FRENCH ANTI CROSS-BORDER AVOIDANCE RULES FROM AN EU PERSPECTIVE

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1) Introduction

It is generally observed that in our modern world two main factors are spurring tax avoidance by companies.

The first one stems from the fact that companies are more and more global. It is meant that numerous companies are nowadays conducting business globally instead of staying within domestic frontiers. This is in part due to the easiness for corporate entities to move all over the world, in other words to set up and manage undertakings worldwide.

The second factor is due to the considerable differences remaining among national laws. Naturally these differences have been leading to tax competition between states.

This combination of factors has prompted companies to move abroad in order to take advantage of more favourable foreign laws, and then has often nudged a certain form of "cherry-picking".

The fundamental problem is that tax is the means whereby a state finances its actions. Then, as soon as somebody (natural or legal person) manages to avoid paying tax domestically while still benefiting from whatever form of advantage there, the state in question will inevitably lose money. In times of crisis it is clear that governments cannot afford to ignore such behaviours. But while an important one it will be shown in this article that this reason is not the only one, and that many others factors have indeed to be taken into account.

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To deal with these issues, States thus adopt in their domestic legislation anti-avoidance rules.

2) Scope of this article

This article will focus on companies. It has been decided not to deal with situations pertaining to individuals. Thus provisions like article 123 bis of the tax code[2], individual exit taxes[3], etc… will be left omitted.

Likewise it has been decided not to put any emphasis on conventional tools[4]. Thus the Limitation on Benefit [LoB] clauses, beneficial ownership concepts, etc… will voluntarily will be also left aside.

Finally the focus put by an increasing number of states on bilateral cooperation (exchange of information, concomitant tax inquiries by administrations of several states …) is worthy a discussion in its own right. It has been decided to leave such a discussion to future studies.

This article will in fact tackle the response given by France in its own domestic legislation to cross-border tax avoidance. In order to achieve this goal, two types of rules have been noticed: some are general, others are specific. Rules can be specific when one takes into consideration the area to which they apply (material or geographical scope) or as regards the persons whose actions they aim to prohibit (personal scope).

3) Definitions: tax mitigation, tax avoidance, and tax evasion

It has proved arduous for the legislative bodies to give a general definition of tax avoidance. Hence the diversity of specific anti-avoidance rules innervating domestic legislations.

In fact the problem stems from the lack of consensus on a precise definition. This is due to the fact that tax practices vary significantly depending on jurisdiction and it is patent that one state's tax avoidance will be another state's tax efficiency. The same divergences also occur at the level of the taxpayer. Therefore, if the objective of setting fixed criteria for tax avoidance is worthy, any result would be flawed, because it is inevitably subjective.

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2 Same aim as article 209 B of the tax code but in relation to individuals (article 209 B will be thoroughly examined later)

3 New French exit tax, codified in article 167 bis of the tax code, following the *De Lasteyrie du Saillant* ECJ case which had found the old French exit tax incompatible with EU law

4 Tools that can be found in double tax conventions (DTC)

As a consequence, tax authorities and tax courts are faced with a plethora of cases, the results of which are not always consistent. Moreover, given the difficulty to rationalise "in abstracto", the "in concreto" thinking has been preferred which has spurred the multiplication of specific anti-avoidance rules. Notwithstanding this situation, the importance of keeping general anti-abuse rules able to palliate the insufficiencies of specific anti-avoidance rules, should not be forgotten.

Despite this absence of a general definition of tax avoidance, attempts have been made to set out the broad shape of the concept.

Philip Baker, [5] in an article entitled "Tax Avoidance, Tax Evasion and Tax Mitigation", recently exposed the issue and endeavoured to rovide some answers. His thesis was that tax avoidance, tax evasion and tax mitigation, although building blocks in international taxation, are not sufficiently understood and that is wrong. The author considered that if it was possible to define tax avoidance by demarcating the frontiers of tax evasion (also called tax fraud[6]) and tax mitigation, it would be more straightforward to proceed by defining tax avoidance. Both approaches deserve to be expounded.

When it is spoken about tax fraud, criminal conducts are dealt with. As such, tax fraud must involve intentional behaviour or actual knowledge of wrong-doing. In other words tax fraud is an intentional violation of the law. Additionally, and because it is criminal, the offence should be statutorily contemplated.

At the opposite of the spectrum is tax mitigation. The idea of an acceptable tax planning has long been recognized by the courts. In the view of Lord Tomlin in the "Duke of Westminster", House of Lords' famous decision[7] : "every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be". The French judicature has also recognized that principle of acceptable tax planning[8]. It thus held that should the

5 Philip Baker "tax avoidance, tax evasion and tax mitigation"
http://www.taxbar.com/documents/Tax_Avoidance_Tax_MitigationPhilip_Baker.pdf

6 The term "tax fraud" should be preferred to the one of "tax evasion". Otherwise difficulties could arise due to semantic divergences. Indeed French usually speak about "tax evasion" to designate what is called elsewhere "tax avoidance".

7 *Inland Revenue Commissioners v. Duke of Westminster*, House of Lords, [1936] AC 1

8 See for example : **CE June 16th 1976, n° 95513 : RJF 9/76 n° 399** (aftermath : the exercise by the taxpayer of an option given by the legislature is not constitutive of an abuse) In that case an exemption from capital gain tax on immovable property was granted when capital gains for a tax year were inferior to 50,000F. In that case, the taxpayer had divided the sale of a property over two tax years in order to spread the capital gain and thus benefiting from that tax exemption.

However the French tax administration considered that there was in fact one unique sale taxpayer have the choice between two different routes, one of which entails a lesser tax burden, there was no obligation for him to choose the more taxed way. Therefore, the sole fact to choose the less taxed way did not in itself constitute an abuse. Finally, this possibility has also been upheld by the European Court of Justice (ECJ) in recent cases. In "Barbier"[9] for example the Court expressly accepted certain forms of tax planning stating that: "a Community national cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other that his State of residence". Similarly in "*Halifax*",[10] a VAT case, the ECJ reminded us that: "taxpayers may choose to structure their business so as to limit their tax liability".

Between the two comes tax avoidance. However, as the frontiers concerning tax mitigation and tax fraud are rather dimmed, the best way to proceed is to define tax avoidance in itself (rather than by the means of a comparison). Philip Baker[11], in his article distinguishes three form of tax avoidance : "countered tax avoidance" where specific legislations counter particular schemes, "abusive tax avoidance" where a taxpayer cannot reasonably argue that no tax is due, and "ill-advised tax avoidance" where technically working schemes are not entered into for ancillary reasons (psychological, material …). Any practices which would not fall under one of these categories would be tax mitigation.

The first form of tax avoidance identified by Prof. Baker, namely "countered tax avoidance" will be dealt with in this article.

Eventually tax harmonisation is assuredly the most effective way to fight tax avoidance. And it may be observed that this course of action is increasingly adopted, especially within the European Union[12]. But the downsides of this method, though effective it may be, must not be minimized. Indeed it is thought that tax competition is the surest way to decrease the tax burden borne by taxpayers. As in an open world a heavy tax system would clearly lead to geographical shifts, states

leading to a capital gain exceeding the exemption. It charged the taxpayer to tax on that amount, adding late interest and penalties. The highest court, contrary to the administration, held that the taxpayer was not prevented to behave as he did. Therefore it dismissed the action of the administration and discharged the taxpayer from the additional taxes imposed on him.

9 *Barbier* paragraph 71

10 *Halifax* paragraph 73

11 Idem footnote 3

12 See for example the **Common Consolidated Corporate Tax Base** (CCCTB) project as detailed in the draft directive released by the European Commission on March 11th 2011 (COM/2011/121)

are encouraged to keep reasonable levels of taxation. A full tax harmonisation would remove this economic imperative that states had in maintaining low tax rates. For this reason a complete tax harmonisation should not be wished; tax competition is at the end of the day beneficial for the taxpayer. The inevitable corollary is that strong anti-avoidance rules are needed. These are discussed in this paper.

4) Structure of the paper

The domestic anti-avoidance rules used in cross border setting will be dealt with first. Different mechanisms set forth by France, be they general or specific, will be broached. These mechanisms will then be scrutinized from an EU perspective.

PART I – FRENCH ANTI CROSS-BORDER AVOIDANCE RULES

I General Anti Avoidance Dispositions

A material feature of the provisions hereinafter is to be applicable primarily in domestic situations. Nevertheless they can also be useful in an international setting since they target, in general, every action aimed at illegally taking advantage of a factual or legal situation.

Contrary to the specific anti-avoidance provisions mentioned in [II] which tackle specific cross border avoidance, these general anti-abuse provisions tackle all forms of abuse, be it in a domestic or a cross border context, and that of course includes tax avoidance.

I.A The Abuse of Law – Article L 64 LPF (The Tax Procedures Code)

At a time where the opportunity of adopting General Anti Avoidance Rules (GAAR) in their legislation is being discussed by a number of states, it seems timely to dwell on the French situation. France does not have a GAAR. However its legal system is towered by the “fraus legis” doctrine. *Article L 64 LPF* codifies this concept.

The scope of the concept of abuse of law, as initially defined in the code, has been extended by the courts. The legislature has then taken note of this evolution. So much that today two types of situation are envisaged by *article L 64 LPF*, both of which if characterised would constitute an abuse of law.

First, a transaction might fall foul of the provision where it is **fictitious**. In addition, *article L 64 LPF* can now be applied to transactions which, “**aim solely at evading tax normally due**, and results in a tax advantage the grant of which would be, notwithstanding formal application of the conditions laid down by the laws or others relevant texts, contrary to the purpose of those provisions".

This second branch is derived from the Conseil d'etat jurisprudence pertaining to "fraus legis". The first decision symptomatic of the evolution was a 1981 case[13], in which it found that *article L 64 LPF* also applied to transactions which, without being fictitious, were designed with the sole aim to avoid taxes. But notwithstanding this extension, the scope of the "abuse of law" theory remained strictly circumscribed (as regards for example the taxes covered). The "Janfin"[14] case added some paramount precisions in that respect. Indeed, in that decision, the judges held that where *article L 64 LPF* was not applicable, the fisc could still make use of the "fraus legis" general doctrine. The definition of "fraus legis" given in this case was afterwards used to redefine the contours of the abuse of law[15]. Finally, the legislature took notice of that jurisprudential evolution in the amended Finance Act for 2008[16] in which it also uncircumscribed the scope of the "abuse of law" theory. As a consequence of this extension, the "fraus legis" concept has lost its practical scope, having been somehow absorbed by *article L 64 LPF*.

The characterisation of an abuse of law generates some consequences. This starts with an increase of 80% of the eluded tax, to which late interest can be added of 0,40% per late month. Besides, where the arrangement constitutes tax evasion, the person incurs additional fines and possibly a prison sentence[17].

