31.

France

Introduction

Statutory rules on transfer pricing adopt the arm's-length principle for cross-border related party transactions. In addition, a considerable number of court cases deal with issues relevant to transfer pricing, which aids in the interpretation and application of the legislation. In parallel with increased resources within the tax administration, recent legislative developments emphasise the focus of the French Tax Administration (FTA) on transfer pricing issues through new rules for documentation as well as tax measures against tax evasion.

Statutory rules

The following main statutory rules address transfer pricing:

- Section 57 of the French tax code (*CGI – Code Général des Impôts*).
- The concept of *acte anormal de gestion* (an abnormal act of management) also allows the FTA to deny tax deduction for expenses which are not related to normal acts of management or could not be deemed to have been incurred for the benefit of the business. The courts decide whether this concept applies by comparing the commercial practices of the company under review with what they judge to be 'normal' acts of management.
- Sections L 13 AA, L 13 AB and L 13 B of the tax procedure code, which set out transfer pricing documentation requirements.
- Section L 188 A of the tax procedure code.

The FTA also released a transfer pricing guide dedicated to small and medium enterprises in November 2006.

In theory, the tax authorities may choose whether to apply Section 57 or the concept of *acte anormal de gestion* when questioning a transfer pricing policy. In reality, this element of choice is likely to be removed by the limitations of each regulation. Section L 13 B reinforces the French Revenue powers of investigation by imposing information requirements in case of a tax audit involving transfer pricing. This law facilitates the application by the French Revenue of Section 57. Section L 188 A extends the statute of limitations when the French Revenue requests information from another state under the exchange of information clause of the applicable tax treaty.

Section 57 – Indirect transfer of profits

Section 57 was introduced into the French tax code on 31 May 1933, and has been regularly updated since this date.

Section 57 provides that 'To determine the income tax owed by companies that either depend on or control enterprises outside France, any profits transferred to those enterprises indirectly via increases or decreases in purchase or selling prices, or by any other means, shall be added back into the taxable income shown in the companies' accounts. The same procedure shall apply to companies that depend on an enterprise or a group that also controls enterprises outside France'.

It may be applied only in relation to cross-border transfer pricing issues. Enforcement of Section 57 requires the tax authorities to prove that a dependent relationship existed between the parties involved in the transaction under review and that a transfer of profits occurred. However, it is not necessary to prove dependency when applying Section 57 to transfers between entities in France and related entities operating in tax havens.

Dependency can be legal or *de facto*. Legal dependency is relatively easy for the tax authorities to prove. It is defined as direct control by a foreign entity of the share capital or voting rights of the French entity under review. It can also mean dependency through indirect control, such as through common management. *De facto* control results from the commercial relationship that exists between two or more enterprises. For example, where the prices of goods sold by A are fixed by B, or where A and B use the same trade names or produce the same product, there does not have to be any direct common ownership. However, the fact that a large proportion of two or more companies' turnover results from transactions conducted between themselves does not necessarily mean that there is *de facto* dependency. The Tax Administrative Court of Paris ruled on 13 February 1997 that there was de facto control in the following situation: One French company in charge of the distribution of books published by a Swiss corporation was using personnel and equipment provided by a subsidiary of the Swiss entity, had the same management as the Swiss entity, and had authority on the choice of books to be distributed.

A transfer of profits may be inferred where, for example, transactions occur at prices higher or lower than prevailing market prices. This includes all types of transactions, including commodities, services, royalties, management services or financing.

Acte anormal de gestion

This concept, which derives from Section 39 of the CGI, was developed by the *Conseil d'Etat* (CE), the French supreme tax court in charge of corporate income tax issues.

For the determination of taxable income, expenses are tax deductible only to the extent that they are incurred for the benefit of the business or within the framework of normal commercial management.

To invoke the concept of an *acte anormal de gestion*, it is necessary to prove that a transfer of profits has taken place and that there was a deliberate intention to move profits or losses from one taxpayer to another. It may be applied to domestic and international transfer prices as well as to corporations or branches.

Under this concept, a tax deduction may be refused for charges not incurred for the benefit of the business or not arising from normal commercial operations.

Section L 13 AA – Transfer pricing documentation requirements

The Amended Finance Act for 2009, passed on 31 December 2009, introduced into French law new requirements for transfer pricing documentation. Following the adoption of the new documentation requirements, the FTA recently released specific guidance to clarify the transfer pricing documentation law (Regulation 4 A-10-10). The new general transfer pricing documentation requirements apply to tax years beginning on or after 1 January 2010 and to any one of the following types of entities located in France:

a. With turnover or gross assets on the balance sheet exceeding 400 million euro (EUR).
b. That hold directly or indirectly more than 50% of capital or voting rights of a legal entity mentioned in (a).
c. With more than 50% of their capital or voting rights held directly or indirectly by a legal entity mentioned in (a).
d. That benefit from a ruling granting a worldwide tax consolidation regime.
e. That are part of a French tax group in which at least one legal entity of the tax group meets one of the requirements mentioned under (a), (b), (c) or (d).

The regulations state that the permanent establishments are also within the scope of the transfer pricing documentation requirements.

The new law requires formal and compulsory transfer pricing documentation, including the following information:

- General information on the group:
  - General description of the activity, including changes occurred during the audited years.
  - General description of the legal and operational structures forming the group identifying the related companies engaged in the intragroup transactions.
  - Description of the functions performed and of the risks borne by the related companies to the extent they have an impact in the audited company.
  - Identification of main intangible assets having a link to the audited company (e.g. patents, trademarks, trade names, know-how, etc.).
  - Broad description of the transfer pricing policy.

According to the administrative regulations, such general information should allow the FTA to understand the economic, legal, financial and fiscal environment of the group. The main entities of the group must be presented, with a level of detail depending on the importance of their activity within the group, but also depending on how much their functions and assets impact the group's transfer pricing policy.

- Specific information on the audited company and on the transfer pricing policy. In particular, the following elements should be provided:
  - Description of its activities, including changes that took place during the audited period.
  - Information on operations carried out with related parties, including nature and amount of flows (global flows per category of transactions; this covers royalties in particular).
  - List of cost-sharing agreements, advance pricing agreements (APAs) and rulings obtained having an impact on the results of the company.
  - Description of the transfer pricing policy with an explanation on the selection and application of the retained method, in compliance with the arm's-length principle and with the analysis of the functions performed, of the risks borne and of the assets used by the audited company.

- Where relevant, an analysis of the comparability elements taken into account in the application of the retained transfer pricing method.

According to the regulations, such specific information should allow the FTA to assess whether the transfer pricing policy applied is compliant with the Organisation for Economic Co-operation and Development's (OECD) arm's-length principle.

The audited company may also provide any other relevant documents.

The complete set of documentation should be maintained and provided immediately upon request (which could be the first day of a tax audit). The regulations, however, provide for a 30-day extension if the documentation is not available or incomplete, with a possible additional extension of 30 days.

