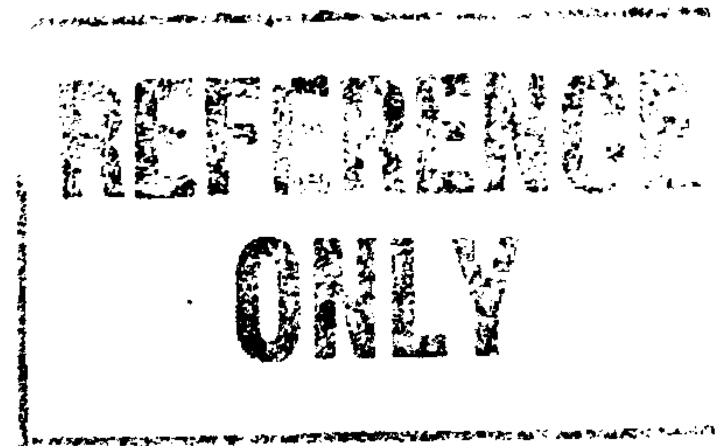

A STUDY OF THE LEGAL EFFECT OF THE MAIN PROVISIONS OF THE INCOME TAX TREATY BETWEEN FRANCE AND THE UNITED KINGDOM

by

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Sophie A. Hoquet McKee

This thesis is believed to be the first exhaustive work on the 1968 double taxation agreement between France and the United Kingdom. An attempt has been made to provide a comprehensive and thorough analysis of this particular tax convention.

The thesis first investigates matters relevant to all categories of treaties:- treaty making power, the relationship between a treaty and domestic legislation and the rules of treaty interpretation. It then proceeds to study the specific structure, nature, scope and function of double taxation agreements.

A comparative approach has been taken to the study of all relevant legal concepts in the field of company and revenue law. An attempt has been made to compare the British and French anti-avoidance legislation relating to international transactions and to draw conclusions as to their respective impact.

The purpose of existence of the double taxation agreement between France and the United Kingdom is to settle the problems of international double taxation. This thesis analyses the taxation rules applicable to different classes of income and the respective rights to tax of both the state of source and the state of residence. Its main objective is to provide an exhaustive explanation of the rules of taxation, together with an illustration of their practical operation. It is hoped that this has been achieved through a systematic analysis of commentaries, articles of doctrine (academic discussion), publications of Revenue authorities and case law.

It is hoped that this work will extend beyond British and French frontiers and that some of the suggestions and recommendations made in it will find a place in a world-wide context. An attempt has been made to make some contribution towards an improvement in the negotiation of double taxation agreements at Government level and an amelioration of their application by taxpayers, tax authorities and jurisdictions.

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CHAPTER 1

MECHANICS OF TREATY MAKING

Section 1: Definition and Terminology

According to article 1(a) of the Vienna Convention on the Law of Treaties,[1]

> ... Treaty means an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation.

Treaty is a general term; other words have a more specific meaning: convention (convention) is the term currently used to refer to treaties dealing with double taxation matters;[2] thus the Convention between the United Kingdom of Great Britain and Northern Ireland and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income of 22 May 1968.[3]

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1. It was adopted by the United Nations Conference of the Vienna Convention on the Law of Treaties on 22 May 1969.

2. See J.D.B. Oliver, "Double Tax Treaty Vocabulary", British Tax Review (hereinafter cited as BTR) (1974), p. 262.

3. This convention will hereinafter be cited as UK/F tax convention. The text of the Convention may be found in: English, United Kingdom Treaty Series No. 6 (1970, London: HMSO) Cmnd. 4253; British Tax Encyclopedia (London: Sweet & Maxwell) Vol. 5, Part 9-401; Simon's Taxes, Vol. F, Division F4.5, p. 1135; also in Halsbury's Statutory Instruments (London: Butterworths, 1978) Vol. 11 (pt. 4A) S.I. No. 1869. In French, Journal Officiel de la République Française, 25 Novembre 1969, 11476;
/Continued over

In its domestic legislation, when dealing with double taxation relief,[4] the United Kingdom refers to arrangements. Although this particular word normally applies to a double tax treaty between the United Kingdom and one of its Colonies or Protectorates,[5] the Inland Revenue has commented that there are no hard and fast rules and in the case of ss. 497 *et seq*. of the Income and Corporation Taxes Act of 1970, arrangement is to mean double taxation treaty in general.[6]

The word agreement is also commonly used in the UK to designate a tax convention although it normally applies to a tax convention between the UK and an independent member of the Commonwealth.[7]

The French legislation consistently uses the word *convention*, *convention internationale relative aux doubles impositions* to be precise.[8]

An amendment to a tax convention is called a

Footnote continued from page 1:

Dossiers Internationaux Francis Lefebvre, *Grande Bretagne* (Paris: Francis Lefebvre, 1980), p. 193; *Recueils Pratiques du Droit des Affaires dans les Pays du Marché Commun* (Paris: Jupiter) Tome V 22-V-1968.

4. *Income and Corporation Taxes Act* (hereinafter cited as ICTA 1970), ss. 497 *et seq*.

5. See J.D.B. Oliver, *op.cit.*, note 2 above, at p. 363.

6. *Ibid*.

7. *Ibid.* In the present work, the words treaty, convention, agreement and arrangement will be used equally.

8. For instance, *Code Général des Impôts* (hereinafter cited as CGI) arts. 4 *bis*, 165 *bis*, 209-I.

Protocol (*Avenant*) and a further amendment a Supplementary Protocol (*Avenant Additionnnel*).[9]

The latest tax convention between the UK and France has been amended twice since it was signed on 22 May 1968; a first Protocol was signed on 10 February 1971, a Supplementary Protocol on 14 May 1973.[10]

Agreement was reached at official level in London in December 1978 about the text of a proposed Protocol to the UK/F agreement relating to the double taxation of UK and French residents carrying on activities in connection with the exploration or exploitation of the sea bed and sub-soil and their natural resources.[11]

Following a request to the Technical Division of the Inland Revenue about this Protocol, the following answer was received in a letter dated 13 July 1982: "The proposed Protocol has been initialled but has not yet been approved".

Section 2: The Making of a Treaty

§1. Power to Make a Treaty

Both in the United Kingdom and in France, the

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9. See J.D.B. Oliver, *op.cit.*, note 2 above.

10. S.I. 1973 No. 1328; *décret* No. 74-164 of 22 February 1974, *Official Journal*, 28 February 1974, 2319; S.I. 1971 No. 718; *décret* No. 71-642 of 15 July 1971, *Official Journal*, 3 August 1971, 7692. See Note to Double Taxation Relief (Taxes on Income) (France) Order 1968, S.I. 1968 No. 1869, *Halsbury's Statutory Instruments*, Vol. 11 (1978) p. 173.

11. Information issued by the Inland Revenue on 18 December 1978, British Tax Encyclopaedia, (hereinafter cited as BTE), § 10.174.

making of a treaty is an act of the executive.

I. United Kingdom

The treaty making power is a power, which in British Constitutional Law is vested in the Crown. The Crown means the executive or Central Government.[12]

Treaties may be negotiated at Head of State level, which is rare nowadays, or at Government level.

The previous tax convention between the United Kingdom and France, signed on 14 December 1950, was concluded at Head of State level: it was entered into by the President of the French Republic and His Majesty the King, who had personally appointed plenipotentiaries.[13]

The difference between treaties negotiated at Head of State level and Government level lies in the designation of plenipotentiaries.

In the former type of treaties, the Head of State, personally appoints plenipotentiaries. In the latter form of treaty, the Secretary of State for Foreign and Commonwealth Affairs who, on his appointment, is given General Full Powers to represent the Crown in the conclusion of treaties, will delegate his general power to negotiate to plenipotentiaries.[14]

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12. Halsbury's Laws of England (London: Butterworths, 4th ed., 1977) Vol. 8, § 985.

13. Jurisclasseur Droit International, Vol. 4 Fascicule 380-40, p. 1.

14. Lasok, "Les Traités Internationaux dans le Système Juridique Anglais", Revue Générale de Droit International Public (hereinafter cited as RGDIP) (1961), p. 961.

The 1968 tax convention between the United Kingdom and France, which has replaced the 1950 agreement, was concluded at Government level.

II. France

Article 52 of the Constitution of 4 October 1958 states:

> The President of the Republic shall negotiate and ratify treaties (*traités*). He shall be informed of all negotiations leading to the conclusion of an international agreement (*accord international*) not subject to ratification.[15]

France also makes a distinction between treaties concluded at Head of State level and those concluded at Government level. The former are called *traités en forme solennelle*; they are not widely used today.

The modern form of international agreement, especially in relation to technical matters such as double taxation agreements, is the *accord en forme simplifiée*: the President of the Republic does not formally intervene in the negotiation and signature; a *traité en forme simplifiée* is concluded amongst Governments.[16]

When a treaty is *en forme solennelle*, the President himself delegates his signature to *ad hoc* plenipoten-

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15. As translated in A. von Mehren, *The Civil Law System* (Boston and Toronto: Little, Brown & Company, 2nd ed., 1977), p. 240.

16. *Jurisclasseur Droit International*, Vol. 3 Fascicule 350, § 100.

tiaries; he is solely competent to appoint representatives provided with a written authorisation to negotiate and conclude a treaty. When an agreement is _en forme simplifiée_, the Government does not have to appoint plenipotentiaries, but the individual who signs the convention on behalf of his Government must be provided with the powers authorising him to commit his Government.[17]

The 1968 tax convention between the UK and France was entered into in the name of the respective Governments of each country. Before the signature, it is stated:

> In witness whereof the undersigned, duly authorised thereto by their respective Governments have signed this convention. (_En foi de quoi, les soussignés dûment autorisés à cet effet par leurs Gouvernements respectifs ont signé la présente convention._)

The convention was signed by Lord Chalfont for the Government of Great Britain and Northern Ireland and by Monsieur G. de Courcel for the Government of the French Republic.

§2. _Ratification_

> Ratification is the term used for the final confirmation given by the parties to an international treaty concluded by their representatives ... the function of ratification is, therefore, to make the treaty binding; if it is refused the treaty falls to the ground in consequence. [18]

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17. _Ibid._, Vol. 1 Fascicule 11, p. 8.
18. L. Oppenheim, _International Law, a Treatise_ (London: Longmans, 8th ed., 1955), Vol. 1, at p. 903.

The cooperation of Parliament is necessary both in the UK and in France for the ratification of a tax convention. Once signed by the representatives of their respective Governments, the agreement between the UK and France had to be subject to Parliamentary scrutiny before it could come into force. In each country, the legislative power exercises some form of control over the action of the executive.

I. The Intervention of Parliament

A. United Kingdom

A treaty requires legislation in the United Kingdom in order to take effect in that country.[19] As regards tax conventions in particular, the procedure to be followed is described under s. 497(8) of the Income and Corporation Taxes Act of 1970.[20] This section describes the method of incorporation of a tax convention into domestic legislation.

The ICTA 1970, in its s. 497(1) in particular, is an enabling act; it empowers the executive to make an Order and give effect to a convention. Power to make a convention applicable in the United Kingdom is delegated by Parliament to the executive: the Order is made under

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19. The leading case on this point is The Parlement Belge (1879) L.R. 4 P.D., p. 129.

20. The convention presently in force between the UK and France was entered into prior to the enactment of the ICTA 1970 and the Order was made under s. 347 of the 1952 Income Tax Act, but both texts are identical.

the authority of the enabling act, through which Parliament maintains control over the enactment of a convention. S. 497(8) states:

> Before any Order proposed to be made under this section is submitted to Her Majesty in Council, a draft thereof shall be laid before the House of Commons, and an Order shall not be submitted unless an Address is presented to Her Majesty by that House praying that the Order be made.

The intervention of Parliament is limited to that of the House of Commons because the House of Lords traditionally has restricted powers in matters related to finance and taxation.[21]

A draft Order is laid before the House of Commons. It includes a tax convention presented as a schedule to a draft statutory instrument.[22]

As to the meaning of "laying a draft order before the House of Commons", it is explained in the Laying of Documents before Parliament (Interpretation) Act of 1948:[23]

> The laying of any instrument ... is to be construed as a reference to the taking, during the existence of a Parliament, of such action as is directed by virtue of

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21. Erskine May, Parliamentary Practice (London: Butterworths 19th ed., 1976) Chapter XXXI, p. 795.

22. Where power to make an Order is conferred to Her Majesty in Council as is the case under ICTA 1970, s. 497(1), any document by which that power is exercised is known as a "statutory instrument"; see The Statutory Instruments Act 1946 (s. 1), Halsbury's Laws of England (London: Butterworths, 1971), Vol. 32, p. 668.

23. Halsbury's Statutes of England (London: Butterworths, 1976) at p.678.

> any Standing Order[24] ... or other direction of that House ... or as is accepted by virtue of the practice of that House for the time being as constituting such laying ...

A convention will not take effect until a Draft Order in Council has expressly been approved by Parliament.[25] The approval of Parliament takes the form of an Address.

Once the Order is made, the procedure of scrutiny of Parliament has been completed and a tax convention may be said to have been incorporated into domestic legislation.

B. France

Article 53 of the French Constitution of 1958 states:[26]

> Peace treaties, commercial treaties ... those that imply a commitment for the finances of the State, those that modify provisions of a legislative nature ... may be ratified or approved only by a law.[27] They shall go into effect only after having been ratified or approved. [28]

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24. A Standing Order is one of the sources from which the forms and rules of parliamentary procedure are drawn; see Erskine May, op.cit., note 21 above, p. 208.

25. Erskine May, op.cit., note 21 above, p. 577.

26. As translated in A. von Mehren, op.cit., note 15 above, p. 240.

27. Ratification applies to traités en forme solenelle, approval to accords en forme simplifiee: Ch. Rousseau, Droit International Public (Paris: Dalloz, 9th ed., 1979), p. 23.

28. For a substantial development on art. 53 of the 1958 Constitution, L. Saïdj, Le Parlement et les Traités. La loi Relative à la ratification ou à l'Approbation des Engagements Internationaux (Paris: LGDJ, 1979),

/Continued over

Tax conventions modify to a certain extent domestic legislation and imply a commitment for the finances of the state.[29]

The double taxation agreement between the United Kingdom and France was submitted to Parliament: A *loi* No. 69-972 of 24 October 1969 authorises the approval of the UK/F tax convention.

The law is made of a single article authorising the approval. It is signed by the President of the Republic, the Prime Minister and the Minister of Foreign Affairs. It was published in the *Journal Officiel de la République Française*.[30]

II. Role of the Executive

A. United Kingdom

The Double Taxation Relief (Taxes on Income) (France) Order was made on 22 November 1968. The Convention is printed as a schedule to it. The document takes the form of a Statutory Instrument.[31] Immediately after a Statutory Instrument has been made, it must be

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Footnote 28 continued from page 9.
reviewed in *Revue Critique de Droit International Privé* (hereinafter cited as RCDIP), 1981, No. 2.

29. *Jurisclasseur Droit International*, *op.cit.*, note 16 above, § 125.

30. Official Journal, 26 October 1969, 10563.

31. S.I. 1968. No. 1869.

sent to the Queen's Printer of Acts of Parliament, printed and put on sale.[32] Statutory Instruments are numbered in the order in which they are received by the Statutory Publications Office.[33]

B. France

The law of authorisation of approval voted by Parliament was followed by a decree of approval (décret d'approbation) of the President of the Republic. It was published in the Official Journal and the text of the convention is annexed to it.[34]

The décret is composed of two articles. Article 1 announces the publication of the text of the convention.

Article 2 states: The Prime Minister and the Ministry of Foreign Affairs are in charge of the implementation (application) of the present décret.

Prior to these two articles, reference is made to the relevant articles of the Constitution (52 to 55), the date of the signature (22 May 1968), the statute authorising the approval (Loi No. 69-972) and a décret (No. 53-192 of 14 March 1953)[35] dealing with ratification and

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32. Erskine May, op.cit., note 21 above, p. 575.

33. Statutory Instruments Regulations of 1947, S.I. 1948, No. I.

34. Décret No. 69-1050 of 21 November 1969 published in the Official Journal of 25 November of the same year.

35. RCDIP (1953), p. 182.

publication of international commitments undertaken by France.

The *décret* of approval is one and the same as the decision of publication of the agreement.

One document therefore fulfils three functions:

- it shows the *a posteriori* approval of the President
- it publishes officially the text of the convention
- it makes the convention applicable in the French legal order.

In relation with the procedure of ratification as a whole, the *Cour de Cassation* has recently decided[36] that the courts could not exercise control over the procedure of ratification of international conventions. The administrative courts take the same approach and refuse to check on the ratification.[37]

§3. Publication

I. United Kingdom

The double taxation relief Order was published as a statutory instrument[38] and the text of the convention

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36. *R. v. Office de la Jeunesse d'Emmendingen*, decision of 25 January 1977, *Journal du Droit International* (Paris: Editions Techniques, 1977), Vol. 104, p. 470. For an interesting commentary of the decision, see RCDIP (1978), Vol. 67, p. 351.

37. *Ibid*., at pp. 364-365.

38. Statutory Instruments 1968 Part III Section 1 (London: HMSO, 1969), pp. 4924-4939.

is set out as a schedule to this Order. It was also published in United Kingdom Treaty Series No. 6 (1970) Cmnd. 4253.[39]

II. France

The text of the convention is officially published as an annex to the décret of the President of the Republic mentioned earlier.[40]

In relation to the problem of publication of international conventions, a decision of the French Supreme Court involving a double taxation agreement should be mentioned. In 1972, the chambre commerciale of the Cour de Cassation decided that the double taxation convention concluded by France and the Republic of Senegal could not be applied by the courts because it had not been regularly published.[41]

Section 3: Comparison

Despite some differences, which should not be

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39. "A Command Paper is a paper presented to Parliament or laid upon the table of either House in pursuance of an Act of Parliament, but on the initiative of the Minister responsible." Abraham & Hautrey, A Parliamentary Dictionary (London: Butterworths, 1956), p. 55.

40. See note 34 above.

41. Gossard v. Receveur des Finances à Compiègne (1972), Recueil Dalloz Sirey, Sommaires de Jurisprudence, p. 152.

neglected, the procedure of treaty making in the United Kingdom and in France is very similar.

British constitutional law does not formally introduce the distinction between traité en forme solenelle and accord en forme simplifiée,[42] but it does in practice the same thing, without giving it a formal name, when making a distinction between treaties where "full powers" are signed by Her Majesty the Queen, and treaties where "full powers" are granted by the Secretary of State for Foreign Affairs.[43]

The double taxation convention between the United Kingdom and France is an accord en forme simplifiée. Both Heads of State - Her Majesty the Queen and the President of the Republic - did not formally intervene in the conclusion of the Convention.

The Convention was entered into by the respective Governments of each country.

As far as terminology is concerned, it is in practice sometimes confusing. The French Constitution uses the word traité for a formal document signed and ratified by the Head of State,[44] and the word accord for agreements which do not require ratification, but approval.[45]

The difference between a traité and an accord is that the former requires ratification whereas the latter

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42. France has formally introduced the distinction in the Constitution itself in 1958.

43. See above p. 4.

44. Constitution of 1958, art. 52, §1.

45. Ibid., art. 52, §2.

requires approval. An *accord* will be approved; this amounts to an *a posteriori* intervention of the President of the Republic to agree to an international agreement to which he has not formally taken part. In practice, both ratification of a *traité* and approval of an *accord* are executed by means of a *décret*. One is a *décret* of ratification, the other one a *décret* of approval.

The intervention of Parliament is necessary in both countries before a tax convention can enter into force.

France carefully distinguishes between ratification and approval, whereas the United Kingdom uses the word ratification in a general sense covering both treaties where Her Majesty the Queen has personally delegated her powers and treaties where "Full Powers" were granted by the Secretary of State for Foreign Affairs.[46]

The intervention of Parliament is required in France by the text of the Constitution itself. Parliament includes the National Assembly (*Assemblée Nationale*) and the Senate (*Sénat*).

The participation of Parliament in the United Kingdom is limited to that of the House of Commons, and such intervention is required by an Act of Parliament.

The role of the legislature is rather limited in both countries; laying before the House of Commons in the UK and the vote of a statute (*loi*) in France are the means by which the legislative bodies are informed.

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46. See above p. 4.

The *a posteriori* approval of the President and the making of an Order in Council will make the Convention binding in each country; the Convention becomes part of the domestic legislations.

The problem of conflict between a statute and the Convention will be discussed in the next chapter.

The text of the Convention is only published officially once in France. It is published in the Official Journal (*Journal Officiel*) as an annex to the *décret* of approval.

In the United Kingdom, it is published in more than one publication. It comes out in the Treaty Series and in the Statutory Instruments.

CHAPTER 2

RELATIONSHIP BETWEEN A CONVENTION AND DOMESTIC LEGISLATION

The aim of the present chapter is to focus on the relationship between a treaty and a law, more specifically between a tax convention and domestic legislation.

Is there supremacy of a convention over prior and/or posterior legislation? If such supremacy exists, does it suffer any exception?

Can a provision of a tax convention worsen the position of a taxpayer resident in one of the signatory countries?

It will be shown that, where in relation to treaty making power, the positions in the United Kingdom and in France were very similar, the same conclusion may not be arrived at when dealing with conflicts between a convention and domestic legislation.

These problems do not have a single simple solution; they will be examined separately in each country, by means of a study of the relevant texts and decisions, before a comparison may be attempted.

The attitude of the courts will also be examined as regards treaties in general before turning to the specific problem of double taxation agreements.

Section 1: United Kingdom

§1. Relationship Between a Treaty and Domestic Legislation

I. Doctrine of Parliamentary Sovereignty

In the UK, the relationship between a treaty and domestic legislation is dominated by the doctrine of parliamentary sovereignty. According to Dicey,

> Parliament has the right to make or unmake any law whatever. No person or body is recognised by the law of England[1] as having a right to override or set aside the legislation of Parliament. [2]

The relationship between a treaty and a provision of domestic legislation is not regarded in the UK as a problem of superiority of the former over the latter because a treaty only has effect in the UK when it is incorporated into the domestic legal system by appropriate means.

In case of a conflict between a treaty and domestic legislation, the courts will compare the treaty as incorporated in the domestic legal system and the provision of domestic legislation. There is no supremacy of a treaty over a statute.

If Parliament shows an intention of repudiating a treaty, the Act of Parliament carrying out the repudiation

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1. At the time Dicey was writing, England was often used as a synonym for the United Kingdom.

2. A. Dicey, Introduction to the Study of the Law of the Constitution (London: Macmillan & Co. Ltd. 10th ed., 1959), p. xxxv.

will prevail. A decision involving the Treaty of Rome, Macarthys Ltd v. Wendy Smith, will illustrate these statements.[3]

II. Case Law

The facts of the case were as follows:

A woman was appointed to be manageress of a stockroom 4 months after the post had been vacated by a man. She was paid £50 a week whereas the employer had paid the male employee £60 a week.

The plaintiff advocated a contradiction between a provision of the Equal Pay Act 1970 (as amended by the Sex Discrimination Act 1975) and Art. 119 of the Treaty of Rome.[4]

A conflict arose between a provision of the Treaty and a subsequent provision of domestic legislation. Lord Denning stated:

> The provisions of Art. 119 of the Treaty of Rome take priority over anything in our English statute on equal pay which is inconsistent with art. 119. That priority is given by our own law. It is given by the European Communites Act 1972 itself. [5]

---

3. Common Market Law Reports (hereinafter cited as CMLR) (1979), p. 44; also All England Law Reports (hereinafter cited as All ER) (1979) 3, p. 325. The decision of the Court of Appeal after reference to the Court of Justice of the European Communities may be found in All ER (1981), p. 111.

4. The European Communities Act commenced on 1 January 1973.

5. All ER (1981), p. 111, at p. 120 g.

Priority is given to the Treaty because of the Act of Parliament of 1972. At no stage is the Treaty given some superior status for being an international agreement.

Further, Lord Denning stated:

> If the time should come when our Parliament deliberately passes an Act - with the intention of repudiating the Treaty or any provision in it - or intentionally of acting inconsistently with it - and says so in express terms - then I should have thought that it would be the duty of our Courts to follow the statute of our Parliament. 6

§2. Relationship Between a Tax Convention and Domestic Legislation

How do the principles stated above apply in relation to tax conventions? An answer to the problem of the relationship between a tax convention and domestic legislation is provided by a statutory provision, art. 497(1) of ICTA 1970.

In addition, the courts have had to deal with this problem.

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6. CMLR (1979) at p. 47. Lord Denning had already mentioned this idea in an earlier decision, Blackburn v. Attorney General (1971)Weekly Law Reports (hereinafter cited as WLR), p. 1037, at p. 1060. This view finds support amongst academics; see for instance O. Hood Phillips, Law Quarterly Review (hereinafter cited as LQR) (1979), Vol. 95, pp. 167-171 and (1980), Vol. 96, pp. 31-34.

I. Superiority of a Tax Convention over Domestic Legislation

A. ICTA 1970, s. 497(1)

S. 497(1) of the ICTA 1970 provides:

> If Her Majesty by Order in Council declares that arrangements specified in the Order have been made with the government of any territory outside the United Kingdom with a view to affording relief from double taxation in relation to income tax or corporation tax and any taxes of a similar character imposed by the laws of that territory, and that it is expedient that those arrangements should have effect, then, subject to the provisions of this Part of this Act, the arrangement shall, notwithstanding anything in any enactment, have effect in relation to income tax and corporation tax in so far as they provide -
>
> (a) for relief from income tax, or from corporation tax in respect of income, or
>
> (b) for charging the income arising from sources in the United Kingdom to persons not resident in the United Kingdom, or
>
> (c) for determining the income to be attributed -
>
> (i) to persons not resident in the United Kingdom and their agencies, branches or or establishments in the United Kingdom, or
>
> (ii) to persons resident in the United Kingdom who have special relationships with persons not so resident, (or
>
> (d) for conferring on persons not resident in the United Kingdom the right to a tax credit under section 86 of the Finance Act 1972 in respect of qualifying distributions made to them by companies which are so resident.

S. 497(1) gives effect to a double taxation agreement in the UK legal system. If this section at first sight appears to set aside domestic legislation in favour

of a tax convention in case of a conflict ("notwithstanding anything in any enactment"), a closer study shows that the scope of this statement is diminished in practice.

S. 497(1)(a) limits the extent to which the arrangements take effect to the extent that they provide for relief from tax.

S. 497(1)(b) applies to non-residents exclusively.

A tax convention does not provide "for charging" UK source income; a UK source income paid to a non UK resident is already charged to tax under UK domestic law. However, s. 497(1)(b) gives effect to treaty provisions which either exempt or reduce the rate of tax to be charged on UK source interest, dividends or royalties paid to non residents for instance.

S. 497(1)(c)(i) gives effect to the provision in tax conventions dealing with the taxation of industrial and commercial profits and s. 497(1)(c)(ii) to the article entitled "Associated Enterprises" in the OECD Model, art. 8 of the UK/F tax convention. The domestic counterparts of this provision are article 57 of the French General Tax Code and s. 485 of the 1970 Income and Corporation Taxes Acts.

B. Ostime v. Australian Mutual Provident Society

This particular decision[7] examines the relationship

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7. House of Lords (hereinafter cited as HL) (1960) Appeal Cases (hereinafter cited as AC), p. 459, 38 Tax Cases (hereinafter cited as TC), p. 492.

between an Act of Parliament and a subsequent double taxation agreement. The facts of the case were as follows:

The taxpayer, a mutual provident society with its head office in Sidney, Australia, carried on life insurance business there, and in the UK through a branch in London. It was assessed to UK income tax on sums which notionally were profits of its business of insurance: the assessment was made under Schedule D Case III to the Income Tax Act of 1918 (rule 3 in particular) which imposed upon an insurance company not having its head office in the UK but carrying on life insurance business through a branch or agency in the UK, a charge to UK income tax in respect of a specified proportion of the income from its worldwide life insurance fund.

The taxpayer contested this assessment on the basis that a provision of the Double Taxation Relief Order between Australia and the UK of 1947 was to apply rather than the domestic rule.

Although the central issue of this case was the qualification of the income, this is not relevant for the present purpose. But the problem of conflict between domestic law and treaty law was resolved in the following way:

> ... there is a conflict between the provisions of rule 3 and those provisions of the Double Taxation Relief Agreement which deal with the taxation of industrial and commercial profits ... and ...

On the basis of what is today s. 497(1), Lord Radcliffe went on to say:

> ... It is plain therefore, that if there is a conflict, the unilateral legislation of the United Kingdom must give way.

In addition, Lord Radcliffe answers the following question: is the income taxed under rule 3 business income or investment income? Coming to the conclusion that it is business income, Lord Radcliffe states that the taxpayer cannot be taxed at all on the basis of rule 3 because it would violate the double taxation agreement.[8]

The opinion of Lord Denning - although dissenting on the qualification of the relevant income - is interesting with the problem of the relationship between tax conventions and domestic legislation, because it is formulated in broad and general terms.

> ... They (arrangements) have been embodied in an agreement and given statutory force in each country. They override any other enactment ... [9]

This particular case does not concentrate specifically on the relationship between a convention and domestic legislation. One has the feeling that a problem of conflict could not arise in court because a convention is to prevail over a statute on the basis of what is today s. 497(1) of ICTA 1970.

However, the survey of the following decisions will show that the problem has not been so simply and

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8. (1960) AC, at p. 481.

9. <u>Ibid.</u> at p. 484.

definitely solved - if at all.

Ostime v. Australian Mutual Providence Society involved a conflict between existing legislation and a convention which came into force afterwards. The decisions to be examined now involve a conflict between an existing convention and a subsequent statute.

II. Limitations to the Superiority of Conventions

A. Decisions of the courts

The extent to which unilateral tax legislation can override a tax convention was the central issue of two decisions of Supreme Courts , the House of Lords and the Privy Council.

- Collco Dealings Ltd v. Inland Revenue Commissioners

Collco Dealings Ltd v. Inland Revenue Commissioners[10] is a decision of 1961. It involves a conflict between the Double Taxation Relief Agreement entered into by the United Kingdom and Eire (1952) and a later enactment, a provision of the Finance Act (No. 2) of 1955.

The facts of the case were as follows:

An Irish resident company asked for repayment of United Kingdom income tax suffered on some dividends received in 1957. The claim of the plaintiffs was based on provisions of the double taxation agreement between the

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10. (1962) AC, p. 1.

United Kingdom and Eire. The United Kingdom Revenue contended that the provisions of a subsequent Finance Act applied.

Their Lordships all agree to dismiss the appeal of the plaintiff but they agreed to do so on different grounds which are summarised here:

- Viscount Simonds

> The company has no right under any agreement. Its right arises under the Act of Parliament which confirms the agreement and gives it the force of law. ... Neither Comity of Nations nor rule of international law can be invoked to prevent a sovereign state from taking what steps it thinks fit to protect its own revenue laws from gross abuse or to save its own citizens from unjust discrimination in favour of foreigners.

- Lord Morton of Henryton

> If the statute is unambiguous its provisions must be followed.
> ... After a treaty has been made, circumstances may alter and it may be reasonable to take unilateral action in the expectation that the other party to the treaty will not object.

- Lord Radcliffe

Looking at the possibility of giving the domestic provision a restricted meaning in order for it not to be in conflict with an earlier international agreement, he said that such restrictive interpretation is possible in order to avoid a breach of international law. However, when the departure from observance of the Comity of Nations

> consists in no more than a provision inconsistent with an inter-governmental agreement about taxation, which by its own terms is subordinated to the approval of the respective legislatures ... I think that there is no useful aid to be obtained from this principle of interpretation.

Priority was given to the tax convention in the Ostime case on the basis of s. 51 of the FA (No. 2) 1945, today s. 497(1) of the ICTA 1970, ("notwithstanding anything in any enactment"). It was not specified in the decision that such was the case because the convention was subsequent to a provision of domestic legislation.

In the Collco case, the argument is mainly based on a conflict between two provisions of domestic legislation; the tax convention is not treated as an international treaty but only considered through the Order which incorporated it in the UK domestic law.

Although it is not expressly mentioned, the doctrine of Parliamentary Sovereignty underlies all the opinions. "The sovereign power of the Queen in Parliament extends to breaking treaties" says Lord Diplock in Salomon v. Commissioners of Customs and Excise.[11]

In addition, Collco is a decision which was rendered on the basis of s. 513 of ICTA 1970. This section is entitled "Relief under agreements with Republic of Ireland". It was repealed from 6 April 1976.[12]

The treatment of double taxation agreements with Ireland is presently dealt with in FA 1976, s. 49.

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11. (1967) 2 Q.B. p. 116, at p. 143.

12. See ICTA 1970, s. 513, Amendments. For the text of s. 513, see Butterworths Tax Handbook, 1975-76, 14th edition.

Although reference is made in s. 49(1) to s. 497 of ICTA 1970 ("If in the year 1976 Her Majesty by Order in Council under section 497 of the Taxes Act declare ..."), s. 49 does not contain the key sentence "notwithstanding anything in any enactment", which is an essential part of s. 497(1).

It may be thought that the outcome of the Collco case - involving an arrangement with Ireland - could be explained by the absence of the crucial part of sentence "notwithstanding anything in any enactment".

- Woodend (K.V. Ceylon) Rubber and Tea Co Ltd v. Commissioners of Inland Revenue

Woodend (K.V. Ceylon) Rubber and Tea Co Ltd v. Commissioners of Inland Revenue is a decision of the Privy Council.[13]

The facts of this case involve a conflict between the United Kingdom-Ceylon taxation agreement and a provision of a subsequent Act of Parliament of Ceylon, s. 53 C of the Income Tax (Amendment) Act of 1959. The posterior statute was held to prevail.

Woodend Rubber and Tea Co Ltd argued that an additional tax of 33½ per cent (claimed under the Income Tax Amendment Act 1959) was not due to be paid because such a tax was inconsistent with one or more provisions of the double taxation agreement, which had entered into force in 1950.

Their Lordships, in this particular case, have

13. WLR (1970) 3, p. 10; (1970) AC, p. 321.

looked mainly at the intention of the Ceylon legislature: did it intend to set aside a particular point in the double taxation agreement? As the 1959 Act was a statute of very comprehensive character introducing radical changes in the taxation laws of Ceylon, their Lordships came to the conclusion that the legislature could not have overlooked the scope of the new measure.

The 1950 and 1959 Acts were also compared and their Lordships considered the possibility of interpreting the 1959 Act as a function of the 1950 Act, but such interpretation was rejected as giving too narrow a meaning to the words: "the general words must receive their full meaning".

- General Reinsurance Co Ltd v. Tomlinson (Inspector of Taxes)

Another case appeared in 1970 before the Chancery Division of the High Court, General Reinsurance Co Ltd v. Tomlinson (Inspector of Taxes).[14] It involved the 1950 double taxation agreement between the UK and the Netherlands and a subsequent statute, the Income Tax Act of 1952.

General Reinsurance Co Ltd was a Dutch company carrying on the business of reinsurance with a branch in London. It was common ground that the branch was a

14. (1970) WLR, p. 566.

permanent establishment under the treaty.

One of the questions the Chancery Division of the High Court had to answer was whether profits (on realisations of investments representing funds arising from underwriting activities in London) of General Reinsurance's branch should be included in the computation of its profits for the purposes of Case I of Schedule D of the ITA 1952, or whether these profits (and dividends and interest) should be excluded from the computation for Case I purposes under the double taxation agreement between the UK and Netherlands of 1950.

The company contended the latter on the basis that surpluses in respect of investments comprised in the US Trust Fund, dividends and interest arising from dollar investments, should be excluded from the computation for Case I purposes under the tax agreement since such surpluses , dividends and interest were derived from sources outside the UK and formed no part of the commercial profits attributable to General Reinsurance branch in the UK.

General Reinsurance argued that if the provisions of the convention were in conflict with UK tax law, the former was to prevail on the basis of s. 347 of the 1952 ITA.

Foster J. came to the conlusion that there was no conflict between the convention and subsequent UK legislation.

He however stated, on the basis of s. 347 of

the ITA 1952[15] and the decision of the House of Lords of 1960, Ostime v. Australian Mutual Provident Society, "the provisions of the ITA 1952 are overridden by the provisions of a double taxation agreement".[16]

The General Reinsurance Company Ltd case involved a convention and a statute posterior to it; the Ostime case involved a conflict between a statute and a convention posterior to it.

It seems that, in the General Reinsurance case, had there been a conflict, Foster J. would have made the convention prevail over a posterior statute contrary to it. This attitude would have been in contradiction with the Collco and Woodend cases, but the former involves an Irish agreement and the latter a posterior statute of the Ceylon Parliament.

B. Statutory limitations

The extent to which the provisions of a tax convention override domestic law is limited by ICTA 1970, s. 497 itself. The words "notwithstanding anything in any enactment" in s. 497(1) are preceded by the words "subject to the provisions of this part of this Act".

One of the provisions of Part XVIII is s. 498, which deals with unilateral relief. Therefore tax

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15. To be found presently under ICTA 1970, s. 497.

16. (1970) WLR, at p. 581 C.

conventions take effect, subject to the provisions on unilateral relief. Does this mean that a taxpayer can opt to be taxed under a provision of domestic legislation if it is more favourable to him? If such a taxpayer is a non resident, could he claim the benefit of the UK legislation, if more favourable, to the exclusion of the treaty, on the basis of the non-discrimination clause of the treaty?

It seems that the main limitation to the application of a tax convention may be summed up as follows: a tax convention takes effect only if it does not set aside more favourable provisions of domestic legislation.[17]

It would therefore seem that in the United Kingdom, on the basis of the limitation introduced in s. 497(1) ("subject to the provisions of this part of this Act"), a treaty provision cannot worsen the position of a taxpayer. This is confirmed by s. 497(1)(a) which limits the effect of an arrangement to the extent that it provides for relief from tax.[18]

However, although this particular point does not involve the UK/F agreement, but that between the United Kingdom and the United States, it is interesting to mention the following:

S. 16 of FA 1979 provides that the double

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17. For a concurrent opinion, see J.B.D. Oliver, Double Tax Treaties in United Kingdom Tax Law, BTR (1970), p. 388, at p. 393.

18. Ibid.

taxation agreement between the United States and the United Kingdom signed on 31 December 1975 is to be treated as an arrangement under ICTA 1970, s. 497 notwithstanding the fact that the UK/US agreement "withdraws relief from tax for periods before the making of the Order".

One of the limitations which s. 497 imposes on the application of a double taxation agreement is that

> the arrangements shall ... have effect in relation to income tax and corporation tax in so far as they provide for relief from income tax, or from corporation tax ...[19]

One may deduce from this that if this condition is not fulfilled, the double taxation agreement will not have effect.

However, s. 16 of FA 1979 makes an exception to this and provides that the UK/US agreement is to have effect despite the fact that it "withdraws relief from tax for periods before the making of the Order".

This is an illustration that a double taxation agreement may worsen the position of a taxpayer in the United Kingdom.

Furthermore, in relation to the UK/F double taxation agreement of 1968, art. 9(1)(b) provides that a maximum of 15 per cent. withholding tax can be levied when the recipient of the dividend is a resident of France entitled to a tax credit in respect of such a dividend.

Under UK domestic law, there is no tax withheld

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19. ICTA 1970, s. 497(1)(a).

on payments of dividends to non residents. Does this situation not mean that a French resident who receives a dividend from a company in the UK of which he is a shareholder is worse off under the UK/F agreement because his dividend will have been subject to a withholding tax?

The provision of the convention specifies "tax may also be charged in the UK, and according to the law of the UK ...".

As the law of the UK does not provide for such tax, does the tax administration levy a 15 per cent. tax, in which case the position of the taxpayer is worsened, or does it levy nothing?

These queries have been submitted to the Inland Revenue and the following answers were promptly received: The law of the UK referred to in art. 9A(1)(b) is ICTA 1970, s. 497(1) which provides that notwithstanding any enactment, double taxation conventions shall have effect in relation to income tax and corporation tax insofar as they provide (b) for charging the income arising from sources in the UK to persons non resident in the UK.

> The non resident taxpayer is not in a worse position as a result of this provision since he is not entitled to payment of the tax credit attaching to a dividend paid by a United Kingdom company unless a double taxation convention specifically so provides or section 98, Finance Act 1972 applies.

Section II: France

§1. Relationship between a Treaty and Domestic Legislation

I. Article 55 of the Constitution

The supremacy of a treaty over domestic legislation is established by the text of the Constitution of 1958 itself. Article 55 states:

> Treaties (*traités*) or agreements (*accords*) duly ratified or approved shall, upon their publication, have an authority superior to that of laws (*lois*), subject, for each agreement or treaty, to its application by the other party. 20

The application of art. 55 raises two essential questions: the problem of the relationship between a treaty and domestic law which will be developed here and the question of reciprocity ("subject ... to its application by the other party").

Although the principle of supremacy is expressed in what appears to be clear and unambiguous terms, its application has raised difficulties. There are numerous decisions of the courts dealing with this problem.

The situation in relation to the Treaty of Rome will first of all be summarised in order to illustrate that the problem is not as easily resolved as a reading of

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20. As translated in A. von Mehren, *op.cit*. Chapter 1, note 15 above, p. 240. The condition of reciprocity will not be developed here, but for a recent analysis, see a note by G. Calonec under CE 29 May 1981, *Arrêt Reckhou*, *Dalloz*, *Jurisprudence*, p. 137.

art. 55 may suggest. The particular problem of the relationship between a tax convention and domestic legislation will then be examined.

II. Application by the Courts

A. Statute anterior to a treaty

An important decision of 1970 is Administration des contributions indirectes et comité interprofessionnel des vins doux v. Ramel.[21] The facts of this case may be summarised as follows:

A French undertaking had imported wine from Italy. The anti-fraud department of the police analysed samples and detected excessive sweetening. The managing director of the undertaking was prosecuted and the Tax Administration initiated a parallel prosecution on the ground of violation of the General Tax Code (Code Général des Impôts, hereinafter cited as CGI).

Ramel opposed the latter allegation on the grounds that the provisions of the Code conflicted with art. 95 of the EEC Treaty.[22]

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21. Decision of 22 October 1970, CMLR (1971) p. 315; also, Juris-Classeur Périodique (hereinafter cited as JCP) 71, II, 16671.

22. Art. 95 of the Treaty of Rome states:

    No Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products.

    Furthermore, no Member State shall impose on the products of other Member States any

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At first instance, Ramel won and the decision was confirmed by the *Cour d'Appel* of Lyons. The *pourvoi* before the *Cour de Cassation* was brought by the *Administration des Contributions Indirectes*.

The issue was a conflict between provisions of French domestic law (arts. 401, 434, 443 *et seq*. of the General Tax Code) and an article of the subsequent Treaty of Rome, art. 95.

The *Cour de Cassation* rejected the *pourvoi*: it referred to art. 55 of the Constitution and added:

> The principle of territoriality of taxation laws could not overrule international law whose authority must prevail by virtue of constitutional law. [23]

The *Cour de Cassation* upheld the Treaty of Rome over domestic law.

B. *Statute posterior to a treaty*

This problem has led to a conflict between both French Supreme Courts, the *Cour de Cassation* and the

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Footnote 22 continued from page 36.

> internal taxation of such a nature as to afford indirect protection to other products.
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> Member States shall, not later than at the beginning of the second stage, repeal or amend any provisions existing when this Treaty enters into force which conflict with the preceding rules.

23. This position was subsequently confirmed: *A. Guerrini*, *Cour de Cassation*, 7 January 1972, Recueil *Dalloz Sirey* (hereinafter cited as D) (1972), p. 497, *note* J. Rideau.

Conseil d'Etat.[24]

1) Conseil d'Etat

In 1968, the Conseil d'Etat, Supreme Administrative Court, followed the arguments of the Commissaire du Gouvernement, Madame Questiaux, and refused to apply an EEC Regulation (No. 19) contrary to an earlier provision of domestic legislation.[25]

Madame Questiaux, *inter alia*, said:

> ... you cannot, in our opinion, control the conformity of the ordonnance with the treaty ... if the legislator has manifested a precise will, if the national statute places itself as a necessary intermediary between the treaty and the application required of it, no provision of the Constitution, article 55 in particular, excuses the judge from respecting that will. 26

The speech of the Commissaire du Gouvernement is more committed than the decision itself which does not

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24. The organisation of French courts is characterised by a separation between administrative and judicial courts: principle of separation of administrative and judicial authorities, statute of 16-24 August 1790, art. 13. For a complete survey of the French Supreme Courts, see La Cour Judiciaire Suprême, une Enquête Comparative, Revue Internationale de Droit Comparé (hereinafter cited as RIDC), (1978). Also, Z.M. Nedjati and J.E. Trice, English and Continental Systems of Administrative Law (Oxford: North Holland Publishing Company, 1978) Chapter 3 in particular.

25. Syndicat Général des Fabricants de Semoule de France, Conseil d'Etat, 1 March 1968, Dalloz (hereinafter cited as D.) (1968) I, p. 286; also Actualité Juridique de Droit Administratif (hereinafter cited as AJDA) (1968), p. 235; also CMLR (1970), p. 395.

26. *Ibid.*, CMLR, p. 404-405.

make any general statement of constitutional law but restricts itself to the facts.

However, the decision has been widely criticised and its approach has not been followed by the *Cour de Cassation*.

2) *Cour de Cassation*

The mixed chamber (*chambre mixte*) of the *Cour de Cassation*[27] rendered in 1975 a decision in relation to a conflict between a treaty and a posterior statute: *Administration des Douanes* v. *Société Cafés Jacques Vabre et J. Weigel et Companie SARL*.[28]

The question was whether the imposition of internal consumption tax on soluble coffees imported from Holland into France, laid down under section 265 of the Customs Code, was lawful. The plaintiff maintained that it was unlawful because it contravened art. 95 of the Treaty of Rome.

The case involved a conflict between a provision of the Treaty of Rome and a subsequent provision of domestic

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27. A *chambre mixte* is an *ad hoc* chamber whose basic role is to prevent conflicts and harmonize decisions of the different chambers of the *Cour*.

28. Decision of 24 May 1975, CMLR (1975), p. 336; D (1974), p. 159, *note* J. Rideau; *Gazette du Palais* (hereinafter cited as GP) (1975) 2.470. For a commentary, see J. Foyer and D. Holleaux, RCDIP (1976), Vol. 65, p. 347; for a more general survey, see George A. Bermann, *"French Treaties and French Courts: Two Problems in Supremacy"*, *International and Comparative Law Quarterly* (hereinafter cited as ICLQ) (1979), p. 458.

legislation.

The *chambre mixte* based its decision by relying on art. 55 of the Constitution. M. Touffait, *Procureur Général*, had asked for the reasoning to be based on the very nature of the legal order instituted by the Rome Treaty.[29]

Since that decision, the *Cour de Cassation*, the plenary assembly (*assemblée plénière*) in particular,[30] has confirmed the superiority of a treaty other than the Treaty of Rome over a posterior statute.[31]

The *Cour de Cassation* seems determined to give priority to a treaty, whether legislation was enacted before or after its publication.

The question as to whether the *Jacques Vabre* decision applies only to the Treaty of Rome or whether it can be generalised and applied to all international agreements is not definitely settled. It is submitted that the wording of the decision of 1975, in as much as it refers

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29. CMLR (1975), p. 363.

30. A special group of 25 senior members of the *Cour de Cassation*, gathering when a second *pourvoi* is brought before the *Cour*, on the same point of law as the first one. A *pourvoi* is a request brought by a party before the *Cour de Cassation* when it wants to challenge the final decision of a lower court on a point of law.

31. *Bloch* v. *Société Filtex*, 14 October 1977, RCDIP, Vol. 67, p. 166, *note* Batiffol. The case involved a conflict between a convention entered into by Switzerland and France (15 June 1869) and a statute of 1901. The relevant provisions involved rules of competence of a jurisdiction. More recently, *M. Glinel, président de la SA "Voréal"*, 14 January 1980; for a commentary see *Revue trimestrielle de Droit Européen* (1981), p. 369.

to art. 55 contrary to the recommendation of M. Touffait, and the decision of 1977 which does not involve the Treaty of Rome favours the latter solution. However, the essential part of the *Jacques Vabre* decision does indirectly refer to the specificity of the Community legal order.

§2. *Relationship Between a Tax Convention and Domestic Legislation*

The French courts do not seem to have been challenged with a case involving a conflict between a tax convention and domestic legislation. The relationship between a tax convention and domestic legislation seems more simple than the problems of conflict between an international treaty and domestic legislation in general. The reason for this is the existence, in the *Code Général des Impôts*, of a provision dealing specifically with that problem.

The rule is formulated in art. 4 *bis* 2° and 165 *bis* as regards income tax (*impôt sur le revenu*) and art. 209-I as regards corporation tax (*impôt sur les sociétés*).

France is entitled to tax any income whose taxation is attributed to it by an international tax convention.

Priority is given to tax conventions over domestic legislation according to this provision. In other words, if French domestic law exempts a particular category of income, but a treaty provision states that the particular

income "may be taxed" in France or "shall be taxable" in France, it will be so taxed, despite the absence of a charging provision under French internal law.[32]

This rule was introduced in 1959[33] and its original aim was to suppress double exemptions. It was designed to meet the situation in which a convention exempted certain income from tax in the other contracting state (as a country of source for example) at the same time that French domestic law exempted the same income from tax in France (as the country of residence for example).[34]

When authorised by a provision of a double taxation agreement, France will tax certain categories of income which would not be taxable according to French domestic legislation. It is therefore clear that in France, the position of a taxpayer can be worsened by a provision of a double taxation agreement.[35]

France may be attributed by a treaty the right to tax certain categories of income; such income is not taxable according to French domestic legislation but this will not stop the tax administration from levying the tax on the basis of art. 209-I.

Certain conventions have limited the scope of

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32. Répertoire Dalloz, Impôts, at p. 145.

33. Law of 28 December 1959, No. 59-472, art. 3-III.

34. Harvard Law School, World Tax Series, Taxation in France (Chicago: Commerce Clearing House Inc., 1966), pp. 796-797 and 844.

35. For a concurrent view, see M. Cozian, Semaine Juridique, Edition Commerce et Industrie (hereinafter cited as JCP ed CI) (1980), p. 148.

the French provision.

Such is not the case for the UK/F double taxation agreement, but art. 32 §3 of the convention between the United States and France of 1967 is drafted in the following way:[36]

> The provision of the present Convention shall not be construed to restrict in any manner any exclusion, exemption, deduction, credit or other allowance now or hereafter accorded
> (a) by the laws of one of the Contracting States in the determination of the tax imposed by that State, or
> (b) by any other agreement between the Contracting States. [37]

If a particular income is exempt from tax under French domestic law, it cannot become chargeable to tax as a result of a provision of the tax convention between the US and France.

The effect of art. 26 §3 is to set aside the provisions of the French Tax Code examined above.

Section 3: Comparison

Relationship Between a Treaty and Domestic Legislation

As regards treaties in general, the position in the UK and in France in case of a conflict between a

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36. G. Gest, L'Imposition des Bénéfices des Sociétés Françaises aux Etats-Unis (Paris: LGDJ, 1979), pp. 22-23.

37. The text of this convention may be found in European Taxation (Amsterdam: International Bureau of Fiscal Documentation) Supplementary Service Section C3.

provision of a treaty and domestic legislation differs substantially.

France, the Cour de Cassation in particular, gives priority to a treaty over domestic legislation. On the other hand, the Conseil d'Etat, on the basis that the courts in France have no right to control the constitutionality of statutes, maintains that a statute posterior to a treaty and contrary to it is to prevail.

The English courts also maintain that a statute posterior to a treaty and contrary to it will prevail over an earlier treaty.

But the motivation of the English courts is completely different: the solution provided is based on the doctrine of the sovereignty of Parliament. First of all, a treaty will not be considered by the courts in the UK unless it has been incorporated in the domestic legal order. This was done by means of an Act of Parliament in the case of the Treaty of Rome.

Once a treaty is incorporated into domestic law, the UK courts no longer refer to it as a treaty but as an Act or any other domestic form it may take. Before UK courts, a treaty does not rank higher than a statute or other forms of domestic legislation.

In France, the Constitution itself, in its art. 55, places treaties higher than statutes in the hierarchy of legal norms. A treaty in France does not need to be incorporated into the domestic legal system in order to become applicable in the same way as in the UK; there is no such thing in France as a "loi des Communautés

Européennes", which would have followed the signature of the Treaty of Rome in 1958.

Relationship Between a Tax Convention and Domestic Legislation

As regards tax matters, most issues giving rise to litigation will appear in France before the Conseil d'Etat because the administrative courts are generally competent in relation to direct taxes. This does not however mean that a statute posterior to a double taxation agreement will prevail over an earlier tax convention. The General Tax Code contains specific provisions dealing with the relationship between a tax convention and domestic legislation; the former is to prevail.

In the UK, the House of Lords has given priority to a statute posterior to a treaty provision, but the case (Collco case) involved a UK/Eire convention which, as has been examined, is of a specific nature. However, the same approach was taken by the Privy Council: it seems that in Ceylon, a bilateral tax agreement may be unilaterally altered by a subsequent Act of Parliament.

On the other hand, two decisions of UK courts have given priority to a convention over domestic legislation: the first decision, Ostime, involved a conflict between a convention and an earlier provision of domestic legislation. The second one, General Reinsurance Co Ltd, involved a statute posterior to a convention but it is only a decision rendered by a lower court.

CHAPTER 3

INTERPRETATION OF TAX CONVENTIONS

Section 1: Rules of Interpreation Prescribed by the Text of the Convention

§1. Definition of Technical Terms

I. Definitions Set Out in the Articles

The UK/F agreement contains numerous definitions of technical terms:

- Certain articles, such as articles 1, 2 and 3 are entirely devoted to definitions: article 1 for instance defines the taxes which in the United Kingdom and in France are the object of the convention.

A definition may take the form of an enumeration, such as the enumeration of the particular domestic taxes to which the convention applies, or it may take a more general form. For instance art. 1(2) states that the convention will also apply to any identical or substantially similar future taxes, imposed in addition to, or in place of the existing taxes. The UK/F agreement has not been extended in its application to any other tax and applies only to the ones listed under art. 1(1).[1]

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1. Following a request of confirmation made to the Board of Inland Revenue, the following answer was received in a letter dated 1 September 1982:

   There have been no extensions to any taxes

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The use of enumerations for the purpose of definitions is to be approved when it is clear, precise and does not leave room for uncertainty. However, enumerations can be misleading when they are not limitative, or use words whose meaning is questionable or inexistent under domestic laws. For instance, art. 4(2) makes an enumeration of what are to be treated as permanent establishments, the latter being defined in general terms under art. 4(1). Art. 4(2) lists, inter alia, a place of management (un siège de direction). From the point of view of a UK lawyer, this word should be meaningful in as much as the residence of companies for the purposes of UK tax is determined as a function of the place of management and control of the company; but from a French point of view, this word is not familiar; it is not a legal term commonly used nor does it refer to something specific.

A word, permanent establishment (établissement stable), which is not part of the UK or French legal terminologies is therefore defined by another word which does not have any specific meaning in the French context and gives rise to unsurmountable difficulties in the UK.[2]

A similar point could be made as regards words such as workshop, office, which are also part of the enumeration under art. 4.2.

Footnote 1 continued from page 46.

other than those mentioned in Article 1, either in the United Kingdom or in France by exchange of letters.

2. See below, Part I Chapter 2.

Art. 3 states: "the term 'resident of France' means ... any person who is resident in France for the purposes of French tax". But the concept of residence does not exist under French law in relation to companies, nor individuals.

Common definitions are to be welcomed because they should alleviate difficulties and uncertainties, but if states are going to develop autonomous concepts of international tax law for the purposes of avoiding double taxation, they are to do so clearly.

- Sometimes, the convention provides rules of determination of a particular concept only when the definitions under domestic laws lead to a conflict. The treaty definition of a term is not to be used unless the French and the UK notions clash.

Art. 3(2) for instance, gives rules of determination of residence in case an individual is resident in both contracting states according to the respective domestic laws. The definition provided under art. 3(2) is not to be used unless an individual can be said to be resident of both contracting states.

II. Clause de renvoi to Domestic Legislation

- General clause[3]

Art. 2(3) of the UK/F agreement provides:

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3. For an application of this clause in the Franco-Canadian tax convention of 15 June 1953, see Conseil d'Etat, 26 November 1975, Revue des Décisions du Conseil d'Etat (hereinafter cited as RDCE) (1975), p. 597.

> In the application of the provisions of this Convention by a Contracting State any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of this Convention.

This is also expressed, although in different terms, in art. 3(2) of the 1977 OECD Model. It provides a general rule of interpretation of terms used in the convention but not defined therein: when a term is used in the convention but not defined in its text, the domestic meaning of that term is to be used; undefined terms are to be interpreted in accordance with domestic law. This can lead to discrepancies when a term does not have the same meaning in the French and UK legal systems. In addition, terms may have different meanings in different areas of law.[4]

For instance, in France a company is a subsidiary (filiale) of another if the other company owns more than one half of its share capital.[5] On the other hand, for tax purposes , in order to benefit from the affiliation privilege (régime des sociétés mères et filiales) a company is considered to be a subsidiary of another if the parent holds 10 per cent. or more of its share capital.[6]

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4. Only rarely will the text of a convention refer to a particular area of law; for instance, reference to droit privé (general law) in art. 5(2)(b) of the UK/F agreement.

5. Law on commercial companies of 24 July 1966, art. 354. The meaning of subsidiary under English law is developed in Part II, Chapter 1, Section 3.

6. CGI, arts. 145(1)(b) and 216.

Consequently, the outcome of a case before a court may be different according to whether it comes before a French or an English court, because each of them will give a particular word the meaning it has under its domestic system.

Another problem arises in relation to the domestic law which is to be applied: should one apply the provisions of the convention which were applicable at the time of the signature, of the ratification (a long gap may exist between both; for instance, the UK/US agreement only came into force in 1980, but was signed in 1975) or should the provisions in force at the time of the litigation govern? This latter solution, although most practical, gives each state the possibility to modify the convention through an alteration of its domestic law.

- Specific clause de renvoi

They constitute exceptions to the general clause de renvoi. Such clauses exist for instance in the UK/F agreement in relation to immovable property. The term "immovable property ... shall be defined in accordance with the law of the contracting state in which the property in question is situated".[7] The rules of taxation of the country of location of immovable property will apply to it. It means for instance that if a problem involving immovable property situated in France reaches an English

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7. Art. 5(2)(a).

court, it will have to apply French law on immovable property; this may give rise to difficulties.

§2. Administrative Procedures

I. Mutual Agreement Procedure

Art. 26(3) and (4) of the UK/F agreement states:

> (3) the competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties arising as to the application of the Convention. In particular, the competent authorities may consult together to endeavour to resolve disputes arising out of the application of para. (2) of Article 6 or Article 8, or the determination of the source of particular items of income.
>
> (4) The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs or for the purpose of giving effect to the provisions of the Convention and for resolving any difficulty as to the application of the Convention.

A special chapter will be devoted to a survey of the mutual agreement procedure.[8]

The use of the mutual agreement procedure is one of the administrative devices offered by the convention itself to solve problems relating to its application. The word interpretation itself is not mentioned in the text of the UK/F agreement - whereas the 1963 and 1977 OECD texts do so - but it may reasonably be thought that both application and interpretation are covered.

A specific reference is made in the provision on

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8. See below, Chapter 8.

mutual agreement procedure to arts. 6(2) and 8 dealing with the computation of profits of a permanent establishment or of a subsidiary on an arm's length basis, but any difficulty as to the application of the convention may be solved through a dialogue between the competent authorities. The words "competent authorities" refer to the Commissioners of Inland Revenue or their authorised representatives in the UK, the Ministry of Economy and Finance (le Ministère de l'Economie et des Finances) or his authorised representative in France.[9]

Both the 1963 Draft and the 1977 OECD Model Conventions mention the possibility of communication between the competent authorities for the purpose of resolving a problem of application or interpretation of a tax convention through a commission consisting of representatives of the competent authorities of the contracting states. Such oral exchange of opinions is not mentioned in the UK/F agreement. As the 1963 Draft referred to it directly, and the UK/F agreement is based on it, one may wonder if the omission was intentional on the part of the negotiators.

II. Exchange of Information

Chapter 9 of the introduction deals exclusively with this problem but it is relevant to quote here art. 27(1) as another administrative procedure which can be followed to interpret the convention. Art 27(1) provides:

The competent authorities shall exchange

9. UK/F agreement, art. 2(1)(d).

> such information as is necessary for carrying out (appliquer) the provisions of this Convention ...

Section 2: Organs Competent to Interpret Tax Conventions

§1. United Kingdom

I. The Courts

In the UK, the courts are competent to interpret a treaty but they will not regard a treaty by itself as being a source of English law in the sense that it imposes duties or confers rights upon private individuals. In order to become binding upon individuals, a treaty must be incorporated into domestic legislation.[10]

The classical statement of the constitutional position in relation to the need for municipal legislation to give effect to international agreements is to be found in the judgment of Lord Atkin in Attorney General for Ontario v. Attorney General for Canada:

> It will be essential to keep in mind the distinction between (i) the formation and (ii) the performance of the obligations constituted by a treaty, using that word as comprising any agreement between two or more sovereign States. Within the British Empire, there is a well established rule that the making of a treaty is an executive act, while the performance of its obligations, if they entail alteration of the existing domestic law, requires legislative action. Unlike some other countries, the stipulations of a treaty duly

10. Cf. Chapter 2.

> ratified do not within the Empire, by virtue of the treaty alone, have the force of law. If the national executive, the government of the day, decide to incur the obligations of a treaty which involve alteration of law they have to run the risk of obtaining the assent of Parliament to the necessary statute or statutes. 11

More recently, in relation to the Treaty of Rome, Lord Denning as Master of the Rolls in the course of a judgment stated:

> Even though the Treaty of Rome has been signed, it has no effect, so far as these Courts are concerned, until it is made an Act of Parliament. Once it is implemented by an Act of Parliament, these Courts must go by the Act of Parliament. 12

Once a treaty has been incorporated into domestic legislation, the English courts do not hesitate to embark on the task of treaty interpretation.[13] They "grapple boldly with the task of interpreting treaties when they are called upon to do so".[14]

Courts are, however, precluded from giving a decision on the appropriateness of a treaty; their role is exclusively judicial and they cannot interfere with the

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11. (1937) AC p. 326, at p. 347. See also Lord McNair, Law of Treaties (Oxford: Clarendon Press, 1961) Chapter 4.

12. McWhirther v. Attorney General (1972), CMLR, Vol. 11, p. 882, per Lord Denning, at p. 886.

13. I.M. Sinclair, "The Principles of Treaty Interpretation and their Application by the English Courts", ICLQ (1963), Vol. 12, pp. 508-551; K. Holloway, Modern Trends in Treaty Law (London: Stevens & Sons, 1967), pp. 288 et seq.

14. McNair, op.cit., note 11 above, p. 358.

function of the executive.[15]

As regards tax conventions, in view of what has just been said in relation to treaties in general, the courts will only be able to interpret them once they will have been incorporated into the UK domestic system by means of an Order in Council.

§2. France

The problem of interpretation of tax conventions is more complex in France, mainly as a consequence of the peculiar organisation of the courts.

I. The Courts

The organisation of the courts is based on the principle of separation of administrative and judicial authorities.[16] The administrative courts are headed by the *Conseil d'Etat*, the judicial (or ordinary) courts, by the *Cour de Cassation*. Both sets of courts are completely separate and independent. In addition, there is a distinction within the ordinary courts between civil and criminal courts. This distinction is reflected in the structure of the *Cour de Cassation* itself which is divided between civil and criminal chambers.

Tax matters are traditionally split in France

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15. *Ibid.*, the position is identical in France; CE 29 January 1971, *Req*. No. 78567 RDCE (1971), p. 49.

16. Statute of 16-24 August 1790, Art. 13.

between ordinary and administrative courts. The administrative courts deal with direct taxes (impôts directs), income tax and corporation tax and the ordinary courts are competent in relation to indirect taxes (impôts indirects), registration duties, stamp duties and customs duties.[17] The main exception to this basic distinction involves VAT (TVA, taxe à la valeur ajoutée) which lies within the competence of the administrative courts.

A. The supreme administrative court: the Conseil d'Etat

In relation to treaties, the administrative courts originally considered they could apply treaties, but they had no power to interpret them. The distinction between application and interpretation may, however, sometimes be hard to make.

The French administrative courts have traditionally declined competence to interpret treaties on the basis of what is known as the théorie des actes de gouvernement.[18]

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17. Martin Norr and Pierre Kerlan, World Tax Series, Taxation in France (Chicago: Commerce Clearing House Inc., 1966), p. 8.

18. This principle has remained the same since a decision of 3 September 1823 Rougemont, Recueil Lebon, p. 675, as quoted in H. Battifol, Droit International Privé (Paris: LGDJ 8th ed., 1976) Vol. 1, p. 47 note 76. Revue génerale de droit international public (hereinafter cited as RGDIP). More recently, Secrétaire d'Etat au Commerce Exterieur v.Hurmi, 20 December 1963, Recueil Lebon, p. 650, as quoted in M. Stassinopoulos, "Remarques sur la Jurisprudence Française Relative à l'Interprétation des Traités Internationaux", RGDIP (1969), vol. 73, p. 5, at p. 7, note 2. Also Droit Public Interne et International, Etudes et

/Continued over

This attitude is based on the theory of separation of powers which has underlined French constitutional law since the revolution of 1789. When faced with a problem of interpretation of an international treaty the Conseil d'Etat will suspend the proceedings (surseoit à statuer) and request an interpretation from the Ministry of Foreign Affairs.[19] The interpretation of the treaty constitutes a question préjudicielle and an answer to it is necessary before the court may reach a decision on the matter.

This procedure will be illustrated by a decision of the Conseil d'Etat of 19 May 1972.[20] This particular decision has been selected - inter alia - because its facts are reasonably simple.

An individual, Mr X, contested a charge to tax for 1962 and 1963 on income from immovable property (revenu des immeubles) and from shares (valeurs mobilières)

Footnote 18 continued from page 56.

Réflexions à la Mémoire de Georges Berlia, "Contribution a l'Interpretation des Traités", (Paris: LGDJ, 1980), pp. 407-441. For an interesting, but largely out of date, study of interpretation of tax treaties by French courts, see M. Chretien, "L'Application et l'Interprétation des Clauses Fiscales des Traités Internationaux par les Tribunaux Français", RCDIP (1951), Vol. 40, p. 41. André de Laubadère, Traité de Droit Administratif (Paris: LGDJ, 8th ed., 1980), §468.

19. C.H. Schreuer, "The Interpretation of Treaties by Domestic Courts", The British Yearbook of International Law (hereinafter cited as BYIL) (1971), Vol. XLV, p. 255.

20. CE, 19 May, 1972, Req. No. 76.534, RDCE (1972), p. 382.

received by his wife in France on the basis that being normally resident in Switzerland (résidant habituellement en Suisse) with his wife he should not be liable to French income tax on such income.

The taxation of immovable property is dealt with under art. 3(1) of the convention, but as regards the income from shares, the Conseil d'Etat decided that the solution depended upon the definition of domicile. Is it the place where individuals have their habitual residence (résidence habituelle) or the place where the centre of their economic interests (centre de leurs intérêts patrimoniaux) is situated?

The Conseil d'Etat decided that the text of the convention was not clear on this point and, considering itself incompetent to interpret a provision of a tax convention, it required from the Ministry of Foreign Affairs an interpretation of art. 2 of the tax convention between Switzerland and France. An answer was provided in the following terms:[21]

> The drafting of this provision shows that the concept of domicile according to this definition has an autonomous character in the sense that it does not correspond to the concepts existing under domestic law.

The Ministry insisted on the presence of the word "foyer" (home) in the definition and emphasised that consequently the family links were to have priority.[22]

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21. Réponse Bourgeois, Journal Officiel des Débats de l'Assemblée Nationale, 26 January 1974, p. 488 No. 1010, as quoted in Ph. Derouin, Bulletin Dupont (1979), No. 12.

22. The domestic French concept of domicile existing at /Continued over

One will note that the answer of the Ministry of Foreign Affairs is not a decision on the facts of the case which gave rise to the question. It only constitutes a guideline for the court. Whenever the Conseil d'Etat suspends its proceedings (surseoit à statuer) until an interpretation is provided by the Ministry of Foreign Affairs, the latter gives the court elements of interpretation of the treaty but it does not apply the treaty to the facts.

Following the answer to its request to the Government, the Conseil d'Etat, in a decision of 7 December 1974,[23] gave the words "foyer permanent d'habitation" (permanent home) the meaning which the Ministry of Foreign Affairs had developed in its answer and applied it to the particular facts of the case.

Is a court bound by an interpretation of the Government? An affirmative answer to this question was recently provided by the French Supreme Court.[24] Not only do the guidelines provided by the Government bind the court which has asked for them but they are also applicable

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Footnote 22 continued from page 58.

the time was not referred to; a treaty concept was being elaborated by the Ministry of Foreign Affairs. These guidelines will be relevant not only for the purposes of the French-Swiss agreement, but for any other treaty provision drafted in the same words.

23. CE, 7 December 1974, Req. No. 76534, Droit Fiscal (1975) comm. 1052.

24. Decision of the Cour de Cassation, 29 March 1979, Dalloz (1979) Informations Rapides, p. 334.

for the future.

This decision is interesting, not solely as an illustration of the procedure followed by the administrative jurisdiction when a provision of a treaty requires interpretation. The answer of the Ministry of Foreign Affairs emphasises the autonomous character to be given to concepts used in tax conventions. In other words, it rejects the assimilation of treaty and domestic concepts. In order to guarantee a proper working of double tax treaties, domestic courts must refrain themselves from applying domestic rules and methods of domestic interpretation to international tax conventions.

A first mitigation to the application of the théorie des actes de gouvernement was brought by the doctrine de l'acte clair: if a treaty is clear, it does not require interpretation, but simply application.

A preliminary request to the Ministry of Foreign Affairs is only required when the text is not clear.[25]

This amounts to giving interpretation a narrow scope, and application a wide one.

A further mitigation has been developed by the concept of acte détachable, whereby matters concerning the interpretation of a treaty could be solved by the administrative courts when they did not interfere with the diplomatic function which constitutes a prerogative of the

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25. Conseil d'Etat, Sieur Pétalas, 3 February 1956, RDCE (1956), p. 44.

executive.[26]

Those two mitigations have brought the positions of the Conseil d'Etat and of the Cour de Cassation closer but differences still remain as will be seen below.

B. The Supreme ordinary court: The Cour de Cassation

The attitude of the Cour de Cassation still differs from that of the Conseil d'Etat. The former considers that judges have power to interpret treaties when they involve private matters (intérêts privés), but not when questions of public international law (questions d'ordre public international) arise.[27]

This principle was first stated in a decision of a civil chamber of the Cour de Cassation, Duc de Richmond of 24 June 1839;[28] it has constantly been applied since.

It is the Cour de Cassation itself which decides

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26. Charles Rousseau, Droit International Public (Paris: Sirey, 1970) Tome I, p. 263 et seq.; also, Paul Guggenheim, Traité de Droit International Public (Genève: Librairie de l'Université, George Cie S.A. 1967) Tome 1, pp. 87-88.

27. Battifol, op.cit., note 18 above, p. 40.

28. Sirey (1839) I, p. 577. For a more recent decision, see Receveur-Percepteur du 5ème arrondissement de Paris v. Chassagne, Semaine Juridique (1963) II, 13270, note Ancel. It involves the double taxation agreement between Belgium and France of 16 May 1931: "judicial courts are competent to interpret treaties except when provisions to interpret involve questions of public international law". Also, Cassation Civile I, 16 December 1968, Bulletin Civil No. 321, p. 242, involving the tax convention between Monaco and France of 1 April 1950.

whether a matter is of intérêt privé or public.[29]

Originally, the positions of the civil and criminal chambers of the Cour de Cassation differed; the criminal chamber favoured the approach of the Conseil d'Etat. Today, its attitude seems to be changing progressively towards that of the civil chambers.[30]

II. The Government: The Ministry of Foreign Affairs

The Ministry of Foreign Affairs will interpret treaties on behalf of the Government. The Ministry will be requested to make a statement by the Conseil d'Etat whenever a problem of interpretation is at stake, and by the Cour de Cassation when the interpretation involves a question of public international law.

The Cour de Cassation has decided that it was bound by the interpretation given by the Ministry of Foreign Affairs. The Conseil d'Etat has come to the same conclusion. The opinion of the Government is also binding for the future.[31]

In practice, when tax conventions are required to be interpreted, the Ministry of Foreign Affairs will consult the Ministry of Finance.

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29. For a detailed analysis, see M. Stassinopoulos, op. cit., note 18 above, pp. 18-24; also, C.H. Schreuer, op.cit., note 19 above, pp. 57-67.

30. Ph.Derouin, op.cit., note 21 above, p. 402. See also Cour de Cassation, Chambre Criminelle, 29 May 1975, Affaire Daniel Wildenstein, Gazette du Palais (hereinafter cited as GP), 28 August 1975, p. 583.

31. Cf. M. Stassinopoulos, op.cit., note 18 above, at p. 9.

The formulation of the interpretation by the Ministry need not take a particular form.

Also, if two Governments reach an agreement on interpretation, the domestic courts are bound by it.[32]

Both French and English courts will be particularly cautious before they examine a tax convention, but for different reasons.

In France, the administrative courts in particular, which are the most important in relation to tax conventions, will put emphasis on the distinction between application and interpretation.

The English courts will insist on the fact that a treaty in itself is not part of English law until it has been incorporated into the domestic system, whereas France will examine a treaty as soon as it is duly ratified and published.

English courts will not stop short of looking at and interpreting international agreements once effect has been given to them in English law, whereas French courts, when confronted with the task of interpreting a treaty will, under certain circumstances developed above, decline to do so until the interpretation requested from the Ministry of Foreign Affairs is known.

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32. Ibid.

Section 3: Methods of Interpretation of Tax Conventions[33]

How are double taxation agreements and that between the UK and France in particular to be interpreted?

The interpretation of a sentence or a word by the French Government, as may be requested from the *Conseil d'Etat* may differ, not only in form but also in substance, from that of an English court on the same point. This is to be regretted as uniformity in interpretation of tax conventions should be one of the guarantees given to the potential investor in either country.

There is support for the view that double taxation agreements should be subject to the rules of interpretation of international treaties but in fact, domestic law still plays an important role.

One will examine first of all how principles of international law play a part in the interpretation of tax conventions and secondly, to what extent domestic law influences the interpretation of provisions of tax conventions.

I. A Convention is an International Treaty

International agreements for the avoidance of double taxation are bilateral treaties

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33. D.A. Ward, "*Principles to Be Applied in Interpreting Tax Treaties*", *Canadian Tax Journal*, 1977, Vol. XXV, No. 3, p. 263, updated in 1980, Bulletin for International Fiscal Documentation, p. 545; Jean van Houtte, "*Principles of Interpretation in Internal and International Law*", International Bureau for Fiscal Documentation (hereinafter cited as IBFD), 1968.

> and these belong to the law of nations in the same way as any other political or economic treaty. If the meaning of a treaty provision is not clear then the problem will be solved in the first place by applying the usual rules governing the interpretation of international public law. 34

The rules of interpretation of international treaties are best described in provisions of the Vienna Convention on the Law of Treaties signed on 23 May 1969,[35] art. 31 in particular.

> Art. 31: General Rules of Interpretation
>
> 1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.
>
> 2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
> (a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;
> (b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
>
> 3. There shall be taken into account together with the context:
> (a) any subsequent agreement between

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34. CDFI 1960, General Report, R. Lenz, p. 294.

35. The Vienna Convention in its art. 84 provides: "The present convention shall enter into force on the 30th day following the date of deposit of the 35th instrument of ratification or accession." See Ian Brownlie, Basic Documents in International Law (Oxford: Clarendon Press, 2nd ed., 1972), p. 233. Although the Vienna Convention has only recently come into force, the practice since its adoption has been to refer to it as if it were already in force: T.O. Elias, The Modern Law of Treaties (Dobbs Ferry, N.Y.: Oceana Publications Inc., 1974), at p. 13.

the parties regarding the interpretation of the treaty or the application of its provisions;

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

Art. 32:

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31 (General Rule of Interpretation), or to determine the meaning when the interpretation according to Article 31 (a) leaves the meaning ambiguous or obscure, or (b) leads to a result which is manifestly absurd or unreasonable.

It may reasonably be thought that the OECD Commentaries to the OECD Model could fall within art. 32.[36]

To what extent do the UK and French courts follow these methods of interpretation of a provision of a double taxation agreement?

First of all, one is to summarise briefly the method of interpretation of treaties generally applied by the courts.

A. United Kingdom

This particular problem has recently been brought before the House of Lords in a case called

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36. For further information on the role of the OECD Commentaries, see below §2.

Fothergill v. Monarch Airlines Ltd.[37]

It involved the interpretation of a provision of the Carriage by Air Act of 1961, which gives the force of law in the United Kingdom to the Warsaw Convention as amended at the 1955 Hague Convention "for the Unification of certain Rules relating to International Carriage by Air".

The attitude of their Lordships will be best reflected in their own words: "Consideration of the purpose of an enactment is always a legitimate part of the process of interpretation".[38]

Lord Diplock, in his opinion, refers to the fact that the UK is now a party to the Vienna Convention on the Law of Treaties. Although it only applies to treaties concluded after it came into force, Lord Diplock feels that what it says in arts. 31 and 32 about interpretation "does no more than codify already existing public international law".[39]

Also, per Lord Scarman, "British courts should now follow broadly the guidelines declared by the Vienna Convention ..."[40]

Lord Fraser of Tullybelton stated:

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37. (1981) AC pp. 251-302; see also James Buchanan & Co Ltd v. Babco Forwarding & Shipping (UK) Ltd (1978) AC p. 141 and Stag Line Ltd v. Foscolo Mango & Co Ltd (1932) AC p. 318.

38. Fothergill v. Monarch Airlines Ltd, ibid., per Lord Wilberforce, at p. 272-F.

39. Ibid., per Lord Diplock, at p. 282-D.

40. Ibid., at p. 290-C.

> ... we are here concerned with construing an Act which gives effect, and actually incorporates, an international convention, and for that purpose a strict literal construction is not appropriate. [41]

It would therefore seem that in interpreting an Act of Parliament which gives effect to an international convention, their Lordships concur in the opinion that a purposive interpretation is to be applied and not a strict and literal interpretation.

The rest of this decision is largely devoted to the "aids" that may be used by judges in helping their task. It will be discussed below.[42]

B. France

As has been stated earlier, French courts do not regard themselves as empowered to interpret a provision of a treaty; such prerogative lies in the executive.

To the extent that courts do play a certain role in the interpretation of treaties, such contribution was examined under Section 2 of the present chapter.

On the particular topic of interpretation of treaties, public international law textbooks refer to decisions of the International Court of Justice.[43]

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41. Ibid., at p. 285-C.

42. Section 4.

43. Charles Rousseau, Droit International Public (Paris: Sirey, 1971), Tome I, p. 255.

II. Role of Domestic Methods of Interpretation

A. United Kingdom

The attitude of the courts in interpreting international treaties conflicts with the traditional approach of the same courts towards the interpretation of tax statutes; the "golden rule" in tax cases is the principle of strict interpretation.

A tax convention is an international treaty; but it is a particular type of treaty - dealing with taxation matters.

The principle of strict interpretation applied for purposes of interpreting tax statutes will be summarised through quotation of decisions.

> ... in a taxing Act, it is impossible I believe, to assume any intention, any governing purpose in the Act, to do more than take such tax as the statute imposes. [44]

Also, in Russel v. Scott,

> ... there is a maxim of income tax law that the subject is not to be taxed unless the words of the taxing statute unambiguously impose the tax upon them. [45]

From Pryce v. Monmouthshire Canal and Railway Companies,

> ... the taxpayer had a right to stand upon a literal construction of the words used, whatever might be the consequence. [46]

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44. Tennant v. Smith (1892) 3 TC, p. 158, at p. 163; this decision and those quoted below were first read in A.J. Easson, Cases and Materials in Revenue Law (London: Sweet & Maxwell, 1973), Chapter 1.

45. Russel v. Scott (1948), 30 TC, p. 394, per Lord Simonds, at p. 424.

46. (1879) AC, p. 197, per Earl Cairns L.C.

In IRC v. Hinchy,

> ... We can only take the intention of Parliament from the words which they have used in the Act ... we must apply them as they stand, however unreasonable or unjust the consequences and however strongly we may suspect that this was not the real intention of Parliament. 47

In view of the conflict between the method of interpretation of international treaties and that applicable to domestic tax legislation, how do the courts deal with interpreting a provision of a tax convention?

The issue has been submitted to the courts on several occasions;[48] attention will be focused here on the most recent case: IRC v. Exxon Corporation.[49]

This decision seems to initiate a change in the approach of the courts towards the interpretation of tax conventions, but such statement must be carefully punctuated with the following comments.

First of all, it is only a judgment of the Chancery Division of the High Court.

The facts of the case may be briefly summarised as follows: the UK subsidiary of Exxon paid a 7 million dividend to its parent in the United States. Income tax at the rate of 15 per cent was deducted from the dividend

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47. (1960), 38 TC, p. 625, per Lord Reid, at p. 652.

48. Lord Strathalmond v. IRC (1972) 3 All ER, p. 715; (1972) WLR, p. 1511; 48 TC,p. 537. Avery Jones v. IRC (1976) 2 All ER, p. 898; 51 TC, p. 443.

49. (1982) STC, pp. 356-369; (1982) WLR pp. 999-1004. For a commentary, see J.F. Avery Jones, "The Context Otherwise Requires", Notes of Cases, BTR (1982), No. 3, pp. 187-191.

and accounted for by the Revenue. Exxon claims repayment of that tax on the basis of a provision of the double taxation agreement in force between the UK and the US at the time.

The outcome of the case revolves round the construction of a few words "resident of the other contracting party", in the second sentence of art. XV of the US/UK tax convention.

The Special Commissioners held that they were bound by an earlier decision, Lord Strathalmond v. IRC, which involved the interpretation of the first sentence of art. XV of the UK/US double taxation agreement.

The Inland Revenue appealed against the decision of the Special Commissioners.

Goulding J. held that the present case was to be distinguished from Lord Strathalmond v. IRC for the following reasons:

- the first and the second sentence of art. XV are similar, but not identical;
- Goulding J. is convinced that Pennycuick V.C. was right in Lord Strathalmond because "this conclusion was clear from the language used".

Penncuick V.C. undoubtedly applied to a provision of a double taxation agreement the principle of strict interpretation: "on the natural and indeed, plain meaning of the words used, the expression ...". No reference is made to the purpose of the provision, nor to the intention of the negotiatiors.

With due respect, the decision of Goulding J.

is to be welcomed as it initiates a change in the traditional UK attitude which consists of interpreting international tax conventions in the same way as national tax statutes; but Goulding J. is to be strongly criticised for doing it in the way he has.

It is felt that the Lord Strathalmond case was wrongly decided. The United Kingdom should not be applying the principle of strict interpretation to double taxation agreements which are international treaties.

Goulding J. does not say that Lord Strathalmond was wrongly decided. On the contrary, he states "I am convinced that he (Pennycuick V.C.) was right because on reading the convention as it stood his conclusion was clear from the language used ..."

It seems that Goulding J. is supporting the decision of Pennycuick V.C. in the Lord Strathalmond case on the basis of an argument which is the cornerstone of the principle of strict interpretation.

Later on, Goulding J. justifies his own solution to the Exxon case on the basis of a rejection of the principle of strict interpretation.

> I think, on a general consideration of the scheme of the Convention, that counsel for the Crown is right in saying that the intended purpose of the second sentence of art. XV can be discerned. Accordingly, although it seems to me that on the plain meaning of the words used, ... I must nevertheless give it a different construction, so that it does not fall of effect.

The primary reason for taking such an approach seems to be that the application of the principle of strict

interpretation would lead to the sentence being deprived of practical consequences.

However, Goulding J. adds:

> I bear in mind that the words of the convention are not those of a regular Parliamentary draftsman but a text agreed on by negotiation between the two contracting governments.

The fact that a double taxation agreement is an international treaty ought to have been the prevailing reason for taking such an approach.

> Although I am thus constrained to do violence to the language of the convention, I see no reason to inflict a deeper wound than necessary.

It is not doing violence to a treaty to interpret it according to the appropriate method.

B. France

In France, there is no substantial difference between the methods of interpretation of tax laws and other laws.

As far as treaties are concerned, France has adhered to the Vienna Convention on the Law of Treaties.

Tax matters are within the competence of the administrative courts: in view of the consistent reluctance of the courts to interpret a provision of a treaty, the executive plays a prominent role.[50]

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50. See above, p. 56 et *seq*.

Section 4: Other Sources of Interpretation of Tax Conventions

§1. French Instruction and English "Form FRA" and Explanatory Notes

In relation to the UK/F agreement of 1968, the French tax administration has published in 1970 an *Instruction*[51] to which reference has already been made on many occasions. Two other *Instructions* followed the 1971 and 1973 amendments to the original text.[52]

Their purpose is to give a commentary on the provisions of the agreement and their modifications. Such *Instructions* are not published in the *Journal Officiel* and they are not binding, but they provide useful information as regards the application of a convention. Sometimes, the *Instruction* only paraphrases the text of the convention, but more often, it explains and develops an article and examines it in the context of the French tax system. It emphasises specific aspects; for instance, for the first time in a tax convention entered into by France, the territorial scope extends to the seabed (*plateau continental*).[53] It examines the provisions of the agreement in an order which

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51. *Bulletin Officiel de la Direction Générale des Impôts (hereinafter cited as BODGI)*, 14 April 1970, 14B-1-70.

52. BODGI, 5 August 1971, 14B-4-71; 23 March 1974, 14B-4-74.

53. *Instruction* of 1970, §222.

helps clarifying certain issues.

The UK tax administration has not issued a comprehensive analysis of the UK/F agreement comparable to the French Instructions, but a form, "Form FRA", written in English and in French, contains notes which, as specified at the end of the document, do not have binding force but are offered as general guidance. Further information may be obtained from the Inspector of Foreign Dividends.

In addition, Explanatory Notes in both languages provide information as regards the different claims under the provisions of the agreement.

§2. Role of the OECD Commentaries

The text of the 1968 UK/F double taxation agreement is based on the 1963 OECD Draft Convention and certain provisions of the latter are transcribed word for word in the UK/F agreement. A new Model double taxation convention was released in 1977 by the OECD; the Committee on Fiscal Affairs considers that existing conventions

> should, as far as possible, be interpreted in the spirit of the new Commentaries even though the provisions of existing conventions do not yet contain the more precise wording of the 1977 Model Convention. [54]

The 1968 UK/F convention alone constitutes a legally binding instrument between the United Kingdom and France but, as with the Instructions and Explanatory Notes,

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54. OECD Presentation of the 1977 Model, §30, at p. 15.

the commentaries may be of assistance in the interpretation of the convention.

Observations on the commentaries have sometimes been inserted at the request of the UK or France when they were unable to concur in the interpretation given in the commentary on the article concerned; these should also be taken into account.

§3. Preparatory Work (*travaux préparatoires*)[55]

As to the use of *travaux préparatoires* in the interpretation of international treaties in general, the position of the judiciary in the United Kingdom is again stated in *Fothergill* v. *Monarch Airlines Ltd*.[56]

The following statements are to be read against the background of another recent case, *Davis* v. *Johnson*,[57] dealing - *inter alia* - with the interpretation of domestic legislation.

Travaux préparatoires and domestic law

The proceedings in Parliament during the passage of a bill may not be resorted to for the purpose of interpreting a provision. "Hansard can never form part of the

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55. The text of art. 32 of the Vienna Convention on the Law of Treaties, dealing with this particular point is printed above, on p.66.

56. (1981) AC, p. 251.

57. *Davis* v. *Johnson* (1979) AC, p. 264; (1978), WLR, p. 553.

'travaux préparatoires' of any Act of Parliament, whether it deals with purely domestic legislation or not".[58]

A report of some official commission or committee that has been laid before Parliament in relation to an Act may be looked at "for the limited purpose of identifying the 'mischief' that the Act was intended to remedy and for such assistance as is derivable from this knowledge in giving the right purposive construction to the Act".[59]

Travaux préparatoires and international treaties

Their Lordships, in the Fothergill case had regard to the practice of courts abroad and to the method they followed in interpreting international conventions.

France is at the centre of their survey. Reference is made to a decision of the Cour de Cassation sitting in Assemblée Plémière, Consorts Lorans v. Air France of 11 January 1977.[60]

The conclusion of the Avocat Général, M.R. Schmelck, are quoted at length, rather than the text of the decision itself.

It may seem strange to see an English court discussing the methods of interpretation of treaties by

58. Fothergill decision, per Lord Diplock, at p. 281B. For a report on the refusal by courts in the UK to consult Hansard, see 44.45.46 Taxes International, June-August 1983.

59. Ibid., C, D.

60. Revue Française de Droit Aérien, Vol. 31-32, p. 268.

French courts when it was stated earlier that French courts do not deal with interpretation of international treaties. A short explanation of this apparent contradiction seems necessary.

Contrary to the attitude of the Conseil d'Etat, the Cour de Cassation considers that it is empowered to interpret a provision of an international treaty when it involves private matters, but not when questions of public international law arise.[61]

To come back to the position in the UK, Lord Wilberforce in the Fothergill case concludes that the use of travaux préparatoires in the interpretation of treaties should be cautious in the UK. Two conditions are to be fulfilled before travaux préparatoires can be used:

- the material is to be public and accessible,
- the travaux préparatoires are to point "clearly and indisputably to a definitive legislative intention".[62]

Lord Diplock goes further than other Lordships in the same Fothergill decision. He states: "I think an English court might well be under a constitutional obligation to do so" (i.e. to make use of the travaux préparatoires for the purposes of interpretation of a treaty provision).

Lord Diplock justifies this statement on the following ground: the UK has ratified the Vienna Convention on the Law of Treaties; it has undertaken an

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61. See above, Section 2.I.B.

62. (1981) AC, p. 251, at p. 278B.

international obligation to interpret future treaties in accordance with it.[63]

In relation to tax treaties, negotiations are never made public. It seems inappropriate therefore to talk about _travaux préparatoires_ in relation to tax treaties unless one is prepared to admit OECD commentaries to qualify as _travaux préparatoires_.

