FRENCH RESTRICTIVE INTERNATIONAL TAX REQUIREMENTS, TRANSFER PRICING and THE CHALLENGES OF VALUATION

- CROSS PERSPECTIVES -

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Setting up operations in a new country, reorganizing distribution networks, transferring assets or temporary assignment of employees within a group - here are some examples of transactions that lead international groups to question the nature of the object of the transfer, its valuation and the tax implications of the transaction.

Economically, the creation of international groups responds to the challenges of economic rationality and a consistent approach to markets.

When operating worldwide, a company must comply with a "transfer pricing" policy, i.e. the prices of transactions between associated companies must correspond to the prices that would have been observed between independent companies if they had complied with "*arm's* length" prices.

The French Finance Act for 2024 significantly strengthened transfer pricing controls.

So, to anticipate these expectations as effectively as possible, as well as the questions of investors and creditors, companies will attach increasing importance to the way in which these valuations are carried out.

Here are a few guidelines to help you make your assessment.

Framework of tax rules applicable until the entry into force of the French Finance Act for 2024

To challenge the tax deductibility of expenses incurred by a company, the French tax administration must in principle **provide proof** that the audited company (i) **decided** (intentional element) (ii) **to impoverish itself for purposes unrelated to its interests** (material element) (French Administrative Supreme Court 21 December 2018, no. 402006, Plén., Sté Croë Suisse).

In the **context of international groups**, however, the French Tax Authorities ("FTA") benefit from a simple presumption enabling them to add-back the "hidden profits" to the taxable income of the paying company (and potentially apply withholding tax and penalties for late payment). As a rule, the burden of proof lies with the FTA (unless the transfer of profits concerns a tax haven, in which case the burden of proof is transferred to the taxpayer). They must indeed **establish proof of the granting of abnormal advantages to related foreign companies**, for example: increased or reduced buying or selling prices, excessive royalties, interest-free loans,… (French Tax Code, art. 57).

In practical terms, to avoid these reassessments, the taxpayer has to demonstrate that it has benefited from a commercial or economic benefit from doing so (for example, the development of its own commercial policy).

The existence of an "abnormality" was generally assessed at the date a contract was entered into, although recently judges have assessed the situation with regard to subsequent years, taking into account the absence of renegotiation or termination of a contract (French Administrative Supreme Court 20 September 2022, no. 461639, 8th and 3rd ch., Sté SAP France Holding).

Following the new rules resulting from the Finance Act for 2024, our recommendation: "anticipate!"

The flagship measure of the French Finance Act for 2024 is the **lowering of the thresholds triggering the obligation for** groups **to document** their transfer prices to €150m for financial years beginning on or after 1er January 2024 (instead of €400m) and the increase in the **minimum penalty** for failure or incomplete documentation (from €10,000 to €50,000 per financial year audited).

The law also makes this **transfer pricing documentation enforceable against companies**. It introduces a simple presumption of profit transfer based on "*the difference between (i) [the company's] profit and (ii) the amount it would have been if this documentation [transfer pricing documentation made available to the tax authorities by the company] had been complied with*" (new Art. 57 of the French Tax Code). **The tax authorities are therefore no longer required to establish the existence of an abnormal advantage.**

This provision requires groups to ensure that the description of their transfer pricing policy and the intra-group contracts attached to the transfer pricing documentation are consistent with its financial statements.

Lastly, the tax authorities' control tools have been strengthened in the case of **hard-to-value intangible assets** as defined by the DAC 6 directive. The tax authorities will now benefit from a longer limitation period of 6 years and will be able to use actual financial data observed after the date of the audited transaction in order to adjust the value of an intangible asset (except in certain specific cases).

In practice, greater care will need to be taken when drafting the contract, particularly when defining the purpose and documenting the prices.

The challenges related to valuation

The tax authorities' extensive powers of control make it all the more important **(i)** to ensure the quality of the valuation carried out and **(ii)** to justify the assumptions made, in particular the analysis of the risks included in the projections used.

Which approach(es) should be chosen?

When it comes to choosing and applying valuation methods, companies can draw on a number of recommendations published by the tax authorities ([1]) as well as by other bodies such as the Autorité des Marchés Financiers (AMF), the International Private Equity Valuation (IPEV), the International Valuation Standards Council (IVSC), professional associations such as the Société Française des Evaluateurs (SFEV), and accounting standards such as IFRS 13, Fair Value Measurement.

These recommendations and best practices converge towards the implementation of a multi-criteria approach whenever possible.

Using a multi-criteria approach can involve combining intrinsic methods (methods based on future cash flows or costs) and extrinsic methods (such as comparable companies or comparable transactions), as well as using valuation benchmarks (e.g. stock market prices). The difficulty lies in the need to rationalise the results obtained and to understand the differences between the methods.

These principles apply equally to the valuation of companies and assets, particularly intangible assets, which are more specifically covered by the new provisions of the Finance Act 2024.

How do you choose the right assumptions and justify them? How do you implement these methods?

Any valuation is based on assumptions, which may (i) be numerous and (ii) vary, sometimes significantly, from one valuer to another. The key assumptions (i.e. those to which the value is particularly sensitive) must therefore be quickly identified and the relevance and robustness of these assumptions checked as a matter of priority.

[1] "L'EVALUATION DES ENTREPRISES ET DES TITRES DE SOCIETES" (November 2006 version, currently being updated): https://www.impots.gouv.fr/sites/default/files/media/1_metier/1_particulier/EV/1_declarer/180_isf/fichedescriptive_4166.pdf

For methods based on cash flows (e.g. Discounted Cash Flows (DCF) method for a company, relief from royalty or excess earnings method for an intangible asset), the main key assumptions may be:

- Sales growth and operating margin trends in the business plan adopted (over the plan horizon and in the terminal value).

- The capital expenditures (CapEx) and working capital requirements (WCR) needed to support growth.

- The discount rate (i.e. the expected rate of return used to determine the present value of future cash flows).

- The long-term growth rate used to calculate the terminal value (for assets and companies valued to infinity).

For methods based on peers (e.g. comparable companies or comparable transactions), the main key assumptions may include the following:

- The relevance and reliability of the aggregate used, which must reflect the expected performance of the company or asset being valued and not include non-recurring items so as not to distort the comparison over time.

- The relevance and reliability of the multiple used, which must be based on a panel of relevant peers.

With the strengthening, under the 2024 Finance Act, of ex-post controls on the valuation of intangible assets, the justification of all these assumptions is becoming particularly important. Now more than ever, it is necessary to test the robustness of these assumptions, by means of market studies, analyses of peers, analyses of reliability in relation to historical trends, and so on. In this way, it will be possible to demonstrate, if necessary, that any ex-post information available to the tax authorities was not anticipated (and could not reasonably have been anticipated) at the time of the valuation.

It is important to emphasize that methods based on multiples are simplified cash flow methods (i.e. expected future cash flows are "crystallized" in a multiple). It is therefore necessary, as with cash flow methods, to ensure the relevance of the sales growth and any induced margin changes included in the multiple used.

In conclusion, the strengthening of the documentation obligation and the extended possibilities for *a posteriori* control of the value by the tax authorities should lead companies to anticipate their intra-group transactions that may have a tax impact. The quality of the drafting of contracts and the proper documentation of the assumptions relating to valuation are essential elements in limiting the risk of the tax authorities calling the transaction into question.