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Transfer Pricing Forum

Transfer Pricing for the International Practitioner

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France

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1. Per the OECD, the impact of the COVID-19 pandemic on economic activity would far outweigh anything experienced during the global financial crisis in 2008-09. What similarities and differences do you see between the 2008 crisis and the current pandemic so far on the practice of transfer pricing in your jurisdiction?

There are at least three main differences between these two crises, making the COVID-19 crisis a more impactful one:

- COVID-19 has directly hit all industrial sectors and the budget of most if not all States worldwide and is not only affecting primarily the financial, insurance, and real estate sectors;
- It may affect the way professionals (will) work and how trades will be performed, from where the work will be performed to the supply chain and the contractual terms, as well as conditions between parties (possible *force majeure* qualification);
- The GDP of most countries will be affected in ways unseen since World War II. In France, the current estimate is a GDP reduction of 11% in 2020 (according to the latest French Finance Ministry communication from June 3, 2020). This will necessarily have an impact on the number of tax audits, the “severity” of certain reassessment positions, and potentially the tax rates and measures which will follow to compensate the State’s budgets for part of this reduction in tax collections and increase in public spending.

As discussed below, the impact on the French and worldwide transfer pricing environment will be huge, in scales probably unseen since the development of a transfer pricing framework.

From a transfer pricing perspective, there are both similarities and differences with the 2008 crisis. Similarities may relate to some intra-group financing aspects where we may again expect a surge in risk premiums (hence spread) and higher volatility of rates. However, issues relating to access to cash are likely to be more important than in the previous crisis. Another important discussion that is likely to be raised relates to the remuneration of entities that deserve a routine remuneration.

2. Business performance as a result of the COVID-19 pandemic:

a. What do you see as the impact of the COVID-19 pandemic on low-risk entities (which typically bear limited risks, and record limited profit margin when the principal entity incurs a loss) in your jurisdiction? Do you see your jurisdiction accepting that such entities can lose money during this unusual economic downturn?

It is certainly too soon to make a definitive judgment on this matter; but just like a launching period in a new territory is considered a justification for a temporary loss position of a limited risk entity, the current economic downturn might allow for the explanation of a similar loss position. However, this should not be systematic and should be based on a careful analysis of the facts and circumstances. Any such decision should be based on an economic analysis, including an analysis of the comparability factors prior to making an adjustment to routine remuneration. Changing the transfer pricing method and moving to profit (loss) split due to the crisis is probably not a good idea, but this does not mean that remuneration of so-called low-risk entities should always remain positive.

The very fact that certain recurring or fixed costs are to be borne by said entity, while the turnover is either reduced by lower local consumption or even local closure, depending on the types of business, will mechanically lead to this loss position. This needs to be analyzed in light of the comparability factors and the economic analysis being relied upon to evaluate the routine remuneration.

One key question, not specific to France obviously, will be to know whether the tax authorities in charge of the low-risk entity will consider that it is the entrepreneur’s responsibility to cover for all or part of this loss, if it is attributable to its own entrepreneurial risk. This will be an exercise to be performed on a case-by-case basis, depending on the actual risks shared between the parties, being noted that low-risk entities are by no means “no-risk” entities, which may also lead to a sharing of the COVID-related loss between

the parties (notably for parties in a profit sharing or cost sharing arrangement). Again, only a detailed analysis of the facts and circumstances can shed light on this.

If such a position is taken by the entrepreneur (either sharing of the loss or complete coverage of the loss), it will be key to assess the amount of the adjustment to compensate the low-risk entity.

It is clear that a unified approach to quantifying the loss and allocating it, originating from the OECD, would be more than helpful to prevent conflicts and double taxation between the States of tax residence of the entrepreneur and the low-risk affiliate. One may however wonder whether such guidance from the OECD would be able to capture and apply to all circumstances.

b. Are there MNEs in your country who are experiencing or likely to experience increased or expanded business opportunities despite the current pandemic? What strategies should these entities be mindful of with regards to their transfer pricing models?

Certain sectors are actually growing under the current circumstances, just like in any crisis. Certain life sciences players (notably medical device manufacturers, biotech, etc.), IT, or food companies have seen huge increases in both demand and market valuations.

For such entities, it is also key to have a reasoned approach to the crisis and to counterbalance any over optimistic approach regarding the generation of taxable profit or the valuation of its assets. Indeed, in the incredibly sensitive and variable markets we currently experience, such a position could change within days and certainly could not constitute a viable, long-term, period of reference for transfer pricing policies or internal valuations. In this context, the OECD guidance on hard-to-value intangibles and restructuring may be particularly relevant.¹

c. How are MNEs in your jurisdiction addressing comparability issues, or how would you advise them to address comparability issues? How should they treat loss-making comparables, to ensure that any adjustments factor in the current global epidemic and adequately reflect economic reality?

As mentioned above, the MNEs will likely not be in a position to wait until the end of 2021 (at best) to get 2020 comparable data to set out their 2020 transfer pricing policy. Based on this assumption, the only other possible method is to use the previous year's data (2018/2019), with a "COVID adjustment." This is likely to be the case for MNEs using the TNMM method notably, but other methods may also be affected one way or another. In this context, adjustments to comparable companies' financials or to taxpayer data may be contemplated. There are various approaches for doing so. For example, one may be able to use statistical analysis to adjust pre-crisis comparable data to the crisis. Another approach involves producing pro-forma financial statements of the tested party "but for" the crisis. At any rate, these approaches should be grounded in facts and circumstances, address comparability issues, and be documented carefully.

On the asset valuation side, we are currently also seeing "COVID-depreciations" on certain valuations, leading to an adjustment over the valuation of assets or companies. We have already experienced such an impact on M&A transactions between third parties, demonstrating that such depreciation or discount is clearly seen on the market but will certainly also be applied in transactions between related parties, where this position will also have to be documented to sustain a possible challenge from the concerned tax authorities.

The impact of certain public subsidies or subventions could also affect the comparability exercise: should they be kept "in" the valuation as they compensate the unprecedented current situation or "out" because they generate a bias in the comparison? It is only if they compensate as accurately as possible the underperformance of a given entity that reliance on previous years as a totally comparable situation could be justified, but it is fair to say that such a demonstration is closer to the "Holy Grail" than any economic reality! Again, a unified approach between OECD countries would be more than welcome to avoid conflicts in this regard, but it may be difficult to develop a unified approach that reflects all circumstances.

d. How likely are the tax authorities in your jurisdiction to consider "economic circumstances" as a relevant comparability factor?

In the authors' opinion, it will be impossible for the French tax authorities to simply not consider or bypass these economic circumstances. Their impact is way too obvious not to be taken into consideration on all transfer pricing-related matters (loss allocation, valuation, etc.).

However, given the progressive decrease in the French corporate income tax rate—which is to set to decrease for larger companies from 31% in 2020 (for the portion of taxable profit over 500,000 EUR) to 27.50% in 2021 and finally set at 25% in 2022 (for these and any other company or PE located in France)—there is a clear risk that the authorities will scrutinize year-on-year shifting of profits and losses. Notably, any anticipated loss to decrease the 2020 taxable profit (by way of write-offs, depreciation, accelerated amortization, capital loss, etc.) will need to be carefully justified and even more so if they are exclusively "COVID-driven," as opposed to any other business justification.

3. How do you see the pandemic affecting APAs? What adjustments are MNEs making – or what adjustments should they make – to ensure that they will be considered to be in compliance with their agreements? Are companies looking to amend (or should they look to amend) their APAs, or are they just documenting changes in anticipation of possible future amendments?

Regarding APAs that are already concluded, each MNE will need to carefully review its content to ensure it is still enforceable and applicable because certain assumptions or economic stability conditions may no longer be met.

As discussed previously, certain MNEs will also want to renegotiate APAs in light of the current circumstances, with all the difficulties which can be anticipated at the level of each concerned State when the question of profit allocation will arise.

For APAs still under review, while it is unclear whether the current “freezing period” applicable in France over numerous judiciary and non-judiciary procedures is applicable to the APA process, we are of the opinion that at least the instruction will be longer than expected and may actually be deferred by the entire freezing period if this procedure is construed as falling within the scope of the ordinance 2020-560 dated May 13, 2020 (which applies, notably, to the tax rulings). In such cases, the applicable period will be extended by the time elapsed between March 12, 2020 and June 23, 2020.

4. Do you think there is a “silver lining” or bright spot about this economic situation that MNEs should be mindful of? What are possible opportunities that otherwise would not be sustainable in the absence of an economic crisis? Reset possibilities? Location-specific advantage?

The current crisis will be a game changer for certain MNEs, disrupting their organization in the future. In this sense, it can be an opportunity to “reset” the transfer pricing policy, in a year where comparability and valuation will be affected. At the same time, it also means the year 2020 is a “risky” year, where debates over said comparability and valuation with the tax authorities will be tough.

Finally, the OECD developments regarding the impact of the COVID crisis and confinement over the permanent establish-

ment (“PE”) characterization must be closely followed, when it comes to such transformative changes to the MNEs. Indeed, these guidelines will probably give insight into the “dos and don’ts” to be followed if remote work is more permanently applied for an MNE and/or if during the crisis certain key personnel were performing their duties in a different State than their usual location for a significant period of time (notably sales and management personnel). Under the current state of the OECD’s tentative position, the sole issue of remote work should not be sufficiently permanent and consistent enough to materialize a PE, but this should be monitored over the coming months. These positions will indeed affect how distant/remote work will be rolled over in organizations safely enough to avoid shifting the center of management of MNEs or key functions when it was not intended.

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¹ See <https://www.oecd.org/tax/transfer-pricing/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf>