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Philippe Derouin is a tax attorney in Paris and recently chaired the French branch of the International Fiscal Association.

In this article, the author discusses recent court rulings that have extended the exemption from France's 3 percent surcharge on dividends distributed by French corporations previously reserved for members of a French tax consolidated group.

France's 3 percent surcharge tax on dividends and deemed dividends distributed by French corporations is in a state of flux. Recent court rulings have extended the scope of an exemption to the surcharge and have also led to the reduction of the taxable basis of the surcharge. Further, President Emmanuel Macron's platform includes the complete abolishment of the tax.

Overview of French Surcharge Taxes

The 3 percent corporate income tax surcharge was introduced into law in 2012 as part of President François Hollande's tax package.[1] It was the third surcharge on French corporation tax. The standard rate of French corporate income tax (*impôt sur les sociétés*, or CIT) stood at 33$^1/_3$ percent for almost 25 years. It is now in the process of progressively being reduced to 28 percent by 2020.[2]

The first social surcharge of 3 percent on the CIT[3] was introduced in 2000 and still applies to some medium-size and large businesses, resulting in an effective corporate tax rate of 34$^1/_3$ percent (to be reduced to 28.84 percent).

A second exceptional surcharge was introduced in 2011 at the rate of 5 percent[4] and was later increased to 10.7 percent,[5] thus resulting in an aggregate corporation tax rate of 37.9 percent. It applied to larger businesses with revenue (turnover) exceeding €250 million. The surcharge has since been cancelled, and it no longer applies for fiscal years beginning on or after January 1, 2017.

A Hybrid Tax

As opposed to the first two surcharges, the 3 percent surcharge is a hybrid tax with some aspects of corporation tax and some features of a dividend tax payable by the issuing corporation with no credit provided to the shareholders.

The first two surcharges effectively increased the corporate tax rate on taxable profits regardless of whether the profits were distributed or retained. The 3 percent surcharge on dividends applies only on effective distribution and is assessed on the full amount distributed by French companies, irrespective of whether they are paid out of taxable profits or other sources (except for

[1] Article 235-*ter* ZCA of the French General Tax Code (Code général des impôts, or CGI), created by article 6 of the Amending Finance Act for 2012, No. 2012-958 of Aug. 16, 2012.

[2] Article 11 of the Finance Act for 2017, No. 2016-1917 of Dec. 29, 2016.

[3] Article 235-*ter* ZC of the CGI, created by article 6 of the Social Security Financing Act for 2000, No. 99-1140 of Dec. 29, 1999.

[4] Article 235-*ter* ZAA of the CGI, created by article 30 of the Amending Finance Act for 2011, No. 2011-1978 of Dec. 28, 2011.

[5] Article 16 of the Finance Act for 2014, No. 2013-1278 of Dec. 29, 2013.

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the repayment of capital). If a French corporation distributes dividends out of fully taxable profits that have already borne the effective tax rate of 37.9 percent (including the now-discontinued exceptional surcharge), the 3 percent surcharge raises the overall effective corporation tax rate to 39.76 percent.

Unlike the other two surcharges, the 3 percent surcharge on dividends applies, upon distribution, to corporate profits that were previously exempt from corporation tax either in accordance with the 95 percent participation exemption on dividends received from subsidiaries or that arise from permanent establishments outside the territorial reach of the French corporation tax. When a company pays dividends out of either of these categories of profits, the 3 percent surcharge on dividends results in a minimum tax charge of 3 percent. If dividends are received from subsidiaries located in tax treaty jurisdictions, the 3 percent surcharge may be relieved by a foreign tax credit.[6]

Only the members of a French tax consolidated group — that is, French corporations that are at least 95 percent held, directly or indirectly, by a common corporate entity, all of which have elected for the French consolidation system — avoided the cumulative effect of the 3 percent surcharge applied to each distribution of dividends.

