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Current International Tax Developments

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Transactions Involving Foreign Securities with Coupon Payments: The French Tax Authorities Bare Their Teeth

Trades in which French resident taxpayers acquire or borrow foreign securities from an offshore shareholder shortly before a scheduled dividend distribution have attracted scrutiny from the French tax authorities (FTA) in recent years. The economic purposes of such trades have been questioned inasmuch as the French entity receiving the dividend is entitled to a foreign tax credit compensating it for any withholding tax levied on that payment, before delivering the shares back to the offshore entity for a preset price reflecting a manufactured dividend. The very large international treaty network of France is probably one of the reasons why the French market has been rather active until recently.

The following example illustrates how a typical trade works. Let's assume that company B will distribute a dividend equal to 100 to its offshore shareholder A (located in a low-tax jurisdiction that does not have a robust double taxation treaty network) and that such dividend would be subject to a 25-percent withholding tax in the state of residence of B. As an offshore shareholder, A would not be able to benefit from a double tax treaty reduced withholding rate or from a usable foreign tax credit compensating the tax withheld in the state of residence of B. As a result, its net dividend income would be equal to 75.

To improve this situation, A decides to sell its B shares for 1,000 to a French resident taxpayer, C, shortly before the scheduled dividend distribution. C will receive a dividend equal to 75[1] and benefit

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from a foreign tax credit equal to the amount withheld in B's state of residence, to the extent that the foreign tax credit does not exceed the amount of French corporate income tax (CIT) due in respect of the dividends.[2] C will thus benefit from a foreign tax credit equal to 25. The B shares will then be delivered back to A for a preset price equal to 910. Thanks to the trade, A has received a manufactured dividend equal to 90 (1,000 - 910), to be compared to the dividend equal to 75 had it not entered into the trade with C. On the other hand, C has received a dividend equal to 75, has been entitled to a foreign tax credit equal to 25 and has realised a tax deductible short term capital loss equal to 90. The trade is thus profitable for C, which realises an accounting loss equal to 15 (75 - 90), has to pay 3.3 of French CIT on a taxable income equal to 10 (100 - 90) but benefits from a foreign tax credit equal to 25. In other words, the FTA bear most of the cost of the withholding tax levied in B's state of residence. It goes without saying that when the FTA understood how such equity trades work, they spared no effort to fight them.

A Report of the U.S. Senate As a Handbook for the FTA's Auditors

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A much noted report by the U.S. Senate on dividend tax abuse,[3] which highlighted a number of features that typically point to abusive transactions,[4] has provided a remarkable handbook for FTA's auditors to decipher how tax-driven equity trades are structured and to challenge the taxpayer's intended tax treatment of the transaction. As a result, the FTA have challenged this type of transactions before the French courts based on anti-abuse provisions and have also asked the French Supreme Administrative Court (the *Conseil d'Etat*) for a new interpretation of existing law in order to reduce the availability of tax credits.

The French *Conseil d'Etat's* Reluctance to Regard Such Transactions As Abusive

Section L 64 of the French Tax Procedure Code allows the FTA to recharacterize arrangements that hide the true nature of a transaction pursuant to provisions "disguising the realization or the transfer of profits or income." The applicable standard of proof is fairly high, and the FTA need to demonstrate either (1) that the transaction is fictitious, or (2) that the transaction, seeking the benefit of a rule of law through its literal application, is inconsistent with the purpose ascribed to the law by the legislator and could not be inspired by any motivation other than the avoidance or reduction of the tax the taxpayer would have borne given its actual situation or activities, if it had not entered into the transaction documents.[5]

Demonstrating that tax-driven equity trades are fictitious has been difficult since (1) the parties to such transactions are generally unrelated, (2) they are acting on arm's-length terms in relation to transactions effected on the stock exchange or in respect of shares listed on a stock exchange, and (3) payment for, and title to, the shares are effectively exchanged between them.

The approach chosen by the FTA to characterize these transactions as abusive was to argue that they are "unfairly" tax-driven schemes. The relevant test is not whether the principal effect of such an arrangement is a tax benefit but whether achieving the tax benefit is the exclusive motive[6] of the parties (or of one of the parties) and the exclusive effect[7] of the scheme.

