

Distribution channels and international taxation

Both the choice of sales mechanisms and the reorganization of commercial functions within a group can entail discussions with the French tax authorities when their implementation leads to the erosion of the tax base in France.

Given the recent developments in French tax case law, a brief overview of the pitfalls to avoid can certainly be useful for international groups doing business in France.

With more than 65 million inhabitants, France is the fifth largest market in the world and the second market in Europe. France also remains the leading tourist destination in the world⁽¹⁾. As such, setting up a place of business in France can be an important issue for foreign companies.

Sales mechanisms are quite diversified and can entail discussions with the French Tax Authorities (“FTA”) when their implementation leads to the erosion of the tax base in France.

1. The main tax concepts that impact international distribution channels

The devices used by the French Tax Authorities to control international groups are primarily structured around two concepts: (i) permanent establishment and (ii) transfer pricing.

(i) A “*permanent establishment*” is made up either by a fixed place of business through which the business of a company is wholly or partly carried on or, in the absence of a fixed place of business, by a dependent agent having the authority to act on behalf of the company in the ordinary course of business.

If the FTA can establish the existence of a permanent establishment in France, they may tax in France part of the income earned by the foreign parent company.

(ii) According to the Organization for Economic Co-operation and Development (“OECD”), transfer prices mean “the prices at which a company transfers tangible or intangible assets or perform services to affiliated companies”.

If the FTA can establish the transfer of profits, they may tax such transfer at the standard corporate income tax rate and, as the case may be, apply a withholding tax, considering that the profits have been distributed to the parent company.

2. Using a distributor

The distributor is a person or entity, acting in his/her/its own name and on his/her/its own behalf, who acquires products from a supplier and resells such products to its clients. This situation describes the standard purchase-resale mechanism. The distributor is remunerated by the gross margin earned on the resale of the products.

When the distributor is affiliated to a foreign group, there exists a risk that the FTA may consider that the agreed prices are different from the prices that would have been applied between two independent entities and, as a consequence, infer that there is a transfer of profits between the two affiliated companies.

To hedge this risk, the relevant companies must prepare and keep all elements likely to justify the transfer pricing policy applied between them, in particular the appropriate tax documentation.

3. Using a representative: *commissionaire* or commercial agent

The *commissionaire* commits towards a principal (the producer) to sell a product or a service in its own name on behalf of the principal. The *commissionaire* enters into a contract with the end customer but it never becomes the owner of the sold product/service^[2].

The commercial agent is permanently entrusted with the negotiation and, as the case may be, the conclusion of contracts in the name and on behalf of its principal (the producer)^[3].

The *commissionaire* and the commercial agent are remunerated by way of commissions.

(i) The representative: a concealed permanent establishment?

In the past, the FTA have tried to establish that a French *commissionaire* of a foreign company was to be considered as a permanent establishment of its principal. According to the FTA, the *commissionaire* was a

dependent agent of the foreign company empowered to engage the parent company in a business relationship with consumers, and, therefore met all the criteria used to establish the existence of a permanent establishment.

However, the *Conseil d'État*¹⁴¹ (French Administrative Supreme Court), sitting as the Court of final appeal, followed the argumentation of the principal and held that “it does not result from these provisions that the agreements concluded by the company ZIMMER SAS (the *commissionaire*) bind the company ZIMMER LIMITED (the principal) towards the *commissionaire*'s clients; as such, whatever its level of dependency vis-à-vis ZIMMER LIMITED, ZIMMER SAS may not be considered as an agent of ZIMMER LIMITED”.

One of the main criteria applied by the *Conseil d'Etat* to deny the existence of a permanent establishment is that the commercial agent or the *commissionaire* has not the power and authority to bind the principal vis-à-vis the end consumers.

When setting up such *commissionaire* or commercial agency contracts, a specific attention must be paid to the legal regularity of the contemplated arrangements and to the drafting of the contractual provisions to avoid that the commercial agent or *commissionaire* be re-qualified as a permanent establishment.

