

France: Tax Conventions

The application of international conventions on double taxation and taxation at source

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There are two ways of looking at the problem of payments for technology:

— Those made from abroad to France: in this case, it is the French company which receives the payments.

— Those made from France to abroad: in this case, it is the French company which makes payments abroad.

This leads to a second question; is there, with the country on whose territory the co-contracting party is located, a treaty for avoiding double taxation?

France is a party to some 50 international conventions in tax matters. They are with the most industrialized countries, but there are also entire areas of the globe which are not covered by these conventions. To give but a few examples, there is only one country in South America, and that is Brazil, which has a convention with France; in Europe itself, Bulgaria, Hungary and Turkey do not have one; the same is true for a part of the Middle East — Jordan, Iraq, Saudi Arabia, and part of the Far East, not to mention "tax havens." Whatever the case may be, the conventions are only applicable to internal law and, therefore, we must be familiar with the internal law before we can know the relief that any convention may encompass.

INTERNAL LAW

First case: the French company receives payments from abroad

Two problems are to be examined: what happens in France, and what happens abroad?

Abroad, the paying party, in principle, may deduct the sum that it is to pay relating to the remuneration for intellectual or material services rendered and, where appropriate, taxation at source is carried out by the payment originating country. But in reality, it is not so simple, since in certain countries, the deduction of payments of certain types is forbidden when they are paid to parent companies.

The ANDEAN PACT, for example, signed May 26, 1969, by Bolivia, Chili, Colombia, Equador and Peru, provides in its Article 21, that royalties paid to foreign parent companies are not to be deductible from the local taxable total.

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In France, where there is no convention with the countries concerned, the tax administration is not aware of what the Bolivian, Chilian, Colombian, etc. administrations do, and therefore, we find ourselves in a situation of double taxation.

Second case: the French company makes payments abroad

Once again, there are two problems to be examined: that of deductibility and that of taxation at source.

Regarding deductibility, there is no distinction to be made between license royalties, know-how royalties and technical assistance royalties. The payments made abroad are deductible, on condition that they are considered reasonable with regard to the service rendered, which conveys the notion of a fair price, or on an international scale, the "arms' length" rule.

In principle, and generally, any royalty or payment made is presumed to be fair, normal and appropriate until proved to the contrary. In other words, it is for the administration to bear the onus of providing that the payment made is excessive, taking into account the service rendered.

But Article 238.A of the Code General des Impots (General Fiscal Regulations), taken from Article 14 of the 1974 Finance Law, in certain cases reverses the onus of proof and requires the paying companies to justify the grounds for, and the reasonable nature of, the sums paid. This occurs when the sums paid are made in countries whose fiscal system is considered privileged.

The administration has not officially published a list of the privileged countries but, following an indiscretion, a fiscal magazine published this list.

Regarding taxation at source, the basis text is the law of December 29, 1976, which rather considerably modified the legislation applicable in this area. That law subjects a whole group of profits made by nonresidents or nonresident companies to French taxation, in particular, revenue resulting from industrial property, where of course, we find license royalties and also know-how royalties and all services rendered or utilized in France, which captures for French taxation any technical assistance royalties, which may have by chance escaped under the first heading.

Therefore, whether for license royalties, know-how royalties or technical assistance, under the terms of the internal French system without convention, these remunerations are subject to French taxation in the form of a taxation at source, the rate and the application range of which were increased by the law of December 1976. Formerly, the reduction was only applicable to license royalties under certain conditions and know-how royalties; the rate was only 24% on a lump-sum basis, reduced by 20% to take into account

expenses and costs borne by the licensor. The new law fixes the taxation rate at 33 $\frac{1}{3}$ % with no deductions permitted.

CONVENTION RATES

The convention rates take precedence over internal legislation; Article 55 of the Constitution states that regularly ratified international conventions prevail over internal law. Therefore, the *sui generis* regulation of the treaties overrides internal fiscal regulations.

Definitions

There is a problem concerning the definition of the three categories of payment: license royalties, know-how royalties, and remuneration for technical assistance. We should also add to this capital gains on patent assignments. In this area, conventions are far from unanimous and the terms are not always identical. The OECD model treaty is given to us as a common denominator on which the most up-to-date conventions are based.

