The impact of aggressive tax planning on workers' rights: the case of AAA France

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PSI FES Global Labour Tax Summit

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Chapter 1: The AAA case

Presentation of the legal restructuring and its impact on the company profit-sharing scheme

Nom de la société – nature de la mission – date
Ce rapport est destiné aux membres du comité d'entreprise

Early 2000s : functional centralization of AAA group

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- **Structure of AAA in the early 2000s :**
  - Decentralized (outside the U.S.) .
  - In France , a holding company controls all operational activities : production (2 sites) and distribution.
- **From a tax standpoint, the holding is considered as the primary contractor and hence can claim all profits and net income, because of :**
  - The specific market conditions in France
  - The existence of domestic brands in French market
  - Historic investments in this market.
- **Centralization of AAA group initiated in the early 2000s, called upon by:**
  - The standardization of consumption habits, product and markets across countries;
  - Concentration and the rise of the retail sector .
- **In France, the legal restructuring is implemented in 2005.**

The "Optima" project in 2005

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- **A Swiss company (Alpha Europe) is created & becomes the primary contractor of the group in Europe. Its mission :**
  - Strategic orientations of European entities
  - Direct responsibility over global brands
- **Commercial companies become "Limited Risk Distributor"**
  - responsible for implementation of the sales policy and customer relationship
  - retain a relative autonomy over local brands.
- **Industrial sites become sub -contracted manufacturers**
  - transform raw materials supplied by the Alpha Europe, based on specific terms of reference and fixed pricing.
- **Holding companies (in each country), formerly the primary contractors become service providers to:**
  - Alpha Europe, and
  - Local operating companies

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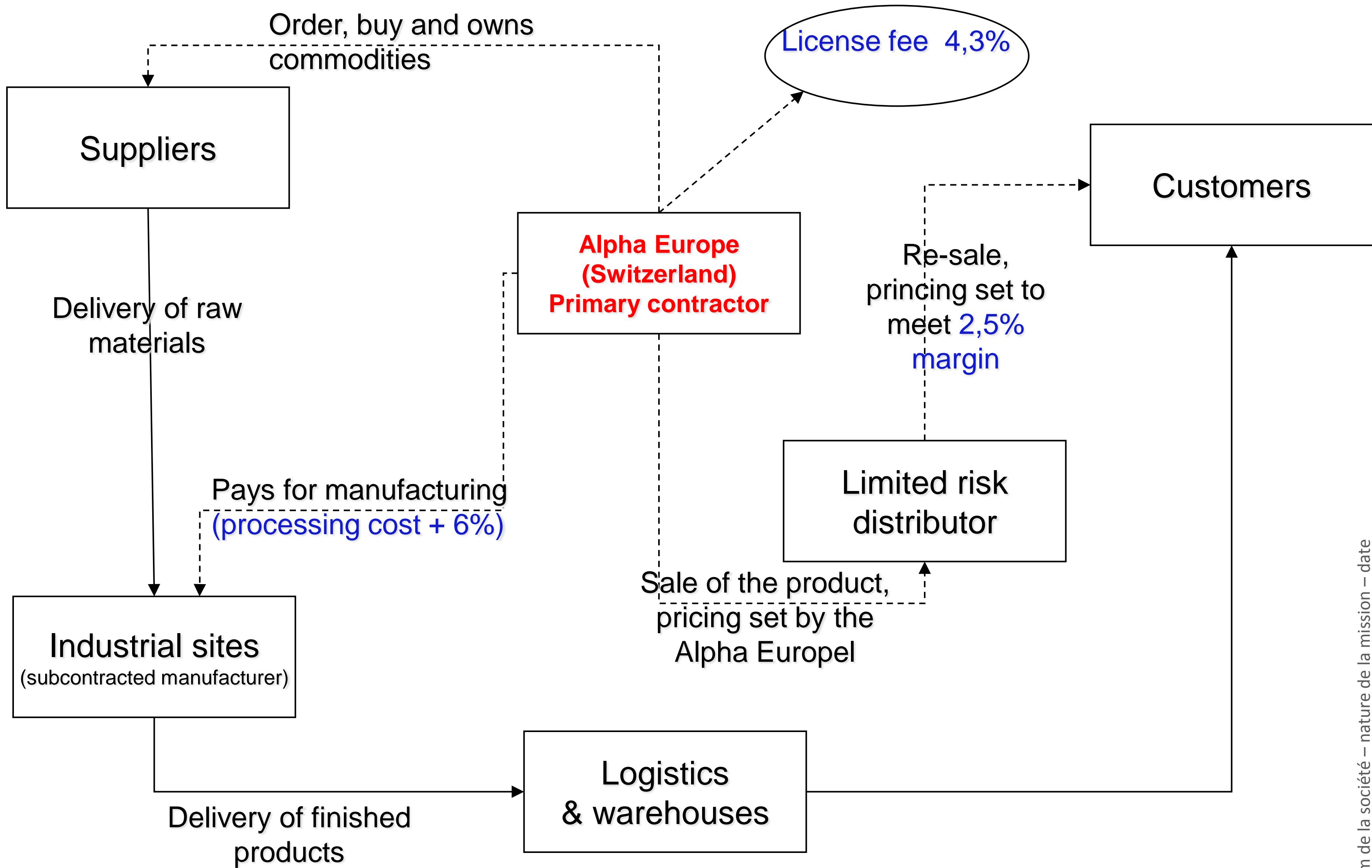
AAA post-2005 (for production and marketing of global brands)



