THE UK AND FRENCH CFC RULES AND COMMUNITY LAW

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In the World and between the Member States of the European Union (EU) there is a strong tax competition. This tax competition has developed itself mostly because of the globalization. On the one hand the States try to attract the foreign investments by granting tax advantages. However on the other hand they tend to set up tax rules hindering tax avoidance.

Among those anti-avoidance tax rules there are the so called "Controlled Foreign Company" regimes (CFC). Those latter are a way to counter the transfer of profits to low-tax jurisdictions.

The CFC legislation has to deal often with the concept of "tax haven". Those countries with very low tax rates or no taxation at all are used for tax avoidance purposes. For instance in the Caymans Islands there are around 10 000 companies for 60 000 residents. For the OECD "tax competition in the form of harmful tax practices can distort trade and investment patterns, erode national tax bases and shift part of the tax burden onto less mobile tax bases, such as labour and consumption, thus adversely affecting employment and undermining the fairness of tax structures2". The 1998 OECD report – "Harmful Tax Competition: An Emerging Global Issue" tried to identify tax haven jurisdictions. However this report did not offer a clear-cut definition of tax haven. It suggested some criteria such as very low or no imposition, laws or administrative practices which prevent effective exchange of information with other governments, lack of transparency and no requirement of a substantial activity.

The CFC rules apply when the parent company has the control of a CFC. It could be the majority of the shares or the voting rights. Most of the time, this regime applies

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2 1998 OECD report – "Harmful Tax Competition: An Emerging Global Issue"

to resident taxpayers. In some countries CFC rules apply to individuals. In the UK's and French CFC rules only legal entities are covered by the regime.

The incompatibility of the French CFC rules with the Community Law

Before the Finance Law 2005 the French CFC legislation was clearly incompatible with the fundamental freedoms protected under the EC treaty (A). Thus they were amended in 2005 before the *Cadbury Schweppes*[3] judgment (B).

The incompatibility before the Finance Law 2005

Like the UK, France has a CFC legislation contained in the article 209B of the French Tax Code. The rules are very similar to the UK one. This similarity has brought the question of the compatibility of the French CFC rules with the Community Law. Before the Finance Law 2005 the redaction of the provision was clearly in breach of the Community Law and more specifically in breach of the freedom of establishment.

Indeed this rule gave to the French Tax Authorities the power to make an exception to the principle of territoriality. The profits realised by a subsidiary of a French parent company established abroad are not taxed in France until they are repatriated as dividends paid to the French parent company. But the CFC legislation allowed the Tax Authorities to tax the profits realised by a subsidiary established in a low-tax jurisdiction in the hand of the French parent company. Thus the French CFC regime was very close to the UK's CFC rules.

The legislation set up a general presumption. All the profits realised by CFC in a low-tax jurisdiction were taxed in France even if the CFC were established within the European Community or in a State with which France had concluded a convention with an exchange of information provision.

However unlike the UK's CFC rules, the French CFC rules were aimed only at tax avoidance and the French parent company was given the opportunity to prove that the CFC was carrying on genuine economic activities, and this would exclude the application of the CFC regime. The CFC rules could apply when the parent company had a threshold of more than 10% of the subsidiary and when the subsidiary was established in a jurisdiction where it has paid less than two thirds of the amount of tax that would have been paid in France on the taxable profits.

When the *Cadbury Schweppes* Case was brought to the ECJ, the French Government decided to change the domestic law by the means of the Finance Law 2005 without waiting for the ruling of the court.

3 [2006] STC 1908

The amended French CFC rules

The French CFC legislation contained in article 209B of the French Tax Code was amended by the Finance Law 2005.

Scope

Since the 1st January 2006 the article 209B applies if a French parent company holds directly or indirectly more than 50% of the shares, interest shares, financial rights or voting rights in a company or a permanent establishment established in a low-tax jurisdiction. The low-tax jurisdiction is a “privileged tax regime”[4] within the meaning of the article 238A of the French Tax Code. The concept of a company benefiting from a privileged tax regime introduces a clear definition of what is considered as a low-tax jurisdiction. In the previous legislation it was made a reference to a significant difference which in practise was reached when the CFC paid less than two thirds of the amount of tax that would have been paid in France on the taxable profits. In the new legislation a privileged tax regime is when the foreign entity is subject to a tax which is less than 50% of the tax that it would have to pay in France.

The French Tax Authorities have the burden of the proof that the 50% test is met. This assessment must be done on a case-by-case basis. That is why in theory there is no list of tax havens but in practice it is obvious that certain countries are more likely to be considered privileged tax regimes, and therefore pose a greater risk when considering where to establish an entity. Moreover the participation in the CFC could be direct or indirect. For instance the participation may be held through a chain of shareholdings or a holding under a “community of interests”. The community of interests could be demonstrated through financial, personal or purely economic links.

