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GENERAL AGREEMENT ON TARIFFS AND TRADE

COUNCIL

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INCOME TAX PRACTICES MAINTAINED BY FRANCE

Addendum

Memorandum Submitted by the Delegation of France

A close examination of the report of the panel appointed to examine the tax practices maintained by France has led the French Government to express formal reservations on the contents of the report and to reject its conclusions. But the French Government stated that a previous question of basic importance arose as regards the definition of export or export activity. This memorandum purports to elaborate further the presentation of this aspect which was made by the representative of France to the Council.

Indeed, as has been stated to the GATT Council, the terms of the report on French practices - like the terms of the reports on Belgian and Netherlands tax practices - suggest, contrary to the terms used in the report on the DISC system, that the panel has a very wide view of the concept of export or export activity. In the view of the French Government, this concept goes far beyond the notion deriving from the letter, the spirit and the practice of the General Agreement.

I. THE CONCEPT OF EXPORT AND EXPORT ACTIVITY

A. The economic context

International trade activities arise within the context of a wider economic process which can be described briefly a follows, in five stages:

- the manufacturing stage: a product is manufactured in a country by an undertaking located in this country (known as the country of origin);

- the stage of sales, by the manufacturer, in the country of origin to an intermediary (the question of the DISC system arises at this particular level);

- the export stage: the product concerned moves across the customs frontier of the country of origin and is transported towards another country known as the country of destination, to the customs frontier of this latter country. These operations are most frequently carried out by undertakings other than the manufacturing company and such undertakings may in fact be foreign companies (shipping companies, for instance);

- the import stage: the product moves across the customs frontier of the country of destination in conformity with the existing procedures of this country. These operations are generally carried out by an independent enterprise in the country of destination, but may also be carried out by branches or subsidiaries of the manufacturing company in the country of origin;

- the distribution stage: which includes, for instance, after crossing the customs frontier of the country of destination, the wholesale and retail stages as well as related operations, such as maintenance and after sale servicing. Here again, the relevant operations are carried out either by undertakings operating at arm's length in the country of destination or by branches or subsidiaries of the manufacturing company in the country of origin.

It is clear that, from the taxation point of view, the first three stages come under the jurisdiction of the country of origin (with the possible exception of shipping activities) and the last two stages come under the jurisdiction of the country of destination.

B. The broader concept of the panel

The main tax practices maintained by France, some of whose possible or fortuitous consequences are brought in question by the panel, are the territoriality principle and the régime applied to the dividends of foreign subsidiaries in the field of corporate profit taxation.

The reasoning which leads to this questioning is as follows: "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 ... there was a partial exemption from direct taxes" (document L/4423, paragraph 50) and therefore a subsidization of exports which is prohibited by the GATT rules. Considering that the territoriality principle consists, in order to avoid double taxation at international level, in not taking into consideration for the purposes of the French tax the profits made by foreign establishments, the panel felt that where the tax in the country of the foreign establishment is less than the French tax, there is a partial exemption from direct taxation, hence a subsidization in favour of exports. Similarly, as the

treatment of dividends paid by subsidiaries consists in a 95 per cent deduction at the level of the parent company, the panel felt in this case also that where the tax on profits and distribution levied in the country of the subsidiary is less than the French tax, there is a partial exemption from direct taxation and therefore a subsidization of exports. In both cases, the question relates to activities performed in a foreign country by branches or subsidiaries of French companies established in that foreign country.

In the above-mentioned process, these activities do not relate to the first three stages but to the last two. Indeed, judging from the purely commercial point of view - without taking account of any activities which they may be engaged in - the branches or subsidiaries located in the country of destination can only perform operations relevant to the fourth and fifth stages. They can perform import operations (customs clearance, procedures to move the goods across the frontier, etc.), distribution operations at the wholesale or the retail levels, and maintenance or after sales operations.

As a result, the panel, in order to condemn these tax practices on the grounds that they constitute a subsidization in favour of exports must hold the view that, within the GATT meaning and therefore within the meaning of its terms of reference, the concept of export includes all five stages referred to above.

This extensive concept is evidenced by the report of the panel (document L/4423). Thus, in paragraph 47, 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". The panel therefore seems to consider that operations performed within the customs territory of the country of destination are part of "export activities" within the meaning of the General Agreement.

C. <u>The concept of export within the meaning of the General Agreement</u>

The French Government does not share the views of the panel. The French Government feels that the normal concept of export and export activities which clearly derives from the text, the spirit and the practice of the General Agreement, is much more restricted.

It will be observed, in the first instance, that, within the strictly commercial meaning, export properly so-called is the third stage of the process described above. Export is indeed characterized by the crossing of the customs frontier of the country of origin and this differentiates export from domestic sales. The concept of "export activity" is a broader concept in that it includes the first three stages of the above-mentioned process, i.e. export in the narrow sense and the two preceding domestic stages within the country of origin (manufacture and sale to a first intermediary).

It is clear that this concept of export (a process which ends at the customs frontier of the country of destination) falls within the letter and the spirit of the General Agreement.

As far as the text of the General Agreement is concerned, it should be noted in the first instance that the very title of the General Agreement - General Agreement on Tariffs and Trade - tallies with this concept: the problems referred to are those that pertain to international trade and customs tariffs, and international trade can be defined as trade exchanges between two customs entities (the country of origin and the country of destination). This is asserted in the preamble of the General Agreement whereby the signatory governments state that they are "desirous to enter into arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce". The whole of the provisions of the agreement does confirm that the agreement covers only international trade and export within the normal meaning of the term, but not domestic trade in the country of destination. Thus, where one deals with most-favoured-nation treatment, mutual concessions, countervailing and anti-dumping duties, export subsidies, treatment of imports or exports, what is referred to is always international trade: the GATT provisions deal with customs procedures, fiscal, economic or administrative treatment of imports or exports, direct subsidies to exported products, fiscal adjustments at the frontier, customs valuation matters, import and export formalities. The objective of the Agreement appears to be the elimination of discrimination and obstacles to trade between the customs frontier and the exporting country and that of the importing country so that imported products should receive the same treatment as domestic products, from the time they cross the customs frontier of the importing country.

This concept also tallies with the GATT spirit and the economic logic on which it is based. It is indeed logical in terms of economics that the GATT rules which tend to encourage countries to eliminate export subsidies or export aid should apply at the export level properly so-called. Inversely, it is logical that, in the import field, these very same rules should encourage importing countries to eliminate discriminatory treatment and obstacles essentially at the frontier level (customs tariffs, quotas, various procedures, etc.) and at subsequent stages (commercial, tax, etc. regulations) to the extent that domestic regulations would tend to create for imports a less favourable situation than in respect of domestic products. These latter obligations are solely for importing countries.

Lastly, this concept obviously tallies with the GATT practice. The problems which are brought before this organization are all related to this normal concept of export, international trade and export activity.

It should be mentioned further that the whole of economic theory concerning export and export activities is based on this concept and views such activities only as a straightforward extension of activities performed in the country itself.

II. THE IMPORTANCE AND THE CONSEQUENCES OF THE CHOSEN DEFINITION OF EXPORT ACTIVITIES

A. Importance with a view to the appreciation of the panel's report on the income tax practices maintained by France

The contents given to the concept of export activities directly influence any appreciation of the report on the French income tax practices. In fact, if one chooses the normal rather than the extensive concept of export activity, the only one which may be entertained under the General Agreement, it is clear that the bringing in question of the French tax practices, which fall outside this concept, no longer has any justification. On the other hand, it should be noted that the condemnation of the DISC system remains unaffected, as this system falls completely within the framework of the concept of export in the normal sense - in this particular case, at the beginning of the second stage referred to above.

The very extensive concept chosen by the panel runs counter to the GATT rules and to the logic of international relations, and from the strictly fiscal point of view, raises two serious economic and political difficulties.

B. The consequences, from the fiscal point of view, of the concept chosen by the panel

(1) An economic distortion

This concept directly leads to economic distortions, in the light of the economy of the panel's reasoning. Indeed, as has been recalled above, the Group lays down as a principle that, throughout the process which it seems to consider as an "export activity", the aggregate tax burden should be at least equal to the burden which would be imposed if the activities in question were conducted solely within the country of origin.

But activities falling within the last two stages of the process described above - such activities occurring solely within the country of destination - may be conducted in three different ways: by a branch or a subsidiary established in the country of destination, of the parent company in the country of origin manufacturing the products, or by undertakings in the country of destination totally independent of the manufacturing company in the country of origin. In order to avoid any distortion, the same tax treatment - in other words, according to the panel, the tax treatment of the country of origin - should therefore be applied in the three cases.

In order to avoid any economic distortion resulting from the tax treatment applied in the first case (i.e. in the case of a branch), the country of origin should apply the treatment known as the "world profit" treatment. In other words, the basis for the taxation of domestic undertakings should be the aggregate results, whether positive or negative, of all the branches or establishments, wherever located throughout the world. Although this raises a political problem (see further on), such a solution can be envisaged and is in fact already applied in many countries.

In order to avoid any economic distortion as a result of the tax treatment applied in the second case (i.e. in the case of a subsidiary), the country of origin should apply the treatment known as the "consolidated profit" treatment. In other words, the basis for the taxation of domestic undertakings should be the aggregate results, whether positive or negative, of all the branches and establishments and also of any subsidiaries having separate legal personality, wherever they may be located throughout the world. The consolidated profit treatment raises such technical problems that no country at present applies it as part of its ordinary law. Unless all countries adopt it, which seems highly unlikely to happen, there would then be a difference between the taxation of a branch and the taxation of a subsidiary, and therefore a possibility of economic distortions occurring.

Lastly, in order to avoid any economic distortion as a result of the tax treatment applied in the third case (activities by an undertaking operating at arm's length within the fourth and fifth stages), the country of origin should be in a position to tax a foreign undertaking conducting no activity within its territory and being fully independent of any enterprises in the country of origin. This is legally absurd and technically impossible. From the legal point of view, the country of origin has absolutely no basis whatsoever to enable it to extend its tax sovereignty to such foreign undertakings.

From the technical point of view, such taxation would not be feasible. Thus, even if the country of origin subjected its domestic companies to the consolidated profit treatment, there would still necessarily be a difference, if one follows the reasoning of the panel, since the sale profit made by a company of the country of destination operating at arm's length on the marketing of imported products could never be taxed in the country of origin, contrary to what would happen with a similar profit realized by a branch or subsidiary. If the tax burden in the country of destination were less than in the country of origin, this would create an obvious economic distortion to the detriment of integrated forms of international trading (marketing branches and subsidiaries).

Thus, if an extensive concept of export activity is maintained, the logic of the panel's reasoning inevitably leads to a serious economic distortion between integrated marketing channels (branches and subsidiaries) and transactions between third parties operating at arm's length, unless all countries adopt the consolidated profit system. As this is not the case at present, the panel which condemns the distortion created, in its view, at the level of the branches as a result of the French practices should also condemn the similar distortion which, in the light of its reasoning, exists at present at the level of the subsidiaries as a result of the practices maintained by all countries throughout the world.

Without entering into more general considerations, it seems obvious from the sole point of view of tax practices that the extensive concept of export which the panel seems to maintain leads to alleged economic distortions that cannot be remedied, which of course is not a satisfactory situation.

Inversely it should be noted in passing, in this respect, that the territoriality principle makes for fiscal neutrality. Indeed activities pertaining to the last two stages, when occurring in the country of destination, are subject to the same tax treatment - that of the country of destination - whatever the form in which the activity is performed (through a branch, a subsidiary, or a company operating at arm's length). Quite obviously, this tallies with economic logic, as the country of origin can take action at the level of those activities coming under its own jurisdiction (i.e. within the last two stages).

(2) A political problem

If the Panel were to consider that any distortion which may exist between integrated trade and any transactions conducted between companies operating at arm's length is immaterial, but that it is desirable to ensure neutrality at the sole level of the forms of integrated trade, the conclusion would be that the only tax treatment consistent with the GATT rules would be the consolidated profit system. In addition to the technical problems referred to above, such a conclusion would raise a basic political problem.

Indeed, although the Panel brings in question the "particular application" of the territoriality principle by France, which has possible and fortuitous consequences inconsistent with the GATT rules, but not apparently the principle itself, what is challenged is the principle itself. In fact, regardless of the application of the territoriality principle, the moment the tax burden in the country of the branch is less than in the home country of the parent company, there is a distortion as understood by the Panel. What is therefore brought in question is indeed the territoriality principle itself - a time-honoured and widespread principle in the field of taxation, which had never given rise to any discussion before. The situation is the same as regards the treatment applied to subsidiaries.

The result would be that, subject to their being possibly condemned in terms of the GATT rules, governments would no longer be free to determine the basic principles on which their tax systems will be based, whereas authority to rule tax matters is a basic component of national sovereignty.

Furthermore, one should observe that the application of the principles themselves could also, if one were to follow the reasoning of the group of experts, lead to considerable distortions. Thus, for instance, although Great Britain and the United States apply the world profit principle, it is clear that the

particular application of the world profit principle by the United States, in particular for the purposes of the foreign tax credit (a device which under a world profit taxation system, is used in order to avoid double taxation), makes it possible under certain circumstances, for part of export activities to escape United States tax. One would thus be led to force governments to adopt a specific tax system not only at the level of the principles themselves, but also as regards their implementation which, quite obviously, is totally unacceptable.

It is therefore clear, in the view of the French Government, that the extensive concept of export which seems to be maintained by the Panel is not consistent with the GATT rules and practices and involves dangerous and unacceptable consequences from the sole fiscal point of view.