Two recent cases decided by the *Conseil d'Etat*, which applied the new "L64" definition of abuse of law in the context of transactions involving the transfer of French tax credits, lead to a disappointing answer for the FTA. The Axa and Goldfarb cases[8] involved several short-term transfers of French shares by a French bank and a French company, with respectively unrelated and related parties, over the dividend date by means of stock loans or under the French civil law mechanism of *vente à réméré* (which gives the seller the right, but not the obligation, to repurchase the securities sold). The dividends received were (both for book and tax purposes) offset by the losses realized on the resale of the shares' ex-dividend. The recipients also received an *avoir fiscal* stapled to the dividends,[9] which was shared between the recipients and the seller/lender through the transactions' financial terms. Since the seller/lender was in a loss position, it would not have been able to use the *avoir fiscal* had it received the dividend directly.

The *Conseil d'Etat* did not find the existence of an abuse of law in either case and held, as a matter of principle, that the sole condition for benefitting from the *avoir fiscal* was to be a shareholder on the dividend date that might suffer economic double taxation. Accordingly, the transactions were held not

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to contradict the legislator's intent.[10] It appears that in both cases, the critical test was whether or not the legal owner of the shares was exposed to the economic risk associated with owning the shares.[11]

The same criteria were used in an even more recent decision by the lower tax Court of Paris. The facts were similar to the Goldfarb transactions. However, the Court noted that the owner of the shares did not take any economic risk, since the issuing company's only remaining activity was to hold a substantial amount of cash, and held that the transaction was fraudulent. The transaction was inconsistent with the aim pursued by the legislator when enacting the *avoir fiscal* (*i.e.,* avoiding economic double taxation) because (1) the income distributed had itself not been taxed inasmuch as it was derived from dividends benefitting from a dividends received deduction, and (2) the tax effect of the dividend received by the buyer/ borrower had been neutralized by a tax deductible provision for depreciation.[12]

The Quest for New Legal Ground

In the Goldfarb and Axa cases, the FTA were seeking a simple and effective legal basis to limit the use of foreign tax credits received by French taxpayers engaged in short-term sales and repurchase transactions with respect to foreign securities with attached dividend payments. While litigating those cases, the French Budget Minister, as the head of the FTA, asked the *Conseil d'Etat* for a clarification of existing law in a nonpublic proceeding. The question he raised was aimed at (1) modifying the method of determining the French taxable income that is the basis for imputation of the foreign tax credit, or (2) disallowing the full imputation of the foreign tax credit to French taxpayers that, in the view of the FTA, were not the "beneficial owners" of such income. Thus, the French Budget Minister proposed an "economic approach" to the determination of the relevant income in order to disallow the imputation of foreign tax credits where the anti-avoidance mechanism of abuse of law could not be applicable.

On March 31, 2009, the *Conseil d'Etat* issued a ruling[13] in response, which stated that expenses of the French recipient of foreign source income may reduce his French taxable income and thus his ability to use the foreign tax credit. However, only expenses directly linked to the acquisition and the holding of the securities that generate the income may be taken into account. Those expenses would not include the interest incurred to finance the acquisition of the securities, the fee that may be paid to the foreign counterparty or intermediary involved in the acquisition of the subject securities or the capital loss that may have been realized by the French entity on the trade. Thus, the economic approach proposed by the French Budget Minister was rejected inasmuch as the Court took the view that it contradicted both domestic corporate tax principles (by making Section 220.1 of the FTC independent from the other provisions of the FTC[14]) and tax treaty provisions (aimed at avoiding double taxation[15]).

At the same time the Budget Minister approached the *Conseil d'Etat*, tax auditors at the lower levels of the FTA kept challenging equity trades before the lower courts. As an alternative to the difficult recharacterization of a tax-driven equity trade based on the abuse of law principle, the tax auditors attempted to narrow the ability to use the foreign tax credit, in particular in an international context. This approach is illustrated by a recent case before the lower tax Court of Montreuil.[16] In that case, a French company had borrowed Italian shares from an Italian counterparty and received a dividend during the term of the loan, thus triggering Italian withholding tax. The FTA took the position that the manufactured dividend paid by the French company to its Italian counterparty under the stock loan arrangement should have been deducted from its income for purposes of assessing the amount of the available Italian tax credit usable against its French corporate income tax liability. The judges rejected this reasoning and concluded that, absent any specific provisions in the double tax treaty, there is no reason to take into account the financing costs incurred in the context of the transaction to reduce the amount of the foreign tax credit usable in France.

