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## French Tax Law: Supreme Court Decision on Foreign Tax Credits

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**The French Supreme Court (*Conseil d'Etat*) Ruled That the France-China Tax Treaty Should Be Construed as Including a Tax Sparing Credit Provision, Under Which French Taxpayers Are Entitled to Foreign Tax Credits Even in The Absence of Any Withholding Tax in China**

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### BACKGROUND

Under the provisions of the tax treaty between France and China, interest received by a French resident from Chinese sources gives right to a foreign tax credit in France corresponding to the withholding tax applicable in China. In order to foster French investments in China, the treaty used to provide that such withholding tax was deemed to be equal to 10% of the gross amount of the interest paid to French residents, irrespective of the actual withholding tax in China.

Natixis had claimed the benefit of such tax credits with respect to interest received from Chinese counterparties, but the French tax administration denied such claim, arguing that the relevant provision of the France-China tax treaty should be read as only a “matching credit” provision, entitling French tax residents to the benefit of the 10% tax credit only when a withholding tax – even minimal – was actually paid in China. Natixis, however, argued that this provision should be read as a “tax sparing” provision, entitling French tax residents to the benefit of the tax credit even in the absence of any withholding tax in China.

The lower courts ruled in favor of the French tax authorities and disallowed the grant of tax credits to Natixis, since Natixis could not prove that a withholding tax had actually been paid in China. These decisions were inspired by a previous decision of the French administrative Supreme Court in 2006<sup>1</sup> regarding the France-Brazil income tax treaty, in which the Supreme Court concluded that, based on the specific drafting of such treaty, the relevant provision was a matching credit provision.

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However, since the France-China tax treaty did not include the same specific language, Natixis believed that the France-Brazil precedent should not apply, and appealed before the French Supreme Court.

Another claim made by Natixis, which was not to be decided by the Supreme Court at this stage, related to the computation of the tax sparing credits. French taxpayers generally consider that for a net interest income of 100 euros received from Chinese sources, the tax sparing credit is equal to 10 euros. However, Natixis is arguing that, if the withholding tax rate in China was indeed equal to 10% (which is the fiction created by the tax treaty), a net income of 100 euros for the French beneficiary would correspond to a gross interest income of 111 euros. The tax credit should thus be equal to 11 euros in the example, and not 10 euros.

Sullivan & Cromwell LLP represented Natixis in this litigation.

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### DECISION

On 25 February 2015, the French Supreme Court ruled in favor of Natixis. The Court decided that the France-China income tax treaty granted French tax residents a foreign tax credit even if no withholding tax was actually paid in China, and distinguished this case from the previous decision concerning the France-Brazil tax treaty. The Supreme Court followed the conclusions of the advocate general, which considered that this interpretation was in line with the literal reading of the treaty, as well as the doctrine and preparatory notes related to the revised treaty between France and China.

The litigation also involved the tax credit provisions of income tax treaties signed between France and Argentina, Indonesia, Turkey and India. In such tax treaties, the language was different as the tax sparing provision was applicable only if the withholding tax reduction or exemption was due to specific investment incentive provisions under local law. Because of such reference to specific provisions under local law, the Supreme Court ruled that French taxpayers had to prove either that a withholding tax was applied in these jurisdictions, or that the exemption of withholding tax was due to such investment incentive provisions.

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### ENDNOTE

<sup>1</sup> Administrative Supreme Court, July 26, 2006, n° 284930, *Société Natexis Banques populaires*.

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