The cumulative effect of the surcharge was criticized by many practitioners (including this author) shortly after the 3 percent surcharge was introduced as contrary to Directive 2011/96/EU of November 30, 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states of the European Union (the parent-subsidiary directive).[7] Commentators also questioned the restricted scope of the exemption for intragroup distributions as potentially being discriminatory and infringing the EU freedom of establishment principle.[8]

Less than one year after the introduction of the French 3 percent corporation tax surcharge on dividends, Belgium introduced the so-called fairness tax, a 5.15 percent tax on distributed profits that have not been effectively taxed as a result of specified tax deductions.[9] The Belgian fairness tax shares attributes with the French 3 percent surcharge on dividends, and it attracted similar criticism.

Challenges and Court Decisions

Both the Belgian "fairness tax" and the French 3 percent surcharge have been challenged before the European Commission on several EU legal grounds and before national courts on similar grounds and constitutional bases. The European Commission issued a formal notice to the French government initializing the infringement procedure.[10]

In Belgium, the Constitutional Court referred questions to the Court of Justice of the European Union.[11] In France, the Council of State (Conseil d'État), typically the country's highest administrative court with jurisdiction for tax matters, referred the question of discrimination stemming from the exemption for French consolidated groups to the French Constitutional Council (Conseil constitutionnel)[12] and the

[6]Official Bulletin of Public Finances-Taxes (BOFIP), BOI-IS-AUT-30 (June 1, 2016), para. 240.

[7]Philippe Derouin, "La Contribution de 3 [percent] sur les Montants Distribués et le Régime des Sociétés Mères et Filiales: De Charydbe en Scylla?" 40 *Droit fiscal* 457 (Oct. 4, 2012); Emmanuel Dinh, "Contribution de 3 [percent] au Titre des Montants Distribués: Quelle Compatibilité Avec les Engagements Internationaux de la France?" 10 *Droit Fiscal* 178 (Mar. 7, 2013); and Cyril Valentin and Bertrand Lacombe, "La Nouvelle Contribution de 3 [percent] sur les Revenus Distribués à L'épreuve du Droit Communautaire," 3 *RTD Fin*. 132 (2012).

[8]Dinh, *supra* note 7, sections 19-23.

[9]Law of July 30, 2013, containing miscellaneous provisions: introduction of the fairness tax, published in the Belgian official gazette on Aug. 1, 2013.

Articles 43 to 51 of the act on various provisions of July 30, 2013, MB, Aug. 1, 2013.

[10]Feb. 26, 2015, infringement procedure 2013/4329 [CHAP(2015)991].

[11]*X v. Ministerraad* (or Council of Ministers), No. 11/2016 (2015), registered with the CJEU as C-68/15 (CJEU 2017).

[12]*Layher*, No. 399506 (COS 2016), registered with the French Constitutional Council as 2016-571 QPC (2016). *See* RJF 10/16 No. 866, opinion of Nathalie Escaut, at 1223, *Droit Fiscal*, No. 27 (July 7, 2016), comm. 397. The author has served as co-counsel with Marc Pelletier of Frenkel & Associés to Layher SAS in this case and in the related matters before the Constitutional Council and the Council of State (see notes 14 and 16 *infra*).

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questions regarding compliance with the EU parent-subsidiary directive to the CJEU.[13]

The French Constitutional Council found that limiting the exemption to French groups violated the constitutional principle of equal rights.[14] It postponed the effect of its ruling until January 1, 2017, in order to enable the government and Parliament to amend the law, which they did.[15] As a result of that amendment, going forward, the exemption also applies to distributions by French subsidiaries to foreign entities that satisfy the conditions for the French consolidation, other than the condition that they be taxable in France. In March the French Council of State found that the previous legislation also violated the equal rights provisions in the European Convention on Human Rights.[16] This decision should open the door for companies to seek the reimbursement of taxes paid before December 31, 2016.

On May 17 the CJEU issued its interim rulings on both the Belgian and French taxes.[17] Applying the EU parent-subsidiary directive, the Court found that article 5 does not preclude the fairness tax because it should not be regarded as a withholding tax for the purposes of the directive. This implicitly extends to the French surcharge as well. However, the CJEU found that article 4 of the same directive precludes Belgium and France from applying the disputed taxes to the redistribution of dividends received from subsidiaries. The matters should now return to the respective national courts for final decisions.

