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PRACTITIONERS' CORNER

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France has amended its guidelines on the computation of credit relief on foreign-source income under double taxation treaties after infringement

proceedings were initiated by the European Commission. The changes benefit French resident taxpayers and extend to income from sources in non-EU treaty countries to bring France into compliance with the Court of Justice of the European Union rulings.

Under pressure from an infringement action by the European Commission, the French Public Finances General Directorate (Direction Générale des Finances Publiques (DGFIP)) has changed its guidelines on the computation of credit relief on foreign-source income under double taxation treaties to favor French resident taxpayers. The amendments, made by the French tax authority in December 2014 and July 2015, also apply to income from non-EU treaty countries.

Background

Unlike many other jurisdictions, France has no domestic legislation on foreign tax relief. French resident individuals are liable for French income taxes on their worldwide income and depend on double taxation treaties, when applicable, for foreign tax relief. The majority of tax treaties entered into by France follow the

OECD model convention, particularly in relation to their methods for eliminating double taxation.

Older French treaties generally apply the exemption method, except in relation to dividends, interest, royalties, and occasionally other forms of income. More recent French treaties, however, apply the credit method with a special feature: The credit relief on active income, pensions, real estate income and gains, and some other forms of income is equal to the French tax attributable to the foreign-source income, even if the foreign tax on that income is lower. In other words, the credit relief on most income is equal to the maximum deduction available under the ordinary credit method. This credit relief can be expected to yield the same results as an exemption with progression, in which income is taxed at an effective rate determined with reference to the taxpayer's worldwide income.

The OECD and U.N. model conventions do not address how the credit or exemption methods should treat losses, special deductions, or allowances available under the domestic legislation of the taxpayer's country of residence.¹ The nondiscrimination principle contained in article 24 of each model convention states that the source country is not obliged to grant residents of other contracting states any personal allowances, reliefs, or reductions that are granted to its own residents. However, neither the OECD nor the U.N. model convention directly addresses taxation in the taxpayer's country of residence.

¹See OECD Model Convention with Respect to Taxes on Income and on Capital (2014), commentary to article 23A and 23B; and U.N. Model Double Taxation Convention between Developed and Developing Countries (2011), commentary to article 23.

Former French Practice

In the absence of domestic legislation on this issue, the DGFIP had been reducing the foreign tax credit by an amount of these allowances that was determined with reference to the relieved foreign-source income.

As an example, assume a French resident taxpayer earns a gross taxable income of €100,000, out of which €60,000 is from French sources and €40,000 is sourced from a treaty country. Further assume that the taxpayer is single, has a dependent child, and has made maintenance payments amounting to €20,000, which are fully deductible under French tax law. This taxpayer's income tax would have been computed as shown in Table 1.

Table 1. Computation of Taxes Under Previous Guidelines (in €)

Gross worldwide income	100,000
Maintenance payment	(20,000)
Net taxable income	80,000
Income tax (per 2015 tariff)	19,268
Child allowance for single parent	(3,558)
Net income tax before FTC	15,710
FTC — $15,710 \times 40,000 / €100,000$	(6,284)
Net income tax payable	9,426

The highest tax court in France endorsed this method in two decisions.² One case involved the deduction of alimony for the benefit of a dependent child by a French resident with business income from German sources; the other related to the deduction of expenses by a French resident auditor with professional income from the United States. The Conseil d'État held in both decisions that the deductions ought to be reduced in proportion to the FTCs available to the taxpayer.

In some cases, the FTC could have been canceled out by tax credits or allowances available under French domestic law. For example, assume that the taxpayer from the previous example made a tax-favored investment — for example, in an overseas territory — that qualified for a tax allowance of €10,000 that was creditable against income tax for that year, with any excess

²The child allowance was not implicated in either case. See CE, July 26, 2011, nos. 308679 (Saucé) and 308968 (Türkheim), RJF 11/11 nos. 1206 and 1207, Dr. fisc. 2011 No. 41 comm. 558.

to be carried on for future years. Before the amendment was in place, this tax allowance would have been applied before the FTC, reducing the credit to €2,284 ($5,710 \times 40/100$) and the final tax bill to €3,426.

This method was rejected by the Conseil d'État in relation to an old version of the France-Germany tax treaty, which granted relief by way of exemption of the foreign-source income.³ However, the French tax authorities considered that this precedent was not applicable to the credit method.

CJEU Case Law

The Court of Justice of the European Union has taken a different view from the Conseil d'État on this issue, holding that personal allowances should be fully available in the taxpayer's country of residence.

