

French Tax Authorities Issue Transfer Pricing Guide

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The French tax authorities have issued a statement of practice on transfer pricing for small and medium-size enterprises and have announced that the simplified advance pricing agreement procedure might be extended to larger companies.

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The French tax authorities (FTA) have issued a statement of practice on transfer pricing for small and medium-size enterprises and have announced that the simplified advance pricing agreement procedure might be extended to larger companies.

Statement of Practice 4 A-13-06 of November 28, 2006, informs taxpayers that a newly issued booklet called "Transfer Prices -- Guide for SMEs" is now available³ that describes the simplified advance pricing agreement procedure that the FTA puts at the disposal of SMEs that are willing to secure their transfer pricing policies.⁴

The guide is not legally binding and appears to be a road map proposed by the FTA. In that respect, it proves helpful also to larger companies. It is the first official publication from the FTA that describes the practical steps in designing an arm's-length transfer pricing policy. It also contains useful information on the FTA's expectations regarding the definition and justification of a transfer pricing policy.

In light of the success of the simplified APA procedure -- seven SMEs have already applied -- the FTA announced on February 7 at a seminar of the Mouvement des Entreprises de France, an employers' union, that it is considering enlarging the procedure's scope to enterprises that exceed the SME thresholds.

The statement of practice is the latest contribution to a series of measures taken by the FTA over the last two years regarding the APA procedure and double taxation dispute resolution,⁵ including:

- The guidelines that introduced the French APA procedure by the 2004 Amending Finance Bill (under French Tax Procedure Code (FTPC) article L 80 B-7) were codified into law. This measure, which came into force January 1, 2005, granted a legal value to the APA procedure by including APAs among those official positions of the FTA on which taxpayers may rely, and it authorized the FTA to execute unilateral agreements. The measure was noted in a statement of practice dated June 24, 2005.
- The 2004 Amending Finance Bill introduced the suspension of tax collection when a taxpayer introduces a mutual agreement procedure or the procedure set forth by the European Arbitration Convention (codified under FTPC article L 189 A). Because the FTA deadline to collect tax is suspended during that procedure, French taxpayers pay tax at the end of the procedure (based on the agreement between the competent authorities involved), thus limiting the financial cost of the procedure. (The Code of Conduct approved by ECOFIN on December 7, 2004, regarding the European Arbitration Convention recommended the introduction of this provision to EU member states.)
- A new statement of practice was issued February 23, 2006, on the mutual agreement procedure and on the procedure set forth by the European Arbitration Convention. On the latter procedure, the statement of practice takes into account the Code of Conduct approved by ECOFIN on December 7, 2004, regarding the European Arbitration Convention.

Transfer Prices -- Guide for SMEs

The transfer pricing guide seeks to inform SMEs of the tax risks associated with transfer pricing and the measures to prevent or reduce them. The guide is not binding on the FTA (contrary to a statement of practice). Because it is not directed at practitioners, the guide does not enter into detailed technical

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explanations, but provides an overview of the French transfer pricing legislation. The guide also addresses several recommendations from the OECD transfer pricing guidelines.

Chapter One: The Enterprise and Transfer Prices

In the first subchapter, the guide defines major concepts such as transfer prices, associated enterprises, and arm's-length price.

The second subchapter addresses the practical steps that an enterprise must take to define an arm's-length transfer pricing policy, in particular:

Functional Analysis For enterprises carrying out several activities, the guide indicates that management accounts can be used to determine the profitability of each activity. The guide explains that a principal entrepreneur is the enterprise that assumes the main risks and makes the strategic decisions. In general, the principal entrepreneur owns key intangibles (for example, brands, patents, or know-how) and bears the associated costs (for example, research and development, management of the brands, and advertising). The guide says this notion is crucial because within a group, the principal entrepreneur receives the residual profit or loss (that is, the remaining profit or loss once all entities have received arm's-length compensation). According to the guide, a strategy conducted for a limited period (for example, the launch of a new product) can explain additional expenses or a drop-in margin. However, the cost of that strategy must be borne by the entity that, over time, will earn most of the profit resulting from the strategy.

Choice of Transfer Pricing Method The guide describes the five methods recommended by the OECD transfer pricing guidelines. The method must be appropriate for the circumstances; a complex method and detailed documentation could be implemented only for significant transactions.

The resale minus method requires that the functions and risks assumed and the products sold be identical or comparable. If the functions and risks are comparable, differences in products can be accepted.

The profit-split method, in practice, first compensates the routine functions of the parties according to a traditional method before allocating the residual profit according to an appropriate key. The FTA seems to favor a residual profit-split approach rather than a true profit-split approach. The guide indicates that the profit-split method can be of interest to confirm *a posteriori* the results achieved by the main transfer pricing method.