The new system wants to prevent artificial schemes as well. The threshold is reduced to 5% (instead of 50%) when “*more than 50% of the shares, interest shares, financial rights or voting rights in the CFC is held by companies established in France*", even if unrelated. If the CFC is listed, there is an additional condition which is called “action de concert”[5]. That means that the companies act together under an agreement. In the same way, the threshold is reduced to 5% when more than 50% of the shares, interest shares, financial rights or voting rights in the CFC

4 *French Anti-Abuse International Tax Legislation: Recent Developments,* Bruno Gouthière, in European Taxation, November 2006, section 3.2

5 *Overview of the French CFC Legislation,* Bruno Gouthière, in European Taxation February 2008, section 2.2

are held by companies that are directly or indirectly in a relationship of dependence or control with regard between each other"[6].

Two safe harbour provisions were implemented in the new CFC legislation. The first provision is called the "EU exception". In brief the CFC legislation does not apply if the CFC is established within the EU. The point is to avoid the general application of this anti-abuse measure which constitutes an obstacle to the freedom of establishment. It is agreed that the implementation of a foreign entity or the holding of the shares of that foreign entity by the French parent company is not an artificial arrangement with the aim to circumvent the French tax law.

As the French CFC legislation was amended before the ECJ ruling in *Cadbury Schweppes* the notion of artificial arrangement refers to the *ICI*[7] case. As far as the CFC is established within the EU the article 209B does not apply unless the French tax authorities can prove that the CFC is a wholly artificial arrangement aimed to circumvent the French tax law. The assessment of a wholly artificial arrangement is deemed to be based on objective factors. The foreign entity must exist physically with a staff and equipments. The burden of the proof is on the French tax authorities' shoulders. And in any case the French parent company keeps the opportunity to prove that its CFC is actually established and carries on genuine activities[8].

Another exemption exists when the profits of the CFC derive from an effective industrial or commercial activity carried on in the Host State. There are two exceptions to this exemption.

"The active test exception" arises when the profits arise "*more than 20% from the management, holding or increase of shares, debt claims or similar assets on its own account or for enterprises belonging to a group of companies with which the French parent company has a relationship of dependence or control, or from the sale or licence of intangibles relating to industrial, literary or artistic property; or arise for more than 50% from the provision of services, including financial services, to a group of enterprises with which the French company has relations of dependence or control*".[9]

The last exception is the general safe harbour clause. The French legislation provides that the application of the CFC rules is excluded when "*the principal effect of the operations of the CFC is not to locate profits in a country in which it benefits*

6 Article 209B, French Tax Code

7 ECJ, 16 July 1998, *Imperial Chemical Industrie plc.* Para 26

8 Article 209B, French Tax Code

9 Article 209B, French Tax Code.

from a privileged tax regime"[10] within the meaning of article 238A. In this situation the burden of the proof is switched on the French company.

Application of the CFC

When the two tests (threshold and privileged tax regime) are met, the first consequence is the taxation of the profits of the CFC in France. The French parent company is subject to corporate tax on the profits arising from the CFC. The French legislation states that the profits realised in a privileged tax regime are deemed to be distributed to the French parent company.

The amount of tax depends of the threshold. The tax is computed on the profits of a PE or a 100% held subsidiary. Otherwise the tax is computed on the profits in proportion to the shares, interest shares or financial rights held by the French parent company[11].

The profits arising from a CFC are merged with the profits of the parent company. In a way there is an advantage because the foreign profits can be offset against the French losses. In contrast the foreign losses cannot be taken into account to be offset against the French profits. Only the profits of the CFC are taken into account in France, never the losses.

To compute the French tax on the foreign income, the ordinary French tax rules are applied. However the foreign income cannot benefit from the favourable tax regime on distribution of dividends between subsidiaries and parent companies[12]. In fact when a French or foreign subsidiary distributes a dividend to its French parent company, the distribution is exempted from taxation in France. To apply this "parent-subsidiary regime" some conditions must be fulfilled. The French parent company must be subject to corporate income tax and the subsidiary must be a limited company. The parent company must hold 5% or more of the shares, or the voting rights, or the financial rights of the subsidiary. The 5% holding must be kept by the parent company during at least two years.

Under this legislation the dividends paid by the subsidiaries to the French parent company are exempt but a charge of 5% of the amount of dividends remains taxable. In the case of the CFC legislation the foreign income is deemed to be distributed in France but the exemption does not apply to this distribution. Thus some mechanisms were set up to avoid double taxation. The principle is that the income taxed in

10 Article 209B, French Tax Code

11 *Overview of the French CFC Legislation,* Bruno Gouthière, in European Taxation February 2008, section 5.3

12 *Overview of the French CFC Legislation,* Bruno Gouthière, in European Taxation February 2008, section 5.3

France under the CFC legislation cannot be taxed twice. That means that if the foreign income which has been taxed in France under article 209B is effectively distributed, this income is not taxed again in France.

Some tax credits are granted by the legislation[13]. First a credit is granted in respect of foreign taxes that are of the same or similar nature as French corporate income tax. Secondly, where there is a tax treaty, most of the time a tax credit is granted if the foreign income distributed to the French parent company has suffered a withholding tax in the Host State.

Article 209B provides also contains reporting requirements[14]. Under certain conditions, the French parent company must report to the tax authorities the existence of subsidiaries or permanent establishments that potentially could fall within the scope of the CFC legislation. Those reporting requirements apply when the CFC benefits from a privileged tax regime but the CFC legislation cannot apply because the CFC is established in the European Union or carries on genuine economic activities. This is a kind of protection because when the obligations are fulfilled there could be no further adjustment under the article 209B.

In an international context, the application of the CFC rules could have harmful consequences for the multinational companies. Some precautions must be taken to avoid those consequences. The best one is to use jurisdictions in the EU. The French tax authorities will have to prove that an arrangement is artificial and aimed at circumvent the French tax law. The proof is not easy to bring; even if the CFC is not established in the EU, the French tax authorities will have to prove that the CFC is established in a privileged tax regime, supposing that they have, or are able to obtain, all the fiscal information about this jurisdiction.

The *Cadbury Schweppes* case had consequences on the UK's and French CFC rules. They were amended but some new issues have appeared.

New issues arising from the new UK's and French CFC rules

Issue arising from the French CFC rules

Interpretation of the "wholly artificial arrangement" by the French tax authorities
The position of the French tax authorities concerning the concept of "wholly artificial arrangement" has been awaited by the French tax community. In practice many scheme use a foreign entity to locate some profits in a low-tax jurisdiction.

13 *Overview of the French CFC Legislation,* Bruno Gouthière, in European Taxation February 2008, section 5.4

14 *Overview of the French CFC Legislation,* Bruno Gouthière, in European Taxation February 2008, section 5.5

The first step for the tax authorities was to refer to the *ICI* case which first stated the concept of artificial arrangement.

But the tax authorities were not able to set out clear conditions for the application of this concept. The tax authorities considered that they had to assess the intention of the French parent company and to prove that it was to circumvent French tax law by implementing a CFC in a low-tax jurisdiction within the EU (Luxembourg, Belgium, Ireland and now more and more jurisdictions such as Estonia or Rumania).

Then the *Cadbury Schweppes* case came out and the tax authorities have drafted a regulation[15] about the artificial arrangement taking into account the ruling of the ECJ. In this regulation the reference to the intention of the French company has been deleted and replaced by the new ECJ conditions.

The application of article 209B is excluded when the CFC carries on genuine activities with staff and equipments. However an issue can arise when dealing with holding companies. For instance if a French parent company holds a subsidiary which has an activity of holding shares or provide financial services it could be difficult to meet the conditions of staff or equipments. But in the same time it is not a “letterbox” or “front company”.[16] This kind of CFC is exercising the freedom of establishment for the French parent company. In this situation the tax authorities would examine the aim of the CFC and verify whether the entity is used to locate profits in a privileged tax regime. They would assess the nature of the activity.

In relation to the burden of proof the French tax authorities do not have a clear position. Practitioners agree on the point that the tax authorities have the burden of proof according to the ruling of the ECJ. In fact as far as there is no general presumption it is for the tax authorities to prove that the French company is using the CFC as an artificial arrangement to circumvent French tax law. But in any case the French company must be given the opportunity to provide evidence to prove that the CFC carries on genuine activities.

There is another issue with the wording of the French law. The French law focuses on the concept of “artificial arrangement” whereas the ruling of the ECJ focuses on the concept of “wholly artificial arrangement”. There is no case on this subject but the authors agree that the French Courts should apply the concept of artificial arrangements according to the conditions set out by the ECJ.

The concept of abuse of law overlapping the “artificial arrangement”

The French jurisprudence defines the concept of "abuse of law". The definition of this concept could overlap the concept of artificial arrangement. The definition of

15 Instruction 4 H-1-07

16 In Cadbury Schweppes, para 68

the abuse of law comes from a decision of the Supreme Administrative Court, the Conseil d'Etat. The tax authorities have the power to demonstrate that a scheme is fictitious or that the only aim of a certain scheme is to circumvent French tax law.

This concept of abuse of law is much easier to apply and could be used to apply the CFC legislation in an EU situation instead of the concept of artificial arrangement. For instance the French tax authorities could just argue that a French taxpayer has entered into a fictitious transaction or a transaction of which the only aim is to circumvent French tax law. To be successful in their argument, the French tax authorities must demonstrate that the abuse of law is qualified because the taxpayer by using a tax rule went further than the objectives pursued by the authors in order to avoid or reduce its tax charges[17].

Thus this concept of abuse of law which has a very broad definition could be used to escape from the concept of artificial arrangement. Indeed an artificial arrangement could be a fictitious scheme or an effective implementation with the only purpose to circumvent French tax law.

This concept is very subjective that is why this issue will come up soon in a case.

17 Conseil d'Etat, 27 September 2006, *Janfin Case*