France; European Union

Tax on Non-Resident Substantial Shareholders' Capital Gains Violates EU Law, French Court Says

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In a decision published on 21 December 2022 (Tax Authorities v. Runa Capital Fund I LP, decision no. 447568/2022, the French Supreme Administrative Court (*Conseil d'Etat*) ruled that) the tax on capital gains made by non-resident shareholders from the sale of a substantial shareholding in a French company may not exceed the taxation applicable to resident shareholders who are in a similar situation, pursuant to EU law. However, the refund of the tax levied in breach of EU law may not lead to a reverse discrimination either.

Facts and issue

The case involved a venture capital company resident in the Cayman Islands, which sold a substantial shareholding in a French company in 2014.

The capital gain was subject to tax applicable to non-resident substantial shareholders under article 244 bis B of the General Tax Code. Subject to treaty provisions, this tax applies to non-resident shareholders who hold, at the time of the sale (or have held at any time in the 5 preceding years), more than 25% of the rights in the profits of the French company. The rate of the tax was 45% in 2014.

The taxpayer upheld that the tax violated the free movement of capital provided for in article 63 of the Treaty on the Functioning of the European Union (TFEU), since the level of taxation would have been much lower in a purely domestic situation.

Decision

The decision of the Court provides some innovative solutions.

Firstly, the Court ruled that the issue at hand must be analysed in the light of the free movement of capital, and not the freedom of establishment, since it applies irrespective of the voting rights held by the non-resident shareholder, even if the shareholder no longer holds any rights in the profits of the French company at the time of the sale. The tax is thus not intended to apply only to those shareholdings which enable the shareholder to exert a definite influence on a company's decisions and to determine its activities.

Secondly, the Court ruled that overseas countries and territories referred to in Part 4 of the TFEU (e.g. the Cayman Islands before the Brexit, as a British overseas territory) may benefit, as third countries, from the free movement of capital set by article 63 of the TFEU. A company resident in the Cayman Islands in 2014 could thus challenge the tax on the grounds of the free movement of capital.

Thirdly, the Court confirmed that the tax created a discrimination contrary to the free movement of capital in so far as it exceeded the tax applicable in a purely domestic situation. Moreover, article 64 of the TFEU (standstill clause) is not applicable in so far as the French rules did not remain unchanged since 31 December 1993 (the tax was extended to non-resident companies subject to corporate income tax with effect from 2 January 1994 only).

Finally, the Court ruled that when a non-resident shareholder is subject to a discriminatory tax treatment, the shareholder may only obtain the refund of the fraction of tax necessary to restore an equivalence of treatment with resident shareholders, but not the full amount of tax. This solution is contrary to the position adopted by the Court 2 years ago with respect to an Italian parent company (*see* France-2, News 19 October 2020). In the decision of 14 October 2020, the Court did rule that the tax contrary to EU law must be fully refunded, not just the fraction exceeding the amount that would have been paid by a resident taxpayer.

In the case at hand, lower judges granted a full refund of the tax on the ground that it violated the free movement of capital. According to the Court, lower judges should have compared the amount of tax paid by the non-resident taxpayer with the amount of tax due by a resident taxpayer in a similar situation, to refund only the fraction of tax necessary to restore an equivalence of treatment. The Court therefore annulled the judgement of lower judges and sent the case back for a new review.

Note: Under the current system, the rate of the capital gains tax are identical to those applicable to resident shareholders (i.e. 12.8% for individuals and 25% for companies). However, the base of the tax is not always similar for resident and non-resident shareholders (in particular, when resident shareholders benefit from the participation exemption, capital gains are taxed on 12% of their amount only, leading to an effective tax rate of 3%). Therefore, there may be cases where the tax is still contrary to the free movement of capital.

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