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Freedom of Establishment and Transfer Pricing Threats for the EU Single Market

This article aims to examine the arguments and conclusions made by Advocate General Bobek in his Opinion delivered on 14 December 2017 in *Hornbach-Baumarkt* (C-382/16) and their potential consequences for taxpayers in EU Member States. In particular, it argues that cross-border situations targeted by the arm's length principle (ALP) are comparable with purely domestic situations, which escape the burden of compliance with the ALP. The German transfer pricing rules may be considered disproportionate to the aim they pursue due to the limitation on a taxpayer's rights to provide the commercial justifications for the transactions that do not comply with the ALP resulting from the parent company's status as a shareholder.

1. Facts of the Case[1]

Hornbach is a public limited company established in Germany. It indirectly owns 100% of two foreign subsidiaries ("foreign group companies"), both of which were established in the Netherlands.

In September 2002, Hornbach issued comfort letters for no consideration in favour of the foreign group companies to the bank providing financing to those companies. At that moment, the foreign group companies had negative equity capital and required the bank loans in order to continue their business operations.

Since Hornbach did not agree on any remuneration for issuing the comfort letters, the German Tax Office concluded that the gratuitous provision of comfort letters to the related subsidiary did not satisfy the arm's length requirement. The *Gesetz über die Besteuerung bei Auslandsbeziehungen* (German Foreign Transactions Tax Act (hereinafter FTTA Act)[2] provided the legal basis for the application of the arm's length principle (ALP).[3] Therefore, the Tax Office made income corrections to reflect the notional income that would have been received by Hornbach had it conducted the relevant transactions on arm's length terms. However, the FTTA Act denied the right for a taxpayer to provide the commercial reasons for non-arm's length conditions resulting from transactions with related parties.

Hornbach argued that the application of transfer pricing rules to the issuance of a guarantee by a resident of one Member State in favour of a subsidiary in another Member State was contrary to the European Union's single market freedoms, in particular, to the freedom of establishment, since the adjustment of the tax base would not occur in purely domestic situations. Moreover, Hornbach considered that the absence of a possibility to provide commercial justifications, resulting from its status as a shareholder, contradicted the principle of proportionality under EU law.

In light of the foregoing, the German Finance Court referred the question to the Court of Justice of the European Union (ECJ) (concerning whether the freedom of establishment under EU law precludes legislation of Member States), which provided the following:

– the right for the tax administration to adjust the income of a resident taxpayer from its business relations with a company established in another Member State in which that taxpayer has a direct or indirect shareholding of at least 25% if the conditions of their transactions depart from those that would have been agreed on by unrelated third parties if that income had been earned pursuant to arm's length terms; and
– that the legislation in question does not afford the resident taxpayer the opportunity to present evidence that the terms were agreed for commercial reasons resulting from its status as a shareholder of the company established in the other Member State.[4]

The structure of this article will mirror the following 4-step analysis usually undertaken by the ECJ:

(1) Which freedom is the relevant one? (*see* section 2.)

(2) Is there any restriction or discrimination? (*see* section 3.)

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1. DE: Opinion of Advocate General Bobek, 14 Dec. 2017, Case C-382/16, *Hornbach-Baumarkt AG v. Finanzamt Landau*, ECJ Case Law IBFD.
2. DE: Gesetz über die Besteuerung bei Auslandsbeziehungen (Außensteuergesetz 1972 – AstG 1972), zuletzt geändert durch Art. 5 G v. 27.6.2017 I 2074 [Foreign (International) Transactions Tax Act (FTTA 1972)] (amended 2017), National Legislation IBFD, also available at http://www.gesetze-im-internet.de/astg/__1.html.
3. Id., at para. 1.
4. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at para. 15.

(3) Is the restriction/discrimination justified? (*see* section 4.)

(4) Are the rules proportional in light of their aim? (*see* section 5.)

2. Which Freedom Is the Relevant One?

The German Finance Court in the referred question specified that the German transfer pricing rules should be examined on the issue of compatibility with the freedom of establishment.[5]

In *Hornbach-Baumarkt*, the foreign group companies were 100% owned by Hornbach. Moreover, the German transfer pricing rules were applied only in related-party situations of control. However, the additional analysis on whether the free movement of capital was applicable in this case was not required. There is a long-standing ECJ practice[6] of national legislation, applicable in cases of "relationships of interdependence",[7] falling under the scope of the provisions of the TFEU[8] on the freedom of establishment, which is also confirmed by the Advocate General's Opinion in the case being analysed (*Hornbach-Baumarkt* (C-382/16)).

3. Is There Any Restriction or Discrimination?

In *Hornbach-Baumarkt*, AG Bobek argued that the German transfer pricing legislation is neither restrictive nor discriminative because of the lack of comparability between cross-border and domestic situations targeted by the ALP,[9] an absence of less favourable treatment,[10] and an absence of restrictive measures.[11]

3.1. The presumed lack of comparability

AG Bobek's Opinion in the present case started by analysing the issue of the comparability of a domestic parent company with a foreign subsidiary, and a domestic parent company with a domestic subsidiary in transactions targeted by the ALP. This comparability analysis is an important difference between AG Bobek's Opinion in *Hornbach-Baumarkt* and the Court's decision in *SGI* (C-311/08) (as well as AG Kokott's Opinion in *SGI*)[12] where this topic was not analysed at the restriction/discrimination level.

In *Hornbach-Baumarkt*, AG Bobek emphasized that the *SGI* decision cannot be transposed onto the present case exactly, due to the absence of the comparability analysis in *SGI*.[13]

Therefore, the comparability analysis is of particular interest in *Hornbach-Baumarkt* as the decision is directly dependent on the outcome of this analysis. If the situations at stake are recognized as not comparable, the Court may not apply the steps (3) and (4) in section 1. This section will proceed first with analysing the general ECJ practice concerning comparability analysis in tax matters, discussing its relevance for the present case. Next, it will analyse the issue of whether a cross-border situation is comparable to a domestic situation in light of the application of the ALP.

3.1.1. Comparability analysis in tax matters at the discrimination level

One of the key elements of the ECJ decisions in direct taxation is comparability analysis.[14] The application of different rules to comparable situations or the application of similar rules to non-comparable situations has led to discrimination.[15] The ECJ case law on direct taxes does not provide clear criteria for comparability analysis. However, an overview of the ECJ's practice in this area allows to identify several different stages of a comparability analysis applied by the Court at the discrimination level, namely:

(i) choice of comparator;
(ii) choice of factors (criteria) for comparison; and
(iii) comparability of the treatment under the (domestic provision) measure under analysis.

