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COMPARATIVE TAX LAW FOR THE INTERNATIONAL PRACTITIONER

Determining the interest deduction of a branch, PE, or subsidiary

FACTS

FCo is a limited liability business entity formed under the law of Foreign Country ("FC") and engaged in a trade or business, directly and indirectly through wholly-owned subsidiaries, in a number of countries. (As used here, a "subsidiary" is a separate limited liability business entity, but not necessarily a corporation for income tax purposes.) FCo is engaged directly in a trade or business in Host Country ("HC") and the trade or business is considered a branch for HC income tax purposes ("HBr"). The head office of FCo contributed a certain amount of capital to HBr, which amount is reflected on the books that HBr keeps for accounting purposes ("accounting books"). The head office of FCo also has certain loans outstanding to HBr, which are also reflected on HBr's accounting books. In addition, FCo, through its head office, HBr, and other foreign branches, has borrowed from third parties worldwide. The FCo group, consisting of FCo and its subsidiaries, currently has no contact with HC other than through HBr, and FCo is considered a corporation for HC income tax purposes.

QUESTIONS

1 (a) Assuming no income tax treaty applies, how is HBr's interest deduction determined for HC income tax purposes?

(b) Do loans made by the head office of FCo to HBr have any relevance to this determination?

(c) Does the amount of capital reflected on HBr's accounting books have any such relevance?

(d) Is it necessary to determine an amount of capital allocable to HBr?

(e) Discuss how the determination of HBr's interest deduction might vary based on the type of business in which HBr is engaged (e.g., whether or not it is engaged in a banking business).

2 (a) Assuming an income tax treaty applies and HBr constitutes a permanent establishment for purposes of the treaty ("HPE") how is HPE's interest deduction determined?

(b) What significance, if any, does the OECD 2008 Report on the Attribution of Profits to Permanent Establishments have in this regard?

(c) Do any income tax treaties of HC reflect this report?

3 (a) If, in the income tax treaty context, the tax authorities of FC determine that HPE is overcapitalised and thus treat HPE as paying more interest to the head office of FCo, is there a risk of double taxation?

(b) If so, how might this be addressed by FCo?

4 Assume instead that FCo establishes the trade or business in HC as part of a newly-formed subsidiary formed under the law of HC and that the subsidiary ("HCo") is a corporation for HC income tax purposes. How is HCo's interest deduction determined for HC income tax purposes, first assuming no income tax treaty applies and then assuming one does apply?

Contents

THE TAX MANAGEMENT INTERNATIONAL FORUM is designed to present a comparative study of typical internationa tax law problems by FORUM members who are distinguished practitioners in major industrial countries. Their scholarly discussions focus on the operational questions posed by a fact pattern under the statutory and decisional laws of their respective FORUM country, with practical recommendations whenever appropriate.

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I. Introduction

The treatment of interest paid by a branch remains a relatively grey theoretical area from a French tax point of view. It will be seen, however, that, in practice, this is essentially an issue for the banking industry. This paper first addresses the issue from an internal law perspective (see II. below) and then from a tax treaty perspective (see III. below). It then goes on to discuss how inconsistent treatment between a head office and its branch can be resolved (see IV. below) and finally looks at how a subsidiary would be treated as compared to a branch (see V. below).

II. Determination of French branch HBr's interest deduction under French internal law

The answers to the questions raised will be very different depending on whether HBr is a branch of a regular corporation (see II.A. below) or the branch of a bank (see II.B. below).

A. Rules for foreign corporations in general

The deductibility of interest paid by a branch can be subject to limitation either based on the territoriality rules (see II.A.1. and 2. below) or on the general thin capitalisation rules contained in the French Tax Code (see II.A.3. below).

1. Introduction: French territorial approach to the taxation of branches

Unlike most countries, France has a territorial approach and corporate tax is payable by corporations only on business executed in France. This territorial approach does not give rise to any significant differences between the French tax treatment of a French branch of a foreign corporation and the tax treatment of other countries with respect to branches of foreign corporations situated in those countries (but it does give rise to differences in the reverse situation, i.e. where a French corporation has a branch abroad, see III. below).

The French branch of a foreign corporation (HBr) is in principle subject to the same tax rules as a French corporation under French internal law. The French branch is subject to French corporate income tax (currently at the rate of 34.42 percent, including the social contribution) on the taxable income that is attributable to the activity of the branch. How this attribution is made is discussed below, and more particularly how capital and debts should be allocated between the branch and its head office.

