Contents

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THE FORUM

4 **ARGENTINA**
Manuel M. Benites
Pérez Alati, Grondona, Benites, Arntsen & Martínez de Hoz, Buenos Aires

11 **BELGIUM**
Jacques Malherbe and Henk Verstraete Esq.
Liedekerke Wolters Waelbroeck Kirkpatrick, Brussels

17 **BRAZIL**
Gustavo Brigagão and Rodrigo Brunell
Ulhôa Canto, Rezende e Guerra Advogados, Rio de Janeiro

21 **CANADA**
Elinore Richardson, Toronto, Ontario
Larissa Tkachenko, Borden Ladner Gervais LLP, Toronto, Ontario

28 **PEOPLE'S REPUBLIC OF CHINA**
Stephen Nelson, Peng Tao and Tina Xia
DLA Piper, Hong Kong, New York & Beijing

33 **DENMARK**
Nikolaj Bjørnholm, Hannes Snellman,Attorneys, Copenhagen

38 **FRANCE**
Thierry Pons, Cabinet Pons, Paris

43 **GERMANY**
Dr Jörg-Dietrich Kramer, Bruhl

48 **INDIA**
Kanwal Gupta and Shruti Sinha, Deloitte Haskins & Sells, Mumbai

55 **IRELAND**
Peter Maher and Philip McQueston, A & L Goodbody, Dublin

56 **ITALY**
Giovanni Rolle
R&A Studio Tributario Associato - Member of WTS Alliance, Turin - Milan

62 **THE NETHERLANDS**
Maarten J.C. Merkus and Bastiaan L. de Kroon
KPMG Meijburg & Co Tax Lawyers, Amsterdam

65 **SPAIN**
Luís Briones and Cristina Alba, Baker & McKenzie, SLP, Madrid

70 **SWITZERLAND**
Peter Altenburger and Katja Krech, ALTENBURGE LTD legal + tax, Zurich

73 **UNITED KINGDOM**
Gary R Richards, Berwin Leighton Paisner LLP, London

78 **UNITED STATES**
Herman B. Bouma, Esq.
Buchanan Ingersoll & Rooney PC, Washington, DC

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Current taxation by Host Country of income earned by Controlled Foreign Corporations

FACTS

HCo, a limited liability business entity formed under the law of Host Country ("HC"), is engaged in a trade or business worldwide through other business entities. HCo wholly owns Sub1, incorporated under the law of Third Country, which in turn wholly owns Sub2, incorporated under the law of Foreign Country ("FC"). Sub2 is engaged in a trade or business in FC. HCo, Sub1, and Sub2 are treated as corporations for HC, Third Country, and FC income tax purposes.

QUESTIONS

1. Does HC have a so-called "controlled foreign corporation" ("CFC") regime for currently taxing to HCo all or some part of the income realised by Sub2 (even though the value of that income is not yet considered distributed to HCo)?

If yes:

a. Briefly describe the history and objectives of the regime.

b. What is the definition of a CFC for purposes of the regime? In particular, what are the definitions of "corporation", "foreign", and controlled"? Could the CFC regime apply if Sub1 were instead wholly owned by an individual who is a resident of HC? What if Sub1 were wholly owned by a trust or partnership?

c. What types of income of Sub2 are subject to current taxation? Are there any "safe harbour" rules pursuant to which income is exempt from current inclusion? Is it significant whether HCo had a "tax avoidance purpose" in setting up Sub2?

d. Is current taxation of all or some part of Sub2's income also triggered in certain other circumstances, e.g., if Sub2 has participated in a boycott, made bribes, or made "investments in HC property"?

e. What rules are, or may be, used to determine income for purposes of the CFC regime, e.g., FC financial accounting rules, HC financial accounting rules, IFRS, FC income tax rules, HC income tax rules, or HC "earnings & profits" rules?

f. How would HCo's pro rata share of income subject to current taxation be determined if, instead of the facts assumed, 70 percent of the stock value of Sub1 was in common stock held by HCo and the remaining 30 percent was in preferred stock held by an unrelated party?