Hence, the decision of the Court about whether there has been discriminatory treatment "often turns upon the precise choice of comparator"[16] and the comparability criterion.[17] In recent cases, however, the Court consistently applies a fourth step, that being:

(iv) comparability based on the objective of the measure impugned (which is also used at the justification level).

In this context, the following different perspectives regarding the comparability analysis used by the Court can be observed.

– In some cases, the Court conducted a full comparability analysis, comprising all four stages mentioned above. If a cross-border situation seemed to be treated less favourably at the third stage (*see* point (iii) above), the Court proceeded with the comparison of the objective of that particular EU Member

5. Id. at para. 15.
6. *See* BE: ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle (SGI) v. Belgian State,* [2010] ECR I-00487, ECJ Case Law IBFD, at paras. 27-28. NL: ECJ, 13 Apr. 2000, Case C-251/98, *C. Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem,* [2000] ECR I-02787, ECJ Case Law IBFD, at paras. 21-22. UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue,* [2006] ECR I-07995, ECJ Case Law IBFD, at para. 31.
7. "Relationships of interdependence" refers to a situation where one company in the question has a holding in the capital of the other which enables it to exercise definite influence over that company's decisions and to determine its activities. *See Baars* (C-251/98), at paras. 10-12.
8. Consolidated Version of the Treaty on the Functioning of the European Union, OJEU C 326/47 (2012), EU Law IBFD [hereinafter TFEU].
9. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at paras. 59-70.
10. Id., at paras. 70-86.
11. Id., at paras. 87-93.
12. *See SGI* (C-311/08) and BE: Opinion of Advocate General Kokott, 10 Sept. 2009, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*, ECJ Case Law IBFD.
13. Id., at para. 56.
14. *See* M. Lang, *Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions and Contradictions,* 18 EC Tax Review 3, p. 98. (2009), available at http://www.kluwerlawonline.com/document.php?id=ECTA2009015.
15. *See* DE: ECJ,14 Feb. 1995, Case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker*, [1995] ECR I-225, para. 30, ECJ Case Law IBFD.
16. DE: Opinion of Advocate General Sharpston, 8 Nov. 2007, Case C-293/06, *Deutsche Shell GmbH v. Finanzamt für Großunternehmen in Hamburg,* [2008] ECR I- 1129, para. 34, ECJ Case Law IBFD.
17. *See* R. Szudoczky, *Hungary: Hervis (C-385/12), Berlington Hungary (C-98/14), Delphi Hungary (C-654/13)*, in *ECJ – Recent Developments in Direct Taxation 2014*: Schriftenreihe IStR Band 91 pp. 65-89 (M.Lang et al. eds., Linde 2014).

State's legislation[18] (*see* point (iv)).[19] Recent case law shows a tendency for this approach being preferable for the Court.

– In other cases, the analysis of the Court was limited to the first three stages (*see* points (i)-(iii) above). Even though the Court found the disputable measure to be discriminatory, it did not compare the treatment of persons in different situations based on the objective of legislation at the level of restriction analysis (point (iv)).

– In some cases, the Court did not search for a comparator, but jumped directly to the second and third stages of the comparability analysis (*see* points (ii) and (iii) above). The Court implicitly presumed that the tax treatment of cross-border situations should have been analysed in comparison to the domestic similar situations. The Court also assumed comparability of situations as a rule, "if there existed a certain degree of substitutability between the cross-border transaction at issue and similar but purely internal transactions".[20] In the present case, it would mean that the parent company with the resident subsidiary should have been compared as such to a parent company with a foreign subsidiary without a detailed analysis of the grounds for choice of such a comparator.[21]

– Finally, in some cases, the Court conducted comparability analysis only based on point (iv) above, the objective of the legislation impugned and reasons why the measure was intentionally built to be applicable only to cross-border transactions. The Court analysed the policy goals (e.g. legitimate aim, objective and purpose of the legislation) leading to a different treatment of cross-border and domestic situations or one cross-border and other cross-border situations. Therefore, the different treatment was acceptable if the situations could not be compared based on the objective of the legislation.

Interestingly enough, in recent case law, the Court has performed an analysis of the objective of the legislation twice – firstly, at the level of discrimination/restriction and then at the level of justification, analysing whether the aim of the legislation was legitimate in justifying a restriction in light of the European Union's fundamental freedoms. However, the same analysis may de facto lead to totally different consequences depending on the way of proceeding.

18. *See*, for example, DK: ECJ, 17 July 2014, Case C-48/13, *Nordea Bank Danmark A/S v. Skatteministeriet*, ECJ Case Law IBFD, *Schumacker* (C-279/93), BE: ECJ, 22 Dec. 2008, Case C-282/07, *Belgian State v. Truck Center SA*, ECJ Case Law IBFD, DE: ECJ, 11 Sept. 2014, Case C-47/12, *Kronos International Inc. v. Finanzamt Leverkusen*, ECJ Case Law IBFD, *OHMI - Rexair* (T-133/13).
19. *See*, for example, *Nordea Bank* (C-48/13), *Schumacker* (C-279/93), *Truck Center SA* (C-282/07), *Kronos International* (C-47/12), *OHMI - Rexair* (T-133/13).
20. J. Englisch, *Taxation of cross-border dividends and EC fundamental freedoms*, Intertax 38, p. 203 (2010).
21. P. Wattel, *Non-Discrimination à la Cour: the CJEU's (lack of) Comparability Analysis in Direct Tax Cases*, 55 European Taxn. 12, p. 543 (2005), Journals IBFD.

3.1.2. *What are the potential consequences of using objective comparability analysis in* Hornbach-Baumarkt *at the stage of the restriction analysis?*

For the purposes of the assessment of comparability analysis, AG Bobek in *Hornbach-Baumarkt* focused on the objectives of the German legislation to establish comparability.[22] The AG stressed that "according to settled case-law, the comparability of a cross-border situation with an internal situation must be examined having regard to the aim pursued by the national provisions at issue".[23] Therefore, the AG suggested that the assessment of comparability analysis should have taken into account the legitimate aim of the transfer pricing legislation when defining the *tertium comparationis*.[24] In such a way, AG Bobek transferred the analysis of the legitimate aim of the legislation from the justification level, where it was usually performed, to the discrimination/restriction level. As stated in section 3.1.1., the ECJ has frequently analysed the aim of legislation both at comparability and at justification level.[25] Essentially, the Court, as well as the AG in this case, looked at the same factor, that being the objective of the legislation, twice. Firstly, at the comparability stage, the Court examined the object and purpose of a legislation to ascertain that the situations were not comparable. Then, it re-examined the legitimate aim from the point of view at justification level.[26]

The potential risk of such an approach could be that if the Court concludes that the different treatment of a resident parent company with a resident subsidiary and a resident parent company with a foreign subsidiary is acceptable because the situations are incomparable based on the object of the legislation, it will not analyse the justifications and the proportionality test. Therefore, the Court will not analyse whether the different treatment is proportionate to a legitimate aim pursued by a transfer pricing regulation.