The remainder of this article will examine the bases for these rulings and their implications for French corporations and their international investors.

[13]Council of State, *Association française des entreprises privées*, No. 399024 (2016), registered with the CJEU as C-365/16 (CJEU 2016). *See* RJF 10/16, No. 866, opinion of Escaut at 1223, *Droit Fiscal*, No. 27 (July 7, 2016), comm. 397.

[14]Constitutional Council, No. 2016-571 QPC (2016). *See* official commentary (in French).

[15]Article 95 of the Amending Finance Act for 2016, No. 2016-1918 of Dec. 29, 2016, amending article 235-*ter* ZCA.

[16]Council of State, No. 399506, *Layher* SAS, Mar. 29, 2017. *See* RJF 6/17, No. 614, opinion of Romain Victor, *Droit Fiscal* No. 25 (June 22, 2017) comm. 365.

[17]*X v. Ministerraad*, C-68/15 (CJEU 2017); opinion of Advocate General Juliane Kokott (delivered on Nov. 17, 2016), which was followed by the rulings on the EU parent-subsidiary directive but differs from the Belgian ruling on the freedom of establishment issue; and *Association française des entreprises privées and Others v. France*, C-365/16 (CJEU 2017).

Exemption for Controlling Corporations

The French legislature included a special exemption in order to avoid the cumulative effect of the 3 percent surcharge on dividends paid between companies in the same French tax consolidated group. In linking the exemption to the existence of a French tax consolidated group, the legislature required both that the conditions for a French tax consolidation were satisfied and that the entities effectively elected for consolidation. French tax consolidation is available to French corporate taxpayers when a common shareholder controls at least 95 percent of the capital of the consolidated entities for at least one full fiscal year.[18]

Generally, a non-French company may be the head of a French tax consolidated group only if it has a PE in France to which the investment in the French subsidiaries can be allocated.[19] An EU or European Economic Area company without a PE in France may be the common shareholder of consolidated French entities,[20] but the EU/EEA company would not be a member of the group. Therefore, the 3 percent surcharge would apply to distributions paid by 95 percent-owned French subsidiaries to a non-French controlling corporate shareholder, while similar distributions paid to a similarly controlling shareholder based in France would have been exempt. The difference of treatment was obvious, and the question was whether it could be justified by a difference in situation or a valid purpose.

In *Layher*, the French Constitutional Council held there was no valid justification for the difference since the French tax consolidation was only relevant to the corporation tax (along with the first two surcharges), while the 3 percent surcharge was a separate tax with taxable events and taxable amounts that were not connected to the corporate profits that are subject to corporation tax.[21] On those grounds, the court found specific language in the exemption paragraph of article 235-*ter* ZCA of the French general tax code was contrary to the constitutional

[18]Article 223 A of the CGI.

[19]BOFIP, BOI-IS-GPE-10-30-40 (May 6, 2015), para. 150.

[20]*Supra* note 18, para. 2.

[21]*Supra* note 14.

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principle of equal rights.[22] In its decision, the court expressly mentioned the situation of French subsidiaries of foreign companies. However, the court refused to decide whether the exemption should be extended or abolished to meet the constitutional requirements. Instead, it allowed the Parliament to decide and postponed the cancellation of the provision until January 1, 2017.

Parliament amended the law to extend the exemption to dividends distributed after January 1 by a French company to any French or foreign entity that would have been entitled to elect for French tax consolidation if it had been taxable in France, provided the foreign entity, and any other intermediate corporate shareholder, is based in a country with an appropriate tax information agreement (including the U.S., Japan, and many other jurisdictions).[23] Thus, the law is no longer discriminatory, including as to dividends paid by French subsidiaries of multinational groups to parent, or intermediate holding, companies located in appropriate jurisdictions outside France or even outside the EU. In this respect, the decision (and ensuing legislation), based on the French constitutional principle of equal rights, has a wider scope than a similar decision based on EU freedom of establishment would have, because the latter's direct effect would have been limited to EU cross-border situations and would not have extended directly to third countries.