Article 12 of the OECD model treaty, latest edition 1977, discusses royalties and gives the following definition:

"The term 'Royalty' used in this article describes all kinds of remuneration for the use or the granting of the use of a copyright (literary, artistic or scientific journal, including cinematographic films), a patent, trademark, or business name, a design or model, a drawing, formula or secret process, and also for the use or granting of the use of industrial, commercial or scientific equipment, or information relating to experience acquired in an industrial, commercial or scientific field."

This document is accompanied by a commentary to which the 24 Administration members of the OECD have subscribed, and to which we may therefore refer:

"In qualification of the royalties for remunerations paid for information referring to an experience acquired in an industrial, commercial or scientific field, paragraph 2 refers to the notion of know-how. Certain groups and specialized authors have formulated definitions of know-how, which do not basically diverge regarding the fundamentals. One of these definitions, given by the Association of Offices for the Protection of Industrial Property, stipulates that know-how is the overall nondivulged information patentable or not, which is necessary for the industrial direct reproduction, under the same conditions, of a product or process."

Not constituting royalties: remuneration obtained for after-sales service, services carried out by a seller under the terms of a guarantee due to the purchaser, pure technical assistance, such as consultations given by an engineer, an advocate or chartered accountant.

Therefore, technical assistance is not necessarily subject to the license royalty system rate. It seems that would only be so if it is closely linked to the license contract or the transfer of know-how.

These definitions are necessary since, where license or know-how royalties are concerned, and also directly related technical assistance, rules are provided in the conventions and in certain cases, provide for the possibility for the country of origin of the royalty to apply a

tax. On the other hand, in the case of pure technical assistance, so that the debit country may apply taxation, the beneficiary of the remuneration must have a physical installation in this country. Therefore, we change from one kind of revenue to another.

In the case of a royalty paid from abroad to France

First, what happens abroad?

(i) If the remuneration is connected with a physical installation of the creditor in the foreign country, that is to say, what is called in convention terminology, "a stable establishment", the foreign country taxes on the whole of the remuneration by applying all of its fiscal legislation. However, there not only needs to be a stable establishment, there also needs to be an economic connection with the remuneration: if a glass and chemical company has an installation abroad in the form of a "chemical" subsidiary, and it receives a "glass" royalty, it goes without saying that there is no economic connection between the two; therefore, there is no fiscal connection.

(ii) If there is no connection, three cases may arise:

— 1st case: The foreign country cancels all taxes, by virtue of the treaty drawn up with France. This is the most frequent case. In the OECD model, it is intended that the debiting party's country refrains from applying a tax on royalties originating on its territory.

— 2nd case: The foreign country partially maintains its national fiscal rate. Limitation of taxation is defined as a percentage of the gross royalty, without deduction of costs, for example: 25% with Brazil, 15% with Algeria and Thailand, and Brazil in certain cases, 10% with Canada, Iran, Israel, 5% with the United States, etc.

— 3rd case: The foreign country wholly maintains its national fiscal rate. This is particularly the case with India, Lebanon, Singapore and Tunisia.

However, in the foreign country the problem of capital gains tax may arise on the assignment of patents. In certain cases, this gain is subject to the same rate as royalties, as in Algeria, Austria, Canada, Israel and the United States, or on the other hand, it is subject to a special capital gains tax, in which the country of origin of the gain does not have the right to tax it, unless it concerns a stable establishment with which the gain is connected.

Now, what happens in France, still in the case of payment from abroad to France?

(i) If there is no taxation in the foreign country, as in most conventions, we are back to the general case. Common French tax law is applied (taxed at 50%, except in case of the granting of an exclusive license as described above).

(ii) If there is taxation in the foreign country, the foreign taxation is taken into account in the calculation of the French tax, and more often, the taxation applied abroad is imputed to the amount of the French tax. To take a very diagrammatic example, let us suppose that the foreign country takes a unit of 10 on a royalty which has a gross total of 100. In France, 100 is taken as the tax base, and the theoretical tax is 50. The 10 units taxed abroad are deducted from the 50, therefore, 10 will have been paid abroad, and 40 in France, a total of 50, that is to say, the French internal rate. This is the method used for application of the deduction

against the actual amount.

But France wanted to make a gesture to favor the transfer of technology to certain developing countries, with the following reasoning: Although the country in question makes a sacrifice regarding its fiscal receipts, the French administration acts as if this sacrifice had not been made. In other words, if the developing country lowers the royalty tax rate from 20% to 10%, it gives the licensor, in France, a credit of 20. Thus, the sacrifice made goes in fact to the profit of the company which has granted the licenses in this country. This is what is in fiscal terminology called "matching credits", that is to say, a credit which is real, due to a tax which has not been paid. This situation is found particularly in relation with Brazil, Iran and Morocco.