Problems which may arise in relation to the language of a convention are solved by a provision of the UK/F double taxation agreement itself.[64]

Preceding immediately the signature of the text of the convention, it is indicated that both French and English texts are to be regarded as authentic in the following terms:

> Done in duplicate at London, this 22nd day of May 1968 in the English and French languages, both texts being equally authoritative. (_Fait à Londres, le 22 May 1968, en double exemplaire en langue française et anglaise, les deux textes faisant également foi._)

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63. _Ibid_., at p. 283C.

64. Problems of language in treaties are also developed in the _Fothergill_ decision.

CHAPTER 4

PERSONAL SCOPE

Section 1: Absence of a Specific Provision on Personal Scope in the UK/F Agreement

The purpose of the present chapter is to try and answer the following question: to whom does the UK/F tax convention apply?

The UK/F tax convention does not state *in extenso* that it applies to residents.

However, by reading articles it seems that the convention applies to residents because they are referred to in the text of articles. This statement is confirmed by the *Instruction* issued by the French tax authorities in 1970.[1]

The application of the convention to residents is subject to an exception formulated in art. 25 dealing with non-discrimination. The scope of that particular provision is extended to all nationals of each contracting state, whether or not they be resident of one of them.[2]

In the 1977 OECD Model Convention, art. 26 on exchange of information states: "The article on exchange

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1. *Instruction* of 14 April 1970, BODGI 14-1-70, §221-1.

2. 1977 OECD Model, commentary on art. 24 dealing with non-discrimination, §12, p. 162.

of information is not restricted by art. 1" (art. 1 of the 1977 Model deals with personal scope). Such provision was not included in the 1963 Draft convention, nor in the 1968 UK/F agreement.

One may wonder if this article, art. 26 of the 1977 OECD Model, could constitute a further exception to the fact that the UK/F agreement applies to residents. The answer may be thought to be in the affirmative considering that the OECD committee recommended in the presentation of the 1977 Model that "existing conventions should be interpreted in the spirit of the new commentaries".

Residents to which the UK/F convention applies are defined in art. 3(1) of that convention: for its purposes, the term "resident of the United Kingdom" (_résident du Royaume-Uni_) and "resident of France" (_résident de France_) mean respectively any person (_toute personne_) who is resident in the United Kingdom (_résident du Royaume-Uni_) for the purposes of United Kingdom tax and any person who is resident in France for the purposes of French tax.

The definition of resident consists in a _renvoi_ to the respective domestic legislations; it is only in case of conflict between the definitions given by the two national legal systems, _i.e._ when both claim that a person is resident in their country for tax purposes, that the convention provides a solution.[3] Ultimately, the question

3. On the particular problem of residence of companies, see Part I, Chapter 2.

may be settled through the mutual agreement procedure.[4]

A resident of the United Kingdom, for instance, is defined as a person who is resident in the UK for the purposes of UK tax.[5]

The expression "person" is defined in art. 2(1)(f) of the convention; it comprises an individual, a company and any other body of persons (_tous autres groupements de personnes_).

The use of the word "individual" does not seem to give rise to particular difficulties; but the use of the term "company" ("_société_") and "body of persons" ("_groupement de personnes_") does.

First of all, the translation into English of the word "_société_" is inaccurate, because "_sociétiés_" include both companies and partnerships.

The meaning of "company" is developed as meaning "any body corporate (_toute personne morale_) or any entity which is treated as a body corporate for tax purposes" (_considérée comme une personne morale aux fins d'imposition_).[6]

French "_sociétés en nom collectif_", for instance, may elect to be subject to corporation tax rather than income tax in the hands of each individual partner; it can therefore be treated as a body corporate for tax purposes, but it is a body corporate under French law at

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4. On the mutual agreement procedure, see Introduction, Chapter 8.

5. UK/F, art. 3(1).

6. UK/F, art. 2(1)(g).

any rate.

What does "any entity which is treated as a body corporate for tax purposes" refer to?

The scope of the expression "body of persons" is not clear. Under UK domestic law, in the Taxes Acts, "body of persons" means any body politic, corporate or collegiate, and any company, fraternity, fellowship and society of persons whether corporate or not corporate.

The translation into French of "body of persons" (groupement de personnes) does not seem to have a definite and specific legal meaning; it could designate a gathering of people in the street!

Trusts, which do not exist under French domestic law, but constitute an essential device under UK domestic law, are not referred to.[7]

Section 2: Comparison with Other Tax Conventions

§1. 1963 and 1977 OECD Conventions

There is a separate provision on personal scope

7. A trust arises where one person holds property for the benefit of another. A trust exists when a person in whom property is vested is found in equity to hold the property for the benefit of some other person. A person who creates a trust is called a settlor; a person in whom property is vested subject to a trust is called a trustee; a person entitled to benefit under a trust is called a beneficiary. Property vested in a trustee is called trust property. See, in general, K. Smith and D.J. Keenan, English Law (London: Pitman, 6th ed., 1979) at p. 166; also G.W. Keeton and L.A. Sheridan, Digest of the English Law of Trusts (Milton: Professional Books Ltd, 1979).

in both OECD Draft and Model conventions. Article 1 of the Draft is entitled "Personal Scope" and refers to "persons who are residents of one or both of the Contracting States".

§2. 1977 US Treasury Model Income Tax Treaty

Although this is totally outside the scope of the UK/F agreement, it is interesting to point out the saving clause contained in Article 1 of the above mentioned treaty. The United States reserves its right to determine the US income tax liability of US citizens, individuals or corporations as if the treaty had not come into effect. The United States tax their citizens worldwide with no exemption for residence abroad.

The United States have accordingly introduced a reservation on Article 1 of the OECD 1977 Model Convention.

§3. Other Conventions

As in the UK/F tax convention, there is no separate provision on personal scope in the United States/ Switzerland agreement; it must be determined specifically in the context of each provision.[8] The same can be said of the double taxation agreement between the United States

8. Muller, L'Imposition aux Etats-Unis des Sociétés Etrangères (Montreux: Gauguin et Laubscher, 1974).

and France of 1967, whereas the recently enacted United States/United Kingdom agreement contains a provision on personal scope.

CHAPTER 5

TAXES COVERED

Section 1: Taxes Covered by the Convention

§1. United Kingdom

I. Income Tax Including Surtax

Surtax was an excess liability to tax on those better able to pay. This double tax system (income tax and surtax) which applied to individuals was abolished and replaced in 1973 by a single tax on income. The investment income surcharge (*surcharge sur les revenus de placement*) was concurrently introduced; it is charged on investment income in excess of a sum to be determined each year in the Finance Act; it is £6250 for 1982/83, £7,100 for 1983/84.

The effect of the new system of income tax plus investment income surcharge is the same as the old system of income tax and surtax.

Basic rate of income tax (30 per cent. for the financial year 1983/84) is levied on income; if an individual's total income exceeds a certain figure, income tax will be levied at a higher rate.

The fiscal tax year for income tax purposes runs from 6 April in one year to 5 April in the following year.

Since 1979, the top marginal rates have been

reduced drastically.[1]

A long band of income is taxed at basic rate.[2] Smaller bands are taxed at higher rates.[3]

Tax shall be charged "in respect of all property, profits or gains respectively described or comprised in the schedules contained in the following sections ..."[4]

The system of schedules (cédules), still prevailing today, originates in the fact that taxpayers at first were required to make a tax return for each income of a different source. The doctrine of the source still governs the interpretation of a schedule in as much as that every piece of income must have a source.[5]

The UK tax system makes a distinction between

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1. For 1983/84, the top marginal rate is 60 per cent. for taxable income over £36,000.

2. For 1983/84, £0-14,600. The effect of this reduction in rates of tax may be summarised in the following terms: "... the tax due on the salaries of around £100,000 of the chief executives of major companies such as BP and ICI was reduced by £20,000 or £400 a week". See J.A. Kay and M.A. King, The British Tax System (Oxford: University Press, 2nd ed., 1980), Chapter 3, at p. 28.

3. For instance, for 1983/84 £14,601 - £17,200 at 40 per cent.

4. ICTA 1970, s.1. For a sketchy historical background to the taxation laws in the United Kingdom, see Hubert Monroe, Intolerable Inquisition? Reflections on the Law of Tax (London: Stevens & Sons, 1981) Chapter 1, pp. 1-21. For an interesting document on budgetary reform in the UK, see the Report of a Committee chaired by Lord Armstrong of Sanderstead, Budgetary Reform in the United Kingdom (Oxford: University Press, 1980), carried out for the Institute of Fiscal Studies.

5. Brown v. National Provident Institution (1921) AC, p. 222.

earned income and investment income and taxes the latter more heavily. Where an individual has investment income of over a certain sum,[6] an additional rate known as investment income surcharge of 15 per cent. is charged on the excess.

There is no statutory definition of income, beyond the statement that income is taxable if it falls within one or other of the Schedules of the Taxes Act 1970.[7]

Income tax is one,[8] each schedule has not only its own rules for computation of income but also different dates for payment. There is no general rule that income and losses under each Schedule are aggregated so enabling a loss under one Schedule to be set off against a profit under another.[9]

Unless a particular receipt comes within one or other of the schedules, it is not taxable income.[10] Although Schedule D Case VI is a residuary case to catch receipts not caught by the other schedules and cases, and

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6. FA 1983, £7,100.

7. ICTA 1970, s.1.

8. London City Council v. Attorney General (1901) AC, p. 26; the classic statement on this point may be found on pp. 35-36.

9. J. Tiley, Revenue Law (London: Butterworths, 3rd ed., 1981), p. 42.

10. Ibid., p. 46.

the schedules include the wide phrase "annual profits", the courts have construed that phrase in a narrow way - profits are only income if they possess a quality of recurrence.[11]

The essential characteristics of the different schedules will be outlined here.

Schedule A

Income tax under schedule A is charged on income from rents and other forms of income from land. Those include rent charges, ground rents for instance. The rents chargeable are those which arise from leases of land in the UK.[12]

Rents from furnished lettings are not taxed under schedule A, but schedule D case VI.

The basis of assessment is the actual income receivable less allowable expenses paid.

Allowable expenses include for instance maintenance, repairs, but not improvements, services provided by the landlord.[13]

Schedule B

Income tax under schedule B is charged in respect of the occupation of woodlands in the UK managed on a commercial basis with a view to the realisation of profits.

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11. Moss' Empires Ltd v. IRC (1937) AC, p. 785, 21 TC, p. 264.
12. ICTA 1970, s. 67.
13. Ibid., s. 72.

Tax is payable on one third of the annual value of the land for the year.[14]

Schedule C

Tax is charged under schedule C in respect of profits arising from public revenue dividends payable in the UK.[15]

Schedule D

Schedule D taxes annual profits or gains which fall into one or other of its six cases.[16]

- Case I taxes profits or gains arising from any trade.
- Case II taxes profits or gains arising from a profession or vocation.

The rules relating to both Cases I and II are very similar; they will be examined together.

- <u>What is a trade?</u>

A trade is defined in the following terms: "trade includes every trade, manufacture, adventure or concern in the nature of trade".[17] The question whether there is a trade, as defined, is one of fact.

Difficulties on the interpretation to be given

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14. *Ibid.*, s. 92. The annual value is the rent that would be obtained if the land was let.

15. *Ibid.*, s. 93.

16. ICTA 1970, Part VI, s. 108.

17. *Ibid.*, s. 526(5).

to this sentence arose, in particular, in relation to "adventure or concern in the nature of a trade", as it seems to regard a single transaction as a trading transaction.

The 1955 Royal Commission on the Taxation of Profits and Income[18] outlined six factors, the badges of trade, to determine whether or not a single transaction was a trading transaction.[19] Numerous decisions of the courts have contributed to a better understanding of the meaning and scope of the badges of trade.[20]

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18. Royal Commission on the Taxation of Profits and Income (1955), Final Report Cmnd. 9474; for a general appraisal, Arthur Johnstone, "Twenty-five Years on From the Royal Commission", BTR (1980), pp. 294-303.

19. Badges of trade include the subject matter of the transaction, the length of ownership, the frequency of similar transactions, the circumstances responsible for the realisation, supplementary work or in connection with the property realised and the motive.

20. See in particular Martin v. Lowry (1927) AC, p. 312 single purchase of 44 million yards of aeroplane linen; disposal through a selling organisation over 12 months. The operation was held to constitute trading although it was a single transaction. Cape Brandy Syndicate v. IRC (1921) 2 KB, p. 403, where South African Brandy was acquired for blending and resale in the UK by three persons who happened to be members of certain firms engaged in the wine trade. The taxpayer was held assessable on the profits of the adventure in the nature of trade. Turner v. Last (1965) 42 TC, p. 417: a quick sale invites a scrutiny of the evidence to see whether the acquisition was with that intent. Leach v. Pogson (1962), 40 TC, p. 585: the taxpayer had set up a driving school in early 1954; the business was incorporated. In December 1955 he transferred it to a newly formed company in return for cash and shares. He subsequently started other schools which he likewise transferred to companies. It was agreed that he was liable to income tax on the profits from the subsequent transactions but the taxpayer argued that he was not liable in respect of the profit on the first. It was held that he was so liable and that the subsequent transactions could be used to support that

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- The basis of assessing profits

"The normal basis of assessment is the preceding year basis: the income is taxed by reference to the income from the source during the preceding year; in each year of assessment, "the assessment is based on the profits of the accounting period ending in the preceding year of assessment".[21] For instance, a trader who prepares yearly accounts to 31 December each year will be assessed in 1983-1984 on the profits of the year ended 31 December 1983.[22]

- Computation of the profits of a trade

The fundamental distinction between income and capital is to be introduced here as income receipts and expenditure only will be taken into account for the determination of the profits of a trade.

Income is not defined by the Taxes Act and the courts have had to fill in the lacuna.

Footnote 20 continued from page 91.

conclusion. IRC v. Livingston (1927) 11 TC, p. 538; the taxpayer, a ship repairer, together with a blacksmith and a fish salesman's employee, purchased a cargo vessel which they converted into a steam drifter and then sold without themselves using it for fishing. The alterations took nearly four months and were carried out by two of the three for wages. The Court of Session held that the profit was taxable.

21. Pinson, Revenue Law (London: Sweet & Maxwell, 14th ed., 1981), 2-79, p. 62.

22. Rules for opening, closing years and changes in ownership are respectively described in ICTA 1970, ss. 115-117, 118 and 154.

The courts have struggled to try and make a clear dividing line to separate income and capital. There is no single infallible test.[23]

An element is brought in as soon as it is earned, deducted as soon as the liability arises. This is referred to as the arising basis, as opposed to the cash basis where a recepit is only brought in when it is received. No sum is to be deducted unless it is "wholly and exclusively laid out or expended for the purposes of the trade,

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23. For instance, on the receipt side compare Van der Berghs v. Clark (1935) AC, p. 431, and Sabine v. Lookers (1958) 38 TC, p. 120. In the first case, the appellant company entered into an agreement with a competing Dutch company in 1912. The agreement provided - inter alia - for the sharing of profits, the bringing in of any other margarine concerns they might acquire. It was intended to last until 1926 but the outbreak of the war upset the arrangement and the Dutch company agreed in 1927 to pay the appellant company £450,000 for cancellation of the agreement. The House of Lords held that the sum was paid for loss of future rights under the agreement which was a capital asset and therefore was a capital receipt. In Sabine v. Lookers, the taxpayers held the main distributorship for the Austin motor company in the Manchester area; they were not allowed to enter into any agreement with any other manufacturer. Sums paid for variation of that contract were held capital receipts. On the expenditure side, Regent Oil Company Ltd v. Strick (1965) 3 WLR, p. 636; B.P. Australia Ltd v. Australian Commissioner of Taxation (1965) 3 WLR, p. 608. The Regent Oil Company Ltd decision was a decision of the House of Lords; B.P. Australia Ltd, a decision of the Privy Council. Although the members of the courts in these two decisions were identical, although both decisions were given on the same day and involved payments made by petrol companies to retailers for an exclusivity tie, the House of Lords held the payments to be of a capital nature while the Privy Council came to the opposite conclusion. For an excellent analysis of these last two cases, see P.G. Whiteman, "The Borderline between Capital and Income" BTR (1966), pp. 115-122. For a more general recent article, see D. Davies, Capital Revenue Expenditure, LQR (1980), p. 351.

profession or vocation".[24]

The very important case of Sharkey v. Wernher[25] relates to the problem where a trader disposes of some part of his trading stock other than in the course of his trade.

In this particular case, which states the rule to be applied in general, the wife of the respondent ran a stud farm. The profits of the stud farm were chargeable under schedule D case I. She also ran horse racing and training activities, which were agreed not to constitute trading. She transferred five horses from the stud farm to the racing stables. The issue revolves round the question of the sum to be credited as a receipt. The

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24. ICTA 1970, s. 130 gives a long enumeration of disallowed expenditures. Illustrative cases: Bowden v. Russell & Russell (1965) 1 WLR, p. 711: the sole partner of a firm of solicitors attended meetings of the American Bar Association in Washington. He went in an unofficial capacity, was accompanied by his wife. No claim was made in respect of expenses attributable to her. He admitted that this was a holiday but argued that his attendance was in order to acquire new clients and maintain the firm's efficiency; the Revenue refused the deduction and won. On the other hand, in Edwards v. Warmsley Hensall & Co (1968) 1 All ER, p. 1089, a partner in a firm of accountants went to represent the firm at a congress in New York. There was no evidence of any other purpose; the expenses were held deductible. In Morgan v. Tate & Lyle (1955) AC, p. 21, the company successfully claimed to be entitled to deduct expenses incurred in a publicity campaign to defeat the proposed nationalisation of the company.

25. (1956) AC, p. 58; 36 TC, p. 275. For further details, see Whiteman and Wheatcroft on Income Tax (London: Sweet & Maxwell, 2nd ed., 1980); also an article by Sheppard, "Taxation of Imputed Income and the Rule in Sharkey v. Wernher", Canadian Bar Review, December 1973, p. 617.

House of Lords held that the market value should be credited in the accounts.[26]

In Mason v. Innes[27] the author Hammond Innes had written a book called The Doomed Oasis. Shortly before completing the manuscript, he assigned the copyright to his father by way of gift. The Revenue assessed the author on the estimated value of the rights in the book as if it were the author's income, and contended unsuccessfully that the rule in Sharkey v. Wernher applied to a gift by an author of his rights in an unpublished novel. The Court of Appeal rejected that contention: the proposition in Sharkey v. Wernher is confined to the cases of traders who keep stock in trade and does not extend to professional men.

Schedule D Case III taxes interest, annuities and other annual payments together with discounts and those dividends from public revenue.

Schedule D Case IV taxes the profits or gains arising from securities outside the United Kingdom.

Schedule D Case V taxes the profits or gains

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26. Petrotim Securities Ltd v. Ayres (1964) 1 All ER, p. 269. This decision extended the rule in Sharkey v. Wernher to the case where the trader gives away part of his stock in trade.

27. (1967) 2 All ER, p. 926; for a commentary, see (1967) 3 TR, pp. 76-80 and 209-214.

arising from possessions out of the United Kingdom.

Case VI taxes any annual profits or gains not falling under any other case or Schedule. Although the scope of this Case appears at first very wide, the courts have reduced it quite noticeably.[28]

Generally the tax under Schedule D is due on a preceding year basis with special rules for opening and closing years; but for Case VI, it is due on a current year basis. The tax is due on 1 January, but for Cases I and II, it is payable in two equal instalments, one on 1 January and the other on 1 July.[29]

Schedule E[30]

ICTA 1970, s. 181 states:

> Tax under this Schedule shall be charged in respect of any office or employment on emoluments therefrom which fall under one, or more than one ... cases.

Schedule E has three cases according to the location of the employment. The tax is due on a current year basis and is usually collected by PAYE (Pay As You Earn).

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28. Leeming v. Jones (1930) 1 KB, p. 279; profits are only income if they possess a quality of recurrence.

29. ICTA 1970, s. 4(2). This paragraph constitutes only a very broad and general presentation of the UK tax system. Schedules and Cases will be examined in detail when relevant in subsequent chapters.

30. ICTA 1970, Part VIII, ss. 181-207.

- Definition of office or employment

As far as employment is concerned, the distinction is between a contract of service and a contract for services. An individual working under a contract of service is an employee, one working under a contract for services is self-employed.[31]

An office is described as denoting a permanent position which has an existence independent of the person who holds it.[32]

The expression "emoluments" includes all salaries, fees, wages, perquisites and profits of any sort. It includes not only money, but anything representing money's worth. For a gift or gratuitous payment to be deductible under Schedule E, the employee must have received it in his personal capacity, and not in his capacity as an employee.[33]

Expenditures are deductible under Schedule E only when they are incurred wholly, exclusively and necessarily in the performance of the employment.[34]

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31. Winfield v. London Philharmonic Orchestra Ltd (1979) Industrial Cases Report, p. 726; Addisson v. London Philharmonic Orchestra Ltd (The Times, 20 October 1980); There is an interesting short article on this problem in the Industrial Law Journal (1981), pp. 124-128.

32. In Edwards v. Clinch (1979) STC, p. 148, a person appointed to act as an inspector at a public inquiry did not hold an office since the post had no existence independent of him; there was neither continuity nor permanence.

33. ICTA 1970, s. 183(1).

34. In Hochstrasser v. Mayes (1959) Ch, p. 22, at p. 33, Upjohn said: "the payment must be made in reference to the services the employee renders by virtue of his office and it must be something in the nature of a
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When compared to the relief provisions under schedule D, the sole addition of the word "necessarily" makes the rules under schedule E more stringent.[35]

There is no specific schedule dealing with directors and highly remunerated employees, but various provisions are scattered in the Finance Acts.[36]

Schedule F

Schedule F[37] taxes distributions by companies resident in the UK; the tax is due on the dividends of the year of assessment and is in effect deducted at source.

- Total income

Total income means the total income of an individual from all sources.[38]

Taxable income is total income minus reliefs deductible from total income, i.e. personal reliefs. They take into consideration the personal circumstances of

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Footnote 34 continued from page 97.

reward for services past, present or future. In Laidler v. Perry (1966) Lord Reid expressed doubts on the use of the word "reward", and the House of Lords has followed him in subsequent decisions. See Tiley, op.cit., note 9 above, p. 114.

35. Simpson v. Tate (1925) 2 KB, p. 214. S. 192 allows the deduction from emoluments of subscriptions to certain professional bodies.

36. For instance, Finance Act 1976, ss. 60-69.

37. ICTA 1970, s. 232.

38. It is estimated in accordance with ICTA 1970, s. 528.

individual taxpayers.

In the UK, the taxable unit is normally husband and wife, but wives may elect to be taxed separately in respect of earned income as opposed to investment income.[39]

The UK system allows a married man to deduct a larger amount by way of personal relief if his wife is living with him, but gives no deduction for children. The general rule is that a woman's income is deemed for income tax purposes to be her husband's so far as it relates to a year of assessment at the beginning of which she is married to and living with her husband.

This is subject to the possibility for the wife to make a wife's earning election.[40]

II. Corporation Tax[41]

Corporation tax was first introduced in the United Kingdom in 1965. It applies to "companies" which for this purpose are defined as all bodies corporate or unincorporate associations, but the definition of a company excludes partnerships.[42]

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39. FA 1971, s. 23 as amended by FA 1976, s. 36.

40. For a possible reform, Green Paper - Taxation of Husband and Wife, November 1980.

41. ICTA 1970, ss. 303-328. On the prospective of changes, see The Green Paper on Corporation Tax, Cmnd. 8456 (London: HMSO, December 1981). For a review, Taxation Practitioner, March 1982, pp. 67-69; Taxation, 16 January 1982, pp. 436-438. For a historical development, R. White "The Changing Faced Taxation - Corportation Tax, BTR (1981), No. 6, pp. 349-360.

42. Ibid., s. 526(5); Conservative Central Office v.
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The corporation tax system taxes the profits (bénéfices) of a company, i.e. its income (revenus) and chargeable gains (plus values imposables), the latter being subject to an effective tax rate of 30 per cent. (only 15/26ths of the net gains are included in the company total profits).[43]

For corporation tax purposes a fiscal year is called a financial year; it runs from 1 April until 31 March.[44]

Assessment to corporation tax is made by reference to an accounting period (exercice comptable) which may or may not coincide with the financial year.[45] The rate of corporation tax is always fixed in arrears in the Budget. It has been 52 per cent. since 1973. A special rate of 40 per cent., reduced to 38 per cent. for the financial year 1983/84, applies to small companies. For 1983/84 the small companies rate applies to companies whose profits do not exceed £100,000, with marginal relief if profits do not exceed £500,000.[46]

Until 1973, companies paid tax according to a

Footnote 42 continued from page 99.

Burrell (1980) STC, p. 410; this case inter alia provides for a rather complete definition of an unincorporate association.

43. FA 1972, s. 93.

44. ICTA 1970, s. 238(1).

45. Ibid., ss. 243(3) and 527(1).

46. Finance Act 1983. The word "small" relates to the profits of a company, not to its assets.

a system referred to as the classical system: the company paid tax on its profits and the shareholder who received a dividend paid an income tax on it. This system contained an element of economic double taxation.[47]

The effect of the classical system was said to discourage the payment of dividends: where the company retained profits, the total tax burden was comparatively lower than when it paid out all of its net profits. The classical system has been replaced by the imputation system in April 1973.[48]

The main characteristics of the new system may be summarised as follows:

- A resident company[49] is liable to corporation tax on its worldwide profits at a rate of 52 per cent. Corporation tax applies to all profits, whether distributed in the form of dividends or not.
- When it distributes a dividend, a UK resident company pays the Inland Revenue Advance Corporation Tax (ACT, Acompte sur l'impôt sur les sociétés) equal to 3/7th of the distributed dividend. The ACT is the counterpart of

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47. See S.N. Frommel, "L'Impôt sur les Sociétés et la Distribution de Dividendes au Royaume-Uni" (Paris: Jurisprudence Générale Dalloz, 1974) No. 1; also, by the same author, "Réflexions sur les Conséquences du Remboursement du Crédit d'Impôt Britannique aux Actionnaires Américains", Réflexions offertes à Paul Sibille (Bruxelles: Bruylant, 1981).

48. ICTA 1970, s. 238. The imputation system will only be outlined here and dealt with in more detail under Part I, Chapter 5.

49. The problem of residence of companies is treated under Part I, Chapter 2.

the tax credit (_crédit d'impôt_) granted to the shareholder: it amounts to 30 per cent. of the dividend grossed up (_majoré_).

The ACT is set off against the corporation tax liability. The difference represents the mainstream corporation tax (MCT, _complément d'impôt_), which remains to be paid by the company to the Inland Revenue.

- The ACT cannot be set off against corporation tax on chargeable gains. The income of a company is computed according to income tax rules;[50] the chargeable gains are computed according to capital gains tax rules.[51]
- The tax credit will be deducted from the income tax liability of the shareholder and he may receive a refund if the tax credit represents more than his tax liability. A shareholder who is liable to tax at the basic rate (_taux de base_, 30 per cent. for the financial year 1983-84) of income tax, has no further tax to pay.

Charges on income may be deducted from the total profits of a company once they have been ascertained.[52]

A trade loss can be offset against any other income. Furthermore, in the case of a company, a trading loss can be offset against any other income and chargeable gains; a loss may be offset against profits of the current accounting period and the preceding one.[53]

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50. ICTA 1970, ss. 129-250-251.
51. _Ibid._, s. 265.
52. ICTA 1970, ss. 248, 177(8), 304(2), 269.
53. _Ibid._, s. 177.

III. Capital Gains Tax (impôt sur les plus values en capital)

The capital gains tax in its present form was first introduced in 1965.

The 1979 Capital Gains Tax Act (herinafter cited as CGTA 1979) is a consolidating act, not a codifying one.

Capital gains tax (CGT) is charged on chargeable gains accruing to, that is realised by, a person, other than a company, during a year of assessment. As a matter of fact CGT applies to both individuals and companies: in the case of companies, it is not called capital gains tax but corporation tax. The charge to corporation tax on capital gains is made at a lower rate than the rate of corporation tax, in fact, a rate equal to that of capital gains tax. Chargeable gains accrue only on chargeable disposals of assets. All forms of property are assets whether situated in the UK or not.[54] Property is not further defined in the statute.

The concept of disposal is not defined in the statute either. It has been suggested that any form of transfer or alienation of the beneficial title to an asset from one person to another involves a disposal by the one and an acquisition by the other.

Generally speaking, capital gains tax is charged on chargeable gains accruing to a person in a year of

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54. CGTA 1979, s. 19(1).

assessment during any part of which he is resident in the UK, or during which he is ordinarily resident in the UK.[55]

The rate for capital gains tax has remained static since 1965 at 30 per cent. For the fiscal year 1983/84 there is a £5,300 annual exemption for gains accruing to individuals. Only one relief is given to husband and wife living together.

§2. France

I. Income Tax on the Income of Individuals

This particular tax is referred to in French as *impôt sur le revenu des personnes physiques*, abbreviated as IRPP.

Article 1 of the General Tax Code (*Code Général des Impôts*, CGI) defines the tax on income (*impôt sur le revenu*) as a single annual tax on the income of individuals.[56]

Who is chargeable to income tax?

Under French law, in the absence of a tax treaty

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55. *Ibid.*, s. 2.

56. The *impôt sur le revenu des personnes physiques* is dealt with under CGI, Book 1, Part 1, Title 1, Chapter 1; in other words, from article 1 to article 204 of the General Tax Code. In relation to this particular tax, see in general L. Halpern, *Taxes in France* (London: Butterworths 3rd ed., 1980) Chapter 3, pp. 57-83; also World Tax Series Harvard Law School, *Taxation in France* (Chicago: Commerce Clearing House Inc., 1966) pp. 98-117; Francis Lefebvre, *Les Impôts en France* (Paris: Editions Francis Lefebvre, 11th ed., 1981-82) pp. 129-191; *Ministère du Budget, Direction Générale des Impôts, Précis de Fiscalité* I *1980* (hereinafter cited as DGI I) pp. 15-375.

individuals are liable to income tax who have their tax domicile (*domicile fiscal*) in France, and those who are not domiciled in France for tax purposes but have income arising there (*revenus de source française*).[57]

Article 4B and 4 *bis* of the General Tax Code provide for a definition of *domicile fiscal*. Its scope has been expanded by a statute of 29 December 1976[58] applicable as from 1 January 1977.

The present definition may be summarised as follows:

Individuals who have in France their permanent home (*foyer*) or their main place of abode (*lieu de séjour principal*) will be considered as having their *domicile fiscal* in France. A person who carries on a professional activity in France whether a wage earner or not, unless he can prove this activity to be ancillary (*activité exercée à titre accessoire*) is also deemed to have his *domicile fiscal* in France.

An individual having the centre of his economic interests (*centre des intérêts économiques*) in France is to be considered to have his *domicile fiscal* there. Individuals are also liable to income tax, whether or not they have their *domicile fiscal* in France when a particular income they receive is taxable in France under a double taxation agreement.[59]

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57. CGI, art. 4A.

58. Law No. 76-1234 of 26 December 1976.

59. CGI, art. 4 *bis* 2°.

For the purpose of income taxation, the family is regarded as an economic unit in France. Each head of a household (chef de famille) is liable to income tax for his personal earnings, those of his spouse and dependent children (enfants à charge).[60] This is often referred to as the règle de l'imposition par foyer (rule of household taxation). The concept of chef de famille has been eliminated. Both spouses have to sign the income tax return, although the taxable unit remains the foyer. Tax will be charged in the name of either spouse. The children's income may be assessed separately under specific circumstances.[61] A married woman can be assessed separately if she is separated from her husband and does not live with him, or when she is authorised to live apart whilst not yet divorced.[62]

The calculation of income tax follows the system of family parts (système du quotient familial).

The family net income[63] is divided into a number of parts.[64] The number of parts (quotient familial) is a factor of the number of members of the family. For instance:

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60. CGI, art. 6(1).

61. CGI, arts. 6(2) and 2 bis, 196, 196A.

62. CGI, art. 6(3).

63. For its determination, see below.

64. CGI, arts. 194 and 195.

	Number of parts
Unmarried woman, divorced or widowed person	1
Married couple without children	2
Married couple with one dependent child	2½
Married couple with three dependent children	3½

The result of the operation gives the taxable amount for one part (<u>montant du revenu imposable correspondant à une part</u>).

A scale (<u>barême</u>) is established each year by the Finance Law (<u>Loi de Finance</u>).

The scale establishes <u>tranches</u> (slices of income) and determines the rate of tax to be applied to each <u>tranche</u> of the taxable amount. A certain percentage, ranging from 0 to 60 per cent., applies to each <u>tranche</u>. The 1983 Finance law has introduced a higher rate of 65 per cent. for taxable income of a <u>tranche</u> over 195,000 Francs.

Subsequently, the amount of tax arrived at is multiplied by the number of family parts.

The family income - including that of the children - is first aggregated whether it comes from spouse or child and is then divided according to the number of people in the family, a child counting as a half save for single parent families, where the first child counts as a whole. A married couple with two children would have their income divided into three parts. The general rates of tax are then applied to each part separately and the tax due is the aggregate.

For 1981 income and for subsequent years, the reduction in tax resulting from the system of family parts

will be limited to 7,500 Francs for each one-half share in addition to the one share for single persons and two shares for a married couple.[65]

No indexation of the 7,500 Francs is provided for in the law.

The 1983 Finance Law raises this ceiling to 8,450 Francs.[66]

The year of assessment coincides with the calendar year. The income of a calendar year is taxed in that same year.[67] 1981 income is taxable in 1981, but in fact the liability is generally assessed and the tax collected the following year, having had regard to the tax form filled in by the taxpayer at the beginning of 1982. A tax form has to be returned by 1 March each year.[68]

There is no statutory definition of the word income, but it is underlined by the idea of recurrence.

However, the definition of income does not always follow this idea. For instance, the statute of 5 July 1978 introduced the taxation of net capital gains of individuals on disposal of shares or debentures (_imposition des gains nets en capital réalisés à l'occasion de cessions à titre onéreux de valeurs mobilières et de droits sociaux_). There is no element of recurrence in this

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65. Finance Law for 1982, art. 12.V.1. For a commentary, see European Taxation (1982), pp. 123-127.

66. 1983 Finance Law, No. 82-1126 of 29.12.1982, _Semaine Juridique, Edition Commerce et Industrie_ (hereinafter cited as JCP ed CI) No. 2, 13 January 1983, 11196; also _Journal Officiel_ of 30 December 1982, p. 3923.

67. CGI, art. 12.

68. CGI, art. 175.

particular income.[69]

In the case of individuals, the IRPP applies on a worldwide basis to income from all sources, foreign and domestic.[70] France does not grant a credit for foreign taxes. When an individual domiciled in France receives income from abroad, such income will be taxable in France, but from the taxable base will be deducted the various sums paid as taxes on that income abroad. For instance an individual domiciled in France receives a foreign income of 100. In its country of source, the income was subject to different taxes, the total of which amounts to 34; the taxable base of the income will be 66 (100 - 34).[71]

It is possible for certain categories of income to be assessed on a notional basis (régime du forfait, régime forfaitaire). Such a basis of assessment cannot be used when the taxpayer's turnover (chiffre d'affaires) exceeds limits laid down in Finance Acts.

A taxpayer may elect for the assessment on an actual basis.

One distinguishes between the normal actual basis of assessment (bénéfice réel) and the simplified

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69. Statute of 5 July 1978. It abolished the system of taxation of capital gains (plus values) introduced by a Statute of 19 July 1976. The statute of 5 July 1978 becomes applicable as from 1 January 1979. For details, see DGI I op.cit., note 56 above, p. 104.

70. Reform of 1959, Law No. 59-1472 of 28 December 1959, art. 14.

71. CDFI 1981, Berlin Volume LXV 1b, French Report, at p. 340.

actual basis of assessment (*bénéfice réel simplifié*). The latter applies compulsorily to taxpayers whose turnover is above the limit set for the notional basis but does not exceed twice that amount. The simplified actual basis is optional for taxpayers who would otherwise be assessed on the notional basis.[72]

The different categories of income

Each category of taxable income is determined according to different rules which will be outlined here.

- Income from real property (*revenu foncier*)

It is dealt in the General Tax Code under arts. 14 - 33 *quater*.[73] It basically includes rents from land and buildings, rents from furnished lettings, profits or gains from mines and quarries.

If the property is devoted to an industrial, commercial, agricultural use, or if it is used in connection with a non-commercial activity (such as that of a lawyer or a dentist) it will not be classified as income from real property but included in the computation of the connected activity. The costs of repair and maintenance, the cost of management and taxes (land taxes for instance, *contributions foncières*), and interest paid with respect

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72. For a study of the advantages and drawbacks of the various methods of assessment, see L. Halpern, *op. cit.*, note 56 above, §§1690 *et seq*.

73. DGI I, *op.cit.*, note 56 above, §§200-242.

to the property may be deducted. An additional notional deduction (15 per cent. for agricultural properties, 20 per cent for urban properties) is allowed to represent any further management expenses (frais de gestion) and depreciation (amortissement).

In case of a loss, it can only be deducted from another income of the same category, but it may be carried forward for five years.

- Remunerations allocated to managers and members of certain companies and partnerships (rémunérations allouées aux gérants et aux associés de certaines sociétés)[74]

This category of income is dealt with under art. 62 of the General Tax Code. It is treated as a separate category of income.

This provision applies to remunerations paid to:

. Managers holding a majority of shares in limited liability companies subject to corporation tax (gérants majoritaires de sociétés à responsabilité limitée soumis au régime des sociétés de capitaux).

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74. There is only one word in French for company and partnership, société. For a complete classification of companies and partnerships under French law, see below, Part I, Chapter 1. The manager (gérant) of a société à responsabilité limitée (SARL, limited liability company) is said to be a gérant majoritaire when he holds a majority of the company's shares either alone or jointly with other managers. The shares of a manager's spouse or dependent children are taken into account; so will be a de facto control exercised by an individual who does not have the title of gérant. See L. Halpern, op.cit., note 56 above, p. 66.

. Managers of partnerships limited by shares (_gérants de sociétés de personnes_) general partners of limited partnerships (_commandités des sociétés en commandite simple_), members of silent partnerships when they have chosen to be assessed to corporation tax (_membres des sociétés en participation qui ont opté pour le régime fiscal des sociétés de capitaux_).

The word remuneration is to be given a very wide meaning: it includes salary (_traitements_), notional refund of expenses (_remboursement forfaitaire de frais_), whether in cash or in kind.

The remunerations dealt with under art. 62 of CGI are allowable for the determination of corporation tax (_impôt sur les sociétés_) as long as they correspond to the performance of a service (_travail effectif_) and they are not excessive.[75]

The particularity of this provision lies with the fact that remunerations are here treated differently from the wages of a manager of a share company (_dirigeant de société anonyme_) to whom the regime described under the following paragraph applies.

- Salaries, wages, pensions and life annuities (_traitements, salaires, pensions et rentes viagères_)[76]

This is dealt with under arts. 79 _et seq_. of the _Code général des impôts_.

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75. CGI, arts. 211 and 39-1-1°.

76. DGI I, _op.cit._, note 56 above, §§400-491.

An employee may choose to deduct his actual expenses (_régime des frais réels_) or he may take a standard expense deduction (_régime des déductions forfaitaires_) which amounts to 10 per cent. of his total net income.[77] The total net income is obtained after deduction of contributions to retirement funds (_retenue en vue de constitution de pensions ou de retraites_, art. 83-1°), social security payments (_cotisations aux assurances sociales_) and other social security schemes.

The 10 per cent. notional deduction has a minimum and a maximum, modified each year by the Finance Law. The respective limits of the Finance Act 1982 are 1800 F and 50,900 F. It applies to salaries received (_perçus_) in 1981.

Some employments are allowed an additional deduction which may for instance amount to 10 per cent. (miners), 25 per cent. (actors), or 30 per cent. (journalists, commercial travellers (VRP, _Voyageurs, Représentants et Placiers de commerce_)).

Broadly speaking, pensions and life annuities are taxed in the same way as employment income.

- Non commercial profits (_bénéfices des professions non commerciales_)[78]

These include profits from the exercise of a

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77. It includes benefits in kind and since 1979, it also includes sickness payments made by the social security (_sécurité sociale_) but there are exceptions; see, DGI I, _ibid._, §421, p. 206.

78. CGI, arts. 92-104A; DGI I, _op.cit._, note 56 above, §§500-592.

liberal profession (*profession libérale*) (doctors, lawyers for instance) profits from the holding of a non commercial office and from other non commercial activities which are not within the scope of other categories of income examined here. Profits arising from a regular speculative activity on a stock exchange are taxable as non commercial profits. The taxpayer here also has an option to report either the actual net income of his activity; this is described as the *régime de la déclaration controlée*. He may decide to follow the system of administrative evaluation (*régime de l'évaluation administrative*).[79]

- Income from movable property (*revenus de capitaux mobiliers*)

This basically includes income from shares (*actions* and *parts sociales*) and income from debentures (*obligations*). Income from shares may be referred to as dividends (*dividendes*), that of debentures as interests (*intérêts*).

The taxation of these categories of income, under both domestic and treaty law, will be dealt with in subsequent chapters.

- Agricultural profits (*bénéfices agricoles*)[80]

This Category of income includes all farming profits and profits of forestry.

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79. *Ibid.*, art. 95.

80. *Ibid.*, arts. 63-78.

Three regimes may be applied to the taxpayer:[81]

· Assessment on a notional basis (_régime du bénéfice forfaitaire_).[82] It applies to farmers (_exploitants agricoles_) whose annual turnover does not exceed 500,000 Frs over two consecutive years. It is established by a determination of the average income per unit of land surface of all farms of the same category. Particular circumstances are not taken into account. The income of an individual farmer is arrived at by multiplying his number of hectares of farmland by the notional average income per hectare. This figure is determined by the tax commission of the _département_, which is an administrative division of the country.

. Assessment on a simplified actual basis (_régime simplifié d'imposition d'après le bénéfice réel_).[83]

. Assessment on an actual basis (_régime normal de bénéfice réel_).[84]

- Industrial and commercial profits (_bénéfices industriels et commerciaux_)[85]

When applied in the context of income tax, the

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81. CGI, arts. 63-90; DGI I, _op.cit._, note 56 above, §§300-397, pp. 159-198.

82. CGI, arts. 64-68.

83. _Ibid._, arts. 68A-68E.

84. _Ibid._, arts. 69A-69 _quinquiès_.

85. _Ibid._, arts. 34-60; DGI I, _op.cit._, note 56 above, §§1000-1306. The rules of assessment of industrial and commercial profits described in Part 1 of DGI I are mostly applicable to companies liable to corporation tax. They will be outlined under §2 of this section.

rules of determination of industrial and commercial profits have certain particularities, inherent to the nature of French income tax:

. in certain circumstances, profits may be computed according to the régime forfaitaire (assessment on a notional basis).

. Income tax on industrial and commercial profits is assessed on a worldwide basis whereas in relation to corporation tax, the territorial principle (principe de territorialité) applies.

Determination of the net taxable income

The rules for measuring income of each category have been summarised above.

The various net incomes from all categories (revenus nets catégoriels) are then added to give the total net income (revenu net global).

From that amount may be deducted personal allowances (charges)[86] and tax reliefs (abattements).[87] The

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86. CGI, arts. 156-II, 163 bis and 238 bis. They are respectively related to the main residence (habitation principale), savings invested in shares (épargne investie en actions) and donations to charities (dons versés à des oeuvres); see also DGI I, op.cit., note 56 above, §§58-100, pp. 40-58.

87. A charge is to be distinguished from an abattement because the former has a general character, whereas the latter is a deduction consequent to a particular situation, often old age. See in particular CGI, art. 157 bis, Finance Act 1980: A taxpayer who will be 65 years of age and over on the 31 December of the year of assessment will be granted a tax relief on his income. The amount of tax relief is proportional to the income of the taxpayer.

result constitutes the net total taxable income (revenu net global imposable).

As noted before, the head of the household (chef de famille) is liable for the income tax which is established according to the system of quotient familial explained earlier.[88]

Special provisions

It is interesting to point out, as part of the general comments on the French income tax system, a few specific provisions whose effect is to render as efficient as possible the assessment and collection of income tax in that country.

- CGI, arts. 176-177-179

The tax administration may require clarification (éclaircissements) and supportive evidence (justifications) to the allegations of a taxpayer. The latter has 30 days to provide the information requested, which can be extended to two months when arts. 120-123 of the General Tax Code are at stake.[89]

The tax administration may rectify the tax return of the taxpayer in accordance with the procédure de

88. As stated earlier, the 1983 French law abolishes the concept of chef de famille; consequently both spouses are put on an equal footing with regard to the tax liability of the household.

89. See DGI I, op.cit., note 56 above, p. 105.

redressement unifiée.[90]

A stronger sanction, *taxation d'office*, may be imposed on the taxpayer if he fails to reply to the inspector's requests, or when he is equivocal and vague. In this particular case, the burden of proof is shifted from the tax administration on to the taxpayer and it is for him to prove that his taxation is exaggerated.[91]

The essential difference between the *procédure de redressement unifiée* and the *taxation d'office* (official assessment) lies in the burden of proof which lies with the tax administration in the former, but the taxpayer in the latter.

- CGI, art. 168: Notional assessment based on external signs of wealth (*taxation forfaitaire d'après certains éléments du train de vie*)

The tax administration is entitled to charge tax on an estimate income arrived at by application of a scale (*barême*) to certain elements of the taxpayer's way of life such as residences, servants, motor cars, race horses, saddle horses, yachts, private aircraft, subscriptions to golf clubs and hunting rights.

The tax administration is allowed to make use of art. 168 only if two conditions are met:

. The notional sum arrived at once the scale is applied

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90. CGI, art. 1649 *quinquiès* A.

91. *Ibid.*, art. 181.

to various elements of the taxpayer's way of life must exceed 45,000 Frs.

· Secondly, there must be a disproportion (disproportion marquée) between the taxpayer's way of life and his declared income.

- CGI, art. 180: Official assessment by reference to obvious personal expenditure (taxation d'office d'après les dépenses personnelles ostensibles ou notoires)

This is an alternative to the provision just mentioned. This procedure is based on the expenditure (dépenses) of the taxpayer. It is rarely used, only when the application of arts. 176-177 and 179 has proved fruitless.

II. Corporation Tax (impôt sur les sociétés)[92]

This introduction will only give an outline of the general principles underlying the system of corporation tax in France. A more complete study of the classification of companies and partnerships and a proper examination of the methods of company taxation will be undertaken in subsequent chapters.

- Who is chargeable to corporation tax?

Article 206 of the Code Général des Impôts

92. Corporation tax is dealt with in the General Tax Code under Book 1 Title 1 Chapter 2, arts. 205-223 quinquiès A; also DGI I, op.cit., note 56 above, §§1000-1719, pp. 1-233; also Francis Lefebvre, op.cit., note 56 above, pp. 21-108; L. Halpern, op.cit., note 56 above, pp. 9-45; also R. Roblot, French Business Taxation (London: Oyez Publishing, 1974).

gives an enumeration of _sociétés_ (companies or partnerships) liable to corporation tax.

This enumeration is subject to numerous exceptions mentioned in article 206 itself and other articles.[93]

Corporation tax essentially applies to:

. Share companies (_sociétés anonymes_, SA) and limited liability companies (_sociétés a responsabilité limitée_, SARL) which have not elected to be taxed as _sociétés de personnes_.[94]

. Partnerships limited by shares (_sociétés en commandite par actions_, SCA).

. With the exception of civil partnerships (_sociétés civiles_) whose activity consists in the construction of buildings with a view to sale,[95] other civil partnerships may be liable to corporation tax when they carry out an industrial or commercial activity.[96]

. General commercial partnerships (_sociétés en nom_

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93. For instance, arts. 207-208. Some exceptions are specific in the sense that they only apply to _sociétés_ located in certain areas (overseas departments, art. 208 _quater_) or to _sociétés_ newly constituted.

94. CGI, art. 239 _bis_ A. Such company must have been constituted between 1 August 1962 and 31 December 1970 and the application of the regime of taxation of partnerships is limited to five years. Their share capital is to be equal or superior to 10,000 F. Further conditions are set out in CGI, Annex III, arts. 46 _quinquies_ - 46 _duodéciès_.

95. CGI, art. 239 _ter_.

96. For further details on the types of activity, see CGI, arts. 34-35.

collectif), limited partnerships (sociétés en commandite simple) and silent partnerships (sociétés en participation) may be subject to corporation tax when they make a special election.[97]

. Certain public organisations (établissements publics), when undertaking specific activities.[98]

Territorial principle (principe de territorialité)

Article 209 of the General Tax Code - inter alia - states that corporation tax (impôt sur les sociétés) is imposed only on those profits which a company derives from business activities carried out in France (bénéfices réalisés dans les entreprises exploitées en France) and profits in respect of which the right to tax is given to France under a double taxation agreement.

This last sentence relating to double taxation agreements is a first exception to the territorial principle.

Furthermore, upon approval of the Ministry of economy and finance a French resident company may elect to be subject to corporation tax on its worldwide income (bénéfice mondial) or on a consolidated basis (bénéfice consolidé), or to include in the consolidation one or more of its 95 per cent. owned French subsidiaries.[99]

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97. CGI, arts. 206(3) and 239.

98. CGI, art. 206(5).

99. S.N. Frommel, Taxation of Branches and Subsidiaries in Western Europe, Canada and the USA (London: Kluwer Deventer, 2nd ed., 1978), p. 181. For further explanations, see Part I, Chapter 3.

All *sociétés* (partnerships or companies) liable to corporation tax, whether compulsorily or after an election, have to fill in a tax return each year. The return must be made within three months of the end of the accounting period.[100] It is made on a special form issued by the tax administration and must be remitted to the appropriate inspector of taxes.

The rate of corporation tax is 50 per cent. and it has remained unchanged since 1958. It is reduced to 15 per cent. on long term capital gains (*plus values à long terme*) arising from the disposal of assets acquired at least two years before. Short term capital gains (*plus values à court terme*) on the disposal of assets (acquisition within the preceding two years) are subject to the full rate of 50 per cent. but the charge may be spread over three accounting periods.

Article 223 *septiès* of the General Tax Code states that all entities subject to corporation tax must pay a minimum annual corporation tax of 3000 Frs. This payment is referred to as *imposition forfaitaire annuelle*. It is deductible only from the tax due during the year of payment and the two following ones.

- *Determination of the net taxable income*

Article 38-1 of the *Code Général des Impôts* defines the taxable profit (*bénéfice imposable*) as the net

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100. CGI, art. 223.

profit (bénéfice net) arising from all the activities of whatever nature of the firm, including in particular the disposal of any fixed assets (les cessions d'éléments quelconques de l'actif) whether in the course of carrying on the trade or in the course of closing it down.

Art. 38-2 provides:

> The net profit is the difference between the value of the net assets at the beginning and at the end of the accounting period, less amounts introduced and plus amounts withdrawn during the period by the proprietors (par l'exploitant ou par les associes).[101]

III. Complementary Tax (taxe complémentaire)

This used to be a flat rate tax on certain categories of income other than wages and salaries. Its existence may be explained by historical reasons. A two tax system (proportional tax and progressive surtax) existed in France until 1959. Once this system disappeared, the complementary tax was introduced to compensate for the loss in revenue resulting from the reform.[102] It was originally imposed at a rate of 9 per cent., subsequently at 8 then 6 per cent. It was abolished in 1969.[103] It was last used for the taxation in 1970 of income received (perçus) in 1969.

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101. For the translation, see L. Halpern, op.cit., note 56 above at p. 13. See also Individual Income Tax. The computation of ITT and surcharge under the Finance Law 1982, European Taxation (1982).

102. World Tax Series, op.cit., note 56 above, p. 116.

103. Law (loi) No. 69-1161 of 24 December 1969, art. 5.

IV. Any Withholding Tax (retenue a la source), Prepayment (précompte) or Advance Payment with Respect to the Aforesaid Taxes

Withholding taxes, whether of a domestic or treaty origin will be examined at a later stage.

A short definition of the tax credit (*avoir fiscal*) is necessary before describing the compensatory tax (*précompte mobilier*).

When a French resident company distributes a dividend, subject to French corporation tax, the amount of the dividend is notionally increased by an *avoir fiscal*.[104] For example:

Taxable profit of a company	200	
Corporation tax (50 per cent.)	100	
Dividend distributed to shareholder		100
+ *avoir fiscal*		50
		150
Tax liability of the shareholder (40% of 150)		60
less *avoir fiscal*		50
assuming his marginal rate would be 40%		10
Net income in the hands of the shareholder		90

104. On possible modifications to the existing system of taxation of dividends, see "Rapport Daustrème": it is a 600 page report produced by a group of experts appointed in September 1981 by the Ministry of Finance. It proposes - *inter alia* - to replace the system of *avoir fiscal* by the following: dividends would be deductible by the distributing company to the extent of 50 per cent. of the company's taxable profits; an additional deduction would apply for dividends paid on newly issued shares. No modification in this respect has been introduced in the 1983 Finance Law.

The *précompte* is the counterpart of the *avoir fiscal*. When dividends are paid out of profits which have not been subject to a 50 per cent. corporation tax or which have been subject to a smaller rate (this is the case for instance when profits from which the dividends are drawn arise abroad), the company must make a payment which is to compensate for the *avoir fiscal* attached to the distributed dividend.[105]

Section 2: Extension to Other Taxes

Article 2(4) of the 1977 OECD Model and article 1(2) of the UK/F agreement provide in similar terms for the extension of the convention to other taxes.

Such a provision is necessary in order to avoid the convention from becoming inoperative in case of a modification of its domestic taxation laws by either contracting state.

The UK/F convention is to apply to "any identical or substantially similar future taxes which are imposed in addition to, or in place of, the existing taxes by either Contracting State ..."

Change which occur in the respective taxation laws of the contracting states are to be notified to each other.

The UK/F agreement has not been extended to UK

105. The concepts of *avoir fiscal* and *précompte mobilier* will be further developed in subsequent chapters.

taxes such as the Development Land Tax (DLT) and the Petroleum Revenue Tax (PTR) which were both created after 1968.

The development land tax applies to all realisations of development value in land in the United Kingdom. The Development Land Tax Act of 1976 fixes the rate of development land tax at 80 per cent. Liability to development land tax arises when an interest in land in the UK is disposed of on or after 1 August 1976, or a project of material development is begun on any land in the UK after the same date. Development land tax will be chargeable only on the development value of the land.[106]

The Petroleum Revenue Tax has not been incorporated in the enumeration of taxes covered by the UK/F agreement but art. 2(2)(b) of the more recent double taxation convention between the United Kingdom and the United States includes the PRT as a UK tax covered by the treaty.[107]

In France, a business tax (_taxe professionnelle_)[108] has replaced the business licence tax (_patente_). It is a tax on income imposed on individuals or companies who carry

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106. Development Land Tax Act, ss. 1 and 2; also Robert W. Maas, _Development Land Tax_ (London: Tolley Publishing Company Ltd, 2nd ed., 1979) Chapters 1 and 2.

107. Arthur Young McClelland Moores & Co, _United Kingdom/United States Tax Treaty_, p. 8; Arthur Anderson & Co., _US/UK Double Tax Treaty_ (London: Tolley, 1980), p. 21.

108. Law (_loi_) No. 75-678 of 29 July 1975. It is applicable in Metropolitan France since 1 January 1976, and since 1 January 1979 in Overseas Departments; DGI II, §6100. Any time the _Précis de Fiscalité_ published by the _Direction Générale des Impôts_ (abbreviated as DGI I or II) has been quoted in this particular chapter, it refers to numbers of paragraphs in the 1980 edition; any modification introduced by a subsequent edition until 1983, will have been incorporated.

on a non wage earning or salaried professional activity (_activité professionnelle non salariée_). It has not been added to the list of taxes covered by the UK/F agreement because it is a local indirect tax.

Section 3: Conclusion

Income Tax

When the 1968 double taxation agreement between the UK and France was signed, the UK still applied to individuals a double tax system on income, the taxes being income tax and surtax. The change to a single progressive income tax was brought by the 1971 Finance Act: surtax was abolished and higher rates of income tax on upper ranges of income were introduced. The standard rate of income tax was replaced by the basic rate (30 per cent. for 1983-84) chargeable on the first band of an individual's taxable income.[109] If an individual's taxable income exceeds the basic rate limit, he will be charged at a higher rate or rates.

In addition, where an individual's taxable income includes investment income in excess of a certain amount, an additional rate of 15 per cent., known as investment income surcharge is imposed.[110]

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109. Taxable income means the amount of an individual's income after making deductions for personal reliefs.

110. FA 1971, s. 32(3): Investment income is that which is not earned income.

The UK therefore taxes more heavily investment income than earned income. This differentiation does not exist in France and it is as early as 1959 that the double tax system was abolished for individuals.[111]

The tax year runs from 6 April to 5 April in the UK,[112] from 1 January to 31 December in France.

In the UK, the smallest rate of income taxation is the basic rate, 30 per cent. for 1983-84; it applies to a large band of an individual's income.[113] The smallest rate of taxation is 5 per cent. in France, but it applies to a much smaller band of income. The French scale (barême) ranges from 5 per cent. to 60 per cent; the UK highest rate is also 60 per cent. but there is the additional 15 per cent. on investment income.

The United Kingdom and France adopt a similar formula to arrive at taxable income: gross income less deductions = net income; less allowances and reliefs

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111. The taxes were called taxe proportionelle et surtaxe progressive.

112. ICTA 1970, s. 2(2). Different rules apply to corporation tax in the UK, but not in France: in the UK, financial years run from 1 April to 31 March, ICTA 1970, s. 527. This strange date for the tax year has its"origin in a Decree by the Church in the 12th century that the legal year should begin on 25th March, which was adjusted in 1750 to 6th April on the changeover to the Gregorian calendar when 11 days were lost plus a further day caused by the leap year" Cf. J.F. Avery Jones, "The Concepts of Residence and Domicile", European Taxation (1981), at pp. 173-174.

113. The Board of Inland Revenue publishes a report each year, the 124th Report for the year ended 31 March 1981, Cmnd. 8514, which gives information about the yield of the different taxes, the cost of administering them; it also includes tables, an account of recent developments, information on staff and organisation of the Department.

= taxable income.

However, the procedures followed by each tax administration to arrive at the taxable income differ quite substantially.

Income tax is charged in the UK according to schedules (cédules);[114] in France the division of categories of income (revenus catégoriels) is different,[115] and the rules of computation of taxable income within each category or schedule have little in common. The methods of computation of taxable income in the UK and France have more in common still than they have with the American system which takes a global unitary approach to the taxation of income at federal level.

The system of taxation of income on a notional basis (régime forfaitaire) is quite popular in France as regards certain categories of income, for instance agricultural profits and industrial commercial profits. Its purpose is to simplify and speed up the tax assessment. The notional basis only applies where the annual turnover of the relevant taxpayer does not exceed certain limits. The notional assessment is supposed to represent the profit which the enterprise would normally make;[116] as regards

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114. The ICTA 1970 is a consolidating act. Before 1970, the different classes of income were combined in schedules to the Income Tax Acts.

115. J.P. Casimir, "La Résurrection des Catégories Cédulaires dans l'Impôt sur le Revenu Français, Réflexions offertes à Paul Sibille (Bruxelles: Bruytant, 1981), pp. 305-312.

116. CGI, art. 51.

industrial and commercial profits, the authorities arrive at a notional assessment on the basis of information in relation to purchases, sales, stock, expenses, family circumstances and other factors.[117] An appeal can be made against the notional assessment to the tax commission for the _département_ and from there to the administrative tribunal (_tribunal administratif_).

Such method of taxation finds no counterpart in the UK.

The normal taxable unit in the UK is husband and wife, but the spouses may elect to be taxed separately in respect of earned income, but not in respect of investment income.

In France, the family is the normal taxable unit and the conditions for separate assessment of a married woman are more stringent (separation, divorce).

A married man in the UK may deduct a larger amount by way of personal relief if his wife is living with him,[118] but there is no deduction for children, nor is their income usually aggregated with that of their parents.

If the wife earns income and the spouses do not elect for separate assessment, the husband is entitled to a wife's earned income relief, being the amount of

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117. _Ibid._, art. 302 _sexiès_.

118. £2795 (married man's allowance) for the year 1983-84; ICTA 1970, s. 8(1)(a).

earned income or £1,785, whichever is the less. It does not affect the husband's claim to the married man's relief.

By contrast under the French system of quotient familial, the family income including that of the children is first aggregated and then divided according to the number of people in the family.

In the UK, a woman's income is deemed for income tax purposes to be her husband's so far as it relates to a year of assessment at the beginning of which they were married and living together.[119] There is no reciprocal right.

In France, each individual liable to income tax is to fill in each year a form entitled Déclaration des Revenus.[120] For married couples, only one form is to be filled in by the chef de famille (head of the household), the husband normally. It will include his income, his wife's and children.

The PAYE system (Pay As You Earn) is compulsorily applied in the United Kingdom to individuals taxable under Schedule E; such a system is only optional in France, and not very popular at present.[121]

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119. ICTA 1970, s. 37; FA 1976, s. 36; BTR (1975), p.134. On possible reform, see Green Paper - Taxation of Husband and Wife, November 1980.

120. CGI, art. 170.

121. In relation to the tax treatment of employment income, see Malcolm Gammie and Carol Lucas, "Income Tax, Some International Comparisons" BTR (1979), pp. 274-293, including tables.

Corporation Tax

France applies the territorial principle (*principe de territorialité*)[122] and taxation on a world-wide basis is only the exception, whereas it is the rule in the UK.

The rates of corporation tax in both countries are close enough, 52 per cent. in the United Kingdom, 50 per cent. in France. It may be altered yearly in the United Kingdom in the Finance Act, but has not been modified since 1973. It has not been changed in France since it was introduced in 1965.

However, the provisions on stock relief and capital allowance are so generous in the United Kingdom that companies in this countries can hardly be said to contribute to the tax system.[123] A recent survey found that 11 of the largest 20 industrial firms did not pay any corporation tax for the tax year ended in 1979.[124] Such a statement could not be made in relation to companies in France.

Finally, partnerships can never be assessed to

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122. CGI, art. 209. For a substantial development on the territorial principle, see Part I, Chapter 2.

123. J.A. Kay and M.A. King, *The British Tax System* (Oxford: University Press, 2nd ed., 1980) Chapter 12, p. 171.

124. These include companies such as Dunlop, Esso and Rio Tinto Zinc; they were quoted as the most profitable in the manufacturing section. See Official Report on UK Parliament discussing corporation tax provisions of the 1982 Finance Bill, Standing Committee A, 20 May 1982: discussion on clause 19 in particular, column 256-258.

corporation tax in the United Kingdom, whereas such an election is possible for certain categories of partnerships in France.

Miscellaneous

In relation to the particular problem of tax enforcement powers available in different countries, the Inland Revenue has published an interesting and revealing paper.[125]

The overall impression of the Committee on Enforcement Powers is that the foreign powers surveyed - the French ones *inter alia* - are stronger than the British ones.[126]

The scope of the comparison involves three main areas:

- power to obtain information from third parties: TNA 1970, s. 20(3), arts. 54-55;
- power of entry, search and seizure: TMA 1970, s. 20C, art. 1987 of the General Tax Code;
- penalties for failure to make a return and for making incorrect returns: TMA 1970, s. 7, arts. 1725-1729, 1730, 1741.[127]

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125. Inland Revenue, Policy Division ENF/81/5 (b) International comparisons.

126. Other countries involved are Canada, Australia, New Zealand, Germany and the Netherlands.

127. Translations of CGI, arts. 54, 1987, 1991, 2002, 2002(b), 94 of Annex III and art. 77 for the 1980 Finance Law are set out in Appendix "C" of the document.

CHAPTER 6

TERRITORIAL EXTENSION

Section 1: Territorial Scope of the Convention

§1. International Law: General Definitions

The definitions of both the UK and France in art. 2(1) of the UK/F double taxation agreement refer to international law.

It seems necessary, as a preliminary, to give certain definitions of the law of the sea which will be of relevance for the purposes of this chapter.[1]

The limited purpose of this paragraph will be to develop in a few words the following diagram:

Land	Internal waters	territorial sea	high seas
(terre)	(eaux intérieures)	(mer territoriale)	(haute mer)
			continental shelf
			contiguous zone (zone contigue)

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1. On the law of the sea in general, see Ian Brownlie, Principles of Public International Law (Oxford: Clarendon Press, 2nd ed., 1973) Part IV, pp. 183-251; D.W. Greig, International Law (London: Butterworths, 2nd ed., 1976), pp. 184-209; Michael Akehurst, A Modern Introduction to International Law (London: George Allen and Unwin Ltd, 3rd ed., 1977) Chapter 13, pp. 161-182; Ch. Rousseau, Droit International Public (Paris: Dalloz, 9th ed., 1979), pp. 225-275.

The regime of the law of the sea is still presently governed by the 1958 UN Conventions signed in Geneva. The third UN Conference on the Law of the Sea, meeting intermittently since 1974, has finally agreed upon a new comprehensive convention.[2]

The new convention on the law of the sea was signed in 1982, but it has not yet come into force.[3]

The UK is opposed to an early signing on the grounds that the deep sea mining provisions were unacceptable.

On 10 December 1982,[4] the Convention was opened to signature. France has signed both the Final Act of the Conference and the Convention. The United States have signed the Final Act, but not the Convention. The United Kingdom has adopted the same attitude.

The following definitions are based on the text of 1958.

The sea may be said to be divided into different zones, each of which is subject to different rules.

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2. M. Akehurst, ibid., p. 161. See also B.H. Oxman, "The Third United Nations Conference on the Law of the Sea: the 10th session (1981)", American Journal of International Law (1982), Vol. 76, pp. 1-23.

3. Financial Times, 3 December 1982, p. 8 and 6 December 1982, p. 3.

4. UN Convention on the Law of the Sea, done at Montego Bay on 10 December 1982; International Legal Materials (1982), Vol. XXI, No. 6, p. 1261. For a list of countries who have signed the Final Act and/or the Convention, see p. 1477.

- Internal Waters (*eaux intérieures*)

Internal waters consist of ports, harbours, rivers, lakes and canals. They are subject to the absolute territorial sovereignty of the state to which they are attached.[5]

- Territorial Sea (*mer territoriale*)

It extends beyond the internal waters.

Article 1 of the Geneva Convention on the Territorial Sea of 29 April 1958 defines the territorial sea in the following terms:

> The sovereignty of a state extends, beyond its land territory and its internal waters, to a belt of sea adjacent to its coast, described as the territorial sea.[6]

The normal baseline from which the width of the territorial sea is measured is the low water line (*i.e.* the line of the shore reached by the sea at low tide).[7]

Its width is a very controversial question in international law as no arrangement was reached in Geneva in 1958. There is no general consensus on the issue.

Article 1 of the 1958 Geneva convention on the territorial sea says that the coastal state exercises sovereignty over its territorial sea. The sovereignty is

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5. D.W. Greig, *op.cit.*, note 1 above, p. 193.

6. Documents, *New Directions in the Law of the Sea* (New York: Oceana Publications Inc., 1973), Vol. 1.

7. Geneva Convention on the Territorial Sea, 1958, art. 3.

nevertheless subject to a number of exceptions in favour of the ships of foreign states, for instance the right of innocent passage.[8]

The 1958 Convention on Territorial Sea also names a zone of the high seas contiguous to the territorial sea, the contiguous zone (zone contigue) where the coastal state may exercise the control necessary to prevent infringement of its customs, fiscal, immigration or sanitary regulations.[9] The contiguous zone may not extend beyond 12 miles from the low water mark.

- High Seas (haute mer)

All parts of the sea which do not form part of the territorial sea or internal waters of a state constitute the high seas.[10]

- Continental Shelf (plateau continental)

Another convention was signed in Geneva in 1958; it deals with the continental shelf. Article 1 defines it:

> For the purposes of these articles, the term "continental shelf" is used as referring (a) to the seabed and subsoil of the submarine areas adjacent to the coast but outside the area of the territorial sea,

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8. Ibid., art. 14; D.W. Greig, op.cit., note 1 above, p. 193.

9. Ibid., art. 24.

10. Convention on the High Seas, Geneva 29 April 1958, art. 1.

to a depth of 200 metres or, beyond that limit, to where the depth of the superjacent waters admits of the exploitation of the natural resources of the said areas; (b) to the seabed and subsoil of similar submarine areas adjacent to the coasts of islands.

Article 2 provides that the coastal state exercises over the continental shelf sovereign rights for the purpose of exploring it and exploiting its natural resources.

The inner limit of the continental shelf is the outer edge of the territorial sea but its outer limit is subject to much debate and controversy.[11]

§2. The Continental Shelf Between the UK and France

The particular problem of the size of the continental shelf between the UK and France is to be examined now.[12]

Although both the UK and France were parties to the 1958 Geneva Convention on the continental shelf, France had made reservations at the time of accession to the convention, which the UK subsequently objected to.

The UK and France engaged in negotiations looking toward delimitation of their continental shelf boundary from 1970 to 1974.

The negotiations resulted in some agreement but

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11. See Brownlie, op.cit., note 1 above, for a summary of the arguments, pp. 224-228.

12. Ch. Rousseau, Droit International Public (Paris: Sirey, 1980), Vol. IV, p. 453.

areas of difference remained and both sides decided to enter into an arbitration agreement (compromis d'arbitrage). It was signed on 10 July 1975.[13] The opinion of the court is a lengthy document, dated 30 June 1977. It delimits the boundaries of the continental shelf between the UK and France. East of 30 minutes longitude west of Greenwich, the two sides agreed in principle that the boundary should be based on the principle of equidistance. The UK and France were in fundamental disagreement concerning the portion of the continental shelf boundary west of 30 minutes longitude west of Greenwich. It is on this point that the two sides entered into an arbitration agreement.[14]

The agreement determines the continental shelf boundary between 30 minutes longitude west of Greenwich

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13. For the text of the arbitration agreement, see Revue Générale de Droit International Public (hereinafter cited as RGDIP) (1976), pp. 677-681 or JO of 19 February 1976, p. 1157. The text of the decision of 30 June 1977 may be obtained from La Documentation Française (1977). For a detailed analysis of the decision, see D.A. Colson, "The UK-France Continental Shelf Arbitration", The American Journal of International Law (hereinafter cited as AJIL) (1978), pp. 95-112; also E. Zoller, "L'affaire de la Mer d'Iroise", Annuaire Français de Droit International (hereinafter cited as AFDI) (1977), pp. 359-407. For a map, ibid., p. 360. A copy of this map may be found in Appendix I to this chapter. A décret No. 77-528 of 13 May 1977 (JO 26 May 1977) describes the status of the arbitration court in charge of the delimitation of the continental shelf between the UK and France. It is established in Geneva. For details, see Juris-classeur de Droit International, Vol. 4 Fascicule 359-1A.

14. D.A. Colston, op.cit., note 13 above, at p. 97.

to the 1,000-metre isobath in the Atlantic.[15]

The Court of Arbitration found that the Continental Shelf Convention was a treaty in force between the UK and France. But, it found appropriate to take into account recent developments in customary law. Customary law would apply in the Bay of Granville (the Channel Islands area). In the Atlantic area, art. 6 of the Continental Shelf Convention would be applied.[16] As regards the Channel Islands, it was held:

> The presence of these British Islands ... will manifestly result in a substantial diminution of the area of continental shelf which would otherwise accrue to the French Republic. This fact by itself appears to the Court to be, *prima facie*, a circumstance creative of inequity and calling for a method of delimitation that in some measure redresses the inequity. 17

However, the French position was not fully accepted by the Court because certain equitable considerations regarding the size, population and economy of the Channel Islands were to be taken into consideration.

The Court decided to draw a primary boundary equidistant from the French coast and the coast of the UK mainland; secondly, a boundary was to be drawn between the French shelf south of the mid-Channel equidistant line and the Channel Islands; this line should be drawn 12 miles from the baselines of the Channel Islands.

As regards the Atlantic area, art. 6 of the Continental Shelf area applied but the Court held that the additional projection of the Scillies into the

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15. *Ibid.*, see map as Appendix I.
16. *Ibid.*, at p. 102.
17. D.A. Colson, *op.cit.*, note 13 above, at p. 108.

Atlantic constituted an element of distortion material enough to justify a boundary other than that proposed by the UK. The method of delimitation proposed by France was also rejected.[18] The Court decided for a modified form of equidistance which would abate the disproportionality. This is a compromise between the UK and French submissions.

In October 1977 the UK requested from the arbitration court a clarification on the decision of 30 June 1977.[19] The decision of 14 March 1978 puts an end to the problem of the continental shelf between the UK and France.[20]

§3. United Kingdom

According to art. 2(1)(a) of the UK/F double taxation agreement,

> the term "United Kingdom" means Great Britain and Northern Ireland, including any area outside the territorial sea of the United Kingdom which is, in accordance with international law, an area within which the United Kingdom may exercise rights with respect to the sea bed and subsoil and their natural resources.

United Kingdom includes Great Britain (Scotland, Wales and England) and Northern Ireland.

It is implied that the internal waters and

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18. *Ibid.*, at p. 110.

19. The request was based on art. 3, §2 of the *compromis d'arbitrage* of 10 July 1975.

20. For a complete analysis, see E. Zoller, *ibid.*, pp. 1293-1303.

territorial sea are included in the word "United Kingdom". The UK still claims today 3 miles to be the length of its territorial sea.[21] In addition the text of art. 2(1) specifies that United Kingdom also includes "any area outside the territorial sea ... within which the United Kingdom may exercise rights with respect to the sea bed and subsoil and their natural resources".

This long sentence designates the continental shelf; as has been described above, it is an area outside the territorial sea and the words used in art. 2(1)(a) of the UK/F agreement paraphrase the definition of the continental shelf under the 1958 convention, art. 1 in particular.[22]

- The Continental Shelf Act

In the UK, the Continental Shelf Act[23] was enacted in 1958 to give effect to certain provisions of the 1958 Geneva Convention.

S. 1(1) states:

> Any rights exercisable by the United Kingdom outside the territorial waters with respect to the seabed and subsoil and

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21. Brownlie, op.cit., note 1 above, pp. 192-193.

22. Some treaties (Denmark, Italy, Jersey, Sweden and Switzerland) confine the definition to the land mass plus the territorial sea. Cf. R.F. Hayllar and R.T. Pleasance, UK Taxation of Offshore Oil and Gas (London: Butterworths, 1977), Chapter 23, 23.04.

23. Public General Acts and Measures of 1964, Part I, Chapter 29, p. 385; also Anne G. Lavies, J. Gordon McClure, UK Oil and Tax Legislation. Tax and Financial Planning Ltd, 1981.

their natural resources, ... are hereby vested in Her Majesty.

These rights are exercisable in those areas designated by the Queen (the so-called designated areas).[24]

Fiscal implications were first established in the Finance Act 1973, s. 38 in particular. For tax purposes, the UK is extended to cover the territorial sea of the UK and the continental shelf.[25] Any profits from the exploitation of natural resources in such areas will be subject to UK tax.[26]

Subsequently in 1975 the Oil Taxation Act was introduced.

The exact boundaries of the continental shelf between the UK and France are described in the decision of 1977 mentioned above.

Under the 1968 UK/F tax convention, the definition of permanent establishment does not specifically include an oil or gas well, which the 1977 US/UK treaty, for instance, does include.[27]

The definition of the United Kingdom under UK/F, art. 2(1) does include the Continental Shelf.

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24. Continental Shelf Act, s. 1(7).

25. Rowland's Tax Guide 81-82 (London: Butterworths, 5th ed., 1981), p. 197. Also, European Taxation (1975) pp. 220-241.

26. Ibid.

27. For the taxation of business profits from oil or gas wells under the UK/US tax treaty, see R.F. Hayllar and R.T. Pleasance, op.cit., note 22 above, pp. 174-176.

Under the UK/F tax convention does a French resident company which owns a platform situated on the UK continental shelf have a permanent establishment in the UK?

Art. 4(8)(f) refers to a place of extraction of natural resources as an example of permanent establishment; it does not refer to the exploration of such resources, whether on or off-shore. One is to refer to the general definition of permanent establishment in order to decide if such a platform qualifies as a permanent establishment (a fixed place of business in which the business of the enterprise is wholly or partly carried on).[28]

The UK Revenue is very likely to answer positively to the above question but a clear answer should be provided when the third amendment to the UK/F tax convention, signed in December 1978, comes into force. It deals with taxation of UK and French residents carrying on activities in connection with the exploration or exploitation of the seabed and subsoil and their natural resources.[29]

On the other hand, the treaty between the UK and Jersey or that with Switzerland does not include in its definition of the United Kingdom the continental shelf of the United Kingdom. Under either of these treaties, the

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28. See 1977 OECD Commentary on art. 5, §14, p. 62.

29. See BTE, §10.174; also Introduction, Chapter 1, Section 1.

definition of the UK does not extend beyond the three mile limit.

If a Swiss resident company has a permanent establishment on the UK continental shelf, but not in the UK, it may claim exemption from UK tax on profits arising on the continental shelf.[30]

§4 France

Art. 2(1)(b) states:

> the term "France" means the European and Overseas Departments (Guadeloupe, Guyane, Martinique and Réunion) of the French Republic, including any area outside the territorial sea of France which is, in accordance with international law, an area within which France may exercise rights with respect to the seabed and subsoil and their natural resources;

Reference is made in the exact same terms as in the case of the definition of the UK to international law. The continental shelf is also to be included in the definition of France.

Under domestic law, in 1968 a law was enacted in order to deal with the exploration of the continental shelf and the exploitation of its natural resources.[31] For tax purposes, products from the continental shelf shall

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30. R.F. Hayllar and R.T.Pleasance, op.cit., note 22, above, 23.06, p. 176.

31. Law No. 68-1181 of 30 December 1968 and Décret No. 71-360 of 6 May 1971. It is in conformity with the Geneva Convention on the Continental Shelf. Cf. New Directions in the Law of the Sea, op.cit., note 6 above, pp. 310-320. France ratified the Geneva Convention in 1965 (décret No. 65-1049 of 29 November 1965, JO 4 December 1965) but with reservations.

be regarded as coming from France.[32]

In 1971, France published a law[33] relating to the delimitation of the French territorial sea: the French territorial waters extend to a limit fixed at 12 miles measured from the baselines. The United Kingdom only claims 3 miles of territorial sea.

Section 2: Power of Extension to Other Territories

> Art. 29 of the UK/F tax agreement provides:
>
> (1) This Convention may be extended either in its entirety or with any necessary modifications, to any territory to which this article applies and which imposes taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions as to termination, as may be specified and agreed between the Contracting States in Notes to be exchanged for this purpose.
>
> (2) Unless otherwise agreed by both Contracting States, the termination of the Convention by one of them under Article 31 shall terminate, in the manner provided in that article, the application of the Convention to any territory to which it has been extended under this Article.

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32. Law of 1968, *ibid.*, art. 15.

33. Law No. 71-1060 of 24 December 1971, JO 30 December 1971. More recently the French Government has enacted legislation with regard to exploration and exploitation of mineral resources of the deep seabed (*grands fonds marins*): Law No. 81-1135 of 23 December 1981, *Recueil Dalloz Sirey*, 20 January 1982, p. 11; *Décret No. 82-111 of 29* January 1982, *ibid.*, 17 February 1982, p. 75; also *La Semaine Juridique, Edition Commerce et Industrie* (hereinafter cited as *JCF ed. CI*) January 1982, No. 2, 52123. For a translation of the law of 23 December 1981 into English, see International Legal Materials (1982), Vol. 21, No. 4.

§1. Procedure

For the convention to be extended to territories other than those enumerated under art. 2(1) and (2), one preliminary condition must be fulfilled: the territory considered for the purpose of extension must impose "taxes substantially similar in character to those to which the convention applies". Apart from this single prerequisite condition, the procedure of extension is rather informal as it may be carried out by a simple exchange of notes; the procedure of extension is also flexible as it may be extended as a whole or with necessary modifications.

Art. 29(2) states that unless agreed differently, the termination of the main agreement terminates its application to any territory to which it had been extended.

A. United Kingdom

In relation to the United Kingdom, the above mentioned article applies to "any territory other than the United Kingdom for whose international relations the United Kingdom is responsible".[34]

B. France

The French General Tax Code (CGI, Code Général des Impôts) does not directly apply to overseas territories.

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34. Art. 29(3)(a).

Consequently, an express provision is necessary for the Convention to apply to Overseas Territories (TOM, _Territoires d'Outre Mer_).[35]

Art. 29(3)(b) provides for the application of the UK/F tax agreement to Overseas Territories, _i.e._ Nouvelle Calédonie, Polynésie, St Pierre et Miquelon and Comores.[36]

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35. See Tixier, Gest, Kerogues, _Droit Fiscal International_ (Paris: LITEC, 1981), p. 165.

36. See _Jurisclasseur de Droit International_, Vol. 4, _fascicule_ 380-40, pp. 6-7.

APPENDIX I

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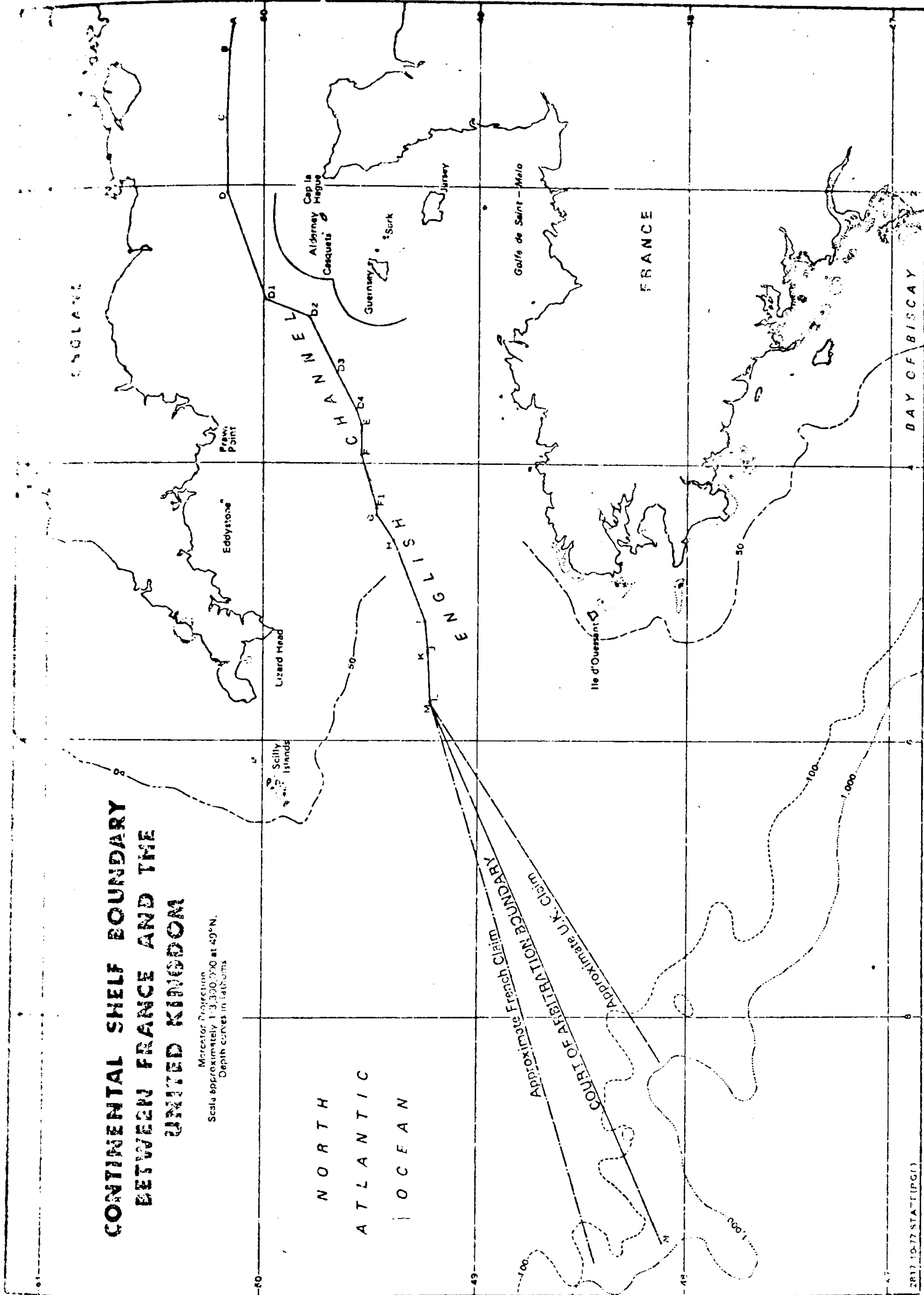

CHAPTER 7

ENTRY INTO FORCE AND TERMINATION

Section 1: Termination of the Previous Convention

§1. Principle

The United Kingdom and France had previously entered into a tax convention, signed in Paris on 14 December 1950 (hereinafter cited as the old convention).

Since 1950, the tax legislation of each contracting state has been quite substantially modified. The necessity of a new agreement was felt after the reform in France of personal income tax in 1959 and the reform of taxation of companies (*fiscalité des entreprises*) in 1965. In the United Kingdom, corporation tax was introduced in 1965.[1]

The new convention was signed in Paris on 22 May 1968.

Art. 30(2) of the 1968 convention states:

> (The 1950 convention) shall terminate and cease to have effect in relation to any tax with effect from the date on which this Convention has effect in relation to that tax ...

In other words the 1968 convention takes effect as from the dates stated in its text in relation to the various taxes.

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1. *Documents de l'Assemblée Nationale*, Second ordinary session of 1968, *Annexe* No. 689, p. 1307.

The application of the new convention has started, in both countries, and in relation to the different taxes, at different times.

§2. Exceptions

The principle stated above suffered some exceptions, favourable to the taxpayer. These exceptions were both limited in time and in scope.

A taxpayer, whether an individual or a company, who owed money to the UK Inland Revenue only (not to the French tax authorities), where the old convention granted him relief and the new one did not, could still claim the application of the 1950 agreement.[2]

These exceptions applied to income tax (including surtax) for any year of assessment beginning before 29 October 1969 (date of entry into force of the new convention) and to corporation tax for any financial year beginning before that same date.

Normally in the United Kingdom, the new convention applied retroactively with respect to corporation tax from 6 April 1964 onwards.[3]

However, if the application of the old convention was advantageous to the company from the point of view of relief granted from British tax, the exception stated in art. 30 allowed that company to postpone the application of

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2. Art. 30(2); also Instruction of 14 April 1970, §274, p. 38.

3. Art. 30(1)(a).

the new convention until 6 April 1970.

Section 2: Entry Into Force of the New Convention

The convention of 22 May 1968 (date of signature) entered into force on 29 October 1969. The date of entry into force is essentially of academic interest as the most important date is the date of first application. The provisions of the new convention were applied at different dates in relation to the different taxes. The provisions of the convention dealing with the different types of income applied retroactively. The dates of first application in fact preceded the date of signature.

§1. United Kingdom

In the United Kingdom, as regards,

- income tax (including surtax), the new convention has had effect for any year of assessment beginning on or after 6 April 1966, except for income tax on dividends paid before 6 April 1966;
- corporation tax, the new provisions have been applying for any financial year beginning on or after 1 April 1964;
- capital gains tax, since the year of assessment beginning on or after 6 April 1966.[4]

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4. Art. 30(1)(a).

§2. France

In France, the new convention has had effect,

- for withholding tax and prepayment (*précompte*) relating to any amounts payable on or after 1 January 1966;
- as regards other taxes, for the assessment year 1966 and subsequent years.[5]

Section 3: Modifications of the Original Text

(See Table, Appendix 1)

The original text of the 1968 double taxation agreement has been modified twice.

- An amending protocol was signed on 10 February 1971. It came into force on 7 May 1971. The purpose of this first modification was to grant the French "*avoir fiscal*" to portfolio investors in the UK who receive dividends from French companies. The new provisions were applicable to dividends paid as from 7 May 1971.
- A supplementary amending protocol was signed on 14 May 1973, following the introduction of the imputation system in the UK. Its effect was to grant portfolio investors resident in France the UK tax credit to which UK residents were entitled. The new provisions have been applicable to dividends paid as from 6 April 1973.
- A Press Release of the Inland Revenue dated 18 December 1978[6] stated that formal agreement had been reached

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5. Art. 30(1)(b); also *Instruction* of 14 April 1970, §273, pp. 37-38.
6. British Tax Encyclopaedia, §10.174.

between the UK and France for a further amendment to the 1968 convention between the UK and France. Such protocol relates to the double taxation of UK and French residents carrying on activities in connection with the exploration or exploitation of the seabed and subsoil and their natural resources. It has not yet come into force. Following a request at the Inland Revenue, it has been confirmed that the proposed Protocol has not yet been approved.[7]

Section 4: Termination of the New Convention

This is dealt with under art. 31 of the UK/F convention.

No provision limits the duration of the convention; it is to apply indefinitely unless either contracting state notifies the other of its intention to bring the agreement to an end. It must do so on or before 30 June in any calendar year after 1971 so that it can take effect in the following year.

With respect to termination, separate provisions have been elaborated in the convention in relation to the different taxes in order to take into account the particularities of domestic law.

In the United Kingdom, the convention will cease to have effect:

- as far as income tax (including surtax) and capital

7. Personal request, answer dated 13 July 1982.

gains tax are concerned, for any year of assessment beginning on or after 6 April in the calendar year next following that of the notice;

- for corporation tax, for any financial year beginning on or after 1 April 1983 if notice was given in 1982 for instance.

In France, the convention shall cease to have effect:

- for withholding tax and prepayment (<u>précompte</u>) relating to any amounts payable on or after 1 January 1983 if notice was given in 1982;

- as regards other taxes, for the assessment year following that in which the notice is given and for subsequent years.[8]

Articles 3 in the amending protocol and the supplementary amending protocol respectively state that they shall remain in force as long as the convention remains in force.

Therefore, in case of termination of the convention itself, the protocols would automatically be terminated at the same time.

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8. Art. 31(b).

Appendix I: Modifications of the Original Text

PROTOCOLS	AMENDING PROTOCOL	SUPPLEMENTARY AMENDING PROTOCOL
Signature	10 February 1971	14 May 1973
Ratification	F. Décret No. 71-642 of 15 July 1971	F. Décret No. 74-164 of 22 February 1974
	UK. Order in Council 30 April 1971, S.I. 1971, No. 718	UK. Order in Council 27 July 1973, S.I. 1973 No. 1328
Publication	Official Journal 2 & 3 August 1971	Official Journal 28 February 1974
	Statutory Instruments 1971 Part II Section 1 p. 1940 (London: HMSO, 1971)	Statutory Instruments 1973 Part II Section 2, p. 4053 (London: HMSO, 1973)
Entry into Force	7 May 1971	2 August 1973
Application	applicable to dividends paid as from 7 May 1971	applicable to dividends paid as from 6 April 1973
Alteration	original article 9, §§(5)(6) & (7) of the convention signed on 22 May 1968	article 9 as already amended and consequential amendment to article 6, §(5)
Purpose	granting of the "avoir fiscal" to individuals the portfolio investors resident in the UK who receive dividends from French companies.	consequence of the introduction of the imputation system of corporation tax in the UK; granting of tax credit to individuals and portfolio investors.

