

# In the Courts

## France

### French Supreme Court Finds Zimmer Does Not Constitute PE of U.K. Parent

**T**he French Supreme Court March 31 held that a commissionaire does not constitute a permanent establishment of its U.K. parent, overturning a 2007 decision by the French Administrative Court of Appeals. [*Société Zimmer Ltd., Conseil D'Etat, Nos. 304715 and 308525, decision filed 3/31/10*]

The Supreme Court took a strictly legal approach to the case in holding that a sales contract concluded by Zimmer SAS, a French commissionaire, in its own name on behalf of its U.K. principal "does not bind the principal vis-à-vis the commissionaire's client," according to Laurence Delorme, a transfer pricing consultant and lawyer in Paris.

Delorme said the decision clarifies an area of great uncertainty for taxpayers operating under similar structures. She also said the Supreme Court addressed the key question—ignored by the appeals court—of whether the commissionaire legally binds the principal regarding clients.

The Paris Administrative Court of Appeals Feb. 2, 2007, had ruled that Zimmer SAS constituted a PE of Zimmer Ltd. in the United Kingdom because the French entity was a dependent agent of the U.K. principal and could sign agreements that were binding on the U.K. enterprise (16 *Transfer Pricing Report* 132, 6/27/07).

Zimmer Ltd., which specializes in orthopedics, sold its products in France through Zimmer SAS under a buy-sell arrangement. In 1996, the French company was converted into a commissionaire acting in its own name on behalf of Zimmer Ltd., an undisclosed principal. Following an audit of Zimmer SAS for 1994-96, the French tax authorities claimed Zimmer Ltd. had a fixed place of business in France under Article 4.1 of the France-U.K. treaty and also that while acting as a commissionaire, Zimmer SAS was a dependent agent with the power to bind Zimmer Ltd. in commercial transactions.

Delorme noted that while the Court of Appeals did not agree with the tax authority that Zimmer had a fixed place of business in France, it nevertheless found the company was a PE of the U.K. principal.

**Appeals Court Reasoning.** In support of its finding of PE, she said, the appeals court pointed out that Zimmer SAS could:

- accept orders from customers;
- display quotes and documents in the context of tender offers;
- conclude sales contracts on behalf of Zimmer Ltd. without the prior approval of the principal; and
- enter into price negotiations and grant discounts or payment terms to customers without specific prior approval of the principal.

The appeals court found Zimmer SAS's inability to conclude contracts in the name of the U.K. principal was irrelevant considering its ability to bind the principal in commercial transactions pertaining to Zimmer Ltd.'s own activity, Delorme said. The court also said Zimmer SAS could not be deemed to be acting as an independent agent under Articles 4.4 and 4.5 of the France-U.K. treaty because it acted under the control and instructions of Zimmer Ltd. regarding sales terms, promotion projects, and the development of new brochures.

**Legal Analysis.** Delorme said the appeals court failed to analyze the legal effects of the commissionaire arrangement, and in so doing ignored the key question in the case: whether the commissionaire "contractually binds—legally—its principal vis-à-vis its clients."

The Supreme Court, on the other hand, conducted an analysis beginning with French commercial law—old article 94 and new article L 132-1—as applicable to the status of a commissionaire, she said. Quoting from (and translating) the case, Delorme said the court found that

agreements concluded by the commissionaire, even though they are concluded for the account of its principal, do not directly bind the latter vis-à-vis the commissionaire's clients; it follows that a commissionaire cannot, in principle, be deemed to constitute a permanent establishment of its own principal, solely as a result of selling the principal's products or services by signing contracts in its own name, under application of the commissionaire agreement.

The court in confirming the legal status of a commissionaire and its relationship with its clients "adopts a position which is fully consistent with prevailing doctrine and court cases, whereby the commissionaire is solely liable vis-à-vis its client to the full execution of the contract, and the principal is not bound by the commissionaire's actions," Delorme said.

She noted that the decision rejects a purely factual analysis of the condition regarding the "authority to bind." The ability to bind "in fact," she said, is not recognized under civil law, but facts can be considered when analyzing the economic dependence of the commissionaire—something not disputed in the case.

**Risk of Requalification.** Delorme said the Supreme Court introduces some reference to substance over form in its analysis and thus leaves open the possibility that the tax authorities could "requalify" the commissionaire agreement if it appears that the commissionaire legally binds its principal.

Quoting from the decision again, she pointed to the court's statement that the commissionaire does not legally bind its principal and cannot be deemed a PE

unless it results, either from the terms of the commissionaire agreement itself, or from any other finding resulting from the investigation, that despite the

qualification as commission agreement given by the parties to the agreement, the principal is personally bound by the contracts signed with third parties by the commissionaire, which in such a case must be regarded as its representative and constitute a permanent establishment.

While the risk of requalification exists, she said, this argument may be difficult to invoke because the tax authorities may not use factual observations to establish such an allegation.

BY MOLLY MOSES

## India

### Mumbai ITAT Upholds Use of TNMM, Remands for Operating Margin Details

**T**he Mumbai International Tax Appellate Tribunal held April 5 that to determine the arm's-length price of an international transaction, the profit margin should be applied only to the international transactions and not to the total transactions of the taxpayer. [*Two International Pvt. Ltd., Tara Jewels Exports Pvt. Ltd., and Tara Ultimo Pvt. Ltd. v. ACIT, Mumbai ITAT, decision filed 4/5/10*]

In the case, the ITAT upheld the transfer pricing officer's determination that the transactional net margin method (TNMM) rather than the cost plus method was the best method to use, but agreed with the taxpayer that the TPO should not have applied the gross profit margins to the company's gross sales. The tribunal remanded the case for more information on the company's profit margins to determine the correct arm's-length prices.

Hasnain Shroff of KMPG in Mumbai said the ruling "reiterated that the computation of the transfer pricing adjustment should be restricted only to the international transactions of the taxpayer and not on the entire company." Shroff added that the same determination was made by the Delhi ITAT in *IL Jin Electronics (I) Pvt. Ltd. v. Asst. Comr. of Income Tax* (18 Transfer Pricing Report 1217, 4/8/10).

Shroff said the ITAT's application of only the net profit margin and determination that there was no scope for reducing interest and other overhead from it is "a very strict interpretation of law and warrants the taxpayer to document the reasons for adopting a profit indicator different from the net profit margin to benchmark its international transactions."

**Finished Jewelry Sales.** The taxpayer sold finished jewelry to its associated enterprises as well as to unrelated third-parties and enjoyed a 100 percent tax holiday under Section 10A of the Income Tax Act.

The taxpayer chose cost plus as the most appropriate method to benchmark its transactions for the cross-border sale of finished jewelry to its associated enterprises. The taxpayer also determined that because the 19.37 percent gross profit margin from its transactions with associated enterprises was higher than the 16.95 percent gross profit margin earned from its transactions with unrelated parties, the transactions were arm's-length.

For 2004-05, the TPO rejected cost plus as the most appropriate method on the grounds that the taxpayer could not provide detailed calculations of the margins. Moreover, the TPO observed that the unrelated-party transactions cited by the taxpayer were functionally different in terms, conditions, and risks undertaken when compared to the transactions with the associated enterprises.

The TPO instead used TNMM, provided a comparables set with an arithmetical mean of 7.25 percent operating profit/total costs, and made an income adjustment of 25.7 million rupees (US\$578,500) by applying 7.25 percent to the total costs of the taxpayer to find out the sales and then deducting the uncontrolled sales to determine the arm's-length price for the transactions with associated enterprises.

The taxpayer accepted the use of TNMM, yet protested that the TPO erred in computing the adjustment on total sales and should have computed the adjustment based only on the sales of the associated enterprises.

The TPO rejected the taxpayer's rectification application under Section 154. The taxpayer then appealed to the Commissioner of Income Tax (Appeals) and prevailed. The taxing authority appealed to the ITAT, arguing that the TPO properly rejected the taxpayer's Section 154 rectification application on the grounds that the taxpayer failed to give separate details for the gross profit margin on sales to related and unrelated parties. Accordingly, the ITAT cannot review Section 154 rectification application, the taxing authority contended.

**CIT(A) Ruling.** The CIT(A) held that under Section 92C(3), the taxing authority should determine the arm's-length price in relation to the transactions with associated enterprises only and not with the unrelated parties.

The CIT(A) then recomputed the arm's-length price by applying 7.25 percent of the associated enterprises' cost—arrived at by apportioning the total costs in the sales ratio—and observed that after considering the plus-or-minus-five-percent range, the international transactions were within the arm's-length range and therefore no adjustment was warranted.

**ITAT Ruling.** The ITAT agreed with the taxpayer that the TPO incorrectly applied the 7.25 percent net profit margin on the gross sales and followed a complicated procedure to arrive at the adjustment amount.

The ITAT also took issue with the CIT(A)'s determination that no adjustment could have been made. The tribunal set aside the CIT(A)'s order and sent the case back to the assessing officer on the following grounds:

- clarification is needed on whether the margins computed by the TPO were operating margins or net margins (the tribunal observed that only the net profit margin should be considered for TNMM); and
- additional details are needed on the breakdown of costs between the associated enterprises and the unrelated parties.

On remand, the tribunal also directed the assessing officer to use TNMM to benchmark the international transactions. The ITAT further directed the assessing officer to calculate the adjustment by reducing the net profit declared by the taxpayer from the gross sales, dividing the same in the controlled and uncontrolled sales ratio and applying the net profit rate.

BY TAMU N. WRIGHT

(Publication page references are not available for this document.)

Tax Management Transfer Pricing Report  
In the Courts  
June 27, 2007

**FRANCE: COURT FINDS FRENCH COMMISSIONAIRE WAS DEPENDENT AGENT OF U.K. PRINCIPAL**

The Paris Administrative Court of Appeals (second level jurisdiction) has ruled that the French commissioner of a U.K.-based principal constituted a permanent establishment in France because the French entity was a dependent agent of its U.K. principal and could sign agreements that were binding on the U.K. enterprise.[CAA Paris n° 05PA02361, 2 Feb. 2007, Societe Zimmer Ltd.]

In ruling that the commissioner constituted a PE, the Appeals Court said it was irrelevant whether the French concern acted in its own name and could not actually conclude contracts in the name of the principal.

The court decision has caused a great stir among French practitioners, according to Laurence Delorme of PricewaterhouseCoopers France (Landwell & Associates, correspondent law firm in Neuilly-sur-Seine). "The expectation is that the risk of commissioner structures being viewed as qualifying as permanent establishments of their foreign principals will increase in France following this case," she said. While the case may be appealed to the French Supreme Tax Court (Conseil d'Etat), the French tax authority in the interim will believe it has a valuable tool in addition to transfer pricing with which to attack commissioner structures, Delorme said.

Commissionaire Conversion.

The court ruling involves Zimmer Ltd., a U.K. company that specializes in orthopedics. Zimmer sold its products in France through its affiliated distribution company, Zimmer SAS, under a buy-sell arrangement. In 1995, the French entity was converted into a commissioner, Delorme noted.

Following a tax audit covering the years 1994-1996, France's tax authority, Direction Generale des Impots (DGI), claimed that Zimmer Ltd. had a "fixed place of business" in France under provisions of the France-U.K. tax treaty and that while acting as a commissioner, Zimmer SAS was a dependent agent with the power to conclude binding contracts for Zimmer Ltd.

Zimmer Ltd. was deemed liable for corporate income tax in France, plus a 40 percent penalty for failing to file a tax return, Delorme said. The court of appeals did not sustain the DGI's position that Zimmer Ltd. had a fixed place of business, but it agreed that Zimmer SAS was a PE of its U.K. principal, she noted.

Ability to Bind, Dependent Agent.

**(Publication page references are not available for this document.)**

The court's position was based on the fact that "Zimmer SAS had the ability to bind Zimmer Ltd. in commercial transactions pertaining to Zimmer Ltd.'s own activity," Delorme said. The court analyzed the terms and provisions of the commissionaire agreement in force between the U.K. principal and the French company, she added, noting that under the agreement, the commissionaire "could accept orders from customers, display quotes and documents in the context of tender offers, [and] conclude sales contracts on behalf of Zimmer Ltd. without the prior approval of the latter." Further, Zimmer SAS could "enter into price negotiations, grant discounts or payment terms to current or new customers without specific prior approval from Zimmer Ltd.," she said.

The court rejected arguments that Zimmer SAS acted in its own name and could not actually conclude contracts in the name of the principal, saying the two facts were irrelevant considering the French commissionaire's ability to bind its U.K. principal in commercial transactions pertaining to Zimmer Ltd.'s own activity, the practitioner added.

Zimmer SAS further could not be deemed to be acting as an independent agent under the France-U.K. tax treaty because it acted under the control and instructions of Zimmer Ltd. with respect to sales terms, promotion projects, and the development of new brochures, the court ruled. The principal was assuming the risks of the business and Zimmer SAS was acting exclusively for Zimmer Ltd., the tribunal noted.

Decision's Impact.

Delorme said the decision is likely to have far-reaching effect in France because any French commissionaire with a single foreign principal is under an increased threat of being qualified as a PE of its principal. However, she asserted that the court's decision raises a number of questions that may be considered on appeal:

- The court based its position on an extensive analysis of the Organization for Economic Cooperation and Development commentaries on Article 5, which say an enterprise, other than an independent agent, is considered a PE if that enterprise has the power to bind the foreign company in France on a regular basis, which allows it to conclude contracts in the name of the foreign company. In the case of a commissionaire structure, the commissionaire concludes contracts in its own name. The key question therefore is whether the commissionaire contractually binds its principal vis-a-vis its clients, Delorme said. "To answer this question, a thorough analysis of the legal effects of the commissionaire arrangement would have been necessary. Such legal analysis was totally ignored by the court," she contended, saying one would hope that such analysis will be done by the Supreme Tax Court.

- The decision discriminates between commissionaires acting on behalf of foreign principals and those acting on behalf of French principals, the latter not being exposed to such a risk of being qualified as permanent establishment of their principal and taxed accordingly.

**(Publication page references are not available for this document.)**

- The decision does not say what amount of profit should be allocated to the PE nor to the resulting double taxation issue. A multinational group runs the risk of being taxed twice for the same taxable results: once in the country of the principal, and once more in the country of the affiliated commissionaire. Such double taxation could normally be eliminated under mutual agreement procedures, but this can be a time-consuming process and agreement between competent authorities is not certain (outside the European Union).

Looking ahead, Delorme said the Zimmer Ltd. decision will confirm and even encourage the DGI "in its tendency to use assessments on PE grounds as a weapon to challenge commissionaire structures and more broadly to attack what they perceive as tax avoidance, where the conversion generating a significant reduction in French profits is not supported by changes, in substance, in the functional and risk profile of the French entity."

By Mitchell J. Tropin

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