Substance over form in Group taxation

Introduction

First of all, the principle of substance over appearance, which is a basic principle of IFRS consists of presenting transactions and other **events in terms of their substance or economic reality**, rather than just their legal form.

Beyond the apparent legal qualification of the transactions (often linked to a legal formality), it is a question **of analyzing all the clauses of a contract** (assignment, provision of services, loan, borrowing, etc.) **to determine the economic substance of the transaction**. It is therefore not a question of opposing the economy to the legal but of determining, through the reading of the legal, the economic reality of the transaction.

Under **IFRS** (**International Financial Reporting Standards**) and **GAAP** (**Generally Accepted Accounting Principles**), companies must recognize transactions based on their economic substance.

In order to :

- Prevent financial manipulation
- Ensure fair taxation
- Increase transparency

Example: If a company sells an asset but retains control over it, the transaction may still be recognized as a secure loan rather than a sale.

Courts may disregard legal forms if they are merely a way to avoid taxes or regulations.

Example: If a business sets up a shell company just to avoid taxes while conducting business as usual, tax authorities may treat the income as belonging to the main company.

- The notion of "true and fair view" (“image fidèle” in French) is closely linked to the objectives assigned to financial information.

ANC Regulation No. 2020-01 (**Article 271-1**) specifies in this regard that the objectives of the financial information specific to consolidated financial statements must be taken into account.

ANC Regulation No. 2020-01 does not mention a specific principle for consolidated financial statements that would ensure their autonomy from individual financial statements, as general accounting principles are now clearly common to both consolidated and individual financial statements.

- Thus, except for the elimination of the impact of entries recorded solely for the application of tax legislation, the principles previously cited by CRC Regulation No. 99-02 (§ 300) have not been retained by ANC Regulation No. 2020-01. These include:

    - **The principle of substance over form** (“principe de predominance de la substance sur l’apparence” in French) ; and
    - **The matching principle** (“principe de rattachement des charges aux produits” in French

The **ATAD Directive** (« Anti-Tax Avoidance Directive ») is a European directive aimed at **fighting tax evasion and aggressive tax planning** by companies within the EU. It was adopted in 2016 (ATAD 1) and supplemented in 2017 (ATAD 2).

France transposed its key measures into national law through various finance laws.

The main ATAD measures transposed into French law :

I. The limitation on the deductibility of interest expenses

- Inspired by **the OECD BEPS rules**, this measure limits the deduction of net financial expenses to **30% of taxable EBITDA** or **€3 million** (Article 212 bis of the French tax code – CGI).

II. The Controlled Foreign Company (CFC) rules

- **Objective** : to prevent the artificial shifting of profits to low-tax-jurisdictions.
- France has strenghtened its CFC regime (**Article 209 B of the CGI**), taxing in France the profits of a controlled entity located in a privileged tax jurisdiction, unless it carries out real economic activity.

III. Anti-hybrid measures (ATAD 2, transposed in 2020)

- These measures combat tax mismatches between states that result in deductions without inclusion or double deduction.
- These rules prevent the exploitation of differences in tax qualification between EU member states (**Article 205 B of the CGI**).

IV. General anti-abuse rule (GAAR)

- Allows tax authorities to disregard arrangements whose main purpose is to obtain a tax advantage contrary to the law's intent.
- In France, this was incorporated into **article 205 A of the CGI**, aligning with the existing anti-abuse clause.

These measures aim to **harmonize** and **strengthen the fight against tax avoidance** across the EU, in line with OECD recommendations and the BEPS project.

I. The limitation on the deductibility of interest expenses

- **Article 212 bis of the French General Tax Code (CGI)** : net financial expenses are deductible from taxable income only up to the higher of the following two limits: **€3 million** or **30% of taxable income before (notably) net financial expenses, depreciation, amortization, and loss carryforwards ("taxable EBITDA").**
- In a tax consolidation regime, this mechanism applies **at the level of the consolidated group.**

- **The amount of net financial expenses is understood as:**
  - The total amount of deductible financial expenses after applying Article 212-I of the CGI (interest rate limitation);

  - Reduced by the total amount of taxable financial income and other equivalent revenues compensating funds made available to or left at the disposal of the company.

Article 209 B

Article 209 B of the French General Tax Code (CGI) allows for the taxation of profits made by intermediary companies owned by French companies in countries with privileged tax regimes.

When a company subject to corporate tax (IS) operates a business outside France under a privileged tax regime, the profits from that business are considered part of the company's overall profits.

To qualify as having a "privileged tax regime," the tax difference must be at least 40%.

This system is similar to the CFC (Controlled Foreign Corporation) rules in the United States, which allow for taxing the undistributed earnings of foreign subsidiaries at the parent company level.