The FTA may assess a maximum penalty of 5% on the transfer pricing adjustment in the case of missing or incomplete documentation, with a minimum of EUR 10,000 per audited year. If there is no transfer pricing adjustment, the penalty imposed is EUR 10,000 per audited year for missing or incomplete documentation.

Therefore, it is advisable for companies within the scope of the new regulations to maintain contemporaneous documentation in anticipation of tax audits considering the stricter deadlines and penalties.

Companies outside the scope would remain subject to documentation requests during tax audits. Even if penalties are lower and deadlines not so strict, these companies would still be at risk of arbitrary reassessments for not having transfer pricing documentation in place.

Section L 13 AB

Operations that are conducted by French companies with an associated entity situated in a non-cooperative state or territory are subject to an additional documentation obligation. The French company must notably provide the financial statements of the associated entity.

Section L 13 B

Because of the new documentation requirements, Section L13 B is now applied mainly to small and medium businesses (SMBs). The Economic and Financial Act, published on 13 April 1996, contains procedures for transfer pricing examinations. This legislation gives the FTA a clear right to request information on the taxpayers' transfer pricing policy in the course of a tax examination when it has evidence upon which to presume that an indirect transfer of profits abroad has occurred, as defined by Section 57 of the French tax code. This procedure applies only in the course of a normal examination.

Four types of information may be requested under this procedure:

- The nature of the intercompany transactions.
- The method for determining prices for transactions.
- The activities of the foreign enterprises, companies or joint ventures.
- The tax treatment of the intercompany transactions.

Requests shall include a notification of the expected response time to the audited enterprise. The time allowed for response, which shall be no less than two months, may be extended upon justification to a total of no more than three months.

If an enterprise has responded inadequately, the administration may demand additional information within 30 days with a formal notice. This notice shall specify the desired additional information and mention the penalties in case of non-response. Thereafter, the sanctions imposed on the taxpayer will be twofold:

- A EUR 10,000 fine for each period under audit.
- The right for the FTA to reassess the taxpayer's profits on the basis of the information at its disposal. (This procedure, however, remains controversial. The burden of proof of the dependence and of the non-arm's-length character of the transactions rests with the FTA).

On 23 July 1998, the FTA published a regulation commenting on the provisions of Section L 13 B. This regulation specifies in particular that resorting to Section L 13 B is neither obligatory nor systematic – it takes place only if the tax inspector has not been provided with sufficient explanations during the tax audit.

Regarding the transfer pricing method used, any method invoked by the enterprise can be considered acceptable, provided that it is justified by contracts or internal memos describing the method, extracts of the general or analytical accounts, economic analyses (notably on the markets), the functions fulfilled, the risks assumed and the comparables retained. The FTA still broadly interprets elements required to justify the transfer pricing method.

Section L 188 A

Section L 188 A provides for an extension of the statute of limitations and is open to the authorities when they request information from foreign tax administrations before the end of the initial statute of limitations. The new statute of limitations expires at the end of the year following the year when the information requested is obtained or, failing response, at the end of the fifth year following the year that is audited. For example, if the financial year corresponds to the calendar year, intragroup transactions conducted in 2001 may, in principle, be investigated within the framework of the authorities investigating a company, up to 31 December 2004. If a request for information is put to a foreign tax authority in December 2005, these transactions may remain open to reassessment for the years 2006 and 2007.

The extension of the statute of limitation applies if there is a request for information bearing on intragroup transactions or on entities established in countries with favourable tax regimes (French tax code Section 209 B), but also in cases of requests for information with relevance to the foreign assets, credits, income or activities of a French taxpayer.

Other regulations

In addition to the legislation specific to transfer pricing described above, the following texts and regulations are relevant to the issue:

- The terms of various tax treaties.

- Sections of the French tax code that deal with related issues such as transactions with entities in tax havens.

Section 238 A limits the deductibility in France of commissions and other payments paid to entities located in tax havens. A company is deemed to benefit from a privileged tax regime when the difference between the foreign corporate tax and the tax that would have been paid in France exceeds 50%.

Under Section 209 B, income which is transferred under certain conditions to a controlled foreign company (CFC) or a permanent establishment (PE) which enjoys a privileged tax regime has to be recaptured in France and is subject to corporate income tax. These French CFC rules may not be applied if the foreign company is located in a member state of the European Union (EU) and if the arrangement in question is not an artificial arrangement set up only to obtain a tax advantage. In its regulations, the FTA makes a reference to the ICI and Cadbury Schweppes ECJ cases to explain the meaning of 'artificial arrangements' mentioned in the EU safeguard clause (Administrative regulation: 4 H-1-07).

French CFC rules do not apply to foreign-controlled entities which carry on an active trade or business in a non EU country where they benefit from a privileged tax regime. For fiscal years ending on 31 December 2012, and thereafter, the burden of the proof rests with the taxpayers.

- Sections of the French tax code that deal with specific measures against states or territories considered to be non-cooperative:

As from 1 January 2010, new Section 238 0-A defines, from a French perspective, non-cooperative states or territories (NCST) as a country or territory that:

- is not a member of the EU
- has been reviewed and monitored by the OECD Global Forum on Transparency and Exchange of Information
- has not concluded at least 12 administrative assistance agreements/treaties that allow a complete exchange of information for tax purposes, and
- has not concluded such an agreement/treaty with France.

The NCST list is updated annually to take into account, in particular, the effective implementation of the tax information exchange agreements.

As of 1 January 2012, NCST are the following states or territories: Botswana, Brunei, Guatemala, Marshall Islands, Montserrat, Niue, Philippines, and Republic of Nauru.

Withholding tax on passive income is increased to 50% for operations with NCST. Amounts paid to entities located in an NCST may also not be tax deductible for French corporate income tax purposes.

- The first pure transfer pricing regulation was issued on 4 May 1973, in the form of a note. This regulation is the main element of the FTA doctrine, and in April 1983, the tax authorities finalised and published this commentary on their interpretation of the transfer pricing legislation once the Section 57 was amended to cover transactions with tax havens.

- A new regulation published on 23 February 2006, on bilateral and EU mutual agreement procedures.
- Regulations published on 7 September 1999, on bilateral advance pricing agreements and 24 June 2005, on unilateral advance pricing agreements.
- The tax authorities' commentary on legal cases involving transfer pricing, which has been issued over the years in the form of administrative regulations[1].

Legal cases

Several cases over the years have established important principles for dealing with transfer pricing issues. These are summarised below:

Parent-subsidiary relations: expenses invoiced by a foreign parent company

SA Borsumij Whery France, CAA (Cour Administrative d'Appel) Paris 11 February 1997

The administration considered that the reimbursement of such a charge represented a transfer of profits abroad 'insofar as the French company has not substantiated the reality of the services, invoiced in a vague manner for services which the French company could perform itself'. The submission of 'incomplete documents of a general nature' was deemed to be insufficient. This analysis was then confirmed by the French Supreme Tax Court.

Parent-subsidiary relations: partnership

SA Cogedac, CE 23 November 2001

A parent company and its subsidiary incorporated a partnership in which the subsidiary contributed its purchasing platform. Ninety percent of the benefits were attributed to the parent company. In the absence of a significant contribution from the parent company to the activity of the partnership, and considering the lack of commercial interest for the subsidiary to enter into the partnership convention, the *Conseil d'Etat* ruled that the conclusion of the partnership convention by the subsidiary was constitutive of an abnormal act of management.

Reality of services

SA Bossard Consultants, CAA Paris 17 March 1998

A subsidiary company, which paid royalties for a licence of a trademark to its parent company, could not deduct part of the sums paid as a temporary increase of the royalties by one point because it could not justify the reality of the public relations and promotion activities in respect of the trademark that the temporary increase was purported to cover.

Date to use when appraising a transfer pricing transaction

CE Ford France 16 March 1990 and CAA Paris 4 October 1994

The transaction must be appraised on the basis of facts known (or facts that could have reasonably been known in the circumstances) at the time the contract was made. The use of hindsight is not permitted.

1 The French Revenue has merged all its regulations in a new database since 12 September 2012. We will modify in our next update the previous references.

Comparable searches

Société Pharmatique Industrie, CAA Paris 12 July 1994; CE Galerie Vercel 28 September 1988; SARL Solodet, CE, 21 February 1990; Reynolds Tobacco, CAA Paris, 20 November 1990; Lindt et Sprungli CE, 4 December 2002; Novartis Groupe France SA, CAA Paris, 25 June 2008; Man Camions et Bus, CAA Versailles, 5 May 2009; Microsoft France, CAA Versailles, 16 February 2012; Eduard Kettner, CAA Paris, 29 March 2012

The Pharmatique Industrie case illustrates the type of comparison that the courts require from the FTA and taxpayers. The tax authorities used five products of similar commercial reputation, distributed by three companies operating in the same pharmaceutical sector with comparable turnovers, as comparable evidence in a transfer pricing dispute.

The CE is very careful when examining comparable situations. For example, the CE, on 28 September 1998, refused to consider that situations were comparable when the FTA was relying on isolated French-based transactions when the situation under audit involved a long-lasting relationship between a French entity and its US subsidiary.

In Solodet, the comparison was rejected because the comparable products were sold in Germany rather than in France. It was judged that both the prevailing market conditions and the end use of the products in Germany were different, and that therefore the companies identified by the tax authorities were, in fact, not comparable to the French company under review.

In Reynolds Tobacco, the 2%-3% commission received by the French entity was deemed by the courts to be an arm's-length amount, even though competitors were receiving about 8% for providing similar services. This was decided on the basis that the services provided by the French company were sufficiently, if only slightly, different, and this justified the lower rate charged.

In Lindt & Sprungli, the CE approved the position taken by the FTA, even though the FTA did not support its position by reference to independent comparable data, but rather through facts and circumstances of the case at stake.

In the Novartis Groupe France SA case, the court stated that if the FTA intends to use prices existing between other companies or a profit split approach by considering the global margin realised on one product at group level to reassess the French entity, it must demonstrate that the price invoiced to the French entity by a related company does not comply with the arm's-length principle with a relevant and exhaustive economical analysis. In this case, the court notably criticized the fact that the FTA did not perform a comparable search.

In Man Camions et Bus, the Court of Appeals stated that a comparability study performed by the FTA has to be based on independent comparables acting in similar conditions and markets. In this case, the FTA did not establish that foreign European markets were similar to the French market and therefore rejected the pan-European comparable study performed by the FTA. The fact that the French entity has been loss-making for years is not, in isolation, sufficient to prove the existence of a transfer of benefit out of France.

In the Microsoft case, the distribution activity of a French subsidiary of an American group was transferred to its Irish sister company. The French subsidiary was then converted into the sales agent of the Irish subsidiary. The Commission rate earned by the French subsidiary was reduced from 25% to 18%. The French tax authorities, taking into account the previous 25% commission rate, considered that it should not have been reduced and reinstated the corresponding income into the French company's taxable income. To support their position, the French tax authorities conducted a benchmarking study. However, the Court of Appeals ruled that the mere fact that the commission rate has been reduced does not demonstrate the transfer of profits abroad. Moreover, the Court confirmed that the transfer of profits abroad was not proved due to the irrelevance of the methods used and of the comparables found by the French tax authorities. The companies were not suitable for comparison because they were not in the same market as Microsoft France and that some of them were not independent companies.

Regarding the provision of intragroup services, in the Kettner case, the Paris Administrative Court of Appeals considered that, in order to demonstrate a transfer of profits abroad, the French tax authorities have to make a comparison with independent companies in order to show to what extent the fees paid for the services did not meet the arm's-length principle.

Concept of group interest

n° 2372, CE, 24 February 1978; Sovifram, CE 3 June 1992; Société Nord Eclair, CAA Nancy, 6 March 1996; SA Rocadis, CE 26 September 2001;

The French courts consistently have supported the tax authorities in refusing to accept the idea of the interests of the group as a whole serving as sufficient justification for a particular intragroup transfer pricing policy. However, charges at cost were accepted by the courts when the charges were invoiced by a parent entity to a subsidiary, according to the 24 February 1978 CE decision.

In the 1992 decision, the CE ruled that selling at a loss imported wines by a French subsidiary to its foreign parent company is constitutive of an abnormal act of management if the French company does not obtain any counterparty. The mere facts that the French subsidiary was its parent company's exclusive provider or that the French subsidiary benefited of its parent company's clientele was not deemed to constitute a sufficient counterpart.

In a 6 March 1996 decision, the Nancy appeals court expressly accepted an invoicing of charges at cost between two sister entities. This conclusion may derive from the fact that the FTA was challenging the flow of invoices and suggested that the invoicing should have gone through the parent company, so that the loss would have been incurred by the parent entity rather than one of the sister entities. In the Rocadis decision in 2001, the CE accepted the concept of group of interest between the members of a distribution network. The CE did not adhere to the general group concept approach, but the French court reckoned with the specificity of functioning of this specific distribution network.

Economic or commercial benefit

Boutique 2 M, CE 27 July 1988; CAA Nancy, SAS Mc Cormick France, 8 December 2011

In a number of cases over the years, the courts have accepted taxpayers' arguments that their transfer prices satisfied the arm's-length principle because even if they were at first sight higher or lower than what would have been expected (i.e. standard market prices), they resulted in some economic or commercial benefit for them. For example, their prices increased market share.

For example, in the SAS Mc Cormick France case, products were sold by a French company to a related foreign company at a price lower than the market price and the manufacturing cost. The court considered that there was no counterpart in a situation where the considered company could not justify the alleged new clients brought by the group, free loans, and financial contributions received from the group.