As a general principle, French taxable income is determined by reference to book entries. This applies not only in the case of a French corporation but also in the case of a French branch of a foreign corporation. Unlike in some other countries, taxable income is not unconnected with the results shown in the accounts although a number of book-to-tax adjustments are required by French law in computing the taxable income of a corporation or a branch. More precisely, Article 38- 2 of the French Tax Code refers not to the income shown in the P&L account, but to the "variation in net equity" in the balance sheet. In practice, this "variation in net equity" is directly related to the net income in the P&L, but the wording indicates the importance of the allocation of assets and liabilities in the territorial balance sheet.

In the specific case of a branch, the determination of taxable income will require not only that the flows of income and expenses that are attributable to the branch be identified, but also that assets and liabilities be allocated to the branch so as to reflect its overall activity. The allocation of an asset to a branch also means that a liability will have to be registered in the branch balance sheet to reflect how the acquisition of the asset was financed.

French tax law does not provide any specific rule as how the allocation of these items (assets and liabilities, income and expenses) should be made or apportioned between a branch and its head office. The allocation of assets, etc. to the balance sheet and P&L account of a French branch is determined purely in accordance with an economic analysis of what items relate to the French activity and what items do not.

In most cases, assets will be allocated to a branch because they relate to the activity of the branch. In some cases however, the allocation of an asset can be the result of a management decision, for example, in the case for shares[1] whose allocation to a branch depends on the decision to report them in the branch balance sheet filed with the tax return. (Shares allocated to a branch can benefit from the participation exemption and the allocation of shares of a subsidiary to a branch allows the subsidiary to be included in the tax consolidated group formed by the branch).

The French Tax Administration indicates in its guidelines[2] that when the allocation of items to a branch cannot be determined based on either the organisation of the corporation or the accounts, then an apportionment should be made (either on a

proportional basis or based on a comparison to similar corporations). However, apportionment should be regarded as an alternative method to be used only when no allocation has been made by the corporation. This is even more the case in the context of tax treaties, which generally provide that proportional methods are to be used only when direct allocation is not possible (see II. below).

The above principles also apply with respect to the financing of assets attributed to a branch: the law does not provide any guidance specific to branches of foreign entities requiring a head office to fund the activity of its branch by attributing a minimum allocation of capital free of an interest charge, or by attributing debts, or by letting the branch borrow locally from third parties. However, it will be seen below that the French Tax Administration has a different view and considers that there are some unwritten rules that do apply.

2. Deduction of interest paid between a branch and a head office

2.1. Is interest paid by a branch to its head office deductible?

A branch is treated as a separate taxable entity, independent from its head office, and is in principle subject to the same rules as a local French corporation (including the thin capitalisation rules, see II.A.3. below).

There is, however, one particular rule that is germane to the subject discussed in this paper, which is that payments of interest made by a branch to its head office are in some cases not deductible in arriving at the taxable income of the branch. This rule derives not from the law but from French administrative guidance,[3] which provides that interest (and royalties) paid by or due from a branch to its head office is (are) not deductible, on the grounds that a branch and its head office are part of the same entity and that such payments are entirely notional.

There was initially some doubt as to whether this principle of the non-deductibility of internal interest applied to all interest paid by a branch to its head office or only where the loan provided by the head office was financed out of its own capital. A decision of a local court of appeal[4] initially held that the prohibition of a deduction applies to all interest paid by a branch to its head office, irrespective of how the head office financed the loan. This seems, however, to have been an isolated case. Another local court of appeal[5] more recently accepted that, in principle, interest paid by a foreign head office could be deducted from local French income, although, because the corporation concerned did not adduce evidence of the existence of the loan giving rise to the interest, the deduction was rejected in practice. (The fact that the case concerned real estate income, rather than a branch, does not affect the analysis).

In a later statement of practice,[6] the French Tax Administration again invoked the principle of the non-deductibility of internal interest, but immediately went on to state that a branch can deduct the repayment of expenses borne by the head office, when such expenses are related to the activity of the branch. The same guidance also includes some comments on banks that will be discussed separately in II.B. below.

In practice, the French Tax Administration has now accepted that the restriction on the deductibility of interest applies only when the loan is purely notional because the head office has no debt that can be regarded as partly or totally allocated to the French branch: interest effectively borne by the head office on behalf of the branch can be repaid, but purely notional interest cannot.

