LUND UNIVERSITY
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MASTER THESIS IN EUROPEAN AND INTERNATIONAL TAX LAW

Allocation of burden of proof that the arm's length principle was(not) breached under the TFEU Fundamental Freedoms

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List of abbreviations

EU	**European Union**
ECJ	**European Court of Justice**
OECD	**Organization for economic cooperation and development**
TP Guidelines	**OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations**
TFEU	**Treaty of functioning of European Union**
EU TPD	**European Union Transfer Pricing Documentation**

1. Introduction

1.1 The Background: In the globalized economy many countries struggle with the profit shifting to low-tax jurisdictions. The generally accepted legal mechanism for counteracting such practice is the arm's length principle. This principle stipulates that the prices in transactions between related parties should reflect the prices that would have been agreed between unrelated companies. Accordingly, the tax authorities are entitled to adjust the profits of the controlled enterprise if the prices in its transactions with related company do not satisfy the arm's length principle. In that way countries are able to prevent erosion of tax base. Important question when it comes to applying this principle is how the burden of proof that this principle was (not) followed should be allocated between tax authorities and taxpayers. It appears that this issue will become all the more important in the future since The OECD took position that arm's length principle should be applied to dealings between a head office and its permanent establishment as well.[1]

1.2 The Purpose: In EU Law framework the balanced allocation of taxing powers and counteracting tax avoidance are recognized by the European Court of Justice as legitimate aims pursued by the Member States. Thus, the Member States are allowed to differentiate between cross-border and domestic economic operators if such measures are appropriate and proportionate for attaining such aim.[2] Accordingly, the main question of this assignment will be to investigate how do exercising of the fundamental freedoms stipulated in the TFEU and exercising of tax sovereignty of the Member States correlate with each other when it comes to burden of proving that the arm's length principle was (not) followed. The purpose of this work will be to contribute to clarifying the issue of how the burden of proof that arm's length principle was (not) followed in inter-company transactions should be allocated within the EU Law context.

1.3 The Outline: In the second part of this paper the relevant case law of The European Court of justice will be analyzed. In the third part, the issue of how these judgments correlate with OECD Transfer Pricing Guidelines[3] will be dealt with. Double-Tax Treaties of the majority of The EU Member States are based on the OECD Model Convention on Income and on Capital[4]. OECD Commentary on the Model Convention on Income and on Capital in part that deals with the Article 9 of the OECD Model refers to TP Guidelines for Multinational Enterprises and Tax

[1] OECD Model Tax Convention on Income and Capital (Full Version), July 2010, C(7)-6,7
[2] Case C-414/06 Lidl Belgium GmbH & Co. KG Finanzamt Heilbronn [2008], Case C-231/05 Oy AA [2007], [2] Case C-337/08 X Holding BV v Staatsecretarisvan Financien [2010]

[3] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010
[4] OECD Model Tax Convention on Income and Capital (Full Version), July 2010, C(9)-1

Administrations[5]. Accordingly, TP Guidelines should be included in this research. Based on the conclusions from the second part and the third part, in the fourth part, an analysis of certain EU Member States Transfer Pricing rules in relation to the topic of this work will be made. Since, in the course of this research, it was not possible to investigate Transfer Pricing regimes in all EU Member States, the analyses will include transfer pricing provisions and court decisions of certain Member States that were found in works of doctrine and other secondary sources. These provisions will be used as examples to show what kind of transfer pricing regimes breach EU Law. In the fifth part, concluding remarks will be made based on the findings from the previous parts.

1.4 Method and Materials: In order to fulfill the purpose of this research the relevant judgments of the ECJ will be dealt with in the second part. The judgments will be systematized chronologically in order to show what is law as it stands today? In the third part the findings from the second and the third part will be contrasted to particular chapters of the TP Guidelines that concern the burden of proof. In the fourth part the transfer pricing policies of certain Member States will be analyzed from an EU Law perspective. In the fifth part concluding remarks will be made. With regard to materials, the judgments of the ECJ, TP Guidelines, doctrinal articles and books will be used. In the part of this work that concern national legal provisions of the Member States and decisions of national courts secondary sources will be used due to language barriers.

[5] Model Tax Convention on Income and Capital (Full Version), July 2010, page 442

2. EU Legal Framework

In this part of the paper the question that will be dealt with is what are the legal requirements to which Transfer Pricing rules of the EU Member States should be complied with in EU Law context? The cases will be discussed in three subsections: first subsection will deal with the arm's length principle and EU Law; second subsection will deal with the development of EU Law principle of prohibition of abuse of law while in the third part certain judgments that set the limits to imposing administrative requirements to cross-border economic operators will be considered.

2.1 Arm's length principle and EU Law

When it comes to status of arm's length principle within the ECJ's case-law three judgments deserve particular attention: Lankhorst-Hohrost case, Test Claimants in the Thin Cap Litigation Group and SGI case. It should be noted that not all of this cases concern transfer pricing. However, they are relevant for the issue of what are EU legal requirements to which transfer pricing regimes of EU Member States has to be complied with.