CHAPTER 8

MUTUAL AGREEMENT PROCEDURE

Section 1: Article 26 of the UK/F Convention Compared with the OECD 1963 Draft and 1977 Model Convention

The mutual agreement procedure (procédure amiable) is set out under art. 26 of the UK/F agreement; it is dealt with in arts. 25 both in the text of the 1963 OECD Draft and 1977 Model convention.[1]

The text of art. 25 in the 1977 Model slightly differs from that of its 1963 counterpart, in particular in the following respects.

§1. Location of a Complaint

In principle, a taxpayer who thinks he is not being assessed to tax in accordance with the convention has to present his case to the competent authority of the state of which he is a resident.

However, when a complaint emanates from a person who is a national of one State but a resident of the other, on the grounds that he has been subject to discrimination

1. On OECD art. 25, see S.I. Roberts, "Reflections on the Concepts of the Mutual Agreement Procedure of the OECD Convention: A United States View", Réflexions Offertes à Paul Sibille (Bruxelles: Bruylant, 1981), pp. 786. 798.

in that other state under art. 24, §1, he will be allowed to lodge his complaint with the competent authority of the Contracting State of which he is a national.[2]

This reference to art. 24 on non-discrimination and nationality was first introduced in 1977.

However, the 1968 UK/F convention had indirectly achieved an identical result by giving the option to a taxpayer of submitting his claim to the competent authority of "either state",[3] and not to the competent authority of the "state of which he is a resident".[4]

§2. Time Limit

According to the 1977 OECD Model, for a case to be submitted to the competent authorities, there is a time limit of three years, starting with "the first notification of the action resulting in taxation not in accordance with the provisions of the Convention". This time limit did not exist in the 1963 Draft nor in the 1968 UK/F convention.

The intention behind the three year limit is to protect administrations against late objections; three years must be regarded as a minimum. The disposition fixing the starting point of the three year limit is to be interpreted in a way most favourable to the taxpayer.[5]

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2. 1977 OECD Model, art. 25, §1.
3. UK/F convention, art. 26, §1.
4. 1963 OECD Draft Convention, art. 25, §1.
5. OECD Commentary on art. 25, §§16-17, p. 178.

How does this three year limit compare with British and French domestic provisions?

- In the United Kingdom, a claim is made by a taxpayer to an inspector.[6] The time limit for making a claim is set out in the Taxes Management Act of 1970 (hereinafter cited as TMA 1970), s. 43(1) in particular: it is generally six years, subject to provisions prescribing a longer or shorter period.

An appeal may be brought against the decision of the inspector on a claim by giving written notice to the inspector within 30 days of receipt of written notice of that decision.[7] An appeal is dealt with by commissioners. If dissatisfied with the decision of the commissioners on a point of law, the case may go before the High Court,[8] the Court of Appeal and House of Lords in the usual way.

It is interesting to examine briefly the converse situation and compare the time limits for a taxpayer to complain and those imposed on the tax administration to make an assessment. The normal time limit for a tax inspector to make an assessment on a taxpayer is six years from the end of the year to which the assessment relates.[9]

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6. TMA 1970, s. 43(2).

7. Ibid., s. 31(1).

8. Ibid., s. 56(2).

9. TMA 1970, s. 34. An assessment for 1974-75 must be made by 5 April 1981.

This provision is subject to exceptions which allow a longer period in particular cases.

Where there has been a loss of tax for the Revenue through neglect, an assessment for a further six years back may be made.[10]

S. 36 of the TMA 1970 provides that where any form of fraud or wilful default has been committed, assessment of that person may be made at any time. The onus of proving fraud or wilful default is on the Crown.[11]

- In France, when a taxpayer disagrees with the amount of an assessment, he is to write his claim to the director of taxes of the *département* no later than the 31 December of the year following the year in which the assessment was made. This time limit is shorter than that of four years available to the administration for assessing back duty.[12]

A comparison similar to that made for the UK may be outlined: for direct taxes (income tax and corporation tax) the general rule is that the authorities can go back four years and no longer.[13] No assessment may be made after 31 December of the fourth year following the year to

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10. *Ibid.*, s. 37.

11. For a development, see J. Tiley, *Revenue Law* (London: Butterworths, 3rd ed., 1981) §4:04, pp. 29-30.

12. CGI, arts. 1931-1932.

13. CGI, art. 1966.1; rules may be different with regard to indirect taxes (registration duties, stamp duty and others), CGI, art. 1974.

which it is to relate. The four year limit is referred to as _délai de répétition_ or _délai de reprise_. For instance, as regards tax on income for 1980, an assessment will only be possible until 31 December 1984.[14]

This general rule is subject to exceptions, where the _droit de répétition_ of the tax authorities is extended: the time limit is six years in case of fraud.[15] In case of omission or under declaration (_insuffisance d'imposition_) revealed during the course of a criminal law suit (_instance devant les tribunaux répressifs_) or contentious proceedings, it may be assessed by the end of the year following their revelation.[16]

An assessment made outside those time limits (_délais de prescription_) are null and void except where it relates to a liability of which the taxpayer has been notified within the proper limits.[17]

Considering the fact that the UK/F agreement does not contain a time limit for a claim to be presented, it may reasonably be thought that domestic provisions would apply in each country, six years in the UK and the 31 December of the year following that of the assessment in France.

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14. _Précis de Fiscalité_, DGI II, §7006.

15. CGI, art. 1974 _bis_.

16. _Ibid_., art. 1966-3; DGI II, §7010.

17. _Ibid_., art. 1975.

§3, Implementation of an Agreement

An agreement reached by the competent authorities of both states shall be implemented regardless of time limits provided by the domestic laws of the contracting states.[18]

This precision was neither contained in the 1963 Draft, nor in the text of the 1968 UK/F convention. The UK/F convention was drafted after the 1963 Draft but the OECD Committee on Fiscal Affairs has recommended an application of the provisions of 1977 to conventions signed prior to it.[19]

However, the UK has entered a reservation with regard to this particular point; it considers that the implementation of reliefs and refunds following a mutual agreement procedure ought to remain linked to time limits prescribed by their domestic laws.[20]

The effect of the UK reservation is to limit the implementation of relief and refunds following a mutual agreement procedure to six years.

Section 2: Scope of the Mutual Agreement Procedure in the UK/F Convention

§1. Individual Complaint of a Taxpayer (Specific Case Provision)[21]

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18. 1977 OECD Model, art. 25, §2.
19. See Presentation of the 1977 OECD Model, §30 at p. 15.
20. OECD Commentary on art. 25, Reservation on the article, §47, p. 183.
21. This terminology is used in an article of J.F. Avery /Continued over

I. Conditions of a Complaint

A taxpayer, whether an individual or a company, may lodge a complaint with the competent authority of either contracting state if he considers that his liability to tax is "not in accordance with the provisions" of the convention. The complainant does not have to wait until the debated taxation has been charged against or notified to him.[22] It is sufficient for him to establish that an act or decision, whether legislative or regulatory in nature, will probably result in taxation contrary to the convention.

The scope of the sentence "not in accordance with the provisions" of the convention at first appears wide: the terms used are not specific and narrow, but rather vague and open to numerous extensive interpretations. The prerequisite conditions to lodging a complaint are very loose.

The scope of the procedure is in fact less ambiguous than it first appears. First of all, an individual complaint may only relate to the taxes covered by

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Footnote 21 continued from page 162.

Jones et al., "The Legal Nature of the Mutual Agreement Procedure under the OECD Model Convention", BTR (1979) pp. 333-353, (1980) pp. 13-27. A translation into French of this article has been published in Fiscalité Européenne, Revue 1980-4, pp. 13-44. On the Mutual Agreement Procedure, see also "Tax Treaties and Competent Authorities", Ed. V di Francesco and N. Liakasa (1978); the British view is developed by B. Pollard, pp. 271-279, the French view by P. Kerlan, pp. 219-262.

22. Commentary on art. 25, §11, p. 176.

the convention. That is to say, income tax, corporation tax, including any connected withholding tax, prepayment or advance payment in France.[23]

- Secondly, the competent authority of the contracting state where the complaint has been first introduced is entirely free to decide upon its validity. It may accept it, consider it justified and give it a solution. It may just as well reject it, and the plaintiff has no means to appeal against that decision.

In France, the refusal of the competent authority to initiate the mutual agreement procedure did not need to be explained until a recent _circulaire_ of 31 August 1979 dealing specifically with the motivation of administrative acts (_motivation des actes administratifs_).[24]

- Thirdly, the competent authority may, at its entire discretion, decide to settle the matter on its own, or it may choose to consult with the competent authority of the other contracting state. The latter step is the setting in motion of the mutual agreement procedure. It is a procedure between states, whereas the earlier stage only involved a taxpayer and a single competent authority.

- Fourthly, where originally the competent authority is under an obligation to consider whether the complaint is justified and to give an answer to the taxpayer,[25]

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23. UK/F Convention, art. 1(1).

24. _Cahiers de Droit Fiscal International_ (CDFI) (Berlin, 1981), Volume LXVIa: _Mutual Agreement - Procedure and Practice_. See in particular, French report, p. 302.

25. OECD Commentary on art. 25, §§19-21.

once both competent authorities are involved, they are under a duty to negotiate and attempt to find an appropriate solution, but under no duty to find it, and under no obligation to reach an agreement.[26]

Once a solution is offered through the mutual agreement procedure, the commentary of the OECD Model suggests that its implementation be subject to the acceptance of the taxpayer. The acceptance of the taxpayer is required neither by the texts of the 1963 and 1977 OECD conventions nor by that of the UK/F agreement, but it is the view both in the UK and in France that the acceptance of the taxpayer is required for implementation.[27]

II. Relationship Between the Mutual Agreement Procedure and Court Proceedings

A taxpayer who wishes to lodge a complaint under art. 26 of the UK/F convention is not deprived of the remedies provided by his domestic law.

The mutual agreement procedure is an additional remedy, at the disposal of the taxpayer, not a substitute for domestic remedies.

As far as conflicts between the outcome of a mutual agreement procedure and a court decision are concerned

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26. Ibid., §§24-25. The case of dual residence is an exception to this because competent authorities must in that case reach an agreement; UK/F convention, art. 3(2)(d).

27. CDFI Berlin, English Report, pp. 359-370; French Report, pp. 297-306.

the OECD takes a liberal and flexible approach.[28]

A taxpayer may apply to the competent authority whether or not he has exhausted all remedies under domestic law. In other words, he does not need to wait for a final decision of a court before he can try and set in motion a mutual agreement procedure.

- Mutual agreement prior to court decision

Once a taxpayer obtains a settlement through the mutual agreement procedure, he is to withdraw his lawsuit in relation to that problem. However the OECD commentary suggests that

> he be allowed to defer acceptance of the solution agreed upon as a result of the mutual agreement procedure until the court has delivered its judgment in the still pending case. 29

The United Kingdom and France take the view that once a taxpayer has accepted a mutual agreement, he should withdraw any proceedings before a court.[30]

- Mutual agreement and court proceedings started at the same time

When considering whether a taxpayer could be allowed to start both an action in court and a request

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28. 1977 OECD Model, commentary on art 25, §19, §28.

29. Ibid., §28.

30. J.F. Avery Jones, op.cit., note 21 above, p. 339.

before the competent authority and chooses later the solution most favourable to him, the positions of British and French authorities are not so clear.

The French Director of International Tax Affairs has stated that competent authorities would be likely to wait for the court decision before making a decision.[31]

The British take the view that while the mutual agreement procedure is invoked, proceedings before domestic courts should remain in abeyance and be employed only if the taxpayer is not satisfied with the outcome of the mutual agreement procedure.[32] If a court decision is rendered first, the competent authority is not likely to interfere further.[33]

In view of this, the best course for an unhappy British or French taxpayer may be to lodge first a complaint with the competent authority. If the outcome of such a complaint fails to satisfy him, he may refuse it and therefore not be bound by it. He can then start court proceedings as long as time limits are still open.

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31. Ibid. J.F. Avery Jones shows astonishment when reading this statement in view of the fact that under French law, the effect of an earlier court decision is that the French competent authority cannot re-open the case. Both statements are contradictory, in the sense that the statement of the French Director of International Tax Affairs suggests that the competent authority, once a court decision has been rendered, could modify it; the second sentence denies such possibility. It would seem that in practice, the tax administration would not modify a decision of the courts. Cf. IFA 1981, French Report, p. 302.

32. IFA 1981, English Report, p. 365.

33. Ibid.

There is a risk in choosing this order in as much as if the competent authorities take a long time, the taxpayer may loose his right to bring an action before a court. On the other hand, if he starts with the court proceedings, he may well not be able to have its outcome altered. This is definite in France: a claim under a mutual agreement procedure will not be received once a decision of the courts has been rendered.[34]

In the United Kingdom, the competent authority may not wish to interfere. However, there is no rule in that country saying that a court decision could not be modified by a subsequent mutual agreement.

§2. Problems of Interpretation of a Provision of the Convention

The provisions of the 1977 OECD Model (art. 25(3)) and of the UK/F agreement (art. 26(3)(5) and (6)) in relation to this particular aspect of mutual agreement procedure are divergent.

I. The UK/F Provision is Narrower than the OECD Provision

- At no stage does the UK/F provision refer to the "interpretation" of the convention; it only mentions its "application". However, it may be thought that both application and interpretation are covered.[35] The text

34. IFA 1981, French Report, p. 300.

35. See above Chapter 3.

of the 1963 Draft, on which the UK/F agreement is based, referred both to application and interpretation.

- In both the 1963 Draft and the 1977 Model, the reference to application and interpretation is made in broad and general terms. In contrast, the 1968 convention makes specific detailed reference to the mutual agreement procedure in relation to specific articles, art. 6(2) (formulation of the arm's length principle to be applied to an enterprise and its permanent establishment), art. 8 (associated enterprises), or the determination of the source of a particular item of income.

- The 1968 convention makes no reference to a possible consultation between the competent authorities to eliminate double taxation "in cases not provided for in the convention".[36]

II. The Scope of the UK/F Agreement is Wider Than That of its OECD Counterparts

Art. 26(5) emphasises the application of the mutual agreement procedure in France in relation to art. 8; art. 26(6) specifies that in the United Kingdom, when profits have been included in the accounts of two associated enterprises such amount is to be treated for the purpose of the elimination of double taxation as income from a source in France of an enterprise of the

36. 1963 and 1977 OECD Conventions art. 25(3), last sentence. This is referred to as the legislative provision in J.F. Avery Jones' article and analysed in Part 2, BTR (1980), pp. 13-18.

United Kingdom and credit is to be given accordingly in respect of the extra French tax chargeable as a result of the inclusion of the profits in the accounts of both enterprises.[37]

Is this short enumeration of art. 8 exhaustive as to the areas in which the procedure may be applied? Or is it merely a non limitative illustration which can be extended? The latter opinion is favoured.

One could also suggest that in relation to disputes arising out of the application of arts. 6(2), 8, or the determination of the source of an item of income, the competent authorities are under more pressure to find a solution than in other matters.

Section 3: Mechanics of the Mutual Agreement Procedure

§1. Preliminary Stage: Procedure Between a Person and a Competent Authority

I. Definition of "Competent Authorities"

Such a definition is given by the text of the convention itself, art. 2(1)(d) in particular: in the

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37. The *Instruction* of 14 April 1970, 14 F-1-70, §221-2 also *recommends* the use of the mutual agreement procedure in relation to the proper qualification of certain incomes (arts. 11 §7, 12, §4). This is not provided for in the text of the convention itself. This is a rare example of a case where the *Instruction* actually adds to the convention. The *Instruction* in its heading makes reference to the *difficulties* of interpretation (*difficultés d'interprétation*) of the convention. This is an encouragement for thinking that the word application in art. 26 in fact covers both the application and interpretation of the convention.

United Kingdom, it designates the Commissioners of Inland Revenue or their authorised representative; in France, competent authorities mean the Minister of Economy and Finance (le Ministre de l'Economie et des Finances) or his authorised representative.[38]

II. The Role of the Competent Authority

As stated earlier, a taxpayer is under no obligation to make use of the mutual agreement procedure. If he does, the competent authority of a contracting state (A) discretionarily decides to consult the competent authority of the other contracting state (B). If A decides not to consult B, A is under a duty to provide the taxpayer with a solution. The latter is not bound by it unless he accepts it. There is no appeal against a unilateral decision of the competent authority.

§2. Procedure Between the Competent Authority of Both Contracting States

This has been examined earlier in this chapter.

However, the reader ought to be reminded of important points.

The initiative of the mutual agreement procedure lies with the competent authority of the state where the

38. The relevant address is: Ministère du Budget. Service de la législation fiscale - 93, Rue de Rivoli - Paris - Sous Direction E.

complaint has originally been lodged.

The competent authorities are under no obligation to reach an agreement. However, arts. 26(5) and (6) of the UK/F agreement do seem to put them under a stronger obligation in specific circumstances.

Section 4: Conclusion

Mutual agreement procedures often relate to transfer pricing matters. These arise between an industrialised country, where the level of tax is high, and a less or underdeveloped country or a tax haven whose tax burden is not as heavy, in order to attract investors.

It may therefore be thought that little use of the mutual agreement procedure has been made between the United Kingdom and France particularly in this respect, as neither country answers any of the characteristics mentioned above.

However, it is very difficult to assess what goes on between the tax administrations in relation to a mutual agreement procedure because very little information is published, and when there is publication, it is not always official and it does not always take place in both contracting states.

This is to be strongly criticised because a proper publication of mutual agreements could provide a guide for investors, save money in the sense that subsequent requests could be avoided if they had been answered in earlier cases.

However, the latter statement largely depends on the legal status of a mutual agreement. In a case involving an individual taxpayer A, could the mutual agreement be taken into account by another taxpayer B who would be in the same position?[39]

In the case of a mutual agreement dealing with the interpretation of a provision or the avoidance of double taxation not covered by the convention, could the mutual agreement be considered to be legally binding?

There is no authority in the United Kingdom nor in France in relation to these important questions.[40]

In the United Kingdom, the Inland Revenue publishes leaflets which are to be treated as pure guidance by the taxpayers. They have no binding force.[41] In France, the tax administration publishes an Instruction in relation to each double taxation agreement entered into. Such Instruction is not legally binding but it is meant to help and facilitate the implementation of a particular convention; it carries a lot of strength.

Could a mutual agreement be granted a similar status? If it was, an appropriate publication and distribution ought to be carried out.

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39. There is a case for not publishing a mutual agreement involving individuals so as to protect their privacy; however some information could be relevant to other taxpayers, and figures need not be quoted. Conversely, there is no ground for not publishing a mutual agreement dealing with the interpretation of a treaty provision.

40. J.F. Avery Jones, op.cit., note 21 above, p. 346.

41. For instance, Double Taxation Relief (1978) I.R.6.

When a mutual agreement occurs in relation to the interpretation of a provision of a treaty, France is in a special position because the interpretation is given by the Ministry of Foreign Affairs. Such interpretation is binding and officially published. The validity and binding character of the interpretation is not derived from the use of the mutual agreement procedure but from the intervention of the Government.[42]

A mutual agreement does not generally have a binding force in France; the above example is only an exception. In general, interpretative mutual agreements are binding on the administrations[43] but not on the courts (unless they involve an interpretation by the Ministry of Foreign Affairs in France). In the United Kingdom it is thought that the Inland Revenue could argue before a court an interpretation which would be different from that stated in a mutual agreement.[44]

The Inland Revenue has received very few requests for starting the mutual agreement procedure. It is in fact hardly ever used in that country, and most cases up to 1977 have been with the United States.[45]

The most obvious reason seems to be that the

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42. J.F. Avery Jones, op.cit., note 21 above, p. 348.

43. 1977 OECD Model, §33.

44. J.F. Avery Jones, op.cit., note 21 above, pp. 352-353.

45. CDFI Berlin, 1981, p. 360. By contrast, in France in the past 10 years, over 140 claims have been dealt with by the Service des Relations Internationales (Bureau E1 and E2); cf. CDFI Berlin 1981, p. 114.

method of starting the procedure is not well known and there is no publication on the matters which have been settled under the procedure.

This is often justified by saying that each particular case is decided upon its facts and that the solution is more often equitable than legal.

However, the Inland Revenue has shown signs of willingness to change this attitude by issuing an increasing number of statements about its views on various matters; it does publish material about certain concessions applied in general cases.

There is no set form for a claim to be submitted to the UK Inland Revenue; a simple letter stating out the important facts will be sufficient. It is to be addressed to the Assistant Secretary, International Tax Policy Division, Board of Inland Revenue, Somerset House, London.

In France, the claim is also informal; the taxpayer must substantiate his claim by submitting the necessary material with his application.[46]

Following the 1981 Congress of the International Fiscal Association, recommendations were made to improve the functioning of the mutual agreement procedure:[47]

- in relation to the taxpayer:

. he should have the right to submit a request for mutual agreement procedure to be instituted and such request

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46. Ibid., p. 114.

47. 35th IFA Congress 1981, Resolution on Mutual Agreement Procedure and Practice.

should not be unreasonably refused;

. he should be kept informed of the proceedings and be authorised to submit his observations during the procedure.

- in relation to the tax authorities:

. an obligation should be imposed upon the authorities to pursue negotiation so as to reach an agreement;

. measures should be taken so that the interpretation of a provision on which a settlement has been reached in the mutual agreement procedure should take precedence over the definitions under domestic law;

. the results of mutual agreement procedures initiated with a view to filling gaps in treaty coverage should be given the force of law;

. efforts should be made as regards the publication of the results of the mutual agreement procedure.

CHAPTER 9

EXCHANGE OF INFORMATION[1]

Article 27 of the UK/F double taxation agreement provides:[2]

> (1) The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or for the prevention of fraud or for the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of this Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons other than persons (including a Court or administrative body) concerned with the assessment or collection, or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of this Convention.
>
> (2) In no case shall the provisions of paragraph (1) be construed so as to impose on the competent authorities of either Contracting State the obligation:
> a) to carry out administrative measures at variance with the laws or administrative practice prevailing in either Contracting State;

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1. The French tax authorities published on 17 December 1981 an Instruction setting out the position of France on mutual assistance in tax matters; BODGI No. 231, No.. 13K.81. For a substantial commentary in English, see European Taxation (1982), pp. 211-220. In the UK, FA 1978, s. 77 in particular implements EEC Directive No. 77/799 issued on 19 December 1977 dealing with mutual assistance by the competent authorities of member states in the field of direct taxes. The 1977 Directive has been amended by a more recent directive of 6 December 1979.

2. Counterparts in OECD conventions may be found under art. 26.

b) to supply particulars which are not obtainable under the laws or in the normal course of the administration in that or the other Contracting State; or
c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

Section 1: Comparison with Equivalent OECD Provisions

§1. Distinction between OECD 1963 and 1977

Modifications in the wording, the form of art. 26 of the 1963 OECD Draft convention were felt necessary when the 1977 Model was being drafted, but the substance of the provision remained virtually unchanged. The purpose of the modifications was to clarify the meaning of the provision and avoid grounds for different interpretation.[3]

Only a minor innovation has been brought in.

Under the 1963 Draft, information could only be disclosed to persons or authorities involved in the assessment or collection of taxes covered by the text of the convention (art. 26(1)). In the 1977 Model, it has been specified that "persons or authorities" included courts and administrative bodies (tribunaux et organismes

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3. For a comprehensive comparison of the 1963 Draft and 1977 Model, see the proceedings of the 1977 IFA Seminar held in Vienna published by Kluwer from the Netherlands.

administratifs). Furthermore, the last sentence of art. 26(1) opens the possibility for the "persons or authorities" to disclose information in a court session held in public or in decisions which contain the name of the taxpayer.

Once information has been rendered public because it has been used in court proceedings or in court decisions, it "can be quoted from the court files or decisions for other purposes even as possible evidence".[4]

Can this innovation be applied to the UK/F procedure on exchange of information? The text of the 1968 agreement obviously does not refer to it. The Committee on Fiscal Affairs recommended at the time of publication of the 1977 Model that existing conventions be interpreted in the spirit of the new commentaries; the United Kingdom or France may object to information being made public by courts in the way just described, or once public, being used for other purposes.

It is thought that an exchange of letters between both countries could clarify the issue.

§2. Scope of Article 27

The UK/F convention goes further than the OECD in its provision on exchange of information: it recommends its application in relation to "the prevention of

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4. See commentary on art. 26 of the 1977 OECD Model, §13, p. 186.

fraud" (_prévenir la fraude_) and "the administration of statutory provisions against legal avoidance" (_appliquer les dispositions règlementaires tendant à combattre l'évasion fiscale_).

The OECD terminology is more vague: the purpose of the exchange of information is limited to the "carrying out" of the provisions of the convention.

The drafters of the UK/F convention have wished to permit the exchange of information to take place in a wider range of circumstances than those set out in the OECD provisions.

From a point of view of terminology, it is interesting to note the association of the words "legal avoidance" in the English version of the convention; it is translated into French as "_évasion légale_". The use of the word "legal" may appear superfluous; it may seem a redundancy, because in English the use of the word avoidance connotes a legal action whereas tax evasion (_fraude fiscale_) connotes an illegal one.[5]

The extensive approach as regards the article on exchange of information is characteristic of the conventions to which the UK is a party.

Art. 26(1) of the US/UK double taxation agreement is drafted in similar terms, whereas the double taxation agreement between the United States and France entered into in 1967 sticks closely to the OECD provisions.

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5. Deloitte Haskins & Sells, _Double Taxation Relief_ (London: Tolley Publishing Company Limited 1979), §7-13, pp. 100-101.

Another interesting feature of the US/UK double taxation agreement ought to be pointed out here.

The tax administrations of the two countries have entered into a working arrangement[6] under the terms of the exchange of information provision for the simultaneous examination of the affairs of related taxpayers with substantial operations in both countries. Under this arrangement,

> each country's tax authority will separately examine the affairs of the taxpayers within its own jurisdiction but the tax authorities will coordinate their examination of important cases in order to make more efficient and effective use of their powers to exchange information. 7

It does not seem that such a type of arrangement presently exists between the UK and France.[8]

In addition, the US/UK agreement (art. 26(2)) (and that between the US and France, art. 27 in particular) provides for one country to give strictly limited assistance to the other in the collection of tax (*recouvrement des impôts*). Under the US/UK tax convention, the UK will endeavour to ensure that people not entitled to the treaty

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6. The text of the working arrangement between the US Internal Revenue Service and the UK Board of Inland Revenue may be found in BTR (1978), pp. 453-455.

7. Written answer of Mr Denzil Davies to a parliamentary question, *ibid*.; the text of the written answer and working arrangement may also be found in N. Hamilton, *US/UK Double Taxation* (London: Company Communications Centre Ltd, 1980), pp. 137-140.

8. This statement has been confirmed following a request to the Board of Inland Revenue.

benefits do not escape US tax, but it will not in fact collect US tax on behalf of the US.[9]

Section 2: Procedure of Exchange of Information

§1. Purpose

The purpose of the cooperation of the fiscal authorities does not only involve the application of the convention itself but also the implementation of domestic legislation and the prevention of fraud (tax evasion) in general.

The ambit of the amount of information crossing the Channel in both directions does mostly depend on the good will of the authorities concerned. As the 1970 *Instruction* of the French Tax Administration puts it,

> it will be advisable (*il conviendra*) not to insist when, in relation to a particular case, the British Administration will declare itself not to be able to provide for the assistance required under the agreement, because of its domestic legislation or practice. [10]

§2. Method

Information may be exchanged in different ways:[11]

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9. Arthur Andersen & Co, *The US/UK Double Tax Treaty* (London: Tolley Publishing Co Ltd, 1980), p. 156.

10. *Instruction* of 14 April 1970, 14-G-1-70, at p. 109.

11. Commentary to art. 26, OECD Model, §9, p. 186.

- upon a direct request from the competent authority of one contracting state to the other in relation to a particular case;
- automatically, when an administrative machinery has been set up with regard to specific information;
- spontaneously if the competent authority of a contracting state feels that information in its possession may be of some interest and relevance to the other state.

Requests must be sent in France by the Directions des Services Fiscaux to the Direction Générale sous le timbre de la legislation, Office III E 2.[12]

The scope of the provision on exchange of information may seem ambitious, but in practice it is reduced by the numerous limitations impinging on the principle of collaboration between competent authorities.

Section 3: Limitations

§1. The Rule of Secrecy

Information exchanged under such a provision has a restricted circulation: it can only be communicated to persons involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes covered by the convention.

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12. Instruction of 14 April 1970, 14-G-1-70, §212.

This has been marginally attenuated by the wording of the 1977 Model.[13]

§2. Taxes Covered

The procedure of exchange of information can only involve in the United Kingdom the income tax, corporation tax and capital gains tax; in France, the income tax (IRPP, *impôt sur le revenu des personnes physiques*), the corporation tax (IS, *impôt sur les sociétés*), and any withholding tax, prepayment (*précompte*) or advance payment with respect to the aforesaid taxes.[14] It cannot for instance, involve the UK Petroleum Revenue Tax or any turnover taxes in either country.

§3. Provisions of Domestic Law

The procedure of exchange of information is further limited by the fact that a contracting state is not bound to go beyond its own national laws and administrative practice in giving information to the other contracting state. A contracting state cannot benefit from the system of the other if it is wider than its own, if it is more flexible than its own on disclosure of information.[15]

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13. See above p.178.

14. See art. 1 of the UK/F tax convention.

15. OECD Commentary on art. 26, p. 187.

If the United Kingdom required some information from France which, under UK law, could be disclosed, France can refuse to disclose the information if steps to do so were forbidden under French Law.

In 1980, the United Kingdom and France passed legislation dealing with the control over the giving of information to foreign countries; it will be briefly examined in this context.

Legislation existed in this area before in both countries, but their effect was limited to the shipping field: the Shipping Contracts and Commercial Documents Act of 1964 in the UK, and a law (loi) of 28 July 1968 in France,[16] complemented by a degree (décret) of 6 January 1969.

The purpose of the new legislation is to increase the protection available in the defence of British and French interests.[17]

The 1964 Act has been repealed by the 1980 Protection of Trading Interests Act[18] whilst the 1980 French law largely modifies its predecessor.

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16. Law No. 68-678, (1968) JO 7267.

17. For a commentary on the 1980 Acts, see A.V. Lowe, "Blocking Extraterritorial Jurisdiction: the British Protection of Trading Interests Act, 1980", American Journal of International Law (hereinafter cited as AJIL) (1980), Vol. 75, pp. 257-282; "The 1980 French Law on Documents and Information", ibid., p. 382; also, Bate C. Toms, "The French Response to the Extraterritorial Application of US Antitrust Laws", The International Lawyer (1981), Vol. 15, pp. 585-614.

18. 1980 Act, s. 6.

The UK Act contains essentially three measures, the first one being the most relevant one for the purpose of this chapter:

- an extension of the power of the British Government to forbid compliance by British citizens and businesses with orders of foreign authorities;
- a prohibition on the enforcement of certain foreign judgments by British courts;
- it also allows recovery of the penal element of multiple damage awards given by foreign courts.

The powers of the Secretary of State under the 1980 Protection of Trading Interests Act are wider than those in the 1964 Act in two respects essentially:

- they relate to measures for the control of business of any sort and not just shipping activities;[19]
- the criterion for the exercise of the Secretary's powers is no longer an infringement on the "jurisdiction" of the UK[20] but "damage or threat to damage the trading interests of the UK".[21]

In other words, the new act is not restricted to carriage of goods or persons by sea and the criterion of damage or potential damage to the trading interests of the UK is broader than that of the UK jurisdiction.

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19. Ibid., s. 1(1).
20. 1964 Act, s. 1(1) and (2).
21. 1980 Act, s. (1)(b).

S. 2(1) of the 1980 Act allows the Secretary of State to direct persons within the UK not to comply with requirements, actual or omminent by foreign courts, tribunals or authorities to produce commercial documents or information located outside the territorial jurisdiction of any such authority.

The counterpart of this section in the French law may be found under art. 1 bis: it forbids all persons, resident or nationals, French or foreign to request, seek to obtain or transmit in writing, orally or in any form, documents or information of an economic, commercial, industrial, financial or technical nature intended for the constitution of evidence in connection with pending or prospective foreign judicial or administrative proceedings.

It seems that the scope of the UK Act may be said to be wider than the scope of the French law inasmuch as the latter refers to "threaten the sovereignty, security or essential economic interests of France ..."[22] whereas the former protects "the trading interests of the UK".[23]

The French text seems to indicate that only interference with important French interests will be taken

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22. Law of 1980, No. 80.538, art. 1.

23. 1980 Act provides: '"trade" includes any activity carried on in the course of a business of any interest and "trading interest" shall be construed accordingly'.

into consideration.

Another difference between the UK ACt and the French law is that the latter subjects its prohibitions to the application of international treaties or agreements which provide otherwise.

In other words, the 1980 French law on documents and information will not apply if there exists a provision of an international treaty contrary to it.

Does this limitation mean that the application of the new French law does not impinge on the article on exchange of information in the UK/F double taxation agreement? It would, except that the procedure of exchange of information applies between the tax authorities of the countries concerned, whereas the 1980 law applies to "persons". The scope of each provision is distinct.

However, the new law is likely to have some effect in relation to tax matters; for instance, intercompany transactions require special documentation of an economic, commercial, industrial and financial character to be communicated in order to establish an arm's length price.

As regards the problem of transfer pricing between multinational enterprises, the communication of information by the French branch or subsidiary of a non resident company to its foreign head office or parent may be affected by the new law.

In the United Kingdom, where companies are taxed on a worldwide basis, profits of the foreign branches and subsidiaries of a UK resident company are normally computed

according to UK tax rules and information will be required, for instance, from the French operation of a UK parent or head office. Will the new French law not give rise to difficulties in this respect?

Conversely the same points could be argued from an English standpoint.

The procedure on exchange of information described under art. 27 of the UK/F agreement applies exclusively to exchange of information between tax authorities, and not between companies; the article itself states that it may not impose obligations upon the tax administrations heavier than those to which they are subject according to their domestic law.[24]

It would therefore seem that the exchange of information article does not prevent the application of the 1980 British and French provisions.

In practice, the purpose of the enactment of the new legislations both in the UK and in France has been to protect domestic interests against the extraterritorial scope of the American antitrust laws.[25]

The UK Act and the French law in their formulation are directed against foreign authorities in general, but it is well known that they are primarily intended to

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24. UK/F, art. 27(2)(b).

25. The Sherman Act 1980 and the Clayton Act 1914 essentially. For a commentary, see Comparative Law Yearbook (1979) Vol. 3, pp. 215-245 and (1980) Vol. 4, Part III entitled "Antitrust", pp. 299-314.

deal with incursions upon British and French interests by the United States. It is therefore unlikely that the new provisions - on either side of the Channel - will be used as weapons against one another.

§4. Trade, Business ... Professional Secret or Trade Process, Public Policy (*ordre public*)

Any information which could violate any of the above mentioned items or which would endanger public policy may not be communicated.

A taxpayer who would not want a certain piece of information to be communicated to the tax authorities of the other contracting state may rely on the argument that disclosure would amount to violation of a trade or professional secret.

It may be difficult to determine the limit of the restriction. A wide construction of the different terms may lead to a complete rejection of the provision on exchange of information and render it obsolete.

§5. Collection of Taxes (*recouvrement des impôts*)

No cooperation between competent authorities is planned by the text of the convention in relation to collection of taxes.[26]

26. See *Instruction*, *op.cit.*, note 10 above, p. 109.

The recently enacted US/UK tax treaty has provisions in relation to collection of taxes (art. 26(2)(3)) but it has been pointed out that the scope of the cooperation was in fact extremely limited on the UK side.

PART I: IN THE ABSENCE OF A CONVENTION

CHAPTER 1

BASIC CONCEPTS

Section 1: Introduction to Commercial Law

§1. Background

In the United Kingdom, there is basically no distinction between the principles of the law applicable to business or commercial transactions and those applicable to ordinary civil transactions. In other words, there is no separate body of rules for commercial transactions.

However, commercial matters are dealt with by a specialised court, the Commercial Court which is part of the Queen's Bench Division; the latter is one of the three divisions of the High Court of Justice.

The Commercial Court has only been institutionalised in 1970 (Administration of Justice Act, s. 3). Specialised judges have been assigned to commercial cases, a special "commercial list" has been drawn up but these judges apply the same principles of law as the rest of the judges: this organisation has only been set up for administrative convenience and purposes.

The law merchant was absorbed in the United Kingdom by the common law in the 18th century.

The position is somewhat different in France.[1]

The purpose of this introductory section is to familiarise the reader with the particularities of French commercial law. Such a background is necessary for a correct understanding of company law, as the most important forms of companies are commercial companies.

Unlike the situation in the United Kingdom, commercial law (le droit commercial) in France has not been absorbed by civil law (droit civil). Both categories of law remain separate.

In other European countries, fusion of these two areas of private law (droit privé)[2] has taken place, but France has not yet decided to do so.[3]

Switzerland has opted for an intermediary position: the distinction between civil and commercial law remains, but the codification has been put together (Law of Obligations, 1907).

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1. For a good short summary of the distinction between civil and commercial law, see Otto Kahn-Freund, A Source Book on French Law (Oxford: Clarendon Press, 2nd ed., 1979), pp. 255-270; also, Amos and Walton, Introduction to French Law (Oxford: Clarendon Press, 3rd ed., 1967) Chapter XV, pp. 340-370, although some of it is out of date; Barry Nicholas, French Law of Contract (London: Butterworths, 1981), pp. 25-27.

2. For an outline of the fundamental distinction of public and private law in France, see Otto Kahn-Freund, op.cit., note 1 above, pp. 203-228; also Alex Weil, Precis de Droit Civil, Introduction Générale (Paris: Dalloz, 3rd ed., 1973) §§32-37, pp. 33-40; Carol Harlaw, "Public" and "Private" Law: Definition without Distinction, Modern Law Review, Vol. 43, May 1980, pp. 341.265; J.P. Marty, "Distinction du Droit Civil et du Droit Commercial dans la Legislation Contemporaine", Revue Trimestrielle de Droit Commercial et de Droit Economique, No. 4, Dec. 1981, pp. 681-702.

3. For a discussion on the drawbacks and advantages of /Continued over

§2. Sources of Commercial Law in France[4]

The French Commercial Code (Code de Commerce)[5] was first promulgated in 1807, after the Civil Code (1804), but in fact the codification of commercial law long preceded that of civil law because the Code de Commerce of 1807 essentially incorporated two earlier Ordonnances associated with Colbert, the Ordonnance sur le commerce de terre of 1673 and the Ordonnance sur le commerce de mer of 1681.[6]

Today, very little remains of the original provisions. The two main sources of commercial law are laws (lois) and decrees (décrets); ordinances (ordonnances) have also more exceptionally been enacted in the field of commercial law.

A paragraph on French constitutional law is required to explain the meaning of the words loi, décret and ordonnance.

Footnote 3 continued from page 193.

maintaining the distinction, see M. de Juglart and B. Ippolito, Droit Commercial (Paris: Editions Montchrestien, 2nd ed., 1975) Title I, Chapter II, pp. 22-28.

4. For a complete description of sources of French Commercial law, see Paul Didier, Droit Commercial (Paris: Presses Universitaires de France, 1970), Tome 1, Introduction, pp. 25-211.

5. For a translation into English of the Commercial Code, see Parker School of Foreign and Comparative Law, Columbia University, French Law (N.Y.: Matthew Bender, 1981).

6. Tables on historical evolution of French commercial law, ibid., pp. 16-21.

The constitution of the Fifth Republic came into force on 4 October 1958 and it introduced fundamental changes in relation to the law making power.[7]

The theory of the sovereignty of Parliament, the National Assembly and the Senate (l'assemblée nationale et le sénat) were abandoned and the powers of Parliament were considerably restricted. Parliament is now only competent to legislate in certain specific areas; it has a "compétence d'attribution": its scope of action is enumerated,[8] limited and under strict control. General competence to legislate now belongs to the executive.[9] A shift of the general legislative competence has been operated in favour of the executive.

Furthermore, in order to carry out its programme, the Government may ask Parliament to authorise it for a limited period of time to take through ordinances (ordonnances) measures that are normally within the domain of law.[10]

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7. In relation to this specific question, see A. Hariou, J. Gicquel and P. Gélard, Droit Constitutionnel et Institutions Politiques (Paris: Editions Montcherestien, 6th ed., 1974) Title II, Chapter IV, Section III, pp. 1063-1074; P. Pactet, Institutions Politiques, Droit Constitutionnel (Paris: Masson et Cie, 3rd ed., 1974) Chapter 17, pp. 202-216; Otto Kahn-Freund, op.cit., note 1 above, pp. 38-67; "Dix années de jurisprudence du Conseil Constituionnel en matière de répartition des compétences législatives et règlementaires", Actualité Juridique de Droit Administratif (hereinafter cited as AJDA) (1970), pp. 259-275. In English, Barry Nicholas, "Loi, Règlement and Judicial Review in the Fifth Republic", Public Law (1970) pp. 251-276; Sophie Hoquet-McKee, "The Law Making Power in France since 1958", City of London Law Review, Spring 1980, pp. 1-5.

8. Constitution of 1958, art. 34.

9. Ibid., art. 37.

10. Ibid., art.38; a translation of these articles of /Continued over

The most important part of modern commercial law is contained in laws (lois), often complemented by decrees (décrets). For instance, the main body of rules concerning commercial companies and partnerships (sociétés commerciales) is contained in a loi of 24 July 1966,[11] complemented by a décret of 23 March 1967;[12] the commercial registry is dealt with under another décret of 23 March 1967.[13]

The doctrine, opinion of academic writers and

Footnote 10 continued from page 195.

the French constitution may be found in A. von Mehren, The Civil Law System (Boston and Toronto: Little, Brown and Company, 2nd ed., 1977), pp. 236-237; also in Five Constitutions (London: Pelican, 1979), p.290.

11. Loi No. 66-537 of 24 July 1966 on commercial companies and partnerships; the date of a loi refers to the date of its promulgation i.e. of its incorporation in a décret signed by the President of the Republic. Through the promulgation of a law, the President of the Republic testifies (atteste) its existence and lawfulness (régularité); he also orders its publication. Once promulgated, a law becomes executory (exécutoire); see Constitution of 4 October 1958, art. 10. The promulgation is to be differentiated from the publication. A law is published when it is inserted in the Official Journal of the French Republic (Journal Officiel de la République Française). Publication renders a law compulsory (obligatoire) and brings it into force. The number preceding the date of the law helps avoiding confusion when several laws (or decrees) are promulgated on the same day (here 537); 66 refers to the year of promulgation).

12. Décret No. 67-236 of 23 March 1967 on commercial partnerships and companies.

13. Décret No. 67-237 of 23 March 1967 on the Commercial Registry.

specialised practitioners, plays a much more important role in France as a source of law in general, and of commercial law in particular, than it does in the United Kingdom.

Decisions of the courts published in law journals are often accompanied with valuable explanations, analysis, criticism provided by legal writers.

The doctrine has largely contributed to the discovery and development of "general principles of law" (principes généraux du droit) and exercises a continuous influence over legislation.[14]

The decisions of the courts (jurisprudence) also form a salient part of sources of commercial law; the next paragraph will be devoted to a survey of the organisation of commercial courts in France.

§3. Organisation of the Commercial Courts

The dichotomy of public and private law may also be found in the organisation of French courts.[15]

The commercial courts (tribunaux consulaires or tribunaux de commerce) are courts of special jurisdiction

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14. Otto Kahn Freund op.cit., note 1 above, pp. 166-176; Alex Weil, op.cit., note 2 above, §§180-185.

15. Law of 16 August 1790, art. 13 which states the principle of separation of administrative and judicial authorities; see also a table on the organisation of the ordinary courts, as opposed to the administrative courts, in Otto Kahn Freund, op.cit., note 1 above, at p. 278.

(tribunaux d'exception); that is to say that they are competent only when jurisdiction is granted to them expressly by a law.

The tribunaux de commerce are the only French courts on which professional judges do not sit.[16] The judges are businessmen, elected for periods of two years; they may be re-elected, but for no more than ten years in all. Electors are French merchants (commerçants français) and businessmen (chefs d'entreprise) of 21 years of age at least, enrolled in the Commercial Registry (registre du commerce et des sociétés). They first elect délégués consulaires who in turn elect the judges to be. A juge consulaire is not remunerated but the office is prestigious to hold.

Three judges form a court.

Appeal from a decision (jugement) of a tribunal de commerce lies before an ordinary court of appeal (cour d'appel) and eventually, a point of law will be challenged before the Cour de Cassation by means of a pourvoi.

§4. The Scope of Commercial Law

To whom does commercial law apply? What is the

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16. See Amos and Walton, op.cit., note 1 above, pp. 343-344; A. von Mehren, op.cit., note 10 above, p. 100; M. de Juglard and B. Ippolito, op.cit., note 3 above, pp. 71-132. A short article on the working of the commercial courts in Paris appeared in the Financial Times, A.H. Hermann, "The Charms of French Justice", 12 March 1981, p. 18.

competence of the commercial courts? Who is a merchant?

Article 1 of the Commercial Code defines a merchant as a person whose regular occupation is to engage in commercial transactions.[17]

What is a commercial transaction?

A list of commercial transactions is contained in art. 632 and 633 of the Commercial Code. The most important commercial transactions are:

- all purchases of movables (biens meubles) for resale;
- all purchases of immovables (biens immeubles) for resale, unless the purchaser intended to build one or several constructions (édifier un ou plusiers bâtiments) and resell them as a whole (en bloc) or individually (ou par locaux). This type of transactions dealing in particular with immovables, which are traditionally within the competence of the civil courts, has come within the competence of the commercial courts in 1970;[17]
- all operations of an intermediary (intermédiaire) for the purchase or sale of real property, businesses (fonds de commerce), shares (actions ou parts) of real estate companies or partnerships (sociétés immobilières);
- business (entreprise) of hiring movables (location de meubles);
- business of manufacturing, commission agents, carriage by land or by sea (transport par terre ou par eau);
- all operations of exchange (change), banking and brokerage (courtage);

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17. Law of 9 July 1970, No. 70-601, art. 23.

- bills of exchange (lettres de change) between any persons.

Article 633 deals with maritime activities. It involves essentially dealings in ships by way of purchase, sale, charter, marine insurance and other contracts relating to maritime commerce.

In addition, an ordinary civil transaction may become commercial in nature by reason of the fact that it is entered into by a merchant in the course of his business. This is often referred to as the théorie de l'accessoire.[18] This is a direct application of the Latin maxim, accessorium sequitur principale (l'accessoire doit suivre le principal).

For instance, a contract of employment (contrat de travail) entered into by a merchant (commerçant) and an employee, a wage earner (salarié) is a commercial contract "par accessoire" for the merchant.[18] The same could be said of an insurance contracted by the merchant for the purpose of insuring his business premises of a loan contracted by him for business purposes.[19]

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18. For further explanation, see M. de Juglard and B. Ippolito, op.cit., note 3 above, pp. 180-185. Cour de Cassation of February 1962, Gazette du Palais (hereinafter cited as GP), 1962.1, p. 350.

19. There are exceptions to the théorie de l'accessoire, in particular in relation to driving activities of merchants; décret of 22 December 1958 provides for the exclusive jurisdiction of the Tribunal de Grande Instance with regards accidents in which merchants are involved, even if they occurred in the course of their business activity.

The contract of service between a merchant and his employee may also be classified as a mixed transaction (acte mixte). As just stated above, it is a commercial transaction for the merchant because he has entered into it in the course of his business, but it is an ordinary civil contract from the point of view of the employee.

The rules of competence of the courts as regards actes mixtes may be summarised as follows: the position of the defendant (défendeur) is to be taken into consideration. If, from his point of view, the transaction is civil (in the example, if the employee is the defendant), the civil court will have jurisdiction, in this particular case, the labour courts (conseils de prud'hommes). If the defendant is the merchant, the plaintiff may choose to bring his action before the civil court or the commercial court.[20]

§5. Particularities of French Commercial Law

The importance of the distinction between Droit civil and Droit commercial has diminished, but there are still differences in substantive law and in procedural law, the latter being the salient ones.[21]

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20. M. de Juglard and B. Ippolito, op.cit., note 3 above, pp. 192-195.

21. C. Lyon Caen, "De l'Influence du Droit Commercial sur le Droit Civil depuis 1804", Livre du Centenaire du Code Civil (1904), p. 207.

I. Substantive Law

- *Mise en demeure* (putting in default)

A debtor (*debiteur*) in a commercial transaction may become liable to pay legal interest simply upon the creditors indicating by means of a registered letter (*lettre recommandée*) that he wishes to be paid. There is no need, as in a civil transaction, for a formal *mise en demeure* of the debtor by a *sommation* or by an equivalent instrument.[22]

- *Solidarité* (joint and several liability for debts)

Co-debtors, under a commercial contract, are presumed to be jointly and severally liable whereas in a civil contract, *solidarité* must be expressly stipulated.[23] In other words, a creditor will be able to claim his total debt from only one debtor of his choice, who will subsequently claim from the others their share of the debt.

- The legal rate of interest (*taux de l'interêt moratoire, interêt par jour de retard à compter du jour de la sommation*) used to be higher in commercial matters than in civil matters, but the distinction has been abolished by a Law of 11 July 1975.[24]

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22. A *sommation* is a form of demand in writing served by a *bailiff (huissier)*; it is not a judicial demand. An equivalent instrument is a judicial demand by a writ of summons (*assignation*), *Code Civil*, art. 1146.

23. *Ibid.*, art. 1202.

24. A. Solal, GP (1975), p. 726.

II. Procedural Law

- Commercial procedure, as opposed to civil procedure can generally be said to be less formalistic and speedier: for the collection of contractual debts, the commercial courts follow an exceptionally swift procedure, the *procédure d'injonction de payer*.[25]

- Special insolvency proceedings: compulsory liquidation (*liquidation des biens*) or scheme of arrangement under the supervision of the court (*règlement judiciaire*). If these procedures are to be applied to individuals they must be merchants. For partnerships and companies (*sociétés*), they are to be legal persons.[26] Article 2 of the *loi* dealing with these matters states that those proceedings may also be initiated by a debtor, whatever the nature of his debt (*quelque soit la nature de sa créance*).

- Commercial debts are barred after a maximum of 10 years[27] unless shorter periods are laid down; the normal *délai de prescription* (time limit) in civil matters is 30 years.[28]

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25. The scope of the *procédure d'injonction de payer* has been widened by the *décrets* No. 72-790 of 28 August 1972 and No. 73-135 of 13 February 1973. There is no longer a ceiling (*plafond*) as to the sums involved as long as the debt (*créance*) has a contractual source (*a une cause contractuelle*).

26. Law of 13 July 1967, art. 1.

27. *Code de Commerce*, art. 189 *bis*.

28. *Code Civil*, art. 2262.

- Certain duties are imposed on merchants, whether individuals or companies:

. Registration in the commercial register (*inscription au registre du commerce et des sociétés*). The organisation of the *registre du commerce et des sociétés* is regulated by two *décrets* of 23 March 1967.[29] Its purpose is to register individual merchants and commercial companies and partnerships and to insert subsequent modifications of their organisations.[30]

There are local registers (*registres locaux*) kept by officials of the commercial courts (*greffiers des tribunaux de commerce*) and a national register to centralise all information in Paris. It is kept by the *Institut National de la Propriété Industrielle* (INPI).

The primary effect of the registration of a partnership or company on the commercial register is to confer it legal personality (*personalité morale*).

. Maintenance of proper books of accounts (*livres de commerce*). Two books are to be kept compulsorily: the *livre journal* which sums up day to day operations and the *inventaire*, inventory. An *inventaire* is a detailed chart of the assets of the business. It is also compulsory to archive for 10 years books of account and all copies of letters sent.[31]

. Jurisdiction of the commercial courts at first

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29. *Décrets* No. 67-237 and 238.

30. *Ibid.*, No. 67-237, art. 1.

31. *Code de Commerce*, arts. 8-9 and 11.

instance. An appeal from a first instance decision will be brought before a court of appeal. The decision of the court of appeal may be challenged on a apoint of law through a pourvoi before the Cour de Cassation.

. Article 1325 of the Civil Code requires a copy to be made of an instrument under private signature (acte sous seing privé) that contains a synallagmatic agreement (contrat synallagmatique) for each party having an interest in it. Such formality is dispensed with in commercial matters.

. Rules of evidence: the rules of evidence in civil law do not apply to commercial law. Art. 1341 of the Civil Code[32] provides that an instrument must be executed before a notary (notaire) or under private signature (sous signature privée) for all things exceeding the amount or value determined by a décret (décret No. 80-523 of 15 July 1980, art. 1; the amount or value mentioned in article 1341 of the Civil Code has been fixed at 5000 Francs), even for voluntary deposits, no proof by witnesses (preuve par témoins) against or beyond the contents of an instrument, all of which is without prejudice to what is prescribed in the statutes relating to commerce.

The rule is attenuated by art. 1347, which sets aside art. 1341 where there is a beginning of written proof (commencement de preuve par écrit). Article 7 of the law of 12 July 1980 introduces modifications in art. 1348 of the Civil Code.

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32. As modified by a loi No. 80-525 of 12 July 1980.

Article 109 of the Commercial Code states:[33]

> In respect of merchants (*à l'égard des commerçants*), commercial transactions can be proved by all kinds of evidence (*par tous moyens*) unless otherwise provided by law (*à moins qu'il n'en soit autrement disposé par la loi*).

The relevance and importance of this lengthy preliminary section will be better perceived when the various forms of business organisation, in France in particular, are examined. Indeed, the dominating forms of French companies, *sociétés à responsabilité limitée* (SARL) and *sociétés anonymes* (SA) are commercial by the form, that is to say that particularities described in this section will apply to them as commercial companies (*sociétés commerciales*).[34]

Section 2: Sources of Company Law

§1. United Kingdom[35]

Company law is governed by statutes, the five Companies Acts of 1948, 1967, 1976, 1980 and 1981, and

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33. *Loi* No. 80-525 of 12 July 1980, Title VII, Official *Journal*, 13 July 1980, at p. 1755.

34. See J.P. Marty, *op.cit.*, note 2 above.

35. There is no UK company law as such; one talks about English company law, but for this purpose, England includes Wales. On the origin and development of modern English companies, see Charlesworth and Cain, *Company Law* (London: Stevens & Sons, 12th ed., 1981) pp. 1-21; L.C.B. Gower, *The Principles of Modern Company Law* (London: Stevens & Sons, 4th ed., 1979), pp. 29-93.

numerous decisions of the courts.[36]

Provisions of other Acts of Parliament are often also relevant to company law matters, but attention will be devoted here to the Companies Acts only.[37]

Despite the growing amount of legislation, some areas of company law are still largely regulated by case law and the importance of the decisions of the courts is not to be underestimated.[38]

French lawyers are used to finding the basic principles of the law in a code and laws (lois), secondary rules in decrees (décrets) and the judicial application and interpretation of such principles in the decisions of the courts.[39]

Company law in England operates differently: basic rules and principles are to be found in decisions of the Courts. Some of them are very old, and although they

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36. For a presentation of the 1980 Act see C.M. Schmitthof, "The Companies Act 1980, A General Survey" in Palmer's Company Law, Fourth Cumulative Supplement to Volume I of the 22nd edition (London: Stevens & Sons, 1980); and in French, A. Tunc, "La Loi Britannique de 1980 sur Les Sociétés Anonymes" RIDC (1981) No. 1, pp. 91-97. For a presentation of the 1981 Act see P.N. McNonnies, The Companies Act 1981: A Practical Guide (London: Oyez Publishing Ltd, 1981); also C.B. Ames and M.J. Woodford, "Accounting and Disclosure Requirements of the Companies Act 1981", Accountants Digest, Winter 1981/82/2, 112.

37. For instance, Misrepresentation Act, 1967; Health and Safety at Work Act, 1974; Insolvency Act, 1976, s.9; Banking Act, 1979; and most Finance Acts (for instance FA 1973, s. 47(3) separate statement of capital).

38. For instance, directors' duties, the doctrine of ultra vires.

39. A Tunc, "A French Lawyer Looks at British Company Law", Modern Law Review (hereinafter cited as MLR) 1982, pp. 1-17.

may not correspond to 20th century economic realities the courts still consider themselves bound by them.[40]

> The problem of English company law, in the eyes of a French lawyer, lies in the rigidity of the basic rules or principles enunciated in judicial decisions. [41]

Another problem, which has particularly negative consequences in company law, is that of the drafting of Acts of Parliament.

> In the United Kingdom, Acts of Parliament seem to be drafted in complete distrust of the courts, in complete negation of any intelligence or even common sense of the judges. [42]

In France, the function of the legislation is to state in broad terms the principles and main rules, leaving to the judge the task of applying them and adjusting them to modern needs; in the UK, the aim of Parliament is to leave no room to the judges to manoeuvre and

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40. For instance, the doctrine of ultra vires.

41. A. Tunc, op.cit., note 39 above, at p. 5; see also C.M. Schmitthoff, "Should Precedents Be Binding?", Journal of Business Law, July 1982, pp. 290-302.

42. Ibid., at p. 8. For further information on this problem, see J.A.C. Smith, "Legislative Drafting - English and Continental, 1 Statute Law Review, p. 14. Also, W. Dale, "Statutory Reform. The Draftsman and the Judge", ICLQ (1980) 30, p. 141; by the same author, Legislative Drafting, A New Approach (London: Butterworths, 1977). Also, A.L. Goodhart, "Precedent in English and Continental Law", LQR (1934), pp. 40-65; Lord Devlin, "Judges as Lawmakers", MLR (1976), pp. 1-16; Max Atkinson, "Law Making Judges", University of Tasmania Law Review 1981, Vol. 7, p. 47; Lord Renton, "Interpretation of Legislation", N.J. Jamieson, "Would a 'Parliamentary' Counsel by any Other Name Be More of a Law Draftsman?", Statute Law, Spring 1982, pp. 7-22; A.A. Levasseur, "Bridging the Channel", Louisiana Law Review (1980), pp. 69-80.

statutes are full of details which often lead to total confusion.

Companies Acts are very long. The 1980 Act is 150 pages long; it is to be added to the 460 pages of the earlier Acts. The 1981 Act adds a further 185 pages.

In comparison, the whole of the French _loi_ (law) and the _décret_ (decree) on companies are contained in 176 pages of the _Petits Codes Dalloz_.

The 1980 Companies Act also provides a good illustration of the level of complexity an English statute may reach: the repetition of the expression "subject to" (ss. 1-5-6-17-20-21-22-24 etc.); the overuse of the word "relevant" (s. 5 "relevant balance sheet", s. 13 "relevant balance sheet", "relevant application", in ss. 13-14-17-19-26-37-43-51-53-56); it has been used in 17 different contexts, the expression it qualifies not appearing in the Act as a whole, but in single sections.[43]

This could be avoided by simply describing, at the beginning of a particular section, the matter to which a provision relates.

The 1980 Companies Act also contains far too many definitions. This may be a consequence of the fact that many concepts of the EEC directive on company law,[44]

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43. W. Dale, _op.cit._, note 42 above, p. 147.

44. The 1980 Companies Act is a direct consequence of the entry of Britain into the Common Market, more precisely of the implementation into the British legal system of the 2nd EEC Directive on company law. Article 189(3) of the Treaty of Rome states:

/Continued over

which it is trying to implement, are new to the UK lawyer, but the number of definitions make the Act as a whole unreadable.

Further developments are to concentrate on the 1980 Act mainly because of the fundamental modifications it has introduced in the traditional English approach to company law.

The trends of the 1980 Act may be summarised as follows:[45]

A new classification of companies has been introduced. Under the old law (s. 28 of the 1948 Act in particular) the residual form of company was the public company. This position is now reversed. The 1980 Act provides that all companies shall be private companies unless they satisfy the requirements of a public company. The private company has become the residual form and a company is a public limited company (plc, s. 2(2)) only if it fulfils the requirements of the Act (s. 1).

Footnote 44 continued from page 209.

"A directive shall be binding as to the result to be achieved, upon each Member State to which it is addressed but shall leave to the national authorities the choice of form and methods". For details, see A. Parry and G. Hardy, EEC Law (London: Sweet & Maxwell, 2nd ed., 1981), Chapter 8; K. Lipstein, "Un Juriste Anglais dans la Communauté Européenne", RIDC (1978), No. 2 pp. 493-504.

45. I would like to use the opportunity of this footnote to express my gratitude to Lady Oliver, Head of the Law Department at the City of London Polytechnic. I attended her lectures in English Company Law in 1980-81, and without her, I would not have been able to write this chapter and many others.

The 1980 Act is mostly concerned with public companies. Ss. 1 and 15 are the only provisions dealing with private companies specifically. The rest of the provisions applies either to both categories or, very often, to public companies only. The effect of the new Act is to expand quite considerably the distinction between public and private companies.

The terminology used in the Act is highly technical and complex, in particular in relation to the new provisions on loans to directors[46] and insider dealing.[47] Very often, each word of a sentence requires an explanation, one or several definitions. A lot of concepts introduced are new to the British lawyer and where some innovations can only be welcomed, for instance the provision on minimum capital (s. 85) and those on distributions of dividends (ss. 39-40), the introduction of some form of procedure for the control of the payments of shares in kind (s. 24),[48] others do turn out to be useless and utterly ineffective (ss. 26-46 and 74 for instance).

The modifications introduced in relation to the distribution of dividends are also to be outlined because they bring in major innovations.[49]

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46. For an explanation, see Mark Dyer, The Company Lawyer (1981), Vol. 1, No. 4, p. 190.

47. Ibid., David Sugarman and T. Ashe, (1981), Vol. 2, No. 1, p. 13.

48. In France, Law of 24 July 1966, art. 80: appointment by the court of one or more commissaires aux apports.

49. M. Renshal, "The Companies Act 1980" (2) The Company Lawyer (1981), Vol. 1, No. 4, p. 194.

Before the 1980 Act, all rules on dividends were to be found in cases; the notion of distributable profits was very wide and so lax that one could distribute profits out of capital.

For instance, trading losses in previous years could be disregarded; one did not need to make up for the years of loss.[50] Furthermore, unrealised losses on fixed assets needed not be taken into account. A dividend could be distributed on the strength of an unrealised profit on a piece of land.[51]

All these rules have gone and are presently replaced by Part 3 of the 1980 Companies Act, ss. 39-45.

S. 39 introduces major changes in English law: a company's profits available for distribution are its accumulated realised profits, less its accumulated realised losses.[52]

Past trading losses now have to be taken into account and no distribution can take place on the strength of an unrealised profit.

As regard the 1981 Companies Act, its purpose is to enact into English law the rules as to companies' accounts contained in the Fourth Harmonisation Directive issued by the Council of Ministers of the European

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50. Ammonia Soda Co. v. Chamberlain (1918), 1 Ch., p. 331.

51. Rimbula Valley (Ceylon) Tea Co. v. Laurie (1961) All ER, p. 769.

52. Distribution is defined under s. 45(2).

Communities in 1978.[53]

It also contains new provisions regulating company names, the use of business names of enterprises other than companies,[54] and provides for the purchase by companies of their own shares.

§2. France

The Loi No. 66-537 of 24 July 1966 (509 articles) is presently the most important source of French company law.[55] It is a good consolidation of earlier solutions which had been elaborated by the courts and were scattered in several different laws, decrees and ordinances; it eliminated obsolete provisions and case law.[56] It also introduced important innovations and overall, despite some insufficiencies, it is thought to be a positive step, a good basis for company law.[57]

The loi of 1966 was complemented by a décret

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53. Official Journal of 25 July 1978, No. L.222(11).

54. On the 1981 Companies Act see The Company Lawyer, 1982, Nos. 1, 2, 3.

55. For a translation of this law, Commercial Laws of the World, Book 8, Foreign Tax Law Association Inc., PO Box 340, Alachua, Florida 32615; also Doing Business in France (New York: Commerce Clearing House Inc.) looseleaf.

56. For a history and development of French legislation, see G. Ripert and R. Roblot, Traité Elémentaire de Droit Commercial (Paris: LGDJ, 10th ed., 1980), Vol. 1, Second Part, Preliminary chapter.

57. For a different opinion, R. Rodiere, Droit Commercial (Paris: Dalloz, 10th ed., 1980), Introduction.

No. 67-236 of 23 March 1967.

The first EEC directive on company law came out on 9 March 1968 but the French loi was already ahead of it.

The loi of 1966 has been reshaped and amended several times,[58] recently by a law of 1978, dealing in particular with silent partnerships (sociétés en participation). The law of 4 January 1978 modified Title IX of book III of the Civil Code (arts. 1872-2 in particular) and abrogated the corresponding sections of the law of 1966.[59]

The 1966 Law on commercial companies has been further modified by a law of 30 December 1981.[60]

The purpose of this modification is to harmonise French law with the second directive of the European Communities adopted on 13 December 1976.[61]

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58. For instance, loi No. 70-1284 of 31 December 1970, ordonnance No. 69-1176 of 20 December 1969, loi No. 73-1169 of 23 December 1973.

59. Also, décret No. 78-404 of 3 July 1978. For a commentary on the 1978 law, J. Guyénot, "Le Régime des Sociétés en Participation après la Réforme des Sociétés par la loi No. 78-9 du 4 Janvier 1978, modifiant le Titre IX du Livre III du Code Civil", GP (1978), pp. 386-393.

60. Law No. 81-1162 of 30 December 1981, OJ No. 306, pp. 3593-3597.

61. For the text of the directive, see Journal Officiel des Communautés Européennes (hereinafter cited as JOCE) L 26 of 31 January 1977, also Revue Trimestrielle de Droit Européen (hereinafter cited as RTDE) 1978, at p. 761. For a commentary on changes which the directive will introduce into French law, ibid., p. 729; also J. Denecker, "La Deuxième Directive des Communautés Européennes", Revue des Sociétés, 1977, p. 661; A. Cordoliani, "Constitution de la Société, Maintien et Modification de son Capital, dans les Etats Membres de la CEE", JCP, 1978, 12649; also Guyon et Coquereau, /Continued over

The essential modification introduced by the law of 1981 relates to the minimum capital of share companies (SA, sociétés anonymes). It is 1,500,000 Francs when a SA raises capital publicly, and 250,000 Francs when it does not.[62] Existing companies have until 31 December 1983 to comply with this new provision.[63]

Other innovations may be summarised as follows:

When a partnership or company is transformed into a share company, one or several auditors (commissaires) will value the assets of the partnership or company about to be transformed. They will submit a report to the members. The members must expressly approve it, otherwise the transformation will be void.[64]

Such provision already existed in the case of transformation of a limited liability company (SARL, Société à responsabilité limitée) into a SA.[65] The effect

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Footnote 61 continued from page 214.

JCP, 1982, II, 13740; J. Richard, JCP ed. CI, no. 12, 10512; also APS, "Le Nouveau Régime Juridique des Sociétés Commerciales après la Loi du 30 Decembre 1981", GP, 20 April 1982. As a consequence of the second directive, the décret No. 67.236 of 23 March 1967 has also been modified, Décret No. 82.460 of 2 June 1982. For a commentary on this 1982 décret, see JCP ed CI, 24 June 1982, No. 25, 52800, and No. 28/29, 10828.

62. This modifies art. 71 of the law of 1966.

63. Law of 1981, art. 33; this is an exception. As regards other provisions existing companies will have to comply by 1 July 1982. "Statuts" (articles of association) will have to be modified accordingly by 1 July 1985.

64. New art. 72-1 of the law of 24 July 1966, art. 4 of the law of 30 December 1981.

65. Art. 69 of the law of 1966. This provision refers to /Continued over

of the new provision is therefore to extend the procedure to the transformation of other types of partnerships or companies into share companies.

When a company acquires, within two years of its registration on the commercial registry, an asset which belongs to one of its members and amounts to at least 10 per cent. of the capital, a _commissaire_ will have to value it and the general meeting will have to agree upon it.[66]

Other new provisions deal with reduction and increase of capital, the purchase by companies of their own shares (new articles 217 217.1-8, 164, 454-1) and the distribution of dividends. As regards the latter, articles 346, 347 and 350 of the law of 1966 are modified.

No distribution of dividends is allowed when the net assets (_actif net_) are or are becoming lower than the share capital and the non-distributable reserves. Under the law of 1966, it was possible to distribute an interim dividend (_accompte sur dividende_) upon a decision of the board of directors (_conseil d'administration_) or board of management (_directoire_) under certain circumstances. The law of 1981 has modified the conditions of distribution of interim dividends.

Footnote 65 continued from page 215.

commissaires aux comptes (special auditors) whereas _the 1981 law refers to_ _commissaires_. These _commissaires_ are subject to the same incompatibilities as _commissaires aux comptes_ (law of 1966, art. 220), _but are they the same individuals?_

66. New art. 157-1 of the Law of 1966.

Section 3: Forms of Business Organisations

§1. United Kingdom

I. Partnerships

In the United Kingdom, a partnership is defined in section 1 of the Partnership Act of 1890 as the relation which subsists between persons carrying on a business with a view of profit.[67]

In England and Wales, a partnership is characterised by the fact that it is not a legal entity (*personne morale*). In contrast, the law of Scotland recognises a partnership as a legal person distinct from the partners of whom it is composed.[68]

Every partner is jointly liable with the other partners for all the partnership's debts and obligations incurred while he is a partner.[69]

Subject to any agreement between the partners, the partnership is dissolved on the death or bankruptcy of a partner.[70]

The relationship between a partner and a partnership to which he is a member is one of agency;[71] a

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67. In relation to partnerships in general, Charlesworth & Cain, *Company Law* (London: Stevens & Sons, 12th ed., 1983), pp. 31-36.

68. Partnership Act 1890, s. 4(2).

69. *Ibid.*, s. 9.

70. *Ibid.*, s. 33(1).

71. *Ibid.*, s. 5.

person cannot be introduced as a partner without the consent of all other existing partners. As mentioned earlier, the members are jointly liable for all the debts of the partnership unless a person decides to be a limited partner in a limited partnership.[72]

There are two types of partnerships in the United Kingdom:

- the general partnership

All the members in it have unlimited liability, implied authority to bind the partnership in all partnership matters and the right to take part in its management.

- the limited partnership

It contains one or more partners whose liability is limited to the amount of their contribution. It has not been in practice much used because the private limited company is little more trouble to establish and it enables all the partners to have limited liability.[73]

II. Companies[74]

A. Limited companies

a) Company limited by shares

1) Private company

The 1980 Companies Act introduced a new

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72. Limited Partnership Act, 1907.

73. See L.C.B. Gower, The Modern Principles of Company Law (London: Stevens & Sons, 4th ed., 1979), pp. 50-52.

74. In February 1981, a consultative document entitled "A New Form of Incorporation for Small Firms" was published, Cmnd 8171; it considers the case for introducing into UK law a new form of corporate entity specially adapted to the small family firm.

classification of companies.

Under the 1948 Act, s. 28 in particular, 3 clauses characterised an English private company: the restriction on the transfer of shares, the limit on the number of members to 50 and the prohibition of offer of shares and debentures to the public. S. 28 of the 1948 Act has now been repealed. Only the prohibition of offer of shares and debentures to the public has been maintained in the 1980 Act.

Under the old classification, every company was a public company unless it had the 3 characteristics just described. Today, the situation is reversed; every company is a private company unless it satisfies the requirements of a public company; the private company has become the residual form of company.

2) Public company

A company is a public company only if it satisfies the special requirements laid down in the 1980 Act.[75]

Public company is defined by s. 1 of the 1980 Act:

> public company means a company limited by shares or limited by guarantee and having a share capital, being a company -
> (a) the memorandum of which states that the company is to be a public company; and
> (b) in relation to which the provisions of the Companies Acts as to the registration or re-registration of a company

75. See Clive M. Schmitthof, Palmer's Company Law, Fourth Cumulative Supplement to Volume I of the 22nd ed., up to date to 1 July 1980 (London: Stevens & Sons, 1980); L.C.B. Gower's Principles of Modern Company Law, Supplement to 4th ed., 1980 (London: Stevens & Sons, 1981).

> as a public company have been complied with on or after the appointed day ...

The new characteristics of the English public company may be summarised as follows:

The minimum number of persons who may form a public company shall be 2 (s. 2(1)).

The name of a public company must end with the words "public limited company" (plc) (s. 2(2)). This is undoubtedly an improvement, as before both types of company had the same designation "limited" (or "Ltd").

The issued capital must not be less than the "authorised minimum" (s. 6(1)(a)), presently fixed at £50,000 (s. 85). It may be subject to modification by statutory instrument.

Each of the allotted shares shall be paid up to 25 per cent. of their value plus any premium (s. 6(1)(b)).

A trading certificate is still necessary for a public company to commence business (s. 4), whereas a certificate of incorporation is sufficient for a private company, but a statutory meeting is no longer required (Schedule 4).

b) <u>Company limited by guarantee</u>

A company limited by guarantee is a company which has the liability of its members limited by the memorandum to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up (s. 1(2)(b), 1948 Act).

The existence of such a company has been

recognised in the 1980 Act but its creation is prohibited in the future (s. 112,, 1980 Act); therefore, such an organisation is likely to die progressively.

It is normally charitable, educational companies which adopt such a form, not business organisations.[76]

B. Unlimited company

In an unlimited company, there is no limit on the liability of members. It is very similar to a partnership but in a partnership the partners owe a debt directly to the creditors; in an unlimited company, there is no direct connection between members and creditors.

Such a company may or may not have a share capital.

The advantages of such a form of business organisation are essentially that of the status symbol it represents; also, if certain conditions are fulfilled, they need not file accounts.[77]

These conditions are set out in s. 1(8) of the 1976 Companies Act.

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76. The City of London Polytechnic is a Company limited by guarantee.

77. In relation to this point, it is interesting to notice that it is only in 1967 that exempt private companies were abolished. Since then, limited companies of all sorts have to file accounts (s. 45, 1967 Act).

§2. France[78]

There is only one word in French for company and partnership, that is société.

For tax purposes, a distinction is in fact made between sociétés de personnes (partnerships) and sociétés de capitaux (companies).

Contrary to the English approach, sociétés de personnes generally have legal personality.

The most fundamental distinction to introduce in an attempted classification of the different forms of business organisations in France is certainly that between civil and commercial organisations. The background, the importance and practicalities of this distinction have been developed under Section 1 of the present chapter.

Here, to try and match the presentation of the UK classification, the distinction between partnerships and companies will be used as a criterion of classification.

I. Partnerships

A. Civil partnerships (société civile)

The civil partnership is governed by the Civil Code, but it may be commercial if its objects are such.

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78. See in general M.J. Ellis and P.M. Storm editors, Business Law in Europe (The Netherlands: Kluwer, 1982); also J. Le Gall, French Company Law (London: Oyez Publishing, 1974); G.A. Zaphiriou, European Business Law (London: Sweet & Maxwell, 1970) Chapters 5 and 10 in particular.

Until 1978, a *société civile* did not have to be registered.

Partners have unlimited liability for the debts of the partnership in proportion to their share in the capital of the partnership. Spouses may be partners in a *société civile*, since they are not jointly liable for the partnership debts.

B. General partnership (*société en nom collectif*)

It is the most popular form of commercial partnership.

A *société en nom collectif* must be registered on the commercial registry (*registre du commerce et des sociétés*); its formation must be publicised in a legal gazette and its name must consist of the name of each of the partners, or of the name of one or several of them followed by the words "and company" ("*et compagnie*"). Each partner is deemed to trade under the name of the partnership, and the debts and obligations of the partnership are deemed to be his own. As a result of this joint and several liability, spouses cannot be members of such an association.[79]

C. Silent partnership (*société en participation*)

The *société en participation* is the least formal of all French business organisations.[80] A *société en*

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79. Law of 24 July 1966, art. 10-22.

80. See in general R. Roblot, *Traité Elémentaire de Droit Commercial* (Paris: LGDJ, 10th ed., 1980), §§887-901.

participation does not have legal personality.[81]

It may take one of two forms: the traditional société en participation occulte, unknown to third parties or the société en participation ostensible, disclosed to the public. The latter replaces the old société civile which did not have to be registered, whereas a société civile is presently under the obligation to register and it has legal personality.

Because of its nature, a société en participation has no assets distinct from those of the partners. The partners retain the ownership and legal possession of whatever they contribute, and the partnership merely has the use of such assets. The partnership has neither a distinctive name nor a registered office. Its flexibility and its lack of publicity have made it very attractive to, for example, bank consortia and marketing and research groups.

II. Companies

For all practical purposes, there are only two viable forms of associations in France which correspond with the English company, the société à responsabilité limité (SARL) and the société anonyme (SA).

A. SARL[82]

It is particularly suitable for the small and

81. Code Civil, art. 1871, al. 1.

82. Law of 24 July 1966, arts. 34-69.

medium sized businesses.

It is similar to the English private company in that its shares (*parts sociales*) cannot be issued to the public or listed on a Stock Exchange; it cannot issue bearer shares (*actions au porteur*) and there are restrictions on the transfer of shares - 75 per cent. majority of members required for transfer to non-members. There must be no more than 50 shareholders. The SARL requires a minimum share capital of 20,000 Francs, which must be fully subscribed and paid-up at the time of incorporation.

It must also be registered at the Commercial Registry on formation, though thereafter its annual accounts are not required to be filed. It is also required by law to have at least one manager (*gérant*), who can be appointed for an unlimited period of time.

B. SA

The other important form of company is the *société anonyme*, the share company, which may or may not issue shares to the public.[83]

The SA is designed for companies with a large membership and especially those which wish to be quoted on a Stock Exchange. Its members' liability is likewise limited to the value of their shares (*actions*). It must have a minimum of 7 shareholders, and no maximum is imposed. Its minimum share capital is dependent on whether it wishes to appeal for public subscription (*avec*

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83. Law of 1966, arts. 70-250.

appel public à l'épargne) when it will be 1,500,000 Francs and otherwise only 250,000 Francs.[84]

Its minimum share capital must be subscribed in full and at least one quarter thereof fully paid-up at the time of incorporation. Its incorporation may be simultaneous if the promoters make up all the initial capital or by stages where there is to be an appeal for public subscription. This will involve, as with the English public company, preparation of articles of association, issue of a prospectus, preliminary general meeting and subscription by the public.

An SA may, unlike the SARL, issue debentures (*obligations*). Its creation must be registered at the commercial registry and its annual accounts must also be publicised. Its board of directors (*conseil d'administration*) must have a minimum of three members, the number being fixed by the company's articles, with twelve as a maximum.

There is an alternative form of management structure, inspired by the German model of *Aktiengesellschaft*, composed of a board of management (*directoire*) and a supervisory board (*conseil de surveillance*). It is not in practice very popular.

Until the law of 1981, there was no general obligation for companies to have the shares they issued

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84. This is very recent; art. 71 of the law of 1966 has been modified by a law of 31 December 1981. The old figures were 500,000 Francs when capital was raised publicly and 100,000 Francs otherwise.

registered in the name of their owners.[85] Shares were most commonly held in the bearer form.

Bearer shares (or non-registered shares, actions au porteur) could be sold without payment of a 4.80 per cent. registration duty (droit d'enregistrement) provided by art. 726 of the General Tax Code.[86] They could also be used as a vehicle to disguise wealth.

For the purposes of imposing the new wealth tax (impôt sur les grandes fortunes) the Finance Law of 1982 requires that companies convert their bearer shares into nominative shares (actions nominatives) if the shares are not quoted on a Stock Exchange or if no permission has been obtained for trade on the Stock Exchange.[87]

This formality must be complied with before 1 October 1982,[88] at the risk of having the managers (gérants), chairman of the board of directors or supervisory board (président du conseil d'administration ou du directoire)

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85. There were only a limited number of cases where the registered form was compulsory: shares issued for contribution in cash until they were fully paid up (art. 270 of the law of 1966); shares held in reserve for exchange for convertible debentures (art. 205); shares bought by SAs for distribution to their employees (art. 217(1)). This latter exception was introduced by an ordonnance of 17 August 1967 (No. 67-695). Art. 217(1) has been modified by the law of 1981.

86. The transfer of parts sociales must always be made by written instrument. It is entered into the Commercial Registry and always subject to a 4,80 per cent registration duty.

87. Finance Law, art. 94-I. This involves shares issued on the French territory and subject to French law.

88. Ibid.

being presumed to be the owner for purposes of estate duties (droits de mutation par décès) and net wealth tax.

The articles of association (statuts) will be amended to comply with the transformation; the change will be carried out through an extraordinary general meeting (assemblée générale extraordinaire)[89] or with the contribution of the president of the commercial court.[90]

After 1 October 1982, owners of bearer shares will be deprived of the right to receive dividends, to attend shareholders' meetings and to vote.[91] At a date to be fixed by decree, rights to any outstanding bearer shares will be required to be sold.

In addition, art. 94-II requires that within eighteen months of a decree on this subject, all French securities (valeurs mobilières), whether shares or debentures and whether or not quoted on a Stock Exchange, must be registered in a special account held by the issuing legal entity (personne morale émettrice) or by a qualified intermediary (intermédiaire habilité).

The penalties for non-compliance are the same as for art. 94-I.

III. Groupement d'interêt économique (GIE)

It was created by an Ordonnance No. 67-821 of

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89. Law of 1966, art. 499 al. 2.

90. Ibid., al. 3.

91. Art. 94-I of the Finance Law 1982, al. 3.

23 September 1967; it is not strictly speaking a partnership or a company, but rather an institution with the object of extending the economic activities of its members and is used for such projects as sales promotion, representation abroad, market research and joint technical, financial or commercial services. A GIE is a joint venture, with legal personality; it is subject to registration and publicity. The members, at least two, have unlimited and joint and several liability, but this will in practice be nullified by the fact that their members will be companies with limited liability. The members, and not the entity, are subject to tax on its profits.

Section 4: Comparison

§1. Private Company and SARL[92]

. Since the 1980 Companies Act, the English private company is the residual form of company: all companies shall be private unless they satisfy the requirements of a public company.

The SARL could not be said to be a residual form of company. Each form of French company is adapted to a

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92. Certain authors, such as S.N. Frommel, would not make this comparison. His classification of companies is based on the idea that the strict equivalent of the French "share company" is the English "registered company limited by shares" which may in turn be public or private; see Taxation of Branches and Subsidiaries in Western Europe, Canada and the USA (London: Kluwer Publishing Ltd, 2nd ed., 1978), p. 109. The salient differences outlined below tend to give support to that view.

different type of business, the SARL suits small or medium size businesses, the SA larger ones.

. There is a minimum capital requirement for an SARL of 20,000 Francs.[93] There is no counterpart in England. As there has to be a minimum of two shareholders for a private company to be formed, and the smallest coin available in England is a halfpenny, it seems that the minimum capital of a private company is a penny.

. The maximum number of subscribers is limited to 50 in France;[94] such a limitation has been abolished in England for the private company in the 1980 Companies Act.

. In France, a share in an SARL is a part sociale; a share is an action when it is issued by a société anonyme. No such distinction exists in the UK; a share is a share whether it is issued by a public or private company. Neither shares in private companies nor parts sociales in SARL may be offered to the public.

Since the abolition of exchange control in the UK in 1979, private companies may issue bearer shares. On the other hand, in France, parts sociales are not in the bearer form.

. Neither SARL nor private companies can issue

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93. Law of 24 July 1966, art. 35.

94. Ibid., art. 36.

debentures (obligations).

. The management of an SARL is carried out by managers (gérants); the management structure of an SA is different. There is not such a difference in the management structure of private and public companies in the UK; both are governed by a board of directors.

. Since 1967, the private company has to disclose its accounts, whereas the SARL has no such obligation.

§2. Public Company and SA

. As to the minimum capital of an SA, France makes a distinction between SAs which go to the public for funds (appel public à l'épargne) and those which do not. The former require a minimum capital of 1,500,000 Francs, the latter 500,000 Francs.[95]

The 1980 Companies Act introduced an authorised minimum capital as regards public companies.[96] It is presently £50,000, subject to modification by the Secretary of State by means of a Statutory Instrument.

. The need for a trading certificate in order to commence business has been unfortunately maintained in

95. Law of 31 December 1981.

96. The use of the word public in English may be misleading because it does not mean that its shares are publicly held or that they are listed on a Stock Exchange.

England, whereas registration on the Commercial Register is sufficient in France.

A French company comes into existence as a legal person on entry in the Register whilst an English company becomes a legal entity as from the date on the certificate.[97]

More differences exist, although the effect of the 1980 Companies Act is to bring the public company closer to the French SA or its German counterpart, the Aktiengesellschaft (AG).

§3. Differences Common to Both Forms of Companies

. Weighted voting

In France, one share carries one vote. This is the rule and it is only subject to limited and specific exceptions stated in art. 75 of the law of 1966: its paragraph 1 provides that double voting rights (droit de vote double) may be conferred upon registered shares (actions nominatives) which are entirely paid up (entièrement libérées) and have been registered for at least two years in the name of the same shareholder.

In sharp contrast, weighted voting is freely available in England. It is lawful and amongst other things, a convenient way to prevent the removal of

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97. 1948 Companies Act, s. 13(2).

directors.[98]

. There is in France a single document to govern the company, *les statuts*; in England, there are two, the memorandum of association which contains - *inter alia* - the name and objects of the company and the amount of its share capital, and the articles of association containing the rules for its internal management; the *statuts* contain all these matters.

. *The secretary of a company*

In England, every company must have a secretary who, like the directors, is an officer of the company. A director may act as a secretary, provided he is not the sole director.[99]

The office of secretary has no equivalent in France.

Because of a secretary's growing status in the administration of the company, the 1980 Companies Act, s. 79 in particular, purports to require professional qualifications for secretaries and introduce one qualified officer in companies, although the provision in practice is utterly ineffective.

. *Directors*

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98. See *Bushell* v. *Faith* (1970) AC, p. 1099, a decision of the House of Lords.

99. 1948 Companies Act, ss. 177-179.

The office

Both in England and in France, a director of a company can be an individual or a corporate person.[100]

English law has no requirement in relation to capacity: an infant can be a director; s. 185(1) of the 1948 Companies Act on the age limit of 70 can easily be dispensed with.[101] Nor does English law request qualifications of any sort.

In France, the articles of association (statuts) are to include an age limit; if they fail to do so, art. 90.1(2) of the law of 1966 provides that only one third of the directors (administrateurs) may be over 70.

The law in England does not require a director to be a shareholder. In France, each administrateur is to own a number of shares to be determined in the articles of association. The shares of the administrateurs must be in the registered form, or kept in a bank (déposées en banque) if held in a bearer form; he may not alienate them.[102] This provides for a guarantee of his management (actes de gestion).[103]

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100. For a definition of a director, see s. 455 of the 1948 Companies Act; also, s. 63 of the 1980 Act (shadow director). For the corresponding more drastic provisions in French law, see art. 91 of the law of 1966.

101. 1948 Act, s. 185(5).

102. Art. 95 of the law of 1966, art. 82 of the décret of 1967. However, since the Finance Law of 1982, bearer shares are all to be transformed into nominative shares before 1 October 1982.

103. The position as regards gérants of an SARL is different; for instance, they may or may not be members; it is possible to have a single manager.

The liability of managers (*gérants*) of SARL and directors (*administrateurs*) of SA in France is a lot more burdensome than that of directors in the UK.

The liability of *gérants* is described under arts. 52 and 66 of the law of 1966: it may be individual or joint and several, civil and/or criminal.

A manager may be sued by third parties or members in the case of personal damage, or by one or several members for damage to the company.[104]

Article 99 of the Law of 13 July 1967 on *règlementation judiciaire* (scheme of arrangement with creditors under the supervision of the court) and *liquidation des biens* (compulsory winding up) makes provision for the possibility of making managers personally liable for the debts of the company. The burden of proof is on the managers to show that they performed their duties actively and with all necessary conscientiousness (*ils ont apporté à la gestion des affaires sociales toute l'activité et la diligence nécessaires*).

Similar duties and liabilities weigh on directors of SA.[105]

The responsibilities at the top of a company are properly defined in France and the liabilities assessed. The board of directors (*conseil d'administration*) elects from amongst its members a chairman;[106] he may be

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104. Arts. 45 and 46 of the *Décret* of 1967.

105. Arts. 244-250 of the law of 1966. Penalties regarding the management of SA are described under ss. 437-489.

106. Law of 1966, art. 110.

dismissed at any moment. He is vested with the broadest powers to act on behalf of the company unless a power is expressly reserved to the shareholders or to the board; he assumes under his responsibility the general management of the company.[107] He may be required to be assisted by one or two general managers (_directeurs généraux_), but their powers cannot encroach upon his own;[108] they are determined by the board, in agreement with the chairman.[109]

By contrast, in the UK, art. 107 of Table A provides:

> The directors may from time to time appoint one or more of their body to the office of managing director for such period and on such terms as they think fit.

The duties of directors

In France and in England, directors' duties may be divided in two categories:

- duties based on judicial decisions
- duties imposed by statute.

In France, the predominant part of the law relating to directors' duties is contained in statutory provisions; the decisions, although their importance should not be undervalued, only interpret the statutory provisions, and therefore fulfil a secondary function.

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107. _Ibid._, art. 113.

108. _Ibid._, art. 115.

109. _Ibid._, art. 117.

The position in England is the reverse. Most directors' duties are expressed and developed in decisions of the courts: the duty of care, i.e. the duty not to be negligent, is not mentioned in any statute and rests solely on case law, sometimes very old.[110] The fiduciary duty, i.e. the duty to act in good faith for the benefit of the company, is also largely developed by the judgments of the courts. Statutory provisions essentially relate to prohibitions of tax free payments, loans to directors, and matters of disclosure.

The contrast between the United Kingdom and France may be extended to the level of the duties imposed on directors in each country.

In general, it can be said that in English law, the duty of care is low: a director is required "to act with such care as is reasonable to expect from him, having regard to his knowledge and experience".[111]

The standard is weak and the approach not very objective, therefore uncertain. The duties of directors are owed to the company, and not to individual shareholders or anyone else.[112] Their enforcement may therefore give rise to problems where a director at fault controls the company.[113]

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110. For instance, Charitable Corporation v. Sutton (1742).