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The 2005-2008 tax audit procedure

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- **Following this legal restructuring the profits of the business entity in France fell sharply .**
  - Distributors used to have an operating margin above 10 %,
  - That rate falls to 2.5 % after the restructuring.
- **The French tax authorities considered that the new transfer pricing policy constitutes an indirect transfer of profits.**
  - It challenged the status Alpha Europe as the primary contractor.
  - its creation had not resulted in sales growth (although it captured all profits from France)
- **The Swiss entity did not have the means to fulfil its strategic functions :**
  - essential functions are subcontracted because the entity does not have sufficient human and material resource;
  - capitalisation of the entity is insufficient to cope with the risks to which it claims to be exposed to
  - Trademarks are owned by another group entity
  - Marketing policy is the competence of other Group entities whose staff are partly employed by the French holding company of the Group.
- **As a result of the tax audit, several tens of EUR millions are claimed in tax arrears for 2005-2008**

Response by the company to the tax audit

- **Regarding the primary contractor status of Alpha Europe**
  - Alpha Europe is legally entitled to produce and sell under the global brands of the group
  - It supports all major risks associated with the Group's business in the region.
  - It has the responsibility over introducing new products ; It is therefore exposed to product risks and the costs associated.
- **AAA concedes that Alpha Europe outsources essential tasks related to its activity. However :**
  - it still controls and oversees implementation of the activities that are subcontracted, and Alpha Europe is accountable for their impacts and results and pays for the remuneration of subcontractors.
  - it owns the license rights for the group global brands for Europe region.
- **Regarding the shift of the French entities from primary contractor to service provider, and to limited risk distributors:**
  - The profitability of the French distribution company has been reduced to take account of reduced exposure to market risk (and based on comparability analysis and consistent with the OECD arm's length principle).
  - The French distribution company does not hold any intangible rights on the product it sells

Arbitrage decision of the National Commission for Direct taxes and taxes on revenues (appeal procedure)

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- **French tax administration did not challenge the legal reality of the contracts signed in 2005 by the Swiss entity**
  - Holding the trademark licenses for Europe, and
  - exposed to key marketing risk of products whose distribution is managed the French distribution company
- **However, the application of the arm's length principle should not be limited to the contractual terms, it should be grounded on a realistic analysis of the respective responsibilities of the Swiss entity and of the French company in order to determine whether**
  - 2.5 % (guaranteed) net margin rate of the French company is legitimate
  - All profits to be transferred to the Swiss entity.
- **To justify its net margin of only 2.5%, the French company submitted a comparability analysis which revealed that**
  - Its net margin was in the lowest quartile of the control group of distributors in the market place,
  - Despite the fact that its exposure to risk would be in higher quartiles

- **Rather than capturing all the profits made in France, it would make sense for the Swiss entity**
  - to be remuneration like a headquarter of an MNE (cost plus 6%)
  - to which could be added a sort of “insurance premium” ;
- **Accordingly,**
  - the Commission rejected the claims made by the French tax administration regarding the fictional nature of the risks borne by the Swiss entity,
  - At the same time however, the low 2.5% net margin that is left to the French company does not have a normal character and is drawn from dubious application of transfer pricing.
- **The Commission “invited the parties” to :**
  - Better take into account the low risk exposure of the Swiss entity
  - Better determine the extent of services provided by the French distributor and market risks to which it is exposed to

