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The *Papillon* Decision: Upcoming French Tax Group Reform

by Jérôme Delaurière

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In the *Société Papillon* decision (Case C-418/07, *Doc 2008-25188* or *2008 WTD 231-11*), the European Court of Justice on November 28, 2008, held that French tax group rules preventing tax consolidation of French subsidiaries owned by a French parent company through an intermediary company resident in another EU state constitute a restriction on the freedom of establishment (article 43 of the EC Treaty).

Simply stated, French tax group rules allow the French subsidiaries' parent company to compute and pay corporation tax on the net profits of the group members. In practice, this regime allows, among other benefits, the losses of one group member to be immediately offset by the profits of the other group members.

This regime only applies if the French parent company holds at least 95 percent of the share capital of the French subsidiaries, either directly or through other group members that are subject to French corporation tax and have the same fiscal year-end.

In the past, the French tax authorities have agreed that the French branch of a foreign company could elect to be the parent company of a French tax group (provided the shares held in the French subsidiaries are booked in the tax balance sheet of the French branch).

In a 2005 statement of practice, the French tax authorities also accepted that the French branch of a foreign company could be a member of the French tax group headed by the parent company owning the foreign company.

In these situations, only the income attributable to the French branch (as opposed to the overall income of the foreign company) is taken into account for the purpose of computing the tax group results.

Before the *Papillon* decision, the French tax authorities had refused to allow a French parent company to set up a French tax group with a French subsidiary held through a foreign company that does not have any branch in France (which is not subject to corporation tax in France for a portion of its revenues).

I. The *Papillon* Decision

Société Papillon, a French company that owned a French subsidiary through a Dutch company (which did not have a French branch), claimed that such refusal violated the freedom of establishment principle.

The ECJ confirmed the existence of an impermissible restriction insofar as the tax rule denied the Papillon Co. the right to use the profits and losses of its indirect subsidiary, solely because of the non-French residence of the intermediate Dutch subsidiary.

The ECJ rejected the French government's arguments, claiming that the French restriction was necessary to prevent double deduction in France of the same losses. In particular, the French tax authorities gave the example of a French subsidiary owned by a French parent company through an intermediary company (resident in an EU member state) being in a tax loss position. If the French subsidiary were allowed to join the French tax group set up by the French parent, the parent could deduct:

- the depreciation booked regarding the shares held in the intermediary company; and
- the tax losses incurred by the French subsidiary.

Despite this argument, the ECJ held that the restriction exceeded what is necessary to prevent double deduction and that the practical difficulties invoked by the French tax authorities could not justify an automatic limitation. In particular, the ECJ allowed the French tax authorities to request the necessary tax filings to avoid double deduction and mentioned the existence of the mutual assistance directive, which would allow the French tax authorities to share information.

II. Consequences of *Papillon*

The French tax authorities' intention is not to dramatically reform the French corporation tax rules, nor to amend the French corporation tax territoriality principle. Their principal objective is to amend the French tax group rules under a reform *a minima* to take into account the consequences of *Papillon*.

Introducing the *Papillon* decision's consequences into the French tax code could make the French tax group regime much more complex.

However, introducing the *Papillon* decision's consequences into the French tax code could raise many difficulties and, as claimed by the French tax authorities before the ECJ, make the French tax group regime much more complex.

Below are some of the main issues raised by the upcoming reform caused by *Papillon*.

A. Timing

None of the various finance laws passed by the French Parliament by the end of 2008 contained tax provisions amending the French tax group regime in accordance with *Papillon*. Thus, the consequences of the *Papillon* decision will most likely only be introduced in the French tax code by the end of 2009 and will apply, at the earliest, retroactive to January 1, 2009.

For the previous years, *Papillon* should be considered as a Court decision that reveals the incompatibility of French tax group rules with the EC Treaty. Thus, in accordance with article L190 of the Tax Procedure Code, the decision should allow taxpayers (in a situation comparable to *Papillon*) to claim refund of French corporation tax paid after January 1, 2005. Those claims should be filed by the end of 2010 at the latest (article R196-1 of the Tax Procedure Code), under the condition that the French parent can demonstrate that, for example, it was profit-making during the relevant years and could have used its French subsidiary's tax losses, had it been allowed to tax consolidate its subsidiary.