The first judgment that had far-reaching consequences to transfer pricing provisions of the EU Member States is Lankhorst-Hohrost judgment.[6] The case concerned a German company that was a subsidiary of Dutch company which was itself a subsidiary of another Dutch company. The grand-parent company granted a loan to Lankhorst. The loan was followed by letter of support under which grand-parent waived repayment if third party creditors made claims against Lankhorst. The Loan enabled Lankhorst to reduce its bank borrowing. In corporation tax assessment notices The German tax authorities deemed interest paid to grand parent company as a covert distribution of profits and charged 30% tax on that payment. The issue brought before the ECJ was whether application of the rules that concern covert distribution of profits only for repayments in respect of loan capital which a company limited by shares subject to unlimited taxation has obtained from a shareholder not entitled to corporation tax credit breaches EU Law. As regards the taxation of interest paid by subsidiary companies to their parent companies in return for loan capital, such a restriction introduces a difference in treatment between resident subsidiary companies according to whether or not their parent company has its seat in Germany. In addition from order for reference it was apparent that there is no entitlement to corporation tax credit, first for non-residents and, second, for corporations governed by German law which are exempt from corporation tax, namely legal persons governed by public law and those carrying on business in a specific field or performing tasks which should be encouraged. The ECJ held that situation of a company such as the parent company of Lakhorst Hohorst, which is carrying on a business for profit and is subject to corporation tax, cannot be validly compared to

[6] Case 324/00 Lankhorst Hohorst GmbH v Finanzamt Steinfurt [2002]

that of the latter category of corporations. Thus, it was apparent that national provision at issue made a distinction between domestic and foreign entities based on nationality. The ECJ did not accept justifications of German government based on the need to prevent tax avoidance and to ensure the coherence of the tax system. The ECJ concluded that such a provision is contrary to Community law. This decision was received critics from scholars. As Kordewener argues, the additional argument that the shareholder concerned will in any event be subject to a tax legislation of the State in which it is established is still not very convincing even though it has now been repeated several times. As long as the area of direct taxes is not harmonized, each Member State is responsible for its own tax system and must therefore also be entitled to protect its own tax system and must therefore be entitled to protect its own tax system properly.[7] Wattel argues that Lankhorst-Hohorst implied having either to give up CFC legislation, thin cap rules, earning striping rules, transfer pricing documentation requirements etc. in cross border situations or to apply them in a domestic situation as well. Many Member States did the latter because they could not afford to give them up in cross-border situations. Without them, tax advisors would have reduced the domestic corporation tax base of multinational to naught. Denmark, Germany, Spain and UK changed their Thin Cap rules and arm's length pricing rules so as to also encompass domestic group financing and transfer pricing.[8] It is clear that decision was incorrect because the ECJ did not take into account the need of The EU Member States to exercise its tax sovereignty.

The ECJ changed its approach in Test Claimants in the Thin Cap group litigation case[9]. This case concerned a number of claims for restitution and or compensation brought by a group of companies against Commissioners of Inland revenue in the High Court of Justice of England and Wales. Each of the cases involved UK resident companies that were at least 75 % owned directly or indirectly, by foreign resident parent companies. Namely the ability of resident companies to deduct, for tax purposes, an interest paid on a loan finance granted by direct or indirect parent company which is resident in another Member State was denied, where that resident company would not have been subject to such restriction if the interest had been paid on a loan finance granted by a parent company which was resident in the first Member State. The Court rejected arguments that such measure was necessary in order to secure the cohesion of the tax system but accepted justification based on the need to fight abusive practices. The ECJ ruled that such legislation is contrary to Community law unless: '*that legislation provides for a consideration of objective and verifiable elements which makes it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, and allows taxpayers to produce, if appropriate and without being subject to undue administrative constraints, evidence as to the commercial justification for the transaction in question and, secondly, where it is established that such an arrangement exists, such legislation treats that interest as a distribution only in so far as it exceeds what would have been agreed upon at arm's length.'*[10] As Wattel argues, this is much rational and practicable result than Lakhorst-Hohorst and it means that the arm's length test has become part of the Court

[7] Axel Cordewener, Company Taxation, Cross Border Financing and Thin Capitalization in the EU Internal Market: Some Comments on Lankhorst-Hohorst GmbH, European Taxation April 2003, Journals IBFD page 106

[8] Ben J.M. Terra, Peter J. Wattel, European Tax Law, sixth edition (abridged student edition), 2012 Wolters Kluwer Law & Business, page 382

[9] Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commisionaries of Inland Revenue [2007]

[10] Case C-524/04, paragraph 92

assessment under its rule of reason of whether restrictive tax measures can be justified by mandatory requirements of public interest, such as the need to prevent tax avoidance and the need to preserve balanced allocation of taxing powers among The Member States. Further, Wattel stressed out that the ECJ accepted the arm's length test as an objective and verifiable test of absence of artifice.[11] On the other hand, some authors criticize such decision by holding that the fact that the country of resident subsidiary may reclassify the interest as dividends, but the non-resident parent company's country is not bound to apply such a classification and may continue to consider the payment as interest, is not logical and contrary to the objective of a harmonized tax system.[12] Wattel's opinion seems more convincing because the direct taxation is not harmonized area of EU Law and the fundamental freedoms provisions do not guarantee the neutrality of cross-border movements. This judgment is important because it allows the Member States to differentiate between foreign and domestic economic operators to an extent to which the arm's length principle is applicable. However, it only allowed the application of the arm's length principle as an anti-avoidance measure. Although the ECJ has shown more flexible approach to measures that differentiate between domestic and cross-border situations it was still unclear how this principle correlates with balanced allocation of taxing power concept that became increasingly important after The Marks and Spencer judgment.[13] The answer to this question was given in the SGI case[14] that concerned a case of a Belgian company that was refused a business expense for a director remuneration paid to the company established in another Member State on the ground that the sums paid were disproportionate and unrelated to the economic benefit of the service in question. The question that was brought before the ECJ was whether it is in accordance with Community Law to tax a resident company in respect of an unusual or gratuitous advantage granted to a company established in an another Member State whereas in identical circumstances in respect of an advantage granted to a Belgian company it would not be taxed. The ECJ ruled: '*National legislation which provides for a consideration of objective verifiable elements in order to determine whether a transaction represents an artificial arrangement is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to maintain balanced allocation of the power to tax between the Member States and to prevent tax avoidance where, first, on each occasion on which there is a suspicion that transaction goes beyond what the companies concerned would have agreed under fully competitive conditions, the taxpayer is given an opportunity without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may be for such transaction. Second, where consideration of such elements leads to the conclusion that the transaction in question goes beyond what the companies concerned would have agreed under fully competitive conditions, the corrective tax measure must be confined to the part which would have been agreed if the*

[11] Ben J.M. Terra, Peter J. Wattel, European Tax Law, sixth edition (abridged student edition), 2012 Wolters Kluwer Law & Business, page 384

[12] Gracia M Lucena Mozo, Thin Capitalization: An Unanswered Question Following Recent Spanish Thin Amendments, European Taxation August 2012, Journals IBFD, page 415

[13] Case C-446/03 Marks and Spencer plc v David Halsey (Her Majesty's Inspector of taxes) [2005] Case C-414/06 Lidl Belgium GmbH & Co. KG Finanzamt Heilbronn [2008], Case C-231/05 Oy AA [2007], [13] Case C-337/08 X Holding BV v Staatsecretarisvan Financien [2010]

[14] Case C-311/08 Societe de Gestion Industrielle (SGI) v Belgian State [2010]

companies did not have relation of interdependence.' In addition, the ECJ did not accept the argument of the Belgian government that applying Convention 90/436/EEC ('The Arbitration Convention') greatly diminishes the risk of double taxation.[15] The ECJ held: '*an additional administrative and financial burden is imposed on the company which has submitted its case to such a procedure. Moreover, a procedure aimed at resolution by mutual agreement, followed, if necessary, by an arbitration procedure, may extend over several years. During that period, the company in question must bear the burden of double taxation. Furthermore, it is apparent, in particular in the light of the matters set out at paragraph 29 above, that the legislation at issue in the main proceedings is applicable in certain situations falling outside the scope of the Convention.*'[16]. Opinions are divided in the doctrine when it comes to implications of the SGI judgment. ECJ Task Force of the CFE argues that the ECJ contradicts itself because in paragraph 65 the ECJ holds that the measure restricting freedom of establishment may be justified if it specifically targets wholly artificial arrangements designed to circumvent the legislation of the Member State concerned. While in the paragraph 66, the ECJ holds that if such a restriction cannot be justified on the grounds of fighting wholly artificial arrangements it can be justified on the grounds of counteracting tax avoidance taken together with that of balanced allocation of taxing powers.[17] While, Baker infers from these two paragraphs that although the ECJ could have been a little bit clearer on this point, it does appear that the ECJ is making a difference between combating wholly artificial arrangements and combating tax avoidance.[18] On the other hand, Wattel argues that a balanced allocation of taxing power, the fiscal principle of territoriality, and cohesion of tax system all seem to pivot around the same concept of tax base integrity for both States involved (source state and residence state), that are both free in the present state of EU Law, to exercise in parallel the taxing power they asserted on the basis of source residence, nationality, or territoriality. Obviously, also the prevention of abuse pivots around tax base integrity, but as observed, on a smaller area of the same scope, namely reduced by one, possibly two limiting conditions: motives and artifice.[19] In my view Baker's opinion is wrong because it is hard to accept that the ECJ had an intention to preclude its previous case law on abusive practices without giving any new definition of what tax avoidance really is in EU Law context (this question was dealt more extensively in section 2.2).This approach would cause great uncertainty. Anyway, what is important, this judgment confirmed what was ruled in Thin Cap but there is one important difference between the Thin Cap judgment and the subsequent SGI judgment. In the Thin Cap the justification based on the coherence of tax system was rejected and need to encounter tax avoidance was accepted while in SGI judgment was held that the

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[15] Case C-318/10, paragraph 47

[16] Case C-318/10, paragraph 54

[17] The ECJ Task Force of the CFE, Opinion Statement of The CFE on the Case Law of the European Court of Justice on Transfer Pricing Related to Loans (Decision of 21 January 2010 in Case C-311/08 SGI), European Taxation June 2012, page 314, Journals IBFD

[18] Philip Baker, Transfer Pricing and Community Law: The SGI case, Intertax, Kluwer Law International BV The Netherlands, Volume 38, issue 4, page195

[19] Ben J.M. Terra, Peter J. Wattel, European Tax Law, sixth edition (abridged student edition), 2012 Wolters Kluwer Law & Business, page 491

restrictive measure may be regarded as justified by the objective of prevention of tax avoidance, taken together with that of preserving the balanced allocation of taxing powers. As Baker rightly argues, this judgment confirms that cross-border transfer pricing provisions may be justified, even if they operate only cross-border and even if they have a restrictive effect, provided that they secure the balanced allocation of tax jurisdiction and they are necessary for combating tax avoidance.[20] Hilling argues that a joint assessment of the two grounds may serve to justify rules not specifically designed to prevent typical evasive transactions but with a broad applicability, serving to protect the tax base more generally.[21] Accordingly, the ECJ in SGI allowed the Member States to restrict cross-border movements on those grounds to an extent to which the arm's length principle is applicable. Thus, the significance of this judgment lies in the fact that the arm's length principle was accepted both as an anti-avoidance measure and as an instrument for achieving the balanced allocation of taxing powers between the Member States. With regard to burden of proof this judgment gives some indications. Namely, in paragraph 73 the ECJ held: '*According to the Belgian Government, the burden of proof as to the existence of an unusual or gratuitous advantage within the meaning of the legislation at issue in the main proceeding rests with the national tax authorities. It states that the burden of proof as to the existence of an unusual or gratuitous advantage within the meaning of the legislation at issue in the main proceedings rests with the national tax authorities. It states that when those authorities apply that legislation, the taxpayer is given an opportunity to provide evidence of any commercial justification that there may have been for the transaction in question. The taxpayer has a month, a period which may be extended within which to establish that no unusual or gratuitous advantage is involved, having regard to the circumstances in which the transaction was effected. If, however, those authorities persist in their intention of using a revised assessment and do not accept the taxpayer's argument, the latter can challenge the assessment and do not accept taxpayer's arguments, the latter can challenge the assessment before the national court. The Belgian government adds that where the legislation at issue in the main proceedings is applied, only the unusual or gratuitous part of the advantage in question is added back to the profits of the company which granted it. In those circumstances, subject to verification to be carried out by the referring court as regards the last two points, which concern the interpretation and application of Belgian law, it must be concluded in light of the forgoing, that national legislation such as that at issue in the main proceedings is proportionate to the set of objectives pursued by it'*[22]. Meussen argues that the ECJ held in this case that it is vital that the burden of proof be primarily with the tax administration, and that taxpayers must be given the opportunity of counterproof without

[20] Philip Baker, Transfer Pricing and Community Law: The SGI case, Intertax, Kluwer Law International BV The Netherlands, Voulume 38, issue 4 page 196

[21] Maria Hilling, Justifications and Proportionality: An analysis of the ECJ's assessment of National Rules for the Prevention of Tax Avoidance, Intertax, Kluwer Law International BV The Netherlands, 2013Volume 41 Issue 5, page 301

[22] Case C-311/08, paragraph 73-75

undue administrative constraints subject to judicial review before a national court.[23] My opinion is that the ECJ was not unambiguous when it comes to allocation of burden of proof that the arm's length principle was not followed. The ECJ gave more precise answer to this issue in SIAT judgment[24] (this case was dealt with in section 2.2 due to structure followed in this work)

2.2 Development of EU law principle of prohibition of abuse of law

Since it was determined in section 2.1 that the ECJ accepted that the Member States may apply transfer pricing rules only in cross-border situations under the condition of proportionality in this section, as well in the section 2.3, content of proportionality requirement will be closely examined. The first case in which the ECJ dealt extensively with the issue of countering abusive practices is Leur-Bloem case[25]. This case concerned the issue of whether it is an exchange of shares within the meaning of Article 2 (d) Council Directive 90/434/EEC only if its effect is to merge the business of the acquiring company and that of another company permanently in a single unit from a financial and economic point of view. The ECJ held that the laying down the general rule automatically excluding certain categories of operations from the tax advantage would go further then it is necessary for preventing such tax evasion or tax avoidance and would undermine the aim pursued by the Directive. The ECJ referred to the purpose of the Directive as a limit to depriving economic operators of the Directive benefits on the grounds of abusive practices.[26] What is important in this decision is that the ECJ has set out the limits for the Member States to counteract tax avoidance. On the one hand, it is not allowed to lay down anti-avoidance rules that are generally applicable. On the other hand, when assessing whether the situation is abusive the purpose of the provision at issue should be observed. However, this case dealt only with the Directive provision. Thus, it remained unclear whether these findings of the Court apply also when the primary law is concerned. In that respect the ICI judgment[27] is rather important.

[23] Prof. Dr Gerard T.K. Meussen, The SGI case: The ECJ Approves Belgian System of Selective Profit Corrections in relation to foreign Group Companies in Relation to Foreign Group Companies, European Taxation June 2010, Journals IBFD, page 249

[24] Case C-318/10 Societe d'investment pour l'agriculture tropicale SA (SIAT) v Belgian State [2012]

[25] Case C-28/95 A.Leur Bloem v. Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2 [1997]

[26] Case C-28/95, paragraph 44

[27] Case C-264/96 Imperial Chemical Industries and Kenneth Hall Colmer (Her Majesty's Inspector of Taxes) [1998]

This case concerned a UK holding company that had held shares in company majority of which were incorporated in other Member States. The national legislation granted a tax relief subject to condition that its activity consists wholly or mainly in holding shares of domestic companies. The Company argued that it was discriminated against contrary to Community Law. The issue brought before the Court was whether these provision is contrary to freedom of establishment. The UK outlined the risk of tax avoidance as a justification which the ECJ did not accept holding that:' *…the legislation at issue does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting the tax benefits, but applies generally to all situations in which the majority of a group's subsidiaries are established for whatever reason, outside UK.' However, the establishment of a company outside the United Kingdom does not of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment.*[28] After this judgment it was clear that it is against Community Law for the Member States to impose anti-avoidance measures that will be generally applicable. It is important to note that the Court referred to reasons for establishing the subsidiary abroad ('whatever reason'). One could argue that this was a hint of the motive test that will be developed later in Halifax[29] and Cadbury Schweppes[30] judgments.

The landmark judgment for the development of the principle of prohibition of EU Law is Centros ltd judgment.[31] This case concerned two Danish citizens who founded a company in UK and subsequently tried to set up a branch of that company in Denmark. The registration was refused on the grounds that the Company, which does not trade in the UK, was in fact seeking to establish in Denmark, not a branch but its principle establishment, by circumventing the national rules concerning payment of minimum capital. The ECJ held it was immaterial that the company was formed in one Member State only for the purpose of establishing itself in the second, where it's main, or indeed entire business is to be conducted. Further, the ECJ held that the question of the application of fundamentals freedom provision is different from the question whether or not a Member State may adopt measures in order to prevent attempts by certain of its nationals to evade domestic legislation by having recourse to the possibilities offered by the Treaty. Finally, the ECJ concluded that:' *…it is contrary to Community law for a Member State to refuse to register a branch of a company formed in accordance with the law of another member state, in which it has its registered office but in which it conducts no business, where the branch is intended to enable the company in question to register a branch is intended to enable the company in question to carry on its entire business in the State in which that branch is to be created, while avoiding the need to form a company there, thus evading the application of the rules governing the formation of companies which, in that State, are more restrictive as regards the paying of minimum share of capital.'*[32] As De La Feria argues, this case has helped to

[28] Case C-264/96, paragraph 26

[29] Case 252/02 Halifax plc, Leeds Permanent Development Services Ltd and Country wide Property Investments Ltd v Commissioners of Customs and Excise [2006]

[30] Case 196/04 Cadbury Schweppes Ltd V Commissioners of Inland revenue [2006]

[31] Case C-212/97 Centros Ltd v Erhvevrs-og Selskabsstyrelsen [1999]

delineate the concept of abuse for EU proposes. Further, she argues that the ECJ failed to establish definite criteria which situations were abusive, and which were not.[33] The Court was clear that Member State may impose restrictions on exercise of treaty freedoms. However, they cannot deprive economic operators of those rights to that extent. In other words, Member States cannot put barricades for economic operators from another Member States in order to protect their legitimate interests.

The ECJ dealt with an issue of abuse test in Emsland-Starke Gmbh case[34]. This case concerned a company that exported goods from Germany to Switzerland and immediately after the release for home use in Switzerland the exported goods were transported back to Germany unaltered and by the same mean of transport under an external Community transit procedure and were released for home use in that Member State on payment of relevant import duties. When German authorities determined that the goods were immediately imported back to Germany they sought the refunds granted back. The question before the ECJ was whether it is against Community Law for the exporter to loose his right to refund in circumstances described above. The ECJ held: *'A finding of an abuse requires, first, the combination of objective circumstances in which despite the formal observance of the conditions laid down by the Community rules, the purpose of those rules has not been achieved. It requires, second, a subjective element consisting in the intention to obtain an advantage from the Community rules by creating artificially the conditions laid down for obtaining it.'*[35]

This test was slightly modified in Halifax judgment[36]. This case concerned a group of companies whose activities where mostly exempt for VAT purposes and consequently it could not deduct input VAT. That group made an aggressive tax planning scheme in order to obtain a right to deduct VAT. The ECJ was asked, in this case, to give a judgment on the issue whether the doctrine of abuse of rights as developed by the Court operate to disallow the Appellants their claims for recovery of relief for input tax arising from the implementation of relevant transactions. The case concerned the applicability of the Directive (67/227/EEC). It is important to outline that the AG in his opinion on this case stressed that: '*An interpretation of the Sixth Directive (Directive 67/227/EEC) according to this principle cannot but have the most obvious consequence to be expected in the context of legal interpretation that the right is not in fact conferred, contrary to the literal meaning of the legal provision. If this interpretation entails any kind of derogation, it will be only from the text of the rule, not from the rule itself, which comprises more than its literal element.'* [37] The ECJ

[33] De La Feria, Prohibition of Abuse of Community Law : The Creation of a New General Principle of EC Law through Tax, Common Market Law Review 45: 395-441, 2008, Kluwer Law International, pp. 405-407

[34] Case C-110/99 Emsland-Starke GmbH and Hauptzollamt-Jonas [2000]
[35] Case C-110/99, paragraph 52, 53
[36] Case C-255/02
[37] Opinion of Advocate General Poiares Maduro in Halifax and Others, delivered on 7 April 2005, paragraph 79.

confirmed this reasoning and stressed out the relevance of purposive interpretation for determining whether abusive practice is present: '*In the view of the foregoing considerations, it would appear that, in the sphere of VAT, an abusive practice can be found to exist only if, first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. As the Advocate General observed, in point 89 of his Opinion, the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages.*'[38] Accordingly, subjective element from Emsland-Starke was replaced with 'objective factors' term. This judgment introduced a rather vague term of 'essential aim of transactions'. Consequently, it was not clear to what extent should a transaction be motivated by tax reasons in order to be considered abusive. This lack of clarity was removed in The Cadbury Schweppes case[39] which concerned a UK company that had two subsidiaries in Ireland and in third states and that was subject to a charge of tax on the profits of those subsidiaries because they were subjected to lower taxes in Ireland. The Court held that domestic legislation should be applied in a way to target only wholly artificial arrangements and that in order to find that such arrangement exists there must be in addition to a subjective element consisting in the intention to obtain a tax advantage, objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment has not been achieved. [40] However, the ECJ again introduced subjective element into abuse test. As HImenez argues, Thin Cap Group Litigation judgment[41] (see part 2.1) brought the Cadbury Schweppes doctrine more in line with Halifax.[42] Namely, it was held in Thin Cap that if a taxpayer provides evidence of 'commercial justification' for transactions in question there would not be 'purely artificial arrangement entered into for tax reasons alone'. Consequently, the test was again objective since the absence of commercial justification made an arrangement abusive.