As far as past distributions are concerned, a finding of an infringement of the EU freedom of establishment would have clearly entitled taxpayers to a refund of any surcharge paid upon distributions to qualifying EU parent companies (as was the case in *Layher*). This remains true, even though the decision of the French Constitutional Council has no retrospective effect. In a second decision in the *Layher* case, the French Council of State held that, because of the same issue of discrimination identified by the Constitutional Council, the law was also contrary to the European Convention on Human Rights and, accordingly, could not be enforced.[24] The principle of equal rights under the European Convention also has a wider scope than the EU freedom of establishment. Therefore, subject to the relevant statute of limitations,[25] restitution may be claimed by French subsidiaries of most non-French groups for any money paid in accordance with the 3 percent surcharge on dividends distributed before January 1 to qualifying foreign companies, whether in Europe or in third countries.

Inclusion of Dividends Received in Taxable Base

The second method for avoiding the cumulative taxation of dividends involves excluding dividends received from subsidiaries from the taxable bases of the French 3 percent surcharge, or similarly, of the Belgian fairness tax. In Belgium, the fairness tax does not apply to exempt dividends that are redistributed during the same fiscal year, but it would apply if those dividends are redistributed after the year in which they were received. Under French law, no relief applies to the redistribution of dividends from domestic, EU, and some other sources (including the U.S., Japan, Norway, and Switzerland). Credit relief only applies under some double taxation agreements if the dividends from subsidiaries bore a dividend withholding tax in the source country.[26]

The CJEU found both laws violated the EU's parent-subsidiary directive, precisely insofar as dividends received from subsidiaries formed part of the base used for the French 3 percent surcharge or the Belgian fairness tax upon their redistribution by a parent company.[27] In the pair of rulings dated May 17, the CJEU explained that the parent-subsidiary directive aims to eliminate double taxation at the parent-company level of profits passed from a subsidiary to its parent. More specifically, article 4 seeks to avoid taxing a nonresident subsidiary that distributes profits to a resident parent and then, again, taxes the parent on the same profits in the other state.

The Court then noted that in language mirrored in the ruling on the Belgian fairness tax,

[22] *See* articles 6 and 13 of the Declaration of Human and Civic Rights of 1789.

[23] *Supra* note 15.

[24] *Supra* note 16 (referring to article 14 of the European Convention and article 1 of the first protocol).

[25] Article R. 196-1 of the French Tax Procedure Code.

[26] BOFIP, June 1, 2016, *supra* note 6.

[27] *Supra* note 17.

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dividends received from subsidiaries were 95 percent exempt from corporation tax and that:

> in so far as the basis of assessment of the [French surcharge] comprises the dividends distributed by a parent company, that basis of assessment may also include the profits produced by the subsidiaries of that parent company which are established in other Member States, which results in the taxation of those profits at a rate above the 5 percent ceiling provided for in Article 4(3) of Directive 2011/96.

Both the Belgian and French governments took the view that article 4 of the parent-subsidiary directive only applied when a parent company receives profits distributed by its subsidiary. They argued that the directive should not preclude either the fairness tax or the surcharge since they applied upon the distribution or redistribution of those earnings by the parent company.

The CJEU dismissed this interpretation in both decisions, noting that it did not stem from the wording, the context, or the purpose of the directive. In the French case, referencing the related holding in the decision on the Belgian tax, the Court explained:

> Firstly, that, by providing that the Member State of the parent company [is] to "refrain from taxing such profits," that provision prohibits the Member States from taxing the parent company in respect of profits distributed by the subsidiary to its parent company, without distinction as to whether the taxable event of the taxation of the parent company is the receipt of those profits or their redistribution.
>
> Secondly, since Directive 2011/96 pursues . . . the objective of eliminating double taxation of profits distributed by a subsidiary to its parent company at the level of the parent company, taxation of that parent company by its Member State in respect of those profits, which would have the effect of making the profits subject to taxation exceeding the ceiling of 5 [percent] laid down in Article 4(3) of that directive, would lead to a double taxation at the level of the parent company contrary to that directive.

