GENERAL AGREEMENT ON
TARIFFS AND TRADE

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INCOME TAX PRACTICES MAINTAINED BY FRANCE

Report of the Panel

1. The Panel's terms of reference were established by the Council on 30 July 1973 (C/M/89, paragraph 7):

> "To examine the matter referred by the United States to the CONTRACTING PARTIES pursuant to paragraph 2 of Article XXIII, relating to income tax practices maintained by France and to make such findings as will assist the CONTRACTING PARTIES in making the recommendations or rulings provided for in paragraph 2 of Article XXIII."

2. The Chairman of the Council informed the Council of the agreed composition of the Panel on 17 February 1976 (C/M/112, paragraph 17):

Chairman:	Mr. L.J. Mariadason	(Counsellor, Permanent Mission of Sri Lanka, Geneva)
Members:	Mr. W. Falconer	(Director of Trade Policy, Department of Trade and Industry, Wellington)
	Mr. F. Forte	(Professor of Public Finance, University of Turin)
	Mr. T. Gabrielsson	(Counsellor of Embassy, Permanent Delegation of Sweden to the European Communities, Brussels)
	Mr. A.R. Prest	(Professor of Economics of the Public Sector, London School of Economics)

3. In the course of its work the Panel held consultations with the United States and France. Background arguments and relevant information submitted by both parties, their replies to questions put by the Panel as well as all relevant GATT documentation served as a basis for the examination of the matter.

4. The Panel met on 16-18 March, 28 June-1 July and 26-30 July 1976 and concluded its report through a postal procedure.

5. The United States requested the Panel to find that the tax practices of France violated Article XVI:4 and that there was therefore a prima facie case that these practices were nullifying or impairing benefits accruing to it under the General Agreement.

6. The United States also suggested that the four complaints on the DISC legislation and income tax practices in France, Belgium and the Netherlands should be considered together because they raised the same principles concerning the application of the GATT.

Factual aspects of the practices in question

7. The following is a brief factual description of the tax practices complained of by the United States as the Panel understood them.

8. The French income tax system for corporations is based on the territoriality principle which, in general, taxes income earned in France but not income arising outside France. It is a principle deriving from the history of the French system dating back to the beginning of the century. French companies are liable to corporation tax solely in respect of profits made by enterprises operating in France and of profits taxable by France under an international double taxation agreement (Article 209:1 of Code Générale des Impots).

9. Under the territoriality rule as applied by France, profits generated by undertakings operated abroad are exempt from French taxation. On the other hand, a French company is not entitled to any foreign tax credit and cannot deduct losses suffered abroad, apart from exceptions specified below.

10. If a subsidiary is a purely fictitious corporation located abroad and all its activities are directed from France, tax is levied in France on total profits for the reason that all corporations, regardless of nationality or location of the statutory head office, which have an effective management headquarters in France are taxable in France.

11. Ninety-five per cent of dividends from the French or foreign subsidiaries of a French company is excluded from the profits of the parent corporation. Participation by the parent in the subsidiary must exceed 10 per cent (Article 145 and 216 of CGI). This arrangement stems from the desire to avoid double taxation of the dividends of subsidiaries.

12. Dealings between French companies and their branches, subsidiaries or associated companies in foreign countries must in principle be conducted as if the companies were independent enterprises, each being regarded as a separate distinct economic entity ("arm's-length" relationship; Article 57 of the CGI). French tax authorities are empowered to make the necessary inspections and rectifications.

The actual application of the principle is interpreted in administrative notes in 1959, 1972 and 1973, according to which officials are requested to take into consideration foreign competitive conditions and commercial operations as a whole, not a single transaction alone. The problems of international tax fraud and evasion are also dealt with in other parts of French law, notably Article 1649 quinquies B and Article 155A of CGI.

13. In certain cases provision can be made for losses abroad and certain expenditures relating thereto (Article 39 octies A of the CGI). After 1 January 1973 this treatment applies only to new establishments, is limited on account of the permitted amount of the reduction, and is limited to five years in time.