It is an exception to the principle of territoriality, designed to discourage companies subject to corporate tax (IS) from shifting part of their profits to subsidiaries located in states or territories outside France, where they benefit from a privileged tax regime.

The aim is to discourage French companies from relocating part of their activities to avoid taxation in France. It is this objective that leads to the non-application of Article 209 B unless there is evidence of an abuse of rights through tax fraud.

According to the European Court of Justice ruling on September 12, 2006, case 196/04, *Cadbury Schweppes Plc* (CF-IX-7530), the existence of an artificial arrangement designed to bypass tax laws is determined based on objective criteria.

The provisions of Article 209 B of the French Tax Code do not apply if the company can prove it has a real presence (offices, staff, and equipment) and is actively engaged in economic activity (see paragraph 70 of the ruling: "The resident company, which is best placed to do so, must provide evidence of the real presence of the controlled foreign company and its actual activities"). The following example illustrates an artificial arrangement.

Example: A French company's investment in a financial company in an EU country with a favorable tax regime is an artificial arrangement if the company lacks expertise in financial investments, depends on the bank that created it for managing investments and making strategic decisions, its shareholders do not attend meetings, and it lacks substance. This structure aims to take advantage of tax exemptions on financial flows (exemption on financial income in the country of the financial company and benefit from the parent-subsidiary tax regime in France for distributions).

So, the article 209 B of the CGI will not apply if the company can demonstrate that the operations of the foreign entity are not primarily intended to shift profits to a country with a privileged tax regime.

This condition is generally met when the foreign company or entity primarily conducts genuine industrial or commercial activities within the territory of the state where it is established or headquartered.

Article 238 A

Article 238 A of the CGI allows the tax authorities to reintegrate into the tax owed by the taxpayer any charges that were unduly deducted (abnormal or excessive) when the taxpayer fails to prove the existence of the transaction.

This primarily applies to situations where profits have been indirectly transferred to companies established in countries with a "privileged tax regime."

Although the entire expense may not be deductible, only the portion recognized as abnormal or excessive will be reintegrated.

Under Article 238 A of the French General Tax Code (CGI), the tax administration does not need to provide evidence of any advantage.

The expenses related to these amounts will be presumed to lack any counterpart and, therefore, will be non-deductible. It is sufficient for the transaction to be listed on the legal list.

This presumption is difficult to challenge, as the taxpayer must demonstrate, on one hand, the actual provision of the service, and on the other hand, the normal nature of the remuneration.

When amounts are paid or owed to individuals or entities domiciled or established in a non-cooperative state or territory, whether or not these beneficiaries are subject to a privileged tax regime, the expenses related to these amounts cannot be deducted from the taxable base.

The Council of State (CE) clarified how to assess the tax situation of the foreign beneficiary.

In the first scenario, the tax administration must prove that the recipient of the amounts paid is subject to a privileged tax regime, using all relevant criteria (such as rate and tax base) for taxing activities similar to those performed by the recipient in the country where they are established.

In the second scenario, the tax situation of the account holder must be assessed by comparing the hypothetical tax they would have faced had they been established in that state.

Article 155 A

This measure targets the taxation of companies that rent out artists or athletes, known in the USA as "rent-a-star companies," and is primarily applied to artists.

In general, an artist, whether residing in France or not, aims to reduce their tax burden.

To do so, they set up a company, usually in a country with more favorable tax rates than France, which receives their fees.

The artist works as an employee of this company and receives a modest salary compared to what they could earn.

This salary is taxed in France as income, while the fees are taxed in the foreign country under its corporate tax system.

If the artist is tax resident in France, they are taxed on all their income, both from France and abroad.

If the artist is tax resident abroad, they are still liable for tax on income from services performed in France.

Article 155 A of the CGI is consistent with the Constitution, under the condition that its application not lead to the double taxation of the same amount.

Beneficial owner in the context of dividends
(CE, 2024, Sté Foncière Vélizy Rose)

The Council of State denies the status of beneficial owner to an intermediate holding company for the withholding tax exemption provided under Article 119 ter of the French General Tax Code (CGI) and the application of the tax treaty concluded with the state of residence of the beneficial owners, due to the lack of proof of their tax residency.

The taxpayer who, in the context of a tax audit or before the judge, must establish the status of beneficial owner of the recipient of the disputed income will certainly have to demonstrate the economic substance of the latter. This includes proving that its formation and interposition are justified for economic reasons other than tax motives.

This situation is thus largely comparable to the one encountered during the implementation of the tax abuse of rights procedure, where the lack of substance of a company is put forward by the tax administration.

In this particular case, there was no legal obligation for the company to return the received dividends. However, the Council of State considered the immediacy of the payment, made the day after the dividend distribution, as a factual indicator of the lack of effective beneficiary status. In this regard, the existence of a legal obligation to return the dividends has been relevant in certain cases to assess the effective beneficiary status of the income in question.

