ARE HOLDING COMPANIES SO TWENTIETH CENTURY? A LOOK AT RECENT DEVELOPMENTS IN FRANCE

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INTRODUCTION

Historically, holding companies have been used by corporate groups to place certain assets in certain locations to serve certain markets. They have also been used by individuals for wealth management and estate planning purposes. Today, holding companies located in an E.U. Member State or elsewhere are likely to face challenges when interacting with group members in France. Claims of treaty benefits are regularly challenged by French tax authorities. Whether the benefit is a tax treaty related withholding tax exemption on dividends or royalties or access to E.U. Directives such as the Parent-Subsidiary Directive, French tax authorities regularly challenge the claim of a recipient to receive the anticipated tax benefit. Often, French tax authorities contend that the recipient of income is not the "beneficial owner" of the income, and for that reason, is not entitled to the treaty benefit claimed.

Today, French tax law attacks the use by nonresident individuals who establish foreign holding companies that own assets in France or who indirectly derive income from those assets. Examples are foreign professional athletes, performers, engineers, and the like who own holding companies located in their residence state that regularly receive revenue originating in France. These ownership structures may trigger application of certain anti-abuse rules leading to unfavorable tax consequences. Here, other anti-abuse rules come into play. Also, it is not uncommon for French tax authorities to challenge the tax residence of an ultimate beneficial owner ("U.B.O.") who is regularly present in France. For these individuals, navigating the French tax environment can be daunting as a series of anti-abuse rules can be asserted in the course of a tax examination.

This article focuses on risks faced by a foreign holding company that expects to benefit from favorable tax regimes for French-source income, only to find that French tax authorities successfully challenge its status as the beneficial owner of the income. Under the view of French tax authorities and courts, a foreign holding company is properly treated as the beneficial owner of a stream of income only when it has economic substance and plays a meaningful role in the transaction under examination.

KEY-ELEMENTS – A PRACTICAL PERSPECTIVE

Without rehashing the Danish Cases decided by the European Court of Justice ("E.C.J.") in February 2019, the decision has been followed in several French cases regarding claims of treaty benefits and the application of the E.U. Parent-Subsidiary Directive. The Danish Cases have given rise to legal uncertainty when it comes to discerning between (i) the circumstances in which a holding company will be viewed to be the beneficial owner of an income stream and (ii) the circumstances in which a holding company will be viewed to be part of an abusive tax plan. At the time the

Danish Cases were decided, French case law did not provide guidance as to the circumstances in which a purported owner was considered to be the beneficial owner. The lack of guidance in the law lead to an increase in the number of tax audits, which in turn lead to several court decisions leading to a recent clarification by the French *Conseil d'Etat*:

- Will the assertion by French tax authorities that a holding company is not the beneficial owner of an income stream trigger a general presumption of tax fraud by the taxpayer?
- Will an assertion by French tax authorities that a holding company is not the beneficial owner of an income stream trigger a presumption of abusive tax planning?
- Is an assertion by French tax authorities that a holding company is not the beneficial owner of an income stream a game changer in practice?

Several relatively recent decisions indicate that a challenge to the beneficial ownership of French source income by a foreign holding company has become a key strategy that is used by French tax authorities. In practice, it may be easier for the tax authorities to achieve a favorable decision under the beneficial ownership test than under the other standard anti-abuse rules of French tax law. Over the past few years, several decisions have addressed the issue, and the notion of beneficial ownership is a key issue to be carefully considered along with standard anti-abuse rules that are at the disposal of the French tax administration. Among such anti-abuse rules are:

- The abuse of law principle (Article L64 of the French Tax Procedure Code -"F.T.P.C.") that is applied to arrangements that are characterized exclusively as tax-driven schemes.
- The general anti-abuse rules ("G.A.A.R.") introduced to implement the A.T.A.D. Directive that allow French tax authorities to broaden tax audits of shell companies. The French G.A.A.R. is based on the principal purpose test ("French P.P.T.") set out by Article L64 A of the F.T.P.C. as a catch-all clause. It provides that no account is given to arrangements that have been put into place for the main purpose (or one of the main purposes) of obtaining a tax advantage that defeats the object or purpose of applicable tax law and that are not genuine in light of all relevant facts and circumstances.
- The specific anti-abuse rule related to the withholding tax exemption on outbound dividends under the E.U. Parent-Subsidiary Directive (Article 119 *ter* 3 of the French tax code ("F.T.C."). The withholding tax exemption for dividends paid by a French corporation to a parent resident in an E.U. jurisdiction is denied where the dividend is part of an arrangement that has as a main objective the tax exemption, itself, rather than a valid commercial reason that reflects economic reality. The French tax authorities provide in their guidelines that the notion of a "commercial reason" is understood in the broad sense of any economic justification, even if it is not linked to the exercise of a commercial activity such as defined by the French tax code. Asset-holding structures carrying on financial activities or structures serving an organizational purpose are expressly mentioned as being likely to be considered as valid commercial reasons for the application of these provisions.