In all instances where this argument is put forward, the deemed benefit must be specific and reasonable in relation to the loss or reduced revenue recognised by the French company. Where the taxpayer has been able to prove only a potential benefit, the transfer pricing policy has been adjusted.

In such cases the burden of proof lies with the taxpayer. Various court decisions have established that this applies whether the tax authorities are attempting to enforce Section 57 of the tax code or the concept of *acte anormal de gestion*.

Legal protection of the intangible licensed as royalty payment

Bentone Sud, CAA Paris 15 June 1999

Despite the fact that the patents were no longer protected and there was a lack of actual transfer of know-how, the Appeal Court of Paris accepted the deductibility of a licence fee covering patents and know-how, in addition to a trademark and a regular supply of equipment. The court judged that the access to the trademark and the right to access products made by the licensor were a valid justification for the payment of royalty. This decision is unique.

Decisions such as the above-mentioned Lindt & Sprungli confirmed that the lack of legal protection is a critical factor for the courts in appraising the arm's-length nature of a royalty flow.

Existence of a written agreement

Electrolux, CE 23 October 1991; Barassi, CAA Lyon 1 February 1995

The court ruled in Electrolux that the lack of a written agreement signed prior to transactions taking place was not relevant to the transfer pricing policy under dispute because the ongoing trade between the related companies under review supported the transfer price as described to the tax authorities.

Once an agreement has been signed, the parties must abide by it. If circumstances change and the terms no longer apply, it must be amended.

Despite the above court decision, a contemporaneous written agreement is advisable in all instances.

Sale of assets

N°17055, CE 21 November 1980; Berri Ponthieu, CE 21 June 1995
In Berri Ponthieu, the court decided that the sale of shares in a listed entity at book value, which was lower than the prevailing market value, was a non-arm's-length transaction, even though the sale was a group reorganisation.

Similarly, the acquisition of shares at a price exceeding the market value is also a non-arm's-length transaction, unless there are special circumstances.

Sale of goods or services

SARL Rougier-Hornitex, CE 26 June 1996; SNAT, CE 31 July 1992; Rouleau, CAA Bordeaux 27 December 2001; Etablissements Georges Legros, CAA Lyon, 29 October 2010; SAS Unilever France, CAA Versailles, 5 December 2011; Nestle Entreprises, CAA Versailles, March 27, 2012
The sale of products or services to related parties at a price below prevailing domestic or international prices is not considered an arm's-length transaction.

In Rougier-Hornitex, the CE decided that a sale at a loss of services by a subsidiary to a parent company during the subsidiary's first two financial years was not an abnormal act of management. The price of the services, even though generating operating losses, was not below the market price and therefore was considered an arm's-length transaction

In the Rouleau case, the court ruled that the tax authorities did not establish an *acte anormal de gestion* by only referencing that the sales of goods and services were below the market price of uncomparable products and below a cost price determined retrospectively and including charges linked to the fact that the company was working at under-capacity.

In the Etablissements Georges Legros case, the Court of Appeals decided that setting an intragroup currency conversion rate different from the market rate can constitute a transfer of profits as defined by the Section 57 of the French tax code if it results in a price increase. In this case, such an increase in the prices was not justified by economic reasons.

In the SAS Unilever Case, a French manufacturing company was remunerated on a cost-plus basis. The company, which was in a situation of under-activity, invoiced to a foreign-related company not its actual costs (higher than for other factories of the group) but lower theoretical costs corresponding to a possible more efficient functioning. It has been judged that the resulting negative margin did not justify a reassessment. The judge considered that the French tax authorities did not prove that the transfer prices were not market prices.

Recently, the Versailles Administrative Court of Appeals ruled against the taxpayer in the following case. A French affiliate sold mineral water to a Japanese related company. The transfer pricing method resulted in a net margin of 33% for the Japanese related company deemed to be too high by the French tax authorities. They took into account the fact that in Japan, a bottle of mineral water distributed by the Japanese related company was sold to end customers at a EUR 2.5 price while the highest market price in a country where the related distributor recognised a routine 6% margin was EUR 0.78, i.e. 3.2 times lower; the net margin in Japan should have been limited accordingly to 6% times 3.2, i.e. 19% according to the French tax authorities. The taxpayer argued that the Japanese related company was not a routine distributor, but a co-entrepreneur. The court however considered that it did not bring enough evidence for such as statement, and the transfer pricing adjustment was confirmed by the court.

Commission

n°39049 and 29805 CE, 26 June 1985Vansthal France, CAA 11 March 1993
A number of court decisions address situations where companies used related intermediaries whose activities did not justify the level of commission or remuneration paid to them. For example, the decision of the Court of Appeal in Nancy on 11 March 1993 disallowed a transfer pricing policy under which a 20%-40% mark-up was added to payments to a Swiss entity because in its capacity as a billing centre it bore no risk.

However, where taxpayers have been able to justify the nature and value of the services provided, the courts have invariably accepted the commission paid. For example, a 5% commission was found to be acceptable between A and B, where B was assisting A with promoting its exports to Italy (CE 26 June 1985).

Royalties

Caterpillar, CE 25 October 1989 ; Cap Gemini, CE 7 November 2005
In Caterpillar, a 5% royalty was judged to be an arm's-length rate for the manufacturing and assembling operations. In this case, the court refused to accept that there should be different rates for the two different activities.

In Cap Gemini, the French tax Supreme Court stated that the FTA did not demonstrate the indirect transfer of benefit in the absence of a comparability study. The criticised transaction consisted of a royalty-free licence of the Cap Gemini trademark and logo. The court considered that the fact that French subsidiaries were charged with a 4% royalty, whereas European and American subsidiaries were charged no or lower royalty, was not relevant. The court considered that the value of a trademark and logo may differ depending on each situation and market. Different situations may request different royalty rates. In its ruling, the Conseil d'Etat reaffirmed that a transfer pricing reassessment must be based on solid evidence.

Commissionaire and permanent establishment (dependent agent)

Zimmer Limited, CAA Paris 2 February 2007, CE 31 March 2010
In Zimmer Limited, the Administrative Court of Paris stated that a commissionaire of a UK principal company constituted a permanent establishment of that company in France. The French company, Zimmer SAS, distributes in France the products for Zimmer Limited and was converted into a commissionaire (acting in its own name but on behalf of Zimmer Ltd.) in 1995. The FTA considered that Zimmer SAS constituted a permanent establishment of Zimmer Limited in France because the French entity had the power to bind its UK principal in commercial transactions related to its own activities. Zimmer Limited should, therefore, be taxed on the profits generated in France according to Section 209 of the FTC and Article 4 of the double-tax convention between France and the United Kingdom.

The court concluded that Zimmer SAS constituted a permanent establishment of Zimmer Limited in France and that, accordingly, the taxation in France of the profits attributed to such permanent establishment for the years under audit was fully justified.

