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Transfer Pricing Rules under the ECJ's Scrutiny: Green Light for Non-Arm's Length Transactions?

This article analyses the ECJ decision in *Hornbach-Baumarkt* (C-382/16) from 31 May 2018 and its implications for the transfer pricing legislations of EU Member States. First, to argue that cross-border transactions targeted by the arm's length principle are comparable to purely domestic ones, the article scrutinizes the situations when the application of the transfer pricing rules is domestically relevant. Second, the article examines the justification of balanced allocation of taxing powers to the restrictive measure and its possible criteria for proportionality. Finally, the article analyses whether the ECJ allows related parties to act on non-arm's length terms within the European Union.

1. Facts of the Case[1]

Hornbach-Baumarkt AG (hereinafter - Hornbach)[2] is a public limited company established in Germany. In September 2002, Hornbach issued comfort letters for no consideration in favour of its two foreign fully owned subsidiaries ("foreign group companies"), both of which were established in the Netherlands, to the bank providing financing to those companies. The foreign group companies had negative equity capital and required the bank loans in order to continue their business operations.

The German Tax Office considered gratuitous provision of comfort letters to the related subsidiary not to satisfy the arm's length requirement provided by *Gesetz über die Besteuerung bei Auslandsbeziehungen* (German Foreign Transactions Tax Act (hereinafter FTTA)).[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. At the same time, the Tax Office denied the right for a taxpayer to provide the commercial reasons for non-arm's length conditions resulting from the parent company's shareholder status.

Hornbach considered the fact that corrections would not be made, if Hornbach had owned domestic subsidiaries, to be a restriction to the freedom of establishment. Moreover, the absence of a possibility to provide commercial justifications, resulting from Hornbach's status as a shareholder, did not comply with 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), whether the German arm's length principle under the FTTA is compatible with the freedom of establishment under EU law.

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

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

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

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

2. Are Transfer Pricing Rules Restrictive to the Freedom of Establishment?[4]

The first step of the ECJ analysis is to establish whether domestic legislation restricts the exercise of cross-bor-

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1. This article is the continuation and extension of the article by R. Petruzzi & S. Buriak, *Freedom of Establishment and Transfer Pricing Threats for EU Single Market*, 25 Intl. Transfer Pricing J. 4 (2018), Journals IBFD. The stated article examined 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.
2. Hornbach-Baumarkt Aktiengesellschaft (AG - Public Limited Company), registered by German District Court Landau HRB 2311 on 20 August 1992, company's webpage: http://www.hornbach-holding.de/de/.
3. 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.
4. *See*, DE: Opinion of Advocate General Bobek, 14 Dec. 2017, Case C-382/16, *Hornbach-Baumarkt AG v. Finanzamt Landau*, ECJ Case Law IBFD.
Advocate General Bobek in *Hornbach-Baumarkt* concluded that the German transfer pricing rules were in line with the freedom of establishment under EU law, as they did not constitute neither restriction, nor discrimination to a freedom of establishment. Moreover, the Advocate General concluded that even if the ECJ would find a domestic legislation to be a restrictive to the freedom at stake, the rule establishing the arm's length principle under the German legislation was justified by the legitimate aim of the balanced allocation of powers of taxation

der activities by the taxpayer or discriminates against the cross-border arrangements compared to domestic ones.[5] The presence of either any restriction or discrimination is sufficient to imply that domestic legislation restricts the exercise of the freedom of establishment. However, a mere restriction-oriented approach faces the problem that any difference in taxation among Member States could be a restriction to the freedom of establishment.[6] Therefore, the ECJ in *Hornbach-Baumarkt* also examined the German arm's length principle rule in the light of differences in the tax treatment of cross-border and domestic arrangements.

The comparability analysis encompassed in the discrimination test might involve several stages: (1) the choice of the comparator and factors for comparison; (2) the examination of applicable tax treatment of comparators (prima facie comparability), (3) and the objectives of a domestic legislator when applying the different treatment to comparable cross-border and domestic situations (objectives comparability).[7]

At the first stage, in *Hornbach-Baumarkt*, the Court indicated the domestic group as an appropriate comparator in respect of transaction of gratuitous provision of comfort letters or financial guarantees. Paragraph 1 of the FTTA entitles the German tax authorities to make a correction to an income of a taxpayer only in connection to its business relations outside Germany. By contrast, the correction is not permissible in respect of comparable related-party transactions within Germany. Compliant with the previous ECJ practice, the Court ruled that the difference in treatment of taxpayers based on the place where the companies with which an agreement on non-arm's length terms have been made have their registered office is liable to constitute a restriction to a freedom of establishment. Thereby the taxpayer might be deterred from acquiring, creating or maintaining a subsidiary in another Member State.[8]

The German government attempted to defend its tax policy considering that the domestic and cross-border situations targeted by the arm's length principle are not objectively comparable. Germany argued that it did not have the power to impose tax on the income of subsidiaries established in other Member States,[9] whereas in purely domestic conditions there was no difference for Germany whether to tax the group income in the hands of the parent company or in its subsidiary in Germany.[10] In this respect, the Court fairly pointed out that those arguments relate to the justification derived from the principle of territoriality, rather than the objective comparability of the cross-border and domestic situations.[11]

The ECJ in this conclusion significantly derogated from the Opinion of AG Bobek on this case. The AG argued that the German arm's length principle should not be regarded as discriminative if applied only to cross-border activities, since the transactions with foreign subsidiaries are not objectively comparable to domestic activities in the light of the arm's length principle precisely because of "the principle of territoriality and [the] inability to exercise jurisdiction to tax over foreign subsidiaries".[12] In contrast, in purely domestic conditions, the profits of the group do not leak out one jurisdiction, and, accordingly, do not escape the taxation.

However, the position of the ECJ in *Hornbach-Baumarkt* seems to be sound in the light of the Court's case law[13] and its aim to safeguard the principles of free movement in the EU Internal Market.

First, the EU fundamental freedoms were adopted to equalize the treatment of cross-border and domestic activities within the Internal Market.[14] The objective of the freedom of establishment under article 49 of the Treaty of Functioning of the European Union (TFEU) is to ensure the legal persons can "carry on an economic activity in a stable and continuous way in another Member State".[15] The right of tax authorities to make corrections to the income of companies in respect of their cross-border activities together with the lack of possibility for corresponding adjustments of income in other Member States may result in economic double taxation, which in turn might disrupt a stable and continuous economic activity. Especially, this concern is relevant when a tax authority makes unjustifiable corrections to the income and limits the right of a taxpayer to some types of commercial reasons that can rebut that correction. For example, in the present case, the double taxation results in a higher cost of raising the capital for a foreign subsidiary compared to a domestic subsidiary. Having those concerns in mind, a company might be prevented from establishing a subsidiary in other Member States.

and prevention of profits shifting. Addressing the limitations imposed by the German legislation on the types of the commercial justifications that are considered legitimate, the AG concluded that the rule did not go beyond what was necessary to achieve its legitimate purposes.

