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Recent Developments in International Taxation

France

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Withholding taxes applicable to French-source income paid to foreign entities

Capital gains

Article 2 of the 2021 Amending Finance Bill[1] has modified paragraph 1 of Article 244 bis B of the French Tax code (FTC). This states that capital gains realised by a non-resident taxpayer on the sale of a substantial shareholding – ie at least 25 per cent directly or indirectly held – in a French company that does not qualify as a real estate company, is subject in France to a withholding tax (25 per cent in 2022) upon the sale of part or all of the French company shares.

Until this came into force, there were no legal exceptions regarding this withholding tax liability when the seller is a parent company established in a European Union Member State. Meanwhile, a French parent company selling shares of a subsidiary could benefit from a partial exemption of corporate income tax on its capital gain (an allowance of 88 per cent is applicable on the net capital gain due to the domestic participation-exemption regime). Indeed, the French tax authorities admitted in their guidelines that foreign parent companies established in an EU Member State were entitled to claim a partial refund of the capital gain withholding tax of 25 per cent to avoid discrimination under EU law. In the *AVM International Holding* case, dated 14 October 2020,[2] the French Administrative Supreme Court ruled that the previous version of Article 244 bis B of the FTC infringed EU law because it created discrimination between French parent companies and EU parent companies, and that the interpretative French tax authorities' guidelines could not apply under these conditions.

The modification introduced by the 2021 Amending Finance Bill aims to correct this EU law incompatibility. Article 244 bis B of the FTC now provides that a seller that is a foreign legal entity and the registered office of which is:

- in an EU Member State;
- in a cooperative European Economic Area (EEA) state; or
- in a cooperative third state, as long as the seller does not effectively participate in the management or in the control of the company whose shares are sold;

may henceforth obtain a refund of the portion of the withholding tax on the sale gain that exceeds the French corporate income tax to which it would have been liable if it had been located in France. Accordingly, the seller that meets the conditions of the domestic participation exemption regime can benefit from a refund of 88 per cent of the withholding tax of 25 per cent (current standard corporate income tax rate) in order to reach a taxation of 12 per cent of the net capital gain (after the application of the 88 per cent allowance granted under this domestic regime).

Furthermore, according to the new article, foreign investment funds (or 'UCIs') are now also exempt from withholding tax on realised French capital gains. The aim is to avoid discrimination when compared to French UCIs, which are exempt from corporate income tax on capital gains under domestic law. The conditions required to benefit from this withholding tax exemption differ depending on whether the UCI is established in an EU Member State or in a third country.

In the first case, it is sufficient for the EU UCI to satisfy the following two conditions:

- to raise capital from a certain number of investors in order to invest in it, in accordance with a defined investment policy, in the interest of these investors; and
- to have characteristics similar to those of French UCIs.

UCIs established in a non-EU country must meet these same requirements in order to benefit from the capital gain tax exemption. It is also required that they do not effectively participate in the management or in the control of the French company whose shares are sold.

These measures apply to the sales or redemptions of French company shares made since 30 June 2021.

Royalties and fees for services performed or used in France

The provisions of Article 182 B of the FTC have also been modified by Article 24 of the 2022 Finance Bill.[3] Article 182 B of the FTC provides for a withholding tax on certain French source income (royalties and fees paid regarding services performed or used in France) paid to non-residents. Until the reform, the taxable basis of this withholding tax was constituted by the gross amount of the sums paid, without deduction of any expense.

Accordingly, it was argued there was discrimination between a French taxpayer subject to corporate income tax on its net income only and a foreign entity subject to withholding tax on the gross amount of its French income. From 1 January 2022, foreign entities established in an EU or EEA state receiving French-source income that falls within the scope of Article 182 B of the FTC benefit from a flat rate deduction of ten per cent: this represents deemed expenses applied immediately upon the levying of the withholding tax. In addition, when the amount of expenses that they have actually incurred is higher than the amount deducted on a flat rate basis, they may request *a posteriori*, under certain conditions, the refund of the difference between the withholding tax levied and the withholding tax, calculated on the basis of the actual expenses incurred for the acquisition and conservation of the income.[4]

Distributions

Article 119 bis, 2 of the FTC, which provides for a withholding tax on French-source distributed income, has also been modified by the 2022 Finance Bill. From 1 January 2022, foreign legal entities subject to the French withholding tax on distributed income under Article 119 bis, 2 of the FTC can request the refund of the difference between the withholding tax effectively paid and the recalculated withholding tax, taking into account the actual expenses incurred for the acquisition and conservation of the distributed income. This is available if the three following conditions are met:

- The beneficiaries of the sums are legal entities established in the EU or EEA, or in a third country. When it is established in a third country, an additional condition is that the shareholding held in the distributing entity does not allow the beneficiary to participate effectively in the management or control of the French distributing entity;
- The acquisition and conservation expenses of this income would have been deductible under French law if the beneficiary had been located in France; and
- The tax rules in the state of residence do not allow the beneficiary to offset the French withholding tax.

Double tax treaties

Requirements to be met to qualify as a resident for the purpose of the application of a double tax treaty

On 2 February 2022, the French Administrative Supreme court ruled[5] that a Tunisian company benefiting in Tunisia from a temporary and partial corporate income tax exemption should be regarded as a tax resident in Tunisia within the meaning of the France–Tunisia double tax treaty dated 28 May 1973.

In this case law, the dispute concerned a Tunisian company placed under the 'totally exporting' company regime, under which a company incorporated in Tunisia is exempt from any Tunisian tax on the profits derived from exports, but remains fully subject to tax on the profits arising from activity carried out in Tunisia.

The French tax authorities challenged the application of the France–Tunisia double tax treaty to the Tunisian company as a Tunisian resident, considering the broad domestic tax exemption applying on its profit. Indeed, until now, the usual position of the French tax authorities was to consider that a resident for tax treaty purposes must be fully taxable on a worldwide basis in its state of residence.

For the application of the France–Tunisia double tax treaty dated 28 May 1973, the terms 'resident of a Contracting State', according to Article 3, section 1, refer to 'any person who, under the laws of that State, is liable to any taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature'.

The Administrative Supreme Court ruled that, since the Tunisian domestic exemption applied only to profits from exports but not to those likely to come from an activity carried out in Tunisia, the Tunisian company should be considered as 'subject to corporate income tax in Tunisia on the basis of its activity'. This was regardless of whether it had made any turnover on the local market and therefore had actually paid any tax in Tunisia.

The fact that the company's tax liability is limited to the income that has its source in its state of residence does not in itself prevent it from being qualified as a treaty resident, if it is subject to tax by virtue of its activity – contrary to the usual position of the French tax authorities.

However, it should be noted that this decision was rendered for the application of the provisions of a tax treaty that did not include the second sentence of Article 4, section 1, introduced in 1977 in the Organisation for Economic Cooperation and Development (OECD) Model Tax Convention, according to which the notion of resident 'does not include persons who are subject to tax in that State only in respect of income from sources in that State'.

Application of the tax treaty between France and the United States regarding the sale of shares in a partnership

In a decision dated 2 February 2022,[6] the Administrative Supreme Court ruled on the tax qualification of the sale gain of shares in a foreign partnership.

In this case, a French tax resident sold its stake (25 per cent) in a US limited liability company, assimilated to a partnership for the purposes of the double tax treaty between France and the

US dated 31 August 1994. Under the provisions of this tax treaty, France should apply a tax transparent treatment to the income received or paid through a US partnership. However, under French domestic law, foreign partnerships are not subject to a tax transparency regime.

The question to be determined was if, due to the transparency regime required by the tax treaty, the sale of shares in a US partnership by a French tax resident should be viewed as the sale of partnership assets or a classic sale of company shares.

In this case law, the French Administrative Supreme Court considered that the transfer of shares in a US partnership cannot be considered as having been made through this entity, regardless of whether this entity is considered transparent under US tax law. Pursuant to the France–US double tax treaty, the court considered that income derived from the transfer by a French tax resident of shares in a partnership constitutes capital gains covered by Article 13, section 6, which gives the transferor's state of residence the exclusive right to tax it (in this case, France).

Accordingly, the French Administrative Supreme court follows the usual French legal analysis and does not accept a full transparency tax treatment for a US partnership held by French resident, which should have led to disregarding the partnership as a separate entity for tax purposes.

Application of the tax treaty between France and the state of residence of the beneficial owner of French-source royalties

The Administrative Supreme Court ruled in the *Planet* case, dated 20 May 2022,[7] that the double tax treaty between France and the state of residence of the beneficial owner of French-source royalties should be applied directly. This disregards any treaty between France and the state of the apparent recipients.

In this case law, a French company, which distributed sports programmes developed by a New Zealand company, paid the corresponding royalties to two interposed entities established in Belgium and Malta respectively.

Considering the company established in New Zealand as the beneficial owner of these royalties, the French tax authorities levied a withholding tax on these royalties at the reduced rate of ten per cent provided for in Article 12, section 2 of the tax treaty between France and New Zealand of 30 November 1979. Indeed, this article states that royalties are taxable in their source state, but the withholding tax in the source state cannot exceed ten per cent of the gross amount of the royalties when the person receiving the royalties is the beneficial owner.

Until now, court precedents dealing with this type of triangular configuration involving a mere intermediary and a beneficial owner only ruled on the possibility of challenging a treaty advantage claimed by the taxpayer on the basis of the double tax treaty concluded between France and the state of residence of the apparent beneficiary.

In the present case, the Administrative Supreme Court ruled for the first time on the legal question of the applicability of the double tax treaty concluded between France and the state of residence of the beneficial owner. The Court added that the fact that the payments were made to Belgian and Maltese companies does not prevent the application of the treaty with

New Zealand, provided that the New Zealand company is the beneficial owner – even if the payment is legally made to third parties.

New double tax treaty between France and Belgium covering income tax and wealth tax

A new double tax treaty was signed on 9 November 2021 between France and Belgium which will replace the current income tax treaty (signed on 10 March 1964). This new treaty includes some base erosion profit shifting (BEPS) treaty-related measures introduced in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI) and in the 2017 OECD Model accepted by France and Belgium. This treaty will enter into force in 2023 at the earliest, following the achievement of the ratification process in each state.

The new treaty provides for a definition of the tax residence that is in line with the OECD Model. According to this, a person is resident within the meaning of the treaty when they are treated as a resident by one of the contracting states and is effectively subject to tax in that state. This condition of being subject to tax was not included in the 1964 treaty for characterising a resident of France or Belgium. In this way, tax-exempt entities or persons (such as investment funds or foundations) can no longer be treated as residents under the treaty. However, the Additional Protocol states in paragraph 6 that investment funds and pension funds established in a contracting state, and receiving dividends or interests from the other contracting state, may benefit from Articles 10 (dividends) and 11 (interests) of the treaty even if they are not tax residents.

The treaty also includes a new definition of the permanent establishment in line with the MLI provisions aimed at preventing the artificial avoidance of the permanent establishment status. The definition of the dependent agent is extended to cover persons authorised to sign contracts in the name and/or on behalf of the foreign company. In addition, a person who usually plays the main role to conclude contracts that are routinely entered into without any significant modification by the company may also constitute a dependent agent. The anti-fragmentation rule preventing the abuse of the preparatory or auxiliary activities exception at group level has been also included.

In addition, the treaty modifies the treatment of passive income – ie, dividends, interests and royalties. Thus, the benefits of Articles 10 (dividends), 11 (interests) and 12 (royalties) are conditional on the person receiving the income being the beneficial owner (and not the apparent owner).

The dividend definition now includes income that is treated as distributed income under domestic tax law, whereas the 1964 treaty had a narrow definition of the term 'dividends' (restricted to distributions voted during company shareholders meetings only). This modification allows deemed and hidden distributions, which could be now subject to the treaty withholding tax. Dividends paid by a resident company to a parent company resident in other Member States, holding a shareholding of at least ten per cent, are fully exempt provided that the shareholding has been held for at least 365 days. This withholding exemption regarding dividends differs from the one provided for by the Parent-Subsidiary EU Directive – allowing a full exemption from a five per cent shareholding but held for at least two years.

Concerning interests and royalties, the treaty provides for exclusive taxation in the state of residence of the beneficial owner, instead of a withholding tax at the maximum rate of 15 per cent provided for by the 1964 treaty.

According to Article 13, capital gains resulting from the sale of real estate assets or shares in a real estate company (ie, a company whose assets value is more than 50 per cent derived directly or indirectly from real estate that is not used for the company's own business) are taxable in the state where that real estate is located. Until now, the 1964 treaty did not expressively address the gain resulting from the sale of shares in a real estate company. Capital gains resulting from the sale of shares in non-real estate companies are only taxable in the state of residence of the seller. However, an exit tax provision allows the taxation of the sale gain of a shareholding of more than 25 per cent in a company in the state of this company, but only if the seller is an individual who was previously tax resident in that state for at least six of the past ten years.

Finally, the treaty introduces many new anti-abuse provisions. The preamble of the new treaty replicates Article 6 of the MLI by specifying that the purpose of the treaty is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion. Article 28 contains a general anti-abuse rule based on the 'principal purpose test' by providing that a treaty benefit may be denied where it is reasonable to conclude that one of the principal purposes of the arrangement or transaction in question was to gain the benefit. Paragraph 16 of the Additional Protocol expressly provides that France may apply its own anti-abuse provisions under domestic law (in particular, the controlled foreign corporation (CFC) rules).

Foreign trusts established in a tax haven: the settlor is deemed to hold ten per cent of the trust in application of the French anti-avoidance measure

According to Article 123 bis of the FTC, any individual who is a tax resident in France and who directly or indirectly holds at least ten per cent of the shares, financial rights or voting rights in a legal entity incorporated abroad, of which the assets are mainly composed of financial and monetary assets, is directly taxable in France on the income of this entity, provided that this entity is subject abroad to a favorable tax regime (tax burden lower than 40 per cent of the tax burden of a comparable French entity). This domestic CFC provision targeting individuals should also cover foreign trusts, which are viewed as legal entities in this respect. However, in practice, the French tax authorities had difficulties proving that the parties of a trust (the settlor and/or the beneficiaries) could be considered as holding more than ten per cent of the shares, voting or financial rights in the trust like in a standard company, particularly when the trust is discretionary and irrevocable.[8]

Article 133 of the 2022 Finance Bill, dated 30 December 2021, introduced a presumption of ownership for the settlor or the deemed settlor (ie, the beneficiary is deemed to be the settlor for French tax purposes upon the demise of the initial settlor according to French trust law) of a foreign trust. In this case, since 1 January 2022, the ten per cent ownership requirement is deemed to be met for the purpose of the application of Article 123 bis of the FTC, giving rise to the direct income tax liability of this settlor regarding trust profits.

The taxpayer may discard this presumption of ownership by providing evidence supporting the contrary – ie that they have no voting rights nor financial rights in the trust. However, this proof cannot only consist in the irrevocable nature of the trust and the discretionary power of its trustee.

Permanent establishment qualification and concealed activity

In the *Conversant* case, dated 11 December 2020, the Administrative Supreme Court ruled on the notion of permanent establishment, as defined by the France–Ireland tax treaty of 21 March 1968, and adopted an extensive interpretation of the dependent agent. According to this case law, even in the pre-BEPS double tax treaties, a French agent can be regarded as having a binding power to characterise a dependent agent, if it can decide the terms of the contracts and/or decide to engage the customer relationship with the client. This is regardless of the fact that the foreign principal remains the signatory of these contracts in their name, as long as there is only a formal validation of these contracts at the foreign principal level. This solution of the Administrative Supreme Court contradicted the previous *Google* case, dated 25 April 2019, in the Paris Administrative Court of Appeal.

By its decision, the Administrative Supreme Court quashed the previous decision of the Court of Appeal, having ruled in favour of the company, and sent back to the same appeal court for a new judgment.

In a new judgment dated 21 December 2021,[9] the Paris Administrative Court of Appeal confirmed the position of the Administrative Supreme Court on the existence of a permanent establishment, but rejected the application of the 80 per cent surcharge and the ten-year recovery period applicable in the case of concealed activity. Until now, the case law of the tax courts widely admitted the characterisation of a concealed activity in the case of a dispute regarding an undeclared French permanent establishment of foreign companies. According to the Court, it was difficult for the company to define the scope of taxable services rendered in France in the digital sector at the time. It was only after the tax years in question that the case law adapted its position on the traditional notion of permanent establishment in the digital economy. According to the court, given the major uncertainties that existed during those years regarding the taxation of international groups operating in this sector, the failure of the taxpayer to file a return must be considered as having constituted an error justifying its failure to fulfil its obligations. The company could therefore not be regarded as having carried out a concealed activity. The Court thus recognised a right to error of the permanent establishment.

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[1] 2021 Amending Finance Bill, no 2021-953, 19 July 2021.
[2] No 421524.
[3] 2022 Finance Act, no 2021-1900, 30 December 2021.
[4] Art 235, *quinquies* of the FTC.
[5] No 443018.
[6] No 443154.
[7] No 444451.
[8] No 19PA00458.
[9] 20PA03971.