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Tax Newsletter

January 2019

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Dear Reader,

Welcome to the fourth edition of the biannual Tax newsletter from the Norton Rose Fulbright Paris Tax Department. As with previous editions, the presented publications are a selection of case law decisions that we believe are most relevant to your practices.

We wish you a happy New Year and hope you enjoy our newsletter.

Yours truly,

Antoine Colonna d'Istria

January 24th, 2019

Corporate tax

The justification of the interest rate paid by private companies

Paris Administrative Court, 7 June 2018, #1613999/2-3, Paule Ka Holding

The decision issued by the Paris Administrative Court, dated 7 June 2018, deals with the justification of the interest rate paid by private companies.

In this case, Paule Ka Holding was the subject of an accounting audit. It was subject to additional corporate tax contributions due to the refusal of the deductibility of an exceptional charge and the partial reversal of the deduction of interest arising from bonds subscribed to by shareholders pursuant to the limitations provided for in 1 (3) of Article 39 and in Article 212 of the French General Tax Code. The company deducted interest paid to an affiliated company at a rate greater than the limit provided for in Article 39. The latter has not justified the rate by a loan offer, but by a study.

How can the interest rate paid by private companies be justified?

One of the main questions raised by the application of Article 212 I (a) of the French General Tax Code concerns the possibility for taxpayers to justify the interest rates charged on their shareholder loans in the absence of a loan offer issued by a bank that is contemporary to their conclusion (an offer that the tax authorities tend to require systematically during checks).

The Montreuil Administrative Court[1], in a decision dated 30 March 2017, had already pointed out that the tax authorities are not justified in demanding this offer because the relevance of the interest rates charged can be shown in a study.

In this decision, the judges of the Paris Administrative Court argued that the tax authorities are not justified in requiring a contemporary loan offer to be produced for the disputed transactions. The tax authorities must therefore demonstrate that the studies provided are lacking in integrity.

However, the judges confirmed their refusal to consider the *bond market* as a reliable external comparable. Indeed, the decision seems to preclude any possibility for a borrower to take advantage of bond market rates to establish the interest rate it charges to related companies. They point out that the reference to bonds does not provide any indication of the rate the company could have obtained from a credit institution.

It follows that only loans granted by credit institutions should be able to be used as external comparables. This therefore restricts Article 212, which provides for the possibility of recourse to "financial institutions”. This restriction is contrary to the legislator’s intent, which was to use the comparable rate charged under loan transactions in the open market.[2]

Indirect transfer of profits abroad: is the proof still as demanding?

French Council of State, 19 September 2018, #405779, Minister against Philips

A French Company carried out a research activity on projects related to electronic components and semiconductors, for which it received subsidies from the competitiveness fund for companies from the State, as well as amounts in respect of the Research Tax Credit. It entered into a general services agreement with its Dutch parent company to transfer ownership of the non-patentable intangible rights arising from its semiconductor research and development activities to its parent company, through billing the costs related to these activities, plus a profit margin of 10% .

In two accounting audits, the tax authorities examined the procedures for determining this cost plus, and found that the basis of the costs invoiced by the French company to its parent company had been reduced by the amount, on the one hand, of subsidies paid by the State for research and innovation actions under the competitiveness fund for companies and, on the other hand, of RTC refunds. It also noted that the general services agreement did not expressly stipulate that the cost plus re-invoiced to the parent company was the cost actually incurred, net of the amount of public aid.

[1] Montreuil Administrative Court, 30 March 2017, # 1506904

[2] National Assembly, Finance Committee., Report # 2568, 12 October 2005, p.460

Assuming that the company should not have deducted the amount of the subsidies and the RTC from which it had benefited to determine the costs incurred for its research activity on behalf of its parent company, the auditor withheld the gross costs, that is to say without deducting the subsidies, to determine the margin rate applied by the company. Depending on the years at issue, it reached a rate of between 5 and 9%, lower than the rate of 10% provided for by the general services agreement. It compared these rates with those of five comparable companies, and concluded that there was a transfer of profits.

The trial judges granted the discharge of the taxes, noting that the tax authorities did not provide evidence of an unfair advantage by comparison (panel and insufficient comparables) and that they did not propose any alternative methods that could replace it .

