FRANCE: Governmental Incentive Programs in a Post-BEPS and Limited State Aid World

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I. Attracting and retaining business residents

In the context of a post-BEPS world, where we might assume that double non-taxation opportunities have largely been eradicated and countries are revising their tax systems to target businesses (wherever located, and having perhaps only a digital presence) based upon the economic activity of their residents (as customers of the targeted businesses), source country taxation is about to expand rapidly. Residence countries of those target businesses will be asked (or simply expected) to provide some relief against double taxation (exemption or credit) for those affected businesses. This shift has been accompanied by consideration by residence countries of ways to attract and retain economic activity by these highly profitable and productive target businesses.

France has historically been a high-tax country, not only with regard to its high corporate income tax rate (33.33% for several years) but also because of the imposition of several minor taxes adding to the corporate tax (additional contributions, including the 3.3 % social contribution tax assessed on corporate tax, or the 0.16% contribution assessed on the gross turnover, thereby raising the effective tax rate to more than 35%, even without taking into account temporary surcharges due in 2017 and 2018). The effective rate of tax has constantly fluctuated over the last 20 years, depending on the budget pressure, so giving little previsibility to investors (including in 2018 where an exceptional tax was levied to finance the cost of massive tax litigation lost by the French State, based on EU legislation).

This high rate of tax was compensated for with a reduced tax basis (territorial approach) and with tax credits mechanisms, some of which had to be repealed because of EU rules, either because the mechanism could be regarded as a state aid, or because it could be regarded as creating discrimination not compatible with the freedoms guaranteed by the EU treaty (the European Court of Justice has historically taken restrictive views on justifications of a discrimination based on the coherence of a tax system, by limiting its analysis to the direct effect of a rule without looking to secondary adjustments or later taxation). The explanation below will focus on a broad overview of the system rather than entering into the details of each rule and provision.

A. Positive tax-related incentives to attract and retain business and tax basis

The high rate of tax (33.33%, plus social contributions, see above) used to be substantially compensated until 2003 by the granting of a tax credit (the “avoir fiscal” which was initially equal to 50% of the distributed dividend so that the credit almost matched the corporate tax paid on the gross dividend, and was refunded to foreign investors under most tax treaties), but this mechanism was repealed after the ECJ found it discriminatory because it was limited to French source dividend income. This tax credit on French source dividends was not considered a state aid, but the discrimination between the investment in French and foreign shares had to be cancelled by granting the same credit on dividends received by residents not only from EU, but also non-EU sources, which quickly led to the cancelling of this onerous tax credit system (the claims for the past based on this ECJ case law did not allow, however, in practice any

effective refund of the credit on foreign dividends, which is a poor overall result, except for the French budget).

The effect of the historic high rate of tax was also (and still is) significantly tempered by the French territorial approach, which limits the taxable basis to French source income. Income realized abroad by foreign PEs or branches is in principle not taxable (with the exception of income realized by a CFC, in the case where the CFC allows an artificial shift of income which should normally be attributed to the French entity). Dividends received from foreign subsidiaries are also exempt from tax under the participation exemption rules. The counterparty of this restrictive tax nexus is that losses realized abroad cannot be offset against French source profits. A derogatory regime allowing such foreign losses to be offset against French source profits used to allow such imputation and was removed several years ago (in 2011) because it was probably not compliant with the EU rules.

The income tax rate was recently reduced to face competition by most European countries. The income tax rate is now reduced to 31% and should, in principle (subject to changes in the law, because the CIT is often used as a variable element in the budget) reduce further to 28% in 2020, 26.5% in 2021 and 25% in 2022, with reduced rates applying to small businesses.

The main tax incentive still in force concerns the sale and concession of industrial property, benefiting from a lower capital gains tax rate of 15%, and R&D expenses, which permits a 30% tax credit (reduced to 5% on annual expenses in excess of 100M euros) on eligible expenses. This latter regime is scrutinized by the EU authorities. A tax credit (the "CICE") related to the employment of low-salaried employees (2.5 times the minimum remuneration) existed until January 1, 2019, but has been removed and transformed into a permanent reduction in social contributions.

B. Tax disincentives on transfer of business and tax basis

France has been very proactive in implementing anti-avoidance measures against any situation allowing companies to shift tax basis abroad artificially, even before the implementation of BEPS rules spread these rules to other EU countries (thus triggering potential state aid issues when these compulsory rules are not applied in some EU countries—kind of a poison pill diffused by high-tax countries).

Apart from these anti-avoidance rules, due to the French territorial approach, the transfer to a foreign state of French assets, which would no longer be taxable in France after the transfer, is in principle a taxable event in all situations. Symmetrically, foreign assets (i.e., assets not attributed taxwise to the French business) are, in principle, never taxable. Hence, the territorial approach significantly reduces the potential tax impact of a corporate migration since income and gains from foreign assets of an expatriating French corporation are never taxable in France (before, after, or at the time of migration). This represents a marked contrast to the position in countries that tax their resident companies on a worldwide basis, where migration of a corporation has a substantial effect on the taxation of the migrating company's foreign income.