g. How exactly is HCo taxed on the income subject to current taxation, e.g., is the value of the income deemed to be paid directly to HCo ("hopscotched") or is it deemed to flow up through Sub1? Are credits given for foreign income taxes incurred by Sub2 to FC with respect to the income being currently taxed to HCo? If yes, how is the amount of such credits determined? What if Third Country has its own CFC regime and income of Sub2 is currently taxed to Sub1?

h. What adjustments are made to ensure that the value of currently taxed income of Sub2 is not taxed again by HC when it is considered distributed or the stock of Sub2 is sold?

i. What if part of HCo's indirect interest in Sub2 were held through a corporation that did not constitute a CFC for HC income tax purposes?

j. What is the impact, if any, on HC's CFC regime of any treaties that HC has entered into, e.g., income tax treaties or the European Union "Constitution"? If HC is a member of the EU, how has HC's domestic tax law (including case law and administrative guidance) been impacted by the ECJ's Cadbury Schweppes decision?

2. Are there any other regimes in HC's income tax law under which income realised by an entity that is not itself subject to taxation by HC might be currently taxed to direct or indirect owners of the entity that are residents of HC? If yes:

a. Briefly summarise the rules of such regime(s).

b. What is the impact, if any, on such regime(s) of any treaties that HC has entered into?

Host Country FRANCE

Thierry Pons
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I. The CFC regime of France

A. History and objectives of the French CFC regime

Controlled foreign corporation (CFC) rules were introduced into the French legislation by the 1980 Finance Law in the form of Article 209B of the French Tax Code (FTC). The rules allow the French Tax Administration (FTA), in certain circumstances, to impose French tax on the results of a French corporation's foreign subsidiary or branch that is subject to a privileged tax regime abroad.

Although, historically, inspired by the US rules, the French CFC regime relies on different technical assumptions because of the French territoriality rules. France has a territorial tax system under which corporate tax is payable by corporations only on business executed in France. The income of its foreign branches is in principle ignored in determining a corporation's French taxable basis. In addition, the double taxation of dividends from foreign subsidiaries is eliminated by the exemption of the dividends (only a lump sum 5 percent of the dividends, which is deemed to correspond to shareholder costs, is taxed) rather than a tax credit (the former tax credit, the *avoir fiscal* has been repealed).

Thus, a French corporation ("FrenchCo") that has branches and subsidiaries abroad is in principle not taxed on its foreign profits. This is in contrast to the tax systems of countries like the United States, which tax worldwide profits, use tax credits to avoid the double taxation of dividends received from foreign subsidiaries, and have CFC rules that allow the taxation of foreign income that should, in principle, anyway become taxable at some stage i.e., when (and if) it is distributed to be accelerated.

The French CFC rules allow for the taxation of foreign profits derived by branches and subsidiaries established or incorporated in low tax countries. However, Article 209B of the FTC provides safe harbour rules that can significantly narrow the extent of the situations in which Article 209B applies. As a result of the restrictive stance taken by the FTA, the scope of the safe harbour rules, which are discussed in more detail I.C., below, is open to debate and indeed is currently the subject of litigation.

After its implementation in 1980, Article 209B of the FTC was first amended to extend its scope to encompass foreign branches, which were not covered by the regime as initially introduced. After that amendment, no significant changes were made until those introduced by the Law of December 30, 2004, which substantially amended the CFC provisions in response to certain French and European court decisions.

The first 2004 amendment consisted of a change to the characterisation of the income taxed in the hands of a FrenchCo consequent on the French *Schneider* case,[1] so as to allow for the taxation of CFC income in a treaty context. In its initial version, Article 209B of the FTC provided that a FrenchCo was to be taxed on the "profits" derived by its CFC. The French High Court ruled that such taxation was not consistent with the provision in tax treaties under which business profits are taxable in the State in which they are derived. The law was changed to provide that, in the case of a subsidiary, taxation proceeds on the basis that there is a deemed distribution by the CFC to the FrenchCo. The consequences of this change and the potential impact of treaties on the application of the French CFC rules are discussed in more detail in I.G., below.