14. French companies are allowed to set up certain reserves to cover risks in respect of medium-term credit for sales or projects carried out abroad (Annex IV, Articles 7 and 4 bis of the CGI, with comments in notes from 1960 and 1968).

15. Exports are excluded from the application of the inflation levy introduced in France on 1 January 1975. The levy has not been applied in practice. After having been abolished from 1 September 1975, it was re-established in principle for 1976 and is to be applied if increases in prices of manufactures exceed 2 per cent over a period of three months.

16. An exporter's card system was in force between 1957 and 1973. The card was issued after an enquiry as to the circumstances and respectability of the company; card-holders could make purchases free of value-added tax without needing to make the ordinary security deposits. Card-holders could originally apply a 15 per cent supplementary depreciation to certain assets. This rule has been abolished in respect of assets acquired since 1 January 1965.

Main arguments

A. Article XVI:4

17. The representative of the United States recalled that Article XVI:4 prohibited the use of export subsidies, that France had signed the Declaration giving effect to that paragraph and that France therefore had an obligation not to grant export subsidies which led to "the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." He also recalled that the illustrative list of measures to be considered as subsidies in the sense of Article XVI:4, which was proposed by France, included the following items: (c) "The remission calculated in relation to exports, of direct taxes ... on industrial or commercial enterprises" and (d) "The exemption in respect of exported goods of ... taxes, other than ... indirect taxes levied at one or several stages on the same goods if sold for internal consumption ...".

Effects of the territoriality principle as applied by France for taxation of foreign profits

18. The representative of the United States pointed out that France followed the territoriality principle of taxation, and that as a result, did not tax the export sales income of foreign branches or foreign sales subsidiaries of domestic manufacturing firms. Taxes on such income were for the most part permanently forgiven rather than merely deferred. He stated that the exclusion apparently extended to foreign source income from activities carried out by a French selling corporation through its own agents or employees abroad even without a foreign permanent establishment, as income from transactions which were separate from the corporation's French operations and which constituted complete commercial cycles outside France were excludable. The representative of the United States argued that these provisions, and relaxed intercompany pricing rules and other practices in relation to export transactions, created a distortion in conditions of international competition in that they afforded remission or exemption of direct taxes in respect of exports in violation of France's commitment as a contracting party under Article XVI:4. The permanent exemption could be freely used by the domestic manufacturing firm. The relative tax burden on the sales of products for export as against domestic sales was lower as a result of the remission.

19. The representative of the United States argued that, by organizing a foreign branch or subsidiary in a low-tax country, a French manufacturing firm could enjoy the low-tax rate on that portion of the total export sales income which was allocated to the foreign branch or foreign sales subsidiary, that the amount of export sales income allocated to foreign sources was generally substantial, that under the French system the right to tax foreign income was given up. He concluded that as a minimum the sales element of export earnings was exempt from taxation and therefore subsidized in violation of Article XVI:4.

20. In reply, the representative of France stated that the territoriality principle was introduced at the beginning of the century with the introduction of income tax. The principle was in conformity with the international fiscal doctrine prevailing in Europe and was supported by numerous international studies. It was in no case a special rule intended to promote exports. Moreover, it was part of a concept which respected the fiscal sovereignty of States and which enabled double taxation to be avoided through exemption.

21. The representative of France went on to state that the tax base was always the sales price and hence the same whether the sale was effected by the exporter to an independent third party, to a subsidiary or to a branch abroad, the relations between the French company and its branch or subsidiary having to be those that would have existed with an independent third party. Furthermore, the territoriality

principle ensured equality of competition at the tax level - i.e. non-discrimination - in the purchaser's country since the tax burden was the same in France whatever the modalities of the transaction.

22. The representative of France added that the provisions of French law stipulating that foreign establishments or branches of foreign subsidiaries of French companies were not subject to French tax, could be applicable only where there was a material installation abroad and effective transactions were carried out there. These activities had to be entirely separable from the activities in France. No transaction could be exempted from French tax if it was directed from France and a substantial part of foreign source income could become liable to French taxation. This income could, in fact, be taxed both at home and abroad if there was no double taxation convention because France had no crediting device to avoid double taxation.

23. The representative of France said that the territoriality rule was virtually inoperative in respect of tax havens. Since undertakings that used such facilities did so mainly through subsidiaries, or at least through corporations having a separate legal personality, if they relied on tax haven subsidiaries for tax evasion purposes, they had no interest in distributing the dividends. The representative of France added that French companies had far fewer possibilities than United States enterprises for making use of subsidiaries established in tax havens and that the rules relating to inter-company pricing and the fight against misuse of the law were fully applicable. French companies were required under the foreign exchange regulations to obtain permission from the Bank of France for any transfer abroad, to declare their foreign investment and repatriate the income. In conclusion the representative of France stated that most marketing subsidiaries were set up to meet real needs and were located in export markets and not in tax havens.

24. The representative of France concluded from the above that the territoriality principle afforded no advantage to exporters. It complied with both the principles and the text of the General Agreement since there was no exemption from direct tax in respect of exports that could afford a direct or indirect aid to the exporter.

25. Commenting on this reply, the representative of the United States argued that it was the effect of the legislation and not the intent behind it which was important. He argued that because France had in force some fifty bilateral tax treaties and thirty more were in various stages of negotiation, a foreign tax credit was generally available and even in the absence of a credit there were few instances in which international double taxation would result under the French system. He went on to argue that the statement to the effect that the tax base was always the sales price failed to indicate the significance of sales profits allocated to foreign sources and escaping French taxation. With respect to repatriation, the representative of the United States introduced data for 1972-73 to show that only about two thirds of the profits of French investments in the

United States were actually repatriated. Furthermore, the fact that the practices had been in operation for several years was irrelevant. The language of the 1955 amendments to the General Agreement (which, inter alia, introduced paragraph 4 of Article XVI), and the 1960 Declaration giving effect to Article XVI:4 as well as the Standstill Declaration made it absolutely clear that the contracting parties adhering to the 1960 Declaration had an obligation to cease to grant any subsidies whether or not the subsidies were granted pursuant to legislation existing in 1947, unless a specific reservation was made.

Inter-company pricing rules

26. The United States representative argued that when the profits of a foreign subsidiary were not taxed the inter-company pricing rules of the country of manufacture became more important and that the French tax authorities could adjust inter-company transactions between French and foreign affiliated entities which might have the effect of indirectly transferring profits abroad. He referred to a Note of the French Administration of 1959 laying down that the arm's-length pricing rules should not be applied strictly to taxpayers who were increasing French exports or establishing foreign operations to sell French products. He argued that two later Notes, of 1972 and 1973, confirmed that the practice of the French tax authorities was not to apply arm's-length pricing where the taxpayer could prove that deviations from arm's-length pricing had been motivated by foreign competitive conditions and not by the intention to transfer profits. The United States representative concluded that the relaxed inter-company pricing rules amounted to a calculated exemption from French tax of virtually the entire profit from the manufacture and sale of export goods, approaching the maximum subsidy which could be implemented by any tax mechanism.

27. The representative of France said that the arm's-length principle was basic to its system but that, in the case of related enterprises, the whole marketing process had to be taken into account. He stated that if the marketing company suffered a loss it would be abnormal for the manufacturing company to make a profit and so increase that loss and that a decision by the manufacturing company to sell at cost price should then be viewed as a normal management decision dictated by obvious commercial requirements, not as a transfer of profits. This might appear to be a departure from the arm's-length principle but this was not the case because it was extremely likely that a similar situation might develop between independent companies since an independent third party might not accept a situation in which it suffered a loss at the marketing stage and the supplier made a profit.

28. The representative of France also stated that the administrative notes of 1959 and 1972 were merely intended to remind officials of the problem and had nothing to do with transfers for tax evasion purposes. This was also quite clear from the 1973 note, in which the need to make use of the provision as a weapon against transfers of profits to tax havens, for example, was brought to the attention of officials.

29. In a comment, the United States representative said that he did not accept the French contention that the practice of allocating profits to sales operations when the sales operation would otherwise have a loss approximated to an arm's-length result since unrelated buyers and sellers frequently had very different profit and loss results from their transactions.

Effects of the territoriality principle as applied by France for taxation of foreign dividends

30. The representative of the United States stated that under the territorial principle, profits of a foreign subsidiary were not consolidated with the profits of its French parent, and so not taxed in France. He went on to make the point that even if the subsidiaries' profits were repatriated in the form of a dividend, 95 per cent of it was deducted from the taxable income of the company, whether or not the foreign subsidiary was subject to taxes in its country of residence, and whether or not the rate of tax applied by that country was less than the French rate. In fact, the dividend was not expected to be taxed at all, as the remaining 5 per cent was considered to be deducted as ordinary expenses against the taxes of the recipient corporation. He argued that this amounted to a permanent exemption from taxation. He added that the fact that French corporations were also entitled to a 95 per cent deduction for dividends from a domestic subsidiary appeared to give domestic and foreign subsidiaries the same tax treatment but pointed out that the foreign subsidiary paid no French tax. As French parents did not pay corporation income tax when they received foreign source income, there was an equalization tax of 33 1/3 per cent on the gross dividend paid to the shareholders. However, shareholders of French companies were entitled to a tax credit of 50 per cent which compensated for this equalization tax.

31. The representative of France replied that the United States while making a specific argument was, in fact, criticizing the principle on which the French system was based. He said moreover that it was misleading to present the exemption method as a general form of relief since, in most instances, the subsidiary was

subject to the usual foreign taxation and there was often an additional levy when the allocation was made. He added that the system had existed in French legislation since 1920 but had never given rise to criticism.

32. The representative of the United States, commenting on this reply, said that the United States did not question the intent of countries following the territoriality principle. The important question, he said, was the effect and not the intent of the legislation.

Relation to the DISC legislation

33. The representative of the United States argued in general that, if the DISC legislation violated the General Agreement, then the tax practices of France, which operated to exempt a portion of sales income of exporting firms from direct taxes, must be found to constitute even clearer subsidies in violation of Article XVI:4. Whereas the DISC legislation provided only a deferral, the tax practices of France amounted to a remission or exemption. The United States compared the effects of the principles behind its tax policy regarding foreign source income and the effects of the principles behind France's legislation. It did not question the territoriality principle in so far as it represented a reasonable approach to the avoidance of double taxation, but argued that the intent of nations was irrelevant and that the effect of the French practices was that foreign income which included the sales element on exports was not taxed by the home country and that there was therefore a remission or exemption of taxes. The focus should not, according to the United States, be on the tax rates of host countries, but on the home country and its potential for shifting export income abroad thus escaping virtually all tax. The United States added that if it had utilized the territoriality principle it would have collected significantly less than the $3.8 billion which, it was estimated, would be collected on foreign source income in 1976.

34. In reply the representative of France stated that, as regards income derived from export by French or American companies, an overall examination of the rules applicable in the various possible situations - as distinct from the highlighting of the particular outcomes of some specific rules in exceptional and limited circumstances - showed that the systems applied by the two countries led in the aggregate to similar results, if the distortion introduced by the DISC system were excluded. The French tax system appeared, on the whole, less favourable to international corporate activities because it had been designed on the basis of the territorial principle and took only very imperfect account of the uncertainties of international trade. By contrast, the American system, while apparently more consistent and of wider application as regards foreign source incomes including income earned in tax havens, contained provisions which were highly favourable to international corporate activities and which offered many possibilities for the non-taxation of certain foreign incomes.

Other specific measures

- Special incentives for the establishment of foreign branches

35. The representative of the United States argued that French tax law provided special incentives to establish a foreign branch for export sales as opposed to a domestic branch. A French company was, for instance, entitled to deduct the cost of marketing studies, legal studies, travel and salaries of personnel investigating the establishment of a foreign sales office, representative office or liaison or information office. By permitting these costs to be deducted against domestic income, the expenses incurred in generating export sales income produced a disproportionate tax benefit as compared to comparable domestic expenses. The representative of the United States added that certain overhead expenses incurred in the operation of such an office for its first three fiscal years could be deducted and that, while the general rule was that this deduction resulted only in deferral, there was a provision by which the deferral could become permanent remission if a special authorization was granted by the Ministry of Finance.

36. In reply the representative of France said the fact that the territoriality rule precluded deduction of losses or expenses incurred abroad was a serious handicap to the establishment of French undertakings abroad, which had led France to provide certain very limited relaxations. He pointed out that the system referred to was substantially modified and restricted in 1972, and that its provisions applied only to operations initiated prior to 1 January 1973. A new régime allowing only a temporary deduction, in the form of a reserve limited to five years and offset against profits from the sixth year onwards, was now in force. The deduction was never on a final basis. The new régime was designed to help establishments abroad and was not directly linked to exports. Because of the limited scope and very restrictive implementing provisions, it was of very slight significance and did not constitute an export subsidy within the meaning of Article XVI:4.

37. Commenting on this, the representative of the United States said that non-deduction was of minor significance, as foreign losses were not deductible only if they were incurred by undertakings operated outside France and stressed that during the start-up phase, during which losses were expected, the undertakings could be operated from France.

Medium-term credits; inflation levy; exporters' card

38. The representative of the United States complained that an export company which extended medium-term credit on export sales was entitled to a special deduction for a reserve to cover the risks of extending credits abroad, and pointed out that if the credit were repaid by instalments, the French corporation would have the use of the incremental cash payments attributable to the deferral of tax for a considerable period of time.

39. The representative of France replied that this provision was adopted in 1960 and had not been subject to criticism until now. He said that, in fact, it only concerned sales of capital goods, and that the flat-rate reserve for medium-term foreign credit was in no way a breach of the GATT rules.

40. The representative of the United States also took up the French Inflation Levy which imposed a temporary and refundable tax on gains in order to curb inflation; the taxpayer had the right to exclude any export income from the calculation of the tax base for this purpose. He argued that whatever the intent of the legislation, its result would be to create a price differential.

41. The representative of France explained that the levy had not been made applicable to exports because it was designed to combat price increases in France and because price formation internationally was governed by factors other than those operating in the French market. He added that the inflation levy had never been applied in practice.

42. France denied a number of contentions relating to the system of exporters' cards which had been in force from 1957 to 1973.

Bi-level pricing

43. Referring to the provision in Article XVI:4 relating to the sale of products for export "at a price lower than the comparable price charged for the like product to buyers in the domestic market", the representative of the United States argued that, if the Panel on DISC found that when the CONTRACTING PARTIES agreed that exemption of direct taxes in respect of exported goods was generally to be considered a subsidy within the meaning of Article XVI:4 they intended to create a presumption that such tax practices resulted in lower export prices in relation to domestic prices, and if the DISC Panel went on to find that the deferral of taxes on export sales income provided by DISC resulted in lower export prices, then the Panel on French Tax Practices had likewise to find that the tax practices of France, providing for the total or partial exemption of export sales income of exporters located within France, were more likely to result in lower export prices and, therefore, were even more clearly prohibited by Article XVI:4.

44. The representative of France maintained that their practices were neither subsidies which should have been notified to the CONTRACTING PARTIES to GATT, nor subsidies contrary to Article XVI:4, and that none of the provisions criticized by the United States were likely to lead to double pricing in the sense of that Article.

B. Article XXIII:2 nullification or impairment of benefits

45. The representative of the United States argued that a prima facie case of nullification or impairment was established where it was determined that the measure complained against violated the General Agreement and that, since the tax practices of France constituted prohibited subsidies within the meaning of Article XVI:4, they had resulted in the prima facie nullification or impairment of benefits accruing to the United States under the General Agreement.

46. The French position was that its practices were not in contravention of the GATT and that there was not, therefore, a prima facie case of nullification or impairment.

Conclusions

47. The Panel started by examining the effects of the income tax practices before it in economic terms. The Panel noted that the particular application of the territoriality principle by France allowed some part of export activities, belonging to an economic process originating in the country, to be outside the scope of French taxes. In this way France has foregone revenue from this source and created a possibility of a pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries.

48. The Panel found that however much the practices may have been an incidental consequence of French taxation principles rather than a specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market. The Panel also considered that the fact that the practices might also act as an incentive to investment abroad was not relevant in this context.

49. The Panel also noted that the tax treatment of dividends from abroad ensured that the benefits referred to above were fully preserved.

50. In circumstances where different tax treatment in different countries resulted in a smaller total tax bill in aggregate being paid on exports than on sales in the home market, the Panel concluded that there was a partial exemption from direct taxes. The Panel further concluded that the practices were covered by one or both items (c) and (d) of the illustrative list of 1960 (BISD, 9 Suppl. p.186).

51. The Panel noted that the contracting parties that had accepted the 1960 Declaration had agreed that the practices in the illustrative list were generally to be considered as subsidies in the sense of Article XVI:4. The Panel further

noted that these contracting parties considered that, in general, the practices contained in the illustrative list could be presumed to result in bi-level pricing and that this presumption could therefore be applied to the French practices. The Panel concluded, however, from the words "generally to be considered" that these contracting parties did not consider that the presumption was absolute.

52. The Panel considered that, from an economic point of view, there was a presumption that an export subsidy would lead to any or a combination of the following consequences in the export sector: (a) lowering of prices, (b) increase of sales effort, and (c) increase of profits per unit. Because France was an important supplier in certain export sectors it was to be expected that all of these effects would occur and that, if one occurred, the other two would not necessarily be excluded. A concentration of the subsidy benefits on prices could lead to substantial reductions in prices. The Panel did not consider that a reduction in prices in export markets needed automatically to be accompanied by similar reductions in domestic markets. The Panel added that the extent to which tax havens existed was well known and that they considered this some evidence of the extent to which bi-level pricing had probably occurred.

53. The Panel therefore concluded that the French tax practices in some cases had effects which were not in accordance with French obligations under Article XVI:4.

54. The Panel noted that the allocation of profits between companies and their foreign operations was made in accordance with the arm's-length pricing principle but that there were formal exceptions to this principle and concluded that the benefit would be increased to the extent that arm's-length pricing was not fully observed.

55. The Panel considered that deductions against domestic profits of certain costs and losses relating to certain specific foreign operations outside the scope of domestic taxation constituted an additional exemption which reinforced their conclusions. The Panel did not consider that the other specific practices, which had been raised relating to medium-term credit, the inflation levy and exporters' cards, altered the general picture outlined above.

56. The Panel considered that the fact that these arrangements might have existed before the General Agreement was not a justification for them and noted that France had made no reservation with respect to the standstill agreement or to the 1960 Declaration (BISD, 9 Suppl. p.32).

57. The Panel was of the view that, given the size and breadth of the export subsidy, it was likely that it had led to an increase in French exports in some sectors and, although the possibility could not be ruled out that the tax

arrangements would encourage production abroad and a decrease in exports in other sectors, nonetheless concluded that it was also covered by the notification obligation of Article XVI:1.

58. In the light of the above, and bearing in mind the precedent set by the Uruguayan case (BISD, 11 Suppl. p.100), the Panel found that there was a prima facie case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement.