Transfer Pricing Forum

Transfer Pricing for the International Practitioner

Bloomberg Tax

Volume: 14 Issue: 1

OCTOBER 2024

pro.bloombergtax.com

France

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1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

The French tax authorities will scrutinize any situation which could demonstrate a transfer pricing anomaly regarding contract manufacturing operations, such as drastic changes in profitability and/or recurring tax or accounting loss position. In such a situation, the French tax authorities may consider that a contract manufacturer should be structurally profitable, given its routine operations, and thus generate a low but guaranteed net margin from its operations, or be sheltered from profit variations.

It is therefore crucial to be able to explain such changes, particularly if they are justified by contractual documentation providing for certain adjustments or risk allocations explaining a temporary loss position or drop in profitability, or by market or other exceptional circumstances (such as an industrial incident on the manufacturing site or transport circuit, temporary rise in raw material costs, strikes, etc.).

The conversion of an entrepreneur or full-fledged manufacturer into a contract manufacturer, in the course of so-called "business restructuring" or similar operations. This situation can lead to two different types of risks. The French tax authorities may request an indemnification or characterize the taxable transfer of the clientele or business out of the French company to another related company, leading to a corporate income tax and registration duties reassessment at the respective rates of 25% and 5%, applied over the value which has been deemed transferred by the authorities.

As an illustration of this focus, Article 116 of the French 2024 Finance Act, in alignment with the OECD Transfer Pricing Guidelines, introduces new provisions for the valuation of intangible assets in transfers between associated enterprises by adding Article 238 bis-0 I ter to the French General Tax Code ("CGI").

Consequently, the tax administration is authorized to adjust the transfer value of a hard-to-value intangible asset based on financial results obtained after the financial year in which the transaction took place (see new Article 238 bis-0 I ter of the CGI). The notion of hard-to-value intangible assets refers to the definition in E.2 of EU Council Directive 2011/16 (DAC 6) (see also: CGI, art. 1649 AH, II, E, 2°), which covers assets for which no reliable comparables exist at the time of transfer, and where the projections of future cash flows or expected revenues are marked by a high degree of uncertainty, making it difficult to assess their future success.

However, the tax administration is not entitled to challenge the value determined under the following circumstances:

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- Where the taxpayer provides detailed information on the forecasts used at the time of the transfer to establish the pricing. This could include the consideration of risks and reasonably foreseeable events and their likelihood, and demonstrate that the significant variance between these forecasts and actual results is either due to unforeseen events at the time of pricing, or to foreseeable events whose probability was not significantly underestimated or overestimated at the time of the transaction;
- Where the transaction is covered by a bilateral or multilateral advance pricing agreement in effect for the relevant period between the states of the transferor and transferee;
- Where the discrepancy between the valuation based on forecasts made at the time of the transaction and the valuation based on actual results is less than 20%;
- Where a five-year commercialization period has elapsed since the year in which the asset or right first generated income from an unrelated entity and, during this period, the difference between the initial forecasts and actual results is less than 20%.

From a procedural point of view, Article 116 of the French 2024 Finance Act also extended the tax authorities' statutes of limitation for such disposals, which now extends to the end of the sixth year following the year in respect of which the tax is due (see new Article L.171 B of the French Tax Procedure Code). In addition, the tax authorities are authorized to verify such disposals without this being considered a repeat of a tax audit (as provided in the amendment to article L.51 of the French Tax Procedure Code).

These new rules apply to fiscal years beginning on or after January 1, 2024, and will enable the authorities to reassess any form of transfer of clientele, business or "hard-to-value IP," such as trademarks or patents to which a business is attached.

It is therefore crucial to investigate whether a formal or informal/de facto transfer of assets, functions, and/or risks has occurred and should be remunerated for the transferee and if so, to determine, usually using a mix of several valuation methods, a fair market value for this transfer.

The authorities may also consider that transfer to be not effective in the absence of major changes at the level of the former entrepreneur entity. This could be the case if the bulk of the workforce and key personnel remain with the parent company, and/or if the clientele are still mainly in contact with or are developed and managed by the former entrepreneur. In such a case, the authorities will reassess the company to increase its profits or profitability up to their former levels. This assessment will be dependent on the circumstances and which assets, functions, and/or risks have been considered transferred.

It is key to ensure that there is no mismatch between the contractual documentation justifying the qualification and the remuneration of the involved parties, on the one hand, and their actual roles in the operations on the other hand, to avoid or at least limit the risk of reassessment by the tax authorities.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

As a preliminary remark, it should be noted that the French authorities' approach to benchmarking and remuneration method for contract or toll manufacturing activities would not diverge from the OECD positions in this respect.

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The French authorities would therefore determine whether a CUP method can be applied, in accordance with the OECD Guidelines (Part II, B.1, 2.18), before considering other methods, preferably the cost-plus method (Part II, D.1, 2.45). This is corroborated by the SME Guide to Transfer Pricing issued by the French tax authorities (page 16). This SME guide also emphasizes the fact that cost-plus methods are not appropriate in the case of sophisticated manufactured products or if IP (patents/know-how) are intensively used in the manufacturing operations. Therefore, a cost-plus method will, unsurprisingly, be considered appropriate for limited risk manufacturers only, contrary to manufacturing operations performed by entrepreneur entities or manufacturers using valuable IP or undertaking complex functions or bearing significant risks. Finally, these general principles are also confirmed by the French administrative guidelines (BOI-BIC-BASE-80-10-10).

a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;

The more limited functions and risks held by a toll manufacturer when compared to a contract manufacturer would imply a more limited remuneration level but should also prevent the toll manufacturer from any risk regarding raw materials (such as risks of loss, variations in purchase prices, and/or foreign exchange risks…).

In the context of this article, we consider the term "contract manufacturer" to refer to situations where the manufacturer purchases the essential inputs needed to manufacture the products and then sells the manufactured products to its client. The contract manufacturer also owns the manufacturing assets required for its production activities. Similarly, we consider the term "toll manufacturers" to refer to situations where the manufacturer does not purchase the essential inputs needed for its manufacturing activities but that such inputs needed to manufacture its products are made available by its principal/client. As compared to the contract manufacturer, we consider the toll manufacturer to own the manufacturing assets required for its production activities.

In practice, it is particularly difficult to identify toll manufacturers on commercial databases typically relied upon to perform comparable company searches. Based on experience, independent toll manufacturers are typically also involved in contract or full-fledged manufacturing activities, making it difficult to identify pure independent tollers on commercial databases. Absent the availability of internal comparable data accessible to the taxpayer where one would observe the remuneration of toll manufacturing activities, the approach to determine the remuneration of a toll manufacturer often entails relying on contract or full-fledged manufacturers and attempting to perform some adjustments.

The typical adjustment entails a working capital adjustment. Considering its profile, the toll manufacturer should not own significant inventory of input products required for its manufacturing process. This may be different from contract and full-fledged manufacturers, where we would expect them to have such inventory. Similarly, a working capital adjustment relating to the accounts payable and accounts receivable may also be considered to reflect any difference in terms of financial risks assumed by the toll manufacturer when compared to full-fledged or contract manufacturers.

A broader issue relates to the need to adjust for what one could refer to as functional intensity. To the extent that there are such differences, one may wish to contemplate an adjustment. We have seen taxpayers argue that the toll manufacturing status of the tested party may lead to targeting the lower end of the interquartile range of returns (where return on total costs is a commonly used profit level indicator (PLI)). While pragmatic, this approach may not be reliable in all circumstances. In particular, if

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the input costs are a significant part of the cost base of a contract or full-fledged manufacturer, considering that such costs would be absent from the toll manufacturer's cost base, applying a cost based PLI observed from the contract manufacturer may lead to under remunerating the toll manufacturer. This would particularly be the case in situations where the contract manufacturer and the toll manufacturer own similar industrial assets. In such a case, we would strongly encourage the taxpayer to consider an adjustment to the remuneration of the toll manufacturer in order to ensure suitable levels of comparability. In practice however, a solution would be to rely on an asset-based PLI, albeit not widely used in France at this stage. This is perhaps due to the fact that taxpayers and tax authorities may be reluctant to rely on statutory accounting data to determine such PLI, as balance sheet data in this form may not necessarily reflect the market value of the assets. Yet, from a comparability standpoint, this remains an issue that needs to be addressed when evaluating the remuneration of toll manufacturers.

b. Adjustment for a contract manufacturer with capital intensive operations;

The increased function and risks associated with capital intensive operations should be reflected in the remuneration of a contract manufacturer (higher remuneration for higher added value functions), as this would be expected to be reflected in a third-party arrangement.

Everything else being equal, capital-intensive operations should translate into higher levels of tangible assets in the balance sheet of the contract manufacturer, relative to manufacturers involved in less capital-intensive activities. In the case of a toll manufacturer, we believe that a possible answer lies in a careful review of the balance sheet data and considering an asset-based profit level indicator. While such asset-based indicators are commonly used in transfer pricing analyses in North America, they seem to be much less relied upon in France, perhaps for the reasons mentioned above.

