TAX LAW

EMPLOYEE PROFIT SHARING

• The "Macron" bill

The French bill for the promotion of economic growth, economic activity and equal economic opportunities, known as the "Macron" bill, was introduced into parliament on 11 December 2014. After a lengthy debate, it was adopted by the French National Assembly (Assemblée Nationale) after a further reading on 18 June 2015 and is again under debate in the French Senate (Sénat).

We will shortly be sending you a special newsletter on the measures contained in this bill concerning, in particular, tax law, employment law and economic law.

For the time being, we address below some of the less controversial measures, in particular those aimed at encouraging employee share ownership plans and the "regime des impatriés" (tax treatment of "impatriate" employees sent by foreign companies on secondment to France).

✔ Allocation of free shares

The system for taxing the benefit derived from the allocation of free shares is currently very onerous and complicated, both for the beneficiary of the shares and the company having allocated them.

The company, as employer, is currently required to pay a contribution of 30% of the value of the shares on the date of allocation. However, this cost is partially compensated by the fact that the company has the option to deduct certain expenses relating to the share allocation from its taxable income. As for the gain achieved by the beneficiary[1], it is subject to income tax as a salary and to social security contributions as and when the shares are transferred[2]. The beneficiary, as employee, also pays a contribution equal to 10% of the value of the shares on the date of allocation.

The *Macron* bill provides for various amendments of the currently applicable tax system in order to increase the attractiveness of free shares:

- reduction of the employer contribution from 30% to 20%, based on the value of the shares at the time they are acquired (rather than at the time they are allocated) and payment of the contribution after they are acquired (rather than at the time they are allocated);
- exemption from this contribution for SMEs that have not paid out dividends over the last three years;

[1] Allocations made before 28/09/2012
[2] The beneficiary will further be potentially subject to capital gains tax at the time the shares are transferred

- taxation of the beneficiaries in accordance with the rules applicable to capital gains on securities that include, in particular, tax allowances applicable to minimum retention periods[3];
- elimination of the 10% employee contribution;
- reduction of the minimum total acquisition and retention period of the shares from four years to two years for SMEs.

✔ **Start-up stock-options (Bons de Souscription d'actions Pour les Créateurs d'Entreprises – BSPCE)**

BSPCE options could be issued by companies created via a restructuring carried out further to a business transfer, as well as by a group's subsidiaries provided that 75% of their share capital or voting rights is held by the parent company.

✔ **Tax treatment of "impatriate" employees**

Employees and certain senior executives sent from abroad to work in France currently benefit from an income tax rebate of approximately 30% and an exemption from wealth tax on foreign property for a period of five years.

The bill aims to improve this tax treatment by allowing "impatriate" employees to continue to benefit from these tax allowances for a period of five years in the event that they change positions within the company established in France or within another company established in France and belonging to the same group.

• **Management packages**

A management package concerns a company's employees, executives and senior executives and its purpose is to compensate them financially for their contribution towards the company's performance, in a similar way to its shareholders or partners.

Various instruments can be used in the scope of management packages: free shares, share subscription warrants (Bons de Souscription d'Actions – BSA), shares with share subscription warrants (Actions à Bons de Souscription d'Actions – ABSA), preferred shares, as well as start-up stock options (Bons de Souscription d'actions Pour les Créateurs d'Entreprises – BSPCE), capital gains refund mechanisms or stock-options granted on a contractual basis.

Currently, the tax treatment of management packages is imprecise and the tax and social security authorities tend to consider the benefit procured from them as an additional salary, on the grounds that the beneficiaries do not take any risks comparable to those taken by a shareholder or partner. As the related tax consequences can be costly for private individuals, taxpayers generally give priority to a settlement as opposed to a dispute. However, there are now some beginnings of case law on the subject.

The French Council of State (Conseil d'Etat) rendered a decision on 26 September 2014 (N°. 3655573) in favour of the Tax Authorities. In the case concerned, it ruled that the stock-option allocated to the taxpayer in the scope of a management package had been granted to him solely on account of his position, and that the latter's entitlement not to exercise the option showed that there was no capital risk involved in the transaction (even though an allowance for losses was provided for, the amount of which was considered by the court as unsubstantial).

[3] As was previously the case, social security contributions will also be due at the applicable rates.

Thus, the Tax Authorities requalified the gain achieved through the management package as a salary (rather than a capital gain).

This issue concerning the absence of risk had already been raised before the Comité de l'Abus de Droit Fiscal (unfair tax treatment committee) in case No. 2013-36. The Committee ruled that the limited risk that existed was insufficient to represent a shareholder's risk.

Lawmakers recently indirectly intervened in the debate: it is no longer possible, since 1 January 2014, to include BSAs or preferred shares in a share save scheme (Plan d'Epargne en Actions – PEA).