The High Court has never had to rule on this exact question, but the position it has taken seems to acknowledge that a branch has a significant degree of autonomy from its head office for example, the High Court has accepted that a French head office may take a deduction for a debt waiver in favor of its foreign branch,[7] which would seem to give support to the fiction that a branch is a separate entity. Under that approach, it seems perfectly logical that a deduction should be allowed for interest charged by a head office to its branch, but it is by no means certain that the High Court would go so far as to agree to the deduction of purely notional interest when the head office is entirely financed out of its own equity.

2.2. What is the nature of the expense attributable to a branch?

When a loan is taken out by a head office and interest is subsequently charged to its branch, a potential matter for debate is whether the expense charged by the head office to the branch should be characterised as a repayment of interest or as part of the head office charges[8].

The first analysis would seem to be more consistent with the principle according to which not only income and expenses but also assets and liabilities should be allocated between the head office and the branch, but the question has not been addressed. In practice, the treatment would depend on whether the loan concerned is to finance assets attributed to the branch (in which case the debt and related interest would have to be allocated to the branch), or is to finance assets attributed to the head office and partly recharged to the branch as part of head office costs (in which case no debt would be attributed to the branch accounts and the head office cost analysis would be more logical).[9]

In either case, the interest charged to the branch as such or as part of the head office expense should be equal to the interest effectively charged to the head office.

Potentially a question arises as to whether the characterisation (as interest or head office charge) might have withholding tax consequences. In fact it should have no such consequences even when the charge-back is characterised as interest, because even where there is no applicable tax treaty, French domestic law[10] exempts interest on loans contracted abroad and, in any event, the case law indicates that the loan in these circumstances is not to be regarded as contracted in France.[11] The two characterisations could, however, have different consequences if the debt allocated to the branch were denominated in a foreign currency (for example, for the treatment of foreign exchange differences).

2.3. The allocation of a minimum "Free Capital"

The French Tax Administration has raised another issue in the course of its audits of branches of foreign banks over the last 20 years by requiring that a minimum capital allocation be made to such branches free of interest. So far the Administration has not raised this issue outside the banking industry: no minimum "free capital" (funding made available by a head office free of an interest charge) is required to be allocated to a branch in any other industry sector.

The question of the allocation of free capital was referred to in a Statement of Practice of January 12, 2005,[12] which indicated that an interest deduction could be disallowed to French branches of foreign banks "for the amounts made available to the branch that cover the capital requirements of an independent entity." What this somewhat obscure statement means for banks is explained in II.B. below.

The absence of a rule for apportioning capital and debt for branches other than banks is implicitly confirmed in the guidelines[13] issued by the French Tax Administration with regard to the thin capitalisation rules, in which the Administration noted that if no "free capital" has been allocated to a branch, the equity used to compute the debt to equity ratio under Article 212 of the French Tax Code (see II.A.3. below) will be equal to the income for the year.

2.4. Summary of applicable rules in a non-treaty context for corporations other than banks

In view of the above, and although the guidance issued by the French Tax Administration is far from explicit, it seems that the treatment of interest paid by a French branch can be summarised as follows for corporations in general (excluding banks):

- No interest is deductible on a purely internal loan between the head office and the branch. This will be the case when the head office is entirely financed by capital and has no loan on its balance sheet.
- Interest due from the branch to the head office that corresponds to the allocation of a debt entered into by the head office will be deductible if the loan is to finance an asset attributed to the branch (the allocation of debts requires a symmetrical analysis of assets).
- When the head office is financed partly by capital and partly by loans, interest repaid by the branch to the head office may be deducted, but this requires that the loans can be attributed to the financing of French assets, i.e., it is simply a matter of proving the appropriate allocation of the debt. Apart from the requirement of establishing that the loans finance the French activity, nothing in the law requires that a minimum capital allocation should be made by the head office to the branch. The Tax Administration has taken an unofficial position on this matter, but only in relation to banks (see II.B. below).
- Interest on loans taken out locally by the branch can also be deducted, to the extent that the loans are economically related to the activity of the branch or finance assets reported on the books of the branch.

The deduction of interest paid to related parties is in all cases subject to the thin capitalisation rules, which are described in II.A.3. below.

3. The thin capitalisation rules

French branches of foreign corporations are subject to thin capitalisation rules with respect to interest paid by them to third parties in the same way as other French corporations.

The rules apply only with respect to interest paid to shareholders or related parties of the borrowing entity (in that respect a head office and its branch are to be regarded as the same entity for purposes of determining the nature of the relationship with the lender). The rules, therefore, potentially apply to loans that a branch may have directly contracted with a distinct lending entity or to loans that the head office may have contracted with a shareholder or related party and allocated to the branch.