The second substantial amendment concerned the safe harbour rules and was a consequence of the European Court of Justice's (ECJ's) important decision in *Cadbury Schweppes*.[2] In *Cadbury Schweppes*, the ECJ held that the UK CFC regime (which was comparable to the regime provided for in Article 209B of the FTC) constituted an obstacle to the freedom of establishment, which was not permissible except where it could be justified by a compelling reason, i.e., where it was necessary "to prevent conduct involving the creation of wholly artificial arrangements which do not

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reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory."

The more detailed discussion of the current incarnation of the safe harbour rules (in I.C., below) will show that there remain major doubts as to how these rules should be interpreted, which in turn can have substantial implications for the scope of Article 209B of the FTC.

B. Definition of a CFC

A FrenchCo will be subject to taxation under Article 209B of the FTC if it holds, directly or indirectly, more than 50 percent of the shares, voting rights or financial rights in a legal entity incorporated outside France in a country where it is subject to a privileged tax regime as defined in Article 238 of FTC. Article 209B also applies to foreign branches established in such countries.

A foreign tax system is considered to be a privileged tax regime if, under that regime, the amount of tax borne by the local entity on its income is less than half the tax that would have been payable in France on the same income computed under French tax rules. As the comparison is made by applying the French corporate tax rate (33.33 percent) and the additional contribution (3.3 percent of corporate tax due in excess of EUR 763,000), the threshold would be around half of 34.4 percent of the income computed under French rules.

As regards the minimum holding in the CFC, the 50 percent threshold can be tested by reference to voting rights or financial rights (the financial rights and voting rights are tested separately, they are not aggregated). The percentage of shares, financial rights or voting rights held indirectly through a chain of shareholdings is obtained by multiplying the successive holding percentages. Rights held by related parties with which FrenchCo has a common interest (whether of a personal, financial or economic nature) may also be taken into consideration in computing whether the 50 percent holding threshold is reached.

The 50 percent threshold can be reduced to 5 percent when the holdings have been artificially fragmented. Specifically, the 5 percent threshold applies when more than 50 percent of the shares in the CFC are held either by other corporations established in France or by related parties of the FrenchCo.

C. Types of income subject to the CFC regime the Safe harbour rules

Technically, Article 209B of the FTC allows any kind of income derived by a foreign branch or CFC to be taxed. However, Article 209B II and B III provide safe harbour rules that prevent the CFC provisions from applying when the branch or CFC carries on a genuine activity (i.e., to "active income") or is not used to avoid tax.

As noted in I.A., above, the safe harbour rules were amended by the Law of December 30, 2004 (which took effect from 2006) so as to reflect the principles laid down by the ECJ in *Cadbury Schweppes*.

Before describing these rules (and the new wording is rather complex unnecessarily so despite the fact that the 2004 Law was supposed to clarify the situation), it is worth commenting on their purpose.

As noted above, Article 209B of the FTC represents an obvious exception to French territoriality principles and its purpose, as indicated in the relevant parliamentary discussions, seems clearly to be to combat tax avoidance. This purpose is also consistent with the ECJ's delineation of the scope of CFC rules, which limits the application of such rules to tax avoidance situations.

The purpose of the safe harbour rules should therefore be to define those situations in which there is no French tax avoidance so as to limit the scope of application of Article 209B of the FTC to those situations in which there is such avoidance. Historically, however, the FTA has taken a restrictive position with regard to the interpretation of the safe harbour rules that can result in Article 209B being applied in situations in which no tax is avoided in France. This is, for example, the case where a subsidiary (CFC) is created and held by another foreign subsidiary (Foreign SubCo) of FrenchCo for local tax reasons. If there is no tax effect in France for FrenchCo, the safe harbour rules should allow FrenchCo to escape the application of Article 209B, even if the CFC has only passive income. Another example is provided by the "Trojan horse" situation, in which a French group gains control of a foreign group that has stakes in CFCs. Article 209B should probably never apply in such circumstances, but this is not currently the position of the FTA.

