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DIRECT INVESTMENT IN FRANCE:

LAW AND TAXES

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I. FOREIGN DIRECT INVESTMENT IN FRANCE

Direct investment in France[1] by non-French persons is subject to governmental regulations.[2] The primary purpose of these regulations is to enable the French Ministry of Finance, in liaison with other authorities, to examine the merits of any proposed foreign investment in France. Most foreign direct investment must be approved in advance by the Ministry in order to protect the French economy from foreign domination and to encourage increased employment and improved technology. To these ends, the regulations confer on the Ministry the right to refuse its consent to most proposed investments. In carrying out its responsibilities, the Ministry's policy in recent years has been to favor the formation of new companies over the acquisition of existing businesses.

A. *Underlying Concepts*

The French regulations define "direct investment" as follows:

> ... the purchase, the creation or the extension of any businesses, branches or personal enterprises.... any other operations, whether separate or forming part of a larger transaction spread over a period of time, the effect of which is to enable one or more persons to acquire or to increase control

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1. "France" includes the French Overseas Departments; territories, except the Côte Française de Somalis; and Monaco.

2. The regulations governing direct investment are embodied in Law No. 66-1008 of Dec. 28, 1966, [1966] J.O. 11621, [1967] D.S.L. 30 and Decree No. 67-78 of Jan. 27, 1967, [1967] J.O. 1073, [1967] D.S.L. 81, *as amended and implemented,* Decree No. 71-143 of Feb. 22, 1971, [1971] J.O. 1832, [1971] D.S.L. 129 *and* Decree No. 71-144 of Feb. 22, 1971, [1971] J.O. 1833, [1971] D.S.L. 129.

> over a company carrying on an industrial, agricultural, commercial, financial or real estate activity, under any form whatsoever, or to develop a company already controlled by them.... However, a minority shareholder not exceeding twenty per cent of the equity capital of a company whose stock is quoted on a stock exchange is in no case regarded as a direct investment.[3]

The term "company" in this definition is given an expansive contruction by the Ministry. The two most common forms of corporate organization in France—the *société anonyme*, equivalent to a publicly held corporation, and the *société à responsibilité limitée*, roughly equivalent to a closed corporation—are covered. Without going into technical detail, the term also includes the *société en commandite, société en nom collectif, société en participation*, and *société civile.*

"Control" is not defined under the regulations and is rather unclear as a matter of French law. In practice, this leaves the Ministry of Finance with a substantial measure of discretion. As noted above, a minority stockholder of less than twenty per cent of a listed stock is specifically exempted. As far as unlisted stock is concerned the Ministry, however, may allow foreign investors to acquire significantly larger minority interests without subjecting them to the direct investment regulations. For example, shareholdings of less than 50 per cent of the equity capital of either a *société anonyme*, which is not listed on a stock exchange and whose shareholders are disclosed, or a *société à responsabilité limitée* generally are not considered sufficient to give control to the shareholder. Once a company becomes foreign-controlled, however, all additions of capital that increase the percentage of foreign shareholding are subject to the regulations.

The acquisition of controlling shares of stock is not the only transaction that is subject to the direct investment restrictions. Loans, guarantees, counter-guarantees, purchases of debts, purchases of real estate or rights over land or mineral resources, and even patent, trademark or know-how licensing arrangements may result in the application of the regulations when they enable the investor to develop, acquire or extend control over a company. Moreover, the combination of a minority equity interest with one or more of the above transactions also may lead to the extension of the regulations over the resultant "control."

The "development of a business" contemplated by the regulations includes the addition of assets, as well as money, to an existing foreign-controlled business beyond normal self-generated growth. The foreign contributions need not result in a percentage increase in the

3. Decree No. 67-78 of Jan. 27, 1967, [1967] J.O. 1073, [1967] D.S.L. 81.

equity ownership of the French company in order to be treated as a direct investment. But the reinvestment of earnings by a foreign-controlled company, by way of capitalization or otherwise, is not regarded as an extension of the company and prior Ministry approval is not required.

B. *Application to the Ministry*

Prior to effecting any direct investment in France, application must be made to the Ministry of Finance, *Direction du Tresor.*[4] Applications must be filed by:

(1) a legal entity with its head office outside France, or an individual residing habitually outside France; or
(2) a company organized under French law which is directly or indirectly under foreign control; or
(3) an establishment in France of a foreign company, *e.g.*, a French branch or division.

The sale to any of the entities or persons listed above of an interest in a French company—which, when added to an existing interest, would give the non-resident control—requires an application from the purchaser even though the seller does not reside in France.[5] The

4. If the direct investment is made in a real estate development company, the application must be filed with the Banque de France.

5. The rules set forth in this article apply to direct investment in France by residents of the European Economic Community (EEC). Formerly, EEC members were brought under the rules covering all foreign investors. The EEC Commission, however, contended that these rules conflicted with the Treaty of Rome, which provided for the free circulation of capital between France and the other members of the EEC. In order, therefore, to avoid judicial action by the EEC Commission, the French Government exempted EEC members from the normal requirement of application to the Ministry of Finance. Decree No. 71-143 of Feb. 22, 1971, [1971] J.O. 1832, [1971] D.S.L. 129. Simultaneously, however, the French Government found it indispensible to maintain investment from the EEC within the scope of the Exchange Control Regulations that are currently applied to all foreign financial transactions of any kind. Thus, on the same day that the exemption was given, France required EEC members to apply to the Ministry of Finance prior to entering *any* financial transaction, including direct investment in France; and where there is to be a transfer of capital, permission must first be obtained from the Ministry. Decree No. 71-144 of Feb. 22, 1971, [1971] J.O. 1833, [1971] D.S.L. 129. Thus, French compliance with the dictate of the EEC Commission was purely formal and, as long as the Exchange Control Regulations remain in force, the formalistic device will stand and direct investment from other members of the EEC will be treated the same as when they were subject to the specific rules governing foreign direct investment set out in this article.

obligation to file an application is imposed only upon the investor or purchaser. Therefore, only the purchaser is liable for failure to file the application, unless it can be established that the seller has acted as an accomplice. The Ministry of Finance has no time period within which it must act on an application. However, it usually issues a written consent within two months following receipt of the application.

1. *Contents of the Application.*—The significant items of information required in the application are:

(1) the full name, address and nationality of each investor, or in the case of a corporation, the place of incorporation and registered office; and
(2) a brief description of the investor's business, including, in the case of a corporation, a balance sheet for the last three financial years, its capitalization, its bank references and—if it is a subsidiary corporation—similar information concerning the parent; and
(3) a description of the proposed activities in France, detailing the source of the funds to be invested, the reasons for the investment, and the benefits to the French economy to be derived therefrom.

In addition to the information required in the application, where the formation of a new company is envisaged, a cash flow chart showing the contemplated inflows and outflows for the first four years of operation must be annexed to the application.

2. *Exemptions in the Case of Certain Borrowed Funds.*—Normally, the guarantee or counter-guarantee of a foreign-controlled company's cash borrowing by any resident or non-resident affiliated company is subject to the direct investment regulations. For example, a loan guaranteed by the French company's foreign parent or by a sister French subsidiary usually demands that an application be filed for the Ministry's approval. Likewise, a loan guaranteed by a foreign bank and counter-guaranteed by an affiliate of the French company falls within the regulations. But when all of the following conditions are satisfied, no application need be filed with the Ministry:

(1) the guaranteed operations must be current business operations of the borrowing company that do not constitute addition of new assets or expansion beyond normal self-generated growth; and
(2) the indebtedness of the borrowing company to French lenders must at least equal the borrowing company's foreign current assets;[6] if non-residents do not wholly control the borrowing company then French indebtedness must match the foreign equity interest; and

6. Foreign current assets includes reserves, undistributed earnings and unmatured foreign borrowings, as well as the borrowing company's equity capital.

(3) the total amount of the current guarantee and all guarantees previously granted in favor of the borrowing company must not exceed two million francs.

If a foreign-controlled French company borrows money abroad from a foreign affiliate, or from an unrelated foreign lender with the guarantee of a foreign affiliate, the transaction is normally treated as a direct investment in France and an application for Ministry approval must be filed. This requirement has been relaxed, however, in the case of short-term debt. Although there is no written exemption, the practice within the Ministry is not to demand an application for one year term loans obtained from the foreign parent, or from other lenders with the parent's guarantee. However, even though the transaction is not deemed to be subject to the direct investment regulations, special permission from the Ministry may still be required.[7]

3. *Liquidation of Direct Investments.*—There is no restriction on the repatriation of proceeds or liquidation of a direct investment in France. Ministry approval is not required and no prior notification need be sent to the French Government. However, the regulations do demand that the Ministry be informed of the liquidation within twenty days following its completion. In the case of repatriation of funds, appropriate evidence of the transfer must be furnished to the authorities by the bank handling the transaction. It bears repeating that if the liquidation is effected by a sale of a controlling interest in a French company to a non-resident, the purchaser is a direct investor in France and must file an application accordingly.

II. Financing Direct Investment in France

A. *Capital Requirements*

1. *Minimum Foreign Capital.*—The foreign investor is required to finance at least half of a direct investment from abroad during the life of the investment.[8] Where the foreign interests represent only a fraction of the aggregate equity of the French entity, the foreign funds may be reduced pro rata by such fraction. For example, if a

7. See pp. 366-67 *infra.*

8. Following the devaluation of the dollar, the French Government has temporarily waived this requirement in an attempt to discourage the inflow of foreign currencies in France. Recently the Ministry requires that new investments be financed with the lowest practicable paid in capital and the maximum borrowing of francs in France.

direct investor owns one-half of a French company, one-quarter of the total financing must consist of foreign capital. Where the investor has subscribed all the initial capital for a wholly-owned subsidiary with foreign funds, as is usually the case, subsequent loans from French sources may be made to match the foreign funds. For purposes of the capitalization requirement, foreign funds include the equity capital initially or subsequently contributed by the direct investor, the proportionate reserves and undistributed earnings, and funds borrowed from the foreign parent or other foreign sources. All transfers of foreign capital must be made through banks authorized by the French Exchange Control Authorities, *intermédiaires agrées*. Moreover, unless an external account in francs is debited, a sale of foreign currencies for francs must be transacted in the corresponding amount on the French exchange market.

2. *Minimum Equity Capital.*—Although there are no written regulations to this effect, the Ministry of Finance reserves the right to require a foreign-controlled company to capitalize its undistributed earnings or loans, or to increase its equity capital by any other means if the company's capitalization is deemed insufficent. The Ministry may use one of two tests to determine whether the company's capitalization is sufficient. The first is linked with the fixed assets: the equity capital must be at least equal to the fixed assets. The second is based on the company's indebtedness: the equity capital must be at least equal to the total debt including borrowings from shareholders. To facilitate policing of these capitalization guidelines, each foreign-controlled company is required to supply the Ministry with copies of its balance sheet and accounts annually.

B. *Foreign Borrowing*

In the normal situation, if a foreign-controlled French company borrows money abroad, the loan is subject to the direct investment regulations. However, even if the loan does not qualify as a direct investment, the Ministry of Finance must grant special permission before the transaction can be consummated. This requirement is relaxed only if the following conditions are satisfied:

(1) borrowed foreign currencies must be converted into francs on the French exchange market immediately or a foreign franc account must be debited;
(2) the term of the loan must exceed one year;
(3) there must be no prior redemption clause;
(4) any renewal provision must be for a minimum of one year;
(5) the annual interest rate may not exceed the normal market rate;

(6) the total amount of the outstanding loans exempted from regulation by the Ministry of Finance must not exceed two million francs at any time, except for certain businesses such as an import-export company;
(7) a copy of the loan agreement must be furnished to the *intermédiaires agrées* through which the transfer of funds is made.

III. PATENT RIGHTS, TRADEMARKS AND KNOW-HOW

The French Ministry of Industry, *Service de la Propriété Industrielle*, must be notified of all contracts relating to patent rights, trademarks and know-how, if rights in such properties pass between a resident of France or a company with head offices in France and an individual residing abroad or a company with head offices abroad.[9] This rule is nearly catholic in scope. Any agreement, direct or supplemental, for the acquisition, sale or licensing of such properties falls within its provisions. Moreover, "know-how" is deemed to include manufacturing rights, technical assistance, designs, engineering acumen, tests, research developments, and scientific and technical information relating to all branches of industrial and agricultural activities; although cultural exchanges and purely commercial activities are excluded. However, unlike the application required with respect to direct investments, the Ministry of Industry has no right to object to the agreement and the notification may be made up to one month after the execution of the agreement.

The French party must inform the Ministry of Industry at the end of each year of the amount of royalties transferred to or from abroad pursuant to the agreement. Any set-off of royalties due from or to the French party also must be reported. The Ministry communicates such reports to the tax authorities and the latter may object to the French licensee's royalties deduction from taxable profits if the royalties are fixed unreasonably high.

IV. TAXES

On the assumption that a U.S. person is the direct investor and the vehicle for effecting a direct investment in France is a *société anonyme* unless otherwise noted, the following French and United States taxes apply to the investment.

9. Decree No. 70-441 of May 26, 1970, [1970] J.O. 4991, [1970] D.S.L. 129.

A. *French Taxes*

1. *Acquisition of Interest.*—The transfer of property to a French corporation is subject to a registration tax, either on creation of the corporation or on an increase in the corporation's capital. Cash contributions are subject to a one per cent registration tax[10] and contributions in kind of certain assets, such as real estate, leasehold rights and goodwill, are subject to an 11.4 per cent registration tax. However, the rate of the registration tax is reduced to one per cent for all contributions if the transferor is subject to the French corporate income tax.

The acquisition of an interest in a French corporation through the purchase of shares is subject to a 4.2 per cent registration tax. There is no registration tax, however, if the shares are issued by a *société anonyme* and either there is no bilateral deed or other instrument of sale or the instrument is executed outside France.[11] The acquisition of 100 per cent of the stock of a French corporation might be treated as the acquisition of the underlying assets, business and goodwill of such corporation. If so, four distinct taxes may be applicable:

(1) A registration tax would be payable on the purchase price at rates that vary from 20 per cent on goodwill, furniture, equipment and machinery to 4.2 per cent on inventory. In certain instances, the value added tax may be substituted for the registration tax.

(2) The purchasers would be liable for a *droit d'apport* at the rate of one per cent, apparently based on the purchase price of the shares.[12]

(3) The French corporation would be liable for an income tax on the increased value of its fixed assets. This tax applies at the regular corporate income tax rate of 50 per cent of the net gains realized with respect to fixed assets sold or otherwise disposed of within two years after their acquisition, and at a reduced rate of 10 per cent of the net gains realized with respect to fixed assets sold or disposed of more than two years after their acquisition.[13]

(4) Each selling stockholder, whether individual or corporate, would be liable for income taxation at the rate applicable to such stockholder on a pro rata share of an amount equivalent to the liquidating dividend if the corporation were being liquidated.[14]

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10. CODE GENERAL DES IMPOST, arts. 714. I & I bis [hereinafter cited as C.G.I.].

11. C.G.I., art. 727.1.

12. C.G.I., arts. 694 & 1216 ter.

13. C.G.I., art. 219.I.a.

2. *Annual Taxation.*—A French corporation is subject to an annual income tax at the rate of 50 per cent on its taxable income.[15] The computation of taxable income is subject to many special rules. For example, interest paid to shareholders is deductible only if certain special rules are satisfied,[16] and interest and royalties are deductible only to the extent that the amount approximates a rate established by arm's length negotiation. There are also special rules concerning dividend income and capital gains. A French corporation may be entitled to an investment credit—although, as in the United States, this credit is enacted and repealed from time to time. It may also be entitled to special tax and other benefits if it operates in certain regions in France.

A French corporation also is subject to other taxes, such as the value added taxes at varying rates—the "standard" rate is currently 23 per cent—and payroll taxes if the corporation has employees. These taxes normally are deductible for income tax purposes.[17]

3. *Interest and Royalties.*—Interest and royalties paid by a French corporation to United States residents who are not effectively connected with a permanent establishment in France are subject to ten per cent and five per cent withholding taxes,[18] respectively. The fact that the United States recipient owns the shares of stock of a French corporation is not taken into account in determining whether such person has a permanent establishment in France.[19] If the recipient of the interest or royalties is also a shareholder in the paying corporation, all or a portion of such amounts might be treated as dividends.[20]

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14. Taxation of liquidating distributions is discussed *infra* p. 371.

15. C.G.I., arts. 206.1 & 219.1.

16. Interest paid to shareholders is deductible only to the extent that the rate does not exceed the rate charged by the Bank of France on secured loans, currently 8 per cent, plus 2 per cent. C.G.I., art. 34.1.1. Interest paid to controlling shareholders in certain cases is deductible only to the extent that the total loan does not exceed total capital. C.G.I., art. 212; Ordinance of Sept. 28, 1967. Any interest paid to a creditor-shareholder which exceeds either of these two rules is treated as a dividend and is taxed accordingly.

17. C.G.I., art. 39.1.4.

18. Convention with France with respect to Taxes on Income and Property, July 28, 1967, arts. 10 & 11, [1968] 4 U.S.T. 5281, T.I.A.S. No. 6518 (effective Aug. 11, 1968) [hereinafter cited as Convention].

19. Convention, *supra* note 18, at art. 4 (6).

20. *See also* Convention, *supra* note 18, at art. 8; C.G.I., art. 57; and INT. REV. CODE of 1954, § 482 [hereinafter cited as INT. REV. CODE].

4. *Dividends.*—Dividends paid by a French corporation to United States residents are subject to a fifteen per cent withholding tax if such dividends are not effectively connected with a permanent establishment in France of the American resident.[21] The withholding rate is reduced to five per cent if the American shareholder is a corporation that owns at least ten per cent of the outstanding shares of the French corporation, and if not more than 25 per cent of the gross income of the French corporation for the applicable tax year consisted of specified types of interest and dividends.[22]

The French Government has recently agreed to grant a tax credit in the form of a cash refund to American shareholders who receive dividends from French corporations. The tax credit is similar to the credit allowed French shareholders and is known as the *avoir fiscal.* The credit is equal to one-half the French corporate income tax applicable to the dividends collected at the corporate level. However, the French withholding tax will apply to the cash refund as well as to the dividend. The new credit will not apply to an American corporation that owns ten per cent or more of the stock of the paying French corporation. This credit was incorporated into a protocol between France and the United States signed October 12, 1970, and ratified by the United States Senate on December 29, 1971.[23] The effective date of the protocol is retroactive to January 1, 1970.

Dividends paid out of the income of a French corporation that were not subject to French corporate income tax, such as income from certain foreign operations and certain dividend income, or out of income that was earned more than five years prior to the dividend, are subject to a special French tax at the rate of 50 per cent of such dividends. This tax is known as the *précompte mobilier.*[24] American shareholders, however, are entitled to a refund of the *précompte* under the income tax Convention of 1968.[25]

5. *Disposition of Interest.*—The sale or exchange of shares of stock in a French corporation by an American shareholder is exempt from French income tax if:

(1) the shares constitute capital assets in the hands of the shareholder; and
(2) the gain is not effectively connected with a permanent establishment of the recipient in France; and

21. Convention, *supra* note 18, at art. 9 (2) (a).

22. Convention, *supra* note 18, at art. 9 (2) (b).

23. Protocol to the Convention with France with respect to Taxes on Income and Property, July 28, 1967, [1968] 4 U.S.T. 5280, T.I.A.S. No. 6518.

24. C.G.I., art. 223, sexies.

25. Convention, *supra* note 18, at art. 9 (5).

(3) if the recipient is an individual, the gain is not effectively connected to a fixed base in France of the recipient and the recipient was not in France for a period, or periods in the aggregate, exceeding 183 days during the taxable year. [26]

The sale or exchange of the shares, however, might be subject to a 4.8 per cent registration tax. In addition, the sale of shares may be treated as the sale of the business, thereby causing the selling shareholders to be taxed as though they received a liquidating dividend. [27]

If an individual acquires shares in a French corporation by inheritance, the French inheritance tax would apply whether or not he is domiciled in France. If the individual is an American citizen or resident, however, he would be entitled to a credit against the United States estate tax for the French inheritance tax, subject to applicable limitations. [28]

On dissolution, a French corporation is subject to income tax at the usual rates on its operating income up to the date of liquidation, including gain from the sale of its assets, on its inventory gain and on any deferred income. In addition, the French corporation is subject to a registration tax on the transfer of its business or clientele at the rate of twenty per cent. In certain instances, as noted above, the sale of shares in a French corporation is treated as the sale of its business, which means that registration taxes and income taxes apply to the French corporation.[29] Payments to a shareholder by a French corporation in liquidation are taxable as dividend distributions, presumably measured by the difference between the liquidating distribution and the shareholder's basis in the shares. [30]

B. *United States Taxes*

1. *Acquisition of Interest.*—The transfer of assets by a U.S. person to a foreign corporation in exchange for shares of the corporation may constitute either a taxable or non-taxable exchange for federal income tax purposes. If the transfer constitutes a taxable sale or exchange, then the gain will be taxed either as ordinary income or capital gain, depending on the character of the assets transferred. [31] Gain from the

26. Convention, *supra* note 18, at art. 12.

27. See text accompanying note 13 *supra.*

28. Convention with France on Double Taxation and Fiscal Assistance, Oct. 18, 1946, art. 5, 64 Stat. (3) B3 (1952), T.I.A.S. No. 1982.

29. See text accompanying note 13 *supra.*

30. C.G.I., art. 161.

31. INT. REV. CODE § 1221. *See also* INT. REV. CODE §§ 1245, 1250 (recapture of depreciation).

sale or exchange of a patent, invention, model, design, copyright, secret formula or process, or any other similar property right to a foreign corporation by an American who owns, directly or indirectly, 50 per cent or more of the voting stock of such foreign corporation is taxable as ordinary income rather than as a capital gain.[32]

If the transfer constitutes a non-taxable exchange,[33] then a ruling prior to the exchange is required in order to render the transaction tax-free.[34] It should be noted that such a ruling may take several months to obtain. If know-how is transferred in a transaction that constitutes a tax-free incorporation under section 351 of the Internal Revenue Code, the transfer will be tax-free only to the extent that the know-how constitutes "property."[35] If a *société à responsabilité limitée* or other French legal entity is used instead of a *société anonyme*, a question may arise whether such a vehicle constitutes a corporation for United States income tax purposes.[36]

A U.S. person who acquires either an initial or additional five per cent or more in value of the stock of a foreign corporation is required to file an information return concerning such acquisitions on Form 959. In addition, United States citizens or residents who are officers or directors of foreign corporations are required to file information returns on Form 959 regarding certain acquisitions of stock in their corporations by U.S. persons.[37]

If the direct investment takes the form of the acquisition of the stock or debt obligations of a foreign corporation, such acquisition may be subject to the interest equalization tax.[38] Currently, the rate of the interest equalization tax applicable to the acquisition of stock is 11.25 per cent. There are, however, various exclusions and exemptions from this tax. For example, the interest equalization tax does not apply to the acquisition by a U.S. person of the stock or debt of a foreign corporation if, immediately after the acquisition, such person owns ten per cent or more of the total combined voting power of all classes of stock of such foreign corporation. This exemption is not

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32. INT. REV. CODE § 1249.

33. *E.g.*, INT. REV. CODE § 351 (tax-free incorporation); INT. REV. CODE § 367 (contribution to capital); and INT. REV. CODE § 368 (tax-free reorganization).

34. INT. REV. CODE § 367; *see* REV. PROC. 68-23, 1968-1 CUM. BULL. 821.

35. *See* REV. PROC. 69-19, 1969-2 CUM. BULL. 288.

36. *See* Abbott Laboratories Int'l Co. v. United States, 267 F.2d 940 (7th Cir. 1959); Treas. Reg. § 301.7701; G.C.M. 9067, X-1 CUM. BULL. 337.

37. INT. REV. CODE § 6046.

38. INT. REV. CODE § 4911.

available, however, if the foreign corporation was formed or availed of for purposes of avoiding the interest equalization tax.[39] Direct investment in France by Americans may also be subject to the foreign direct investment regulations administered by the Department of Commerce. In addition to restrictions on foreign direct investment, these regulations impose reporting and filing requirements on the direct investor.

2. *Annual Taxation.*—A French corporation that is not engaged in trade or business in the United States and not deriving income from United States sources is not subject to the annual United States corporate income tax, notwithstanding the fact that it has United States shareholders and constitutes a controlled foreign corporation or a foreign personal holding company.[40] United States Treasury Regulations indicate that a non-resident foreign corporation is not subject to the accumulated earnings tax or the personal holding company tax if the corporation does not derive income from sources within the United States, even though the corporation has individual American shareholders.[41] Further, despite the fact that 80 per cent or more of a French corporation is owned by a United States corporation, it may not be included in a consolidated income tax return for federal tax purposes.[42]

A foreign corporation owned, directly or indirectly, by U.S. persons may constitute a controlled foreign corporation or a foreign personal holding company. In such case, certain of its U.S. shareholders must include a portion of such corporation's annual income in their annual federal income tax returns, and certain information returns must be filed in respect of such corporation.[43]

A foreign corporation is a controlled foreign corporation if more than 50 per cent of its voting power is owned by U.S. shareholders.[44] A U.S. shareholder is defined for this purpose as a U.S. person who owns, directly or indirectly, or is considered as owning by applying certain constructive ownership rules, ten per cent or more of the combined voting power of the foreign corporation.[45] If a foreign corporation constitutes a controlled foreign corporation, then those U.S. persons who own ten per cent or more of its voting stock are required to include their pro rata share of certain income earned by the foreign

39. INT. REV. CODE § 4915.
40. INT. REV. CODE §§ 881-82; Convention, *supra* note 18, at art. 6.
41. Treas. Regs. §§ 1.532-1(c), 1.541-1(b).
42. INT. REV. CODE § 1504 (b) (3).
43. INT. REV. CODE §§ 551, 951, 6035, 6038.
44. INT. REV. CODE § 957(a).
45. INT. REV. CODE § 951(b).

corporation in their annual federal income tax returns.[46] The income of the controlled foreign corporation that must be reported in the federal income tax return of certain of its U.S. shareholders includes income derived from the insurance of U.S. risks, certain passive income (such as certain dividends, interest and royalties), certain income derived in connection with the sale of personal property that is purchased from or sold to a related person, and certain service income derived in connection with the performance of certain services for or on behalf of a related person.[47] The sales and service income of a controlled foreign corporation would not be taxed to its shareholders, however, if the income is derived from or connected with the country of incorporation of the controlled foreign corporation.[48] The income of a controlled foreign corporation that is taxable to certain of its U.S. shareholders is taxable to such shareholders whether or not such income is distributed to them. It is to be noted, however, that U.S. shareholders who are taxable on the income of a controlled foreign corporation are entitled to a foreign tax credit for the foreign taxes paid by the controlled foreign corporation, even though such shareholders are individuals, if they elect to be taxed at corporate rates on such income.[49]

A foreign corporation will constitute a foreign personal holding company if at least 60 per cent of its gross income for the taxable year constitutes certain passive income (such as dividends, interest, royalties and gain from the sale or exchange of stock or securities) and at any time during the taxable year more than 50 per cent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States.[50] If a foreign corporation constitutes a foreign personal holding company, its undistributed income is included in the gross income of its U.S. shareholders (including U.S. citizens, residents and domestic corporations).[51]

3. *Dividends.*—Dividends paid by a foreign corporation are subject to federal income tax as ordinary income when received by United States shareholders. An American corporate shareholder is not entitled to the so-called "85 per cent dividends received deduction" on dividends from a foreign corporation that is not engaged in trade or

46. INT. REV. CODE § 951(a).
47. INT. REV. CODE §§ 952-954.
48. INT. REV. CODE §§ 954(d)(1)(A)-(B), 954(e)(2).
49. INT. REV. CODE § 962.
50. INT. REV. CODE § 552.
51. INT. REV. CODE § 551.

business in the United States.[52] Furthermore, a dividend in kind received by an American corporate shareholder from a foreign corporation that is not engaged in trade or business in the United States is taxable to the extent of the fair market value of the property distributed, although the distribution will reduce the earnings and profits of the distributor by only the adjusted basis of the property.[53]

Upon receipt of a dividend from a foreign corporation, an American shareholder is entitled to a direct foreign tax credit for the amount of withholding tax imposed on the dividend.[54] In addition, a United States corporation that owns ten per cent or more of the voting stock of the paying foreign corporation is entitled to a foreign tax credit for a portion of the foreign income taxes paid by the foreign corporation and its subsidiaries, subject to applicable limitations.[55]

4. *Interest and Royalties.*—Americans who receive interest or royalties from a foreign corporation are entitled to a direct foreign tax credit for any foreign withholding taxes imposed upon such items.[56] Interest is taxable as ordinary income. Royalties are taxable as either ordinary income or capital gain, depending on whether there was a disposition of all substantial rights in property,[57] or unless there was a disposition to a foreign corporation that is 50 per cent or more controlled by the transferor, in which case the royalties are taxable as ordinary income.

5. *Disposition of Interest.*—An American is normally subject to tax at capital gains rates on his gain from the sale or exchange of the shares of stock of a corporation including redemption or liquidation.[58] If the foreign corporation constitutes a controlled foreign corporation, however, all or a portion of the gain recognized on the sale or exchange by United States shareholders owning ten per cent or more of the voting stock of the corporation is treated as a dividend.[59] The impact of this so-called section 1248 tax may be reduced by passing the shares at death, since the beneficiary receives a stepped-up basis on the shares.[60] It is to be noted that the rules applicable to

52. INT. REV. CODE §§ 243, 245.

53. INT. REV. CODE § 301(b)(1)(C); REV. RUL. 71-65, 1971-6 INT. REV. BULL. 13.

54. INT. REV. CODE § 901.

55. INT. REV. CODE § 902.

56. INT. REV. CODE § 901.

57. INT. REV. CODE § 1249. *See generally* Tax Management Memorandum, TMM 70-20, October 5, 1970.

58. INT. REV. CODE § 1201. *But see* INT. REV. CODE § 302.

59. INT. REV. CODE § 1248.

60. INT. REV. CODE § 1014.

collapsible corporations might apply to the gain from the sale or exchange of shares of stock in a foreign corporation.[61]

No gain or loss is recognized on the receipt by a United States corporation of property distributed in complete liquidation of another corporation, either domestic or foreign, if the recipient corporation owns at least 80 per cent of the voting stock of the liquidated corporation.[62] To make the liquidation of a foreign subsidiary tax-free, however, an advance ruling under section 367 is required. The Internal Revenue Service has indicated that a favorable ruling will be issued only if the domestic corporation agrees to include in its income as a dividend the earnings and profits of the foreign corporation that are attributable to the stock owned by the domestic corporation, although the domestic corporation will be entitled to a foreign tax credit for the foreign income taxes paid by the foreign corporation.[63]

V. Conclusion

This article has outlined the application of the French investment regulations as they pertain to proposed foreign investment in the French economy. In addition, it has examined the United States and French tax laws affecting direct investment in France by United States investors. Because results will vary with each particular application of these regulations and because of the complexity and the frequency of change of the tax and exchange control laws, any contemplated transaction should be reviewed and analyzed with only the most current data.

61. INT. REV. CODE § 341; *see* REV. RUL. 56-104, 1956-1 CUM. BULL. 178.

62. INT. REV. CODE § 332.

63. REV. PROC. 68-23, 1968-1 CUM. BULL. 821.