For purposes of the rules, a related party in relation to a corporation is defined as a person who directly or indirectly owns the majority of the capital of the corporation or has the effective control of and the power to decide in relation to the corporation (here FCo). Two corporations are also related parties when they are controlled by the same person.

3.1. Limit on interest rate

Articles 39-1-3 and 212 of the French Tax Code limit the interest rate that can be charged on loans granted by a shareholder or a related party to the average variable rate used by credit institutions for loans to corporations over more than two years (4.81 percent in 2009). However, in the case of a loan granted by a related party, the limitation does not apply if the corporation (in this case, the branch) shows that the rate that would have been charged by an independent credit institution would have been higher.

3.2. Thin capitalisation

Thin capitalisation rules have applied since January 1, 2007 with respect to interest paid to a related party (they do not apply to interest paid to other, non-controlling shareholders) when all the following three thresholds are reached:

- The first limit (debt ratio) applies when the average amount of loans or other advances granted during the financial year by affiliated companies exceeds one-and-a-half times the stockholders' equity (at either the beginning or the end of the borrowing corporation's financial year the corporation can choose); the limit potentially applies with respect to interest on the excess.

  In the case of a branch, the equity is computed taking into account the "free capital" made available by the head office to the branch without charging interest. This "free capital" is in principle reported in the balance sheet submitted by the branch to the French Tax Administration with its tax return. The Administration has indicated in its guidelines[14] on the thin capitalisation rules that if no "free capital" has been allocated to the branch, the equity used to compute the 1:1.5 ratio will be equal to the income of the year. Hence, the guidelines allow a great deal of flexibility in determining whether the amounts made available by the head office are to be regarded as debt or capital, at least for corporations other than banks.
- The second limit (interest coverage ratio) applies when interest paid to related parties is in excess to 25 percent of the net operating income before taxes, increased by this interest, depreciation allowances and part of the rent under leasing agreements.
- The third limit (ratio of interest received from related parties) applies when the borrowing corporation receives interest from affiliated companies in excess of interest it pays to related parties. In practice, this latter ratio allows for the exemption of situations in which a corporation re-lends amounts lent to it.

  Where these three thresholds are cumulatively exceeded, the excess on the most favourable threshold must be added back to taxable income. The excess interest can be carried forward to subsequent years. However, an annual 5 percent

reduction applies to the deduction of the interest carried forward as from the second year (i.e. the ability to deduct the excess interest carried forward is entirely lost after the 21st financial year of carry forward).

However, a corporation considered to be thinly capitalised is exempt from making any adjustment in the following cases:

- No add back has to be made when the amount of excess interest is EUR150,000 or less.
- The rules do not apply when the consolidated debt to equity ratio of the group to which the paying corporation belongs is higher than the debt to equity ratio (all debts included) of the paying corporation.

B. Special rules for banks

1. History and background

For 20 years, the French Tax Administration has reassessed branches of foreign banks on the grounds that they should be allocated a minimum capital free of interest. So far, the Administration has not raised this issue outside of the banking industry: no minimum "free capital" has to be allocated to branches in other industry sectors (including pure broker dealers and insurance companies).

As already noted, the law contains no specific requirement concerning the funding of branches and this is also the case with regard to the branches of banks. Nor has the French Tax Administration issued any clear guidelines explaining its position. The Administration indicated in an old Statement of Practice[15] concerning banks that the treatment of "quasi capital" attributed to a branch would be different from that of other advances made by a head office to its branch: interest would be deductible in the case of the latter but not in the case of the former, which is in fact exactly the same rule as would apply in the case of a corporation that is not a bank.

The French Tax Administration also alluded to this issue in a Statement of Practice issued on January 12, 2005,[16] which stated that an interest deduction would be disallowed for French branches of foreign banks "for the amounts made available to the branch which cover the capital requirements of an independent entity," without defining what this statement meant.

The thin capitalisation legislation (see above for the application of the rules to corporations other than banks) provides that banks are excluded from the application of the thin capitalisation rules. This is also the case with regard to branches of banks, but the French Tax Administration notes in a number of paragraphs of the recent Statement of Practice commenting on the thin capitalisation rules[17] that the exclusion of banks from the application of those rules does not preclude the possibility of requiring that capital be allocated to branches of foreign banks, without giving any detail as to how this would be done.

