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Exemption from surtax on distributions within tax-consolidated groups ruled unconstitutional

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France's constitutional court issued a decision on 30 September 2016, concluding that the exemption from the 3% surtax on distributions made within a tax-consolidated group does not comply with the equality principle in the French constitution and, therefore, is unconstitutional. The exemption is to be abolished as from 1 January 2017, but other ongoing proceedings bring into question the validity of the surtax itself.

The 3% surtax, imposed on French entities subject to corporate income tax (including French permanent establishments of foreign companies), is levied on most dividend distributions. The surtax is levied at the level of the distributing company and is calculated based on the gross amount of the dividend, with the tax due at the time of the distribution. An exemption from the 3% surtax is provided for dividends paid between members of a French tax-consolidated group. Profits distributed by a French tax-consolidated group company to a nongroup company, or vice-versa, and any distributions made within a non-tax-consolidated group are outside the scope of the exemption.

Decision of the court

The constitutional court concluded that the exemption from the surtax violates the equality principle in the French constitution. According to the court, the difference in treatment between distributions made within a tax-consolidated group (which is composed of French members only) and those within a non-tax-consolidated group cannot be justified by the difference in situations or by reason of the public interest, even if the 95% holding requirements necessary to set-up a French tax-consolidated group are met (and particularly in the case where the parent company is established outside France). To protect tax-consolidated groups from unexpected exposure to the 3% surtax for distributions already made, the exemption will be automatically abolished as from 1 January 2017, unless a new law is enacted before then.

Potential consequences of the decision

Different consequences of the constitutional court decision are possible, depending on whether the French legislature takes action:

- If the legislature takes no action, the exemption will be abolished as from 1 January 2017. French companies that are members of a tax-consolidated group will be subject to the 3% surtax on their intragroup distributions as from that date.
- If the legislature takes action before the end of 2016 in the finance laws that are under discussion, several outcomes are possible:
  - The complete abolition of the surtax (which seems unrealistic, given the needs of the French budget);
  - Introduction of a law that abolishes the exemption for tax-consolidated groups, which would apply as from the date of an official announcement by the government (i.e. the law would not apply retroactively; this option seems unlikely given recent government practice);
  - Abolition of the tax-consolidated group exemption for distributions made on or after 1 January 2017, combined with a reduction of the 3% surtax rate to limit the impact of the repeal of the exemption for French tax-consolidated groups. Dividends distributed to parent companies established outside France (both EU and non-EU parents) also would be subject to the reduced surtax rate under this scenario (this option appears plausible but is not the government's preferred option at this stage); or
  - Introduction of a new tax to "replace" the 3% surtax with a measure that has the same budgetary effect, but that would support group companies that reinvest profits in their subsidiaries (based on a recent interview given by the French State Secretary of the Budget).

Distributions already paid would not be affected.

Comments and actions

Ongoing proceedings based on EU law and tax treaties still question the validity of the surtax itself: Arguments that the 3% surtax on dividend distributions is itself invalid based on EU law continue to be relevant, since France's Administrative Supreme Court referred a case to the Court of Justice of the European Union (CJEU) on 27 June 2016, requesting a preliminary ruling on whether the surtax is in line with the EU parent-subsidiary directive (for prior coverage, see the *World Tax Advisor* article dated 9 September 2016).

Additionally, the infringement procedure launched by the European Commission in 2015 against the French surtax is ongoing and the opinion of the advocate general of the CJEU in the case relating to Belgium's fairness tax, which raises issues similar to the French surtax, should be released in the near future.

There are compelling arguments in favor of repealing the 3% surtax on dividend distributions, due to its potential incompatibility with EU law, particularly in cases where 95% or more of the capital of the distributing company is held by its parent company.

Depending on how the CJEU rules in the case involving the parent-subsidiary directive, potentially affected EU and non-EU groups with French companies that have paid the 3% surtax on dividend distributions in the past, or that expect to pay the surtax, should consider filing protective claims based on EU law and relevant tax treaties to protect their rights to claim a reimbursement of the surtax.

Since the statute of limitations on certain distributions soon will be expiring, claims to recover the 3% surtax paid in 2014 must be filed before 31 December 2016.

Impact on distributions within a French tax group: Tax-consolidated groups should review their distribution plans and be prepared to take appropriate actions before the end of 2016, in light of potential changes included in the upcoming finance laws.