In the present case, this means that the Court will not decide about whether the limitation on the right to provide certain types of commercial justifications is proportionate to the aim of the transfer pricing legislation. Therefore, such a decision might potentially provide unreasonable discretion to EU Member States to create disproportional limitations for taxpayers in their transfer pricing legislation. This seems to be confirmed by AG Kokott in *Nordea Bank Denmark* (Case C-48/13):

> 26. The Court's entire case-law does not make it clear in which circumstances a difference in the situations compared should preclude their objective comparability.
>
> 27. If it is ultimately concluded that the situations are not objectively comparable, then, unlike in the context of considering a ground of justification, there is no examination of the proportionality of the difference in treatment of domestic and cross-border situations. It is thus no longer possible to strike

22. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at para. 57.
23. Id., at para. 57.
24. Id., at para. 61.
25. Id., at para. 61.
26. *See* DK: Opinion of Advocate General Kokott, 13 Mar. 2014, Case C-48/13, *Nordea Bank Danmark A/S v. Skatteministeriet*, ECJ Case Law IBFD.

an appropriate balance between the objectives associated with the fundamental freedom and those underlying the ground for differentiation between domestic and cross-border situations. A balanced solution is therefore guaranteed only where the ground for a difference in treatment is considered in the context of the examination of a ground of justification.

28. Consequently, if there is no need to examine the objective comparability of the situations and such an examination does not produce appropriate results, the Court should in future dispense with it. The merits of a difference in treatment should be assessed solely by reference to whether there is a ground capable of providing a proportionate justification for that difference in treatment.[27]

However, the Court did not support the position of AG Kokott in *Nordea Bank Denmark* and continued to apply the comparison of *objectives* in the later practice.[28] Nevertheless, the authors would tend to agree with the Opinion of AG Kokott, establishing that the comparison of objectives should not be regarded as decisive at the discrimination/restriction level. The legitimate aim of the legislation should be considered only at the stage of the analysis concerning the justifications If the object and purpose of the legislation at issue justify the measure at stake, then the legislation will not be recognized as incompatible with the European Union's fundamental freedoms. However, in such situation (the decision on the case), the Court will have a chance to deal with the issue of the proportionality of the measure and its legitimate aim.

A shortcoming in analysing the objective of the legislation at the discrimination/restriction level may result in a possible misunderstanding by the Court of the genuine intention of a legislator.[29] By labelling the situations as incomparable on the grounds that the objectives of the legislation are different, the Court may overlook whether other less burdensome measures could serve the same object. In this scenario, the comparability based on the objective of the legislation would be acceptable if the proportionality test had been integrated into discrimination/restriction level.[30] However, it would be quite unreasonable to apply the same test twice.

The suggestion to abolish comparability analysis based on the objective of the legislation would mean that the Court must focus on determining the right comparator and comparability factors, excluding the object of the legislation, e.g. whether the situation targeted by the ALP may occur in domestic conditions and whether such situation may lead to the same economic results.

In light of the foregoing, the Court in *Hornbach-Baumarkt* had the chance to dispense with the objective comparison, since, as mentioned above, stopping the Court analysis of the case at discrimination/restriction level could lead to raising the discretion of the legislative bodies of EU Member States to adopt disproportionate measures for their rules dealing with cross-border situations.

3.1.3. Are cross-border and domestic situations targeted by the APL comparable?

As the *objective* comparison did not produce a desirable result in *Hornbach-Baumarkt*, the Court could only focus on the comparability analysis based on the first three stages in section 3.1.1.

The first step required the Court to determine a correct comparator for establishing the presence, or lack thereof, of discrimination at issue. In the cases involving the taxation of companies on the basis of their cross-border transactions with their subsidiaries, the Court could compare the treatment of a domestic parent company and a foreign subsidiary with a domestic parent company and a domestic subsidiary.[31]

The AG in *Hornbach-Baumarkt* accurately stressed that "inequality consists not only in treating the same situations differently, but also treating objectively different situations in the same way". The AG supported his statement with the argument that the transfer pricing legislation was adopted exactly because parent companies with domestic subsidiaries and those with foreign subsidiaries are not the same. Therefore, the AG chose the purely domestic group as a comparator. In this regard, it seems that the AG implicitly applied such factors for the comparability analysis as (i) the relation of interdependence based on the shareholding threshold; and (ii) whether or not the subsidiary entered entering into a transaction or arrangement that did not comply with the ALP by two comparators.

Essentially, the AG built a line of argumentation based on the reasoning that foreign and domestic subsidiaries are not comparable "for the specific purpose of making sure that tax does not escape the jurisdiction of a Member State"[32] using the approach of comparability analysis based on the objective of the legislation.

The logic behind this statement is that the application of transfer pricing rules might not make sense in domestic situations, as the tax avoidance that they tend to prevent only occurs in cross-border situations (although some exceptions to this logic – mentioned below – may exist). The cross-border situation targeted by transfer pricing rules may seem to be incomparable with the domestic situations, also due to the assumption that comparable domestic situations simply do not occur. [33] The authors would, however, tend to argue that cross-border situations

27. AG Opinion in *Nordea Bank Denmark* (Case C-48/13), at paras. 26-28.
28. *See Nordea Bank* (C-48/13), *Schumacker* (C-279/93), *Truck Center SA* (C-282/07), *Kronos International* (C-47/12), *OHMI - Rexair* (T-133/13).
29. J. Englisch, *supra* n. 20, at p. 197.
30. BE: Opinion of Advocate General Kokott, 18 Sept. 2008, Case C-282/07, *SPF Finances v. Truck Center SA*, [2008] ECR I-10767, para. 37, ECJ Case law IBFD.
31. *See* UK: ECJ, 16 July 1998, Case C-264/96, *Imperial Chemical Industries (ICI) v. Kenneth Hall Colmer*, ECJ Case Law IBFD; UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. Halsey (Her Majesty's Inspector of Taxes)*, ECJ Case Law IBFD; NL: ECJ, 18 Sept. 2003, Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financiën*, ECJ Case Law IBFD; DE: ECJ, 12 Dec. 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, ECJ Case Law IBFD; UK: ECJ, 13 Mar. 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, ECJ Case Law IBFD.
32. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at para. 60.
33. Wattel, *supra* n. 21, at p. 553.

targeted by the transfer pricing rules are comparable to domestic situations.