The extensive application of Article 209B of the FTC in situations in which no tax is avoided in France is clearly unacceptable in an EU context, as is evident from the position of the ECJ, which has stated that:[3]

> "In order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to *escaping the tax normally due on the profits generated by activities carried out on national territory*."

The FTA's position is probably also not compatible, in a non-EU context, with the intention of the French parliament in implementing Article 209B of the FTC and the safe harbour rules. There is outstanding litigation on this matter that should clarify both the purpose of Article 209B and the scope of the safe harbour rules, i.e., whether Article 209B should apply

mechanically even when no tax avoidance is achieved or whether its application should be limited strictly to cases in which there is avoidance of French tax. *Cadbury Schweppes* clearly confirmed that only the second interpretation is sustainable in an EU context, and there are very strong arguments for suggesting that the same approach should prevail in a non-EU context and even with respect to a CFC located in a state with which France has no tax treaty.

The provisions applicable since 2006 provide different safe harbour definitions in: 1) an EU context; 2) a non-EU context; and 3) in addition, specific rules were recently enacted to cover situations involving investments in "non-cooperative States".

1. EU context

As regards branches and CFCs established in the EU, Article 209B II of the FTC exempts from the application of the CFC regime situations that do not constitute artificial arrangements designed to circumvent the French tax legislation. The definition of such artificial arrangements directly refers to the *Cadbury Schweppes* decision and is very close to the definition of "abuse of law." This safe harbour clause implicitly covers situations in which the branch or CFC carries on a genuine activity, with staff and premises in the other EU Member State. Except in situations in which a genuine activity exists, the difficulty for FrenchCo is that it bears the burden of a proof that is defined negatively: i.e., it must prove that it *did not* create an artificial arrangement to avoid French tax. In its comments on the clause, the FTA has indicated that such proof may be adduced by any means. In fact, the FTA seems to look mainly to the existence of a genuine activity and business, while an analysis of the rule indicates that it ought also to be possible to rely on other factors, including the minimisation of taxes other than French taxes (which is present, for example, in the "Trojan horse" situation described above).

2. Non-EU context

As regards the safe harbour rules applicable to a non-EU branch or CFC, Article 209B III refers to situations in which the branch or CFC carries on a genuine activity. The new wording removes the requirement contained in Article 209B before the 2004 amendments that the activity be carried on "in the local market," which created unnecessary disputes over what a "local market" was.

The second paragraph of Article 209B III provides specific rules that apply to certain tainted income derived by a non-EU branch or CFC and require the FrenchCo to prove that the establishment of the foreign entity concerned mainly had "an effect other than to allow the location of profits in a state or territory where it is subject to a privileged regime of taxation." This additional evidence is required when more than 20 percent of the CFC income derives from the management of financial or intangible assets by the branch or CFC, for its own account, or for the account of a related party belonging to the same group, or when more than 50 percent of the CFC income is derived from the same management income increased by income for the supply of services to related parties belonging to the same group.

In both these two cases, the FrenchCo must provide evidence of the absence of tax objectives. This requirement is in fact quite close to the requirements applying in the case of EU branches and CFCs, except that the law in this context does not expressly refer to avoiding French tax. There is consequently potential for debate as to whether the existence of a non-French tax optimisation purpose would satisfy the safe harbour rule requirements thus allowing the application of Article 209B of the FTC to be avoided, but there are strong arguments suggesting that this should be the case.

3. Investments in "non-cooperative States"

In 2010, the safe harbour rules were amended as regards their application with respect to branches and CFCs located in "non-cooperative States," as defined in the law. However, the list of non-cooperative States published by the FTA is, so far, very short.[4] It is technically possible that the list could be extended to encompass even countries that have signed tax treaties with France but that do not effectively exchange tax information with France. Moreover, the difference in the scope of the application of the safe harbour rules to these countries is in practice immaterial when compared to the scope of their application to other countries: the FrenchCo must establish the reality of the activity carried on by the CFC and, in the case of tainted group activities, the FrenchCo must also prove that the setting up of the structure mainly had "an effect other than to allow the location of profits in a state or territory where it is subject to a privileged regime of taxation." The rule requires that the company must provide all the information required to support this proof, which is in fact the same requirement as applies in situations other than those involving non-cooperative States.

In short, despite the quite complex wording of Articles 209B II and B III of the FTC, the position of branches and CFCs in the EU is not that different from that of branches and CFCs outside the EU, or even of branches and CFCs in non-cooperative States: in all instances, the FrenchCo must prove that no tax has been artificially avoided in France. In practice however, the FTA is probably going to be more demanding as to the level of proof for a branch/CFC in a non-cooperative State than for an EU branch/CFC. In all situations, it is strongly recommended that French-

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Cos maintain comprehensive documentation of their CFCs' activities (including transfer pricing policies) to provide to the FTA.

D. Rules used to determine CFC income

The profits of a foreign branch or CFC are deemed to be derived by the FrenchCo on the first day of the year of FrenchCo opening after the close of the year of the CFC. (For example, if the CFC's year closes on September 30, N and FrenchCo's on December 31, N, the CFC income of the year to September 30, N is taxable as income of FrenchCo on January 1, N+1 and taxed as N+1 income.) The income is computed according to French tax rules and French GAAP.

Dividends received by a CFC are exempt from tax in the same way as other dividends received by FrenchCos (i.e., 95 percent exemption if the CFC owns more than 5 percent of the capital of the distributing corporation). Dividends received from corporations in non-cooperative States do not benefit from the 95 percent exemption. This exclusion was introduced in 2009, the previous version of the law providing an exemption for dividends received from corporations resident in countries with tax treaties providing for an exchange of tax information with France. While the concept of "non-cooperative States" is technically wider than the concept used in the prior exclusion, as noted in I.C., above, the number of jurisdictions designated as non-cooperative States is in practice, so far, very limited.

Long-term capital gains on the sale of investment stock held by a CFC are also 95 percent exempt.

Losses incurred by a CFC or foreign branch cannot be offset against the FrenchCo's profits or the profits of another CFC, but can be carried forward to offset the income of that branch or CFC in subsequent years. Losses incurred by the FrenchCo can, by contrast, be set off against the profits of its CFC or branch (which was not possible before 2006).

E. Rules for determining pro-rata shares

Obviously, where a FrenchCo has a foreign branch or owns directly all of the shares of a CFC, its *pro rata* share in the income of the branch or CFC will be 100 percent, and it can be taxed on all of that foreign income, except when the safe harbour rules apply to the income.

The situation is slightly more complicated when the FrenchCo meets the 50 percent participation threshold that triggers the application of Article 209B of the FTC, but part of the 50 percent is held indirectly:

Firstly, while voting rights are taken into account in computing whether the 50 percent threshold is reached, they are ignored in computing the proportion of the CFC income to be included in the taxable income of the FrenchCo, as are shares held by related parties with which the French corporation has a common interest but that are not owned directly or indirectly by the FrenchCo.

Secondly,[5] to avoid double taxation, financial rights held indirectly in the CFC by another, intermediary, French entity that is already subject to tax in France under Article 209B on the CFC income are ignored. Hence, where there is a chain of holdings, the entity liable to tax under Article 209B is the entity that is at the tier closest to the CFC.

F. Adjustments to prevent double taxation on actual distributions or the sale of stock

The tax paid locally by a branch or CFC can be credited against the tax payable by the FrenchCo on the CFC income, provided such local tax can be "assimilated to" French corporation tax. This requires certain conditions to be met, i.e., that: the local tax is computed as a percentage of income; the tax is not deductible from income; and payment of the tax is final and "without counterparty" (meaning, for example, that there can be no entitlement to a refund). In the case of an indirect subsidiary, the tax paid locally can be credited in proportion to the financial rights held, directly or indirectly, in that subsidiary by the FrenchCo subject to Article 209B of the FTC.

Withholding tax imposed on dividends, interest or royalties received by a branch or CFC and paid in a country with which France has signed a tax treaty can also be credited in accordance with the terms of the treaty concerned (although taxes paid in non-cooperative States cannot be credited).