Particularly important is Kofoed case[43] that concerned the issue whether the tax authorities may react to a possible abuse of rights even though the national legislature has not enacted specific measures to transpose Article 11 of Directive 90/434. This Article provides that a Member State may refuse to apply or withdraw the benefit of all or any part of the provisions of Titles II, III and IV of the directive where it appears that the exchange of shares has tax evasion or tax avoidance as its principal objective or as one of its principle objectives. The ECJ held: '*Thus, Article 11(1)(a) of Directive 90/434 reflects the general Community law principle that abuse of rights is prohibited. Individuals must not improperly or fraudulently take advantage of provisions of Community law. The*

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[38] Case 255/02, paragraph 74 and 75
[39] Case C-196/04
[40] Case C-196/04, paragraph 72
[41] Case C-524/04
[42] Adolfo Martin Himenez, Towards a Homogeneous Theory of Abuse in EU (Direct) Tax Law, Bulletin for International Taxation, April/May 2012, Journals IBFD, page 277

[43] Case C-321/05 Hans Markus Kofoed v. Skatteministeriet [2007]

application of Community legislation cannot be extended to cover abusive practices, that is to say, transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by Community law'. [44] This case is important because the Court for the first time refers to the General Community law principle that abuse of rights is prohibited.[45] However, this judgment did not say clearly whether there is an obligation imposed on the Member State to counteract abusive practices even when the EU Law is not involved. This issue was dealt with 3M Italia case[46]. This case concerned an Italian company that was involved in judicial proceedings with the tax authorities. The 3M Italia claimed that the tax determined by the tax authorities was too high. On the other hand, the tax authorities claimed that 3M Italia was involved in sham transaction. When the case reached the Supreme Court the company exercised its right to settlement with the tax authorities by way of which it paid only 5 % of the disputed sum. The Italian Supreme Court was also on the position that the 3M Italia was involved in sham transactions. Consequently, The Italian Supreme Court referred a question to the ECJ for a preliminary ruling where it asked whether such a provision is incompatible with Community Law. What is important, the ECJ held: '*Finally, in any event, it is clear that no general principle exists in European Union law which might entail an obligation of the Member States to combat abusive practices in the field of direct taxation and which would preclude the application of a provision such as that at issue in the main proceedings where the taxable transaction proceeds from such practices and European Union law is not involved*.' The relevance of this judgment lies in the fact that the principle of prohibition of EU Law is applied only where the EU Law is concerned. In other words, the obligation for The Member States to fight abusive practices in situation where the EU Law is not concerned can only be imposed through harmonization measures.

Particularly significant is recent SIAT judgment[47] because in this judgment the ECJ gave guidance as to how the burden of proof should be allocated with regard to existence of abusive practices. The case concerned the issue of whether a national provision that provided that the payments for supplies of goods or services are not to be regarded as deductible business expenses where they are made or attributed directly or indirectly to taxpayer resident in another Member State, or to a foreign establishment, which, by virtue of the legislation in the country of establishment , is not subject there to a tax on income or is subject there, as regards the relevant income, to a tax regime which is appreciably more advantageous than the applicable regime in the former Member State, unless the taxpayer proves that such payments relate to genuine and proper transactions and do not exceed the normal limits, whereas, under the general rule, such payments are to be regarded as deductible business expenses If they are necessary for acquiring or retaining taxable income and if the taxpayer demonstrates authenticity and amount of those expenses. The ECJ rightly observed that: '*the rule at issue was not delimited with sufficient precision at the outset and, in a situation where the service provider is established in a Member State other than The*

[44] Case C-321/05, paragraph 38

[45] Adolfo Martin Himenez, Towards a Homogeneous Theory of Abuse in EU (Direct) Tax Law, Bulletin for International Taxation, April, May 2012, Journals IBFD, page 280

[46] Minstero dell Economia e delle Finanze and Agencia delle Entrate v 3M Italia SpA [2012]

[47] Case C-318/10 Societe d'investment pour l'agriculture tropicale SA (SIAT) v Belgian State [2012]

Kingdom of Belgium and is subject there to a tax regime which is more advantageous and whether, as a result, the special rule will apply.' Furthermore, the Court referred to AG's opinion, where it was held that: '*this special rule requires that Belgian taxpayer to provide as matter of course, proof that all the services are genuine and proper and that all related payments are normal, without the tax authority being required to produce even prima facie evidence of tax evasion or avoidance'*[48]. The disputed legal provision was an anti-avoidance rule by its nature and as such it could not be formulated in such a broad manner ('appreciably advantageous tax regime') and shift the burden of proof, exclusively, to tax payers without restricting the freedom to provide services to an extent that is not proportionate to the aim of countering tax avoidance. This judgment is also significant because it confirms that in the anti-avoidance matters the burden of proof lies initially with the tax authorities and that anti-avoidance measures may not leave room for arbitrariness of the tax authorities.

