SUBSIDIARITY OF TAX TREATIES IN RELATION TO DOMESTIC LAW

Philippe MARTIN

Conseil d'Etat (France)

I. The subsidiarity principle. 1) Origin. 2) Legal consequences. II. Main issues. 1) Double non-taxation. 2) Qualification of income. 3) The use of tax treaties against taxpayers

The subsidiarity of tax treaties is a concept shaped by French case law and it may seem typically French. But it relates to general issues that may arise in various tax jurisdictions. After explaining the origin of this concept and its legal consequences, these issues will be addressed.

I. THE SUBSIDIARITY PRINCIPLE

1) Origin

Art. 55 of the French Constitution states that international treaties, following ratification and publication, are superior to French legislation. Courts, therefore, set aside all statutes that are contrary to a tax treaty, even if the statute was enacted after the treaty (*Conseil d'Etat* (Supreme Administrative Court), 20 October 1989, Decision No. 108243, *Nicolo*, RJF 11/89 n° 1266). Accordingly, there is no treaty override in France.

In French case law, the principle of superiority coexists with the principle of subsidiarity of tax treaties in relation to domestic law, which might appear to be paradoxical. However, subsidiarity means only that, intellectually, the application of domestic law is a first step, before applying tax treaties. The subsidiarity principle is also referred to as the "priority of domestic law".

The concept of subsidiarity is a consequence of the primary object of tax treaties, which is the avoidance of double taxation. In this regard, a tax treaty becomes useless if there is no right to tax under domestic tax law, as there is no risk of double taxation. The founding decision in French case law shows this logic (*Conseil d'Etat*, 19 December 1975, Decision No. 84774, RJF 2/76 n° 77). In this case, the *Conseil d'Etat* quashed a decision by a lower court that had asked information from the French Ministry of Foreign Affairs on the wording of a tax treaty. The *Conseil d'Etat* stated that the lower court should have checked first whether the income was taxable under French domestic tax law before wondering whether the tax treaty blocked the application of French domestic law.

Currently, the wording of the subsidiarity principle is to be found in the *Schneider Electric* case regarding CFC (*Conseil d'Etat*, 28 June 2002, Decision No. 232276, *Schneider Electric*, RJF 10/02 n° 1080).

2) Legal consequences

The main legal consequences of the subsidiarity principle are mentioned in the *Shneider Electric* decision, which includes a paragraph explaining the contents of this principle.

The first consequence is that the French tax administration cannot rely on treaty provisions alone to tax an item of income. Domestic legislation is needed. This is the « protective effect » of subsidiarity for taxpayers. It means that the allocation of the right to tax by the tax treaty to a contracting state does not, by itself, provide sufficient legal grounds for taxation in that state.

The second consequence is that courts should look first at domestic law, to check if an item of income is taxable, and under which qualification. Then courts should, if this income is taxable under domestic law, compare its domestic qualification with treaty provisions and check if the tax treaty blocks the application of domestic tax law.

II. MAIN ISSUES

1) Double non-taxation

The first issue arising from the subsidiarity principle is the risk of double non-taxation. Logically, subsidiarity can lead to double non-taxation if a tax treaty grants taxing rights to a contracting state, with exemption in the other state, but the domestic law of the first state does not provide for taxation.

However, domestic « stopgap » legislation can prevent double non-taxation. In France, a law of 28 December 1959, codified in Arts. 4 bis, 165 bis and 209 of the *code général des impôts* (general tax code), provides that, with regard to personal and corporate income tax, all income attributed to France by a tax treaty is taxable in France. Accordingly, in practical terms, the protective effect of the subsidiarity principle is greatly diminished

The methodology for applying this law of 1959 has been clarified by a recent case (*Conseil d'Etat*, 31 July 2009, Decision No. 296471, *Overseas Thoroughbred Racing Stud Farms Ltd*, RJF 11/09 n° 979). In a first step, the right to tax must be ascertained in the ordinary provisions of domestic tax law. Then, in a second step, tax treaties must be checked to ascertain whether or not they allow France to tax. In a third step, when ordinary domestic law does not tax but the tax treaty gives France the right to tax, the stopgap provisions deriving from the law of 1959 must be taken into account and interpreted to see whether or not they provide, in the given case, an alternate legal base for taxation. At this last stage, the resolution of the taxation issue rests solely on the interpretation of the scope of the 1959 stopgap legislation.

Due to the very wide wording of the 1959 law, this scope has been debated and raises several issues that are still partly undecided. The *Overseas* case clarified that the 1959 law covers all the insufficiencies of domestic territoriality provisions and is not only designed to cover the foreign business income of a French company, in order to make up for the narrow territorial rule of the French corporate income tax. The *Overseas* decision applies the 1959 law to the French income of a non-resident.

There appears to be no temptation to argue that this law could overrule, on the basis of the treaty allocation of taxing rights, substantive provisions in domestic law exempting taxpayers for economic or social reasons, for example, small businesses, widows and war veterans.

There is some uncertainty regarding the effects of this law when taxing rights are given to France by a tax treaty, but domestic law does not provide for a specific taxing mechanism. One example is outbound income when there is no specific withholding tax mechanism in domestic law, or the domestic withholding tax covers some items of income but not exactly the one attributed by the tax treaty. In this case, does the stopgap provision allow an extensive interpretation of domestic withholding tax mechanisms, or do general income taxation rules apply or is there a technical void in domestic law?

2) Qualification of income

The second issue arising from the subsidiarity principle is the potential influence the domestic qualification of income may have on the treaty qualification.

The subsidiarity principle has resulted in the concept that income must be characterized first in domestic law before being compared to the categories of income distinguished by a tax treaty. Such a method is written in the general wording of the *Schneider* case regarding subsidiarity. This wording states that, in ascertaining taxability in domestic law, the court must identify the qualification of income. Then, the court must compare this domestic qualification with the treaty provisions.

This does not mean that treaty concepts cannot be interpreted as wider or narrower than comparable domestic concepts, unless domestic definitions become applicable under Art. 3(2) of OECD Model-type tax treaties. Domestic qualifications are a starting point for looking at the variety of categories of income listed by the tax treaty. In many cases, following legal analysis in domestic law, income may be assigned to several articles in a tax treaty, which requires considering treaty solutions to separate these categories. For instance capital gains, income from immovable property, dividends and other types of income can also be business profits, and conflicts are normally resolved by applying treaty provisions, not domestic law.

In practical terms, the major effect of this prior characterization in domestic law can be seen in the area of domestic tax fictions, such as deeming provisions. It may not be coincidental that the landmark *Schneider* wording was written in a case concerning CFC legislation.

When confronting these domestic fictions with tax treaties, various approaches could be considered. Courts could disregard the tax treaty completely, as in the case of notional income, or apply the tax fiction as it is designed in domestic law when looking at treaty provisions, or look at treaty provisions without applying the domestic fiction, i.e. using the real characterization or attribution of income, before the fiction is applied.

French case law has chosen the second option, thereby applying the provisions of tax treaties to the income as characterized in the domestic fiction. This has been done for the branch tax (Art. 115 quinquies of the general tax code), as analysed in domestic law as a deemed distribution (*Conseil d'Etat*, 31 January 2001, Decision No. 199543, *Bank Polska Kasa Opieki*, RJF 4/01 n° 489), for the old CFC regime (Art. 209 B of the general tax code), as analysed in domestic law as a "look-through" provision leading to Art. 7 of OECD Model-type tax treaties (the *Schneider* decision), and for the artiste provision (Art. 155 A of the general tax code), as analysed in domestic law as looking through a company receiving the income and therefore meaning that the income is derived by the artist from his activities under Art. 17(1) of OECD Model-type tax treaties (*Conseil d'Etat*, 28 March 2008, Decision No. 271366, *Aznavour*, RJF 6/08 n° 629). The application of the tax treaty worked to the advantage of the taxpayer in the first two cases, but not in the third. This approach provides treaty protection, whilst adhering to the legal analysis of the domestic provision.

But this approach may lead to a risk of « fine tuning » by the tax administration and Parliament. Legislation may fine tune the domestic fiction so as to change the treaty articles that might apply. Following the *Schneider* decision, the French CFC legislation was changed in 2005 to use the "deemed distribution" approach in order to avoid Art. 7 of the OECD Model. Some commentators wonder whether or not this might be questionable treaty override.

3) The use of tax treaties against taxpayers

The third issue arising from the subsidiarity principle is how far taxpayers can stick to domestic law and ignore tax treaties.

The subsidiarity principle has given rise to a debate in tax doctrine regarding a potential consequence. This might be that, if tax treaties are meant to avoid double taxation and cannot provide a legal base for domestic taxation, consequently, they should never increase the tax burden of a taxpayer (a principle of *non-aggravation*).

In some cases, the taxpayer wants to stick to domestic law whereas the French tax administration wants to use a tax treaty against the taxpayer. The taxpayer challenges the use of the tax treaty against him, arguing that tax treaties, under the subsidiarity principle, cannot provide legal grounds for taxation.