Still, the risk of corporate migration by French businesses became a real issue due to the increasing gap in tax rates applied throughout the EU, but the question arose as to whether the EU principles encouraged the free migration of corporations, without the obstacle of taxation occurring upon transfer.

The exit tax rules (articles 201, 221-2 of the FTC) as amended in 2012, provide two different rules, depending on where the transfer is operated. In summary, the transfer of a corporation to an EU State (or, under some conditions, European Economic Area (EEE)) triggers the taxation of unrealized or deferred gains on assets transferred, but the taxpayer can elect either to immediately pay the tax, or to spread the taxation over five years. The benefit of the deferral ceases to be available if the assets are disposed of during the five-year period after the transfer, if the assets are transferred to a non-EU State, or if the company fails to make its annual installment payment. In the case of a transfer outside these States, the transfer of the head office triggers in principle the full and immediate taxation of profits and unrealized gains. Article 221.3 of the FTC theoretically provides that the transfer of the head office of a corporation outside the EU should escape immediate taxation under Article 221.2 when it is decided by the shareholders in the circumstances set down in Article L225-97 of the Commerce Code. However, this text refers to treaties signed with other States to allow and regulate such transfers, and no such treaty has yet been signed by France. It seems, therefore, that the transfer of a head office outside the EU is unlikely to escape the immediate taxation of unrealized gains (if any) under Article 221-2.

In the case of a merger or contribution of assets of a French corporation into an EU entity (under the EU merger Directive), which remains a more frequent case than a straight transfer of the head office, the French tax code (article 210 C of the FTC) used to require that a ruling be obtained before the transaction so as to benefit from the merger regime. This requirement was regarded as discriminatory by the EUCJ (EUCJ 8 March 2017 case 14/16) and had to be withdrawn. Such cross-border transactions within the EU are now benefiting from the merger regime without prior authorization, but only where the assets remain taxable in France by virtue of being attributed to a French PE maintained in France, and it may be taxed afterward.

Apart from these exit and merger rules, France does not have rules against "inversion" (transfer of control of a resident group to a foreign group) as they exist in other States. However, again, these rules would make less sense in view of the territorial approach (taxation of French source income and exemption of foreign source dividends) which do not create much leverage to such a rule, compared to other countries using a worldwide tax basis and a tax credit system to tax dividends, like the United States.

II. Taxing digital services

The issue of taxing the players in the digital economy (especially Google, Apple, Facebook, and Amazon, so-called "GAFAs") has become, over the years, as in other countries, a very sensitive issue. There has been strong political pressure to counter what was, rightly or erroneously, seen as aggressive tax planning or even tax evasion. Two different sets of questions had to be addressed: can these situations, involving digital products and services, be taxed under existing rules, and, if not, how should the rules be changed ?

Concerning the possibility of taxing at source, in the place of consumption, VAT is an obvious and natural way to allow such taxation on B to C activities. However, this method is ineffective in levying any tax as far as B to B transactions on advertisement services are concerned because, as is the case in most of these activities, VAT on B to B transactions is necessarily recoverable by the entity to which it is invoiced and consequently does not generate real tax income for the State.

In addition to the VAT solution being excluded, solutions relying on tax audits based on existing corporate tax concepts and anti-avoidance rules and a change of corporate tax nexus

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rule do not seem an efficient way to address the issue. Still, the French government has been pushing hard, under the political pressure of recent events, to create a new digital tax.

1) Tax evasion

Some foreign corporations involved in these digital businesses were subject to tax audits, sometimes preceded by specific on-site police investigations, so as to identify possible elements allowing to substantiate the existence of a PE, or of a wrong allocation of profits under accepted transfer pricing policies. These procedures did not seem to allow substantial reassessments based on existing treaty approaches and concepts. In a judgement of July 12, 2017, n°150517 "*Google Ireland*", the Paris tribunal found for example that the French subsidiary of Google, which was providing marketing and support services to Google Ireland, although it could be regarded as a dependent agent, did not have the power to bind Google Ireland and therefore did not constitute a PE of the latter (the reassessments at stake were in the region of 1.1 billion euros including corporate tax, VAT and local taxes). Similar conclusions were reached by the court of appeal of Paris more recently, on similar questions (CAA Paris, 9e ch., March 1, 2018, n° 17PA01538, ValueClick).

2) Change in corporate tax nexus

It is interesting to note that the possibility of taxing a business without the presence of a PE has existed in France for a long time. Article 209 of the FTC defining the scope of French corporate tax refers to business carried out in France, which French case law has extended to encompass situations in which the foreign corporation has no fixed place of business, but carries out a "full commercial cycle" in France.

The "full commercial cycle" concept derives from old 1942 court decisions. This concept was subsequently incorporated into administrative guidelines. The concept refers to situations in which a nonresident carries out a significant number of business operations that, taken together, constitute a comprehensive business in France (one transaction, or only a few transactions would not be sufficient). The classic example of a full commercial cycle is repetitive operations of buying and selling goods or services in France. Another well-known example is furnished by the case of a radio station located in Monaco but receiving advertising fees for transmitting radio broadcasts received by French listeners and is a technical precursor of the "GAFA" model.

