Transfer Pricing Forum

Transfer Pricing for the International Practitioner

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France

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

From a general perspective, the French Tax Authorities (FTA) will focus on the usual markers at the French company level that can signal a potential transfer pricing (TP) risk or inaccuracy, namely:

- recurring tax loss position, notably following an initial launching period;
- significant swings in profitability despite no external signs of a business model change;
- significant changes in the balance sheet and/or profits and loss (P&L); or
- intragroup asset sales or any form of official or undisclosed business restructuring (which may be evidenced by a drop in turnover and/or clients for instance).

Of course, transfer pricing audits can also be triggered by the need for the FTA to check:

- whether a previously agreed upon TP position during a former tax audit is still consistently applied;
- whether a transfer pricing position resulting from an advance pricing agreement (APA) or a mutual agreement procedure (MAP) has been appropriately complied with;
- whether a company has amended its TP policy if challenged successfully by a final determination from the tax courts following a tax litigation; or
- a specific TP position, if a possible issue or request has been raised by another tax authority during exchange of information procedures.

Finally, French subsidiaries of MNEs as well as French MNEs themselves are usually subject to general tax audits that will encompass transfer pricing matters on a routine basis, often once every two or three years, with the normal statute of limitations being three fiscal years (FYs) in France. During these routine audits, the FTA will of course expect an update on the following:

- the TP legal documentation (Master/Local Files, agreements, update of the perimeter depending on whether any company has entered or exited the TP perimeter…); and
- the TP economic documentation (notably by updating the FYs over which comparables have been reviewed and other economic studies have been performed).

Beyond these usual "triggers" for a TP audit, other circumstances can lead to an audit or discussions with the FTA.

For instance, the authors have witnessed tax audits focusing on permanent establishment (PE) issues, notably a PE of foreign MNEs at the level of their French subsidiaries, ending in TP discussions. It is indeed rather frequent that if such a PE cannot be characterized by the FTA, the latter considers that the French subsidiary holds more functions or risks than initially considered by the MNE and requires a different or higher remuneration for its role vis-à-vis the MNE's related foreign companies. Similarly, but less frequently, anti-hybrid provisions or other thin capitalization provisions impacting financial interest deductibility can lead to discussions on the appropriate level of an interest rate from a TP perspective. There are of course other examples of non-TP discussions leading to TP debates: a VAT audit can be an opportunity to spot certain operations or flows, the French Digital Service Tax filling requirements can be an opportunity to identify similar elements as well as the DAC 6 Directive (2018/822) provisions implemented in France (under Article 1649 AD and 1649 AH of the French Tax Code, FTC).

Regarding measures and technology used for TP purposes, many tools are and will be made available to the FTA.

First of all, mandatory TP documentation applies to MNEs with annual turnover (*excluding VAT*) or gross balance sheet assets of €400 million or more (L13 AA French Tax Procedure Code (FTPC)). This obligation also extends to legal entities controlling or controlled by a company with annual turnover (*excluding VAT*) or gross balance sheet assets of €400 million or more. Finally, this obligation also applies to legal entities that are members of a tax consolidation group when this group includes at least one legal entity that meets one of the above conditions.

This €400 million threshold is reduced in the 2024 budget law to €150 million (the 2024 budget law was published on September 27, 2023, and is being discussed in the French Parliament). The former Minister of Public Accounts Gabriel Attal announced in May 2023 that the 2024 budget law would include a reform aimed at "making large companies more accountable," which would mean lowering the threshold for mandatory TP documentation. This declaration was confirmed recently in the beginning of June through a press kit, which stated that in order to make companies more responsible for their transfer pricing policy, a potential measure would be to "lower the threshold for transfer pricing documentation. The new threshold could be set at €150 million in sales." The 2024 budget law indeed integrates this new threshold.

This documentation must be made available to the tax authorities during the start of a tax audit (as soon as the auditor goes on the site for the first time). If the company does not produce the declaration (or produces an incomplete one) when the tax audit begins, the tax administration will give it a formal notice to produce or complete it within 30 days.

The company may request an extension of up to two months to produce the declarations. In that case, the tax administration must notify the company of its decision and the newly granted deadline.

If, in the end, the company fails to submit the documentation on time, it risks being fined a minimum of €10,000 (increased to €50,000 by the 2024 budget law) for each year covered by the tax audit, up to the highest of the following amounts:

- 0.5% of the value of the transactions concerned by the documents or additions not forwarded to the tax authorities; or

- 5% of the rectification of income based on Article 57 of the FTC (the Article used to enforce the arm's length principle in French law).

On a digital level, when a company keeps its accounts in an electronic form, where computer processing is envisaged, tax officials (the Brigade de verifications des comptabilités informatisées (BVCI)) will inform the taxpayer in writing of the nature of the investigations required (under Article L47 A of the FTPC).

The following three options are left to the taxpayer:

a) The agents carry out the audit on the equipment used by the taxpayer (who must take all necessary measures to preserve the integrity of the data and the security of the hardware and software).
b) The taxpayer may ask to carry out all or part of the processing required for the audit.
c) The taxpayer may request that the audit not be carried out on the company's equipment. In this case, the taxpayer provides the auditor with copies of the documents, data, and processing required to carry out the audit.

A *Fichier des Ecritures Comptables* (FEC) must be provided to the tax administration before the audit starts and within a maximum of 15 days from receipt of the tax audit notice (under Article L 47 AA,1 of the FTPC).

The FEC is basically an accounting entries file in an electronic format. The copies of files given to the auditor must meet the standards set out by the FTPC (under Articles L47 A, 1 and L47 A, 2). This file allows the auditor to evaluate the data electronically.

Failure to submit the FEC, or submission of files that do not comply with the required standards, may result in a fine of €5 000 or, in the event of rectification and if the amount is higher, an increase of 10% in the taxes payable by the company (under Article 1729 D of the FTC).

The tax administration must destroy the files in their entirety before the tax is assessed or after the notice of non-rectification is sent.

Beyond these general TP measures, documentation, and audit tools, the FTA can rely on other required information including TP content.

First, Country-by-Country Reporting ("CbCR") provisions are applicable under French law. CbCR applies to groups with consolidated annual turnover (excluding VAT) of €750 million or more (under Article 223 quinquies C of the FTC), including companies with foreign branches or companies that own or control, directly or indirectly, entities established outside of France. "Groups" are defined as (under Article 46 quater-0 YE, II of annex III of the FTC) the whole of a legal entity, the subsidiaries included in the consolidated financial statements, and their branches.

The declaration must include financial data expressed in euros (for example: sales, tax paid, capital stock…), information on the group's main activity (e.g., R&D, manufacturing etc…), and a list of the group's entities and their activities.

The declaration must be filed in electronic format within 12 months of the end of each financial year (failure to transmit the documents may result in a fine of up to €100,000 under Article 1729 F of the FTC). Obviously, at the MNE level, this disclosure can be key to identifying operations that lead to debatable profit shifting.

Also, certain French companies have to file an annual TP "short form" (Cerfa #2257). This short form must be filed by companies with annual turnover (excluding VAT) or gross balance sheet assets of €50 million or more (under Article 223 quinquies B of the FTC**)**. This obligation is extended to companies that are owned directly or indirectly by an entity or that owns directly or indirectly an entity that passes this €50 million threshold. This obligation also applies to companies that are members of a tax consolidation group when this group includes at least one legal entity that meets one of the above conditions.

The TP short form contains general information about the group (such as a description of the activity, a list of the main intangible assets, and a general presentation of the group's TP policy…) and some specific information about the company (summary statement of transactions with associated companies when the aggregate amount by type of transaction exceeds €100,000, presentation of the TP policy…).This short form can be a useful and an easily exploitable document to identify any year-over-year changes at the company level, for instance.

From a technological perspective, the FTA can use data mining tools to identify possible TP issues or discrepancies. This technology was first introduced in 2014 with the creation by the tax authorities of a specific unit dedicated to the use of AI tools. Since then, data mining has taken a dominant place in targeting tax audits. In 2022, half of the tax audits (52%) were started using data mining. Moreover, with the forthcoming reform of electronic invoicing (initially planned for July 2024 but postponed by the forthcoming 2024 budget law), the FTA will have greater access to data, and will be able to carry out consistency checks on transfer pricing.

In particular, the reform provides for data to be transmitted almost continuously to the tax authorities for outgoing flows (i.e., intra-Community deliveries and exports) and incoming flows (i.e., intra-Community acquisitions). The tax authorities will then have access to data (such as the FEC and management data) that will enable them to carry out more in-depth consistency checks on groups' transfer pricing policies using AI and data mining technology, in particular.

Former Minister of Public Accounts Gabriel Attal also stated that for tax audits, "priority will be given to auditing the largest groups, while strengthening tax support for businesses."

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

TP audits can be performed by the local tax authorities based upon the corporate domicile of the concerned company.

At the central level, a specific division of tax audit is in charge of the largest taxpayers and international matters, including TP, and is called the *Direction des Verifications Nationales et Internationales* (DVNI). Responsible for auditing large/multinational companies (sales in excess of €152.4 million and services in excess of €76.2 million), the DVNI is made up of some 30 brigades specialized in the economic sector and 9 brigades specialized in computerized accounting systems, for a total of some 350 public finance inspectors in the field. The BVCI also assists the general brigades with audits.

Once the TP documentation has been provided at the start of the tax audit, and assuming the concerned tax audit is a contentious one, which is the most usual (jeopardy assessments require either fraud or undisclosed activities or severe accounting failures to be implemented), back and forth exchanges will take place between the taxpayer and the tax inspector. During exchanges of information and Q&A, both in physical meetings and by email or written correspondence, the tax inspector will ask questions or more directly challenge the documentation provided. If at the end of this adversarial process the tax inspector is not satisfied with the information or answers provided, he or she will inform the taxpayer and its advisers of the prospective tax reassessment and its basis during the final summary meeting (*réunion de synthèse*), before a written notice is given to the taxpayer, laying out the details of the position of the FTA. From there, the normal course of appeals, claims, and tax procedure, followed by tax litigation, can proceed.

Each TP case is different, but the main tendencies we can identify from recent tax audits in terms of approaches from the FTA are:

- There is a tendency to shift the burden of proof to the French taxpayer. Indeed, while comparable studies from the taxpayer and their advisers have often been criticized or challenged by the FTA, sometimes the concerned tax inspector does not have its own study allowing it to sustain its position or disclose contemporaneously its own set of comparables, which would allow the taxpayer to conduct a similar critical review.

  There are some situations where the requests for justification go beyond the territorial scope of a French tax audit. For instance, on certain centralized management fee flows or cost sharing arrangements, the FTA can require a full breakdown and justification of costs or allocations to non-French entities, which leads, in practice, to a critical review or audit of non-French entities and/or to use this information to challenge the deductibility of the share of services borne by the audited French company. This also means that a significant volume of foreign entity-related information will be requested. The authors have also seen requests to provide the Master File of foreign parent companies of French subsidiaries subject to a French tax audit, or at least excerpts from such a File, leading to confidentiality issues.
- The FTA tends to challenge the systematic use of the transactional net margin method (TNMM) and cost plus methods for complex transactions or even for distributor companies with a certain level of functions or risks. As seen in other countries, the approach from the FTA tends to use profit sharing methods as the preferred method or at least use it to test the profitability level achieved by a TNMM or cost plus method. This approach has been confirmed during a seminar with the Head of the central tax audit services, Mr Frédéric Iannucci, during summer 2022.
- The authors have seen a significant number of TP reassessments resulting in settlements between the FTA and the taxpayers, before any tax litigation has started.

Also, a new mechanism enabling officials from EU member states' tax administrations to take part in joint tax audits has been implemented in the FTPC (since January 1, 2023, under Article L45 of the FTPC). As such, they may, with the authorization of the competent authorities, assist or participate in administrative procedures taking place in France or in the territory of one or more other EU member states. The information obtained may be used against taxpayers in accordance with the control procedures applicable in France. This procedure is new; thus, there is still very limited practical experience from it.

In addition, the legislature has already planned to extend the powers of administrative officers (starting January 1, 2024) of other EU member states by granting them the power to:

- question taxpayers and examine documents; and
- collect evidence during tax audits.

Regarding the burden of proof, the French transfer pricing regulations state that the tax authorities bear it. However, it is in fact not so clear-cut in practice, as the authorities tend to shift the burden to the taxpayer.