Benchmark Study Publicly available databases can be used to search external comparables, and the guide defines the steps that must be followed in performing a benchmark study:

- Review the characteristics of the goods or services and search for enterprises operating in the same industry (using activity codes), on the same territory, and for the same period as the one for which the transfer pricing policy is being validated.
- Select enterprises that perform the same functions as those of the enterprise concerned.
- Select an independence indicator, which shows the independence of an enterprise vis-à-vis its shareholders. A high independence indicates that the transactions are likely to be performed at arm's length.
- Review the data available on the enterprises to keep only those that have the same profile as the enterprise concerned (for example, turnover, number of employees, existence of intangible assets, and activity limited to the local market).
- Select an appropriate profit level indicator (for example, gross or net margin, return on sales, and operating income/expenses).

Regarding the results of the comparables retained, the transfer pricing policy of the taxpayer should seek to reach the median result of the sample retained, but the result achieved can also be within the arm's-length range, which is defined as the interquartile range achieved by the sample retained.

Chapter Two: The FTA and Transfer Prices

Chapter 2 contains a description of:

- the provisions applicable in tax audits (in particular, article 57 of the French Tax Code, which allows the FTA to reassess non-arm's-length transfer prices, and FTPC article L 13B, which allows the FTA to require specific information from the taxpayer);
- the APA procedure; and
- the international procedures available to avoid double taxation in case of a transfer pricing reassessment (mutual agreement procedure and procedure set forth by the European Arbitration Convention).

This chapter also addresses the transfer pricing documentation. It first reminds readers that, unlike rules applicable in other European countries, the French legislation doesn't require transfer pricing documentation to be attached to an enterprise's annual tax return. However, in a tax audit, the taxpayer should be able to justify its transfer pricing policy. The guide recommends preparing that documentation before any tax audit, and it suggests including the following information:

- relationships between the French enterprise and foreign enterprise (for example, a corporate chart);
- activities performed, the nature of the transactions, financial stakes, methods retained, risks assumed, and assets used by the associated enterprises;
- justification of the compliance of the transfer pricing policy with the arm's-length principle (for example, market analysis, functional analysis, economic rationale justifying the method retained, and benchmark study); and
- practical implementation of cross-invoicing.

The guide also recommends the following:

- keep all documents used to define and implement the transfer pricing policy (for example, correspondence, internal memos, advice from outside consultants, minutes of meetings, or press articles);
- choose a transfer pricing policy that is appropriate in view of the features of the enterprise;
- check the consistency within the group regarding (1) unjustified use of different prices for the same product sold to third parties and associated enterprises; (2) whether enterprise is regularly in a loss position although group is profitmaking; (3) intangible assets with a high value that are not, or are insufficiently, compensated; and (4) a share of the consolidated profit allocated to each group entity.

Appendices

The guide also contains two appendices. The first provides the definition of terms in the guide. The second contains charts that summarize the allocation of functions, risks, and assets among associated enterprises. The FTA often uses these types of charts in tax audits when requesting that the taxpayer provide a simplified functional analysis.

Simplified APA Procedure

The FTA recognizes that the APA procedure can be complex and burdensome, and it proposes to:

- limit the information required to introduce the procedure;
- assist SMEs in performing the functional analysis and in choosing the transfer pricing method;
- perform the benchmark studies on a trial basis and at the request of the SME; and

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- limit the information requested in the context of the annual report that must be remitted by the company once the APA is concluded.

The simplified APA procedure is available to SMEs that fulfill the following conditions (article 44 *septies* -- IV of the French Tax Code):

- they must have fewer than 250 employees and realize a yearly turnover (taxes excluded) of a maximum of €50 million or have a total balance sheet of a maximum of €43 million; and
- less than 25 percent of their share capital or voting rights must be held by one or more enterprises that do not fulfill the conditions above.

The FTA said it would show flexibility in applying those conditions.

Though it is not mentioned in the statement of practice, the unilateral APA procedure is available to SMEs. The FTA gives preference to the negotiation and execution of bilateral APAs; although they should remain an exception, unilateral APAs are available in limited cases (Statement of Practice 4 A-11-05, dated June 24, 2005).

APA Request

The simplified APA procedure is filed with the team in charge of the APA program (Bureau CF3), in the central administration of the Direction Générale des Impôts. In the statement of practice, the FTA recommends the SMEs have a preliminary meeting with Bureau CF3, before any official filing, to describe the APA request. At that meeting, the FTA and SME can discuss the functional analysis and the documentation necessary to support the request.

The statement of practice lists the documents that the SME must provide to support its request:

- a description of the corporate structure of the group;
- a list of transactions with associated enterprises and prices applied;
- a functional analysis;
- a description and justification of the transfer pricing method retained; and
- the tax returns of the foreign companies involved.