The French Government Strikes Back

The French government reacted to the *Conseil d'Etat's* 2010 report by including new anti-abuse provisions in the Finance Bill for 2011.[17] Prior to this reform, for a given financial year, the amount of the foreign tax credit that might be used in France to offset French CIT was limited, under the "capping rule," to an amount corresponding to the French corporate income tax owed with respect to such foreign income without

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further precision (in the view of most market participants such income amounted to the gross dividend). The new anti-abuse provision aims at overruling the *Conseil d'Etat*'s opinion disclosed in its 2010 report. Indeed, the use of the foreign tax credit will be limited by deducting from the relevant foreign income certain expenses incurred in connection with earning such income. Where a French corporate taxpayer receives a dividend or interest payment in respect of goods or rights (including securities) which were previously owned by a counterparty (or a "related person" within the meaning of article 39.12 of the FTC[18]) that is entitled subsequently to reacquire those goods or rights, the amount of relevant foreign income would be reduced by any expenses incurred in connection with earning such income including (1) the capital loss realized upon disposal of the underlying goods or rights, and (2) the monies, other than the purchase price, paid to the counterparty or any entity regarded as "related" (within the meaning of Article 39-12 of the FTC) to such person.

The critical test under the new anti-abuse provision is whether or not the previous owner of the shares (or any related person) may either repurchase such shares or otherwise retains the possibility of holding them again after the trade. How the FTA will determine whether there is an entitlement to recover ownership remains to be seen. The statute indicates that a contractual agreement or undertaking (which might be independent from the share purchase/loan agreement itself) would be necessary. It is likely that *ventes à réméré* and share loans are within the scope of the new anti-abuse amendment. However, it could be inferred from the narrow scope of the new statutory provisions that more complex transactions would remain beyond its scope.

In addition, the new law includes a safe harbor for taxpayers that are able to prove that a transaction's main goal or effect was not to benefit from the foreign tax credit. Although the (unclear) scope of this safe harbor still needs to be defined by the FTA, it is likely that it would apply where the taxpayer can demonstrate that the transaction was motivated by economic reasons (*e.g.,* the seller needing cash or the buyer needing to reach a certain percentage of shareholding), so that the main purpose of the transaction was not to take advantage of the foreign tax credit.

Conclusion

The FTA's suspicion with respect to trades involving foreign securities over dividend record dates has increased in recent years, and French auditors have unsuccessfully attempted to challenge those transactions on the grounds of abuse of law, the beneficial owner provisions provided for in the double tax treaties, or on a creative interpretation of the domestic rules concerning foreign tax credits. The FTA are from now on armed with a new anti-abuse provision, but the most complex and well thought-out transactions that ensure that the previous owner of the shares is not contractually entitled to repossess them may not be affected. In this regard, whether or not the French entity bears the economic risk attached to being a shareholder still appears to be the critical test.

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Endnotes

[1] Assuming that C is not eligible for a reduced withholding tax rate that might be provided for by the applicable double tax treaty entered into between France and B's state of residence. The economic results of the example provided in text would not be affected by the availability of a reduced withholding tax rate. A reduction in the withholding tax would reduce the amount of the foreign tax credit, but the reduction in the foreign tax credit benefit would be offset by the reduction in the amount of foreign withholding tax paid.

[2] This "capping rule" is set forth by Section 220.1 of the French tax code (FTC). In this example, the "capping rule" would not limit the ability to use the foreign tax credit. Indeed, such dividends would be subject to French CIT at the normal rate of 33.33 percent. As a result, the foreign tax credit, equal to the amount withheld in B's state of residence (*i.e.,* 25), would be lower than the French CIT due in respect of the dividends (*i.e.,* 33.33% x 100 = 33.33).