This internal law concept[1] is not, however, compatible with treaty definitions, which traditionally refer to a fixed place of business or a dependent agent and can only apply in the case of foreign providers not located in a treaty country (e.g., the futurist developments of floating cities on "seasteading platforms" escaping any state sovereignty, and consequently, treaties.

Solutions involving corporate tax always fail due to the difficulty to change the traditional criteria in existing tax treaties without a worldwide consensus. It is difficult (and adventurous) to define the precise scope of the digital economy to which these new criterias would apply. The change in nexus would raise general complex issues on the taxation in the country of source of all other business activities, which has been a traditional debate between emerging economies and OECD States, before the latters became more sensitive about a small part of the worldwide business. It is also difficult to implement new territoriality rules on "digital PEs" applicable to some foreign providers without addressing at the same time the treatment of resident providers developing similar business subject to equivalent rules abroad. The solution probably relies more on a reduction of the gap in tax rates applicable in the various States so as to reduce the tax arbitrage related to the location of a corporation and its intangibles assets. Reduction of the French income tax rate to 25%, even if it remains above the average rate of other countries, will significantly reduce such arbitrage.

In the Finance Bill for 2017, the French Parliament tried to introduce a provision (Article 209 C of the FTC) that would in essence have functioned as a kind of reverse controlled foreign corporation (CFC) mechanism: instead of taxing the foreign income of CFCs or other foreign entities controlled by French resident entities (as provided for by Article 209 B), the proposed measure would have taxed foreign controlling entities on income deemed attributable to their French agents.

In summary, proposed Article 209 C of the ITC was aimed at a foreign corporation, whether or not established in France, carrying on activities consisting of sales of goods or supplies of services on the French market, through a dependent agent or a website, when "*there are serious reasons*" to consider that the activities of the foreign corporation had the purpose of avoiding or reducing tax due in France. When applicable, Article 209 C would have allowed France to impose tax on the income arising from such activities that would normally have been due in the absence of an "artificial arrangement."

There was, however, no explanation as to what the tax normally due would have been and why, if the tax would normally have been due under other ordinary provisions of the FTC, these existing ordinary provisions were not sufficiently effective to tax the foreign entity, without a provision as ambiguous as Article 209 C having to be implemented. The proposal also indicated that the provision could be used in a tax audit based on a decision of the tax authorities to apply the presumption with respect to the taxpayer under audit, thus leaving a great deal of autonomy to the Administration in deciding whether or not to implement the provision.

Unsurprisingly, this new provision (originating as it did in an isolated initiative of the Parliament, and voted contrary to the will of the government) was rejected and annulled by the French Constitutional Council before coming into force, based on the principle that Parliament cannot surrender to the tax administration the constitutional prerogative, which is its alone, to define the scope of taxation: apart from the fact that it was based on a number of apparently very vague concepts, proposed Article 209 C was worded in such a way as to leave too great a power of interpretation to the tax administration.

Although it was not necessary for the Constitutional Council to express its opinion on all the constitutional principles involved (one constitutional reason to annul the law being sufficient), proposed Article 209 C, as worded, could also raise other difficulties in relation to equality principles (equality with respect to taxation and with respect to the law) prohibiting discrimination, and the principle of certainty of rights, both provided for by the 1789 Declaration of Human and Citizens Rights, which is part of the French Constitution.

3) A new digital services tax?

The 28 EU countries did not reach an unanimous agreement (Denmark, Sweden, Finland, Ireland opposed the project) required for the creation of a new European digital tax, although the final proposal was assessed on a restricted basis.

Further to this failure to reach a large consensus, some countries, including France, may implement this tax on a unilateral basis. The French national assembly adopted on April 8, 2019, a bill creating a new tax, based on the recent discussions at the EU level, but with a larger taxable basis. This tax would apply to businesses with a turnover of more than 750M euros world-

wide and more than 25M euros in France. The 3% tax would be assessed on the turnover generated by on-line advertisements, the sale of data for advertisement purposes and the creation of links with internauts on marketplaces (i.e., a wider definition than the one proposed to the EU vote, which excluded the two last elements). The (modest) expected return on this tax in France is 400M euros in 2019 and 650M euros in 2020 onward. It is estimated that nearly 30 groups are concerned (including some French). The tax is presented as a first step before a more global agreement is reached on this matter.

The French Senate confirmed the law on May 23, 2019. It is too early (our comments are written one week after confirmation by the Senate) to give much more details about this law, which will have to pass several tests before being enacted, including with respect to the EU treaty, the EU VAT Directive, tax treaties (especially with the United States) and a diplomatic test with the United States, which stated that the tax is discriminatory.

III. Allocating income to a host country PE

France is following OECD standards concerning the allocation of income to a PE or within a group, and corporate income tax is always computed based on net income attributable to the taxable entity. Even concerning withholding tax, which might apply on digital services (but only in a non-treaty context) on payments to a foreign supplier, there is a strong basis to allow a computation on a net basis, which should be soon confirmed by coming court decisions.

NOTES

[1] See a more complete description of this concept in BNA Bloomberg, Vol. 38, “Income tax consequences for foreign service providers”—FRANCE p. 29.

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