RONALD P. SOKOL*

French Taxation of Inter-Company Transfer Agreements: Article 57 v. Section 482

Introduction

It is increasingly apparent, and equally inevitable, that the tough questions arising out of the allocation of income and deductions between related taxpayers residing in different countries have become more acute. The tax authorities of each country responsible for collecting revenue understandably want to get their fair slice of the pie. In the United States, the knife used to cut the pie is section 482, labeled by one commentator as "an *in terrorem* provision of the Internal Revenue Code. . . ."[1] Although that provision has been around since 1928, the IRS only began to use it aggressively in the international field in the 1960s.[2] That other major industrial countries now want to put a knife in the pie is only natural. To fail to do so would be to acquiesce in a distortion of the revenue base.[3] The lost revenue potential is significant. Of adjustments made by the IRS in 1968 and 1969, for example, the average for a pricing misallocation was $1,796,000 per adjustment.[4] Obviously the impact of such a tax adjustment on an individual corporation can be dramatic. Moreover, the correlative adjustment of the foreign tax situation may no longer be possible.[5]

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*J.D., LL.M. University of Virginia. Member of the Wisconsin Bar; Registered conseil juridique in France. Law Offices of Ronald P. Sokol, Aix-en-Provence.

[1]Kragen, *Avoidance of International Double Taxation Arising from § 482 Reallocation,* 60 CALIF. L. REV. 1493 (1972).

[2]*Id.* at 1494.

[3]Kauder, *International Allocations of Income: Problems of Administration and Compliance,* 9 J. INT. L. & ECON. 1, 6 (1974).

[4]*Id.* at 21 citing U.S. Department of Treasury, Summary Study of International Cases Involving Section 482 of the Internal Revenue Code, January 8, 1973.

[5]Bischel, Tax Allocations Concerning Inter-Company Pricing Transactions in Foreign Operations: A Reappraisal, 13 VA. J. INT. L. 490, 500 *passim* (1973).

The purpose of this article is to examine the equivalent French provision, Article 57 of the *Code Général des Impôts,* and to compare in a general way the tests applied by the respective taxing authorities of the two countries.[6] France now follows the United States, Japan, and West Germany as the fourth industrial power in the free world. It is, moreover, moving rapidly towards a tax system similar to our own. And there are scattered signs indicating that a more vigorous protection of the tax base can be expected.[7]

In the area of allocation of income and deductions, legal counsel in France is considerably hindered by the paucity of published guidelines. Even in the United States, where the rules have evolved further, there has been "a continuous stream of comment and criticism from the U.S. business community."[8] Criteria have tended to a high degree of generality. Most cases seem to be settled in the United States, not on the basis of an application of the Regulations, but "on what would be termed a 'horsetrade' basis."[9] In France the difficulties of offering legal counsel are even more acute and call for not only a knowledge of the relevant case law, which is sparse, and the single general instruction issued by the French tax authorities,[10] but a sensitivity to, and awareness of, underlying local and national economic realities. In this respect, advising in this area often seems more akin to offering antitrust counsel than tax counsel. The rules are amorphous, uncertain, mercurial, and the stakes high. It is within this framework that one must examine the French allocation problem known in France under the name of the indirect transfer of profits.

Statutory Framework

Indirect transfer of profits are subject to a three-pronged fiscal attack under Section 482 of the U.S. Internal Revenue Code, Article 57 of the French Code Général des Impôts (made applicable to French corporations by Articles 209

[6]The only significant commentary in English on Article 57 that has appeared to date appears to be the discussion included in the World Tax Series of the Harvard Law School, *Taxation in France* §§ 11/2.6b and *Shifting of Profits from and to Foreign Subsidiaries,* 13 EUROPEAN TAXATION 265 (1972); *See also* Lefebvre, *Taxes in France* § 221 (1977) and Madere, *International Pricing: Allocation Guidelines and Relief from Double Taxation,* 10 TEXAS INT. L. J. 108 (1975). Lefebvre gives a good introductory survey of the French tax system. Madere discusses the Section 482 equivalent provisions in various countries including France. For further recent discussion see *International Taxation and Transfer Pricing,* 1976 CORPORATION LAW INSTITUTE, FORDHAM UNIVERSITY SCHOOL OF LAW, pp. 161-189 (1977).