In view of the list of documents that was given in the statement of practice of September 7, 1999 -- addressing only the bilateral APA procedure -- this list may seem short. Under the standard APA procedure, the FTA usually requests the following documentation to introduce the APA request (and can request more later):

- a description of the corporate structure of the group;
- the presentation of the group: activity, organization, and main transactions of the companies covered by the APA request;
- a list of the group's competitors;
- for the French entities covered by the APA request and for the three most recent fiscal years: tax returns, a report of the statutory auditors (*commissaires aux comptes*), and a management report (*rapports de gestion*);
- a functional analysis of the entities covered by the request; and
- an economic study supporting the proposed transfer pricing method.
- Although the list of documents requested under the simplified APA procedure does not seem much shorter than that requested under the standard APA procedure, the FTA probably will require less-detailed information under the simplified APA procedure.

Even considering that the APA process requires a certain transparency from the taxpayer, the required

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disclosure of the foreign tax returns of foreign companies seems surprising. In a tax audit, the FTA cannot, in principle, require French companies to provide tax returns of, or financial information on, foreign companies. The FTA can, however, use the exchange of information provisions of tax treaties to obtain that information. Given that an APA seeks to determine the arm's-length allocation of the tax basis between France and at least one other state, the tax treatment of that allocated tax basis should be irrelevant. And handing over foreign tax returns of foreign companies could raise practical issues, particularly if the French SME does not control the foreign company and is not entitled to request them.

In the standard APA procedure, financial data on foreign entities are generally provided only if the retained method makes it necessary -- for instance, as with a profit split. We hope the FTA will follow the same approach in the context of the simplified APA procedure.

Benchmark Studies

The statement of practice indicates that, in principle, the SME should also show that the transfer pricing method applied is arm's length (via internal or external comparables). However, the FTA recognizes that it may be difficult to provide that justification. Consequently, on a trial basis, and at the request of the SME, the FTA could perform benchmark studies in public databases for the SME's account.

This is one of the most interesting aspects of the statement of practice. Given the technicalities and costs associated (either internal costs (access to and use of the databases) or external costs (fees of external advisers)) with the realization of a benchmark study, this proposal may remove a difficulty faced by SMEs when creating and justifying their transfer pricing policy. However, it raises several issues. Depending on the number of SMEs introducing an APA request and requesting assistance from the FTA, the FTA may lack resources to perform the studies. And by performing benchmark studies, the FTA will play an active role in determining the SME's transfer pricing policy. This may seem contradictory to a principle of French tax law according to which the FTA is not allowed to interfere in the management of a taxpayer; more practically, what will happen if the SME disagrees with the FTA's benchmark study?

The FTA seems to have anticipated those difficulties. The performance of benchmark studies for the account of the SME is proposed on a trial basis. Also, the FTA would perform studies at the SME's request. Finally, the statement of practice provides that the benchmark studies would be made in addition to the justifications presented by the SME. The SME should therefore have elements that could give a first indication of the profitability that should be achieved, and the benchmark studies could check the appropriateness of these first elements.

Annual Report

Once the APA is signed, the taxpayer must provide an annual report showing compliance with the APA terms. For SMEs, the statement of practice indicates that the annual report will be limited to the following:

- detailed calculations of the compensations set forth by the APA;
- a description of the substantial modifications to the business conditions mentioned in the APA request.

These elements represent the minimum information that is requested by the FTA for the APA annual report.

Conclusion

As stated in the guide, transfer pricing is a main focus for the FTA during tax audits.

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The publication of the guide and the implementation of a simplified APA procedure for SMEs are additional steps to help taxpayers better understand transfer pricing issues.

This latest development clarifies the general approach of the FTA. The FTA endorses the OECD transfer pricing guidelines and the recommendations of the European Union Joint Transfer Pricing Forum, but, given the complexity of the matter, it also promotes flexibility and favors pragmatic approaches.

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FOOTNOTES

¹ This booklet is available on Internet at www.impots.gouv.fr (documentation -- international). To date, this booklet is available only in French.

² The simplified APA procedure dedicated to SMEs was announced in a statement of practice of June 24, 2005.

³ This booklet is available on Internet at www.impots.gouv.fr (documentation -- international). To date, this booklet is available only in French.

⁴ The simplified APA procedure dedicated to SMEs was announced in a statement of practice of June 24, 2005.

⁵ These measures and the simplification of the APA procedure for SMEs were recommended by the report "Improving the Certainty and Reputation of French Tax Law in Order to Make France More Attractive to Foreign Firms" by Bruno Gibert, *Avocat*, with the assistance of inspectors of finances Corso Bavagnoli and Jean-Baptiste Nicolas, September 15, 2004.

END OF FOOTNOTES

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