Unfortunately, the French Tax Administration has never formalised in regulations how the free capital (or quasi capital) and advances could be computed in practice, apart from making an unclear reference to the "capital requirement of an independent person," which fails to explain why, and if, there should be a difference in the determination of the free capital as between banks and other corporations. As noted above, even in the case of a corporation other than a bank, no interest can be deducted by a branch if no debt is allocated to it: the difference seems therefore not to be a difference of principle (no interest is ever deductible with respect to free capital), but a difference as to the method of computing the free capital.

The absence of any officially published method has not prevented the audit teams from applying their own internal method described in II.B.2. below in the course of their audits of foreign banks.

2. Method used by audit teams

The French Tax Administration systematically reassesses banks whose branches' "free capital" is not proportional to the "Cooke ratio" (a solvency ratio used for regulatory purposes) of their head offices. Such reassessments were initially based on Article 57 of the French Tax Code, which provides that no deduction may be taken for non-arm's length transactions with foreign related parties, but the Administration has changed its position and now relies on the territoriality rules applicable to French corporate tax.

The French Tax Administration computes the minimum capital to be allocated to a branch by applying the Cooke ratio of the head office to the risk-weighted assets of the branch. When the capital allocated by the head office to the branch is lower than the minimum capital allocation computed by the Administration, the Administration reassesses an amount equal to the market interest on the insufficiency.

When making the reassessment, the French Tax Administration has taken the following positions:

2.1. Concerning the head office ratio:

- The Administration usually refers to the published consolidated ratio of the group because this is easily available, but it also usually accepts the application of the ratio computed by the head office, which, of course, makes more sense because it is hard to understand how and why a distinct entity could grant free capital to a branch of another legal entity. This can, however, lead to some difficulties when the head office does not compute a ratio in its home country.
- The Administration has not adopted a clear position on whether this ratio should be corrected depending on the composition of the equity of the head office. In the author's opinion, its makes no sense to take into account elements other than pure equity. In particular, elements of tier two and tier three equity of the head office should be ignored (for example, it is wholly unfair to require the head office to allocate part of subordinated loans without charging interest and it is also impossible for the head office to allocate part of its unrealised gains to the branch), but such a correction is not always accepted by the Administration, which is highly debatable.

2.2. Concerning the assets of the branch:

- The minimum capital requirement is computed by applying the head office ratio to risk-weighted assets and off-balance sheet engagements of the branch. In the author's opinion, it makes no sense to take into account off-balance sheet engagements, since these elements do not generate any interest charge for the branch. This shows that the method is really more a way of imputing income to the branch rather than a limitation on interest paid by the branch.

3. Critique of this method in a non-treaty context

The approach of the French Tax Administration is highly debatable, both in terms of principle and method of computation; it is currently the subject of litigation in a number of cases at the level of the lower courts, but the High Court has not yet ruled on this matter. This paper will confine itself to highlighting the main arguments raised in the course of this litigation:

- Reassessment on this basis is not consistent with the principle confirmed by case law[18] according to which, outside the thin capitalisation rules provided by Article 212 of the French Tax Code (see above), corporations are free to decide how they should be financed. The Administration has objected that the case law concerns subsidiaries rather than branches, but there is in fact no reason why a banking branch should be treated any differently from any other corporation to which only the thin capitalisation rules of Article 212 apply.

  In practice, reassessment on this basis results in banking branches being taxed, with respect to a significant portion of their income, on their gross turnover without an interest deduction (the ratio used by the Administration ranges from 5 to 13 percent or more depending on the head office ratio). There is in fact very little reason for taking such a harsh position with regard to banking business: other industries also need capital and yet are allowed an interest deduction, and the interest deduction is an even more important element in the determination of income for a bank (whose business is to be an intermediary, not to place its equity) than it is for other corporations.

- The Cooke ratio is not an appropriate ratio for computing the minimum capital requirement. It is a ratio used for regulatory purposes to guarantee the solvency of a bank and consequently takes into account elements of equity other than net equity, such as subordinated debt and unrealised gains, and provisions that cannot physically be allocated as free capital.
- In any event, reference to the ratio of the group is not consistent with the reference made by the Administration to an independent entity, where the equity ratio (tier 1), under current regulatory requirements, should amount to 4 percent. The reference to the head office ratio is contrary to the French territoriality rules described in I.A.1. above and inconsistent in economic terms. (Why should variations in the net equity of the head office resulting from the derivation of income in the home country or by other branches elsewhere in the world, or distributions made by the head office have any impact on the determination of the French taxable base?)

In addition, reassessment on this basis is highly discriminatory, which creates significant doubts as to its legitimacy in a treaty context (see III. below).

III. Determination of HPE's interest deduction under an income tax treaty to which France is a party

Again, the position of corporations in general and banks in particular will be discussed separately (at III.A. and B. below, respectively).

A. Rules for foreign corporations in general

There is no significant difference between the treatment of a "branch" in a non-treaty context and that of a permanent establishment (PE) where there is an applicable tax treaty: the deduction of interest is limited to the interest that relates to French-booked liabilities these liabilities do not necessarily have to originate in France, but the corporation must justify the existence of the loan concerned and its allocation to the French activity.

This was confirmed by a local court in the context of the France-United States treaty in a case that concerned interest paid by a French branch to its U.S. head office.[19] The court referred to the fact that, under Article 6 of the treaty (as then applicable), a branch is to be treated as a distinct and independent entity and that the treaty allows the deduction of interest whose payment has a "reasonable relation" with profits of the branch. This strongly supported the fact that interest was deductible but, in the author's opinion, the same reasoning should prevail in a non-treaty context: the rules described above should also apply.

This position has also been confirmed by the French Tax Administration in the context of more recent treaties with countries using the UN Model Convention and the guidance on these treaties, which generally include provisions on this matter. The France-Algeria tax treaty, for example, which was signed in 1999, indicates that, except where they represent a repayment of costs, internal charges such as royalties or interest are not deductible by a PE. The comments confirm that interest paid to third parties by a head office and allocated to a branch should be deductible if the loan relates to the PE. The treaty adds that this rule limiting the deduction of interest does not apply to banks.

The thin capitalisation rules in Article 212 of the French Tax Code described above also apply in a treaty context. In fact, the rules were modified in 2006 so as to stop the discrimination that resulted under the prior rules, which exempted interest paid to French holding companies from the thin capitalisation rules, but not interest paid to foreign holding companies.

Consequently, there will not be a significant difference between the deductibility of interest for a branch under French domestic rules or a PE where a treaty applies in the case of businesses other than banks.

B. Rules for banks

The reassessment procedure discussed in II.B. above in relation to branches of banks in a non-treaty context is also widely implemented by the French Tax Administration in relation to branches of banks incorporated in countries that have signed tax treaties with France and in EU countries.

In fact, such reassessments are commonly made with respect to branches of EU banks because the EU Banking Directive reduced or cancelled local capital requirements by providing that the regulatory ratio should be computed only at the level of the head office.

However, as will be seen from the discussion that follows, the method followed by the French Tax Administration is difficult to justify in a treaty context (see III.B.1. below) and this analysis does not appear to be changed by the relevant OECD guidelines (see III.B.2. below).

1. Is the principle of reassessment compatible with France's tax treaties?

1.1. Compatibility with the "Business Profit" Article

The provisions of the tax treaties that France has signed to date correspond to previous versions of the OECD Model Convention (see III.B.2. below for the potential impact of new Article 7 of the OECD Model and the OECD report on the Attribution of Profits to Permanent Establishments) and do not include any specific comments on the treatment of banks.

Paradoxically, the French Tax Administration invokes the tax treaty provisions referring to the independent entity principle to argue that a branch should be allocated a minimum capital. The author believes that these provisions precisely condemn such reassessment, for a number of reasons in addition to those that can be adduced in a non-treaty context;

It has been decided in French case law that the purpose of tax treaties is to allocate the right to tax between the Contracting States and to avoid double taxation treaties cannot be used to assess or create a tax liability that does not exist under domestic law. This is even more the case when the treaties have nothing to say about such reassessment;

Such reassessment in reality represents an apportionment method, the use of which is only authorised by the tax treaties when the accounts of a branch are not sufficient to allow the branch income to be determined in a satisfactory manner;

Under French law, no rules apart from the thin capitalisation rules apply to independent corporations in this context. Reference to the "independent entity" principle cannot therefore justify a regulatory ratio being used to determine a minimum capital allocation for tax purposes;

Invoking the "independent entity" principle is in total contradiction to resorting to the ratio of the head office, since a branch is supposed to compute its income with respect to its own situation; and

Last but not least, such reassessment is incompatible with treaty non-discrimination rules.

1.2. Compatibility with the non-discrimination principle

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.

The minimum capital requirement imposed by the French Tax Administration is highly debatable in this respect, since a French corporation or subsidiary cannot be reassessed based on its debt to equity ratio, except in the situation specified in Article 212 of the French Tax Code. Resorting to a regulatory ratio, such as the Cooke ratio, is also highly discriminatory in the sense that the Administration would never be able to require or impose such a level of capitalisation for tax purposes in relation to a French corporation, even a bank. France's tax treaties generally include non-discrimination rules providing that branches should not be treated less favourably than subsidiaries or local corporations.

Moreover, the principle of freedom of establishment enshrined in Article 43 of the EC Treaty constitutes a very serious obstacle to the application of these rules when the head office is located in an EU Member State and the European Court of Justice has had occasion a number of times to condemn domestic rules that give rise to such discrimination[20].

Branches of banks in France's treaty partner countries and EU banks consequently have strong grounds for challenging the minimum capital requirement imposed by the French Tax Administration.

2. What is the effect of the new OECD Guidance?

2.1. Background

On November 24, 2009, the OECD issued a new proposed version of Article 7 (Business Profits) of the OECD Model Convention and is shortly to publish the final new version. A part of this new version of Article 7 deals with the question of "free capital."

In addition, in 2006, the OECD issued a report on the Attribution of Profits to Permanent Establishments, which provides extensive commentary on the question of the allocation of free capital in the specific context of a banking branch. The report accepts the idea that a minimum capital should be allocated, but does not come down in favour of any one method that would allow double taxation to be avoided. The report indicates three authorised methods that countries could resort to:

- A capital allocation approach, under which a bank's actual "free" capital is allocated in accordance with the attribution of financial assets and risks. Under this approach, capital is allocated based on the proportion that the risk-weighted assets of a PE bear to the total risk-weighted assets of the entity as a whole.
- A thin capitalisation approach, under which a PE would have attributed to it the same amount of "free" capital as would an independent banking enterprise carrying on the same or similar activities under the same or similar conditions in the host jurisdiction of the PE.
- An alternative safe harbour approach, the quasi-thin capitalisation/regulatory minimum capital approach, which would require a PE to have at least the same amount of "free" capital attributed to it as would be required for regulatory purposes for an independent banking enterprise operating in the host country.

The method currently used by the French Tax Administration corresponds to the first of the above methods, but there is nothing in the law (apart from the thin capitalisation rules in Article 212 of the French Tax Code) that confirms that any of these methods may be applied.

2.2. Does the Guidance have any impact on current or future reassessments?

The French Tax Administration refers to these OECD guidelines when reassessing banks, but the author believes that the proposed changes will not have any impact on the current analysis, at least for a very long time, for the following reasons:

- These changes in the OECD Model Convention and the related comments do not constitute applicable law. They only serve as an explanation as to how future tax treaties signed by France that include such a provision on the allocation of capital should be interpreted. Because the process is so slow, it will be a considerable time before these changes give rise to effective amendments in France's treaties.

- Notwithstanding this OECD project, the Administration did not include any of the methods proposed in the OECD report in the new treaties recently signed by France, including the new treaty with the United Kingdom. Nor does the new protocol to the France-United States tax treaty include any provision on this matter This is regrettable in view of the large number of groups in the banking industry concerned with this question (on both sides), which must rely on cumbersome treaty procedures to avoid double taxation resulting from differences in the computation of free capital and debt allocation in the different countries.
- In any event, even if new treaties were signed that incorporated these changes, the reassessments would remain open to challenge on the basis of the arguments set out above under domestic law (unless a specific provision were included in the domestic thin capitalisation rules) or under EU non-discrimination principles.

IV. Resolution of Inconsistent Treatment of HPE by France and FC

Inconsistencies in the treatment of a branch and its head office can occur when a foreign corporation has a branch in France (see IV.A. below), but also in the reverse situation when a French corporation has a branch abroad (see IV.B: below).

A. Inconsistency of treatment between a French branch (HPE) and a foreign head office (FCo)

There are numerous situations involving banks where a French PE is reassessed and where there is a risk that the foreign country in which the head office is located will not grant a tax credit in order to avoid the double taxation resulting from such reassessment, because that country does not accept the method used by the French Tax Administration.

Where there is an applicable tax treaty, the only solution is either to litigate locally or to rely on procedures provided for either by the tax treaty concerned or by the EU Arbitration Convention to undo the double taxation, but these procedures remain time-consuming and risky, even though they have been significantly improved.

It is regrettable that, although the French Tax Administration invokes the rules set out in the OECD report to support its position on the application of a ratio based on risk-weighted assets, no treaty recently signed by France provides any clarification as to an agreed method between the two Contracting States allowing double taxation to be avoided.