[7]Law N° 1234 of December 29, 1976 taxing persons fiscally domiciled in France on worldwide income is only the most visible and perhaps dramatic of recent moves.

[8]Kauder, *supra* note 3 at 23. *See also* Bischel, *supra* note 5 at 515.

[9]Kragen, *supra* note 1 at n. 17.

[10]Note of 4 May 1973, B.O.D.G.I., N° 82, May 9, 1973.

and 221),[11] and Article 8 of the U.S.-French double taxation treaty of 28 July 1967.[12] It is useful to look at the language of each of these provisions to appreciate the scope and discretion that they confer upon the tax authorities of the two countries:

> Article 57. For the establishment of income tax due by enterprises which are in a position of dependence on or which possess the control of an enterprise located outside of France, profits indirectly transferred to the latter, either by increasing or decreasing the purchase or selling price or by any other means, are reintegrated in the final accounting. It shall be the same in respect to enterprises which are in a position of dependance on another enterprise or on a group of enterprises holding as well the control of enterprises located outside of France.
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> In the absence of specific data for accomplishing the reintegration, the taxable income shall be determined by comparison with similar enterprises normally managed.[13]
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> Section 482. Allocation of Income and Deductions Among Taxpayers. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary . . . may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.
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> Article 8. Related persons (1) Where a resident of a Contracting State and a resident of the other Contracting State are related and where such related persons make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, then any income which would, but for those arrangements or conditions, have accrued to the resident of the first Contracting State but, by reason of those arrangements or conditions, has not so accrued, may be included in the income of the resident of the first Contracting state . . .and taxed accordingly.

The legislative history shows that Article 8 was simply meant to be a treaty analogue to section 482, and it will not be discussed further here. No reported cases appear to have occurred under it, either in the United States or in France,

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[11]In certain instances involving countries having a privileged fiscal relationship with France Art. 238A of the CGI is also relevant. It will not be discussed here as Art. 57 is sufficiently broad to cover the problem.

[12]Convention between the United States of America and the French Republic with Respect to Taxes on Income and Property, 19 UST 5280, TIAS 6518.

[13]The translation is the author's. The French text is as follows:

> Article 57. Pour l'établissement de l'impôt sur le revenu dû par les entreprises qui sont sous la dépendance ou qui possèdent le contrôle d'entreprises situées hors de France, les bénéfices indirectement transférés à ces derniers, soit par voie de majoration ou de diminution des prix d'achat ou de vente, soit par tout autre moyen, sont incorporés aux résultats accusés par les comptabilités. Il est procédé de même à l'ègard des entreprises qui sont sous la dépendance d'une entreprisé ou d'un groupe possédant également le contrôle d'entreprises situées hors de France.
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> A défaut d'éléments précis pour opérer les redressements . . . les produits imposables sont déterminés par comparison avec ceux des entreprises similaires exploitées normalement.

probably because the administrative authorities of both countries prefer to utilize the respective clauses of their own tax codes, that is, Article 57 or section 482.

Enforcement Framework

Two final provisions should be kept in view prior to discussing the above provisions: Article 27 of the U.S.-French treaty of 1967 specifically provides that "The two Contracting States undertake to lend assistance and support to each other in the collection of the taxes to which the present Convention relates" and Article 26(1) states that "The competent authorities of the Contracting States shall exchange such information as is pertinent to carrying out the provisions of this Convention or preventing fraud or fiscal evasion in relation to the taxes which are the subject of this Convention." A recent U.S. federal appellate court decision interpreted an analogous article in the U.S.-Canadian tax treaty to mean that the Canadian government can utilize the enforcement machinery of the IRS to enforce a purely Canadian tax obligation against a Canadian company. *United States v. Burbank and Co.*[14] Thus, under both the treaty provisions and the *Burbank* case, the French tax authorities can obtain access to corporate documents and all necessary information that it might need to determine if any indirect transfer of profits by a French company has occurred.

General Guidelines

For Article 57 to be invoked by the tax authorities two requirements must first be met:

(1) There must be a link of dependency between the French company and the foreign company. The link can be either a formal, legal link or simply a factual link, such as the same people involved in both companies, although no legal ties bind them. This link of dependency ("liens de dépendance") ordinarily is not difficult to discern and will not be discussed further here. Normally it can be assumed as one of the obvious parameters of the problem.

(2) There must be an indirect transfer abroad of profits not arising out of the normal management of a company ("transfert indirect de bénéficies à l'étranger ne relevant pas de la gestion normale de l'éntreprise."

These indirect transfers can occur through any one of five methods set forth by the French administration:[15]

(a) increasing or decreasing the purchase or sale price,

[14]525 F.2d 9 (2d Cir. 1975), *cert. den.* 97 Sup. Ct. 2647 (1976).
[15]Note of 4 May 1973, *supra* note 10.

(b) excessive royalties or royalties without consideration,
(c) no interest or low interest loans,
(d) cancellation of interest due under a loan agreement or cancellation of debt, and
(e) conferring benefits out of proportion to the service or performance received.

The French administration lists these methods for illustrative purposes and does not feel limited by them. In any event, they would appear broad enough to cover most indirect transfers.

Presumption of Indirect Transfer

Of major importance to the application of Article 57 is the use of a presumption by the French Administration which turns not upon the *intent* behind the transfer of profits, but upon *the existence of advantages accorded by a French company to a foreign company.* If the Administration concludes that such advantages exist, then there automatically arises a rebuttable presumption that there has been an indirect transfer of profits, and the Administration accordingly can invoke Article 57. Unless the company can rebut the presumption by specific evidence that the transfer was for sound and normal business reasons, the government wins its case by virtue of the presumption.

Allocation and Penalties

The profits that were indirectly transferred are reintegrated into the company's income. There is also potential liability for tax fraud under Article 1741 of the French Tax Code which carries a penalty of 5000 to 30,000 francs and can be accompanied by one to five years imprisonment. If the tax fraud occurs through the use of false, absent, or inaccurate invoices, the fine can be 5000 to 100,000 francs, and imprisonment for two to five years.

Existence of Advantages and Pertinent Case Law

The vagueness of the test phrased in terms of "the existence of advantages"[16] makes it a potentially lethal weapon in the hands of the tax authorities. It should also be noted that the transfer of "advantages" could encompass the shifting of losses, although Article 57 itself speaks only of profits.

[16]Dictionnaire Joly, *Sociétés Anonymes* T-3, Série A, Impôts sur Bénéfices § 13, Feuillet N° 21.

The statutory language calls for a comparison of taxable income of other companies similarly situated and managed normally. The theory used by the Administration is "the act of abnormal management" ("l'acte de gestion mal"). If there are other companies in France to which the corporation in question can be compared, this is surely the route the tax administration will follow. However, the law, at least by implication, does allow the company to show that there exist sound business reasons for the transfer. If, for example, a French firm pays to a foreign subsidiary sums which it fixes annually, unilaterally and at its discretion, and the transferor is unable to show that the sums were in payment of services actually rendered, then the sums have been reintegrated into income pursuant to Article 57.[17]

The critical presumption of an indirect transfer in violation of Article 57 also comes into play as soon as a no interest or a low interest loan is involved.[18] The same presumption occurs if interest normally due is not demanded in payment. Again, the threory is that such a course of action is not a normal part of management in a commercial context. However, the Conseil d'Etat has permitted no-interest loans between a parent corporation and a subsidiary, and rejected the tax authorities invocation of Article 57, when the subsidiary had serious financial difficulties which would have jeopardized the credit rating of the parent corporation and caused problems more serious than the loss of interest.[19]

The Conseil d'Etat has accepted the principle of a fixed sum paid by one related corporation to another to offset promotional expenses or other expenses.[20] The rub is that the fee must not exceed that which would be "normally due." It is not entirely clear under the existing law whether "normally due" refers to what would be due between unrelated companies or whether the transferor can legitimately take into consideration the fact of association and the financial strength of its subsidiary, as in the no-interest loan for a financially weak subsidiary cited above and approved by the Conseil d'Etat in 1967. Logically, the test should apply to fixed sums paid to offset promotional and other expenses as well as to loans. Prudence, however, would suggest that logic is a dangerous guide in this area. The least dangerous path, as indicated by the case law, is to divide common expenses as a function of gross sales of the subsidiary over gross sales of the entire family of companies.[21] This is not always a useful method, and it is not the only one permitted. What would appear to be

[17]C.E. 22 Dec. 1958, N° 40337 to 40341. *See Lefebvre,* IMPÔTS DIRECTS, VOL. II, BIC XVII § 50 (15 Oct. 1975).