An example of this is the case SA Tropicana, Administrative Court of Appeal of Douai (*"Cour administrative d'appel"*), 25 August 2022, N°20DA01106.[1]

In this case, the tax authorities considered that they were not required to prove the existence of a dependence because a company was located in a privileged tax country (Under Article 238 A of the FTC, a "privileged tax country" means a country where the company is not taxable, or is subject to taxes on profits or income that are 40% or more lower than the tax on profits or income for which they would have been liable under ordinary French law, had they been domiciled or established in France).

The Court of Appeal found that this demonstration was insufficient since a low rate of corporate income tax does not prove the existence of a privileged tax regime, which made it impossible for the tax authorities to rely on such a regime in order to be exempt from establishing the existence of links of dependence. However, the authorities, who had the burden of proof, did not establish any relationship of dependence between the two companies within the meaning of Article 57 of the FTC.

Many decisions issued by the French Supreme Administrative Court (*"Conseil d'Etat"*) show that the basis of the application of Article 57 of the FTC is the dependence between related parties involved in the transactions. The *Conseil d'Etat* ensures that the burden of proof lies with the tax authorities and has not hesitated to reject the tax authorities' position if their case was not adequately proven.

Examples of relevant decisions include:

On one hand, a recent decision from the Administrative Court of Appeal of Lyon, 25 May 2023, N°21LY03690[2] shows that the burden of proof falls on the FTA, which needs to wisely choose the comparables when trying to demonstrate indirect profit transfers based on Article 57 of the FTC.

In this case, the tax authorities had compared a French company's net margin rate, calculated after the deduction of financial expenses, with that of independent companies with no financial functions, using a sample of 14 independent companies.

However, even if the activity or turnover was similar, the products distributed by the applicant were solely intended for the industrial sector, whereas the sample of comparable companies selected by the tax

[1] https://juricaf.org/arret/FRANCE-COURADMINISTRATIVEDAPPELDEDOUAI-20220825-20DA01106
[2] https://www.legifrance.gouv.fr/ceta/id/CETATEXT000047624987?init=true&page=1&query=21LY03690&searchField=ALL&tab_selection=all

authorities included companies that were selling to private individuals, and companies that distributed household equipment to professionals for resale to private individuals.

In this respect, the margin differences observed by the FTA were explained by the difference in situation between the French company and nine companies on the panel.

While the remaining five companies were, by the French company's own admission, relevant comparables, their operating margins appeared consistent with the margin levels it had achieved.

The Administrative Court of Appeal concluded that, in the absence of appropriate comparables, the FTA had not established the existence of an advantage by comparison and therefore could not invoke the presumption of Article 57 of the FTC.

On the other hand, two decisions from the Administrative Court of Appeal of Paris, 1st of March 2023, n°21PA06438[3] and n°21PA06439[4] seemed to cast doubt on the burden of proof.

In these two decisions (with identically worded rulings), the facts were as follows: a French company marketed goods abroad, either through subsidiaries or independent sales agents, depending on the territory.

The FTA considered the difference between the intermediation commission paid to subsidiaries (similar to what the company would get acting as a direct reseller) and that paid to independent agents (20% of selling price) to be unjustified, and therefore qualified it as a transfer of profits abroad.

In this case, the Administrative Court of Appeal of Paris seemed to largely limit the comparison of factors examined as evidenced by the following:

- the Court did not draw any conclusions from the fact that the markets compared were significantly different geographically and strategically; and
- with regard to the functions performed, a key point in determining remuneration, the Court noted the taxpayer's argument that its subsidiaries performed far more important functions than third-party agents, even when they acted as intermediaries, but nevertheless concluded that the documents it produced were not sufficiently conclusive.

[3] https://www.legifrance.gouv.fr/ceta/id/CETATEXT000047259053?init=true&page=1&query=21PA06438+&searchField=ALL&tab_selection=all
[4] https://www.legifrance.gouv.fr/ceta/id/CETATEXT000047259054?init=true&page=1&query=21PA06439&searchField=ALL&tab_selection=all

This decision raises questions about the burden of proof: if the French company seems, on reading the decision, not to have provided sufficient evidence to justify a functional difference, it can legitimately be asked what evidence is in the file on the basis of which the tax administration is able to provide proof that there is no functional difference and therefore the remuneration between the subsidiaries' activity as agents and that of the independent intermediaries should be identical.

