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The French tax authorities have issued a statement of practice (4C-7-07, dated May 10) regarding the consequences of the ECJ *Denkavit* decision (C-170/05) for the French dividend withholding tax system. (For the judgment, see *Doc 2006-24958 or 2006 WTD 241-13*.)

Under the judgment, the ECJ claimed that French withholding tax applicable to outbound dividends was a discriminatory measure that was incompatible with the EC Treaty insofar as French parent companies could be almost fully exempt from any double taxation on profits distributed by a resident company, whereas nonresident parent companies were subject to a 25 percent domestic withholding tax (subject to the application of tax treaties and, since then, the EU parent-subsidiary directive.)

As expected, one of the direct results of this decision has been to allow non-French resident shareholders to claim the benefit of the existing 5 percent French domestic participation exemption threshold (5 percent voting and financial rights), which allows companies to avoid any French withholding tax on dividends paid by their subsidiary. (For prior coverage, see *Tax Notes Int'l*, Jan. 29, 2007, p. 303.) Thus, despite that the *Denkavit* decision has been rendered in the context of the freedom of establishment (as noted in paragraph 3 of the statement of practice), it seems that the French tax authorities agree implicitly that it is also applicable in the context of the free movement of capital.

To receive the exemption, the shareholder must enjoy an exemption regime in his own country of residence (such as the Dutch participation exemption regime, as was the case in *Denkavit*), and as a result of that, the shareholder must not be in a position to credit the French withholding tax against its own tax. Also, the parties must not have entered into an artificial arrangement for tax avoidance.[1]

The exemption applies to residents of the European Economic Area as well as the European Union, provided the recipient shareholder's country of residence has entered into a qualifying tax treaty with France.

Based on the general drafting of the statement of practice, it appears that when shareholders comply with the conditions listed above, the French withholding tax exemption is automatically applicable. Therefore, in this case, tax need not be withheld in advance by the subsidiary (thus avoiding the need for the shareholder to then claim a refund of the withholding tax).

Conversely, the statement of practice provides for a refund procedure for French withholding tax should the impossibility to credit the French tax in the country of residence arise after the dividend has been distributed and the tax has been withheld. The French tax authorities cite, by way of example, cases in which the shareholder is in a tax loss position or is being liquidated.

The new French withholding tax regime deriving from the statement of practice merits several observations. In particular, the interpretation of *Denkavit* by the French tax authorities under the statement of practice seems to be favorable to foreign shareholders.

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[1]Introduction in its doctrine by the French tax authorities of the ECJ concept of "wholly artificial arrangement" (for an illustration of the use of this concept, *cf. Test Claimants*, C 524/04 no. 72 regarding U.K. thin capitalization rules). This concept has already been inserted in the French tax code regarding French CFC rules under the new article 209 B.

First, and not surprisingly, the mechanical effect of the statement of practice is to lower the minimum threshold requirement provided under the EU parent-subsidiary directive. The current EU parent-subsidiary threshold is 15 percent as of 2007 and will be reduced to 10 percent in 2009. As indicated above, the exemption will now be immediately available for dividends paid to 5 percent shareholders.

Another element is that the statement of practice does not specify the type of exemption regime that the shareholder must enjoy to benefit from this withholding tax exemption (that is, specific participation regime or general corporate tax exemption). Given the broad drafting of the statement of practice, one may wonder if shareholders that enjoy a general tax exemption regime in their own country can also claim the benefit of this new exemption of French withholding tax. This analysis would be favorable compared with the situation of French resident shareholders that benefit from a general corporation tax exemption, because those shareholders are usually not allowed to claim the benefit of the French dividend participation exemption. Similarly, the benefit of the withholding exemption provided for under the EU parent-subsidiary directive requires that the shareholder be subject to tax without the possibility of exemption.