5. *See*, AG Opinion in *Hornbach-Baumarkt* (C-382/16), at paras. 29-38.
6. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at para. 44.
7. R. Petruzzi & S. Buriak, *Freedom of Establishment and Transfer Pricing Threats for EU Single Market*, 25 Intl. Transfer Pricing J. 4 (2018), Journals IBFD.
8. DE: ECJ, 31 May 2018, Case C-382/16, *Hornbach-Baumarkt AG v. Finanzamt Landau* [2018], ECJ Case Law IBFD, at paras. 33 and 35.
9. *Hornbach-Baumarkt* (C-382/16), at para. 38.
10. *Hornbach-Baumarkt* (C-382/16), at para. 39.
11. *Hornbach-Baumarkt* (C-382/16), at para. 40
12. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at para. 60. For arguments against the approach of the AG and for the position of the Court *see*, R. Petruzzi & S. Buriak, *supra* n. 7, at sec. 3.1.4.
13. *See* LU: ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, ECR I-02471, ECJ Case Law IBFD; NL: ECJ, 18 Sept. 2003, Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financiën*, ECJ Case Law IBFD; UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. Halsey (Her Majesty's Inspector of Taxes)*, [2005] ECR I-10837, ECJ Case Law IBFD; DE: ECJ, 23 Feb. 2006, Case C-471/04, *Keller Holding v. Finanzamt Offenbach am Main-land*, ECJ Case Law IBFD.
14. *Marks & Spencer* (Case C-446/03), at para. 37. In effect, acceptance of the proposition that the Member State in which a company seeks to establish itself may freely apply to it a different treatment solely by reason of the fact that its registered office is situated in another Member State would deprive article 43 EC of all meaning.
15. *European Union – Fact Sheets,* Freedom of establishment and freedom to provide services, available at: http://www.europarl.europa.eu/factsheets/en/sheet/40/freedom-of-establishment-and-freedom-to-provide-services (accessed 20 July 2018).

Second, the objective comparability test, in principle, might justify the restrictive or discriminative domestic rules imposed by Member States, when the comparable domestic situation does not exist,[16] or where the application of some rules to domestic transactions lead to economically preposterous consequences.[17] Accordingly, the question is whether the domestic group might also economically benefit from the absence of application of the arm's length principle at the domestic level, and whether there are circumstances when the application of the arm's length principle is relevant for purely domestic transactions.

The analysis of the legislation of the Member States shows that some countries also apply their transfer pricing rules domestically to prevent specific tax avoidance schemes at a domestic level. For example, arm's length rules may apply domestically when one of the related entities is loss-making and domestic legislation does not provide a group consolidated regime, when one of the group members has a loss carried forward, or when one of the related companies is entitled to a lower tax rate than its group member.[18] Table 1 provides a comparative analysis of the EU Member States' provisions on the following criteria: (1) the existence of different corporate tax rates according to the size and amount of profits of taxpayers; (2) the presence of a consolidated group regime; (3) the cross-border or (and) domestic application of the arm's length principle.

For example, Croatia's transfer pricing rules apply to domestic transactions if one of the parties is operating at a loss, has tax losses carried forward, pays a lower tax rate, or is entitled to a tax relief. The Slovenian transfer pricing legislation provides that the arm's length principle applies domestically if a related company has a beneficial tax position that might be used to minimize the tax due at a group level.[19] The legislation of the majority of the Member States does not contain the right to opt for a consolidated group regime, and, therefore, to offset the losses of one related company against the profit of another. However, the non-application of the arm's length principle or other anti-abuse rules to the situations described allows the domestic groups to offset their profits against their losses, or to transfer some part of profits to a related company with a lower effective tax rate, and as a consequence, to decrease the taxable amount at the group level. Therefore, some jurisdictions apply their transfer pricing rules to domestic transaction with the objective to prevent tax avoidance and to ensure their right to exercise their taxing powers on the proper amount of income generated by the separate entities.

Therefore, the Court came to a fair and reasonable conclusion that the application of the arm's length principle only to cross-border transactions is restrictive and discriminative compared to comparable domestic transactions. First, the transfer pricing requirements impose additional high-demand requirements for compliance on taxpayers. Second, some domestic tax systems also leave the field for tax minimization (or avoidance) in purely domestic conditions. Therefore, the lack of application of the arm's length principle to domestic transactions might provide domestic groups with a more favourable tax position. The principle of territoriality may justify the inability of the Member States to ensure equal treatment due to their limited discretion to exercise control over the activities in other jurisdictions, but the principle should not be regarded as the ground for objective incomparability in the light of the arm's length principle.

3. Justifications for the Discriminative Cross-Border Application of the Arm's Length Principle

The German government raised the statement that the application of the arm's length principle to cross-border transactions is justified "by the overriding reason in the public interest of the preservation of the balanced allocation of the powers to tax".[20] The ECJ agreed that the settled case-law provides that the "balanced allocation of the powers to tax between the Member States *may be capable* of justifying a difference in treatment where the system in question is designed to prevent conduct liable to jeopardise the right of a Member State to exercise its power to tax in relation to activities carried out on its territory" (emphasis added).[21]

Therefore, at the first glance, the ECJ focused only on the examination of the balanced allocation of taxing powers as a potentially justifiable aim of the legislation. The ECJ distinguished potential actions that could refrain Germany from exercising its tax jurisdiction in relation to activities carried out on its territory and the German domestic arm's length principle rule aimed to prevent this. Thereby, the Court held that cross-border transactions between related companies undermine the balanced allocation of taxing powers between Member States when they accomplish transfer of profits (i) in the form of unusual advantages;[22] (ii) in the form of gratuitous advantages;[23] (iii) under the conditions, which are not aligned with market conditions.[24] Finally, the Court agreed that the German arm's length principle rule was "appropriate for ensuring the preservation of the allocation of powers of taxation between the Member States".[25] Therefore, it might be argued that the Court accepted the balanced

16. *See*, for example, NL: ECJ, 22 Feb. 2018, Case C-398/16, *X BV and X NV v. Staatssecretaris van Financiën*, ECJ Case Law IBFD.
17. *See*, for example, DE: ECJ, 11 Sept. 2014, Case C-47/12, *Kronos International Inc. v. Finanzamt Leverkusen*, ECJ Case Law IBFD.
18. R. Petruzzi & S. Buriak, *supra* n. 7, at sec. 3.1.3.
19. SI: Zakon o davku od dohodkov pravnih oseb [Corporate Income Tax Law] 2006 (amended 2017 with RS, št. 69/17), art. 16, National Legislation IBFD.
20. *Hornbach-Baumarkt* (C-382/16), at para. 42.
21. *Hornbach-Baumarkt* (C-382/16), at para. 44.
The Court referred to *Rewe Zentralfinanz* (C-347/04), *Oy AA* (C-231/05), and *Masco Denmark and Damixa* (C-593/14) to argue that the balanced allocation might be capable to justify the domestic restrictive rules. However, none of these cases accepted that that the balanced allocation of taxing powers alone (without the legitimate aim to prevent tax avoidance) is sufficient for this purpose.
22. *Hornbach-Baumarkt* (C-382/16), at para. 44.
23. Id.
24. *Hornbach-Baumarkt* (C-382/16), at para. 45.
25. *Hornbach-Baumarkt* (C-382/16), at para 47.