This is a rapidly changing subject and the Tax Authorities are currently focusing all their attention on it. Various aspects require careful analysis: the terms and conditions under which stock-option instruments are awarded and their exercise triggered, the need for a significant and equitable subscription price, the need to take the entire contractual relationship into account, and the contracts underlying the management package.

HOLDING COMPANIES: PERMANENT UNCERTAINTY AS TO TAX TREATMENT

- **Meaning of "active holding company" (société holding animatrice)**

Depending on whether a holding company is active or passive, it has access to various different tax treatments, in particular: exemption from the wealth tax on business assets, partial exemption from transfer duties on donations under the Dutreil agreement, exemption of SME shares from wealth tax, etc.

With regard to the exemption from wealth tax on business property, Article 885 O quater of the French Tax Code (Code Général des Impôts) excludes from the scope of exemption the shares of companies whose "main business activity" is the management of their own assets. By contrast, it could be deducted that the shares of companies having a minor non-trading activity are included in the scope of exemption.

However, the Tax Authorities generally require the holding company to have exclusive control over its subsidiaries. As for the French Tax Authorities' guidelines, they merely require that the company effectively participates in their control.

In a decision dated 11 December 2014 (No.13/06937), the Paris Court of First Instance (Tribunal de Grande Instance) considered, contrary to the Tax Authorities' position, that a holding company that actively controls its subsidiaries can hold a minority interest in a company that it does not actively control without losing its qualification as an active holding company.

Currently, it is difficult for an entrepreneur to be sure that shares held in companies via a holding company, i.e. as business assets, are exempt from wealth tax.

Various questions remain to be answered, in particular:

- Is the holding company required to hold a majority interest in its subsidiaries? According to the Paris Court of First Instance, the answer would appear to be no.
- What conditions must be met by the holding company to be qualified as an "active" holding company? The Tax Authorities were planning to publish guidelines on the subject, which have not been completed as yet.

• **Intercompany management services within a group**

The tax reassessments now issued in relation to the recharging of management services render this subject all the more complex. In theory, an active holding company provides shared services and recharges a share of these services to its subsidiaries. In practice, these recharged services generally include services rendered by the manager, who is often the manager of the holding company and the subsidiaries.

However, based on the decisions of the Commercial Chamber of the French Court of Final Appeal (Cour de Cassation) dated 14 September 2010 (No. 09-16084) and 23 October 2012 (No. 11-23376), the Tax Administration's position is to refuse the deduction of a share of management fees from the amount recharged on the grounds that the services agreement is redundant in relation to the manager's function, where the subsidiaries do not directly pay any remuneration for such function.

This position is highly questionable not only in view of the provisions of the Tax Code but also from an economic and practical viewpoint (given that the Tax Authorities consider that the cost, and therefore the VAT, is not deductible, therefore reassessing the corporate contribution on added value (CVAE) accordingly). Indeed, the manager generally performs both management duties and operational duties (sales, strategic, human resources, etc.).

Thus, pending further case law decisions, it would be advisable for subsidiaries to each pay a minimum fee directly to the manager. Failing this, if a subsidiary takes the decision not to remunerate its manager, it should then avoid making any reference to a management fee in the services agreement, which must only provide for the remuneration of technical duties (commercial, financial, legal, etc.). As a precaution, it would also be advisable, where possible, to appoint the parent company as the managing entity. However, in the latter case, there would be an issue concerning wealth tax exemption since the business asset qualification implies that the shareholder must be the manager of the company concerned.

• **Other issues concerning holding companies**

Holding companies also experience issues due to constant change in the rules applicable to VAT and payroll tax, which are potentially costly. In some cases, it may be advisable to examine the possibility of converting an active holding company into a non-operating holding company, or the need to invest through a holding company.

For a long time, holding companies, whether active or not, were popular for asset management purposes and for their favourable tax treatment (dividends taxed at around 1.7%, capital gains taxed at around 4%). A holding company's members wishing to reinvest their yield (dividends, capital gains) can limit their tax-related costs. This was particularly the case before the new tax treatment of private individuals' capital gains was implemented (after the so-called "Pigeon" movement).

Currently, if a shareholder holds shares in a company directly (without investing through a holding company, the tax rate is favourable due to the tax allowances applicable to minimum retention periods: if the shares are held for more than 8 years, the overall tax rate is 31.25% or 22.25% for SMEs.

In addition, the dividend tax rate is still high (approximately 42.5%) for shareholders who are private individuals (whether they invest via a holding company or directly).

Interestingly, it could be possible for holding companies to carry out a share capital decrease not triggered by losses which would allow their shareholders, under certain conditions, to acquire part of the cash available in the holding company and be taxed for capital gains as private individuals (rather than according to the rules applicable to capital gains on securities). This possibility requires careful analysis.