Another example of possible preferential treatment in favor of foreign shareholders is that, as indicated by the ECJ in *Denkavit*, French parent companies are not fully relieved from double taxation under the French parent-subsidiary exemption regime. A 5 percent portion of the dividends received remains taxable at the level of the parent company (unless the actual expenses of the parent are verified to be lower). Given that the French corporation tax rate is 34.43 percent (taking into account a 3.3 percent additional contribution), French parent companies generally bear a cost of 1.72 percent on those dividends, meaning that French double taxation is allowed on this 5 percent portion of the dividend. Therefore, that the statement of practice fully relieves the dividend paid by French subsidiaries to EU residents from double taxation can place nonresident shareholders in a slightly better position than French shareholders (unless the country of the recipient has also chosen to tax 5 percent of the dividend, in which case there is no preferential treatment).[2]

Most significantly, the statement of practice does not appear to require that the 5 percent threshold be complied with during a minimum holding period. If this interpretation were to be confirmed, it would mean that the new French withholding tax regime issued from the *Denkavit* decision is still discriminatory — but this time vis-à-vis French parent companies. Indeed, the exemption applicable to dividends received by French parent companies from their subsidiaries is claimed back if the 5 percent threshold is not met within a two-year holding period. Therefore, profits distributed to nonresident parent companies now could always be relieved from double taxation (including if they do not meet the two-year holding period requirement), whereas French parent companies receiving such profits are not relieved from double taxation if they do not meet the two-year holding period requirement.

This interpretation seems to go beyond the ECJ *Denkavit* decision insofar as the conclusion of this decision is that French parents and nonresident parent companies have to be treated in a nondiscriminatory way, provided they are in a comparable situation.[3] Our view is that such a decision has not generally precluded EU members from applying withholding tax on outbound dividends, specifically in a situation in which resident shareholders are not protected against such double taxation and, therefore, in which nonresident shareholders were not discriminated against by the source country.

It should also be noted that should this interpretation be confirmed,[4] the absence of a holding period requirement would also be more favorable than the EU parent-subsidiary regime to the extent that to benefit from that regime, French domestic law[5] provides that the nonresident shareholder must hold (or agree to hold) the threshold for a minimum period of two years.

Finally, that the statement of practice provides for a refund procedure of the French withholding tax if the impossibility to credit the French tax results from, for example, the tax loss position of the shareholder or the shareholder being liquidated also appears to be favorable to nonresident taxpayers in comparison with the narrow scope of the *Denkavit* decision. Indeed, under this decision, the ECJ has mainly investigated the field of double taxation in

[2]This issue already exists under the existing EU parent-subsidiary directive whereby non-French recipients are fully relieved from French withholding tax on dividends and, therefore, suffer no double taxation (at least in France), whereas French parent shareholders suffer a French taxation on 5 percent of French source dividends.

[3]*Cf.* in particular point 28, 29, and 37 of the *Denkavit* decision.

[4]The French tax authorities may have decided not to impose a two-year holding period in the statement of practice because they consider that such a provision has to be passed by the French Parliament to be legally applicable and that such a requirement could not be enforced through a statement of practice.

[5]*Cf.* article 119 *ter* of the French tax code.

the context of the application of a participation exemption in the country of the recipient of the dividend, but not in the context of a nonresident shareholder that is not in a position to credit a French tax because of his own personal tax situation in its country of residence. At this early stage, we will merely outline that this (too generous?) refund procedure will likely give rise to complex situations in the event, for instance, the shareholders' tax loss situation is temporary or is due to the application of specific tax deductions that would not be allowed under French tax law. Furthermore, allowing nonresident shareholders to be exempt from French withholding tax because they are in a position of tax loss in their country of residence could allow the shareholders to use their losses twice: in their own country of residence, to avoid paying domestic tax, and in France, to avoid paying the French withholding tax on dividends.

It will be particularly interesting over the coming months to follow how French tax authorities intend to apply this favorable statement of practice and ascertain whether the apparently liberal spirit of the statement of practice will indeed be confirmed by its application. ◆

♦ *Jérôme Delaurière, avocat, Gibson Dunn & Crutcher, Paris*