- The specific anti-abuse rule related to the French corporate income tax (Article 205 A of the F.T.C.), which results, in particular, in the denial of the French participation exemption regime for intercompany dividends or capital gains realized from the disposition of shares of a subsidiary.
- The specific anti-abuse rule of the favorable French merger tax regime (Article 210-0 A of FTC).

All these recent tools provide French tax authorities with a broad choice of strategy in challenging a withholding tax exemption for a payment to a holding company based outside France.

SHIFT TOWARDS ECONOMIC JUSTIFICATION FOR THE USE OF A HOLDING COMPANY

Before the implementation of G.A.A.R. and the increased importance of the beneficial ownership concept (this concept has not been introduced recently but in 1977 in the relevant O.E.C.D. Commentary), the position of French judges regarding the use of offshore holding companies in a cross-border context was influenced the substance-over-form doctrine. In practice, tax treaty benefits and benefits under the Parent-Subsidiary Directive were allowed as long as the holding company maintained business premises, full-time employees, and business assets.

However, in line with the classical economic approach of the O.E.C.D. and the holding in the Danish Cases, discussions that are now being held with French tax authorities have a different focus. The questions raised now look to determine whether (i) the foreign holding company should be recognized as the actual beneficial owner of the French income or (ii) the foreign holding company serves merely as a conduit to other persons. Substance is no longer enough. French tax authorities follow the money trail. This approach makes it much easier for tax authorities to successfully deny a tax benefit.

Clarifications Regarding Holding Companies: Good News but Not Enough

In recent cases, French judges have attempted to identify several relevant criteria, but the relative importance of each depends on the facts and circumstances that are present in the case. There is no hierarchical value that applies to each fact pattern. The entire bundle of facts is evaluated by the judges and those facts that are viewed to be most material to the transaction before the court are given the most weight in reaching a decision. As a result, uncertainty continues to exist, especially for pure holding companies that have little substance in terms of head count, function, and activities. Typically, such companies are regarded by the French tax authorities as existing merely to receive funds mostly for the purpose of paying dividends to U.B.O.'s or reinvesting in new ventures as decided by business managers located in third countries, possibly outside the European Union and without any income tax treaty concluded with France. In other words, the structures are viewed to be established for treaty shopping purposes.

The distinction between the apparent recipient and the actual beneficial owner already existed under certain tax treaties negotiated by France. For example, the tax treaties concluded with Switzerland, Panama, Andorra, and Luxembourg exclude pass-through entities from receiving treaty benefits. Moreover, denial of treaty

benefits for double dip financing arrangements were already provided in tax treaties concluded with Italy and Qatar. Similarly, requirements under which the intent of the beneficial owner must be in line with a genuine arrangement reflecting economic reality appear in tax treaties with the U.K., Qatar, Japan, and Malta.

Decisions of French judges who apply a beneficial ownership test in various fact patterns apply all of the above concepts when evaluating factors on a case-by-case basis. In practice, factors that are not economically relevant to the facts presented should be identified first, leaving the decision of the judge to be influenced by the facts of the case deemed to be the most relevant. However, in practice it is difficult to anticipate the factors that will be viewed by a judge to be material in any particular fact pattern.

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Recent Cases

Recent decisions and their underlying facts are helpful guides when structuring a group of companies involving a French subsidiary. Below are a few illustrative cases in chronological order, that may provide some guidance in appropriate fact patterns. Note, however, that each case before each judge was decided based those facts that were viewed to be the most material by that judge.

Conseil d'Etat Decisions n°430594 and 432845 of February 5, 2021

These decisions confirmed that the notion of beneficial ownership is separate from the notion of abuse from a French tax point of view.

