# Insights: Transfer Pricing

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## Proposed measures to tighten transfer pricing regulations in France

On June 6, 2013 the French Ministry of Finance published a report titled "Task force for comparing international practices in fighting tax avoidance realized via intra-group economic and financial transactions."[1]

The task force was organized by the Inspection Generale des Finances (a supervisory agency within the Ministry of Finance) and visited five countries: Germany, Canada, US, the Netherlands, and the UK.

The report draws three general conclusions:

- France's "weapons" in the area of transfer pricing audits are weaker than those of the visited countries;
- the visited countries do not consider that transfer pricing audits generate a significant and quick growth of tax income; and
- the global transfer pricing discipline is weakened by the attitude of some non-Organisation for Economic Cooperation and Development (OECD) economies and by the debate about replacing the arm's length standard with a system based on a formulary apportionment.

The report analyzes in detail the technical issues related to transfer pricing regulation globally and, more specifically in relation to the features of the French system today. The issues related to "undeclared" permanent establishments (PEs) are mentioned as being particularly difficult to deal with. The report reviews in detail the transfer pricing framework of the five foreign countries and identifies three major weaknesses of the French system compared with the others:

- the arm's length principle is not directly reflected in the French law;
- there is a lack of administrative instructions beyond those covering few specific topics, i.e.: Advance Pricing Agreements (APAs), Mutual Agreement Procedures (MAPs), and transfer pricing documentation; and
- there is a lack of Supreme Court judgments in relation to the application of the arm's length principle.

[1] "Mission de comparaisons internationales sur la lutte contre l'évasion fiscale *via* les échanges économiques et financiers intra-groupe." **http://www.economie.gouv.fr/files/2013-note-IGF-evasion-fiscale.pdf**. The report was published in French; we are not aware yet of an English translation of the report.

The report ends with a list of specific proposals:

- modify the French tax code to include an explicit reference to the arm's length principle;
- modify the rules establishing the burden of proof principles, i.e. shifting the burden of proof from the tax administration to taxpayers for subjects that are considered particularly risky: business restructurings; related entities benefitting from a "privileged" (low) tax regime; recurring losses;
- modify the penalty regime for violations of the transfer pricing documentation requirements (today penalties are applicable on the basis of the assessed amount at a rate that can go up to five percent; the proposal applies documentation penalties on the basis of the total amount of intercompany transactions); [2]
- allow tax authorities access to management accounts of audited companies;
- promote a more frequent utilization of the profit split method; and
- abolish the automatic suspension of the collection of assessed amounts for which the taxpayer has requested a MAP.

Some of the report recommendations are likely to be reflected in the next budget law by the end of the year.

The report seems to be driven by an overall view that more aggressive measures are required to effectively fight tax avoidance in the area of transfer pricing. Most proposals, if implemented, will require all taxpayers to carefully review their practices. In the short term, the issues that would require taxpayers' urgent attention are those related to PE and business restructuring.

## Revival of the permanent establishment issues?

As outlined above, although focused on transfer pricing, the report includes some comments about PE issues, considered to be difficult and linked to transfer pricing.

Up until recently, the French tax authorities have been perceived for many years as mainly choosing the option of challenging transfer prices rather than the PE dimension, in cases where a local subsidiary of a multinational group could potentially be challenged as representing an undisclosed PE of a foreign-related entity. Now there are increasing signs that the climate may be changing. For example, a few days after the report publication, the head of DVNI (the French tax administration's division, dedicated to national and international tax audits of large companies), speaking at a seminar dedicated to the OECD BEPS project, focused his speech on examples of how to identify undeclared PEs of foreign multinationals in France. He stressed in particular the example of a local subsidiary allegedly providing only support services, but in reality performing selling activities. He

[2] In the meantime, a new provision that would require transfer pricing documentation to be sent together with the tax return (instead of just being available at the beginning of a tax audit, under the current rules) has been inserted within the text of a proposed law relating to measures fighting tax fraud and financial crime. The law has already been approved by the main body of the French Parliament and is on a fast track for final approval. The text of the draft's new provision only modifies the delivery terms of documentation and not its content. An overview of current French documentation rules can be found in: Alberto Pluviano, "France and Italy Documentation Requirements—A Comparative View," *Insights: Transfer Pricing*, February 2011: **http://crai.com/uploadedFiles/TP-France-and-Italy-doc-requirements-A1.pdf**.

mentioned the audit technique of interviewing the local customers of the multinational group to establish who is actually concluding contracts with them. This audit technique is already frequently used by Italian tax authorities, but it may lead to misleading results if utilized too aggressively, without proper verification and validation of the reliability of the sources of information.

## Focus on business restructuring

French tax authorities already place a lot of emphasis on auditing business restructuring cases and challenging them.

The proposed shift of the burden of proof to taxpayers would make the defense of situations, where the multinational group estimated that no indemnities were due to a French entity in relation to a business restructuring, much more difficult.

A recent court case[3] illustrates some of the main concerns on the subject and the uncertainties following this court decision. In brief summary, the French tax authorities challenged the lack of indemnity for the transfer of a cash pooling activity (entirely dedicated to group entities, i.e. with no "external" customers) from a French entity to a Swiss entity of the multinational group. The first level Court decision in 2011 supported the position of the tax authorities only modifying (reducing) the assessed amount. In 2013, the Court of Appeal of Paris reversed the first level decision for reasons related to the quantification of the indemnity but didn't take a position about whether or not an indemnity was due.

Conceptually, the arm's length principle should be the main driver to analyze a business restructuring case and therefore the jurisprudence may have a relatively limited influence on other cases. In practice, however, France has a strong judicial culture and a clear principle set by a court decision is likely to influence the tax authorities' behavior. Lacking a clear decision, tax audits are likely to continue to also focus on transfers of purely internal routine functions from a French entity to another foreign entity within a multinational group.

## Conclusion

The introduction of relatively soft documentation requirements in 2010, coupled with the fact that in the meantime other countries' tax authorities have been comparatively more aggressive in transfer pricing audits, has led many taxpayers to consider France as a country where transfer pricing issues could be managed following a "reactive" approach.

The recent developments in terms of PE and business restructuring should drive multinational groups to review their strategy and consider a proactive approach, meaning:

- for PE issues, the groups operating under a model that could raise concerns should consider reviewing the economic and business fundamentals justifying their mode of operation and also monitor the coherence of actual behaviors with the legal framework;

[3] TA Paris No. 0902095, May 11, 2011, NESTLE; CAA Paris No. 11PA02914, February 5, 2013.

- for business restructuring issues (potentially affecting any business, not only because reorganizations are more frequent in today's economy, but also because the French tax authorities are also clearly focusing on the restructuring of internal functions), all multinational groups should consider reviewing the more likely scenarios of future business restructurings and make a preliminary assessment of whether or not, following the principles of Chapter IX of the OECD Transfer Pricing Guidelines, the French entity should be indemnified in case of restructuring. This analysis would be particularly important because Chapter IX places a lot of emphasis on comparability and, therefore, a good analysis performed in advance may lead to identifying good comparables and allowing multinationals to organize their documentation, while a reactive approach may come too late to identify and document a good defense.

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