Therefore, in resume, the actual sum of taxation abroad is imputed, or a fictitious sum over the actual sum. But the France/Foreign country conventions stipulate that imputation can only be made to the amount of the French tax corresponding to the revenue in question.

Until a relatively recent time, this condition, which appeared in the conventions was a filler clause, and did not appear in the least to have been the subject of special attention on the part of the administration which in case of verification, counted tax credits and did not exactly concern itself with the obstacles in question. But the administration stipulated in an instruction on April 1, 1976, that the imputation of foreign taxation could only be carried out on the fraction of the French tax, exactly corresponding to the revenue in question. But how much is the corresponding French tax on a license royalty?

Let us take an example: A patented invention has been developed by a company or bought by a company, and is the subject of a grant. Since this patent is the subject of depreciation, the 50% tax strictly relating to the royalty should be found in the accounts, deducting, particularly, depreciation of the patent.

If there was no purchase, in principle, the research expenses should have been accounted in order to know what the taxable sum is. Obviously, this is very difficult, and this is why the administration declared in its instruction of April 1, 1976:

"Determination of the net amount royalties used as a basis for calculation for the relating tax, may, in certain cases, be particularly difficult. In order to prevent difficulties inevitably posed by an exact apportionment of operating costs, between the foreign source royalties and the other categories of receipts, it is allowed, for practical rule purposes, for the net expression of the amount of the said royalties to be obtained by breaking down the net operating profit into the proportion of the gross amount of royalties from a State in relation to the company's total receipts."

The company's turnover is taken and the rule of three is applied. This rule is applied per country of origin to the revenue in question. Therefore, with this administrative rule, since the taxes applied abroad are on the gross amount, and here we require the net, there is a risk of, in many cases, meeting with the obstacle which results from the 1976 instruction.

If it relates to an exclusive license royalty, which is taxed at 15%, the administration will not go as far as establishing the net amount; it confines itself to limiting the imputation to 15% of the gross royalty.

But in the case of a royalty from a foreign country, where there is, for example, taxation at source of 50%,

the French licensor, on a gross royalty of 100, receives a net royalty in France limited to 50, and he has a tax credit of 50 which he may only use up to the 15 level. This is the situation with which the licensor is confronted in a country such as India or in any country in which the taxation at source is at the capital gains tax rate.

More often, there is no taxation at source if the convention is in accordance with the model convention which eliminates taxation at source in the debtor country.

If it is for technical assistance, there are two cases: (i) if the technical assistance consists of the installation in France of a "stable establishment" (in the conventional sense of the term), of the foreign company, there is no taxation since this company has an installation in France, and (ii) if it has no stable establishment, there is no taxation either since it is outside the jurisdiction.

Regarding royalties from licenses and know-how, there is a duty, but this duty is expressly limited to 19 cases.

Therefore, special attention must be paid to contractual conditions and a question should be asked if it is not advantageous to draw up separate technical assistance contracts to extract the technical assistance royalty, in a way, from the problem of taxation at source when it is so provided for in the conventions.

The "arm's length" problem

When there is a convention, there is a little more security since the two administrations are parties to the matter. They have signed a treaty and if one administration increases a royalty received since it considers it insufficient, it can be normally expected that the other administration permits the debiting company to increase the royalty that it pays accordingly, for the determination of its profit. If not, there would be two taxations. But this is not evident, since the conventions are designed to eliminate double legal taxation.

However, in this particular case, if there is an increase on one side, and no decrease on the other, and if they are different companies, legally independent, it may be legally maintained that there is no double taxation since the legal persons are different. The French administration does not systematically oppose this argument, but it still remains that the other administration must agree to adopt the same attitude.

A community directive proposal which is currently being submitted to the European Parliament, provides for, in exceptional cases, but obviously within the framework of the European Economic Community, the obligation of the administrations to come to an agreement in case of an increase on the "arm's-length" basis; in other words, it provides for the increase on one side to be obligatorily matched by a reduction on the other.

On an international scale, when we speak of royalties, it is generally in the sense of royalties calculated in relation to turnover. We can quote a case in which the royalty was a proportion of the profit and in which a certain administration maintained that it was not a royalty but it was a joint company, as of when the payment depended on the financial result, with all the consequences that may represent on an international scale for the taxation of the company which granted the license.