In cassation, the Minister raised a single plea. According to him, for the calculation of the cost plus method, the mere fact that government subsidies were deducted from costs was sufficient to characterise the existence of a benefit in kind. His theory was not accepted.

Indeed, the French Council of State refused to censor the judgement handed down by the Administrative Court of Appeal of Versailles, and considered that the deduction of subsidies to determine the sale price of the product of its research to be invoiced by the French company to its foreign parent company cannot be considered, by itself and independently of the level of the sale price to which this deduction leads by applying the contractual calculation method, as a benefit for assuming the existence of a transfer of profits abroad within the meaning of Article 57 of the French General Tax Code. It added that the fact that the contract between the two companies does not specifically stipulate that subsidies are deducted from the cost plus considered does not alter that analysis.

Permanent establishments without management autonomy

French Council of State, 10th - 9th chambers combined, 18 October2018, #405468

In this case, Aravis Business Retreats Limited, a company incorporated under English law, organises seminars and courses that it designs and markets in the United Kingdom[3]. These courses and seminars are held in a chalet that it rents in Haute-Savoie. The lease is for 9 years.

The company was the subject of an accounting audit and automatic taxation for hidden activity in France relating, in terms of corporation tax, to the 2005 and 2006 financial years, as the tax authorities believed that it was operating a business in France through an autonomous establishment.

Aravis Business Retreats Limited applied to the Grenoble Administrative Court for the discharge of the supplementary corporate tax assessments and the penalties to which it was subject for the 2005 and 2006 financial years. In a judgement dated 8 December 2014, the Grenoble Administrative Court rejected its application. Then, in a judgement dated 27 September 2016, the Administrative Court of Appeal of Lyon dismissed the appeal made by the company against this judgement. The company then appealed to the French Council of State.

A permanent establishment does not need to be autonomous

According to paragraph 1 of Article 6 of the Franco-British Convention of 22 May 1968: "The industrial and commercial profits of a company of a contracting state are only taxable in this State, unless the company conducts its activity in the other contracting State through a permanent establishment situated therein. If the company conducts its activity in this way, the industrial and commercial profits of the company are taxable in the other State, but only to the extent that they are attributable to said permanent establishment. "Paragraph 1 of Article 4 of the same Convention states: "Within the meaning of this Convention, the expression "permanent establishment" means a fixed place of business in which the activity is wholly or partly carried out".

The judges of the French Council of State argued that in holding that the applicant company was operating an independent company in France, while the company had no management autonomy, the Administrative Court of Appeal tainted its

[3] French Council of State, 10th - 9th chambers combined, 18/10/2018, 405468

judgement with an error of the legal qualification of the facts.

However, the judges considered that the company had permanent premises in France constituting a fixed place of business where it carried out part of its activity, through its employees and service providers receiving instructions from it. The judges therefore approved the decision of the Administrative Court of Appeal by deeming it as having a permanent establishment in France within the meaning of the provisions of point 3 of Article 4 of the Franco-British Convention.

Hidden activity and establishment

The tax authorities applied an additional penalty on the grounds of the discovery of a hidden activity.

The French Council of State began by establishing a presumption by stating that it follows from Article 1728 of the French General Tax Code that if a taxpayer has not filed the declarations which it was required to make within the legal period, or made its activity known to a centre for business formalities or the Registry of the Commercial Court, the tax authorities must be deemed to provide proof, which is incumbent on them, of the hidden exercise of the professional activity if the taxpayer is not itself in a position to establish that it has made an error in justifying that it has not fulfilled any of these reporting obligations.

Consequently, the French Council of State specified that, however, in the case of a taxpayer who claims it has met all of its tax obligations in a State other than France, the justification of the error committed must be assessed taking into account both the level of taxation in that other State and the procedures for exchanging information between the tax authorities of both states.

Therefore, the judges emphasized that in view of the existence of an administrative assistance clause to fight against tax evasion in the Franco-British Convention and the slight difference between the amount of additional corporate tax contributions to which the French tax authorities intended to subject it and to which it was subject in the United Kingdom, where it had filed its tax returns, the company at issue must be regarded as having misunderstood the scope of its tax obligations to the French tax authorities.

A transformation of reserves into bonds redeemable as shares is abusive

French Council of State, 9th - 10th chambers combined, 03 December 2018, #406617

As part of the restructuring of the Manpower Group in December 2003, the parent company of the Manpower Group incorporated under US law, Manpower Inc., sold to the Danish company Manpower Europe Holdings APS the securities of its French subsidiary, Manpower France, a simplified joint stock company (SAS) which has since become Manpower France Holding, of which it held 99.31% of the capital, for a sum of 315 million euros and securities of the Danish company.

On 29 December 2003, the general meeting of SAS Manpower France decided to carry out an exceptional distribution of dividends of 317 million euros by deducting from the "Other reserves" item, including 315 million euros in favour of its new Danish shareholder.

During the same general meeting, the shareholders of SAS Manpower France decided to issue bonds redeemable as shares (BRS) for a total amount of 317 million euros, subscribed for up to 315 million euros by the Danish company Manpower Holdings APS. These bonds, issued for a period of seven years, were remunerated by interest set at a market rate but capped, for each financial year, at a level equal to the algebraic sum of the accounting results of SAS Manpower France and its more than 95% owned subsidiaries, before tax and interest due on the BRS.

On 31 December 2003, the Danish company Manpower Europe Holdings APS cleared the debt owed to Manpower Inc. by acquiring securities in the French company by the sale of all the BRS issued by SAS Manpower France which it held.

Following two accounting audits of SAS Manpower France Holding relating respectively to the financial years ended in 2003 and 2004 and the financial years ended in 2005, 2006 and 2007, the tax authorities questioned, according to the procedure for the repression of abuse of rights laid down in Article L. 64 of the Book of Tax Procedures, the deduction of interest remunerating the BRS issued on 29 December 2003, considering that the decision to proceed simultaneously with an exceptional distribution of dividends taken from

the reserves and an issue of BRS for the same amount was made for the sole purpose of generating deductible interest expenses for Manpower France and thereby mitigating its tax burden.

The amounts reintegrated as such in the company's results gave rise to additional corporation tax, corporation tax contributions and social contributions, which, for the financial years closed from 2005 to 2007, were accompanied by the 80% increase provided for in Article 1729 of the French General Tax Code. They were also considered as distributed income and were subject, for the year 2006, to withholding tax in accordance with the provisions of Article 119 bis (2) of the French General Tax Code.

The court held that these two simultaneous transactions, not resulting in any financial flows and not affecting the structure of the balance sheet, showed the taxpayer's intention to mitigate its normal tax burden by artificially deducting the interest earned on the BRS issued from its income. It then rejected the other arguments put forward by the applicant to justify the disputed transactions, relating in particular to the pursuit of a group restructuring.

Therefore, the judges point out that by deducing from these sovereign appreciations, free from distortion, that the transactions pursued a purely fiscal objective, the Court of Appeal, which did not have to determine whether the interest paid had been taxed in the United States, did not commit an error of law and accurately qualified the facts submitted to it.

The conditions of the deduction of management fees

Administrative Court of Appeal of PARIS, 2nd Chamber, 10 October 2018, #17PA02373

In this case, SARL Fideclic, a 99.99% subsidiary of WMG e-com, itself a 92.85% subsidiary of SAS Webmediagroup, deducted the intra-group management fees that had been invoiced to it by this SAS from its profit. The tax authorities challenged the deductibility of these management fees by questioning the reality of the services in question.

The applicant company argued that the disputed fees were linked to the re-invoicing of various costs borne by its parent company because of activities carried out for its own benefit, that it would have thus benefited from the skills of employees of its parent company, which would therefore be justified in charging it for part of the corresponding wages.

The Paris Administrative Court began by reiterating that it is for the company to prove that the fee is certain in principle and in its amount, but also that it corresponds to services that were actually rendered to it. This justification is given "by producing any sufficiently precise information on the nature of the disputed fee, as well as the existence and value of the consideration withdrawn". If the tax authorities then want to question the deductibility of a fee, it must prove that the fee "is not deductible by nature, it is devoid of consideration, it has a consideration of no interest to the taxpayer or the remuneration for such consideration is excessive". Here, the Administrative Court of Appeal adopts the established case law of the French Council of State which established the principle that the deductibility of costs corresponding to services remains subject to the condition that the company can establish the reality of these services, by producing documents specifying the nature and extent of the services provided. In this regard, under the rules governing the allocation of the burden of proof before the administrative judge, if it is the responsibility of each party to establish the facts it is relying on in support of its claims, the evidence that only one party is able to hold can only be claimed by that party.

The judges agreed with the tax authorities on the ground that the evidence submitted was "vague and imprecise" and that it does not "identify either the exact nature of the activities or the dates on which, or under what conditions, they were carried out". Consequently, the judges concluded that the company has not received any consideration for the expenses incurred, and that the deductibility of management fees cannot therefore be permitted. For the avoidance of any doubt, the judges noted that:

- The invoices produced, bearing only the words "management fees", without any details concerning the nature and extent of the services provided, could not alone be regarded

as justifying the reality and the amount of the services invoiced.

- In the light of traditional case law, although an invoice is in principle sufficient to give rise to a presumption of reality of the service provided, its probative value is less strong on intra-group relations, and the tax authorities can fight this presumption by criticising such invoices. Invoices that are not sufficiently accurate (in this case, annual invoices mentioning only the amount of turnover generated by the company, and, by applying a percentage to this turnover, the amount of the fees due for the services) may not be sufficient to establish the reality of the alleged services.
- In this case, the company merely provided emails, minutes of general meetings and screenshots of web pages showing lists of files.
- The special management report presenting the regulated agreements mentioned the re-invoicing of intra-group costs, but did not establish the existence of a re-invoicing agreement concluded between the SARL and the SAS "even if it were verbal", or justify that the invoices in question actually had the services provided in return for their amounts.
- The company had its own resources to perform the services in question. The company claimed to have benefited from services essential to its activity since it did not have its own resources in terms of marketing, logistics, purchase or technical development of the website. However, like the tax authorities, the Court noted the existence of adequate resources specific to the company: it had a marketing manager, a purchasing manager and a payroll deemed to be sufficient.
- During the audit, some of the applicant company's managers have expressed their lack of familiarity with the conditions under which certain amounts had been re-invoiced, and the fact that this re-invoicing was excessive.

Value added tax

The ECJ rules on the deductibility of VAT charged on the acquisition of securities by a holding company

European Court of Justice, 5 July 2018, C-320/17, Marle Participation SARL

A holding company whose sole economic activity involved the leasing of a building for the benefit of its subsidiaries deducted all VAT resulting from a restructuring transaction leading to the acquisition and sale of securities in companies.

During a tax audit, the tax authorities refused this VAT deduction and conducted VAT recalls on the grounds that the expenses for which it was claiming a VAT deduction were used to carry out capital transactions outside the scope of the right of deduction.

After disputing these VAT recalls in the Administrative Court and then before the Administrative Court of Appeal, the holding company appealed to the French Council of State, which posed the following preliminary question to the ECJ: should the VAT directive be interpreted as meaning that the leasing of a building by a holding company to its subsidiary is an interference in the management of the latter, characterising an economic activity and giving an entitlement to deduct VAT on the expenses incurred by the company in acquiring interests in this subsidiary?

According to the established case law of the ECJ, the interference of a holding company in the management of the companies in which it has acquired interests is an economic activity insofar as it involves the implementation of transactions subject to VAT, such as, in particular, the provision of administrative, accounting, financial, commercial, IT and technical services by the holding company to its subsidiaries.

According to this decision by the ECJ, the concept of "the interference of a holding company in the management of its subsidiary" must, in general, cover all the transactions constituting an economic activity, within the meaning of the VAT directive, carried out by the holding company in favour of its subsidiary. This includes the leasing of a building constituting an "interference in the management" of the subsidiary, giving an entitlement to deduct VAT on the expenses incurred by the company in acquiring interests in this subsidiary, provided that this provision of services (i) is of a permanent nature, (ii) that it is carried out for a fee and (iii) that it is taxed, which implies that this leasing is not exempt, and (iv) that there is a direct link between the service rendered by the provider and the counter-value received from the beneficiary.

