emphasises the *function* of the transferred assets. Consequently, the assets transferred *must be able* to operate as an independent undertaking.³⁵ This means, in my opinion, that the branch of activity *itself* must have some particular characteristics. How the assets are actually used by the vendor or by the acquirer seems to be of secondary interest.

4 The Influence of EC Law on the Concept Branch of Activity

The influence of EC Law on the concept *branch of activity* on *transfers of assets* according to the Merger Directive and its implementation in SITC is obvious. Swedish law has to be interpreted in line with EC Law (so-called *indirect effect*).³⁶ Furthermore, the concept of *branch of activity* may have *direct effect*, which means that EC Law shall be applied instead of national law if national law conflicts with EC Law.³⁷

More complicated is the influence of EC Law on the concept *branch of activity* on *under-price transactions*, since these are not EC harmonised, but a completely national phenomenon. The complicating factor is that the definition of *branch of activity* is placed in the same provision, namely Chapter 2 § 25 SITC, for both transfers of assets and under-price transactions. Would it be possible to interpret Chapter 2 § 25 differently in the context of transfers of assets than for under-price transactions? Or are Swedish courts obliged to apply the definition of *branch of activity* in C-43/00 *Andersen og Jensen* on the totally national concept under-price transactions?

In my opinion, it is clear that EC Law does not demand that Chapter 2 § 25 SITC is interpreted in line with EC Law and EC Case Law when it comes to under-price transactions. However, the ECJ is probably competent to give a preliminary ruling on the interpretation of Chapter 2 § 25 SITC, not only regarding transfers of assets but also concerning under-price transactions, even

³³ Nilsson, Peter, Rydin, Urban, *Omstrukturering av enskild näringsverksamhet*, Skattenytt 1999 at 481-482 and Silfverberg, Christer, *Benefika överföringar av företagsförmögenhet*, Skattenytt 1999 at 513.

³⁴ RÅ 1976:6 and RÅ 1992 not 242. See Nilsson/Rydin 1999 at 482.

³⁵ C-43/00 para. 35.

³⁶ See Ståhl, Kristina, Österman, Roger P, *EG-skatterätt*, Uppsala 2000 at 34-37.

³⁷ See for example 8/81 *Ursula Becker v Finanzamt Münster-Innenstadt*, ECR 1982 at 53. See also Ståhl/Österman 2000 at 32-34.

though an under-price transaction concerns an un-harmonised field of law. In the case C-28/95, *Leur-Bloem*, the ECJ stated that it is competent, and almost always obliged, to give preliminary rulings regarding the interpretation of EC provisions.³⁸ Furthermore, the ECJ held that it has jurisdiction to render preliminary rulings on questions concerning EC provisions, even in situations where the facts of the cases are outside the scope of EC Law.³⁹

Due to the preparatory works, the list of definitions and explanations in Chapter 2 SITC should be applied generally, if nothing else is stated elsewhere in SITC.⁴⁰ Accordingly, the basic idea behind the list in Chapter 2 SITC is to find general definitions, which should be applied uniformly. It would therefore be contrary to the basic idea behind the preparatory works to interpret and apply the concept *branch of activity* in one way for transfers of assets and in another way for under-price transactions. As the preparatory works are such an important source of law, normally the courts would follow the preparatory works. If Chapter 2 § 25 SITC should be interpreted in the same way for transfers of assets as for under-price transactions, the Swedish courts would have to interpret the provision according to C-43/00, *Andersen og Jensen*. Otherwise, the courts would not be able to withhold the idea of the generality of the list and at the same time fulfil the requirements of EC Law.

Another interesting question is whether the Swedish constitution allows the courts to interpret and apply one provision, in this case Chapter 2 § 2 SITC, differently. Are the courts *allowed* to interpret and apply the concept *branch of activity* according to C-43/00, *Andersen og Jensen*, for transfers of assets and in another way for under-price transactions? The Swedish Constitution states:

Courts of law, administrative authorities and others performing tasks within the public administration shall have regard in their work to the equality of all persons before the law and shall observe objectivity and impartiality.⁴¹

The demand of equality of all persons before the law in the Constitution is sometimes called the *principle of equal treatment*.⁴² The provision also contains the so-called *principle of objectivity*, which means that the courts and the administrative authorities shall observe objectivity and impartiality.⁴³

One way to deal with the problem would be to consider a different application and interpretation of Chapter 2 § 25 SITC as contrary to the principles of equality and objectivity. All taxable persons are indeed not treated in the same way, when the concept *branch of activity* is interpreted according to C-43/00, *Andersen og Jensen*, in some cases but not in others.

³⁸ C-28/95 A. *Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2*, ECR 1997 at I- 4161 para. 25.

³⁹ C-28/95 para. 27.

⁴⁰ SOU 1997:2 Part II, *Inkomstskattelag* para. 15-16.

⁴¹ Chapter 1 § 9 of the Swedish constitution (*Regeringsformen*) (1974:152).

⁴² See Pålsson, Robert, *Riksskatteverkets rekommendationer. Allmänna råd och uttalanden på skatteområdet*, Uppsala 1995 at 136-138.

⁴³ Pålsson 1995 at 136-138.

Another way to deal with the problem would be to find that a taxable person, who carries out a transfer of assets, is not in a comparable situation with a taxable person, who performs an under-price transaction. Under that view, the different treatment would be justified, since it is fair to treat people and companies that are in different situations differently. It may even be wrong to treat them in the same way.

In my opinion, it is justified to treat taxable persons differently, depending on whether they carry out a transfer of assets or an under-price transaction. This is also the case regarding one definition of a *branch of activity*. Due to Chapter 23 § 7 SITC a block of shares may be deemed to be a branch of activity. However, in this case, the legislators have chosen a different definition of the concept that is used exclusively for under-price transactions.

When the legislators have chosen to define the concept *branch of activity* in one and the same provision, in my opinion, the situation is different. In that case the legislators explicitly have chosen an equal treatment. Therefore, there is, in my opinion, much to suggest that different applications and interpretations of the courts would be contrary to the principle of equal treatment. Consequently, the concept *branch of activity* probably has to be interpreted and applied according to C-43/00, *Andersen og Jensen*, if the requirements of EC Law as well as the Swedish Constitution shall be fulfilled.

When a common definition of the concept *branch of activity* was placed in Chapter 2 § 25 SITC, the scope of EC Law expanded. This was not due to demands from the EU, but to the requirements of national law. The courts may probably even ask for a preliminary ruling from the ECJ regarding an under-price transaction. For the tax payers, a preliminary ruling does not always have positive effects, since a preliminary ruling delays the legal procedure and the final judgment for several years. In my opinion, the consequences of general definitions appear difficult to foresee. This is especially the case when concepts from EC harmonised fields of law are defined in the same way and provision as concepts from non-harmonised areas.

5 Concluding Remarks

In this article, the concept *branch of activity* has been analysed. The concept is of significant importance for tax treatment of restructures of companies, since the tax relief for transfers of assets as well as under-price transactions often depends on this concept.

The restructure method *transfer of assets* is EC harmonised in the Merger Directive. Consequently, the Merger Directive as well as the case law of the ECJ is of significant importance for the interpretation of the concept *branch of activity* in this case. Until recently, there has not been any case law on the concept *branch of activity* and indeed only one case on the Merger Directive.⁴⁴ However, in the case C-43/00, *Andersen og Jensen*, the ECJ discussed the concept in detail. One main conclusion of the case is that the definition of a branch of activity should be carried out with a functional approach.

⁴⁴ C-28/95, *Leur-Bloem*.

The restructure method *under-price transaction* is a completely Swedish phenomenon. There is not much Swedish case law on the concept *branch of activity*, but the only judgment from the Supreme Administrative Court dealt with an under-price transaction. Also the older case law concerns under-price transactions, as well as most of the discussions in the preparatory works and in the tax literature.

In this article, I have discussed the question whether the definition of a branch of activity in the case C-43/00, *Andersen og Jensen*, not only has implications for the EC harmonised transfers of assets but also for the national under-price transactions. I have found out that the preparatory works presuppose that the definitions in Chapter 2 § 25 SITC are interpreted and applied uniformly, as long as nothing else is stated in other provisions of SITC. Since the concept *branch of activity* has to be interpreted according to C-43/00, *Andersen og Jensen*, when it comes to transfers of assets, the only way to achieve a uniform interpretation appears to be to apply the EC case law on under-price transactions. I have also found, that it appears contrary to the principle of equal treatment and the principle of objectivity in the Swedish Constitution to apply and interpret one and the same provision – Chapter 2 § 2 SITC, differently when deciding whether a branch of activity has been transferred or not.

My conclusion is that the case C-43/00, *Andersen og Jensen*, is very important for the interpretation of the concept *branch of activity*. This is not only the case concerning transfers of assets but also regarding under-price transactions.