From above considered case law scholars draw different conclusions. Zalasinski argues that the principle of prohibition of abuse of EU Law continue to exist in three different forms: as a principle of interpretation by which the ECJ determines the legitimate scope of subjective rights derived from EU Law, as principle stemming from legislative acts of the council and as a principle stemming from the rule of reason in applying fundamental freedoms non discrimination/non restriction test which is inspired by the criteria determined for the abuse of the freedoms.[49] On the other hand, Himenez argues that the evolution of the ECJ's case law following Cadbury Schweppes and Halifax appears to point in the direction that the principle of interdiction of abuse of EU Law is uniformly applied and understood in tax cases, with regard to its structural elements and content, no matter whether they refer to EU Treaty freedoms or secondary EU Law.[50] The latter opinion sounds more convincing. My view is that although the ECJ uses different expressions and formulations in its case law that concerns abusive practices it is apparent that in all of them only the arrangements that are deprived of any economic substance are targeted. Accordingly, it can be inferred from the above discussed case law of the ECJ that there is a legal basis for Member States to encounter abusive practices. More specifically, when it comes to the area of direct taxation, the Member States are allowed to introduce measures that will be applied to cross-border transactions and not to internal situations as well. However, such measures should be appropriate and proportionate to the aim pursued. They should target wholly artificial arrangements sole purpose of which is to obtain a tax advantage. Furthermore such measures may not introduce general presumption of tax avoidance (Cadbury Schweppes and ICI judgments). In addition, it can be inferred from SIAT that when it comes to rejecting tax advantages on the grounds of abusive practices the initial burden of proof is on the tax authorities ('they should produce prima facie evidence').

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[48] Case 318/10, paragraphs 27 and 55

[49] Dr Adam Zalasinski, The Principal of Prevention of (Direct Tax) Abuse: Scope an Legal Nature-Remarks on 3M Italia Case, European Taxation, September 2012, Journals IBFD, page 452

[50] Adolfo Martin Himenez, Towards a Homogeneous Theory of Abuse in EU (Direct) Tax Law, Bulletin for International Taxation, April, May 2012, Journals IBFD, page 284

2.3 Administrative requirements

In EU Legal context

The first important case that deals with an issue of an extent to which administrative requirements could be applied is Futura judgment[51].This case concerned a Luxembourg branch of a French company which was denied a right to carry forward losses on the ground that its accounts relating to the activities carried in the Luxembourg were not kept and held in accordance with the Luxembourg relevant rules. The ECJ precluded such legislation but ruled that the Member State concerned may require: *'that that the non-resident taxpayer demonstrate clearly and precisely that the amount of loses which he claims to have incurred corresponds, under its domestic rules governing the calculation of income and losses which were applicable in the financial years concerned, to the amount of the losses actually incurred in that State by the taxpayer.'*[52] Even though this case did not concern transfer pricing issue this judgment appears to be applicable to transfer pricing matters as well. This judgment appears to be striking a right balance between the need to ensure fiscal supervision and hinder cross-border movements to least extent possible. The ECJ gave further guidance in respect of the fiscal supervision requirements in Meilicke judgment.[53] This case concerned the issue of what evidence can the Member States require from residents that have shares in other Member States in order to approve them tax deduction for underlying tax paid on corporate income from which dividends were paid to them. The ECJ held that: *As regards the burden of proof and degree of detail which the evidence required must meet in order to benefit from a tax credit in respect of dividends paid by a capital company established in another Member State, it must be borne in mind that the tax authorities of a Member State are entitled to require the taxpayer to provide such proof as they may consider necessary in order to determine whether the conditions for a tax advantage provided for in the legislation at issue have been met and, consequently, whether or not to grant that advantage. Such an assessment must not be conducted too formalistically, so that the provision of documentary evidence which lacks the degree of detail and is not presented in the form of corporation tax certificate provided for by the Member State of taxation of a shareholder having received dividends from a capital company established in another Member State of taxation but which enables the tax authorities of the Member State of taxation to ascertain, clearly and precisely, whether the conditions for obtaining a tax advantage provided for in the legislation at issue have been met, must be considered by those authorities to be equivalent to the production of*

[51] Case C-250/95 Futura Participationis Singer and Administration des Contributions [1997]
[52] Case C-250/95, paragraph 43
[53] Case C-262/09 Wienand Meilicke, Heidi Christa Weyde, Marina Stoffer v. Finanzamt Bonn-Innenstadt[2011]

the above-mentioned certificate.[54] It can be argued that the Futura requirements are watered down by the ECJ in this judgment by obliging the Member States to accept documentary evidence even though it 'lacks a degree of details'.

This line of reasoning was confirmed, in Acorr SA rulling[55]. This judgment concerned a French company that received dividends from its subsidiaries established in other Member States and redistributed those dividends and which was deprived of the tax benefit that would be given in a domestic situation. The question that was brought before the ECJ (among others that are not that relevant for the topic of this work) was whether the principle of effectiveness and equivalence preclude that the reimbursement for a lack of such benefits be subject to condition that the taxpayer produces evidence of the tax paid abroad. The Court held: '*As regards compliance with the principle of effectiveness, it should be noted, first, that the evidence required should enable the tax authorities of the Member State of taxation to ascertain, clearly and precisely, whether the conditions for obtaining a tax advantage are met, but it does not need to take any particular form and the assessment must not be conducted too formalistically.'*[56] What can be inferred from these two judgments is that the need for fiscal supervision has been consistently recognized by the ECJ.