CORPORATE FINANCING OF INNOVATIE BUSINESSES: CAPITAL VENTURE

The 2013 Amending Finance Act (No. 2013-1279 dated 29 December 2013) introduced a system for extraordinary write-offs over 5 years, intended for companies subject to corporation tax and investing in the share capital of SMEs, with a view to promoting equity investment. The 2014 Second Amending Finance Act (No. 2014-1655 dated 29 December 2014) rendered this system more flexible in order to take into account the European Commission's guidelines with regard to EU law concerning State subsidies.

This system should help accelerate capital venture by allowing investors to partially offset risks. However, a decree must be issued setting the terms and conditions of application of the Act, after being re-approved by the European Commission.

The SME must, in particular:

- be a community SME (i.e. comply with the definition of a community SME); and
- have incurred, during the previous financial year, certain research costs eligible for the research tax credit and representing at least 10% of its tax-deductible expenses for the year concerned (in at least one of the last three financial years).

The total amount of subscriptions to which it will be entitled in the scope of this measure cannot exceed EUR 15m.

Investors will not be allowed to invest in SMEs in which they already hold shares and, after subscribing, must not hold more than 20% of the share capital or voting rights of the SME.

The potential creation of an intercompany loan proposed by the Macron bill is of similar intent as it promotes connections between start-ups/SMEs and large corporate groups.

STRUCTURINGS QUALIFIED AS ILLICIT BY THE FRENCH TAX AUTHORITIES

Since 1 April, a "list of illicit practices and structurings" has been posted on the Public Finance Directorate General's website (http://www.economie.gouv.fr/dgfip/carte-des-pratiques-et-montages-abusifs). It contains 17 types of structuring that the Tax Authorities consider as unlawful. Some of them have been subject to case law decisions or opinions issued by the Comité de l'Abus de Droit Fiscal (unfair tax treatment committee) effectively declaring them as unlawful. Others have not yet been subject to court proceedings.

This is part of the Tax Authorities' plan to take preventive action in the scope of a number of measures intended to improve relations between the Tax Authorities and taxpayers. If taxpayers resort to one or more of these types of structuring, they must contact the Tax Authorities with a view to analysing and rectifying their situation if necessary. The Tax Authorities will then assess, based on the circumstances, the resulting potential financial consequences.

The question is whether this interpretation of tax law is to be considered as formal, and therefore challengeable, or merely as information intended for taxpayers.

TRANSFER PRICING

- **Trademark royalties**

On 18 February 2014, the Administrative Court of Appeal of Versailles issued an order (No. 11VE03460) concerning trademark royalties. Interestingly, in the case concerned, Aquarelle Europe (which later became Nestlé Waters Europe) produced and distributed mineral water under the trademark Aquarelle, now Nestlé Aquarelle. When the French company started distribution under the Nestlé trademark, it paid trademark royalties to a partnership of three Swiss companies for the use of the Nestlé trademark.

The Tax Authorities attempted to challenge the royalties on the grounds that they resulted in a transfer of profit abroad. They considered that the Nestlé trademark did not have any value for the purpose of selling mineral water, the brand being considered as specialised in dehydrated products and chocolate. Moreover, the Tax Authorities asserted that the market release of Nestlé Aquarelle water was a failure (the advertisement and promotion costs exceeded the benefit gained by Nestlé).

The Administrative Court of Appeal ruled in favour of Nestlé and maintained that the absence of profit and the low turnover was not sufficient to demonstrate an absence of value of the trademark insofar as the company was in the process of launching the product on the market.

- **Non-interference in business management**

On 23 January 2015, the French Council of State (*Conseil d'Etat*) issued a decision (No. 369214) in which it reaffirmed that it is not the Tax Authorities' responsibility to decide as to the appropriateness of a company's management decisions, and ruled that the amount of promotional costs cannot be challenged on the grounds of an abnormal management decision.

In the case concerned, a pharmaceutical company had spent more than the average amount spent by companies in the sector on the promotion of its products (between 40 and 45% of turnover, whereas the average is 12%). The Tax Authorities maintained that these higher than average expenses were abnormal and should be added back to the company's income.

The Tax Authorities also put forward the evidently excessive amount of risk taken by the company as grounds for an abnormal management decision, without success. These grounds are only used in exceptional circumstances.

As a reminder, in order to be deductible, an expense must:

- be incurred in the direct interest of the company's business (Council of State decision dated 6 January 1986, No. 42795; Council of State decision dated 6 January 1986, No. 42765) or in the scope of the ordinary operating of the company;
- correspond to an existing expense and be supported by sufficient evidence;
- be recognised in the expenses for the financial year in which it was incurred.

The Tax Authorities are then responsible for proving the abnormal nature of the expense.