This issue has appeared in several situations. Domestic legislation may grant personal income tax benefits (deductions, credits) to domiciled taxpayers. Taxpayers who are domiciled under domestic tax legislation will claim these benefits and sometimes the tax administration will deny them because these taxpayers are residents of another state under the tie-breaker provisions of a tax treaty.

In other situations, a domestic withholding tax will apply to payments made to non domiciled persons. The tax administration may want to apply it to persons who are domiciled under domestic tax legislation but are residents of another state under the tie-breaker provisions of a tax treaty.

Besides these residence cases, the subsidiarity principle has been argued by taxpayers in order to benefit from domestic deduction of losses or expenses in spite of treaty provisions used by the tax administration in order to deny such deductions.

Regarding the issue of domestic domicile vs. treaty residence, the main court decision so far has solved the issue through interpretation of the domestic provision (*Conseil d'Etat*, 8 July 2002, Decision No. 225159, *Lecat*, RJF 11/02 n° 1202). This case involved a taxpayer who was domiciled in France under domestic tax law but resident of Belgium under the tie-breaker rules of the France-Belgium tax treaty. At stake were various tax benefits applied to the overall income of domiciled taxpayers. The *Conseil d'Etat* decided that the domestic provisions granting tax benefits linked to French domicile must be interpreted in line with the territoriality of the personal income tax, whereby domicile means taxation on worldwide income. If the tax treaty makes France into a source state, only taxing French-source income, the condition is not met any more.

A recent case addresses the issue of domestic deduction of losses (*Conseil d'Etat*, 12 July 2013, Decision No. 351702, *BNP Paribas*, RJF 10/13 n° 911). The French bank *BNP Paribas* deducted in France provisions for the depreciation of its shares of a full Canadian subsidiary. The French tax administration denied this deduction on the grounds of the France-Canada tax treaty of 2 May 1975. Under Art. 13(3) of this treaty, capital gains from the alienation of substantial participations (at least 25%) in a company are taxable in the state of residence of this company. (Canada in the case). Art. 23(3) of the treaty provided for an exemption in France when income is taxable in Canada under Art. 13(3). According to the French tax administration, provisions for depreciation of shares are not deductible in France when a tax treaty denies French tax jurisdiction for the taxation of capital gains on the same shares.

The taxpayer used the subsidiarity principle, arguing that the deduction should be allowed because it is justified in domestic tax law (capital gains are taxable, capital losses are deductible, therefore provisions for depreciation are deductible). In this view, only the taxpayer can claim the benefit of a tax treaty. If the tax administration is allowed to use the tax treaty against the taxpayer, it means that taxation is legally based on the treaty, which is against the subsidiarity principle.

The *Conseil d'Etat* denied the claim by *BNP Paribas*. The first step was to recall a basic principle of domestic tax law, whereby a provision for future losses or expenses is deductible only if the loss or expense is deductible. Therefore the issue was reduced to the tax treatment of losses on the sale of shares. Then the court decision states that if a tax treaty denies French jurisdiction over capital gains on the sale of substantial participations, then capital losses on such substantial participations are not deductible in France. In the case, it means that future capital gains will not be taxable in France, therefore future capital losses will not be deductible in France, therefore provisions for depreciation are not deductible. The loss of tax jurisdiction by France affects the tax treatment of all aspects of the item of income.

Another way to reach this outcome could be through a domestic « symmetry » principle. Under French domestic tax law, a loss or expense is usually deductible only where related income is taxable. Capital losses are deductible only if capital gains on the same items are taxable. Therefore a tax treaty breaks this symmetry if France is denied jurisdiction on capital gains, which means that the deduction of capital losses must be denied to restore the symmetry.

On all three issues (legal effect of attribution of taxing rights by treaties, impact of domestic qualifications and use of tax treaties against taxpayers), new litigation can be expected with the subsidiarity principle at the center of arguments. This principle is not purely theoretical, it affects tax practice.

It must be reminded, however, that the subsidiarity principle relies on one object of tax treaties, which is the allocation of taxing rights between states in order to avoid double taxation. But the drafters of tax treaties could decide to write other provisions, that could affect more directly the taxation of income in the contracting states. In such an event, the superiority principle might prevail and lead to the direct application of the treaty to a tax situation. Treaties in other fields than taxation, depending on their provisions, can regulate directly the behavior of national authorities and the rights and obligations of individuals. Then there might be a Constitutional debate about the degree of Parliamentary approval of tax rules through treaties, but that is another complex story.