The jurisprudence has pointed out that, for an abuse of law (other than by a fiction) to be found, the exclusively fiscal aim was necessary but not sufficient. This solely tax driven argument must in addition be contrary to the legislator intention **or** result in an arrangement devoid of any substance (be it juridical or economic substance). This substance parameter is paramount in that it is mirroring the proportionality requirement expressed by the ECJ in its case law.

13 CE June 10th 1981, n° 19079 : RJF 9/81 n° 787

14 CE September 27th 2006, n° 260050, *Sté Janfin* : RJF 12/06 n° 1583

15 See for example : CE February 28th 2007, n° 284565, *Min v. Persicot* : RJF 5/07 n° 599

16 It must however be noticed that the law slightly departs from the jurisprudence, indeed it uses the passive form in its wording (the jurisprudence was using the active form). As concluded by Bruno Gouthiere it implies that the taxpayer does not necessarily have to be party to the transaction.

17 Article 1741 FTC

An interesting example of this corporate substance notion is seen in the "Sté Andros"[18] case. In that case a French parent company held a 22.99% shareholding in the capital of a Panamanian subsidiary (which in turn owned the operating Luxembourg company). This allowed it to benefit from the French participation-exemption regime, while escaping the application of *article 209 B FTC*[19] due to the threshold not being reached. The court found that the situation was characteristic of an abuse of law, because the Panamanian company was devoid of any substance.

I.B The Abnormal Act of Management

1) Operation of the rule

The abnormal act of management theory aims at forbidding, in calculating the taxable income, the deduction of expenses which either would not have been incurred in the interest of the enterprise, or which would not be linked to a "normal" management. In other words such expenses would not be deductible, being considered as "abnormal".

There is no specific legal basis for this theory. This is mostly a jurisprudential construction by which the judges have somewhat generalised the reading of *article 39-5 FTC*. This article provides that "[certain deducted expenses] can be added-back to the taxable income where they are excessive or where evidence has not been produced that they were incurred in the direct interest of the enterprise". The principle is nowadays widely accepted, and is applied by the courts both in domestic and international contexts.

2) Its combination with others anti-avoidance rules

The abnormal act of management must not be confused with the "abuse of law" doctrine. Indeed the former targets situations which are **contrary** to the interest of the enterprise, whereas the latter is precisely aimed at preventing transactions which (though illegal) **benefit** the enterprise.

Moreover the rationale of the concept is close to that which underlies *article 57 FTC* pertaining to transfer pricing issues[20]. This explains that the first be in theory applicable in situations falling under the scope of the second.

The observation is also true as regards *article 212 FTC*.

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18 CE December 10th 2008, n° 295977, *Sté Andros* : RJF 3/09 n° 255

19 See hereinafter the developments on article 209 B FTC

20 See hereinafter for further developments on the question

II SPECIFIC ANTI AVOIDANCE DISPOSITIONS

In this second part, it will be focused successively on the 3% tax on immovable property [II.A]; CFC rules [II.B]; transfer pricing and thin capitalisation rules [II.C].

The 3% tax on immovable property is particular to France in that it is rarely encountered in others tax systems; nevertheless, as will be shown, it is indeed a mechanism to be reckoned with.

These mechanisms have been found of relevance in particular because they have all been challenged at least once by the European Court of Justice. In other words, our aim is not to make an exhaustive examination of every existing anti-avoidance provision provided by French tax law. Rather it is to outline the main ones and to highlight the influence that EU law has on them.

II.A 3% tax on immovable property

This 3% tax is charged on immovable property (and on rights giving access to immovable property) owned in France by resident and non-resident legal persons.

1. *Articles 990 D to G* of the French tax code (FTC)

According to *article 990 D (1) FTC* of the tax code, "legal persons which, directly or through an intermediary, own one or more properties situated in France or are the holders of rights *in rem* over such property are liable to pay an annual tax of 3% of the commercial value of these properties rights"[21].

The purpose of this provision is to discourage the acquisition, by legal persons established in tax havens, of immovable properties situated in France. Indeed, in such situations, it is often impossible for the tax administration to know the shareholders' identity. It follows the impossibility to subject them to tax (especially wealth tax and stamp duty). The legislature took note of this practical difficulty; the 3% tax on immovable property was conceived as a substitute for these taxes.

Article 990 E FTC of the tax code provides for some exemptions. The main ones are presented here. They can be classified into three categories. The two first ones have regard to the company itself, the third one mainly depends on the legal entity's behaviour.

1) Legal entities are exonerated when immovable assets located in France

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21 Translations of French tax code provisions to be found in this article are not official but are the work of the author

represent less than 50% of the company's assets in France. Only properties[22] which are not affected to the business of the company are taken into account for the purpose of the calculation of the 50% ratio. This ratio can thus be obtained by a simple formula[23].

Likewise, companies whose shares are listed on a regulated stock exchange escape the 3% tax.

2) The exemptions forming the second category apply in certain circumstances and require a localisation criterion to be met.

This series of exemptions aims at exempting entities owning properties whose market value is minimal, and certain entities by reason of their legal form.

The localisation criterion is paramount in that it must also be fulfilled to benefit from the third exemption. It is then worth further examination. To be exonerated a legal entity must have its registered office : in France, or in an European Union Member State, or in a state having concluded with France a convention for administrative assistance to combat tax avoidance and tax evasion, or in a state having concluded with France a treaty containing a non-discrimination clause.

Should the company satisfy one of these test and enter into the scope of exemptions, the 3% tax would not apply.

3) The third prong of the exemption test is the source of numerous litigation as far as the 3% tax is concerned. In this occurrence the exemption can either be total or partial.

It is total when the legal person communicates each year, or takes on and respects the obligation to communicate to the tax authority, at its request, the location, description, and value of the properties in their possession as of January 1st of each year; the identity an address of **all** shareholders holding more than 1% of the shares; and the number of shares held by each of them.

It is partial when the legal person targeted declares each year, by May 15th at latest, the location, description, and value of the properties in their possession as of January 1st; the identity and the address of shareholders holding more than 1% of the shares **which they are aware of**; and the number of shares held by each of them. In this second case the exemption is given a pro-rata[24].

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22 By "properties" it is meant both properties and rights *in rem* over such property

23 Ratio = market value of properties situated in France and not affected to the business of the company / market value of all French assets of the company

24 Pro-rata = number of shares held by shareholders whose identity and address have been unveiled / total of shares

The idea underlying this third series of exception is that this information will allow the tax authorities to tax the shareholders. Although the latter are generally established in tax havens, they will be liable to pay wealth tax, stamp duty, etc. on their immovable properties.

2. Compliance with International law

While the disposition was first intended to apply to foreign companies only, the legislature has extended the scope of the article to encompass French companies. This evolution can be explained by the need to conform with double tax conventions which usually provide for a non-discrimination clause. Nevertheless, owing to the numerous opportunities of exemption, it can be observed that in practice French companies are not concerned with this tax.

Thus the 3% tax will generally apply to foreign companies established in states having not concluded any convention for administrative assistance with France and for which anonymity of shareholders is maintained.

To conclude, the exceptions available have led in practice to reducing to a trickle the scope of the 3% tax.

II.B Controlled Foreign Company -CFC- rules

According to article 209 B of the French tax code, the profits of either branches or subsidiaries of a French company will be added back to the results of the latter company, when the former are established in a tax haven.

Article 123 bis of the French tax code has the same goal as far as individuals are concerned. This provision will not be dealt with in the following developments.

In its present form, article 209 B FTC states that "when a legal person established in France and liable to corporate income tax operates an enterprise outside France or holds, directly or indirectly, more than 50% of the shares, financial rights or voting rights in a legal entity established outside France, and the said enterprise or legal entity benefits from a favourable tax regime within the meaning of article 238 A FTC, that enterprise or legal entity's profits are liable to corporate income tax [in France]."

It adds: "When earned by a legal entity those profits are deemed to be distributed to the French legal person, and are thus taxable as such in proportion to the shares or financial rights which the legal person established in France holds directly or indirectly[25]."

To summarize, this article leads to the imposition in France of the profits of branches or subsidiaries established in tax havens of French companies. By doing so, this article has a dissuasive effect since it removes any advantage that could have resulted from the localisation of benefits in a tax haven.

1. Conditions for application

It is paramount to consider in more depth the conditions and effects of *article 209 B FTC* in order to get a fair understanding of this provision. This article lays down some conditions which, if met, will trigger some consequences.

The first condition is that the legal person established in France must be liable to corporate income tax. In consequence it does not apply to individuals, but might be so to permanent establishment in France of foreign company when that permanent establishment holds the shares, financial rights or voting rights required.

The second core condition is that the enterprise being operated outside France or the legal entity established outside France benefits from a favourable tax regime. The legislature refers to *article 238 A FTC* to assess whether this is the case. According to the latter provision it is up to the tax authority to prove that the foreign entity is indeed paying less than 50% tax than that to which it would have been liable to had it be established in France.

The third one pertains to the holding threshold. The triggering threshold provided for by *article 209 B FTC* is currently fixed at 50%. In such a situation it might be presumed that if the foreign entity does not distribute its profits, it is because of a decision in that sense from the French controlling legal person. Thus it does not seem unreasonable to deem these profits distributed and accordingly, to subject them to tax in France. Furthermore the provision specifies that both direct and indirect holdings have to be taken into account.

Regarding the last condition, an anti-abuse mechanism exists which is called "anti-fractioning clause". It aims at preventing the artificial splitting of shareholdings. According to that clause, the triggering threshold is lowered to 5% (instead of 50%) if more than 50% of the shares, financial rights or voting rights in the legal entity established outside

25 This provision is aimed at taking these very profits out of the scope of article 7 OECD MTC (the article applying to business profits)
see "*3. compliance with International law*" for further developments on this question

France are either held by enterprises established in France (even if these French enterprises are not linked), or by enterprises which are linked to the French legal entity (even if these linked enterprises are not established in France).

Still regarding the last condition, the 50% holding is calculated by taking into account both direct and indirect participations.

2. Consequences of application

Firstly profits of the foreign entity are taxable in France. Nevertheless a distinction must be drawn between foreign branches and foreign subsidiaries. If the foreign entity is a branch, its whole profits are taxable in France. However if the foreign entity is a subsidiary, the profits are taxable in France only in proportion to the shares or financial rights which the legal person established in France holds directly and indirectly. Moreover the fact that foreign profits are taxable in France does not imply the deductibility of potential foreign losses.

Secondly the question must be asked of the elimination of double taxation. To achieve this goal *article 209 B FTC* provides for an imputation mechanism. It is permitted to deduct from the French tax, taxes of a similar nature paid in the source state[26]. It is also allowed to deduct withholding taxes in most cases[27]. Finally at the time when the foreign entity distributes its profits, such a distribution will not appear in the taxable income of the French recipient company. Indeed the French entity will be entitled to deduct from its taxable income the distributions received.

Precision: As regards the first effect (taxation of the profits of the foreign entity in France), it is worth noting that the French participation-exemption regime is not fully excluded. On the one hand, it is applicable in the case of a foreign holding company receiving dividends from a third company, and which satisfies the conditions required to benefit from the participation-exemption regime. In such a case the effect of *article 209 B FTC* would be neutralized. One the other hand, it is not applicable if the foreign entity makes capital gains instead of receiving dividends[28].

Important exceptions to the operation of *article 209 B FTC* exist which will be tackled further in this paper (see the part dedicated to the compliance of the provision with EU law).

26 Article 209 B I-4 FTC

27 Article 209 B I-5 FTC

28 Inst. January 16th 2007 : BOI 4 H-1-07 **qualified by** Inst. August 2nd 2007 : BOI 14 H-1-07 which allows, in some circumstances, a 95% exemption on long term capital gains

3. Compliance with International law

The issue of the compatibility of *article 209 B FTC* with Double Tax Conventions has been dealt with by the Conseil d'Etat in the *Schneider Electric* case[29]. In that case the France/Switzerland DTC was at stake; but the findings of the French highest court were applicable to many a DTC.

The circumstances in that jurisprudence led to the operation of *article 209 B FTC* being superseded by the operation of the DTC. In other words the latter removed all the practical scope of the anti-avoidance disposition.

One the one hand, *Article 7 DTC* exonerated **business income** [in France] had they not been earned through a permanent establishment in France; and that assuredly was the case of profits earned through a foreign CFC. One the other hand, the DTC allocated taxing rights to the state of residence [France] in situations where the latter received **deemed dividends**. Therefore the question asked to the Conseil d'Etat was whether the profits deemed attributed to the French parent company under *article 209 B FTC* were business income within the meaning of *article 7 DTC*, or whether they constituted deemed dividends. The French highest administrative court held in favour of the first solution. The DTC provision exonerated that which the domestic provision taxed. This jurisprudence thus had the effect of removing all the practical scope of the anti-avoidance disposition.

The legislature consequently modified the wording of *article 209 B FTC*. From this modification onwards, the profits earned through the CFC have been deemed to be distributed by the latter to its French shareholders. By deeming those profits to be distributed, the characterisation of "**movable income**" henceforth applied to them, thereby removing them from the juridical scope of *article 7 DTC*, and as a consequence re-including them in the practical scope of *article 209 B FTC.*

II.C Transfer Pricing and Thin Capitalisation

The OECD has long been thinking of the transfer pricing issue and has suggested an approach to deal with this problem. Therefore the proposed OECD approach will be discussed before handling the French provisions, which in fact replicate the OECD approach in French domestic law.

Afterwards, the French thin-capitalisation rules will be tackled which, in an international context, are sometimes seen as constituting a sub-set of the transfer pricing rules.

29 CE June 28th 2002, n° 232276, *Min v. Sté Schneider Electric* : RJF 10/02 n° 1080

1. *Article 9 of the OECD Model Tax Convention (MTC) and article 57 of the French tax code (FTC): transfer pricing rules*

According to Bruno Gouthiere, the idea underlying this concept is that "prices can be agreed between associated enterprises, member of a same group, whereas they would not have been so had the enterprises not been linked and had they complied with the arm's length principle". By agreeing such prices, enterprises would be able to play artificially with the localization of profits.

The OECD has spearheaded the discussion on how to rectify these agreed prices in order for them to comply with market prices.

A) The OECD approach

As previously noted above the OECD works on transfer pricing are paramount. The basic approach is set forth in *article 9 MTC* and its commentaries. Besides, the OECD Committee on Fiscal Affairs has expressed its understanding on transfer pricing by issuing a set of comprehensive guidelines. These are intended to bring forward the understanding on the question.

National tax administrations constantly, and explicitly, refer to these OECD transfer pricing guidelines. They constitute then the basis any transfer pricing legislation. It is then necessary to drawing the outlines in order to understand the spirit of the report.

Article 9-1 MTC introduces the need for a two-steps analysis. This article states that "[when] conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".

First, as explained in the OECD guidelines, this article lays down the need for a comparability analysis. The comparison must occur between, on the one hand, conditions made or imposed between associated enterprises, and on the other hand, conditions made between independent enterprises. In that comparability analysis multiple factors must be taken into account which are detailed in the report. These factors are, inter alia, the characteristics of property or services, the contractual terms, the economic circumstances, the business strategies. A functional analysis (more or less like the one required by *article 7 MTC* on business profits) must also be undertaken, because a remuneration of a transaction has to reflect the functions assumed by each party. This comparability analysis is at the very heart of all reasoning on transfer pricing.

The second step is the determination of the profits which would have accrued at arm's length. The OECD suggests five methods in that regard. Three methods are based on the transactions[30]; they are the ones favoured by the OECD. The remaining two methods are based on the profits[31]; according to the OECD they should only be used as a last resort.

Article 9-2 MTC then deals with the treatment accorded to cross-border economic double taxation[32]. It states that "where a contracting state includes in the profits of an enterprise of that state – and taxes accordingly – **profits on which an enterprise of the other contracting state has been charged to tax in that other state** and the profits so included are profits which would have accrued to the enterprise of the first-mentioned state if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then **that other state shall make an appropriate adjustment to the amount of the taxes charged therein on those profits**"[33]. This provision aims at avoiding a same amount being taxed twice. Therefore it is not triggered where for example the other state is a tax haven which does not tax the sum.

However, that indent does not deal with secondary adjustments. A secondary adjustment would aim at restoring the economic reality (primary adjustments are purely fiscal). Indeed the money representing the profits subject to the primary adjustment is still in the hands of the enterprise of the other contracting state; a secondary adjustment would aim at reflecting that economic reality. It is up to domestic legislations to provide for this secondary adjustment. As will be seen later, this is the option chosen by France.

B) The French tool: article 57 FTC

1) First, *Article 57 FTC* is close in ambition to others provisions. But still some differences remain. It is close for example to *article 238 A FTC* which aims at adding back to the tax base certain payments made to persons in tax havens. But the former is wider since it targets all states, and not only tax havens. This fundamental difference apart, both provisions are relatively similar. The Administrative Court of Appeal of

30 Traditional transaction methods : comparable uncontrolled price method, resale price method and cost plus method

31 Transactional profit methods : transactional net margin method and transaction profit split method

32 Let us precise here that, as the French provision does not provide any specific mechanism for the elimination of double taxation, the provisions of the OECD MTC will be given full effect (provided the DTC follows this model)

33 This is the "primary adjustment"

Paris has recalled this similarity in the "SA Adibu"[34] case where it stated that the tax administration was attempting to change the legal basis for tax from *article 238 A FTC* to *article 57 FTC*. It is also admitted that the tax administrations could, alternatively, rely on the concept of mismanagement behaviour as described above.

As a second remark it should be emphasized that *article 9 MTC* and *article 57 FTC* must receive the same interpretation. This is the meaning of an administrative doctrine[35] released by Bercy.

2) After these preliminary thoughts let us examine the provision in itself. Some conditions have to be met which, if fulfilled, will trigger consequences.

The proof burden weigh on the tax administration involved. The fisc has to establish two things: first the parties must be connected; second there must be a transfer of benefits to the foreign entity.

The first condition requires a connection between the French entity and the foreign entity. Therefore it is possible to single out three potential situations. Firstly, the case of a French entity controlled by a foreign entity; secondly, the case of a French entity controlling a foreign entity; and thirdly, the situation where both the French and the foreign entities are under common control of a third person (entity, group or consortium). What is interesting is the meaning given to the concept of control. Indeed it might be either legal or factual. A legal dependency of one entity to the other (or otherwise stated a connection situation) is found where an entity holds a major part of the share capital of another or the majority of voting rights likely to be exercised in a general meeting. The concept of factual dependency is more dim. The recognition of which will depend on the factual circumstances. A French advocate general[36] used to define it as "the ability to dictate economic conditions unfavourable to the controlled entity but in line with the interest of the controlling entity".

As far as the second condition is concerned it is required to establish the existence of a transfer of benefits. More precisely the tax administration must demonstrate an indirect transfer of benefits abroad. This indirect transfer can take many forms, among which are: the purchase at a higher price ; sale at lower price; excessive remunerations for services; excessive royalties ; excessive interest; sharing of foreign entity overheads...The French courts reckon that any advantage must be established by a

34 CAA Paris February 2nd 1995, n° 89-819, *SA Adibu* : RJF 12/95 n° 1363

35 D. adm. 4 A 1213, n° 6

36 Advocate General Philippe Martin opinion in CE March 18th 1994, n° 68799-70814, *SA Sovemarco-Europe* : RJF 5/94 n° 532

comparison with similar uncontrolled transactions. Where appropriate it might also be possible to ascertain the transfer of benefits by highlighting an unjustified gap between the price paid and what the service is really worth[37].

It is important to notice that the first condition does not have to be met in the case of transfer of benefits involving tax havens. The underlying idea is to alleviate the task of tax administrations. Indeed, given the high secrecy still surrounding tax havens it would have proved impossible for them to establish the connection link. Therefore the French code takes note of this situation by releasing the tax administration from its duty in this particular case.

In practice these two requirements imply following the method put forward in the OECD guidelines. In other words a functional analysis must first be held which leads to attributing functions, risks and assets to each entity. Then the most suitable transfer pricing method must be chosen to arrive, via a comparability analysis, at an arm's length pricing of the transaction.

The application of *Article 57 FTC* produces two consequences. First an adjustment of taxable profits in France[38], second a deemed distribution of the amount of the adjustment[39].

As regards the primary adjustment, this means that the profits indirectly transferred abroad are added-back to the profits shown in the French company's accounts. The credit to the P/L account is of the amount of transferred profits. Where appropriate this amount can be determined by a comparison with taxable profits of entities operating at arm's length (*article 57 para. 4 FTC*). The effect of this adjustment is to subject the amount to tax in France.

Besides, the added-back sums are deemed distributed (it can be explained by the fact that in reality the cash is still in the foreign entity, the adjustment only takes place for tax purposes). Subject to Double Tax Conventions, these deemed distributions suffer withholding tax[40]. *Article 119 bis 2° FTC*, referring to *article 187 1° para. 3 FTC*, sets a rate of 25%. Nevertheless this withholding tax is calculated "inside", therefore the applicable rate is eventually 25/75 of the deemed distribution[41].

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37 See for example: CE November 7th 2005, n° 266436 and 266438, *Min v. Sté Cap Gemini* : RJF 1/06 n° 17

38 This constitutes the primary adjustment

39 This is the so-called "secondary adjustment" contemplated above

40 CAA Paris January 21st 2005, n° 01-873: RJF 2005. 433

41 Let us assume a distribution of 100 by the payer. This suffers a wt of 25%, so that the payee eventually receives 75. It follows that considering the situation of the payee, the wt is 25/75 (or 1/3) of the amount received

2. *Article 212 of the French tax code (FTC): thin-capitalisation rules*

The technique consisting of financing a company through debt rather than through equity can be interesting, especially in an international context.

This is in part due to the fact that interest, unlike dividends, is deductible from the taxable income of the payer. That fact permits taxable profits to be shifted abroad, by subtracting them to the scope of French tax and subjecting them to foreign tax. The technique takes an even more attractive twist when the interest are exonerated from withholding tax and eventually from any tax in the payee country. Having sheltered the interest in the payee country, the idea would then be to send them back to a French holding via dividends which would in turn benefit from the participation-exemption regime.

The French tax code provides some mechanisms intended to fight against such abuses, the foremost of which is described in *article 212 FTC*[42].

1) If the UK assimilates thin-capitalisation issues to the transfer pricing problematic[43], so that the former constitutes a sub-set of the latter, that is not the position adopted by the French legislature which dedicates specific provisions to the matter.

   It is true that, in an international context, both aim at preventing transfer of benefits abroad. But as far as thin-capitalisation rules are concerned, it is done by putting a cap on interest deductibility. On the other hand in transfer pricing matters, the mechanism of which does not only aim at counteracting the payment of abnormally high interest, the Arm's length Principle prevail.

   The question of how *article 57 FTC* and *article 212 FTC* combine together has been dealt with both by the French courts and the tax administration. Their opinions bring light to the issue at stake.

   The French highest administrative court took the position in the recent "*SA Andritz*"[44] test case. The Conseil d'Etat considered that *article 57 FTC* (interpreted in accordance with *article 9 MTC*) did **authorise** the states to appreciate whether the remuneration of a loan was at arm's length, but **did not allow** them to take a position on the fact of whether the decision to finance by borrowing instead of equity was normal. Therefore it appears

42 Such practices can also be combated via *article 238 A FTC* whose purpose is to reintegrate certain payments made to persons in tax havens. Or even through the abuse of law doctrine

43 In the UK thin-capitalisation is counteracted by means of arm's length transfer pricing principles

44 CE December 30th 2003, n° 233894, *SA Andritz* : RJF 3/04 n° 238

clear that it will prove impossible, under *article 57 MTC*, to criticize a company for being thinly-capitalised. Moreover, Bercy[45] issued a paper in 2005 whereby it expressed its intention to line up on the Conseil d'Etat jurisprudence[46]. It upheld in substance that *article 57 FTC* provisions only permitted to oppose an abnormal interest rate.

2) After these preliminary remarks the provision in itself needs to be examined.

Article 212 FTC is the most important provision insofar as thin-capitalisation is concerned. The first indent of this provision puts a cap on the deductible interest rate, whereas the second one aims at limiting the amount of borrowing the remuneration of which can be deducted.

This provision, though initially intended for associated enterprises only, has seen its scope extended by the Finance Act for 2011. Henceforth it also applies to the lending of money between independent (non-associated) enterprises, when an associated enterprise guarantees the repayment of such loan. This amendment aims at apprehending schemes in which a third company was interposed in order to get around the limitations.

2.a) *Article 212 I FTC* : the cross-reference to *article 39-1 3° FTC*

Article 39-1 3° FTC looks at **shareholders**. But its scope has been extended by *article 212 FTC* which looks at every **associated enterprise**[47]. The first mentioned provision provides that interest is deductible within the limit of those calculated at a rate equal to the *annual average (1st)* of the *average effective rates made by credit institutions (2nd)* for *floating rate loans to enterprises* (3rd) whose term is superior to *two years* (4th). In practice this rate is revised every year. For fiscal years ending between 31th December 2011 and 31th January 2012 (that is to say for most cases) it was fixed at 3,99%.

Therefore, any interest paid above this ceiling would have to be added-back to the taxable income of the payer.

2.b) *Article 212 II FTC* : the ratios of thin-capitalisation

Besides the limit of *article 39-1 3° FTC* there exist an overall cap of deductible interest. It is calculated according to the instructions given in *article 212 II FTC*, the wording of which refers to three formula, each of these formula being intended to calculate a certain limit.

If the overall amount of interest **paid to associated enterprises** exceeds

45 Bercy : the French finance ministry

46 Inst. January 12th 2005 : BOI 13 O-2-05

47 Including thus sisters companies (vertical **and horizontal** relationships)

simultaneously those three limits, then the fraction of interest exceeding the highest of those limits shall not be deductible[48].

The first limit (L1) is calculated as follow:

$$L1 = \text{amount of interest paid}^{49} \times 1.5 \times \frac{\text{amount of equity}}{\text{average amount of debt borrowed to associated enterprises}}$$

The second limit (L2) is calculated as follow:

$$L2 = \frac{25 \times \text{net profits before tax (including interest paid)}}{100}$$

The third limit (L3) is the following:

$$L3 = \text{amount of interest received}^{50}$$

Example: let us assume a French Company A having 1,000,000 euro equity and 5,000,000 euro debt which it borrowed from associated enterprises. Company A makes net profits before tax of 750,000 euro (including interest paid to associated enterprises). It pays 500,000 euro interest to its associated lenders and receives 100,000 euro interest from its associated borrowers.

$$L1 = 500{,}000 \times 1.5 \times \frac{1{,}000{,}000}{5{,}000{,}000} = 150{,}000$$

$$L2 = \frac{25 \times 750{,}000}{100} = 187{,}500$$

$$L3 = 100{,}000$$

Conclusion: the overall amount of interest paid to associated enterprises exceeds simultaneously those three limits. As a consequence the fraction of interest exceeding the highest of those limits is not deductible.

So: 500,000 – 187,500 = 312,500

Conclusion 2: the fraction of non-deductible interest is 312,500. They will have to be added-back to the taxable profits.

An important precision is put forward by *article 212 FTC*. Indeed, those interest which have been found to be non-deductible in year Y can be

48 This fraction is still deductible if it is inferior to 150,000 euro

49 It is meant interest paid **to associated enterprises**

50 It is meant interest received **from associated enterprises**

carried forward in order to be deducted in Y+1[51]. The amount still not deducted can be carried forward on the following years; but from this second year onward an abatement of 5% of the carrying amount must be practised each year. It is evident that this provision will only apply where an enterprise has paid specially high interest in year Y, and where it is not expected to pay such high interest on the following years; in others cases, where the amount of paid interest exceeds on a recurrent basis the limitations of *article 212 FTC*, the provision loses most of its practical interest.

Moreover, this provision provides some exceptions. It does not apply, for example, to finance companies[52]. It is not applicable either when the enterprise demonstrates that its indebtedness ratio is lower than the indebtedness ratio of the group to which it belongs[53].

PART II – THE NECESSITY TO COMPLY WITH EU LAW

I The Reference Framework

Thinking about the reference framework implies first describing the norms constituting the normative framework [I.A]. It implies then to describe that which can be seen as conflicting with this normative framework, namely to discuss the concepts of abuse, abusive practices, and tax avoidance in EU law [I.B].

I.A The fundamental freedoms and state aid provisions

A fundamental objective of the EU is the establishment of an internal market. This is defined in article 26-2 TFEU. This provision provides that "the internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties". This is a critical article since it lays down the essential reference against which domestic legislation will have to be assessed, namely the four fundamental freedoms.

From a perusal of the ECJ case law it appears that two fundamental freedoms are especially relevant in tax law, namely the freedom of establishment and (but to a lesser extent) free movement of capital.

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51 But the same limitations apply in Y+1 and so on

52 Article 212 II 2 1° FTC

Company within a group whose aim is to receive passive income from the other companies of the group and, in turn, to provide finance to these companies

53 Article 212 III FTC

But though essential they are, the fundamental freedoms do not constitute the only reference to be taken into account. State aid provisions also have a decisive influence in analysing the compliance obligations, though to a lesser extent as far as anti-avoidance rules are concerned. Article 107-1 TFEU states "Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market".

Two recent decisions give examples of the circumstances in which this provision could be invoked. The first is a decision of the commission, the second a judgment of the ECJ. In the "Umicore" decision[54] the commission held that **agreements with the tax administration** can be brought to its knowledge and analysed in terms of State aids. The "*Paint Graphos*" case[55] pertained to the question of whether the **absence of anti-avoidance rules** could constitute a State aid. Though non-conclusive, the "*Paint Graphos*" case could be interpreted in that sense. It follows that in certain circumstances Member states could be forced to introduce anti-avoidance rules.

As far as the four fundamental freedoms are concerned the compliance obligations weighing on Member States are regularly reminded by the jurisprudence of the ECJ through the use of the following phrase "although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with EU".

In respect of this statement, the fact for Member States to exercise their competence "with Community law" means two things.

First, there must be no discrimination, unless it is justified on grounds provided for by the TFEU itself (generally public policy, public security of public health).

Second, there must be no restriction, unless it is justified on general interest grounds and abiding with the principle of proportionality[56]. Among the few general interest justifications accepted by the ECJ, it is the one based on tax evasion that is

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54 EU Comm., dec. May 26th 2010, n° 2011/276/EU

55 Cases C-78/08 to C-80/08, Paint Graphos

56 According to the *Gebhard* para. 37 formula "national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it"

relevant in this paper (in addition, a justification based on the effectiveness of fiscal supervision relevant in third country settings).

I.B The concepts of abusive practices and tax avoidance in EU law

I.B.1 The coincidence of abuse, abusive practices, and tax avoidance

As seen above, EU citizens have been bestowed rights by the TFEU. But some railings are necessary in order to ensure first that they do not use them in an unwanted way, and second that Member States do not prejudice them either.

The concept of abuse is not just a domestic notion. It is well known in EU law as well, where it has long been fought by the courts. Indeed, our current understanding of abuse has been developed by the ECJ (especially but not exclusively) in the tax law area.

There is a line of cases which is particularly symptomatic of the court's views on the concept of abuse. It pertains to those cases where companies were formed in a Member State A in order to bypass certain national rules of a Member State B, but which conducted their business entirely through branches or subsidiaries in that Member State B[57]. In those cases the ECJ regarded as abuse the fact for national of a MS to attempt "undercover of the rights created by the treaty, improperly to circumvent their national legislation or to (…) improperly or fraudulently taking advantage of provisions of Community law"[58].

Two types of abuses are described in this mantra. First, the invocation of an EU right in order to **circumvent national legislation**. Second, the invocation of an EU right in a way **contrary to the aim of the provision** which confers this right. As developed by Nicoleta Ionescu in her doctoral paper[59], the degree of legal harmonisation explains this dichotomy. Indeed, the first type of abuse usually takes place in a non-harmonised context (like direct tax), whereas the second one usually occurs in an harmonised setting (like indirect tax). In that second hypothesis the violated rules are EU rules, not domestic rules.

The "*Leclerc*"[60] and "*General Milk Products*"[61] cases are also enlightening on this notion of abuse. They respectively pertained to exportation followed by re-

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57 See for example : *Segers*, *Centros*, and *Inspire Act* (freedom of establishment)

58 *Centros* paragraph 24

59 Ionescu N., "l'abus de droit en droit communautaire" http://www.tesisenred.net/bitstream/handle/10803/5210/rni1de1.pdf?sequence=1

60 *Leclerc* paragraph 27

61 *General Milk Product* paragraph 22

importation, and vice-versa. The court recalled in the first of these cases that there would be abuse where "the sole purpose of re-importation [would be] to circumvent the legislation in question".

More recently, in the "*Kofoed*" jurisprudence the court erected this concept of abuse as a general principle of EU law. Indeed it stated that it was a "**general Community principle** that abuse of rights is prohibited"[62].

This general principle of EU law that prohibits abuse of rights is particularly important in harmonised settings, because no domestic anti-abuse rules exist to reprehend a particular scheme or a particular behaviour. But when, in a non-harmonised setting, domestic anti-abuse rules do exist (be these rules general or specific), the problem grows trickier, because such rules must be kept compliant with EU law[63].

The problem is that these domestic rules are usually restrictive of the fundamental freedoms. Therefore keeping them compliant with EU law means two things. First, they must be justified by the need to fight against tax evasion. Second, they must not be disproportionate.

If the prohibition of abusive practices[64] has mostly been developed in the indirect tax field, it must be noticed that it is ultimately very similar to the justification based on tax evasion found in the direct tax field. Indeed, this justification based on tax evasion will succeed as far as the domestic rules are **specifically aimed at preventing "conduct involving the creation of wholly artificial arrangements which do not reflect economic reality**"[65]. And "wholly artificial arrangements" amounts to "abusive practices" of EU law[66]. Therefore requiring the "Halifax" test on abusive practices to be extended to the direct tax field[67]. By reconciling the concepts of "abusive practices" and "tax evasion", the indirect and direct tax fields are thereby brought closer.

To conclude, a domestic anti-avoidance will not automatically be acceptable when

62 *Kofoed* paragraph 38

63 To a certain extent the domestic anti-avoidance rules outweigh the general EU anti-abuse rule; but the latter does not disappear for all that. Indeed, checking the conformity of these domestic anti-avoidance rules with EU law, as will be seen in this article, will require the assessment of the scheme or behaviour itself against that general EU principle

64 The concept of "abusive practices" seems to us to be nothing more then a subset, **in the tax field**, of the "abuse of a fundamental freedom" concept

65 *Cadbury Schweppes* paragraphs **51** and 55

66 *Cadbury Schweppes* paragraphs **55** and 64 by induction

67 *Cadbury Schweppes* paragraph 64

it is applied in an EU context, for such a rule will have to be specifically designed to prevent abusive practices of EU law.

I.B.2 The two pronged test for characterisation of abusive practices

In *Halifax*, the ECJ laid out two conditions to characterising an abusive practice. First, the transaction concerned, notwithstanding a formal application of the rules, must "result in the accrual of a tax advantage the grant of which would be contrary to the purpose those rules"[68] (be they Community rules, or domestic rules). This is the first, objective, test. Second, "the essential aim of the transaction concerned [must be] to obtain a tax advantage"[69]. This is the second, subjective, test.

The first test implies to find out the primary aim of the provision at stake, that is to say getting the intention of the redactor of the text. This is assuredly an arduous task since it refers to subjective elements; it is all the more difficult in the possible absence of additional documentation (as preparatory work). On the other hand, a proponent of this test would highlight that it in fact requires to find out what the redactor did not intend the provision to allow. And that is easier than to find out what it really intended to permit.

The second test is the source of numerous disputes. It focuses on the meaning to be given to the mantra "essential fiscal aim". Indeed both the domestic definition of abuse of law[70] and subsequent ECJ cases are making use of the concept of "exclusively fiscal aim" instead, thereby creating confusion. Whilst the Court, following its "*Halifax*" jurisprudence, clearly held in favour of an "essential fiscal aim" in its "*Part Service*"[71] case, the "*Ampliscientifica*"[72] decision on the contrary was founded on the "exclusively fiscal aim" criterion.

In fact, in the "*Halifax*" case itself the path chosen by the Court was not that clear. Whilst paragraph 74 of the judgment highlights the "essential aim" requirement, paragraph 82 suggests a stricter criterion. Indeed it writes: "it is clear (…) that the **sole purpose** of the transactions at issue in the main proceedings was to obtain a tax advantage". This sentence has spurred some to consider that the case was consecrating the "exclusively fiscal aim" criterion. However that is not our opinion. An attentive scrutiny of subsequent case law, especially "*Part Service*" is particularly enlightening in that respect. Speaking about the "*Halifax*" case, the

68 *Halifax* paragraph 74 and 75

69 Idem footnote 15

70 See developments above

71 *Part Service* paragraphs 44-45

72 *Ampliscientifica* paragraphs 27-30

judges in "*Part Service*" held, in reply to the first question asked to them for preliminary ruling, that "when it stated, in paragraph 82 of that judgment, that in any event, the transactions at issue had the sole purpose of obtaining a tax advantage, it was **not establishing that circumstance as a condition for the existence of an abusive practice**, but simply pointing out that, in the matter before the referring court in that case, the minimum threshold for classifying a practice as abusive had been passed "[73]. Therefore, it concluded that "the Sixth Directive [had to] be interpreted as meaning that there [could] be a finding of an abusive practice when the accrual of a tax advantage [constituted] the principal aim of the transaction of transactions at issue"[74].

Notwithstanding this clarification, the question arose again following the "*Ampliscientifica*" jurisprudence. In the latter case the court did not refer to the "essential aim"; nor did it expressly affirm the "exclusive aim". It is nevertheless admitted that the case must be understood as favouring this second option. The salient passage begins with the court reminding the principle of prohibition of abuse of rights, which is intended to ensure "that Community legislation is not extended to cover abusive practices by economic operators, that is to say transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by Community law"[75]. The judges then make clear that "the effect of that principle is therefore to prohibit wholly artificial arrangements which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage"[76]. These two paragraphs are a mere reiteration of "*Halifax*" and "*Cadbury Schweppes*". Therefore, one might say that "*Ampliscientifica*" only implicitly takes side for the "exclusive aim". It does so by not making any reference to the "essential aim". The question now is whether, by remaining silent, the court intended both to dismiss this criterion and to endorse the "exclusive aim" approach. In other words can an omission be interpreted as a rejection? It is reasonable to assume that if the court did not find opportune to refer to the "essential aim", it intended that criterion to be dismissed. Two recent cases, "*Weald Leasing*" and "*RBSD*", follow the path taken by "*Ampliscientifica*". But in the absence of conclusive decision it is yet to be precised which will be chosen in the future.

Adding to the general blur, the contours of these concepts remain to be defined. In the opinion of Bruno Gouthiere it seems that "an exclusively fiscal aim" would be a 95% fiscal aim, whereas an "essential fiscal aim" would rather be a 60% fiscal aim. Two criticisms can be raised against this statement. First, and very concretely,

73 *Part Service* paragraph 44

74 *Part Service* paragraph 45

75 *Ampliscientifica* paragraph 27

76 *Ampliscientifica* paragraph 28

how can the exact proportion of fiscal aim be assessed? Second, issues arise for borderline situations (what about between 60% and 95%?). This will trigger, it is assumed, numerous litigation in the future.

The interests of two protagonists are weighed in the balance. On one side of the balance are the interests of tax administrations, whereas on the other side are the interest of the taxpayers.

One might perceive in this uncertainty the will of tax administrations, relayed by the ECJ, to keep the criteria vague in order to encompass as many situations as possible. It is our opinion that the vaguer this definition of abusive practices remains, the easier it is for tax administration to deal with specific behaviours. A strict definition would obviously exclude from its scope various situations. Knowing that tax administrations are now explicitly asked to collect, especially through tax penalties, certain amount of money; it is therefore led to multiply the tax controls. Thus, though bringing legal certainty for taxpayer, too precise a definition would entail unfavourable consequences for the public finances.

But on the other hand uncertainty brings insecurity which is always deleterious for business and might discourage entrepreneurial initiative. That is why it is recommended that the ECJ chooses once and for all an objective and unequivocal criterion, keeping in mind the imperative of economic life.

II The Compliance with this Framework

Compliance with both general [II.A] and specific [II.B] dispositions is worth discussion.

II.A The compliance of the general anti-avoidance dispositions with European Union law

The operation and compliance of *Article L 64 LPF* with EU law has not yet been the subject of an ECJ case. The issue has however been discussed by the French courts. Let it be recalled, as a preliminary remark, that this provision expressly refers to the concept of tax evasion. Therefore the risk that it might be unconventional, because still applying in absence of any tax evasion, can be set aside here.

The "Conseil d'Etat" stated on the compatibility of *article L 64 LPF* with EU law in a "Min. c/ Sté Sagal" case[77]. Relying on the European Court of Justice case law,

77 CE May 18th 2005, n° 267087, *Min. c/ Sté Sagal* : RJF 8-9/05 n° 910

especially on "*ICI*"[78] and "*De Lasteyrie du Saillant*"[79] cases, it considered that *article L 64 LPF* constituted a restriction, justified though, to the freedom of establishment. Yet, as the restriction was justified, compatibility with EU law was proclaimed.

Indeed, the French highest administrative Court held that the operation of *article L 64 LPF* complied with the requirements laid down in those two cases. Namely that the domestic provision be "specifically designed to exclude from a tax advantage purely artificial arrangements aimed at circumventing French tax law".

Despite the fact that this "*Sagal*" case is becoming old, its solution has never been overturned. First, the EU referential has been consistent since then. Second, the 30th December 2008 amended Finance Act[80] revising *article L 64 LPF* has not led to such a change which would have signed the end of that jurisprudence. It remains thus good law.

II.B The compliance of the specific anti-avoidance dispositions with European Union law

French specific anti-avoidance dispositions having been the subject matter of ECJ cases are numerous. Besides, some cases relating to similar foreign mechanisms provide important insight on the compatibility of the French provisions.

It will be discussed here of the compatibility with EU law of the four mechanisms detailed in Part I. Contrary to the abuse of law doctrine, which supposes the existence of a fraud, these mechanisms do not refer necessarily to the concept of tax evasion. Therefore there might be a risk that they be unconventional, because possibly applying in absence of any tax evasion. In such situations, the presence of safeguard clauses might constitute a clue of the Euro-compatibility of the mechanisms.

It is interesting to notice first that France has usually had a proactive behaviour, trying as much as possible to anticipate the European Court of Justice cases. This is symptomatic regarding CFC rules and also, though to a lesser extent, regarding thin-capitalisation and transfer pricing mechanisms. However, such a remark cannot be made regarding the 3% tax, the operation of which has been subject to ECJ condemnations.

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78 *ICI* paragraph 26

79 *De Lasteyrie du Saillant* paragraph 50

80 LOI n° 2008-1443 of 30th December 2008

II.B.1 3% tax on immovable property

The French 3% tax on immovable property has been the subject of three cases of the ECJ, two of which are very recent. "*ELISA*" starts a line of case law followed by "prunus" and culminating with "rimbaud". These cases are enlightening on the issue of the compliance of the 3% tax with EU law.

The compliance issues, regarding this tax, revolved around the exchange of informations requirements.

1. ELISA (Européenne et Luxembourgeoise d'Investissements SA): the intra- EU situation

1) The ECJ first dealt with the 3% tax on immovable property in the "*ELISA*" case. Even though the impact of the "*ELISA*" case was significant, it must not be forgotten that the situation at stake turned on facts concerning Member States. As a consequence "the answers to the question referred for a preliminary ruling are relevant only to relations between Member States"[81]. This significant caveat must be kept in mind.

ELISA was a Luxembourg holding company. It owned immovable properties in France and, in that capacity, was liable to the 3% tax on those assets.

Application of the "national treatment test" to the facts of the case showed a restriction on the free movement of capital. On the one hand a company established in France was exempted when it made the necessary disclosures. On the other hand a company established in another EU Member State was imposed an additional requirement. In order to be exempted that other Member State had to have concluded with France a convention on administrative assistance to combat tax avoidance and tax evasion, or a treaty containing a non-discrimination clause.

The French government argued that this restriction was justified on the ground of the need to combat tax evasion. The ECJ agreed with this justification, holding that "the disputed tax makes it possible to combat practices which have no other objective than to avoid payment of tax on capital which would otherwise be payable by natural persons in France, or at least to make such practices less attractive. It is therefore appropriate to the objective of combating tax evasion"[82].

The salient part of the *ELISA* case is the proportionality analysis made by

81 *ELISA* paragraph 19

82 *ELISA* paragraph 88

the court. In principle, EU secondary law[83] may be relied on by Member States **in order to obtain any information necessary to enable them to effect a correct assessment** of any given tax. But even though the exchange of information directive was not available in the facts of the case, the ECJ held that that fact alone could not justify the refusal of the tax exemption. There was no reason why the tax authorities should not "request from the taxpayer [himself] the evidence that they consider they need to effect a correct assessment of the tax and duties concerned and, where appropriate, refuse the exemption applied for if that evidence is not supplied"[84]. The ECJ further clarified that ELISA should have been given the opportunity to produce evidence that it was not "attempting to avoid or evade the payment of taxes"[85]. To that effect, the increased burden weighing on the shoulders of the tax administration was considered as irrelevant.

The fact that the possibility for the taxpayer to produce documentary evidence to establish the identity of the shareholders and any other necessary information was not encompassed within the relevant French provisions made it disproportionate to the aim it pursued. Accordingly the rules were incompatible with the free movement of capital as expressed in article 63 TFEU.

As has been demonstrated by Tom O'Shea the solution of the court was perfectly in keeping with previous case law[86]. O'Shea reminded us that in "*Futura*", in an analogous situation, the ECJ had told us that "provided the taxpayer demonstrates clearly and precisely the amount of the losses concerned, the Luxembourg authorities cannot refuse to allow him to carry them forward"[87]. In "*Cadbury Schweppes*" too the court held that the taxpayer "[had to] be given the opportunity to produce evidence that the CFC [was] actually established and that its activities [were] genuine"[88].

2) Following *ELISA*, French legislation was amended. Moreover, in consequential judgments the "Cour de cassation" further clarified the recast regime.

83 Here : **Directive 77/799** of 19th December 1977 concerning mutual assistance in the field of direct taxation

84 *ELISA* paragraph 95

85 *ELISA* paragraph 96

86 See Tom O'Shea, "French rule obstructs free movement of capital, ECJ concludes" (2008) Tax Notes International

87 *Futura* paragraph 39

88 *Cadbury Schweppes* paragraph 70

Firstly, the amended Finance Act for 2007 [89] introduced an additional exception in *article 990 E FTC*. Indeed, besides the circumstance of entities having their registered office in France, or in a state having concluded with France a convention on administrative assistance to combat tax avoidance and tax evasion or a treaty containing a non-discrimination clause, **entities having their registered office in a European Union Member State now benefit from the same exemptions**. This amendment, aiming at complying with EU law by solving the contrariety found by the court in “ELISA”, reminds us that EU law is supreme. Therefore domestic legislations must be kept compliant, if necessary by being amended nay repealed.

Secondly, the judicature has brought both confirmations and precisions through the mouth of the French highest judicial court. The “Cour de cassation”[90], which had stayed the proceedings in a “*Sté Elisa*” case[91] and referred a question to the ECJ for a preliminary ruling, was sent back the case after the question referred was answered by the ECJ. It can be observed that in this second “*Sté Elisa*” case[92], the “Cour de cassation” relied scrupulously on the findings of its European homologue, thereby bringing to an end these long-running developments.

Thus, the “Cour de cassation” **overruled the judgment of the Administrative Court of Appeal** which had found that the company could not avail itself from the exemptions provided by the Code in the absence of a convention on administrative assistance or a treaty containing a non-discrimination clause.

2. *Rimbaud and Prunus: the extra-EU situations*

The geographical scope of these two cases is wider than that of “*ELISA*” and thus are worth examination. Indeed those cases were not confined to relations between Member States. “*Prunus*” was concerned with Third Countries whilst “*Rimbaud*” featured European Economic Area States.

89 LOI n° 2007-1824 of 25th December 2007

90 Here the Cour de cassation (supreme court of the judiciary order), and not the Conseil d'Etat (supreme court of the administrative order), was competent. The 3% tax falling under its competence (so do wealth tax and stamp duties)

91 Cass. Com. December 13th 2005, n° 02-10.359, *Sté Elisa*: Bull. 2005, IV, n° 249

92 Cass. Com. April 8th 2008, n° 02-10.359, *Sté Elisa* : RJF 7/08 n° 913

1) *Rimbaud* and *Prunus* cases

1.a) The “*Rimbaud*” case staged a Liechtenstein[93] resident company which owned immovable property in France. As such the company was subject to the 3% tax unless an exemption applied.

Making several cross-references to its “*ELISA*” judgment, the court in “*Rimbaud*” also found that the disputed rules restricted the free movement of capital (which was protected here under article 40 of the EEA agreement)[94].

Indeed, whilst a company established in France was exempted when it disclosed some information, a company established in an EEA State was imposed an additional requirement. In order to be exempted that EEA State had to have concluded with France a convention on administrative assistance to combat tax avoidance and tax evasion, or a treaty containing a non-discrimination clause.

The justification put forward by the French government was based on the fight against tax evasion and the need to safeguard the effectiveness of fiscal supervision. The second limb of the justification had not been argued in “*ELISA*”.

The court began by recalling its “*ELISA*” case before making a crucial distinction. Indeed it held, following its “*A*”[95] and “*Commission v Italy*”[96] line of case, that “the case-law concerning restrictions on the exercise of the freedoms of movement within the European Union cannot be transposed in its entirety to movements of capital between Member States and non-Member States, since such movements **take place in a different legal context**”[97]. It then proceeded to define that different context. Mainly, the relations between states in the second situation were characterised by the unavailability of Directive 77/799 on mutual assistance[98].

93 Liechtenstein, as well as Iceland and Norway, is a member of the European Economic Area (EEA) agreement but not of the EU

94 The old version of article 990 E FTC was being scrutinized, not the current version as revised after ELISA. The court's judgment is nevertheless still relevant under the amended version of the provision

95 *A* paragraph 60

96 *Commission v Italy* paragraph 69

97 *Rimbaud* paragraph 40

98 The legal context remained different even though it must be noticed that in ELISA the Luxembourg authorities were under no obligation under the directive to provide informations. The derogation within the scope of which it fell had to be construed narrowly. Indeed it formed part of a general system for the exchange of information. Thus the possibility given to the taxpayer to produce evidence was intended to limit this derogation, and “to prevent it from acting to the detriment of the taxpayer”(*Rimbaud* paragraph 49)

Due to this general unavailability it was impossible for the French authorities to obtain the information they needed to exercise an effective supervision of the information provided by the company. The court concluded that "where the legislation of a Member State makes the grant of a tax advantage dependent on satisfying requirements, compliance with which can be verified only by obtaining information from the competent authorities of an EEA country which is not a Member State of the EU, it is in principle legitimate for the Member State to refuse to grant that advantage if – in particular, because that non-Member State is not bound under an agreement to provide information – it proves impossible to obtain such information from that country"[99].

The Court's conclusion was that France was not precluded to maintain national legislation such as that in the proceedings. In other words it could treat investments made by EEA companies in France differently from similar investment made by EU companies. That meant here that it was allowed to make the exemption conditional on the existence of a convention on mutual assistance or a treaty containing a non-discrimination clause.

1.b) In the "*Prunus*" case the question was asked of the application of the disputed tax to Third Countries. More precisely the focus was on Overseas Countries and Territories (OCTs)[100], one of which are the British Virgin Islands (BVI). The Court of justice first clarifies that OCT must here be assimilated to third countries[101]. Then, relying heavily on its previous case law and without surprise, it found that the French rules restricted the free movement of capital[102].

"*Prunus*" does more than just recalling the "*ELISA*" and "*Rimbaud*" cases. It gives insight into the application of the derogation provided by article 64-1 TFEU. This provision constitutes what is commonly called the" grandfathered clause". Its wording provides that "the provisions of Article 63 shall be without prejudice to the application to third countries of any restrictions which exist on 31 December 1993 under national or Union law adopted in respect of the movement of capital to or from third countries involving direct investment – including in real estate – (…)". In the main proceedings the French tax did exist before 31 December 1993, furthermore only minor changes in the wording had been made between

99 *Rimbaud* paragraph 44

100 These are listed in Annex II of the TFEU

101 *Prunus* paragraphs 30 and 31

102 Here again the old version of article 990 E FTC was being scrutinized, not the current version as revised after ELISA. The court's judgment is nevertheless still relevant under the amended version of the provision

the initial version and the one in force at the time of the case.

The court thus concluded that "restrictions imposed by national legislation such as that at issue in the main proceedings [were] permissible in relation to OCTs under article 64-1 TFEU"[103].

By the application of this provision, the court is somehow dodging a substantive analysis. This course of action, though laudable, does little to precise its previous case-law. After the application of the justification based on tax avoidance and effectiveness of fiscal supervision to EEA states, what would have been interesting was to precise the case of Third Countries.

Nevertheless one must reasonably assume that had article 64-1 not applied, the general interest justifications used in "*A*" and "*Rimbaud*" would have been of relevance. As BVI and France had concluded neither a convention on administrative assistance nor a treaty containing a non-discrimination clause, operation of the French 3% tax, though leading to a restriction on freedom of capital, would have been justified in the same manner.

In fact, the scope of the derogation contained in article 64-1 TFEU being limited, this case-law retains huge significance. Indeed the latter is relevant in presence of rules that did not exist on the 31 December 1993 as well as in presence "portfolio investments". However the 3% tax on immovable property does not appear to have been subject to changes likely to prevent the taxpayer to avail from the derogation; the case of "portfolio investment" is therefore the main hypothesis where the general interest justifications would be used rather than the grandfathered clause.

2) *Rimbaud* and *Prunus* aftermath

The "*Rimbaud*" case confirms the compatibility, as far as EEA states are concerned, of the French 3% tax on immovable property with the free movement of capital guaranteed by the TFEU and the EEA agreement. Therefore, *article 990 E FTC* which does not provide any specific exemptions for these states, is none the less treaty compliant. The three existing exemptions (legal entity established in the EU / in a state having concluded with France a convention on administrative assistance / in a state having concluded with France a treaty containing a non-discrimination clause) are sufficient for the mechanism to be consistent with the EU obligations. Concerning third countries, the same conclusion can indirectly be inferred from the "*Prunus*" case.

To conclude, it seems today that *article 990 E FTC* in its current redaction does not contravene the fundamental freedoms.

103 *Prunus* paragraph 37

The Cour de Cassation has applied the findings of the court of the European Court of Justice in the domestic context. Besides the "Sté Elisa" case above mentioned, the French highest civil Court ruled on the topic in several cases. The "Sté Pacar"[104] judgment, though anterior to the two above mentioned ECJ cases, is symptomatic of the position adopted by the Cour de cassation.

This "*Sté Pacar*" case recalled us that the "Elisa" ECJ jurisprudence was not applicable to a Panamanian company. In the light of the findings of the ECJ, this solution can only be approved, and shall thus be kept up.

II.B.2 CFC

Even when all the conditions required to trigger the application of the provision are met, some exceptions still exist which are usually gathered under the vocable "safeguard clause". They are threefold and reduce considerably the scope of the statute. In fact it is necessary to distinguish the situation where the CFC is established within the EU [1] from the situation where it is not [2].

The compliance issues, regarding this mechanism, revolved around the imperative of a "wholly artificial arrangement".

1. Article 209 B II FTC: the circumstance of a CFC established within the EU

1) This exception is intended to make the mechanism compliant with the fundamental freedoms. What is remarkable is that it has been introduced prior to the ECJ jurisprudence which is the authority on the subject, namely the *Cadbury Schweppes* case. The French legislature, to a certain extent, anticipated that jurisprudence.

The exception applies provided two conditions are met. First, the enterprise (or the legal entity), is established **within the European Union**. Second, the enterprise operated (or the shares, financial rights or voting rights held in the legal entity), does not constitute an **artificial arrangement** whose aim would be to circumvent domestic legislation.

2) The *Cadbury Schweppes* case has confirmed the necessity of this EU exception in circumstances where the conformity of UK CFC rules was scrutinized.

In that case the UK parent company of a UK group had set up a subsidiary in Ireland. More precisely the subsidiary was incorporated in the International Financial Services Centre (IFSC) in Dublin in order to benefit

104 Cass. Com, May 20th 2008, n° 07-13.734, *Sté Pacar* : RJF 10/08 n° 1141

from a special 10% tax rate on its profits. As a consequence of this low tax rate the UK CFC rules were triggered.

Application of the national treatment test showed that: on the one hand, a UK parent company with a subsidiary in a low tax jurisdiction was being attributed the profits of its subsidiary on an arising basis; and that on the other hand, a UK parent company with a subsidiary in the UK had not the profits of its subsidiary attributed to its tax base[105]. The court concluded that this different treatment constituted a restriction on the freedom of establishment[106].

The justification part is cardinal. Indeed, should this restriction be justified then the UK regime would be considered compliant with EU law (subject to proportionality requirement). Two assertions of the court stand out. First, a domestic regime can be justified on the ground of prevention of abusive practices where "it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned"[107] (it is important here to highlight the "specifically related" exigency). But no general presumption of tax evasion can be drawn from the mere setting up of a secondary establishment in another MS.

The second assertion emphasizes the importance of not forgetting the objective of the freedom of establishment[108]. This objective is twofold. It implies first an "actual establishment" of the CFC in the host MS; it implies too the exercise of a "genuine economic activity" there. As a consequence the court prohibits conduct involving "the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory"[109]. According to the ECJ, such conduct would be constitutive of abusive practices, likely to justify a restriction on freedom of establishment.

The developments on proportionality are cardinal in two respects; they rely on the two assertions above mentioned. First, the court made an application of the "*Halifax*" test for abusive practices in order to characterising the "wholly artificial arrangement" (thereby confirming the equation of this latter concept with the notion of abusive practices). In

105 *Cadbury Schweppes* paragraph 44

106 *Cadbury Schweppes* paragraph 46 in fine

107 *Cadbury Schweppes* paragraph 51 (reiterating for example *ICI* paragraph 26)

108 *Cadbury Schweppes* paragraph 52

109 *Cadbury Schweppes* paragraph 55

application of this test, described previously in this paper, there must be in addition to the violation of the objective of the freedom of establishment, a subjective element characterised by the intention to obtain a tax advantage[110].

Second, and as a logical consequence of the second part of the justification analysis, the domestic anti-avoidance mechanism must be prohibited for being disproportionate where the establishment of the CFC reflects "economic reality"[111], that is to say where it involves an "actual establishment" and a "genuine economic activity"[112].

From a comparison of the French rule with the EU requirements, there appears to be a difference, which might well constitute a breach of EU law.

Indeed, **France exempts** the holding company where the conduct is not constitutive of an **artificial arrangement** whose aim would be to circumvent domestic legislation. EU law on the contrary deals with **wholly artificial arrangements**. *A contrario*, **France taxes** the holding company on the profits of the CFC where the conduct is constitutive of an artificial arrangement, whereas EU law authorises to tax in presence of a wholly artificial arrangement only. The domestic criterion is wider than the EU criterion. Therefore, the situations which will lead to the application of French CFC rules are more numerous according to French law than authorised under EU case law.

French legislation was implemented before the *Cadbury Schweppes* case was held; that fact can explain that contrariety. But contrary to the UK legislation only a slight amendment would be required to put it in conformity with the ECJ jurisprudence, and this should be done. We have no domestic case law yet on this issue.

2. *Article 209 B III and III bis FTC: the circumstance of a CFC not established within the EU*

French rules dealing with CFC established in Third Countries have been revised by the second amended Finance Act for 2012. In order to get a better understanding of the change, it is important to recall the former system.

1) The old system: a distinction introduced amongst non-EU countries

1.a) When the CFC is not established within the European Union, the previous

110 It is interesting to notice that in this case, and more generally in the direct tax field, no precision is given on whether this intention must be exclusive or essential

111 *Cadbury Schweppes* paragraph 65

112 *Cadbury Schweppes* paragraph 66

exception cannot be claimed.

But *Article 209 B III FTC*, in its version applicable as of December 30th 2009, wrote that *article 209 B I FTC* was also not applicable should the enterprise (or legal entity) have earned profits from an **effective industrial or commercial activity** exercised in the territory of the state where it was established (or had it seat). That effective industrial or commercial activity being assumed, it followed that the Tax Administration had to bring a negative, and so a quasi-impossible, proof. In other words the fisc had to show the absence of any effective industrial or commercial activity.

This was in theory applicable both for CFC established within and outside the EU, but in the former case the provision was in practice superseded by the first exception.

Two exceptions to this rule existed. First, where more than 20% of the profits of the CFC were earned from financial or intangible assets (that is to say dividends, interest, royalties ...). Second, where more than 50% of the profits of the CFC were earned from financial or intangible assets **and** from the provision of intra-group services.

On the contrary, in cases where the CFC was established (or had its seat) in a Non-Cooperative State or Territory (NCST), Article 209 B III bis FTC provided that it was up to the parent company to provide evidences that its profits were derived from an effective industrial or commercial activity and did not exceed the same above mentioned thresholds.

1.b) Finally, where neither the TC exception, nor the NCST exception applied, it was nevertheless still possible to avail oneself from one particular administrative doctrine[113],codified in Article 209 B in fine FTC. This text added that it was always possible to demonstrate that the principal effect of the operation of the CFC was not to locate profits in a low tax jurisdiction. The proof burden was allocated the same way as above.

2) The new system: an identical treatment for all non-EU countries

The second amended Finance Act for 2012 has somehow extended the regime previously designed for the NCST to all non-EU countries.

Indeed, Article 209 B III FTC in its version in force as of August 16th 2012, which will apply as of December 31th 2012 (Article 209 B III bis FTC being repealed) henceforth provides that it is up to the parent company to demonstrate that the principal effect of the operation of the CFC is not to locate profits in a low tax jurisdiction. In other words the taxpayer carries the proof burden in all non-EU situations. It is thus a complete reversal of the proof burden in favour of the Tax Administration.

113 See **Inst. January 16th 2007 : BOI 4 H-1-07** aforesaid

It is important to notice that this condition is deemed fulfilled when the taxpayer provides evidences that its profits are derived from an effective industrial or commercial activity.

3) Final thoughts

It could be argued that the EU exception should be extended to EEA states, nay to Third Countries, in order for the French provision to be kept compliant with article 63 TFEU on free movement of capital. The question is all the more relevant that, at first glance, the latest amendment made to the provision, which makes even more different the tax treatment of EU and non-EU CFC, does not seem to be part of such a trend.

In that regard one might thought that suffice it to refer to the developments on the French 3% tax on immovable properties, especially to the "*Rimbaud*", and to a lesser extent "*Prunus*" cases. Indeed, following those cases it would be recalled that a restriction in an EEA or Third Country setting takes place in a different legal context to a restriction in a EU environment. Therefore extending the exception to EEA states, nay to Third Countries, would not be necessary.

But there is a substantial difference between *article 990 D to G FTC* and *article 209 B FTC*. Indeed, the second one does not make the exemption conditional upon the exchange of information. The situation is therefore radically different and might justify a different approach.

That is the path that seems to have been taken by the English Court of Appeal in the *Vodafone 2* case[114]. In that case the UK Court held in substance that the EU exception had to be extended to EEA states. This extension should occur in situations where the CFC is "actually established" and carry "genuine economic activities" there.

This requirement is very close to the second French exception (the effective industrial or commercial activity). Therefore it will be interesting to see in the future what will be the view of the French courts on the subject.

II.B.3 TP and thin-capitalisation

The particularities of these two provisions first, justify a joint examination. Besides, such a reasoning is logical since they have been examined jointly in our Part 1. Finally, this approach is defended by the fact that the contribution of EU law in these two respective areas presents similarities.

It is to be noticed that whereas the compliance with EU law of thin-capitalisation

114 *Vodafone 2 v. HMRC*, Court of Appeal, May 22nd 2009

rules is ensured at the restriction[115] analysis level, the compliance with EU law of transfer pricing rules (and, by the bye, CFC rules) is ensured at the justification nay proportionality analysis level. This will be developed further. But we could already point the fact that thin-capitalisation rules are the only ones to apply both in domestic and cross-border situations thereby requiring, perhaps even more acutely, the absence of any discrimination.

Thin-capitalisation rules will be broached first; transfer pricing rules will then be tackled.

1. The affirmation of the non-restriction imperative regarding thin-capitalisation rules (the elimination of the restriction)

This imperative, before to be raised and dealt with by France, was first tackled by the ECJ in its "*Lankhorst-Hohorst*" case. The ECJ upheld its position in two subsequent European cases: "*Thin cap glo*" and "*Lammers Van Cleeff*".