Table 1 – The relevance of the domestic transfer pricing rules for EU Member States[1]			
Country	**Corporate tax rates**	**Consolidated regimes for domestic groups**	**ALP Requirement**
Austria	25%	Yes (>50%, optional)	Cross-border[2]
Belgium	29%	No	Domestic and cross-border[3]
Bulgaria	10%	No	Domestic and cross-border[4]
Croatia	18% (12%)	No	Domestic and cross-border[5]
Cyprus	12.5%	No	Domestic and cross-border[6]
Czech Republic	19%	No	Domestic and cross-border[7]
Denmark	22%	Yes (>10%, mandatory)	Domestic and cross-border[8]
Estonia	20% (gross profit), 14%	No	Domestic and cross-border[9]
Finland	20%	No (group contributions allowed)	Cross-border[10]
France	33.33% (28, 15%)	Yes (>95%, optional)	Cross-border[11]
Germany	15%	Yes (optional)	Cross-border[12]
Greece	29%	No	Domestic and cross-border[13]
Hungary	9%	No	Domestic and cross-border[14]
Ireland	25%, 12.5%	Yes (partial)	Domestic and cross-border[15]
Italy	24%	Yes (>50%, optional)	Cross-border[16]
Latvia	20% (gross profit), 15%	No	Domestic and cross-border[17]
Lithuania	15% (5%)	No	Domestic and cross-border[18]
Luxembourg	18%	Yes (optional)	Domestic and cross-border[19]
Malta	35% (0%-15%)	No	Cross-border[20]
Netherlands	25%, 20%	Yes (>95%, optional)	Domestic and cross-border[21]
Poland	19% (15%)	Yes (>75%, optional)	Domestic and cross-border[22]
Portugal	21% (17%)	Yes (>75%, optional)	Domestic and cross-border[23]
Romania	16%	No	Domestic or cross-border[24]
Slovakia	21%	No	Domestic and cross-border[25]
Slovenia	19% (0%)	No	Domestic and cross-border[26]
Spain	25%	Yes (>75%, optional)	Domestic and cross-border[27]
Sweden	22%	No	Cross-border[28]
United Kingdom	19%	No (but group relief, >75%)	Domestic and cross-border[29]

1. The information presented in the Table is based on the translated national legislation of the countries, as well as Tax guides and highlights provided by Deloitte, and Quick References Tables IBFD. The Table encompasses a best effort of the authors to collect the examined information from the domestic law of EU Member States. In the cases of mismatches of the information, please contact svitlana.buriak@wu.ac.at or raffaele.petruzzi@wu.ac.at.
2. AT: Einkommensteuergesetz [Income Tax Code] 1988, sec. 6 para. 6, National Legislation IBFD.
3. BE: Impôt sur les Revenus [Belgian Income Tax Code] 1992, art. 185, para. 2, art. 26, 54, 79, 207 and 344, National Legislation IBFD.
4. BG: Закон за корпоративното подоходно облагане [Corporate Income Tax Act] 2006 (amended 2018 with SG No. 103/28.12.2017), ch. 4, art. 15, National Legislation IBFD.
5. HR: Zakon o Porezu na Dobit [Profit Tax Act] 2004, art. 13, National Legislation IBFD.
6. CY: Assessment and Collection of Taxes Law No. 4/1978 published in the Official Gazette No. 4621 of 15 July 2002, last amended on 6 Oct. 2017 (amended 2017), art. 33, National Legislation IBFD.
7. CZ: The Czech Income Tax Act 586/1992 Coll., sec. 23 para. 7, National Legislation IBFD.
8. DK: Ligningsloven [Tax Assessment Act] 2016 (amended 2018), sec. 2, National Legislation IBFD.
9. EE: Tulumaksuseadus [Income Tax Act] 1999 (amended 2017 with RT I, 31.12.2016, 3), sec. 10 art. 50(4); sec. 2 art. 8 National Legislation IBFD.
10. FI: Laki verotusmenettelystä [Law on Tax Procedure] 18.12.1995/1558 (amended 2018), sec. 31, National Legislation IBFD.
11. FR: Code Général des Impôts [General Tax Code] (amended 2018) art. 57 (last amended LOI n 2014-891 du 8 août 2014 - art. 19), National Legislation IBFD.
12. 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.
13. GR: Foros eisodimatos phisikon prosopon [New Income Tax Code] art. 2 and Circular 1142/2015, National Legislation IBFD.
14. HU: 1996. évi LXXXI. törvény a társasági adóról és az osztalékadóról [Act LXXXI of 1996 on Corporate Tax and Dividend Tax], sec. 18, point 23, National Legislation IBFD.
15. IE: The Taxes Consolidation Act 1997 (as inserted by section 42 Finance Act 2010), sec. 835 (C-D), National Legislation IBFD.
16. IT: Testo Unico delle Imposte sui Redditi [Income Tax Code] 1986 (amended 2017 with L. 4 novembre 2017, n. 172.) art. 9 and art. 110, National Legislation IBFD.
17. LV: (2017.g. 28.jūlija) Uzņēmumu ienākuma nodokļa likums [Corporate Income Tax Law 2017] sec. 4(2)(2)(e) ; Likums "Par nodokļiem un nodevām" [Law on Taxes and Duties] 1995, sec. 1(18), National Legislation IBFD.
18. LT: Law on Corporate Income Tax, 20 December 2001 No. IX-675 Vilnius (amended 2017), art. 40, National Legislation IBFD.
19. LU: Loi modifiée du 4 décembre 1967 concernant l´impôt sur le revenu [Income Tax Law - 1967] (amended 2018), art. 56 and 56bis, National Legislation IBFD.
20. MT: ATT DWAR L-AMMINISTRAZZJONI TAT-TAXXA (Kapitolu 372) [Income Tax Management Act (Cap 372 of the Laws of Malta)], art. 5(6), National Legislation IBFD.
21. NL: Wet op de vennootschapsbelasting 1969 [The Dutch Corporation Tax Act 1969] sec. 8b, National Legislation IBFD.
22. PL: Ustawa o podatku dochodowym od osób prawnych 1992 [Corporate Income Tax act 1992], art. 11 paras. 1-5, National Legislation IBFD.
23. PT: Código Do Imposto Sobre O Rendimento Das Pessoas Coletivas [Corporate Income Tax Code] 1988, art. 63, National Legislation IBFD.
24. RO: Codul fiscal [Tax Code] approved by Law no. 227/2015, art. 11, National Legislation IBFD.
25. SK: Zákon o dani z príjmov 595/2003 [Income Tax Act 2003] (amended 2018), sec. 2, 17 and 18, National Legislation IBFD.
26. SI: Zakon o davku od dohodkov pravnih oseb [Corporate Income Tax Law] 2006 (amended 2017 with RS, št. 69/17), art. 16, National Legislation IBFD.
27. ES: Ley del Impuesto sobre Sociedades 27/2014 [Corporate Income tax Law 2014], art. 18.1, National Legislation IBFD.
28. SE: Inkomstskattelag (1999:1229) [Income Tax Act 1999:1229], sec. 14 para. 19, National Legislation IBFD.
29. UK: Taxation (International and Other Provisions) Act 2010, sec. 147-148, National Legislation IBFD.

allocation of taxing powers as a sole justification for the German legislation as such being at issue.

However, the Court in its conclusion on examination of the justification slightly reformulated the purpose of the transfer pricing legislation at issue compared to what was argued by the German government. Accordingly, the ECJ has broadly provided that the German rule "seeks to prevent profits generated in the Member State concerned from being transferred outside the tax jurisdiction of the Member State…via transactions that are not in accordance with market conditions, without being taxed" and legislation with that purpose "is appropriate or ensuring the preservation of the allocation of powers of taxation between the Member States".[26]

Establishing the criteria for the proportionality of the German domestic legislation, the Court concretized that purpose. The Court has developed the proportionality test in the case of domestic legislation, which aims "to attain the objectives relating to the need to maintain the balanced allocation of the power to tax between the Member States and to prevent tax avoidance" and "to determine whether a transaction represents an artificial arrangement". Hence, the Court implicitly relied on prevention of tax avoidance as a purpose of German domestic legislation.

As the proportionality analysis is part of the examination of justifications for a restrictive domestic legislation, it is unclear whether the Court in the end accepted the balanced allocation of powers of taxation as a sole justification or bundled this objective together with the objective for prevention of tax avoidance.

For example, in *Thin Cap Group Litigation* (C-524/04)[27] and *SGI* (C-311/08),[28] the Court stressed the following:

> 72. …a national measure restricting freedom of establishment may be justified where it specifically targets wholly artificial arrangements designed to circumvent the legislation of the Member State concerned[29]
>
> 66. … national legislation which is not specifically designed to exclude from the tax advantage it confers such purely artificial arrangements … may nevertheless be regarded as justified by the objective of preventing tax avoidance, *taken together* with that of preserving the balanced allocation of the power to impose taxes between the Member States. (Emphasis added)

However, in contrast to previous ECJ cases, in *Hornbach-Baumarkt*, the German government did not impose that the aim of the German legislation at issue was also to combat tax avoidance in addition to the aim of balanced allocation of taxing powers. Moreover, the German government did not advance any arguments related to risk of tax avoidance present in the *Hornbach-Baumarkt* case.[30] Therefore, it could be questioned whether the Court may design justifications that might justify the national measure on its own or whether it is the responsibility of the government to justify its restrictive domestic legislation.

The discriminatory restrictions on the freedom of establishment may be justified on the grounds of public policy, public security, public health or other grounds. At the same time, the ECJ case law leaves the burden of proof with the Member State to show that their rules may be justified on one of the public interest grounds.[31] If the EU Member States design the discriminative or restrictive measures, they should be capable themselves of presenting sufficient grounds and reasons for such policy decisions to justify the infringement of the fundamental freedoms. If there are other potential grounds that would have justified the legislation of Member States but were not raised by them, the Court should strike down the legislation.

The Court did not provide a clear conclusion that the reason of balanced allocation of powers of taxation (the justification raised by the government) may solely justify the restrictive measure in the light of the freedom of establishment because the consideration of combating tax avoidance was raised when analysing the proportionality of the German legislation. Likewise, the ECJ reasoning affected the proportionality analysis in the case, which is discussed in the following section.[32]

4. Proportionality of the German Legislation at Issue

The Court provided the requirements for proportionality of the domestic restrictive rule for legislation which seeks (i) to prevent tax avoidance and (ii) ensure balanced allocation of taxing powers, which are the following:[33]

(i) a taxpayer should be given an opportunity to provide evidence of any commercial justification that there may have been for that transaction;
(ii) the corrective measure must, where required, be confined to the part which exceeds what would have been agreed between the companies in question under market conditions.

Since the fulfilment of the second proportionality requirement by the German Tax Office was not a subject to debate between it and Hornbach, the ECJ put only the first pro-

26. Id.
27. 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.
28. 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.
29. *See*, *Thin Cap Group Litigation* (C-524/04), at para. 26; DE: ECJ, 12 Dec. 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, ECJ Case Law IBFD, at para. 37; *Marks & Spencer* (Case C-446/03), at para. 57; and 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. 51.
30. *Hornbach-Baumarkt* (C-382/16), at para. 55.
31. N. Bammens, *Non-Discrimination in European Tax Law: General Remarks* in *The Principle of Non-discrimination in International and European Tax Law* pp. 521-569 (N. Bammens, IBFD Doctoral Series 2013) Online Books IBFD. *See*, for example, IT: ECJ, 10 Feb. 2009, Case C-110/05, *Commission of the European Communities v. Italian Republic* [2009] I-00519, at para. 66; PL: ECJ, 16 July 2009, Case C-165/08, *Commission of the European Communities v. Republic of Poland* [2009] I-06843, at para. 52.
32. In *Hornbach-Baumarkt* (C-382/16), in the authors' opinion, the Court might have gone too far in its competence to imply that impugned measure is justified by bundled legitimate aim of prevention of shifting the profits abroad, which includes both the balanced allocation of taxing powers and prevention of tax avoidance.
33. *Hornbach-Baumarkt* (C-382/16), at para. 49.

portionality test under its scrutiny. More specifically, as the German tax authorities did not generally deny the right to provide commercial reasons, but only a specific type of justification, the main discussion was around the issue "whether any commercial justification may include economic reasons resulting from the very existence of a relationship of interdependence between the parent company … and its [foreign] subsidiaries".[34]

Before examining the commercial reasons grounded on the relationship of interdependence and their relevance to establishing the arm's length price, it is important to take recourse to the ECJ case law on the proportionality criteria for such justifications as prevention of tax avoidance and balanced allocation of taxing powers that might be invoked by the Member States to defend its transfer pricing domestic rules.

The restrictive laws might be justified by the legislative aim of combating tax avoidance, where they specifically target artificial arrangements made solely to evade a domestic tax rule at issue.[35] The artificial arrangement under the ECJ case law is an arrangement that is lacks economic genuineness and is entered into with a sole purpose to achieve a tax advantage.[36] Therefore, the arrangement should be referred to as artificial if it is performed "without any underlying commercial justification".[37] With respect to the arm's length principle, in *Thin Cap Group Litigation* (C-524/04), the Court ruled that the fact that the arrangement is performed on non-arm's length terms indicates "an objective element, which can be independently verified in order to determine whether the transaction in question represents … a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation."[38] To prevent undue administrative constraints, a taxpayer should have been able to provide those commercial justifications, which can rebut the tax authorities' conclusion that the targeted arrangement is artificial.[39]

In *X-Holding*[40] and *National Grid Indus,*[41] the ECJ accepted the balanced allocation of taxing powers as sole justification for the restrictive domestic rules at issue.[42] With regard to proportionality considerations, the ECJ in both cases applied different proportionality tests scrupulously analysing the economic effects of the specific measures.

According to the case law, it might be argued that there is no one-size-fits-all proportionality test when it comes to balanced allocation. The scope of this justification is just way too broad. Therefore, for each domestic legislation at stake, the Court may accept allocation as a stand-alone justification, but it has to develop a specific proportionality test.

In *Hornbach-Baumarkt,* the ECJ applied the same proportionality test that was developed in the *Thin Cap Group Litigation* (C-524/04) in relation to the artificiality of non-arm's length transactions[43] and confirmed in *SGI* (C-311/08). However, as argued in section 3. of this article, the German government did not justify its domestic arm's length principle rule on the ground of prevention of tax avoidance and tackling of artificial arrangements. Therefore, the issue remains why the Court still applied a proportionality test corresponding to justification of prevention of tax avoidance.

Probably, the German government could predict that if it had brought up the justification of prevention of tax avoidance, the subsequent proportionality criterion of granting the right to taxpayers to provide any types of commercial justifications[44] would have evidently questioned the legitimacy of its domestic transfer pricing rules. Hence, the German government probably attempted to avoid that proportionality test.

It is also evident that the ECJ wanted to allow the circumvention of the proportionality test. Accordingly, the Court, first, implied that the legislation at issue was seeking to combat tax avoidance, and then argued that the transfer pricing legislation of the Member States should allow all types of commercial justifications. In the authors' opinion, the Court could have achieved the same outcome of the case relying only on the balanced allocation of taxing powers as a justification raised by the German government. In particular, the Court could examine the economic circumstances supporting the application of the arm's length principle and economic conditions that do not require the application of the arm's length principle, as they may not affect the balance in allocation of taxing powers between the Member States. Hence, the arm's length principle should apply only to the types of transactions that may undermine the taxing powers of the Member State. It should not go beyond its legitimate aim, namely the arm's length principle should not apply to some specific types of activities that cannot affect the balance of the allocation of powers of taxation between the Member States.[45]

34. *Hornbach-Baumarkt* (C-382/16), at para. 52.
35. *Cadbury Schweppes* (C-196/04); *Thin Cap Group Litigation* (C-524/04).
36. M. Hilling, *Justifications and Proportionality: An Analysis of the CJEU's Assessment of National Rules for the Prevention of Tax Avoidance*, 41 Intertax 5, pp. 297-298 (2013).
37. *Thin Cap Group Litigation* (C-524/04), at para. 81; AG Opinion in *Thin Cap Group Litigation* (C-524/04), at para. 61.
38. *Thin Cap Group Litigation* (C-524/04), at para. 81.
39. *Thin Cap Group Litigation* (C-524/04), at paras. 82-83; *SGI* (C-311/08).
40. NL: ECJ, 25 Feb. 2010, Case C-337/08, *X Holding BV v. Staatssecretaris van Financiën*, ECJ Case Law IBFD. The Dutch government invoked the balanced allocation of powers of taxation as a sole justification to its domestic rule, which prevented the formation of a single tax entity of a Dutch parent company with a non-resident subsidiary.
41. NL: ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus BV v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, paras. 22 and 42-49, ECJ Case Law IBFD. The ECJ also justified the Dutch domestic rule, which imposed a tax on company incorporated under the law of a Member State, which transfers its place of effective management to another Member State on occasion of that transfer (i.e. exit taxes).
42. *X Holding BV* (C-337/08), at para. 33.
43. *Thin Cap Group Litigation* (C-524/04), at paras. 71-84.
44. *SGI* (C-311/08); *Thin Cap Group Litigation* (C-524/04).
45. With this aim, the Court could examine (1) the economic nature of comfort letters and the conditions under the comfort letter issued by Hornbach as considered and presented to the Court by the German Tax Office; (2) whether under specific circumstances the gratuitous issuance of comfort letters may be argued by taxpayers as such that does not undermine the balanced allocation of powers of taxation. The second issue is whether the limitations on the rights of taxpayer to provide the commercial reasons for transactions that arise from the relationship of interdependence precludes establishing those circumstances when allocation of taxing powers between the Member States is not misbalanced.

5. Transfer Pricing Implications for the Proportionality Test

The arm's length principle applies where the conditions of transactions between related parties in respect of their commercial and financial relations differ from those that are or would be agreed upon between independent parties. In this regard, it is important to note that article 9 of the OECD Model, referred to as the "authoritative statement" of the arm's length principle, primarily refers to commercial and financial relations and not to transactions and most certainly not to entity profits. The OECD TP Guidelines place a considerable emphasis on the fact that the determination of the arm's length principle should first of all be based on a proper identification of the commercial and financial relations within the group and on the accurate delineation of the actual transactions against that relational background.[46] The commercial and financial relations may take different forms. For the purposes of the analysis of the *Hornbach-Baumarkt* case, it is important to examine the distinction between intra-group services and shareholder activities and the influence of that distinction on the financial transactions between the related parties.

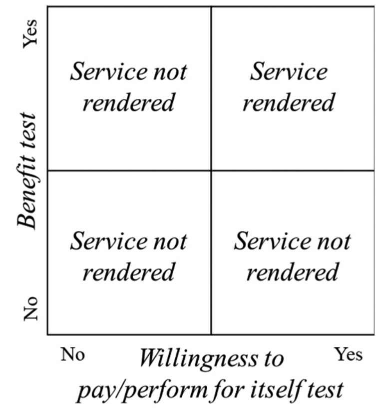
5.1. The type of relationship: Intra-group services vis-à-vis shareholder activities

The determination of the arm's length nature of transactions between related parties requires the performance of a four-step analysis, aimed at determining (1) the identification of the commercial or financial relations,[47] (2) the recognition of the accurately delineated transaction,[48] (3) the selection of the transfer pricing method,[49] and (4) the application of the transfer pricing method.[50] Steps 1 and 2 will ultimately answer whether any compensation for the tested transaction can be chargeable/deductible, while steps 3 and 4 are aimed at determining the arm's length charge of the intra-group services.

In the case of intra-group services, steps 1 and 2 should assess whether an intra-group service was rendered, by means of assessing the "benefit test" and the "willingness to pay/perform for itself test". Based on the "benefit test", it should be determined "whether the activity provides a respective group member with economic or commercial value to enhance or maintain its business position".[51] Based on the "willing to pay/perform for itself test", it should be determined "whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself".[52]

When both the tests are fulfilled, one can argue that the intra-group[53] service is rendered and, accordingly, steps 3 and 4 above should be performed. However, if one of the criteria is missing, "such type of activity would not be considered as an intra-group service, and thus would not justify a charge to other group members".[54] Figure 1 illustrates such concepts:

Figure 1



Within non-chargeable intra-group services, "shareholder activities" are a specific category defined by the following characteristics:

(i) the parent company performs an activity solely because of an ownership interest in another group member and for the sake of its own benefit;
(ii) under comparable facts and circumstances, an independent enterprise would not have been willing to pay for or to perform similar activity.

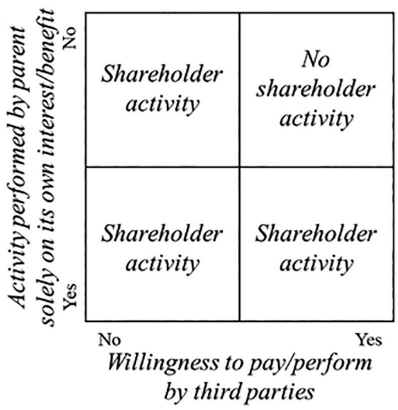
Figure 2 illustrates such concepts.

The analysis of the economic nature of guarantees and comfort letters in section 5.2. will aim to align the respective transactions with one of the provided possibilities of parent-subsidiary relations.

The risk of imbalance of allocation of taxing powers exists only when intra-group services are rendered. The shareholder's activity, which is not targeted by an accurate appli-

46. S. Gonnet, *Risks Redefined in Transfer Pricing Post-BEPS*, in *Transfer Pricing in Post-BEPS World* p. 34 (M. Lang, A. Storck, R. Petruzzi eds., Wolters Kluwer 2016).
47. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, ch. I D.1. (OECD 2017), International Organizations' Documentation IBFD [hereinafter OECD Guidelines].
48. *OECD Guidelines*, at ch. I D.1.
49. *OECD Guidelines*, at ch. II Part I.
50. *OECD Guidelines*, at ch. II Parts II-III.
51. *OECD Guidelines*, at ch. VII B.1.1. para. 7.8.; UN Practical Manual on Transfer Pricing for Developing Countries, para. B.4.1.2. (UN 2017) International Organizations' Documentation IBFD [hereinafter UN Manual], available at http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf (accessed 20 July 2018).
52. *OECD Guidelines*, at ch. VII B.1.1. para. 7.8.; UN Manual, paras. B.4.2.3.-B.4.2.5.
53. *See*, for example, 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 Case Law IBFD. In *H Group Holding*, 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.
See also, NL: HR, 25 Nov. 2011, No. 08/05323 (No. 10/05161, 10/05394, 10/00516). In this case, the Dutch Supreme Court provided that 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.
54. *OECD Guidelines*, at ch. VII B.1.1. para. 7.9.

Figure 2



cation of the arm's length principle, cannot undermine the balance in the allocation of powers of taxation between Member States. Accordingly, the transfer pricing rule providing the right for corrections of income in accordance with the arm's length principle should be seen as proportional to the legitimate aim of the balanced allocation of taxing power to the extent it targets only the transaction of intra-group provision of services and goods.

5.2. The terms of the transaction: The economic nature of comfort letters

In an intra-group context, comfort letters consist of a promise (generally, not legally binding) provided by a company belonging to the group (in most cases, the parent company) to a third party (usually a financial institution) stating that it will not take actions that would compromise the financial stability of another group company (usually receiving a loan from the financial institution).[55] Such a promise may include an indication that the parent will continue to be the parent of the subsidiary until the loan is settled. Comfort letters may sometimes contain a statement of comfort that the parent will support the subsidiary in some manner until the debt obligation is satisfied.[56] This statement might be referred to as a keep-well statement, which is a declaration by a parent company that it will provide its subsidiary with additional capital to prevent it from defaulting.[57]

Comfort letters (as well as letters of intent and keep-well agreements) are generally defined as "implicit guarantees", as opposed to explicit credit guarantees that are also referred to as "formal guarantees". This distinction is fundamental to assess the level of enforceability of each different type of financial guarantee, which varies depending on their terms and conditions. In general, explicit credit guarantees are the most legally binding on the guarantor; comfort letters are the least.[58]

In some circumstances, a parent company may well be unwilling or unable to provide a legally binding guarantee in favour of a subsidiary. In many of these cases, the parent might be willing instead to issue a comfort letter. A comfort letter is issued by the parent to the lender to support the subsidiary without actually guaranteeing the loan.[59] The distinction between "implicit guarantees" and "formal guarantees" is crucial for transfer pricing purposes: while the provision of the former from the parent company to its subsidiary will be perceived akin to a contribution of capital (hence, a shareholder activity, not requiring any remuneration by means of a guarantee fee), the latter will be seen as real intra-group services that should be remunerated by an arm's length guarantee fee, when satisfying the "benefit test" and the "willingness to pay/perform for itself test".

Indeed, an intra-group guarantee fee will be usually chargeable in the following situations:[60]
– the intra-group financial guarantee provides direct and identifiable economic and/or commercial benefits to the guaranteed entity;
– an independent party would be willing to pay for the intra-group financial guarantee; or
– the guaranteed entity achieves a better creditworthiness because of the intra-group financial guarantee.

On the other hand, an intra-group guarantee fee will usually not be chargeable in the following situations:[61]
– the guaranteed entity achieves a better creditworthiness only because of its group affiliation, i.e. issue of implicit support;
– when the debtor has no debt capacity or credit status and, therefore, would not be able to access the capital market without the financial guarantee; or
– the financial guarantee has been requested by the creditor in order to avoid that the parent company diverts the funds of the financed company, i.e. moral hazard issues.

The comfort letters issued gratuitously by Hornbach in favour of its group companies contained the following statements of its obligations:

– Hornbach undertook to refrain from divesting of or changing its shareholding in Hornbach Holding BV and to ensure that the latter would likewise refrain from divesting of or changing its shareholding in the foreign group companies without giving the bank a written notice 3 weeks in advance.[62]

55. R. Petruzzi, *Transfer Pricing Aspects of Intra-Group Financing* p. 132 (Wolters Kluwer 2016).
56. T.G. Noland & J.R. Hardin, *A Closer Look at Comfort and Verification Letters*, J. of Corporate Acc. & Fin. p. 82 (2018), available at https://onlinelibrary.wiley.com/doi/pdf/10.1002/jcaf.22305 (accessed 20 July 2018).
57. PwC, *Navigating the complexity: Findings from the financial transactions transfer pricing global survey 2013* p. 227, Country Surveys IBFD, available at: https://www.pwc.com/gx/en/tax/transfer-pricing/assets/full-report-2013.pdf (accessed 20 July 2018).
58. R. Petruzzi, *supra* n. 55, at p. 132.
59. T.G. Noland & J.R. Hardin, *supra* n. 56, at p. 82.
60. R. Petruzzi, *supra* n. 55, at p. 135.
61. R. Petruzzi, *supra* n. 55, at p. 135; 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; E.D. Ryan, C.E. Erivona, D.G. Chamberlain, *A Transfer Pricing Framework for Loan Guarantee Fees*, BNA Tax Management Transfer Pricing Report 11, p. 850. (2003).
62. *Hornbach-Baumarkt* (C-382/16), at para. 9.

– Hornbach irrevocably and unconditionally undertook the obligation to fund the foreign group companies in such a way as to enable them to meet all of their liabilities.[63]

The German tax authorities considered that Hornbach's obligation to fund the foreign group companies to meet all their financial liabilities was a financial commitment of the parent company, which would be remunerated if issued by an independent entity.

At the hearings, the European Commission considered that the charging of a guarantee fee to a mere comfort letter was a little "over the top".[64] In contrast, the AG supported the position of the German government stating that "provision of a guarantee like the one given by the Applicant in its comfort letter has a very real economic value and, in relation to unrelated companies, would be paid for".[65]

As the ECJ has no competence to decide whether the specific comfort letter has an economic value or whether it should be characterized as a comfort letter or financial guarantee, it could consider whether there might be situations when granting a comfort letter or financial guarantee might deviate from the arm's length terms.[66]

The Court, in the light of commercial justifications for the proportionality test, concluded the following:

> 53. In the present case, it is clear from the order for reference that the foreign group companies had negative equity capital and the financing bank made the granting of the loans required for the continuation and expansion of business operations contingent on the provision of comfort letters by Hornbach-Baumarkt AG.
>
> 54. In a situation where the expansion of the business operations of a subsidiary requires additional capital due to the fact that it lacks sufficient equity capital, there may be commercial reasons for a parent company to agree to provide capital on non-arm's-length terms.

As this article argues that the Court would have come to the same conclusion by examining the balanced allocation of taxing powers as a justification for the domestic arm's length principle provision, it is important first to consider the economic rationale behind that Court's conclusion.

Risks accompanying comfort letters and financial guarantees

The ECJ emphasized that the German Tax Office made income tax corrections "taking the view that unrelated third parties, under the same or similar circumstances, would agree on remuneration in exchange for granting the guarantees".[67] Accordingly, the German Tax Office assumed that the comfort letter at issue should have been remunerated in the same manner as a financial guarantee between the independent parties without any distinctions.

However, as mentioned before, comfort letters should be distinguished from an explicit financial guarantee since the latter, typically, generate a legally binding agreement between the lender and the guarantor[68] as well as full credit substitution if the borrower fails to repay the amount of loan or defaults. Letters of comfort usually do not require a remuneration to the extent that they do not impose a legally enforceable obligation on the issuer with regard to the credit exposure of the bank lending money to its subsidiary.[69]

When a parent company issues a guarantee to a bank, it exposes itself to additional risks as it is legally committed to fulfil the loan conditions if the borrower defaults. Any other lesser form of credit support with no legally binding commitment involves no explicit assumption of risk. Therefore, the delineation of the risks under the financial guarantee or comfort letter depends on the presence of legally binding and enforceable commitments under their terms. The higher level of legally binding commitment and higher level of enforceability available to a lender may lead to better conditions of loan granted to the guaranteed entity, and consequently, higher benefit to him. Hence, it is up to the tax authorities and domestic courts of the Member States to decide the nature of the commitments under the comfort letters and financial guarantees in accordance with their domestic legislation.

In *Hornbach-Baumarkt*, it is up to the discretion of the German tax authorities and the domestic court to define the risks attributed to Hornbach and the foreign group companies under the comfort letter. If the comfort letter was not legally binding and enforceable, it is difficult to argue that it empowered a principal with any substantial benefit that might be present in financial guarantees.

The exposure to an additional risk by the parent company does not automatically indicate the presence of a benefit to the guaranteed entity. The crucial indicators are whether a guaranteed entity obtained better conditions on a loan, i.e. better credit rating and interest rate. In *Hornbach-Baumarkt,* Hornbach argued many times that foreign group companies could not obtain a loan without a comfort letter, which might be evidence of the benefit attributed

63. *Hornbach-Baumarkt* (C-382/16), at para. 10.
64. *Hornbach-Baumarkt* (C-382/16), at para. 107.
65. AG Opinion in *Hornbach-Baumarkt* (C-382/16), at paras. 100, 108.
66. The letter of comfort at issue did not provide the promisor to make a direct payment to a bank in the case of a subsidiary's default, but to finance a subsidiary to meet its debt obligations in the future. First, an explicit guarantee in principle requires a prompt payment of a credit exposure in full when a subsidiary is in default and maybe already ceased to exist. A comfort letter prescribes that a parent company may (if the comfort letter is legally enforceable at all) finance the subsidiary in future by means of capital injection, which is a tax-neutral transaction, or by means of loan, which separately might require remuneration as an intra-group service. Secondly, the parent company by issuing such comfort letter acts only in its capacity and interest of shareholder as independent company cannot, in principle, provide comparable equity commitments. Finally, even though a creditor might enforce the obligation of a parent company to top up the capital of a subsidiary, the parent company will act only as a shareholder in this scenario and its activity will be neutral for tax purposes.
67. *Hornbach-Baumarkt* (C-382/16), at para. 11.
68. S.K. Bilaney, *Is a Letter of Comfort a Chargeable Intra-Group Service?*, Intl. Transfer Pricing J. May/June pp. 200-203 (2017), available at https://online.ibfd.org/collections/itpj/printversion/pdf/itpj_2017_03_int_1.pdf.
69. Id., at pp. 200-201.

to the foreign group companies. However, as mentioned above, the guaranteed entity having no debt capacity or credit status is one of the reasons for not charging any guarantee fee, in an arm's length situation.

In this regard, Hornbach also argued that no other company would provide the guarantee to the foreign group companies due to their bad financial conditions. Therefore, Hornbach exposed itself to higher risk than an independent company could tolerate. Taking a higher risk than would be reasonable under the market conditions is clear evidence that the parent company is acting in its own benefit, i.e. the expansion of the business influence and activity. Hence, the benefit to a subsidiary is offset against the benefit to the parent company. Moreover, the benefit to a subsidiary, i.e. obtaining a loan, is a part and condition for a benefit to the parent company. The subsidiary should not pay remuneration for the economic benefits of the parent company.

Functions under the comfort letters and financial guarantees and economic rationale behind the tax consequences

A financial guarantee undermines the obligation of a guarantor to pay the amount of loan in the case of the default of the guaranteed entity. According to the typical terms of a financial guarantee, if the principal defaults, the guarantor will pay the amount of loan guaranteed. Consequently, the guarantor deducts a corresponding loss from its tax base. Accordingly, the jurisdiction of the guarantor may charge a lower amount of taxes after the loss is deducted. Therefore, from a tax perspective, the tax residence jurisdiction of a guarantor offsets the loss of tax revenue against its profits in the form of guarantee fees paid under the financial guarantee to ensure a balanced allocation of taxing powers.

In contrast, the comfort letter in *Hornbach-Baumarkt* indicated the obligation of Hornbach to ensure appropriate funding of its subsidiary to meet all the financial obligations under the loan agreement not to go into default. To comply with its obligations, Hornbach would have two available options:

(1) it could make injections into the capital of its foreign group companies; or
(2) it could provide a loan to its group subsidiaries to meet their financial obligations.

The activity under the first scenario may be performed only by a shareholder. There is no comparable independent transaction to argue that independent party would pay for such activity. Accordingly, a shareholder, fulfilling an obligation to provide its subsidiary with a sufficient capital, acts only in its capacity of shareholder. Hence, under the comfort letter, Hornbach made a commitment effective in the future to make appropriate investments into its foreign subsidiary. From a tax perspective, such an investment may result in loss or in profit for the parent company in situations, respectively, when the subsidiary goes into default or distributes dividends or when the parent company realizes capital gains. In *Hornbach-Baumarkt*, Germany in the first scenario would obtain the taxing powers over the dividends or capital gains, which is a way to secure tax revenue in Germany against potential losses in investment activity. However, Germany is willing to secure a possible loss as a result of obligations under the comfort letter by requiring and taxing both the fee for the comfort letter and future potential dividends or capital gains.

In the second scenario, the German tax authorities require the fee for a promise to provide a loan in the future from the parent company to its subsidiary. If the loan is granted by Hornbach to its foreign group members under the terms of the comfort letter, the German Tax Office would require this loan to be remunerated again on the arm's length terms. Therefore, in the second scenario, Hornbach would be subject to taxation twice: at the moment of making a promise to perform an activity and at the moment of the actual provision of a loan.

Therefore, in both scenarios, Germany would impose taxes over cross-border activities that will be performed in the future. Most probably, when financing under the comfort letter is provided, the German tax authorities would consider it to be a second tax triggering fact. This effect by no means supports the German government's justification of balanced allocation of taxing powers.

Moreover, the German tax authorities did not take into account the nature of the activity performed when applying its domestic arm's length principle. Applying the arm's length principle to shareholder's activity, which normally does not require remuneration, is a restriction to the freedom of establishment that cannot be justified by balanced allocation of taxing powers.

Balanced allocation of taxing powers and the arm's length principle

The domestic legislation of the Member State establishing a possibility for correction of income in accordance with the arm's length principle should be considered proportional to its aim (i.e. balanced allocation of taxing powers) only if it affects cross-border transactions that have the potential to undermine a balanced allocation of taxing powers of a Member State.

Accordingly, a first requirement of this transaction is to be the intra-group provision of services or goods. The second requirement is that the activity or transaction should be per se taxable in the state imposing the assessment. If a transaction is tax neutral, there is no chance to alter the balance of the allocation of taxing powers. In this respect, intra-group services should be distinguished from shareholders' activities, which do not have to be remunerated. Hornbach's comfort letter may constitute an example of such shareholder activity.

An accurate delineation of the actual transaction with respect to commercial and economic relations between the parties is a requirement for proportionality of the domestic arm's length principle with its legitimate aim. In the present case, an accurate delineation requires considering whether the arrangement at issue is an intra-group service or a shareholder activity. If a tax authority comes to a wrong conclusion, domestic legislation should grant a taxpayer the right to provide commercial reasons that the transaction at issue is a shareholder activity, and hence, a guarantee fee should not be charged. These commercial reasons are directly derived from the parent company's status as a shareholder. However, German domestic legislation limits the right of a taxpayer to defend the appropriateness of its activity and compliance with the transfer pricing legislation. Such limitation should be regarded as disproportional to the aim of the legislation of balanced allocation of taxing powers.

6. Green Light for Non-Arm's Length Transactions?

Even though the ECJ in *Hornbach-Baumarkt* relied on the proportionality test, which is typical for the legislation aiming to prevent tax avoidance, the Court came to the same conclusion, that the German arm's length principle is proportional if it grants the taxpayer the right to provide any commercial justifications to a transaction or an arrangement.[70] However, the ECJ added some further wording the interpretation of which might seem controversial.

The ECJ, examining the taxpayer's right to provide commercial justifications, observed the following:

> 54. In a situation where the expansion of the business operations of a subsidiary requires additional capital due to the fact that it lacks sufficient equity capital, there may be commercial reasons for a parent company to agree to provide capital *on non-arm's-length terms*.[71] (Emphasis added)
>
> 56. Accordingly, there may be a commercial justification by virtue of the fact that Hornbach-Baumarkt AG is a shareholder in the foreign group companies, which would justify the conclusion of the transaction at issue in the main proceedings *under terms that deviated from arm's-length terms*… The gratuitous granting of comfort letters containing a guarantee statement, *even though companies independent from one another would have agreed on remuneration for such guarantees*, could be explained by the economic interest of Hornbach-Baumarkt AG itself in the financial success of the foreign group companies, in which it participates through the distribution of profits, as well as by a certain responsibility of the applicant in the main proceedings, as a shareholder, in the financing of those companies. (Emphasis added)

Thereby, the ECJ's wording might generate confusion about under what circumstances the Court allowed the cross-border activity within the European Union to be not aligned with the arm's length terms. The issue is whether "arm's length terms", as stated by the Court, refer to *comparison with third party behaviour* or to the transaction being in line with the *arm's length principle*.

If one interprets "arm's length terms" according to the first meaning above (i.e. there may be commercial reasons for a parent company to agree to provide capital terms deviating from third parties' behaviour), the ECJ came to the right conclusion: in those circumstances, as mentioned before, no third party would have provided a guarantee and the parent company should not have charged any guarantee fee. The taxpayer should, therefore, be able to provide commercial reasons for this behaviour, in line with the correct application of the arm's length principle. In this case, the relevance of the arm's length principle would be safeguarded, since the provision of commercial reasons should be granted only in cases of correct application of the principle.[72]

If one interprets "arm's length terms" in the second way (i.e. there may be commercial reasons for a parent company to agree to provide capital terms deviating from the arm's length principle), the Court might have come to the controversial conclusion that commercial reasons might be provided also for transactions that are not in line with the arm's length principle. In this case, the arm's length principle might be "emptied" of its meaning at the EU level, since a taxpayer would be able to justify its commercial reasons also when they lead to a transaction that is not in line with the arm's length principle.

The authors hope that the Court was referring to the first interpretation when referring to "arm's length terms". To avoid such confusion, a better wording would probably have been "not in line with arm's length behaviour" instead of "non-arm's length terms".

However, the first interpretation might not be necessary shared, in light of the wording of paragraph 56 of the decision in *Hornbach-Baumarkt*. Here, the Court considered that non-arm's length terms might be accepted by the tax authorities, even though "companies independent from one another would have agreed on remuneration for such guarantees",[73] if a parent company has an economic interest in the financial success of the foreign group companies. A parent company will always be interested in the financial success of its subsidiary and, hence, the acceptance of commercial reasons in situations not in line with the arm's length principle (i.e. in cases where, at arm's length, companies would have agreed on a remuneration for such guarantees), as mentioned above, might empty the arm's length principle of its legal and economic relevance.

70. The taxpayer should be given the opportunity to prove "any commercial justification" behind the transaction (this comes from *Thin Cap Group Litigation* (C-524/04), at para. 82; *SGI* (C-311/08).
71. *Hornbach-Baumarkt* (C-382/16), at para. 54.
72. A transaction that does not happen between unrelated parties could still be in line with the arm's length principle. The OECD Guidelines clearly state this in para. 1.11, where they say "The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length." This concept is crucial, since most transactions between MNEs do not happen between unrelated parties. Therefore, when a controlled transaction does not happen between unrelated parties (e.g. imagine an MNE that produces and sells within the group a product that nobody else does or transactions involving unique and valuable intangibles), the MNE will still be able to demonstrate the arm's length nature of that transactions by means, inter alia, of the business reasons supporting the transaction.
73. *Hornbach-Baumarkt* (C-382/16), at para. 56.

7. Conclusions

Transfer pricing rules, when applied only to cross-border situations, constitute a restriction to the freedom of establishment as they apply a discriminative tax treatment to companies with foreign subsidiaries. However, these rules may be justifiable by the sole legitimate aim of balanced allocation of taxing powers. At the same time, transfer pricing legislations should not go beyond their legitimate aims. Accordingly, transfer pricing adjustments should apply only to avoid cross-border transactions or arrangements from undermining the balanced allocation of taxing powers by shifting profits abroad. Moreover, when tax authorities apply their transfer pricing rules contrary to the purpose of balanced allocation of their taxing powers, taxpayers should have the right to provide their commercial reasons.

However, in *Hornbach-Baumarkt*, the ECJ specified that such commercial reasons might be provided also in the presence of non-arm's length terms. Even more, the Court underlined that those commercial reasons might be provided even in cases where independent parties would have behaved differently. These conclusions, might potentially undermine the relevance of the arm's length principle in the EU transfer pricing rules, ultimately leading to the following alternative outcomes:

– Nothing will change compared to the current situation, since the wording of the ECJ does not seem to clearly deprive the arm's length principle of its relevance.

– In order to avoid such confusion and the emptying of the arm's length principle, more countries will apply their TP rules also to domestic transactions.

– The arm's length principle might potentially be emptied of its meaning at the EU level and EU Member States should consider strengthening their transfer pricing rules.

The impact of the *Hornbach-Baumarkt* case is yet to be assessed.

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