Following the conclusions of the 'Rapporteur public', Ms. Julie Burguburu, the High Court (CE 31 March 2010) nullified the earlier decision of the Paris court and agreed with the taxpayer. The High Court reconfirmed that a company has a permanent establishment in a state if it employs a person who has the authority to bind the company in a business relationship and that person is not independent vis-à-vis the company. Two criteria, therefore, need to be met in order to be qualified as a permanent establishment. The two criteria are dependence and the authority to engage.

The High Court does not address the issue of dependence, which was not debated in this case because the dependency was already established.

Concerning the authority to engage, the High Court quotes article 94 of the Commerce Code included in article L-132-1 of the new code and notes that the commissionaire acts in its own name and cannot conclude contracts in the name of its principal. It underlines that the commissionaire does not legally bind its principal because of the nature of the contract. The High Court concludes that a commissionaire cannot constitute a permanent establishment of the principal. However, the High Court also sets certain limits by stating that when it derives from either the terms and conditions of the commissionaire's contract or any element identified during the examination of the case that the principal is personally bound by the contract agreement concluded by the commissionaire with third parties, and the commissionaire then constitutes a permanent establishment of the principal.

Cross border business restructuring

Sociétè Nestlé Finance International LTD, TA Paris, 11 May 2011
In the Nestlé case, a French company transferred its cash pooling activity to a related Swiss entity. The cash pooling function had been purely administrative, carried out exclusively for the benefit of parties related to the French company. The French company did not receive any compensation for the transfer of the cash pooling activity. The Administrative Court concluded that the transfer of an internal administrative function to a foreign entity – even if the function only involved other affiliated companies 'captive clientele' – required the payment of arm's-length compensation.

This decision has been appealed and therefore could be superseded by a subsequent decision of the Administrative Court of Appeals or the Supreme Administrative Court.

Financial charges and revenue

Interest charges

N° 75420 and n° 77533, CE, 16 November 1988; Société Arthur Loyd, CAA Paris 1 February 1994; Montlaur Sakakini, CAA Lyon, 25 October 1995; SNC Immobilière GSE, CE, 7 September 2009; France Immobilier Groupe, CAA Paris, 29 September 2009; Société d'acquisitions immobilières, CE, 22 January 2010.
The interest rate charged to a subsidiary by a French entity must be comparable with the interest rate the French entity would receive from a third party bank for an investment similar in terms and risk. The interest rate used by the courts as a reference in Montlaur Sakakini is the rate that the lender could have obtained from a third party bank.

In the France Immobilier Group decision, the Court of Appeal considered that the level of the interest rate should not be assessed by reference to the debts contracted by the lender, but should be based on the financing conditions that the lender could have obtained from a third-party bank.

In the Société d'acquisitions immobilières decision, the High Court decided that the cash advance granted by a sub-subsidiary to its 'grandmother' in difficulty with which it had no business relations, even accompanied by the payment of interest, could constitute an abnormal act of management if the amount lent is clearly disproportionate to the creditworthiness of the borrowing company.

In practice, when an interest rate has to be set up, reference should be made to the rate that would be obtained by the borrower (stand alone approach), which is in line with the rules set by Article 212 of the French Tax Code (*see below*).

Deferral of payments

Baker International, CAA Bordeaux, 6 April 1994
Payment deferral: If interest is not charged in respect of deferrals of payments granted to a related company, it is considered either an abnormal act of management or is subject to Section 57 of the tax code.

Absence of charges for guarantees

Soladi, CAA Nancy 30 April 1998; Carrefour, CE, 17 February 1992
It is deemed to be an abnormal act of management to provide an explicit financial guarantee free of charge, unless direct actual benefit for the entity providing this support can be justified. In a decision of 17 February 1992, the French Supreme Court considered as arm's length a rate of 0.25% for this service, while the FTA was seeking 1%. The remuneration asked for this service should be commensurate with the risk incurred as well as with the market value of this service, irrespective of the actual cost.

Debt waivers

SA Les Editions JC; CE 11 February 1994; Télécoise, CE, 16 May 2003; Guerlain, CE, 23 April 2008; Beauté Créateurs SAS, CAA Paris, 12 May 2010; Société Générale, CAA Versailles, 29 June 2010; Delpeyrat Chevalier, CAA Bordeaux, 15 March 2011
The arm's-length principle also applies to debt waivers. France-based entities may waive all or part of outstanding loans to related foreign entities to the extent that they can justify some own benefit as a result of this financial assistance.

In Télécoise, the High Tax Court determined that a French company is allowed to deduct a provision for bad debt in relation to its foreign branch whenever the debt is related to its foreign business operations carried out through the branch. However, the French company must establish that the operation has a direct commercial benefit on the business activities carried out in France.

In the Guerlain decision, a French company waived its receivables towards two foreign branches in Australia and Singapore of its Hong Kong subsidiary. The judge made a reference to the consolidated results of the subsidiary (including those of the two branches), which were positive despite the financial difficulties of the branches; this was one of the arguments put forward by the judge to reject the deductibility of the waiver of the receivables in France.

In the Beauté Créateurs SAS case, the Court of Appeals applied the principle settled in the Télécoise and Guerlain cases. In this case, the court permitted the deduction of the debt waiver granted to its foreign branch by the headquarters in France because the branch provided services for the benefit of the French headquarters which increased the sales in France and thus developed the business in France.

In the Société Générale case, the parent company granted an advance to a foreign subsidiary to face its financial difficulties and to meet the capital ratio requirements demanded by the local authority. The parent company granted a debt waiver to its subsidiary. The court ruled that such a debt waiver of a financial nature did not constitute an abnormal act of management if it allowed the parent company to avoid suffering a negative impact on its reputation from the bankruptcy of its subsidiary, even where the subsidiary in question is a small one.

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In the Delpeyrat Chevalier case, in order to refuse the deductibility of the debt waiver, the Court of Appeals took into account the turnover generated by the operations conducted with the foreign subsidiary, which was very limited.

Choice of the financing mode of a company's operations

SA Andritz, CE 30 December 2003, n° 23-3894; Banca Di Roma, CAA Paris, 16 December 2010

The terms of Article 57 of the French Tax Code (FTC) do not have the purpose, nor the effect, of allowing the administration to assess the 'normal' nature of the choice made by a foreign company to finance through a loan, rather than equity, the activity of an owned or controlled French company, and to deduce, if the need arises, tax consequences (cf. Article 212 of the FTC – thin capitalisation).

In the Banca di Roma case, the Court of Appeals reiterated that the FTA is not allowed to decide whether a business is to be financed through debt or equity.

Management charges

Allocation of charges

N° 2372, CE 24 February 1978; Société Office Dépôt France SNC, TA Montreuil, 5 January 2012

Management charges must be shared among all of the group entities benefiting from the corresponding services. Not allocating charges among all receiving group companies is considered to be an *acte anormal de gestion*.

Management charges should generally be allocated on the basis of a detailed analysis, taking into account which of the services the company received. However, when such a breakdown would be a cumbersome exercise unlikely to result in an accurate allocation, the charges may be allocated on the basis of a less detailed calculation, such as turnover.

In the Société Office Dépôt France SNC case, a US company recharged to its French subsidiary a portion of audit costs relating to a report meant to check the efficiency of internal control within the group, in compliance with the Sarbannes-Oxley legislation. The judge considered that such costs were incurred in the interest of the US company only, and were accordingly not tax deductible in France.

Justifying the services

Gibert-Marine, CAA Bordeaux 12 December 1995; Société Labouchède, CE, 22 June 1983; SA Mat transport, CAA Nancy 5 July 2001

The basis of fees paid for management services will be examined in a tax audit. The taxpayer will have to provide evidence about the nature, content, and value of the services rendered by the supplier to justify the fees paid and to receive a tax deduction for them. In this context, an invoice alone is not sufficient proof.

Payments for seconded executives

n°52754, CE, 30 March 1987; Oudot Ministerial commentary, 7 September 1987

It was considered that the costs of an executive seconded from a French company to a Swiss subsidiary should be charged to the Swiss company, unless the French entity could demonstrate a commercial or economic benefit from not doing so.

Burden of proof

As a rule, the burden of proof lies with the tax authorities, unless the transfer of profits concerns a tax haven, in which case the burden of proof is transferred to the taxpayer.

However, there is now a legal requirement for taxpayers to provide documentation supporting their transfer pricing policies. Although in theory the burden of proof lies with the tax administration, in practical terms, the burden of proof has always fallen on the taxpayer where the tax authorities have deemed a profit shift to have taken place or inappropriate transfer pricing to exist.

Tax audit procedures

Selection of companies for audit

Generally speaking, transfer prices are audited as part of a formal tax audit on all issues. There are no rules as to which companies come under investigation. Major companies are audited every three to four years, unless in a loss-making situation in which the statute bar limitation rules for corporate income tax are less crucial to the tax administration. Nowadays, almost all sectors are audited, including French wholly owned entities and subsidiaries of non-France-based groups.

The audit procedure

Tax audits are generally carried out through the following procedure:

- Written notice is sent to the taxpayer informing of the date of the auditor’s first visit and the particular taxes and years under investigation. The taxpayer may use a professional advisor to assist during the investigation.
- The auditor’s site visits take place at the taxpayer’s main premises, either the registered offices or the main place of operations. The auditor’s on-site presence can last from a few days to several months, depending on the size of the taxpayer’s business and the number and complexity of issues under review. There is no maximum limit to the time the auditor may spend on-site. The auditor may be assisted by information systems or specialists taken from a dedicated group within the tax administration, as well as by FTA transfer pricing experts.
- Throughout the auditor’s visit(s), regular dialogue takes place between the taxpayer and the tax inspector.

- On-site investigations by the tax inspector cease when the inspector is satisfied that all outstanding questions have been answered. At this point, written notice of any underpayment is sent to the taxpayer.
- The taxpayer must provide a written response to the notice within 30 days of receipt. In the response, the taxpayer must either accept or reject the proposed adjustment. If s/he chooses to contest the reassessment, the taxpayer must set out detailed and convincing arguments to support his/her case. At this point, the taxpayer may ask to meet the tax inspector's superior. Such a request is generally not denied. After this meeting the taxpayer may then also request a meeting with the local head of the tax audit division (i.e. the appeals officer or *Interlocuteur départemental*).
- After considering the written arguments of the taxpayer (and generally only after the meetings described above have taken place), the tax authorities either reaffirms or amends their initial position in a letter. There is no time limit within which the tax authorities must provide their response.
- In their final response, the tax authorities are obliged to offer the taxpayer the opportunity to take his/her case to the *Commission Départmentale*. This body consists of representatives of the taxpayer and the tax authorities and is responsible for reviewing technical, as opposed to legal, tax issues. Both parties are entitled to submit reports to the commission, which hears both arguments before issuing a decision. The decision, however, is not binding on the FTA.
- The tax authorities are allowed to raise an assessment to collect the tax only once the Commission has reached its final decision, at the latest within three years from the date of the assessment notice (unless an application for mutual agreement procedure has been filed – *see mutual agreement procedure paragraph below*).

Revised assessments and the appeals procedure

If the taxpayer still wants to appeal against the revised assessment, then s/he may submit a *réclamation pré-contentieuse*, a claim prior to court action, to the tax authorities. If there is no response from the tax authorities within six months of the claim submittal, then the taxpayer may elect to take the case to court. Otherwise, s/he can wait for the tax authorities to release their decision, after which the taxpayer has two months from that date to take the case to court.

The first court in which the case may be heard is the *Tribunal Administratif* (TA). Arguments are submitted in writing, although either or both parties may be called to the actual court hearing. Like the *Cour Administrative d'Appel* (CAA), the TA may appoint an independent expert to review the facts presented by both parties before giving its judgment.

Either party may appeal the TA's decision; this appeal would be heard by the CAA. The plaintiff has two months from the announcement of the TA's decision in which to make an application to the CAA.

In very limited circumstances, either party may ask the CE to hear the case. The CE is the supreme corporate and income-tax court, and once it has heard the case it will either issue its own final ruling or instruct the CAA to review the initial ruling decision reached by the TA.

Depending on the provisions of the tax treaty that applies, a taxpayer may at any time decide to pursue a competent authority claim instead of litigation. It is also possible to pursue both routes at the same time.

Additional tax and penalties

Interest at the rate of 0.40% per month, or 4.8% per year, is charged for late payment or underpayment of corporate income tax. These amounts are not deductible for the corporate income-tax basis.

If the good faith of the entity is challenged, which tends to be frequent when transfer pricing issues are scrutinised, a penalty of 40% or even 80% of the tax avoided is levied (*pénalités pour manquement délibéré*). This extra charge is obviously not deductible from the corporate income-tax basis.

In addition, a transfer pricing adjustment may lead to VAT and *taxe profesionnelle*, or local tax on business activity, as well as a deemed dividend issue, depending on treaty provisions.

Resources available to the tax authorities

The resources available to the tax authorities to devote to transfer pricing investigations are increasing. Major multinational entities are audited by the *Direction des Vérifications Nationales et Internationales* (DVNI or National and International Audit Administration).

The DVNI is responsible for auditing all companies with a turnover in excess of EUR 152.4 million for industrial companies or in excess of EUR 76.2 million for service companies.

With 30 auditing teams divided by sectors, the DVNI's level of industry-specific knowledge is high. General tax auditors may be assisted by tax inspectors specialised in transfer pricing (30ème Brigade). They can also use dedicated teams in charge of computer-assisted audit or audit of tax credits for research and development expenses.

Use and availability of comparable information

Various databases are available that contain the financial accounts of most of the companies, whether or not listed on the stock exchange. These include InfoGreffe, Diane and Amadeus databases.

The FTA has extensive access to Diane and Amadeus. The inspectors specialised in transfer pricing commonly use these tools to check taxpayer's benchmarks or produce their own alternative comparable studies. The DVNI is increasingly inclined to accept or even perform pan-European benchmarks.

Risk transactions or industries

Conversion schemes with a transfer pricing element are currently scrutinised in audit situations.

The legal cases listed above illustrate that other sectors, such as retail, may also occasionally be investigated. In addition, it is worth noting that the DVNI's transfer pricing and financial inspectors recently have been put together on the same team to enhance efficiency in transfer pricing audits involving valuation issues.

Limitation of double taxation and competent authority proceedings

The FTA does not publish data on competent authority proceedings.

Advance pricing agreements (APAs)

French tax regulations provide for official APA procedures. Between 1999 and 2004, only bilateral APAs were accepted. The rectifying Finance Bill of 2004 (Article 20) codifies the legal basis for APAs and extends their scope to unilateral APAs. The APA procedure is now included in the tax procedures code (*see Article L. 80 B 7° of the Livre des procédures fiscales*). Previously, the only domestic authorisation was through a 1999 FTA regulation. In addition, an APA procedure requesting limited documentation and simplified monitoring is now available to small- and medium-size enterprises.

Bilateral APAs

In a regulation issued on 7 September 1999, the tax administration defines the conditions under which it would be willing to grant a bilateral APA. This may be initiated only with states that have signed a treaty with France containing a section equivalent to Section 25.3 of the OECD model treaty. This regulation is a fundamental change from the prior opinion expressed by the central tax administration, where they saw an APA procedure as a breach of the principle of equality. Under this regulation, the application process can be initiated in France or in the other state. The application may cover all transactions or only certain transactions, covering all or part of the companies' operations (product, function, type of transaction or line of business). Through preliminary meetings with the FTA, the exact scope of the information (tax, financial, legal, industrial, commercial, etc.) to be provided is defined. A formal request may then be addressed to the FTA. Within two months of this application, the same application must be submitted to the other tax administration. An indicative list of information to be provided is included in this regulation, but the basic idea behind this list is to establish constant debate and exchange of information with the FTA as part of the review of the application. Once the review is completed, a draft ruling is issued for final approval by the taxpayer.

The ruling defines the parties, transactions, transfer pricing method(s) elected, assumptions used, revision formula, date of application of the ruling and its duration (three to five years), and contents of the annual report to be issued by the taxpayer. The ruling may not have a retroactive effect, except within the limit of the financial year during which the application is made.

Unilateral APAs

Unilateral APAs, which until the rectifying Finance Bill of 2004 were not authorised in France, may now be accepted by the French administration. However, in a regulation issued on 24 June 2005, the FTA made it clear that it would still favour the conclusion of bilateral APAs. Unilateral APAs could be granted in cases such as:

- If the bilateral tax treaty does not provide for a MAP.
- If, despite the MAP provided in the bilateral tax treaty, the foreign competent authority refuses to conclude an APA.
- For simple issues such as management fees and allocation key issues.

Small- and medium-size (SME) enterprises: simplified APA procedure
As the standard APA procedure can be burdensome, a simplified APA procedure for SMEs is available as from 28 November 2006. The simplified procedure proposed by the FTA includes the following:

- Less transfer pricing documentation is required for the APA request. The documentation is limited to a legal chart of the group, the list of transactions and prices between related parties, functional analysis, description and justification of the transfer pricing method, and the financial statements of the foreign companies involved in the transactions.
- The FTA assists in the preparation of the functional analysis and in the choice of the appropriate transfer pricing method.
- An economic analysis is also requested. During an experimental period, the FTA may perform the benchmarking analysis at the request of the SME.
- Simplified content of the annual compliance report requested in the follow-up years of the APA (e.g. details of the computation of the remuneration and a statement on the substantial changes to the activity conditions described in the APA request, such as activities, functions performed, risks borne, legal/de facto dependence, assets used, accounting methods).

Only SMEs that meet the following two criteria are eligible for the simplified APA procedure:

- SMEs with (1) fewer than 250 employees, and (2) a net turnover of less than EUR 50 million or with assets that do not exceed EUR 43 million.
- 25% or more of the capital or voting rights are not owned by one enterprise, or jointly by several enterprises that do not meet the conditions of the previous paragraph.

To determine whether the criteria are met, reference should be made to the financial year preceding that in which the request to initiate the procedure is submitted.

Mutual agreement procedure (MAP)
The rectifying Finance Bill of 2004 (Article 21) suspends the collection of taxes when, following a notice of reassessment, a competent authority procedure is undertaken by the taxpayer to eliminate double taxation (*see Article L. 189 A of the Tax Procedures Code, Livre des procédures fiscales*). Prior to this amendment, after issuing a notice of reassessment the FTA had three years to issue a notice of collection, notwithstanding the taxpayer's undertaking of a competent authority procedure. In this situation, given the average length of a competent authority procedure in France (three years and seven months), the FTA had to collect the taxes before the outcome of the competent authority procedure. After receipt of the notice of collection, the taxpayer could, and still may, request to benefit from deferral of payment of taxes if appealing to domestic remedies. However, under the deferral of payment procedure, the taxpayer incurs interest for late payment from the date stated in the notice of collection.

Under the new tax collection regime, the three-year statute of limitation (relating to issuance of the notice of collection) is suspended starting from the opening date of the competent authority procedure. The suspension holds until the end of the third month following the date of the notice given to the taxpayer that states the outcome of the competent authority procedure. Suspension of tax collection applies to competent authority procedures pursuant to the relevant tax treaty and the European Arbitration Convention.

The suspension of tax collection is applicable to competent authority procedures opened as from 1 January 2005.

In February 2006, the French revenue issued a new regulation regarding MAP. This detailed regulation provides guidance pertaining to the scope, conditions and implementation of the MAP in France. It also aims to apply the recommendations encapsulated in the code of conduct elaborated by the EU Joint Transfer Pricing Forum with respect to the implementation on the EU Arbitration Convention.

Binding permanent establishment (PE) ruling

The rectifying Finance Bill for 2004 (Article 19) extends the tax ruling procedure to PEs (Article L. 80 B 6° of the Tax Procedures Code, *Livre des procédures fiscales*). Under the extended procedure, foreign companies may request a ruling from the FTA stating whether their business activity in France constitutes a PE or a 'fixed place of business', according to the bilateral tax treaty between France and the parent company's country of residence. Not only may the ruling apply to subsidiaries, but also it can relate to agents, regardless of whether they are independent (*see Article 5 §6 OECD Model Convention*), or branches, regardless of whether their only purpose is to hold and deliver the parent company's goods (*see Article 5 §4 OECD Model Convention*). When a request for a ruling is sent, the FTA has three months to reply. If the FTA does not reply within that time period, the request is automatically approved. The French subsidiary of the foreign company is, therefore, not deemed a PE in France, and the group is not liable for corporate income tax in France, consequently avoiding double taxation.