B. Inconsistency of treatment between a foreign branch and a French head office

As noted above, unlike most countries, France has a territorial approach and taxes only business executed in France. As a consequence, profits attributed to a foreign branch of a French corporation are not taxed in France and foreign losses are not deductible from the French taxable base. As in the reverse situation (involving a French branch), the allocation to the branch balance sheet and P&L account is determined only in accordance with an economic analysis of what items relate to the French activity and what do not.

If, in a tax treaty context, the tax authorities of a foreign country determine that the PE of a French corporation in that country is overcapitalised, there is a risk of "double taxation" if the French Tax Administration does not agree to an increased interest deduction for the French corporation.

Thus, the amount by which the branch's interest deduction is reduced would be "doubly taxed" by France and the foreign country (France does not grant a foreign tax credit for the additional foreign country income tax owed, so the problem could not be mitigated in that way) . The problem could only be addressed by invoking the mutual agreement or arbitrage procedure under the applicable tax treaty or the equivalent EU procedure.

V. Determination of HSub's interest deduction

Under the alternative factual scenario, it is assumed that FCo establishes its trade or business in France as a subsidiary (HCo) incorporated in France and subject to French corporate tax. How is HCo's interest deduction determined for French income tax purposes, first assuming no income tax treaty applies and then assuming one does apply? It is assumed that local subsidiary HCo has all of its activity in France the situation in which the subsidiary has part of its assets abroad is not considered here (see IV. in that regard).

The situation is in fact much simpler in the case of a subsidiary than in the case of a branch.

A. Corporations in general

According to French case law, corporations are free to decide how they finance themselves and the French Tax Administration cannot challenge the method of financing, except when the specific rules on thin capitalisation in Article 212 of the French Tax Code (see II.A.3. above) are applicable. The thin capitalisation rules in Article 212 described above in relation to branches are applicable in the same manner in relation to subsidiaries. France's tax treaties do not affect the application of the thin capitalisation rules

B. Banking subsidiaries

Banks are excluded from the application of thin capitalisation rules in Article 212 of the French Tax Code and this is also true for banking subsidiaries. Nor do the rules described above on the deduction of interest paid by a branch to its head office apply in the case of a subsidiary. Thus, the French Tax Administration has no say in the level of capitalisation of a banking subsidiary: the requirements applying to a banking subsidiary in terms of financing derive only from the regulatory constraints.

NOTES

[1] See High Court: CE April, 20 2005, n 251568 *Figesbal.*

[2] Doc. Adm. H 1414, March 1, 1995.

[3] *Réponse Mesmin JO AN*, Jan. 19, 1981

[4] CAA Paris, May 28, 1991, n 2918 *Weston Hyde Products Ltd.*

[5] See Local Court of Appeal, CAA Lyon, Oct. 20, 1992, n°90709 *SA Cheryll.*

[6] Doc. Adm. H 1414, March 1, 1995.

[7] CE, May 16, 2003, n° 222956 sect., *Sté Télécoise.*

[8] See B. Gouthière in « Les impôts dans les affaires internationales » ed. F Lefebvre.

[9] See CE, Oct. 7, 1988, n°45857 in which the High Court ruled that part of the financing for the acquisition of the real estate where a French head office is located should be regarded as included in head office expenses allocated to the branch and not deductible for the head office (CE Oct. 7, 1988, n° 45857, 8e et 7e *sous-sections*).

[10] French Tax Code (FTC), Art. 131 *quater*. The new Finance bill cancels the withholding tax, but provides that a 50% withholding tax applies to interest paid to companies located in non-cooperative countries.

[11] See CE, Feb. 9, 1973, n° 83695 and CE Oct. 20, 2000, n°182165.

[12] Instr. Jan. 12, 2005, 13 O 2 05.
[13] Instr. Dec. 31, 2007 4 H 8 07.
[14] Instr. Dec. 31, 2007, 4 H 8 07.
[15] 4 H 1414 n°41
[16] Instr. Jan. 12, 2005 13 O 2 05.
[17] Instr. Dec. 31, 2007 4 H 8 07.
[18] CE, Dec.30, 2003 n°233894, *SA Andritz*.
[19] E.g., in the context of the France-United Sates tax treaty: TA Versailles, July 2, 2004, n° 00-4261, 7e ch., *Sté MCDonald's system of France*.
[20] See ECJ *Thin Cap Group* C-524/04, March 13, 2007, or ECJ C-170/05, Dec. 14, 2006, *Denkavit International BV*.