At any rate, even if a profit and loss statement based PLI is relied upon (such as return on total costs), it is clearly worth checking the comparability of the comparable companies in terms of asset intensity, and we would strongly recommend the taxpayer to consider an adjustment if there are large differences in terms of asset intensity between the tested party and the comparable. While a detailed discussion of such adjustments is beyond the scope of this article, checking the return on assets of the comparable companies and testing the correlation between return on assets and return on total costs for the comparable may be a way to ensure that a profit and loss based PLI does not lead to overly distorted results.

c. Capacity utilization for the contract manufacturer and implications for transfer pricing;

Capacity utilization can impact the pricing of certain transactions, for instance by way of discounts based upon product volumes ordered by the manufacturer's client or use of certain available production capacities of the manufacturer, as t would be reflected in a third-party transaction.

In our view, capacity utilization needs to be analyzed in the context of the risk framework developed in the OECD Transfer Pricing Guidelines (paragraphs 1.56 to 1.106). In our experience, capacity utilization is often a consequence of the materialization of strategic and marketplace risks. In this context, the OECD recommends ensuring that an entity that assumes such risks has the means to control such risks, as well as the financial means to assume those risks. The OECD risk framework was substantially revised in the 2017 version of the OECD Transfer Pricing Guidelines. It is certainly not the simplest part of the Guidelines, yet it does offer a detailed framework. In the (rare) instances where we have had to rely on this framework in the context of tax audits in France, it has proven very useful in framing the discussion

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with the tax authorities. As long as the risk related capacity utilization is borne by both the comparable companies and the tested party, then no adjustment is needed. Otherwise, an adjustment is needed to reflect the risk differential. Such an adjustment can, for example, be based on a measure of volatility whenever comparable companies are exposed to capacity utilization risk while the tested party is not.

d. Any other considerations.

We often witness situations where the application of the cost-plus method to related non-French manufacturers are challenged at the related French distributor end. In these situations, notably for limited-risk distributors, the French authorities are likely to require the application of a TNMM method to determine a distribution margin and therefore challenge a cost-plus method under which the non-French manufacturer will enjoy a structural profit position. This is notably the case for industries impacted by a general decrease in end-customer demand or prices, or higher/new regulations impacting the distribution functions profitability. A Supreme Court case in the medical devices industry illustrates this situation (French Supreme Court, June 6, 2018, n°409647, SCS General Electric Medical Systems). This position is likely to create a conflict between the use of a cost-plus method at the manufacturer's end, and a TNMM at the distributor's end, requiring the determination of which entity is the actual entrepreneur. These conflicts can be anticipated and resolved via bilateral or multilateral APAs but can also lead to double taxation and conflicted views between the tax authorities involved regarding the profiles of the parties and the appropriate remuneration method.

Also, for routine manufacturers, both the French tax authorities and courts will expect that a cost-plus method will apply to a full, direct and indirect cost base. This is illustrated by an Appeal Court decision (Bordeaux Administrative Appeal Court, October 29, 2020, n°18BX03395), which ruled that a so-called "marginal cost-plus" based upon variable costs and only a 25% of fixed costs should be challenged and replaced by a full cost base, including all direct and indirect manufacturing costs, given the routine nature of the operations held by the manufacturer and its lack of entrepreneur profile.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;

b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;

c. Other issues pertaining to government subsidies or grants.

In third-party contractual relationships, the impact of such subsidies or grants to the manufacturer is likely to be considered when determining the pricing for the manufacturing operations. Therefore, in a transfer pricing intragroup context, this impact should also be considered. This approach has been illustrated by a recent case which, even if it relates to R&D services invoiced between related parties, should apply in a manufacturing context. Indeed, the Versailles Administrative Appeal Court ruled that the benefit of the French R&D tax credit, which is a form of public subsidy, should impact the level of R&D services to be recharged by a French service provider to a related service beneficiary (Versailles Administrative Appeal Court, March 29, 2022, STMicroelectronics Alps, n°20VE02081). In this case, the cost base used for the recharge of these services was reduced by the amount of R&D tax credit granted to the French service

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provider by the French State. This decrease in the cost base was challenged by the French tax authorities, but the Versailles Court ruled that this decrease was not, per se, an abnormal transfer of profit between the two companies, while the authorities had not demonstrated that third parties would not factor the impact of subventions or related tax credit in the pricing of their transactions. This position reiterates an older position from the French Supreme Court (Philips France, September 19, 2018, n°405779), which dealt with the impact of public subsidies over the cost base of intragroup services.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

It would be expected, notably for low-risk contract manufacturers and even more for toll manufacturers, that any financing or FX rate cost in relation to their activities would be reflected when their remuneration is determined. Since typically financing or FX costs are not included in the cost base when a cost based PLIs is relied upon, we would expect an adjustment to the PLI to be performed if the comparable companies relied upon to set the cost-based return were to incur significantly different financing or FX related costs.

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