Nevertheless, the payment of the received income does not, by itself, constitute an indicator that alone would invalidate the recipient’s status as the effective beneficiary. Indeed, the judge has already acknowledged the effective beneficiary status of the income recipient despite the full return of the income.

In fact, the taxpayer, before the judge, must establish the effective beneficiary status of the income recipient in question will certainly need to demonstrate the economic substance of that recipient, showing that its formation and interposition are justified for economic reasons other than fiscal ones. This situation can be seen as quite similar to the one encountered in the application of the tax abuse of rights procedure when the tax administration challenges the lack of substance of a company. I will elaborate of that notion later.

The assessment of the effective beneficiary status is based on the analysis of a set of indicators, specific to each situation.

Moreover, the search for this status must be conducted on a flow-by-flow basis.

General anti-abuse rule (GAAR)

Abuse of rights to prevent any artificial arrangement

An act may appear regular on the surface while being deemed irregular by the courts due to the purpose pursued by its author. An agreement that has no other purpose than to evade taxation may thus be subject to challenge under the theory of abuse of rights for tax evasion.

Tax abuse of rights is referred to in Article 64 of the French Tax Procedures Code (LPF), which penalizes operations driven by an exclusively fiscal purpose and that disregard the objectives intended by the legislator when establishing the parent company regime.

The abuse of rights procedure allows the tax administration to oppose the application of the parent subsidiary regime when the creation of an intermediate subsidiary is purely fictitious or constitutes tax evasion.

For instance, the parent company inserts a subsidiary that has no economic necessity in order to benefit from the exemption provided by the parent-subsidiary regime.

General Anti-Abuse Clause

Article 205 A of the French General Tax Code (CGI), introduces an anti-abuse mechanism applicable to corporate tax for fiscal years starting from January 1st, 2019.

This mechanism is the result of the transposition of the general anti-abuse clause established by EU Directive of July 12th, 2016 (the "ATAD" directive), which applies to all companies liable to corporate tax within the European Union. The wording of this clause is identical to that of Article 6 of the ATAD directive.

The generalization of the anti-abuse clause to corporate tax, as set out in Article 205 A of the CGI, has rendered the anti-abuse clause specific to the parent-subsidiary regime, previously outlined in Article 145 of the CGI, obsolete. As a result, Article 108 of Law of December 28th, 2018, repealed the latter clause for fiscal years starting from January 1, 2019.

In accordance with Article L 80 B, 9° bis of the French Tax Procedure Code (LPF), companies wishing to secure the tax treatment of an operation they plan to carry out can request confirmation from the tax administration, within the framework of a "rescrit" procedure, that the provisions of the aforementioned Article 205 A of the CGI do not apply to them, based on a written, precise, and complete presentation of the operation.

So, The general anti-abuse clause is a tax base rule for corporate tax. It applies for the establishment of corporate tax and can be enforced when the situation constituting the abuse involves, among other things, the tax rate or base, or tax reductions or credits, whether or not the company is the beneficiary.

In accordance with Article 205 A of the CGI, any scheme or series of schemes that have been set up with the primary objective, or one of the main objectives, of obtaining a tax advantage that is contrary to the purpose or intent of the applicable tax law, shall not be taken into account for the establishment of the corporate tax if they are not deemed genuine, taking into account all relevant facts and circumstances.

The general anti-abuse clause, applies equally to a single transaction or act, or to transactions or acts taken as a whole. Furthermore, a scheme may include several stages or parts, and the anti-abuse rule may only apply to one of these stages or parts.

The application of the anti-abuse clause requires the fulfillment of two conditions:

- The scheme, or series of schemes, has been set up with the primary objective of obtaining a tax advantage that goes against the purpose or intent of the applicable tax law.
- The scheme, or series of schemes, is not considered genuine, meaning it lacks economic justification.

The combination of these two conditions leads to the application of the general anti-abuse clause to transactions or acts whose primary purpose is to obtain a tax advantage that contradicts the purpose or intent of the applicable tax law.

Soft law to combat artificial arrangements : « l’acte anormal de gestion »

“L’acte anormal de gestion” can be defined as an act of management that is contrary to the company's best interest.

This can be the case for expenses made in the personal interest of the entrepreneur, expenses that would normally be borne by third parties, or excessive expenses.

For example, the French Council of State ruled that an abnormal act of management is an act by which a company decides to impoverish itself for purposes unrelated to its own interest (Council of State, plenary session, December 21st, 2018, Croë Suisse Ltd case).

This concept can be invoked by the tax authorities to adjust companies that apply excessively high royalty rates without genuine economic substance…