X Co. was a U.K. resident. It acted as the collector of revenue on behalf of artists that licensed the use, broadcast and distribution of musical works. X Co. argued that Article 13 of the U.K.-France Income Tax Treaty provides for a withholding tax exemption regarding royalty payments made to a U.K. licensor by a French licensee. However, X Co. was not regarded by the French tax authorities as the beneficial owner of the royalty payments. Consequently, the treaty was not regarded by the French tax authorities as applicable to X Co.

In the case, the court recognized (i) X Co had economic substance, (ii) the artists legally assigned their rights to X Co., and (iii) X Co.'s Board of Directors determined the allocation of income from the exploitation of licensed works. However, the court determined that the U.K. company was not the beneficial owner of the royalties for purposes of the exemption provided by Article 13. Of importance to the decision was the fact that the bulk of the royalties received by X Co. were ultimately paid to the composers and musicians. The court found them to be the beneficial owners of the French source income collected by X Co.

Conseil d'Etat Decision n°454980 of March 11, 2022

The case dealt with a Swiss holding company that derived dividends from its French subsidiary. The Swiss holding company was wholly owned by Mr. X, an individual who was a Portuguese tax resident.

At the time of the challenge by French tax authorities, the Swiss holding company was in existence for 36 years. It received dividends from subsidiaries in several countries including France. The proceeds of dividend income were held by the Swiss holding company. Nonetheless, the French tax authorities disallowed application of the withholding tax exemption for dividends, contending that the Swiss company

lacked substance, as it had no employees, no material resources, and no physical activity.

The court upheld the disallowance. It did not matter that dividends received by the Swiss company were not distributed to Mr. X as dividends. Nor did it matter that the profits were automatically transferred to reserves or retained earnings of the Swiss company. The funds held by the Swiss holding company were regarded as being, at the disposal of Mr. X, the sole shareholder of the Swiss company, and Mr. X had a history of borrowing funds from the Swiss holding company. These facts demonstrated that the Swiss company did not have the right to use the funds for its own needs. Rather, it acted as a mere conduit company.

Conseil d'Etat Decision n°444451 of May 20, 2022

The case involved F Co., a French company distributing sport programs to fitness clubs. F Co. had initially signed a distribution contract for fitness programs with a New Zealand company, N Co. At some point following a tax audit, the contractual arrangement was revised and F Co. signed subdistribution agreements for the same programs with a Belgian company and a Maltese company.

The payments made by the French company to the Belgian company were characterized as royalties, which were exempt from withholding tax in France in application of the France-Belgium Income Tax Treaty. In comparison, royalties paid directly to N Co., a resident of New Zealand, would have been subject to a 10% withholding tax under the France-New Zealand Income tax treaty. Sums paid as royalties to the Maltese company were subject to a withholding tax rate of 10% under the France-Malta Income Tax Treaty. The rate was identical to the 10% rate in the France-New Zealand Income Tax Treaty.

The French tax authorities challenged the application of the exemption as it considered the Belgian holding company to be a conduit company without any power to use the royalties earned. They reassessed F Co. by applying the France-New Zealand Income Tax Treaty, considering that the New Zealand company was the actual beneficial owner of the sums paid by F Co.

The court of original jurisdiction in France focused its analysis on the character of the income. Were the payments properly characterized as royalties or income from provision of services? It did not decide if the application of the France-New Zealand Income Tax Treaty was appropriate. Note that Article 12 of the France-New Zealand Income Tax Treaty refers to (i) royalties paid to a *resident* and (ii) the *resident* status of the payee, suggesting that benefits under the treaty required a direct payment of royalties to a resident of New Zealand.

The *Conseil d'Etat* refused to apply article 12 literally, concluding that when an agent or representative of a treaty resident is located in a third country, it is possible to apply the tax treaty concluded between the state of residence of the beneficial owner and the state of the income's source, provided that the beneficial owner is clearly identified. Consequently, the judges sitting in the court of original jurisdiction should have determined whether the New Zealand company was the actual beneficial owner of the royalty income.

The decision of the *Conseil d'Etat* is consistent with O.E.C.D. Commentary on point. As in effect since 2017, the O.E.C.D. Commentary provides in pertinent part as follows:

> Subject to other conditions imposed by the Article and the other provisions of the Convention, the exemption from taxation in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer, in those cases where the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1997 to clarify this point, which has been the consistent position of all member countries).[1]

In practice, the principle is important for foreign based groups that face a strict approach by French tax authorities regarding license fees paid to an intermediate holding company, even when there is no risk of treaty shopping by the U.B.O. Example include circumstances where (i) the U.B.O. sets up an intermediary licensing company that is based in the same country as the U.B.O. or (ii) the U.B.O. sets up an intermediary licensing company in a third country that has an income tax treaty in effect with France that provided equivalent relief in regard to French withholding tax on royalties.