For example, Company A, resident of country X, provides a financial guarantee without a consideration to its domestic subsidiary. Company B, also resident of country X, provides the same guarantee on the same conditions to its subsidiary in country Y. In both cases, the company and its subsidiary are related parties, and in both cases, the transaction may not be in line with the ALP (assuming that the provision of both guarantees requires intra-group compensation). In the first case, however, the transfer pricing legislation is not applicable, whereas in the second case, it is. One can argue that cross-border situations in this example are accompanied by tax avoidance or the economically unjustified shifting of profits, whereas in purely domestic situations, tax avoidance is excluded. However, tax avoidance is also possible in purely domestic comparable situations in specific circumstances. For example, the domestic legislation may provide different tax regimes for different types of companies. If such companies are related parties, they can abuse the imperfections of the domestic tax legislation. Another example is where the jurisdiction has special restrictions for offsetting losses in transactions between the related parties. The fact that a transaction is purely domestic does not exclude the possibility for the taxpayers to abuse the loopholes present in the national tax system and, consequently, the loss of revenues for the jurisdictions.

For this reason, some countries apply their transfer pricing legislation to domestic situations also. This is the case, for example, for Italy.[34] Moreover, the Honourable Supreme Court of India in the case of *GlaxoSmithKline v. CIT* recommended to expand the scope of transfer pricing to specified domestic transactions. The Court emphasized that in domestic transactions, the under-invoicing of sales and over-invoicing of expenses ordinarily will be revenue neutral in nature, except in two circumstances: where one of the related entities is (i) loss-making or (ii) liable to pay tax at a lower rate and the profits are shifted to such an entity.[35]

Nevertheless, it is also true that global markets offer more significant possibilities for tax arbitrage to multinational enterprises,[36] by means, for example, of lower tax rates, different types of taxes, lower compliance burdens, etc. However, countries often apply their transfer pricing rules only to cross-border transactions so as not to lose the significant revenues, ignoring the possible lower losses of revenues in domestic transactions. The reason for this is that in domestic situations, the administrative burden to target all non-arm's length transactions within one jurisdiction may be higher than the presumed loss of revenues. However, no threshold for tax avoidance exists to argue that situations resulting in minor losses in domestic situations are not comparable to situations resulting in higher losses in cross-border situations. Therefore, cross-border and domestic situations are comparable for the purposes of the application of transfer pricing rules as both the domestic tax system and international tax system may create the imperfections that could be exploited for tax planning purposes.

3.1.4. Does the principle of territoriality lead to non-comparability?

The "[p]rinciple of territoriality and [the] inability to exercise jurisdiction to tax over foreign subsidiaries" is the second argument of AG Bobek in *Hornbach-Baumarkt* in support of the absence of comparability.[37] In *Futura Participations and Singer* (C-250/95), the ECJ defines the principle of territoriality, which should mean that EU Member States tax resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that state.[38] Previously, the principle of territoriality was unsuccessful as a way to justify the restrictive tax measures in *Bosal* (C-168/01), *Marks & Spencer* (C-446/03) and *Keller Holding* (C-471/04).

Nevertheless, AG Bobek in the present case transferred the principle of territoriality, which he defined as "preserving the balanced allocation of the powers of taxation", from the level of justification to the level of comparability analysis. The AG argued:

> 63. It would indeed be paradoxical for the Court to solemnly acknowledge "the principle of territoriality enshrined in international tax law and recognized by Community law" and, at the same time, to hold that one can completely assimilate the transfer of revenues outside a Member State's tax jurisdiction with transfers inside that Member State's tax jurisdiction.

In this regard, it is not clear how AG Bobek differentiates between the transfer of revenues outside an EU Member State and transfers within it. It could be suggested that the AG finds transactions, such as the transfer of profits within one jurisdiction and cross-border transfers, not comparable as the latter create additional risks of base erosion and profit shifting and lead to the "cross-border leakage of taxable income"[39] due to the lack of capacity of the tax administration to exercise their taxing rights in another jurisdiction.

However, the EU fundamental freedoms, such as the freedom of establishment and the free movement of capital, were adopted precisely in order to make these transactions the same and to mitigate the differences in the treatment of domestic and cross-border transactions. At the same time, it does not mean that EU Member States are not allowed to mitigate the additional risks that are created in cross-border situations. For this purpose, the justification test exists in the ECJ's practice to decide whether the restriction on cross-border transactions is justified and proportionate to a legitimate aim. However, the principle

34. *See*, IT: Italian Legislative Decree No. 147 of 14 Sept. 2015 and IT: Supreme Court Decision No. 17955, 24 July 2013; Supreme Court No. 8849, 16 Apr. 2014; Supreme Court No. 13475, 13 June 2014.
35. IN: SCOI, 10 Nov. 2010, *CIT v. Glaxo Smithkline (Asia).*
36. R. Leitch & K. Barrett, *Multinational Transfer Pricing: Objectives and Constraints*, 11 Journal of Accounting Literature, p. 47 (1992).
37. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at para. 60.
38. LU: ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, ECR I-02471, para. 22, ECJ Case Law IBFD.
39. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at para. 66.

of territoriality should only be assessed as grounds for justification and not for the lack of comparability.

The second issue is that the comparability analysis should be based on a "subject to tax" criterion.[40] AG Bobek in the present case emphasized that the treatment of separate legal entities (i.e. parent companies) is under the consideration of the comparability analysis in the case.[41] However, at the same time, the AG based his Opinion on the following assumption:

> 32. […] When faced with questions of taxation of groups and freedom of establishment, legal entities are not compared in splendid isolation. They are not compared with total disregard to the circumstances and treatment of related entities. The circumstances and treatment of those related entities should, on the contrary, be relevant and integrated into the legal analysis.
>
> 33. That observation is crucial in the present case. It is indeed agreed by all parties that there is a difference in treatment at the level of the individual legal entity.[42]

It is difficult to agree with the approach of the AG in the light of the EU law and the principle of territoriality in fiscal matters. The Court, in *Hornbach-Baumarkt*, questions the compatibility of the measure of the domestic legislation which extends its action only to the entities within its jurisdictional fiscal authority. Therefore, in the case of the cross-border groups, the ALP under the domestic provision targets only one entity. Due to unilateral measures of the transfer pricing rules under the domestic law, it would be wrong to say that the overall treatment of the domestic and cross-border group will be the same, i.e. supporting a "zero-sum" argument which is also discussed below. The latter result may be achieved only through the full harmonization of the transfer pricing rules within the EU internal market and the system of simultaneous corresponding and downward adjustments.

Therefore, a resident parent company should be compared to another resident company within one jurisdiction in its relationship with the resident and non-resident subsidiaries. The treatment of the subsidiaries is not under consideration in this case. Regarding the treatment of the parent companies, the treatment of the German Hornbach is being compared to the treatment of a hypothetical German company in their relations with Dutch and German subsidiaries accordingly. Both parent companies in this example are residents of the same jurisdiction (i.e. Germany) and both are subject to the same income tax. Therefore, it is difficult to imagine why the principle of territoriality should preclude the comparability of two parent companies that are resident in the same jurisdiction.

3.2. The presumed lack of less favourable treatment

If the ECJ decides that parent companies with foreign subsidiaries are comparable to parent companies with domestic subsidiaries, it will proceed with the analysis of whether the treatment of the former is less favourable than the treatment of the latter. In this regard, AG Bobek in his Opinion in *Hornbach-Baumarkt* addresses the arguments used in *SGI* (C-311/08), but comes to an opposite conclusion, that being that the treatment is not less favourable and is not restrictive. The main discussion concerns the "zero-sum" argument and the risk of double taxation. The AG defines the "zero-sum" argument as follows:

> 71. […] in the case of transactions that are not at arm's-length between parent and subsidiary companies, which are both resident in Germany, profits are not taxed in the hands of the parent but they will be in the hands of the subsidiary. As a result, on a global view of the group, the tax burden remains the same.[43]

In previous case law, however, the Court mentioned that less favourable treatment in one Member State can be offset in another Member State where the measure is not a restriction to any of the freedoms. In *Commission v. Spain* (C-487/08), the Court, with the reference to its decision in *Amurta* (C-379/05),[44] argued that:

> 66. […] A Member State cannot rely on the existence of a tax advantage granted unilaterally by another Member State in order to escape its obligations under the Treaty.[45]

Nevertheless, the Court considered that the obligation to offset a disadvantageous treatment should correspond to the obligations of the other Member State that derive from a double tax treaty, whereas the unilateral application of domestic legislation does not have such an effect.[46] Therefore, the issue is whether this concept may be applicable to the tax treaty between two EU Member States that requires calculation of the tax base on the ALP only, but which does not assure any further harmonization of the transfer pricing rules to determine the arm's length price. For example, disregarding the differences in tax systems, e.g. different tax rates, being subject to tax, etc., the "zero-sum" situation will not be achieved if:

- the readjustment of profits at the parent's level will not correspond to a readjustment of profits at the foreign subsidiary level;
- the net loss result for the financial year at the level of the subsidiary cannot be offset with the profits of the foreign parent company;
- countries do not accept the commercial justifications for the price of the transactions;
- different jurisdictions make different adjustments of the price on the basis of different comparability analyses; and
- the jurisdictions have different characterization rules, etc.

Therefore, the application of the ALP itself cannot be supported by the "zero-sum" argument as the ALP is capable of leading to a "zero-sum" situation only in combination with the harmonization of transfer pricing rules.

It also seems that the argument that the application of the ALP leads to a "zero-sum" situation cannot co-ex-

40. Wattel *supra* n. 21, at pp. 542 and 545.
41. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at para. 33.
42. Id., at paras. 32-33.
43. Id., at para. 71.
44. NL: ECJ, 8 Nov. 2007, Case C-379/05, *Amurta SGPS v. Inspecteur van de Belastingdienst*, [2007] ECR I- 09569, para. 78, ECJ Case Law IBFD.
45. *See* ECJ, 3 June 2010, Case C-487/08, *Commission v. Spain*, [2010] I-04843, para. 66, ECJ Case Law IBFD.
46. Id., at para. 66.

ist with the statement that the risk of double taxation, or double taxation as such effected by the unilateral application of the ALP is fully permissible and that the Member States are not obliged in the latter scenario to eliminate the disparities. AG Bobek stated in *Hornach-Baumarkt* that EU Member States do not have an obligation to reduce double taxation and that the risk of double taxation does not prevent EU Member States from imposing taxes on profits in their jurisdictions.[47] Moreover, the AG emphasized that the risk of double taxation in cross-border situations cannot seem discriminatory or restrictive, as in domestic situations the risk of double taxation simply does not exist even if the differences in treatment are eliminated.[48] The arguments of the AG are very reasonable. However, the following points also deserve consideration.

Addressing the issue of the double taxation in the Member States, the Court ruled that double taxation, i.e. the disadvantages that could arise from the parallel exercise of tax competences by different Member States, does not constitute a restriction prohibited by the EC Treaty to the extent that such an exercise should be deemed *not discriminatory*.[49] As it was stated above, the treatment of the cross-border and domestic groups is discriminatory as (i) the ALP is applicable only to the cross-border related parties' transactions (while the domestic groups are also capable of avoiding taxation under specific circumstances); and (ii) the unilateral application of the domestic ALP does not result in a "zero-sum" situation.

The Court has, in many decisions, ruled that EU Member States are not obliged to prevent juridical double taxation and that they have full discretion about whether to enter the tax treaties for elimination of double taxation.[50] It is also worth noting that the unilateral application of the ALP without a corresponding adjustment transfer creates economical, rather than juridical, double taxation. In this regard, it is possible to address the objective of the ALP under the domestic law to decide whether there is an obligation for an EU Member State to eliminate double taxation. If the EU Member States argue that the objective of the ALP domestic provision is to make their tax treaties' obligations effective[51] and to fairly allocate the taxing powers, it is difficult to assume how double taxation is compatible with this purpose. However, if the objective of the legislation is the prevention of abuse, the legislation might have the consequent negative effect on a taxpayer, that being double taxation, which Member States are not obliged to redress. However, the latter scenario should be limited only to the artificial arrangements under the Court's concept of abuse.

Therefore, the application of the ALP to cross-border transactions only constitutes the less favourable treatment of a taxpayer, in so far as there is no measure prescribed by EU Member States' double tax treaties or by domestic legislation aiming to eliminate the negative consequence of economic double taxation and to ensure a "zero-sum" result.

3.3. The presumed lack of restriction

Finally, AG Bobek raised the rhetorical question: "Can the requirement for companies to calculate their tax base on the basis of arm's-length conditions really be viewed as a restriction on freedom of establishment?"[52] In this regard, it is important to highlight that no requirement to calculate the tax base according to the ALP exists for domestic groups. The additional requirement for compliance (e.g. the tax calculation itself, the submission of additional documentation, the provision of commercial reasons for the arm's length nature of transactions) is already sufficient grounds to conclude that the treatment of cross-border transactions is more cumbersome. EU law aims to treat domestic and cross-border transactions between the EU Member States in the same way. Each additional obstacle can be regarded as a restriction. This argument is supported by the ECJ's statement in *SGI* (C-311/08):[53]

> 50. […] [I]t should be noted that, for legislation to be regarded as a restriction on freedom of establishment, it is sufficient that it be capable of restricting the exercise of that freedom in a Member State by companies established in another Member State, without there being any need to establish that the legislation in question has actually had the effect of leading some of those companies to refrain from acquiring, creating or maintaining a subsidiary in the first Member State.

It is reasonable that smaller companies willing to avoid additional costs for compliance and complexities connected with the application of the ALP would give up the idea of establishing the subsidiary in another EU Member State. In the light of the foregoing, the treatment of resident parent companies with foreign subsidiaries is less favourable than the treatment of domestic groups and is a restriction to the freedom of establishment in the light of EU law.

4. Is the Restriction/Discrimination Justified?

As mentioned above, it is very important not to dismiss the case on grounds of the objective comparison of situations. The justification level allows governments to provide justifications for the restrictive measures grounded in the legitimate aim of the legislation, albeit in conjunction with clear evidence that a measure impugned is proportional to a legitimate aim of the restrictive legislation.

AG Bobek concluded that German transfer pricing rules are justified by the legitimate aim of the legislator of the *balanced allocation of taxing rights* and the *prevention of shifting of profits.* The same approach was previously

47. Id., at para. 76.
48. Id., at para. 79.
49. *See*, BE: ECJ, 14 Nov. 2006, Case C-513/04, *Mark Kerckhaert and Bernadette Morres v. Belgische Staat*, paras. 19-20 and 24, ECJ Case Law IBFD; NL: ECJ, 20 May 2008, Case C-194/06, *Staatssecretaris van Financiën v. Orange European Smallcap Fund NV*, paras. 41, 42 and 47, ECJ Case Law IBFD.
50. BE: ECJ, 16 July 2009, Case C-128/08, *Jacques Damseaux v. Belgian State*, ECR I-06823, paras. 29-30, ECJ Case Law IBFD.
51. *Thin Cap Group Litigation* (C-524/04), at para. 52.
52. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at para. 88.
53. *SGI* (C-311/08), at para. 50 (with reference to *Thin Cap Group Litigation* (C-524/04), at para. 62; and FI: ECJ, 18 July 2007, Case C-231/05, *Oy AA* [2007] ECR I-6373, para. 42, ECJ Case Law IBFD.

used by the Court. Whereas in *Thin Cap GLO*,[54] the Court admitted, as a possible justification for the ALP, the need to fight abusive practices, but denied the need to ensure the cohesion of the tax system, in *SGI* (C-311/08),[55] it admitted both the need to prevent tax avoidance and the need to maintain the balanced allocation of the power to tax between the EU Member States.[56] Therefore, the AG rightly confirmed the previous approach of the Court that the transfer pricing rules may be justified if the aim is dual, i.e. to prevent tax avoidance and fairly allocate taxing rights between EU Member States.

5. Are the Rules Proportional in Light of Their Aim?

AG Bobek stated that "in principle, in order for a measure that is considered to be a restriction on the freedom of establishment to be justified, it must not only pursue a legitimate aim, but also be proportionate. The means must not go beyond what is necessary to achieve the aim".[57] In this regard, in *Hornbach-Baumarkt*, the AG deals with several arguments discussed in sections 5.1.-5.2. In particular, two of the three arguments raise the difficulties with the application of the ALP to comfort letters and commercial justifications.

5.1. The application of the ALP to comfort letters

AG Bobek in *Hornbach-Baumarkt* stated that comfort letters "clearly have an economic value … at least to the extent they are binding and provide financial guarantees" and '"in relation to unrelated companies [that] would be paid for".[58] Therefore, AG Bobek argues that the application of the ALP and adjustments to the tax base amounting to the sum of the advantages granted is proportionate to the aim of the German transfer pricing legislation. Nevertheless, some additional clarifications are needed in order to assess whether comfort letters have a real economic value.[59]

Comfort letters are financial guarantees (hence, intra-group services) and consist of a promise (i.e. are generally not legally binding) by a company belonging to the group (in most cases, the parent company) stating that it will not take actions that would compromise the financial stability of another group company.[60] These are usually considered as "implicit" guarantees (as opposed to "formal" or "explicit" guarantees), since they are generally not legally binding. What is more, amongst the various types of financial guarantees, comfort letters have a lower level of enforceability.

In intra-group relations, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations [hereinafter OECD Guidelines][61] provide the "benefit test" to determine whether intra-group services are actually rendered. Thereby, they emphasize that "under the arm's length principle, the question whether an intragroup service has been rendered … should depend on whether the [guarantee] provides [a] group [company] with economic or commercial value to enhance or maintain its business position". Therefore, the OECD Guidelines, as a first step, would require that the question be addressed as to whether comfort letters confer a benefit to the guaranteed entity.

For the guaranteed transactions, the value of the guarantee is deemed to be "the present value of the lower interest that, given the guarantee, that person will pay with respect to what he or she would have expected to have paid in the absence of collateral".[62] Therefore, the benefit may be considered as obtaining by means of the guaranteed transaction more beneficial conditions regarding the loan arrangement, e.g. higher credit rating, lower rate, etc. In this regard, the question arises as to whether the financial conditions of the guaranteed transaction would allow the guarantee to be received from the third, unrelated person or to receive any loan without obtaining a guarantee. If not, the following issue is whether comfort letters, such as those at stake in *Hornbach-Baumarkt*, should be considered to be chargeable intra-group services and consequently remunerated with an arm's length fee.

The OECD Guidelines distinguish shareholder activities from the normal intra-group services. They define shareholder activities as activities of the company that are performed "solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder".[63] The crucial importance of the differentiation of shareholder activities and intra-group services is that costs related to the shareholder activities should not be charged as a service to other group companies. Therefore, the issue here is whether providing a comfort letter, such as the one in the case at stake, can be recognized as a shareholder activity or as an intra-group service. Indeed, an intra-group service fee should be charged if (i) the service provides a respective group member with economic or commercial value (benefit test)[64] and (ii) the activity is one that an independent enterprise would have been willing to pay for or perform itself.[65]

54. *Thin Cap Group Litigation* (C-524/04), at para. 92.
55. *SGI* (C-311/08), at para. 72.
56. R. Petruzzi, *Transfer Pricing and EU Law: the Effects of SGI on Thin Cap GLO*, 1 Diritto e pratica tributaria internazionale, pp. 77-95 (2013).
57. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at para. 104.
58. Id., at para. 108.
59. Generally, a letter of comfort does not constitute a guarantee and, hence, creates no liability for the taxpayer. However, the tax administration usually has the right to recharacterize the formal arrangements in accordance with their real economic substance. Therefore, letters of comfort, such as that in the present case of *Hornbach-Baumarkt*, are analysed as the explicit financial guarantees and intra-group services rendered.
60. R. Petruzzi, *Transfer Pricing Aspects of Intra-Group Financing* p.132. (Kluwer Law International 2016).
61. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, ch. VII B.1.1. (OECD 2017), International Organizations' Documentation IBFD [hereinafter *OECD Guidelines*].
62. F. Pizzutilo, *Loan Guarantees: An Option Pricing Theory Perspective*, 5 International Journal of Economics and Financial Issues 4, pp. 905-909 (2015).
63. *OECD Guidelines*, at. ch. VII B.1.2., para. 7.9.
64. Id., at para. ch. VII B.1.1, para. 7.6.
65. Id., at para. ch. VII B.1.1, para. 7.6.

In *Hornbach-Baumarkt*, the comfort letter may be considered as not giving rise to any remuneration at arm's length for the following reasons:

- As previously mentioned, comfort letters are usually considered "implicit" guarantees, as they are not legally binding and have a lower level of enforceability. This means that, at arm's length, they do not provide much value to the recipient (i.e. the guaranteed entity) and, therefore, should not be remunerated. This is confirmed by many countries' practice.
- In the specific case at stake, the comfort letters provided by the German parent company in favour of its foreign subsidiaries might be seen as shareholder activities. Indeed, as mentioned before, at the moment of the provision of the comfort letters, the foreign group companies had negative equity capital and required the bank loans to continue their business operations. At arm's length, an independent third party, taking into account the negative financial conditions of the subsidiaries, would not take the risk and would not provide the financial guarantee to them.[66] Therefore, the provision of any guarantee (i.e. even an "explicit" guarantee) could be economically compared to an equity contribution by the parent company into the capital of its subsidiaries, therefore not requiring any deductible remuneration.[67]

To further confirm this, in *H. Group Holding Inc.*,[68] the US Tax Court found that the financial guarantees do not qualify as services and are not subject to allocation if they are provided to the benefit of the parent company. Likewise, the US Tax Court ruled that business development activities and owner relations may belong to the category of shareholder activities.[69] According to the Dutch Supreme Court,[70] if a company provides a guarantee for a bank loan entered into by its parent whereby that company runs a bad debt risk that would not have been accepted by an independent party, the company must be assumed to have accepted the risk with the intention of serving only the interests of its shareholder in the absence of exceptional circumstances. In *Micro Inc. Limited*,[71] the Indian Tribunal supported the concept of "shareholder activities" and ruled that guarantees in some circumstances may be viewed as ownership contributions. In *Bharti Airtel* and *Redington India*,[72] the Indian Tribunal held that the determination of an arm's length price might not be necessary where the guarantee issued by a taxpayer does not involve any cost and, hence, is outside the ambit of international transactions.

The Australia Transfer Pricing legislation also provides a two-step analysis, i.e. the "benefit receiver" and "willingness of independent parties to provide the same service". In this regard, it explicitly emphasizes that the relationship between the parent and the subsidiary should be taken into account. In some circumstances, the provision of the financial guarantee by the parent company to its subsidiary serves to the benefit of the parent company, who may otherwise suffer more onerous financial commitments in respect of the subsidiary:[73]

> 87. […] For example, if the guarantee arrangement were not put in place the parent may have to increase its borrowings, pay interest and inject additional equity into the subsidiary. In addition the parent may suffer some other disadvantage or cost. For example, the parent may have to redirect internal funding or be exposed to foreign exchange risk.
>
> 96. Where a guarantee is provided by a parent to a subsidiary that is otherwise not creditworthy, the subsequent borrowing by the subsidiary results in the incurring of the costs of that debt that would otherwise be borne by the parent if it had to provide the debt funding.[74]

Addressing the issue of whether an independent party with insufficient tolerance to debt funding could obtain a guarantee from an independent party dealing wholly independently with the borrower, the Australian Taxation Office concluded that there will be no adequate comparables to ascertain the arm's lengths considerations.[75] The underlying principles in relation to guarantee and shareholder activity are also applicable in the case of a legally binding letter of comfort.[76] Indeed, as mentioned above, where the guarantee is given by the parent company to its highly leveraged subsidiary that would not obtain the loan or guarantee from the independent person, it compensates for the inadequacies in a capital structure of the company, in particular a lack of shareholders' funds.[77] The subsidiary is not expected to pay for the acquisition of the equity it needs for its formation and viability.[78] Therefore, the risks borne by the shareholders providing the guarantee of such kind should be considered as shareholders' risks related to the formation of the company and in the benefit of shareholders' future interest to receive the dividends.

Based on this analysis, comfort letters very rarely create a benefit for the guaranteed entity and, even in the presence of a benefit, in the case at stake, any benefit could be perceived as a shareholder activity (due to the negative

66. Id., at para. ch. VII B.1.1, para. 7.6.
67. A. Russo & O. Moerer, *Introduction*, in *Transfer Pricing and Intra-Group Financing* p. 33 (A. Bakker & M.M. Levey eds., IBFD 2012), Online Books IBFD; R. Petruzzi, *Transfer Pricing Aspects of Intra-Group Financing* p. 133 (Kluwer Law International 2016).
68. US: T.C., 5 Oct. 1999, *H Group Holding, Inc. and Subsidiaries, Formerly HG, Inc. and Subsidiaries, et al. v. Commissioner*, 78 T.C.M. 533, Tax Treaty Caw Law IBFD.
69. R. Mitra, A. Hans & A. Jain, *Intra-group services and shareholder activities*, 15 Bloomberg BNA Transfer Pricing International Journal 8 (2014), available at https://www.pwc.in/assets/pdfs/news-alert-tax/2014/pwc_thought_leadership-6_august_2014-intra-group_services_and_shareholder_activities.pdf.
70. *See* NL: HR, 25 Nov. 2011, No. 08/05323 (No. 10/05161, 10/05394, 10/00516). In this case, the Dutch Supreme Court confirmed the existence of a non-business loan in Dutch tax law. The decision is also a clarification of the Supreme Court's ruling of 9 May 2008 (NL: HR, 9 May 2008, BNB 2008/191).
71. IN: ITAT Ahmedabad, 27 Nov. 2015, *Micro Ink Ltd. v. ACIT*, ITA 2873/Ahd/10), Tax Treaty Case Law IBFD.
72. IN: ITAT Delhi, 11 Mar. 2014, *Bharti Airtel Ltd. v. ACIT*, ITA 5816/Del/2012, Tax Treaty Case Law IBFD.
73. Australian Taxation Office, *Intra-group finance guarantees and loans: Application of Australia's transfer pricing and thin capitalisation rules*, 2008-08/7290 (ATO 2008), available at http://www.transferpricing.com/pdf/Australia_Thin%20Capitalisation.pdf.
74. Id., at para. 96.
75. Id., at para. 99.
76. Id., at para. 123.
77. Id., at para. 102.
78. Id., at para. 103.

financial situation of the guaranteed entities), and hence, not requiring any deductible remuneration.

The UN Transfer Pricing Manual[79] also emphasizes that a case-by-case approach can be the only viable approach to conclude that the intra-group service is rendered. In every case, the tax administration should assess the conditions and reasons for issuing the comfort letter or financial guarantee to decide whether the guarantee should be considered as a service or as a capital contribution. If the guarantee is considered as a capital contribution, the adjustment of the tax base at the parent level puts the parent company in a less favourable position in comparison with the shareholder's domestic activity and does not advance the legitimate aim of balance allocation of taxing rights and prevention of tax avoidance. Therefore, such legislation is disproportionate to the aim of transfer pricing legislation.

5.2. Right to provide commercial justifications

In practice, the application of transfer pricing rules in *Hornbach-Baumarkt* by two countries may lead to two different results in two jurisdictions. The ALP is far from representing the economic reality of the transaction.[80] Therefore, in order for the transfer pricing legislation to be proportionate to the aim it pursues, the ECJ's practice requires that national legislation guarantees the right for taxpayers to provide the commercial justifications for their transactions.

The commercial reasons complement the transfer pricing analysis conducted by the tax administration based on a real economic activity carried out within the country. Thus, the right to provide commercial justifications complements the legitimate aim of the fair allocation of taxing powers.

In *Thin Cap GLO* (C-524/04), the Court concluded that arm's length rules are proportionate as far as they "allow the taxpayers to produce … evidence as to commercial justifications for the transactions in question",[81] whereas in *SGI* (C-311/08), the Court declared that the proportionality test is fulfilled if "the taxpayer is given an opportunity … to provide evidence of *any* commercial justification that there may have been for that transaction" [emphasis added].[82]

AG Bobek in *Hornbach-Baumarkt* does not deny the requirement to provide the right to present the commercial justification in general, but rather addresses the issue of "what type of commercial justification is acceptable".[83] On this issue, the AG concluded that legislation which "does not afford the resident taxpayer the opportunity to present evidence that the terms were agreed on for commercial reasons resulting from its status of shareholder of the company established in the other Member States"[84] is compatible with the freedom of establishment. This argument cannot be supported in the light of the arguments presented above, that under some circumstances the cross-border transaction may be regarded as a shareholder activity.

If the comfort letter at issue can be considered as a capital contribution, then the taxpayer may justify the absence of a guarantee fee by relying on its status as a shareholder providing a shareholder activity, which is, in principle, a "commercial reason resulting from its status as a shareholder of the company established in the other Member State".

The right to provide the commercial evidence does not automatically justify the price of the transaction, but increases the possibility for the tax administration to access the real economic conditions of the transaction and fairly tax the profits generated in its jurisdiction.

The limitation on the types of commercial justifications (i) contradict the previous ECJ practice; (ii) unreasonably and disproportionally limit the rights of taxpayers; and (iii) may create a precedent for EU Member States in a way in which they can automatically deny certain types of commercial justifications.

Transfer pricing legislation that limits the right of the taxpayers to provide some types of commercial justifications should not be regarded as proportionate to its legitimate aim. Therefore, the German transfer pricing legislation would not meet the proportionality principle.

6. Conclusion

The ECJ decision in *Hornbach-Baumarkt* will become an important precedent for the transfer pricing legislation of EU Member States. The Court has to coherently analyse the arguments presented by AG Bobek in the light of previous judicial practice and international transfer pricing practice.

The prima facie comparison analysis shows that cross-border and domestic situations of a resident company with a non-resident subsidiary and a resident company with a resident company are comparable, whereas the former is treated less favourably. Therefore, the transfer pricing legislation might constitute a restriction to the freedom of establishment in the EU context.

The national transfer pricing legislation may be compatible with EU law as it pursues the legitimate aim of the balanced allocation of taxing powers and the prevention of profit shifting. At the same time, the restriction provided by the transfer pricing rules should be proportionate to the legitimate aim of the legislation, i.e. to granting the right to provide commercial justifications. The restrictions on the

79. *UN Practical Manual on Transfer Pricing for Developing Countries*, para. 1.6.8 (UN 2017), available at http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf.
80. R. Petruzzi, *supra* n. 60, at pp. 77-95.
81. *Thin Cap Group Litigation* (C-524/04), at para. 91.
82. *SGI* (C-311/08), at para. 72.
83. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at para. 112.
84. Id., at para. 135.

types of commercial justifications disproportionally limit the rights of taxpayers.

In the light of foregoing, the German transfer pricing rules may not be compatible with the freedom of establishment according to article 49 in conjunction with article 54 of TFEU.[85]

85. Art. 49 and art. 54 TFEU.