(ii) The commission: a transfer price?

Insofar as in these mechanisms the representatives never become the owner of the products/services, the main risk arises from the payment of commissions.

The subsidiary (*commissionaire* or commercial agent) must be able to prove that the remuneration it receives from the group is in line with the remuneration that would have been paid to an independent company, in accordance with the arm's length principle.

To mitigate this risk, the relevant companies must - as indicated above - duly prepare and keep all elements capable of justifying the applied transfer pricing policy, in particular the appropriate tax documentation.

When an efficient sales mechanism has been put in place, it is usually safer to stick to it because the reorganization of commercial functions within an international group may be highly risky from a tax perspective.

4. Reorganizing commercial functions

The OECD defines business restructuring transactions as the cross-border redeployment of functions, assets and/or risks among related entities.

With respect to sales channels, this concerns in practice restructuring transactions where full-fledged distributors become *commissionaires* or commercial agents acting on behalf of a related entity.

In these two cases, the FTA has considered in the past that the distributor has transferred its clientele.

This re-qualification as transfer of clientele can entail (i) the payment of registration fees calculated on the basis of the market value of the clientele deemed transferred^[5], and (ii) a tax re-assessment in respect of the transfer prices, i.e. the taxation of the theoretical “capital gain” earned by the French subsidiary at the standard corporate income tax rate (33.1/3%), and the taxation of the alleged distribution paid to the foreign parent company.

In a case that is still pending, the FTA relied on the above principles to impose a tax re-assessment on the French subsidiary of an English company that used to operate as a distributor before being converted into a *commissionaire*. The FTA have tried to demonstrate that there had been a transfer of clientele from the distributor to the English parent company.

The Paris Administrative Court of Appeals^[6] considered that “*given the nature of the commissionaire contract, i.e. a contract that is not an autonomous contract but a prerequisite to the conclusion of other contracts that it [the commissionaire] signs in its own name and on behalf of its principal, the company Ballantine’s Mumm Distribution, may not be deemed as having transferred its clientele*”.

Indeed, legally speaking, the *commissionaire* acts in its own name and hides the principal from the sight of the client who has no legal relationship whatever with the latter. Only the *commissionaire* is personally bound towards the end customer^[7]. In the commented matter, the Paris Administrative Court of Appeals thus held that the *commissionaire* had kept its clientele.

The outcome would have been probably different if the distributor owning the clientele had been converted into a commercial agent, i.e. a transparent intermediary not involved in the transaction with the final customer.

Yet, despite the apparent sound reasoning of the Paris Administrative Court of Appeals, the FTA have decided to appeal before the *Cour de Cassation* (French Supreme Court).

The debate that will continue to oppose the FTA and businesses mainly focuses on the ownership of the clientele. In other words, the underlying question is: did the business restructuring transaction have the purpose or the effect of transferring the clientele to the foreign parent company.

In addition, the change in the status of the French subsidiary entails a real change of activity and the impossibility to use the losses recorded prior to the change of activity.

Consequently, when reorganizing the commercial functions of an international group – and perhaps even more



than when determining the most appropriate distribution channels -, a careful diagnostic of the tax implications should be performed to minimize the costs of the reorganization and contain the risks.

[1] Source: Invest in France Agency

[2] The status as *commissionaire* is defined in Article L 132-1 of the French Commercial Code

[3] The status as commercial agent is defined in Article L 132-1 of the French Commercial Code

[4] *Conseil d'État*, 10th and 9th Subsections, March 31, 2012 Sté Zimmer Ltd.

[5] Exonerated below 23,000€, 3% from 23,000€ to 200,000€ and 5% in excess of 200,000€

[6] 9th Chamber of the Paris Administrative Court of Appeals, December 31, 2012, *Sté des participations et d'études des boissons sans alcool*

[7] Settled case-law of the *Cour de Cassation* (e.g. Commercial Chamber of the *Cour de Cassation*, July 15, 1963)

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