Turning more specifically to the French surcharge, the CJEU continued:

> It is irrelevant whether or not the tax measure is classified as corporation tax. In that regard, it suffices to note that Article 4(1)(a) of Directive 2011/96 does not make its application subject to a tax in particular. That provision provides that the Member State of the parent company is to refrain from taxing the profits distributed by the non-resident subsidiary thereof. That provision thus seeks to avoid Member States adopting tax measures which lead to double taxation of parent companies in respect of those profits.

On those grounds, the Court ruled that the parent-subsidiary directive:

> must be interpreted as precluding a tax measure laid down by the Member State of a parent company, such as [the French 3 percent surcharge] at issue in the main proceedings, providing for the levy of a tax when the parent company distributes dividends and the basis of assessment of which tax is the amounts of the dividends distributed, including those coming from that company's non-resident subsidiaries.

The Court ruled similarly that the directive precludes Belgium's fairness tax to apply:

> in so far as that legislation, in a situation where profits received by a parent company from its subsidiary are distributed by the parent company after the year in which they were received, has the consequence of subjecting those profits to taxation exceeding the 5 percent ceiling provided for in that provision.

The CJEU also considered whether the Belgian fairness tax and the French 3 percent surcharge should be regarded as withholding taxes for purposes of article 5 of the parent-subsidiary directive, a characterization that could affect outbound dividends, as opposed to article 4, which affects inbound dividends. The Court

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found the Belgian tax was not a withholding tax because the taxable party was not the shareholder but rather the distributing company. While the Court was able to abstain from expressly making an equivalent ruling in the French case, the conclusion should also apply to the surcharge tax.

Next Steps

The CJEU's interpretation of the parent-subsidiary directive is clear and binding upon national courts and authorities. Article 1 of the directive states that it applies to distributions of profits by a company in an EU member state that come from one or more subsidiaries in other member states. Therefore, the prohibition of article 4 directly applies to the distribution of profits of Belgian and French companies that come from subsidiaries of other European member states.

However, neither the Belgian nor the French law draws a distinction between the location of subsidiaries. In transposing the parent-subsidiary directive, both national legislatures chose to apply the same treatment to purely internal situations as well as to relations with subsidiaries located in third countries in addition to those governed by the directive. In other words, they aligned their domestic legislation with the European directive. Under the French Constitution, the alignment may be required by the principle of equal rights.[28] The Constitutional Council has ruled accordingly, particularly as to the parent-subsidiary directive.[29]

Belgian and French courts must now decide whether dividends from domestic and third-country sources should also be excluded from the taxable basis of the fairness tax and the 3 percent surcharge upon redistribution of those dividends to the parent companies. The financial consequences could be substantial, especially in France, where the aggregated amount of dividends paid between subsidiaries and parent corporations represents approximately one-half of the base of the 3 percent surcharge.

Potentially, a similar challenge to the French 3 percent surcharge could be initiated as to profits arising from PEs outside France. Based on the relevant double taxation agreements, and assuming that the 3 percent surcharge is substantially similar to corporation tax and therefore covered by those treaties, the question is whether the exemption clause should apply, like article 4 of the parent-subsidiary directive, without distinction as to whether the taxable event is the realization of profits in the PE or in their redistribution.[30] There is no reported precedent on the point.

In the near future, the French 3 percent surcharge could be abolished altogether, as President Macron proposed in his election platform. As part of the plan to reduce taxes on businesses, the candidate selected the 3 percent surcharge as one target. Because no finance bill is expected before the fall, any reform would probably not apply before year-end.

Subject to the applicable statute of limitations, some French companies may apply for reduction and restitutions of taxes paid on past distributions. Because the 3 percent surcharge was not deductible for corporation tax purposes, any reduction or refund would not be liable to French corporation tax. The financial impact could reach approximately €900 million per fiscal year. ■

[28] Articles 6 and 13 of the Declaration of Human and Civic Rights of 1789.

[29] *Metro Holding France SA*, Constitutional Council, No. 2015-520 QPC (2016) (with official commentary in French). *See also Natixis SA*, Constitutional Council, No. 2016-553 QPC (2016) (with official commentary in French).

[30] *See* Derouin, *supra* note 7, at paras. 16 to 18; and Dinh, *supra* note 7, at paras. 12 to 14.

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