[18]Lefebvre, *Id.* at § 51.

[19]C.E. 13 Jan. 1967, N° 68139.

[20]C.E. 8 May 1944, N° 66968 and 68362. *See* LEFEBVRE, *supra* note 17 at § 52b.

[21]C.E. 25 April 1960, N° 45089.

critical is that there be a fair relationship between the transfer and the benefits received.

Ambiguity of Normal Management Test

The test employed by the French tax authorities and by the case law seems to return to the concept of "normal management." What is unclear—and critical—is whether the fact that the companies are related can be taken into consideration to determine what is "normal management." Neither the institutions and interpretations of the French tax administration, nor the French case law on the subject, nor the principal French tax treatises and looseleaf services directly confront this ambiguity.

This ambiguity in fact gives rise to two separate theories of the multinational company: (1) "The separate entity theory views each of a MNC's subsidiaries which carry on business of a continuing and substantial nature as separate and independent entities." while "The unitary entity theory . . . views a group of affiliates as a single business which for reasons of legal convenience is divided into purely formal, separately-incorporated subsidiaries."[22]

Obviously the test of what is normal management will differ according to the theory adopted. Under the separate entity theory it would be to maximize profits for the entity in question, whereas under the unitary entity theory it would be to maximize overall profits of the entire business group. Under this latter theory, indirect transfer of profits to minimize taxes and assist new subsidiaries in getting started could certainly not be considered abnormal acts of business management. But of course they are so considered both by the French and U.S. tax authorities. It is clear that, by and large, the tax administration and the courts adhere to the "separate entity theory."

Arm's Length Test in the United States

To appreciate the probable scope and trend of the French law, it is useful to look at some of the various tests applied by the IRS and the American case law:

1. Does the transfer price clearly reflect income? The regulations provide three specific methods of testing this in intercompany sale of goods situations, which will not be discussed here.
2. Are the business activities legitimate, that is, is there a legitimate business purpose?

[22]Note, *Multinational Corporations and Income Allocation under Section 482 of the Internal Revenue Code,* 89 HARV. L. REV. 1202, 1205 (1976).

3. Is tax avoidance one of the purposes?
4. What percentage of total MNC income is the subsidiary receiving and how does it compare to its percentage of total MNC capital?
5. What percentage of total MNC payroll does the subsidiary have and how does it compare to subsidiary income as a percentage of MNC income?

The second test should be singled out because while the question of legitimate business purposes is raised, the general rule under section 482 in the United States is that transfer price manipulations will not be excused by the existence of a legitimate business purpose. (Reg. section 1.482-1(c); *Eli Lilly and Co. v. United States,*[23]). The decision of the French Conseil d'Etat, the highest court in tax matters, in 1967 clearly disagrees. There the court approved the no-interest loan to its financially troubled subsidiary.

Even in the United States the situation is not quite as clear as the *Eli Lilly* case would have it. In that case the court specifically stated: "The thrust of section 482 is to put controlled taxpayers on a parity with uncontrolled taxpayers."[24] But the direction of the law is clear enough: "the decisions evidence a distinct historical trend from a test of 'reasonableness' of the profits reported by each entity to a strict 'arm's length' test of what the profits of each entity would have been if they were unrelated parties bargaining with each other."[25] In the words of another commentator: "Intercompany prices must be set for section 482 purposes at levels which would have been charged unrelated parties in comparable arm's length transactions. . . . Moreover, it will be no defence to a charge of non-arm's length pricing that the deviation from arm's length was inadvertent, . . . or that no income is realized from a transaction by other members of the controlled group. . . ."[26] The Regulations define an "arm's length" charge for services rendered as "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts."[27]