111. Re Brazilian Rubber Plantations and Estates Ltd (1911) 1 Ch. p. 425 at p. 437 per Neville J.

112. Re City Equitable Fire Insurance Co Ltd (1925) Ch. p. 407, per Romer J. at p. 428.

113. N.W. Transportation Co. v. Beatty (1887) 12 AC, p. 589.

The level of the duties of directors in England should be raised to a better standard,[114] and also put into statutory provisions in order to be specific, clear and precise.[115]

Furthermore, the breach of duties should lead to effective and appropriate liability which could not be escaped as easily as at present.[116]

The doctrine of *ultra vires*

The reason for the presence of the doctrine of *ultra vires* in the United Kingdom is historical. Such a doctrine is unknown in Germany; it exists in France, but it is applied differently.

The doctrine of *ultra vires* is still part of the English system to a certain extent because of an improper and insufficient attempt to do away with it in the European Communites Act of 1972.

The entry of the United Kingdom into the EEC was to introduce modifications through the implementation of the first directive on company law of 9 March 1968, art. 9 in particular: it offers a choice between a total abolition of the doctrine or its maintenance as long as a better protection of outsiders was provided. Article 9 states:

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114. Jenkins Committee which reported in 1962 (Report of the Company Law Committee, Cmnd 1749), in particular §99(a)(i), (iii) and (iv).

115. For a different opinion, see A. Tunc, *op.cit.*, note 39 above, p. 13.

116. For a proper development on directors' duties, see L.C.B. Gower, *op.cit.*, note 73 above, Chapter 24.

> 1. Acts done by the organs of the company shall be binding upon it even if those acts are not within the objects of the company, unless such acts exceed the powers that the law confers or allows to be conferred
>
> objects of the company, if it proves that the third party knew that the act was outside those objects or could not in view of the circumstances have been unaware of it; disclosure of the statutes shall not of itself be sufficient proof thereof.
>
> 2. The limits of the powers of the organs of the company, arising under the statutes or from a decision of the competent organs, may never be relied on as against third parties, even if they have been disclosed.

1. The first paragraph does away with the doctrine of ultra vires as a whole. The second paragraph in its application guarantees that the doctrine is kept, but outsiders are much better protected.

2. This deals with the authority, the powers of directors.

Both the United Kingdom and France have decided to maintain the doctrine of ultra vires as part of their system, and not to do away with it and catch up with Germany, which never had the doctrine.

France applied the directive word for word and implemented it in the law of 24 July 1966.[117] The French equivalent of the doctrine of ultra vires is referred to as spécialité statutaire and, as will be outlined, their impact is different.

The United Kingdom, on the other hand, attempted to achieve a similar position, but has failed to do so.

Section 9(1) of the European Communities Act of

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117. Art. 113, as amended by Ordonnance No. 69-1176 of 20 December 1969.

1972 provides:

> In favour of a person dealing with a company in good faith, any transactions decided on by the directors shall be deemed to be one which is within the capacity of the company to enter into, and the powers of the directors to bind the company shall be deemed free of any limitations under the memorandum or articles of association; and a party to a transaction so decided shall not be bound to enquire as to the capacity of the company to enter into it or as any such limitation on the powers of the directors and shall be presumed to have acted in good faith unless the contrary is proved.

The position of the company has not been modified; it still cannot sue on an _ultra vires_ contract.

The concept of 'good faith' has been introduced in article 9(1): as opposed to the situation in France where knowledge (_connaissance_) is to be established before a contract can be said to be _ultra vires_, good faith must be shown in the United Kingdom. What is the meaning of good faith? What does the word transaction cover? Does it include gifts? Why is a transaction _deemed_ to be within the capacity of a company, and not simply within the capacity of the company?

The French text, like the EEC model deals separately with the capacity of the company (acts outside the objects, _actes qui ne relèvent pas de l'objet social_) and then with the powers of directors (restrictions on the authority of the board of directors).

As in the French version, do "transaction decided on by the directors" include both executory and non-executory directors?

There are no cases presently available to answer

all these questions and the 1980 Act has not even attempted to resolve the difficulties.

Section 5: Conclusion

It may generally be said that there is a trend for English company law to become closer to continental company law. This is primarily a consequence of the entry of the United Kingdom into the European Communities.

Some provisions recently introduced can only be welcomed. For instance, the new classification of companies, the requirement of a minimum capital for public companies, the allotment of shares, the distribution of dividends, the enactment of the rules as to company's accounts contained in the Fourth Harmonisation Directive issued by the Council of Ministers of the European Communities in 1978,[118] and incorporated in the 1981 Companies Act.

However, some rules of continental company law have been incorporated into the English system, but so poorly that the result, the intended effect, is totally missed.

An illustration of this statement is provided by ss. 26 and 29 of the 1980 Companies Act.

The documents of a company in the United Kingdom are drawn up by the promoters, usually businessmen, people who want the company to be formed, assisted by professional

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118. Official Journal (1978) L. 222(11).

people such as solicitors and accountants. The subscribers to those documents (memorandum and articles of association), <u>i.e.</u> their signatories, are normally different people, often clerks, individuals who have no personal interest in the formation of the company. The subscribers must take at least one share.[119] New provisions with regard to subscribers have been introduced in the 1980 Act. They only affect public companies but their impact in practice is nil.

> A public company ... shall not ... enter into an agreement with a relevant person for the transfer by him during the initial period of one or more non-cash assets to the company or another for a consideration to be given by the company equal in value at the time of the agreement to at least one tenth of the nominal value of the company's share capital issued at that time.

"Relevant person" designates a subscriber and "initial period", a period of two years beginning with the date of the trading certificate.[120]

The drafters of this section have followed word for word the EEC 2nd directive which is of continental inspiration and have applied it to British subscribers, <u>i.e.</u> clerks who hold one share.

The EEC provision is in fact meant to catch the promoters who, on the Continent, are also normally the subscribers.

S. 29 of the same Act which requires a subscriber

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119. <u>Ibid</u>., s. 2(4)(b).

120. Second EEC Company Law Directive, OJ 1977, L 26/1.

to pay for his shares in cash, is equally insignificant.

An agreement such as described above, for instance the selling of property by a subscriber to the company at a price at least equal to one tenth of the share capital, cannot take place within two years of issue of the trading certificate unless a valuation by independent accountants is carried out, a report is made to the company and the terms of the agreement approved by an ordinary resolution.

Despite numerous modifications and additions to certain areas of English company law, the reforms are very fragmented, very specific and no attempt is being made of a deep revision of the law in this particular area.

Primarily, consolidation of the 1948, 1967, 1976, 1980 and 1981 Acts is required.

Secondly, numerous items belonging traditionally to the English system remain and ought to be removed, for the sake of general improvement and harmonisation.

For instance, the need for a trading certificate is no longer felt; floating charges and weighted voting ought to disappear in order to provide for a better protection of creditors; the existing doctrine of ultra vires is to be clarified through a clear redrafting of section 9 of the European Communities Act of 1972.

In France, the state of company law was reasonably satisfactory after the enactment of the law of 1966 and the decree of 1967. An effort had been made towards consolidation and clarification.

However, since then, the original law has been

modified too often,[121] and confusion, lack of concision and clarity will soon apply to the state of French company law.

121. The following list is an incomplete enumeration of laws, decrees and ordinances which have modified the original texts of 1966 and 1967: Laws Nos. 69-12 of 6 January 1969, 67-16 of 4 January 1967, 67-559 of 12 July 1967, 78-9 of 4 January 1978, 81-1162 of 30 December 1981; decrees Nos. 68-25 of 2 January 1968, 69-1226 of 24 December 1969, 71-615 of 23 July 1971, 73-224 of 22 February 1973, 74-319 of 23 April 1974; ordinances Nos. 67-695 of 17 August 1967, 69-1176 of 20 December 1969.

CHAPTER 2

RESIDENCE AND NATIONALITY OF COMPANIES

Section 1: Residence of Companies

§1. United Kingdom[1]

I. The Importance of the Concept of Residence

Residence is a concept of primary importance in the legal system of the UK.

A company resident in the United Kingdom is taxable in respect of its worldwide income,[2] a non-resident company is taxable on income arising from sources within the UK.

II. Existing Law

A. Absence of statutory provision

The Taxes Acts contain no definition of the

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1. See in general, G.S.F. Piper and W.B. Deadman, Residence and Domicile for United Kingdom Tax Purposes (London: Guild Press, 1981); Cheshire and North, Private International Law (London: Butterworths, 10th ed., 1979), pp. 188-191; Dicey and Morris, The Conflict of Laws (London: Stevens & Sons, 10th ed., 1980), Vol. 2, pp. 728-731; Tiley, Revenue Law (London: Butterworths, 3rd ed., 1981), pp. 627-633; J.F. Avery Jones, "Domicile and Residence in the United Kingdom", European Taxation (1981), pp. 172-177; Pyrez, Canadian Tax Journal (1973) Vol. 21, p. 374; Resident & Non Resident Companies Simon's Taxes, Vol. D, 04-101-126, pp. 603-636; D.F. Mead, Residence and Domicile, ICA Tax Digest No. 11.

2. ICTA 1970, s. 243(1).

term "residence".

This is subject to an exception, s. 482 of the ICTA 1970. This section deals with migration of companies. In its paragraph (7), it is stated that for the purposes of the section, the residence of a body corporate shall be determined according to the location of the "central management and control of its trade or business".

The draftsmen of the section have borrowed the expression "central management and control" from Lord Loreburn's speech in De Beers Consolidated Mines Ltd v. Howe:

> ... a company resides, for the purposes of income tax, where its real business is carried on ... and the real business is carried on where central management and control actually abides." 3

For other purposes than that of s.482, the statement of Lord Loreburn is regarded as the test of determination of the residence of a company: Lord Radcliffe, in a more recent decision, has said about the De Beers decision:

> This judgement must be treated today as if the test which it laid down was as precise and unequivocal as a positive statutory injunction. 4

B. Case law[5]

It is generally thought - and the Inland Revenue

3. (1906) AC, p. 455, at p. 458.

4. Unit Construction Co Ltd v. Bullock (1960) AC, p. 351, at p. 366.

5. For a clear analysis of the case law on this point,
/Continued over

shares this view[6] - that "central management and control" means the place where the directors of a company meet. This test is artificial and enables companies to arrange a tax residence different from the place where the operations are really carried on. This is one of the reasons for the Revenue to wish to alter the existing rules.[7]

Support for the view of the Inland Revenue may be found in most decisions; others may be used to support a different view.

- De Beers Consolidated Mines Ltd v. Howe

The company was incorporated in South Africa, where the whole of its profits were made from the mining and disposal of diamonds; shareholders' meetings were held in South Africa, diamonds were sold through a London syndicate. Directors met both in London and South Africa,

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Footnote 5 continued from page 246.

Sumption, Taxation of Overseas Income and Gains (London: Butterworths, 3rd ed., 1982) Chapter 9, pp. 139-153. Also "Residence - Assessment of Present Law", Taxation Practitioner, Annex to the company residence proposals published by the Inland Revenue, April 1982, pp. 89-90-124.

6. BTR, Current Tax Intelligence: Corporation Tax, p. 444. Extract from a Command Paper (5845, "Wages and Conditions of African Workers Employed by British Firms in South Africa"): "If for example the meetings of the directors who manage the company's business are held in the United Kingdom the central management and control would normally be regarded as exercised in the United Kingdom and the company would be resident here for tax purposes".

7. For a complete development on the 1981 proposals, see below, p. 258 et seq.

but the majority of them lived and met in London. Despite the fact that the profits of the company arose entirely from the mining of diamonds in South Africa, the House of Lords held the company to be resident where the "central management and control actually abides".[8] Real control was held to be exercised at the London meetings of directors as business policy was decided there.[9]

This case illustrates the fact that a foreign company, a company incorporated abroad, may be resident in the UK.

Two subsequent cases brought in confusion: Swedish Central Rail Co Ltd v. Thompson[10] and Egyptian Delta Land and Investment Co v. Todd.[11]

Both cases involved investment companies. The former was incorporated in England in 1870; its object was to construct and run a railway in Sweden. Its registered office was in London. In 1900, it leased the railway to a transport company for 50 years at an annual rent of £33,500 payable in England. In the same year,

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8. (1906) AC, p. 455, at p. 458.

9. For concurrent decisions, see American Thread Co v. Joyce (1913) 6 TC, p. 1: the control that is important is that of the directors, rather than the shareholders. John Hood & Co Ltd v. Magee (1918) 7 TC, p. 327: a company is resident where its controlling board meets rather than where its directors are resident. Also, Bradbury v. English Sewing Co Ltd (1923) AC, p. 744.

10. (1925) AC, p. 495, 9 TC, p. 370.

11. (1929) AC, p. 1, 14 TC, p. 138.

the articles of association were altered so as to transfer the management and control to Sweden. Subsequently, general meetings of shareholders and board meetings were held in Stockholm. The only way profits were transferred to England was in the form of dividends due to English shareholders. The secretary resided in London, where annual accounts were made up and audited.

In the Egyptian case, the company was incorporated in England in 1904 for the purpose of acquiring and disposing of any land served by the Egyptian Railways Ltd. The business was controlled, managed and directed entirely in Cairo. In London, there was a registered office to satisfy the requirements of the Companies Act. The company employed a man to keep the necessary documents and post the name of the company on the door of his office but the job of this man was to be secretary of public companies.

The House of Lords held in the Swedish case that the company was resident both in England and in Sweden; it decided in the Egyptian case that the company was resident only in Egypt.

These two decisions are difficult to reconcile.[12] The business done in England was far more substantial in the Swedish than in the Egyptian case. However, how is the decision in the Swedish case to be reconciled with the rule that a company resides where its real business is

12. Tiley, op.cit., note 1 above, at pp. 791-793.

carried on and that the "real business is carried on where the central management and control actually abides"?[13]

In the Egyptian case, Lord Cave and Lord Dunedin were not prepared to apply the doctrine of incorporation as a test for residence and say that the company was resident in the UK because it was registered there. However, both concurred in saying that registration and the other circumstances were sufficient for the company to be resident in the UK.[14]

In Union Corporation v. IRC,[15] the Court of Appeal attempted to redefine "central management and control".

Lord Evershed MR claimed that "central management and control" could mean something other than "final and supreme authority":

> Where the central power and authority abides does not demand that the court should look and look only, to the place where is found the final and supreme authority.

In order to constitute residence he said,

> there must not only be some substantial business operations in any given country but also present there some part of the

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13. Cf. De Beers Consolidated Mines Co Ltd at p. 458.

14. Op.cit., note 11 above, at p. 505.

15. (1952) 1 All ER, p. 646, confirmed by the House of Lords (1953) 1 All ER, p. 729. For a commentary on this particular decision, see Law Quarterly Review (hereinafter cited as LQR) Vol. 67, pp. 446-449 and Vol. 68, pp. 307-311.

superior and directing authority of
the company.

Lord Evershed found the latter in the meetings in South Africa of the minority of directors!

The case that is going to be summarised now is particularly relevant because it involves the United Kingdom and France. It is a decision of the Court of Appeal of 1927, B.W. Noble Ltd v. Mitchell (Inspector of Taxes).[16]

A company of insurance brokers was registered in England. The French business of the company was carried out in Paris by one of the directors of the board. He was appointed resident director in France and conducted the business there under a power of attorney from the company. He attended a few board meetings in London, made some reports to the other directors, but they did not interfere with his conduct of the business in Paris. Separate accounts of the Paris business were kept there; the results were incorporated in the balance sheet of the company but no part of the French profits was ever remitted to London.

The company contended that the control of the Paris business was in Paris and not in London and that the profits therefrom were not to be subject to UK income tax.

The Special Commissioners decided against the company. This attitude was supported by the High Court and the Court of Appeal, which held that control of the

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16. 1926-1927 TC, pp. 372-412.

Paris business was with the Board of directors in London, that their authority was not diverted by the power of attorney. Mr Gabus, the Paris director, was not under his power of attorney "an independent plenipotentiary who could do what he liked".[17]

The argument of those who claim that the location of board meetings is not the sole criterion to determine the residence of a company essentially rests on one decision, Unit Construction Co Ltd v. Bullock (Inspector of Taxes).[18]

It is on the basis of this decision that some contend that the present law on residence of companies for tax purposes need not be modified!

The facts of the case may be summarised as follows:

Three subsidiary companies had been incorporated in Kenya. The articles of association stated that management and control were in the hands of directors, that meetings could be held anywhere outside the UK. The Kenya companies incurred substantial losses and the UK parent company took over the management and control in an attempt to save its investment.

The House of Lords held the subsidiaries to be resident in the UK on the basis that the business was in fact managed by UK directors, despite the provision of the articles of association. The House of Lords rendered

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17. Ibid., at p. 410.

18. (1960) AC, p. 351; 38 TC, p. 734.

that decision by looking at *de facto* control, not *de jure* control.

The *Unit Construction* case could also be used as a case supporting the view that residence is determined by location of board meetings. Indeed, the House of Lords held the company not to be resident in Kenya but in the UK; it is because central management and control was in fact exercised from the UK that the Kenya subsidiaries were held to be resident in the UK. It is on the basis that decisions relating to the subsidiaries in Kenya were made in London at the board meetings, that the subsidiaries were held to be resident in the United Kingdom. This seems strong support for saying that residence is where board meetings meet.

C. Concluding remarks

Those who argue that the Revenue is wrong in saying that location of board meetings is the sole artificial test to determine the residence of companies use fragments of certain decisions to demonstrate their point. Those who argue the contrary use other fragments of the same decisions: arguments in favour and against a modification of existing law are sometimes found in the same decisions!

It is thought that the present law on residence of companies is unsatisfactory and can be misleading.

If one supports the view that there is a single

criterion to determine whether a company is resident in the UK or not, that criterion is said to be the location of board meetings. Such a criterion may have the advantage of being clear and simple, but it allows companies with minimum effort to easily organise themselves in such a way that they escape corporation tax in the UK. A company may be incorporated in the UK, manufacturing may take place in the UK, but as long as directors fly outside the UK to meet as a board, the business will not be liable to UK corporation tax, if it does not have UK source income.

Conversely, if one claims that location of board meetings is not the sole criterion,[19] then, what is the test? How does one determine the residence of a company for tax purposes?

If the test is "the place where they really carry on their business",[20] "where the business of the company is really carried, directed and carried on"[21] where is the necessity of embodying a principle formulated in decisions of the courts into a statute in a country where decisions of the courts are regarded as the first source of law?

Such an attitude would be justified in France

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19. J.B.D. Oliver, "Company Residence", BTR (1982) Current Notes, pp. 1-11.

20. The Cesena Sulphur Company Ltd v. Nicholson (1876) 1 TC, p. 83, at p. 103.

21. The American Thread Company v. Joyce (1913) 6 TC, p. 163, at p. 165.

where statutes are the primary source of law; in the UK, case law is the primary source of law.

Considering the usual approach of the UK towards legislation, a statutory definition of residence would need to be commented upon by the courts for its meaning to be assessed.

Finally, one may say that the need for clarification is essential.

Legislation will not clarify the situation for reasons outlined above. Would a decision of the House of Lords on the issue dissipate all confusions? One has to wait for it.

III. Proposed Reform

A. Is a reform necessary?

1) Arguments in favour

The Board of Inland Revenue is very isolated in thinking that a change in existing law on residence of companies is necessary.[22]

Its arguments in favour of such a change may be summarised as follows:

- the present definition assimilates a company's residence to the location of formal meetings of its board of directors. Such a criterion is easy to manipulate so as to avoid liability to UK corporation tax. It may also

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22. Simon's Tax Intelligence (hereinafter cited as STI) (1981), pp. 39-40. This development is written in the present tense; it follows events chronologically from January 1981 to July 1983.

result in a company being resident in a place other than that where the business is managed on a daily basis.

- The abolition of exchange control in 1979 has rendered ICTA 1970, s. 482 inappropriate. The Revenue proposes that s. 482 "cease(s) to have effect".[23] This would bring the tax legislation into line with the relaxation of exchange control.

- The Revenue shows concern at the fact that a subsidiary could be given the same residence as its parent where the parent exerts a strong influence on the management decisions made by the board of the subsidiary.

- The existing law is uncertain; cases are old, do not correspond to modern realities and they lack consistency.

- The Revenue wishes to bring the UK tax law into line with that of other countries, European partners in particular, and the OECD concept of residence of companies.[24]

These arguments were first put forward in the consultative document issued in January 1981,[25] and simply

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23. Does this amount to a repeal of s. 482?

24. The consultative document in its paragraph 5, states the existence of confusion as regards the relationship between the UK test of "central management and control" and the OECD test of "place of effective management". Such a statement on the part of the Inland Revenue is surprising in view of the commentary by the UK authorities to the 1977 OECD Model Convention: "it has been made clear, on the United Kingdom side, that this expression (management and control) means the 'effective management' of the enterprise"; commentary on art. 4, §23, p. 57. This point will be reconsidered in a Statement of Practice issued by the Inland Revenue in July 1983; see below, 5).

25. 16 Taxes International, February 1981, pp. 3-5.

reiterated in an introduction to the draft legislation published in November of the same year.[26]

2) Opposition

The proposals of the Board of Inland Revenue[27] have been met with unanimous hostility. It seems that not only the substance of the proposals is strongly opposed but the idea that a change is at all necessary is objected to.

The main arguments of all opponents, although coming from different backgrounds,[28] may be put together in the following way:[29]

- The present state of the law does permit the Inland Revenue to look beyond board meetings, and the Inland Revenue has sufficient power to determine the residence of a company. Unit Construction Co Ltd v. Bullock (Inspector of Taxes) is quoted as support for this statement.
- The existing test is well established, well understood, has proved certain and efficient.

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26. Board of Inland Revenue, "International Tax Avoidance", pp. 3-8.

27. For a description of these proposals, see below, B. 1) and 2).

28. For instance, Institute of Taxation, Institute of Directors, City Tax Committee, CBI, International Chamber of Commerce, British Overseas and Commonwealth Banks Association, British Insurance Association, academics, the Law Society. See also the Report of the Working Party of the Institute for Fiscal Studies.

29. For an overview of the responses to the consultative document, see 21 Taxes International, July 1981.

- The proposed changes will discourage multinational enterprises from undertaking activities in the UK in the future.[30]

- The proposed use of the place of incorporation as a criterion to determine residence has been particularly strongly rejected on the basis that it would be very inflexible.

- So has the possibility to have two sets of rules on residence, one for trading companies and one for non trading companies.

- The possibility of a multiple test is also regarded as totally unsatisfactory because it would be subjective.

- Finally, it has been reiterated that none of the new proposed tests would clarify the situation, nor bring any certainty into this area of law. Any of the proposals as a criterion for residence would be as difficult to define as "central management and control".[31]

B. Analysis of the proposed reform

1) Consultative paper: January 1981[32]

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30. It would also encourage others to move out of the UK; see Financial Times, 5 March 1982.

31. The consultative committee of Accountancy bodies states: "We accept, however, that a concise statutory definition of residence might be helpful ... but we do not see the distinction between that definition (effective management) and that of 'central management and control'." 21 Taxes International, at pp. 40-41.

32. STI 1981, pp. 39-40; 16 Taxes International, February 1981. For a commentary, David R. Davies, "Inland Revenue Proposals on Company Residence and Tax Havens and the Corporate Sector", Intertax, April 1981/4, pp. 157-160.

This document puts forward suggestions as to the test(s) which could replace the existing "central management and control":

- place of effective management, existing OECD test;[33]
- central administration and principal place of business as found in art. 58 of the Treaty of Rome;
- day to day management, principal administrative functions, principal acts of management or principal place of business;
- place of incorporation.

The paper also makes suggestions as to the working of the new provisions:

- there could be a single test or multiple ones;
- a distinction could be introduced between trading and non trading companies.

The new rules would be incorporated in a statute.

2) Draft legislation: November 1981[34]

As a result of widespread criticism following the publication of the consultative document, the Government has "appreciated the misgivings expressed in the representations" but still "believe(s) that the basic

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33. See above, footnote 21.

34. For a commentary, Alan G. Davies, "The British Revenue: Problems of Company Residence and the Use of Tax Haven Subsidiary Companies: Proposals for a New Legislation in the Finance Bill 1982", European Taxation (1981), pp. 379-382; J.B.D. Oliver, "Company Residence", Current Notes BTR (1982), pp. 1-11.

proposal to redefine company residence should receive further public consideration".

The "place from which the management of the company's business as a whole is conducted"[35] is the latest proposed test.

The idea of a multiple test has been abandoned, the American example of the rule of incorporation dropped, and the harmonisation with OECD or EEC concepts set aside for the time being.

A distinction is introduced where management is exercised in different places; residence will be the "place from which is conducted the immediate day to day management of the business as a whole".

The differentiation between trading and non trading companies also seems to have been abandoned.

The Inland Revenue requested further comments on the draft legislation and proposed to introduce legislation on company residence and other international avoidance provisions in the 1982 Finance Bill.

The legislation on company residence would only come into force on 6 April 1983.

If this is to be the final draft of the statutory definition of residence of companies, many problems arise.

It seems very difficult to assess the concept of "management of a company's business as a whole", especially as subsection (3) of Draft Clause 1 provides that

35. Draft Clause, s. 1(1).

reference to the company's business are references to those trading or other activities which principally constitute the company's business. The purpose of subsection (3) seems to be to set aside the supervisory level of management as a test of determination of residence.

If a company carries out two different and separate activities in two different places with no overall control apart from that of the board of directors, does the application of the new criterion mean that the company has two residences, or none at all?

The test of where a company trades is formulated in very similar terms to those proposed as a definition of residence. Yet, the tests have different purposes. Trading in (as opposed to trading with) will determine liability to UK tax on UK source income; UK residence will determine liability to UK corporation tax on worldwide profits.

Another consequence of the proposed legislation is likely to be that there will be many more cases of dual residence than previously.

3) Budget speech: March 1982

In the fortnight preceding the Budget Speech of the Chancellor of the Exchequer in the House of Commons, major multinationals in the UK - Shell, BAT Industries, ICI and Unilever for example - threatened to move their financial operations out of the UK if the proposed

legislation on international tax avoidance was included in the Budget.[36]

These multinationals have reacted rather violently against the proposed legislation mainly because its enactment could increase substantially their liability to UK corporation tax.

At present, a UK company can move its funds in the form of a loan to a subsidiary situated in a tax haven country where taxation is low or nonexistent and earn interest there without the Revenue taxing it: the directors occasionally meet there; it is sufficient under existing law to make that company resident in the tax haven, therefore not liable to UK corporation tax and income earned abroad is not taxable until remitted to the UK in the form of dividends.

Furthermore, the tax haven subsidiary may lend its funds back to the UK parent and the UK parent can further reduce its liability to UK tax by offsetting the interest payments.

The existing system of taxation combined with the abolition of exchange control has made tax avoidance relatively easy for multinationals and the widely drawn

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36. Financial Times, 5 March 1982, p. 1. See also the Lex Column on the back page. Financial Times, 8 March 1982: the rebellion of multinationals was directed not only against provisions on company residence but on other measures designed to counteract tax avoidance - a new charge on the income of certain tax haven companies under UK control and "upstreams loans".

proposed legislation would bring not only restrictions on practices such as the one just described but also a general uncertainty for companies in the planning of their tax affairs as the provisions which purport to counter the use of tax havens by UK companies in particular leave substantial discretionary power to the Board of Inland Revenue.[37]

In his Budget speech on 9 March 1982, the Chancellor plainly stated that further consultation was required before legislation on tax avoidance could reach the statute book.

The "yellow peril" - title which the colour of the cover has earned the draft legislation - is therefore set aside for the time being.

4) "Taxation of International Business": December 1982

A third document was issued by the Board of Inland Revenue in December 1982. It contains revised proposals to counter the use of UK controlled companies in low tax countries to avoid UK corporation tax. It invites representations on the new draft clauses; written comments are to be sent to Somerset House not later than 14 February 1983.

As far as the introduction of a statutory definition of the term "residence" for corporation tax purposes is concerned, such perspective is presently abandoned.

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37. See Commentary on Draft legislation, p. 9.

No statutory definition of residence will be introduced in the 1983 Finance Act. The reason for postponing such a move is - in the words of the December 1982 consultative paper - "the widespread unease produced amongst the business community ..."[38] In the meantime the Inland Revenue will issue a Statement of Practice in order to clarify the application of the present test of "central management and control".

5) Statement of Practice: July 1983[39]

As promised in December 1982, the Inland Revenue issued on 27 July 1983 a Statement of Practice (SP 6/83)[39] whose purpose is to clarify the application of the test of company residence.

After a summary of the case law and of the meaning given by the courts to the expression "central management and control", the statement of practice describes the approach the Inland Revenue will follow where doubts arise about the location of the residence of a

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38. "Taxation of International Business", Board of Inland Revenue, December 1982, at p. 6. For commentaries on this document, see 43 Taxes International, p. 22; Taxation Practitioner, February 1983, pp. 30-45; European Taxation (1983) pp. 91-99; BTR (1983), pp. 1-8; Financial Times, 31 March 1983.

39. For the full text of the Statement of Practice, see Taxation, Issue of 6 August 1983. The text of the Statement of Practice is also printed in 46 Taxes International, August 1983.

particular company.

> They first try to ascertain whether the directors of the company in fact exercise central management and control.
>
> If so, they seek to determine where the directors exercise this central management and control (which is not necessarily where they meet).
>
> In cases where the directors apparently do not exercise central management and control of the company, the Revenue then look to establish where and by whom it is exercised.

In this statement of practice, the Inland Revenue also "revises its view" with regard to a confusion, pointed out earlier,[40] amid the relationship between the UK test of "central management and control" and the OECD test of "place of effective management".

The Inland Revenue now considers that "effective management may, in some cases, be found at a place different from the place of central management and control".

IV. Change of Residence of a Company, s. 482[41]

A. Existing provision

The modification of the residence of a company is presently governed by s. 482(1)(a) of ICTA 1970. This section subjects the change of residence of a company to the consent of the Treasury.

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40. See above, footnote 24.

41. J.B.D. Oliver, "Are We Talking about the Same Thing?", Current Notes, BTR (1981), pp. 72-77.

This section was introduced in 1951 to prohibit the transfer of residence from the UK, but a company wishing to do so could do it by getting permission under s. 482 or otherwise.[42]

The sanction to non respect of this section is criminal rather than, for instance, deeming the company still to be resident in the UK. It seems that no prosecution has ever been brought.[43]

B. Proposal

Following the abolition of exchange control in 1979, the continuation of s. 482 is called into question.

The starting point of the review of company residence is said to be the case for the repeal of s. 482 and the need for some replacement.[44]

However, in the draft legislation on company residence, it is stated:

> (5) Section 482 of the Income and Corporation Taxes Act 1970 (restriction on migration etc. of companies) shall cease to have effect.

The proposed legislation does not expressly say "repeal". Is the expression "cease to have effect" equivalent?

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42. A. Davies, op.cit., note 34 above. See also below, Part I Chapter 6.

43. "Company Residence - A consultative document", § 2.

44. "Taxation of International Business", op.cit., note 38 above.

In accordance with their decision not to introduce a statutory definition of the term "residence" for corporation tax purposes, the Inland Revenue has decided to retain section 482 of the Taxes Act.

§2. France

The word "residence" is not used either in the French General Tax Code, nor in decisions of the French courts on domestic issues. However, courts do make use of the expression when dealing with double taxation agreements as it is a fundamental connecting factor: the personal scope of a tax convention is defined by the fact that it applies to residents.

"Siège social" of a company is the French counterpart of "residence" as understood under domestic UK legislation; both are connecting factors of paramount importance.

In theory, the criterion which determines the liability of a company to French corporation tax is stated in art. 209 of the General Tax Code: a company is liable to French corporation tax on the profits from business activity carried out in France.[45] This applies to French domestic matters, but it will be seen that in the context of double taxation conventions, the siège social plays a predominant role.[46]

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45. The meaning of this expression is developed in Part I, Chapter 3 entitled "Taxation of Foreign Income of Resident Companies".

46. See Part II, Chapter 1, Section 1.

For present purposes, _i.e._ the survey of domestic law, it seems logical to examine the concept of _siège social_ in the next section, dealing with nationality of companies, as _siège social_ is primarily the domestic criterion that determines the nationality of a company.

Section 2: Nationality of Companies

§1. United Kingdom: The Registered Office[47]

I. Determination

"A company shall at all times have a registered office to which all communications and notices may be addressed".[48]

The registered office is an administrative headquarters; it may or may not be the place where the business of the company is carried out. A company frequently does not carry on its business at its registered office.

It is with the registered office that the Department of Trade will get in touch; it is also the place where a writ would be served. Some documents are to be kept there, such as the register of members, of debenture holders, of directors and secretaries, the register of charges,[49] of directors' interests in shares and debentures.[50]

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47. Charlesworth and Cain, Company Law (London: Stevens & Sons, 12th ed., 1983), pp. 68-71.

48. Companies Act 1976, s. 23(1).

49. Companies Act 1948, ss. 110-113-80-200-104.

50. Companies Act 1967, ss. 27-28-29 and 31.

The memorandum of association is to state whether the registered office will be located in England, Scotland or Wales;[51] it is a compulsory clause of the memorandum. The actual address of the registered office is not required at this stage; it will be filed after incorporation. The location of the registered office cannot be subsequently altered, whereas the address can.

The location of the registered office determines whether the company should be incorporated in England, Scotland or Wales and after incorporation, it determines the domicile of the company: if the memorandum states that the registered office is to be in England, the company will be incorporated in England; it will have an English domicile.

England follows the doctrine of incorporation: the existence of a company as a legal person is determined by the law of the country in which it is incorporated.[52] In other words, an English company is a company which has its registered office, its domicile in England. If a company may be said to have a nationality, it will be determined by the country from which it derives its legal personality.[53] A company incorporated in England is an

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51. Companies Act 1948. s. 2(1)(b) and Companies Act 1976, s. 30.

52. Lazard Brothers & Co v. Midland Bank Ltd (1933) AC, p. 289. The same approach is taken in the Netherlands, and in the United States for instance. See in general, R.E.L. Vaughan Williams and M. Chrussachi, "The Nationality of Corporations" LQR (1933), pp. 334-349.

53. Kuenigl v. Donnersmarck (1955) 1 QB, p. 515, at p. 535 per McNair J.

English company, with British nationality.

II. Alteration

The registered office of a company cannot be changed from England to Scotland, or *vice versa*. However, the address of a company can be modified.

A company is domiciled where it is incorporated and cannot change this domicile.[54]

It would therefore seem impossible to alter the nationality of a company incorporated in the United Kingdom. Such an alteration can only be carried out by Act of Parliament.[55] The practical importance of this is minor as residence is the salient feature taken into consideration when it comes to taxing a company.

§2. France: The *Siège Social*

I. Determination

The French system does not follow the doctrine of incorporation. France sees this system as formalistic and arbitrary.

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54. *Gasque* v. *IRC* (1940) 2 KB, p. 80; see Charlesworth and Cain, *op.cit.* note 47 above pp. 71-75.

55. S. 15 of the Companies Act of 1948 was loosely drafted and used for the purpose of altering the domicile of a company. It was repealed by the 1967 Act and the only possibilities of alteration of domicile are an Act of Parliament or winding up and re-form.

Its approach to the problem of nationality of companies, the existence of a company as a legal person and the law applicable to a corporate body is certainly different and more realistic than the UK approach. but it has the disadvantage of being complex.

There is presently no general provision to determine the nationality of a company. The concept of nationality is used in France in a number of different contexts and for various purposes.[56]

Article 3 of the Law of 24 July 1966 on commercial companies provides:

> Companies whose seat (siège social) is situated on French territory are subject to French law.
>
> Third parties may rely on the "registered office" (siège statutaire) but the company may not invoke it against third parties if its real seat (siège réel) is situated elsewhere.

This provision only provides for a solution to a conflict of laws, but does not tackle the determination of nationality of companies.[57] Its purpose is limited to the determination of the law applicable (loi applicable).

In practice, siège statutaire and siège réel are

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56. Joseph Frossard, "Un Vide Législatif: la Nationalité des Sociétés", Recueil Dalloz Sirey (1969), Chronique, pp. 9-18; also Nouveau Repertoire de Droit (Paris: Dalloz, 2nd ed., 1965) and Mise à jour 1980, Vol. 4, §§2279-2297. A. Lazarus, Ch. Leben, A. Lyon-Caen, B. Verdier, L'Entreprise Multinationale Face au Droit (Paris: LITEC, 1977), Titre 3, Chapitre 1, pp. 187-236.

57. Ibid., p. 9. The concepts of conflict of laws (conflits de lois) and nationality (nationalité) are often assimilated.

a single place. Siège statutaire is often translated as registered office but it can be very misleading because the siège statutaire does not determine the domicile of a company in the English sense.

French courts have traditionally chosen the siège social as the criterion of determination of the nationality of a company.[58]

In Compagnie des Caoutchoucs de Panang v. Administration de l'Enregistrement[59] the Cour de Cassation decided that the siège social is located where the legal, financial, administrative and technical management of the company are essentially carried out, not where only an operation (exploitation) and secondary management (direction de caractère secondaire) are held.

In Compagnie Franco-Asiatique des Pétroles v. Administration de l'Enregistrement,[60] the Cour de Cassation decided that the siège social prevailed over the centre d'exploitation (centre of operations). It looked essentially at the board of directors (conseil d'administration) but also took into account other factual elements such as the location of shareholders' meetings and the place where

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58. See in general Yvon Loussouarn, Pierre Bourel, Droit International Privé (Paris: Dalloz, 2nd ed., 1980), pp. 804-816.

59. Cour de Cassation, Chambre des Requêtes, 17 July 1937, Sirey (1938), p. 41.

60. Cour de Cassation, 25 April 1950, RCDIP (1951), p. 291 note Y. Loussouarn.

the accounts were kept.

The siège social must be sincere (réel) and correspond to the place of central management of the company; it is not to determine the nationality of a company when it is a mere fiction.

The use of siège social as a criterion to determine the nationality of a company is rejected in war time. Control replaces it: in Mercier et Cie v. Etat Allemand,[61] the siège social was said to have no relevance; the nationality of a general commercial partnership was at stake and it was held that if all its members have the same nationality, that of the partnership itself cannot be different. The nationality of members was also held to be of primary importance in May, Krotoshiner et Autres which involved a SARL.[62]

Between the two world wars, the criterion of siège social prevailed again: in the case of La Soie Artificielle de Calais, the Cour de Cassation held the company, whose seat was in France but with a majority of English capital, to be French.[63]

In its decision of 17 July 1930, the Cour de Cassation held a general commercial partnership, Graf, to be French because its seat was situated in France, despite

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61. Tribunal Arbitral Mixte Franco Allemand, 27 October 1923, S. (1924), p. 25.

62. 3 January 1940, D.(1940) p. 35.

63. Rey v. Société la Soie Artificielle de Calais, 24 December 1928, S. (1929), p. 121, note Niboyet.

the fact that it had been formed by Swiss nationals.[64]

However, the Cour de Cassation in a decision of 12 May 1931 held the company Remington Typewriter to be a foreign company despite the fact that its siège social was located in France.[65] The company had been formed by an American parent. Its siège social was in Paris, but the board of directors was composed exclusively of aliens and it only sold machines made in American by the parent. The problem was to determine whether the benefit of the law of 30 June 1926 on the renewal of commercial leases (loi du 30 juin 1926 relative au renouvellement des baux commerciaux) - which was only applicable to French individuals and sociétés - could be granted to Remington Typewriter. Although its siege social was located in Paris, the company was held not to be French. The control test was not the determining factor either; the role of the company set up in France was only to sell machinery manufactured in America and it is this element, the fact that the centre of operations (centre d'exploitation) was located abroad which led the Chambre des Requêtes[66] of the

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64. L'Etat Français v. Graf (1930), D, p. 163, note Camerlynck; S. 1931-1, p. 4; Clunet (1931) p. 654; RCDIP (1931) p. 128, note Calbe. The Cour de Cassation held that the "société was born in France and lived there".

65. Société Remington Typewriter v. Kahn, 12 May 1931, S. (1932) p. 57, note Niboyet; also D. (1933), p. 60, note Silz.

66. The Chambre des Requêtes was abolished in 1947. Its function was to screen (filtrer) matters brought before the Cour de Cassation. It could dismiss a case when it considered that it did not constitute a prima facie issue or otherwise transmit it to another chamber for decision on a point of law.

Cour de Cassation to decide that the company was foreign.

Further confusion was brought in by two decisions rendered by the highest jurisdictions in the country:

- in 1959, the Tribunal des Conflits[67] in its decision Société Mayol Arbona et Cie[68] rejected a unitary concept of nationality when applied to companies and decided that nationality could only be determined in the context of specific legislation. The case involved an SARL which contested being under an obligation to pay a special tax - prélèvement exceptionnel de lutte contre l'inflation - on the ground that it had Spanish nationality.

- The Conseil d'Etat was to follow this approach in a decision rendered shortly afterwards.[69] The facts of this particular case involved an SA, but were similar to those of the Mayol, Arbona case.

The decision of the Cour de Cassation of 30 March 1971[70] was long awaited because it settles the problem of nationality of companies, subsequent to the

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67. The Tribunal des Conflits is a jurisdiction dealing exclusively with the solution to conflicts between the administrative and regular courts. For further developments, see Brown and Garner, French Administrative Law (London: Butterworths, 3rd ed., 1983).

68. Tribunal des Conflits, 23 November 1959, JCP (1960-62) 11430, note Aymond; also RCDIP (1960) p. 180, note Loussouarn.

69. Conseil d'Etat, 22 February 1960, D.(1960), p. 671, note Blanchet.

70. Caisse Centrale de Réassurance des Mutuelles Agricoles v. Mutuelle Centrale d'Assurances et de Reassurance des Mutuelles Agricoles et Société Générale, RCDIP (1971) p. 451, note Lagarde.

independence of Algeria. The Cour de Cassation strongly reaffirmed the principle according to which the nationality of a company is determined by the location of its siège social. However, the criterion "is no longer applied where the sovereignty over the territory on which the siège social is located is altered". The change in sovereignty constitutes an exception: in order for the company to keep its French nationality, two conditions must be fulfilled:

- the company must be controlled by French nationals,[71]
- it must transfer its seat in France.

More recently, decisions have put emphasis on the siège social as the basic criterion to determine the nationality of a company, taking also into account the presence of a real centre of operations (exploitation effective).[72]

From these decisions, it would seem

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71. This element is only used to limit the number of companies which can transfer their seat after independence: only companies under French control may do so.

72. See in general, Ripert et Roblot, Traité Elémentaire de Droit Commercial, op.cit. note 56 Chapter I above, §1035 p. 691. Cour de Cassation, Epelbaum v. Société Shell, 8 February 1972, RCDIP (1973), p. 299; also J. Clunet (1973), p. 218, note Oppetit; Epelbaum v. Société Shell Française, 10 March 1976, Revue des Sociétés (1977) p. 305, note Bismuth. The Cour de Cassation held that Shell Française was entitled to the benefits granted to French nationals by the legislation on commercial leases. The Cour de Cassation did not look at Shell Berre as a subsidiary of a foreign group. The siège social was the prevailing factor; as it was located in France, as the company had its main establishments, its management and its centre of operations in France, it was held to be subject to French law.

possible to conclude that the _siège social_ is in France the essential criterion of determination of the nationality of a company.

The location of the _siège social_ will determine the law applicable to a company.

The different elements which allow to determine the location of the _siège social_ are not always given the same importance (location of board meetings, of general meetings, day to day management, place where accounts are kept ...) and clarification by way of legislation would be welcomed here.

However, the principle of determination of the nationality of a company as a function of the location of the _siège social_ is subject to limitations for instance, in cases related to a war or postwar situation; also when independence is granted to a territory. The control over a company, the nationality of its members and directors will then be taken into account.

In addition, limitations to the application of the doctrine of the _siège social_ have been brought in by specific provisions. A number of special laws (_lois_) involving certain activities of public interest also take into consideration the nationality of members, and that of the manager (_gérant_) of an SARL because of his wide powers.[73]

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73. For instance, Code of Civil Aviation, Decree of 30 March 1967, art. R. 330-2.

A company with a seat in France is said to be a foreign company if it is under foreign control for the purposes of a Decree of 27 January 1967 dealing with the regulation of direct investment.[74]

Companies with their siège social in France but controlled by foreigners are to declare to the Minister of Finance (Ministre des Finances) their investment in France and obtain a preliminary authorisation (autorisation préalable) for it.[75]

The purpose of the determination of the nationality of a company is not solely to decide the law applicable to it. Although the principle of non discrimination between national and foreign companies is making progress,[76] differentiations are still made in France between French and foreign companies.[77] Foreign companies are not entitled to carry out certain activities connected with the public order or national security.[78]

Some legislation concerns exclusively foreign

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74. It has been completed and modified by subsequent decrees: 24 November 1968, 22 February 1976, 26 July 1974. Cf. Ripert op.cit., note 72 above, §1718(1).

75. A 20 per cent. participation in the share capital of the company amounts to control. The French tax administration will also take other factors into account to determine control: see Circulaire of 28 June 1977.

76. See below, Part II, Chapter 1 Section 5.

77. See above, Remington Typewriter, at p. 274.

78. For illustrations, see J. Frossard, op.cit., note 56 above, p. 14.

companies.

II. Alteration

A company may change its nationality. In order to do so, a unanimous decision of the members (*associés*) is the only requirement for an SARL.[79]

In the case of an SA, only an extraordinary shareholders' meeting (*assemblée générale extraordinaire*) may decide the change of nationality, provided a special convention between France and the receiving country (*pays d'acceuil*) authorises the company to acquire the nationality of the receiving country and keep its legal personality upon transfer.[80]

The change of nationality corresponds to a transfer of the seat of the company.

In case of a transfer of the *siège* of a company, it is regarded by the French tax authority as a (*cession*) and corporation tax (*impôt sur les sociétés*) is established according to the rules described in articles 201-1 and 3 of the General Tax Code. The tax due on profits realised (*bénéfices réalisés*) but not yet imposed is immediately established. Within 10 days, the company is to let the tax administration of the exact date of the transfer.[81]

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79. Law of 24 July 1966, art. 60, §1.

80. *Ibid.*, art. 154.

81. *Journal Officiel des Débats de l'Assemblée Nationale*, 21 October 1975, p. 8678, as quoted in *Revue des Sociétés* (1980), No. 1, p. 183. On the tax consequences of the transfer to France of the seat of a company located abroad, see M. Edwardes-Ker, *International Tax Treaties Service* (hereinafter quoted as ITTS) Commentary on art. 4, p. 18.5005.

CHAPTER 3

TAXATION OF FOREIGN INCOME OF RESIDENT COMPANIES

There will be, in this chapter, a substantial imbalance between the UK section and the French section. This is due to the fact that in France, the application of the territorial principle which will be analysed here is fundamental inasmuch as it determines the liability of a company to French corporation tax.

In the UK, the system is different and the counterpart of the present survey - *i.e.* the examination of the criteria which determine liability to UK corporation tax - is residence, which was examined in Chapter 2 of the present part of this work.

Section 1: United Kingdom

§1. Taxation of Worldwide Income

The United Kingdom levies tax upon the worldwide income (*revenue mondial*) of its resident companies.

The United Kingdom also levies tax upon the income of non-resident companies where the source of the income is in the UK,[1] and upon the income of a branch or agency of a non-resident company.[2]

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1. ICTA 1970, ss. 1-108 and 181.
2. *Ibid.*, s. 246.

Any company which is resident in the United Kingdom[3] is liable to corporation tax in respect of all its profits (income and capital gains), wherever arising, whether or not remitted to the United Kingdom. Any company non-resident in the UK but which carries on a trade in the UK through a branch is liable to tax in respect of:

- trading income arising directly or indirectly to the branch,
- capital gains arising on the disposal of assets used for the purpose of the branch. There is a lower effective rate of corporation tax on capital gains.[4]

Contrary to the position in France, the profits of a foreign branch of a company resident in the United Kingdom are normally added to those of the head office located in the UK. Similarly, losses of the foreign branch may be set off against domestic source profits.

As in France, when part of the activity of the resident company is exercised abroad through a subsidiary, the profits will not be taxed in the UK until they are remitted into the UK as dividends, interest or royalty payments.[5]

This is referred to as tax deferral; the payment of tax on profits realised by subsidiaries located

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3. For the meaning of residence of companies in the UK, see Part I, Chapter 2.

4. For the Financial Year 1983-1984, 30 per cent., whereas the rate of corporation tax is 52 per cent.

5. Tiley, Revenue Law (London: Butterworths, 3rd ed., 1981), p. 812.

abroad may be deferred until the sums are repatriated.

If profits are never repatriated, tax may be avoided. The United States, but not as yet the United Kingdom, have introduced legislation according to which several categories of income of foreign companies located in tax havens, which are controlled by US shareholders, are deemed to be distributed to the US shareholders whether or not such income has actually been received by the US shareholders.[6]

§2. Double Taxation Relief

A company resident in the United Kingdom, therefore taxable on its worldwide income, will be entitled to claim credit for foreign tax suffered on income from an overseas source against the UK corporation tax payable on the income.

A distinction is to be made between the direct foreign tax credit and the indirect foreign tax credit.[7]

- Direct Tax Credit

The distribution made by a foreign subsidiary

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6. A foreign corporation is 'controlled' by US shareholders if more than 50 per cent. of the voting power of its stock is owned by them. See US Internal Revenue Code (hereinafter cited as IRC), Subpart F, ss. 951 *et seq*.

7. See in general CDFI Berlin 1981, Vol. LXVIb, English report, H. McGregor at p. 416. Also, R. Bramwell and J. Dick, *Taxation of Companies* (London: Sweet & Maxwell, 2nd ed., 1979), Chapter 13, p. 154.

may be liable to a withholding tax before it is remitted to the UK, under the provisions of the legislation of the foreign country where the subsidiary is situated. It is for that amount of withholding tax on the dividends received that the UK grants a credit, also called direct tax credit for foreign tax.

- Indirect Tax Credit

The profits of the subsidiary situated abroad may have been subject to corporation tax. It is to compensate for the corporation tax paid abroad that the UK, under certain conditions, will grant a credit for the underlying tax; it is the indirect tax credit. In the case of dividends received by a UK company which holds, or whose parent company holds (whether directly or indirectly), at least 10 per cent. of the voting power of the overseas company,[8] it will be entitled to a credit for the underlying tax. The underlying tax designates the corporation tax which was paid abroad on the profits out of which the distribution was made.

The purpose of the direct and indirect foreign tax credits is to avoid double taxation. However, the amount of the credit for foreign tax which is allowed against corporation tax in respect of any income is

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8. ICTA 1970, s. 498(4), as amended. A smaller percentage will suffice if it stems from all enforced reduction below the 10 per cent. level, as where the Government of the foreign country has compulsorily accepted a voting shareholding. FA 1972, s. 83.

restricted to the corporation tax, after ACT set-off, attributable to that income.[9]

In addition, the limitation country by country applies; credit must be taken foreign source by foreign source, and there can be no averaging of foreign tax credit.

Section 2: France

§1. Territorial Principle (*principe de territorialité*)[10]

I. Characteristics

A. Definition

The territorial principle is formulated in article 209-I of the General Tax Code (*Code Général des Impôts*).

The only profits (*bénéfices*) to be taken into

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9. See in general, ICTA 1970, Part XVIII, Chapter II, ss. 500-512. In particular, s. 505. See also FA 1972, s. 100(3); determination for the purposes of s. 505 of corporation tax attributable to any income or gain.

10. See in general, CDFI (1973) Lauzanne, French Report, Mme Mouillant-Hogberg, pp. 133-145; also *Direction Générale des Impôts*, *Précis de Fiscalité*, Vol. 1, 1981, §1342; also Henri Vallat, "*Les Règles de Territorialité en Matière d'Impôt sur les Sociétés*", JCP ed CI (1981), 9381. J.P. Jarnevic, "*Les Derogations au Principe de Territorialité des Impôts Etablis sur les Bénéfices des Sociétés de Capitaux en Droit Fiscal Français*", *Travaux et Recherches de la Faculté de Droit et de Science Politique de l'Université de Clermont I*, (1978). H. Lazarski, "*The System of 'Territoriality' - The Present Situation - Possible Uses. Anti avoidance Measures*", European Taxation, (1982), pp. 175-182.

account for the computation of corporation tax (impôt sur les sociétés) are profits derived from business activities carried out in France (bénéfices réalisés dans les entreprises exploitées en France) and those whose taxation is allocated to France by an international double taxation agreement (convention internationale relative aux doubles impositions).

The application of the territorial principle, as stated in art. 209-I of the General Tax Code has two sides.

A company resident in France is not taxable on the profits it realises through an activity carried out abroad.

Conversely, the profits realised in France by a non resident company are subject to French corporation tax; the taxation of the non resident company is limited to that of its profits arising in France.

Attention will be focused in the present chapter on the taxation of foreign income of resident companies. The taxation of domestic income of non resident companies will be developed in Chapter 5.

As stated earlier, a company is resident in France when its seat (siège) is situated in France.[11]

The territorial principle as applied to companies liable to corporation tax is to be contrasted with the rules governing the taxation of individuals (personnes

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11. See Part I, Chapter 2, Section 1. France in the present chapter is to include metropolitan France (métropole) and overseas departments (départements d'outre mer, DOM).

physiques).

Individuals who have their tax domicile (domicile fiscal) in France are liable to income tax (impôt sur le revenu) on their worldwide income.[12] Individuals whose tax domicile is situated outside France are subject to income tax only on their French source income. The territorial principle does not apply - unless a tax convention so provides - to personal income tax, even when industrial and commercial profits (bénéfices industriels et commerciaux) are at stake.

B. Consequence

As regards companies, the main consequence of the application of the territorial principle lies in the fact that normally, losses (pertes) incurred by the foreign establishment of a French company cannot be deducted from the profits of the company taxable in France.[13] The profits taxable in France take into account neither the profits of the activity carried out abroad, nor its losses.

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12. Law No. 76-1234 of 29 December 1976, art. 1; CGI, art. 4A. The domicile fiscal is defined in art. 4B of the CGI.

13. See Conseil d'Etat, (hereinafter cited as CE) 12 November 1969: losses of a foreign branch are not deductible from profits taxable in France; 25 October 1972: capital losses consequent upon the liquidation of a branch are not deductible; 25 November 1975: a French resident company may not deduct a provision for risks in relation to its foreign branch. These decisions may be found in the Dupont or the Bulletin des Contributions Directes, and are cited by Philippe Derouin, "The Principle of Territoriality in Case Law", published by the GRAF at the 1980 IFA Congress, held in Paris.

II. Application of the Territorial Principle

A. The courts[14]

The role of the French courts, the administrative jurisdiction essentially (Tribunaux Administratifs and Conseil d'Etat), has been to assess the meaning of "profits derived from business activities carried out in France" ("bénéfices réalisés dans les entreprises exploitées en France").

Recent cases involving French companies doing business abroad will be examined here.

Traditionally, the activity of a French company carried out abroad will not be subject to French corporation tax if it exercised through an establishment (un établissement) i.e. a fixed place of business (installation stable) having a certain degree of autonomy (autonomie propre). Such activity will not be taxable in France either when it is exercised through representatives (représentants) or when the activity amounts to a complete commercial cycle abroad (cycle commercial complet à l'étranger).[15]

Commercial activities abroad which are a simple

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14. For another analysis of recent case law, see H. Lazarski, op.cit., note 10 above.

15. DGI, Précis de Fiscalité, op.cit., note 10 above, §1342, p. 131; Claude Gambier, Les Impôts en France (Paris: Editions Francis Lefebvre, 11th ed., 1982), §41.

extension of the French business are taxable in France. The foreign activity is to be autonomous in order to escape French tax liability.

An examination of decisions involving French companies doing business abroad will be made here. The converse situation, i.e. that of a foreign company doing business in France, will be considered in Chapter 5.

Decisions will be examined in chronological order.

. 1968: Construction of a glass factory (verrerie) in Indonesia.[16]

The Conseil d'Etat held such activity not to amount to an autonomous foreign activity; it was therefore subject to French corporation tax. The work carried out in Indonesia was regarded by the courts as an "activité non détachable" ("non-detachable activity"). It was stated that the technical assistance provided by the French company involved (presence of fourteen engineers and technical officers in Indonesia) could only be regarded as an occasional extension of the activity of the French company, nothing more.

The salient argument of the Conseil d'Etat lies in the fact that the construction had been carried out by a subcontractor (sous-traitant), a Swiss company.[17]

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16. CE, 3 April 1968, Req. No. 70823, Dalloz (1969), p. 241, note Tixier.

17. This argument is specifically set aside in the commentary to art. 5, §3 of the 1977 OECD Model (§18, p. 63, in both English and French versions).

. 1976: Import into Algeria of cereal from the United States.[18]

The expression "business activities carried out in France" has received an extensive meaning in the following decision.

A silent partnership (*société en participation*) had been formed between a French company and a Moroccan company. Its activity was to import into Algeria cereals from the United States. The profits of this activity were held to be taxable in France because France was the country where management decisions had been made, administrative decisions obtained and subsidies received.

. 1978: Construction of a building in Monaco[19]

The construction was carried out by a French SA (*société anonyme*) which had formed a silent partnership with two other French companies in order to fulfil the contract; the contract had been signed in Monaco. The construction was carried out in Monaco, over a period of twenty months and was held to constitute a foreign activity, distinct from the French one, although certain management decisions and certain supply duties had been dealt with by technicians of the French companies working in France.

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18. CE 3 March 1976, *Req*. No. 98600.

19. CE 23 March 1978, *Req*. No. 4883, *Droit Fiscal* (1978) No. 29 *comm*. p. 11; also *Dalloz* (1978) p. 573, *note* Tixier; *Jurisclasseur Droit International Fascicule* 304-1, §54.

The activity in Monaco was considered to be "*détachable*" from that carried out in France.

The *Conseil d'Etat* essentially based its decision on the fact that the construction site operated over long enough a period to amount to an activity carried out abroad. This attitude is in line with the OECD approach. According to the tax treaty terminology, the building site is a permanent establishment (*établissement stable*) and the activities performed in France are of a preparatory nature.[20]

The importance and continuity of the activity carried out in Monaco were the salient factors taken into consideration by the *Conseil d'Etat*.

The profits of the construction were consequently not to be incorporated in the profits subject to French corporation tax.

The decision of the *Conseil d'Etat* of 23 March 1978 is to be welcomed in the sense that it brings closer together the concepts of permanent establishment as described in the OECD Model convention and the domestic concept of "business activities carried out in France". It also amounts to a stricter application of the territorial principle to activities which have actually been carried out on French territory.

This decision was of major importance for all French companies which carry out activities in the Middle

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20. There was at the time of the construction a tax convention between Monaco and France, but it did not contain a provision on permanent establishment.

East and in Latin America because most states situated in these regions, apart from Lebanon and Brazil, have not yet entered into double taxation agreements with France.[21]

. 1978: Delivery in Romania of a "completed" factory (*usine clé en main*)[22]

This case involved a French company which had concluded a contract for the delivery of a factory. The contract involved the delivery of an industrial complex (*ensemble industriel*), its assembly (*montage*), bringing into service (*mise en service*), and training of the staff (*formation du personnel*) in Romania.

The *Conseil d'Etat* declared the operations effectively carried out abroad not to be taxable in France. All of the services effectively rendered abroad such as the construction of buildings, plant assembly, training of management personnel responsible for the functioning of the factory constitute foreign business and profits resulting therefrom are not subject to French corporation tax.

The place where operations were carried out was given a lot of importance by the court, whereas in the decisions of 1968 and March 1978 commented earlier, the court was being less "materialistic" and gave priority to the "détachable" or "non détachable" character of the

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21. *Dalloz* (1978), *note* Tixier, p. 573.

22. CE 23 June 1978, *Req.* No. 99444, *Dupont* (1978), p. 272; *Droit Fiscal* (1978) No. 45, *comm.* p. 1722; J CL *Droit Fiscal International, Fascicule* 304-A, §43; JCP ed CI (1978) I 7337, IV 5901.

activity.

In the conclusions of the *Commissaire du Gouvernement*, M. Fabre, in a subsequent case (30 April 1980) involving the construction of a seawall in the territorial waters of France and Monaco, M. Fabre claims that the solution adopted in the case of 23 June 1978 specifically applies to businesses working solely for export (*à l'exportation*).

For purposes of uniformity and clarity, a different interpretation of the territorial principle as a function of the nature of the activities involved seems uncertain. A single interpretation of art. 209-I of the General Tax Code would be preferable.

. 1979: Purchase and sale of wine in Africa[23]

The purchase and sale of wine, entirely carried out in Africa, have been held to be taxable in France as decisions connected with these transactions were made in France where the company had its seat and its only establishment. All financial transactions were decided or carried out from the seat.

It is the first time that the *Conseil d'Etat* refers to the financial transactions (*mouvements financiers*) as a fundamental criterion of territoriality. Negotiations, purchase and sale contracts were executed abroad.

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23. CE 14 March 1979, *Req*. No. 7098, JCP ed CI (1979) II 13411 *conclusions* M. Rivière. This approach confirms the primacy given to the "*détachable*" or "*non détachable*" character of operations.

. 1981: Drilling platforms (forages pétroliers) in Tunisia, Spain and Gabon[24]

This decision confirms the approach taken by the Conseil d'Etat in 1978 when dealing with a construction site in Monaco.

A French SARL carried out oil drilling in Tunisia, Spain and Gabon. The problem was whether or not profits from these activities were taxable in France. In other words, did such activity amount to business carried out in France (entreprise exploitée en France)?

There was no double taxation agreement between Tunisia and France at the relevant time.[25]

The question of whether the activity amounted to business activity carried out in France was answered in the negative: profits from the Tunisian oil drilling operation were held not to be taxable in France.

The court did not base its decision on the presence of a complete commercial cycle which could be separated from the French activity (cycle commercial complet détachable de l'activité en France). The terms used by the Conseil d'Etat were similar to those of the decision of March 1978 involving the construction site in Monaco:

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24. CE 29 June 1981, Req. No. 16095, JCP ed CI (1982) 10586, p. 164. Only the activity carried out in Tunisia will be examined here as the other countries had double taxation agreements with France at the relevant time; see Part II, Chapter 1, Section 2.

25. Such a convention has since been signed on 28 May 1973 and published in the Journal Officiel of 12-13 November 1975.

the judges took into consideration the importance and continuity of the operations carried out in Tunisia. They also mentioned their technical autonomy (_autonomie technique_). As in the 1978 case, the fact that certain management duties were carried out in France was not regarded as crucial.

In view of the present decisions, it would seem that the attitude of the French courts as regards the interpretation of the territorial principle (CGI, art. 209-I) under domestic law may be summarised as follows:

The rigid criteria of existence of an establishment, a complete commercial cycle abroad, the presence of representatives, seem to be less favoured. Emphasis is put on the importance and continuity of operations realised abroad, the "détachable" character (_charactère "détachable"_) of an activity. However, other factors come into the picture, and sometimes weigh heavily in the decision: location of management decisions (3 March 1976), financial transactions (_mouvements financiers_) (14 March 1979), technical autonomy (_autonomie technique_) (29 June 1981), but with less regularity and consistency.

Some consistency is shown in the decisions of 1968, 23 March 1978, 29 June 1981, but uncertainty remains because of the lack of a single criterion, or several criteria used consistently.

The Minister of Budget (_Ministre du Budget_) has confirmed that the location of the centre of decisions is

not to determine the existence of a complete commercial cycle.[26]

From a comparative point of view, it is interesting to read the written answer of the Minister of Budget - which sets aside the centre of decisions (centre de décisions) as a criterion of liability to French corporation tax - and opposes it to the English doctrine of residence - place of central management and control - as the fundamental present criterion of liability to UK corporation tax.

B. The tax administration

It is suggested that the French tax administration does not always apply consistently the territorial principle. It may take a very restrictive approach when dealing with the activity carried out abroad by a French company, and an extensive one when looking at the activity of a foreign company in France.[27]

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26. Journal Officiel de l'Assemblée Nationale of 22 September 1980 (No. 26341: JCP (1980), ed. CI I, 9189) as quoted in the article of H. Vallat, op.cit., note 10 above, at p. 16.

27. J.P. Meony and R. Beauvais, "The Administrative Practice of the Control on Territoriality Matters of the Corporate Tax" published by the GRAF (Groupe d'Avocats Fiscalistes) at the 1980 IFA Congress held in Paris.

§2. Exceptions to the Territorial Principle[28]

I. Consolidation[29]

A. Worldwide income (bénéfice mondial)

Upon the approval (agrément) of the Ministry of Economy and Finance, a French resident company may elect to consolidate the profits and losses of all its "direct operations" (exploitations directes): the results of all foreign branches (succursales), offices (bureaux), factories and other permanent establishments (établissements stables) which do not have a separate legal personality, will be computed together.

The system has two major advantages:

- to allow compensation between domestic profits and losses incurred in foreign branches. Such opportunity to offset losses against domestic profits is not available under the rules of the territorial principle;
- when dividends are distributed out of profits realised abroad, the compensatory tax (précompte mobilier) need no longer be paid.

B. Consolidated income (bénéfice consolidé)

Also upon approval of the Ministry of Economy and

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28. See in general, Précis de Fiscalité, DGI (1981), Vol. I, §1342-2.
29. CGI, art. 209 quinquiès and Annex II, arts. 103-134; also Précis de Fiscalité, §1350; CDFI Berlin 1981, French Report, Alban Timbart p. 339, at p. 346.

Finance, French resident companies may, for the computation of their taxable profits, consolidate the results of their direct and indirect operations (*exploitations directes et indirectes*) located in France and abroad. Under this system, the profits and losses of all foreign and domestic branches and subsidiaries (*filiales*) will be brought together for the purposes of assessment to tax.

Normally, a company is considered to be a subsidiary in this particular case if the parent holds 50 per cent or more of its share capital.[30]

The advantages of the *bénéfice consolidé* are the same as those of the *bénéfice mondial*, only extended to French and foreign subsidiaries.

As regards foreign losses, both *régimes du bénéfice mondial* and *bénéfice consolidé* allow their deduction from the profits of domestic activities.

As regards foreign profits, in order to avoid double taxation, foreign taxes paid on the profits of foreign operations will be deducted from the corporation tax due in France on those profits. However, foreign taxes have to be comparable to French corporation tax and the sums deducted cannot exceed the amount of French corporation tax that would be due.

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30. However, a lower interest (*participation*) will be taken into account when the legislation of the country where the affiliate is located forbids a 50 per cent. or higher interest, when the nature of the activity of the group requires a lower interest, when France and the other country come to a specific agreement on the matter. Cf. *Précis de Fiscalité* 1980, §1350; CGI, Annex II, art. 114(3).

In addition, if the total losses of a foreign branch or subsidiary cannot be credited against the domestic tax to be paid in France, the non-deducted sums may be carried forward for five years.

This system of foreign tax credit is subject to a per country limitation (limitation par pays).

When either régime du bénéfice mondial or régime du bénéfice consolidé is applied, the taxable results of foreign operations taken into account are computed according to the rules of French tax legislation on corporation tax.

Both régimes constitute not only an exception to the application of the territorial principle but they also ignore the legal personality of subsidiaries.[31]

Consolidated tax returns are rarely used in practice. Ministerial authorisation has only been granted to a limited number of very large companies. It is advantageous to companies who incur losses abroad, but it may also increase the tax bill of companies who realise profits in low tax companies.[32]

II. Deductibility of Costs of Foreign Investments[33]

French companies which set up (implantent)

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31. Claude Gambier, op.cit., note 15 above, §1746.

32. Ibid., §43.

33. Précis de Fiscalité, §§1067-1069: dépenses exposées en vue de l'implantation d'entreprises à l'étranger. B. Castagnède, "Chronique de Fiscalité Internationale", JCP ed CI I (1980), 8787, p. 169.

enterprises abroad are allowed to carry out deductions from their profits taxable in France as long as the profits of the foreign operations are not subject to French corporation tax. In other words, the provisions described below only apply when the business activity of the enterprise is carried out outside France.

A basic distinction is to be made between establishments created before 1 April 1973 and those created since that date.

A. Establishments created before 1 April 1973 (CGI, art. 39 *octiès* 1)

Market research and research expenses (*dépenses d'études et de prospection*) incurred with a view to setting up a sales establishment (*établissement de vente*), a research consultancy or an information office (*bureau de renseignements*) abroad, as well as running costs (*dépenses de fonctionnement*) of such an establishment for the first three years will be deducted from the profits taxable in France.

However, the deduction is only temporary; it has to be added back (*rapporté*) in five equal amounts to the taxable profits of the French head office or parent company, over a five year period starting with the fourth year following that of the creation of the foreign establishment. The deduction may be final upon agreement of the Ministry of Budget.

B. Establishments created as from 1 April 1973 (à compter du 1 Avril 1973) (CGI, art. 39 octiès A)

A distinction is to be made between commercial investments and industrial investments:

1) Commercial investments (CGI, art. 39 octiès A-1)

- Investment realised in a Common Market Country

The French company setting up an enterprise - whether a branch or a subsidiary - may deduct from its taxable profits in France a sum equal to the lower of the losses incurred during the first five years of activity, or the total capital investments over the same period.

- Investment realised outside the Common Market

The only difference lies in the limitation of the deduction to the capital investments during the first five years of activity. Investments in tax havens are excluded.

2) Industrial investments (CGI, art. 39 octiès A-2 and art. 81 of the Finance Law for 1980, NO. 80-30)

The deduction equals half of the capital expenses incurred during the first five years of activity; it was limited to one third before 1 January 1975.

Art. 81 of the Law of 18 January 1980 has extended the advantages of these deductions to banks, building societies (établissements de crédit) and certain financial organisations (organisations financières).[34]

34. Décret No. 80-1063 of 23 December 1980 for an enumeration of the bodies concerned; also Précis de Fiscalité,

/Continued over

All deductions allowed as a consequence of the provisions examined above are subject to Ministerial approval; they are only temporary and must be added back into five equal amounts, over a five year period starting with the sixth year following that of the investment.

III. General Tax Code, art. 209B

A further exception to the principle of non taxation of profits realised abroad has been introduced by article 70 of the 1980 Finance Law, inserted in art. 209B of the General Tax Code.

The application of this provision has been developed in a décret of 30 December 1981.[35] In February 1983, the French Tax Administration issued an Instruction on the application of CGI, art. 209B.[36]

Footnote 34 continued from page 300.

§1069, footnote 2; new art. 39 octiès A-5 of the General Tax Code.

35. Décret No. 81-1173, Official Journal, 31 December 1981, p. 3604; Recueil Dalloz Sirey (1982) Legislation, pp. 40-41; Francis Lefebvre, Mise à jour au 1-1-1982, §878, p. 218; JCP ed CI, III 52162; IFA Congress, Berlin 1981, "Unilateral Measures to Prevent Double Taxation", French Report, Alban Tombart, p. 339, at p. 348; also D.A. van Waardenburg, "Taxation of Profits Derived through Subsidiaries in Low Tax Areas", European Taxation (1983), pp. 179-201.

36. Instruction of 15 February 1983, BODGI 4H-3-83. For a short commentary, 44 Taxes International.

Article 209B provides that when an enterprise (_entreprise_) subject to corporation tax owns directly or indirectly 25 per cent. or more of the shares (_actions ou parts_) of a company[37] established in a foreign state or in a territory situated outside France which has a privileged tax system,[38] such enterprise will be liable to corporation tax in France on the profits realised by the company situated abroad, in proportion to its shareholding therein.

The profits of the foreign company are subject to separate taxation: this means that such profits cannot be set off against the losses of the taxable French enterprise; conversely losses of the foreign company may not be taken into consideration when calculating the taxable profits of the French company.

For purposes of computation of the profits realised abroad, the French rules described in the General

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37. The word company will be used on its own in the rest of the present section for purposes of simplification. In fact, there is only one word in French for company and partnership, that is _société_; each time, _société_ ought to be translated as company and partnership in order to be perfectly accurate.

38. Privileged tax system is defined in CGI, art. 238A: persons are considered to be subject to a privileged tax treatment in the relevant state or territory if they are not subject to tax there or if they are liable to taxes on profits or income substantially lower than the tax in France. The French tax administration has issued non exclusive lists of countries to be treated as having a privileged tax system, see Part I, Chapter 6, Section 2.II.

Tax Code apply.[39]

Art. 209B of the General Tax Code in fact means that the profits of the foreign subsidiary of a French company established in a tax haven are taxable in France, in proportion to the interest (participation) of the parent.

Art. 209B applies to enterprises subject to corporation tax (entreprises passibles de l'impôt sur les sociétés). It includes not only share companies, limited liability companies and partnerships limited by shares, but also commercial partnerships which have elected (opté) to be subject to corporation tax, and civil partnerships which have a commercial activity.[40]

Art. 209B contravenes the rules of the affiliation privilege (régime des sociétés mères et filiales)

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39. The figures of the balance sheet are converted into French Francs on the basis of the exchange rate (taux de change) on the closing of the accounting period (exercice comptable); décret of 30 December, art. 4.

40. This includes civil property partnerships (sociétés civiles immobilières) which purchase immovables (immeubles) in order to resell them (en vue de la revente). It is interesting to note that civil property partnerships are liable to corporation tax, whilst general commercial partnerships (sociétés en nom collectif) are normally not liable to corporation tax but to income tax in the hands of the partners. One of the consequences of the liability of civil partnerships to corporation tax when they have a commercial activity is that any secondary commercial transaction carried out by the civil partnership will justify liability to corporation tax on the whole of its profits. In order to mitigate this the tax administration has decided that civil partnerships having a commercial activity will only be liable to corporation tax when their profits from commercial transactions amount to 1/10 of the total profits of the partnership; ibid., Ministerial Answer to M. Berger, 11 May 1981.

described in arts. 145 and 216 of the General Tax Code.

The effect of the affiliation privilege may be summarised as follows: 95 per cent. of the dividend received by a French parent company from its foreign subsidiary is deductible from the taxable profits of the French company. In other words, only 5 per cent. of the dividend received is subject to French corporation tax. The application of the affiliation privilege is subject to the condition that the parent holds an interest of 10 per cent. or more of the share capital of the subsidiary.

In order to alleviate double taxation, the tax paid by the company situated in the country with a privileged tax system to the local tax authorities is deductible from the tax payable in France on the profits realised abroad. In proportion of the shareholding, provided that this tax is comparable with the French corporation tax.

Art. 209B does not apply when the French company establishes that the main purpose of having a foreign subsidiary in a privileged tax system is not to locate profits there.

This condition is deemed satisfied in particular:

- when the subsidiary's main activity is an effective industrial or commercial one; and[41]
- it carries out its operations mainly on the local market or with companies with which it has no links of

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41. Italics supplied.

interdependence (<u>liens de dépendance</u>).

Art. 70-I of the 1980 Finance Law creates the following presumption: the profits made by the 25 per cent subsidiary of a French company situated in a tax haven are taxable in France, in proportion to the interest of the French company in its foreign subsidiary.

Art. 70-II sets out the conditions for this presumption to be rebutted. In order to escape taxation according to art. 209B, it is for the company - and not the tax administration - to prove that the effect of the operation of the foreign subsidiary is not to locate profits in a tax haven.

Not only is the burden of proof on the taxpayer, but the drafting (<u>rédaction</u>) of the provision indicates that the intention of the taxpayer or his good faith are irrelevant; it is the result, the practical consequences, which are to be taken into account.

The scope of this particular exception to the territorial principle seems wider than those examined earlier. The application of art. 209B is of general character; it is not subject to Ministerial authorisation; it is not temporary in nature.

> Article 70 of the law of January 18, 1980 goes much further as it in fact constitutes a clear condemnation not only of the abuse but of the use of tax havens, even in perfect good faith and for sound business purposes, with the only exception of industrial and commercial operations. [42]

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42. J.C. Goldsmith, "<u>Recourse to Tax Havens, Use and Abuse</u>", French Report, IFA Seminar Paper 1980.

Art. 209B is limiting the use of tax havens to the exercise of industrial and commercial operations by companies or partnerships setting up business there. If the expression "industrial and commercial activity" is taken literally, the setting up of holding companies or service companies in tax havens will lead to taxation on their profits in France. This is contrary to the territorial principle which excludes profits realised abroad from taxation in France.

If for instance, the foreign holding subsidiary company of a French parent makes profits abroad, not in a tax haven - those profits will not be subject to French corporation tax, in application of the territorial principle. The effect of art. 70 of the 1980 Finance Law is that the profits of such a subsidiary - if situated in a tax haven - will be liable to French corporation tax, whereas the profits of a subsidiary carrying on a commercial activity would not be subject to the same tax treatment.

The effect of art. 70 is to penalise non commercial or industrial companies.

Enterprises to which art. 209B applies are to provide information and documents to the French tax authorities in relation to their subsidiaries situated in privileged tax countries at the same time as their annual tax return.[43]

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43. Decree of 30 December 1981, art. 8. It outlines the information and documents to be transmitted: it includes - inter alia - the name and address of companies established in privileged tax countries, all documents required from companies liable to corporation tax.

Article 209B of the General Tax Code may be regarded not only as an exception to the territorial principle, but also as an anti-avoidance provision. It will be considered from that angle in Chapter 6 of the present part of this work.

Conversely, arts. 155A and 238A of the General Tax Code could be treated as exceptions to the territorial principle - which they are.[44] It has arbitrarily been decided to deal with these articles in a specific chapter on domestic anti-avoidance legislation.[45]

IV. Double Taxation Agreements

See below Part II.

Section 3: Conclusion

The United Kingdom and France provide a good illustration of the various methods to tax the foreign income of resident companies.

France generally exempts resident companies from tax in respect of certain categories of income (business income derived through a foreign branch and dividends received from a foreign subsidiary), whereas the English system consists of taxing foreign income at the rate which applies to domestic income. A tax credit is

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44. See _Précis de Fiscalité_, _op.cit._, note 16 above, §§1342-2.

45. See below Part I, Chapter 6, Section V, p. 419.

granted for taxes paid abroad. There is no room for the exemption method in the UK system.

The systems of _bénéfice mondial_ and _bénéfice consolidé_ which are applied in France under specific circumstances and upon government approval, introduce an exception to the territorial principle (_principe de territorialité_): in practice, the scope of this exception is limited as very few companies are given the authorisation.

A further exception was introduced under art. 70 of the 1980 Finance Act.[46] For the first time, the territorial principle was substantially attacked. French companies, as a result of its application, may be taxable on the business income profits of their foreign subsidiaries. This is a step towards the application of the worldwide taxation principle. Article 39, _octiès_ A, may also be regarded as temporary exceptions to the territorial principle.

The application of either worldwide income or consolidated income usually alleviates the tax burden of the group. The reduction is often consequent upon the compensation of profits and losses of the direct and/or indirect operations, whether French or foreign. The provisions of French tax legislation may also diminish the taxable profits if they are less stringent and more liberal than the tax rules applicable where profits are actually realised.

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46. Art. 70 of the 1980 French Finance Act shall be further developed under Part I, Chapter 6.

CHAPTER 4

EFFECT OF THE IMPUTATION SYSTEM ON THE TAXATION OF FOREIGN INCOME

Section 1: The Imputation System

§1. Purpose

The imputation system (*système de l'imputation*) aims at mitigating economic double taxation (*double imposition économique*); it arises where two different persons are taxable in respect of the same income or capital.

Economic double taxation is to be distinguished from juridical double taxation (*double imposition juridique*) where the same income or capital is taxable in the hands of the same person by more than one state.[1]

When a company distributes a dividend, the sums distributed are paid out of profits which have normally been subject to tax, corporation tax in general.

For the sake of simplification and clarity, we shall assume in this paragraph that the dividend is received by an individual shareholder, not by a company.

The sum received by an individual shareholder in the form of a dividend is to be incorporated in his taxable income; it is added to his other sources of

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1. Definitions to be found in the 1977 OECD Model, Commentary on arts. 23A and 23B, §§1-2, p. 145.

income and subject to personal income tax.

In order to avoid the dividend to be taxed fully in the hands of the company in the form of profits, and a second time in the hands of the individual shareholder as part of his income, the imputation system operates so as to alleviate the tax burden on the dividend by way of a tax credit granted to the individual. Part of the tax burden suffered at the level of the company is deducted, imputed on the taxable income of the individual.

The purpose of the imputation system is therefore to reduce the overall tax levied on the dividend.

The imputation system is not the only method of mitigation of economic double taxation, and it may take different forms as will be shown in the coming examples of the United Kingdom, France and Germany.

An alternative method of mitigation consists in taxing retained profits at a higher rate than the rate of corporation tax applied to distributions. The distributed profits are taxed less heavily than the retained profits because they will be subject to further taxation in the hands of the recipient, whereas the retained profits will not be subject to further taxation.

Germany provides a good example of the combination of both methods: retained profits of a company are subject to corporation tax at a higher (56 per cent.) rate than the rate applied to distributed profits (36 per cent.). Moreover, the shareholder who receives the profits

in the form of dividends is granted a credit for the full amount of the tax paid at the level of the company. The economic double taxation is therefore totally eliminated.

When compared to the British or French systems of imputation, the difference lies not only in the fact that in Germany, retained and distributed profits are taxed at different rates, but also in the fact that the 'German credit' compensates for the full amount whereas 'French or British credit' is only partial.[2]

§2. Variation of the Imputation System: Partial Imputation

I. The United Kingdom

A. Corporation tax

Companies resident in the United Kingdom are liable to corporation tax. The rate of corporation tax is 52 per cent for the financial year 1983-84. The financial year runs from 1 April to 31 March. The taxable profits of companies are determined for accounting periods (*exercices comptables*). The rate of corporation tax is determined each year in arrears. There is a reduced rate of corporation tax which has been brought down from 40 to 38 per cent. by the 1983 Finance Act for

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2. For a more comprehensive comparison between Germany and the UK, J. Wiseman, *Comparative Aspects of the Taxation of Business in the United Kingdom and Germany* (London: St Stephen's House, 1980).

companies whose profits do not exceed £100,000 per annum, with marginal relief when the profits do not exceed £500,000.

The effective rate of taxation for capital gains realised by companies is 30 per cent. A capital gain arises when chargeable assets are disposed of. The chargeable gain is normally measured by reference to the excess of net sale proceeds over the cost of acquisitions.

Advance corporation tax (ACT) is an advance payment of corporation tax payable by a company resident in the United Kingdom on a qualifying distribution.[3]

When companies want to distribute their profits in the form of dividends, they have to pay ACT. The rate of ACT is also determined each year in arrears. For the financial year 1983-84 it is 3/7 of the dividend paid, in other words 30 per cent. of the dividend grossed up (*majoré*) by the tax credit. The basic rate of income tax determines the rate of ACT and that of the tax credit.

ACT paid by a company in respect of distributions during an accounting period may be offset against its corporation tax liability for that period.[4] The offset of ACT shall not exceed the amount of ACT on a total distribution equal to the company's income profits.[5] In other words, if a company makes an excessive distribution, if it

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3. FA 1972, s. 84(1).

4. *Ibid*., s. 85(1).

5. *Ibid*., s. 85(2).

decides to distribute more than its total income profits of an accounting period,[6] the only proportion of ACT that can be set off against the corporation tax liability of the company is that which corresponds to the income profits of the relevant accounting period.

When a company distributes dividends and pays ACT on it, the remaining part of its corporation tax liability, after ACT has been set off is referred to as mainstream corporation tax.

Any ACT not set off because of the limits imposed by the 1972 Finance Act outlined above or because the company has no or insufficient income charged to corporation tax for that period, may be set off against the corporation tax liability of the two immediate preceding years or it may be carried forward indefinitely.[7] In certain circumstances, it may be surrendered to other companies in the same group.[8]

B. Taxation of distributions[9]

The economic double taxation of distributions is

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6. It could be the case, for instance, if a company sold a factory and made a large capital gain on it.

7. FA 1972, s. 85(3)(4).

8. Ibid., s. 92 and FA 1973, s. 33. A parent company for the purposes of this section is defined under s. 92(9).

9. Transactions to be treated as distributions are defined in s. 233 of the ICTA 1970, as amended by Schedule 22 of the 1972 Finance Act. FA 1972, s. 84 assesses the liability for corporation tax where a company makes a qualifying distribution. For a definition of qualifying and non qualifying distributions and their consequences, /Continued over

mitigated in the United Kingdom by means of a tax credit (*crédit d'impôt*) granted to shareholders when the distribution takes place. The amount of the tax credit corresponds to the amount of advance corporation tax for which the distributing company is accountable to the Inland Revenue.[10]

The individual shareholder who receives a dividend grossed up by a tax credit is to include it in his personal income for tax purposes. If the recipient of the dividend is subject to the basic rate of income tax (which equals the rate of ACT), he will not be liable to any additional income tax on the distribution except in respect of the investment income surcharge, if applicable. If his personal rate of tax is above the basic rate, he will be liable for the difference to the Treasury. If his personal tax liability is below the total of the tax credit, he will obtain a refund for the difference.[11]

Charities (*oeuvres de bienfaisance*) and pension funds (*caisses de retraite*) are exempt from tax: they will receive from the Treasury a cash payment which corresponds

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Footnote 9 continued from page 313.

see FA 1972, ss. 84(4), 87(5)(6). The underlying idea is that distributions which result in the immediate distribution of reserves are to be regarded as qualifying distributions whilst those distributions which constitute a potential rather than an immediate claim on profits (such as bonus issue of redeemable shares or debentures) are to be regarded as non qualifying distributions.

10. FA 1972, s. 86(1).

11. *Ibid.*, s. 86(4) and ICTA 1970, s. 232(1).

to the tax credit attached to the distributed dividend. The company which distributes the dividend had paid ACT to the Treasury; the latter gives it to the charity or pension fund to which the dividend is distributed.

If a dividend is distributed to a company, it is not incorporated in its taxable profit. The recipient company is not liable to corporation tax on such dividend. The aggregate of the distribution and tax credit attached to it is called franked investment income.[12]

When a company receives franked investment income (FII) during an accounting period, it sets it off against the franked payments (FP) it makes (i.e. its own distributions of dividends) and it is required to pay ACT only in respect of the excess of FP over FII. If FII exceeds FP in an accounting period, the surplus may be carried forward and treated as FII received in the next accounting period.[13]

When a company resident in the United Kingdom distributes dividends to non residents, it is to pay ACT on the sums distributed. No further withholding tax is deducted from those dividends when recipients do not benefit from the tax credit granted to residents.

The United Kingdom has entered into numerous

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12. Ibid.,s. 88 (1).

13. Ibid., s. 89 (1)(2) and (3). Surplus of FII may also be used to set off trading losses, excess charges on income, expenses of management, certain capital allowances (s. 254(1)(2) and (7) of ICTA 1970).

double taxation agreements which extend the benefit of the tax credit to non resident shareholders, individuals, and/or companies.[14] The granting of the tax credit, or half of it[15] to non resident individuals and/or companies is subject to a withholding tax levied on the aggregate of the dividend and tax credit, whose rate is established by the relevant convention.[16]

The double taxation agreement signed between the United Kingdom and the United States on 31 December 1975 was the first one to extend the benefit of half of the tax credit to direct investors. This convention only came into force on 25 April 1980. Protocols or new agreements containing similar advantages have since been negotiated with Finland, Luxemburg, Norway, Sweden, Denmark, Switzerland and the Netherlands.

II. France

A. Corporation tax

In determining the taxable income of a company,

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14. Traditionally, the tax credit was only given to portfolio investors, *i.e.* individual shareholders, whatever the size of their holding and companies which held less than 10 per cent. of the issued share capital of the UK resident company making the distribution. Since 1975, the United Kingdom has entered into new agreements or protocols and granted to direct investors half of the tax credit granted to resident companies.

15. 1975 US/UK double taxation agreement, art. 10.

16. The US/UK agreement provides for a 15 per cent. tax to be withheld on the dividend grossed up by the tax credit, reduced to 5 per cent. when the recipient of the dividend is a direct investor and is only given half of the tax credit. The difference between the withholding and the tax credit will be refunded.

rules set forth in the General Tax Code, arts. 38 and 39 in particular, are followed.[17]

Corporation tax is levied at a rate of 50 per cent.[18] This rate has not been modified since 1958.[19]

Capital gains realised by companies are divided into short term and long term gains.[20]

Short term gains are treated as ordinary profits and taxed at the rate of 50 per cent, but the taxpayer may elect to spread the gain over three years.

Long term capital gains are liable to corporation tax at a reduced rate of 15 per cent. Companies may only benefit from the reduced rate on long term capital gains if they constitute a special reserve. There can be no distribution out of such gain. Otherwise, the company would be liable to the normal 50 per cent. rate of tax on the capital gain. The reason for this is to force the company to maintain the gain invested in the company.

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17. See above, Introduction, Chapter 5. For an outline on French corporation tax in English, see Bulletin for International Fiscal Documentation 1980/ 8-9, Vol. 34, p. 347.

18. CGI, art. 219.

19. Claude Gambier, Les Impôts en France (Paris: Editions Francis Lefebvre, 13th ed., 1981), §241.

20. Short term gains (plus values à court terme) are gains from the disposal of fixed assets held for less than two years as well as gains corresponding to depreciation previously allowed regardless of how long the assets (biens) have been held; long term gains (plus values à long terme) arise from the sale of non depreciable assets (biens non amortissables), assets held for two years or more or of depreciable assets (biens amortissables) held for two years or more to the extent that the gain exceeds depreciation previously provided.

In addition, every company is liable to pay a yearly corporation tax of 3,000 Francs.[21] It is referred to as imposition forfaitaire annuelle. This sum is due notwithstanding the profit or loss position of the company. This sum can be set off the corporation tax liability of the current year and the two subsequent ones, but if the company makes no profit during that three year period, the annual tax turns into a final charge.

Companies formed after 1 January 1977 are exempt from the imposition forfaitaire annuelle for the first three years of their existence when the capital has been at 50 per cent. paid up in cash.[22]

The payment of corporation tax takes the form of four instalments (acomptes) due on 15 March, 15 June, 15 September, 15 December. The total of these four payments amounts to 90 per cent. of the taxes paid on the previous year's income and corresponds to the financial year. Within three months of the end of each financial year, the situation is finalised; the settlement is often called régularisation annuelle.

B. Taxation of distributions

When distributions are made out of after tax profits, France applies a partial imputation system. It takes the form of a tax credit called avoir fiscal attached

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21. CGI, art. 223 septiès.

22. Ibid.

to the dividend distributed.[23] The *avoir fiscal* is equal to one half of the amount of the dividend. It will be deducted from the recipient's tax liability and therefore partially mitigates the economic double taxation on distributed profits.