[3] *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*, Staff Report of the Permanent Subcommittee on Investigations of the United States Senate, Sept. 11, 2008.

[4] In particular, the report considers the acquisition and sale of shares (on the market or otherwise) by the parties shortly before and after the dividend payment to be a significant tainting factor of the trades under review. Most blatantly abusive trades generally included a commitment from inception by the U.S. holder to return the shares to their original holder, either directly or, while the trade was facially with the market, indirectly (with the original holder acting through brokers or intermediary parties).

[5] Section L64 of the French Tax Procedure Code has been modified by the Amended Finance Act for 2008 of December 30, 2008 to reflect the most recent *Conseil d'Etat* case law (*see* CE, Feb. 28, 2007, # 284565, *Mme Persicot*, RJF 5/07 # 599, and CE, March 5, 2007, # 284457, *SELARL Pharmacie des Chalonges*, RJF 5/07 # 600) according to which reference to the contradiction between the purpose and the literal application of a rule of law by the taxpayer had been added to the traditional abuse of law definition (as initially expressed in CE, June 10, 1981, # 19079, Plén., RJF 9/81 # 787).

[6] CE, Jan. 17, 1994, # 120157, *Chollet*, RJF 3/94 # 304.

[7] CE, March 5, 2007, *SELARL Pharmacie des Challonges cited supra.*

[8] CE, Sept. 7, 2009, n° 205586, *Axa,* RJF 12/09 #1138, concl. L. Olléon BDCF 12/09. CE, Sept. 7, 2009, n°305596, *Société Henri Goldfarb,* RJF 12/09 #1139.

[9] The cases deal with the old mechanism of "*avoir fiscal*" that was removed as from 2005. Prior to that time, French companies distributing dividends transferred to their shareholders a tax credit ("*avoir fiscal*") equal to 50 percent of the dividend to be offset against their income tax liability. The tax credit was intended to prevent economic double taxation upon distribution of retained earnings.

[10] It is worth noting that some facts were considered irrelevant by the judges (although they could, in a different context, have suggested an artificial arrangement) such as the fact that the transactions were often repeated and involved substantial amounts, on a circular basis or between affiliated companies.

[11] The prevalence of such critical test was confirmed by the *Conseil d'Etat* in a case in which it regarded as abusive the interposition of a Polynesian company (CE Mar. 12, 2010 n° 306368, 3e et 8e s.-s., *Sté Charcuterie du Pacifique*, RJF 6/10 n°620).

[12] TA Paris, Nov. 17, 2010, n°0601719, *Société Kerguelan.*

[13] The ruling was issued to the FTA on Mar. 31, 2009, but taxpayers and practitioners have been aware of the question asked by the French Budget minister and the answer provided by the *Conseil d'Etat* only since May 2010, when the *Conseil d'Etat* released its 2010 Annual Report describing the litigation and advisory work it performed during the past calendar year. *See Conseil d'Etat,* Rapport public 2010, 376-84.

[14] Section 220.1 provides that the foreign tax credit is usable to offset French CIT inasmuch as it does not exceed the amount of French CIT due in respect of the foreign income. The *Conseil d'Etat* considers, in light of this wording, that the general French CIT principles should apply to the foreign income and that nothing allows the FTA to take a different and independent economic approach for the purposes of applying the "capping rule."

[15] The *Conseil d'Etat* notes that the "beneficial owner" provisions included in the OECD model convention allow the application of the reduced withholding tax rate on dividends or interests to be limited to the beneficial owner of such income, but do not permit excluding the possibility of offsetting foreign tax credits.

[16] TA Montreuil, May 27, 2010, n°0905910, *CIC.*

[17] New Article 220 1 a of the FTC. This provision is applicable to tax years ending on or after December 31, 2010 so that it is applicable retroactively to trades entered into in 2010 by French taxpayers closing their fiscal year on December 31, 2010.

[18] Two companies are "related" within the meaning of article 39-12 of the FTC where one holds directly or indirectly more than 50 percent of the other's share capital, manages de facto the other, or is held directly or indirectly by a third entity that itself also controls, directly or indirectly, the other one.

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