The Arm's Length Test can probably be safely considered as the American test. In the author's opinion, it will be adopted as well by the French administration and French courts and will emerge as the French test as well, but at the present time it would, in light of the case law, be an exaggeration to call it the applicable French Law. It is one boundary of the French test but not all of it. Obviously if the Arm's Length Test can be met, the French administra-

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[23]372 F.2d 990, 999 (Ct. Cl. 1967).
[24]*Id.* at
[25]GIFFORD, INTERNATIONAL TAX PLANNING 86 (Tax Management, 1974).
[26]Note, *supra* note 22 at 1213, n. 53.
[27]Reg. § 1.482-b(b)(3).

tion will be satisfied, but if it is not met, it might still be satisfied, if it can be shown that the transfer involved did not arise out of abnormal or suspect management practices. The French test hence might be labeled the Act of Abnormal Management Test (l'acte de gestion anormal) with the French tax administration looking principally, but not only, to the consideration of whether parties acting at arm's length would have acted the same way.

Arm's Length Test v. Golden Egg Strategy

Handling intercompany arrangements and transfers, to the extent possible, as if the companies were not related, and hence dealing at arm's length, has much to commend it as a long-term policy of a multinational company. It is apt (1) substantially to reduce legal fees and costs over a period of years, (2) to save a substantial amount of management time, and (3) to give a more accurate picture of the return on capital.[28] To suggest such a policy by no means undercuts all the advantages of a multinational enterprise.[29]

The arm's length test was also embraced by the United Nations in its *Report of the Group of Eminent Persons to Study the Impact of Multinational Corporations on Development and on International Relations.*[30] It recommended this test whenever possible home and host countries should enforce arm's length pricing. In the United States, for example, "a significant portion (more than a quarter of United States exports by some estimates) of international trade has been transferred from 'arm's length' to intra-enterprise transaction,"[31] and this has led to an increasing use of section 482 by the IRS.

There are also presently attempts under way to formulate some sort of a multilateral treaty to govern the conduct of multinational companies,[32] but the conclusion of such a treaty is probably at least several years away. However, the lack of a treaty will not prevent individual countries from trying to enforce the arm's length standard, as the United States is already trying to do.

Opposing the arm's length test as a long-term corporate policy is the "golden egg strategy." It is to resist vigorously every infringement and restric-

[28]"The operation of arbitrary displacement of profit from one company to another obscures judgment of the true return on capital in any one company and may be counter-productive." TINDALL, MULTINATIONAL ENTERPRISES, p. 285 (Oceana, 1975).

[29]"The essence of the MNC is, in some sense, that it combines—besides capital, management and technology—a web of marketing ties which gives it a competitive edge over economic rivals." Grayson, L.E., *The Means of Regulation of Multinational Corporations* in THE FUTURE OF THE UNITED STATES MULTINATIONAL CORPORATION, p. 142, Unterman and Swent eds. (U. Press of Va. 1975). *See generally* Perlmutter, *Perplexing Routes to M.N.E. Legitimacy: Codes of Conduct for Technology Transfer,* STANFORD J. INT. STUDIES, XI, 169-199 (Spring, 1976).

[30]New York, United Nations, 1974, E/550/Add. 1, pp. 73-75.

[31]*See* Rubin, *The Longer Range Political Role of the Multinational Corporation,* in GLOBAL COMPANIES, G.W. Ball ed., p. 133 (Prentice Hall, 1975).

[32]*See* Rostow, Nye, and Ball, *The Need for International Arrangements,* GLOBAL COMPANIES, *id.* at 156.

tion of the host government and "seek to prove that the goose roasted is worth less than the goose laying golden eggs."[33]

This is a more adventurous policy. If a company's economic weight in the community is heavy enough and the profits important enough, such a policy may be justified. While the factors leading to the decision turn on an evaluation of legal considerations, the decision itself is an economic one, at least as long as laws are not flouted and nonfrivolous arguments can be advanced in support of a particular allocation.

[33]Nye and Rubin, *supra* note 31 at 141.