For instance, a company makes a profit of 200. After corporation tax (50 per cent) the company is left with 100 which it decides to distribute in total to a shareholder. The dividend distributed will be grossed up (*majoré*) with a tax credit (*avoir fiscal*). The shareholder does not actually receive the *avoir fiscal* in cash, 50 in this particular example, but this sum will be deducted from his personal taxable income. The *avoir fiscal* takes the form of a document, *certificat d'avoir fiscal*, given to the shareholder when he receives his dividend.

If we assume that the taxpayer is liable to income tax (*impôt sur le revenu*) at a rate of 40 per cent, his tax liability may be summed up as follows:

(100 + 50) x 40/100	60
Deduction of *avoir fiscal*	50
Tax to be paid on dividend	10

90 (100 - 10) represents the sum kept by the recipient of the dividend after tax. If there was no tax credit, he would be liable to 40 (100 x 40/100) of income tax and he

23. CGI, art. 158 *bis*. In 1982, the French Government seriously considered the abolition of the *avoir fiscal* and its replacement by a tax credit. Such change has not been carried out in the 1983 Finance Law. See *Projet de loi de finances pour 1983, les Notes Bleues*, published by the Ministry of Economy and Finance.

would have been left with 60, instead of 90. If there was no imputation system, the total tax burden on the initial profit of 200 would be 140 (100 of corporation tax + 40 income tax).

The *avoir fiscal* can benefit not only to individual shareholders, but also companies. But whereas an individual can obtain a refund of the *avoir fiscal* when its amount is above his total personal tax liability,[24] such advantage is denied to companies. If the amount of corporation tax due by a company is not high enough to allow for an imputation of the *avoir fiscal*, the benefit of it is lost for the company.[25]

Specific rules apply to the distribution of dividends of a company to another when a parent-subsidiary relationship exists between them. This is described as the affiliation privilege (*régime des sociétés mères et filiales*).[26]

The purpose of the affiliation privilege is to avoid the double taxation of the profits of a subsidiary distributed in the form of dividends to its parent company. The profits of the subsidiary are liable to corporation tax at the rate of 50 per cent. in the hands of the subsidiary; only 5 per cent. of the distribution is again liable to corporation tax in the hands of the parent

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24. CGI, art. 158 *bis*.

25. Claude Gambier, *op.cit.*, note 19 above, §288; CGI, art. 209 *bis*.

26. CGI, arts. 145 and 216.

company.[27]

Considering that the dividends distributed by a subsidiary to its parent are not to be taken into account for the computation of the taxable profit of the parent company, the avoir fiscal attached to this distribution gives no benefit to the parent company. In other words, the parent company cannot deduct the avoir fiscal from its taxable income. However, the parent company will be able to transmit (transmettre) the advantage of the avoir fiscal to its shareholders when it redistributes the amounts received from its subsidiary in the form of dividends.[28]

The avoir fiscal is normally only granted to individuals who have in France their domicile réel (real domicile) or to companies which have their siège social in France.[29] However, the benefit of the avoir fiscal has been extended by double taxation agreements to individuals and certain companies resident abroad, subject to a withholding tax (retenue à la source).

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27. CGI, art. 216.

28. CGI, art. 146-2. When a parent company receives dividends from its subsidiary, the sums received are not subject, in the hands of the parent company, to a 50 per cent. corporation tax. The parent is to pay a compensatory tax (précompte) to the Treasury, in relation to amounts which have not been subject to corporation tax. The compensatory tax is reduced by the tax credits attached to the dividends received from the subsidiary for the past five years at most. The tax credit just mentioned corresponds to the avoir fiscal attached to the dividend distributed by the subsidiary to its parent. If the subsidiary is a foreign one, the tax credit will not exactly correspond to the compensatory tax.

29. CGI, art. 158 ter 1.

Section 2: Taxation of Foreign Income

§1. The United Kingdom

I. Advanced Corporation Tax[30]

Since 1803 dividends distributed by UK resident companies have always been subject to a withholding tax. The rate of the withholding tax has always corresponded to the rate of income tax, presently 30 per cent. The withholding tax has always been regarded as a means of payment in advance of the personal income tax due by individual shareholders who receive dividends.

The nature of the withholding tax has been altered twice in the past 15 years.

- Before 1965, a company was allowed to keep the sum withheld on a distribution in order to make up for the tax it had to pay on its profits. At the time, corporation tax as such did not exist and companies were liable to income tax, at the standard rate which has since been renamed basic rate.

If a company distributed dividends, it could recuperate the income tax it had paid (on the sums out of which the dividends were paid) by deducting it from the distribution.

The main characteristic of this system was the

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30. For a complete analysis of the nature of ACT, see S.N. Frommel, "Réflexions sur les Conséquences du Remboursement du Crédit d'Impôt Britannique aux Actionnaires Américains", Réflexions offertes à Paul Sibille (Bruxelles: Bruylant, 1981).

major difference of treatment of retained and distributed profits, to the advantage of the latter.

- As from April 1966, a company could no longer keep the withholding tax on its distribution, but had to pay it to the Treasury.

- In April 1973, a further modification was introduced.[31] A company is still to pay the withholding tax to the Treasury but this advance payment may be set off against the company's normal end year corporation tax liability. There are limits to the amount that may be set off in any one year.

The terminology has changed: the company now pays advance corporation tax (ACT) to the Treasury and a tax credit, equal to ACT, is attached to the dividends distributed by the company. In fact, ACT is a withholding tax and it is imputed on the tax liability of the individual shareholder who receives the dividend.

The system introduced in 1973 is new only to the extent that the withholding tax is deducted not only from the personal income of the shareholder who receives the dividend - as was the case before - but is also set off against the corporation tax liability of the company.

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31. For a background to the purpose and underlying ideas behind the change of 1973, see Reform of Corporation Tax (London: HMSO, March 1971) Cmnd. 4630, No. 1-3; also Report from the Select Committee on Corporation Tax (London: HMSO, 20 October 1971 (H.C. 622)). See also the more recent Green Paper on Corporation Tax, Cmnd 8456, Chapter 4 in particular on taxation of distributions.

§2. France

I. Précompte Mobilier (Compensatory Tax)

A. Payment

When dividends are distributed out of profits which have not been subject to corporation tax at a rate of 50 per cent., the company is required to pay a compensatory tax equal to the imputation credit attached to the distributed dividends.[32] This will generally be the case when a company distributes income from foreign branches or dividends from foreign subsidiaries.[33]

The *précompte mobilier* is a substitute for corporation tax which a company is to pay when it distributes dividends out of profits which have not been subject to a 50 per cent. corporation tax.[34] As the *avoir fiscal* represents a rebate (*ristourne*) to the shareholder of half of the corporation tax, the company has to compensate for the rebate if it has not paid corporation tax to its normal extent (50 per cent.): the *avoir fiscal* is 50 per cent. for all dividends, whatever their source, but whenever they are paid out of profits that have not actually

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32. CGI, art. 223 *sexiès*.

33. Claude Gambier, *op.cit.*, note 19 above, §§290-291.

34. The *précompte mobilier* is also due when the profits out of which the distribution is made were realised during a financial year closed more than five years earlier. As regards payment of the *précompte* to the Treasury, see CGI, arts. 1679 *ter*, 1649 *quinquiès* C-1.

been taxed at 50 per cent., the company is compelled to reimburse the amount of the tax advantage granted by the state to the shareholders "without justification" to some extent.

The effect of the avoir fiscal - précompte system depending on the source of dividends may be illustrated by a comparison of two companies which distribute a 500 Francs dividend. In Example I, the dividend is paid out of profits subject to a 50 per cent. corporation tax.[35]

Example I

Profits	1000	
Corporation tax (50 per cent)	500	500
Dividend distributed	500	500
Avoir fiscal	250	
Shareholder's income before personal income tax	750	
Total payments by company		1000

In the next example, the dividend is paid out of profits which have not been subject to French corporation tax, the profits of a foreign subsidiary for instance.

Example II

Dividend distributed	500	500
Avoir fiscal	250	
Shareholder's income before personal income tax	750	

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35. The present tables have been largely inspired by tables to be found in Claude Gambier, op.cit., note 19 above.

Compensatory tax paid by the company	250
Total payment by the company	750

The *avoirs fiscaux* in Examples I and II correspond to a refund of corporation tax. In Example I, the actual rate of tax on profits is 25 per cent., instead of 50 per cent., whereas the distribution is neutral from a tax point of view in Example II: the company pays the cost of the shareholder's *avoir fiscal* through the *précompte*. It is therefore more advantageous from the company's point of view to distribute dividends out of profits which have borne a 50 per cent. corporation tax.

B. Refund of compensatory tax (*remboursement du précompte*)

Under domestic legislation, payment of the *avoir fiscal* is not authorised when a distribution is made to non residents. Double taxation agreements generally mitigate this rule in relation to certain categories of non residents.[36]

When distributions are made in the form of dividends to non residents who are not entitled to the *avoir fiscal* (direct investors), the latter may obtain a refund of the compensatory tax corresponding to the dividend received.[37]

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36. See Part II, Chapter 2.

37. Claude Gambier, *op.cit.*, note 19 above, §§296-II(b).

Section 3: Conclusion

As a conclusion, it is interesting to point out the salient differences between the British and French imputation systems.

Although ACT and the *précompte mobilier* are often seen as counterparts on each side of the Channel, they are easy to differentiate:

- The compensatory tax (*précompte mobilier*) is only to be paid to the Treasury when the profits of a company have not been subject to a full rate of corporation tax.[38] The *précompte* represents the counterpart of the *avoir fiscal* given to the shareholder who receives the dividend.

There is no specific condition for a company resident in the United Kingdom to pay Advance Corporation Tax (ACT, *acompte sur l'impôt sur les sociétés*) to the Treasury. When such a company makes a distribution, it pays ACT. The ACT is regarded as an advance payment of income tax by the shareholder who receives the dividend.

Where the *précompte* ultimately compensates for a lack of full payment of corporation tax (*impôt sur les sociétés*), the ACT anticipates a payment of income tax.

- No refund of ACT is granted to resident companies when they distribute dividends to non residents who do not benefit from a tax credit (*crédit d'impôt*). In contrast, the *précompte* can be refunded when no *avoir fiscal* is attached to the distributed dividend; this will be the

38. CGI, art. 223 *sexiès*.

case when the beneficiary of the dividend is a foreign parent company.

In the United Kingdom, dividends paid to non resident shareholders are not subject to a withholding tax when a tax credit is not attached to the dividend distributed. When a tax credit is attached to a distribution, the rate of the withholding tax is determined by convention.

In France, whether or not the avoir fiscal is attached to a dividend, a withholding tax is always deducted from the distributed dividend. The normal rate of such withholding tax, 25 per cent., is often reduced by the text of tax conventions.

Whereas the United Kingdom has shown generosity towards recipients of dividends of UK resident companies, by granting not only portfolio investors but also direct investors, the totality or part of the tax credit originally reserved to resident shareholders France maintains a hard line. Not only the advantage of the avoir fiscal is exclusively given to portfolio investors, but a withholding tax is levied on dividends distributed to non resident direct investors. For instance, under the US/ France tax convention, dividends distributed to US direct investors are subject to a 5 per cent. withholding tax.

CHAPTER 5

TAXATION OF DOMESTIC SOURCE INCOME OF NON RESIDENT COMPANIES

In Chapter 3 of Part I, the principles of taxation of foreign income of resident companies were examined.

The United Kingdom and France happen to be two excellent illustrations of the application of opposite methods of taxation, the principle of worldwide taxation and the territorial principle respectively.

The converse situation will now be considered: the taxation of domestic source income of non resident companies.

The present chapter will limit its scope to the provisions of domestic legislation, *i.e.* in the absence of a tax convention.

The specific problem of taxation of income from real property is also left aside for the time being.

Section 1: United Kingdom[1]

§1. Definition of UK Source Income

I. Terminology

In the absence of a double taxation agreement, a

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1. See in general *Pinson on Revenue Law* (London: Sweet & Maxwell, 14th ed., 1981) Chapter 7; J. Tiley, *Revenue Law* (London: Butterworths, 3rd ed., 1981) Chapter 39, pp.668-670 in particular; *Tolley's Tax Planning* 1980-1981 (London: The Taxlawyer Publishing Company and Tolley Publishing Co Ltd, 2nd ed., 1980) pp. 570-575;
/Continued over

company non resident in the United Kingdom, i.e. managed and controlled outside that country, is liable to UK corporation tax if it "carries on a trade in the UK through a branch or agency".[2] If it does not carry on a trade in the UK, it will be subject to UK income tax on its UK source income.

The expression "to carry on a trade in the UK ..." is specifically British; the legislation of the United States refers to "being engaged in trade or business within the US".[3] The equivalent expression in double taxation agreements based on the OECD Model is "permanent establishment".

Belgium, the Netherlands and Germany use this same expression, permanent establishment, in their domestic legislation, but it does not always have the same meaning and scope as that given to the very same term in the OECD Model convention.

Similarly, the concept of trading in the UK through a branch or agency is not always synonymous to having a permanent establishment in the UK.

Footnote 1 continued from page 329.

Michael Edwardes-Ker, International Tax Strategy (Dublin: In-Depth, 1974 looseleaf) Chapter 2; CDFI 1967, Stockholm, "The Development in Different Countries of the Concept of Permanent Establishment, Notably from the Point of View of the Harmonisation in Future Double Taxation Agreements".

2. ICTA 1970, s. 246(1).

3. G. Gest, L'Imposition des Bénéfices des Sociétés Françaises aux Etats Unis (Paris: LGDJ, 1979), p. 133.

A non resident who wishes to carry on a business activity in the UK will not automatically be liable to UK tax; he will only be subject to corporation tax if he carries on a trade in the UK through a branch or agency. He may not be liable to UK tax at all if he trades "with" the UK (as opposed to "within") and does not have a UK source income.[4] If he does have a UK source income, he will be subject to income tax on that income.

II. Statutory Provisions

A. Principle: ICTA 1970, s. 246(1)

The principle of taxation of non resident companies is expressed in s. 246(1) of ICTA 1970.[5] It provides that a non resident company shall not be chargeable to UK tax unless it carries on a trade in the UK through a branch or agency.

The decisions cited below will develop the meaning which the courts have given to the expression "carry on a trade in the UK through a branch or agency".

B. Exceptions

There are important statutory exceptions to the

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4. J. Chown, Taxation and Multinational Enterprises (London: Longman, 1974), Chapter 3 in particular.

5. S. 108(1)(a)(iii) of the same Act deals with individuals: it states that tax under Schedule D shall be charged in respect of annual profits or gains arising or accruing to any person, although not resident in the United Kingdom, for any trade exercised within the UK.

principle that a non resident carrying on a trade within the UK through a branch or agency will be liable to UK tax on the profits of that trade.

. TMA 1970, s. 82(1)

Profits from sales or transactions carried out by a non resident through his broker or agent in the UK will not be chargeable to tax as long as the broker or agent is not "an authorised person carrying on the regular agency of the non resident". The effect of this sub-section is not to tax casual brokers, those who are not the regular agents of the non resident.[6]

In Fleming v. London Produce Co Ltd, the problem was the tax consequences of New Zealand lamb sent by a New Zealand company to the UK and sold by a UK company to a South African company.

Although this case involves a double taxation agreement, that between the UK and South Africa in particular, it has been felt important to deal with it at this stage because it clarifies the meaning of TMA, s. 82(1) and (2).

The question relevant here is the quality in which the UK company has acted. In which capacity did the UK company act?

. Principal or agent

The meaning of broker under the UK/South Africa

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6. Fleming v. London Produce Co Ltd (1966) TC, p. 582.

1947 tax treaty was assimilated to that of broker under s. 373(1) of ITA 1952, reenacted today as TMA 1970, s. 82.

The treaty provision provides that an enterprise of a contracting state shall not be deemed to have a permanent establishment in the other contracting state merely because it carries on business in that other state through a broker or general commission agent.

Megarry J. held that the UK company had acted as agents for the New Zealand company, and not as principals on the basis that the UK company received a commission for its work and it accounted to the South African company for all the profits of the company.

. Dependent agent or independent agent

Megarry J. held the UK company not to be an independent agent, therefore to be taxable on its profits in the UK for the following reasons: the UK company performed many acts not characteristic of those of a broker; they were lacking in generality of customs; the UK company was little more than the English end of a South African business; Megarry J. stated:

> I do not think it is within either the letter or the spirit of the section that a non resident should be able to escape taxation by virtue of the proviso if in substance what is done is that he carries on business within the United Kingdom through the medium of an agent, who is virtually a sole agent, running the entire business from him and merely sending him remittances on request.

If the broker is a person who acts regularly for the non resident, he will still not be liable to tax on the profits provided:

- he is a person who carries on <u>bona fide</u> brokerage

business in the UK, and

- he receives for the business he carries on for the non resident at least the customary rate of remuneration for the transaction.[7]

. TMA 1970, s. 82(2)

It applies where a non resident executes sales or carries out transactions with other non resident through a person resident in the UK - an agent for instance. S. 82(2) states that this shall not of itself make the resident liable to tax in respect of profits arising from those sales or transactions. This would seem to mean that the agent will not be liable to tax on the profits realised by the non resident, even if he received them. However, Lord Cave LC in Maclaine & Co v. Eccott[8] came to a different conclusion. He held that the agent was liable for his principal's tax when he received the profit. The House of Lords was of the view that the Inland Revenue could assess the non resident directly - rather than the agent; this is a very narrow approach.

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7. Agent is not mentioned at this stage. It is however specified that for the purpose of this subsection, "broker" includes a general commission agent (last sentence of the subsection).

8. (1926) AC, p. 424, at p. 435; J. Tiley, op.cit, note 1 above, at p. 673. There is nothing in TMA 1970 to make liability turn on receipt of profit. See also, Taxation (1953) p. 68; The Accountant, Tax Supplement, 5 January 1946. John Tiley feels that the agent will not be liable for his non resident principal's tax even if he does receive the profits: when neither the goods nor the parties are within the UK jurisdiction, it would be wrong to make the agent liable to tax even if he receives the profits of the transaction.

III. Interpreation by the Courts

The courts make use of a rather formal test in order to determine whether a person is trading "with" or "within" the UK.

A study of the case law shows that a non resident will be considered to be trading within the UK if the contracts for the supply of goods or services are made in the UK. If the contracts are made in the UK, it normally means that the trade is liable to UK tax.[9]

Although this principle is subject to exceptions, it is thought unfortunate to make tax liability turn on a technicality of the English law of contract, the rule of offer and acceptance.

The following cases will summarise this rule of offer and acceptance.

1) Case law on place of acceptance of an offer

Under English law, a contract is an agreement enforceable at law. There are four elements to a contract: the offer, the acceptance, the consideration, and the intention to create legal relations.[10]

In relation to the sale of goods,[11] a trade is

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9. See E.C.D. Norfolk, BTR (1980), p. 70.

10. For an introduction to the English law of contract, see Cheshire and Fifoot, The Law of Contract (London: Butterworths, 10th ed., 1981).

11. Michael Mark, Chalmers: Sale of Goods (London: Butterworths, 18th ed., 1981).

considered to be carried out in the United Kingdom if the contract is made in the United Kingdom.

Under English law, a contract is made at the place at which the acceptance becomes effective.

An offer can be revoked at any time before it has been accepted. Generally, acceptance by post is effective on posting: Adams v. Lindsell.[12] This case applies to an acceptance by letter. Consequently, the offeror may be bound even before he knows of the acceptance and even if the acceptance is lost in the post and never reaches him: Household Fire and Carriage Accident Insurance Co v. Grant.[13]

However, the terms of the offer may require the acceptance to be delivered to the address of the offeror.[14]

The principle of Adams v. Lindsell in relation to a telegram is stated in Bruner v. Moore but in Entores Ltd v. Miles Far East Corporation, it was held that acceptance by telex will be effective only when it has been received.[15]

In Byrne & Co v. Leon van Tienhoven[16] it is stated that an offer can no longer be revoked once it has been accepted. The facts of the case may be summarised

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12. (1818) 1 B & Ad, p. 681.

13. (1879) 4 Ex D. p. 215.

14. Holwell Securities Ltd v. Hughes (1974) 1 WLR, p. 155.

15. (1904) 1 Ch, p. 305 and (1955) 2 QB, p. 327 respectively.

16. (1880) 5 CPD, p. 344.

as follows: one party was in Cardiff, the other one in New York. On 1 October, the defendant offered to sell goods to the plaintiff in New York. The offer was sent by post; the plaintiff received it and accepted it by telegram. On 24 October, the plaintiff received a second letter, a letter of revocation. Was it effective? The court answered this question in the negative: an offer can no longer be revoked once it has been accepted.

2) Place where the contract is made

The following decisions illustrate the interpretation which the courts in England have been giving to the expression "carry on a trade in the UK through a branch or agency".

In Grainger and Son v. Gough,[17] a firm of French wine shippers sold champagne to customers in the United Kingdom. For this purpose, they used the services of an English agent who was obliged to refer all orders back to France for acceptance. The champagne was dispatched from Rheims. The House of Lords held that as no contracts were actually made inside the UK, trade was not being carried on there and there was accordingly no UK tax liability.

The place of the contract distinguished Grainger and Son v. Gough from an earlier case also involving wine merchants, Pommery and Greno v. Apthorpe.[18] The London agents of Pommery held stocks of wine in London; money

17. (1896) AC, p. 325.

18. (1886) 2 TC, p. 182.

received was paid into Pommery's London bank account. The trade was held to be carried on in the UK.

Sulley v. AG[19] involved the purchase of goods in the UK for resale or use in a manufacturing process abroad. It was held not to amount to trading in the UK.

In Taxation Commissioners v. Kirk[20] the goods were not simply bought in the UK but manufactured there for export; this did not amount to trading in the UK either.

In Greenwood v. F.L. Smidth & Co,[21] a Danish cement manufacturer had a permanent office and staff in London. Cement was sold in the UK. However, the company was held not to be trading in the UK because all contracts in respect of business in the UK were made in Denmark.[22]

3) Limitations

These decisions are very generous. Similarly, UK practice is generous as regards representative offices set up in this country for an overseas manufacturer for the purpose of promoting his product. The same generosity

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19. (1860) 2 TC, 149 n.

20. (1900) AC, p. 588.

21. (1922) 1 AC, p. 417.

22. It is likely that under a double taxation agreement, the activity in London would have constituted a permanent establishment and would therefore have been taxable there. This is an example where domestic law is more generous than treaty law.

appears in the banking and finance fields, provided no "trading" is undertaken by their offices.[23]

However, some cases show that the place of the contract is not the only element to take into account when determining whether a person is trading in, and not simply with the UK.

In Maclaine v. Eccott,[24] although Lord Cave described the place where the contract is made as the most important, he listed other factors such as the place where payment for the goods is to be made, the place of delivery of the goods, and he rejected any exhaustive test.[25]

In Firestone Tyre & Rubber Co Ltd v. Lewellin,[26] the American parent of the Firestone group was held to be trading in the United Kingdom through the agency of its United Kingdom subsidiary, although, in fact, the parent company effected no contracts in the United Kingdom at all. In this case, the UK subsidiary manufactured tyres in England and exported them to the order of overseas distributors under master distribution agreements entered into by the parent company. The United Kingdom company kept a margin of 5 per cent. over cost to represent its profit and the balance went to the United States. The House of Lords held that the fulfilling of the order, the

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23. M. Edwardes-Ker, op.cit., note 1 above, Chapter 2, p. 10.

24. (1926) AC, p. 424.

25. Ibid., at p. 432. On the importance of the place of delivery, see Thomas Turner v. Rickman (1898) 4 TC, p. 25, at p. 34.

26. (1957) 1 All ER, p. 561.

delivery of the goods and the payment for them were all done in the UK and that these were matters of equal importance with the question of the formation of the contract. The profit taken by the parent was therefore subject to UK tax.

§2. Methods of Taxation

I. Business Income

Under domestic law a non resident company which carries on a trade in the UK through a branch or agency, is liable to corporation tax on its net profits at the rate of 52 per cent, for the financial year 1983-84.[27]

Corporation tax is computed according to UK domestic rules. The branch or agency is charged for corporation tax on any trading income arising directly or indirectly through or from the branch or agency, and any income from property or rights used by, or held by or for, the branch or agency; it does not include distributions received from UK resident companies, chargeable gains accruing on the disposal of assets situated in the UK.[28]

A branch does not have to account for ACT (advance corporation tax) or remittance to head office.

As regards the collection of tax, the non resident is chargeable to tax in the name of the branch or

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27. ICTA 1970, s. 246(2).

28. *Ibid*., s. 246(2)(a)(b).

agent, whether he receives the profits or not.[29]

When it appears to the Inspector of Taxes that the true amount of profits or gains of a non resident who carries on trade in the UK through a branch or agency cannot be readily ascertained, he may assess the non resident on a percentage of the turnover of his business.[30]

The amount of percentage is to be determined by the Inspector.[31]

When a non resident is chargeable to UK corporation tax in the name of a branch or agent in respect of profits arising from the sale of goods manufactured abroad, he may elect to be assessed on the basis of the profits or gains which might reasonably be expected to have been earned by a merchant, or, where the goods are retailed, by a retailer of the goods sold.[32]

II. Investment Income

Under domestic law, if a non resident has UK source income, but does not carry on a trade in that country through a branch or agency, the income is subject to a withholding tax at the basic rate of income tax, 30 per cent. for the financial year 1983-84.

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29. TMA 1970, s. 78. S. 79 of the same Act seems to repeat s. 78; only the words "directly or indirectly" are added.

30. TMA 1970, s. 80(1).

31. *Ibid.*, s. 80(2). Appeal on the percentage lies to the Commissioners and from there, to the Board of Referees.

32. *Ibid.*, s. 81.

Section 2: France[33]

The taxation of domestic source income of non resident companies is governed by the territorial principle, formulated in art. 209-I of the General Tax Code.

Under domestic law, profits to be taken into account for the computation of French corporation tax are profits derived from business activities carried out in France (bénéfices réalisés dans les entreprises exploitées en France).

A foreign company will only be liable to French corporation tax if it carries out business activities in France (exploite une entreprise en France). This is the threshold of taxation; below it, the foreign company will not be liable to French corporation tax.

The purpose of this section is to assess the meaning of "carrying out a business activity in France", which is the French counterpart of the English expression "carry on a trade in the UK through a branch or agency". The French domestic legislation does not make use of the expression "permanent establishment" either.

Carrying out a business activity in France means carrying a regular commercial activity (exercice habituel

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33. The disparity between the size of this section and that on the UK is due to the fact that the interpretation of art. 209-I of the CGI was substantially developed in Chapter 3. See in general, Précis de Fiscalité, Vol. 1 (1982), §1342. Although it relates to French branches of US corporations, see M. Chisum, "A Critique and Proposal for Reform of the United States Foreign Tax Credit for French Taxation of Branch Profits", Texas International Law Journal (1982), Vol. 17, pp. 63-81.

d'une activité commerciale), through an establishment (établissement), i.e. a fixed place of business (installation stable) which is autonomous (possédant une autonomie propre) it also means that the activity may be carried out through representatives or that the activity is carried out through operations which constitute a complete commercial cycle in France (réalisation d'opérations formant un cycle commercial complet en France).

No further guidance is given in the General Tax Code as to what constitutes a business activity carried out in France.

One has to turn to the decisions of the courts in order to have a clearer picture.

There seems to be some form of symmetry in the interpretation of the territorial principle when the courts consider French companies doing business abroad and foreign companies doing business in France.

The case law examined in Chapter 3 of the present Part is therefore also relevant for the purpose of this chapter.

Attention will be focused here on decisions of the courts which involve foreign companies doing business in France.

. 1980: Construction of a seawall (digue) in Monaco[34]

This case involves the construction of a seawall intended to protect coastal constructions in Monaco. The

34. CE 30 April 1980, Req. No. 5761; Bernard Castagnède, "Fiscalité Internationale", JCP ed CI, 9583, p. 111.

seawall was partly situated in French territorial waters and partly in the territorial waters of Monaco.

The French tax authorities claimed that a fraction of the profits from the construction activity were to be taxed in France as part of the seawall was situated in France.

The Conseil d'Etat rejected this claim on the basis that the site situated in France did not amount to a permanent establishment and that the company had not realised in France a complete commercial cycle which could be separated (détachable) from the activity carried out in Monaco.

This decision is particularly interesting because it sets out clearly the conditions of existence of an establishment under French domestic law: presence of a permanent installation (installation permanente); such installation must contribute to the realisation of a profit,[35] and its management must be autonomous.

As regards the absence of a complete commercial cycle "détachable" from the activity carried out in Monaco, the Conseil d'Etat is taking the same approach, using the same words, as in the earlier cases of 1978 and 1979 involving French companies doing business abroad.[36] This symmetry is to be welcomed.

Profits arising from business activity carried

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35. This particular condition is set aside in the commentary to art. 5 of the 1977 OECD Model Convention; cf. §3, p. 59.

36. See above, Chapter 3 of the present part.

out in France are subject to French corporation tax at the rate of 50 per cent. In addition, these profits are deemed to be distributed to the foreign head office and are further reduced by a 25 per cent. withholding tax.[37]

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37. CGI, art. 115 _quinquiès_. This 25 per cent. withholding tax is reduced to 10 per cent. in the UK/F double taxation agreement.

CHAPTER 6

ANTI-AVOIDANCE PROVISIONS RELATING TO INTERNATIONAL TRANSACTIONS

Section 1: United Kingdom[1]

I. Application of the Arm's Length Principle: ICTA 1970, S. 485

A. General Considerations[2]

What is now s. 485 of ICTA 1970 was first introduced into UK domestic legislation as s. 37 of the 1951 Finance Act.

The section did not have much impact when it was first enacted, but its importance has increased substantially since the early 70s.

In 1975, powers to enable the Inland Revenue to obtain information relevant to s. 485 were enacted through

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1. On tax avoidance in general, see Dr B. Bracewell - Milnes, Tax Avoidance and Evasion (London: Pan Opticum Press, 1980); CDFI Venice 1983, "Tax Avoidance / Tax Evasion", UK Report by B.J. Reynolds; Institute of Economic Affairs, Tax Avoision (London: The Institute of Economic Affairs, 1979); European Taxation (1980), Nos. 5, 6, 7 summarise the Colloquy on International Tax Avoidance and Evasion held in Strasbourg on 5-7 March 1980. J.F. Avery Jones, "Nothing Either Good or Bad, but Thinking Makes It So. The Neutral Element in Anti-Avoidance Legislation", BTR (1983), pp. 9-43 and 113-121.

2. C. Tugendhat, The Multinationals (London: Pelican Library of Business and Management, 1973), Chapter 10, pp. 161-179; J.S. Shulman, "Transfer Pricing in the Multinational Firm", European Business (1969), pp. 46-54.

the 1975 Finance Act, s. 17 in particular. The Board may, by written notice, require a company (or a partnership) to provide information as regards related transactions[3] which may come under the scope of s. 485. Furthermore, the Board may request to inspect books, accounts or other documents or records when the transaction involves a UK resident company and its 51 per cent. non UK resident subsidiary.[4] The Board is entitled to have access to the accounts of the non UK resident subsidiary. However, this provision is substantially attenuated by s. 17(6) which allows the parent company not to comply with the requirement if "it appears to the Board ... that the requirement ought not to have effect".

In 1975 the Oil Taxation Act was also passed. S. 20 provides for the extension of ICTA 1970, s. 485 in its application to transactions by petroleum companies. Details on the definition of a petroleum company and the determination of an arm's length price are contained in Schedule 9 to the relevant Act.[5]

In addition, the Inland Revenue has set up a special unit at its headquarters in London to deal with inter-company pricing.[6]

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3. Related transactions are defined under FA 1975, s. 17(4).

4. FA 1975, s. 17(5)(a)(b).

5. For further details see below, p. 356.

6. _Taxation of Inter Company Transactions in Selected Countries in Europe and USA_ (London: Kluwer, 1979), p. 50.

Finally, in January 1981, the Inland Revenue issued Guidance Notes on the transfer pricing of multinational enterprises.[7]

The purpose of these notes is to give guidance on how to arrive at an arm's length price; it lays down criteria for determining what is an arm's length price. They do not have legal status but they provide a useful indication of the methods applied by the Revenue in determining transfer prices.

A short analysis of the document issued by the Inland Revenue will be carried out below.

B. Analysis of S. 485[8]

1) Structure

S. 485 is very illustrative of the traditional approach of the UK towards the drafting of legislation.

S. 485(1) is constructed in terms of sale of property at an undervalue ("less than") between bodies of persons, *i.e.* companies or partnerships, which control

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7. STI (1981) p. 42; Intertax (1981) No. 8, p. 301; for a commentary, see D. Davies, "*United Kingdom: IR Guidance Notes on Transfer Pricing and Multinational Enterprises*", Intertax (1982), No. 1, pp. 12-18.

8. For an excellent commentary on the section, see Roger White, "*Section 485 - The Law*", BTR (1979) pp. 85-95. In general, see M. Edwardes-Ker, *International Tax Strategy* (Dublin: In-Depth, 1974) Chapter 5; *Pinson on Revenue Law* (London: Sweet & Maxwell, 14th ed., 1982) Chapter 2, 2.44, p. 41; R.K. Ashton, *Anti-Avoidance Legislation* (London: Butterworths, 1981) Chapter 6, pp. 138-149; A.L. Chapman, *Tolley's Tax Planning* (London: Tolley Publishing Co Ltd, 1980), pp. 630-641.

each other or which are under common control.

S. 485(2) is an exact replica of s. 485(1), but involves a sale of property at an overvalue ("greater than").

Apart from the replacement of "less than" by "greater than", both subsections (1) and (2) of s. 485 are identical.

The effect of s. 485(1) and (2) is to allow the Revenue to set aside the price set by the associated bodies of persons and substitute an arm's length price in the computation of taxable profits.

The general principle of arm's length transactions to be carried between associated enterprises is therefore stated in the context of one specific type of transaction, the sale of property.

Furthermore, following the enumeration of conditions necessary to be fulfilled for s. 485 to apply (buyer and seller under common control, under or over value of the sale) the right for the Revenue to substitute a notional price (based on the arm's length principle) to the price agreed between the parties is formulated in rather unclear terms:

> ... in computing the income, profits or losses ... the like consequences shall ensue as would have ensued if the property had been sold for the price which it would have fetched if the transaction had been a transaction between independent persons dealing as aforesaid.

Then, a proviso excludes the application of s. 485 to dealings between UK resident traders.[9]

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9. For details, see section 2: Limitations.

It is only under s. 485(6) that an attempt is made at broadening the scope of the section. The principle of arm's length transactions is also to have effect in relation to "lettings and hirings of property, grants and transfers of rights, interests or licences and the giving of business facilities of whatever kind ..."

This enumeration does not eliminate all uncertainties.[10]

Finally, intermediary subsections include limitations and definitions (body of persons, control).

2) Limitations

The limitations of a most unfortunately drafted provision - but not exceptional in its style - may be summarised here.

- One of the parties to the transaction must be a body of persons under the control of the other party or both bodies of persons must be under common control of another person. A transaction between a UK parent and its foreign subsidiary is covered by s. 485, but a transaction between a UK head office and its overseas branch is not.
- S. 485 only applies when the Board of Inland Revenue so directs; it does not operate automatically. In practice, the procedure is rarely used; the tax authorities generally settle disputes through negotiations. Often the question of s. 485 is raised with the tax authorities in advance of the transaction taking place.

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10. Ibid.

Few directions are made. It was stated in reply to a parliamentary question that only 11 formal directions had been made in the previous six years.[11] In 1978, it was stated that the aggregate of adjustments to profits made since 1974 amounted to 30 M.[12]

- There is presently no case law illustrating the application of s. 485.[13]

It is more a deterrent than anything else.

- S. 485 applies only where one party controls the other;[14] it does not apply where one party has 49 per cent. of the voting power of the other.[15] However, s. 17 of the 1975 Finance Act has widened the definition of control to include power held by nominees and certain connected persons.[16]

As an alternative, s. 130 of ICTA 1970 can also operate to disallow expenditure not "wholly and exclusively" incurred for the purpose of a UK company's trade.

- S. 485 does not have a general overall scope; the Revenue can only challenge particular transactions and

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11. HC Deb., Vol. 924, col. 238.

12. "Recourse to Tax Havens, Use and Abuse", IFA Seminar Paper (1980) UK Report, J.F. Avery Jones, p. 48, at p. 55.

13. CDFI 1971 Washington, UK Report, p. 293, at p. 296. IRC v. Lithgows Limited (1960) 39 TC, p. 270 was concerned with the meaning of control in s. 485.

14. For the purposes of s. 485, control is defined under ICTA 1970, s. 534 (s. 485(6)).

15. M. Edwardes-Ker, op.cit., note 8 above, Chapter 11, at p. 258.

16. This is incorporated in s. 485(5A).

s. 485 cannot be used simply to reallocate profits because trade is not carried out at arm's length.[17]

The Revenue has "power to challenge the price in a specific transaction, not the overall profit; nor can the Revenue make an allocation of net income".[18]

- A particular problem arises in relation to interest free loans or loans with a very low rate of interest. The scope of s. 485(6) is ill-defined and it is sometimes thought that interest is not part of the enumeration, that the "giving of business facilities" does not include interest payments. An argument supporting that view consists in saying that interest free loans do not amount to "transactions" and cannot therefore be within the scope of s. 485.[19] The Revenue considers that such loans fall within "the giving of business facilities".[20]

It appears that the Revenue does not impute interest on interest free loans for foreign subsidiaries if genuine commercial reasons for the loan can be shown.[21]

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17. Cf. J. Tiley, Revenue Law (London: Butterworths, 3rd ed., 1981) Chapter 11, 11-152, p. 258.

18. M. Edwardes-Ker, op.cit., note 8 above, at p. 9.

19. Roger White, op.cit., note 8 above.

20. Ibid. Also, Taxation of Inter Company Transactions in Selected Countries and the USA, op.cit., note above, at p. 26. The Guidance Notes issued in 6 January 1981 specify that interest free loans are within the scope of s. 485 (§ 7); for a different view, see D. Davies, op.cit., note 7 above, p. 14.

21. J. Tiley, op.cit., note 17 above, at p. 258; M. Edwardes-Ker, op.cit., note 8 above, Chapter 7.

The payment of interest at an excessive rate may be attacked under ICTA 1970, s. 233(2)(d)(iii): when the payer is a UK resident company, this provision allows the excess interest to be treated as a dividend.

3) <u>S. 485 as applied to domestic transactions</u>

A proviso to s. 485(1) and (2) expresses that s. 485 does not apply to transactions between related companies which carry on a trade in the UK when the transactions are treated as trading items by both parties.

Does this mean that s. 485 will apply if one of the related companies is an investment company resident in the UK? It would seem that this question is to be answered in the affirmative and it brings an exception to the principle that s. 485 normally applies between a UK resident company and a non UK resident company.

In addition, under certain circumstances, transactions between UK resident petroleum companies will come within the scope of s. 485.

Transactions between related UK resident trading companies come under the scrutiny of ICTA 1970, s. 130(a) according to which only expenses incurred wholly and exclusively for the purposes of the trade shall be deductible in the computation of taxable profits.

In 1963, tax authorities successfully contended that s. 130(e) gave them power to make a tax allocation where trading transactions between two UK companies

were not carried out at arm's length.[22]

It is thought that the use of s. 485 is largely preferred to that of s. 130.[23]

4. Sanctions

If a problem under s. 485 cannot be negotiated informally the Board of Inland Revenue will make a direction against the company in breach of the legislation.

Such direction will result in an adjustment of the price of the transaction, through a substitution of an arm's length price to the original price agreed upon by the two contracting parties.

Taxpayers may appeal against a direction made under s. 485 according to the normal procedure.[24]

The purpose of the Notes issued as guidance by the UK tax authorities in January 1981 is to enlighten the taxpayer to the possible methods followed by the Inland Revenue to arrive at an arm's length price.

The Notes give a definition of an "arm's length price". It is the price which might have been expected if the parties to the transaction had been independent

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22. Petrotim Securities v. Ayres (1964) 41 TC, p. 389. A subsidiary company transferred to its parent securities at a price significantly below their true value. The sale was held not to be made in the course of trading and the loss which arose was not to be a trading loss. The sale was treated as having been made at market value for tax purposes. (Cf. Sharkey v. Wernher (1956) 36 TC, p. 275; see Introduction, Chapter 5).

23. R. White, op.cit., note 8 above, at p. 92.

24. (1974) STC, p. 539.

persons dealing at arm's length.

A description of the different steps of the procedure followed by the Revenue before making a direction under s. 485 is given:

- agreement following negotiations,
- request for information; there is no standard list of questions; s. 17 of the 1975 FA may be applied.

As to the method followed in ascertaining an arm's length price, it is contained in a rather short development: the Revenue may use the comparable uncontrolled price method where a comparison will be made with prices in similar transactions between independent parties; or the resale price method, whereby the resale price is reduced by the appropriate mark up; or the cost plus method where a profit mark up is added to the cost price. Any other method may be used; they do not rank in order of priority. Reference is made to the OECD Report on Multinationals and Transfer Prices, issued by the OECD in 1979 but the extent to which the Revenue is guided by this document remains unclear.

Despite the publication of these guidance notes which is to be welcomed, informal discussions and agreements still seem to remain the most favoured approach to settlement.

C. Other Provisions Which Play a Part in the Determination of Transfer Prices

1) ICTA 1970, s. 130

See above, at p. 351.

2) Oil Taxation Act 1975, s. 20 and Schedule 9

S. 20 and Schedule 9 of the 1975 Oil Taxation Act are concerned with inter company transactions of "petroleum companies".[25]

. Definition of a petroleum company[26]

A company is a petroleum company if it carries on certain activities listed below, or if it is associated[27] with a company carrying on the same activities and its own activity includes the ownership operation or management of ships or pipelines used for transporting petroleum or petroleum products.

The relevant activities are:

- acquisition or disposal of petroleum or of rights to acquire or dispose of petroleum;
- the importation into or the exportation from the United Kingdom of petroleum products or the acquisition or disposal of rights to such importation or exportation;
- the acquisition otherwise than for importation into the United Kingdom of petroleum products outside the United Kingdom or the disposal outside the United Kingdom of petroleum products not exported from the United Kingdom by the company making the disposal;

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25. R.F. Hayllar, R.T. Pleasance UK Taxation of Offshore Oil and Gas (London: Butterworths, 1977) Chapter 21, pp. 157-163.

26. Associated is defined under Schedule 9, §7(2).

27. Schedule 9-12. "Petroleum" and "petroleum products" are defined in §7(1).

- the refining or processing of crude petroleum;
- the extraction of petroleum, either under rights authorising it or under contractual or other arrangements with persons by whom such rights are exercisable; and
- the ownership, operation or management of ships or pipelines used for transporting or conveying petroleum or petroleum products.

. The scope of OTA 1975, Schedule 9

It modifies s. 485 in relation to certain sales to or by petroleum companies. Paragraph 5 of Schedule 9 extends s. 485 so that it may apply when there is no common control.

. Effective date of application of OTA 1975, Schedule 9

These provisions apply to all transactions entered into after 31 December 1971. They also apply to transactions entered into before 31 December 1971, but carried out in total or in part after that date.

However, they will not apply to a transaction entered into before 31 December 1971 if it was carried out within 12 months beginning with the date the transaction was entered into.[28]

II. Exchange Control - Restrictions on Migration of Companies: ICTA 1970, s. 482[29]

A. Presentation

Exchange control regulations - which constitute

28. Oil Taxation Act 1975 (cited as OTA 1975), s. 20(1)(a)(b).
29. General background material: B. Spitz, Tax Havens

/Continued over

an important anti-avoidance device for Governments - have been abolished by the Conservatives in 1979.[30] Since then, UK companies can invest abroad without limit by buying foreign currency at the market rate.[31]

> These changes give companies complete freedom of choice in financing their overseas operations. [32]

> Now that effectively all of the UK exchange controls have been abolished there is no legislation, other than the UK tax legislation, inhibiting a UK resident from setting up a tax free operation, transaction or investment company in any tax haven in the world. [33]

Although there are virtually no restrictions on the transfer of cash abroad, the transfer of trade abroad is controlled under s. 482 of the 1970 Taxes Act.

The Government has noticed this anomaly: "Section 482 is inappropriate following the abolition of

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Footnote 29 continued from page 357.

Encyclopedia, Section on United Kingdom Law and Practice, p. 8; J.F. Avery Jones, ed., "Tax Havens and Measures Against Tax Evasion and Avoidance in the EEC"(London: Associated Business Programmes, 1974) p. 62-64; J.S. Martin and A. Dale Wilson, "Comparative Analysis of Systems of Domestic Taxation of Controlled Foreign Corporations", Vanderbilt Journal of Transnational Law (1981), pp. 99-171, at p. 156; Chown, Taxation and Multinational Enterprise (London: Longman, 1974) pp. 207-213; M. Edwardes-Ker, op.cit., note 8 above, Chapter 4, pp. 2-5; J. Tiley, op.cit., note 17 above; A.L. Chapman ed., op.cit., note 8 above, pp. 228-230, 587-8.

30. The 1947 Exchange Control Act has not been repealed: residents have been relieved from their obligations under the Act by Orders in Council; the Exchange Control (General Exemption) Order 1979, S.I. 1979, No. 1660. Cf. M. Edwardes-Ker, ITSS Bulletin No. 10, p.5.

31. Ibid (1979) Bulletin No. 7, pp. 1-2.

32. Ibid., at p. 2.

33. Ibid., Bulletin No. 10, pp. 1-6, at p. 2.

exchange control",[34] and proposes to repeal s. 482. It does not intend to do so before a new effective definition of company residence and measures to guard against avoidance through tax havens subsidiaries are enacted.[35]

In the consultative paper issued by the Board of Inland Revenue in December 1982, it is clearly spelt out that the Government will not proceed with a statutory definition of the residence of a company in the 1983 Finance Act, in connection with this decision, s. 482 will be retained.[36]

In July 1983, the Board of Inland Revenue

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34. Board of Inland Revenue, "Draft Legislation on International Tax Avoidance" I, Company Residence, 2.iii, at p. 6.

35. Ibid., J. Tiley sees no reason to link the reform of the definition of company residence and the repeal of ICTA 1970, s. 482; cf. J. Tiley, op.cit., note 17 above, Part VII, Chapter 36, 36-20, at p. 632. However, if s. 482 is repealed and the existing definition of company residence is maintained (place of central management and control, location of board meetings in practice) directors will only have to fly and meet abroad for the company not to be resident in the UK and therefore not liable to UK corporation tax on its profits. On the other hand specific legislation against the use of tax havens may be more efficient. For a commentary on s. 482 in relation to company residence, J.B.D. Oliver, "Are We Talking About the Same Thing?", BTR (1981) No. 2, pp. 72-77; Alun G. Davies, "The British Revenue: Problems of Company Residence and the Use of Tax Haven Subsidiary Companies: Proposals for New Legislation in the Finance Bill 1982", European Taxation (1981) pp. 379-382. The author quotes the Report of the Royal Commission on the Taxation of Profits and Income of June 1955 as saying that ICTA 1970, s. 482 "has no real connection with the subject of tax avoidance" and opposes to this the statement by the Inland Revenue that the starting point of the definition of company residence is the case for the repeal of ICTA 1970, s. 482.

36. "Taxation of International Business" issued by the Board of Inland Revenue, at p. 6.

issued a Statement of Practice in order to clarify the definition of residence of a company for tax purposes.[37]

B. Analysis of ICTA 1970, s. 482

The application of s. 482 will only be very broadly outlined in the following paragraph.[38]

S. 482 was originally introduced in the 1951 Finance Act, s. 36 in particular, as a temporary measure.

1) The threat

S. 482(1) lists four types of transactions which are unlawful unless carried out with Treasury consent:

a) Emigration of a company

A UK resident company cannot transfer its residence abroad without Treasury consent.[39] In practice, the Board of Directors of a UK resident company could not decide to meet in any tax haven in order to transfer its residence there.

b) Transfer of business

This provision prevents *inter alia* a UK resident company with a foreign branch to incorporate it as a local subsidiary.

This provision includes the transfer of the whole

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37. SP 83/6, see Part I, Chapter 2.

38. For a complete analysis, see M. Edwardes-Ker, *International Tax Strategy* (Dublin: In-Depth, 1974).

39. Residence is defined under s. 482(7) as the place of central management and control.

trade or business, or any part of it. However, it does not include a "mere transfer of assets ... not resulting in a substantial change in the character or extent of the trade or business".[40] There is no specific guidance as to the interpretation of "mere transfer of assets ..." Business is to be understood widely for the purposes of this section: the holding of investment or property is deemed to be a business carried on by the UK resident company.[41]

c) Creation of shares or debentures

"Debentures" have a very broad meaning and can cover almost any loan.[42]

However, any security given by the UK resident company to a bank or an insurance company will not come within the scope of the present provision.

d) Sale of shares

Prior consent of the Treasury will have to be obtained before a UK resident company can sell in total or in part its foreign subsidiary.

All transactions described above are forbidden unless prior authorisation has been obtained from the Board of Inland Revenue. Violation of this provision constitutes a criminal offence. Penalties include two years'

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40. S. 482(9).

41. S. 482(8).

42. S. 482(2).

imprisonment. There can also be a fine up to three times the total of tax attributable to income arising in the 36 months immediately preceding the offence, or £10,000, whichever is greater.[43]

ICTA 1970, s. 482 is in its application not as stringent as it first appears. No prosecution has so far been brought under s. 482.[44]

2) Mitigations

- The Treasury often allows an operation to be carried either through general consent or specific consent.[45]

If a transaction falls within the classes to which the Treasury has given general consent, there is no need for an application to be filled in.

Otherwise, application for consent is to be made to the Secretary, H.M. Treasury (A.P.), Parliament Street, London. Three copies of all letters of application should be sent.[46]

The application is to give all the information

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43. S. 482(6).

44. J.F. Avery Jones, op.cit., note 29 above; also A. Sumption, Taxation of Overseas Income and Gains (London: Butterworths, 4th ed., 1982), p. 134.

45. The Treasury Memorandum setting out General Consents and the formal application for specific consent may be found in B. Spitz, op.cit., note 29 above, Appendix I, at pp. 23-27. M. Edwardes-Ker in International Tax Strategy analyses the application of the general consents.

46. In practice, applications for consent under ICTA 1970, s. 482 are examined by the Board of Inland Revenue who make their recommendation to the Treasury.

requested.[47] The applicant company is to send a copy of its latest balance sheet and profit and loss account.

Other information is requested; it varies as a function of the nature of the transaction.

- S. 482 only applies to a "body corporate". This designates a company; therefore, individuals and partnerships are excluded from the ambit of s. 482.

- S. 482 does not apply to the setting up of an entirely new venture.[48]

III. Proposals for New Legislation to Curb International Tax Avoidance

A. Chronological Development

On 26 January 1981, the Board of Inland Revenue issued two consultative documents.[49]

One deals with a possible change of the concept

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47. It includes - *inter alia* - the name of the applicant company, the nature of its business and place of its main activities, whether it is public or private, the extent of the overseas holding where UK residents hold less than 80 per cent. of the capital of any class, the name of the directors, their address when they are not UK residents, the tax district to which the company makes its corporation tax return, details of previous applications, the proposed transaction, and so on.

48. As an illustration in relation to the setting up of a business in Guernsey, see *Tolley's Tax Planning*, *op. cit.*, note 8 above at p. 229. Other loopholes can be used: M. Edwardes-Ker in *International Tax Strategy* suggests that s. 482 contravenes the EEC aim of free movement of capital; see Chapter 4, p. 2.

49. The text of both consultative documents may be found in STI, 6 February 1981, pp. 39-42; also in Taxes International, Nos. 21 and 22.

of company residence;[50] the second consultative document is entitled "Tax Havens and the Corporate Sector". Attention will be focused on it in the present paragraph.

Its purpose is to strengthen existing legislation on international tax avoidance: the Inland Revenue considers that if ICTA 1970, s. 482 is to be repealed,[51] as a logical follow up to the abolition of exchange control, new legislation is to be enacted to counter international tax avoidance.

The Inland Revenue wishes to enact provisions to counter avoidance of UK tax by the accumulation of profits in tax haven subsidiaries.

The Inland Revenue did not make available the responses to its consultative documents which were to reach Somerset House by 31 March 1981. Copies of comments submitted to the Inland Revenue by various bodies may, however, be consulted.[52]

The proposals drew a universally unfavourable response.[53]

"In the light of the response to the Consultative Documents" issued in January 1981, the Government

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50. It has been examined at length in the present part of this work, Chapter 2 in particular, section 1.

51. For a development on ICTA 1970, s. 482, see above, II.

52. 21 and 22, Taxes International, July and August 1981.

53. Ibid.

published Draft Legislation in November 1981.[54]

The Draft Legislation includes three sets of provisions: one on the definition of company residence and the repeal of ICTA 1970, s. 482; one to counter the use of tax havens by UK companies in general and a specific provision dealing with loans out of income by foreign subsidiaries to the UK parent ('upstream loans').[55]

Comments were required from the public on the Draft Legislation. They were to be received by 26 February 1982.

Reactions reached the press as major multinationals (Shell, BAT Industries, ICI and Unilever) urged the Government not to include the proposed legislation in the Budget.[56]

In the 1982 Budget Speech delivered on 9 March 1982 by the Chancellor of the Exchequer, proposals on international tax avoidance legislation were left out: they were postponed for further consideration.

The purpose of the legislation would be to counter the use of tax havens by UK companies, to fight their

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54. "International Tax Avoidance", Draft Legislation, November 1981, Introduction. This document may be purchased from HMSO for £2. It is also integrally reproduced in Taxation Practitioner, 28 February 1982, pp. 28-40.

55. The possibility of a specific provision dealing with loans from foreign subsidiaries to their UK parent was envisaged in the consultative document.

56. Financial Times, 5 March 1982, front page; FT, 8 March 1982, p. 5 and p. 14.

accumulation of income in low tax areas. A charge to tax would be introduced on profits of subsidiaries situated in tax havens; a specific provision would deal with loans out of income by overseas subsidiaries to the UK parent companies (upstream loans).

These two sets of rules will be examined in turn.

The proposed legislation will often be compared - not with its Japanese counterpart - but with art. 209B of the French General Tax Code. The purpose of this comparison is not solely of academic interest; it may help measuring the ambit of the proposed alterations in UK tax legislation.

The first striking factor when comparing the UK proposal and French legislation enacted in the 1980 Finance Law - apart from the fact that the latter is on the statute book and the former not yet - is the length of each provision. The French provision is a single article of the General Tax Code, made up of a few lines of a small-sized book; the UK proposal covers 43 typed pages (from p. 15 to p. 58 of the "International Tax Avoidance" document published by the Inland Revenue).

B. Analysis of the Proposed Legislation

1) Charge to tax on profits of controlled foreign companies[57]

a) "International Tax Avoidance": November 1981

. To whom would the proposals apply?

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57. It has been decided that all through this paragraph and
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The Draft Legislation only applies to companies.

Specific legislation exists already as regards the accumulation of income by individuals in low tax areas.[58]

The word company is not defined for the purposes of this proposal. Company normally means any body corporate or unincorporated association, but it does not include a partnership.[59] This definition is excluded in some provisions,[60] and extended to authorised unit trusts in certain circumstances.[61]

It is not clear whether a foreign trust could escape the proposed legislation and accumulate profits in a tax haven.

The charge would apply to a UK resident parent company who has a 10 per cent. or more interest in an overseas company ("foreign controlled company").

In the preliminary commentary to the Draft legislation, the Inland Revenue supports its choice for a 10 per cent. interest threshold on the basis - inter alia -

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Footnote 57 continued from page 366.

the next one, no reference will be made to the numbering of the draft clauses as they are only temporary and will undoubtedly differ in the final legislation - if ever enacted. The term "foreign controlled subsidiary" designates the overseas subsidiary of a UK parent situated in a tax haven.

58. ICTA 1970, s. 478.

59. ICTA 1970, s. 526(5).

60. Ibid., (6).

61. Ibid., s. 354.

that most countries use the same figure.[62] France chose in 1980 a 25 per cent. minimum threshold.

Interest is defined widely; it includes not only a 10 per cent. shareholding but also an interest by virtue of a loan credit for instance.

. To what category of income does the proposal apply?

Only the income of the overseas company comes within the scope of the proposals - capital gains are excluded. No tax liability would arise in respect of capital gains accruing to the controlled foreign subsidiary.

. Condition as regards the location of the overseas company

The Draft legislation provides that it is to enjoy a privileged tax regime.[63]

The test is objective: a system is regarded as privileged if the tax in respect of the profits is less than half the corresponding UK tax.

. Escape clauses

The French counterpart of these proposals, art.

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62. Paragraph 8, at p. 11.

63. To a reader with a little knowledge of any of the tax systems referred to in the consultative document but the Japanese, such a choice for illustration purposes may seem strange; in particular, a lot of the terminology of the proposal on tax haven and the corporate sector seems borrowed from the French counterpart of the UK proposal, art. 209B of the General Tax Code ("privileged tax system", <u>régime fiscal privilegié</u>), engaged in genuine trading activities (cf. art. 209/II "<u>a principalement une activité industrielle ou commerciale</u>").

209B of the General Tax Code creates a presumption which is hard to remit: in order to set aside the consequences of 209B, cumulative conditions are to be fulfilled. There are no alternative tests as in the UK proposals, some of which, the motive test for instance, are very subjective. In France, the activity carried out is to be of a genuine commercial or industrial nature; secondly it is to take place on the local market or with independent companies. The burden of proof is on the company.

In the UK, there are three escape clauses, three means to defend oneself against taxation of profits realised in a tax haven country. The Board of Inland Revenue will not make a direction if any of the following tests apply:

- The genuine trading test

The terminology used here is borrowed from the commentary on the draft legislation. The meaning of each of these expressions is developed in Schedules to the proposed sections.

It will only be met if each of the following conditions are fulfilled: the overseas company is to have a business establishment in its country of residence; its business affairs are to be independently controlled and managed; its business is not to consist of private investment, or delivery of goods to or from the UK or connected persons; if a financial business, less than 50 per cent. of its trading receipts are to be derived from connected or associated persons and the proportion of receipts attributable to distributions from other controlled foreign

companies is not to exceed 5 per cent.

Such test cannot be satisfied by a holding company.

- Acceptable distribution test

The dividend distributed by a trading company is to represent at least 50 per cent. of its profits; that of a company other than a trading company, 90 per cent. of its profits. The distributed income must be remitted to the UK; it is to be paid within reasonable time, not out of specified profits.

- The motive test

Although this test is described in the draft section in vague terms,

> if ... it nevertheless appears to the Board ... that ... avoidance was not the main purpose or one of the main purposes of any transaction ... and the transactions ... were carried out for bona fide commercial reasons, the Board may not give a direction.

it has not been felt necessary to elaborate on it in a Schedule.

Once the conditions described above would be fulfilled, the UK resident company would be liable to UK corporation tax on a share of the profits of the overseas company, pro rata its interest.

If a UK resident company had a 25 per cent. interest in a "foreign controlled subsidiary", a subsidiary located in a tax haven, and the application of the new anti-avoidance provision had not been set aside by any of the tests described above, the UK resident company would

be liable to UK corporation tax on 25 per cent. of the profits - not the capital gains of its tax haven subsidiary.

However, this is not automatic: the company will not be chargeable to tax unless the Board so directs. It is on the basis of the administrative burden a mandatory procedure would create for the tax administration and taxpayers that the Inland Revenue sets it aside. The same argument was invoked as regards directions under ICTA 1970, s. 485.

The following points support the view that the proposals - although ambitious inasmuch as the UK draftsmen look at tax avoidance from an unusually wide angle - do not seem to justify the uproar which they created a few days before the 1982 Budget Speech. This would certainly be the opinion of a continental tax practitioner who deals, on a daily basis, with more stringent provisions incorporated in its domestic legislation.

The following points outline the limited scope of the proposed legislation: the meaning of the word company could be interpreted narrowly and allow numerous other forms of business organisations to accumulate profits in tax haven countries; the term "profits" is also to be interpreted narrowly: it does not include capital gains. The escape clauses are alternative and numerous; the "motive test" is so broadly drafted that its scope is hard to delimit; finally, the power of direction is kept in the hands of the Board of Inland Revenue only.

On the other hand, the lack of precision of the draft legislation, its vagueness makes it extremely dangerous.

The enactment of the proposed legislation would bring uncertainty; companies may have to modify the planning of some of their tax affairs, but the Draft Legislation, as it stands in October 1982 seems to remain lower in strength than its French counterpart for instance.

In addition, in the United States where such a type of legislation has been enacted (Subpart F), it has left enough loopholes for companies to manoeuvre.

b) "Taxation of International Business": December 1982[64]

"Taxation of International Business" issued in December 1982 by the Board of Inland Revenue, contains a set of revised proposals to counter the accumulation of profits in tax havens. Representations were to be sent to Somerset House not later than 14 February 1983.

In his Budget Statement the Chancellor announced he would be introducing legislation to take effect from 6 April 1984. The proposed legislation as contained in the Finance Bill was the same as set out in the December 1982 document but it was proposed to table amendments to the Bill in order to give effect to certain changes in the

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64. A copy of "Taxation of International Business" may be obtained from the Board of Inland Revenue (£3.20). See also Taxation Practitioner (1983) pp. 30-45; European Taxation (1983) pp. 91-99; Simon's Tax Intelligence (1983) pp. 58-66; BTR (1983) Current Notes, pp. 1-6; Financial Times, 3 March 1983.

light of representations received.

The 1983 Finance Bill was drastically shortened following the decision, announced on 9 May 1983, to call a General Election exactly a month later.

The proposed provisions on controlled foreign companies have been deleted from the original Finance Bill. A Summer Finance Bill (Finance (No. 2) Act 1983) received Royal Assent at the end of July 1983 but contained no provision on controlled foreign companies.

On 25 July 1983 the Chancellor of the Exchequer, Mr Nigel Lawson, stated in Parliament that he proposed to include these proposals in the 1984 Finance Bill; they could be subject to modifications.

At the time of writing, the content of the proposals that will be included in the 1984 Finance Bill are unknown.

The following paragraph will briefly summarise the contents of the December 1982 consultative document; an outline of the amendments that were to be tabled at Committee Stage is also provided.

The Inland Revenue proposes, in its second consultative document, that a UK resident company with an interest of 10 per cent or more in a controlled foreign company will, if the Board so direct, be liable to corporation tax on its pro rata share of the overseas company's taxable profits (excluding capital gains) for any accounting period for which the direction is given.

A controlled foreign company is a company that is resident outside the UK, controlled by UK residents and

subject to a lower level of taxation in its country of residence, i.e. the local tax paid is less than half of the UK tax that would have been payable had the controlled foreign company been resident in the UK (the 'notional UK tax').

The Inland Revenue has issued a provisional list of countries that will not be regarded as low tax countries. It is a non-statutory list, and it is proposed to finalise it once the Finance Bill becomes law. The list is formed of two parts: Part I includes countries not regarded as low tax; Part II includes those not regarded as 'low tax', subject to qualifications. The latter includes Ireland, Luxembourg, the Netherlands and Singapore. The former is too lengthy to be enumerated here but it can be found inter alia in Taxation issue of 19 March 1983, at p. 709.

A direction may only be made on a UK resident company which has, together with connected or associated persons, at least a 10 per cent. holding in a controlled foreign company.

Profits will normally be apportioned by reference to a person's shareholding in the controlled foreign company, but other rules will apply where other kinds of interests exist. Interest in a controlled foreign company is widely defined. If no rule applies, the apportionment will be made on a "just and equitable basis".

No direction will be made in a UK company if the controlled foreign company satisfies any of the three following tests.

- The acceptable distribution test. A company will be deemed to have met this test if it pays to UK residents a dividend equal to at least 50 per cent. of its available profits, or 90 per cent. if it is not a trading company. Available profits are profits available for distribution within 18 months of the end of the accounting period in question.

- The exempt activities test. A company will be regarded as being engaged in exempt activities if it fulfils all the following conditions: it must occupy with a reasonable degree of permanence premises in the country of residence from which it mainly carries on its business; the business affairs must be effectively controlled and managed in its country of residence; it must have an adequate number of employees. Also any services the company provides to non-residents of that country must not be performed in the UK, unless they are merely incidental or subject to UK tax.

A number of specific activities are banned (holding securities, patents or copyrights, dealing in securities, leasing, dealing in goods for delivery to or from the Uk and so on).

- The motive test. Where the two other tests do not apply, a controlled foreign company may be outside the proposed rules if the Revenue can be persuaded that (a) the transactions were undertaken for bona fide commercial reasons; and (b) where they have resulted in a reduction of UK tax, it was either minimal or tax reduction was not one of the main purposes of the transactions; and

(c) if there was a diversion of profits from the UK, this was not one of the underlying reasons for the existence of the foreign controlled company.

The amendments to the 1983 Bill which the Government proposed to table are stated in a Press Release of 30 March 1983. They can be summarised as follows:

- to base the charge on an apportionment of profits rather than 'notional UK tax';
- to modify the "acceptable distribution" test;
- to provide more information for UK companies subject to a direction/assessment;
- to modify the "exempt activities" test;
- to clarify the motive test;
- to allow relief for losses incurred prior to the first direction;
- to introduce a monetary _de minimis_ provision.

Methods of providing clearance arrangements for the purposes of the legislation were also being considered.

After the legislation is enacted, a technical unit in the Head Office of the Inland Revenue would be available to provide - _inter alia_ - advice on the interpretation of the legislation, on its application to group structures, advance clearance where shares in a controlled foreign company are sold.

2) _Upstream loans_

An upstream loan is a loan made to a UK parent

company by an overseas subsidiary out of income.

A loan made to a UK resident company out of the profits of an overseas company, whether situated in a tax haven or not, would be treated as income.

This removes the tax advantage of remittance by way of loan rather than dividend.

The proposal would tax such a loan as dividends save insofar as they had already been charged to UK tax.

The corollary of this is that interest on such loans would not be allowable for tax nor would repayment of the loan attract repayment of the tax.

The loan would be treated as a deemed dividend. It would therefore be treated as income in the hands of the UK company.

The specific provision on upstream loans incorporated in the draft legislation has received the following welcome: "a piece of nonsense that should be buried before Budget day"; "The draft legislation is technically a disaster"; "the most inept piece of legislation in the history of taxing statutes - and this is a prize for which the competition is formidable".[65]

It is stated in the third consultative document issued by the Inland Revenue in December 1982 that the problem of upstream loans is to be given further consideration. There is no provision on it in the 1983 Finance Act.

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65. Financial Times, 15 March 1982, T. Hughes, Tax Manager with Deloitte Haskins Sell.

Section 2: France[66]

I. Application of the Arm's Length Principle, CGI, art. 57

The United States first introduced in 1921 legislation allowing the tax authorities to scrutinise transactions between related taxpayers.

The purpose of s. 482 of the Internal Revenue Code is to allow the Revenue to ascertain whether common control is being used to reduce, avoid or escape taxes. It allows the authorities to determine the taxable income a controlled taxpayer would have had if, in the conduct of his affairs, he had been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[67]

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66. For general comments in English on French anti-avoidance legislation, see Taxation of Intercompany Transactions in Selected Countries in Europe and USA (The Netherlands: Kluwer, 1979); J.F. Avery Jones, ed., Tax Havens and Measures against Tax Evasion and Avoidance in the EEC (London: Associated Business Programmes, 1974) Chapter 2 in particular, by J.C. Goldsmith, J.S. Martin, A. Dale Wilson; "Comparative Analysis of Systems of Domestic Taxation of Controlled Foreign Corporations, Vanderbilt Journal of Transnational Law (1981) p. 148; CDFI 1971 Washington, Vol. LVIb, "Criteria for the Allocation of Items of Income and Expense between Related Corporations in Different States, Whether or Not Parties to Tax Conventions" French Report, P. Dequesne, pp. 187-203, summary in English at p. 202; also CDFI 1975 London, Vol. 60b, "Allocation of Expenses in International Arm's Length Transactions of Related Companies", French Report, Yann Bergall, pp. 157-168; B. Spitz, Tax Haven Encyclopedia; P. Graham and J.M. Tron, "Tax Treatment in France of International Transactions between Affiliated Companies", BTR (1974) pp. 368-377; J. Cosson, Les Industriels de la Fraude Fiscale (Paris: Seuil, 1971); J.P. leGall and Cl. Lazarus, "The French Approach to Intercompany Pricing", International Tax Report (1978) Nos. 2, 3.

67. For a translation in French of IRC, s. 482, see G. Gest,
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The Finance Law of 1933 first introduced in France a provision to resist the transfer of income to foreign related parties; it was incorporated in the General Tax Code as article 57.

Article 57 provides:

> For the assessment of income tax due by enterprises which are controlled by (sont sous la dépendance) or which control enterprises established outside France (situées hors de France), profits indirectly transferred to the latter, either through the increase (majoration), or the reduction (diminution) of purchase or sales prices or through any other means, shall be added (incorporés) to the results shown in the accounts. The same procedure is followed with respect to enterprises which are controlled by an enterprise or a group of enterprises situated outside France.
>
> In the absence of specific information (éléments précis) enabling the assessments (redressements) provided for in the preceding paragraph to be made, the taxable profits shall be determined by way of comparison with the profits of similar enterprises (entreprises similaires), whose businesses are conducted under normal conditions (exploitées normalement).[68]

Art. 57 applies to income tax (impôt sur le revenu); it has been extended by art. 209-I to apply to corporation tax.

Footnote 67 continued from page 378.

L'Imposition des Bénéfices des Sociétés Françaises aux Etats Unis (Paris: LGDJ, 1979) pp. 379-302; see also CDFI 1975 London, US Report, pp. 129-143; for a general criticism of s. 482, H. Bartlett Brown, G.E. Zeitlin, "Multinational Corporations and Income Allocation under S. 482 of the IRC" Harvard Law Review (1975-76) pp. 1202-1238.

68. The text in French is: "Pour l'établissement de l'impôt sur le revenu dû par les entreprises qui sont sous la

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The French tax administration issued on 4 May 1973 an Instruction which details the conditions of application of CGI, art. 57.[69]

Footnote 68 continued from page 379.

dépendance ou qui possèdent le contrôle d'entreprises situées hors de France, les bénéfices indirectement transférés à ces dernières, soit par voix de majoration ou de diminution des prix d'achat ou de vente, soit par tout autre moyen, sont incorporés aux résultats accusés par les comptabilités. Il est procédé de même à l'égard des entreprises qui sont sous la dependance d'une entreprise ou d'un groupe possédant également le contrôle d'entreprises situées hors de France.

"A défaut d'éléments précis pour opérer les redressements prévus à l'alinea précédent, les produits imposables sont determinés par comparaison avec ceux des entreprises similaires exploitées normalement."

English translations of this provision may also be found in Taxes International, October 1981; B. Spitz, Tax Havens Encyclopedia; European Taxation (1981) at p. 352; BTR (1974); IFA Seminar Paper, "Recourse to Tax Havens, Use and Abuse" (1980) at p. 36; Michael Edwardes-Ker, International Tax Strategy.

69. Bulletin Officiel de la Direction Générale des Impôts (hereinafter cited as BODGI) 4A-2-1973. For an excellent analysis of art. 57, C. Lazarus, L'entreprise Multinationale Face Au Droit (Paris: Librairies Techniques, 1977) Titre III, Chapter 2, pp. 236-269. See also J.P. le Gall, "La Règle de l'Arm's Length Serait-elle Incompaptible avec le Traité de Rome?" Droit et Pratique du Commerce International (hereinafter cited as DPCI) (1982) pp. 65-85. Also F.Goré, B. Jadaud, Droit Fiscal des Affaires (Paris: Dalloz, 1980). See also, DGI, Précis de Fiscalité, Vol. I, para 1007; Tixier Gest, Kerogues, Droit Fiscal International (Libraires Techniques, 2nd ed., 1979) pp. 93-105; J.M. Iron, "Les Mesures de Contrôle Français en Matière de Fiscalité Internationale", DPCI (1978) pp. 109-126. Art. 90.II of the 1982 Finance law has strengthened the application of art. 57. For a description of the modification, see below, C.

A. Conditions of Application

Two conditions are required for the application of art. 57:

- the existence of links of interdependence (liens de dépendance)[70] between the enterprises involved, and
- the shifting of profits abroad (transfert de bénéfices à l'étranger).

1) Existence of links of interdependence between the French and the foreign enterprise

Art. 57 only applies to the relationship between French and foreign companies.

Links of interdependence may be legal or factual.

a) Legal links

They exist, for instance, when a company holds a predominant part (part prépondérante) of the share capital of another or when it holds the absolute majority of votes in shareholders' meetings; also, when one enterprise has, within the other directly or through an intermediary (par personne interposée) the power to make decisions.

There is no requirement for a minimum interest to be held from one company into another.

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70. The counterpart of the expression 'links of interdependence' is 'control' in the UK and the US; the OECD refers to 'associated enterprises': the same concept - although with slight variations - is expressed with different terms in different countries.

The expression intermediary includes managers (*gérants*), directors (*administrateurs*) and any person who has an interest in the business or capital of both enterprises.[71]

French subsidiaries of foreign companies and French companies with subsidiaries abroad are primary targets for art. 57.[72]

Permanent establishments and branches may also come within the domain of application of this article considering that a head office and its branch situated on either side of the border are treated for tax purposes as two separate enterprises.[73]

b) *De facto* links (*dépendance de fait*)

The links of interdependence between a French enterprise and its foreign affiliate may be contractual, or a simple consequence of the factual relationship between them.[74]

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71. *Instruction of 4 May 1973*, *op.cit.*, note 69 above, I. A.a, at p. 6, 1 §615, at pp. 722-723.

72. CE 23 February 1966, *Req*. No. 64-449; this decision is cited as an illustration in the *Instruction* of 1973 relative to art. 57.

73. This is a consequence of the territorial principle: cf. CDFI Washington 1971, II, at p. 138; J.M. Tron, *op.cit.*, note 69 above, at p. 373.

74. The text of the *Instruction* states that the *de facto* links of interdependence may be contractual or result from conditions ..." It is awkward to talk about *de facto* dependence as opposed to legal dependence when the link is of a contractual nature.

The following decision illustrates the attitude of the Conseil d'Etat as regards the interpretation of de facto links.

A French company paid to a Moroccan company a fee out of proportion with the services rendered by the latter to the former. The fee was calculated on the basis of all the profits of the French company, despite the fact that the Moroccan company only contributed to a fraction of the profits of the French company. The Conseil d'Etat held the French and Moroccan companies to be interdependent for the purpose of art. 57.[75]

2) Shifting of profits abroad

The tax administration must also show that an indirect transfer of profits abroad is taking place. The transfer of profits may result from an increase (majoration) or a deduction (diminution) of purchase or sale prices. It may also result from the payment of excessive royalties, the granting of an interest free loan (l'octroi d'un prêt sans interêt), waivers of claim (remise de dettes) or an advantage out of proportion with the service rendered.

The following decisions will provide illustrations:

- increase or reduction of purchase or sale price

The tax administration is to control that the

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75. CE 6 May 1966, Req. No. 62-129.

French subsidiary is not buying from its foreign parent at a marked up price (prix majoré); or that the French subsidiary is not selling items to its foreign parent at a reduced price.

In order to establish the existence of a transfer, the "dubious" price is to be compared with the price paid for the same item by independent companies.[76]

- interest free loan

A French company had granted a loan to its foreign subsidiary. The annual rate of interest was fixed at 7 per cent. but the French parent company did not receive the payment of the interest in 1957 and 1958. The tax administration contended that the absence of payment of interest amounted to an indirect transfer of profits abroad and added to the results of the parent company an amount equal to the interest unpaid.

The Conseil d'Etat rendered a decision in favour of the tax authorities.[77]

More recently, in 1982, on two separate occasions, the Conseil d'Etat has had to examine the tax treatment of interest free loans granted by French parent companies to their UK subsidiaries.[78]

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76. CE 29 January 1964, Req. No. 47-515, JCP 1964 II, 74369. It may be helpful to consult the customs authorities or the Direction Nationale des Enquêtes et de la Documentation (DNED) 48, boulevard des Batignolles, Paris 17 ème. Instruction of 9 May 1973, B.1, at p.7.

77. CE 23 February 1966, Semaine Juridique, Edition Commerce et Industrie (hereinafter cited as JCP ed CI), 80410; Recueil des décisions du Conseil d'Etat (hereinafter cited as RDCE) (1966) p. 139.

78. CE 2 June 1983, Req. No. 23342 and CE 26 November 1982,
/Continued over

In the first case, the interest free loan had been granted to a UK subsidiary which was starting operations. The French parent demonstrated that the loss of profits it had incurred by not charging interest (6.769 Francs in 1972 and 15.339 Francs in 1973) was very limited in comparison with the increase of its exports sales to the UK (498,178 Francs in 1971 and 2,557,364 Francs in 1973) and of its corresponding export profit. The Conseil d'Etat accepted this demonstration and held that no transfer of profits had taken place: the decision of the French parent company not to charge interest on the loan was an act of normal management (acte de gestion normale).

In the second case, the French parent contended that its UK subsidiary was in financial difficulties. The Conseil d'Etat rejected that contention on the following grounds: firstly, had the UK subsidiary paid normal interest on the loan granted to it free of charge by its French parent, the former would only have incurred a deficit of 25,000 Francs in 1975 and it would not have had to be wound up, contrary to the French parent's contention. Secondly, the French company was not able to prove that it had gained benefits as a result of the interest free loan granted to the UK subsidiary.

The Conseil d'Etat held a transfer of profits to have taken place.

Footnote 78 continued from page 384.

Req. No. 24360. These two decisions were reported in 44 Taxes International (1983) p. 21.

- advantage out of proportion with the service rendered

In a decision of 9 March 1979, the Conseil d'Etat held the granting of a guarantee (caution) by a French parent to its foreign subsidiaries to amount to an indirect transfer of profits under art. 57 of the General Tax Code, as no remuneration had been paid to the parent company for the service rendered.[79]

Another decision dealt with an excessive fee paid by the French subsidiary of an American parent to an audit firm in return for services rendered mainly in the interest of the parent. The fee was considered to be only partially deductible from the profits of the French company, not because the work of the audit firm was carried out essentially in the interest of the US parent company, but because its content, held to be rather superficial, did not justify such a fee.[80]

The burden of proof is on the tax authorities: it had to demonstrate both cumulative conditions described above: the existence of links of interdependence between a French and a foreign company, and that of a shift of profits abroad.

Once the tax authorities have established the

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79. CE 9 March 1979, Req. No. 10454, RDCE (1979) pp. 108-111.

80. Jurisclasseur de Droit Fiscal International, Fascicule 304-A. CE 29 March 1978, Req. No. 4062, Droit Fiscal (1978) No. 29, comm. 1180.

existence of abnormal benefits, the effect of article 57 is to create a presumption of transfer of profits abroad and the burden of proof shifts on to the taxpayer. He has to show that such benefits were legitimate under the circumstances.

B. Method of Reallocation of Profits

As regards the existence of abnormal benefits, the matter may be brought before the Commission Départementales des Impôts which will give an opinion on the facts.

As regards the application of art. 57, the presumption created by it is not irrebutable and the company is still entitled to fight it and show that the advantages did not in fact amount to a transfer of profits abroad.[81]

The company is to show that the benefits conceded were motivated by genuine commercial reasons.[82] In practice, tax inspectors will not apply art. 57 in respect of sales which, for commercial reasons have been made

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81. Instruction of 9 May 1973, II-A, at p. 10. The Commission is presided over by a judge of an administrative court (tribunal administratif); it consists of three tax inspectors and four independent delegates appointed by the Chambre de Commerce et d'Industrie to represent the interest of the taxapyer. Cf. Taxation of Inter Company Transactions in Selected Countries in Europe and the USA (London: Kluwer, 1979) at p. 44.

82. Note of 27 August 1959, Bulletin Officiel des Contributions Directes (hereinafter cited as BOCD) (1959) II-893; also, note of 18 May 1972, BODGI, 4A-6-72.

to foreign companies at price near to cost.

In reviewing inter-company pricing the tax authorities have not applied art. 57 when the advantages granted to the foreign affiliate "could be considered as long term investments made in the interests of the French manufacturing industry" or "if a French company reduces its margin to meet competition in the foreign country and can show that it does not intend to accumulate excessive profits in the foreign country".[83]

For instance, the Conseil d'Etat decided that a parent company could charge preferential prices to a subsidiary which had some difficulty in carrying out its business.[84]

Similarly, in a decision of 1967, the French company invoked its personal financial and commercial interests in the prosperity of its foreign subsidiaries.[85]

In a decision of 1970, the Conseil d'Etat considered as legitimate the financial help provided by a parent company to its foreign subsidiary that was in difficulty. The decision was based on the fact that the prosperity of the French company could be in jeopardy if the financial situation of the subsidiary worsened.[86]

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83. The Tax Management International Forum, April 1980, Vol. 1 No. 2, p. 8.

84. Taxation of Intercompany Transactions in Selected Countries in Europe and the USA, op.cit., note 81 above, at p. 53.

85. CE 13 January 1967, Req. No. 68139.

86. CE 11 December 1970, Req. No 78696.

This position has been confirmed more recently.[87]

A company X owned 99.97 per cent of the share capital of B. In December 1972, X waived a debt from B and deducted the sum from the profits of its accounting period ending on 31 December 1972.

The tax authorities contested the deduction.

The Conseil d'Etat gave satisfaction to X on the following grounds: it was in the own interest of X to help Y, which was facing financial problems; such waiver of debt was an act of normal management.

It is interesting to notice that in this particular decision, no reference is made to CGI, art. 57. The outcome of the case is based on the doctrine of a normal management act (doctrine de l'acte normal de gestion).

An even more recent case confirms this position.[88] Its facts were similar to the ones just outlined; a parent brewery company had waived a debt in favour of its German subsidiary which was in a difficult financial situation.

The Conseil d'Etat allowed the debt to be deducted from the profits of the parent on the basis that the parent attempted to avoid the liquidation (dépôt de bilan) of its

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87. CE 30 April 1980, Req. No. 16253, RDCE (1980), pp. 206-207.

88. CE 27 November 1981, Req. No. 16814, RDCE (1981), pp. 452-454. The same approach is taken in the 1982 decision examined above involving an interest free loan from a French parent to its UK subsidiary starting operations.

German subsidiary. Such liquidation would have hampered the reputation and the commercial activities of the parent itself.

The legal basis on which the opinion of the Conseil d'Etat is based is interesting: as in the case of April 1980, the Conseil d'Etat contended that the parent company performed a normal act of management.

It stated in addition that the waiver of debt (abandon de créance) did not amount to a transfer of profits in the sense of CGI, art. 57, nor in the sense of art. 5 of the 1959 double taxation agreement between France and Germany.

This last statement is important inasmuch as the Conseil d'Etat seems to treat on an equal footing CGI, art. 57 and a provision of a double taxation agreement dealing with the respect of the arm's length principle.

If the relevant company has not been able to rebut the presumption of art. 57 and the tax authorities do not consider that the benefits granted could be justified on commercial grounds, the profits shifted abroad will be added to the results of the accounts of the French company for the year during which the transfer occurred.

If exact figures are not available to determine the amount of profits shifted abroad, it will be determined by comparison with similar enterprises normally managed.[89]

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89. This method can only be used if specific information is not available: CE 23 November 1960, Req. No. 68139.

In addition, profits shifted abroad are deemed to have been distributed and are subject to a 25 per cent. withholding tax.[90]

C. <u>Finance Law 1982, Art. 90-II</u>

The 1982 Finance Law has strengthened the application of art. 57.[91]

The French tax administration need not prove the existence of links of interdependence or the existence of control when the transfer is carried out with enterprises situated in a foreign state or a territory outside France which have a privileged tax system.[92]

It may be difficult for the French tax authorities to prove the existence of links of interdependence between two companies, one of which is situated in a tax haven country. This company may show consistent unwillingness to submit information to the French authorities and the intention of the Government in the 1982 Finance Law has been to facilitate the task of the tax authorities.

The modification brought in does not operate a shift in the burden of proof which is still on the tax authorities, but it alleviates it when the related company is situated in a tax haven.

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90. 25 per cent. is reduced to 10 per cent. under the UK/F double taxation agreement.

91. Art. 90-II of the Law No. 81-1160 of 30 December 1981. See DGI, <u>Précis de Fiscalité</u>, Vol. 1 (1982), §1007-1; JCP ed CI (1982) III, 52149.

92. For a definition, see CGI, art. 238A, al. 2, DGI, §1071.

In fact, art. 90-II of the 1982 Finance Law extends the scope of art. 57 beyond the transactions carried out between related parties. The condition of existence of control or of links of interdependence is dropped when a transfer of profits is realised in favour of a company situated in a privileged tax country.

The new provision creates a presumption: if transfer pricing exists between two companies, and one of them is situated in a privileged tax country, the new provision establishes a presumption that the two companies are related; however, it is still for the tax authorities to bring the proof of existence of a transfer price, an abnormal advantage granted to the company situated in a privileged tax country.

D. Comparison with UK, ICTA 1970, s. 485

The purpose of the following comparison is to outline the differences between UK and French legislation on transfer pricing, of ICTA 1970, s. 485 and CGI, art. 57 respectively.[93]

France preceded the UK (1933 and 1951) in the passing of the legislation, but both countries took a very long time to explain their respective provision: an Instruction was only published in France in 1973 and Guidance Notes in the UK in 1981.

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93. The table in the Appendix to this Chapter summarises the present comparison.

Overall, it may be said that the French legislation is more stringent than the UK legislation, wider in scope generally; the following enumeration will justify this statement:

- A transaction between a UK resident head office and its overseas branch is not covered by s. 485, whereas the same transaction in France between a French resident head office and its foreign branch comes within the scope of art. 57.

- Parties to a transaction must be under common legal control in the UK, whereas legal and de facto links of interdependence will be taken into consideration in France.

- As regards the definition of control,[94] no minimum interest is required in France for art. 57 to apply; in the UK, control means holding more than half of the shares in the other company.

- There is doubt as to whether an interest free loan comes within s. 485; no such uncertainty exists as regards the scope of art. 57.

- S. 485 does not operate automatically, only if the Revenue so directs. There are no decisions of the courts on the application of this section. The French courts have dealt with art. 57 numerous times.

- However, in a single respect, s. 485 is wider in scope than art. 57: art. 57 only applies to the relationship between a French resident and a foreign affiliate;

94. Different countries use different names to describe the same concept: 'control' in the US and the UK, 'links of interdependence' in France, 'associated enterprises' in the OECD Model convention.

s. 485 may involve two UK resident companies, if one of them is a trading company and the other, an investment company.

II. Provision Against the Shifting of Certain Payments to Privileged Tax Jurisdictions: CGI, art. 238A

Article 14 of the 1974 Finance Law[95] introduced a provision aimed at refraining the transfer of profits abroad through payments of certain types of income to persons situated in tax havens.

This provision was codified in art. 238A of the General Tax Code and subsequently explained in an Instruction of 26 June 1975.[96]

Further details as to the meaning of "state or territory subject to a privileged tax treatment", and accompanying lists are contained in a Note issued by the tax authorities on 9 October 1975.[97]

The scope of art. 238A has been extended by the Finance Law for 1982, art. 90-I in particular.[98]

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95. Law No. 73-1150 of 27 December 1973.

96. BODGI 4C-8-75.

97. BODGI 4C-2-75; Jurisclasseur de Droit International, Fascicule 304-A, No. 68 bis. Also, Droit Fiscal (1975) No. 46-47, comm. 4933; JCP ed CI IV, 4933. Unless otherwise specified, the sources used for the purpose of II. and the following paragraphs are the same as those spelt out in the footnotes in I.

98. Law No. 81-1160, Official Journal of 31 December 1981, 3554; DGI, Précis de Fiscalité (1982) Vol. 1, §1071. For a commentary, B. Castagnède, "Fiscalité Internationale", JCP ed CI (1982) 10586, p. 161.

APPENDIX

United Kingdom, s. 485 of ICTA 1970	France, art. 57 of the General Tax Code
Finance Act 1951	Finance Law for 1933
Guidance Notes issued in 1981	*Instruction* issued in 1973
A transaction between a UK resident company and its overseas branch is not covered	A transaction between a French resident company and its foreign branch is covered
Normally applies to UK resident companies; there are exceptions: s. 485 will apply to a transaction between a UK resident trading company and a UK resident investment company	Only applies to a French company and its foreign affiliate
Parties to the transaction must be under common legal control	Parties to the transaction may have legal or *de facto* links of interdependence
Control generally means holding more than half of the shares.	No minimum interest required
No decisions of the courts on s. 485. It does not operate automatically, only if the Revenue directs that it should apply.	Numerous decisions on art. 57. Applies automatically once required conditions are fulfilled.
An interest free loan from a parent to its subsidiary may not be covered.	An interest free loan is definitely covered.
There is only one paragraph in the Inland Revenue Guidance Notes of 1981 on the determination of an arm's length price. The paragraph is vague; it makes a general reference to the OECD publication on transfer pricing.	The development on determination of an arm's length price is more substantial and more specific.

Differences as regard the drafting of each section have been left aside.

The extension involves any payment (tout versement) made to an account held in a financial institution or establishment (organisme financier) situated in a foreign state or territory which has a privileged tax regime.

Art. 238A states:

> Interest, arrears and other proceeds of obligations, debt claims, deposits and guarantees, royalties from assignment or granting of exploitation licences, patents, trademarks, methods or formulas for manufacturing and other similar rights or service fees, paid or due by an individual or a legal entity domiciled or established in France to individuals or legal entities domiciled or established in a foreign State or a territory situated outside France and are subject there to a privileged tax treatment, are not allowed as deductible expenses for the determination of tax unless the payer proves that the expenditure corresponds to genuine transactions and that it is not abnormal or exaggerated.
>
> For the application of the preceding paragraph, persons are considered to be subject to a privileged tax treatment in the relevant State or territory if they are not subject to tax there or if they are liable to taxes on profits or income substantially lower than the tax in France. 99

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99. The French text is: "Les intérêts, arrérages et autres produits des obligations, créances, dépôts et cautionnements, les redevances de cession ou concession de licences d'exploitation, de brevêts d'invention, de marques de fabrique, procédés ou formules de fabrication et autres droits analogues ou les rémunérations de service, payés ou dûs par une personne physique ou morale domiciliée ou établie en France à des personnes physiques ou morales qui sont domiciliees ou établies dans un Etat étranger ou un territoire situé hors de France et y sont soumises à un régime fiscal privilégié, ne sont admis comme charges deductibles pour l'établissement de l'impôt que si le debiteur apporte la preuve que les dépenses correspondent à des operations réelles et qu'elles ne présentent pas un caractère anormal ou exagéré.