But such a non-discriminatory treatment is not only required by EU law. Indeed, it is also required by international law in the presence of a DTC containing a non-discrimination clause.

1) The predication of EU law: acting at the justification level

The "*Lankhorst-Hohorst*" case staged a German Sub Co which had been granted a loan by its Dutch Parent Co, and which therefore paid interest to this Netherlands Parent Co. The issue arose from the combination of two German rules. The first one regarded the flows of interest as being flows of dividends, and taxed them accordingly, instead of allowing their deduction. The second one, intended as an exception to the first one, nonetheless allowed such deduction where the lender was entitled to the "corporation tax credit". But problematically, it was evidenced that a non-resident lender was not granted the said tax credit, and therefore could not avail from the exception. Whereas in fact, such tax credit was reserved to resident lenders.

As a consequence, it was revealed by the national treatment test that a German Co was treated differently depending on the residence of its lender. Should the latter be resident in Germany, interest was deductible. But

115 Regarding the terms "restriction" and "discrimination", it is our understanding that the second one has to be understood as an epithet of the first.

By that it is meant that all the situations are restrictions. But when **the national treatment test** involves nationals (or residents) of different states, then and only then, the **restriction becomes discriminatory** (directly on ground of nationality or indirectly on ground of residence) should it be resident abroad, interest was treated as dividends. That, according to the ECJ, constituted a restriction on the freedom of establishment guaranteed by the TFEU[116].

The justification analysis of the "*Lankhorst-Hohorst*" case is key. The ECJ considered that the restriction was not justified. It considered so because "the legislation at issue here [did] not have the **specific purpose** of preventing wholly artificial arrangements (…) but [applied] generally to any situation in which the parent company [had] its seat, **for whatever reason**, outside Germany"[117].

This criterion was used once before in "*ICI*" paragraph 26. In "*Cadbury Schweppes*" paragraph 51, a posterior case, the court would develop its understanding of that criterion, especially as regards the meaning of a "wholly artificial arrangement", taking into account the evolutions occurred in the indirect tax field.

The position of the ECJ on the matter was reiterated in its "*Thin cap glo*"[118] case, the facts of which were very similar to those of "*Lankhorst-Hohorst*", and in which the european court made several cross-references to this previous jurisprudence. The court recalled that "a national measure restricting freedom of establishment [could] be justified where it **specifically [targeted]** wholly artificial arrangements designed to circumvent the legislation of the MS concerned"[119].

In order for that requirement to be met, the taxpayer was to be given an opportunity "to provide evidence of any commercial justification"[120]. So that in the absence of a "wholly artificial arrangement" the anti-avoidance domestic legislation would not apply. In addition, in case where such an arrangement was nevertheless found, the "re-characterisation of interest paid as distribution [had to be] limited to the proportion of that interest which [exceeded] what would have been agreed [at arm's length]"[121]. Should these two criteria be fulfilled the domestic provision could be said to have the specific purpose of preventing wholly artificial arrangement. Therefore any restriction would be justified, and this justification would not be disproportionate.

116 *Lankhorst-Hohorst* paragraph 32

117 *Lankhorst-Hohorst* paragraph 37

118 This "Thin cap glo" case was held after amendments were made to article 212 FTC. It can be seen as an endorsement of the new French mechanism

119 *Thin cap glo* paragraphs 72 and 79

120 *Thin cap glo* paragraph 82

121 *Thin cap glo* paragraph 83

The "*Lammers Van Cleeff*" case, apart from making an application of these principles, does not provide any further information.

2) The compliance by France: the removal of all restriction

Against this European backdrop, the French supreme administrative court, followed by the legislature, held that the former mechanism provided for in *article 212 FTC* was not EU compliant, nor treaty compliant, because it was discriminatory. There followed an amendment of that former mechanism, which led to the version described in Part 1, which now seems to abide by both EU and treaty requirements.

The problem of that former mechanism stemmed from an exception which was provided in *article 212 FTC*. Indeed the recipient of the interest was susceptible to benefit from an exception where it could be regarded as a parent company under *article 145 FTC*[122]. But in order to fall foul of this latter provision this recipient of the interest had to be liable to French corporation tax at the normal rate, which assuredly was not the case of foreign companies. Therefore, unlike domestic parent companies, foreign parent companies could never benefit from the exception. This difference of treatment was condemned by the Conseil d'Etat in the two paramount following cases.

2.a) The compliance with EU law requirements

Like in respect of the French CFC rules, the French judicature (and then legislature) has not waited a condemnation of France by the European court to ensure the compatibility of their domestic mechanism with EU law. Even though here, contrary to CFC rules, France could explicitly rely on a clear and anterior ECJ case[123].

The question was tackled by the French supreme administrative court in "*Sarl Coreal Gestion*"[124]. In that case interest was paid by a French subsidiary to its German parent company. The French court relied on the principle of freedom of establishment contained in article 49 TFEU to hold the mechanism incompatible with EU law.

2.b) The compliance with international law requirements

In a non-EU context, the question was dealt with by the French supreme administrative court, on the same day as "*Sarl Coreal Gestion*", in "*Andritz*".

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122 Article 145 FTC, in conjunction with article 216 FTC, provides for the participation-exemption regime

123 Contrary to the Cadbury Schweppes case (regarding CFC rules) which was posterior to the French domestic law modifications

124 CE December 30th 2003, n° 249047, *Min v. Sarl Coréal Gestion* : RJF 3/04 n° 233

In that case interest were paid by a French subsidiary to its Austrian parent company (Austria at that time was not an EU MS, and thus could not be imposed the EU requirements). In circumstances which were therefore similar to the ones in "*Sarl Coreal Gestion*", the French court in "*Andritz*" [125] relied on the non-discrimination clause embedded in the France/Austria DTC to reach the same conclusion.

2.c) The amendments to the mechanism

Article 212 FTC henceforth treats the flows of interest the same way, wherever be the lender`s residence, and wherever be the borrower shareholders` nationality or residence.

What is interesting is that, instead of extending the exception to foreign parent companies, the legislature withdrew it for domestic parent companies. Thereby both solving the discriminatory different treatment and protecting the French public finances. As a consequence *article 212 FTC* now seems perfectly compliant to EU law.

In other words it would have been possible for France to stipulate that the mechanism would have applied, in intra-EU situation, only to wholly artificial arrangements (i.e. implementation of a safeguard clause). That was, as has been seen previously, the path adopted as regard *article 209 B FTC*. In such a case the restriction would have remained, but it would have been justified by the need to prevent tax evasion. But France chose the suppression of the restriction itself, which it cannot be blamed for!

2. *The temperament to the non-restriction imperative regarding transfer pricing rules (the acceptability of a "justified" restriction)*

As far as transfer pricing rules are concerned no court, be it European or national, has ever directly dealt with the compatibility of *article 57 FTC* with EU law. However, an examination of EU case law pertaining to foreign similar mechanisms gives some clues on the question. Likewise, a recent Conseil d'Etat jurisprudence enhances our understanding on the issue.

1) the compliance of the French mechanism : acting at the justification level

As for the operation of *article 209 B FTC*, a safeguard clause applies in the case of *article 57 FTC.* And as for this former provision, such an exception is likely to render the mechanism compliant with EU law.

The salient decision on that question is the "*Sté Soutiran*"[126] case, which was held last year by the "Conseil d'Etat". Contrary to the position of

125 CE December 30th 2003, n° 233894, *SA Andritz* : RJF 3/04 n° 238

126 CE March 2nd 2011, n° 342099, *Sté Soutiran et Cie* : RJF 6/11 n° 733

France regarding Thin-capitalisation rules, where any restriction was removed, this jurisprudence suggests that France ensures the Euro-compatibility of the mechanism at the level of the justification analysis.

Indeed, the said case highlights the fact that the indirect transfer of benefits abroad is only assumed via a rebuttable presumption; i.e the company can provide evidences that the advantages granted to the foreign entity were justified by the getting of favourable return, and did not constitute an indirect transfer of benefits abroad.

2) The endorsement of the French mechanism by the ECJ

The importance of this exception in an EU context has been recalled in "*SGI*", which *inter alia* reiterates some fundamental teachings of "*Thin cap glo*".

The "*Société de Gestion Industrielle*" *(SGI)* case pertained to Belgian transfer pricing rules. The facts staged a Belgian company which was granting 'unusual' and 'gratuitous' advantages to foreign associated companies. The problem stemmed from the fact that under Belgian rules the amount of these advantages was added-back to the taxable profits of SGI, whereas it would not have been so had the associated companies been Belgian resident[127].

Application of the national treatment test thus revealed that a Belgian company was treated less favourably when it had foreign associated companies than when it had domestic associated companies. Therefore a restriction on the freedom of establishment was found[128].

As usual the European court then proceeded to examine a potential justification to the restriction. The court recalled first that "a national measure restricting freedom of establishment [could] be justified where it **specifically [targeted]** wholly artificial arrangements designed to circumvent the legislation of the MS concerned"[129].

Additionally, and for the first time as far as domestic anti-avoidance rules are concerned, a new justification was accepted by the ECJ that could possibly be used in combination with the previous one, in case the latter be insufficient. Indeed, where a national measure would not be specifically designed to prohibit wholly artificial arrangements, the justification based on tax avoidance, **taken together** with the justification based on the balanced allocation of the power to impose taxes between MS, could still

127 *SGI* paragraph 42

128 *SGI* paragraph 44

129 *SGI* paragraph 65

justify the restriction[130]. That extension of the justification analysis can be seen as revealing the will of the European court to back up national anti-avoidance rules. Or, in other words, to encourage the fight against tax avoidance, if necessary by accepting restrictions on the TFEU which would not have normally been justifiable.

It is also necessary that the justification be proportionate. That is why, as for thin-capitalisation rules, the possibility must be given to the taxpayer to provide **commercial justifications** to exonerate himself from the domestic rule[131]. That requirement echoes the safeguard clause provided by *article 57 FTC*, and suggests the compatibility of the latter provision with EU law. Moreover, if need be, any corrective measure should be limited to the amount exceeding what would have been agreed in a transaction at arm's length[132].

Conclusion

We endeavoured, in this paper, to provide a reflection on the compatibility of French anti cross-border avoidance rules with EU law.

To conclude it should be said:

First, that some mechanisms which the ECJ found to be restrictive have been modified, so that to remove the restrictions.

Second, that in other cases restrictions remain, but being justified though by overriding reason of general interest, mostly the need to fight against tax evasion.

In general it might be said that France has had a proactive attitude, trying as much as possible to avoid condemnation by the ECJ. Where condemnation there was, both judicature and legislature have shown good will and efficiency to amend its domestic provisions in order to render them compliant with EU law.

To sum up, the ECJ case law suggests that most of French anti cross-border avoidance rules are today compatible with EU law, either because they are not restrictive or because such restriction is justified.

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130 *SGI* paragraph 66

131 *SGI* paragraph 71

132 *SGI* paragraph 72