As a result, the costs related to the acquisition of interests in its subsidiaries, borne by the holding company participating in the management of its subsidiaries by leasing a building to them, and which, as such, is pursuing an economic activity, must therefore be considered as part of its overheads and the VAT paid in this respect must, in principle, be fully deductible.

Deductibility of VAT on advisory expenses in case of failure of a public takeover bid

European Court of Justice, 17 October 2018, C-249/17, Ryanair

In this case, Ryanair had planned to launch a takeover bid to acquire the competing airline Aer Lingus. If the transaction were successful, it was expected that Ryanair would provide management services subject to VAT to this new subsidiary.

Due to the incompatibility of the proposed merger with competition law, the takeover could not be completed (Ryanair was only able to acquire about 29% of Aer Lingus' shares), in such a way that the service activity initially planned was not ultimately implemented. Although this acquisition failed for competition law reasons, Ryanair had already incurred significant expenses for consulting services and other services related to the proposed acquisition.

In this context, a dispute arose with the Irish tax authorities based on the issue of deducting the VAT on the consulting costs initially incurred by Ryanair.

Ryanair appealed against the rejection decision before the Irish courts. In a decision dated 8 May 2017, the Supreme Court stayed proceedings and submitted to the Court, pursuant to Article 267 TFEU, the following questions for a preliminary ruling:

- Is the future intention to provide management services to the target company of an acquisition (if the acquisition in question is

successful) sufficient to establish that the potential purchaser is pursuing an economic activity for the purposes of Article 4 of the Sixth VAT Directive, so that the VAT applied to that potential purchaser for the goods or services supplied with a view to facilitating the acquisition could eventually be treated as VAT upstream of the proposed economic activity, consisting of providing such management services?

- Can it be considered that there is a sufficient "direct and immediate link" between the professional services provided in connection with this potential acquisition and downstream services, consisting of the potential provision of management services to the target company of an acquisition (if the acquisition in question is successful), thus making it possible to deduct the VAT related to the aforementioned professional services?

In accordance with the case law of the Court, the General Counsel found that the fact that this takeover did not take place and that Aer Lingus did not continue to operate under the full control of Ryanair has no influence on that conclusion. The only thing that counts is the intention to pursue an economic activity, confirmed by objective circumstances. The fact that the takeover of Aer Lingus did not ultimately take place cannot call into question such an intention a posteriori.

In order to grant the deduction, the ECJ made a combined application of its case law on mixed holding companies and its case law relating to the VAT on preparatory acts for launching an economic activity.

Therefore, according to the case law of the Court, a holding company has taxable status when it directly or indirectly interferes in the management of the subsidiaries by providing them with services subject to VAT. Furthermore, any person who has the intention, confirmed by objective evidence, to start an economic activity independently and who incurs the first investment expenditure for these purposes, must be regarded as a taxable person as the preparatory activities in this respect are economic activities; the resulting right of deduction is retained even if, subsequently, the planned economic activity is not carried out.

In this case, the Court notes that the consulting costs were incurred by Ryanair even though it, through the proposed acquisition of shares in the target company, intended to carry out an economic activity consisting of providing the latter with management services fully subject to VAT. It was therefore appropriate to grant it a full deduction of the VAT on the consulting costs incurred as overhead costs attributable to this economic activity (management services) giving a full entitlement to a deduction.

The ECJ therefore confirmed the deductibility of VAT on the consulting costs related to the preparation of a public takeover bid, with the intention to provide management services to the target company after the takeover.

Various

The new Directive on the automatic and mandatory exchange of aggressive cross-border tax planning arrangements is immediately applicable

Article published in Option Finance n°1471, dated 16 July 2018 – Antoine Colonna d'Istria

The European Directive on reporting obligations by intermediaries and taxpayers to the tax authorities of cross-border arrangements classed as potentially aggressive (DAC 6) came into force on 25 June 2018. It now requires taxpayers and their advisors to work to keep and collect information and documents related to these transactions.

Indeed, although the Member States have until 31 December 2019 to transpose the Directive, its date of entry into force marks the starting point of the reporting obligation, to the extent that all cross-border transactions carried out between 25 June 2018 and 1 July 2020 must be declared between 1 July 2020 and 31 August 2020.