Pour l'application de l'alinéa qui precède, les personnes sont regardées comme soumises a un régime fiscal privilegie dans l'Etat ou le territoire considère que

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Broadly speaking, art.238A states that interest, royalties, management and service fees paid by a French resident - whether an individual, a partnership or a company - to a person abroad subject to a privileged tax treatment shall not be allowed as deductible expenses if the payer cannot prove both that the expense was incurred in respect of genuine operations and that it is not abnormal or exaggerated in amount.[100]

A. Conditions of Application

1) Personal scope

To whom does art. 238A apply? The terminology used in the text of the provision is broad and general: 'individuals or legal entities'. This includes all taxpayers: individuals subject to income tax, partnerships and companies, whether subject to income tax or corporation tax.

Two persons are involved in the type of transaction which art. 238A is attempting to refrain: one is a resident of France, the other one is situated in a country or territory with a privileged tax system.[101]

Footnote 99 continued from page 396.

si elles n'y sont pas imposables ou si elles y sont assujéties à des impôts sur les bénéfices ou les revenus notablement moins élevés qu'en France."

100. M. Edwardes-Ker, op.cit., note 8 above, Chapter 4, Section 4, at p. 12. For a commentary in English, see Pennera, Intertax (1976), p. 125.

101. For a development on this concept, see below, 3).

2) Income covered

The application of art. 238A can only involve certain categories of payments by a French resident to a foreign resident in a tax haven: the relevant payments are enumerated in art. 238A, §1. It basically includes interest, royalties, management and service fees and, since the 1982 Finance Law, payments to a financial institution. Art. 238A applies to payments actually made or simply due.

The nature of the income only is to be taken into consideration: whether the service has been rendered in France or abroad is immaterial for the purpose of the application of art. 238A.[102]

3) The concept of privileged tax regime (régime fiscal privilégié)

The second paragraph of art. 238A specifies that a privileged tax treatment is deemed to exist when the recipient of the relevant income is either not taxed, or liable to tax at a substantially lower rate than in France.

Further details are provided in the text of the Instruction.

It is for the tax authorities to establish that the recipient is situated in a country with a privileged tax treatment; the Instruction gives information as to how the existence of a "privileged tax treatment" can be

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102. Instruction of 26 June 1975.

established. There are two possibilities: either the recipient is not taxable at all on his income received (a) or he is liable to tax, but at a substantially lower rate than in France (b).

a) <u>The recipient is not taxable in the country or territory where he is resident</u>

This situation arises in one of two cases:

- either there is no tax on business profits or on profits from professional activities, no income tax. Such places include Andorra, Bahrein, Caiman Islands, Bahamas, Bermuda, Campione, Kuwait, New Caledonia, New Hebrides, Nauru, Monaco, Caicos Islands, Uruguay and French Polynesia.[103]

- or, income enumerated in art. 238A which does not have its source in the country of residence of the recipient is not taxable there. These include Costa Rica, Lebanon, Liberia, Panama, Djibouti, Uruguay and Venezuela.[104]

b) <u>The recipient is subject to substantially lower taxes in his country or territory of residence</u>[105]

The main area of difficulty is to determine on

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103. It is emphasised that the lists published by the tax administration are not exhaustive, and subject to possible amendments.

104. Uruguay is mentioned twice because since 1-1-1974 total exemption only applies to personal income tax.

105. Angola, Antigua, Netherland Antilles, Barbados, Gibraltar, Grenada, Isle of Man (Guernsey, Jersey,
/Continued over

what basis a country or a territory may be said to impose substantially lower taxes than in France. How is "substantially lower" to be interpreted?

The *Instruction* offers good guidance as to how to approach the problem:

- On what basis are the tax systems of two countries to be compared?

Each case is to be examined in the light of its particular facts. However, a comparison is to be made according to the following rules.

. In order to make a comparison, one will have to look at the system of taxation of categories of income in general, and not only consider a specific example of taxation in both countries.

. The comparison is not to involve the French and the foreign systems as a whole; however, if the recipient is an individual, it will be appropriate to compare income tax in France and in the other country: for instance, one may compare the liability to tax in both countries of a married man, with no children who has a net total income of 100,000 Francs.[106]

Similarly, if the recipient is liable to corporation tax, the French 50 per cent.rate of corporation tax

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Footnote 105 continued from page 399.

Aurigny, Sercq and Hern), Gilbert and Ellice Islands, Hong Kong, Solomon Islands, British Virgin Islands, Jamaica, Liechtenstein, Luxemburg Montserrat, St Helen, St Vincent, Switzerland, Tonga Archipelago.

106. *Instruction* of 26 June 1975, I.3b, at p. 18.

will be compared to the charge on business profits in the other country.

. The comparison is to take into account special features of a tax system such as in Switzerland for instance the treatment of certain types of companies, service companies, holding companies or domiciliary companies.

- How to appreciate whether a country or a territory is a tax haven?

If the recipient is a married man with no children and a net total income of 100,000 Francs, he will be deemed to be subject to a privileged tax treatment if his liability to income tax is inferior in the proportion of one third to his liability in France on the same amount, in identical circumstances. If the recipient is liable to corporation tax, the same proportion of one third will constitute the threshold.

In addition, other factors of a financial, economic and political nature may be taken into consideration.

B. Effect of Art. 238A

When interest, royalties, management or service fees are paid by a French resident to a foreign resident subject to a privileged tax treatment, the effect of art. 238A is

. to deem the payment not to correspond to a genuine transaction, and

. to deem the payment to be abnormal or exaggerated.

In order to avoid the sanctions of art. 238A, the

taxpayer has to show both that the payment corresponds to a genuine transaction and that it is not abnormal or exaggerated. The onus of proof borne by the taxpayer is very heavy.[107]

C. Sanctions

If the taxpayer is not able to rebut the double presumption described above, the payment (interest, royalties, management or service fees) that has been transferred to a tax haven will be incorporated in the taxable profits of the French resident company.

A distinction is to be made:[108]

- if the taxpayer is not able to prove that the sums paid abroad correspond to a genuine transaction, they will be incorporated in the profits taxable in France in total.
- if the taxpayer manages to prove that the payment corresponds to a genuine transaction but does not convince the authorities that such payment is normal and not exaggerated, a fraction only will be added back to the profits

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107. If in a particular case both arts. 57 and 238A were applicable, the tax administration may favour art. 238A on the basis that the heavy burden of proof is on the taxpayer, and art. 238A does not require the proof of existence of links of interdependence.

108. This distinction is not made in the text of art. 238A itself, but in the Instruction of 26 June 1975. It is doubtful whether such apportionment would be possible under UK law, had it not expressly stated in the statutory provision. This illustrates the substantial difference in interpretation of legislation in the UK and France, previously dealt with in the Introduction, Chapter 3 in particular.

taxable in France.

A further distinction is introduced in the tax treatment of the sums reintegrated in the profits of the French company subject to corporation tax:

- Such sums are to be treated as distributed income when

  · before or after reintegration, the results of the accounting period out of which they were subtracted show a profit.[109]

  · the results of the relevant accounting period still showing a loss after the reintegration of deductible expenses, the individual or body corporate who receives the sums is a shareholder (actionnaire ou porteur de parts) of the French company.[110]

A change in the qualification of these sums disallowed as deductible expenses is consequent on the application of a domestic provision: it can only take place if it does not contravene a double taxation agreement.[111]

Subject to this reservation, the sums added back to profits taxable in France will be subject to a 25 per cent, withholding tax, which may be reduced by tax agreements.

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109. CGI, art. $109\text{-}1\text{-}1^{o}$ and 110, first subparagraph.

110. Ibid., art. $109\text{-}1\text{-}2^{o}$.

111. Treaties prevail over domestic legislation, see Introduction, Chapter 2 in particular. This hypothesis is essentially of academic interest since France systematically avoids concluding double taxation agreements with tax haven countries. The withholding taxes imposed on income payable to nonresidents are indirectly a means to combat the abuse of tax havens; cf. IFA Seminar (1980), op.cit., note 12 above, at p. 35.

- Otherwise, the sums added back will be subject to withholding taxes, which may also be reduced by tax agreements.

III. Provision Against the Use of Foreign Personal Service Companies Situated in Low Tax Jurisdictions: CGI, Art. 155A

This provision is essentially aimed at putting a stop to tax devices used by athletes and entertainers.

It was introduced by the Finance Law for 1973,[112] art. 18 in particular, codified as art. 155A of the General Tax Code.

Its application was developed in an Instruction issued by the tax administration on 27 July 1973.[113]

Basically, art. 155A allows the taxation in France of amounts charged by foreign entities for services rendered by French residents.

The impact of art. 155A has been substantially increased: it has been amended by the 1980 Finance Law,[114] art. 71 in particular.

The old and new wordings of art. 155A are transcribed here.

Art. 155A as originally enacted in 1973 stated:

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112. Law of 20 December 1972, No. 72-1121, JCP ed CI (1973) III, 39929.

113. Bulletin Officiel des Contributions Directes (hereinafter cited as BOCD) 5-G-12-73.

114. Law of 18 January 1980, No. 80-30.

Notwithstanding any provision to the contrary, sums received by a company or other legal entity with its seat outside France as remuneration for services rendered by one or several persons established in France are taxable in the name of such persons:

1) either when such persons hold directly or indirectly the control of these companies or legal entities; or
2) when such persons fail to prove that these companies or legal entities have an industrial or commercial activity other than the rendering of services; or
3) in any case, when these companies or legal entities have their seat in a country which does not have a double taxation agreement on income with France.

The new version of art. 155A is drafted in the following terms:

I. Sums received by a person domiciled or established outside France as a remuneration for services rendered by one or more persons domiciled or established in France are taxable in the name of such persons:

- either when such persons control directly or indirectly the person who receives the remuneration for services;
- or when they fail to prove that the person has, predominantly, an industrial or commercial activity other than the rendering of services;
- or, in any case, when the person who receives the remuneration for services is domiciled or established in a foreign State or a territory situated outside France where he/it is subject to a privileged tax treatment as defined in art. 238A of the General Tax Code.

II. The rules set out in I. are also applicable to persons domiciled outside France for services rendered in France. In that case, by way of exceptions to arts. 182A and 182B of the present Code, the tax is assessed according to the rules of art. 197A and collected _par voie de rôle_.

III. The person who receives the remuneration for services is jointly and severally liable, to the extent of that

remuneration, for taxes due by the person rendering the services. 115

Attention will be here focused on the 1980 drafting of art. 155A as it is the law applied today. Reference will be made to the original text in order to assess the extent of the alterations brought in by the 1980 Finance Law.

A. Conditions of Application

1) Constant conditions

The scope of art. 155A is narrow inasmuch as it

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115. The text in France is: "I. Les sommes perçues par une personne domiciliée ou établie hors de France en rémunération de services rendus par une ou plusieurs personnes domiciliées ou établies en France sont imposables au nom de ces dernières:
- soit, lorsque celles-ci contrôlent directement ou indirectement la personne qui perçoit la rémunération de services;
- soit lorsqu'elles n'établissent pas que cette personne exerce, de manière prépondérante, une activité industrielle ou commerciale, autre que la prestation de services;
- soit, en tout état de cause, lorsque la personne qui perçoit la remuneration des services est domiciliée ou établie dans un Etat étranger ou un territoire situé hors de France où elle est soumise à un régime fiscal privilégié au sens mentionne a l'article 238A du présent code.
"II. Les règles prevues au I. ci-dessus sont agalement applicables aux personnes domiciliées hors de France pour les services rendus en France. Dans ce cas, par dérogation aux dispositions des articles 182A et 182B du présent code, l'impôt est établi dans les conditions prévues à l'article 197A et recouvré par voie de rôle.
"III. La personne qui perçoit la rémunération des services est solidairement responsable, à hauteur de cette rémunération, des impositions dûes par la personne qui les rend."
For a commentary on the new wording, see B. Castagnède, Chronique, Fiscalité Internationale JCP ed CI (1981) at p. 170; Tixier Kerogues et Gest, Droit Fiscal
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only applies to a single category of income, remuneration for services rendered (rémuneration de services rendus).

In the original text of 1973, the recipient of the sums received as remuneration for services rendered was to be a company or other legal entity. It was therefore possible to escape art. 155A by having an individual as recipient of the relevant sums. The 1980 drafting has modified this condition: the recipient is a "person". This is a broad general term which includes individuals, partnerships and companies.

Both payer and recipient have to be situated in different countries, one of which is France. The 1973 version of art. 155A only applied to sums paid by a French resident to a non resident. Art. 155A II. of the new provision extends to persons domiciled outside France for services rendered in France.[116] The purpose of this new paragraph is to bring within the scope of art. 155A individuals domiciled abroad who exercise a substantial part of their activity in France.

2) Alternative conditions

Another condition is to be fulfilled before 155A

Footnote 115 continued from page 406.

International (Paris: Litec, 2nd ed., 1979) pp. 110-117; DGI, Précis de Fiscalité, Vol. 1 (1982), §593.

116. It is interesting to notice that the new drafting uses the wide word 'person', but then only refers to 'domiciled' which seems to indicate that individuals only are at stake.

can be applied, but it is an alternative one. If any of the following conditions is fulfilled, 155A presumes the income to be taxable in France.

- The French resident controls the foreign resident who receives the income; or

- the French resident cannot establish that the non resident mainly (de façon prépondérante) has an industrial or commercial activity.

The 1980 version strengthens the application of the article.

Originally, the resident had to prove that the non resident had an industrial or commercial activity; the importance of the other activity did not matter. Today the industrial or commercial aspect of the activity of the non resident is to be the main activity; the rendering of services can only be a secondary, auxiliary, minor activity.

- The non resident is situated in a State or a territory with a privileged tax treatment, as defined in CGI, art. 238A. Previously, the condition was that the country of residence of the recipient was not to have signed a double taxation agreement with France.

As the lists which accompany art. 238A are not exhaustive and subject to possible amendments,[117] the effect of this modification has also been to reinforce the position of the French tax authorities.

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117. See above, II.

B. Sanctions

The sums artificially shifted abroad are taxable in France.

In addition, since the 1980 Finance Law, the payer and the recipient are jointly and severally liable for the payment of the tax in France.

IV. Application of the Doctrine of Abuse of Law (*abus de droit*) to Tax Matters: Art. L64 of the *Livre des Procédures Fiscales* (ex CGI, art. 1649 *quinquiès* B)[118]

A. General Characteristics[119]

This provision was introduced into French tax legislation by a law of 27 December 1963, art. 41-2 in particular.[120] It was originally incorporated as art. 156 *quinquiès* of the General Tax Code, then art. 244, then art. 1649 *quinquiès* B and presently in art. L64 of the

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118. The scope of this provision is wider than the scope of the present chapter as it may also apply to domestic transactions.

119. For a general development in English and French on art. 1649 *quinquiès* B, R. Chuilon and J. Rioux, "*Investissements Etrangers en France*" (Levallois: *Nouvelles Editions Fiduciaires*, 1980) pp. 33-40 and 66-72. This document was distributed by the *Société Juridique et Fiscale de France* at the 1980 IFA Congress held in Paris. In French only, DGI, *Précis de fiscalité* (1982) Vol. 2, §7179.

120. Law No. 63-1716 of 27 December 1963.

Livre des Procédures Fiscales.[121]

Art. 1649 quinquiès B of the General Tax Code states:[122]

> Transactions that dissimulate the true nature of a contract or an agreement under an appearance that is subject to lower registration duties, or disguise profits or a transfer of profits or income, or enable to avoid in whole or in part turnover taxes relating to the operations carried out pursuant to that contract or agreement may not be invoked against the tax administration which bears the onus of proving the true nature of the transaction before the tax judge if, in order to establish the true nature of the transaction, it has failed to consult a special consultative committee for advice, the composition of which is given in art. 1653C or it has issued an assessment to tax not in conformity with the opinion of the committee.

Art. L64 of the Livre des Procédures Fiscales states:

> One may not invoke against the tax administration transactions that dissimulate the true nature of a contract or an agreement with provisions:
> a) which give rise to lower registration duties;
> b) or which disguise profits or a transfer of profits or income;

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121. Article 78 of the Finance Law for 1962 (law No. 61-1396) states the principle of a complete reorganisation (refonte) of the Code Général des Impôts in order to lighten and simplify its presentation. Two decrees of 1981 (Dalloz (1981) pp. 331-336) start carrying out this reorganisation. The Livre des Procédures Fiscales is divided into three parts: the first one will include all laws (lois), the second one will contain regulations (règlements) and the third one circulars (arrêtés). Art. L64 replaces art. 1649 quinquiès B; it is inserted in the first part because it was originally a loi of 27 December 1963, art. 41-2. The name of the Code Général des Impôts will eventually be modified to that of Code des Impôts.

122. Other translations may be found - inter alia - in European Taxation (1975) at p. 114; B. Spitz, op.cit.

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c) or which allow to avoid in whole or in part turnover taxes relating to the operations carried out pursuant to a contract or a convention.

The administration may restore the true nature of the transaction at stake. If it has failed to consult the consultative committee for the repression of abuse of law, or if it has not followed its opinion, it bears the onus of proving the validity of the reallocation. 123

The special consultative committee, le comité consultatif pour la répresssion des abus de droit, includes a judge of the Conseil d'Etat as chairman, a judge of the Cour de Cassation, a law professor and the head of the state tax department (directeur général des impôts).[124]

The burden of proof normally lies on the tax authorities unless it receives from the special consultative

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Footnote 122 continued from page 410.

note 68 above, at p. 8, French section; J.F. Avery Jones, op.cit., note 66 above, at p. 18.

123. The text in French is: "IV. Procédure de répression des abus de droit

"Art. L 64. Ne peuvent être opposés à l'administration des impôts les actes qui dissimulent la portée véritable d'un contrat ou d'une convention à l'aide de clauses:
a) Qui donnent ouverture à des droits d'enregistrement ou à une taxe de publicité foncière moins élevés;
b) Ou qui déguisent soit une réalisation, soit un transfert de bénéfices ou de revenus;
c) Ou qui permettent d'éviter, en totalité ou en partie, le paiement des taxes sur le chiffre d' affaires correspondant aux operations effectuées en execution d'un contrat ou d'une convention.

"L'administration est en droit de restituer son véritable caractère à l'opération litigieuse. Si elle s'est abstenue de prendre l'avis du comité consultatif pour la répression des abus de droit ou ne s'est pas rangée à l'avis de ce comité, il lui appartient d'apporter la preuve du bien-fondé du redressement.

124. CGI, art. 1653C: the first three members are appointed by the Ministry of Economy and Finance.

committee, which it may or may not consult, an opinion in favour of its allegations.

In other words, the burden of proof lies on the tax authorities if it has not consulted that committee or if the committee gives an opinion in favour of the taxpayer. Otherwise, when the committee supports the contentions of the tax administration, the burden of proof is shifted on to the taxpayer.

If the tax administration is able to prove its allegations, the fine is equal to twice the tax which ought to have been paid, had there been no dissimulation. All parties to the transaction or convention are jointly and severally liable for the debt.[125]

B. Scope of the Provision

There is a disagreement amongst academic writers (la doctrine) as to the precise scope of Art. L64.

1) Simulation

Some of them, led by M. Cozian, believe that art. L64 deals with 'sham' (simulation), but not the doctrine of abuse of law:

> On a certainement exagéré le caractère exhorbitant de cette procédure de l'abus de droit; si l'on analyse la lettre de l'article 1649 quinquiès B et la jurisprudence qui l'invoque, on s'apercoit que cette procédure n'est que l'expression

125. CGI, art. 1732.

du droit commun de la simulation et qu'elle ne consacre aucunement, quoiqu'on en dise, la théorie de la fraude à la loi fiscale. [126]

Le texte réprime seulement la dissimulation juridique; elle ne stigmatise pas l'habileté fiscale. [127]

M. Cozian bases his argument on a literal reading of art. L64 (use of the words dissimulate, disguise, for instance).

According to him, there would be no such thing as abusive exercise of a right in French law for tax purposes, only a prohibition of "sham" formulated in art. L64.

To support his view, M. Cozian quotes - inter alia - a decision of the Conseil d'Etat of 1979[128] where the central consideration was whether the transaction dissimulated a different reality. As they did not, the transactions could not be set aside. When applying art. 1649 quinquiès B, one can try and determine whether the apparent transaction covers a different reality. If it does, then the transaction may be set aside; if it does not, there is nothing wrong with organising one's affairs so as to minimise one's tax bill.

M. Cozian, in his interpretation of L64 of the Livre des Procédures Fiscales, limits the ambit of that provision; he is only prepared to treat it as an

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126. M. Cozian, Etude, "La gestion fiscale de l'entreprise", Dupont (1980) Chronique 5-80, p. 202, at p. 204. A footnote on that page quotes numerous articles on the subject.

127. Ibid., at p. 206.

128. CE 23 February 1979, No. 6688, Droit Fiscal (1979) No. 48, comm. 2367.

application of the law of sham (simulation) applied to tax matters.

M. Cozian takes a very English approach when reading this particular provision of the French Tax Code. His view is not shared by many others.[129]

2) Tax fraud

It is more generally thought that not only can fictitious transactions be set aside but also those inspired by no other reason than to avoid tax.[130]

The following decision of the Conseil d'Etat supports this view.[131]

It involved a couple with eight children who decided to incorporate their wine growing business (exploitation viticole) into a civil partnership. The parents lived in a house located on the vineyard. Improvements were carried out on the house. The money spent on these improvements was deducted from the profits of the business on the basis that the house was rented to the civil partnership and that the parents were living there for business reasons.

The tax administration attacked both the constitution of the civil partnership and the deduction of the

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129. P. Derouin, G. Tixier, Commentary below a decision of 24 June 1981, Recueil Dalloz Sirey (1982), pp. 94-98.

130. Ibid.

131. CE 10 June 1981, Plenary Assembly, Req. No. 19079, RDCE (1981) p. 248.

cost of improvements on the basis of art. 1649 quinquiès B.

The Conseil d'Etat held that the tax authorities had to prove that the operations were fictitious or that they could be motivated by no other reason than the intention to reduce or eliminate taxation.

The court went on to say that the civil partnership was regularly constituted that its operating was efficient and normal; the improvements to the house were not fictitious. In addition the couple claimed that such organisation of the business would maintain its unity after their death and the court held that there was no reason to doubt this motivation.

This decision seems to favour the view that art. L64 covers sham (i.e. something untrue), but also abus de droit (i.e. something true but abusive).

This view will be further supported by the following short survey which will examine the application of art. L64 to a particular point of company law: the transfer of the quasi totality of shares of a company.

C. Application of the Doctrine of abus de droit: the Transfer of the Quasi Totality of Shares of a Company

This particular topic has been the object of much discussion and controversy.[132]

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132. M. Edwardes-Ker, op.cit., note 8 above, Chapter 4, Section 3, p. 8 and Chapter 13, section 12, pp. 20-23; H. Lazarski, "Tax Implications of Takeover of Private Companies", European Taxation (1975) and (1981), pp. 112-119 and pp. 121-125; Th. Rose and J.C. Samaran, "Corporate Takeovers in France", Droit et

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The purpose of its inclusion here is only to try and clarify the issue in view of the latest developments.

The existing difficulty stems from the fact that, on the basis of art. L64 (1649 quinquies B) the tax authorities may deem the transfer of the quasi totality of shares (actions ou parts sociales)[133] to amount to a transfer of the business and tax it accordingly.

The burden of proof lies on the tax authorities to show that the transfer of shares in reality constitutes a transfer of the underlying business of the company, unless they have obtained a favourable opinion from the committee described in CGI, art. 1653C.

The difference in taxation of the two operations is not negligible.

A transfer of business is treated as liquidation of the company and creation of a new one. This gives rise to droits de mutation,[134] capital gains tax at the rate

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Footnote 132 continued from page 415.

Pratique du Commerce International, (1975) p. 35; T. Delahaye, "Le Choix de la Voie la Moins Imposée", Etude de Droit Comparé (Bruxelles: Bruylant, 1977) pp. 163-185; CE 24 June 1981, Recueil Dalloz Sirey (1982) pp. 94-98, commentary P. Derouin and G. Tixier; J. Cordery, "Acquiring a Company in France", Business Law Review (1982) pp. 279-283.

133. The transfer of the quasi totality of shares is defined as 2/3 of the votes expressed in an extraordinary general meeting for a share company and as 3/4 of the share capital in an SARL. Cf. arts. 60 and 153 of the law of 1966 on commercial companies and partnerships, Instruction of 3 March 1981, BODGI, 7H-2-81, I. 5, p. 4.

134. CGI, arts. 719, 809. 13° and 810 III.

of 15 or 50 per cent. depending on whether gains qualify as short term (15 per cent.) or long term (50 per cent.).

Sums received by individual shareholders will be incorporated in their taxable income; they are treated as dividends, but do not benefit from the *avoir fiscal*: they will consequently be subject to personal income tax at full rate.

In addition, VAT charges are more substantial than in the case of a transfer of shares.[135]

A transfer of shares only gives rise to a 4.80 per cent. rate of registration duty (*droit d'enregistrement*),[136] and the vendor will be subject to capital gains tax at 15 per cent.[137]

There were uncertainties as to the criteria on which the tax administration did rely on analysing a transfer of shares as a transfer of assets.

Answers to Parliamentary questions originally attempted to clarify the situation,[138] but they did not

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135. *Ibid.*, art. 726.

136. *Ibid.*, art. 160.

137. M. Edwardes-Ker, *op.cit.*, note 8 above, at p. 20.

138. *Réponse Martin*, *Journal Officiel des Débats du Sénat (1968)* No. 7480; *Réponse Cornelle*, 31 May 1969, *Journal Officiel des Débats de l'Assemblée Nationale (1969)* p. 1499; *Réponse Gantier* of 30 November 1978, *Journal Officiel des Débats de l'Assemblée Nationale (1978)* p. 8545; *Réponse Delfosse*, 29 October 1979, No. 17269. These Parliamentary answers are quoted and sometimes translated into English in the articles of H. Lazarski cited earlier, note 132 above.

prove sufficient.

The tax administration therefore issued an _Instruction_[139] which sets out the criteria under which the authorities would attack on the basis of art. L64.

In essence, there is no difference in policy in the Parliamentary answers and the _Instruction_. The latter is to be welcomed inasmuch as it clearly lists the elements which the authorities will consider:

- the transfer of the major part of the share capital is only an indication (_indice_); it is not sufficient proof of existence of a transfer of business;
- other factors will be taken into consideration: an important change in the objects of the company, but not a simple extension of an existing activity or the creation of a minor new one; the transformation of the existing company into a new type of company, the change of the seat of the company, the alteration of the name, an abnormal capital increase.

However, at no stage does the _Instruction_ refer to the intention of the parties. All criteria enumerated are objective ones whereas it has been the consistent attitude of the courts when looking at this particular issue to state that tax authorities could not succeed under art. L64 unless they were able to prove that the intention of the parties was to transfer the business as a whole.

Does the drafting of the _Instruction_ not favour

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139. _Instruction_ of 3 March 1981, BODGI 7H-2-81.

the view of M. Cozian?

However, a decision such as that of 24 June 1981 supports the other approach.[140]

The chairman and managing director of a share company held 2988 out of the 3000 shares of a company. He sold 2987 of his shares to two subsidiaries of a group of companies. The tax authorities attacked the transaction on the basis that the transfer of shares covered a transfer of business.

The court rendered a decision in favour of the taxpayer on the following grounds: after transfer, the share company was not liquidated it was not transformed into another type of company, its objects remained the same, its activity went on in the same field, no major alteration took place amongst its assets, immovable property in particular.

The court came to the conclusion that the tax administration had not been able to prove that the parties intended to realise a transaction different from a transfer of shares.

V. Taxation of Profits of Subsidiaries Situated in Tax Havens: CGI, Art. 209B

Art. 209B of the General Tax Code has already been examined in Part I, Chapter 3, Section 2, §2, III.

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140. CE 24 June 1981, Recueil Dalloz Sirey (1982) at p. 94; also RDCE (1981) p. 285; Droit Fiscal (1981) comm. 1789.

Here, art. 209B will be examined only as an anti-avoidance provision.

Art. 209B was introduced by the 1980 Finance Law, art. 70.

It is the French version of foreign counterparts known as Subpart F in the United States, FAPI in Canada and *Aussensteuergesetz* in Germany; in the United Kingdom the provision is still in the form of Draft Legislation.[141]

Art. 209B provides:[142]

> I. As from 1 January 1980, when an enterprise subject to corporation tax holds directly or indirectly, at least 25 per cent. of the shares in a company established in a foreign State or in a territory situated outside France which have a privileged tax regime as defined in art. 238A of the General Tax Code, the enterprise is subject to corporation tax on the profits of the foreign company in proportion to its shareholding.
>
> These profits will be the subject of a separate assessment. They are deemed to be earned on the first day of the month which follows the end of the foreign company's accounting period and are determined according to the rules laid down in the General Tax Code.
>
> The tax paid locally by the foreign company is deductible in the proportion mentioned in the first paragraph from the tax assessed in France, provided that such tax is comparable to corporation tax.
>
> II. The provisions of I. above do not apply if the enterprise can establish that the operations of the foreign company do not have as main effect to locate profits in a country with a privileged tax regime.

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141. See Section 1 of the present chapter.

142. The present translation is largely drawn from that of M. Edwardes-Ker, *op.cit.*, note 8 above, at p. 6.

Such condition is deemed fulfilled:

- when the foreign company mainly conducts a genuine industrial or commercial activity;
- and, it carries out its operations mainly on the local market or with enterprises with which it does not have links of interdependence, this link being defined in the same conditions as in art. 39 terdéciès 1 bis, second paragraph, of the General Tax Code.

III. A decree of the Conseil d'Etat will lay down the conditions in which the preceding provisions will apply, in particular measures permitting the avoidance of the double taxation of profits, effectively imputed and the enterprise's reporting obligations. 143

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143. The text in French is:

"I. Lorsqu'une entreprise passible de l'impôt sur les sociétés détient directement ou indirectement 25 pour cent. au moins des actions ou parts d'une société établie dans un Etat étranger ou un territoire situé hors de France dont le régime fiscal est privilegié au sens mentionné a l'article 238A, cette entreprise est soumise à l'impôt sur les sociétés sur les résultats bénéficiaires de la société étrangere dans la proportion des droits sociaux qu'elle y détient.

"Ces bénéfices font l'objet d'une imposition séparée. Ils sont reputés acquis le premier jour du mois qui suit la clôture de l'exercice de la société étrangere et sont détermines selon les règles fixées par le présent code.

"L'impôt acquitté localement par la société étrangère est imputable dans la proportion mentionnée au premier alinéa sur l'impôt établi en France à condition d'être comparable à l'impôt sur les sociétés.

"II. Les dispositions du I. ne s'appliquent pas si l'entreprise établit que les opérations de la société étrangère n'ont pas principalement pour effet de permettre la localisation de bénéfices dans un pays à régime fiscal privilégié. Cette condition est réputée remplie notamment:

- lorsque la société étrangère a principalement une activité industrielle ou commercialee effective;
- et qu'elle réalise ses operations de façon prépondérante sur le marché local ou avec des entreprises avec lesquelles il n'existe pas de liens de dépendance, ce lien étant apprécié dans les mêmes conditions qu'à l'article 39 terdéciès I bis, deuxième alinéa.

/Continued over

Links of interdependence were defined in art. 42 of the 1972 Finance Law,[144] codified as art. 39 _terdéciès_ 1 _bis_, 2nd _alinéa_ of the General Tax Code:

> Links of interdependence are deemed to exist between two enterprises: when one holds directly or through an intermediary the majority of the share capital of the other or in fact exercises the decision making power in such enterprise; when they are both placed, according to conditions defined in the preceding paragraph, under the control of the same third enterprise. 145

The relevant decree is of the 30 December 1981.[146]

Footnote 143 continued from page 421.

"III. _Un décret en Conseil d'Etat fixe les conditions d'application des dispositions qui précèdent, et notamment les modalités permettant d'éviter la double imposition des bénéfices effectivement repartis ainsi que les obligations déclaratives de l'entreprise_."

The _décret_ mentioned under III was published on 30 December 1981 (No. 81-1173, Journal Officiel, 31 December 1981, p. 3604). An _Instruction_ on this provision was issued by the tax authorities on 15 February 1983, BODGI 4H-3-85. For a short commentary, see 44 Taxes International.

144. Law No. 71-1061 of 29 December 1971, art. 42.

145. The text in French is: "_Des liens de dépendance sont réputés exister entre deux entreprises: lorsque l'une détient directement ou par personne interposée la majorité du capital social de l'autre ou y exerce en fait le pouvoir de decision; lorsqu'elles sont placées l'une et l'autre, dans des conditions définies à l'alinea précédent, sous le contrôle d'une même tierce entreprise_."

146. _Décret_ No. 81-1173, Official Journal of 31 December 1981, _Recueil Dalloz Sirey_ 1982, _Législation_, pp. 40-41.

A. Conditions of Application

1) Liability to corporation tax

The French enterprise is to be subject to corporation tax. This condition excludes a general commercial partnership for instance from the scope of art. 209B, unless it has elected to be subject to corporation tax instead of income tax in the hands of its partners. It may be said at this stage that the impact of art. 209B is limited; it does not apply to individuals.

2) Minimum shareholding

The French enterprise is to hold directly or indirectly 25 per cent. or more of the shares of a "société" established in a tax haven.

The meaning of this sentence has been developed in the décret of 30 December 1981. Art. 1 in particular defines the indirect holding: an enterprise will be treated as holding indirectly 25 per cent. of a "société" situated in a tax haven either:

- when 25 per cent. of its shares are held through a chaîne de participation.[147] The percentage so held is determined by multiplying the successive rates of participation (taux de participation);

- when shares are held by individuals or legal entities which have with the company such links that they form a

147. See CGI Annexe II, art. 114-2.

genuine community of interest (<u>des liens de nature à établir une véritable communauté d'interêt</u>).

The purpose of the latter definition is to include within art. 209B the case of an enterprise liable to French corporation tax which could be liable to that same tax on profits realised by a tax haven company although it did not hold 25 per cent. of its share capital on the basis that a third person (<u>tierce personne</u>) formed with the French enterprise a community of interest which held 25 per cent. or more of the share capital of the tax haven company.

3) <u>Subsidiary established in a country with a privileged tax system</u>

The <u>société</u> is to be established in a foreign State or a territory situated outside France which has a privileged tax system. The meaning of privileged tax system (<u>régime fiscal privilégié</u>) has been developed by the French tax authorities when the expression was first used in art. 238A of the General Tax Code.[148]

B. <u>Effect</u>

The effect of art. 209B is to create a presumption whereby the subsidiary is situated in a tax haven for tax avoidance purposes.

Art. 209B penalises such behaviour by taxing

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148. See above in this Chapter, Section 2, II.

the subsidiary in the same way it would be taxed if located in France, in proportion to the shareholding of the parent.

The onus of proof is on the French parent to rebut such presumption. It has to convince the tax authorities that the purpose of location of its subsidiary in a tax haven is not tax avoidance. In order to do so, the French company is to establish two factors:

- it must show that it carries on a genuine industrial or commercial activity in its state or territory of situation,
- it carries out operations mainly on the local market or with companies with which it has no links of interdependence.

The strength of the presumption has been measured in Chapter 3 above.

C. Sanction

The foreign subsidiary situated in a tax haven country will be subject to tax in France on its profits, in proportion to the shareholding of the parent.

For instance, if the parent company, resident in France owns 40 per cent. of a company situated in a privileged tax country as defined earlier on, 40 per cent. of the profits of the foreign subsidiary will be subject to French corporation tax.

This is an exception to the territorial principle inasmuch as profits realised abroad are liable to

French corporation tax.

If the foreign subsidiary has paid in its country of location a tax on its profits comparable to French corporation tax, such tax will be deductible, again in proportion of the shareholding of the parent, 40 per cent. in the example mentioned here.[149]

In addition, taxes withheld on distributions from the tax haven subsidiary to the French parent according to double taxation agreements are also deductible from the profits subject to corporation tax in France.[150] This hypothesis seems rather academic considering the attitude of the French authorities which traditionally do not sign tax conventions with tax havens.

VI. Taxation of Non Resident Legal Entities with Real Estate Property in France: CGI, Art. 209A

This provision was introduced by the law of 29 December 1976, art. 13 in particular incorporated in the General Tax Code as art. 209A and applicable as from 1 January 1977. Its application was clarified by an Instruction of 8 February 1982.[151] Art. 209A has been

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149. CGI, art. 209-B-I (last paragraph).

150. Décret of 30 December 1981, art. 6.

151. BODGI, 4H-3-82. Commentary: JCP ed CI, No. 41, 14 October 1982, 10923, at p. 325. See also H. Lazarski, "Taxation of Real Property Owned by Foreign Companies" European Taxation (1979) pp. 39-45, also (1983) pp. 42-45 for a study of the alteration brought about by the 1983 Finance Law. This modification is examined in detail at the end of this development as the change took place after the commentary on 209A enabled in 1977, had already been written.

repealed by the 1983 Finance Law, but both old and new provisions will be examined here in turn.

The counterpart of art. 209A as regards individuals may be found in CGI, art. 164C. It was also introduced by the Law of 29 December 1976, art. 7.[152]

Art. 209A provides:

> If a legal entity whose seat is situated outside France has the disposal of one or several real estate properties situated in France or lends them free of charge or charges a rent lower than the true rental value, it is subject to corporation tax on a basis which cannot be inferior to three times the rental value of the relevant property or properties. When the occupier has his tax domicile in France, he is jointly and severally liable for the payment of this tax.
>
> The taxation as outlined in the first paragraph does not apply to non profit making organisations which carry out a voluntary activity of a social, philanthropic, educational or cultural nature and which establish that the performance of such activity in France justifies the ownership or disposal of the real estate properties at stake. 153

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152. For an analysis of this particular provision, see Claude Gambier, Les Impôts en France (Paris: Editions Francis Lefebvre, 12th ed., 1982) §§644 (individuals) and 710 (legal entities).

153. The text in French is:
"Si une personne morale dont le siège est situé hors de France a la disposition d'une ou plusieurs propriétés immobilières situées en France ou en concède la jouissance gratuitement ou moyennant un loyer inférieur à la valeur locative réelle, elle est soumise à l'impôt sur les sociétés sur une base qui ne peut être inferieure à trois fois la valeur locative reelle de cette ou de ces propriétés. Lorsque l'occupant a son domicile fiscal en France, il est solidairement responsable du paiement de cette imposition.

"Il n'est pas fait application de la taxation prévue au premier alinéa aux organismes à but non lucratif qui exercent une activité désinteressee de caractère sociale ou philanthropique, éducatif ou culturel et qui établissent que l'exercice de cette activité en France justifie la possession ou la disposition des propriétés immobilières en cause."

A. Conditions of Application

1) Definition of immovables

Art. 209A involves first of all buildings to be lived in (immeubles à usage d'habitation); it may also concern other categories of immovables such as land (terrains), woods (bois), ponds (étangs) and hunting grounds (chasses).[154]

2) Non resident legal entity

a) Principle

Art. 209A applies to legal entities (personnes morales): it does not apply to individuals. It applies to legal entities who have their seat outside France: its scope is limited to non resident legal entities.

b) Exception

Non profit making organisations (organismes à but non lucratif) are exempt from art. 209A.

In order to qualify as a non profit making organisation, a legal entity is to fulfil the following conditions:

- it is to carry out a voluntary activity (activité désintéressée).

In order for this condition to be fulfilled,

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154. Instruction of 8 February 1982, Section I B.1, p. 7.

the organisation is to be managed on a voluntary basis by persons who have no direct or indirect personal interest in the results of the activity carried out; in addition, there is to be no direct or indirect distribution of profits.

- the activity carried out is to be of a social, philanthropic, educational or cultural nature.

- the non profit making organisation has to prove that its ownership or disposal of real property are necessary for the purposes of its activity; it has to show that such property is exclusively assigned to the voluntary activity carried out in France.[155]

Non resident legal entities who have a permanent establishment in France are taxable on their profits realised in France and on the basis of the territorial principle.[156]

Is a non resident company with a permanent establishment in France taxable on the basis of art. 209A for real property which it owns or disposes of in France? As in the case of non profit making organisations, such real estate property will not be subject to art. 209A as long as it is genuinely assigned to the activity carried out in France.

3) Ownership or disposal

Art. 209A applies not only to legal entities who

155. Instruction of 8 February 1982, I.A.

156. CGI, art. 209-I.

own (possèdent) real estate property either directly or indirectly through French real estate partnerships or companies,[157] but also to legal entities who have at their disposal (disposent) the use of real estate property such as a non resident company who rents a building situated in France.

According to arts. 5 and 13 of the UK/F double taxation agreement, income (revenus) and gains (plus values) from immovable property are taxable in the contracting state in which the property is situated.

Art. 5(3) provides that income from the direct use, letting (location ou affermage) or use in any other form (ainsi que toute autre forme d'exploitation) of immovable property will be taxed in the country of situation of the property. A UK resident legal entity who owns immovable property (biens immobilièrs) situated in France will be taxable in France on income or gains from such a property on the basis of French domestic law, art. 209A in this case. The existence of a double taxation agreement does not set aside domestic legislation in this case as the convention itself refers to the domestic law.

B. Taxation

1) Corporation tax

Legal entities who are within the scope of art. 209A (as described in A. of the present section) are subject to corporation tax on all their operations realised

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157. *Ibid.*, arts. 8 and 1655 *ter*.

in France. According to art. 209A, the basis of corporation tax cannot be lower than three times the real rental value of immovables situated in France, whether owned or rented.

Normally, the basis of corporation tax will amount to three times the rental value of the property. The rate of corporation tax is 50 per cent.

Suppose a non resident company owns a flat in France and lends it free of charge to an individual. The non resident company will be subject to tax at the rate of 50 per cent, on an amount equal to three times the rental value of the flat.

If the same non resident company rents the flat for a sum lower than the true rental value, such a sum declared to the tax authorities as income from the immovable will be set aside and the non resident company will be subject to tax on the basis of three times the real rental value of the property.

On the other hand, if the basis for taxation is higher than three times the rental value, the latter will be set aside for the purposes of art. 209A of the General Tax Code. Three times the true rental value only constitutes a minimum threshold of taxation.[158]

Subject to international tax conventions art. 244 _bis_ A of the General Tax Code provides that gains on

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158. An example with figures is given in the Annexe to the _Instruction_ of 12 February 1982, at p. 12.

the disposal of immovable property (plus values de cession immobilières) realised in France by a non resident legal entity are subject to a levy of one third. This levy of one third is deductible from the corporation tax due by the non resident legal entity, but no refund will take place if the levy exceeds the liability to corporation tax.[159]

2) Impôt de distribution

According to art. 115 quinquiès of the General Tax Code, profits realised in France by a non resident company are subject to a 25 per cent. withholding tax on the assumption that the profits are wholly distributed abroad. This rate of tax is often reduced by double taxation agreements, to 10 per cent. of the profits of the permanent establishment under the UK/F double taxation agreement.[160]

In the context of art. 209A, and of the UK/F double taxation agreement, the following points are to be mentioned: the withholding tax is only due if the permanent establishment, as defined in art. 4 of the UK/F agreement, exists. For the purposes of the UK/F double taxation agreement, a UK resident company whose activity in France exclusively consists in renting immovables cannot be said to have a permanent establishment in France. The withholding tax is therefore not to be levied.

159. Ministerial answer to M. Seitlinger, member of the National Assembly, Journal Officiel des Débats de l'Assemblée Nationale of 30 November 1978, p. 8544, BODGI, 8M-5-79, as quoted in the Instruction of 12 February 1982, Section II.A.b, at p. 12.

160. UK/F agreement, art. 10.

C. The 1983 Finance Law

Art. 209A has been repealed by art. 4(I) of the 1983 Finance Law.[161] It has been replaced by a much more stringent provision set out in art. 4(II) of the 1983 Finance Law.[162] It came into force as from 1 January 1983.

Art. 209A subjected real property held by foreign companies to corporation tax on a notional income of three times the real rental value (*valeur locative réelle*) of such property. The 1983 Finance Law imposes a 3 per cent. annual tax on the market value (*valeur vénale*) of immovable property (*immeubles*) or rights in immovable property (*droits immobilièrs*) owned directly or through a third party by companies which have their seat outside France.[163]

The new tax applies irrespective of the nature of the company or partnership which owns immovables in France. It may be a company (*société de capitaux*), a civil partnership (*société civile*) or a partnership. As long as the owner is, according to the domestic legislation where the *siège social statutaire* is located, a legal personality separate from that of its members, the new tax applies. For purposes of the new tax *Anstalten* (establishments) and *Stiftungen* (foundations) of Leichtenstein are

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161. Law No. 82-1126 of 29 December 1982. See *Précis de Fiscalité* (1983) Vol. 1, §1434 and Vol. 2, §§4650-4662.

162. For an analysis of the new provision, see H. Lazarski, "*New Measures Affecting Real Property Owned by Foreign Companies and Other Developments*", European Taxation (1983) pp. 39-45.

163. Finance Law 1983, art. 4 II.1.

deemed to have a separate legal personality.[164]

The third party is jointly liable for the payment of the 3 per cent. annual tax. Taxpayers must declare each year, by 15 May at the latest, the location, description and value of the properties to be taxed.

There are a limited number of exceptions to the application of the new tax; it does not apply to the following categories:

- legal entities whose immovable property is located in France except immovable property used for industrial, commercial, agricultural or professional purposes - represent less than 50 per cent. of the French assets.
- legal entities which have their seat in a country or territory having entered with France a treaty for administrative assistance for purposes of preventing fraud and tax evasion (convention d'assistance administrative en vue de lutter contre la fraude et l'évasion fiscales) and declare each year the location, description and value of the immovables owned on 1 January, the names and address of their associates (associés) on the same date as well as the number of shares (actions ou parts) held by each of them.
- international organisations, sovereign foreign states, and foreign public institutions.
- pension funds (caisses de retraite) and other non profitable organisations (organismes à but non lucratif) which perform a non profitable activity of a social,

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164. Précis, §4651.

philanthropic, educational or cultural nature and prove that the ownership of immovable property is justified by their activity.

The tax authorities may require sociétés liable to the new tax to designate within 90 days of their request a representative in France entitled to deal with the assessment and payment of the tax.[165]

The text of the Finance Law itself offers one possibility to avoid the payment of the 3 per cent. tax on the market value of immovables situated in France and owned by foreign entities: the legal entity may - before 31 December 1983 - transfer the ownership of the immovables held in France to an individual associate. Such transfer will be subject to a notional 15 per cent. tax (taxe forfaitaire égale à 15 pour cent.) of the market value of these immovables.

The payment of the 15 per cent. notional tax will free the legal entity from any earlier liability to tax under the old art. 209A unless a tax control (vérification fiscale) had been started or announced (engagée ou annoncée) before 19 October 1982.

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165. CGI, art. 223 quinquiès A.

APPENDIX I: FRANCE: ANTI-AVOIDANCE LEGISLATION

Provision of the law	Finance Law 1933	Finance Law 1974, art. 14	Finance Law 1972, art. 18	Law of 27 December 1963, art. 41-2	Law of 29 December 1976 art. 13	Finance La 1980, art. 70
Article of the General Tax Code	art. 57, extended to companies by art. 209-1	art. 238A	art. 155A	art. 1649 quinquiès B now L64 du livre des procédures fiscales	art. 209A repealed by Finance Law 1983	art. 209B
Décret						No. 81 of 30 December 1981
Instruction	4 May 1973	26 June 1975 and Note of 9 October 1975	27 July 1973	3 March 1981 (transfer of shares)	8 February 1982	15 February 1983
Amendments	Finance Law 1982, art. 90-II	Finance Law 1982, art. 90-I	Finance Law 1980, art. 71			

PART II: UNDER THE TAX CONVENTION BETWEEN THE UNITED KINGDOM AND FRANCE

CHAPTER 1

BASIC PRINCIPLES

Section 1: Determination of the Residence and Nationality of Companies

§1. Determination of the Residence of Companies

I. Priority of Domestic Legislation

The residence of a company in the UK and French contexts has been examined in a previous chapter.[1]

The expression "residence" as such is not used in French domestic legal terminology. In the UK, the residence of a company is a familiar concept: a UK resident company is liable to UK corporation tax on its worldwide profits. Whether a company is resident or not in the UK is determined as a function of the location of the place of its central management and control.[2]

The situation in France as regards double taxation agreements is to be examined more closely.

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1. See Part I, Chapter 2.

2. The Statement of Practice on company residence published in July 1983 by the Board of Inland Revenue shares this view.

Article 3(1) of the UK/F tax convention of 22 May 1968 states that for the purpose of the convention, the term "resident in France" means any person who is resident in France for the purposes of French tax.

The term "person" comprises an individual, a company and any other body of persons.[3]

Under the double taxation agreement between the United States and France,[4] the same problem arises because "resident in France" is defined in the same way as in the UK/F agreement.

The Instruction of 27 May 1969 on the convention between the United States and France explains the application of the convention: it states that "resident in France for the purposes of French tax" means in relation to companies those "whose seat is in France, economic interest grouping (groupements d'intérêt économiques)".[5]

No such explanation is given in the text of the Instruction of 14 April 1970 explaining the UK/F agreement. However, a resident company is one that has either its siège statutaire or its siège effectif[6] in France which is the same as saying "a French company".

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3. UK/F, art. 2(1)(f).

4. Convention of 24 July 1967.

5. Instruction of 27 May 1969, §5.

6. For a detailed study of these expressions, see Part I, Chapter 2.

II. <u>Application of the Convention in Case of Dual Residence</u>

It is only when a company is resident in both countries that one will turn to the text of the convention.

Such situation will arise if the UK tax authorities consider that central management and control of a company is exercised in the UK, whilst the French tax administration will contend that the *siège social* of the same company is located in France.

In the absence of a double taxation agreement, such profits would be imposed twice.

The treaty provision on company residence may only be resorted to when a conflict has arisen between two domestic systems and both states claim a company to be resident of their territory.

The text of the UK/F double taxation convention provides:

> Where ... a person other than an individual is a resident of both contracting states then it shall be deemed to be a resident of the contracting state in which its place of effective management is situated. [7]

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7. This provision of the UK/F agreement follows exactly its counterpart in the 1977 Model (art. 4(3)). However, such is not always the case: the new double taxation agreement between the USA and the UK which came into force in 1980 offers a good illustration of an exception to the OECD Model: according to the text originally signed in December 1975, a corporation that was resident in both countries was to be "outside the scope of the convention". The convention was amended before it came into force and presently states that a dual resident corporation will be merely not entitled to claim certain reliefs or exemptions from tax which are provided by the convention, but will benefit from several of its provisions such as art. 24 on non-discrimination. The
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The provision refers to a "person other than an individual". It designates first of all a company. Furthermore, art. 2(1)(f) of the convention defines the term "person" as comprising an individual, a company and any other body of persons.

The Instruction of 14 April 1970 issued by the French tax authorities in order to explain and clarify the application of the UK/F convention states that art. 3(3) refers to companies and all other bodies of persons (groupements de personnes) which are not considered as individuals, regardless of the fact that they have or not legal personality.[8] The intention of the French tax administration here seems to give this provision as wide a scope as possible. It would include not only a société en nom collectif or a société en commandite simple, which have legal personality but also a silent partnership (société en participation), the only remaining form of French business organisation which, after the 1978 reform,[9] does not have legal personality.

Footnote 7 continued from page 439.

new US/UK agreement contains a provision for resolving dual residence of individuals but no corresponding provision applies for dually resident companies. For further developments, see Arthur Andersen & Co, The US/UK Double Tax Treaty (London: Tolley Publishing Ltd, 1980), p. 30.

8. Instruction, §121, p. 6. The same statement is made in the commentary on art. 4 of the OECD Model, §3.21.

9. Law No. 78-9 of 4 January 1978. See R. Rodière and B. Oppetit, Droit Commercial (Paris: Dalloz, 10th ed., 1980) pp. 323-328; also Code Civil, art. 1871, new §1 in particular; see also Part I, Chapter 1, Section 3.

In the UK, it applies to companies only as partnerships do not have legal personality, except in Scotland.

The element to use in order to determine the residence of a company in case of a conflict between domestic legislations is the situation of the place of effective management (siège de direction effective).[10]

The text of the French Instruction slightly develops this notion by saying that it designates the place where the business is managed and controlled (lieu où les affaires sont dirigées et controlées).

A decision of the Conseil d'Etat of 24 June 1981 deals with the problem of determination of the residence of a company in the context of the UK/F double taxation agreement.[11]

Although the agreement at stake in that case is that of 1950, which preceded the 1968 agreement in force today, the respective provisions on residence of companies

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10. One could argue that this does not differ from the UK test on residence of companies. The commentary on art. 4 of the 1977 OECD Model concerning the definition of resident provides in its §23: "Concerning conventions concluded by the United Kingdom which provide that a company shall be regarded as resident in a state in which its business is managed and controlled, it has been made clear, on the United Kingdom side, that this expression means the effective management of the enterprise." The position of the UK Board of Inland Revenue on this point has been revised by a Statement of Practice on a clarification of the meaning of the residence of a company for corporation tax purposes issued at the end of July 1983; see above Part I, Chapter 6, Section 3.

11. CE, 24 June 1981, Req. No. 17.341, reported in M. Edwardes-Ker, International Tax Treaty Service (hereinafter cited as ITTS) pp. 18-5003, May 1982.

are not substantially different in both texts.

The case involves a company registered in the United Kingdom with its registered office in London. Its only activity was the running of a hotel in France. It distributed dividends to its shareholders and paid fees to its directors; it claimed, successfully at first, the reduced treaty rate of withholding tax on such sums, 10 per cent. instead of 18 per cent. under French domestic law, on the basis that it was a UK resident company which derived profits from a permanent establishment in France.[12]

In 1963, the French tax authorities invited the company to withhold tax at 18 per cent., and a 1963 tax audit established that the company's affairs were entirely managed and controlled in France, therefore the company was resident in France. The company agreed to that, but argued unsuccessfully that a claim from the French tax authorities was barred because of time limit.

No conflict actually arose in that case as regards the meaning of residence. Only a change of opinion on the part of the French tax authorities, which was accepted by the company.

There was no issue of dual residence and the company was regarded as having its fiscal domicile in France because its affairs were entirely managed and

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12. Art. 2(9) of the 1950 UK/F tax agreement states: "a company shall be regarded as resident in the UK if its business is managed and controlled in the UK and as having its fiscal domicile in France if its business is managed and controlled in France".

controlled in France.

The terminology has been altered between 1950 and 1968: the place of effective management has replaced that of management and control, but the substance of the provision has not been modified.[13]

III. The Possible Consequences of a Modification in the Definition of Company Residence under UK Domestic Law

If the proposals of the Inland Revenue in connection with corporate residence are implemented, and if their application in the context of the UK/F agreement led to a particular difficulty, one could resort to art. 26 on mutual agreement procedure or art. 27 on exchange of information.[14] Competent authorities could communicate to each other particulars which would contribute to a proper determination of the place of effective management. However, no new definition of the residence of a company will be incorporated in the 1983 Finance Act; a Statement of

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13. Could it be the same if, under UK domestic law, the place from which the management of the company as a whole is conducted replaced the central management and control test as was suggested in "International Tax Avoidance" a consultative document issued by the UK Inland Revenue in 1981. See Part I, Chapter 6, Section 3.

14. These two provisions have been considered in two chapters of the Introduction, 8 and 9 respectively. Reference is made in the OECD Model commentary on the mutual agreement procedure agreement (art. 25) to its application in relation to the determination of residence (§8, at p. 176); it concerns more specifically individuals (ref. to art. 4, §2) but there seems to be no obstacles for it to be used in relation to companies.

Practice was issued by the Board of Inland Revenue instead at the end of July 1983; it clarifies the meaning of the expression![15]

§2. Nationality of Companies

Art. 25 of the UK/F double taxation agreement provides:

> (1) The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subject.
>
> (2) The term "national" means:
> (a) in relation to the United Kingdom
> (ii) all legal persons associated and other entities deriving their status as such from the law in force in the United Kingdom.
>
> (b) in relation to France
> (ii) all legal persons, associations and other entities deriving their status as such from the law in force in France.
>
> (7) In this article, the term "taxation" means taxes of every kind and description.

The domestic criteria which determine the nationality of a company have been examined in Part I, Chapter 2.

In France, the nationality of a company is determined by the location of its siège social; the UK follows the doctrine of incorporation, i.e. the nationality of a

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15. For a description of the Statement of Practice, see Part I, Chapter 6, Section 3.

company is determined as a function of the location of its registered office.

For the purposes of the UK/F double taxation agreement, art. 25 in particular, the criterion of determination of the nationality of a company is defined in the exact same words in relation to the UK and to France: the country of incorporation determines the nationality of a company.

The choice of such criterion is only valid for the purposes of art. 25 of the UK/F double taxation agreement; it is only relevant for the purposes of that article inasmuch as the rest of the convention applies to "residents" and not to "nationals".

A complete analysis of art. 25 of the UK/F agreement will be carried out under Section 5 of the present chapter.

Section 2: The Concept of Permanent Establishment[16]

§1. Definition of a Permanent Establishment: Art. 4 of the UK/F Double Taxation Agreement

I. Analysis of Art. 4

The most recent bilateral tax agreement between

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16. See in general, G. Dalimier, "Conventions Fiscales Internationales: Variations sur le Thème de l'Etablissement Stable", Journal du Droit International (1976) pp. 5-21. Also CDFI (1967) Stockholm "The Development in Different Countries of the Concept of Permanent

/Continued over

the United Kingdom and France was signed on 22 May 1968; article 4 is therefore based on the 1963 OECD Draft Convention (art. 5) and not on the latest 1977 Model convention, although the differences between both OECD texts are minor as regards this particular provision.

The text of art. 4 of the UK/F agreement follows exactly art. 5 of the Draft Convention.

The only difference lies in the addition in the 1968 UK/F agreement of a paragraph (7) dealing specifically with insurance companies.[17]

Each part of art. 4 will be examined individually, in the light of the OECD Commentaries and the explanations of the Instruction issued by the French tax authorities.

Another source of information on the meaning of permanent establishment may be found in the decisions of the courts. Although the decisions which directly involve the UK/F double taxation agreement are not numerous, others are based on treaty provisions which are, on this particular point, very similar, if not an exact replica of art. 5 of the OECD.

Footnote 16 continued from page 445.

Establishment, Notably from the Point of View of Harmonisation in Future Double Taxation Agreements", UK Report, D.A. Longman, pp. 521-552, at p. 525. Also Publication of the International Bureau of Fiscal Documentation No. 24 by H.I. Lazerow (1976).

17. For a development on this particular point, see below, D.

Some decisions will be examined in the following paragraphs.

The presentation of this paragraph does not exactly follow the sequence of paragraphs in art. 4 of the UK/F agreement. One will first consider what a permanent establishment amounts to, before looking at the activities which do not constitute a permanent establishment.

A. General definition: art. 4(1)[18]

Art. 4(1) of the UK/F tax agreement provides:

> For the purposes of this Convention the term "permanent establishment" (*établissement stable*) means a fixed place of business (*installation fixe d'affaires*) in which the business of the enterprise is wholly or partly carried on.

The words used for this definition are very vague and wide; they leave a lot of scope for interpretation.

Paragraphs 4 and 7 of that same article extend further the definition of permanent establishment whilst paragraphs 3, 5 and 6 restrict it quite drastically.

Article 4(1) outlines the essential characteristics of a permanent establishment:

- existence of a place of business
- this place of business is to be established in a place with a certain degree of permanence
- some activity is to be carried on through it: this

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18. See OECD commentary on art. 5(1) pp. 59-61; *Juris-classeur de Droit International*, *Fascicule* 353 C.

refers to the presence of persons who conduct the activity from the place of business.

The OECD commentary on this paragraph offers guidelines as to the meaning to be given to these words and examples, but each individual case is to be examined in the light of its particular facts.

B. Illustrations: art. 4(2)

Art. 4(2) contains a list of examples of permanent establishments. This list is not exhaustive; it is to be read against the background of the general definition of art. 4(1).[19]

In 1981, the Conseil d'Etat has taken the opportunity to emphasize that the list of examples of permanent establishments was not exhaustive.[20]

The relevant decision involved the tax convention between Spain and France signed on 8 January 1963.[21] The enumeration of examples of permanent establishments in the Franco-Spanish convention is comparable to that under the UK/F agreement.

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19. OECD Commentary on art. 4, §11, at p. 61.

20. CE 29 June 1981, Req. No. 16095, Recueil Dalloz Sirey, Jurisprudence, p. 625. This decision will be further developed in subsequent pages.

21. Spain and France have since concluded a new double taxation agreement dated 27 June 1973 but the provision of this latest agreement is comparable to that of 1963 as regards the definition of a permanent establishment. cf. M. Edwardes-Ker, ITTS, May 1982, art. 5, p. 34 5012.

The case involved a drilling site operating in Spain for months; the problem was whether or not such a site amounted to a permanent establishment; the *Conseil d'Etat* considered that a permanent establishment existed in Spain on the basis - *inter alia* - that "the enumeration laid down in the aforementioned art. 4 of the convention not being limitative, the scope of this article extends to any establishment of a nature or of a consistency similar to those in the enumerated examples".[22]

Both provisions of the Franco-Spanish conventions, that of 1963 and of 1973, do not contain a drilling site as an example of permanent establishment; neither does the UK/F agreement.

The rest of the decision will be examined in another context.

a) Place of management (*siège de direction*)

b) A branch (*une succursale*)[23]

Under UK domestic law, non residents are subject to UK tax on their profits from trading *within* as opposed to trading *with* the United Kingdom;[24] a non resident

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22. As translated in M. Edwardes-Ker, *ibid*.

23. The rules of domestic law have been examined in detail in Part I, Chapters 3 and 5.

24. ICTA 1970, s. 108(1)(a)(iii).

company is not subject to UK corporation tax unless it carries on a trade in the United Kingdom through a branch or agency.[25]

An overseas company which establishes a place of business in Great Britain is subject to certain obligations: it has to file with the Registrar of Companies a copy of its instruments of incorporation, particulars of directors and the names and addresses of one or more persons resident in Great Britain authorised to accept service and any notice required to be served on the company.[26]

Under French law a foreign company with a branch (succursale) or agency (agence) or "any other establishment" in France has to file certain documents with the Registre du Commerce et des Sociétés.[27]

In the UK, the definition of a branch as a permanent establishment under treaty law is generally considered to be more favourable to the taxpayer than the definition which applies in the absence of a treaty.[28]

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25. Ibid., s. 246(1).

26. 1948 Companies Act, s. 406 and s. 407(1)(a)(b)(c): an "overseas company" designates a company incorporated outside Great Britain, anywhere except in England or in Scotland. See G.B. Smethurst, "Overseas Companies: Establishing a Place of Business in Great Britain", Business Law Review (1982) pp. 311-314.

27. Décret No. 67-237 of 23 March 1967, art. 2.20.

28. A.L. Chapman, Tolley's Tax Planning (London: The Tax Lawyer Publishing Company, 1980), pp. 572-573. The UK domestic legislation (ICTA 1970, s. 246) has been examined in detail in Part I, Chapter 5.

Double taxation treaties not only reduce the circumstances in which UK tax will be charged on the business profits of a non resident company operating in the UK; they also limit the amount of profits subject to UK tax.[29]

Under French domestic law, a non resident company will be subject to French tax if the company carries on "business activities in France".[30] The application of double taxation agreements also seems more favourable to the taxpayer in France.[31]

c) <u>An office (un bureau)</u>

The present case involves the double taxation agreement between Canada and France signed on 16 March 1951.[32]

A Canadian company set up a wholly owned Canadian subsidiary which in turn set up an office in Paris. The Canadian subsidiary bought a controlling interest in a French company. The French company was to build a factory and the French Government helped the financing of the

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29. *Ibid.*, see below II.

30. CGI, art. 209-I; for a detailed analysis of the meaning of this expression, see Part I, Chapters 3 and 5.

31. Tixier Gest Kérogues, *Droit Fiscal International* (Paris: LITEC, 2nd ed., 1979), §551, p. 211.

32. CE 4 April 1973, *Req.* No. 81-342, 81-695, RDCE 1973, p. 278; also reported in M. Edwardes-Ker, ITTS, p. 34.5006.

factory through a 10 million Francs loan to the French company. The Canadian subsidiary guaranteed 4 million Francs of the 10 million loan, secured by a portfolio of shares held by the French office and figuring on its balance sheet. The guarantee was signed by the manager of the French office. Furthermore, a loan from the Canadian subsidiary to the French company was administered by the French office; however, the funds for the loan were provided by the Canadian subsidiary, and the French office did not have the power, nor the means to make the loan.

The Conseil d'Etat held the French office to be a permanent establishment.

d) A factory

e) A workshop

f) A mine, quarry or other place of extraction of natural resources

This paragraph deals with the extraction of natural resources, but not the exploration of such resources whether on or off-shore. The question whether these activities are carried out through a permanent establishment is governed by the general definition of permanent establishment.[33]

33. OECD Commentary on art. 5, §14.

This is an exact replica of the 1963 OECD provision, as the rest of the article is.

The 1977 Model has modified the scope of this provision: "oil or gas well" has been added. This reflects the development of energy related activities.[34] The OECD Commentary specifies that "any other place of extraction of natural resources" is to include for instance "places of extraction of hydrocarbons, whether on or off-shore".

g) A building site or construction or assembly project which exists for more than twelve months

In the 1977 Model, the provision on building sites is no longer part of the enumeration under art. 5, §2: it forms a separate paragraph (3) which runs as follows: "a building site or construction or installation projects constitute a permanent establishment only if it lasts more than twelve months".

The commentary on this particular provision[35] is far more substantial than that on the 1963 Draft. It states - inter alia - "the twelve months test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally

34. M. Edwardes-Ker, International Tax Strategy (Dublin: In-Depth, 1974 - loose-leaf), editorial on art. 5, p. 13.

35. Paragraphs 15-19, pp. 62-63.

unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically."

The above mentioned decision of the Conseil d'Etat of 29 June 1981 is also relevant in the present context.[36]

The question was whether drilling sites in Spain amounted to a permanent establishment under the Franco-Spanish treaty of 1963. The Conseil d'Etat answered this question in the affirmative, not only because the list of permanent establishments in art. 4 is not exhaustive, but also on the basis that:

> in choosing as an example of permanent establishment a building site which exists for more than twelve months, the drafters of the convention have not intended to exclude from the category of permanent establishment an activity carried out by the enterprise for more than twelve months in the same country through several successive sites.

The Conseil d'Etat treats several successive sites as one; the text of the decision does not specify that those sites are connected, that they form a coherent whole commercially and geographically. It seems that the French Supreme administrative court is taking an approach even wider than that of the OECD Commentators.

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36. The drafting of the provision of the Franco-Spanish tax treaty of 1973 on building sites (art. 5(2)(g)) is exactly the same as art. 4(2)(g) of the UK/F agreement.

C. Dependent agents as permanent establishments: art. 4(4)

Art. 4(4) states:

> A person acting in a Contracting State on behalf of an enterprise of the other Contracting State - other than an agent of an independent status to whom paragraph (5) applies - shall be deemed to be a permanent establishment in the first mentioned State if he has, and habitually exercises in that State, an authority to conclude contracts (pouvoirs lui permettant de conclure des contrats) in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise (limitée à l'achat de marchandises) for the enterprise.

Several conditions are to be fulfilled for an agent to qualify as a permanent establishment:

- the agent is to be dependent; independent agents fall under a separate paragraph;
- the agent is to have authority to conclude contracts in the name of the enterprise;[37]
- the agent is to exercise habitually this authority;
- his activity is not to be limited to purchasing.[38]

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37. See M. Edwardes-Ker, op.cit., note 34 above, Chapter 2, pp. 6-8. The author indicates how to draft a clause to be inserted in an agent's contract of employment so that he does not have authority to conclude contracts and will therefore not be taxable on the profits of his activity. The clause runs as follows: "The agent is given no general or specific authority whatsoever to negotiate or conclude contracts in the name of the group. Any attempt to exercise such non-existent authority by the agent shall be deemed a fundamental breach of contract by the agent entitling the employer to terminate this contract forthwith without any form of compensation and without prejudice to any other rights of the group against the agent for such breach of contract."

38. Instruction, of 14 April 1970, §2331-2.

The key questions are: does he have authority to conclude contracts? does he exercise it habitually? The basic criterion to determine whether the presence of an agent creates or not a permanent establishment lies in the scope of his activity.[39]

Under a double taxation agreement, if the agent may conclude contracts in the UK and does so habitually, he will be a permanent establishment for purposes of tax conventions. However, the contracts must relate to the operations which constitute the business of the enterprise. If the agent has authority to engage employees and enter into contracts of employment, it is not relevant.[40]

When the agent's activities are limited to the purchase of goods or merchandise for the enterprise, they do not amount to a permanent establishment.[41] One may doubt that this would apply in the UK in the absence of a convention.

The 1977 Model has broadened the exception: it has extended the type of activities which an agent could exercise without qualifying as a permanent establishment.

Under the 1963 Draft convention, and the UK/F agreement, dependent agents do not qualify as permanent establishment if their activity is limited to the purchase of goods or merchandise for the enterprise.

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39. _Jurisclasseur de Droit International_, _Fascicule_ 353C, §§22-30.

40. §32 of the 1977 OECD Commentary.

41. UK/F, art. 4(4).

Paragraph 5 of art. 5 of the 1977 Model provides that when the activities of the agent amount to any of those which do not qualify as permanent establishment (use of facilities solely for the purpose of storage, display and so on), he will not qualify as a permanent establishment.

The taxation of dependent agents in tax treaties is more generous than the UK domestic rules on taxation of agents, although the latter are regarded as generous already.[42]

Domestic law aims at increasing a country's tax base; this explains that it is generally more advantageous to rely on a treaty provision.

The following decision involves the 1968 tax convention between France and Algeria.[43] It deals with income tax, not corporation tax, but it is an important decision as regards the meaning of dependent agents as permanent establishment.

The treaty between France and Algeria does not contain a provision comparable to art. 5(4)(a) or (b) of the OECD Model, art. 4(4)(a) or (b) of the UK/F agreement, which exclude the use of facilities or the maintenance of goods solely for the purpose of storage or delivery.

A wool wholesaler had transferred from Algeria to France the seat of his business. He had kept in

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42. In particular in the banking and finance field, see Tiley, Revenue Law (London: Butterworths, 3rd ed., 1981), at p. 667.

43. CE 25 July 1980, Req. No. 11535, JCP ed. CI (1980), Chronique, 9583, at p. 114.

Algeria a warehouse for the purpose of temporary storage of goods whilst waiting to be delivered. The Algerian authorities confiscated the place. The wholesaler deducted from his profits in France the loss resulting from the confiscation. The French tax authorities unsuccessfully contended that the warehouse constituted a permanent establishment. The Conseil d'Etat held that the local agent in Algeria only received the goods and delivered them. He had no power to contract on behalf of the wholesaler nor to take orders. Consequently, the loss was deductible for French tax purposes because the warehouse did not constitute a permanent establishment.

D. Insurance enterprises: art. 4(7)

The criterion of taxation in a contracting state as regards this type of enterprise is not the existence of a permanent establishment in that state but the collection of premiums: an insurance enterprise of a contracting state shall be deemed to have a permanent establishment in the other contracting state if it collects premiums there or insures risks situated there through an agent established there but not including a broker, general commission agent or any other agent of an independent status. There is no need for a "fixed place of business" to be maintained in France by a UK insurance enterprise in order to justify taxation by the French tax authorities on the profits of its activity carried out in France. The collection of premiums in France is sufficient to justify taxation

in that country.

The insertion of this provision was justified on the grounds that French agencies of UK insurance enterprises sometimes did not meet the normal requirements of existence of a permanent establishment (i.e. fixed place of business or dependent agent) and therefore escaped taxation in France on the profits arising from their business carried on there.[44]

The effect of the introduction of a special provision dealing with insurance enterprises may be summarised as follows: a UK insurance enterprise, for instance, is deemed to have a permanent establishment in France if it collects premiums there or insures risks situated there through a dependent agent established there.

The presence of the dependent agent collecting premiums or insuring local risks is sufficient.

On the other hand, the impact of this approach is restricted to the collection of insurance premiums,

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44. See 1977 OECD Model, commentary on art. 5, §38, p. 68; it has not seemed advisable to insert a provision on insurance enterprises in the OECD Model because the decision as to whether or not a provision along these lines should be included in a convention essentially depends on factual and legal considerations in each contracting state. See also Instruction of 14 April 1970; it specifies that when an insurance enterprise of a contracting state has a permanent establishment in the other contracting state, the reinsurance premiums (primes de réassurance) collected by this enterprise will be taken into account for the computation of taxable profits only in the state where the enterprise is resident unless this activity of reinsurance constitutes a permanent establishment in that other state.

and does not extend to reinsurance premiums.

The effect of art. 5(7) of the UK/F agreement is back-dated to 1 January 1966.[45]

E. Business activities or facilities which do not constitute a permanent establishment: art. 4(3)

Art. 4(3) provides:

> The term "permanent establishment" shall not be deemed to include:
> (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
> (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
> (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
> (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information for the enterprise;
> (e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise. [46]

First of all, art. 4(3) lists a number of specific business activities or facilities which are not permanent establishments. This provision is an exact replica

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45. Instruction of 14 April 1970, §2331-11 and §273-2; also UK/F agreement, art. 30(1)(b).

46. The 1977 Model modified its 1963 predecessor in one respect: a new article 5(4)(f), which did not exist in the 1963 Draft, provides that the maintenance of a fixed place of business solely for any combination of business activities or the use of facilities mentioned in subsections (a) to (e) does not qualify as a permanent establishment, provided it remains of a preparatory or auxiliary character.

of its OECD counterpart.

The use of facilities or the maintenance of a stock solely for the purpose of storage display or delivery of goods belonging to an enterprise of the other contracting state are not permanent establishments.[47]

Similarly, if a stock of goods belonging to an enterprise is maintained solely for the purpose of being processed by another enterprise, the maintenance of that stock does not amount to a permanent establishment.[48]

Finally, the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, collecting information,[49] advertising, supplying information, or scientific research, does not constitute a permanent establishment.

The maintenance of a fixed place of business for any similar activities which have a preparatory or auxiliary character are also excluded from the definition of a permanent establishment.

The 1977 OECD commentary considers an activity to have a preparatory or auxiliary character if it does not in itself form "an essential and significant part of the activity of the enterprise as a whole".[50]

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47. Art. 4(3)(a)(b).

48. Art. 4(3)(c).

49. This is intended to cover newspaper bureaux; cf. OECD commentary, §21, at p. 64.

50. Ibid., §23, at p. 64.

The maintenance of a fixed place of business in order to supply spare parts to customers for machinery supplied and its repair would amount to a permanent establishment, as it goes beyond pure delivery. After sales organisations will be treated as permanent establishments when their activities are not merely auxiliary.[51]

A representative office may be set up in France by a UK resident company. It will not be liable to French tax as long as its activity is limited to any of those enumerated above or a combination of them. The maintenance of a fixed place of business solely for the purpose of supplying information and/or advertising for instance does not generate liability to French tax.

It is easier to establish a representative office in France than a subsidiary. Both will qualify as direct investments and will be subject to exchange control regulations, but a representative office need not register with the Registry of Commerce and Companies.[52]

F. Independent agents: art. 4(5)

> An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State because it carries on business in that other State through a broker (courtier), a general commission agent (commissionaire général) or any other agent (intermédiaire) of an

51. Ibid., §24 at p. 65.

52. M. Edwardes-Ker, op.cit., note 34 above, Chapter 2, Section 6, p. 11. Also, International Business Lawyer (1982) Vol. 10.

> independent status, where such persons are acting in the ordinary course of their business.

The effect of this provision is to exclude an independent agent from qualifying as a permanent establishment.

A person will come within the scope of art. 4(5) if:

- he is independent legally and economically from the enterprise situated in the other contracting state, and
- he acts in the ordinary course of his business when acting on behalf of the company.

In Fleming v. London Produce Co Ltd,[53] it was stated that the court could determine whether a particular company was or was not an independent agent within the meaning of a double taxation agreement - the 1947 agreement between the UK and South Africa in that case - in the same way as it would determine whether the company was or was not a broker under the corresponding provision in UK domestic law, that is s. 82 of the 1970 TMA today. In other words, the court assimilated the domestic concept of "broker" to the treaty concept of "independent agent". In the relevant case, the UK company was held to be a permanent establishment of a South African company. Megarry J. rejected the contention of the company according to which it acted as broker for the South African company; 95 per cent. of the business of the South African company was done by the UK agent which did not have many other customers.

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53. (1968) 2 All ER, p. 975; 44 TC, p. 582; see also Part I, Chapter 5.

G. Subsidiaries as permanent establishments: art. 4(6)

Art. 4(6) states:

> The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

The existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that a subsidiary is a separate legal entity for taxation purposes.[54]

A subsidiary will constitute a permanent establishment if it has and habitually exercises an authority to conclude contracts in the name of the parent company and if it cannot be regarded as an independent agent.[55]

In Firestone Tyre and Rubber Co Ltd v. Lewellin,[56] an American company was held to be carrying on a trade in the UK through its subsidiary and therefore the profits kept by the parent were subject to UK tax.

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54. OECD Commentary on art. 5(7), §39.

55. Ibid., §40.

56. (1957) 1 All ER, p. 561. This case is examined in further detail in Part I, Chapter 5.

§2. Application

I. Principle

The criterion of the "permanent establishment" is used in a double taxation agreement to determine whether a particular type of income is or is not to be taxed in the country from which it originates.

An enterprise of one state will not be taxed in the other state unless it carries on business in that other state through a permanent establishment located there.

Once the existence of a permanent establishment has been determined, a set of basic rules determines how the profits of such a permanent establishment are to be taxed.

The rules vary according to the nature of the income; a distinction is introduced between business income and investment income.[57]

Although these rules will be developed below in a separate chapter, they ought to be outlined here for the sake of clarity and completeness.

A. Business income[57]

1) Existence of a permanent establishment

In principle, the business income of a company

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57. For the purposes of illustration, it has been arbitrarily decided to consider a UK resident company with a permanent establishment in France.

resident in the United Kingdom shall be taxable only in the UK, unless the company carries on business in France through a permanent establishment situated there.[58]

2) Profits attributable to the permanent establishment

If the UK resident company carries on business in France through a permanent establishment, the business income of the UK resident company may be taxed in France, but only so much of the profits as is attributable to the permanent establishment situated in France are taxable in France.[59]

The right to tax does not extend to profits that the enterprise may derive from France other than through the permanent establishment.

The test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits.[60]

French tax authorities will look at the different sources of profits that the UK resident company derives from France and will apply to each the permanent establishment test.[61]

This prevents the application of the "force of attraction principle", whereby all the French source income,

58. UK/F agreement, art. 6(1).

59. Ibid.

60. OECD Commentary on art. 7, II, §4, p. 73.

61. Ibid.

i.e. business income and investment income, whatever their source would be "attracted" to the French activity carried out through the French permanent establishment. Income from French source, although totally unrelated to the French business would be subject to French corporation tax.

The UK/F agreement applies the "effectively connected" rule: only so much of the profits that are attributable to the permanent establishment are taxable in France.

Business income means industrial and commercial profits which do not belong to categories of income covered by other articles of a double taxation agreement.

B. Investment income

In application of the UK/F tax treaty, investment income paid by a French permanent establishment of a UK resident company is either exempt from tax in France,[62] or subject to a withholding tax the maximum rate of which is fixed by the treaty.[63]

There is one major exception to this rule: investment income will be taxed as part of the business income of the permanent establishment if the two following conditions are fulfilled.

- if the UK resident company who receives the investment income carries on business through a permanent establishment

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62. UK/F, art. 12 on royalties. See below, Chapter 2.

63. UK/F, arts. 9 and 11 on dividends and interest respectively. See below, Chapter 2.

in France and derives dividends, interest or royalties from France; and

- "the holding in respect of which the dividends are paid" or "the debt claim in respect of which the interest is paid" or "the right of property in respect of which the royalties are paid" is effectively connected with such permanent establishment.[64]

The investment income is effectively connected with a permanent establishment when the shares, debt claims, or the rights of property form part of the assets of the permanent establishment.[65]

II. Exception

Article 7 of the UK/F agreement runs as follows:

> Profits which a resident of one of the Contracting States derives from the operation of ships or aircraft in international traffic shall be taxable only in that State.

The term international traffic is defined as including "any voyage of a ship or aircraft other than a voyage solely between places in the Contracting State which is not the Contracting State of which a person deriving the profits of the operation of a ship or aircraft is a resident".[66]

This provision dealing with the taxation of

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64. UK/F, arts. 9(8), 11(4) and 12(3).

65. See OECD Commentary on arts. 10(4), 11(4) and 12(3).

66. UK/F agreement, arts. 2(1)(i).

profits from international traffic constitutes an exception to art. 6 and the principle of taxation in the country of situation of the permanent establishment. This particular type of profit is only taxable in the state of residence of the beneficiary; the location of the source of the profit is excluded as a criterion of taxation.[67]

From the UK point of view (this applies reciprocally in France) an entreprise française de navigation is exempt from tax in the UK on its business profits. This exemption, contrary to art. 6, is not subject to the absence of a permanent establishment. There would be no reason for such a company not to open an office in the UK.

Section 3: Subsidiary as a Separate Legal Entity

§1. Definition of a Subsidiary Under Domestic Legislation

I. United Kingdom

A. Company law

1) Statutory provisions

In English company law, one traditionally distinguishes between a subsidiary company and its holding company.

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67. Instruction of 14 April 1970, §2333. Dossiers Internationaux: Grande Bretagne (Paris: Editions F. Lefèbvre, 1980), §71.

The meaning of the terms "subsidiary" and "holding company" is given in section 154 of the Companies Act of 1948.

There are three alternative criteria to determine that a company B is the subsidiary of another company A:

- A is a member of B and controls the composition of the board of directors of B; to be a member of B, A only needs to hold one share of B; as regards control, A is deemed to control the composition of B's board if, by the exercise of a power exercisable by it without the consent of any other person, A can appoint or remove all or the majority of the directors.[68] Power to appoint or remove a majority of the board means power _de jure_: a company with shares entitling it to no more than 50 per cent. of the votes of another will not be regarded as controlling that other.

However, to maintain the existing board of a public company (or elect a new one) which has a very large number of dispersed shareholders, all that is required is to pass a resolution with the requisite majority of _those voting_[69] and the existing board with control of the proxy voting machinery will find it easier to get its supporters

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68. The conditions under which A is deemed to have power to appoint a director of B are stated under art. 154(2)(a), (b) and (c).

69. Italics supplied.

to vote.[70]

Other provisions recognise that a *de facto*, as opposed to a *de jure* control may be exercised; for instance, s. 4 of the 1967 Companies Act compels a company which holds more than 10 per cent. of the equity share capital of another body corporate to name it, state its place of incorporation, give particulars of the shares held in its financial statements.[71]

- A holds more than half of B's equity share capital.[72]

This alternative test is dubious because non-voting equity shares still exist in the UK, therefore a majority holding of the equity may not confer voting control.[73]

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70. See L.C.B. Gower's *Principles of Modern Company Law* (London: Stevens & Sons, 4th ed., 1979) and Supplement, Chapter 22, pp. 538-540 in particular.

71. *Ibid*., at p. 120. However, s. 4(3) introduces limitations to the disclosure if the other body corporate is incorporated outside the UK or, being incorporated in the UK, carries on business outside the UK if the disclosure would be harmful to the business of the company in the opinion of the directors or if the Board of Trade agree that the information need not be disclosed. S. 4(4) introduces further subjective limitations.

72. Equity share capital is defined under s. 154(5) as the issued share capital excluding any part of it which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution. This will normally exclude preference shares so that in effect the equity share capital is the company's issued ordinary shares.

73. In practice, one company is in control of another if it holds less than half of the other's equity share capital, *e.g.* if the first holds 30 per cent. of the second's ordinary shares. The Jenkins Report (§156) recommended s. 154(2) to be repealed so that the definition of a subsidiary be based solely on membership and control. See Charlesworth & Cain, *Company Law* (London: Stevens & Sons, 11th ed., 1977) at pp. 57-59; also Gower's *Principles of Company Law*, *op.cit*., note 70 above, pp. 117-121.

- B is a subsidiary of a third company C which is itself a subsidiary of A. In such a case, B is also a subsidiary of A.

Section 154(5) also provides that in the section, the expression "company" includes any body corporate. A reference to a body corporate is to be construed as including a company incorporated outside the UK.[74]

Where a holding-subsidiary relationship is established, certain provisions, limited in number and in scope, recognise the group as a true entity and disregard the subsidiary as a separate entity. The most important of these provisions relate to accounts. The holding's profit and loss account and balance sheet are to be presented in the form of group accounts normally by consolidating the figures of the subsidiaries with those of the holding company.[75] Other provisions deal with special requirements regarding directors' contracts of service or for services, substantial property transactions involving directors, loans to directors and connected persons.[76]

Overall, despite the growing number of provisions which regard all the companies within a group as part of

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74. 1948 Act, s. 455(3).

75. 1948 Companies Act, ss. 150-153, Schedule 8, Part II (as amended by the 1967 and 1976 Acts).

76. 1980 Companies Act, ss. 47-53, 61, 73 and 74. Further disclosure requirements in group accounts are to be found in ss. 54-59 of the 1980 Act.

the same entity, it must be emphasized that these provisions are scattered, and of very limited scope.[77]

2) Case law

The courts in the UK do not seem prepared to go very far towards the recognition of a group as an autonomous entity, but their attitude is often unpredictable:

- In Firestone Tyre & Rubber Co v. Llewellin,[78] the House of Lords treated a subsidiary as an agent of the parent company: it was held that although the English subsidiary was a separate legal entity which was selling its own goods, the sales were the means whereby the American parent company carried on its business in Europe and the subsidiary was assimilated to a branch.

- The Court of Appeal in 1975 reaffirmed as a fundamental principle of English law that:

> ... Each company in a group of companies is a separate legal entity possessed of separate legal rights and liabilities so that the rights of one company in a group cannot be exercised by another company in that group ... [79]

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77. One of the major drawbacks of this situation is clearly formulated by Templeman in Re Southard & Co Ltd (1979) 1 WLR, p. 1198, at p. 1208: "... if one of the subsidiaries declines into insolvency ... the parent company and the other subsidiary companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent subsidiary".

78. (1957) 1 WLR, p. 464. See also a decision of the Court of Appeal, Littlewoods Stores v. IRC (1969) 1 WLR, p. 1241, where a subsidiary company was also treated as an agent; the subsidiary held the land on trust for the parent.

79. The Albazero (1975) 3 WLR, p. 491, per Roskill LJ at p. 521. This decision was reversed by the House of Lords, (1977) AC, p. 774.

A case where the courts have regarded a subsidiary as agent can always be matched with another in which they have refused to do so.[80]

It seems impossible to deduct from decisions any single criterion which will be decisive in all circumstances.

- In DHN Ltd v. Tower Hamlets,[81] a decision of the Court of Appeal, Lord Denning and his two colleagues lifted the veil of incorporation and treated a parent company and its two subsidiaries as one. The group here was treated as one entity.[82]

- In Lonhro Ltd v. Shell Petroleum,[83] a distinction was drawn between a wholly domestic group and a multinational one with local boards subject to the laws of foreign countries. There, the courts refused to order Shell and BP to disclose documents in the possession of their wholly owned subsidiaries in Rhodesia. The subsidiaries had local boards which were allowed considerable autonomy and they refused to make the documents available to the parent companies. The documents were not within the "power" of

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80. L.C.B. Gower's Principles of Modern Company Law, op.cit., note 70 above, pp. 129-132.

81. (1976) 1 WLR, p. 852.

82. Ibid., per Lord Denning MR, at p. 860. In Woolfson v. Strathclyde Regional Council (1979) 38 P & CR, p. 521, the House of Lords refused to lift the veil on the basis that it is only permissible to do so if the company is a "façade".

83. (1980) 1 WLR, p. 687. This decision confirms that of the Court of Appeal presided over by Lord Denning MR: ibid., at p. 367.

Shell and BP to disclose.

B. Tax law[84]

1) Definition

Broadly, a company is a subsidiary if the other company owns the relevant percentage of its ordinary share capital - more than 50 per cent., 75 per cent. or more, 90 per cent. or more and even 100 per cent.[85]

To each percentage of holding corresponds the application of certain provisions.

The subsidiary relationship is defined by reference to beneficial ownership of "ordinary share capital".

A company is a "51 per cent. subsidiary" of another if more than 50 per cent. of its ordinary share capital is owned directly or indirectly by that other company.

The 51 per cent. subsidiary relationship exists where more than 50 per cent., 50.1 per cent. for instance, of the ordinary share capital of one company is owned by another.[86]

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84. R. Bramwell, J. Dick, Taxation of Companies (London: Sweet & Maxwell, 2nd ed., 1979) Chapters 1 and 9; J. Tiley, op.cit., note 42 above, Chapter 30.

85. ICTA 1970, s. 532(1). Ordinary share capital means all issued share capital of the company, other than capital the holders whereof have a right to a dividend at a fixed rate, but have not a right to share in the profits of the company; ibid., s. 526(5). Share capital qualifies as "ordinary share capital" notwithstanding that it carries no vote. The subsidiary relationship can exist even though the parent has no control over the subsidiary.

86. R. Bramwell, op.cit., note 84 above, Chapter 1, p. 1.

For the 75 and 90 per cent. subsidiaries, 75 and 90 actually represent minimum figures.

2) Consequences

a) Group relief[87]

The system of group relief covers the relationship between a parent company and its subsidiaries and that between a consortium of companies and a trading company through which a joint venture is being conducted.[88]

. Conditions of application of the group relief provisions between a parent company and its subsidiaries

Two companies are members of a group if one is a 75 per cent. subsidiary of the other or both are 75 per cent. subsidiaries of a third company.[89]

The parent subsidiary relationship necessary for the application of the group relief provisions will be deemed not to exist if a profit on the sale of the shares which one company owned directly or indirectly in another was treated as a trading receipt of its trade.[90]

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87. See in general BTR (1967) pp. 239-242.

88. For the purposes of group relief, a company is owned by a consortium if all of the ordinary share capital of that company is directly and beneficially owned by 5 or fewer companies. Those companies are called the members of the consortium: ICTA 1970, s.258(8)(a).