The fact that, contrary to Société Papillon, the taxpayer did not make a timely tax group election to include the French subsidiary in its own tax group should not prevent the taxpayer from filing a valid claim. Indeed, the French Supreme Court held that one cannot argue that a taxpayer should have acted in a certain manner if the applicable law at that time did not allow it to act in that manner.[1]

In practice, however, it remains unclear how the French tax authorities and French courts will apply the French tax group rules for past financial years, given that the applicable rules never anticipated the *Papillon* decision and are clearly not adapted to the situation in which a nonresident company has been interposed between French tax consolidated companies. In the *Papillon* situation, the French tax authorities have unofficially confirmed that the case has been amicably settled. Therefore, *Papillon* will not itself generate any additional guidelines for similar future claims.

B. Scope

The French tax authorities must determine the outcome of *Papillon* for purposes of enforcing the tax integration regime, for example:

- Is the number of EU entities interposed between the French parent and its French subsidiaries relevant? Even though in the *Papillon* situation only one Dutch entity was interposed, the *Papillon* decision should be applicable irrespective of the number of interposed EU entities. However, interposing more than one foreign intermediary entity will add another layer of complexity as far as the French tax group rules adjustments are concerned (cf. II.C below).
- In the presence of two existing tax groups, will the *Papillon* solution remain optional? In Figure 1, will the new law: (i) allow F2 and F3 to maintain French tax group no. 2; or (ii) will it oblige F2 and F3 to join French tax group no. 1 set up by F and F1? The *Papillon* decision should not force the French companies that have set up two tax groups (as a result of the French tax authorities' doctrine applicable before *Papillon*) to merge their tax groups. Alternatively, the law should provide that the merger should be done in a tax-neutral manner (without being considered a termination event

[1]French Supreme Court, Apr. 9, 2004, *Caisse interfédérale de Crédit Mutuel de Bretagne.*

of the tax group formed by F2 and F3). Regardless, the offsetting rules applicable to the tax losses of French tax group no. 2 will have to be clarified.

Figure 1

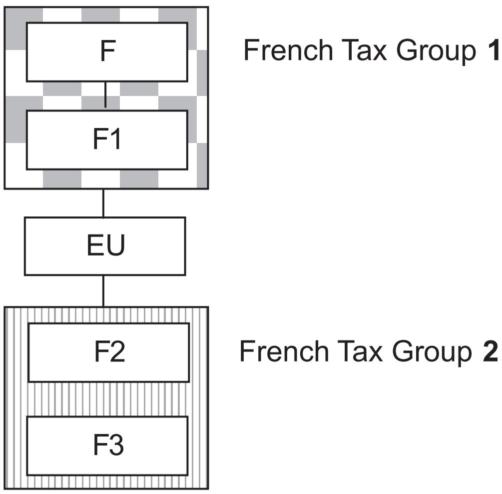
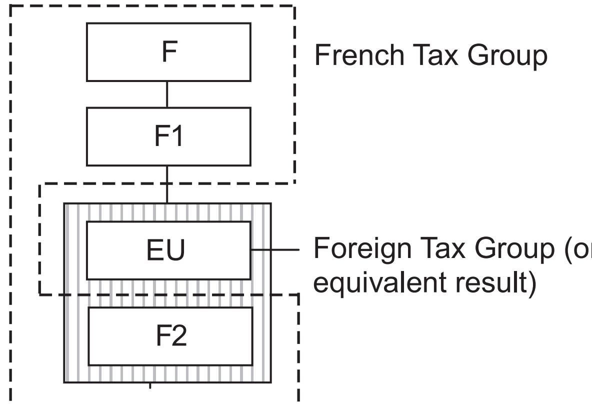


Figure 2



- Another issue is whether the fact that the tax losses of the French subsidiary (F2 in Figure 2) are already taken into account in the member state of the intermediary company could preclude the French subsidiary from being tax consolidated with the French parent (that is, double deduction of tax losses). This issue should only be relevant for the member state when the intermediary company is tax resident, and should not prevent the tax consolidation of the French subsidiary in France.