The approval binds the FTA, which may not issue tax reassessments for periods prior to the ruling. This new procedure is, however, limited exclusively to taxpayers acting in good faith (*contribuables de bonne foi*), that is, taxpayers having provided all the useful elements to decide whether a business constitutes a PE and has not provided wrong or incomplete information. The tax authorities may change their decision regarding periods after the ruling, as long as the taxpayer is informed of that change. This procedure is applicable as from 1 January 2005 (*see Decree of 8 September 2005*).

Liaison with customs authorities

The tax authorities have the authority to use information gathered by the customs authorities when challenging a transfer pricing policy.

OECD issues

The French tax authorities have not published a formal interpretation of transfer pricing guidelines issued by the OECD. Indeed, there has not yet been any commentary on the guidelines issued in July 1995. At various times, however, such as at public seminars, the tax authorities have indicated that they do refer to the OECD principles during audits and settlement procedures.

An explicit reference to the OECD principles was made for the first time in the regulation of 23 July 1998. Reference to these principles is also made in the APA and transfer pricing documentation regulations referred to above.

The courts tend to use the OECD's principles as guidelines (Fisons, TA Lyon, 25 April 1990).

Joint investigations

There is little information about joint investigations, although it is generally thought that the tax authorities participate more in these now than in the past. In particular, the French authorities tend to join forces with their counterparts in the United States, Germany, Belgium and the United Kingdom.

Interest deductibility

Thin capitalisation

To counter thin capitalisation situations more efficiently, the French 2006 Finance Bill adopted a new system, applicable from January 2007. The scope of the old thin capitalisation rule had been limited by two major decisions of the French Supreme Court on December 2003 (*Conseil d'Etat, Andritz SA and Correal Gestion*) and by a regulation dated 12 January 2005.

The 2007 provisions provide for the repeal of the existing thin capitalisation legislation and replacement by an entirely new set of rules, which cover the interest rate charged and thin capitalisation. These new thin capitalisation rules apply to all types of financing granted to a French entity by any French or foreign-related party.

Interest rate limitations

Under the revised Article 212 of the CGI, the tax deduction of interest paid to related parties is limited to the higher of (1) the average annual interest rate charged by lending institutions to companies for medium-term (two years or more) variable-rate loans, or (2) the interest that the indebted company could have obtained from independent banks under similar circumstances.

The arm's-length criterion mentioned in (2) is a new feature for France. This provision is likely to shift the burden of proof to the taxpayer, as the French tax authorities, in practice, likely will seek to apply the average annual interest rate. Once companies have passed this interest rate test, French indebted companies must pass a second test, namely the debt ratio.

Debt ratio

In addition, the new thin capitalisation rules provide that a portion of interest paid to related parties, which is deductible under the interest rate test, may be disqualified as a deduction if it exceeds all of the three following limitations during the same financial year:

- Interest relating to financing of any kind granted by related parties within the limit of 1.5 times the net equity of the borrower.
- 25% of the adjusted net income before tax 'résultat courant avant impôt', defined as operating income increased by financial income), before related party interest, amortisation and certain specific lease payments.
- Interest income received from related parties (there is no limitation on thin capitalisation grounds when the enterprise is in a net lending position vis-à-vis related entities).

The portion of interest that exceeds the above three limits may not be deducted in the accounting period, unless it amounts to less than EUR 150,000.

For these purposes, 'related parties' are defined as (1) a parent company and a subsidiary whose capital is held more than 50%, directly or indirectly, by the parent company, or which is de facto controlled by the parent company, or (2) two companies which are controlled, directly or indirectly, by a common parent company.

The 2010 Finance Bill brought all financings (including bank loans) secured by a 'related party' within the scope of the thin capitalisation limitations. Thus, any financing in respect of which a related party grants a guarantee or security is treated as related party debt.

Carry-forward of excess interests
That portion of the interest expense that is not immediately deductible by the French enterprise in the accounting period in which it is incurred may be carried forward without a time limit for relief in subsequent years, provided that there is excess capacity in the subsequent years, based on the second limitation mentioned above. However, the excess amount is reduced by 5% each year, from the second accounting period following that in which the interest expense was incurred.

Exceptions
The new provisions provide for several exceptions.

These new rules do not apply to interest payable by banks and lending institutions, or to certain specific situations (e.g. interest in connection with intragroup cash pools or in connection with certain leasing transactions).

In addition, the thin capitalisation rules do not apply if the French indebted company can demonstrate that the debt-to-equity ratio of the worldwide group to which it belongs exceeds its own debt-to-equity ratio.

Also, deductibility of interest is facilitated within a French tax-consolidated group. The new thin capitalisation rules apply to each enterprise member of the group taken on a standalone basis.

However, any excess interest incurred by such an enterprise may not be carried forward by that enterprise. Instead, it is appropriated at the group level. Subject to certain limitations, the consolidating company may deduct extra 'disqualified' interest. Any remaining excess interest may be carried forward for possible deduction at the group level in future accounting periods, less the 5% rebate.

The FTA issued an administrative regulation regarding these new complex rules on 31 December 2007 (Administrative regulation: 4 H-8-07). The guidelines provide the French tax authorities' interpretation of Section 212 of the French tax code relating to thin capitalisation rules. They clarify the legal provisions and provide practical guidance on the computation of the three tests.

In particular, the guidelines state that Section 212 is applicable to PE of foreign companies. It provides clarification on how the debt-to-equity ratio would be applied in the case of PEs where the entities do not have a share capital, per se.

The guidelines also detail the exclusion of 'treasury centre' and 'leasing agreements' from the scope of the thin capitalisation rules, and they describe the specific conditions under which the thin capitalisation rules would allow deduction at a tax group level (Section 223B of the French tax code) for those interests that have failed the three tests at the level of a subsidiary on a standalone basis.

Carrez amendment
On 1 January 2012, new tax rules entered into force with regard to the deductibility of interest and other expenses from share acquisitions (section 209 IX of the French tax code).

Under this new legislation, the deduction of interest expenses incurred in France by a company for purposes of the acquisition of shares qualifying for the French participation exemption regime is subject to restrictions, unless the French acquiring company can prove that the decisions relating to such shares are being taken by it and where the group exercises control (or influence) over the acquired company, such control (or influence) is exercised by the French acquiring company or one of its affiliates established in France.

If the French company fails to provide such evidence, the company owning the shares is required to recapture a part of its financial expenses incurred during each financial year running over the eight-year period following the year during which the acquisition took place. This rule applies retroactively to acquisitions made as far back as 2004, but deductions disallowances can be applied only starting from a company's 2012 fiscal year.

2013 Finance bill
Under the current French tax system, interest expenses are fully deductible from the tax base for the calculation of the corporate income tax, subject to certain limitations.

The Bill proposes to limit the deduction of interest expenses for companies. Companies will be allowed to deduct:

- 85% of the total amount of deductible interest paid in 2012 and 2013.
- 75% of the total amount of deductible interest paid as from 2014.

However, the restriction will only apply if over EUR 3 million of interest is deducted by a company.