89. Ibid., s. 258(5)(a).

90. Ibid., s. 258(7)(a)(b).

Nor will a company qualify as a subsidiary of another for group relief purposes when it owns directly or indirectly 75 per cent. of the share capital of a non resident company.[91]

The group relief provisions could not therefore apply to a UK resident company and its 75 per cent. French subsidiary.

. Application

When the above conditions are fulfilled, relief from corporation tax may be surrendered by one company (the surrendering company) to another (the claimant company): a loss incurred by the surrendering company may be set off against the total profits of the claimant company for corporation tax purposes.[92] Capital allowances,[93] excess management expenses of investment companies,[94] excess charges on income,[95] of a surrendering company may also be set off for purposes of corporation tax against the total profits of the claimant company.

b) Intra group dividends: group income

This involves the distribution of dividends from

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91. Ibid., s. 258(7)(c). The consequences of this particular provision in relation to art. 24 of the UK/F tax agreement on non discrimination are discussed in Part II, Chapter 1, Section 5.

92. ICTA 1970, s. 259(1).

93. Ibid., s. 259(2).

94. Ibid., s. 259(3).

95. Ibid., s. 259(6).

a subsidiary company to its parent. The benefit of this provision is limited to UK resident companies.

Normally, a subsidiary which distributes dividends to its parent pays advance corporation tax (ACT) on the distribution; the parent receives franked investment income (FII) i.e. the dividend plus a tax credit.

The parent and its subsidiary may elect not to follow the procedure just described;[96] if the subsidiary is a 51 per cent. subsidiary, it may pay the dividend gross, i.e. it does not pay ACT on it. The parent company could not operate similarly when paying a dividend to its subsidiary.[97]

Dividends paid and received in that way are "group income". They are not subject to corporation tax in the hands of the parent.[98]

c) Surrender of ACT[99]

The application of the imputation system in the UK is characterised by the payment of ACT.[100] Such a

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96. As to the procedure of election, see ICTA 1970, s. 257.

97. ICTA 1970, s. 256(1).

98. The exemption is total whereas in the French affiliation privilege, only 95 per cent. of the distribution is exempt. Also, in order for group income to apply in the UK, the subsidiary is to be a 51 per cent. subsidiary. In France, the minimum interest is 10 per cent.

99. BTR (1973) pp. 151-152.

100. For a full description of the UK imputation system, see Part I, Chapter 4.

tax is payable in respect of all "qualifying distributions" made by UK resident companies. ACT is normally due when the distribution is made.

ACT paid by a company in an accounting period may offset the mainstream corporation tax due by the company on its profits for that accounting period.

A company cannot offset its payment for ACT against its liability to mainstream corporation tax indefinitely.[101] "A convenient way of expressing this limitation is as an amount equal to tax at the basic rate on the company's income".[102]

When a company has a surplus of ACT from an accounting period, it may carry it backwards and then forwards.[103]

The carry back was limited to two years; in his 1983 Budget Speech delivered on 15 March, the Chancellor of the Exchequer announced that the period over which a company may carry back surplus ACT is to be extended progressively from the present maximum of 2 years to 6 years. He also stated that for accounting periods ending after 31 March 1984, double tax relief would be allowed against the full corporation tax on income which has become foreign tax in priority to set-off for ACT. This provision of the 1983 Finance Bill was deleted in order to enable it to be enacted prior to the dissolution of Parliament; a

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101. FA 1972, s. 85(1).

102. *Ibid.*, s. 85(2).

103. R. Bramwell, *op.cit.*, note 84 above, 8-08, at p. 96.

general election took place in the UK on 9 June 1983.

A carry forward is unlimited.[104] A surplus of ACT carried backward or forward can only be used to off-set a company's liability to mainstream corporation tax in another accounting period.

The application of surrender of ACT is restricted to surplus ACT arising in respect of dividends, not all qualifying distributions.

It is an alternative to carrying a surplus backward or forward.

Surplus ACT may be surrendered to one or several 51 per cent. subsidiaries.[105] The surplus surrendered is treated in the hands of the subsidiary as an amount of ACT paid by the subsidiary itself.[106]

The power to surrender is advantageous to companies whose subsidiaries trade overseas.[107] When foreign taxes have been paid by those subsidiaries, ACT can be passed on to those with the lowest foreign tax who have therefore the highest UK tax liability. The lower a tax will be abroad, the lower the foreign tax credit, the higher the liability to tax in the UK. It will be advantageous to be able to offset surplus ACT against a high

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104. FA 1972, s. 85(3).

105. Ibid., s. 92(1).

106. R. Bramwell, op.cit., note 84 above, 8-10, p. 98.

107. J. Tiley, op.cit., note 42 above, Chapter 30; BTR (1973) at p. 152.

liability to mainstream corporation tax.

II. France

Under French domestic law, the definition of a subsidiary (filiale) differs also according to the area of law concerned.

A. Company law

For the purposes of company law (droit des sociétés) the law (loi) of 24 July 1966 states that a company (société) is a subsidiary of another if the other company, the parent (société mère) owns more than one half of its share capital. The law of 1966 defines the concept of subsidiary exclusively as a function of the percentage held by a company in the share capital of another.[108]

A company is said to have an interest (participation) in another if it holds between 10 and 50 per cent. of its capital.[109]

B. Tax law

Under the provisions of tax law (droit fiscal), the benefit of the affiliation privilege (régime des

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108. Art. 354.

109. Art. 355. See also R. Rodière, op.cit., note 9 above §362, p. 422; G. Ripert, Traité Elémentaire de Droit Commercial (Paris: LGDJ, 10th ed., 1981) §712, at p. 461.

sociétés mères et filiales) is granted to a subsidiary if the parent holds 10 per cent. or more of its share capital (capital social). No such percentage is required when the cost of the investment exceeds 10 million Francs;[110] in the case of shares received in consideration of the transfer of a business to a company under the special rules for mergers, the affiliation privilege applies, irrespective of the percentage held by the parent. The 1983 Finance Law[111] has reduced the scope of application of the affiliation privilege: it only applies when a parent holds 10 per cent. or more of the share capital of its subsidiary.

Under the affiliation privilege, a parent company which has a holding of at least 10 per cent. in another company is entitled to deduct from its taxable profits a sum equal to 95 per cent. of the dividend received from that other company.

. Conditions of application

- Both parent and subsidiary companies must be subject to corporation tax;
- The seat of the parent company must be situated in France; the subsidiary may be non resident;
- As stated earlier, the minimum interest is 10 per cent.;
- The shares of the subsidiary held by the parent company

110. CGI, art. 145.

111. Law No. 82-1126 of 29 December 1982, art. 15-II.

must be in the registered form or lodged with a bank;

- Where the parent company did not actually subscribe for the shares when they were issued, it must give the undertaking to retain them for at least two years.[112]

. Effects of the affiliation privilege

The distribution of the subsidiary to the parent company is not totally exempt from corporation tax in the hands of the parent; only 95 per cent. of it is exempt. The remaining 5 per cent. is taxable in the hands of the parent; it is intended to represent the expenses of holding the interest concerned; it is levied on the dividend grossed up by the <u>avoir fiscal</u>.

When the seat of the subsidiary is situated abroad, the tax credit is represented by the withholding tax levied by the tax authorities on the dividend.

Under the terms of the UK/F tax agreement, there is no tax withheld on the dividend and tax credit paid by a subsidiary to its French parent.[113]

. Relationship between a French parent and its French subsidiary

The parent company may not deduct from its

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112. Claude Gambier, <u>Les Impôts en France</u> (Paris: Ed. F. Lefebvre, 12th ed., 1981-82), §283.

113. UK/F agreement, art. 9-A(1)(c). A 15 per cent. withholding tax is levied (art. 9-A(1)(b)) when the French parent holds less than 10 per cent. of the share capital of the UK subsidiary, but the affiliation privilege normally does not apply in that case.

liability to corporation tax on its other profits the *avoir fiscal* attached to the dividend received from the subsidiary. In other words, the parent is not entitled to the *avoir fiscal* attached to the dividend distributed by the subsidiary.

However, when the parent company pays a dividend to its shareholders, it can pass on to them the benefit of the *avoir fiscal* which it could not make use of. Such *avoir fiscal* is creditable against the *précompte mobilier* which the parent company has had to pay because the profits out of which the distribution is made have not been subject to corporation tax at the normal rate of 50 per cent.[114]

When both companies are resident in France, the 50 per cent. *avoir fiscal* completely covers the 50 per cent. *précompte mobilier*.

. Relationship between a French parent and its UK subsidiary

The development above applies, subject to one modification: no tax credit is attached to the dividend distributed by the UK subsidiary to its French parent. The French parent will therefore be liable to pay the *précompte*.[115]

The affiliation privilege constitutes an exception to the present situation as regards groups of companies in

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114. CGI, art. 146-2; C.Gambier, *op.cit.*, note 112 above, §§390-392.

115. UK/F agreement, art. 9-A(1)(c).

France, which do not have a status of their own, equivalent to that of the German Konzernecht for instance.[116]

A group of companies in France is only dealt with as an entity in specific and remote provisions of the various branches of the law.[117]

§3. Choice of a Subsidiary or a Branch[118]

It is impossible to formulate an overall statement as to whether it is better to form a subsidiary abroad or to establish a branch. Each particular case needs to be examined in the light of its own facts; not only does one need to take tax factors into consideration but also commercial, economic and legal ones.

The purpose of forming a subsidiary or establishing a branch abroad is to get established on the local market and the following survey will point out to the

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116. Aktiengesetz of 6 September 1965. For a development on it, see F. Wooldridge, "The Definition of a Group of Companies in European Law", The Journal of Business Law (1982) pp. 272-280.

117. For instance company law, art. 356 of the law of 1966; tax law as regards the nationality of subsidiaries of foreign companies. Paris 20 March 1944, Dalloz (1945) 24, note Basdevant. For a general brief survey, see R. Rodière op.cit., note 9 above, §§ 369-386; G. Ripert, op.cit., note 109 above, pp. 488-499.

118. See in general M. Edwardes-Ker, op.cit., note 34 above Chapter 3; G.B. Smethurst, "Overseas Companies: Establishing a Place of Business in Great Britain", Business Law Review (1982), pp. 311-314: the author examines the requirements of the Companies Acts and suggests that foreign companies should consider operating through a branch more often.

reader some of the problems to look into before deciding to set up a branch or a subsidiary, in the United Kingdom or in France.

I. A Subsidiary is a Separate Legal Entity

One advantage of a branch over a subsidiary is that the legal structure remains simple. A branch is only a division of the company: the head office and its branch remain a single legal entity whereas a subsidiary is an entity separate from its parent.

In a parent-subsidiary relationship, the liability of the subsidiary is limited; the parent is not responsible for the obligations of its foreign subsidiary; conversely, losses of a foreign subsidiary are not deductible from the results of the parent. However, there may be a risk for a subsidiary to be declared to have acted as an agent for its parent and be treated as a branch.[119]

II. Initial Cost

In the United Kingdom and in France, it is marginally cheaper to establish a branch than form a subsidiary.

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119. Firestone Tyre and Rubber Co Ltd v. Lewellin (Inspector of Taxes) (1957) 1 All ER, p. 561.

A. In the United Kingdom[120]

There are no special duties on the creation of a branch.[121]

On registration by a limited company incorporated in the UK, a fixed company registration charge of £50 is to be paid; also stamp duty at the rate of 1 per cent. on the value of contributions to the capital of a company effectively managed in the UK or effectively managed outside the EEC that has its registered office in the UK.[122] There is no distinction made for the purposes of UK stamp duty between contributions of cash and contributions in kind.[123] Stamp duty and other costs involved in the formation of a company are not deductible for purposes of corporation tax.

Any branch or subsidiary of a French resident company which carries on business in the UK will have to register for VAT,[124] unless only exempt supplies are to be made.

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120. International Bureau of Fiscal Documentation (hereinafter cited as IBFD), Guides to European Taxation, Vol. II. The Taxation of Companies in Europe, United Kingdom, Supplement No. 48, April 1983.

121. Ibid., 168.

122. Ibid., 142.

123. Ibid., 145.

124. For details, see Tolley's Tax Planning op.cit., note 28 above, p.583.

B. In France

There are no registration taxes or duties of the establishment of a branch.[125]

On the formation of the capital of a subsidiary, a distinction is to be made between contributions in cash (*apport en espèces*) or in kind (*apport en nature*) against shares and contributions for consideration other than shares (*apports à titre onéreux*). The latter are subject to registration tax rates of 4.8 per cent. to 16.6 per cent., depending on the circumstances.[126]

Contributions of cash to capital against shares are subject to a registration tax (*droit d'apport ordinaire*) of 1 per cent.[127]

Contributions in kind are subject to registration taxes at the rate of 1 per cent. on land buildings contributed to a company subject to corporation tax by another company or legal entity also subject to corporation tax. The rate of the registration tax increases to 11.4 per cent. on land and buildings contributed to a company subject to corporation tax by a *société* or individual not subject to corporation tax.

The rate of registration tax is also 11.4 per cent. on goodwill (clientèle), leasehold rights and shares

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125. IBFD, *op.cit.*, note 120 above, France, Supplement No. 24, January 1979, 131-141.

126. *Ibid.*, 163; also *Précis de Fiscalité*, Vol. 2 (1983) §4600 onwards.

127. CGI, art. 809-810.

of "transparent" real estate companies contributed to a company subject to corporation tax by a company or individual not subject to corporation tax.[128]

III. Taxation of Profits

A. Activities performed through a branch

1) A UK resident company performs activities in France through a branch

. Corporation tax

Under the UK/F convention, a branch is a permanent establishment (art. 4); its profits are subject to French corporation tax at the rate of 50 per cent.

. Impôt de distribution

In addition, the UK resident company is to pay a 10 per cent additional tax on the profits of the branch.[129]

It may be explained by the existence of a provision of French domestic law: art. 115 of the General Tax Code. Art. 115 creates the following presumption: the profits of the branch of a non resident company are deemed distributed to non residents. The domestic rate of the withholding tax on the deemed distributed profits is 25 per cent; it is reduced to 10 per cent in the UK/F double taxation agreement.

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128. IBFD, op.cit., note 120 above, 134-138, pp. 29-30.

129. UK/F, art. 10.

This will find no counterpart in the context of a French resident company carrying on an activity in the UK through a branch.

The payment of this withholding tax may only be provisional: if the non resident company can establish that the profits actually distributed abroad within twelve months following the taxable year are less than the profits realised in France or if it can show that a distribution has been made to residents of France, it will obtain a refund from the French tax authorities.

. Total liability to tax in France

Under domestic law, the profits of a branch of a non resident company are subject to corporation tax at the rate of 50 per cent.. In addition to the French corporation tax payable on the same basis as for a French company, branches of non resident companies pay a withholding tax at the rate of 25 per cent.on their profits after deduction of corporation tax. In the absence of a double taxation agreement, French branches of non resident companies pay tax on distributed income at the rate of 62.5 per cent. (50 per cent. corporation tax plus 25 per cent. on the remaining 50 (12.5)). The terms of art. 10 of the UK/F tax convention reduce the domestic normal rate of 25 per cent. to 10 per cent. (15 per cent. of two thirds, as formulated in art. 10). The tax burden on distributed income of a French branch to its UK head office is therefore 55 per cent. (50 per cent. corporation tax plus 10 per cent. withholding tax on the balance).

In the UK under domestic and treaty law, a credit will be given for taxes paid in France, but the UK foreign tax credit does not exceed the sums that would have been payable in the UK on the same profits.

. UK worldwide principle of taxation

The UK applies the principle of worldwide taxation of the profits of its resident companies. Accordingly, the profits of the French branch of a UK resident company, which does not constitute a separate legal entity resident in France, are liable to UK corporation tax.

The UK mitigates the double taxation on the profits of the French branch by granting a tax credit for tax paid in France on those profits. It does so both under domestic and treaty law. The rate of tax in France (55 per cent.) exceeds that in the UK (50 per cent.). No refund will be given by the UK on the liability to tax in excess of the UK domestic tax due.

2) <u>A French resident company performs activities in the UK through a branch</u>

. Corporation tax

The profits of the UK branch of the French resident company will be subject to corporation tax at the maximum rate of 52 per cent. for the financial year 1983-84. There is no advance corporation tax (ACT) on distribution of the profits of a branch.

If the profits of the UK branch were within the limits of the UK reduced rate of corporation tax applicable to small companies, could the branch benefit from it?

In the Finance Act 1983, the small companies rate (for the financial year 1982, commencing on 1 April 1982 and ending on 31 March 1983) was reduced to 38 per cent..[130] The reduced rate applies where the profits do not exceed £100,000 with marginal relief available when the profits do not exceed £500,000.

One may reasonably think that on the basis of the non discrimination provision of the UK/F agreement,[131] no discrimination is to take place between nationals of the UK and of France and the question above is to be answered in the affirmative. If the benefit of the 38 per cent. rate was not given to the French company, assuming that its total profits are lower than the figure mentioned above, this would amount to a violation of art. 25 on non discrimination: such benefit would be granted to a UK company, but not to a French one.

. Territorial principle

As a consequence of the application of the territorial principle in France, the profits of the UK branch of the French resident company are not liable to French

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130. The small companies rate used to be 40 per cent. On the innovation, see Taxation (1983) p. 661.

131. UK/F, art. 25.

corporation tax; they are realised abroad. Therefore, there is no need for a tax credit to intervene in order to mitigate a double taxation that will not arise.

Profits of a UK branch of a French resident company in the UK will not be taxable in France.

Are the generous UK domestic provisions on stock relief and first year allowance, and other attractive aspects of UK corporation tax applicable to branches of French companies?

On the basis of the non discrimination provision contained in the UK/F tax convention, the question ought to be answered in the affirmative.

However, domestic provisions on group relief for instance do not apply to non resident companies; does this not amount to discrimination on the grounds of nationality?

Profits received by the French resident company from its UK branch may be distributed. Such distribution will be subject to the précompte as it has not been subject to French corporation tax at the rate of 50 per cent.

B. Activities performed through a subsidiary

1) A UK resident company performs activities in France through a subsidiary

. Corporation tax

The profits of the French subsidiary will be liable to corporation tax at the rate of 50 per cent..

. Précompte

In case the profits of the French subsidiary had not been subject to corporation tax at the rate of 50 per cent., the French subsidiary would pay a précompte (compensatory tax) to the French tax authorities on the proportion of its profits which had not been subject to corporation tax at the rate of 50 per cent..

Profits of the French subsidiary on a UK resident company may not be subject to French corporation tax if it carries on its business activity outside France.

. Distribution

When the French subsidiary distributes dividends in the UK, the French tax authorities will levy a tax of 5 or 15 per cent., depending on whether the UK company is a direct investor - i.e. if it controls 10 per cent. or more of the voting power of the French company - or a portfolio investor - i.e. a UK resident company that holds less than 10 per cent. of the voting power.[132] In the absence of a double taxation agreement, a withholding tax is levied at the rate of 25 per cent..[133]

In the UK, the dividends received from the French subsidiary will be subject to UK corporation tax with a credit for taxes paid in France.

. Subsidiary treated as a branch by the UK

The French subsidiary of a UK company may

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132. UK/F, art. 9.

133. CGI, art. 119 bis.

be treated as a branch: the UK company can set up a subsidiary in France and ensure that the subsidiary is in fact resident in the UK under the domestic concept of management and control. Provided that the French subsidiary is 75 per cent.owned by the UK parent, the parent can set off the subsidiary's losses against its own taxable profits under ICTA, s. 258. This technique will be particularly advantageous as the carry forward of tax losses is restricted to 5 years in France.[134]

2) <u>A French resident company performs activities in the UK through a subsidiary</u>

. Corporation tax

The profits of the UK subsidiary will be liable to corporation tax at the rate of 52 per cent.for the financial year 1983-84.

The reduced rate of corporation tax applies to small companies.

. Distribution of dividends

Under the UK/F tax treaty, in the UK ACT is levied on dividends distributed from a UK subsidiary to its French parent; in addition, a 15 per cent.withholding tax is levied when the French investor is a portfolio investor, no withholding tax is due when the investor is a direct investor.[135]

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134. M. Edwardes-Ker, <u>op.cit.</u>, note 34 above, Chapter 3, p. 4.

135. UK/F, art. 9; in the absence of a treaty, there is no withholding tax on dividends.

In France, the profits received by the French parent from its UK subsidiary will be 95 per cent. exempt from French corporation tax as a result of the application of the affiliation privilege which has been developed elsewhere.[136]

From the point of view of a UK resident company wanting to carry on business in France, if the French operation is likely to incur losses in the beginning, a branch operation may be preferable because in application of the principle of taxation on a worldwide basis, the UK company could deduct the losses of the French branch from its own domestic profits.

Subsequently, when the activity of the UK company carried out in France through a branch becomes profitable, its conversion into a subsidiary may be considered.

For the transformation to take place, under s. 482 of the ICTA 1970, the UK resident company will need to obtain the consent of the Treasury because the conversion of a foreign branch into a subsidiary will amount to the transfer of a UK company's trade abroad.

Since the Conservative Government elected in May 1979 abolished exchange control in the autumn of the same year, the consent of the Bank of England under the 1947 Exchange Control Act is no longer required prior to the formation of a subsidiary abroad.

Furthermore the conversion may attract capital

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136. See above, Part I, Chapter 3, pp.304 and 320.

gains tax.[137]

Alternatively, in order to change a branch into a subsidiary, the branch will cease to carry on a trade in the UK; for purposes of corporation tax an accounting period of the transferor company will be deemed to end,[138] and the transferor company's income will be computed as if the trade were discontinued.[139] Terminal loss relief under ICTA 1970, s. 178 is not available and any accrued trading losses will be transferred to the subsidiary.[140]

IV. Treatment of Interest

The branch of a non resident company may not deduct from its taxable profits interest and royalties paid to its foreign head office.

Conversely, interest payments are allowed as deductions when made by a subsidiary to its parent situated abroad, subject to a withholding tax.[141]

However, a UK resident company wanting to set up a subsidiary in France is to be aware of the fact that in France, the deductibility of interest is limited by

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137. ICTA, s. 268A.

138. ICTA 1970, s. 247(3)(c). See, in general, Tolley's Tax Planning, op.cit., note 28 above, at p. 585.

139. Ibid., s. 251.

140. Ibid., s. 252.

141. CE 9 January 1981, Req. No. 10 145, reported in European Taxation (1981) at p. 63.

the existence of a debt/equity ratio. The rule of limitation is formulated in the General Tax Code;[142] it provides that interest on shareholders' loans is not an allowable expense to the extent that it exceeds the rate of interest charged on advances by the Bank of France (*taux des avances de la Banque de France*) plus two percentage points (*majoré de deux points*).

Another restriction is imposed under art. 212 of the same Code: interest paid to controlling shareholders (*associés ou actionnaires possédant, en droit ou en fait, la direction de l'entreprise*) is only deductible to the extent that the total amount of their loans does not exceed one and a half times the company's share capital. Such limitation does not apply to interest payments to a French parent company.[143]

The reverse situation will now be examined, *i.e.* that of a French resident company wanting to set up a subsidiary in the UK.

There is no debt/equity ratio in the UK. However, under domestic legislation, certain interest payments are treated as distributions and are not deductible for corporation tax purposes.[144] The enumeration of

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142. CGI. art. 39-1-3°.

143. S.N. Frommel, *Taxation of Branches and Subsidiaries in Western Europe, Canada and the USA* (London: Kluwer Publishing Ltd, 2nd ed., 1978) Chapter 2, §§19-2, p. 84.

144. ICTA 1970, s. 233(2)(d)(4). See also FA 1982, s. 60.

such non deductible payments includes interest on securities issued by a resident company paid to a non resident company where

- the borrower is a 75 per cent. subsidiary of the lender; or
- both are 75 per cent. subsidiaries of a third company which is not resident in the UK.[145]

This domestic provision has been overridden to a certain extent by the double taxation agreement between the UK and France, art. 11(5) in particular; it is only when more than 50 per cent. of the voting power of a French company (A) is owned by one or several UK persons (B) that the UK provision applies and interest paid by A to B will be treated as a distribution. Otherwise, in any other circumstances, UK domestic law is set aside.[146]

V. VAT

French branches and subsidiaries of foreign companies may broadly be said to be treated in the same way as regards the taxation of their profits.

However, a recent decision of the Conseil d'Etat[147]

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145. It will be pointed out here that for the purposes of this particular provision, a 75 per cent. holding is required whereas 50 per cent. were sufficient for the purpose of the provision examined above.

146. For a proper development on this point, see Chapter 2, Section 2.II.

147. Decision of 9 January 1981, Req. No. 10145, Timex. It reverses the solution arrived at before the tribunal administratif of Besançon on 23 September 1977. This decision is reported in English, European Taxation (1981), p. 63.

emphasizes the importance to be given to the impact of other taxes when deciding to set up a branch or a subsidiary, VAT (TVA, taxe à la valeur ajoutée) in particular.

The relationship between French subsidiary and foreign parent on the one hand, and French branch and foreign head office on the other are treated differently as regards VAT.

Payments made by a parent company to its subsidiary in financial distress in order to prevent the subsidiary's liquidation are regarded as consideration paid by the parent for services rendered by the subsidiary. The service is described as the maintenance of the parent's sales organisation, or the protection of its reputation and trademarks. Such payments are subject to VAT at 17.6 per cent.

When a similar type of payment takes place between a head office and its branch, it takes place within a single legal entity, therefore the liability to VAT does not arise unless specifically provided by the law.[148] The facts of the decision of 1981 involved sums (fonds) received by a French branch from its foreign head office and the Conseil d'Etat held them not to amount to receipts (recettes) and subject to VAT.

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148. Claude Gambier, op.cit., note 112 above, §§ 1027 and 1677.

Section 4: Dealing at Arm's Length

§1. The Arm's Length Principle[149]

I. Definition

> The expression dealing at arm's length is used in connection with transactions between separate but related taxpayers; it indicates that the transactions are carried out under conditions similar to those which would have been agreed upon by unrelated parties. The arm's length principle which has been adopted by the OECD Model and is followed by many countries should be placed in its proper context; in essence, it only provides a guideline for dividing the profits of a group among its members. 150

Setting higher prices on the transfer of goods or services to affiliates in countries where the effective rate of tax is higher and lower prices on transfers to affiliates in tax havens is commonly referred to as transfer pricing; it is the most common form of violation of the arm's length principle:

> it consists in a transfer of profits from one country to another by means of a manipulation of prices, such as an increase of the purchase price or decrease of the selling price. Other methods are "available" to transfer profits from one country to another: over valuation

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149. The translation into French of the expression "arm's length" is not always uniform. The OECD itself suggests two translations: "de pleine concurrence" and "en toute indépendance"; one may also find "conditions commerciales normales".

150. S.N. Frommel, op.cit., note 143 above, at p.73.

of royalties paid in exchange of the grant of a license, a patent; loans can be granted to foreign subsidiaries under abnormal terms, for instance. 151

In the UK/F agreement, the application of the arm's length principle to the relationship between a permanent establishment and its head office is formulated as follows: the profits of the permanent establishment amount to those "which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment".[152]

The present section will consider separately the application of the arm's length principle to the relationship of a branch-head office, (§2) and that between a parent and its subsidiary company (§3).

The lack of respect of the arm's length principle is fought at different levels: the UK and France have enacted specific legislation: ICTA 1970, s. 485 and CGI, art. 57 respectively.

These domestic provisions have been examined in Part 1 of this work, Chapter 6 in particular.

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151. See the Third Report of the French Conseil des Impôts (Tax Council) presented to the President of the Republic in July 1977; Official Journal of the French Republic, 4 August 1977, Editions des documents administratifs. For excerpts in English, see European Taxation (1978) Vol. 18, pp. 114-123. The latest report of the Conseil des Impôts was published on 24 February 1983; it mainly focuses on VAT. See Tax News Service (1983) Vol. 12. The Conseil des Impôts was formed in 1971 by the French Government to further its policy of preventing fiscal irregularity and tax fraud. It is a consultative body, independent from the tax authorities.

152. UK/F agreement, art. 6(2).

The violation of the arm's length principle is also fought against in bilateral tax agreements: arts. 6 and 8 of the UK/F tax convention will be examined below.

Finally, multinational cooperation is taking place: in order to tighten their control, tax authorities have pooled their efforts in certain areas. The main aspect of this international cooperation is to be outlined now.

II. International Cooperation

• In the context of the EEC,[153] a directive has been issued in 1977.[154] It concerns mutual assistance between the tax authorities of the member states. This directive was amended in 1979.[155]

• The Committee on Fiscal Affairs of the OECD has recently shown its particular concern as regards the problem of tax avoidance and evasion in general. In 1980, a report entitled "Tax Evasion and Avoidance" was published. Its purpose is to attempt to delimit the scope of tax

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153. For a recent assessment of the EEC achievements and projects in the field of taxation, see Alex Easson, Tax Harmonisation in the EEC: The Commission's Programme", BTR (1981) No. 6, pp. 329-348.

154. Directive of 19 December 1977, OJEC No. 1336, 27 December 1977 at pp. 15-20. See also, C.S. Simons, "EEC Developments: The EEC Against Tax Evasion", European Taxation (1978) Vol. 18.

155. See Introduction, Chapter 9.

avoidance, compare the attitude of the courts to tax avoidance in various countries and examine the various forms of legislative action used in member countries to fight it.[156]

. In the more specific area of transfer pricing, the OECD has issued in 1979 a document entitled "Transfer Pricing and Multinational Enterprises". The main objectives of the report are to set out the considerations to be taken into account and to describe, where possible, generally agreed practices in determining transfer prices for tax purposes.

The basic point of reference on the entire report is the arm's length price. The Committee on Fiscal Affairs has attempted to set out the means available for determining an arm's length price in connection with transactions between associated enterprises.

The first chapter sums up the problems of application of the arm's length principle; the rest of the publication covers, in some detail, some of the more important types of transfer which take place between associated enterprises: transfer of goods, know-how and trademarks, for instance.

. The United Kingdom and France are taking part in another form of international tax cooperation first disclosed

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156. Committee on Fiscal Affairs (Working Party No. 8), Tax Evasion and Avoidance (Paris: OECD, 1980). The views of the French and British Tax Administrations on the issue appear on pp. 55 and 86 respectively.

by a communication of the French Minister of the Budget on 15 March 1979.[157] This experiment also involves West Germany and the United States and consists in a concerted action of all four countries in order to consolidate and coordinate cooperation in the field of international avoidance and evasion. The cooperation is based on mutual assistance clauses contained in double taxation agreements; it is realised by the following means:

- annual meeting of the heads of tax administrations in order to exchange views and information as regards means of tax avoidance and fraud;
- more regular meetings of civil servants for the purpose of exchange of information.[158]

§2. Application of the Arm's Length Principle to the Relationship between a Branch and its Foreign Head Office

I. Domestic Law

Under UK domestic law, ICTA 1970, s. 485 covers a transaction between a UK parent and its foreign subsidiary, but not a transaction between a UK head office and its overseas branch.[159]

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157. Droit Fiscal (1979) No. 14, comm. p. 696. Also, "La Fraude et l'Evasion Fiscales Internationales", Droit Fiscal (1979) No. 20, pp. 602-605.

158. Ibid.

159. See Part I, Chapter 6, Section 1.I, limitations of s. 485.

Conversely, art. 57 of the French General Tax Code applies to the relationship between a head office and its foreign permanent establishment because they are treated for tax purposes as two separate enterprises.[160]

II. Treaty Law

A. The direct method

1) Branch as a separate entity

For the purposes of computation of profits, those of an enterprise situated in one state shall be taxable in the other only if the enterprise carries on business there through a permanent establishment.[161]

A branch is only a division of a company; the branch and its head office form a single legal entity. However, a fiction is used to determine the taxable base of a branch, or any other type of permanent establishment: the branch is treated as a distinct enterprise, separate from its head office, dealing with it at arm's length.[162]

This approach is not in line with the legal definition of a branch; profits are attributed to a branch on a separate enterprise footing. This technique used to assess the taxable profits of a permanent establishment is

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160. This is a consequence of the territorial principle; see Part I, Chapter 6, Section 2.I.

161. UK/F, art. 6(1).

162. *Ibid.*, art. 6(2).

called the direct method.

Since a branch and its head office are treated as if they were separate, a transaction between them is to be recorded at the value it would have had if the parties were at arm's length.

The UK/F tax agreement follows exactly the OECD Convention.[163]

2) Deductions

Having established that the permanent establishment is treated as an independent enterprise for the determination of its profits in art. 6(2), art. 6(3) of the UK/F agreement gives details as to what is to be treated as a deduction in the course of the computation of profits: executive and general administrative expenses incurred for the purposes of the permanent establishment, irrespective of the fact that such expenses may be incurred in the country of situation of the permanent establishment or elsewhere. Clearly, the place where the expense is incurred is irrelevant, as long as it is incurred for the purposes of the permanent establishment.

A proportionate part of general administrative expenses incurred at the head office, based on the ratio that the permanent establishment's turnover bears to that of

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163. UK/F agreement, art. 6(2) is an exact copy of OECD Draft art. 7(2); only the expression "arm's length" replaces "wholly independently" used in the 1963 Draft.

of the enterprise as a whole, may be "allocated" to a permanent establishment and treated as a deductible expense.[164]

Art. 6(3) excludes as deductible expenses, "those which would not be deductible if the permanent establishment were a separate enterprise". Such an approach is consistent with the treatment of the permanent establishment as a separate enterprise. This specific exclusion of "expenses which would not be deductible if the permanent establishment were a separate enterprise" is not contained in the OECD Draft, nor the Model convention.

Can it be said that interest and royalties qualify as "expenses" and therefore that they are not deductible in the computation of profits of the permanent establishment because interest and royalties would not be deductible from the profits of a subsidiary according to arts. 11(4) and 12(3) of the UK/F tax agreement?[165] It seems that the question is to be answered affirmatively. Such an interpretation is in line with the development contained in the 1977 OECD commentary.[166]

B. The indirect method

This is an alternative to the allocation of profits

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164. OECD Commentary, §15, p. 76.

165. Arts. 11(4) and 12(3) provide that interest and royalties are not deductible; they are treated as business profits, not as investment income.

166. Commentary on art. 7(3), §17 at p. 76: interest and royalty payments made by a permanent establishment to its head office should not be allowed as deductions in computing the permanent establishment's taxable profits.

on the basis of separate accounts described above.

Art. 6(6) of the UK/F agreement provides:

> In so far as the law of a Contracting State which is in force at the date of signature of this Convention provides for determining the profits to be attributed to a permanent establishment on the basis of an apportionment of the total income and expenses of the enterprise, nothing in paragraph (2) shall preclude that Contracting State from determining the profits to be taxed by such an apportionment provided that the result shall be in accordance with the principles laid down in article 25 of this Convention.

Although the wording in the corresponding provision of the OECD convention is not exactly the same, the substance is identical.[167]

This method contemplates not an attribution of profits on a separate enterprise footing, as in art. 6(2), but an apportionment of total profits (_répartition des bénéfices totaux_).

Insofar as domestic legislation of a contracting state allowed at the time of signature the allocation of profits on the basis of an apportionment of total profits, the principle of allocation on the basis of separate accounts stated in the convention may be set aside as long as the results are in conformity with the non discrimination article.

The French tax authorities in the _Instruction_ of 1970 have interpreted art. 6(6) rather extensively: it states that where the French permanent establishment of a UK company does not keep (_n'est pas en mesure de tenir_)

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167. OECD, art. 7(4).

separate accounts (une comptabilité distincte), its profits may be determined according to criteria appropriate to the facts (suivant des critères appropriés aux circonstances de fait) or to the nature of the activity carried out.[168]

When the apportionment method is used, all parts of the enterprise are assumed to have contributed to the profits of the whole enterprise and each is allocated a part thereof, on the basis of one or several criteria.

Criteria are commonly based on the receipts of the enterprise (turnover or commission), its expenses (wages) or its capital structure (proportion of the total capital of the enterprise allocated to each branch).

The result arrived at is likely to be different when the direct and indirect methods are used. Although both national tax administrations and the OECD favour the direct method, one could argue that the indirect method, although arbitrary to a certain extent, less precise and sometimes less accurate because it takes a global, overall approach, should be given preference to the direct method which may correspond better to the economic reality but is based on a fiction and involves technicalities often too complex and subjective.[169]

On the other hand, the application of the indirect method raises the problem of the method used in computing the total profits of an enterprise. Each country may have

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168. Instruction of 1970, §2332-3 (last paragraph).

169. See 1977 OECD Commentary on art. 7(4), §§24-27, pp. 79-80.

its own laws as regards this matter; the UK and France certainly do.

§3. Application of the Arm's Length Principle to the Relationship between a Subsidiary and its Parent

I. Domestic Law: Parent-Subsidiary

A. UK: ICTA 1970, s. 485

This particular provision has been examined in Part I, Chapter 6, Section 1.

B. France: CGI, art. 57

This particular provision has been examined in Part I, Chapter 6, Section 2.

II. Treaty Law: "Associated Enterprises"

The problem of reallocation of profits between related companies is dealt with in art. 8 of the UK/F tax agreement. It provides:

> Where
> (a) an enterprise of a Contracting State participates directly or indirectly in the management (direction), control or capital of the other Contracting State; or
> (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State;
> and in either case 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 (_entreprises indépendantes_), then any profits (_bénéfices_) which would, but for those conditions, have accrued to one of the enterprises (_auraient été obtenus par l'une de ces entreprises_) but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly (_imposés en conséquence_).

This article deals with the parent-subsidiary relationship and companies under common control; it authorises the tax authorities to rewrite the accounts of an enterprise if the existence of special relations between enterprises at stake is reflected in the accounts between them. This article applies the arm's length principle to related companies.

This article is an exact replica of art. 9 of the 1963 Draft Convention on which the UK/F agreement is based.

Taking into consideration the suggestions of the IFA Congress of 1971 (Washington) and 1975 (London), the Committee on Fiscal Affairs has added a paragraph to the text of art. 9 of the 1977 Model. The new paragraph 2 provides for an adjustment to be made in State B when the profits of an enterprise in State A have been revised as a consequence of the application of paragraph 1. The purpose of the adjustment is to relieve the economic double taxation (taxation of the same income in the hands of different persons) created by the rewriting of transactions between A and B. Such an adjustment is not automatic. The tax administration in State B is committed to make an adjustment only if it considers that the adjustment made in State A is justified both in principle and as regards

the amount. No method by which an adjustment is to be made is specified in the new paragraph.[170]

The commitment of Contracting States as regards this provision is limited to the acceptance of the principle of application of an adjustment. States are left free in bilateral negotiations as regards the conditions of the adjustment, its method, and 'secondary adjustments' are alluded. Several very important industrialised countries - although not the UK nor France - have formulated reservations on the new paragraph 2. The United States on the other hand wishes to broaden its scope; such attitude is in line with its corresponding domestic legislation (IRC, s. 482).

An adjustment decided by a foreign tax administration in application of the arm's length principle does not compel the French tax administration to make a correlative adjustment so as to relieve the double taxation. No such obligation exists, neither under domestic law, nor under the terms of the 1968 Convention.

However, problems of correlative adjustments can be settled through the mutual agreement procedure (art. 26).[171] It will be dealt with in France by a special department of the General Tax Administration (Direction Générale des Impôts), "Sous-Direction III E". The approach of the "Sous Direction III E" seems informal, in

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170. See OECD Commentary on art. 9, paragraph 2 in particular, pp. 88-90.

171. Cf. Introduction, Chapter 8.

favour of direct contacts with the competent authorities of the other state involved.[172] In France, as in the United Kingdom, and contrary to the United States, there are no detailed regulations concerning the application of the arm's length principle. Cases are decided in the light of their own circumstances.

Section 5: Non Discrimination[173]

§1. Special Features

I. Principle of Non Discrimination

Art. 25 of the UK/F double taxation agreement - the counterpart of art. 24 of the OECD Draft Convention - establishes that discrimination on the grounds of nationality between two countries party to a tax convention is forbidden and that an enterprise of a contracting state (A) may not be less favourably treated in the other contracting state (B) than an enterprise of (A) in the same circumstances.[174]

For instance, a UK resident company which carries

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172. CDFI 1971, Washington, French Report, p. 197.

173. In general, see Instruction of 14 April 1970, §271, pp. 35-37; F. Lefebvre, op.cit., note 67 above, §§221-228, pp. 136-139; OECD Commentary on art. 24, pp. 162-174; also C. van Raad, "Non Discrimination", BTR (1981) pp. 43-48; CDFI Sidney (1978), "Difference in Tax Treatment between Local and Foreign Investors and Effects of International Treaties", Vol. 63b.

174. Art. 25(1).

on an activity in France may not be treated for tax purposes[175] less favourably than a French enterprise carrying on the same activity.

II. Personal Scope

Contrary to the personal scope of all the other articles of the UK/F tax agreement - which apply to residents of either contracting state - art. 25 applies to nationals, whether or not they are residents of the UK and/or France.

The term "national" means in relation to the UK and French enterprises all legal persons, associations and other entities deriving their status as such from the law in force in the UK and France respectively.[176]

All French and UK nationals are entitled to invoke the benefit of art. 25. This includes nationals who are not UK nor French residents, but residents of a third state.

For instance, a company registered in the UK, *i.e.* of British nationality, but resident in South Africa because its central management and control is exercised there can invoke the provisions of the UK/F agreement when a matter of discrimination on the grounds of nationality is at stake.

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175. *Ibid.*, art. 25(1) states "... shall not be subject in the other Contracting State to any taxation or any requirement connected therewith ..."

176. UK/F, art. 25(2)(a)(ii) and (b)(ii).

III. Criterion of Determination of Nationality for the Purposes of Art. 25

As regards the determination of the nationality of a company, under its domestic law, the UK follows the doctrine of incorporation, i.e. the nationality of a company is determined as a function of the location of its registered office.

In France, the siège social is the criterion to determine nationality.

For the purposes of art. 25, the country of incorporation determines the nationality of a company: nationals mean in relation to both the UK and France all legal persons, associations and other entities deriving their status as such from the law in the UK and in France respectively.[177]

IV. Taxes Covered

The application of the principle of non discrimination on the grounds of nationality is not restricted to the taxes enumerated under art. 1 of the UK/F agreement; it extends to all taxes.[178]

§2. Application

The text of the UK/F agreement emphasises the

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177. UK/F, art. 25(2)(a)(ii) and (b)(ii).

178. Ibid., art. 25(7).

principle of equality of treatment between the permanent establishment of a non resident company and a resident company;[179] it reiterates the same principle in relation to subsidiaries of non resident companies and resident companies.[180]

. Disparity in treatment between the French branch of a UK resident company and the French subsidiary of a UK resident company.

Such disparity in treatment is allowed by the text of the UK/F treaty itself.[181]

In the absence of a tax convention, a distribution by a French branch or a French subsidiary to a non resident company, whether a head office or a parent, are treated equally.

Profits of the branch - which constitutes a permanent establishment - and profits of the subsidiary are subject to French corporation tax at the rate of 50 per cent.. In addition, in order to treat in the same way distribution of profits of branches and subsidiaries, a

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179. Ibid., art. 25(3).

180. Ibid., art. 25(4).

181. UK/F, art. 23(3) states: "The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities; provided that this paragraph shall not prevent a Contracting State from imposing the tax referred to in Article 10". In fact, Contracting State in the last part of this sentence solely refers to France.

25 per cent. tax is withheld on the profits of the branch and on that of the subsidiary.[182]

Under the UK/F tax convention, profits of the French branch of a UK head office and that of the French subsidiary of a UK parent company are also subject to French corporation tax.

In addition, sums remitted to the UK by the French branch are subject to a 10 per cent. withholding tax. This is the result of the application of article 10 of the UK/F tax convention.

Art. 10 states:

> Where a company which is a resident of a Contracting State has a permanent establishment in the other Contracting State, it may be subjected therein to any withholding tax provided by the internal law of that other Contracting State but such tax shall not exceed 15 per cent. of two thirds of the profits of the permanent establishment after payment of the corporation tax on those profits.

This amounts to a 10 per cent. withholding tax on the profits of the French branch of a UK resident company. It is the treaty counterpart of art. 115 *quinquiès* of the General Tax Code.

Article 10 brings the total tax burden of profits of the French branch of a UK head office to 55 per cent..[183]

Dividends distributed by a French subsidiary to its UK parent are subject to a 5 per cent. withholding

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182. CGI, arts. 115 *quinquiès*, 119 *bis*-2, 187-1.

183. 50 per cent. corporation tax + 10 per cent. on the balance.

tax.[184] This brings the total charge to tax on profits of a subsidiary to 52.5 per cent.[185]

- Disparity in treatment arises on the remittance of profits. Under the UK/F tax convention, a withholding tax at the rate of 15 per cent[186] is levied on the distribution of dividends by a UK subsidiary to its French parent which qualifies as a portfolio investor.[187] No such withholding tax is levied under domestic law.

- Interest and royalties paid by a permanent establishment to its foreign head office are not deductible for tax purposes on the state of the location of the permanent establishment.

On the other hand, the same payments made by a subsidiary to its foreign parent are deductible when computing the profits of the subsidiary.

The branch receives a less favourable treatment than the subsidiary but this practice has been approved by the commentators of the OECD Model.[188]

As regards payments of interest from subsidiaries,

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184. UK/F, art. 9.

185. 50 per cent. corporation tax + 5 per cent. on the balance.

186. UK/F, art. 9A(1)(b).

187. I.e. an individual or a company which holds less than 10 per cent. in the voting power of its subsidiary.

188. Commentary on art. 7(3), §17, p. 76.

France introduces further discrimination: in France, the deductibility of interest is limited by the existence of a debt/equity ratio.[189] However, this limitation only applies to interest paid to non resident parents. This amounts to discrimination between French subsidiaries of French resident companies and French subsidiaries of non resident companies.

. Discrimination also exists in the following case: this time, the result is favourable to the UK resident company receiving dividends from its French subsidiary.

When the French précompte is paid on dividends distributed to UK direct investors, who are not entitled to the avoir fiscal,[190] the précompte is refunded under deduction of a withholding tax.

Conversely, ACT is levied on dividends distributed to French direct investors, who are not entitled to the tax credit, but ACT is never refunded.

A UK resident company receiving dividends from France in this particular case is better off than the French resident receiving dividends from the UK.

This development may be illustrated with figures: a French company pays a 50 per cent. précompte on the profits out of which the dividends are distributed to a UK resident

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189. See above, pp. 497-498.

190. The reason for paying such précompte lies in the fact that profit out of which the dividends are paid have not been subject to corporation tax at the rate of 50 per cent.

parent,[191] who holds more than 10 per cent. of the voting power of its French subsidiary. The UK parent is not entitled to the _avoir fiscal_; the _précompte_ is refunded to the French company subject to a 5 per cent. withholding tax.[192]

As regards a UK subsidiary paying a dividend to its parent, which qualifies as a direct investor, ACT is levied in the UK, at the rate of 30 per cent. for the financial year 1983-1984. No tax credit is attached to the dividend distributed, no tax is withheld on the dividend distributed, but the discrimination comes from the fact that no ACT is refunded.

. The following rule provides another illustration of the existence of disparity in treatment on grounds of nationality.

The UK tax legislation on groups of companies only applies to body corporate resident in the UK.[193] Consequently, the UK resident subsidiary of a French parent does not belong to any group unless a holding subsidiary resi the UK is interposed between the UK resident subsidiary and its French parent.

One could argue that on the basis of art. 25 of the UK/F agreement, the group relief ought to be given

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191. UK/F tax convention, art. 9-B(5)(a).

192. _Ibid_., art. 9-A(1)(c).

193. R. Bramwell, _op.cit_., note 84 above, Chapter 5, 5-16, pp. 58-59.

to the UK subsidiary of the French parent to the same extent as if a UK subsidiary of a UK resident parent were at stake, but the Inland Revenue holds a different view.[194]

Group relief provisions and group income provisions do not apply when the receiving company is not resident in the UK.[195]

- The small companies rate of tax normally only applies to UK resident companies. The non discrimination article of the UK/F double taxation agreement should operate so as to extend this advantage to the UK branch of a French resident company, provided it satisfies the conditions for relief.[196] The Inland Revenue has granted this advantage to the UK branch of a Swiss resident company on the basis of the provision on non discrimination in the UK/Swiss tax treaty.

As the UK/F provision on non discrimination is drafted in similar terms, it may reasonably be thought that the same advantage would be granted to the UK branch of a French resident company.

Finally, although the following decision does not involve the UK/F tax agreement, but that between France and

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194. J.B.D. Oliver, "Discrimination", BTR (1977) p. 148, at pp. 151-152; also BTR (1978) p. 75.

195. Ibid. See also a letter of the Inland Revenue to J.B.D. Oliver, BTR (1978) p. 198.

196. FA 1972, s. 95.

Switzerland signed on 9 September 1966, the provision on non discrimination is drafted in similar terms in both treaties and the issues of this decision are of immediate relevance in the context of the UK/F tax convention.[197]

A Swiss company had a French branch. The branch received dividends from French companies. The French companies deducted a 25 per cent. withholding tax from the dividends on the basis of CGI, art. 119 _bis_ 2. It states - _inter alia_ - that a 25 per cent. withholding tax is to be levied on all dividends paid to persons who do not have their _siège_ in France.

This assumes that the _siège_ of the company was in Switzerland where the head office was located.

The Swiss company claimed that its French branch should be regarded as having a _siège_ in France, and that accordingly the 25 per cent. withholding tax should not be levied. In other words, the Swiss company claimed that the French permanent establishment was to be treated as a resident company.

The Swiss company also claimed that the levy of a 25 per cent. withholding tax on dividends distributed to its French branch contravened the non discrimination provision of the tax convention between Switzerland and France.

The _tribunal administratif_ requested the opinion of the Ministry of Foreign Affairs on the issue of discrimination.[198]

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197. CE 19 December 1975, _Req_. No. 84-774 and 91-895, _Droit Fiscal_, 1976, p. 671; also ITTS.OECD Art. 24,p.18.

198. In France, the Government interprets treaties, not the courts; for further information on this point, see Introduction, Chapter 3.

The Ministry stated that art. 26(1) of the Swiss-French tax convention[199] was designed to preclude each contracting state from levying taxes in a way which was discriminatory on the basis of nationality, but that the article did not preclude "the levying of a discriminatory tax based on domicile".[200] He stated that art. 26(3)[201] had a similar scope. Its object was to "forbid a discrimination based on residence, but only such discrimination as could apply between a French national and a Swiss national conducting the same activity".

The decision of the _tribunal administratif_ was rendered in favour of the Swiss company, on the basis of the non discrimination article.

The matter was challenged before the _Conseil d'Etat_. It is interesting to point out that the outcome of this case before the _Conseil d'Etat_ goes against the _conclusions_ of the _Commissaire du Gouvernement_.

He concluded that the 25 per cent withholding tax should be withheld under domestic law, because the branch as such could not be treated as having a _siège_ in France. He then went on to examine whether art. 119 bis-2 was discriminatory on the basis of nationality or residence. The _Commissaire Fabre_ came to the conclusion

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199. _I.e._ art. 24(1) of the OECD Model and art. 25(1) of the 1968 UK/F tax agreement.

200. This first part of the Ministry's answer relates to individuals.

201. _I.e._ OECD art. 24(4) and UK/F art. 25(3).

that art. 119 bis-2 was discriminatory on the basis of residence, but not on the basis of nationality. Therefore, the treaty provision on non discrimination could not be invoked because it only covers non discrimination on the grounds of nationality.

"*Siège*" in art. 119 bis-2 was interpreted as meaning "place of effective management", in fact the treaty definition of residence, in case of dual residence.

The *Conseil d'Etat* did not decide whether the 25 per cent. withholding tax was discriminatory: it held that no withholding tax was due under French domestic law - *i.e.* under art. 119 bis-2. The reason for this lies in the interpretation of the expression "which do not have their *siège* in France" in art. 119 bis-2. The *Conseil d'Etat* has interpreted it as meaning an enterprise which is not subject to French corporation tax. *Siège* in art. 119 bis-2 does not mean registered office, place of incorporation but "an enterprise which was not subject to French corporation tax on this dividend". According to the *Conseil d'Etat*, art. 119 bis-2 only sought to impose a withholding tax on dividends paid to non residents who were not subject to corporation tax in France. The branch was to be regarded as having its *siège* in France because it paid corporation tax in France. Consequently, the 25 per cent. withholding tax was not due.

CHAPTER 2

TAXATION OF CERTAIN CATEGORIES OF INCOME BY THE COUNTRY OF SOURCE OR SITUS

Presentation

Chapters 2 and 3 will examine, with regard to the different classes of income, the respective rights to tax of the state of source or situs (Chapter 2) and of the state of residence (Chapter 3).

In a case of a number of categories of income, an exclusive right to tax is conferred on one of the contracting states; as a rule, this exclusive right to tax is conferred on the state of residence. In the case of other categories of income, the right to tax is not exclusive. As regards dividends (Chapter 2, Section 2, §1) and interest (Chapter 2, Section 2, §2), the right to tax of the state of source is limited.

Chapter 2 is divided into four sections: Section 1 focuses on the taxation of business income, Section 2 is devoted to the taxation of investment income, Section 3 will consider the taxation of income from immoveable property, Section 4, the taxation of capital gains.

Business income is taxed on a net basis in the country of location of the permanent establishment, at the local rate of corporation tax.

Investment income is taxed - if at all - on a gross basis; the taxation takes the form of a withholding

tax. The effect of a tax convention is to reduce or eliminate the domestic rates of the withholding taxes.

Section 1: Industrial and Commercial Profits (bénéfices industriels et commerciaux)

The reader is to approach this section with the previous chapter in mind, Section 2 in particular, dealing with the definition of a permanent establishment (UK/F agreement, art. 4).

Having tried to define a permanent establishment, the following question is now to be answered: which profits of the permanent establishment are to be taxed by the state where it is carried out?

From the moment the existence of a permanent establishment is established, does the treaty authorise the tax authorities to tax its profits without limit? The answer to this question is in the negative and the purpose of the following development is to analyse arts. 6 and 7 of the UK/F Convention and to set out the guidelines to be followed in order to assess the business profits[1] of a permanent establishment.

§1. Definition of Industrial and Commercial Profits

I. Definition and Terminology used in the UK/F Tax Agreement

The term "industrial or commercial profits" means

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1. See in general, Jurisclasseur de Droit International, Fascicule 354B.

income derived by an enterprise from the conduct of a trade or business including income derived by an enterprise from the furnishing of services of employees, or other personnel, but does not include income from immovable property, dividends - unless the recipient has in the other contracting state a permanent establishment with which the holding by virtue of which the dividends are paid is effectively connected - or interest - unless the recipient has in the other contracting state a permanent establishment with which the debt claim is effectively connected - or royalties - unless the recipient has in the other contracting state a permanent establishment with which the right of property is effectively connected.[2]

The UK/F agreement uses the expression "industrial and commercial profits". This particular expression will sound familiar to the French lawyer as "_bénéfices industriels et commerciaux_" designate a specific category of income.

The expression is unknown in UK domestic legal terminology, but it corresponds to the domestic concept of trade.

The OECD counterpart of art. 6 of the UK/F agreement is entitled "Business Profits" (_Bénéfices des Entreprises_). In the text of the provision, the word "profits" is used.

For the purposes of this work, business profits, industrial and commercial profits, business income and profits will be treated as synonymous.

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2. UK/F, arts. 6(5) and 9(8), 11(4) and 12(3).

II. Definitions under Domestic Laws

Under French domestic law, the expression bénéfices industriels et commerciaux is originally part of the terminology on income tax (impôt sur le revenu). The total income of a taxpayer consists of his income arising under different categories - one of which is industrial and commercial profits.[3]

The General Tax Code defines "bénéfices industriels et commerciaux" for the purposes of income tax in arts. 34-35 bis. The determination of profits subject to corporation tax is the same as the determination of industrial and commercial profits subject to income tax.[4] However, a major difference lies in the fact that the territorial principle applies to legal persons, the world-wide principle to individuals.

As regards the application of French domestic income tax, bénéfices industriels et commerciaux include profits from the carrying on of an industrial, commercial and craft (artisanale) activity; it also includes profits realised by "marchands de biens" i.e. persons who purchase buildings, or shares in real estate companies for the

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3. In the General Tax Code, Chapter 1 is entitled "Impôt sur le Revenu" (income tax). The first section of this chapter deals with general considerations (dispositions générales, arts. 1-11); section II is entitled taxable income (revenus imposables); it is divided into several paragraphs, one of which is industrial and commercial profits. Art. 209-I dealing with corporation tax states that profits subject to corporation tax are determined according to arts. 34 to 45, 57 to 58 and so on.

4. Introduction, Chapter 4, Taxes Covered, Section 2.

purpose of selling them again.[5] It also includes profits accruing to persons acting as intermediaries (*intermédiaires*) in the above mentioned transactions, rents arising from the letting of furnished business accommodation and from the letting of furnished residential property on an habitual basis.

Under UK domestic law, profits mean income and capital gains of a company; industrial and commercial profits designate profits of a trade.

Under the UK/F agreement, profits from the letting of a building would not qualify as industrial and commercial profits; they would come within the scope of the provision dealing with immovables.

§2. Computation of Profits

I. Principle

Under the provisions of the UK/F double taxation agreement, a UK resident company will be taxable in France if it carries on business there through a permanent establishment.[6]

A. Existence of a permanent establishment

The concept of permanent establishment has been

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5. CGI, art. 35.I.1°. Under the UK/F tax convention, such category comes under another heading.

6. UK/F art. 6(1). The same rule would apply to a French resident company which carried on an activity in the UK.

examined in Part II, Chapter 1, Section 2.

B. Income taxable as "business profits"

1) Income attributable to a permanent establishment

Only so much of the business profits as are "attributable" to the permanent establishment are taxable in the state of location of the permanent establishment.[7] "The right to tax does not extent to profits that the enterprise may derive from that state otherwise than through the permanent establishment".[8]

In computing the profits that a UK resident company derives from its permanent establishment in France, the French tax authorities will look at the separate sources of profit in France and apply to each of them the permanent establishment test.

The UK/F tax agreement attempts to be more specific than the OECD Draft Convention on which it is based as regards the scope of art. 6.

Income derived from the conduct of a trade or business, income derived from the furnishing of services of employees or other personnel will qualify as industrial and commercial profits.[9]

Income from immovable property, and income

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7. Ibid.

8. Commentary on OECD art. 7(1), 4, p. 73.

9. UK/F, art. 6(5).

received by an individual as compensation for personal (including professional) services will not.[10]

Nor will profits arising from the mere purchase of goods or merchandise by the permanent establishment qualify as business profits of the permanent establishment.[11]

The categories of income excluded from art. 6 are dealt with in separate provisions of the UK/F agreement. For instance, income from immovable property is dealt with under art. 5.

The provisions which the UK/F agreement has added to the 1963 Draft are consistent with a general rule of interpretation stated in the 1977 commentary whereby the provision on industrial and commercial profits will not be applicable to categories of income covered by special articles.

2) The "effectively connected" rule

Investment income (dividends, interest, royalties) whose tax treatment will be described below in Section 2, may be taxed as part of the industrial and commercial profits of the French permanent establishment of a UK resident company, therefore be assimilated to business profits.

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10. Ibid.

11. Ibid., art. 6(4). This is consistent with the definition of permanent establishment in art. 4(3)(d) in particular which deems not to amount to a permanent establishment the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise.

Two conditions need to be fulfilled for investment income to be treated as business income.

- The UK resident company is to carry on business in France through a permanent establishment and derive dividends, interest or royalties from it;

- "the holding by virtue of which the dividends are paid"[12] or "the debt-claim from which the interest arises"[13] or "the right or property giving rise to the royalties"[14] is to be effectively connected with the permanent establishment.

The investment income is effectively connected with a branch or other permanent establishment when the shares, debt-claims or the rights of property form part of the assets of the permanent establishment.[15]

II. Exception

Art. 7 of the UK/F double taxation agreement runs as follows:

> Profits which a resident of one of the Contracting States derives from the operation of ships or aircraft in international traffic shall be taxable only in that State.

International traffic is defined under art. (2)(1)(i) of the UK/F agreement as including "any voyage of a ship or aircraft

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12. UK/F, art. 9(8).

13. Ibid., art. 11(4).

14. Ibid., art. 12(3).

15. See OECD commentary on arts. 10(4), 11(3) and 12(3) which are the counterparts of UK/F arts. 9(8), 11(4) and 12(3).

other than a voyage solely between places in the Contracting State of which a person deriving the profits of the operation of a ship or aircraft is a resident".

Profits for this type of activity are exclusively taxed in the state of residence of the company.[16]

§3. Methods of Taxation

The direct and indirect methods have been examined in Chapter 1.

Section 2: Investment Income

§1. Dividends

I. Definitions

A. Definition of dividends according to the UK/F double taxation agreement

According to art. 9(9), "dividends" as used in that article means:

> income from shares (actions)[17] jouissance shares or jouissance rights (actions ou bons de jouissance)[18] mining shares (parts de

16. See also Chapter 1, Section 4.

17. Under French domestic law, the word parts is used to designate shares in a limited liability company, see Part I, Chapter 1.

18. A company may reimburse the nominal value of a share to a shareholder. Such procedure is called amortissement du capital. The reimbursement is paid out of /Continued over

> *mines*), founders' shares (*parts de fondateurs*) or other rights (*autres parts bénéficiaires*), not being debt-claims (*créances*) participating in profits, as well as income treated as a distribution by the taxation law of the state of which the company making the distribution is a resident. 19

"Dividends" for the purposes of the convention is given a broad and wide meaning: next to a specific enumeration, the definition includes "income treated as a distribution by the taxation law of the state of which the company making the distribution is a resident".

Both the United Kingdom and France treat certain categories of payments, not automatically the same, as distributions; they therefore have to be considered separately.

B. Definition of distributions under domestic legislations

As far as it has been possible for the purposes of this paragraph B., it is attempted to establish a

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Footnote 18 continued from page 533.

profits or reserves, but not out of the share capital. The *amortissement* is regarded as an anticipated payment to the shareholder of his share in the future winding up of a company. The holder of an *action de jouissance* will be entitled to a smaller dividend than that of a capital share (*action de capital*).

An *action de jouissance* is traditionally opposed to an *action de capital*. The latter is a share whose nominal value has not been reimbursed to the shareholder. The purpose of an *amortissement du capital* seems to be for a company to make its future winding up easier; G. Ripert, *Traité Elémentaire de Droit Commercial* (Paris. LGDJ, 10th ed., 1980), Vol. 1, §1176, at p. 761.

19. This provision is similar to the definition of dividends in the OECD Model Convention, art. 10(3).

parallel between the meaning of "distribution" under British and French laws: differences between both systems exist; they are reflected in the following presentation.

1) United Kingdom

In the United Kingdom, the term "distribution" is defined in sections 233 to 237 of ICTA 1970, as amended by section 106 of and Schedule 22 to the 1972 Finance Act.[20]

a) Distributions in respect of shares

Dividends

Any dividend paid to the shareholders of a company, including a capital dividend, is a distribution.[21]

Other transactions will be treated as distributions:

. Any distribution out of the assets of a company in respect of shares. If such a transaction is a repayment of share capital, or if the payment is made for new consideration, it does not constitute a distribution.[22]

. Where share capital is repaid and the company issues

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20. See B. Pinson, Revenue Law (London: Sweet and Maxwell, 14th ed., 1981) Chapter 14, pp. 282-286; also, J. Tiley, Revenue Law (London: Butterworths, 3rd ed., 1981), Chapter 31; R. Bramwell, J. Dick, Taxation of Companies (London: Sweet & Maxwell, 2nd ed., 1979), Chapter 7, pp. 80-89; Booklet Peat, Marwick, Mitchell & Co., UK Corporation Tax, issued in 1979.

21. ICTA 1970, s. 233(2)(a).

22. Ibid., s. 233(2)(b). The meaning of "new consideration" is clearly explained in R. Bramwell, op.cit., note 20 above, 7.03: it does not always refer to consideration that really is new. "The definition of the expression is perhaps best understood as being designed to secure a negative object, that objective being to prevent capitalised reserves from being treated as new considerations."

bonus shares at the time or after the repayment, the bonus issue is to be treated as a distribution.[23] It will not be treated as such if the company is a quoted company, the bonus issue is of share capital other than redeemable share capital and it takes place after 5 April 1973 and more than ten years after the repayment of share capital.[24]

. Any bonus issue of redeemable shares or securities issued in respect of shares or securities in the company.[25]

. Any excess in the market value of an asset transferred by a company to its members, or of a liability transferred to a company over any new consideration given. This does not apply where the assets or liabilities are transferred between UK resident companies one of which is a subsidiary of the other or both are subsidiaries of a third one.[26]

Distribution made in respect of share capital in winding up

Nor do distributions of a company include a distribution made in respect of share capital in a winding up.[27]

b) Distributions in respect of debentures

Transactions between resident companies

Interest paid on debentures of a company is treated

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23. Ibid., s. 234.

24. Cf. FA 1972, Schedule 22, §§5 and 6.

25. Ibid., s. 233(2)(c).

26. Ibid., s. 233(3).

27. ICTA 1970, s. 233(1).

as a distribution if it is paid on bonus issues of debentures,[28] debentures convertible into shares,[29] debentures under which the amount of interest payable depends to any extent on the results of the company's business; debentures where the interest payable is at more than a reasonable commercial rate.[30]

Transactions with non resident companies

In addition, interest paid in respect of debentures issued by a company and held by a non UK resident company is treated as a distribution where any of the following conditions is fulfilled:

- the company which issued the debentures is a 75 per cent. subsidiary of the other company,

- both are 75 per cent. subsidiaries of a third one, non UK resident company,

- both the company which issued the debentures and the non UK resident company are 75 per cent. subsidiaries of a common UK resident parent company, unless 90 per cent. or more of the share capital of the company issuing the debentures is directly owned by a UK resident company.[31]

Art. 11 of the UK/F double taxation agreement dealing with the tax treatment of interest forbids interest

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28. Ibid., s. 233(2)(d)(i).

29. Ibid., s. 233(2)(d)(ii).

30. Ibid., s. 233(2)(d)(iii); only the excess of that interest will be regarded as a distribution.

31. Ibid., s. 233(2)(d)(iv).

payments made at arm's length between two associated companies from being treated as distributions; there is however one exception. The effect of domestic legislation is only partially overridden by treaty law.[32]

2) France

a) Distributions in respect of shares

Dividends

Under French domestic law, a distribution means primarily a dividend. Such types of distribution give rise to the *avoir fiscal*.[33]

Distributions made in respect of share capital in a winding up

As in the United Kingdom, repayments of capital (*remboursements d'apports*) on a liquidation are not treated as a distribution.

Hidden distributions

The following distributions do not entitle recipients to the *avoir fiscal*. The fact that the recipient of a notional distribution is not himself a shareholder does not prevent him being subject to tax in respect of it.[34] According to art. 117 of the General Tax Code, when the identity of the recipient (*bénéficiaire*) of the distribution is not known, the company is invited to reveal it within 30 days. If it refuses to do so, the company is subject to a

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32. For a proper development on this point, see the present chapter, Section 2, §2.

33. *Précis de Fiscalité*, Vol. 1, §§1498-99.

34. CGI, art. 111, §§d and e.

tax penalty (*pénalité fiscale*), non deductible and equal to 120 per cent. of the hidden distribution (*distribution occulte*). The rate of the penalty is reduced to 90 per cent. when the company has spontaneously declared to the tax administration the remuneration of the hidden distribution.[35]

b) *Distributions in respect of debentures*

A distribution is regarded as having taken place where excessive interest is paid on shareholders loan accounts,[36] excessive remuneration is paid to controlling directors[37] and non allowable "sumptuary" expenses (*dépenses somptuaires*) are incurred.[38]

No *avoir fiscal* is attached to such distribution.

c) *Miscellaneous*

According to art. 111 of the General Tax Code, when a company places funds at the disposal of shareholders,

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35. Law No. 80-30 of 18 January 1980, art. 72.

36. CGI, arts. 39-1-3e and 212; also, Claude Gambier, *Les Impôts en France* (Paris: Ed. F. Lefebvre, 12th ed., 1982), §133. To prevent tax avoidance, there are limitations on the deductibility of interest paid to shareholders: interest is in general not allowed where the share capital is not fully paid up (*intégralement libéré*) where the loan accounts of shareholders who control the company exceed one and a half times the share capital; interest is not allowed to the extent that it exceeds by more than 2 percentage points the rate of interest charged on advances by the Bank of France.

37. CGI, art. 39-9-1°; Claude Gambier, *ibid*., §§104-107. Companies are at liberty to pay their directors such remuneration as they think fit but the tax inspector is entitled to satisfy himself that the amounts paid are reasonable. Where he can establish that a remuneration is excessive, the excess will be disallowed and treated as a distribution. Every case is considered individually on its merits.

38. CGI, art. 39-4 (1st and 2nd *alinéas*).

it will be treated as a distribution (*revenu distribué*) unless the company shows that it amounts to a genuine loan (*véritable prêt*) at a proper rate of interest with a fixed repayment date (*date de remboursement*).

Certain other payments and transactions give rise to notional distributions for tax purposes:[39]

- where, following a tax audit (*vérification de comptabilité*), it is established that certain trading receipts have been omitted, a "disinvestment" (*désinvestissement*) is regarded as having taken place. The tax authorities will make an appropriate increase in the company's taxable profits and will also make corresponding adjustments to the amounts regarded as distributed.

Distributions made by French companies whose sole object is the construction, the acquisition of buildings (*immeubles*) or the management (*gestion*) of such buildings are not to be treated as dividends. Such distributions are to be considered as income from immovable property (*revenus immobiliers*).

For the purposes of the UK/F tax convention, the text of the *Instruction* of 14 April 1970[40] specifically excludes from the definition of dividend income from shares (*produits des droits sociaux*) held in French companies whose sole object is the construction or the acquisition of buildings (*immeubles*) in order to divide them into fractions

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39. CGI, art. 109; Claude Gambier, *op.cit.*, note 36 above, §363; L. Halpern, *Taxes in France* (London: Butterworths, 2nd ed., 1981) for the translation into English.

40. CGI, art. 1655 *ter*; Law of 15 March 1963, art. 30; *Instruction*, of 14 April 1970, §2331. See below, Section 3 for a more complete definition of *biens immobiliers*.

to be attributed to their members.

C. Meaning of "control" for the purpose of UK/F, art. 9

The meaning of control is of primary importance in relation to the taxation of distributions under the UK/F double taxation agreement: if the distributing company "controls" the recipient company, the latter will not be entitled to a tax credit.[41]

For the purposes of art. 9,

> a company shall be deemed to control another when either alone or together with one or more associated companies it controls directly or indirectly at least 10 per cent. of the voting power in that other company ... 42

1) Voting power

The UK/F agreement here departs from the OECD Draft and Model Conventions.[43]

The criterion of "voting power" is used under the UK/F agreement rather than that of capital.

The choice of the criterion of "voting power" rather than "capital" for purposes of definition of control is of significance. It has practical consequences due to the differences between the domestic legislations on this matter.

In France, the principle is one share - one vote;

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41. UK/F, art. 9 A-(3) and B-(6)(11)(9a).

42. Ibid., art. 9 C(10).

43. Such departure is mentioned in the 1977 Commentary on art. 10, §15 at p. 93.

it is subject to two exceptions.[44] In the UK, multiple vote is common.

In the UK, voting rights may vary considerably between shareholders. Separate classes of shares are created to reflect the different rights as to dividends, capital and voting.

A company in the UK is entitled to issue shares conferring any rights it thinks fit; "it only has to express its intention for this to be carried out" according to Professor Gower.[45] It seems that the only risk involved is that "if the rights of any class are unreasonably curtailed, the Stock Exchange may refuse a listing". As regards a classification of shares in the UK, the basic distinction is between preference shares and ordinary shares.[46]

Ordinary shares may not be all identical; they may rank equally as regards participation but may be divided into separate classes to reflect the existence of different voting rights. They are often distinguished as "A", "B", "C" ordinary shares. A company will issue non

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44. See below.

45. L.C.B. Gower, Gower's Principles of Modern Company Law (London: Stevens and Sons, 4th ed., 1979), Chapter 17, at p. 413.

46. A preference share confers preference over other classes of shares in respect of dividends. Preference shares carry a fixed rate of dividend payable in priority to the ordinary shares; it usually carries no right to dividend beyond the fixed amount; it may also carry restricted voting rights.

voting "A" ordinary shares. The existence of such shares may ensure that control is in the hands of a small proportion of shareholders. A company may also issue multiple voting shares which carry more than one vote each. This may enable a person who holds a small amount of the share capital to have control over the company if the shares that person holds are multiple voting shares. In *Bushell v. Faith*,[47] against the Companies Act, a provision of the articles which gave a director's shares special voting rights, *e.g.* three votes per share on a poll, on a resolution, was held to be valid.

In France, the situation is less permissive: all companies have a share capital. Shares have a nominal value. Each share carries one vote.

Double voting rights may be conferred upon registered shares which are entirely paid up and have been registered for no less than two years in the name of the same shareholder.[48]

Preference shares (*actions de priorité*, *de préférence*) carrying preferential rights to the profits may also be issued.[49] Preference shares may carry no voting right.[50]

Plural voting shares (*actions à droit de vote*

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47. (1970) AC, p. 1099.

48. Law of 24 July 1966, art. 175.

49. *Ibid*., art. 269.

50. Cf. G. Ripert, *op.cit*., note 18 above, §1186; law of 15 July 1978.

plural) in France are in principle forbidden.[51]

A law of 15 July 1978 has created a new type of share, the action à dividende prioritaire sans droit de vote (share with a priority dividend and no voting right).[52]

Such a type of share entitles directors to raise funds from the outside without losing their control of the company.

2) Associated companies

"Associated companies are defined in the text of the convention itself as meaning that one is "controlled directly or indirectly by the other, or both are controlled directly or indirectly by a third company".[53]

3) Control

According to the UK/F tax treaty, 10 per cent. is the threshold below which control does not exist.

If there is no control, the investor qualifies as a portfolio investor and he is entitled to the tax credit which domestic recipients of dividends are entitled to.

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51. Law of 24 July 1966, art. 175. This principle is subject to an exception formulated in art. 492 of the same law.

52. Law No. 78-741, Dalloz (1978), Legislation, at p. 312. For a commentary, see C. Jauffret Spinosi, Revue des Sociétés (1979), p. 25; also R. Rodière, Droit Commercial (Paris: Dalloz, 10th ed., 1980), §284, at p. 305. This law has been incorporated in the law on commercial companies and partnerships of 1966, at arts. 177-1, 269-1, 269-9, 467-1 to 467-3. See R. Roblot, op.cit., note 18 above, at §1186.

53. UK/F, art. 9 C(10).

The OECD conventions refer to a "direct holding of 25 per cent of the capital". The UK/F convention refers to a direct _or_[54] indirect[55] holding of at least 10 per cent. of the voting power.

This difference in percentages between the OECD and the UK/F double taxation agreement can probably be explained by the fact that under French law, 10 per cent. is the threshold for granting the affiliation privilege and in the UK, 10 per cent. determines the allocation of the credit for underlying tax.

In addition, art. 9(4) provides that if the recipient of the dividend is a company which owns 10 per cent. or more of the class of shares in respect of which the dividends are paid, no tax credit will be attached to the dividends to the extent that they can have been paid only out of income which accrued to the company paying the dividends in a period ending 12 months or more before the date on which the recipient of the dividends became the owner of 10 per cent. or more of the class of shares in question. The main goal of this paragraph is to limit abuses; it will be set aside when shares are acquired for _bona fide_ commercial reasons and not primarily for the purpose of securing the benefit of the tax credit. This specific provision only applies to UK source dividends.[56]

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54. Italics supplied.

55. _Instruction_ of 23 March 1974, BODGI 14-B-74, §2351-4 and 5, p. 21: one of the innovations of the 1973 Supplementary Protocol has been to include both direct and indirect holdings in the definition of control.

56. _Instruction_ of 23 March 1974, §2351-15.

II. The Protocols of 1971 and 1973

Since the convention between the United Kingdom and France was signed in 1968, it has been amended twice, in 1971 and 1973.[57] The modifications introduced by both amending Protocols involve mainly the taxation of dividends.

The amendments have not fundamentally altered the principles of taxation of dividends as stated in the original text of 1968: the taxation (imposition) of dividends is split between the country of residence of the beneficiary and the country of source of the income. Dividends are taxable in principle in the country of residence of the recipient. However, the country of source is also allocated a right to tax, restricted to a withholding tax.

The purpose of the 1971 amendment has been to grant the benefit of the avoir fiscal to a certain category of UK investors in France, portfolio investors.[58] A portfolio investor designates an individual or a company who holds less than 10 per cent. of the voting power in the company paying the dividend.

After the important tax reform which took place in the UK in 1973 (introduction of the imputation system), the aim of the 1973 amendment to the text of the UK/F agreement has been to reciprocate the advantage granted to UK portfolio investors in 1971 and give French portfolio investors the advantage of the tax credit newly introduced.[59]

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57. See Introduction, Chapter 7.

58. Instruction of 5 August 1971, BODGI 14-B-71.

59. Instruction of 23 March 1974, BODGI 14-B-74.

III. Tax Treatment of Dividends under the UK/F Double Taxation Agreement

A. Principle

1) UK source dividends

The present tax treatment of UK source dividends was introduced by the Supplementary Protocol of 14 May 1973 (date of signature); it came into force on 2 August 1973 and was first applied to dividends paid by UK resident companies as from (à compter du) 6 April 1974.[60]

. Principle of taxation in France

Dividends paid by a UK resident company to a French resident may be taxed in France.[61]

If the French parent company holds 10 per cent. or more of the voting power of the UK affiliate, the French parent is exempt from corporation tax on 95 per cent. of the dividends received from the affiliate.

If the French parent company holds less than 10 per cent of the voting power of the UK affiliate, all the dividends received will be subject to tax in France, but the recipient in France is entitled to the tax credit to which a UK resident individual would have been entitled had

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60. Art. 9-A, §§1-4; Instruction of 23 March 1974, BODGI 14-b-74; Francis Lefebvre, Dossiers Internationaux: Grande Bretagne (1980), pp. 158-161.

61. Instruction of 23 March 1974, §21 and 27; art. 2 of the text of the Supplementary Protocol entitled "Double Taxation Relief (Taxes on Income) (France) Order 1973, S.I. 1973 No. 1328.

he received those dividends (art. 9.A(2)). The right to tax granted to the country of residence is not exclusive.

. Withholding tax levied in the UK

- Portfolio investor: 15 per cent.

The country of source of the dividend is entitled to levy a withholding tax at the rate of 15 per cent. when the recipient of the dividend is a portfolio investor, i.e. an individual, whatever the percentage of his shareholding, or a company which does not control, i.e. does not hold 10 per cent. or more of the voting power of the company paying the dividend.[62]

The withholding tax is charged on the aggregate of the amount of the dividend and the tax credit attached to it.

- Direct investor: no withholding tax

Under UK domestic law, there is no withholding tax levied. Under treaty law, the dividend is exempt from withholding tax when the recipient of the dividend in France is a direct investor, i.e. a company which controls the company paying the dividend.[63]

A withholding tax is levied in the UK only if a tax credit is payable to the French resident shareholder, i.e. if he qualifies as a portfolio investor.

Art. 9-A(1)(b) says that a withholding tax is charged on aggregate of dividend and tax credit "according

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62. UK/F, art. 9-A(1)(a), (b) and (3).

63. Art. 9-A(1)(c).

to the law of the UK".

Is this a reference to ACT? Does this mean that ACT is a withholding tax? Does this mean that the effect of the UK/F agreement is not only to grant a tax credit to a French resident portfolio investor, but also to reduce the withholding tax (ACT) from 30 per cent. (financial year 83-84) to 15 per cent. in case of a portfolio investor and eliminate the withholding tax when a direct investor receives the dividend?

If one does not interpret "according to the law of the UK" as being a reference to ACT, what does it refer to? If it does not refer to anything, is it possible that the position of the non resident portfolio investor be worse under the UK/F agreement than under domestic law?

If there is no withholding tax under UK domestic law and the UK/F convention creates a 15 per cent. withholding tax, the recipient of the dividend is in a much worse position under the treaty than under domestic legislation.

Does this interpretation not also contradict the traditional UK approach towards the problem of the relationship between a treaty and domestic legislation according to which the former cannot worsen the position of the taxpayer?[64]

A letter was sent to the Technical Division of the Inland Revenue on 6 December 1982 to submit these questions. The following answer was received early in January

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64. Simon's Taxes (London: Butterworths, 1976), Vol. F, at F 1.201, Issue 217.

1983:

> The law of the United Kingdom referred to in Article 9A(1)(b) is Section 497(1) Income and Corporation Taxes Act 1970 which provides that notwithstanding any enactment the "arrangements" i.e. Double Taxation Conventions shall have effect in relation to income tax and corporation tax insofar as they provide (b) for charging the income arising from sources in the United Kingdom to persons non resident in the United Kingdom. The non-resident taxpayer is not in a worse position as a result of this provision since he is not entitled to payment of the tax credit attaching to a dividend paid by a United Kingdom company unless a Double Taxation Convention specifically so provides or Section 98 Finance Act 1972 applies. If for an example a recipient, who is not within Section 98, of a United Kingdom dividend of say £70 was a resident of a country in which the United Kingdom has no Double Taxation Convention or where the dividend Article in such a Convention did not provide for the payment of the tax credit would only get £70. The French portfolio investor however gets £70 = £30 - £15 = £85.
>
> A Double Taxation Convention does not impose a charge to tax where the tax cannot be charged under domestic law but as I have indicated above the 15% withheld from the aggregate of the dividend plus the tax credit is imposed by domestic law.

. Tax credit

Certain conditions must be met before a resident of France is entitled to the UK tax credit in respect of the dividends he receives:

- the recipient of the dividend must be a resident of France;
- he must be subject to French tax on the dividend;
- he must be an individual, whatever his shareholding, or a company holding less than 10 per cent. of the voting power in the company paying the dividend (portfolio investor);

- no payment of tax credit can be made either where the recipient has a permanent establishment in the UK with which the holding giving rise to the dividends is effectively connected.[65]

When all these conditions are fulfilled, the UK tax credit is granted to the recipient of the dividend paid by the UK company. The payment made to the recipient in France equals the excess of the tax credit over the withholding tax chargeable in the UK on the aggregate of the dividend and tax credit.

For instance:

Dividend distributed to portfolio investor resident in France	70
UK tax credit	30
Taxable income in France	100
Tax to be paid in the UK (withholding tax, 15 per cent.)	15
Amount effectively paid to French resident	85

. Taxation in the country of the recipient (France)

- The recipient is an individual

The dividend received in France by an individual shareholder for instance who owns shares in a UK resident company will be incorporated in his taxable income.

In order to avoid double taxation that would result from the tax levied in the United Kingdom (15 per cent. in this example) and the liability to French tax on

65. Art. 9-c-(8); see below B.

the dividend received, France will give the recipient of the dividend a tax credit of 15 that will be deductible from his charge to tax.

- The recipient is a company
  - Portfolio investor

The treatment just described would apply if the French company held less than 10 per cent. in its UK affiliate.

  - Direct investor

If the recipient in France is a company which qualifies as a direct investor for the purpose of the convention (10 per cent. of the voting power minimum), it also qualifies for the application of the affiliation privilege. The dividend received by the French parent from its UK subsidiary is 95 per cent. exempt from corporation tax in France. No tax credit is attached to the dividend received, no withholding tax is levied in the UK on the distributed dividend. If the French parent company in turn distributes dividends out of the sums it receives from its UK subsidiary it will have to pay a précompte as the profits out of which the dividends are distributed will not have been subject to corporation tax at the rate of 50 per cent.

As regards the procedure to be followed in order to obtain payment of the excess of the tax credit applicable to dividends over the liability to UK tax (at a rate not exceeding 15 per cent. on the aggregate of the amount of the dividend and the tax credit) the Board of

Inland Revenue has issued notes entitled "Form FRA" which provide general guidance but have no binding force.

Forms for claiming relief under the UK/F agreement may be obtained from the Inspector of Foreign Dividends, 1 Blagdon Road, New Malden, Surrey, England KT3 4BB and in France from Inspectors of Taxes (Inspecteurs des Impôts).

Claims for relief must be made within 6 years of the end of the year of assessment to which the income relates.[66]

As regards claims in respect of UK tax credit attributable to UK company dividends, the appropriate claim forms are:

FRA / Individual / Credit

FRA / Company / Credit, No. 5094 DT.

Claims should be made in duplicate if it is the first claim on behalf of the company and the form and duplicate should be sent to the Inspector of Taxes for the district in which the registered office of the company is situated. Otherwise, they should be sent to the Inspector of Foreign Dividends. Original tax credit certificates must be attached.[67]

2) French source dividends[68]

The present mechanism of taxation of French source

66. Form FRA, §5.

67. Form FRA / Company / Credit.

68. Jurisclasseur de Droit International, Fascicule 354 G, published in 1982.

dividends was introduced by the Protocol of 10 February 1971. It came into force on 7 May 1971 and was first applied to dividends paid on that same date.[69]

. Principle of taxation in the UK

Dividends paid by a French resident company to a UK resident may be taxed in the UK.[70] If the UK parent company holds less than 10 per cent. of the voting power of its French affiliate, or if the investor is an individual whatever his shareholding, a tax credit - called in France avoir fiscal[71] - is attached to the distributed dividend. If the UK parent company holds 10 per cent. or more of the voting power of its French affiliate, no avoir fiscal is attached to the dividend distributed.

The right to tax of the country of residence is not exclusive.

. Withholding tax levied in France

Under French domestic legislation, in the absence of a double taxation agreement, a withholding tax is levied at the rate of 25 per cent. on dividends distributed to non residents.[72]

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69. Instruction of 5 August 1971, BODGI 14.B-4-71.

70. UK/F, art. 9-B(5).

71. The mechanics of the avoir fiscal have been examined under Chapter 4 of the Introduction. CGI, art. 242 quater provides that the benefit of the avoir fiscal may be granted to non residents under the terms of double taxation agreements.

72. CGI, art. 119 bis, 187-1.

The effect of the UK/F double taxation agreement is to reduce the rate of tax levied in the country of source of the dividend.

Contrary to the UK, France levies a withholding tax on dividends distributed both to portfolio and direct investors.

- Portfolio investors: 15 per cent.

Dividends distributed to UK portfolio investors are subject to a withholding tax in France at the rate of 15 per cent. In addition, portfolio investors, *i.e.* individuals, whatever their shareholding and companies which hold less than 10 per cent. of the voting power of the French affiliate, receive the *avoir fiscal*, a tax credit attached to the dividend distributed.

- Direct investors: 5 per cent.

A 5 per cent. withholding tax is levied on dividends distributed to UK residents who own more than 10 per cent. of the voting power of the company situated in the other contracting state. No *avoir fiscal* is attached to the dividend distributed.

. Avoir fiscal

When a French source dividend benefits from the *avoir fiscal*, the gross dividend - *i.e.* dividend + *avoir fiscal* - is subject to a 15 per cent. withholding tax levied in France.

When a French source dividend does not benefit from the *avoir fiscal*, the rate of the withholding tax is

5 per cent.

For instance, a UK portfolio investor receives a French source dividend of 100 Francs:

Avoir fiscal attached to the dividend			50
Taxable income to be declared by the UK resident			150
Tax withheld in France (150 x 15 per cent.)		22.50	
The withholding tax includes			
15 per cent. on the dividend itself	15	15	
15 per cent. on the avoir fiscal		7.50	
Avoir fiscal effectively transferred to UK resident	50	22.50	27.50
Total amount paid to the UK resident	(100 + 27.50)		127.50

The UK taxpayer will be given a foreign tax credit to take into account the French withholding tax.

In practice, the UK resident will receive the dividend, less the tax withheld in France under domestic law (100 - 25), *i.e.* 75.

The recipient will have to justify that he is a UK resident. He will then receive a refund of the tax withheld (25) and the payment of the *avoir fiscal* (27.50) a total sum of 52.50. The UK taxpayer will in total receive 75 + 52.50 = 127.50.

The conditions of allocation of the *avoir fiscal* to a UK resident are to be emphasised. A distinction will be made as to the conditions relating to the recipient and to the nature of the distribution.

- *Conditions as to the recipient*

  - If he is an individual, any individual resident

in the UK will benefit from the *avoir fiscal* on dividends received from a French resident company in which he holds shares.

- If the recipient is a company, the benefit of the *avoir fiscal* is granted only to a company which does not control the company paying the dividend,[73] and which is not entitled in computing the amount of credit to be allowed against UK tax to take into account the underlying corporation tax.[74]

- A ministerial decision of 24 November 1971 has extended the benefit of the *avoir fiscal* to some foreign investors in securities (*investisseurs en valeurs mobilières*) situated in an EEC country and who had entered into a tax convention with France. The ministerial decision involves - *inter alia* - investment funds (*fonds d'investissements ou de placement*) with a strong international vocation, non profitable *caisses de prévoyance* and retirement funds (*caisses de retraite*) established in the United Kingdom.[75]

- *Conditions as to the nature of the distribution*

The *avoir fiscal* could not be attached to a distribution which would not qualify for it under domestic law. The benefit of the *avoir fiscal* is subject to conditions

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73. UK/F agreement, art. 9 B-(6)(b)(ii)(aa).

74. *Ibid.*, art. 9 B-(6)(b)(ii)(bb); *Instruction* of 5 August 1971, §2351-4.

75. *Jurisclasseur de Droit International*, *op.cit.*, note 68 above, §67, p. 12; *Instruction* of 31 May 1972, BODGI 14 B 10.72. It also applies to funds established in Germany or Luxemburg.

relating to the nature of the distribution.[76]

Article 158 _ter_ of the General Tax Code enumerates the distributions which qualify for the _avoir fiscal_; some are specifically excluded. Such distributions would not qualify for the _avoir fiscal_ even if the recipient was resident in France. Art. 158 _ter_ excludes - _inter alia_ - hidden distributions (_distributions occultes_).

. _Taxation in the country of the recipient (UK)_

In order to avoid double taxation, a tax credit is granted to the recipient of the French source dividend. The tax credit equals the withholding tax paid in France and will be deductible from the tax bill of the UK resident recipient.[77]

A distinction is to be made between direct and indirect tax credits. The former corresponds to the withholding tax levied in France on the distributed dividend, the latter mitigates the double taxation arising from the fact that the dividend is distributed out of profits which have normally been subject to French corporation tax at the rate of 50 per cent. The direct tax credit is a credit for the withholding tax, the indirect tax credit is a credit for the underlying corporation tax.