The CJEU held in *De Groot*, C-385/00 (CJEU 2002) that the principle of free movement of workers precluded the Dutch proportional method that reduced the full allowance of maintenance payments made by a Dutch resident receiving employment income from Germany, France, and the United Kingdom.⁴ Following this decision, the commission initiated infringement proceedings against Austria, Belgium, and Finland.

In *Beker*, C-168/11 (CJEU 2013), the CJEU confirmed its position by relying on the principle of free movement of capital, which also extends to income from third countries.⁵ The German federal tax court endorsed the CJEU's decision, despite strong resistance from the German federal government.⁶ The CJEU also reached the same conclusion in a third ruling on the matter, basing its decision on the overarching principle of freedom of establishment contained in articles 49 to 55 of the Treaty on the Functioning of the European Union.⁷

³See CE, Apr. 25, 1990, No. 94304, RJF 6/90 No. 640, Dr. fisc. 1990 No. 22 comm. 1061, opinion of Pierre-François Racine, which was followed by the French tax authorities in Bulletin Officiel des Finances Publiques-Impôts (BOFIP), "IR — Impôt Sur Le Revenu," BOI-IR-LIQ-20-30-30 (Nov. 27, 2012), sections 40 and 70, available at <http://bofip.impots.gouv.fr/bofip/6430-PGP.html?identifiant=BOI-IR-20121127>.

⁴*De Groot*, C-385/00 (CJEU 2002), opinion of Advocate General Philippe Leger.

⁵*Beker*, C-168/11 (CJEU 2013), analyzed by Tom O'Shea in "Taxpayers Successfully Challenge German Tax Credit Rules Before ECJ," *Tax Notes Int'l*, Feb. 3, 2014, p. 427.

⁶BFH, Dec. 18, 2013, IR 71/10, ISFR 2014, 303, analyzed by Jörg-Dietrich Kramer in "German Rules on Foreign Tax Credits Not Compatible With EU Law," *Tax Notes Int'l*, July 28, 2014, p. 315.

⁷See *Imfeld and Garcet*, C-303/12 (CJEU 2013). The Belgian constitutional court followed this decision in *CCB/GWH*, Apr. 24, 2014, No. 68/2014.

Commission Infringement Proceedings

Following these rulings, the commission initiated an infringement action against France, issuing a formal notice to this effect on October 16, 2014 (TAXU 2013/4287). The action was based on three criticisms of the French tax system in cases when a resident taxpayer receives income from another EU member state or European Economic Area country, namely that in these situations:

- part of the benefits associated to the personal and family situation is lost;
- the FTC is forfeited when the taxpayer is in a global deficit position; and
- the FTC may be forfeited as a result of the combination of domestic tax allowance or credits and FTCs.

To comply with the first and third points raised by the commission, the DGFIP amended its guidelines in two steps in December 2014 and July 2015. On the second point raised by the commission, the DGFIP has confirmed its position that FTCs may not be carried forward to offset future taxation. Such position is common for both individual and corporate taxpayers and has not been expressly addressed by the CJEU.

New Guidelines

Deductions

The DGFIP first amended its guidelines on general deductions relating to the personal and family situation of the taxpayer, such as the maintenance payments mentioned in the above example.⁸ To determine the portion of French income tax to be attributed to the relieved foreign-source income, the tax authority now accepts that the ratio must be computed with reference to the net taxable income — after the general deductions — instead of the gross global income.⁹

In the above example, the FTC associated to the foreign-source income of €40,000 would now be determined with reference to the net taxable income of €80,000 of the French income tax — that is, a ratio of

40-80 — instead of the gross global income that was previously used and that resulted in the lower ratio of 40-100.

The new guidelines apply in all situations involving double taxation treaties, including those relating to third countries outside the EU and the EEA. The amendments have a broad scope, as demonstrated by the amended statement of practice on the Algeria-France tax treaty.¹⁰ EU law required these extensive changes in relation to investment income and the free movement of capital principle.¹¹ To ensure equal treatment, the same method should be applied to all foreign-source income liable to French income tax at the graduated rates regardless of its nature, except when the treaty clause on foreign tax relief makes no distinction. Equal treatment in this sense is arguably required under the French Constitution.

The method applied in the new guidelines had been endorsed in the past by several French lower courts, before by the Conseil d'État rulings that instead supported the previous method.¹² Now the Conseil d'État's rulings should be regarded as superseded and the lower court's previous precedent as revived.

Tax Credits and Allowances

The DGFIP took a second step to address the commission's criticisms by changing the guidelines on tax credits and allowances.¹³ As an exception to the general rule that tax allowances apply before tax credits, the new guidelines state that under double taxation treaties, the tax credit — equivalent to the French tax on foreign-source income — applies before the domestic tax allowances that can be carried forward into later years.¹⁴

These new guidelines bring the French tax system into compliance with the Conseil d'État ruling on the exemption method¹⁵ as well as the third point raised by the commission in its formal notice of infringement proceedings.

¹⁰See BOFIP, "INT — Convention fiscale entre la France et l'Algérie," BOI-INT-CVB-DZA (Aug. 6, 2002), section 80, as amended on Dec. 26, 2014, available at <http://bofip.impots.gouv.fr/bofip/3061-PGP.html?identifiant=BOI-INT-CVB-DZA-20120912>.

¹¹See *Beker*, C-168/11, *supra* note 5.

¹²See *supra* note 2.

¹³See BOFIP, "IR — Ordre d'imputation des réductions et des crédits d'impôt sur le revenu - Situation du crédit d'impôt égal au montant de l'impôt français correspondant aux revenus et gains de source étrangère soumis au barème progressif prévu par les conventions internationales" (July 29, 2015), available at <http://bofip.impots.gouv.fr/bofip/10187-PGP/version/10?identifiant=ACTU>.

¹⁴See BOFIP, "IR — Réductions et crédits d'impôt," BOI-IR-RICI-20150729 (Jul. 29, 2015), section 35 as amended.

¹⁵See CE, Apr. 25, 1990, *supra* note 3; and BOFIP, *supra* note 3 at sections 40 and 70.

⁸See BOFIP, "INT-Élimination de la double imposition — Revenus de source étrangère — Précisions sur les modalités de calcul du crédit d'impôt égal au montant de l'impôt français" (Dec. 26, 2014), available at <http://bofip.impots.gouv.fr/bofip/9750-PGP/version/8?identifiant=ACTU>.

⁹The amendments can be seen at BOFIP, "INT — Dispositions communes — Droit conventionnel — Modalités d'imposition au regard du droit conventionnel — Élimination de la double imposition," BOI-INT-DG-20-20-100 (Dec. 26, 2014), para. 45, available at <http://bofip.impots.gouv.fr/bofip/4877-PGP.html?identifiant=BOI-INT-DG-20-20-100-20141226>.

It is unclear whether these recent changes also apply to the family allowances that were prorated under the previous system. A lower French tax court has held, however, that the practice is contrary to EU law following *De Groot*.¹⁶ If family allowances are no longer prorated, the computation in the example above would be amended as shown in Table 2.

Table 2. Potential Computation of Family Allowances Under New System (in €)

Global worldwide income	100,000
Maintenance payment	(20,000)
Net taxable income	80,000
Income tax (per 2015 tariff)	19,268
FTC — $19,268 \times 40 / 80$	(9,634)
Family allowance	(3,558)
Net income tax (instead of 9,426 under previous rule; see Table 1)	6,076
Tax credit for favored investment	(10,000)
Excess credit carried forward	(3,924)

Depending on the personal and family circumstances of the taxpayer, the changes instituted by the French tax authorities could have major impact.

Carrying Forward Losses?

In its latest statement of practice, the DGFIP maintained its traditional position that the FTC available

¹⁶See Tribunal administratif de Paris, Feb. 12, 2010, nos. 05/18891 and 05/18895, *Loy*, Jurisdata 2010-031200.

under double taxation treaties may not be carried forward.¹⁷ If the DGFIP adopted this stance in situations in which a French resident taxpayer reports a global net loss, it would contradict the position of the commission in the second point of its formal notice of infringement. Although this issue is unsettled and could affect both individual and corporate taxpayers, neither the French courts nor the CJEU has issued a decision on it.

According to French tax law, global losses recorded in a fiscal year may be carried forward into later years by individual and corporate taxpayers, subject to certain limitations. If carried forward, the previous year's losses are treated as a deductible charge — similar to the maintenance payment in the above example — in the determination of taxable income in the following year.

Under the exemption method, positive income from foreign sources would not reduce the global loss being carried forward, and the benefit from the exemption would be preserved by the taxpayer. Under the credit method, however, positive income from foreign sources would reduce the amount of global losses for the year in which the income was realized and taxed in the source country and accordingly would reduce the amount carried forward to the following year. Denying a tax credit for foreign income from previous years therefore results in an economic double taxation that would not occur in a domestic context or under the exemption method. This difference in tax treatment may be an infringement on the EU fundamental freedoms. As to whether this is justifiable or proportionate, future EU case law may provide some answers. ♦

¹⁷See BOFIP, *supra* note 14 at section 35.