Dividends received by a FrenchCo from a CFC are exempt from corporate tax even the 5 percent portion that normally remains taxable under the French participation exemption. Withholding tax imposed on the distribution of such dividends can be offset against the French tax payable on the CFC income.

The law does not provide a specific rule for dealing with double taxation resulting from CFC taxation in France and in another country with similar CFC rules. The FTA has indicated that such situations need to be examined and resolved in light of the tax treaty between France and the other country (if any). In such situations, however, it is likely to be possible to argue for the application of the safe harbour rules on the grounds that the CFC was created for non-French tax reasons (see I.C., above).

No adjustment is made to any gain on the sale of the shares of a CFC, but such a gain can benefit from the participation exemption for long-term gains. Only shares in CFCs located in non-cooperative States are excluded from the exemption (and, in such circumstances, there is clearly a risk of double taxation when the CFC rules apply).

G. Impact of France's tax treaties

In contrast to the position in some countries (for example, the United States), the French Constitution provides that a treaty automatically takes precedence over domestic law, even law that is enacted after the signing of the treaty.

As noted in I.A., above, the French Supreme Court ruled in *Schneider*[6] that, unless it is expressly authorised by the applicable tax treaty, the taxation of the profits of a foreign branch or CFC is not consistent with the provision in treaties under which business profits are taxed in the state in which they are derived.

This case law continues to apply with respect to foreign branches, so that the taxation of the income of such branches under Article 209B of the FTC depends on whether the applicable tax treaty expressly allows Article 209B to apply, either by referring to it or by providing for a method of elimination of double taxation by way of a tax credit rather than an exemption method. New treaties signed by France generally allow for such taxation, but not all France's treaties have been adapted to that effect.

As regards subsidiaries, the law has been amended so that a FrenchCo is not technically taxed on the profits derived by its CFC, but on a distribution deemed to be made by the CFC. The purpose of the change was to provide for a CFC's income to be taxed as "other income" (when the applicable treaty so allows) or as dividend income (which, depending on the definition of dividend income in the applicable treaty, can create an issue when no income is effectively distributed). The new wording of the law has not yet been tested before the High Court.

II. Other regimes in addition to the CFC regime

Under Article 238 *bis* O I of the FTC, a FrenchCo that transfers assets outside France, whether directly or indirectly, to a person, an organisation, a trust or a comparable institution, with a view to managing in its own interest or assuming for its own account an existing or future commitment or liability, is taxable on the income resulting from the management of such assets. The provisions of Article 238 *bis* O I may apply concurrently with those of Article 209B. Article 238 *bis* OI applies, in priority, to income defined in that Article, with the remaining portion of the CFC income being taxable under Article 209B, so that the same profits are not taxed twice. Article 238 *bis* OI is, however, seldom invoked by the FTA.

Apart from this provision, it is also worth mentioning;

Article 238A of the FTC, which provides that interest, royalties and fees for services payable to an entity located in a tax haven are allowed as deductible expenses only if the debtor supplies proof that the expenses correspond to actual operations and that they are priced at arm's length.

Article 123 *bis* of the FTC, which provides a rule equivalent to section 209B that applies to individuals owning more than 10 percent of an entity located in a tax haven.

NOTES

[1] CE ass. 28 juin 2002 n° 232276, *ministre c/ Sté Schneider Electric*. RJF 10/2002n 1080.

[2] CJCE 12 sept. 2006 aff 196/04 RJF 2006 n 1644.

[3] ECJ 12 sept 2006, 196/04 para. 55

[4] The 2010 list published by the Administration on Feb. 12, 2010 (OJ 17 p. 2923) identifies the following non-cooperative jurisdictions: Anguilla; Belize; Brunei; Costa Rica; Dominica; Grenada; Guatemala; the Cook Islands; the Marshall Islands; Liberia; Montserrat; Nauru; Niue; Panama; Saint Kitts and Nevis; the Philippines; Saint Lucia; and Saint Vincent and the Grenadines.

[5] FTC, Art. 102 T of annex II.

[6] CE ass. 28 juin 2002 n° 232276, *ministre c/ Sté Schneider Electric*. RJF 10/2002n 1080.

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