This reporting obligation is, in principle, borne by all persons involved in providing, directly or through other persons, help, assistance or advice in the design, marketing or organisation of an arrangement that must be declared. When several intermediaries (bankers, lawyers, experts, accountants, etc.) are involved, the reporting obligation is incumbent on all of them, unless it is demonstrated that the cross-border arrangement in question has already been declared by one of them.

The Directive specifies that States may exempt certain intermediaries from this declaration if it is contrary to their rules on professional secrecy. This would probably be the case for lawyers in France but, in this case, they will have to notify the other intermediaries and their taxpaying client of the reporting obligations incumbent upon them.

The cross-border arrangements in question are those with at least one "marker" indicating a potential risk of tax evasion. The Directive makes a distinction between so-called "general" markers and "specific" markers. The general markers are taken into account when the arrangement in question creates a main advantage, or when one of its main advantages is obtaining a tax advantage. These general markers include arrangements for which the taxpayer agrees to comply with a clause prohibiting the disclosure of the tax advantage obtained or which would be remunerated by fees dependent on the tax advantage thus obtained. This main tax advantage concept is also necessary to subject certain specific markers to the disclosure obligation. Examples of this include when one or more participants in the arrangement reside in more than one jurisdiction for tax purposes, when the arrangement includes circular transactions that result in a "carousel" of funds or when the transaction involves acquiring companies to use their tax losses.

In addition, other specific markers may trigger the reporting obligation, even though the arrangement may not fulfil the main advantage criterion, but may contain one of the following circumstances: the beneficiary does not reside in any jurisdiction for tax purposes; the cross-border transactions benefit a person located in a country on the Commission's black list; the transactions allow the deduction of the same depreciation in several jurisdictions; or even transactions that have the effect of eliminating the European regulation on the automatic exchange of information on financial accounts or effective beneficiaries. Some specific markers on transfer prices are also targeted.

Admittedly, at this stage, it is up to States to set the rules for "effective, proportionate or dissuasive" penalties in case of non-compliance with these provisions. However, it is feared that sanctions will be heavy because the tool put in place by this Directive should allow the tax authorities to target its tax inspections much more effectively through data collected prior to transactions conducted by taxpayers that they themselves would have considered likely to be aggressive tax practices.

It would appear that the work to collect the information necessary to fulfil these obligations must start now. It is the responsibility of taxpayers to ensure they are within the scope of this text, in particular by drawing inspiration from what already exists abroad, for example in Great Britain, a pioneer country in this area.

What are the consequences for France of the entry into force of the OECD multilateral treaty?

Article published in Option Finance n° 1482, dated 22 October 2018 – Antoine Colonna d'Istria

On 27 September 2018, France filed its instrument of ratification of the multilateral treaty ("**MLI**") with the OECD.

The MLI will therefore enter into force on 1 January 2019 for France in its relations with States having also filed their instrument of ratification before the end of this year, including in particular the United Kingdom, Japan, Israel, Sweden, Australia and Austria.

The purpose of the MLI is to enforce some of the measures aimed at fighting Base Erosion and Profit Shifting ("**BEPS**") by amending thousands of bilateral tax treaties worldwide. As for France, 91 bilateral treaties would be amended, all identified in the document it filed, in which it also describes the reservations made against the MLI and the various options chosen.

The 91 treaties covered would therefore be amended to include the prevention of tax evasion and tax fraud as one of the essential objectives thereof and to add a reference to the will of the parties to promote their economic relations or improve their cooperation on tax matters.

France unreservedly adopts, for only 60 of the 91 treaties covered, the provision of the MLI which now requires that, in order to benefit from a limitation or exemption of the tax rate on dividends paid by a company of a State, the shareholding conditions imposed by the treaty must be met within a period of 365 days. Of course, this provision would only be applicable if the State in which the beneficiary of such dividends is resident has also adopted this reservation.

Similarly, France chooses to unreservedly apply Article 9(4) of MLI for 75 of the treaties covered, providing for the allocation of tax to the State of the location of the capital gains from the disposition of securities in real estate companies at any time during the 365 days preceding the disposition of such property.

One of the most fundamental changes to the principles of international taxation relates to the concept of a permanent establishment. Indeed, Articles 12, 13 and 14 of the MLI alter the outlines of its classification.

We have observed that France has finally rejected Article 14, which introduces an anti-splitting clause in contracts for construction and assembly sites, which would probably have resulted in a drift, to the detriment of large French groups, of taxable bases to the source States.

However, by unreservedly adopting Article 12, which modifies the criteria for defining independent agents, for the 91 treaties covered France permanently puts an end to the schemes implemented through contracts with principal agents or similar schemes to artificially avoid permanent establishment status.

It would no longer be necessary to prove that the intermediary has the power to conclude contracts on behalf of the foreign company when the administration has established that the intermediary operates in the State concerned which lead to the conclusion of the contracts in question. The legal approach hitherto used by French judges is replaced by a pragmatic approach that is more economical, harder to establish and therefore a source of insecurity.

Finally, France has not challenged the definition of preparatory or ancillary activities that match the exceptions to the concept of a permanent establishment. Moreover, it has not expressed reservations on the second amendment proposed by Article 13 of the MLI containing an "anti-splitting" clause under the exception of preparatory and ancillary activities. This refers to a company or a group of closely related companies that artificially break up a coherent set of activities into several small operations so that each only performs preparatory and ancillary activities at its level, thus benefiting from exceptions to the definition of a permanent establishment. These concepts will certainly be the source of many disputes in the years to come and it seems wise to become acquainted with them now.

Withholding tax on French-source dividends received by a European company: France sentenced

European Court of Justice, 22 November 2018, C-575/17, Sofina SA e.a.

Withholding tax: a cash-flow disadvantage

In this case, Kermadec, a company incorporated under Luxembourg law and a resident of Luxembourg, received, in 2011 and 2012 for the second and in 2013 for the first, dividends from French companies in which it held interests that do not qualify for the benefit of the parent company plan provided for in Articles 145 and 216 of the French General Tax Code. In accordance with Article 119bis (2) of the French General Tax Code, these dividends were therefore subject to withholding tax at the rate of 15% provided for in the tax convention concluded on 1st April 1958 between France and Luxembourg.

The company claimed a refund of the deductions thus levied from the French tax authorities. Being loss-making and, as such, not being liable for the tax on its results in Luxembourg, the company considered that these deductions were carried out in violation of the free movement of capital protected by Article 63 of the Treaty on the Functioning of the European Union.

In this case, the Luxembourg company considered itself to be less favourably treated than a loss-making French company. The French company is actually taxed on the French-source dividends that it only receives when its taxable income becomes profitable again. However, the applicant company indicated that its result was negative during the years at issue under the Luxembourg rules for calculating taxable income, as well as under the French rules.

Indeed, since it does not come under the tax regime for parent companies, a company resident in France that receives dividends paid by a resident company is not exempt from tax in France because of these dividends. Pursuant to Article 38 of the French General Tax Code, these dividends are included in this company's income. If the company is loss-making, these dividends are then deducted from its loss carry-forwards. When the company becomes profitable, this reduction of the loss carry-forward results in the actual taxation of dividends at the ordinary rate of corporation tax for a subsequent financial year.

In its decision of 29 October 2012, the French Council of State[4] indicated that there was no contradiction to the principle of freedom of movement of capital. Like in the GBL Energy judgement of 9 May 2012, the FCS noted a difference in the taxation technique between residents and non-residents, but pointed out that this difference results in a simple cash-flow disadvantage.

In fact, even though non-resident companies are taxed when they are loss-making, resident companies will also be taxed when they become profitable. The dividends received are deducted from the loss carry-forwards. The French Council of State called this difference "offsetting over time". This offsetting cannot constitute a restriction since the dividends received by a loss-making company established in France are deducted from the loss carry-forwards and are necessarily taxed when the company becomes profitable again. It was thus held that this offsetting over time between the collection of the withholding tax against the non-resident company and the payment of the tax by the company established in France uses a different taxation technique for dividends received by the company according to whether it is non-resident or resident.

The French Council of State concluded that the only cash-flow disadvantage in the withholding tax for the non-resident company cannot be regarded as constituting a difference of treatment characterising a restriction on the free movement of capital.

Formal notice from the European Commission

France subsequently received formal notice from the European Commission. Thus, in 2014, it ordered France to change its legislation on withholding tax applicable to non-resident legal entities receiving French-source dividends. More specifically, the Commission believed that there was a restriction on the freedom of movement to the extent that non-resident companies which were

[4] FCS, 29 October 2012, No. 352209, min. vs/ SA Kermadec

in liquidation could never allocate the withholding tax paid in France to the tax paid in their State of residence, as they were not taxed due to their lack of profits. According to the Commission, an unjustified restriction has been introduced, since a company in liquidation, which receives the same income, is not taxed on it.

Therefore, in order to comply with this notice, the legislator introduced a new exemption in the Rectifying Finance Law for 2015, under certain conditions, from withholding tax in favour of non-resident companies located in the European Union or in a State having concluded a tax convention with France.

Therefore, Article 119d of the French General Tax Code now provides for no withholding tax on dividends paid to non-resident companies which, in addition to their tax-loss situation, were, on the date of the disputed distribution, subject to a procedure equivalent to a court-ordered winding-up, or, failing that, were in a state of cessation of payments without possibility of receivership on this date.

However, this measure was not sufficient for the European Commission, which sent France a reasoned notice in May 2017 asking it to abolish the withholding tax applied to loss-making non-resident companies, since this withholding tax results in immediate taxation, without the possibility of reimbursement, of the dividends paid to a company in the European Union or the European Economic Area, in the following situations: firstly, when the company is in structural deficit, though French companies do not pay this tax in comparable situations; secondly, when the company is in a temporary phase of negative returns, though French companies facing the same difficulties are only taxable if the company manages to restore its surplus.

Withholding taxes on dividends paid to loss-making foreign companies: referral to the ECJ

In this case, Belgian resident companies, SOFINA, REBELCO and SIDRO, received dividends from several French companies in which they held interests that did not qualify for the benefit of the parent company plan. These dividends were therefore subject to withholding tax at the reduced rate of 15% according to the Franco-Belgian Tax Convention.

The Belgian companies, which were loss-making, requested the return of the deductions levied, believing that they had been less favourably treated than a loss-making French company.

On 19 April and 28 June 2016, the Montreuil Administrative Court rejected their requests for the return of the withholding taxes levied, as did the Administrative Court of Appeal of Versailles on 20 June 2017. The companies appealed in cassation.

The French Council of State asked the ECJ to decide on the question of the compatibility with European Community law of the withholding tax applied to dividends paid to a loss-making company resident in another Member State[5].

Therefore, the question to the Court was as follows: does the cash-flow disadvantage resulting from the application of a withholding tax on dividends paid to non-resident loss-making companies, whereas loss-making resident companies are only taxed on the amount of dividends they receive in the financial year in which they become profitable again, in itself constitute a difference of treatment characterising a restriction on the free movement of capital?

The Advocate General of the ECJ, Melchior Wathelet, presented his findings on 7 August 2018. The facts are similar to those of the Kermadec case. In his findings, the Advocate General concluded that “Articles 63 and 65 of the TFEU must be interpreted as precluding legislation of a Member State which subjects dividends paid to non-resident loss-making companies to a withholding tax, whereas similar resident companies are not taxed on the amount of the dividends of national origin provided they remain loss-making”. The Advocate General did not accept the arguments as regards the existence of an overriding reason of public interest able to justify the free movement of capital invoked by France: “a restriction on the free movement of capital resulting from a national regulation, which excludes the deduction of costs directly related to the collection of dividends for non-residents only, cannot be justified either by the difference between the ordinary tax rate charged to

[5] French Council of State, 9th - 10th chambers combined, 20/09/2017, 398662

residents for a subsequent financial year and the withholding tax on dividends paid to non-residents, or by the need to ensure the effectiveness of tax collection".

Following the Advocate General's findings, the Court of Justice has just replied that it is opposed to any legislation of a Member State which subjects dividends paid to non-resident loss-making companies to a withholding tax, whereas similar resident companies are not taxed on the amount of the dividends of national origin provided they remain loss-making[6].

[6] ECJ,, 22 November 2018, C-575/17

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