FRENCH
CORPORATION TAX REVIEW

Domestic Tax Law

The retroactivity of French tax law
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Environmental Taxation

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EDITORIAL

The "*Revue de Fiscalité de l'entreprise*" was created in 2011. Its initial purpose was the publication of an annual review of legal scholarship made up of articles in French relating to French tax subjects written by the students of the Master of Corporate Taxation ("*Master de Fiscalité de l'entreprise*", known as "Master 221") of the Paris Dauphine University. The Master, since its creation in 1981, has continually been ranked as one of the top post-graduate degree tax programs in France and Europe and provides students with a high-quality training thanks to the association of both academics and professionals in the teaching team. Our alumni include some of the most renowned tax experts in France, whether they now are tax attorneys or tax directors.

As part of our commitment to continue improving and maintaining the quality of our program, and to open up internationally, after the first four issues in French, we have decided to innovate by publishing, as of this year, the Review in English. The globalization and its impacts on corporate tax issues naturally demands such an evolution. An ever increasing proportion of our students are willing to work abroad and complete their internship abroad. Those who contemplate working in France – still a vast majority - will be hired by major law firms and multinational companies, where their work will be mostly in English. In this context, in addition to the increase of the number of classes given in English in the Master, the idea was conceived to publish the Review in full English version.

This exercise aims at giving our students the opportunity to develop their writing skills in English on technical tax issues. But the Review has another goal: the subject matters of the articles reflect the most recent significant trends in French corporate tax law, whether these changes proceed from new legislations or recent case law. In this sense, the Review also aims at being an actual research tool for both tax specialists and tax students from around the world who may have an interest in the latest evolutions of French tax law.

The articles have been submitted to the Editorial Advisory Board of the Review, composed of the Directors of the Master and of lawyers of the French law firm STCPARTNERS, a member of the Andersen Tax network, our partner. If the choice of the subject matters and the substance of each article have been validated by the Board, it is important to note that each article is signed only by the students, and that the opinions and ideas, form, tone and style are theirs only: we wanted the Review to be *their* Review. Writing these articles was a real challenge for them: in addition to the difficulty for students at the dawn of their professional career to synthetically present complex technical issues and comment on them, the exercise was made in a language which, for most of them, is not their mother tongue. In completing this work, the students made their best efforts to rise to a professional level and comply with the standards of quality and excellence which will be required from them in the exercise of their future profession. They can be proud of what they have achieved.

Hoping you will enjoy reading this brand new issue, we wish a long life to the "French corporation tax Review"!

Thibaut Massart & Emmanuel Dinh,
Editors-in-Chief
Directors of the Master of Corporate Taxation (Master 221), Paris Dauphine University

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TABLE OF CONTENTS

DOMESTIC TAX LAW

The retroactivity of French tax law
by Clément GALMICHE & Douglas KARAASLAN P. 4

How to avoid the limitation rule regarding deduction of interest expenses related to the acquisition of equity shares?
by Marine CALLA & Sasa RAIC P. 9

Management packages: learning from the Gaillochet case
by Johana CHEBAR & Baptiste GACHET P. 14

The research tax credit: topicality and perspectives
by Victor COSSEC & Camille PONS P. 19

INTERNATIONAL TAX LAW

A comparison of the international interpretation of the principle of "*non-aggravation*"
by Francis MAC GOWAN & Charlotte SIGNOL P. 26

Tax consolidation : from Papillon to the horizontal
by Pauline DELAFLOTTE & Laura DRIANCOURT P. 32

Anti-hybrids provisions : back on the French mechanism in early 2015
by Mina BOUHARCHICH & Nicolas DRAGUTINI P. 38

Towards the unification of the French tax treatment applicable to capital gains on real estate realized by non-French residents
by Marianne FIARD & Guillaume WULFOWICZ P. 44

The amendment to the Franco-Luxembourg Convention on capital gains resulting from the sale of shares of property investment in predominantly real estate assets company
by Pauline BARBIER & Soraya BENESSAM P. 50

GREEN TAX

French government adopts the new transition energy tax credit
by Manon de VATTEVILLE and Alexandre CHAGNEAU P. 54

THE RETROACTIVITY OF FRENCH TAX LAW

Clément GALMICHE & Douglas KARAASLAN

Limitation of retroactive tax laws has been subject to recent developments. The « Taxpayer Charter » of 1 December 2014 has little impact. However, 5 December 2014 decision of the French Constitutional Court strengthens the limitation of retroactive laws by protecting taxpayers' legitimate expectations.

1. Retroactive laws can be defined as laws taking effect from a particular date in the past rather than from the present date. As far as tax law is concerned, there are two types of retroactive laws: retroactive tax laws and what could be called retrospective tax laws (or "little retroactivity")[1]. The first are laws that apply to taxable event that occurred prior to them entering into force. The retrospective effect of the second is due to the fact that annual Finance Act applies to on-going fiscal years. Indeed, the taxable event of individual income tax is 31st December of each year and that of corporate income tax is the end of the fiscal year, which is often 31st December. As a consequence, annual Finance Act, which is adopted in the end of the year, enters into force before the taxable event (thus it is not really retroactive) and applies to incomes earned during the year preceding this law. Therefore the taxpayer could not foresee how the income that he/she earned would be taxed.

These two types of retroactive tax laws are concerned by recent case law developments.

However, the degree of limitation of each type of retroactive effect differs. Indeed, retroactive effect of tax laws is strictly limited and recent developments strengthen the protection of taxpayers (I). Retrospective laws have been admitted for a long time and recent limitations set by case law are limited to exceptional situations (II).

I - The strict limitation of retroactive tax laws.

2. Retroactive effect of tax laws has been controlled and limited by the European Court of Human Rights, the French Constitutional Court, and lower jurisdictions applying the Convention for the Protection of Human Rights and Fundamental Freedoms. However, the Constitutional Court did not apply the European notion of « legitimate expectations ». The decisions of 19 December 2013[2] and 5 December 2014[3] protect the effects that could be legitimately expected by taxpayers.

A. The progressive limitation of the retroactive effect of tax laws.

3. In 1986, the French Constitutional Court set two limits to the retroactive effect of tax laws: repressive tax laws must not be retroactive and the force of *res judicata* must be respected[4]. In its 1995 decision, it reminded that the prohibition of retroactive tax laws has constitutional value, in application of article 8 of the Declaration of the Rights of Man and of the Citizen, only in repressive matters. It specifies that the legislator can adopt retroactive tax laws if constitutional requirements remain protected by legal guaranties[5]. Three years later, the Constitutional Court adds a condition to the constitutionality of a retroactive tax law: it

1 O. Fouquet, La rétroactivité des lois fiscales : Rev. Adm. 1994, n°3-4, p.140 et s.

2 French Constitutional Court, Dec. 19th, 2013, 2013-682 DC : A. Marionneau, L'introduction de la notion d'espérance légitime en droit fiscal, *Dr. fisc.* 2014, n° 47, 631.

3 French Constitutional Court, Dec. 5th, 2014, 2014-435 QPC.

4 French Constitutional Court, Dec. 29th, 1986, 86-223 DC.

5 French Constitutional Court, Dec. 29th, 2005, 2005-531 DC.

must be justified by a « sufficient ground of general interest »[6]. It must be noted that a financial ground does not constitute a sufficient ground of general interest[7].

4. The possibility of controlling the constitutionality of laws after they entered into force, given to the Constitutional Court in 2008, through the "priority preliminary ruling on constitutionality" mechanism, enhanced a faster development of constitutional case law on that matter[8]. However, it also led to the creation of the constitutional objective of the fight against tax fraud and evasion, which can justify retroactive tax laws[9].

5. The European Court of Human Rights (ECHR) also plays an important role in the limitation of retroactive tax laws. Article 6§1 of the European Convention for the Protection of Human Rights and Fundamental Freedoms may apply. However, the scope of this article is restricted to repressive matters. ECHR case law about retroactive tax laws is built on Article 1 of the first Protocol to the Convention. ECHR 23 July 2009 judgement is a good example of its case law[10]. Its reasoning is threefold. Firstly, the Court has to determine whether there is a property under above-mentioned Article 1. Such property can be tangible, but also the legitimate expectation to obtain the payment of a receivable[11]. It can be noticed that the ECHR bases its control on a concept that the French Constitutional Court refused to apply. Secondly, it examines whether the State interfered or not in the exercise of the rights protected by the Convention. Then, it has to determine whether or not a public interest ground justifies such interference, which is close to the identification of the general interest. A financial interest is not sufficient to justify a retroactive tax law aimed at circumventing the effects of a judgement that declares a law, a decree or a regulation invalid.

6. The French supreme administrative court, the Council of State, has a similar reasoning. In the Getecom case[12], it held that a debt owed by the tax administration to the taxpayer might give rise to a legitimate expectation to obtain a good. It also reminds that the loss of tax revenues does not constitute a general interest that may justify a violation of the protection of property provided by Article 1 of the first Protocol.

7. Despite the above mentioned case law of other courts on legitimate expectation, the French Constitutional Court refused for a long time to use this concept in its control of the constitutionality of retroactive tax laws[13].

B. Towards a protection of the « legitimate expectations » of taxpayers

8. The French Constitutional Court started protecting, not only « legally consolidated situations » but also « the effects that could legitimately be expected from such situations » in a case concerning social security contributions – and not tax law[14].

9. In its 5 December 2014 decision[15], it applies this reasoning for the first time to tax laws. It sets conditions to the constitutionality of the Finance Act for 2012[16], which creates the exceptional

6 French Constitutional Court, Dec. 18th 1998, 98-404 DC.
7 French Constitutional Court, Dec. 18th, 1998, 98-404 DC.
8 French Constitutional Court, Dec. 10th, 2010, 2010-78 QPC: Sté Imnoma.
9 French Constitutional Court, Sept. 23th,2011, 2011-166 QPC.
10 ECHR, July 23rd, 2009, 30345/05, Joubert v. France.
11 ECHR, Apr. 16th, 2002, 36677/97, Dangeville v. France.
12 CE, 8e et 3e ss-sect., Nov. 19th, 2008, 292948, Sté Gétécom : *Dr. fisc.* 2009, n° 6 comm. 179, concl. N. Escaut, note P. Fumenier ; RJF 2/2009, n° 186 ; BDCF 2/2009, n° 25, concl. N. Escaut.
13 French Constitutional Court, Dec 30th, 1996, 96-385 DC : Loi de finances pour 1997 : RJC 1996, I, p. 691 ; AJDA 1997, p. 161, chron. O. Schrameck ; RTD civ. 1997, p. 412, obs. J. Hauser, and p. 416, obs. J. Mestre
14 French Constitutional Court., Dec. 19th, 2013, 2013-682 DC.
15 French Constitutional Court, Dec. 5th, 2014, 2014-435 QPC.
16 Dec. 28th, 2011 Act, 2011-1977.

tax on high income. This new tax is based on the reference income of the taxpayer. It includes, in addition to incomes subject to progressive income tax, incomes that are subject to a flat withholding tax. At this date, such incomes were exempt from any additional taxation under the progressive scale of income tax.

10. This decision can be compared to the decision of 29 December 2012[17], which related to the abolition of the discharging effect of withholding tax paid on certain types of income. In this decision, the Constitutional Court held, concerning withholding tax paid in 2012, that a sufficient ground of general interest did not justify the retroactive effect of this abolition. The French legislator could not retroactively abolish this discharging effect of the withholding tax. However, the issue was different in the 2014 decision. Indeed, law provisions related to the exceptional tax on high income did not impact the exempting effect of the withholding tax: incomes that gave rise to such withholding tax were not subject to any additional taxation under the progressive scale of income tax, but they were subject to a new tax that was not created by the Parliament at the moment of the payment of the withholding tax[18].

11. However, the French Constitutional Court held that taxpayers could legitimately expect from the application of this withholding tax to be exempt from any additional tax related to these income, except for existing taxes. Taxpayers knew that opting for a withholding tax discharging from additional income tax did not exonerate them from any other existing taxes (e.g. Social security contributions). Nevertheless, they could not anticipate the creation of the exceptional tax on high income[19].

12. As a result, the French Constitutional Court held that « in applying this new tax to incomes that had been subject to the discharging withholding tax, the legislator challenged the effects that could be legitimately expected by taxpayers from the application of such discharging withholding tax ».

13. This decision undoubtedly contributes to strengthen the protection of the taxpayer against the effects of retroactive tax laws. An author points out that the sanction of such subjective retroactive tax laws (*i.e.* relating to the taxpayer's expectations) is a remarkable improvement, which may lead taxpayers and their lawyers to launch more claims, using the possibility of questioning the constitutionality of laws after they entered into force[20].

14. However, the fact that the French Constitutional Court refuses to characterize the concept of « legitimate expectations » as a principle, using a circumlocution, and the ambiguity of this concept[21], give rise to further questions relating to the future developments of case law in that matter.

15. Contrary to retroactive tax laws, case law related to retrospective laws is sparse and provides the taxpayer with a weaker protection.

II - Retrospective effect of tax law in the gun sight

16. The Amended Finance Act and the Finance Act for year N + 1 are adopted in theory between 28 and 30 December of year N and apply to all income received since 1 January of year N[22]. At first sight, such a situation could be viewed as having a retroactive effect but in actual fact, it has to be put into perspective with the event giving rise to taxation. Indeed, the taxable event occurs on December 31 of the calendar year for the individual income tax and at the closing of the fiscal year (most generally on December 31) for corporate income tax. Strictly speaking, such a situation characterizes a retrospective effect and not a retroactive effect, as the provisions come into force before the occurrence

17 French Constitutional Court, Dec 29th, 2012, 2012-662 DC: Finance Act for 2013.
18 Commentaire au cahier du Conseil constitutionnel, Dec 5th, 2014 decision, M. Jean-François V.
19 Commentaire au cahier du Conseil constitutionnel, Dec 5th, 2014 decision, M. Jean-François V.
20 A. Marionneau, L'introduction de la notion d'espérance légitime en droit fiscal, *Dr. fisc.* 2014, n° 47, 631.
21 A. Marionneau, L'introduction de la notion d'espérance légitime en droit fiscal, *Dr. fisc.* 2014, n° 47, 631.
22 Décret 48-1986, Dec. 9th, 1948: Journal Officiel Jan 1st 1949 et s.
Before this "décret" was introduced, the law that entered into force on January 1st N applied to income earned in N.

of the taxable event. By definition a retrospective tax law is a law which repeals a tax benefit arising from a previously established position under the influence of the former law. This is what Olivier Fouquet, a member of the State Council, called «little retroactivity» in 1994[23]. The game rules are subject to change while the game is taking place[24].

Based on this premise, the French Constitutional Court considered that the "little retroactivity" was compliant with the French Constitution, denying any assimilation to the so-called «full retroactivity». But the need for legal certainty the taxpayer is entitled to has led to alter this position either through the recent jurisprudence or political declarations of intent.

A. The constitutionality of the «little retroactivity»

17. Section 34 of the French Constitution of 4 October 1958 provides that «the law sets the rules concerning: the base and the rates of taxes of all kinds» and that «finance acts determine the resources and expenses of State under the conditions and with the reservations provided by an organic law «. Neither principle nor constitutional rule is opposed to the «little retroactivity of tax law[25], the principle being that the legislation cannot deprive the taxpayer of legal guarantees of the constitutional requirements[26]. This principle has been repeatedly applied through "priority preliminary ruling on constitutionality" and particularly in Decision No. 2005-530 DC of December 29, 2005: «At any moment, the legislator, acting in the scope of its jurisdiction, has the liberty to modify anterior legal text or abrogate a law by substituting, where necessary, other provisions». The French Constitutional Court nevertheless specifies that «in doing so, the legislator cannot however deny legal guarantees of Constitutional requirements. In particular, it disregards the guarantee of rights proclaimed in Article 16 of the Declaration in 1789 if there was an infringement to situations legally established which is not justified by a sufficient general interest reason «.

18. At first glance, the «little retroactivity» does not seem concerned since legally it is not retroactive (see above). The decision of 29 December 2012[27] is a very good illustration. It concerned the removal of the flat discharging withholding tax paid in 2012 for certain income[28]. By definition, such a levy discharges the taxpayer from further declaring taxable income. The taxable event occurs before the Finance Act for 2013, hence a retroactive effect excluding this measure from the scope of the «little retroactivity». It is interesting to note that the decision censor provisions of a Finance Act which, like the majority of the Finance Acts, intend to apply to the income of the current year. The reasoning of the judge based on the existence of a legally acquired situation due to the characteristics of the discharging withholding tax, however allows censoring the provisions of the law.

19. On 5 December 2014 on the occasion of a "priority preliminary ruling on constitutionality", the French Constitutional Court upheld the constitutionality of the «little retroactivity». This decision No. 2014-435 QPC concerns the introduction in the Finance Act for 2012[29] of an outstanding contribution on high incomes (CEHR) for income of 2011 subject to the progressive scale of individual income tax, as well as for, those which had already been subject to a flat discharging withholding tax. The application of the «little retroactivity» applies only to earnings which have not been subject to withholding tax since, contrary to what had been ruled in the above mentioned Decision No. 2012-662 DC, the legislator instituted, in the case at hand, a new tax on the date of the discharging withholding tax and not an advance payment of individual income tax.

23 O. Fouquet, La rétroactivité des lois fiscales : Rev. Adm. 1994, n°3-4, p.140 et s.
24 F. Douet. « Petite rétroactivité » et « lois fiscales rétrospectives », JCP Entreprises et affaires, Sept. 2013, n° 38, 1510.
25 French Constitutional Court, Dec. 18th,1998, 98-404 DC.
26 French Constitutional Court, Oct. 10th and 11th, 1984, 84-181 DC.
27 French Constitutional Court., Dec. 29th,2012, 2012-662 DC : Loi de finances pour 2013, préc.
28 Article 9§4 of the Finance Act for 2013.
29 Article 2 of the Finance Act for 2012.

20. The taxable event of the outstanding contribution on high income is December 31 of the year of payment of the incomes not subject a levy. Thus, the Court ruled that, by including income received in 2011 which have not been subject to a withholding tax in the basis of the outstanding contribution on high incomes, the legislator did not infringe the guarantee of rights proclaimed by Article 16 of the Declaration of 1789. The «little retroactivity» is compliant with the French Constitution.

B. Towards a framework for the «little retroactivity»

21. If the principle of legal security was recognized as a general principle of law in 2006[30], its corollary, the principle of legitimate expectations, has long remained only a notion of European law even if the French Constitutional Court referred to it implicitly[31]. The general idea is that economic agents may manage their businesses enjoying reasonable stability in legal situations and therefore in the level of the taxes they suffer. This aims at attracting investors by offering a stable tax landscape. But the «little retroactivity» can be seen as jeopardizing this goal. The reports of Bruno Gibert in 2004[32] and Olivier Fouquet in 2008[33] fall in this sense, as the two amendments rejected by the National Assembly in June 2013.

22. If neither principle nor constitutional rule is opposed to this «little retroactivity», for the first time the State Council, in its decision EPI May 9, 2012[34], set a limit to the retrospective effect of the Finance Act. The French Council of State appreciates this effect in the light of the case law of the European Court of Human Rights (ECHR (see (I-A)). The jurisprudence of the ECHR on the right to peaceful enjoyment of possessions[35], which application to tax law is admitted, allows the assimilation of the legitimate expectation of obtaining a sum of money to a property. In this case, the retroactive application of the abolition of a tax credit infringed above mentioned guarantees since, in establishing explicitly the said tax credit for three years, the legislator had created a legitimate expectation of obtaining restitution of tax, which is a property. But the French Council of State, in accordance with Article 34 of the Constitution, limits the application of this principle to previously time-limited provisions. In the latter case, the anticipated changes will not be made with immediate effect, without prior notice to the taxpayers.

23. On 1 September 2014 the Charter on «New tax governance» was signed by the Finance Minister Michel Sapin as part of strengthening the financial attractiveness of France. It could be criticized as being a sword in the water since the charter has little legal value, it is not binding and makes no recognition of the principle of legitimate expectations while the EPI decision and the Constitutional Court are moving forward in this direction. Conversely, it could be argued that this Charter has significant political value and that the Government cannot go back on its word. Even if legislators and future governments take this commitment on board it is, however, far from a constitutional guarantee.

30 CE, ass., March 24th,2006, 288460, Sté KPMG.
31 French Constitutional Court., Dec. 19th,2013, 2013-682 DC.
32 Fiche V II.B. p73, rapport Gibert, 2004
"This rule leaves taxpayers in the dark with respect to which tax regime will apply to their operations. This lack of visibility hampers the effectiveness of tax incentives".
33 Proposition 4 bis, rapport Fouquet, 2008
"The retroactive changes of the rules hinder the decision-making of economic agents (individuals and companies) and constitute a source of uncertainty".
34 CE, plén. fisc., May 9th, 2012, 308996, min. c/ Sté EPI : *Dr. fisc.* 2012, n° 26, comm. 355, note S. Vailhen ; RJF 7/2012, n° 786, concl. J. Boucher, p. 595
35 Article 1 of the first Protocol to the European Convention for the Protection of Human Rights and Fundamental Freedoms.