The decision is consistent with the O.E.C.D. economic approach instead of a formalist approach where only the direct recipient of the income in question is taken into account. The *Conseil d'Etat* focused on one main purpose of a tax treaty, the elimination of double taxation. To our knowledge, the decision is among first in the E.U. to have provided clarification on that point. It provides a welcome degree of legal certainty to foreign groups operating in France through local subsidiaries.

"The Conseil d'Etat focused on one main purpose of a tax treaty, the elimination of double taxation."

Conseil d'Etat Decision n°471147 of November 8, 2024

This case is important because it confirms that in identifying the beneficial owner of a dividend, facts control rather than legal arrangements among members of a controlled group of companies.

F Co. was a French real estate leasing company, wholly owned by the L Co. 2. In turn, L Co. 2 was wholly owned by L. Co. 1. Each of L Co. 1 and L Co. 2 were Luxembourg companies. L Co. 1 entered into a trust agreement as trustee with four companies resident in Guernsey and an individual resident in Germany serving as grantors and beneficiaries. Under the trust arrangement, L Co. 1 undertook the obligation to pay 90% of the dividends it would receive from L Co. 2 to the four Guernsey companies and the German resident individual that were the trust's grantors and beneficiaries.

On July 2, 2014, F Co. paid an interim dividend of €3.6 million to L Co. 2. The next day, L Co. 2 paid the entire amount to L Co. 1. F Co. did not collect French withholding tax on the dividend payment, in accordance with Article 119 *ter* of the F.T.C., which implements the E.U. Parent-Subsidiary Directive, exempting dividends from withholding tax when distributed to an E.U. parent company.

French tax authorities challenged the application of the exemption, citing as authority Article 119 *bis* of the F.T.C. They also imposed a 10% penalty. No assertion of abuse of law was raised.

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[1] Page C(12)-4 of Model Tax Convention on income and on Capital (Full Version), which appears at page 761 of the Digital Version, as it read on November 21, 2017.

F Co argued that L Co. had real economic substance and could not be classified as a mere conduit entity. The following reasons were given in support:

- L Co. 2 was the full owner of the dividend.
- When L Co. 2 distributed the proceeds of the dividend to its sole shareholder, L Co. 1, the distribution reflected the free exercise of discretion by its directors. In support of that assertion, it pointed to a subsequent year in which L Co.2 received a dividend from F. Co and retained the entire amount received.
- The payment of €3.6 million was justified by the fact that neither the Guernsey companies nor the German resident individual ever received a return on the initial investment of €25m transferred to L Co. 1, three years previously.

The court upheld the tax assessment imposed by the French tax authorities. It considered that the undisputed facts were sufficient to conclude that L Co. 2 was not the beneficial owner of the dividend received from F Co :

- Regarding the €3.6 million distribution, L Co. 2 paid an interim dividend to its sole shareholder, L Co. 1, the day after receiving the F Co. dividend.
- L Co. 2 had no other funds available from which to pay that dividend or any other dividend at the time.
- L Co. 2's sole activity was limited to holding the shares of F Co.
- All of L Co. 2's decisions were totally controlled by its sole shareholder L Co. 1, acting through the joint managers of the two companies.

CONCLUSION

From a French tax perspective, the status of a foreign holding company as the beneficial owner of the amount it receives is determined based on facts of the particular situation. Those facts serve as clues, and no single fact controls in all circumstances.

Nonetheless, the following fact patterns have been determined to be troublesome in recent cases:

- The foreign holding company receiving a payment from a French party does not, itself, conduct a business activity of its own.
- The foreign holding company receiving a payment from a related party in France makes a payment of the same amount shortly thereafter to a related party.
- The foreign holding company receiving a payment from France does not keep any funds for use in its own business.
- The foreign holding company receiving a payment from a related party in France is an offshore holding company benefiting from a tax favorable regime in its country of residence.

- The foreign company receiving a payment from a related party in France does not make economic use of the funds for the purpose of its own business carried on in its country of residence. It does not have the power from a legal or a practical point of view, to use the income received.

Further clarifications would be welcome to enhance legal certainty for international groups operating in France and are eagerly awaited.