. _Compensatory tax (précompte)_

Refund of compensatory tax paid by a French company

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76. _Instruction_ of 5 August 1971, §§2351-8 and 9.

77. _Jurisclasseur de Droit International_, _Fascicule_ 354 G.

on distributions to a UK resident.

The précompte is a tax which a French company is due to pay when it distributes dividends out of profits which have not been subject to a 50 per cent. rate of corporation tax. Such situation arises for instance when the profits have been received by a foreign branch.

The précompte under French domestic law may be refunded when no avoir fiscal is attached to the dividend distributed.

The UK/F tax convention provides that a refund of précompte may be granted to UK direct investors - i.e. those who have not benefited from the avoir fiscal. The refund is treated like a dividend:[78] it is subject to the deduction of the 5 per cent. tax withheld at source in France on the dividend distributed.[79]

- Distribution by a French company to its UK parent of dividends received from abroad.[80]

If we assume that the French subsidiary of a UK resident company distributes dividends received from abroad to its parent, the dividends received in France are 95 per cent. exempt from French corporation tax in the hands of the subsidiary.

A 5 per cent. withholding tax has been levied, at source in France on the dividends distributed to the UK

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78. UK/F, art. 9-B(7)(b).

79. Ibid., art. 9-B(7)(a).

80. The relevant domestic provision is CGI, art. 146-2.

if the UK parent holds 10 per cent. or more of the voting power in it.

When the French company distributes dividends out of the profits received from abroad, the précompte will be due. Can it be refunded? Yes, if the recipient of the dividend is not granted the avoir fiscal. The refund is normally subject to the decution of the 5 per cent. tax withheld at source.

- A French resident company carries out an activity in the UK through a branch.

The profits of the branch will be subject to UK corporation tax. If profits of the branch are remitted to the French parent and dividends are distributed out of those profits, the précompte will be due.

France is to give a tax credit for corporation tax paid in the UK on the profits of the branch; it will be deducted from the précompte due.

3) Comparison

The following differences in relation to the tax treatment of dividends under the UK/F double taxation agreement seem worth being briefly outlined.

. ACT/précompte

The nature of advance corporation tax in the UK and compensatory tax (précompte) in France have been examined in an earlier chapter.[81]

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81. Part I, Chapter 4.

In the context of the UK/F agreement, it is interesting to contrast the UK and French approach. Under certain circumstances, basically when a UK resident does not receive the avoir fiscal, he may be refunded the précompte under deduction of a 5 per cent. withholding tax. In the UK, ACT is never refunded.

. The rates of withholding taxes

There is no symmetry between the rates of withholding tax on French source dividends - 5 per cent. and 15 per cent. for direct and portfolio investors respectively - and on UK source dividends - nil and 15 per cent.

First of all, why is there a difference between the treatment of foreign direct and portfolio investors? In terms of figures and sums of money, those relating to direct investors are undoubtedly more substantial. The difference in rates of taxes may be explained by the fact that a direct investor has the benefit of both direct and indirect tax credits in the UK, and of the affiliation privilege in France; granting a tax credit or the avoir fiscal would only mean a transfer of revenue.

Why are the tax credit and the avoir fiscal only granted to portfolio investors? Is it because a portfolio investor has the advantage of the avoir fiscal or the tax credit that he is subject to more burdensome withholding tax? So far advantages and disadvantages are reciprocal, but the reciprocity is not total.

Why is there a discrepancy between a French source dividend paid to a UK direct investor (5 per cent. withholding

tax) and a UK source dividend paid to a French direct investor. On distribution of such a dividend, the UK company will always pay ACT, and under no circumstances will it be refunded to the French resident who receives the dividend.

On distribution of a dividend from a French resident company to its UK direct investor, the levy of the *précompte* is conditional: the *précompte* will be due only if the profits out of which the dividends are distributed have not been subject to French corporation tax at the rate of 50 per cent. In addition, the *précompte* may be refunded to the UK resident, subject to the deduction of the withholding tax (5 per cent).

. Refund of part of the UK tax credit to certain foreign direct investors

Although the following point goes beyond the scope of the UK/F tax convention, it ought to be mentioned here.

In tax conventions renegociated since the introduction of the imputation system, the UK has been granting its domestic tax credit to non resident portfolio investors; this is consistent with the approach taken in the UK/F tax convention.[82] In addition, the UK has granted half of the tax credit to foreign direct investors. This was applied for the first time in the tax convention between the UK and the US signed in December 1975, which came into

82. The modification to the original 1968 text was brought in by the 1973 Protocol.

force in 1980. The granting of such an advantage is mitigated by a 5 per cent.withholding tax levied on the aggregate of the dividend and half of the tax credit.

Such a favour made to US direct investors in the UK has since been extended to Swiss, Dutch, Norwegian and Finnish direct investors.

The French tax administration has consistently refused to grant such an advantage to foreign direct investors and it levies a 5 per cent.withholding tax on the distribution of a dividend to a non resident direct investor, without him being entitled to any of the avoir fiscal.

B. Exception: dividends "effectively connected" with a permanent establishment (art. 9(8))

Their tax treatment has been examined in Section 1 of the present chapter.

§2. Interest[83]

I. Domestic Legislation

A. United Kingdom

1) Definition of interest

- Absence of a statutory definition of interest

There is no satutory definition of interest in the UK.

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83. The first subject of the 1982 IFA Congress held in Montreal deals with the tax treatment of interest in international economic transactions.

Interest is defined judicially as "payment by time for the use of money".[84]

Halsbury defines interest as "the return of compensation for the use or retention by one person of a sum of money belonging to, or owed to, another".

- Distinction between yearly and short interest

Traditionally, a distinction is made between yearly interest and short interest. The use of the word "yearly" may be a source of confusion: interest may be yearly even though the principal is payable after less than a year, as in a mortgage, or even on demand.[85]

The degree of permanence of the loan is the main factor which determines whether an interest is yearly (or annual) or short.[86]

2) Tax treatment of interest

a) Deductibility of interest payments for purposes of computation of corporation tax

- Principle

Short interest (broadly, interest on loans of less than 1 year) and UK bank interest (interest paid to a UK bank or to the UK branch of a foreign bank) is generally

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84. Bennet v. Ogston (1930), 15 TC, p. 374, per Rowlatt J., at p. 379.

85. Corinthian Securities v. Cato (1969) 3 All ER, p. 463.

86. Ibid. For a more substantial development on the meaning of yearly interest, see J. Tiley, op.cit., note 20 above, 13-34, 13-75;also Rowland's Tax Guide 1981-82 (London: Butterworths, 5th ed., 1981), p. 55.

deductible by trading companies in computing trading income chargeable to corporation tax under Schedule D Case I.

Other interest may only be deducted from profits if it qualifies as a charge on income.

A charge on income is an annual payment which is not deductible in computing the profits arising from a particular source, but is deducted from a company's total profits from all sources.[87]

It includes for instance any yearly interest[88] and other short interest payable in the UK on an advance from a bank carrying on bona fide banking business in the UK,[89] unless that interest is incurred wholly and exclusively for the purpose of a trade and can therefore be deducted from trading income. There are several conditions which must be met however before the allowance can be given and these are very highly detailed.

- Limitations

In the UK, there is no debt/equity ratio.

Under UK domestic law - very often overridden by treaty provisions - certain interest payments are not deductible for corporation tax purposes and are treated as distributions. For instance, where interest on securities issued by a resident company is paid to a non

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87. ICTA 1970, s. 248.

88. Ibid., s. 248(3)(a).

89. Ibid., s. 248(3)(b).

resident company and either the borrower is a 75 per cent. subsidiary of the lender or both borrower and lender are 75 per cent. subsidiaries of a third non resident company.[90]

b) Taxation of interest

Any UK source interest of money, whether yearly or otherwise, is taxed under Schedule D Case III.[91]

Income tax under Schedule D is charged and paid by the person receiving or entitled to the income.

The recipient of an interest is liable to income tax by direct assessment under Case III of Schedule D.[92] Taxation of interest by deduction at source is still applied under specific circumstances.

- Deduction at source

Only certain payments of yearly interest fall within the mechanism of deduction at source: they are governed by ICTA 1970, s. 54.

A yearly interest paid by a company to a non resident is subject to a deduction at source at the basic rate of income tax.[93] The amount withheld by the company paying the interest is to be remitted to the Revenue.[94]

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90. ICTA 1970, s. 233(2)(d)(iv).

91. ICTA 1970, ss. 52-53. These provisions will be developed in the next section, dealing with the tax treatment of royalties.

92. Direct assessment may be opposed to deduction at source by the person making the payment. Such method of taxation applies when an annuity or other annual payment is involved.

93. ICTA 1970, s. 54.

94. Ibid., s. 54(2).

The effect of the UK/F double taxation agreement is to reduce the rate of withholding tax paid by a UK company to a French company from the basic rate of income tax (30 per cent. for the Financial Year 1983-84) to 10 per cent.[95]

Deduction at source as a method of taxation of yearly interest only applies when it is paid by a company to a non resident.

- Direct assessment: payment of gross interest

- Interest payable in the UK on an advance from a bank carrying on a bona fide banking business is not subject to a deduction at source, nor will be interest paid by such a bank in the ordinary course of that business.[96] In other words, the deduction at source method does not apply to bank loans.

There is no statutory definition of a bona fide bank for taxation purposes.[97]

In relation to foreign banks who carry out an activity in the UK through a branch, a list of recognised banks has been published and it is thought that the UK branch of an overseas bank would qualify as a bona fide bank if it was included in that list.[98]

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95. UK/F, art. 11.

96. S. 54(2).

97. G. Pink and S. Lake, "How to Reduce Withholding Tax on Interest Payments by UK Companies", Financial Law Review (1982) A Euromarket Publication, pp. 25-29.

98. Ibid., at p. 25. The list was published following the 1979 Banking Act.

For interest to be paid gross, it is required to be payable in the UK.[99] However, the Inland Revenue issued in 1973 a Press Release stating:

> Where a bank carrying on a bona fide banking business in the UK within the meaning of TA 1970, ss. 54(2)(a), 251(3) makes a loan in a foreign currency carrying yearly interest on such terms that the interest falls to be brought into account as a trading receipt of the business carried on in the UK (and it is brought into account accordingly), the interest is in practice treated for the purposes of the said ss. 54, 251 as payable in the UK and consequently not liable to deduction of income tax at source notwithstanding any provision in the loan agreement for payment to be made by the debtor abroad. 100

- Short interest payments are always paid gross.

c) Interest payments to non residents

- Payment of yearly interest by a company to a non resident person[101]

Such payment will not be treated as a charge on income unless the paying company is resident in the UK and any of the following 3 conditions is fulfilled:

- income tax at the basic rate must be withheld from the payment and accounted for to the Revenue under s. 54, unless such withholding tax is eliminated or reduced under a double taxation agreement;

- the payment is made out of income brought into charge to tax under Case IV or V of Schedule D.[102] This means

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99. S. 54(2)(a).

100. STI, 16 March 1973 (London: Butterworths).

101. ICTA 1970, s. 248(4).

102. It covers respectively income from foreign securities
/Continued over

that the interest is matched by an equivalent amount of foreign source dividend or interest income;

- the payment must be annual interest which is contractually paid abroad and paid wholly or mainly for purposes of the payer's overseas trading activities wherever carried on). If the payer is a parent company, the payment will qualify if it is incurred in relation to corresponding activities of a 75 per cent. UK subsidiary.[103]

The last two conditions require further development. Interest paid by a UK resident company to a non resident will be deductible if it is payable out of foreign source income.

The purpose of the "Swiss roundabout" is for a company to credit foreign source income so that interest on a loan can be deductible.[104]

Both the UK Revenue and the Swiss tax authorities have until now tacitly accepted this rather artificial scheme.

This "roundabout" is usually transacted via Switzerland because no withholding tax is levied on interest payments between the UK and Switzerland under the UK/ Swiss tax treaty.

Footnote 102 continued from page 569.

not charged under Schedule C (public revenue dividends payable in the UK) and income from foreign possessions (including trades carried on wholly abroad).

103. ICTA 1970, s. 249.

104. The mechanics of the Swiss Roundabout are described in N. Edwardes-Ker, <u>International Tax Strategy</u> (Dublin: In-Depth, 1974 - loose-leaf) Chapter 5.

Basically, in a Swiss roundabout, funds borrowed on the European market are loaned to a Swiss subsidiary and then borrowed back.

- A UK company borrows money on the Euromarket.
- The proceeds of that loan are lent on to a Swiss subsidiary. The interest received from the Swiss subsidiary which is received free of Swiss withholding tax is foreign source interest: it can be used to pay interest on the Euroloan.
- The Swiss subsidiary then lends the same sum it had borrowed back to the UK parent giving the Swiss company a small 'turn'. The interest payment by the UK parent is free of withholding tax under the UK/Swiss tax treaty.

The revenue have recently indicated a change of attitude by claiming in essence that interest on funds borrowed by a UK resident must have a UK source and therefore be within Case III and liable to deduction of tax at source. It seems that until this point is litigated, the Swiss Roundabout has stopped turning!

The payment must be annual interest which is: contractually paid abroad and paid wholly or mainly for purposes of the payer's overseas trading activities (or if paid in foreign currency to an unrelated lender, of the payer's trading activities whatever carried on).
If the payer is a parent company, the payment will qualify if it is incurred in relation to corresponding activities of a 75 per cent.UK subsidiary (s. 249).

To take advantage of the provisions of s. 249, and hence avoid tax being withheld at basic rate tax on the payment of interest, foreign loan agreements have often been entered into.

A UK company could then borrow on the Euromarket, and not have to withhold basic rate of income tax on interest payments.

Essentially, to achieve this, the loan was structured as a foreign <u>situs</u> loan so that interest on the loan was regarded as foreign income in the hands of the recipient. Foreign income of a non resident is not within the scope of UK taxation.

Under the loan contract the interest was to be, or required to be paid, and was in fact paid outside the UK. In order to fulfil this test, the loan agreement was drawn up under a non UK law, and by paying the interest abroad to, for instance, a paying agent's bank account abroad.

If the loan was evidenced by a speciality contract (usually an agreement under seal) executed outside the UK, interest thereon ranked as a foreign source income provided the loan was not secured against any land situate in the UK.

On January 26 1983, the Inland Revenue issued a consultative document entitled "<u>Tax Treatment of Interest paid by Companies to Non Residents</u>".[105]

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105. On this consultative document, see 40 Taxes International, February 1983; Taxation Practitioner, March 1983, pp. 71-73; Taxation, 19 March and 30 July 1983; BTR, 1983, pp. 65-70.

The consultative document states that it was mainly issued because, as a result of abolition of exchange control, interest paid by a UK borrower has a UK source, even under a contract governed by foreign law. UK source interest paid to non residents is subject to a deduction (s. 54) and a foreign speciality contract no longer creates foreign source interest, therefore one cannot escape the deduction at source.

A UK borrower may still pay interest gross if the recipient is resident in a country which has a double taxation agreement with the UK which provides for the exemption of interest in the country in which it arises.

Several representations on the document pointed out however that the abolition of exchange control did not alter the law regarding the situs of debts and the location of a source of interest. It remains to be seen what legislation if any will be introduced to deal with this matter, but the Revenue are proposing that certain payments should be permitted to be made gross under s. 248, ICTA 1970.

Charges on income payable by a non resident company trading through a branch or agency in the UK:- unless such charges are covenanted donations to charity, are only deductible if they are incurred wholly and exclusively for the purpose of the trade carried on in the UK and are paid to UK residents. Subject to non discrimination clauses in double taxation agreements, therefore, there is no allowance for charges on income paid to non

residents by a non resident company with a UK branch.[106]

However, there is on exception to this in the latest tax convention between the UK and the USA. Art. 7(3) provides that in the determination of the profits of a permanent establishment, there shall be allowed as deductions those expenses which are incurred for the purposes of the permanent establishment including a reasonable allocation of executive and general administrative expenses and interest.

It is the only treaty which makes a specific allowance for interest. When asked to what extent art. 7(3) was applied in preference to the non discrimination provision (art. 24), the Inland Revenue confirmed the limited application of art. 7(3); it is restricted to trading expenses and does not cover charges on income.

B. France

1) Definition of interest

Under French Revenue law, the taxation of interest comes under the taxation on income from movable property (revenus de capitaux mobiliers) which also includes distributions and income from foreign securities (valeurs mobilières étrangères).

French tax legislation opposes two categories of income from movable property: income from fixed income securities (produits de placements à revenus fixes) and income from variable income securities (produits de titres

106. ICTA 1970, s. 248(4)(5).

à revenus variables).[107]

The latter was dealt with in the previous paragraph; it covers distributions. The former includes negotiable instruments (obligations négociables),[108] loan notes (bons de caisse),[109] debts (créances), deposit and current accounts. Their principal characteristic is that, unlike a dividend for instance, the income to which they give rise is fixed in advance and not dependent upon the realisation of a profit by a company.

The present development will briefly examine the tax treatment of interest from fixed income securities.

2) Tax treatment of interest

a) Deductibility of interest payments for purposes of computation of corporation tax

- Principle

Interest paid by a company is in principle deductible in computing the taxable profits of that company. However, deduction will only take place if the interest

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107. Claude Gambier, op. cit., note 36 above, §§ 400-416.

108. A negotiable obligation is characterised by the fact that it is issued in a series of notes, identical as to amount and as to the dates on which the income is due and on which the obligations themselves are ultimately redeemable.

109. Loan notes (bons de caisse) are notes (titres) issued by industrial or commercial enterprises generally, and by banks in particular, in acknowledgement of loans (en contrepartie de prêts). They fail to qualify as negotiable instruments by not taking the form of a series of identical notes.

paid is genuine, reasonable, incurred for the purposes of the activity carried out by the company.[110]

The French tax administration will refuse to deduct a payment of interest for corporation tax purposes if it considers the payment to be excessive (excessif).[111]

- Limitations

. Interest on shareholders' loans

Interest on shareholders' loans is an allowable expense to the extent that the following conditions are fulfilled:[112]

- the share capital of the company must be fully paid up (entièrement libéré);

- the maximum rate of interest is not to exceed the rate of interest charged on advances by the Bank of France, plus two percentage points (au taux des avances sur titres de la Banque de France, majoré de deux points).

The rate on advances by the Bank of France was last fixed at 10.50 per cent.on 31 August 1977. Therefore interest on shareholders' loans will not be deductible for corporation tax purposes if they exceed 12.50 per cent.[113]

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110. CGI, art. 39-1; CDFI 1982, "The Tax Treatment of Interest in International Economic Transactions", Montreal, French Report, Mme Mouillan-Hogberg, pp. 345-447, at p. 436. Also Précis de Fiscalité, 1982, §§1025-1028 and 1061-1065-I.

111. See CGI, art. 57; Part 1 Chapter 6.

112. CGI, art. 39-1-3°; DGI, vol. 1, §§1064-1065-II, p. 48.

113. This applies to accounting periods (exercices) ended (clos) in 1981.

The above provision applies to shareholders whether they have control over the company or not (_associés dirigeants ou non_).

Furthermore, interest paid on shareholders' loans who exercise, _de facto_ or _de lege_, the management of the company are only deductible if the total amount of the loans does not exceed the value of the share capital, if one is looking at an accounting period starting before the first of January 1971, and one and a half times the share capital if an accounting period opening as from that date is being considered.[114]

This limitation does not apply to interest on a loan granted by one company to another when they qualify for the application of the affiliation privilege.

Shareholders who exercise _de lege_ management (_associés dirigeants de droit_) include:

- in share companies, the chairman of the board of directors (_président du conseil d'administration_), the general manager(s) (_directeur(s) généraux_), members of the board of management (_membres du directoire_), if they are shareholders;
- in limited liability companies, managers (_gérants_).

Shareholders who exercise _de facto_ management include those who in practice exercise an effective and constant supervision over the management of the company, even if they are not granted such powers according to the articles of association (_statuts_).[115]

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114. CGI, art. 212-1°.

115. _Ibid_.

To the extent that the interest payment constitutes a deductible expense for tax purposes, it is treated as interest in the hands of the recipient.[116] Any amount which would not be treated as a deductible expense for corporation tax purposes will be treated as a distribution in the hands of a shareholder, and not as an interest. Such income, treated as a distribution will however not benefit from the avoir fiscal.[117]

. Debt/equity ratio

A debt/equity ratio is a ratio of 'debt' to 'equity', i.e. of loan capital to share capital. The purpose of the existence of a debt/equity ratio is the avoidance of abuse on the part of companies to finance their subsidiaries through loans rather than share capital as the latter is of no tax advantage.[118]

France imposes for tax purposes a ratio of 'debt' to 'equity' in order to limit the deductibility of interest paid by a subsidiary to its foreign parent. The ratio applies only to interest paid to non resident parents.

There is no such ratio if the interest payment is made to a resident company. This is an obvious case of disparity in treatment between French and foreign companies,

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116. CGI, art. 124; DGI, 1982, Vol. 1, §607, at p. 281.

117. DGI, 1982, §§1477 and 1499.

118. Note that the branch of a foreign parent may not as a rule deduct interest (and royalties) paid to its foreign office. This is another example of disparity in treatment between branches and subsidiaries.

in violation of art. 25 of the UK/F tax convention which, following in this respect the OECD Model, prones a principle of non discrimination on grounds of nationality.

b) Taxation of interest

- Prélèvement forfaitaire

The prélèvement forfaitaire is compulsory for companies, optional (sur option) for individuals; it exempts individuals from further liability to income tax.[119]

When an individual, not a company, receives an interest payment, he may choose between two methods of taxation of such payment. The taxation consists of two taxes in both cases. A withholding tax (retenue à la source) is levied at source and in addition, the sum received is included in the taxable income of the individual.[120]

Alternatively, an individual may elect to be subject to a prélèvement forfaitaire, in fact also a withholding tax, at a higher rate which varies according to the nature of the interest payment. If such election is made, there is no further liability to income tax on the payment.

If a withholding tax (retenue à la source) has been levied, it is deductible from the prélèvement.[121] The election for a prélèvement forfaitaire will be beneficial

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119. See below.

120. CGI, art. 125A. Further conditions as regards the possibility to elect for a prélèvement relate to the nature of the payments. They are described under art. 125A IV. Further limitation on the optional prélèvement forfaitaire are set out in art. 125B.

121. Ibid.

to individuals subject to high rates of income taxation. An interest payment which has been subject to the prélèvement libératoire will not be part of the taxable base for purposes of computation of income tax of its recipient.

The prélèvement forfaitaire is compulsorily withheld on payments made to non residents whether individuals or companies.[122]

Under French domestic law there are several rates of prélèvement forfaitaire, depending on the nature and the date of the payment.

Basically, tax at the rate of 38 per cent. is levied on income from créances, dépots and comptes courants as from 1 January 1980. It was 40 per cent. from 16 July 1978 to 1 January 1980 and $33\frac{1}{3}$ per cent. prior to that.

Different rates of tax are levied on different categories of interest payments. For instance,

- 25 per cent. on interest, any income from State loans (emprunts d'Etat) and other negotiable debt instruments (titres d'emprunt négociables) issued by public or private French authorities (collectivités publiques ou privées françaises);
- 38 per cent. on interest on bonds and securities issued as from 21 January 1980 if the recipient of such income communicates his name and tax residence to the tax authorities; if the recipient refuses to communicate such information, the tax is raised to 42 per cent.

- Withholding tax (retenue à la source)[123]

Interest payments are subject to a withholding tax

122. Ibid., art. 125.A.III. (footnote 123 overleaf)

(*retenue à la source*) at the rate of 12 per cent. on interest on negotiable debt instruments (*obligations négociables*) issued before 1 January 1965, 10 per cent. on interest related to instruments issued as from that date.[124]

A complete list of income to which this withholding tax applies may be found under CGI, art. 118. It includes - *inter alia* - *intérêts, arrérages, et tous autres produits des obligations, lots et primes de remboursement*.

The tax is withheld on gross payment. It corresponds to an anticipated payment of income tax.

The recipient of the net sum is entitled to a tax credit equal to the withholding tax. Money will be refunded to an individual if his tax credit exceeds his liability to income tax; no refund will be made to a company.[125]

As regards foreign source interest paid to an individual domiciled in France, the tax credit is limited to the tax withheld at source abroad.[126]

Footnote 123 from page 579.

123. *Précis de Fiscalité 1982*, Vol. 1, §§601-620, pp. 281-286; Henry Lazarski, "*The French Withholding Tax on Interest*", European Taxation, 1981, at p. 13; *Taxation of Companies in Europe*, International Bureau of Fiscal Documentation, 1980 Supplement No. 38.

124. CGI, arts. 119 *bis* and 187-1.

125. *Ibid.*, art. 119 *ter* I-a.

126. *Ibid.*, art. 119 *ter* I-b.

II. UK/F Double Taxation Agreement: Art. 11[127]

A. Definition of interest according to the convention

1) Art. 11(3)

Art. 11(3) provides a definition of "interest" for the purpose of the application of the convention. It runs as follows:

> The term "interest" ("intérêts") as used in this Article means income from Government securities (revenus des fonds publics), bonds or debentures (des obligations d'emprunts), whether or not secured by mortgage (assorties ou non de garanties hypothecaires) and whether or not carrying a right to participate in profits (ou d'une clause de participation aux bénéfices) and debt claims of every kind (créances de toute nature) as well as all other income assimilated to income from money lent by the taxation law of the state in which the income arises (état d'où proviennent les revenus), but does not include income dealt with (visés) in art. 9.[128]

This provision requires some comments which have been thought best made in the form of a comparison between the definition of interest in the UK/F tax convention and its OECD counterpart.[129]

2) Comparison between UK/F, art. 11(3) and OECD Model, art. 11(3)

. Reference to domestic legislations

The definition of interest in the UK/F double

127. On the tax treatment of interest in international conventions, see in general Jurisclasseur de Droit Fiscal International Fascicule 354 F, in pages published in 1982 in particular; also the UK and French report at the 1982 IFA Congress held in Montreal.

128. Art. 9 deals with dividends.

129. 1977 OECD Model Convention, art. 11(3).

taxation agreement includes a reference to domestic laws.[130] No such reference is made in the OECD Model convention.

According to the definition of interest in the UK/F agreement, it includes - inter alia - all income assimilated to interest by the country of source of the income. However, this extensive definition of interest finds a limitation: it does not include dividends.

From art. 11(3), one may come to the conclusion that all income, in addition to the enumeration provided (except dividends), which qualify as interest under UK or French domestic laws, will qualify as interest for the purposes of the UK/F agreement.

This statement is mitigated by art. 11(5), which is to be read with a particular provision of UK domestic law in mind.[131]

Financing foreign activities through loans is usually advantageous from a tax point of view because interest is in principle deductible, whereas dividends are not.

In the UK, there is no debt/equity ratio, but under domestic provisions, certain interest payments are not deductible for corporation tax purposes and are treated as distributions. For instance, where interest (on securities issued by a resident company) is paid to a non resident company and either the borrower is a 75 per cent.

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130. The Committee on Fiscal Affairs does not approve of such a reference: "It has seemed preferable not to include a subsidiary reference to domestic laws in the text"; commentary on art. 11(3), §19 at p. 109.

131. ICTA 1970, s. 233(2)(d)(iv).

subsidiary of the lender or both borrower and lender are 75 per cent. subsidiaries of a third non resident company.[132]

The UK/F tax convention expressly sets aside this provision of UK domestic law[133] - subject to one exception.[134]

Generally speaking, interest paid by a UK resident company to a French resident company cannot be treated as a distribution and taxed accordingly.[135]

However, such payment will be treated as a distribution if made by a UK resident subsidiary to its French parent and 50 per cent. or more of the voting power of the French parent which receives interest from its UK subsidiary is in the hands of UK residents.[136]

. <u>Express exclusion of dividends from the scope of art. 11</u>

Art. 11(3) of the UK/F agreement states that the term "interest" "does not include income dealt with in article 9". Art. 9 deals with dividends. Dividends are not expressly excluded in the OECD definition of interest.

. <u>Excessive interest</u>

Art. 11(6) of the OECD Model applies the arm's

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132. <u>Ibid</u>.

133. UK/F, art. 11(5)(a).

134. <u>Ibid</u>., art. 11(5)(b).

135. This is in line with the definition of interest in art. 11(3) which excludes dividends from its scope.

136. See <u>Instruction</u> of 14 April 1970, §2352-6-b, at p. 14.

length principle to interest payments. Where, as a consequence of a special relationship between the lender and the borrower, the amount of interest paid, having regard to the debt-claim for which it is paid, exceeds the amount that would have been agreed in the absence of such relationship, the amount of interest that exceeds will remain taxable according to the laws of each contracting state.

Art. 11(7) of the UK/F agreement adopts the same principle, but it is more specific as regards the tax treatment to be applied to the excess part of the payments: if the amount of interest paid exceeds the amount that would have been agreed between independent parties, the excess part of the interest payment will be taxed in accordance with art. 9 of the UK/F agreement dealing with dividends. It will not be deductible for purposes of computation of corporation tax.

The UK/F agreement expressly states that the excess part of the interest payment is to be treated as a dividend; the OECD Model does not do so.

3) <u>Determination of the source of an interest payment</u>

Interest shall be deemed to arise in a contracting state when the payer is that state itself, a local authority or a resident of that state.[137]

Where the payer of the interest is a resident of France, the UK or another country, and has in France or in

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137. UK/F, art. 11(6).

the UK a permanent establishment to which the interest paid is effectively connected, and such interest is borne by the permanent establishment, the source of the interest is deemed to be situated in the country of the permanent establishment.[138]

B. Tax treatment of interest according to the convention

1) Principle

a) UK source interest

- Principle of taxation in France

Interest arising in the UK and paid by a resident of France may be taxed in France.[139]

- UK withholding tax: limitation of rate and condition

The state of source of the income has a limited right to tax, but the effect of the treaty is to limit the rate of withholding tax that may be applied, which is equal to the rate of income tax,[140] to 10 per cent. The reduction is allowed if the interest is subject to tax in the hands of its recipient resident in France.

- Claim for reduction of rate of withholding tax

Forms may be obtained from the Inspector of Foreign Dividends, New Malden House, 1 Blagdon Road, New Malden Surrey, and in France from the *Inspecteur des Impôts*.

A claim must be made within six years of the end of the year of assessment to which the income relates.

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138. *Ibid.*

139. Art. 11(1).

140. 30 per cent. for the Financial Year 1983-84.

The appropriate repayment will be made and it can be arranged that the future deductions be made at the treaty rate of 10 per cent., not the domestic rate of income tax, so that no repayment will be necessary. Relief is not allowed automatically. On receipt of a satisfactory claim, the Inspector of Foreign Dividends will consider a repayment of the UK tax in excess of 10 per cent. or if exemption at source is desired from future payments, an authority will be issued to the UK payer authorising them to deduct UK tax at 10 per cent.[141]

- Tax credit

A tax credit is available in France: it corresponds to the 10 per cent. withheld at source in the UK.[142]

The net interest payment received from the UK is incorporated in the taxable income of the French resident. The withholding tax is deducted from the amount of French tax payable in France by the recipient.

b) French source interest

- Principle of taxation in the UK[143]

French source interest paid to a UK resident may be taxed in the UK.

- French withholding tax: limitation of rate and condition

A withholding tax is normally levied in France.

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141. UK Income Tax Form V: Claims by residents of France to relief from UK income tax on interest, royalties, pensions and annuities. This information was given following a letter to the Inspector of Foreign Dividends in September 1983.

142. Instruction of 14 April 1970, at p. 22.

143. UK/F, art. 11(1).

The rate of withholding tax shall not exceed 10 per cent. of the amount of the interest except that interest on bonds (obligations) issued in France before 1 January 1965 may be taxed at a rate not exceeding 12 per cent. of the amount of the interest.[144] The reduction from domestic rates to treaty rates will be allowed if the interest is subject to tax in the hands of its recipient in the UK. However, income from movable property (produits de valeurs mobilières) are exempt from any prélèvement or withholding tax levied in France when paid to sovereign state, international organisations, central banks. This exception covers not only the retenue à la source or prélèvement on income from movable property paid to a non resident, but also the 10 or 12 per cent. withholding tax on bond interests (intérêts d'obligations).[145]

- Claim for reduction of the rate of withholding tax

Forms in France are entitled RF 1 GB (No. 5084) or RF 2 GB (No. 5085).

In a decision of 18 June 1980, the Conseil d'Etat emphasised the importance of claims for relief (demande de dégrèvement).[146]

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144. Ibid., art. 11(2).

145. CGI, arts. 131 quinquiès and 131 sexiès I. Further exemptions may take place upon approval of the Ministry of Economy and Finance: CGI, art. 131 sexies II. This was originally introduced by a ministerial decision of 16 March 1967, explained by a note of 31 May 1967: Droit Fiscal 1967, No. 25, comm. 747; Jurisclasseur de Droit International, Fascicule 354 F, §37.

146. CE, 18 June 1980, Req. No. 2294, JCP ed CI 1981, 9583, at p. 113; also Droit Fiscal 1980, No. 41 comm. 1934.

The facts of the case involve the tax convention between Switzerland and France, but the principle stated could equally apply in the context of the UK/F double taxation agreement.

Similarly to the UK/F tax convention, the Franco-Swiss tax convention reduces the domestic rate of prélèvement on interest payment[147] to a treaty rate of 10 per cent.[148]

The Conseil d'Etat refused to grant the claimant - a Swiss resident company which received interest payments from a French resident company - the reduced rate of withholding tax on the basis that no claim for relief had been submitted.

It is essentially a condition of form which motivated the Conseil d'Etat in its decision. It is based not only on art. 12 of the tax convention between Switzerland and France, dealing with the tax treatment of interest, but also on art. 31 which states that competent authorities are to settle the application of the convention, in particular in relation to art. 12.

The UK/F tax convention has a similar provision, art. 28, which makes a specific reference to art. 11 on taxation of interest.

It may therefore reasonably be thought that a similar problem involving the UK/F convention would have an identical outcome.

It is interesting to point out that matters relating

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147. CGI, art. 125 A-III.
148. Treaty between France and Switzerland, art. 12.

to claims for relief are exclusively dealt with in the French _Instruction_ of 1970 and forms which the UK tax administration has issued; they are not referred to in the text of the convention. In the present case, the _Conseil d'Etat_ has given these documents considerable authority.

- _Tax credit_

A tax credit is available to the UK resident who receives the interest: it represents the withholding tax levied at source in France and it is deductible from the tax due by the beneficiary of the interest in the UK.

2) _Exception_

There is a major exception to the rule that interest paid to a non resident is taxable in the country of residence of the recipient, subject to a withholding tax in the country of source. If a company resident in a contracting state carries on an activity in the other contracting state through a permanent establishment situated in that state, interest will be taxed as part of the "industrial and commercial profits" of the permanent establishment if the debt claim in respect of which the interest is paid is effectively connected with such permanent establishment.[149] Interest is effectively connected with a branch or other permanent establishment when the debt claims form part of

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149. UK/F, art. 11(4). The OECD Model is more specific in this respect than the UK/F agreement: it specifies that the exception applies not only to the existence of a permanent establishment in the state of source of the interest but also a fixed base.

the assets of the permanent establishment.

§3. Royalties[150]

I. The Definition of Royalties Under the Treaty

Art. 12(2) of the UK/F agreement provides:

> The term "royalties" (redevances) as used in this article means payments of any kind received as a consideration for the use (usage) of, or the right to use (concession de l'usage), any copyright (droit d'auteur) of literary (sur une oeuvre litteraire), artistic or scientific work (including cinematographic films and films or tapes for radio or television broadcasting), any patent (brevêt), trademark (marque de fabrique ou de commerce), design or model (dessin ou modèle), plan, secret formula or process (formule secrète ou procédé secret), or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning (ayant trait) industrial, commercial or scientific experience and shall include gains derived from the sale or exchange of any rights or property giving rise (droits ou biens générateurs) to such royalties.

In agreement with the OECD definition of royalties, rights to variable or fixed payments (les droits à

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150. The present paragraph does not generally deal with payment of royalties between associated companies; this particular point has been examined elsewhere: see Chapter 6, Part 1.
For a general background on the law of intellectual property, see W.R. Cornish, Intellectual Property: Patents, Copyright, Trade Marks and Allied Rights (London: Sweet & Maxwell, 1981). On international tax treatment of royalties in general, see M. Edwards-Ker, op.cit., note 104 above, Chapter 8; also CDFI 1975, "Tax Treatment of the Importation and Exportation of Technology Know How, Patents, Other Intangibles and Technical Assistance", Vol. 60 a, French report by Jacques Saint Bauzel, pp. 181-206 and UK report by R. James Pickerill, pp. 297-309. Jurisclasseur de Droit International, Fascicule 354 E; Taxation of Companies in Europe, op.cit., note 123 above, Vol. 11 Supplement No. 38-39 and 41.

des redevances variables ou fixes) as consideration for the working of, or the right to work (pour l'exploitation ou la concession de l'exploitation), mineral deposits (gisements minéraux), sources and other natural resources (richesses du sol) come under art. 5 of the UK/F agreement and are consequently treated as income from immovable property.[151]

The definition of royalties according to the UK/F double taxation agreement differs from its OECD counterpart essentially in two respects:

- The UK/F agreement treats as royalties payments received as a consideration for the use or the right to use film or tapes for radio or television broadcasting; the OECD texts (1963 and 1977) mention cinematographic films only. However, the 1977 OECD commentary specifies that films include those exhibited in cinemas or on the television.

The scope of art. 12 of the UK/F agreement is wider still than its OECD counterpart: it includes rents in respect of tapes for radio and television broadcasting.

- More important is the following difference: the UK/F agreement treats as royalties any gains derived from the sale or exchange of any rights or property giving rise to such royalties (gains provenant de la vente ou de l'échange de droits ou de biens générateurs de telles

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151. Instruction of 14 April 1970, §§2311-1 and 2372. For further developments, see below, Section 3. This is also specified in the OECD commentary on art. 12, §14, p. 117.

redevances).[152]

Traditionally, in double taxation agreements, payments constituting consideration for the sale of equipment are treated differently from those made for the use of equipment. The former would fall under art. 6 (industrial and commercial profits), art. 13 (capital gains), or art. 22 (other income), depending on the case. The British and French negotiators have opted for the application of a very extensive definition of the term royalties.

II. The Tax Treatment of Royalties

1) Under domestic legislation

A. United Kingdom

The tax treatment of technology in the UK is not favourable to taxpayers. "A country whose self-defeating tax rules markedly prejudice the exploiter of technology".[153]

Conversely, France, as will be shown below, may be described as a high tax country offering favourable tax treatment.

Royalty and capital payments may be made.

The tax treatment of payments in respect of

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152. The French version of this particular provision is clearer in as much as it emphasises the particularly wide meaning given to the word royalty: not only does it include payments received as a consideration for the use or right to use numerous items, but also the payments resulting from the sale or the exchange of rights of property of all these items.

153. M. Edwardes-Ker, op.cit., note 104 above, Chapter 8, at p. 5.

industrial property may differ according to the nature of the right to which they are attached; this is why patents and know how will be briefly examined under separate headings.

A further distinction will be made between tax treatment in relation to the computation of corporation tax and the tax imposed on the payment itself.

- Payments or receipts in respect of technology for purposes of corporation tax

. Patents

Expenditure

In computing profits chargeable to corporation tax, expenditure on scientific research relating to the trade is treated as a deductible expense.

A capital sum paid to purchase a patent is amortised in equal amounts over the number of years remaining for the life of the patent.[154]

Royalty payments will be deductible from the profits of the year of payment.

Receipts

A capital sum received on the sale of a patent is also treated as taxable income. This is a particularly unfavourable treatment as the proceeds of the sale of a patent constitute a capital asset, but they are taxed as income.

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154. ICTA 1970, s. 378(2).

A concession is granted in respect of the tax treatment of such a capital sum; its payment may be spread over a period of 6 years.[155]

Royalty receipts are taxable as income.

. Know how[156]

The expression know how is defined in s. 386(7) of the ICTA 1970 as meaning:

> any industrial information and techniques likely to assist in the manufacture or processing of goods or materials, or in the working of a mine, oil-well or other source of mineral deposits (including the searching for, discovery or testing of deposits or the winning of access thereto) or in the carrying out of any agricultural, forestry or fishing operations.

Expenditure

Current annual payments for know how are deductible in the year paid.

Capital payments for know how are not deductible; they can however be amortised in equal instalments over six years.

Receipts

All receipts for know how of a capital or income nature are taxable as income in the year they are received, with no spreading provision.[157]

Where a person disposes of a trade and of know how used for the purpose of the trade at the same time, any payment received is treated as a payment for goodwill for the

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155. Ibid., s. 380(1).

156. Ibid., s. 386.

157. Ibid., s. 386(2).

purposes of corporation tax and capital gains tax. The effect is that the payment will be subject to tax as a capital gain rather than as a trading receipt. This provision does not apply if the parties elect to the contrary or the trade to which the know how is related was carried on wholly outside the UK before the transfer.[158]

- Tax treatment of payments in respect of technology

. Patents

Payments to residents

Ss. 52 or 53 of ICTA 1970 apply to "any royalty or other sum paid in respect of the user of a patent.[159]

The basic rate of income tax is deducted by the payer at the time when he makes the payment and collected from him by the Revenue.[160]

The Taxes Act distinguishes between payments charged with tax under Schedule D Case III which are payable out of "the profits or gains brought into charge to income tax" (s. 52) and those not so payable, i.e. payments payable wholly or in part out of a source other than profits or gains brought into charge to income tax.

S. 53 will apply to payments made by companies as they are chargeable not to income tax, but to corporation

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158. UK Report, IFA 1975, at p. 303.

159. ICTA 1970, ss. 52(2)(a) and 53 (1)(b).

160. For a substantial development on ss. 52-53 of the ICTA, see Pinson, op.cit., note 20 above, Chapter 5, 5-30 - 5-64, pp. 127-142; Tiley, op.cit., note 20 above, pp. 448-457; also an article by J. Tiley, "The Repeal of s. 52 of the Taxes Act 1970", BTR, 1981, No. 5, pp. 263-285.

tax.[161]

The table in Appendix I to this section summarises the conditions and mechanics of taxation of royalties or other sum [162] paid in respect of the user of a patent (i.e. the person who is paying the royalty) under ss. 52 and 53. Its purpose is also to emphasise the differences between both sections.

In addition, patent royalties payable to residents and non residents are subject to a 15 per cent. rate of VAT. If the recipient of the royalty does not have a permanent establishment in the United Kingdom, the payor of the royalty must account for the VAT due to the authorities, but he may credit it against his own liability to VAT.[163]

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161. ICTA 1970, s. 240(4): "No payment made by a company resident in the UK shall ... be treated ... as paid out of profits or gains brought into charge to income tax ..."

162. For the meaning of this expression, see a decision of the House of Lords, Mills v. Jones (1929) 14 TC, p. 769: the words "other sum" include a lump sum awarded to an inventor in respect of the past user of a patent. However, the phrase "royalty or other sum" does not include capital payments, such as a lump sum payment for the grant of an exclusive licence: British Salmson Aero Engines Ltd v. IRC (1938) 22 TC, p. 29. An English company acquired the sole licence to manufacture and sell in the UK engines made by a French company for a period of 10 years in consideration of £25,000 payable as to £15,000 on the signing and as to the balance by 2 payments of £5,000 at intervals of 6 months; in addition, £2,500 was payable "as royalty" during each year of the currency of the licence. The High Court upheld the decision of the Special Commissioners: £25,000 was a capital payment, but the 10 further payments were royalties or other sum paid in respect of the user of a patent.

163. IBFD, Taxation of Companies in Europe, op.cit., note 123 above, Supplement No. 39.

ICTA 1970, s. 52	ICTA 1970, s. 53
Applies when payments charged under Schedule D Case III is payable wholly out of profits or gains brought into charge to income tax.	Applies when payment is not payable or not wholly payable out of profits or gains brought into charge to income tax. S. 53 applies to payments made by companies chargeable to corporation tax.
The person making the payment is entitled (no obligation) to deduct income tax when making the payment, but only at the basic rate.	The person making the payment must (obligation) deduct a sum representing the amount of income tax on the payment.
The payer keeps income tax deducted at the basic rate.	Assessment is made on the person by or through whom the payment is made. The payer must account to the Revenue for tax at the basic rate on the whole sum.
The basic rate of income tax taken into consideration is that for the year of assessment in which the amount becomes due.	The basic rate of income tax is that of the year when the payment is made.
The payee is treated as having paid the amount of income tax which has been deducted.	The payee is regarded as having paid basic rate of income tax.

Payments to non residents

UK residents paying royalties abroad in respect of UK patents are subject to a 30 per cent withholding tax, deducted at source.

The effect in the UK of the UK/F double taxation agreement is to reduce this deduction at source to nil.[164]

Under UK domestic law, no withholding tax is due in respect of payments in respect of non UK patent rights.[165]

A capital sum paid abroad on the sale of a patent will not be subject to any UK withholding tax either.

Where a UK resident purchases a patent right from a non resident which constitutes capital expenditure, no charge to UK tax is made on the non resident unless it is a UK patent right which is being sold. If such is the case, income tax is deducted at source from the payment. The non resident may spread his liability to tax over six years.[166]

. Know how

No withholding tax will be deducted at source in respect of income or capital payments of know how whether UK or foreign.[167]

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164. UK/F, art. 12(1). Such payments are subject to VAT at the rate of 15 per cent.

165. IFA 1975, UK Report, at p. 301.

166. Ibid.

167. M. Edwardes-Ker, op.cit., note 104 above, Chapter 8, at p. 8.

B. France

"France ranks as a very attractive country to locate research and development work."[168]

- Payments or receipts in respect of technology for purposes of corporation tax

. Payments

A royalty (redevance) paid by a French company in respect of technology provided to it is treated as a deductible expense for purposes of computation of corporation tax. There is no distinction in this respect between the tax treatment of the payment involving licensing of a payment or know how.

A capital sum paid for the purchase of a patent does not qualify as a deductible expense. It corresponds to the price of a fixed asset. It may or may not be written off. Patents may be written off, but process (procédés), manufacturing formulae (formules de fabrication) or trade marks (marques) not embodied in a patent cannot be written off. The writing off is calculated on the price of the patent and is normally spread over the actual period of use of the patent.[169]

. Receipts

Principle of treatment as long term capital gains

Profits realised through transfer of technology

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168. M. Edwardes-Ker, op.cit., note 104 above, Chapter 8, p. 11.

169. IFA 1975, French Report, at pp. 183-185.

are incorporated to the taxable profits of the French company.

Two rates of tax, 15 per cent. or 50 per cent., may be applicable, depending upon the nature of the receipt.

A favourable tax treatment, that of long term capital gains, applies to the sale proceeds of patents (*produits des cessions de brevets*), processes and techniques (*procédés et techniques*) and other capital receipts for the grant of exclusive or geographically limited exploitation licences, provided the rights disposed of are rights of a capital nature and have not been acquired for a valuable consideration within the previous two years.[170]

The *Conseil d'Etat* recently interpreted these rules of taxation.[171]

A French resident company had granted the Government of a country A the right to manufacture a particular type of engine; the company agreed to provide the relevant information. The company treated royalty payments received as a result of this contract as long term capital gains.

The French tax authorities subjected such payments to corporation tax at the rate of 50 per cent., on the ground that the royalties did not correspond to the granting of a permanent licence on patent rights, that the

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170. CGI, art. 39 *terdéciès*-1. For a translation, see M. Edwardes-Ker, *op.cit.*, note 104 above, at p. 10.

171. CE 30 April 1980, *Req*. No. 178-50, RDCE 1980, pp. 207-208.

licence could be withdrawn after five years.

The *Conseil d'Etat* held that the application of art. 39 *terdéciès*-- did not require the granting of licences to have a permanent character. However, as regard granting of licences for patents, process and techniques, the application of long term capital gains treatment to receipts in the hands of the licensor was subject to the condition that the licensee could "exploit it usefully" (*l'exploiter utilement*) over a sufficient period of time (*pendant une période suffisante*).

The favourable treatment also applies to know how, even when granted independently of patents.[172]

A favourable tax treatment means that, when received, the sums just described are treated as long term capital gains and subject to a 15 per cent. rate of tax in the hands of the recipient French company instead of the normal 50 per cent. rate of corporation tax.

Sums which do not qualify for the favourable tax treatment are subject to short term capital gains tax, *i.e.* a tax at the rate of 50 per cent, but spread over the year of the sale and the following two years.[173]

Exception: CGI, art. 39 terdéciès-1 bis

The application of the tax treatment of long term capital gains to payments in respect of technology is of great advantage to both licensor (*concédant*) and licensee (*concessionnaire*). The recipient is only taxable on the

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172. *Ibid*., Finance Law 1972, art. 2.

173. *Ibid*., at p. 10.

royalties at the rate of 15 per cent. whilst the payer enjoys tax relief at 50 per cent.

This situation may give rise to abuse.[174] In order to counteract it, art. 39 terdéciès-1 bis of the General Tax Code forbids the application of the long term capital gains tax treatment to royalties when links of interdependence (liens de dépendance) exist between the paying and receiving companies and when royalties have been treated as deductions for corporation tax purposes.

These two conditions are to be considered in turn.

Links of interdependence are deemed to exist:

- when a company holds directly or indirectly the majority of the share capital of the other or exercises in fact the power of decision;
- when both companies are under the control of a third one.

When either of these situations arises, the royalties are to be included in the profits of the company granting the licence and taxed at a rate of 50 per cent. instead of 15 per cent.

The second condition is that the tax treatment of long term capital gains will not apply to royalties when they have been treated as deductions for corporation tax purposes. The tax treatment of long term capital gains

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174. Companies could artificially "make into royalties" income of another nature in order to benefit from the favourable tax treatment of royalties.

will therefore apply when royalties have not been treated as deductions for corporation tax purposes: such is the case when royalties are received by a French company from its foreign subsidiary. If the seat of the licensee company is situated abroad, the royalties have not been deducted from the taxable base of profits subject to French corporation tax. Consequently, the favourable tax treatment of long term capital gains will apply.

Royalties received by a French company from its UK subsidiary will not be subject to a withholding tax in the UK, in application of art. 12(1) of the UK/F tax agreement. In addition, the receipt in France will only be subject to a 15 per cent.rate of tax, not 50 per cent.

- Tax treatment of payments in respect of technology

. Withholding tax (retenue à la source)

A $33\frac{1}{3}$ per cent.withholding tax is levied on the proceeds of the right to use a patent, the proceeds of the sale or the right to use processes or formulas paid to non residents.

In addition, royalties from the sale of licensing of patents payable to non residents are normally subject to VAT in France at the rate of 17.6 per cent.[175]

2) Under the treaty

A. Principle

Exclusive taxation in the state of residence of

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175. Guide to European Taxation, op.cit., note 123 above, No. 38.

the recipient.

The tax treatment of royalties under the UK/F agreement is in principle that of exclusive taxation in the state of residence of the beneficiary of the royalties:

> Royalties arising in a Contracting State and paid to a resident of the other Contracting State who is subject to tax there in respect thereof shall be taxable only in that other state. [176]

The right to tax is not divided between both contracting states as in the case of other investment income (dividends and interest), but when a French company pays a royalty (redevance) to a UK resident, it may not deduct from that payment any withholding tax. The principle of exclusive taxation in the state of residence of the recipient of the royalty is subject to two important exceptions examined under B. below.

The following decision of the Conseil d'Etat[177] deals with the problem of the conditions of imputation of withholding tax levied in the country of source of the royalty against the liability to corporation tax in France.

This decision is not relevant for the purpose of the UK/F double taxation agreement which provides for a nil rate of withholding tax in the country of source of the

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176. UK/F agreement, art. 12(1).

177. CE 19 March 1980, Req. No. 10708, JCP ed.CI, 1980, at p. 172; also reported in English in European Taxation, 1980, at pp. 265-266.

royalty, but it is interesting in the wider context of tax treatment of royalties under double taxation agreements to which France is a party.

A French company had received royalties from Canada, Spain, Japan and the United States. Such payments had been subject to a withholding tax in their country of source and the French company pretended that the taxes withheld at source abroad could be deducted from corporation tax due at 50 per cent., following a supplementary assessment (redressement) by the French tax authorities.

The tax administration on the other hand contended that the tax withheld on royalty payments being liable to a 10 per cent. tax on long term capital gains, could not be deducted from any amount but the liability of the French company to long term capital gains; it certainly could not be imputed on the profits subject to a 50 per cent. rate of corporation tax.

The Conseil d'Etat rendered a decision in favour of the tax administration: the tax credit given in France for tax paid abroad on the payment of the royalty can only be deducted from the liability of the French company to long term capital gains.

The consequence of this decision is that if the liability of the French company to long term capital gains tax is not sufficient to absorb the tax credit given, some double taxation will remain.

B. Exceptions

- The principle of exemption of taxation in the

country of source of a royalty will not apply if the recipient of the royalties being a resident of the other country signatory to the treaty has in the country of source of the royalty a permanent establishment and the right or property in respect of which the royalty is paid is effectively connected with the permanent establishment.[178] These conditions need to be fulfilled cumulatively for the exception to apply.

Royalties are effectively connected with a permanent establishment when the rights or property giving rise to them form part of the assets of the permanent establishment.[179]

- The second exception to the principle of sole taxation in the country of source of the royalty is expressed in art. 12(4):

> Where, owing (par suite) to a special relationship between the payer (débiteur) and the recipient (créancier) or between both of them and some other person, the amount of the royalties paid, having regard to the use, right or information for which they are paid (compte tenu de la prestation pour laquelle elles sont versées), exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this article shall apply only to the last mentioned amount. In that case, the excess part (la partie excédentaire) of the payments, if treated as a dividend or distribution of a company, shall be taxed in accordance with art. 9.

The text of the agreement here applies the arm's length principle to the payment of royalties between associated companies. The advantageous tax treatment of

178. UK/F agreement, art. 12(3).

179. See OECD commentary on art. 12(3).

royalties is limited to the amount that would have been agreed upon if no special relationship existed between the two companies. The excess will be taxed in accordance with art. 9 if treated as a dividend or distribution. This is used as an illustration of the way in which the excess may be treated.[180]

In order to determine the category of income in which the excess should be classified, the circumstances of a case have to be examined individually. In case of difficulty in determining the category of income in which the excess should be classified, the OECD commentary suggests resorting to the mutual agreement procedure.[181]

C. France's reservations on the tax treatment of royalties under the 1977 OECD Model

France has introduced a reservation on art. 12(1) of the 1977 OECD Model which expresses the principle of exclusive taxation of royalties in the country of the beneficial owner's residence: France reserves the right to retain some tax (maintenir une imposition) on French source royalties when flows (le mouvement) of royalties between France and the other contracting states are unbalanced to France's disadvantage (est déséquilibré en défaveur de la France).

This is a broad and dangerous statement. It cannot have any effect on the binding agreement which the UK

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180. OECD commentary on art. 13(4), §§18-20.

181. Ibid., §21. For details on the mutual agreement procedure, see Introduction, Chapter 8.

and France have signed in 1968, but such unilateral statement may indicate a change in the attitude of the French negotiators to future tax conventions as regards the tax treatment of royalties.

Section 3: Income from Immovable Property[182]

§1. Definition of Immovable Property for Purposes of UK/F Double Taxation Agreement

I. Reference to the Law of the State in which the Property is Situated

For purposes of application of the UK/F tax convention, the term "immovable property" ("biens immobiliers") shall be defined in accordance with the law of the contracting state in which the property in question is situated.[183]

The principle of definition of immovable property by reference to the domestic law of the country of location of the immovable finds a limitation.

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182. Jurisclasseur de Droit International, Fascicule 354 A; Notes on the Taxation of Income from Real Property, Leaflet IR 27 (1980), issued by the Board of Inland Revenue; Stuart Lightman, International Property Transactions (Institute for International Research, 1980).

183. UK/F, art. 5(2)(a).

II. Enumeration of Items always Treated as Immovable Property under the Treaty

Irrespective of its qualification under domestic law, some property is always to be treated as immovable property for purposes of application of the UK/F double taxation agreement; thus, property accessory to immovable property (les accessoires), livestock and equipment used in agriculture and forestry. Certain rights also come under the treaty definition of "immovable property"; usufruct (l'usufruit) of immovable property, rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources.[184]

The treaty's enumeration of what constitutes "immovable property" also includes "rights to which the provisions of general law respecting landed property apply" (les droits auxquels s'appliquent les dispositions du droit privé concernant la propriété foncière).

This sentence seems meaningless, certainly in English; it finds an exact replica in the corresponding article of the OECD Model on income from immovable property,[185] but the commentary provides no explanation.

Income derived from the direct use (exploitation directe), letting (location), use in any other form of immovable property (de l'affermage ainsi que de toute

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184. Ibid.

185. Art. 6.

autre forme d'exploitation), income from immovable property of an enterprise or used for the performance of professional services also qualify as income from immovable property and are treated as described below.

When a form of property is listed in art. 5 as constituting immovable property for the purposes of the treaty, the qualification it has under the legislation of the country where it is situated becomes irrelevant.

In the Instruction of 1970 some clarification is given as to the meaning of immovable property for treaty purposes. Income received by partners or shareholders (associés ou actionnaries) in sociétés immobilières transparentes are to be treated for the purposes of the UK/F agreement as income from immovable property and consequently be taxed in the country of situation of the immovable.[186]

This is directly connected with a specific aspect of French law which is briefly summarised here.

French companies are normally subject to corporation tax at the rate of 50 per cent., but this principle suffers numerous exceptions. For instance, companies or partnerships whose sole object is either to build or acquire real estate property in order to divide them into fractions to be attributed to the members, or to manage such property, or to rent it, are deemed not to

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186. Instruction of 14 April 1970, §2331.

have a legal personality separate from that of its members for tax purposes, irrespective of its legal structure (forme juridique). Members of such companies or partnerships - called sociétés transparentes - are subject to income tax or corporation tax on their income received from the société transparente.[187]

Income received from this type of company or partnership is treated as immovable property under French domestic tax law; it is to be treated accordingly under treaty law. It is interesting to point out that the article of the UK/F tax convention dealing with the definition and tax treatment of income from immovable property does not expressly refer to this particular category of income as being income from immovable property. Only the text of the Instruction spells it out; the treaty article only states in general terms that immovable property is to be defined in accordance with the law of the contracting state in which the property is situated. The Instruction also explains that "the law of the contracting state in which that property is situated" refers both to taxation law (droit fiscal) and civil law (droit civil). It is in application of tax law[188] that income from sociétés de copropriété immobilières transparentes is treated as income from immovable property,

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187. CGI, art. 165; for a development on the law of 5 March 1963 (art. 30 in particular) see Jurisclasseur de Droit International, Fascicule 354 A, at p. 2.

188. Law No. 63-254 of 15 March 1963 on uniformisation of tax treatment on income from immovable property.

not in application of civil law.

On the basis that the provision of the treaty refers to "the law" of the contracting state in broad terms, one could argue that the fact that it is tax law, and not civil law which gives the income the character of an immovable does not matter.[189]

III. Specific Exclusion

For the purposes of the UK/F double taxation agreement, ships, boats and aircraft shall not be regarded as immovable property.[190]

§2. Tax Treatment of Income from Immovable Property

A. Right to Tax of the Country of Situation of the Property

"Income from immovable property may be taxed in the Contracting State in which such property is situated."[191]

The right to tax of the state of source has priority over the right to tax of the state of residence of the recipient. Avoidance of double taxation will be achieved in the UK by the tax authorities giving a credit for taxes paid in France on the income from the immovable

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189. This view is shared by Pierre Kerlan, author of the Fascicule in Jurisclasseur de Droit International on Revenus Immobiliers et agricoles, at pp. 3(§9) and 7(§45).

190. UK/F, art. 5(2)(b).

191. UK/F, art. 5(1).

situated there; France applies the exemption method and income from immovable property situated in the UK shall be exempt from French tax.[192]

The function of the treaty is to allocate the right to tax this particular category of income to the state in which the property is situated. The domestic rules of taxation of that state describe the method to apply to assess the liability to tax on that particular income.

In practice, the following steps are to be taken, in this order:

- where is a property or a right to property giving rise to income located?
- does it constitute income from immovable property under the treaty?
- if so, the liability of the taxpayer on that income is to be determined according to the domestic rules of the country of location of such property.

The following case illustrates the application of taxation of immovable property under treaty law.[193] The 1961 tax convention between Canada and France is involved but the outcome would have been identical had it involved the 1968 tax treaty.

A company had its seat in Canada and no permanent

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192. UK/F, art. 24(b)(i); see below Chapter 4.

193. CE 26 November 1975 Req. No. 93187, reported in Droit Fiscal 1976, No. 21, comm. 733, p. 543.

establishment in France; it owned in France _un ensemble immobilier_ and sold several flats.

The company contended that the profit realised on the sale of these flats was not to be regarded as industrial and commercial profits for purposes of the application of the tax convention between Canada and France and therefore, they were not to be taxable in France because there was no permanent establishment situated there.

The tax administration claimed that the profits qualified as income from immovable property and were taxable in the country of location of the property, _i.e._ France.

In order to solve this problem, the _Conseil d'Etat_ referred to a method of interpretation provided in the treaty itself, according to which in the application of the provisions of the convention by a contracting state, any term not otherwise defined shall have the meaning which it has under the laws of the contracting state relating to the taxes which are the subject of the convention.[194] Reference was therefore made to French domestic law: had the profit been realised by a French resident company, it would have been taxable as industrial and commercial profits. The contention of the Canadian company was upheld by the _Conseil d'Etat_.

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194. In the UK/F convention, art. 2(3).

Section 4: Capital Gains[195]

§1. Tax Treatment of Capital Gains according to the Convention: Art. 13

The role of the treaty provision on capital gains is limited to allocating to one contracting state the right to tax a gain: it cannot be construed as giving a state the right to tax capital gains if such right does not exist under domestic law. In other words, a gain may not be subject to taxation on capital gains unless domestic rules so provide, but the treaty provision applies to all taxes levied by a contracting state on capital gains. In addition, the domestic rules of computation are applied to assess the liability of a taxpayer to capital gains tax.

The rules of taxation of gains arising from the alienation of different assets in art. 13 are consistent with those applicable to profits from the same assets.

I. Taxation in the Country of Situation of the Asset which Gives Rise to the Gain

A. Gain from the alienation of immovable property

Income from immovable property may be taxed in

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195. See in general Instruction of 14 April 1970, §2391; also Jurisclasseur de Droit International, Fascicule 354-J published in 1982; 1976 IFA Congress, Vol. 61b, "The Definition of Capital Gains in Various Countries".

the contracting state in which the property is situated.[196] Similarly, gains from the alienation of immovable property may be taxed in the contracting state in which such property is situated.[197] The term "immovable property" is defined in the provision of the convention dealing with the tax treatment of income from immovable property. The scope of art. 13 extends beyond immovable property: it applies to gains from the alienation of shares (parts) or comparable interests (droits analogues) in a real property cooperative (société de copropriété immobilière) or in a company of which the assets consist principally of such property (société dont l'actif est composé principalement de biens immobliers).

The effect of this provision is to allow France to apply fully its domestic rules of taxation on real property (règles de fiscalité immobilière).[198]

B. Gains from the alienation of movable property

Profits of the French permanent establishment of a UK resident company may be taxed in France, subject to the application of the "effectively connected" rule: only so much of the profits realised in France that are attributable to the permanent establishment may be taxed

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196. UK/F, art. 5(1).

197. Ibid., art. 13(1).

198. Instruction of 14 April 1970, §2311-1, 2313 and 2391.

there.

Similarly, gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of the UK has in France including such gains from the alienation of the permanent establishment (alone or together with the whole enterprise) may also be taxed in France.[199]

II. Taxation in the Country of Residence of the Recipient of the Gain

A. Gains from the alienation of ships and aircraft

Profits derived from the operation of ships or aircraft in international traffic shall be taxable only in the state of residence of the recipient of such profits.[200]

Similarly, gains derived by a resident of a contracting state from the alienation of ships and aircraft and movable property pertaining to their operation (*afférents à leur exploitation*) shall be taxable only in the state of residence of the recipient of the gains.[201] This rule of taxation is subject to one condition, expressly stipulated in the treaty provision: the exclusive right to tax allocated to the state of residence of the recipient will only apply if the gain is taxed in that state.

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199. UK/F, art. 13(2).

200. UK/F, art. 7.

201. UK/F, art. 13(2).

The actual taxation of the gain is a condition of application of the treaty rule of taxation. This in fact implies that the country where the gain arises can apply its domestic legislation if no tax is imposed on the gain in the country of residence of the recipient.

The rules of taxation of gains from the alienation of ships and aircraft operated in international traffic under the OECD Model are formulated differently: such gains are taxable only in the contracting state in which the place of effective management of the enterprise is situated.

B. Gains from the alienation of any other property

Gains from the alienation of any property other than those mentioned above, shall, if subject to tax in the contracting state of which the alienator is a resident, be taxable only in that state.[202] This provision applies - *inter alia* - to gains from the alienation of shares in a company, debentures, bonds or other securities.[203] But, as stated above, gains from the alienation of shares or comparable interests in a real property cooperative or in a company of which the assets consist principally of such property, may be taxed in the contracting state in which such property is situated.[204] This specific

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202. *Ibid.*, art. 13(3).

203. *Jurisclasseur de Droit International*, *op.cit.*, note 182 above, §22.

204. UK/F, art. 13(1).

point finds no counterpart in the OECD Model and is of relevance essentially from a French point of view.

It is interesting to note that not all forms of gains resulting from alienation are subject to art. 13 of the UK/F double taxation agreement.

For instance, the negotiators of the 1968 UK/F convention have opted for a very wide definition of the term "royalties": it includes gains derived from the sale or exchange of any rights or property giving rise to royalties as defined in art. 12(2). Such gains arising in a contracting state and paid to a resident of the other contracting state who is subject to tax there shall be taxable only in that other state.

§2. The Importance of Domestic Legislation

The following paragraph will very broadly outline the domestic tax treatment of capital gains.

Both in the United Kingdom and in France the effective rate of taxation of capital gains realised by companies is lower than that levied on business profits. This may be justified by the fact that capital gains are of isolated nature, they are often reinvested in the business and frequently arise to a large extent from inflation.

I. United Kingdom

In the UK, the chargeable gains of companies are

liable to corporation tax and not to capital gains tax.[205] The amount to be included in respect of chargeable gains in a company's total profits for any accounting period is the total gains accruing to the company in the period, after deducting allowable losses, including unrelieved losses brought forward from an earlier period.[206] The chargeable gains are to be computed in accordance with the principles applying for capital gains tax: capital gains is charged on the disposal of assets,[207] and all forms of property are assets for this purpose.[208] However, since 1 April 1973, only a part of the chargeable gains is included in the total profits for an accounting period;[209] a fraction of the gains is thus excluded from the charge to corporation tax and the effective rate charged on capital gains is 30 per cent., and not the normal rate of corporation tax, <u>i.e.</u> 52 per cent. for the financial year 1983-4.

II. <u>France</u>

France also taxes a company's capital gains at a lower rate than the normal rate of corporation tax,

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205. ICTA 1970, s. 238(3).

206. <u>Ibid</u>., s. 265(1). Losses are computed in the same way as gains; Capital Gains Tax Act 1979 (hereinafter cited as CGTA 1979), s. 29.

207. CGTA 1979, s. 1(1).

208. <u>Ibid</u>., s. 19(1).

209. FA 1972, s. 93(1).

50 per cent., but it proceeds differently: rules are based on a distinction between short term gains (plus-values à court terme) and long term gains (plus-values à long terme).[210]

Broadly speaking, a gain is a short term gain where the asset was acquired or created less than two years prior to the disposal. The gain is taxed at the normal 50 per cent. rate of corporation tax, but the company may spread the charge over that and the two succeeding accounting periods. Short term gains are added to profits subject to tax at the full rate of 50 per cent., but the taxpayer may elect to have those short term gains added by equal thirds to profits of the year of realisation and the following two. Long term gains arise from the disposal of assets acquired at least two years previously; they are subject to a reduced rate of 15 per cent. The payment of this reduced rate of tax is conditional. The after tax gain must be transferred during the following period (exercice suivant) to a special reserve in the balance sheet. The special reserve is entitled "special long term capital reserve" (reserve spéciale plus-value a long terme). The company having realised the long term capital gain but having failed to create the special reserve will become liable to a further liability of 35 per cent. on the gain. The same liability will arise if the company makes a distri-

210. CGI, art. 39 duodéciès.

bution out of that reserve.[211] In other words, the benefit of favourable tax rules for long term capital gains is entirely dependent upon the gain being retained in the business.

Gains realised by non resident companies who do not have a permanent establishment in the UK are not taxable there whereas in France, gains realised by a non-resident company, even in the absence of a permanent establishment in France, will be subject to tax.

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211. For exceptions to this rule, see CGI, art. 209 _quater_ A. See also Part I, Chapter 6, Section 2, VI p. 426; also H. Lazarski, "New Measures Affecting Real Property Owned by Foreign Companies and Other Developments" European Taxation (1983) pp. 39-45 and pp. 279-285.

CHAPTER 3

TAXATION OF CERTAIN CATEGORIES OF INCOME BY THE COUNTRY OF RESIDENCE

Section 1: Income Not Expressly Mentioned in the Treaty[1]

Article 22 of the UK/F agreement provides:

> Items of income (les éléments du revenu) of a resident of a Contracting State who is subject to tax there in respect thereof being income of a class (catégorie) or from sources not expressly mentioned in the foregoing Articles of this Convention shall, if the right or holding (à condition que le droit ou la participation géneratrice) from which the income arises is not effectively connected with a permanent establishment in the other Contracting State, be taxable only in the first mentioned State.

Items of income not dealt with by any other article include for instance maintenance payments, prizes or awards, social security payments and gambling winnings.[2]

The general rule is that income of a resident of a contracting state which is not dealt with by any other article of the convention will be taxable only in that person's state of residence. This is subject to the condition that the state of residence in fact taxes the income

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1. Jurisclasseur de Droit International, Fascicule 354-K.

2. Arthur Andersen and Co., The US/UK Double Tax Treaty (London: Tolley Publishing Company Limited, 1980), p. 118.

covered by this article. The purpose of this condition is to avoid non-taxation which could happen if the exclusive right to tax given to the state of residence applied irrespective of whether such right was in fact exercised.[3]

The income concerned is not only income of a class not expressly dealt with but also income from sources not expressly mentioned; the scope of the article extends to income from third states; it is not confined to income arising in the United Kingdom or in France.[4]

Section 2: Industrial or Commercial Profits in the Absence of a Permanent Establishment

In the absence of a permanent establishment in the other contracting state, the industrial or commercial profits of an enterprise of a contracting state shall be taxable only in that state.[5]

Under the convention between the UK and France, the industrial or commercial profits of a French resident enterprise, for instance, shall not be taxed in the UK unless the enterprise carries on business in the UK through a permanent establishment situated in the UK.

These rules have been developed in earlier

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3. OECD Commentary on art. 21 of the 1977 Model, §1.

4. The OECD Model does not include this condition in its model article.

5. UK/F, art. 6(1).

chapters: Part II, Chapter 1, Section 2 and Chapter 2, Section 1.

Section 3: Profits from the Operation of Ships, Boats or Aircraft in International Traffic and Gains from the Alienation of such Ships and Aircraft[6]

See above, Chapter 2, Sections 1 and 4.

6. UK/F, arts. 7 and 13(2).

CHAPTER 4

AVOIDANCE OF INTERNATIONAL DOUBLE TAXATION[1]

Presentation

- The *raison d'être* of double taxation agreements

The claimed fundamental purpose of existence of bilateral tax conventions is the avoidance of double taxation. Double taxation of income or profits inhibits international trade and investments abroad; the stated goal of countries which enter into double taxation agreements is to mitigate - if not eliminate - such double taxation.

A less flattering description of double taxation agreements is also sometimes made: their negotiations in particular have been described as "a naggle (*marchandage*) over revenue sharing between sovereign states".[2]

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1. See in general *Jurisclasseur de Droit International, Fascicule 352, 1976, 1979 and 1982*; *OECD Commentary on arts.* 23A and 23B, pp. 145-161; Tixier, Gest and Kerogues, *Droit Fiscal International* (Paris: LITEC, 2nd ed., 1979) Part 2, Chapter 5, pp. 227-267; D.R. Adams and J. Whalley, *The International Taxation of Multinational Enterprises in Developed Countries* (London: Associated Business Programmes, 1977) Chapter 9, p. 89; *Tolley's Corporation Tax 82/83* (London: Tolley Publishing Company Ltd, 1982) Chapter 22, pp. 91-95; Tolley's *Double Taxation Relief* (London: Tolley Publishing Company Ltd, 1979).

2. John Tiley, *Revenue Law* (London: Butterworths, 2nd ed., 1981) Chapter 40, p. 675.

- Different forms of double taxation

A distinction is made between economic double taxation and juridical double taxation.

There is economic double taxation (double imposition économique) where two different persons are taxable in respect of the same income or capital. Economic double taxation arises for instance where first a company is taxed on its profits and then the share-holders are taxed on the same profits when they receive dividends. Relief to this type of double taxation has been examined both in the United Kingdom and in France in a previous chapter; both adopt a system of partial imputation, although with different modalities.[3]

There is juridical double taxation (double imposition juridique) where the same income or capital is taxable in the hands of the same person by more than one state.[4] The article of the UK/F convention on double taxation relief deals exclusively with juridical double taxation. Under the treaty, juridical double taxation does not arise when either state abandons its right to tax a type of income; such income "shall be taxable only" in one state, usually the state of residence. When an exclusive right to tax is given to one contracting state,

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3. See Part I, Chapter 4.

4. See OECD Commentary on Article 23A and 23B concerning the methods for elimination of double taxation, Preliminary Remarks.

the other state is precluded from taxing, so double taxation is avoided. When an article states that a type of income "may be taxed" in a contracting state, to avoid double taxation, relief is given either by way of credit or under the exemption method.

- <u>Structure of the UK/F tax convention</u>

The 1968 tax convention closely follows the 1963 OECD Draft. The structure of the articles is basically the same: first come definitions,[5] then rules of taxation to be applied to various types of income.[6] The treaty decides which of the contracting states has the exclusive ("shall be taxable only") or primary ("may be taxed") right to tax the different categories of income. If the right to tax a type of income is attributed to any one of the contracting states, as a rule the state of residence of the recipient of the income, the income "shall be taxable only" (in the state of residence). If the right to tax is attributed to both states, the state of residence and the state of source, the income "may be taxed" (in the state of source). A separate article determines the manner in which double taxation is to be avoided.[7] The purpose of the present chapter is to examine this article in particular.

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5. UK/F, arts. 1-4.

6. *Ibid.*, arts. 5-23.

7. *Ibid.*, art. 24.

- <u>Unilateral relief and treaty relief</u>

International double taxation can be mitigated or avoided either by provisions of domestic law ("unilateral relief") or a provision of double taxation agreements ("treaty relief"). Unilateral relief only applies where treaty relief is not available.[8]

The object of this chapter is to study treaty relief but unilateral relief will be briefly outlined.[9]

- <u>Exemption method and credit method</u>

When the rules of taxation of profits of resident companies were examined,[10] the United Kingdom and France happened to provide a good illustration of two very different methods of taxation: the UK levies tax upon the worldwide income of its resident companies,

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8. ICTA 1970, s. 498(3)(b).

9. See in general, <u>Cahiers de Droit Fiscal International</u> Berlin 1981, Vol. 66b, <u>"Unilateral Measures to Prevent Double Taxation"</u>, French report, pp. 339-360, UK Report, pp. 413-428. On unilateral double taxation relief in the UK, see R.H. Hammer, <u>"The Foreign Tax Credit in the US and in the UK"</u>, BTR 1973, p. 107, at pp. 117-125; also J. Tiley, <u>op.cit.</u>, 2 above, Chapter 40. For a summary on the development of unilateral relief, see Deloitte Haskins and Sells, <u>op.cit.</u>, note 1 above, pp. 5 and 7.

10. See Part I, Chapter 3.

France applies the territorial principle and only taxes business profits derived from business activities carried out in France (<u>bénéfices réalisés dans les entreprises exploitées en France</u>).[11]

For the elimination of double taxation, the United Kingdom and France again follow very different principles: the United Kingdom applies the credit method (<u>méthode de l'imputation</u>) and France the exemption method (<u>méthode de l'exemption</u>).

Section 1: The Exemption Method

Under the exemption method, foreign source income is not taxed in the country of residence of the taxpayer.

The UK does not give double taxation relief by way of exemption, but it is the general method adopted in France.

There are two variations of the principle of exemption: full exemption (<u>exemption intégrale</u>) which does not take into account at all the income which may be taxed in the other contracting state; and exemption with progression (<u>exemption avec progressivité, ou méthode du taux effectif</u>) where the right to take into consideration

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11. Also those whose taxation is allocated to France by an international double taxation agreement.

the income taxable in the other contracting state is retained when determining the tax to be imposed on the rest of the income.

France applies the exemption with progression method: "French tax may be computed on income chargeable in France by virtue of this convention at the rate appropriate to the total of the income chargeable in accordance with French law".[12]

§1. Unilateral Relief

A. Tax Treatment of Foreign Dividends

In the case of domestic and foreign dividends received by a France resident company, double taxation is mitigated by the application of the affiliation privilege (*régime des sociétés mères et filiales*): the company which receives the dividends is exempt from French corporation tax on 95 per cent. of the dividends. For the affiliation privilege to apply, a 10 per cent. minimum degree of ownership is required.[13]

B. Tax Treatment of Foreign Branch Business Profits

Under domestic law, the profits of the UK branch

12. See OECD Commentary on art. 23A, pp. 147-156. This section is short because all important points have been developed at length in earlier chapters.

13. For a detailed study of the affiliation privilege, see Part I, Chapter 3.

of a French resident company are wholly exempt from French tax according to the territorial principle.[14]

If such profits are distributed by the French resident company in the form of dividends, the dividends will be subject to a compensatory tax (précompte). The précompte is due because the dividends have been distributed out of profits which have not been subject to French corporation tax at the rate of 50 per cent.[15]

§2. Treaty Relief

In the case of France, income other than dividends and interest[16] is exempt from French tax when it is taxable in the UK under the Convention.[17]

The use of the word "taxable" seems to imply that the exemption method would apply even if the income was not in fact taxed in the UK. This is also the view of the OECD Committee on Fiscal Affairs.[18]

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14. The territorial principle has been examined in detail in Part I, Chapter 3.

15. For a detailed study of the operation of the précompte, see Part I, Chapter 4.

16. On the credit relief given on interest and dividends, see below Section 2. The exception also applies to income derived by public entertainers such as theatre, motion picture, radio or television artistes, musicians and athletes.

17. UK/F, art. 24(b)(i).

18. OECD Commentary on art. 23A, at p. 151: "The state of residence must accordingly give exemption whether or not the right to tax is in effect exercised by the other state".

Section 2: The Credit Method

Credit is given for foreign tax on foreign income by reducing the UK tax on that income by the appropriate amount of foreign tax.[19]

> "Under the credit method, foreign source income is included and domestic tax is computed on the aggregate of domestic and foreign source income, but the country of residence of the taxpayer allows a deduction, from the resulting domestic tax, equal to the foreign tax paid." 20

§1. In the United Kingdom[21]

I. Unilateral Relief

Relief is given in the UK by way of credit against the UK tax charged on foreign income for taxes charged abroad even in the absence of a double taxation agreement between the two countries.[22] Unilateral relief

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19. ICTA 1970, s. 501 and IR6 (1978) §35, p. 9.

20. S.N. Frommel, Taxation of Branches and Subsidiaries in Western Europe, Canada and the USA (London: Kluwer Publishing Ltd, 2nd ed., 1978) at p. 155.

21. See in general Simon's Taxes, Volume F, Revised Third Edition, 1983; also Butterworth's UK Tax Guide 1983-84 (London: Butterworths, 2nd ed., 1983) Chapter 36, pp. 692-711; Rowland's Tax Guide 1983-84 (London: Butterworths, 7th ed., 1983) pp. 152-156; Inland Revenue, Double Taxation Relief, I.R.6 (1978); Arthur Andersen & Co., The US/UK Double Tax Treaty (London: Tolley Publishing Company Ltd, 1980), pp. 120-138.

22. ICTA 1970, s. 498(1).

also applies where a tax convention does not deal with a particular category of income.[23]

Unilateral relief is normally only given to persons resident in the UK in respect of tax charged in the country of source of the income.[24] Credit for foreign tax on foreign income is not to exceed the UK tax charged by reference to that same income; the limit on the credit for foreign tax is the corporation tax attributable to the foreign income.[25] The excess of the foreign tax over the corresponding UK tax cannot be allowed as credit.[26]

The Board of Inland Revenue has examined a number of foreign taxes. It has listed those admitted as allowable for the purposes of unilateral relief and treaty relief and those not eligible for the foreign tax credit.[27] The admissible French taxes are income tax, corporation tax, any withholding tax, prepayment (précompte) or advance payment with respect to the above taxes, property tax (taxe foncière sur les propriétés bâties), refuse disposal tax (taxe d'enlèvement des ordures ménagères).

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23. Simon's Taxes, Vol. F, FJ-147 and ICTA 1970, s. 498(3) proviso (b).

24. I.R.6 (1978) §61, p. 24.

25. ICTA 1970, s. 505 and FA 1972, s. 100.

26. Ibid., §37, p. 10.

27. The Inland Revenue last published lists in January 1982; the document is entitled "Double Taxation Relief - Admissible and Inadmissible Taxes". A copy of it may be found in 22 European Taxation (1982), at pp. 231 and 263. Copies of the document may be obtained for £5 from Somerset House, Room 8, New Wing.

The main taxes enumerated as inadmissible are: tax on unimproved land (*taxe foncière sur les propriétés non bâties*), tax on household occupation (*taxe d'habitation*).[28]

The view of the Inland Revenue is that one should set the tax on a foreign income against the UK tax when that income came to be taxed: if the foreign tax was paid in 1982-83 on current year basis, it would be set against UK tax in 1983-84.[29] This view has received statutory recognition for unilateral relief,[30] and applies to treaty credit relief for French taxes as it is allowed against any UK tax computed "by reference to the same profits".[31]

A. Tax Treatment of Foreign Dividends

Under UK domestic law, relief for foreign dividends is given by way of a foreign tax credit. In addition, an indirect foreign tax credit is given when the recipient holds at least 10 per cent. of the shares of its foreign affiliate.

The direct foreign tax credit covers the tax withheld in France on the distributed dividends;

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28. The list also includes tax for the expenses of Chambers of Agriculture, and two other contributions for agricultural benefits.

29. J. Tiley, *op.cit.*, note 2 above, 40:23, at pp. 682-683.

30. ICTA 1970, s. 498.

31. UK/F, art. 24(a)(i).

the indirect foreign tax credit gives relief for the 50 per cent. corporation tax paid in France on the profits out of which the dividends are distributed.

ACT is paid in respect of dividends paid during an accounting period and set off against the corporation tax due; credit for foreign tax is not allowable against the part of a company's corporation tax liability covered by a set off of ACT - ACT must be set against a company's corporation tax before foreign taxes are credited.[32]

This approach limits the amount of foreign tax that can be relieved by way of credit.

It is proposed to modify the existing situation and provisions to this effect should be introduced in the 1984 Finance Bill: double taxation relief would be set against the corporation tax attributable to the foreign income, before any ACT is set off. The effect of the new provisions will be to absorb credit for foreign tax which may be lost under the existing rules.

Foreign tax unrelieved under unilateral or treaty relief can be treated as an expense in computing the profits liable to UK tax.[33]

A company must choose whether to claim double

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32. Simon's Taxes, F. 2.104.

33. ICTA 1970, s. 516.

taxation relief with the possibility that part of the tax credit will be unrelieved or to treat the foreign tax as an expense. It is not possible to claim double taxation relief up to the limit of UK tax and treat the unrelieved foreign tax as an expense.[34]

Claims for double taxation relief must be made within six years of the end of the chargeable period for which the profits fall to be charged to tax. If a later adjustment to the tax payable in the UK is made, the six year limit applies from the date of the adjustment.[35]

B. Tax Treatment of Foreign Branch Business Profits

The UK applies the worldwide principle of taxation to its resident companies and gives relief by way of credit for taxes paid abroad.

II. Treaty Relief

The treaty provides for relief in the UK by way of credit for taxes paid in France, but the method of giving relief remains a matter of UK domestic law.[36]

French tax payable under the law of France and

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34. Ibid., s. 503(2); Simon's Taxes, Vol. F, F2.105.

35. Ibid., s. 512.

36. ICTA 1970, s. 497(2). The rules described under I are consequently all relevant here.

in accordance with the provisions of the 1968 convention, shall be allowed as a credit against any UK tax computed by reference to the same profits.[37] The allowance of a credit is subject to the provisions of the law of the UK regarding the availability of double tax credit relief.[38]

The maximum amount of double tax credit relief for French tax allowed is equal to the UK corporation tax on the profits which have been subject to French tax.

A. Tax treatment of foreign dividends

When a French resident company pays a dividend to its UK parent which directly controls at least 10 per cent. of the voting power in the French company, the UK parent is entitled not only to a direct tax credit for the withholding tax levied at source in France on the dividend (5 per cent.), but also to an indirect tax credit which corresponds to the French corporation tax paid in France on the profits of the company out of which the dividends were distributed.[39]

The conditions of application of the direct and indirect foreign tax credits under treaty law are the same as under UK domestic law. Only the rate of the tax withheld at source on dividends paid to the UK is reduced to 5 per cent. from the normal rate of 25 per cent..

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37. UK/F, art. 24(a)(i).

38. UK/F, art. 24(a). See above I.

39. UK/F, art. 24(a)(ii).

Where relief for underlying tax is given, the profits underlying the dividends are those appearing in the company's accounts, and not those which are the basis upon which the foreign tax is assessed. This point was the central issue in the Bowater Paper Corporation v. Murgatroyd case, a decision of the House of Lords in 1969.[40]

Although this point has been developed earlier,[41] one has to remember that a reduced rate of withholding tax is also levied on French source interest paid to the UK (10 per cent.) and relief by way of credit is given in the UK for that tax levied at source. Royalties are exempt in the country of source.[42]

Example:

A UK resident company receives a dividend of 100 from its wholly owned French subsidiary. The subsidiary has paid corporation tax in France at the rate of 50 per cent. and the dividend has suffered a withholding tax at the rate of 5 per cent.

	£
Business profits in France	200
Corporation tax at 50% in France	100
	100
Dividend distributed	100
Net dividend received in UK (5% withholding tax)	95
Withholding tax	5
	100

40. (190() 3 All ER, p. 111, 46 TC, p. 37.

41. Part II, Chapter 2, Section 2, §2.

42. Ibid., §3.

		£
Brought forward		100
Gross up for underlying tax 100 x $\frac{0.5}{0.5}$		100
		200
Corporation tax in UK (52%)		104
Double taxation relief		
Underlying tax	100	
Withholding tax	5	
	105	
UK tax payable		Nil

The UK parent is unable to utilise in whole the foreign tax credit available on French income because the French rate of tax (50 per cent. corporation tax and 5 per cent. withholding tax) is greater than the UK corporation tax rate. Relief is given by calculating the rate of foreign tax suffered: The tax payable for a particular accounting period is divided by the profits shown in the accounts and not by the profits as adjusted for French tax purposes (as a result of the Bowater case).

Accounts profits	6000
Foreign tax at 50%	3000
Double tax relief rate 3000/6000 = 50%	

If a dividend of 1000 is paid to the UK parent company, the income is grossed up as follows:

Dividend received (5% withholding tax)	950
Grossing up 1000 x $\frac{50}{50}$	1000
Taxable income	1950
UK Corporation Tax	1014
Double tax relief	(1050)
UK tax payable	Nil

B. Tax treatment of foreign branch business profits

The UK applies the worldwide principle of taxation to companies: income of a French branch of a UK resident company is included in the taxable profits of the UK head office and, after calculating UK tax on the aggregate of the French and UK profits, the UK allows a deduction from the UK tax equal to the French tax paid.

Under the UK/F tax convention, the UK grants relief by giving a credit for French taxes paid on the profits of the French branch of a UK resident company.

§2. In France

France applies the credit method for a limited number of categories of income: dividends and interest which have been taxed in the UK in accordance with the convention paid to a resident of France will be given a tax credit corresponding to the UK tax, but such credit is not to exceed the amount of French tax levied on such

income.[43]

France applies the ordinary imputation (imputation ordinaire); the income tax which may be taxed in the state of source or of the situation of a permanent establishment is not taxed by the state of residence, but it retains the right to take that income into consideration when determining the tax to be imposed on the rest of the income.

The UK/F convention specifies that the tax credit is to benefit only to residents of France. Taxpayers who are not residents of France and whose UK source income is taxable in France because it is attributable to a permanent establishment situated there are not entitled to a credit for UK tax levied on that income.[44]

A 1980 decision of the Conseil d'Etat illustrates the problem of limitation of the tax credit.[45] It does not involve the UK/F tax convention but the principle stated would apply in the same way under the UK/F agreement - although not if royalties were at stake because the UK/F tax convention allocates an exclusive right to tax royalties to the state of residence of the recipient.

A French company had received foreign royalties;

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43. UK/F, art. 24(b)(ii).

44. Instruction of 1 April 1976, BODGI 14 B-1-76, Droit Fiscal 1976, No. 17-18, 5087, as quoted in Juris-classeur de Droit International, Fascicule 352, 1982, at p. 9, §50.

45. CE 19 March 1980, Req. No. 10708, Droit Fiscal 1981, No. 9, comm. 416. This decision has already been examined in the paragraph dealing with the tax treatment of royalties.

they had been subject to a withholding tax abroad. In France, these royalties were subject to the long term capital gains tax regime (10 per cent. taxation at the relevant time).

The tax withheld abroad was superior to 10 per cent.; the company asked for the remnant of the "tax credit" to be deducted from the liability to corporation tax in France, at the rate of 50 per cent.

The Conseil d'Etat rejected the request of the company on the following grounds: the sole purpose of double taxation agreements is to avoid double taxation of a particular category of income; the tax credit granted by a convention is to be deducted from the tax levied on that sole category of income.

The purpose of the credit method is not to diminish the liability to tax of a taxpayer. The role of the French Treasury is not to refund the taxpayer some of the tax which a foreign state has levied, but only to limit its own taxation on an income taxable twice. The underlying idea is that on the whole, a foreign source income is not to be taxed more heavily than an identical French source income would have been.

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