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French Withholding Tax on Capital Gains Realized on Substantial Shareholdings by Non-French Companies Ruled Illegal

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The French Supreme Tax Court (*Conseil d'État*) ruled that the French withholding tax on the capital gain derived from the disposal of a substantial shareholding in a French company by a non-resident company is not compliant with EU law.

IN DEPTH

Background

Under the French participation exemption regime, the capital gain realized by a French parent company subject to French corporate tax upon the sale of a qualifying shareholding is exempt from taxation, subject to the inclusion of a lump sum representing 12% of the capital gain (which makes for an 88% exemption). This 12% inclusion does not constitute a partial taxation of the capital gain, but a way to recapture past deductible expenses in relation to the qualifying shareholding.

Shareholdings may qualify for the participation exemption regime if, *inter alia*, (i) the French parent company holds at least 5% of the outstanding share capital and voting rights of the subsidiary at the time of the sale, (ii) the French parent company has held the relevant shareholding for at least two years, and (iii) the shareholding does not qualify as a French real property interest for French tax purposes.

Subject to the provisions of applicable double tax treaties, the capital gain realized by a non-French company upon the sale of a substantial shareholding in a French company (other than a French real property interest) is subject to a 28% withholding tax. This withholding tax will decrease to 26.5% for fiscal years beginning from January 1, 2021, and to 25% for fiscal years beginning from January 1, 2022. French company shares qualify as a substantial shareholding if the non-French company has owned more than 25% of the financial rights in the French company, directly or indirectly, at any time within the five years preceding the transfer.

In practice, only companies established in jurisdictions without a tax treaty with France, or in jurisdictions with a tax treaty with France that includes a substantial shareholding clause, are subject to the French withholding tax on substantial shareholdings (see a non-exhaustive list at the end of this article).

Even then, in accordance with administrative guidelines, EU companies can benefit from an 88% exemption on their capital gains realized on shareholdings owned for more than two years. This 88% exemption aims to replicate the French participation exemption regime applicable to French companies in order to neutralise a potential unlawful discrimination against EU companies in similar situations.

The Decision of the French Supreme Tax Court

The French Supreme Tax Court held that the French withholding tax gives rise to a difference of treatment between French companies and non-French companies with respect to the taxation of capital gains derived from the disposal of substantial shareholdings in a French company. This difference of treatment constitutes an illegal restriction to the freedom of establishment and the free movement of capital protected by EU law (*Conseil d'État*, 14 October 2020, n° 421524, AVM International Holding).

The French Supreme Tax Court considered that the French tax authorities could not remedy this infringement of EU law through administrative guidelines, since only Parliament may do so. Thus, the claimant (an Italian company) was entitled to a full exemption of its capital gain on the sale of its substantial shareholding.

The Versailles Court of Appeal subsequently held that the French withholding tax is not covered by the standstill clause of the TFEU that would allow France to maintain an otherwise illegal restriction to the free movement of capital (CAA Versailles, 20 October 2020, n° 18VE03012, Runa Capital Fund I LP).

Course of Action

Non-French companies that paid a French withholding tax in 2018, 2019 or 2020 on the sale of a substantial shareholding in a French company they had owned for more than two years could claim a refund (unless this shareholding qualifies as a French real property interest for French tax purposes). Claims must be submitted before 31 December 2020 for gains realised in 2018.

In practice, this potential refund would concern companies established in the following jurisdictions:

- EU or EEA Member States with a treaty that includes a substantial shareholding clause (*i.e.*, Austria, Bulgaria, Cyprus, Hungary, Iceland, Italy, Malta, Spain and Sweden)
- Non-EU or EEA States with a treaty that includes a substantial shareholding clause (*e.g.*, China, Israel, Japan, Kuwait, New Zealand, Saudi Arabia, South Korea, United Arab Emirates)
- Any other state without a treaty (*e.g.*, Denmark, Liechtenstein).

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