- **According to the french companies' profit-sharing scheme, profit redistribution to employee are calculated base on the traditional formula**
- **P = 1 /2 * (B - 5% * C) * S / VA .**
- **This formula is entirely dependent on a key variable, the level of equity, which was subject to change at the time of the Optima restructuring**
- **Given the excessively high level of equity in the French company, the distribution of profits allocated to employees is necessarily close to zero**
- **Profits distributed to employees during 2005-2007 were 40% lower annual average than during the 2000-2004 period**

The legal restructuring of the French company in 2005 (changes in transfer pricing, excessive capitalisation of the French holding company) had a significant negative impact on the redistribution of profits to employees post-2005

Chapter 2 : Lessons to be learned

What the AAA case tells us:

- **1 . Aggressive legal structure**
  - Economic fundamentals are unchanged (the customers are still French) but profits are shifted to a low-tax country.
  - Intra-group contracts are considered legally valid because reflecting the "autonomy of decision" of the parties thanks to the fiction of the "legal personality" of subsidiaries .
  - Economic reality (or substance) of these contracts is quite different however: under the guise of contracts, the group (legal unidentified object) is evading its tax responsibilities.
- **2 . Manipulation of transfer pricing**
  - Transfer pricing needs to be consistent with the arms’ length principle, itself based on market competition
  - How do we measure competition when 60% of international trade are intra-group transactions ?
  - The Arms length principle does not offer protection against manipulation of transfer pricing anymore

- **3 Excessive capitalisation of the French subsidiaries with the unique intent to minimise employees' share of profit distribution.**
  - the French entities, we are told, have few responsibilities and are exposed to limited risks.
  - And yet , the equity on their balance sheet amount to several hundreds million euros ...
  - And shareholder remuneration reaches significant levels: dividends and share buybacks are equivalent to some 20% of the group's revenues

In this context, the French tax law became inoperative:

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- **Notion of “Abuse of rights” (abus de droit) :**
  - If a legal restructuring is not exclusively accounted for tax purpose – and even if it is mainly accounted for – it will fall outside the scope of the Article of Law on Abuse of rights .
- **Notion of “abnormal act of management "**
  - Financial engineering that is set up to meet the “arm's length principle has reach a level of complexity that makes the current legal understanding of “abnormal act” completely obsolete
- **Transfer of profits :**
  - The application of Article 57 (on attribution of profits) is conditional to the existence of dependency between a French company and a foreign company.
  - The burden of proof is on the administration, except for jurisdiction that have “preferred taxation regime” , but surprisingly not for non-cooperative countries and territories.

Some ideas and reform

- **Shift to unitary taxation (formulary apportionment)**
- **Adopt the principle of "substance over form" in tax law to deconstruct the legal arrangements motivated solely by tax evasion.**
- **Adopt MNE-level regulation (national and international) that is adapted to the economic reality of today (globalization , digital economy) .**
- **Reform or move away from the current notion of "legal personality" to counter the contractual engineering for tax planning purpose**
  - Does a subsidiary has sufficient legal autonomy when it is contracting with its parent company ?
  - Can we really speak of a “contract” if, on substance, the contracting parties defend the same economic interests ?

About workers' rights

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- **Their financial rights (incl. profit sharing) are directly affected by the unfair manipulation of transfer pricing and aggressive legal structuring.**
- **"Aggressive social planning" is somehow a by-product of aggressive tax planning.**
- **But it can be sought primarily. This is the case of over-capitalisation of French subsidiaries to minimize or even prevent triggering employee-profit sharing agreements.**
  - In France, overcapitalising a company always is considered as a normal act of management .
  - Undercapitalization however is costly for tax purpose (because it prevent deductibility of interest debt to play in full)

About workers' rights

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- **French tax law is not fit anymore to defend gvt/public interest**
  - theory of abnormal act of management, indirect transfer of profits , abuse of rights
- **Corporate law protects the interests of minority shareholders**
- **Corporate governance regulation protects rights of all the shareholders and of boards.**
- **International accounting standards protect the interests of investors**
- **But labor law has no mechanism to protect collective financial interests of employees :**
  - The introduction of a profit-sharing agreement is only possible with the agreement of the Company management .
  - The statutory formula for calculating employee participation does not offer protection against optimization operations .