As a side note, the 2024 budget law introduces a new mechanism to "make the documentation in which companies present their own transfer pricing policy enforceable against them. This measure will require them to justify any failure to apply their own policy, and to demonstrate compliance with transfer pricing rules." As a result, the TP documentation would therefore be enforceable against the company, and the burden of proof would be reversed in cases where a company would fail to apply its own transfer pricing policy.

The 2024 budget law also provides that the tax authorities now have the option of adjusting the value retained in the context of a transfer of a hard-to-value intangible (HTVI), on the basis of results subsequent to the financial year in which the transaction took place. To help the tax administration control this type of transfer, the limitation period is extended to the sixth year following the one in which the tax is due.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

The first, obvious, preparation is to have TP documentation ready before any tax audit starts, in order to provide it upon first notice at the start of the audit, and to ensure it is as contemporaneous as possible.

Also, a law dated August 10, 2018, known as "ESSOC", has promoted trust in relationships between users, both individuals and companies, and the administration. In particular, this law introduced the right to error, a mechanism to encourage spontaneous regularization (before or during a tax audit). The right to error allows a correction without paying a penalty when the company has made an inaccuracy or omission in a tax return. It does not apply to recidivists or to errors made in bad faith.

Under the regularization procedure, which can encompass TP matters, the taxpayer will have to pay the additional tax resulting from the correction of the inaccuracy or omission, to which the interest on arrears representing the cost of time may be added, but no surcharges or fines.

In a similar vein, France has an advance pricing agreement (APA) mechanism. The French APA guarantees the company that the prices charged in its intra-group (industrial, commercial, or financial) relations do not constitute a transfer of profits within the meaning of Article 57 of the FTC.

Prior to carrying out transactions between affiliated companies, the APA procedure determines a set of appropriate criteria (notably the method to be used, the elements of comparison, and the main assumptions as to future trends), enabling the transfer price applicable to these transactions to be set for a given period (generally 5 years).

This APA constitutes a formal position taken by the tax authorities and is therefore enforceable against them (tax ruling under Article L80 B, 7° of the FTPC), securing the future TP position from a tax audit or litigation perspective.

According to EU statistics, 28 APAs were granted by the FTA (15 EU and 8 non-EU) out of the 44 requests (26 EU and 18 non-EU) made in 2021.

In addition, the Tax Compliance Service (*Service de mise en conformité fiscale* SMEC) is a creation of the ESSOC law and it allows companies to regularize their situation before a tax audit. The mechanism applies in particular to tax irregularities discovered, before or after takeovers, by the new owners and transferees of a company.

All operations liable to attract the 40% surcharge for deliberate failure to comply with tax legislation (under Article 1729 a, of the FTC) concern entities whose tax returns are filed with the department responsible for large companies (DGE). Companies will be required to pay the tax that was evaded but that did not fall under prescription, together with the corresponding penalties and fines.

The spontaneous nature of the company's approach is taken into account by adjusting the rates of the applicable surcharges and late payment interest by means of a settlement. The tax compliance service applies a penalty scale known in advance:

- 80% goes down to 30% (interest reduced by 40%);
- 40% goes down to 15% (interest reduced by 40%);
- 10% goes down to 0% (interest reduced by 50%).

A general tax ruling does exist in French law but was not designed to deal with transfer pricing issues. Therefore, only the APA mechanism (under Article L80 B, 7° of the FTC) can enable a taxpayer to secure its transfer pricing policy with the FTA.

Furthermore, for intra-group asset sales, the French APA does not secure the valuation adopted by the company, but only the method used to determine the fair remuneration. The FTA state in their official documentation that "the agreement concerns the method to be used and not the setting of transfer prices as such within the multinational group."

Finally, the mutual agreement procedure (MAP) is hardly an appropriate tool to secure future disputes because its very nature is to intervene, post-tax audit, to settle an already existing discussion and possible double taxation between States. The FTA is very reluctant to use the MAP as a tool for this purpose, even if in practice, the concerned taxpayer can maintain the same position for fiscal years beyond the ones covered by the MAP.

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