C. French Tax Group Rules Adjustments

As a result of *Papillon*, the French tax authorities will also have to adapt the French tax group rule adjustments to take into account the interposition of a foreign holding company between the French parent and the French subsidiaries. This will most likely result in much more complex French tax group rules.

One example is that dividends distributed to the French parent company by its French subsidiaries are usually exempt from the 5 percent parent-subsidiary minimum taxation (*quote part de frais et charges*). The French tax group rules should be amended to provide that dividends distributed by the foreign intermediary holding should benefit from the exemption, if the dividends correspond to distributions made by the French subsidiaries held by the foreign holding. However, it may be complex in practice to identify which dividends are distributed by the foreign company (in particular if the company also owns foreign companies, or if there are several intermediary companies). Timing issues may also arise if the intermediary holding does not immediately redistribute the dividends received from its French subsidiary.

Another example is that intragroup sales of fixed assets (or debt forgiveness) usually benefit from a rollover under French tax group rules. French tax law should be amended to apply the rollover to sales of fixed assets taking place between the French parent company and the French subsidiaries held through the foreign holding. This rollover should also be extended to intragroup transactions involving the foreign holding itself and the French subsidiaries (such as when debt forgiveness would be granted to the foreign holding, which in turn would grant debt forgiveness to the French subsidiary).

As far as the *Amendement Charasse* rules are concerned,[2] they should now become applicable in the situation of an indirect acquisition of a French subsidiary by a French parent company from its controlling shareholder (that is, when a French parent company buys an EU company that holds a French subsidiary and has tax consolidated the French subsidiary). This will require that the fair market value of the French subsidiary's share is identified in the share purchase agreement of the intermediary company.

Rules will also have to be passed to prevent the risk of double deduction that the French tax authorities have raised regarding *Papillon*. In theory, the new rules should deny the right to deduct the depreciation

[2]Article 223 B of the French Tax Code. In summary terms, this rule denies the deductibility of interest in situations when a tax group member purchases from its controlling shareholder a French company that becomes a member of the same tax group.

booked by the French parent company regarding the shares owned in the intermediary company up to the amount of the depreciation economically justified by the situation of the French subsidiary. In practice, the implementation of this principle could be quite complex. In any event, the scope of tax deductible depreciation of shares has become very narrow in France (mainly relevant for real estate property companies).

III. Conclusion

The *Papillon* situation was relatively straightforward. Indeed, Papillon Co. was not arguing that its Dutch holding company should be allowed to become a member of its French tax group. It was only claiming this right for its French subsidiary owned through its Dutch holding.

However, the ECJ may soon have to examine this more substantial question. Indeed, on July 21, 2008, the Dutch Supreme Court referred to the ECJ a preliminary ruling[3] regarding a cross-border fiscal unity question between a Dutch parent and its Belgian subsidiary. In this case, the Dutch tax authorities refused the request of the Dutch parent company to consolidate its tax profits with the losses of its Belgian subsidiary. The Dutch Supreme Court wondered whether such a refusal could constitute a restriction on the freedom of establishment and if that restriction could be justified in the context of a fiscal unity system and with the principle of fiscal territoriality.

Should the ECJ confirm the existence of an impermissible restriction, it is not certain that the French tax unity and territoriality rules, even amended as a result of the *Papillon* decision, would survive such a tax earthquake. In that respect, the French tax authorities have already opened a door. The 2009 Finance Law now allows small and medium-size French companies to immediately deduct tax losses incurred by their foreign branches or subsidiaries established in an EU member state or a state entering into a tax treaty with France that includes an administrative assistance clause. ◆

[3] *X Holding BV/Staatssecretaris van Financiën*, C-337/08, 2008/C 272/15.