HOW TO AVOID THE LIMITATION RULE REGARDING DEDUCTION OF INTEREST EXPENSES RELATED TO THE ACQUISITION OF EQUITY SHARES?

Marine CALLA & Sasa RAIC

Through its 4th Finance law for 2011, France has implemented a limitation mechanism related to the deduction of financial expenses. Now, with the benefit of hindsight, provided that some requirements are met, such limitation could be avoided.

1- Deduction of financial expenses has always been a major stake for businesses allowing them to make savings and to enhance investment.

However, while companies are aiming to save cash by reducing their taxable income, State authorities are looking to refill the coffers. Under the guise of struggling against tax fraud, the State multiplies limitation rules applicable to financial expenses. Within a few years, France went from a tax heaven for businesses and especially holding companies with highly favorable provisions regarding deduction of financial expenses to a complex system of rules (a legal layer cake) including not less than five limitation mechanisms. Sometimes these measures are not enough precise, in particular regarding their implementation and their articulation. French tax administration admits it indirectly when it declares in its Official Journal (BOFIP) that comments published will help "to clarify the articulation of these different mechanisms".

2- Article 209-IX (or *Carrez* rule) of French Tax Code (FTC) arising from the 4th Finance law for 2011[1], limits the deduction of financial expenses related to the acquisition of equity interests in circumstances where the decision related to these equity interests and the control on the target company are effectively carried out by a foreign company member of the group. This limitation mechanism was originally implemented in order to struggle against tax planning strategies (so called debt push down) consisting in artificially localizing a debt in France through a French company which gets into debt to buy a target company located abroad. Such planning allowed to benefit from French rules related to deduction of interest expenses for the acquisition, combined with the French tax consolidation regime or parent-company regime regarding the exemption of dividends[2].

3- On the basis of the provision of the law, this rule applies not only to the equity interests in foreign companies, but also in French businesses. The scope of this text is extremely large, hence the necessity for the lawmaker to create some exceptions in order to limit the impact. Therefore equity interests in predominantly real estate companies, irrespective of whether listed on the Stock Exchange or not, are excluded from the scope of the limitation rule although the law does not precise so.

Besides when some conditions are alternatively met, the company is not concerned by the limitation mechanism. The first condition is when the company is able to prove that the global value of its equity interests is less than one million euros. The second condition concerns the event when the acquisition is financed by debt for which neither the company nor any other company of the group does bear the charge. Finally the third condition, the same as for the thin capitalization mechanism, prevents the company from the application of the Carrez rule if the company can prove that the gearing ratio of the group it belongs is higher than its own gearing ratio.

1 Finance Act n°2011-1978, 28 December 2011
2 G. Carrez, JOAN CR, 2 December 2011, 2nd session

Even in the case where none of the above mentioned conditions is met, there is another provision preventing from the limitation mechanism : the company must prove that it has a power of decision on the equity interests and that it carries out a control or influence on the target company. This condition underlines the issue of "passive" holdings among which many of them have been activated precisely to avoid interest add-back.

4- On 30th November 2012, the tax administration has published on the BOFIP its definitive guidelines with comments related to article 209-IX of FTC[3]. Some comments of the tax authorities seem to provide a larger interpretation of article 209-IX regarding certain aspects, notably concerning the evidence of control that the company must bring. Indeed this proof of control can be brought by inference of facts as for instance the participation to general assembly of the target company, the presence within the managing body or the involvement in internal strategy of the company.

5- It appears to be necessary at first to analyze this mechanism by confronting the provision of the law to the economic reality (general case). Then it appears interesting to discuss two specific cases which are the holding company and the permanent establishment.

I- General case

6- Article 209-IX of FTC explains in its first paragraph that « financial expenses related to the acquisition of equity interests mentioned in paragraph 3 of a, *quinquies* of I of article 219 are added back in the income of the year when *"the company cannot establish by any mean [...] that decisions related to these equity interests are effectively taken by it or by a company established in France controlling it within the meaning of the I of article L. 233-3 of the French commercial code, or by a company established in France directly controlled by it within the meaning of the same article L 233-2 and, when the control or an influence is carried out on the company which equity interests are owned, no matter if this control or influence is effectively carried out by the company owning the equity interests, or by another company established in France controlling the owner within the meaning of I of article L. 233-3 or by a company established in France directly controlled by the owner within the meaning of the same article."*

7- It is interesting to notice that the lawmaker has provided in the provision of the law an exception to the application of Carrez rule which initially aimed to restrict some operations called LBO (Leverage Buy-Out) that entailed erosion of taxable basis by creating a holding company in France in order to buy a business located abroad. In order to avoid any misunderstanding related to the concept of effective power of decision, the BOFIP clarifies some non-exhaustive aspects of this notion.

The power of decision should be characterized at the level of the company acquiring the equity shares or at the level of the company controlling it and established in France.

Particular significance should be attached to the legal reference to the article defining the power of decision which might vary from one limitation rule of financial expenses to another. In the case in point and contrary to the thin capitalization rule codified in article 212 of FTC, the decisional power is not defined at article 39-12 of FTC but in article L 233-3 of French commercial code. The provision of this article defines the power of decision under its political aspect, notably through the voting rights ownership, the power of nominating or revoking the majority of the management bodies' members.

8- The qualification of a « self-standing decision center » *(« centre de décision autonome »)* is based on a body of evidences[4]. According to the French tax administration, are considered as evidences on the one hand *"the self-standing aspect of the acquisition decision on equity shares, irrespective of whether this decision has been taken by the company owning the shares or by any company controlling it or controlled by a company that*

3 See BOI-IS-BASE 35-30-10 / 20140325

4 See BOI-IS-BASE-35-30-20-20130329; *Dr. Fisc.* N°23

controls it and which is established in France". A practical issue arises then: in principle, acquisition vehicles are created just before the operation, precisely after the acquisition decision has been made. Therefore it would be barely impossible to admit that the newly incorporated holding company has taken a self-standing decision regarding this operation. However the tax administration considers that this only situation is not such as to presume the absence of decision-making power. The evidence can be brought by any mean. We can consider that this tolerance is due to the pre-incorporation acts and commitments takeover theory. These taken over acts and commitments are considered as made by the newly incorporated company. It is nevertheless strongly recommended as the closing date approaches that the newly incorporated holding has substance and is able to sign acquisition documents for instance.

9- On other hand are considered as evidences *"the liberty to make use of shares, to enter into contracts in respect of these shares such as their pledge, their lending or their renting out provided that they keep the ability to participate to the decision process of the company whose shares are landed or rented."* For instance a contractual clause of inalienability would deprive the holding company from its power of decision and might therefore no longer be considered as a self-standing decision center.

In its comments, the tax administration provides some elements regarding evidence that might be relevant to prove the participation to the decision-making process. Among them, there are formal evidences such as *"the existence of documents related to functional, organizational or hierarchical links, e.g. the organizational chart, in order to determine the decision process in force in the company"*; or the presence and involvement in the decision process (General meeting, power of nominating and revoking the managers for instance). French tax administration might be tempted to apply the *de facto* manager's theory defined as *"the one who manages independently and freely the company and behaves as the only decision-maker of the business"*[5]. The decision power is effectively appreciated and not only on the basis of the article of incorporation. There are also some material evidences as the *"proof of existence of a strategic policy at the self-standing decision center's own level or a strategic policy proper to the group it belongs but decided in the business"*[6]. In practice for the holding company it consists in taking part actively to the managing decisions related to the target company, keeping a business plan available upon request which could certify that the strategic policy has been decided at its level. It is also strongly recommended to have managers in the holding company in order to gather more evidence of the existence of a self-standing and effective decision center.

10- It is also necessary to pay attention to the year after which the evidence must be brought. A distinction has to be made whether the equity interests have been acquired before or after the 1st January 2012. In the last case, equity interests have been acquired after January 1st, 2012, proof that the company is a self-standing decision centre must be brought during the year of the acquisition or the year following the operation.

In the event the shares have been acquired before 1st January 2012, the evidence must be provided no later than the end of the first fiscal year beginning on that date. So if a company opens its fiscal year on April 1st, 2012, proof that it is a self-standing decision centre must be made on or before the 1st April 2013.

11- The penalty for failure of proof is very heavy: the company will add back a portion of the financial expenses related to the acquisition of the title every year during the eight years following the year of acquisition, and even though it would later be able to demonstrate its power of decision[7].

5 Cass.Com. n°93-15553, 10 October 1995
6 H. Kruger, La gestion fiscale d'une holding, éd. 2014, Groupe Revue fiduciaire
7 C. Acard, Fiscalité financière, *Dr. Fisc.* N°7-8, 12 February 2015, 142

The counterpart of this severe provision is that if the evidence is provided on time, the company may later not exercise any effective power on the target without falling in the scope of article 209-IX of the FTC.

It is important to remember that this provision, which was initially designed to prevent abuses, sees its scope extended since it now applies to all cases of acquisition of equity shares, even in circumstances where the acquisition of a company in France is performed by a French company via a French Holding company.

12- After discussing the conditions necessary to bring the proof that the company is a self-standing decision center, it is interesting to focus on the specific case of the permanent establishment and the holding company.

II- Specific cases

13- As far as holding companies are concerned, it is necessary to differentiate on one hand holding companies defined as "active" and on the other hand holding known as «passive».

Active holdings are those which actively participate in the conduct of the group's policy and in the management of subsidiaries, and which supply specific services to the group[8]. On the contrary, passive holdings simply manage a portfolio of securities without a real activity, *i.e.* without getting involved in the management of its subsidiaries.

14- The notion of holding is very important particularly since it conditions the granting of preferential treatment applicable to operational companies. However this qualification does not have a legislative source, but ensues from the administrative doctrine, which in practice can be a source of legal insecurity. Recently it has been codified in wealth tax and tax reduction, but the tax administration continues to condition in its own way this concept, which leads to making it unclear.

On several occasions the tax administration has required a total and majority ownership, in a way that the holding had to hold a majority participation in each of its subsidiaries.

15- This qualification of "active holding" is essential within the Carrez rule. Indeed when the holding is passive, it will not be regarded as a self-standing decision center and accordingly cannot be exempted from the application of the limitation rule.

Passive holding companies are considered only exercising the usual benefits as a simple shareholder.

16- The French acquisition vehicle will have to prove that it has effective powers and that its role is not limited to simply exercise its right to information or the right to vote, which is a natural consequence of its quality of shareholder[9]. In practice, the holding must determine the group's policy including ensuring compliance with the group's strategy policy. In order to do so, the holding company could for instance perform the statutory managing functions. It might also appoint a representative in order to manage the subsidiaries.

17- It must appear that the power is centralized at the level of the holding company, the proof of this centralization may be brought by the statement of general meetings or the Statutory Auditors reports[10]. Moreover, the holding can also supply services to the subsidiaries; nevertheless this only criterion is not enough to qualify it as an active holding[11]. Last but not least there is some case law on «animation agreement» which constitute interesting evidence; however it is only applicable if the management is effectively carried out[12].

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8 BOI-IS-Base 35-30-10 §120

9 Cass. com., 7 December 1993 n°91-22099 ; Cass. com., 23 November. 2010, n° 09-70.465, Gratzmuller : JurisData n° 2010-021994 ; BF Lefebvre 3/2011, inf. 334 ; RJF 2011, n° 385. Cass com 10 December 2013 n° 12-23.720 : JurisData n° 2013-028686

10 Dr.fisc.2014, n°13,comm 238 : Société holding animatrice : « Comment établir la réalité de l'activité d'animation du groupe ? »

11 Cass. com., 27 September. 2005, n° 03-20.665, M. Gros : JurisData n° 2005-029931 ; *Dr. fisc.* 2005, n° 50, comm. 811 ; Rev. sociétés 2005, p. 877, note J.-P. Dom ; Bull. Joly Sociétés 2006, n° 9, note J.-L. Médus ; RJF 1/2006, n° 100. - V. Instr. 30 December. 2005 : BOI 7 S-8-05 ; *Dr. fisc.* 2006, n° 3, instr. 13448. Conférence IACF sur les holdings animatrices, 10 June 2013, Luc Jailliais et Éric Ginter

12 CA Paris, 1re ch., 7 July. 2006, n° 05-12395

18- After analysing holding companies, it is now judicious to focus on the permanent establishment.

Mentioning the permanent establishment as a self-standing decision center might sound as an antithesis, since by definition no legal personality is attached to it. It is then difficult to imagine that its own principal establishment does not keep the decision power.

The permanent establishment must record on its own balance sheet the equity interests and prove it has a real independent power of decision on these securities[13]. The establishment must have sufficient operational capacity or substance to be able to take real decision. Therefore the establishment must appoint managers to decide the distributions, define a self-standing strategic policy[14], and finally to ensure the ability of directors to represent the company.

19- In ***Stamping International*** case[15], the Administrative Court of Appeal considered that the foreign company had a permanent establishment in France on the basis that the decision center was located in France and that all administrative and financial acts were carried out in France. Therefore the company has to ensure the qualification of active holding or to have of a self-standing permanent establishment with a decision-making power in France on the target to avoid the application of article 209 IX of FTC.

20- Without richer case law, it is very difficult to outline the practical Carrez mechanism. The comments of the tax administration do not answer all the questions and do not meet the uncertainties that are even larger than the stakes are high. A careful follow-up of the case law has to be made regarding this newest limitation rule (2012) and to analyse it in the light of EU law, especially regarding the freedom of establishment[16].

13 *BOI-IS-BASE 35-30-10 §110*

14 *CAA Versailles, 3e ch., 15 March 2011, n° 09VE00366, Sté Compagnie internationale des wagons-lits et du tourisme : JurisData n° 2011-012634 ; Dr. sociétés 2011, comm. 164, note J.-L. Pierre*

15 CE, 8e et 3e ss-sect., 7 September. 2009, n° 308751

16 *E. Robert, L'amendement Carrez est-il Euro-compatible ?*, taj-stratégie.fr, 23 July 2012

MANAGEMENT PACKAGES: LEARNING FROM THE GAILLOCHET CASE

Johana CHEBAR & Baptiste GACHET

In the case Gaillochet dated 26 September 2014, the Conseil d'Etat[1] approved the reclassification in wages and salaries of the capital gains realized after exercising of a call option. Even if the scope of this judgment must be relativized, it gives a first insight on the validity of management packages that were structured prior to the entry into force on January, 1st 2013 of the taxation of capital gains realized by individuals under the progressive scale of income tax.

In the recent Gaillochet decision of September, 26th 2014[2], the Conseil d'Etat ruled on the reclassification in wages and salaries of the share sale price obtained after exercising of a call option granted in connection with a management package set up for a Leveraged Buy Out («LBO») transaction.

Practitioners eagerly awaited the decision as it concerned for the first time an accretive mechanism called «ratchet». In this case, the manager had acquired at the launching of the LBO transaction a certain number of shares as well as a call option. The exercise of this latter, subject to the reach of a certain return on investment by the fund, granted the right to subscribe for shares at a lower price than the market value.

The decision of the Conseil d'Etat confirms the judgment of the Court of Appeal of Paris[3] and validates the tax adjustment of the French Tax Administration ("FTA"). In order to establish the existence of a benefit in kind justifying a taxation of the capital gain in wages and salaries, the judges adopt a two-step reasoning that is now well established. This latter required to prove on the one hand the existence of a link between the disputed gain and employee functions, and on the other hand the absence or now the «modest» dimension of the financial investment.

This reasoning made, the Conseil d'Etat follows the FTA and decomposes the capital gain into an acquisition capital gain and a sale capital gain[4]. This approach normally provided for stock options mechanisms[5], entails to link the entire selling price to the acquisition capital gain. As part of the unwinding of a LBO transaction, the acquisition

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1 The Conseil d'Etat is the French administrative Supreme Court. It acts as legal adviser and as Supreme Court for administrative law.

2 CE, 3rd and 8th ss sect., Sept. 26, 2014, No. 365573, M. and Mme. Gaillochet, concl. E. Cortot-Bouchet, notes J. Turot, J, J. and T. Jeausserand Audouard: JurisData No. 2014-022460. See also: T. Stucker, «*Les promesses n'engagenet que ceux qui y croient* ...». -... About CE, 3rd and 8th ss-sect, Sep 26, 2014, No. 365573, Semaine Juridique Entreprise et Affaires No 45, Nov 6, 2014, 1574. See also N. Labrune, Maître des requêtes au Conseil d'Etat : "*Les gains de "management package", des objets fiscaux non identifiés ?*" RJF, 2014, p. 1043. See also G. Massé, «*Management Package: l'incertitude de la notion de modicité*» Hebdo édition fiscale, No. LXB: N5064BU4, December 11, 2014.

3 CAA Paris, 2e ch., Nov. 28, 2012, n°11PA04246, min. c/ M. et Mme Gaillochet.

4 If the Conseil d'Etat does not explicitly include in its decision the term acquisition gain or sale gain used by the rapporteur public in his conclusions, it nevertheless relies on this distinction as evidenced in Recital 3 of its decision where it finds that the taxpayer did not allege that the value of shares had fluctuated between the date of exercise of the option and the share disposal.

5 The distinction between acquisition and sale capital gains comes from the tax treatment of stock options provided by Article 80 bis of the FTC. The regime applicable to stock options which was targeted by the prosecutor in his conclusions is not, however included in the decision of the Conseil d'Etat that merely confirm the tax adjustment on the grounds of the benefit in kind and of Articles 79 and 82 of the FTC. We consider that the Conseil d'Etat partially follows the rapporteur public's reasoning. On the one hand it relies on the decomposition analysis of the capital-gain. On the other, it rejects the almost irrebuttable presumption of a reclassification of the acquisition gain in wages and salaries or non commercial profits proposed in the conclusions.

capital gain is indeed zero: the value of securities cannot indeed vary due to the reduced period of time between the exercise of the option and the resale of the shares.

If its scope must be relativized, the Gaillochet case allows measuring the risk of tax adjustment associated with old accretive techniques used to structure management packages. To minimize this risk, the distinction between the functions of shareholder and employee shall be emphasized (I), as well as the existence of a significant financial risk for the investor (II). No doubt these elements will serve litigators while a new wave of tax adjustment cases related to management packages based on equity warrants is getting before French courts.

I. The border between the employee and the manager-shareholder

To characterize the existence of a benefit in kind to be taxed as wages and salaries, the FTA played in the case on the dual personality of the employee-shareholder manager. In support of its analysis, the FTA made three arguments: first, the call option was granted with respect to the manager functions; second, the use of the option was conditioned by the commitment of the manager in the company for a period of at least five years and thirdly, the amount of shares to be acquired was linked to the achievement of a certain internal rate of return ("IRR") threshold by the fund.

Though it is impossible in practice to remove from the contract of acquisition or issuance of the accretive option mechanisms the *intuitu personae* and the conditions related to the maintenance in executive functions, these two elements are not sufficient to establish that the mechanism involved constitutes a cash benefit, taxable in the category of wages and salaries. In a Fontana judgment dated 7 November 2008[6], the Conseil d'Etat had indeed refused the reclassification of a capital gain arising from the payment of an earn-out, even as it was conditioned to the maintenance in functions within the company for a period of six years.

Unless the Gaillochet case is to be regarded as overturning the Fontana case law - which is unlikely given its sole mention in the Recueil Lebon tables - it is more the indexing on the IRR of the number of shares to be issued which appears to be the determinant of the decision.

The Conseil d'Etat judgment is based on the following reasoning: to the extent that the final gain is related to the company's performance and therefore to the efforts of the employed-manager, it then falls under the category of wages and salaries. This decision is particularly unfortunate as it stems from a misunderstanding of the concept of the IRR.

Unlike ratios measuring the operating performance of the LBO's target such as the EBITDA[7], the IRR is a purely financial concept that aims to assess the profitability of an investment. As recalled Jérémie Jeausserand and Tristan Audouard[8], it is only residually linked to the company's performance and therefore even more marginally to the involvement of the management.

A study[9] cited by the previous authors has shown that over the periods 1979-2002 and 2002-2006, «the growth of corporate earnings has had a very limited impact (less than 30%) of the IRR generated by financial investors.»[10] Most of the

6 CE, 3rd and 8th ss-sect., Nov. 7, 2008, No 301642, Fontana et de Framond : JurisData No 2008-081396 ; *Dr. Fisc.* 2008, No 52, comm. 646, concl. L. Olléon ; RJF 1/2009, No56 ; BDCF 1/2009, n°11, concl. L. Olléon. – V. O. Fouquet, « *Dans quelles conditions les plus-values sur les titres non cotés peuvent-elles constituer des bénéfices non commerciaux ?* » : *Dr. Fisc.* 2009, No3, act 15

7 EBITDA: Earnings before interest, taxes, depreciation, and amortization is a financial ratio used to measure the company's ability to generate profits before financial expenses, taxes, depreciation, amortization and provisions.

8 T. Audouard, J. Jeausserand, « *Fiscalité des management packages : quelle conclusion tirer des arrêts de la cour administrative d'appel de Paris du 29 novembre 2012 ?* », Revue de Droif fiscal, n°17, April. 25, 2013, comm. 254.

9 « La lettre Vernimmen », n°84, February, 2010.

10 T. Audouard, J. Jeausserand, « *Fiscalité des management packages : quelle conclusion tirer des arrêts de la cour administrative d'appel de Paris du 29 novembre 2012 ?* », Revue de Droif fiscal, n°17, April. 25, 2013, comm. 254, p. 12.

growth of the IRR results from endogenous factors such as improved cash flows management and the effect of financial leverage, but mostly from exogenous factors such as the significant increase of valuation ratios in the 2000s until the 2008 financial crisis.

II. Anticipate a «real» financial risk

However the only *«contractual link between employee status and the exercise of the promise does not insure, alone, the reclassification of the gain in cash advantage* [11]*.»* Indeed, this evidence is not a sufficient condition. Tax authorities must show a lack of financial risk borne by the managers.

The financial risk's assessment takes into account two components: a financial exposure and hazard. Nicolas Labrune[12], in light of the opinions rendered by the abuse of law's Committee[13], states that a significant investment and the uncertainty linked make up an economic risk.

The definition of risk suggests a preliminary issue concerning the date of its assessment. Indeed two analyses can be made: Either on the date of the acquisition of the option or either at the time of the capital gains. The latter involves a comparison between the return on investment's multiple in terms of initial investment carried out by the managers.

Its use reveals an opportunistic set of mind. It is not only more relevant but also more objective to assess the risk borne by the managers under the existing conditions at the day of their investments. However, in its decision Gaillochet, the Supreme Court prefers an analysis a posteriori[14]. This position, source of legal uncertainty for any investor, should not be construed as a principle methodology for capital risk assessment. In this case, the judges only confirm the position of appellate judges.

Ultimately, the particularly high-level of the return on investment's multiples might explain the surprising decision of the appellate judges, upheld by the High Court. Indeed, the initial investment made by managers only represented a small percentage of the gain[15]. This decision clearly reveals an appreciation in concreto due to the obvious gap between the amounts invested and the gain withdrawn. It is up to the Supreme Court to clarify in the future *«the term of reference to be used to compare the amounts at stake for the taxpayer*[16]*.»*

No matter the answer, given the state of the case law, it is, in fact, the financial risk that subjects the gain to the capital gain regime. In order to avoid a potential taxation of the gain according to the wages and salaries regime, the taxpayer should be able to justify of a real financial exposure and also provide evidence regarding the random aspect of the gain withdrawn.

The sizes of the financial investment as well as the warranties granted by the manager define the main criteria that must be used to determine a financial exposure[17]. In the decision of appeal, the appellate judges had reclassified the gain withdrawn by the manager in wages and salaries. They judged that the earned deposit paid by the manager in exchange for the option call as modest. They came to the conclusion that the manager had not borne any capital risk given the low rate of his investment, in the circumstances of the case.

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11 Thierry Stucker, « *Les promesses n'engagent que ceux qui y croient* ». La Semaine Juridique Entreprise et Affaires, Nov. 6, 2014, n°45, 1574

12 Nicolas Labrune, « *Les gains de "management package", des objets fiscaux non identifiés ?* », RJF 12/14

13 CAD, séance Nov. 29, 2014 : Abuse of law Committee opinions commented by the French tax authorities, CADF/AC n°10/2013

14 CE, 3e et 8e ss-sect., Sept. 26, 2014, n°365573. In this case, the manager had paid an earned deposit in order to purchase call options. This earned deposit made up the manager's financial exposure. The Conseil d'Etat compares the earned deposit with the gain withdrawn at the transfer of the shares acquired by the call option' exercise in order to assess the financial risk borne by the manager.

15 In the Gaillochet case, the earned deposit was less than one percent of the gain withdrawn at the transfer of the shares acquired by the call option's exercise.

16 Nicolas Labrune, « *Les gains de "management package", des objets fiscaux non identifiés ?* », R RJF 12/14

17 See to that effect, TA Cergy-Pointoise, 5e ch., Jul. 17, 2014, n°1209307 : RJF 12/14 n°1100

The judges dismiss the concept of normality by refusing to acknowledge an actual investment from the manager because of the insignificant amount paid. Thus they do not take into account the inherent risk related to the investment, which was in this case the price of the option call. However the use of the term 'modest' should not be interpreted as a principled position of the Supreme Court. Once again, the Supreme Court only «*validates, in law and in fact, the Decision*[18] " of the appellate judges.

The size of the manager's investment could be evaluated according to his estate. This analogy is considered more than subjective. Nevertheless the abuse of law Committee[19] has already made such a comparison in the past when they assessed a manager's investment as being excessive in regard to his financial abilities. However this analogy shall not be applied in the opposite situation. A Financial exposure that represents only a small part of an investor's capital should not, alone, reveal a lack of financial risk.

To certify the shareholder's risk borne by the manager, it would have been wise to carry out a valuation of the call option by an independent expert. It is more relevant to compare the amount invested to «the market value of the option[20]». In fact, it has become the market practice. Although it is difficult to establish a valuation of alternative mechanisms for access to capital, methods such as Black-Scholes, are very much appreciated among practitioners. The FTA, itself, begins to operate its tax adjustment according to this method.

Aside from a significant investment, the concept of financial risk also involves an underlying uncertainty. In its decision Gaillochet[21], the Supreme Court does not take into account this other aspect as he considers that the first condition of the shareholder's risk is not completed. Notwithstanding, in the case of the promise, the hazard relates to the fact of losing or not the earned deposit. In the event that the managers do not exercise the option, they will only lose the amount paid in exchange for the purchase option. The increase of stock value - or market value – cannot reflect a risk borne by the manager as he had the option to purchase or not the call option. However this alternative mechanism for access to capital does not eliminate the hazard. Indeed, «*from the beginning a hazard subsists in the underlying asset's value and there is also a risk of loss in capital equivalent to the amount of the earned deposit paid*[22].» Thus, when a hazard exists, alternative mechanisms for access to capital cannot mechanically represent a lack of financial risk. However in the event that the manager does not pay for the call option at the time of its issuance and that the purchase price is taken off the capital gain's amount, there is no more hazard. Actually, such a mechanism is, nonetheless, coarse and marginal.

Although the judges adjudicate on the financial risk issue, they also adopt an assessment, for us controversial, regarding the date and amount of the benefit in kind granted to the manager. In fact, whilst there is a benefit in kind, it is only set at the time of the call option's acquisition and for a defined amount. Therefore, in this case, the market value of the earned deposit should have been financially valuated. The value superior to the price paid by the manager in order to purchase the call option would, thus, have been a benefit in kind, liable to income tax in the wages and salaries' category.

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18 Nicolas Danan et Christopher Lalloz, « *Première prise de position du Conseil d'Etat au sujet de la fiscalité des management packages* », L'AGEFI Actifs, published on Oct. 13, 2014

19 CADF : Abuse of law Committee opinions given on May and July 2013 sessions, May, 23rd, 2013, aff. n°2013-10, n°2013-11 et n°2013-15 : *Dr. fisc.* 2013, n°36, 395. The Committee ruled on the financial investment of a manager that had purchased a target company's shares. In fact, the manager had purchased the shares with its own resources and the investment represented a substantial part of its revenues. Therefore, in this case, the Committee judged that there was a true financial exposure of the manager.

20 Jérôme Turot, « *Requalification en salaires d'un management package : Le Conseil d'Etat refuse-t-il aux salariés de se faire capitalistes ?* », Revue de droit fiscal, Nov. 20, 2012, n°47, comm. 636

21 CE, 3e et 8e ss-sect., 26 sept. 2014, n°365573

22 Thierry Stucker, « *Les promesses n'engagent que ceux qui y croient* », La Semaine Juridique Entreprise et Affaires, Nov. 6, 2014, n°45, 1574

Accretive mechanism such as call option or warrant granted to the managers are no longer used to the structure management package due to the various litigation and the highly risk of reclassification of capital gain in wages and salaries. Therefore, management packages are structured with shares and dilutive warrants exercised by the fund in the event on non-achievement of the expected IRR.

THE RESEARCH TAX CREDIT: TOPICALITY AND PERSPECTIVES

Victor COSSEC & Camille PONS

The French research tax credit was created in 1983 and revised in 2008. It is the main measure which supports Research and Development activities in French companies. Although it got simplified, it is still complex and has several limits. Nevertheless, it has become indispensable for companies, because of its positive tax effects. Finally, tax adjustments related to RTC have grown in 2014: it is thus crucial to learn from those cases in order to avoid these adjustments in the future.

1. The French research tax credit (RTC) first appeared in 1983. Government Pierre Mauroy II led this initiative, more specifically Laurent Fabius, who was the deputy Minister in charge of Budget. It aimed to respond to the lack of research and development (R&D) expenses in France, which represented a smaller proportion of gross domestic product (GDP) than in a growing number of OECD member countries. French R&D expenses only approached 2% of GDP while they represented at least 2.5% in Germany or in the United States[1]. At first, the basis of the credit was the expenses differential (considering every resource invested in R&D activities) with a very low ceiling: however, it has been a success among French companies. Progressively, the ceiling and the rate increased. By 1988, the computation of the RTC began its first considerable evolution, based on the notion of "quasi-volume": its basis was no more the expenses differential but approached the "volume", *i.e.* the whole amount of expenses related to R&D activities during the fiscal year. This evolution ended in 2004 and the "volume" became the only basis. Though, at the same time, the rate diminished, in order to compensate the increase of the basis. Finally, the RTC strongly evolved in 2008, for the second time: to strengthen the public support for R&D activities in France, the principal rate tripled, the ceiling disappeared and got replaced by a threshold, above which the rate is reduced. Thus, the first reform in 2004 considerably simplified the RTC and its use by companies. The second reform, in 2008, led to its strong development: a total of €5, 3 billion credits are distributed to 15,000 companies every year[2].

2. Public supports for R&D activities are justified by first the positive impact it brings to the national economy and second by the underinvestment of private entities. R&D is a strategic factor of economic policy because it enables to obtain complex expertise, which can create economic dependency situations. Moreover, it is a growth driver: OECD estimates that an increase of 1% of R&D expenses produces an average 0.05% to 0.15% increase of GDP[3]. By bringing companies a power of innovation, they can easily get better profit margins[4] and a long-term market power[5] if investments are recurred. Nevertheless, public support is necessary for companies, since they invest less than they should in R&D. Two types of externalities can explain this phenomenon. On the one hand, R&D produces positive externalities, which can benefit to the competitors. Although

1 OECD Factbook 2006 : Economic, Environmental and Social Statistics
2 Last figures (2012) are provided by Ministry of Education and Research
3 OECD, Tax Incentives for research and development : trends and issues
4 Bronwyn H. Hall, Jacques Mairesse, Pierre Mhonen, NPER Working Paper N°15622
5 Anne Perrot, Fusion, Intégration et Concurrence, Insee Méthodes n°95-96

intellectual property protections exist, technologic and scientific innovations benefit to the whole sector, if not more[6]. Indeed, there is a "free rider" effect, which encourages under-investment. On the other hand, R&D expenses are strongly related to another issue: risk-sharing[7]. Since the probability of success can be very low, R&D projects are risky investments, which foster private under-investment.

3. Thus, the reform from 2008 reflects the central role of the RTC. Although this reform was led by the government François Fillon II, the text was supported by its opponents, especially Laurent Fabius: "I'm attached to it as everyone of us is, not only because it prepares the future but also because, in a previous life, I had the occasion to create it."[8] Eventually, French politicians, who use it as a model for new measures[9] or reclaim its reinforcement[10], now quasi-unanimously support RTC.

I. Presentation of the scheme

4. The research tax credit (RTC) is neither a deduction, nor an exemption that companies can make when they are computing their tax results. It is a tax credit, a State debt. The amount is a percentage rate, based on the sum of the eligible expenses engaged for the "hard[11]" sciences (fundamental, applied research or experimental development operations[12]) which is charged over the due corporate income tax (CIT). All commercial, agricultural and industrial companies are concerned. Other occupations like handcraft activities[13] are excluded, as they are not unambiguously mentioned at the article 244 quarter B II h of the French tax code (FTC). Indeed, the RTC would become applicable if companies managed to demonstrate their industrial character thanks to the recurrent use of automatic machines compared to manual work or skilled craftsmanship[14] for instance. The rates differ between companies which are micro enterprises (20%), companies which are using it for the first time (40% for the first year and 35% for the second year to €100 million, then 5% beyond), companies located in overseas departments of France (50% to €100 million, and then 5% beyond). The classical rate is, finally, 30% to €100 million and then 5% for the amount beyond.

5. To benefit from this credit, two conditions are required: first, the research operations must be located in the European Union (EU) or in a State part of the agreement of the European Economic Area (EEA) or in a State having signed a convention on administrative assistance with France. Finally, this tax credit can only be computed on deductible expenses in the taxation result for the CIT. If the company embraces these conditions, it must fill a 2069 A SD declaration plus join its statement which indicates the amount due for the CIT (statement 2572, for corporations submitted to the corporate income tax). Companies submitted to the income tax must indicate the computed research tax credit amount on their 2042 c statement.

6. The depreciation of assets used for the research operations[15] is taken into account in the computation. The depreciations concerned are those related to new assets, directly linked to research operations. The amount of the depreciation must be weighted according to an allocation key (percentage of the time the machine is used for the research

6 Thomas Helbling, Externalities : prices do not capture all costs, IMF
7 Eric David, Amit Mehta, Troy Norris, Navjot Singh and Tony Tramontin, New frontiers in Pharma R&D investments, McKinsey Insights & Publications
8 JOAN, Première séance du Mercredi 17 octobre 2007
9 CICE et CIR : produits dopants au service de l'emploi, Les Échos
10 Les frondeurs PS réclament une réforme bancaire, AFP
11 CAA Paris, 9e ch., 27 nov. 2014, n° 12PA05144 et n° 13PA01264, SELAS Bruno Kern Avocats, note Ch. Oriol : JurisData n° 2014-029743, excluding « legal » sciences of the scope
12 Mémento fiscal Francis Lefebvre 2014 n°10480
13 CAA Nantes, 1re ch., 12 juin 2014, n° 13NT01922, SARL Enilec Trebor : JurisData n° 2014-029890
14 TA Montreuil, 1re ch., 4 nov. 2013, n° 1204864, SAS Sofiza : JurisData n° 2013-032070
15 BOI-bic-RICI-10-10-20-10-20140404

operations for instance) if the asset is not only used for the eligible research operations. Realization of prototypes and pilot plants[16] are also considered as research operations. At the opposite, are excluded expenses which are not directly linked to research operations (charges related to small equipment like phones, offices supplies). Depreciations of movable and immovable properties, patents and software are in the scope, contrary to depreciation of know-how and licenses. The concerned assets can be hold directly by the company or thanks to a leasing. In this case, the leasing company would have to deliver an attestation mentioning the amount of the rent. Obviously, only tax deductible expenses would be taken into account for the computation of the RTC.

7. Staff expenses[17] are eligible to the RTC too. Salaries, but also their accessories and social security costs are in the scope. As the expenses must be, in a tax point of view, deductible, the payroll tax is excluded. Concerned employees must be only affected to the research. If not, a pro rata temporis must be applied on the salary. Engineers, scientists or searchers salaries are concerned but also supporting technicians. To the opposite, support staff salaries (secretariat or staff in charge of the equipment maintenance) are not included in the computation of the RTC. Different scales can be applied. 200% of the salary of scientific doctors will be taken into account during two years (if they are hired with a permanent contract and if the number of the research employees is stable). Then, the percentage rate is 50%. For the others employees, 50% of the expenses will be retained.

8. Expenses related to sub-contracting with public or private external agencies and organization[18] **are a complex issue.** According to the article 244 quater B of the FTC, the RTC embraces also these expenses. Just as well the staff expenses for scientific doctors, the amount of the expenses will be doubled if there is no dependence between the external agency and the company[19]. For instance, a company contracts out with a University (delivering master diplomas) for a research operation which amount to €100 000. For the RTC, the company will take into account €200 000. If the University benefits from the RTC, it will have to deduct €100 000. In this way, the same expenses do not lead to both RTC. About private organizations, the provider must dispose of an agreement from the French Ministry of Higher Education and Research. Companies which have got this agreement are referred on the Research Ministry website as companies whose deliveries are eligible to the RTC. Finally, there is a capping related to the entrusted missions to external organizations: they cannot overpass three times the amount of other expenses[20] (for charges engaged after 2011, January 1st). Before, the maximum was €2 million[21]. Now, it is €10 million[22], under the condition that there is no relationship of dependence. The limit is not applicable to public organizations. Furthermore, a company which would not have any research operations could not benefit from the RTC for the contracting out charges. To finish, expenses related to advisory for the implementation of the RTC, engaged from 2011, January 1st are excluded of the computation.

9. Other charges are eligible for the RTC computation. For its running cost, a company can take into account 50% of the staff expenses and 75% of the depreciation amounts. Charges covering the standardization plus those related to technological survey (the limit amounts to € 60 000) are also included in the scope.

10. Similar measures appeared after the success of the RTC. The Innovation Tax Credit (ITC) is

16 BOI-BIC-RICI-10-10-10-20 n°90, 12-09-2012
17 BOI-BIC-RICI-10-10-20-20-20140404
18 BOI-BIC-RICI-10-10-20-30-20140404
19 BOI-BIC-RICI-10-10-20-30-20140404 point n°180
20 244 quater B II d bis du CGI
21 Article 45 of the French law n° 2004-1485 of 2004 December 30th of the amending finance law 2004
22 Droit fiscal n° 5, 2015 January 29th, act. 58 : RTC: confirmation of the limits for the external expenses

a measure resulting of the 2013 Finance Act, based on the RTC: the formularies, the notion of innovation compared to the state of the art, the global volume of engaged charge, etc. are similar. Nevertheless, this measure differs from the RTC: first, it targets small and medium companies (SME), which explains its capping of €400 000. Second, its objective is to support the prototype funding by companies. Commonly, it is the concretization of the R&D in a product. It is not possible to cumulate both RTC and ITC for the same expenses[23]. Besides, the Collection Tax Credit (CTC) is a special measure of the RTC[24] dedicated to the clothing sector. Most of the expenses engaged are the same as those eligible for the FTC. The CTC has a particularity: it is subject to the "de minimis" rule, the actual capping amounting to € 200 000.

II. Topicality and outlook

11. In 2013 and 2014, case law about RTC gave more precisions about the application of the measure. Usually, they were in favor of the taxpayer, giving more flexibility to the incentive system. In the precedent case law, it was the opposite: solutions were usually favorable to the French Tax Administration (FTA), confirming its generalized strict interpretation of applicable law (which was argued through administrative instructions and tax rulings).

12. Staff expenses are one possible illustration. Companies must distinguish researchers from technicians. Researchers include not only engineers but also doctoral students working on R&D activities, whereas technicians sustain those activities by providing an essential technical support (this notion was used by the Paris administrative court in a recent case[25]) and working in close collaboration with researchers. In a 2010 tax ruling[26], FTA precised the procedure for applying the researchers' regime to others employees. Indeed, some of them can be assimilated to researchers if their competences, due to their nature and their activities, lead them to have a similar role. Those employees must be directly and exclusively affected to R&D activities. This is the major difference with engineers. Actually, engineers and doctoral students can be subject to partial affectation to R&D activities. This was confirmed by the FTA in a tax ruling, on July 10th, 2012: a ratio is then applied to all costs related to those employees (wages, advantages, etc.). By contrast, employees who are assimilated to researchers must be subject to exclusive affectation. This criterion was confirmed by the Versailles administrative court[27], shortly after the ruling. Besides, interns affected to R&D activities are now taken into account when computing the FTC amount[28] : as they are working closely with researchers, they can be considered as research technicians. This precision is very important since R&D interns can highly contribute to companies' profits. Eventually, the administrative judges confirmed a broad understanding of staff costs, generally, considering profit-sharing and incentives can be viewed as attached to wages[29] and that the tax credit can apply to insurance fees, if those are required by the collective agreement, in proportion to the number of employees affected to R&D activities.

13. The part of the RTC files concerning staff expenses needs to highlight two points. First, the qualifications of employees need to be emphasized, providing their resumes. Effectively, if an employee has a Ph.D., 200% of his wage can be included in the computation basis of the RTC. These information need to be exact and verified, especially when employees are affected to R&D activities, so as to avoid the complete deduction of their wage and attached expenses from the basis in case of tax audit. Besides, the affectation ratio

23 BOI-BIC-RICI-10-10-45-20
24 FTC, article 244 quater
25 CAA Paris, 13 mars 2014, n°13PA01783
26 RES 2010/59, 5/10/2010
27 CAA Versailles, 8 mars 2011, n°10VE00031
28 TA Montreuil, 18 novembre 2013, n°1206938
29 CE, 12 mars 2014, n°365875

which is used to distinguish employees working only on R&D matters (their whole salary is eligible to RTC) and the ones only partially working on R&D operations. Thus, timesheets, work schedules and necessary computations to measure how much they are affected to R&D activities should be available to the FTA.

14. The necessary demonstration of the innovative nature of the research was recently reminded by the Paris administrative court: the application for the RTC must be strongly justified, especially concerning the state of the art[30]. The applicant company must be able to prove that expenses were really used to innovate, to find something new in comparison with the existing technics and to obtain a new standard. It is necessary to provide in the file a review containing the subject of researches, direct publishing, and technical newspapers about problems mentioned in the application file, which detail the reasons of expenses. Highlighting uncertainties and technical barriers is a good way to prove R&D is innovative. FTA also advises to precise the objective of R&D: a patent? Publications? A project, registered at the National Research Agency[31] ? Applicants will also need to summarize the outputs for the company. This is the most sensitive part of the file: it requires much attention.

15. About outsourcing expenses, FTA is very strict but its view is contested. When commenting the Law of Finance, on April 4th, 2014, FTA considered that companies providing outsourcing services cannot benefit from the RTC, even when the client does not apply for the credit concerning its outsourcing expenses. This view has been strongly denounced by professionals. Indeed, this provision seems illogical because it leads to a situation where nobody benefits from the credit, without any economic justification: providing the renunciation evidence by the client would not be sufficient to prove to the FTC that there would not have double benefit of the RTC? This view appears to be stricter that Article 244 quarter B of the FTC, which provides that companies "can benefit" from the FTC, but do not have the obligation to do so. Moreover, if a company is outsourcing R&D activities to a non-certified entity, it will not be able to take into account those expenses when computing its RTC. Then, if the company providing outsourcing services wants to be able to benefit from the RTC on its R&D expenses, it has to renounce to its certification. This can be a major issue for companies who have outsourcing expenses: indeed, they are mainly French SMEs for which RTV is a core finance matter. SMEs who have large R&D expenses would better work with certified outsourcing services providers if RTC is an important support to their activities: thus, related expenses will be automatically viewed as computable for RTC. FTA will not be able to proceed to tax reassessments about this point. A list of certified outsourcing services providers is available on the FTA's website.

16. The RTC is limited to hard sciences, as the FTA reminded. Expenses related to social sciences, such as Law[32], are not concerned by the measure.

17. Generally speaking, the first advice to give to companies is to build a RTC file all along they process to their research operations. In 2014, a lot of tax adjusted companies were incapable to supply enough motivated and accurate files[33]. It is better to constitute a thinner but a more pertinent and demonstrative folder (explaining accurately the research operations, the aim of the R&D project). A « hold all » folder must absolutely be avoided[34]. This file must be scientific and financial. For each expense included in the scope, a special documentation (synthetic and pedagogical) must be constituted. The state of the art, the objective(s) targeted, the different scientific problematics met, the means used in order to over pass the difficulties must be

30 CAA Paris, 27 mai 2014, n°13PA03018

31 Agence Nationale de la Recherche

32 CAA Paris, 9e ch., 27 nov. 2014, n° 12PA05144 et n° 13PA01264, SELAS Bruno Kern Avocats, note Ch. Oriol : JurisData n° 2014-029743, excluant les sciences juridiques du champ d'application du CIR

33 Fidal conference about research tax credit, 2014 November 13rd

34 Jules Bellaiche, Lexbase Hebdo édition fiscale n°592, 2014, November 27th

mentioned. The scientific input, compared to the state of art must be detailed. Finally, bibliographic references as well as a presentation of the R&D teams must be provided in the file[35]. The notice of the 2069-A-SD formulary is quite clear and underlines the key aspects which must appear in the folder. To conclude, maybe the best advice to give is to opt for the fiscal written ruling related to the RTC[36]: thanks to this ruling, the French tax administration gives to the company a position statement according the scientific and technical aspect of the project. The answer, signed by the *Bureau des agréments et rescrits* of the French DGFIP has the value of a definitive position statement. Thus, if the French Tax Administration confirms the newness of the research and consecrates the technicality of the issue, it will only be required then to formalize the file and to check the eligibility of the past or future expenses.

35 L'express, « Contrôle fiscal. Quelles précautions prendre pour que son CIR soit accepté face au fisc ? », Charles Edouard de Cazalet et Thomas Gross.

36 L80 B 3°bis of the French handbook of tax procedures (Livre des Procédures fiscales)

A COMPARISON OF THE INTERNATIONAL INTERPRETATION OF THE PRINCIPLE OF "*NON-AGGRAVATION*"

Charlotte SIGNOL & Francis MAC GOWAN

Sometimes double taxation treaties can impose tax liabilities where none exist under domestic law. To avoid this situation, which would put a tax payer in a worse position, some jurisdictions choose to apply the measure that leaves the taxpayer in a more favourable position. In French law this is called the '*principe de non-aggravation* [1]'. The principle of "*non-aggravation*" does not apply under French tax law, as confirmed by recent *Conseil d'Etat* decisions. As a result, a taxpayer in France may be put in a worse position by virtue of a double taxation treaty than he would have been under French domestic law. This article seeks to highlight how the approach of the French courts in not applying the principle of "*non-aggravation*" differs in varying extents to the approach of other countries.

1. The **Schneider Electric** decision [2] formulated the principle of subsidiarity relating to international taxation and the interplay between domestic law and double taxation treaties. Schneider Electric provides us with a method to follow when deciding how and when do international tax treaties apply. Firstly, one must check whether a taxation applies under domestic law. Secondly, international taxation treaties should be checked to see if it prevents France from applying taxation. To arrive at this principle of subsidiarity the *Conseil d'Etat* referred to article 55 of the 1958 French Constitution which recognizes the supremacy of tax treaties over domestic law but states that, "a treaty cannot, by itself, provide a legal basis for taxation".

2. The opinion that a treaty cannot alone be used as a basis for taxation is shared by most jurisdictions in the world. Under the principle of "*non-aggravation*" a tax treaty cannot create nor place an increased burden on a tax payer. A taxpayer cannot be in a worse position than he would have been if the double taxation treaty did not apply, in other words, if only domestic law were applicable[3]. The principle of "*non-aggravation*" is sometimes known as "the protection of the advantages granted by domestic law". Therefore, if the double taxation treaty increases taxpayers' tax burden they should, in theory, be able to rely on domestic law.

3. The principle of "*non-aggravation*" is in line with the objective of tax treaties. In our increasingly

1 Can be translated as the principle that tax treaties can never make a taxpayer worse off than under domestic law. In the interests of brevity, however, the principle shall be referred to as '*the principle of non-aggravation*' throughout this article.

2 CE, ass., 28 June 2002, n° 232276, Sté Schneider Electric : JurisData n° 2002-080182 ; Rec. CE 2002, p. 233 ; *Dr. fisc.* 2002, n° 36, comm. 657 ; Dr. sociétés 2002, comm. 184, note J.-L. Pierre ; RJF 10/2002, n° 1080, chron. L. Olléon, p. 755 ; BDCF 10/2002, n° 120, concl. S. Austry ; Rev. sociétés 2002, p. 538 et s., obs. O. Fouquet ; LPA 17 August 2002, p. 4 et s., note B. Boutemy, E. Meier et Th. Perrot ; Bull. Joly Sociétés 2002, n° 200, note Ch. Nouel et S. Reeb ; BGFE 2002, n° 4, p. 3 et s., obs. E. Davoudet ; FR Lefebvre 34/2002, p. 14, obs. N. Chahid-Nouraï et P. Couturier ; GAJF 4e, éd. n° 4. - See also P. Dibout, L'inapplicabilité de l'article 209 B du CGI face à la convention franco-suisse du 9 septembre 1966 (à propos de l'arrêt CE, ass., 28 June 2002, Schneider Electric) : *Dr. fisc.* 2002, n° 36, 28.

3 «Qu'en est-il du principe de subsidiarité et du principe de *non-aggravation* en droit fiscal international français ?», E.Zeller, RDAI, 2002, n°1, p.115

globalised world, tax treaties have the goal of encouraging exchange between states by limiting the occurrence of double taxation and by favouring interstate flows[4]. In this context, treaties have the clear goal of reducing tax surcharges linked to international investments. With this in mind, it is strange that a tax treaty can put a taxpayer in a worse position than he would have been under domestic law.

In spite of the fact that the principle of "*non-aggravation*" appears to be a fair method of reducing tax costs for taxpayers, France has decided not to apply it, this will be looked into in greater detail in part (I). In part (II) the varying extents to which countries apply this principal will be reviewed.

I. The Principle of "*Non-Aggravation*" in France

4. Even before the courts have had a chance to interpret the principle of "*non-aggravation*" in France, it is clear at least that the French legislation had implicitly denied the application of the principle of "*non-aggravation*". This conclusion can be drawn from articles 4 Bis, 165 Bis and 209-I of the French Tax Code, which relate to the taxation of revenue which a tax treaty has given France the right to tax. The intention of the French legislature was to fill the gaps in the French tax code to avoid instances of double taxation[5]. These articles in the French Tax Code allow France to tax income which has been attributed to France by virtue of a double tax treaty even if domestic tax law does not give France the right to tax the income. In this context, therefore, a double tax treaty worsens the position of a taxpayer because he will be taxable in France even if there is no domestic tax measure giving France this right.

5. From a case law perspective, legal commentary could have come to the conclusion that the *Conseil d'Etat* recognised the principle of "*non-aggravation*". This can be illustrated by a 1984[6] case where the French judges ruled that an American taxpayer whose salary was taxable in France, by virtue of the double taxation agreement between France and America, was nonetheless not taxable in France in light of the exemption provided by article 164-1 of the French Tax Code. From 2000 onwards however the French courts took a different stance.

6. The *Conseil d'Etat* in ***Lecat 2002***[7] signaled a change in direction in the interpretation of the interplay between domestic law and treaty law. The *Conseil d'Etat* held that the tax advantages conferred by articles 164 A and 199 Septies B of the French Tax Code are limited to parties that are subject to French income tax on all of their income. As a result, an individual considered as domiciled in France pursuant to French domestic law but considered as a resident of Belgium pursuant to the provisions of the double tax treaty between France and Belgium, could not benefit from the advantages granted by French domestic law. This departure from the principle of "*non-aggravation*" has become the norm in French jurisprudence.

7. In ***BNP Paribas 2013***, the company had deducted a provision (on the basis of article 39-1-5 of the French Tax Code) in France for the depreciation of shares that it held in a Canadian subsidiary. The French tax authority denied the company the right to deduct the provision by reference to the Franco-Canadian double taxation treaty which states that Canada can tax substantial participation share transfers relating to Canadian companies. In ***BNP Paribas*** the *Conseil d'Etat* agreed with the French tax authority's decision.

8. In ***BNP Paribas***[8], the *Conseil d'Etat* first reminded the court of the principle that a provision for

4 Fasc. 3560 : Traitement fiscal – Intérêts, R.Coin, *Jurisclasseur Fiscal Impôts Directs Traité*, §113.

5 Parlementary debates, cité par B. Castagnède, *Précis de fiscalité internationale*, PUF, 4ème éd., 2013, p.321

6 CE, 7e et 8e ss-sect., 17 December 1984, n°47293 ; *Dr. fisc.* 1985, n°11, comm. 553., concl. O. Fouquet.

7 CE, 10e et 9e ss-sect., 8 July. 2002, n° 225159, M. Lecat : JurisData n° 2002080194 ; *Dr. fisc.* 2002, n° 41, comm. 801, concl. Mme M.-H. Mitjavile ; RJF 11/2002, n° 1202 ; BDCF 11/2002, n° 133, concl. Mme M.-H. Mitjavile.

8 CE, 3e et 8e ss-sect., 12 June 2013, n°351702, Sté BNP Paribas : JurisData n° 2013-012791 ; *Dr. fisc.* 2013, n°46, comm.511, concl. E.Cortot-Boucher, note E.Dinh.

depreciation of shares is deductible if the expense that it is aimed at anticipating is itself a deductible expense. In the present case, the expense was a capital loss on the share sale. The *Conseil d'Etat* developed a reasoning based on a principle of symmetry by explaining that the tax treaty between France and Canada could apply to 'negative'[9] income. In the case of a transfer of an interest, the capital gain is taxable in Canada and double taxation of the gain is avoided as the capital gain is exempt from taxation in France. This means that the right to tax is granted entirely to Canada. Therefore, capital gains in this situation are not taxable in France. By comparison to the treatment of capital gains, the *Conseil d'Etat* concluded that the capital loss relating to the interest is not deductible, which blocks the deduction of the provision anticipating such a loss. The ***BNP Paribas*** case shows that a tax treaty can prevent a taxpayer from benefitting from advantages that would otherwise be available to him under domestic law. This meant a provision for depreciation was not deductible in France for the taxpayer.

9. In accordance with article 23B of the OECD model most tax treaties signed with France eliminate double taxation through the granting of a tax credit. Withholding taxes give rise to tax credits which can be deducted from tax payable in France. This however is not the case when a taxpayer is in a loss position in France. No tax is payable in France and consequently the tax credit has no tax to be deducted from. This leads to situations where the foreign tax paid is a final cost for the taxpayer because under French law it cannot be carried forward. This explains why certain companies claimed the deduction of the foreign tax from their taxable income, thus increasing the amount of their net ordinary losses to be carried forward.

10. In ***Lummus***[10] ***and Soulès***[11], the *Conseil d'Etat* laid the foundations of the reasoning that was later taken up by the *Conseil d'Etat* in ***Céline 2014***[12]. In these cases, the *Conseil d'Etat* was of the opinion that as the Franco-Algerian double taxation treaty expressly provides for the non-deductibility of foreign taxes, this prevented the deductibility in France of a withholding tax. The *Conseil d'Etat* judged that except where it is expressly stipulated in a tax treaty, net profits taxable in France were calculated taking into account any foreign tax paid, which following article 39-1-4 of the French tax code includes withholding taxes. The ***Céline*** decision put the finishing touches to this line of jurisprudence. The *Conseil d'Etat* explained that even if a company was in a loss making position, withholding taxes paid abroad on license fees received by Céline were not deductible from the company's tax base in France. In any case, the wording of the Franco-Italian and Franco-Japonese tax treaties (which were under consideration in the ***Céline*** case) specify that foreign taxes are not deductible in France.

11. The following conclusions can be drawn from this jurisprudence by classifying types of tax treaties[13]:

➢ those that use clear terms such as "foreign tax is not deductible" prevent the application of article 39-1-4 of the French tax code and therefore the deductibility of foreign taxes;

➢ those that do not mention deductibility of foreign taxes. In this situation foreign taxes can be deducted on the ground of French domestic law[14]; and

9 *«Subsidiarité des conventions fiscales et aggravation de la situation du contribuable. - Ou comment une convention fiscale peut faire obstacle à la déduction d'une provision pour dépréciation de titres»*, E.Dinh, *Dr. fisc.* 2013, n°46, comm.511

10 CE, 7e et 9e ss-sect., 11 July 1991, n°57391, mentionné aux tables du recueil Lebon; *Dr. fisc.* 1993, n°31, comm. 1588; RJF, 10/1991, n°1208; Rev. Sociétés, 1991, p. 808, concl. O. Fouquet.

11 CE, 9° et 10°ss-sect., 20 November 2002, n°230530, publié au recueil Lebon; Dr.fisc. 2002, n° 50, act. 234; Dr. Sociétés 2003, comm. 59, note J. — L. Pierre; RJF, 2/2003, n° 153 : BDCF, 2/2003, n° 19, concl. G. Goulard; BGFE, 2003, n°1, obs. N. Chahid-Nouraï.,

12 CE, 9e et 10e ss-sections, 12 March 2014, n° 362528, Sté Céline ; *Dr. fisc.* 2014, n°22, comm. 356, concl. F. Aladjidi, note Ph. Durand, *Droit fiscal* n°22, 2014, comm. 356.

13 «Principe de subsidiarité : une évolution sans retenue (à la source)— A propos de l'arrêt «Céline» du 12 mars 2014», T.Massart, *La lettre juridique* n°570, 2014.

14 Please see CAA Versailles, 3ème ch., 18 July 2013, n° 12VE00 572 ; Dr. fisc. *2014*, n°4, comm. 93, concl. F. Locatelli, note J. — L. Pierre.

➢ if there is no double tax treaty in place - foreign taxes are deductible in France according to the tax authorities' commentary on the ground of French domestic law[15].

12. In light of the objective of double taxation the decisions in the aforementioned *Conseil d'Etat decisions* are open to criticism. Nevertheless, in situations where there is no tax treaty in place the *Conseil d'Etat's* decisions do put the taxpayer in a better position. Furthermore, these decisions create a situation of double taxation by reducing the amount of losses that can be carried forward by the company to the amount of foreign taxes paid.

13. There is no mention of the non-deductibility of foreign taxes under article 23B the OECD Model Treaty which relates to tax credit method for eliminating double taxation. This is a provision which is added by states when drafting tax treaties and one which is now included in all of France's most recent tax treaties. By way of example the 1984 Franco-Chinese treaty did not have this provision. The new treaty between France and China signed in 2013 has, however, included an article for the non-deductibility of Chinese tax in France. This shows a clear desire by France to prevent the deduction of foreign taxes from French taxable income, which makes it imperative to adopt the principle of "*non-aggravation*" in the French legal system. In spite of the French decision not to apply the principle of "*non-aggravation*" many countries continue to apply it which is in keeping with the objectives of double taxation treaties.

II. The Application of the principle of "*non-aggravation*" in other jurisdictions.

14. French tax law and jurisprudence goes against the practice of many other states which apply the principle of "*non-aggravation*".

15. The Italian legislation has devoted an article of its tax code to the principle of "*non-aggravation*". This can be found in article 169 of the Italian Tax Code and states that if a taxpayer is in a better position under the Italian tax code than a tax treaty then in these circumstances domestic law prevails over treaty law[16].

16. The judges in Luxembourg have also taken a different approach to that of the French courts. A 2005 administrative court case in Luxembourg delivered a judgment that shows a clear difference in approach to that of their French decision in the ***BNP Paribas*** case. The facts of the case are as follows: a Luxembourg company had a permanent establishment ("PE") in Germany by virtue of a see-through entity. According to the German Luxembourg tax treaty, income from this PE is taxable exclusively in Germany. However, according to the Luxembourg tax code, corporation tax is calculated by taking into account income derived from transparent entities even if they are situated abroad. In the present case, the German PE was loss making and the parent company had deducted these losses from its profits in Luxembourg on the basis of domestic law. This deduction was rejected by the tax authority on the grounds that the tax treaty with Germany provided for taxation of "positive" income in Germany and therefore "negative" income was not deductible in Luxembourg. The Luxembourg court held that, unless there is a provision expressly stipulating the contrary, double taxation treaties do not apply to "negative" income and consequently losses can be taken into account in calculating profits in Luxembourg[17]. Had the Luxembourg court not come to this decision they would have been acting contrary to the principle of "*non-aggravation*" and for the Luxembourg judges this is a general principal of tax law which should apply unless there

15 BOI-IS-CHAMP-60-10-40, 12 September 2012, §50. (the French tax instruction)

16 Article 169 du Testo Unico delle imposte sui redditi, cité par «The Italian Tax System: International and EU Obligations and the Realization of Fiscal Federalism», F.Gallo et G.Melis, *Bulletin for International Taxation*, Août-Septembre 2010, IBFD, p.400 et s.

17 Cour administrative du Luxembourg, 10 August 2005, n°19407 : la convention ne peut « être interprétée comme excluant la prise en compte dans l'Etat de résidence d'un revenu négatif réalisé dans l'Etat de source dès lors que le droit interne de l'Etat de résidence prévoit cette faculté pour tenir compte de la capacité contributive globale du contribuable ».

is a measure that prevents its application[18]. We can see the difference in approach between the French and Luxembourg judges in applying the principle of "*non-aggravation*". Nevertheless, following this case the Luxembourg legislation amended the tax code to prevent the deduction of foreign losses from income in Luxembourg, thereby limiting the judges' room to apply the principle of "*non-aggravation*" in future.

17. The principle of "*non-aggravation*" is applied most strictly in North America. The USA applies the principle of "*non-aggravation*" without any restriction and they even include a clause in most of the double taxation treaties enforcing the principle "*non-aggravation*". To illustrate this, the France-US tax treaty it states; "the Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by (a) the laws of: (i) the United States; (ii) France, in the case of a resident (within the meaning of Article 4 (Resident)) or citizen of the United States[19]." We can therefore note that this principle applies without restriction for advantages granted by US legislation but France has restricted its scope.

18. The US goes beyond this clause and allows its taxpayers to choose whether to apply domestic law or treaty law. In the revenue ruling 84-17[20], the IRS clarified the principle of "*non-aggravation*". In the Ruling 84-17, a Polish company carried out three different activities in the USA. Activity A was carried out via a PE, activity B and C were carried out via an independent agent. During the tax year in question the activities of A and B were profitable and activity C was loss making. By virtue of the US-Poland taxation treaty, the profits of activity A were taxable in the USA, whereas the activities B and C were exempt from taxation in the USA. The taxpayer decided to apply the provisions under the US tax code to deduct the losses of activity C from the profits of activity A. For the activity B the taxpayer requested that tax treaty be applied thereby exempting the activity from tax in the USA. The IRS recognized that US tax law could apply to deduct activity C's losses from the profits of activity C because of the principle of "*non-aggravation*". The IRS clarified, however, that the principle could only be used in a coherent manner across all activities, known as 'the anti-cherry picking rule[21]'. This left the Polish company with a choice to either: apply US tax law to all of its activities (allowing activity C's losses to be deducted from the activities A and B); or apply the tax treaty provisions (only the profits of A would be taxable in the US without the option to deduct the losses of activity C).

19. Canada has adopted a similar approach to the USA with respect to the principle of '*non-aggravation*'. The Canadian double taxation treaties also include an article allowing taxpayers to benefit from domestic tax law if it is more advantageous than treaty law[22].

20. The practice in North America can be distinguished from the French approach to the principle of '*non-aggravation*' and although other European countries do apply the principle it is not applied to the same extent as the USA and Canada. This difference in approach can be explained to a certain degree because of the difference in the hierarchy of norms. An example of this is, in France tax treaties have supremacy over domestic law by virtue of the French Constitution and the application of this principle is guaranteed by the *Conseil d'Etat*. In Canada and the USA tax treaties and domestic tax laws have the same legal standing and in case of conflict between the two it is the 'last in time' that prevails. Furthermore, in USA tax legislation is passed by the House of Representatives while international tax treaties

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18 Tribunal administratif du Luxembourg, 1e ch., 15 April 2013, n°30674.

19 Article 29 de la convention conclue entre la France et les Etats-Unis du 31 August 1994.

20 Revenue Ruling 84-17, Department of Treasury, 1984 ; Chap. 43, «Domestic law and Tax treaties : The United States», A.Infanti in *U.S. International Taxation and Tax Treaties*, éd. Matthew Bender, 2005.

21 «US-Italy treaty resurfaces questionable anti-« cherry-picking » rule with respect to royalty payments», J.Libin, *Tax Management International Journal*, 2003 ; 32, 3 ; ABI/INFORM Global, p.156.

22 « The relationship between tax treaties and the income tax act : Cherry Picking », B.ARNOLD, *Canadian Tax Journal*, vol.43, n°4, 1995, p.869 et s.

are entered into by the President and the Senate. It would be unconstitutional if a tax treaty could put the taxpayer in a worse position than he would have been under legislation created by the House of Representatives, the supreme authority in US tax matters[23]. It is, therefore, logical that the principle of '*non-aggravation*' applies without restriction in the USA thereby putting the taxpayer in a stronger position.

In light of the objective of international tax treaties it is clear that the North American approach affords the most protection to taxpayers in their international activities when deciding whether to apply treaty provisions or domestic tax law.

23 « The relationship between tax treaties and the income tax act : Cherry Picking », B.ARNOLD, précité.

TAX CONSOLIDATION : FROM PAPILLON TO THE HORIZONTAL

Pauline DELAFLOTTE & Laura DRIANCOURT

The horizontal tax consolidation newly introduced by the Amending Finance Law 2014, which has followed the Court of Justice of the European Union's (CJEU) decision of the 12th June 2014, raises the questions both of its implementation and of its effects. The first can be tricky while the second could be risky for France, especially considering the European Law and the international conventions.

1. The tax consolidated profits of French sisters companies held directly by a parent company or indirectly through foreign companies, all established in a State member of the European Union (EU) or of the European Economic Area (EEA), has finally been admitted in French Law through the Second Amending Finance Law 2014, voted in December[1]. This text joins the possibility to consolidate the profits of French sub-subsidiaries indirectly held by an intermediary company established in the EU, also called montage «Papillon»[2]. Once again, the French law modification follows a decision of the CJEU, which dates of the 12th June 2014[3].

2. Two kinds of tax consolidation coexist in Europe. In the first one, companies of the same group exchange their losses by internal billings but each remains obliged to pay the corporate income tax. The second one allows companies of the same group to calculate an overall result on which the corporate income tax will be paid by the parent company[4].

3. The Netherlands has chosen this last one, while refusing to extend it to the horizontal consolidation. For that reason, their legislation has been deferred in front of the CJEU, which has given the above decision[5]. In this case, companies established in Netherlands and held indirectly by a German parent company through foreign companies also established in Germany. The Court has considered that there was a limitation to the freedom of establishment and there was no overriding reason relating to the public interest that could justify the impossibility to elect for the horizontal tax consolidation regime.

4. This decision addresses France directly for several reasons: first, France has chosen the same regime than the Netherlands and has also rejected from its law the horizontal consolidation. Into that framework, trial judges had refused this kind of consolidation in 2010, then again in 2012[6]. However, the CJEU has taken care of using terms

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1 Amending Finance Law 2013 n°2014-1655 of the 29th December 2014

2 CJEC, 4ème ch., 27th November2008, aff. C-418/07 : Rec. CJCE, 2008, I, p. 8947 ; *Dr. Fisc.*, 2008, n° 52, comm. 644, note J.-L. Pierre ; RJF, 2/2009, n° 180 ; BDCF, 2/2009, n° 16, concl. J. Kokott.
On this case, see P. Dibout, « Le périmètre des groupes de sociétés et la liberté d'établissement. A propos de CJCE, 27 novembre 2008, aff. C-418/07, Sté Papillon », noticeunder CJCE, 4ème ch., 27th November2008, aff. C-418/07, Sté Papillon : *Dr. Fisc.*, 2008, n° 52, 640.

3 CJEU 2e ch. 12th June2014, SCA Group Holding BV, aff. C-39/13, X AG, aff. C-40/13 and MSA International Holdings BV, aff. C-41/13 : *Dr. Fisc.*,2014, n°37, comm. 524 R. Schneider, « Groupes de sociétés : la CJUE prend position en faveur de l'intégration horizontale » ; RJF 10/14 n°962.
On this case, see M. Abitbol, « Intégration fiscale horizontale aux Pays-Bas : l'envol d'un nouveau « Papillon en direction de la France ? », jurisprudence, fiscalité internationale, *Hebdo Edition Fiscale*, 2014,n°576

4 R. Schneider, « Groupes de sociétés : la CJUE prend position en faveur de l'intégration horizontale », *Dr. Fisc.* 2014, n°37,comm. 524

5 CJEU 2e ch. 12th June2014, see supra

6 Cergy-Pontoise Administrative Court 3rd October2012 n°1102790, IS-V-6050 and Montreuil Administrative Court 14th October 2010 n°08-9608 and 09-2754, RJF 4/11 n° 528

making the decision transposable to the French law, and this, even more than the French and Dutch regimes carry several similarities[7].

5. Thus, two amendments to modify the tax consolidation regime in order to line up with the CJEU rulings have been introduced then rejected in second reading by the Senate in July 2014[8]. A few months later, at the beginning of December, the Versailles Administrative Court of appeal has validated the horizontal consolidation[9]. Finally, the scheme has been voted in the second Amending Finance Law 2014[10].

6. While waiting for the comments of the French Tax Administration (FTA), it is necessary to wonder about the strict conditions of implementation of this regime (I) and of its effects that induce several risks (II).

I. The horizontal consolidation: strict conditions of implementation

7. As a preliminary remark, it is important to specify three points regarding the scope of this regime. First of all, the vertical consolidation parent company characteristics are the same for the horizontal consolidation but lay on the non-resident parent company (NRPC) and the French parent company[11]. Secondly, only companies subjects of the corporate income tax (CIT) in France can be members of the horizontal consolidated group. Therefore, are excluded from that horizontal tax group the NRPC and foreign companies which are subject to an equivalent tax to the CIT in a State member of the EU or of the EEA. Finally, some entities are expressly excluded from the regime, such as groups of assurance companies without capital, cooperative bank and commercial and industrial public establishments[12].

8. Unlike the vertical consolidation, the horizontal one lays on three to four entities: the NRPC, the possible foreign companies, the French parent company and finally the French companies of the group.

9. NRPC First, the non-resident parent company is the economic parent controlling the group's members[13]. It must be established in a State member of the EU or of the EEA, which has concluded with France a tax treaty with an administrative assistance clause against tax fraud or tax evasion. In practice this includes Iceland, Norway and Liechtenstein[14]. said company must also be subject to a tax equivalent to the CIT. Implicitly, the NRPC cannot be established in France[15]. However, it appears possible for a permanent establishment in those countries of a foreign company (e.g. established in a different country of those aforementioned), to be a NRPC. Furthermore, it must not be held over 95%, directly or indirectly, by another legal person subject to CIT or to an equivalent tax, if it is held by companies or establishment localised in a State of the EEA[16]. In case of ownership over 95% by a legal person subject to the French CIT under the conditions provided for by law, the NRPC would be an intermediary company and therefore a so-called «Papillon» tax consolidation type would be possible, which would exclude the option for a horizontal consolidation[17].

7 R. Schneider, « Groupes de sociétés : la CJUE prend position en faveur de l'intégration horizontale », *Dr. Fisc.* 2014, n°37,comm. 524
8 Draftlaw of the 21th July 2014
9 Versailles Administrative Court of Appeal 2nd December2014, n°12VE03694, FR 58/14 inf. 5 p. 7
10 n°2014-1655 of the 29th December2014
11 Feuillet rapide fiscal social 60/14 (Loi de Finances rectificative pour 2014, paru le 30/12/14)
12 Law 2014-891 of the 8th August 2014, art. 20 : IS-V-25100 s.
13 P. Fumenier,« Extension du régime de groupe aux sociétés soeurs détenues par une mère non résidente (intégration fiscale horizontale) », *Dr. Fisc.* 2015, n° 1-2, comm. 20
14 French Tax Code (FTC), art. 223 A, I al. 2 new
15 Ibidem
16 Ibid.
17 Ibid. P. Fumenier,« Extension du régime de groupe aux sociétés soeurs détenues par une mère non résidente (intégration fiscale horizontale) », *Dr. Fisc.* 2015, n° 1-2, comm. 20

10. Foreign companies Furthermore, the ownership of both the French parent company and the French companies by the NRPC can be indirectly achieved through foreign companies[18]. These ones, like the NRPC, must be established in a State member of the EU or of the EEA, which has concluded with France a tax treaty with an administrative assistance clause against tax fraud or tax evasion[19]. Likewise, they must be subject on their own right or on option, without being exempted, to a tax equivalent to CIT in this State[20]. Finally, they must be held directly or indirectly by the NRPC. Therefore, it seems that a foreign companies chain would be forbidden. Practically, it is not possible to determine if it is an omission by the French legislator or a voluntary abstention[21]. From that consideration, we hope for a favourable vision of this text by the FTA. Indeed, if the possibility for a French parent company to consolidate its subsidiaries in a holding chain, was denied to a NRPC, it would violate the freedom of establishment.

11. French parent company Then, the French parent company is the only one liable to the group corporate income tax[22]. To be head of the horizontal tax consolidation group, the company must comply with the general conditions of tax consolidation: being subject on its own right or on option to the ordinary tax rate of CIT in France, choosing the actual taxation regime, not being held over 95% directly or indirectly by another company subject to CIT and being a legal entity at the time of the tax consolidation option. A specific condition to the horizontal regime adds up: the French parent company must be held at least at 95% directly by the NRPC or indirectly through foreign companies[23].

12. French companies of the group Finally, the French companies of the group must also comply with the above-mentioned tax consolidation conditions: being subject on their own right or on option to the ordinary tax rate of CIT in France and having identical closing and opening dates for each company. Regarding the holding threshold, they must be held at 95% directly by the NRPC or indirectly through a foreign company, the French parent company, an intermediary company or a company member of the tax group. However, the law seems to exclude the permanent establishments in France by aiming only companies[24]. Practically, this difference of treatment between subsidiaries and permanent establishments in France of foreign companies could be analysed as a violation of the freedom of establishment. On this point too, it would be necessary to wait for the FTA comments.

13. Finally, it seems that the new scheme, welcome as it draws the relevant consequences of the CJEU rulings, could be complex in its implementation, but also in itsfunctioning and could be partially in contradiction to the European law.

II. The horizontal consolidation: complex and risky effects

14. The horizontal group is organised in the same way than the vertical one, with yet some differences on the retreatments, the cases of termination and the cases of restructuring.

15. Neutralisations: First of all, to calculate the tax result of the tax consolidated group and the tax, some reprocessing must be done. In the horizontal tax consolidation, must be taken into consideration the ownership of the companies members of the group by the NRPC and the foreign companies. Therefore, there are some specific neutralisations to do on the operations realised by companies members of the group with the aforementioned companies. The goal here is to avoid a double deduction of losses or a double

18 FTC, art. 223 A, I al. 2 new
19 Ibidem
20 Ibid.
21 P. Fumenier,« Extension du régime de groupe aux sociétés soeurs détenues par une mère non résidente (intégration fiscale horizontale) », *Dr. Fisc.* 2015, n° 1-2, comm. 20
22 Ibidem
23 FTC, art. 223 A, I al. 2 and 3 new
24 FTA, art. 223 A, I al. 2 new

taxation of benefits. Most of retreatments done are similar to those of the «Papillon» tax consolidation for operations made by companies members of the group with the intermediaries companies[25]. We can quote the neutralisation of participation products[26], of provisions[27], of debt waivers and subventions[28], but also the pre-consolidation tax losses[29], the reinstatement of financial costs under the Charasse amendment and the neutralisation of interests in case of thin capitalisation[30].

16. However, two particularities must be noticed. The first one touches the neutralisation of attendance fees[31] and the second one affects the gains or losses of the equity disposal involving the NRPC or a foreign company[32].

17. Regarding the attendance fees, apart from the usual reinstatement of the portion that has been deducted from the individual result of the subsidiaries members of the group[33], there is also the reinstatement of the share that has been deducted by the French parent company. Indeed, the legislator sees the NRPC as the economic entity controlling the members of the group while the French parent company is only the entity liable for the group tax, with no aspect of effective governance[34]. Practically, the argument does not add up especially for two reasons[35]. The first one is that the sisters companies members of the consolidated group can hold themselves directly or indirectly subsidiaries at 95%, hence the idea that the administrators participate to the governance of the sub-group. The second one is that the idea of a company holding 94,99% of a vertical consolidated group parent company would exercise itself the effective governance of the group. Therefore, we could legitimately hope that this disposition against the French mother company of a horizontal consolidation would fall.

18. Regarding the gains or losses of an equity disposal involving the NRPC or a foreign company, they will be considered as realised outside of the group and will not be neutralised. However, an exception is stated in case of disposal of a company member of the group's shares by another company of the group to the NRPC or a foreign company[36]. Indeed, there will be a neutralisation of the gain of loss, then a de-neutralisation in case the transferred company would no longer be a member of the tax group, or in case of disposal by the NRPC or the foreign company to a company outside the tax group. In this last situation, the deneutralisation is limited to the gain or loss concerning the transferred shares.

19. Then, in addition to the usual cases, there is an important diversity of particular events causing the end of the group and there are specific rules in case of restructuring.

20. Termination of the group Regarding cases of termination of the tax group, we must distinguish changings in the holding conditions of the French parent company from those of the NRPC. In the first situation, the ownership by the NRPC through another company fulfilling the conditions to be head of the tax group, the reduction to less than 95% of the ownership rate by the NRPC, the changing of the parent company or particular cases of restructuring would lead to the end of the tax group. In the second situation, the holding to over 95% by a company subject to CIT («Papillon») or to an equivalent tax in Europe or particular cases of restructuring would cause the end of the tax group.

25 Referral to the Papillon regime
26 FTC, art. 223 B al. 3new
27 FTC, art. 223 B al. 4 and 6new and art. 223 D new
28 FTC, art. 223 B, al. 6 new
29 FTC, art. 223 A, I al. 4 new
30 FTC, art. 223 B, al. 14 and f. new
31 FTC, art. 223 B, al. 5 new
32 FTC, art. 223 F new
33 FTC, art. 223 B
34 Report National Assembly n°2408
35 Feuillet rapide fiscal social 60/14 (Amending Finance law 2014, published the30th December 2014)
36 FTC, art. 223 F new

In these hypotheses, operations of deneutralisation will be the same than a classic group ending, except for one aspect: it would be impossible for the companies members of the tax group to be consolidated in a new tax group within that same fiscal year.

21. Moreover, some events can cause companies of the group to leave it. It can be a reduction to less than 95% of the ownership rate by the NRPC or a change influencing a foreign company involving the exit of subsidiaries that it holds. This last assumption appears in case of reduction to less of 95% of the ownership rate of the foreign company equity by the NRPC, change of tax regime implying that the foreign company is no longer subject to an equivalent tax to CIT or a modification of the closing date of its fiscal year while the foreign legislation allows the matching on the tax group's one.

22. Cases of restructuring Finally, regarding the cases of restructuring, particular cases add up to the usual ones. It is explained by the inclusion of the NRPC. Therefore, for each restructuring operations, the neutralisation will be the same for both the mother company and the NRPC.

23. Practically, taking into consideration the NRPC seems contrary to the European Law because the events regarding foreign companies holding the French mother company have no impact on the vertical tax consolidation. Yet, in the horizontal tax consolidation, the events influencing the NRPC could terminate the group (which is not in the interest of the French group) and a reluctance to the creation of such a tax consolidation[37].

24. Furthermore, this regime will be effective for fiscal years closed from 31st December 2014[38]. However, this is no particular method of implantation planned for that first fiscal year. Therefore, it is likely that the FTA would allow an exceptional delay[39].

25. On the other hand, claims as a conservatory measure[40] can be done to get the restitution of tax that companies members of a horizontal group would not have paid in absence of violation of the European law, according to the decisions of the CJEU of 12th June 2014[41] and of the Versailles Administrative Court of Appeal of the 2nd December 2014[42]. Moreover, in that last case, the claimant company has been able to get the reimbursement of the amount of tax exceeding the tax losses of some of its subsidiaries[43]. Indeed, according to the common delay, before the 31st December of the second year following the one of tax payment, the concerned companies can carry out that claim. In this way, any claim filled before the 31st December 2015 could involve the tax paid in 2013 for 2012 fiscal year.

26. Finally, we can wonder about a potential opening of the horizontal consolidation in an international framework. Regarding the vertical consolidation regime, the article 7 of the OECD tax treaty provides from any tax consolidation at an international level. The text specifies that the beneficiary company will be taxed in its place of establishment, except where there is a permanent establishment. However, this is not the case regarding the horizontal consolidation regime. Therefore, the article 7 of the OECD tax treaty is not an issue. Moreover, through the article 24.5 of the OECD tax treaty, called non-discrimination

37 L. Leclercq, A-M Merle et J. Du Pasquier, « Quelques rapides observations sur le projet de texte relatif à l'intégration fiscale horizontale », *Dr. Fisc.* 2014, n°50, act. 614

38 n°2014-1655 of the 29th December 2014

39 P. Fumenier, « Extension du régime de groupe aux sociétés soeurs détenues par une mère non résidente (intégration fiscale horizontale) », *Dr. Fisc.* 2015, n° 1-2, comm. 20

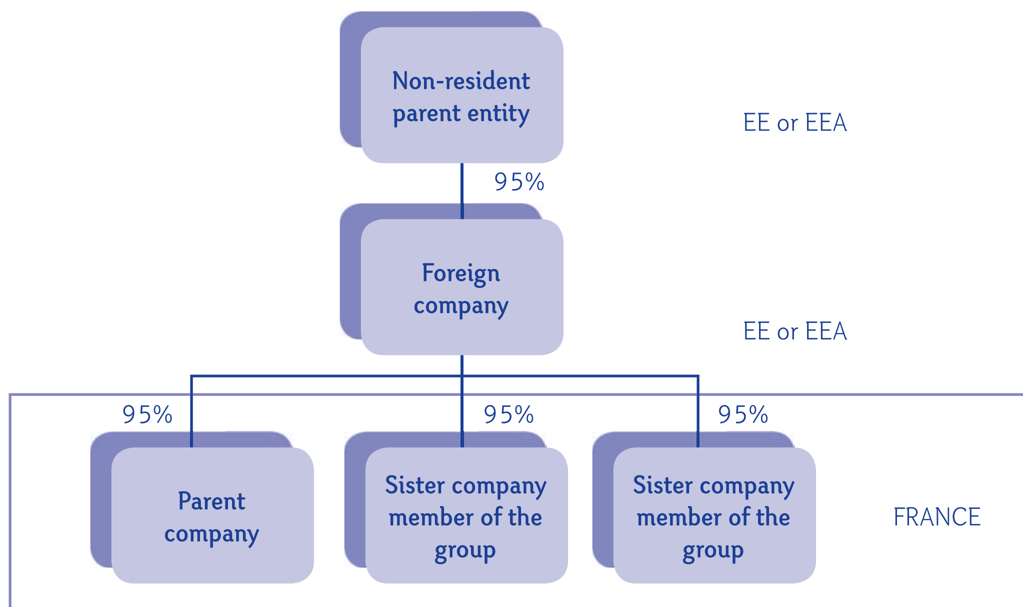
40 Handbook of Tax Procedure, art. L.190

41 CJEU 2e ch. 12th June 2014, SCA Group Holding BV, aff. C-39/13, X AG, aff. C-40/13 aznd MSA International Holdings BV, aff. C-41/13

42 Versailles Administrative Court of Appeal 2nd December 2014, n°12VE03694, FR 58/14 inf. 5 p. 7

43 P. Fumenier, « Extension du régime de groupe aux sociétés soeurs détenues par une mère non résidente (intégration fiscale horizontale) », *Dr. Fisc.* 2015, n° 1-2, comm. 20

clause, it would be possible to accept the option of a horizontal tax consolidation at an international level. Practically, the situation of sisters companies established in France, with a parent company also established in France, seems close to the one of companies established in France with a parent company established abroad. Furthermore, on the basis of conventional law, some judges of the EU have consecrated this option[44].



44 Sweden Supreme Administrative Court, SE : RA 1996 ref. 69
Sweden Suprem Administrative Court, SE : RA, 24th September 1998, 4676-1997, 1998 ref. 49
Finland Supreme Administrative Court, FI : KHO, 10th May 2000, Judgment KHO 10-5-2000/864
London Court of Appeal (Civile Division), 17th Octobre 2012, FCE Bank Plc., EWCA Civ 1290w

ANTI-HYBRIDS PROVISIONS : BACK ON THE FRENCH MECHANISM IN EARLY 2015

Mina BOUHARCHICH & Nicolas DRAGUTINI

Even though French tax administration clarified the French anti-hybrid system in its last comments, several questions remain unanswered, especially regarding its goals. Moreover, it seems that the anti-hybrid system goes against the OECD recommendations.

1- Since 2012[1], the work conducted by both the OECD and the EC[2] shed light on the importance and the need to tackle taxable base erosion and profit shifting. In September 2014 the OECD/G20[3] released a prominent report regarding the Antihybrid arrangements.

According to the OECD hybrid mismatches arrangements refers to an *« arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement[4] ».*

Such arrangements involve entities established in different jurisdictions and sharing financial links. These links present both features of debt and equity. Consequently, the main purpose of these arrangements is to localize debts in countries which grant a deduction for interest charges made under the instrument and to pay these in the meantime in countries which do not tax the payment received under that instrument[5].

2 - In response to these profitable arrangements, countries have reacted in implementing the rules of the OECD and by their own legislation. This is the case of France which decided to make its own rules for avoiding mismatches arrangement and which are analyzed in this article.

3 - The French rules could seem complicated at first but French tax administration provides more clarity throughout the publication of further comments. From then on, if the administration tries to clarify its measures, some incoherence remains (I). Besides, France is not the only European country equipped with such mechanism, even though both OECD and European Commission recommended a common and worldwide approach. This situation questions very seriously the efficiency of theses national approaches and damages once again the competitiveness of the French companies (II).

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1 See the many reports upon the double taxation and double non-taxation topics published since 2012 ; for instance :
Cf. EC, « The internal market : factual examples of double non-taxation cases », March 2012 ;
Cf. OECD (2012), « Hybrid Mismatch Arrangements : Tax Policy and Compliance Issues », OECD Publishing ;
Cf. OCDE (2013), « Declarations on base erosion and profit shifting », OECD Publishing ;
Cf. OCDE (2013), « Action Plan on Base Erosion and Profit Shifting », OECD Publishing.

2 European Commission (EC).

3 OCDE (2014), *«Neutralizing the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project »,* OECD Publishing

4 *OECD (2014),* « Neutralizing the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project », *OECD Publishing.*

5 OECD (2014), *« Neutralizing the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project »,* OECD Publishing.

I French anti-hybrids provisions : more clarity but a remaining incoherence

3 - A better readability. The Finance Bill of 2014 enacted the article 212,I,b of the FTC[6] a non-deduction principle of financial charges of interests paid to related companies under some special circumstances[7]. This limitation applies to the particular case of loans occurring between bound related companies and can be ruled out by proving.

4 – The entities concerned by the mechanism are companies liable to French corporate income tax as well as transparent entities pursuant to article 238 bis K of the FTC, subject to a transparency tax regime and whose securities are accounted on the balance sheet of a company subject to the French corporate income tax. Besides, the French permanent establishments of foreigners companies are also concerned by the regime[8].

The loan operation at the origin of the financial charges supported by the debtor company has to intervene with a related company, using the «links of dependence» criteria defined under the article 39-12 of the FTC. According to this article, two companies are considered as related when one holds directly or through a third party the majority of the capital shares of the other one, or holds the effective control by taking the main decisions, or, when both are placed in the two above-mentioned situations under the control of a third company «.

The creditor company can be indifferently located in France or abroad and be a company subject to corporate income tax, a collective investment fund pursuant to articles L. 214-1 of the Monetary and Financial Code, or a transparent entity subjected to a related transparency regime. In this last case, the applicability of the mechanism is determined by the further condition of the existence of dependence between the creditor entity and its owners.

If the previous conditions are met, the mechanism applies and two remarks can be done as for the contents and as for the burden of the proof it establishes.

5 - In the first place, the regime requires the taxation of the interests under an income tax which amount must be equal at least to the quarter of the income tax determined under the application of French taxation rules.

Since the creation of the mechanism and despite the release of the first FTA comments over the regime, some questions were remaining on its practical involvement[9]. In particular, the point was to know if it was expected a minimal taxation of the interests or of the result, whether it was wanted a taxation of the gross or the net interests, if it was required an effective payment of this minimal tax or not, etc.[10].

Whereas the first FTA comments[11] raised some issues, the second[12] solved the remaining difficulties. We know from now on that the regime aims at a minimal taxation of the gross interests, at least equal to the quarter of the French income tax - possibly completed by the additional taxes - the creditor would have been subject to tax if it was imposed in

6 French Tax Code (FTC)

7 D. Andres & J. Mestoudjian, « Discussions sur la dernière couche d'un millefeuille fiscal », Décideurs stratégie finance droit, guide 2014.

8 Pursuant to FTA lastest comments : BOI-IS-BASE-35-50-20140805.

9 S. Mostafavi & N. André, « Déductibilité fiscale des intérêts afférents à des instruments financiers hybrides : une nouvelle limitation aux contours incertains », Option finance n°1258, P.34-35, 24 February 2014.

10 For example, refer to reflexion driven by the following papers :
Cf. A.Lagarrigue & B. Hardeck, *« Dispositif anti-hybrides : retour sur les difficultés d'application à la lumière des premiers commentaires de l'Administration »* : Dr. fisc. 2014, n°22, comm. 353.
Cf. R. Coin, *« Durcissement des conditions de déduction des intérêts d'emprunts versés à des sociétés liées »* : Dr. fisc. 2014, n°1-2, comm. 25.
Cf. FR 57/13 (published on 27/12/13), *Cf.* FR 23/14 (published on 25/04/14).

11 BOI-IS-BASE-35-50-20140415 published on 15/04/2014.

12 BOI-IS-BASE-35-50-20140805 published on 05/08/2014.

France. We also know that the actual payment of the tax does not matter provided that they integrated a basis taxable to an upper rate to the reference rate. Besides, in the special case where the creditor entity would be subjected to a transparency taxation regime, the minimal taxation would be to appreciate at the level of the entity owners.

6 - The mechanism establishes a particular burden of proof by determining the right of deduction to the minimal taxation proof by the debtor company but only in case of formal requirement by the FTA. Complex at first sight, this mechanics leans in fact on two principles.

The proof can be established by any mean by the debtor company. However it must prove that the interests deducted from its fiscal result during the fiscal year were actually subject to a minimal taxation in the creditor company accounts during the same exercise. In case of non corresponding fiscal exercises between the companies, for example when the debtor would close at a previous date to the creditor, the right for deduction shall be anticipated, except very special cases.

This burden shall intervene only under the request of FTA in the tax audit framework. So, the proof won't consist in establishing a yearly special return[13], but it is nevertheless recommended for companies to precede the FTA control by establishing an *ad hoc* supporting file.

7 - So as it appears, while the article 212,I,b could seem complex in the first way, the administration's comments enabled to dissipate the first concerns arisen from the application of the text. However, beyond the letter of the text, incoherence regarding the goals of the mechanism remains. Indeed, born in a context of reduction of the Budget revenues, the antihybrid provision questions on the consistence of its measures with its formal objectives on one hand and on its compatibility with European law in the other hand.

8 - Incoherence remaining. Reading the parliamentary debates, the creation of the mechanism provided by the article 212,I,b aimed at *«fighting against fiscal optimization allowed by hybrid mismatch arrangements and artificial debts»*[14].This goals were directly coming from the recommendations of the biggest national, European and international institutions to fight fiscal optimization through hybrid mismatch arrangements[15].

According to this objective, the mechanism had to include all cases of arrangements based on hybrid mismatch or artificial debts and exclude, on the contrary, all the other cases based on not-fictitious debts. Yet, by establishing a general principle of not-deduction of the financial charges between related entities when the corresponding product is not subjected to a minimal taxation, the mechanism seems in fact to overtake its objective and go beyond what is necessary to reach it. At the time of the parliamentary debates[16], the Minister of Finance's statements were going in this way, when he stated that *«the article 14 establishes a measure of symmetry into the treatment of financial charges and the interest products»*.

While the Constitutional Council considered that this anti-hybrid provision was compatible in regard to its pursued objective[17], we could still wonder about the consistence between the assigned objective and the means developed to reach it. Furthermore, the mechanism would not seem to avoid totally fiscal optimization by hybrids mismatch arrangements. Indeed, by requiring a minimal taxation of the interest, the regime could

13 BOI-IS-BASE-35-50-20140805, n°120.

14 *Rapport Assemblée Nationale n° 1428*, « Tome II - Examen de la première partie du projet de loi de finances : conditions générales de l'équilibre financier », *p.346*.

15 *Cf.* Rapport AN d'information °1243 ;
Cf. CE, « *Marché intérieur: exemples concrets de cas de double non-imposition* », March 2012 ;
Cf. OCDE, « *Dispositifs hybrides : questions de politique et de disciplines fiscales* », March 2012.

16 C/ JOAN CR 12/12/2013, 3e séance, B. Cazeneuve, p. 38.

17 Cons. const., 29/12/2013, n° 2013-685 DC, recital n° 36.

be avoided by the use of «back-to-back» scheme in which the taxation could still be avoided.

9 - Beyond the national framework, we may also question on compatibility of the French anti-hybrid provision with European law[18]. With the increasing European harmonization promoted by the Court of justice of the European Union (CJEU), this question must be studied, all the more when it comes to measures «of yield»[19].

A law can be considered as not compatible with the right of the European Union when it operates an unjustified discrimination by an imperative general interest consideration. Concerning the French dispositions, it does not set up a difference of treatment as it applies indifferently creditors companies situated in France or in the European territory[20].

Nevertheless, according to the parliamentary debates[21], the inclusion of the French entities in the scope of the French regime would in fact have been on the unique purpose to avoid its incompatibility with the right of the EU. Indeed, if the French creditor entities are taken into account by the provisions, its application to French entities would only seem theoretical. To base the applicability of the article 212,I,b in the French entities creditors, the legislator leans exclusively on the case of companies subjected to special regimes of exemptions[22] while an important part of these regimes seems to plan the non-exemption from the financial products and so, these companies would be excluded from the mechanism.

10 - It is then possible that the appearance of this equal treatment can establish a claim before the CJEU. Otherwise, this appearance can maybe be strong enough to protect the French regime of an European decision of incompatibility. In Sweden, a similar and previous legislation is currently subject to studies of compatibility to the right of the EU by the European Commission[23].

Finally, by anticipating the European and international recommendations[24], France might have taken delay in conformity. Further than the question of the compatibility, this situation notices in the anti-hybrid process of emergence of the product in France which, on the contrary international calls to the coordination and actions of concert purely resulted from French decisions.

II The different anti-hybrids financing provisions in the world : legal uncertainty created by an international lack of coherence

11 - A uniform approach needed. Many states, like France, have undertaken to adopt dispositions concerning hybrids mismatch arrangements. Individually, these actions may match with the goals fixed by the Action 2 of the BEPS Action Plan concerning hybrids[25]. However, these different legislations have several consequences for companies but also for the States.

12 - The phenomenon of globalization inexorably created interactions between the various tax systems and highlighted situations of double deduction

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18 Cf. R. Jouffroy et E. Raingeard, *« Les nouvelles règles anti-hybrides promises à une courte expérience au sein de l'UE »*, Option finance n°1264, p. 6-7, 31 March 2014.

19 Using the expression of the Constituitional Council.
C/Cons. const., 29/12/2013, n° 2013-685 DC, recital n° 34.

20 Or in a State or territory having concluded with France an convention of administrative assistance to fight against fraud and tax evasion.

21 *« Vous semblez penser que ce dispositif n'est pas eurocompatible : c'estpourquoi nous avons prévu qu 'il s'applique partout, y compris en France ! »,*

22 ZFU, ZRR, and JEI special tax regimes.

23 Cf. EU Pilot 4437/13/TAXU - Sweden (09/01/2013).

24 This is what is coming out the parliamentary debates: « Il existe aujourd'hui un consensus international [sur la lutte contre les hybrides] : précédons les autres pays de quelques mois et ils nous suivront ».
Cf. Rapport Assemblée Nationale n° 1428, *« Tome II - Examen de la première partie du projet de loi de finances : conditions générales de l'équilibre financier »*, p.349.

25 OECD, *Action Plan on Base Erosion and Profit Shifting*, 2013

and double non taxation. Then, the extra-state organizations had as objective to remedy these situations by adopting international rules which are clear, predictable and certain both for the public authorities as for the companies.

These last years, and in a context of crisis, the Member states of G20 denounced certain schemes of tax planning which, by identifying the licit possibilities of arbitration and the limits of the optimization, allow certain companies *«to adopt with more insurance of the aggressive fiscal positions»*[26]. This refers to, amongst others, the hybrids mismatch arrangements.

As it was specified, according to the OECD, hybrid mismatch arrangement *«incorporate techniques that exploit a difference in the characterization of an entity or arrangement under the law of two or more tax jurisdictions to produce a mismatch in tax outcome"*[27]. It is the difference of interpretation and of legal qualification that allows a double non imposition or a double deduction.

The Action 2 of the BEPS Plan has exactly the purpose of neutralizing the effects of the hybrid, considered as harmful for the economy and the competitiveness. This Action thus consists in *"developing model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effects of hybrid instruments and entities"*[28].

13 - The starting assumption of the OECD's works is that companies are rational actors who systematically try to minimize their cost and thus their tax[29]. If the use of the hybrid entities or instruments results then from a rational behavior, it is exactly because these present an advantage. So, to eradicate in an effective and long-lasting way, it seems necessary to take into account this component and to fight against the advantage that represent these instruments and entities. It is thus a question of handling the problem to the source.

By adopting this approach, States will later be endowed with rather effective dispositions which go, not only to dissuade the economic agents, but to take off any advantage from these instruments. From then on, acting in a rational way, companies, by themselves, will not resort any more to these instruments.

14 - However, the hybrids phenomenon results exactly from interactions and from weaknesses which remain between the different legislations. If harmonization and coordination is the effective approach, the one privileged by some Member States of G20 does not seem to be the followed way.

Indeed, in this context of crisis, the OECD identifies a major risk: the temptation for the States to focus on the erosion of the tax base through the hybrid mismatch arrangements. Such an approach would have as consequences to adopt dispositions which pursue the unique objective to get this potential loss of tax income. However, not only it seems difficult to identify which State underwent this loss, but also, it does not allow to solve the hybrids' problem but only to handle the consequences with it[30].

Therefore, the OECD warns against the unilateral measures of States and favors a coordinated action. Indeed, several independent individual actions, if it seems to remedy the problem of the double deduction or the double non-imposition, it does not allow to solve the basic problem of hybrids.

As well, the European Commission specified that *« the isolated action of every Member state in answer to the hybrid mismatch arrangements [...] does not allow to solve effectively the problem, because this one ensues from the interaction of the various national fiscal systems »* and because *« coordinated isolated initiatives could create new asymmetries or new tax obstacles »*[31].

26 OCDE (2013), « Action Plan on Base Erosion and Profit Shifting », p.8, OECD Publishing.

27 OECD (2012),«Hybrid Mismatch Arrangements : Tax Policy and Compliance Issues»,p.7, OECD Publishing

28 OCDE, *« BEPS Action 2 : Neutralise the effects of hybrid mismatch arrangements"*, May 2014.

29 *« La concurrence fiscale et l'entreprise »* Synthesis of the 22nd report of the Court of Auditors to the President, December 2014

30 OCDE, *« BEPS Action 2 : Neutralise the effects of hybrid mismatch arrangements"*, p.14, May 2014.

31 CJ, gd ch., 05/02/2014, case C-385/12, Hervis Sport-ésDivatkereskedelmiKft : *Dr. fisc.* 2014, n° 7, act. 111. - and also CJ, 14/02/1995, case C-279/93, FinanzamtKoln-Altstadt c/ Roland Schumacker : Rec. CJ 1995, I, p. 225, concl. Ph. Léger ; *Dr. fisc.* 1995, n° 20, comm. 1089, note A. de Waal ; RJF 3/1995, n° 425. - CJ, 1st ch.,22/03/2007, case C-383/05, Talotta : Rec. CJ 2007, I, p. 2555 ; *Dr. fisc.* 2007, n° 38, comm. 850, note J. Malherbe et M. Wathelet ; RJF 2007, n° 774. - CJ, 1st ch., 18/03/2010, case C-440/08, *Dr. fisc.* 2010, n° 41, 520.

15 - Risk of legal uncertainty. However, such was the approach adopted by France. Indeed, by favoring an approach very widely based on the erosion of tax base, France went beyond the recommendations of BEPS[32]. In fact, the article 212, I, B of the FTC establishes a general principle of symmetry in the treatment of loads and products[33]. Therefore, French dispositions allows to tax income that won't be taxed anywhere else[34] by considering the hybrids mismatch arrangements only as a loss of tax income.

The French dispositions reveal one more time the existence of a fiscal competition between States regarding tax system. If in this domain, a coordinated approach appears to be the most effective, this one seems however impossible. In fact, sovereign States tend more and more to modify one-sidedly their tax system to hold the taxable bases[35].

Yet, such an approach is not beneficial in reality for States. Indeed, as it was specified, various legislations can be sources of possibilities of optimization regarding taxes. It seems in reality harmful, not only within the framework of the fight against the aggressive plans of fiscal optimization, but also in term of competitiveness.

16 - Companies are largely impacted by the coexistence of state actions. Many European countries, like France, adopted national dispositions to fight against instruments and/or hybrid entities. From then on, a company will have to comply with each of these rules and it will have for consequence an increase of its costs. Furthermore, as it was specified, it seems difficult to determine which country was hurt in a transaction involving a hybrid. From then on, for a transnational deal with different dispositions, the company also risks to suffer from a double taxation.

Besides, following the example of the French legislation, certain rules are not limited to the aggressive plans but can also apply to all the situations involving a financing arrangement linked companies even though this would not pursue fiscal optimization[36].

From then on, today, companies evolve in an environment damaged by the multiplicity of rules and reforms which are sources of legal insecurity. Indeed, the anti-hybrid provisions are only a part of a very important legal arsenal limiting the deductibility of financial charges. Even though it represents an instrument of cash management, it seems to be widely damaged[37].

Furthermore, while a financial choice concerns the debt or the capital or both, this one seems finally largely biased. The legislator reduces considerably the interest to opt for the debt[38].

This situation seems paradoxical, when the Council of State sets to the administration since almost fifty years[39] the principle of non-intervention in the management of the company.

In conclusion, a few years ago France was considered as a very attractive tax system, in particular thanks to the possibility of deduction of financial charges. However, today, because of the multiplicity and the acceleration of reforms, our system is one of the most complex

32 A.Lagarrigue et B. Hardeck, *« Dispositif anti-hybrides : retour sur les difficultés d'application à la lumière des premiers commentaires de l'Administration » : Dr. fisc.* 2014, n°22, comm. 353.

33 JOAN CR, 12/12/2013, 3rd session.

34 Report Senate n° 156 about finance law project for 2014, p. 199.

35 *« La concurrence fiscale et l'entreprise »* Synthesis of the 22nd report of the Court of Auditors to the President, December 2014

36 A.Lagarrigue et B. Hardeck, *« Dispositif anti-hybrides : retour sur les difficultés d'application à la lumière des premiers commentaires de l'Administration »* : Dr. fisc. 2014, n°22, comm. 353.

37 L. Le Claire *« L'insécurité des entreprises engendrée par les règles fiscales de déduction des intérêts. — Ou comment « raboter » la compétitivité française »* Dr. fisc. 2013, n°18, comm. 269

38 C. Acard et A. Loran *« Les dernières évolutions en France et dans le monde en matière de déductibilité des charges financières »*, Dr. fisc., April 2013, comm 232

39 CE, 20/12/1963, n° 52308 : *Dr. fisc.* 1964, n° 4-5, comm. 156 et n° 13, doctr. ; Dupont 1964, p. 175. -CE, 8e et 7e ss-sect., 04/11/1983, n° 34516 : JurisData n° 1983-608462 ; *Dr. fisc.* 1984, n° 52, comm. 2363 ; RJF 1/1984, n° 19. - CE, sect., 30/12/2003, n° 233894, SA Andritz : JurisData n° 2003-080472 ; *Dr. fisc.* 2004, n° 16, comm. 427, concl. G. Bachelier, note P. Masquart ; RJF 3/2004, n° 238, chron. L. Olléon, p. 83 ; BGFE 2004, n° 2, p. 12, obs. N. Chahid-Nouraï, concl. G. Bachelier p. 166.

TOWARDS THE UNIFICATION OF THE FRENCH TAX TREATMENT APPLICABLE TO CAPITAL GAINS ON REAL ESTATE REALIZED BY NON-FRENCH RESIDENTS

Marianne FIARD & Guillaume WULFOWICZ

The French tax legislator is going forward with the unification of the tax treatment of capital gains on real estate located in France realized by non-residents in the brand new Finance Bill for 2015. The new rules now align such treatment with the one for French residents following a decision of the French Administrative Supreme Court, the *Conseil d'État*, on October 20th, 2014. This decision erased the former rules for their incompatibility with the European Union's legislation.

1. The taxation of capital gains realized from a sale of real estate owned in France by a non-resident is dealt with by Article 244 bis A of the French Tax Code (FTC). This latter creates a difference of treatment between the tax rates applicable to such gains depending on the taxpayer's place of residency. It appears first that no tax treaty may avoid this discrimination **(I)**. Additionally, notwithstanding the treaty gap, the French Administrative Supreme Court, *the Conseil d'État*, recently considered that difference to be a discrimination to the light of the European Union's free movement of capital principle, following a reform applicable starting January 1st, 2015 **(II).**

I. A discriminatory tax treatment of capital gains based on the place of residency of the taxpayer owning the real estate property

2. First, as a reminder, the French tax rules admit and apply the subsidiarity principle. The application of this principle imposes to look first at the domestic rules rather than international treaties. However, in a case of a conflict between the French Constitution states and such treaties, Article 55 of the French Constitution states those treaties are superior to domestic legislation[1]. This disposal aims to maintain a stand-alone legislation at the state's level. So that tax treaties are drafted to split the tax power between countries and not to create new taxes.

3. It is then without a surprise that French capital gains on real estate realized by non-resident are taxed according to the French domestic rules that may be adapted to the international treaty law.

Under the version of Article 43 of the tax law n°93-1353 of December 30th, 1993, Article 244 A bis of the FTC provides that "*Subject to the application of international treaty law, individuals which tax home is not located in France with regards to Article 4B, and legal persons or groups, regardless of their legal form, which are non-resident aliens, are subject to a direct tax of one third of the capital gains' amount resulting from the sale of real estate, property rights, shares including shares of public and private companies mainly constituted of real estate assets*".

Article 244 bis A of the FTC created a difference based on the place of residency either the seller or the partner of the company through this latter was used to own its French real estate. However, this

1 French Constitution of the 5th Republic of October 4th, 1958, Article 55

discrimination was not to last long with regards to the European Union's legislation[2] and especially the free movement of capital principle. Article 244 bis A of the FTC was consequently modified[3] and erased the discrimination against aliens that had their tax home within the European Union or within a State of the European Economic Space that had agreed of a administrative assistance clause with France. Nevertheless, the discrimination regarding *"third"* states' ("*États tiers*") residents lived on in case of a direct ownership of the real estate property. The French legislator modified a second time that Article 244 bis A of the FTC with the Amending Finance Law for 2005[4] in order to fight against potential attempts of so-called "third" states' investors to interpose a "*screen company*" ("*société écran*") incorporated within a Member State between themselves and the real estate company. This scheme would have allowed them to benefit from the reduced tax rate on capital gains resulting from real estate property's sales[5]. The 2004 modification took away the application of this reduced tax rate to aliens that owning shares in a French company meeting the criteria of Article 8 of the FTC (transparent entities).

4. As a consequence, since 2004, Article 244 bis A of the FTC provides that a "*third*" state's resident not having her or his legal residence within either a state located in the European Economic Space and that agreed on an administrative assistance clause with France or within the European Union (EU) may not enjoy the 19% reduced tax rate on real estate capital gains.

5. Facing this discrimination, non-residents and their legal counsels were used to refer to international tax treaties while their application was strongly limited.

6. In case of a direct holding by a so-called "*third*" state's resident, international tax treaties remained applicable assuming that such a convention existed. If that were the case, those tax treaties usually gave the state the real estate property was located in the taxation power[6]. However, those tax treaties provided some anti-discrimination clauses[7]. That way, a non-resident would not suffer from a different tax treatment than a resident. Otherwise, some treaties provide more explicitly that capital gains must be taxed under the same rules regardless of the owner's residence or quality[8].

Thus, those provisions allowed non-residents to avoid a different tax treatment with regards to the international treaty law's supremacy in the case such non-resident was residing in a "*third*" state that had ratified an OECD Model tax convention[9] with France. It has been judged that those provisions had to be dismissed in the case of an Algerian taxpayer that had his residence in Switzerland and who sold his real estate property that he owned in France[10].

7. Nevertheless, under the 2014 version of Article 244 A bis of the FTC, the situation becomes worse when the real estate property is indirectly held, especially through an entity fulfilling Article 8 of the FTC's criteria, commonly considered as fiscally-transparent (such as a "*Société Civile Immobilière*" also known as "*SCI*"). Indeed, the French tax treatment of such companies is particularly complex. Those companies are subject to the Article 8 of the FTC's rules providing that the profits will be taxed "in the partner's hands", whether this result has been distributed or not. This rule comes after

2 CJCE, Feb 14th, 1995, Case C-279/93, Finanzamt Köln-Alstadt v/ Roland Schumacker
3 Law n°2003-1311, Dec. 30th, 2003, Article 10
4 Law n°2004-1485, Dec. 30th, 2004, article 50
5 Dr. Fisc. N°25, June 25th, 2013, comm. 348, *Les résidents des Etats tiers à l'Union Européenne face à l'imposition discriminatoire des plus-values immobilières: réflexions sur les protections offertes par les conventions fiscales internationales et le droit de l'Union Européenne.*
6 Article 13, OECD Model tax convention
7 Article 24, OECD Model tax convention
8 Article 15, OECD Model tax convention
9 French Constitution of the 5th Republic, Oct. 4th, 1958, Article 55
10 CE, Dec. 30th, 1996, n°128611, Min v/M. Benmiloud

a decision[11] of the French Administrative Supreme Court, *the Conseil d'État*, confirming a thesis developed by Professor Bruno Gouthière[12]. Those companies are legal entities and as a consequence tax entities as well. The taxation of the result "in the partner's hands" represents more a tax collection method of tax collection rather than a real taxation rule. Therefore, on the basis of this tax entity's status, capital gains on real estate property are deemed to be realized in France by a French resident.

Even though such capital gains taxation are determined depending on the taxpayer's place of residency, the tax conventions' protective mechanisms are not applicable with regards to French case law.

Indeed, some surprising decisions were taken by French jurisdictions. That was the case of a Swiss resident who sold its real estate property held in France through a French "*SCI*". The reduced tax rate on capital gains resulting from the sale of real estate property was deemed applicable to him after a decision of the Administrative Court of Appeals of Versailles[13]. Such court considered the anti-discrimination clause of the tax French-Swiss convention applicable in that case. This unexpected decision caused Laurent Lévy Ben Cheton, as the "public rapporteur" of the *Conseil d'État*, individual giving an opinion on the case before the ruling, to declare: *"The decision given by the administrative court of appeals seems to be isolated, and contrary to the French-Swiss tax treaty. Such a solution seems to be contrary to the Quality Invest case law"*[14].

8. Thus, it must be reminded that Article 244 bis A of the FTC, in its 2004 version, provided a difference of treatment differing if the taxpayer were a resident or not and depending on the "*locus*", *i.e.* geographic location, of the French entities' owners. Without the protection through the "tax conventions' shield", those owners as taxpayer could not benefit from the reduced tax rate under such article of the FTC. It was then obvious that French fiscally transparent entities were discriminated on the basis of their shareholders' place of residency. As a consequence, those shareholders could only rely on the European Union's legislation in order to limit the effects of such discriminatory rules.

9. The French Administrative Supreme Court, the *Conseil d'État* put an end to the debate in a decision involving a couple of Swiss residents that held shares within a "*Société Civile Immobilière*", that is a fiscally transparent company, located in France and that had realized capital gains on real estate property[15].

As a reminder, the 19% reduced tax rate at that time was only applicable either to UE residents or to residents of the EEE countries that had signed a tax treaty with France. Taxpayers located in "*third*" states were subject to a 33,3% taxation rate on such French capital gains. This article was concerning both real estate property held in France by non-residents and French shareholders of real companies which main activity is holding real estate property.

10. In this case, the taxpayers were residents of a « *third* » state in the meaning of Article 244 bis A of the FTC applicable at that time, namely, Switzerland. These taxpayers were shareholders in a French transparent partnership holding real estate property *("Société Civile à prépondérance immobilière")*. They were taxed on his capital gains at the 33,3% rate after they sold the shares they

11 CE, 3e, 8e, 9e et 10e ss-sect., Jul. 11th, 2011, n° 317024, min. v/ Sté Quality Invest: JurisData n° 2011-018330; Dr. fisc. 2011, n° 36, comm. 496, concl. L. Olléon, note Ph. Derouin ; Dr. sociétés 2011, comm. 229, note J.-L. Pierre ; RFN 2011, comm. 49, note Ph. Derouin ; Bull. Joly Sociétés 2011, n° 12, § 502, note P. Serlooten ; RJF 10/2011,

12 *Les impôts dans les affaires internationales*, B. Gouthière, éd. Francis Lefebvre.

13 Administrative Court of Appeals of Versailles, Nov. 25th, 2012, n°11VE03111 and n°11VE03119, Mmes Grogg

14 Laurent Lévy Ben Cheton, "public rapporteur" in its conclusions – Administrative Court of Appels of Lyon, 2nd Ch., Jan. 29th, 2013, n°12LY00100, *SCI Saint Etienne et Mme Aime*

15 CE, 3rd/8th SSR, Oct. 10th 2014, n°367234, min. v/ SCI Saint-Etienne et a.: JurisData n° 2014-025561 ; JCP N 2014, n° 49, act. 1251 ; *Dr. fisc.* 2014, n° 48, comm. 659, concl. V. Daumas, note A. Maitrot de la Motte. - V. G. Ladreyt, Lutte contre les mesures fiscales discriminatoires : le TFUE plus efficace que les conventions fiscales bilatérales : *Dr. fisc.* 2014, n° 48, 650.

owned in the partnership. The issue was brought to the French Administrative Supreme Court, *the Conseil d'État*, which judged in favor of the Swiss taxpayer.

As a reminder, any national legislation concerning direct taxes has to comply with the EU's legislation. To that extent, judges controlled the conformity of that 33,3% rate applicable to « *third* » states with the superior European principles.

After going through that control process, judges considered that such a tax rate would violate the free movement of capital principle of Article 56 of the former "Treaty on European Community," current Article 63 of the "Treaty on the Functioning of the European Union"[16].

This 33,3% tax rate « *was to dissuade investors from certain third countries to invest in France and, consequently, constitutes a restriction to free movements of capitals from or travelling to these countries, generally forbidden by Article 56 of the Treaty on European Community* »[17]. The application of the aforementioned tax rate was then disallowed.

Some lower jurisdictions had already pointed out that violation of the free movement of capital principle but admitted such violation was acceptable due to the application of the standstill clause[18].

It must be noted that only the free movement of capital principle could be raised and accepted by the judges in favor of « *third* » states. Indeed, the rest of the European Union's principles protect only the Member states of the European Union[19].

11. Alongside the control of compliance with the European Union's legislation, the French Administrative Supreme Court refused the application of the standstill clause. Such clause, mentioned in Article 57 of the Treaty on European Community, leads to the conformity of legislations restricting the free movement of capital principle provided that those legislations exist without interruption since December 31st, 1993[20].

In this case, the *Conseil d'État* considered this condition to be unfulfilled due to the modification of Article 244 bis A by the Amending Finance Bill of December 30th, 2004 for 2004.

Thus, this article had not existed without interruption and as a consequence the standstill clause was not applicable. The restriction to the free movement of capital was therefore not justified and had to be rejected by the judges.

12. The *Conseil d'État* eventually rejected the last argument brought up by the French Tax Administration (FTA) as well. Indeed, in order to justify the specific tax rate for « *third* » states, the FTA invoked the application of the clause under Article 65 of the Treaty on the Functioning of European Union (TFEU) that allows taxpayers in different situations to be treated differently with regards to their place of residence. Judges in appeal were right to take into account the « *relevant criterion of distinction of the concerned tax measure », namely « the shareholder's place of residence »*. They judged in compliance with the European Union's case law [21] that the difference of treatment for shareholders residing within the European Union, or within a state from the European Economic Area that has signed an administrative assistance clause with France (EEA), was acceptable. Nevertheless,

16 Article 63, Treaty on the functioning of the European Union: *« All the restrictions to free movements of capitals between Member states and between Member states and third states are forbidden".*

17 CE, 3rd/8th SSR, October 20th, 2014, n°367234.

18 Administrative Court of Montreuil-sous-Bois, June 17th, 2011, n°1009312. Administrative Court of appeals of Versailles, June 7th, 2012, n°11VE03611, min. c/ Mme Redler. Administrative Court of appeals of Lyon, January 29th, 2013 n°12LY00100

19 CJEC, February 23rd, 2006, case C-513/03, Van Hilten-Van der Heijden, section 37.

20 CJEC, December 18th, 2007, case C-101/05, Skatteverket c/ A: Rec. CJEC 2007, I, p. 11531, section 48 ; Dr. fisc. 2007, n° 52, act. 1169; RJF 3/2008, n° 378. - CJEU, 3rd ch., May 5th, 2011, case C-384/09, Prunus SARL et Polonium SA: Rec. CJEC, I, p. 3319, section 34 ; Dr. fisc. 2011, n° 24, comm. 393, note A. Maitrot de la Motte ; RJF 7/2011, n° 910.

21 CJEC, December 14th, 2006, case C-170/05, Denkavit ; CJEC, May 10th, 2012, case C-338/11, Santander Asset Management, point 27 : « When a national tax rule establishes a distinction criterion in order to tax distributed earnings, the apprehension of the comparability of situations must be undertaken taking into account such criterion ».

those taxpayers were in an objectively comparable situation with residents of « *third* » states[22].

This is the reason Gilbert Ladreyt, Esq., declared that « *because of the proportional rate under Article 244 bis A of the FTC, the taxation strikes above all a real estate sale, so that the taxpayer's personality completely fades behind this sale operation* »[23]. There was henceforth a need to identify whether that difference of treatment was justified by reasons of general interest in the meaning provided in Article 58 B of the TFEU. However, the judges have not done so in this case.

In all likelihood, the reasons of general interest previously admitted (e.g., the tax system coherence [24], the balanced allocation of taxing powers,[25] or the fight against purely artificial schemes [26]) do not seem evocable in this case. Thus, they cannot justify a difference in treatment depending on the taxpayer's place of residence.

In this sense, Professor Alexandre Maitrot de la Motte [27] explained that « *this is why the French Tax administration had always invoked the standstill clause under Article 64 of the TFEU in front of the judges* » as it was the case in the decision of the Administrative Court of Appeals of Versailles on June 7th, 2012 previously mentioned. Nonetheless, that clause was not applicable in this case of October 20th, 2014, in front of the *Conseil d'État*, and the defenses of the FTA did not convince the judges.

In light of the European Union's legislation, the tax regime applicable to « *third* » states had to consequently be unified and aligned on the regime applying the 16% reduced tax rate to capital gains. The *Conseil d'État* did so in this case and applied that 16% tax rate to the capital gains realized by the Swiss residents.

II. A legislative unification of the treatment of capital gains realized on real estate

13. As a consequence, the French tax legislator adapted the tax regime to the decision of the *Conseil d'État*. It was done first through a bill 28 and then through the modification of Article 244 bis A of the FTC in the Second Amending Finance Bill for 2015, effective starting January 1st 2015[29]. Yet, the rest of the tax regime was not modified. Non residents are then liable to social charges that amount to 15,5% of the capital gains[30] and to the new surtax applicable to capital gains exceeding €50,000 that represents 2% to 6% of the capital gains' amount.

Attention must be brought to the French Supreme Court's initiative in front of the European judges regarding the relevancy of such social charges applicable to taxpayers who do not benefit from any social measure financed by those charges[31]. Indeed a recent decision given by the European Court precises that real estate capital gains are no more subject to those social charges for the reasons we developed.[32].

22 CJEC, October 11th, 2007, case C-443/06, Hollmann, section 45.

23 Dr. Fisc. 2014, January 23rd, 2014, comm. 92, *" Liberté de circulation des capitaux : la clause de gel (TCE, art. 57 ancien; TFUE, art. 64) ne s'applique pas aux investissements immobiliers patrimoniaux".*

24 CJEC, January 28th, 1992, case C-204/90, Bachmann.

25 CJEU, February 11Th, 2010, case C-337/08, X Holding BV

26 CJEC, July 16th, 1998, case C-264/96, Imperial Chemical Industries plc (ICI)

27 *Dr. Fisc.* 2013, June 20th, 2013, comm. 348, « *Les résidents des États tiers à l'Union européenne face à l'imposition discriminatoire des plus-values immobilières : réflexion sur les protections offertes par les conventions fiscales internationales et le droit de l'Union européenne* ».

28 *Bill aiming to tax similarly all the capital gains on real estate realized by the French expatriated at a 19% tax rate*, National Assembly ("*Assemblée Nationale*"), n°2371.

29 Amending Finance Bill for 2014, n°2014-1655, December 29th, 2014, Art. 60 I: « *Although, individuals, individual shareholders of companies or groups which profits are taxed in the partners or shareholders' name, individuals, real estate investment fund mentioned at Article 239 nonies are subject to the tax at the 19% rate.* »

30 Article L.136-7, I bis, L. n°2012-958, French Social Security Code, August 16th, 2012, Article 29 I B 1°.

31 CE, 10th/9th SSR, July 17th, 2013, n°334551 abd n°342944, min. c/ M. de Ruyter : : JurisData n° 2013-018397 ; *Dr. fisc.* 2013, n° 41, comm. 466, concl. É. Crépey.

32 CJUE, C-623/13, 26 février 2015, Ministre de l'économie et des Finances c/ Gérard de Ruyter

In addition to that, a new measure from the Second Amending Finance Bill for 2015 will be effective starting January 1st, 2015. From that date, an European Union resident, or in some cases a resident of the European Economic Area (EEA), will not have to designate a representative in France who is jointly liable for the payment of the capital gains' tax until it is statute-barred[33].

14. Finally, the current tax loophole concerning capital gains realized by residents of Non Co-operative States or Territories (ETNC) in the meaning of Article 238-0 A of the FTC must be emphasized.

In the version prior to the second French Amending Finance Bill for 2015, the tax authorities were applying a strict 75% tax rate to such capital gains. This rate was rejected by the French Supreme court, the Conseil constitutionnel, on the basis « *that the equality requirement regarding the public charges would not be respected if the taxation is confiscatory or would impose an excessive burden on taxpayers with regards to their contributive capacities* »[34].

The lack of such equality then led to the rejection of the 75% tax rate. Actually, the non-residents were subject to social charges of 15,5% and the global taxation rate on the capital gains would have been brought up to 90,5%.

The French government announced that it would « *adjust consequently the taxation's level of those capital gains in a future Finance Bill* »[35].

Meanwhile, residents of Non Co-operative States and territories (ETNC) may take advantage of the tax loophole by applying the 19% tax rate to their capital gains on real estate property. They may also reassess the taxation of such gains realized prior to that date on the basis of the French Supreme Court's decision previously mentioned.

15. Thus, through the intervention of the European Union rules, the French tax rules have made a step towards unifying the tax treatment applicable to capital gains from real estate property held by non-residents. Nonetheless, the unifying process concerning direct ownership is far from completion.

33 Amending Finance Bill for 2014, n°2014-1655, December 29th, 2014, Article 62.
34 Conseil constitutionnel, Decision n° 2014-708 DC, December 29th, 2014.
35 Ministry of Finance, communiqué released on December 29th, 2014, n°143.

THE AMENDMENT TO THE FRANCO-LUXEMBOURG CONVENTION ON CAPITAL GAINS RESULTING FROM THE SALE OF SHARES OF PROPERTY INVESTMENT IN PREDOMINANTLY REAL ESTATE ASSETS COMPANY

Pauline BARBIER & Soraya BENESSAM

The new amendment to the Franco-Luxembourg Convention will question old real estate investment patterns in France through a Luxembourg Holding. Whereas capital gains resulting from the sale of shares of predominantly French Real Estate Asset Company (F.R.E.A.C) by a Luxembourg seller used to benefit from a double dip, nowadays France have the right to tax those capital gains. Conventional law won't object to the application of French domestic laws on the disposal of share in FREAC anymore.

1 France and the Grand Duchy of Luxembourg have renegotiated their convention about the taxation of capital gains resulting from the sell of share of FREAC. The French state was looking for a way to establish the acknowledgment of his right to tax capital gains made by the selling of FREAC[1] by Luxembourg societies.

Discussion lead to the signature on September 5th 2014, of the Fourth amendment to the Tax Convention signed on the 1st April 1958. The bill of right approving the protocol would be introduced at the Luxembourg Parliament at the beginning of the year 2015 thus, the amendment will probably take effect on the January 1st 2016[2].

I – What changes have been introduced by the amendment on the 24th 2006 November.

2 The negotiation on the taxation of capital gains on real estate has evolved in two phases.

On the November 24th 2006, both countries had signed a first amendment related to real estate income (" The 2006 amendment"[3]), because the tax convention did not include specific rules related to the taxation (i) of real estate income in industrial and commercial companies and (ii) of their property capital gain. By contrast the OECD model assimilates in the category of real estate income those coming from an enterprise whereas the Tax Convention

1 Companies which are considered predominantly real estate companies regarding income tax "are companies with assets on the date of the sale of such securities, or at the close of the financial year preceding his sell, is constituted with more than 50% of its actual value by buildings, the rights over buildings, rights in a lease contract (...) or shares in other companies predominantly real estate. For the purposes of these provisions, property or right mentioned in the previous sentence are not taken into account when those properties or rights are affected by the company to its own industrial, commercial, agricultural or to a noncommercial profession «(art. 219, O ae-bis of the French General Tax Code)

2 The amendment will come into force the first day of the month following the receiving day of the last notice of ratification by each state. The amendment will apply on taxable income either from the civil year, which follows his coming into force, or from the reporting period beginning after the civil year that amendment will come into force.

3 The amendment came into force on 27 December 2007 and was applicable from 1 January 2008, more than a year after its signing.

between France and Luxembourg was preventing assimilation of property income with the income on real estate made by FREAC. In 2005 France has begun his negotiations with Luxembourg in order to obtain the signature of an amendment that will enable his to "*get back his right to tax real estate income and capital gains made by industrial and commercial enterprise during their exploitation or the sell of building situated in France*"[4].

The goal of the amendment was to end a difference of interpretation of article 3 and 4 of the Convention between French and Luxembourg jurisdiction which lead to a double dip of income tax and capital gains related to the sale of properties located in France held by Luxembourg companies.

In France the Council of States and the administration considered that as the income and capital gain resulting from the exploitation and sale of immovable property situated in France and held by industrial and commercial companies established in Luxembourg shall be considered as industrial and commercial profits («B.I.C») under Article 4 of the Convention related to business income. Thus, in absence of a Permanent Establishment in France, a Luxembourg company perceiving French-source property income was exclusively taxable in Luxembourg.[5]

On the contrary, in Luxembourg, a judgment of the Administrative Court on the 23rd 2002 April, «La Costa SARL», considered that companies income resulting from the exploitation and sale of real estate fell under Article 3 of the Convention relating to the property income. Those revenues were thus exclusively subject to tax in the State where the real estate were situated. Therefore from a Luxembourg perspective income from real estate situated in France and held by Luxembourg companies were not subject to tax in Luxembourg. The amendment of 2006 enabled to give back to France the right to tax in accordance with the OECD Model principles by amending Article 3 of the Convention stating that *« §1. Real estate income and their accessories (...) shall be taxable only in the State where the property is situated. This also applies to profits from the alienation of such property §2. The provisions of paragraph 1 shall also apply to income resulting from the exploitation and the alienation of enterprise's real estate §3. The provisions of paragraphs 1 and 2 shall also apply to profit arising from the exploitation or the alienation of property made through companies, regardless of their legal form, do not have a distinct moral personality from their members for the purposes of the taxes referred to in Article 1».* So under the new provisions, rental income from real estate and real estate capital gains realized by an industrial and commercial enterprise are now considered as real estate income taxable exclusively in the State of location of the property, regardless of State of residence of the owner and his status[6].

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4 Senate 's Report n°446, second extraordinary session of 2006-2007, on the bill of law allowing the approval of the second amendment to the Tax convention between France and The Grand Duchy of Luxembourg, by the senator M. Adrien Gouteyron.

5 The question was related to the qualification of income. If it was a real estate income, France has the right to tax whereas if it was business income, France had no right to impose in absence of permanent establishment. The Council of State had stated in a judgment «Raffaella» on the 22th May 1992 about Franco-Italian Convention (EC 22 May 1992, No. 63266, 8th and 9th s.-s., SPA Raffaella, RJF No. 1992 960), that in the absence of a self-definition given by the convention, it was appropriate to refer to the definition given by domestic law of income group.
However, according to French tax law, income from properties owned by a business enterprise, such as corporations, are classified in the category of industrial and commercial profits of commercial income. Then, the Raffaella decision was subsequently confirmed by the State Council on the Franco-Luxembourg agreement (in the version prior to the amendment of 2008) in the judgment SARL «SARL of agricultural and forestry investment» (CE 18 March 1994 No. 79971, 9th and 8th sc sc), which considered property income of a Luxembourg company fall under article 4 of the Convention (business income) and not the article 3 (property income). The Administration (BOI No. 149 of 11 August 2000, 8M-BOI 3-00) has drawn conclusions from this analysis in an instruction stating that the capital gain realized by a Luxembourg company in the sale of real estate in France was covered by Article 4 of the Convention and was therefore not taxed in France in the absence of permanent establishment.

6 In contrast, with the previous wording of the amendment, when a property situated in France was the property of a Luxembourg company, the capital gain was considered by the State Council as an exclusively taxable industrial and commercial profit (BIC) in the home state of the company (in this case in Luxembourg).

Furthermore, the taxation of real estate income and their capital gains realized through transparent companies which can not be considered as having a legal personality [7] is also reserved for the State of location of the property pursuant to Article 3.

However, *«the analysis commonly accepted was that the French civil societies, with a distinct personality from their associates, could not be covered by the amendment of 2008»*.[8]. The sale of shares of a civil society or shares of a French corporation owning a building in France by a Luxembourg company remained therefore taxable in Luxembourg, and could benefit from the Luxembourg participation exemption regime. The double dip thus remained possible.

II – The issues tackled by the amendment of 5th 2014 September.

The 2006 amendment did not contain any provision equating FREAC to buildings and therefore did not address the question of the alienation of FREAC shares. The French tax authorities had then announced at a conference of the AFEP-MEDEF on the 19th 2012, January, his intention to renegotiate the Luxembourg tax treaty[9]. The negotiations were intended to enable France to retrieve tax revenue from real property situated on French territory and tax capital gains realized by Luxembourg companies without a permanent establishment in France on the sale of share of a FREAC. The French government has asked the Luxembourg to *«end an obsolete tax provision, and deemed unfair, to the French public finances, inconsistent with the OECD model[10]»*.

Indeed, under the disposition of the Franco-Luxembourg convention previous to the amendment of 2014, the sale by a Luxembourg company of French company share predominantly holding French property was not taxable in France. In parallel, these sales often enjoyed in Luxembourg a corporate tax exemption under the participation exemption regime. The Convention was therefore contrary to the OECD model that provides for the imposition of capital gains on the sale of real estate shares in the State of location of the buildings, and not in the state where is established the sellers. Finally the negotiations culminated in the signing of a new amendment 5 September 2014. This amendment adds a clause assigning the taxation of the sales of share of predominantly real estate company and their capital gains to the states where is located the building. It gives back to France the exclusive rights to tax capital gains from the sale of FREAC according to the rules applicable in domestic law.

The amendment complete Article 3 of the Convention by a paragraph stating that *«gains resulting from the alienation of shares or other rights in a company, a trust or any other institution or entity, whom assets or goods are made from more than 50% of their value or derive more than 50% of value, directly or indirectly through the interposition of one or more other companies, trusts, institutions or entities, of real estate situated in a contractor State or rights to such property shall be taxable only in that State. For the purposes of this provision, are not considered real property used by such company for his activities»* and adds that they» *also apply to the sales by a company of such shares or other rights.* «It should be stressed that the capital gain taxable in France will be the one gained throughout the holding period of the

7 The new provisions related to France are the condominium real estate companies referred to in Article 1655 ter of the CGI.

8 *«The end of»* *the real estate exception «resulting from the Franco-Luxembourg Agreement»* by Julien Saïac, Partner, CMS Bureau Francis Lefebvre

9 *« The Franco-Luxembourg tax treaty (again) in the firing line,»* 3 February 2012, Real estate team Arsene Taxand

10 *«Amendment to the Franco-Luxembourg tax treaty: end of a tax provision deemed obsolete,»* Pierre Appremont, September 16 The Circle

shares and not only the capital gain made since the coming into force of the amendment. Now, the capital gain resulting from the sale of FREAC shares by a Luxembourg company will be subject pursuant to III of Article 244 bis of the CGI, to a levy at the general rate of 19%. This levy will be determined according to the rules of assessment and rate of tax provided in the same conditions as those applicable to the date of alienation to legal persons resident in France[11].

III – The issues left despite of changes made by the amendment of 5th 2014 September.

The new amendment should question the patterns of investment in real estate in France via Luxembourg holding. It remains to know under which conditions, Luxembourg companies indirectly holding French buildings can *«legitimately benefit from the advantages offered by the Convention in its current version.»* [12]

There is no way for the administration would be challenging any alienation made to a third person between the date of signature of the amendment in 2014 and its date of application. Nevertheless, the administration will probably examine carefully internal reorganizations between these dates. The question have been raised during the restructuring organized around the effective date of the amendment of 2006, and tax law abuse committee had render discommodious opinions for taxpayers (cases affaires 2013-29, 2013-30, 2013-31, 2013-32 et 2013-53). Nonetheless, the administration could attempt to challenge the intragroup reclassifications made before the entry into force of the amendment (particularly in 2015) in which the Luxembourg holding sale their FREAC's shares to related entities in order to "drain" their unrealized capital gain. Such transfers would in fact be made under the influence of the current agreement and continue to benefit from the double exemption of capital gains.

As for the future capital gain on the sale of shares to a third party, taxable in France, it would be reduced to the extent of the gain realized on intercompany previous sales. For example: a Luxembourg holding holds shares of a FREAC with an asset value of 100. In 2015, it sells the shares to a related entity for 1000. It realizes a capital gain of 900 which should benefit from double dip currently applicable.

Then, if the related company sells the shares for 1200, over a year after the entry into force of the amendment, then the related Company will realize a capital gain of 300 which should be imposed in France. Whereas if the group have not made a reclassification of shares in 2015, the real capital gains on the sale to third parties and taxed in France would have been equal to 1100. The taxable base loss in France is 800.

11 All the sales made since 1 March 2010 by legal persons resident in a Member State of the European Union, the 3rd Corrective Finance Law for 2009 (« LFR ») stated a principle of equal treatment with French companies subject to corporate tax. For these people, the base of the levy fall under the general law with an overall rate of 33.33% . Moreover, they can benefit from the reduced rate of 19% under the same conditions as French companies (eg in case of transfer of units or shares of REITS (« SIIC ») and FREAC listed in France or abroad) ; *« Taxes in international business »*, Bruno Gouthière, 9th edition, updated to 1 September 2012, Editions Francis Lefebvre , Section « real estate transactions » p 866-867

12 *«The end of» the real estate exception «resulting from the Franco-Luxembourg Agreement»* Julien Saïac, Ibid

FRENCH GOVERNMENT ADOPTS THE NEW TRANSITION ENERGY TAX CREDIT

Manon de Vatteville and Alexandre Chagneau

In the race to become the nation of environmental excellence[1], the French government voted in favor of the new transition energy tax credit mechanism through the Finance Law for 2015.

1. The tax credit mechanism provided for in Article 200 *quarter* of the French Tax Code (hereafter "FTC") has been given a new look through Article 3 of the Finance Law for 2015, which simplifies the former equipment-related tax credit also known as sustainable development tax credit, in order to make it more attractive. The sustainable development tax credit mainly aimed at reducing the home energy consumption and greenhouse gas emissions associated with consumption and achieved great success among French households with 1.4 million beneficiaries, bringing the total amount of tax credit granted to 12 billion euros[2]. By improving access to the mechanism, the French government intends to encourage more households to invest in ecological equipment and maintenance work.

1. A completely redesigned scheme

2. To encourage the energy-efficiency retrofit, the scope of the mechanism has been widely expanded.

Two new kinds of expenses are now eligible to the tax credit:

- the energy transition equipment expenses incurred for a building that has been completed for more than two years. This category targets individual heating meters, condominium water meters and charge systems for electric cars[3]; and
- the specific overseas department expenses, including connection equipment to a cooling network[4], sun-blocking protection equipment for blind and glass panes[5] and equipment for natural ventilation optimization[6]. The latter aims at decreasing the use of ventilation by targeting ceiling fans.

3. On top of the extension of the scope, Article 3 of Finance Law for 2015 includes a simplification of the conditions of eligibility by erasing the "bunch of work"[7] condition from Article 200 *quarter* of the FTC, mandatory condition from 1 January 2014, as well as the financial resource condition. Thus, the mechanism applies to all taxpayers regardless their financial resources.

4. Moreover, the 15% and 25% rates, applicable since 1 January 2014 (respectively for single work and "bunch of work") are replaced by a unique 30% rate, regardless the type of expenses incurred. Nevertheless, the amount of tax credit granted is capped to a maximum amount of €8.000 per single person and €16.000 per couple with joint taxation, with an increase of €400 per each additional dependent person. The reform of the sustainable development tax credit into the energy transition tax credit includes a transitional measure for taxpayers who have already performed a "bunch

1 The sixty commitments for France, François Hollande's project.
2 *« Le point sur »* magazine, Commissioner-General for Sustainable Development, n°147, October 2012.
3 Article 200 *quater*, 1, i new of the FTC.
4 Article 200 *quater*, 1, d, al. 1er modified of the FTC.
5 Article 200 *quater*, 1, j new of the FTC.
6 Article 200 *quater*, 1, k new of the FTC.
7 A bunch of work *(bouquet de travaux)* is a combination of at least two housing energy-efficient actions among a detailed list of expenses. BOFIP BOI-IR-RICI-280-20-10-20140627.

of work" in application of former provisions from 1 January 2014.

5. The taxpayers who performed a "bunch of work" between 1 January 2014 and 31 August 2014 will benefit from the transitional measure set in place, enabling them to get a tax credit in the same conditions as before, *i.e.* application of the former 25% rate[8]. However, the 30% rate will apply for costs incurred from 1 September 2014 to 31 December 2015 because of the retroactive effect[9] to 1 September 2014 provided for in the Finance Law for 2015[10].

6. The transition energy tax credit may be cumulated with other mechanisms such as financial aids from the National Housing Agency[11] or from local authorities, and the interest-free loan, if the fiscal household's income for the year preceding the loan offer is below €25.000 per single person and €35.000 per couple, with an increase of €7.500 per each additional dependent[12].

2. The French Tax Administration highlights the fundamental importance of the eco-friendly "RGE" label[13]

7. To benefit from the transition energy tax credit, renovation work must be realized by certified professionals who received the eco-friendly "RGE" label, *i.e.* an accreditation certifying that they are eco-friendly professionals[14].

Companies having received this label are recognized for their competence in energy-efficient renovation work. All professionals who complete work for sustainable development and energy performance purposes[15] can obtain the eco-friendly "RGE" label by submitting an application to one of the competent bodies.

To be able to deliver the label, the competent entities must be independent, perform site inspections for each applicant and be acknowledged by the French Accreditation Committee *(COFRAC, Comité Français d'Accréditation)*[16].

8. To become eco-friendly certified, companies have to meet different conditions:

- comply with legal and administrative obligations, including the 10-year guarantee;
- designate a technical and operational manager in the company responsible for compliance purposes;
- perform at least two renovation projects that require the eco-friendly "RGE" label every two years; and
- submit to an inspection site in the next two years following the "RGE" accreditation.

On top of that, in case of subcontracting, the ordering company shall use the services of a subcontracting company that received also the eco-friendly "RGE" label[17].

The accreditation is only granted for the activity claimed by the enterprise[18]. In other words, this label is only valid for a specific field of energy-efficient work (electrical work, renewable energy work and so on). For each relevant activity, at least one technical manager has to follow and validate an approved training.

8 Article 3-1-B-4 of Finance Law for 2015.
9 Article 200 *quater*, 1 of the FTC.
10 Article 3, II of the Finance Law for 2015.
11 *Agence National de l'Habitat.*
12 BOFIP, BOI-IR-RICI-280-20-20 §20, 27 juin 2014.
13 19 December 2014 including provisions of the Decree n° 2014812 and of the perfectoral order of 16 July 2014.
14 *RGE* means *Reconnus Garants de l'environnement*
15 Article 46AX CGI.
16 Article 2 of the Decree n°2014-812 of 16 July 2014.
17 BOFIP, BOI-IR-RICI-280-20-30 §70, 19 December 2014.
18 *CIDD/CITE : précisions administratives sur les critères de qualification des entreprises de travaux, Revue de Droit fiscal, Droit fiscal n°3,* 15 January2015, comm.56.

To make the incurred expenses eligible to the transition energy tax credit, the accredited companies have to perform the renovation work but also to provide the necessary equipment.

3. The energy transition represents the cornerstone of the French government's economic and environmental policy

9. Nowadays, sustainable development is one of the main public concerns. During the 2012 French presidential election, the current President, François Hollande, made a point of placing the environmental policy as a major challenge by proposing to decrease France's dependence to nuclear energy for the electricity production, to support the renewable energy sector and to launch an ambitious action plan to improve the energy performance of almost one million of housing[19].

10. The energy transition draft law fixed ambitious goals concerning energy transition and global warming.

According to the draft law, the construction industry is the most important energy consumer in France. In front of this "energy efficiency major deposit"[20], the government decided to increase aids for the energy renovation work to support the pace of renovation work, to create employment in the renovation work sector and to reduce the housing energy bill. To achieve these goals, the French government wants to modify the main instrument available to ensure the housing energy renovation in French households: the tax credit of the article 200 *quarter* of the FTC[21].

11. The simplification of the mechanism aims at encouraging more households to perform energy renovation work. However, are introducing a unique rate and removing the resource condition from the Article actually enough to encourage households to undertake energy-efficient actions?

If it is easier to know the amount of realized savings, the equipment and work that are eligible to the scheme still remains too exhaustive. Some types of equipment have even disappeared from the list drawn up by the French Tax Administration such as photovoltaic panels[22], which blocks the development of a promising renewable energy.

Furthermore, the renovation work cannot be realized by the taxpayer himself, an eco-friendly certified company must perform them. The workforce cost may thus easily cut down the 30%-rate tax advantage, especially in case of small renovation work.

12. In conclusion, the simplification of the tax credit conditions encourages the households to have more interest for the tax energy transition mechanism but such a mechanism remains really attractive for important renovation work only.

However, there is no incentive to trigger the scheme for the households that want to undertake small renovation work, *i.e.* the actual main target of the transition energy tax credit.

Might the energy transition tax credit, the so-called new face of the environmental tax law, actually slowdown our journey to the energy transition? To be continued...

19 Hollande : « I want to make France the nation of environmental excellence », *La Voix du Nord*, 20 September 2013.
20 Energy transition draft law (DEVX1413992L).
21 *« Transformation du CIDD en crédit d'impôt pour la transition énergétique »*, Droit fiscal n°1-2, 8 January 2015.
22 *« 2015, année charnière pour nos énergies », Kazeco – le média de l'économie,* 14 January 2015.

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