Accordingly, in transfer pricing matters, the Member States are allowed to allocate the burden of proof on the tax payer that his transactions with related party established abroad satisfy arm's length principle.

2.4 Concluding remarks about the EU Law framework to which transfer pricing regimes of the Member States should be accorded with

From above made considerations the legal landscape to which Transfer Pricing regimes of the Member States should be complied with can be summarized as follows:

- Counteracting tax avoidance is a legitimate aim recognized by the ECJ. In addition, when applying anti-avoidance measures that are restrictive, from an EU Law perspective, tax authorities should bear initial burden of proof (SIAT[57])

[54] Case C-262/09, paragraph 45, 46
[55] Case C-310/09 Ministre du Budget, des Comptes publics et de la Fonction publique v Accor SA [2011]
[56] Case C-310/09, paragraph 99
[57] Case C-318/10

- Transfer Pricing rules are accepted as rules that will be applied only to cross-border situations. However, those rules have to satisfy the proportionality test. In other words they should restrict cross-border trade to less extent possible (Thin Cap[58] and SGI[59])

- Need for fiscal supervision on the side of the Member State is recognized within EU Law. However, flexible approach is required. (Futura[60], Meiclicke Accor[61])

3. OECD Transfer Pricing Guidelines in the EU Law context

Since the tax authorities of many tax authorities of European countries use TP Guidelines to transfer pricing cases, it would be appropriate to examine how do provisions of Transfer Pricing guidelines, that concern burden of proof, fit in the EU Law context?

The part of the TP Guidelines that concern burden of proof is very general. Virtually, it was held there that Member States of the OECD have different rules regarding the burden of proof but that in most of them tax authorities carry the burden of proof both during a tax audit and in court proceedings. It was also stated that neither taxpayers nor tax authorities should abuse burden of proof.[62] However, there are other provisions of the TP Guidelines that give an indication how the burden of proof should be allocated in specific situations. Namely, in Chapter I was held that there are two situations were it could be suitable for tax authorities to reject transactions between related parties or give a transaction another character. Those are situations where the economic substance of transaction is different from its form or the form and substance of transaction are the same but transaction as a whole diverges from what would be agreed upon the arm's length to an extent that is impossible to make appropriate adjustments. It was stressed out in the Guidelines that in both set of circumstances described above that character of the transactions may derive from the relationship between the parties rather than be determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimize tax. It was also stressed out that the tax authorities may reject or re-characterize transactions between

[58] Case C-524/04
[59] Case C-311/08
[60] Case C-250/95
[61] Case C-310/09
[62] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010, Chapter IV, pp 142-145

related parties where there is a good reason to doubt the economic substance of a particular transactions[63]. Thus, these measures are directed towards tax avoidance.

It can be inferred that these measures do not breach EU Law because they are targeting wholly artificial arrangements which is in accordance with the ECJ rulings in Test Claimants in The Thin Cap Group Litigation[64], SGI[65] and Cadbury Schweppes[66]. Furthermore, the fact that tax authorities should have a 'good reason to doubt the economic substance' implies that they should have initial burden of proof when applying this measure, which is in accordance with SIAT[67]. Namely, in SIAT the ECJ held that tax authorities should provide prima facie evidence of avoidance or abuse in order to reject deduction for expenses incurred.[68] The same logic underpins this recommendation given in the Guidelines. That logic implies that in order for tax authorities to get authorization to apply harsh measures towards taxpayers, they should provide satisfactory evidence that indicates a lack of economic substance.

4. Analysis of Transfer pricing legislation and court decisions in certain EU Member States from an EU Law aspect

This part will be divided in two sections. The first will deal with Transfer Pricing provisions of certain Member States that concern administrative requirements and that where disputed in the doctrine from an EU Law aspect.

[63] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010, Chapter I, page 54-56
[64] Case C-524/04
[65] Case C-311/08
[66] Case C-196/04
[67] Case C-318/10
[68] Case C-318/10

The second will deal with an issue of what transfer pricing adjustments and under which conditions can tax authorities in the EU make and stay compatible with Community Law requirements.

4.1 Transfer pricing compliance provisions: How far can the Member States from EU Law perspective?

Transfer pricing compliance measures are necessary for the Member States of the EU in order to exercise their taxing rights. However, they should satisfy the proportionality requirements as given in the judgments of the ECJ.

4.1.1. Documentation requirements in Spanish transfer pricing legislation

In Spain (business entities must prepare and maintain certain prescribed documentation when they enter into transactions with related parties. These requirements also apply to transactions entered into with entities located in tax havens, even if these are not related parties. Documentation regarding the group to which the taxpayer belongs, which can be prepared and maintained by the dominant company, setting out: 1) a general description of the group; 2) the associated enterprises engaged in controlled transactions; 3) a general description of the nature, amounts and flows of the controlled transactions; 4) a general description of functions performed and risk assumed by the group's entities; 5) an inventory of intangible property; 6) a description of the group's transfer pricing policy, including the transfer pricing method; 7) an inventory of cost sharing and service agreements; 8) information about relevant APA's or MAP's; and 9) the group's annual report. Qualifying small and medium-sized companies need not to prepare and maintain this documentation. Taxpayer-specific documentation, setting out: 1) taxpayer data and information on the related entities, as well as a detailed description of the nature, characteristics and amounts of the transactions performed; 2) a comparability analysis; 3) a description of the elected valuation method; 4) the allocation criteria for services rendered jointly and for sharing costs agreements; and 5) any other relevant information for determining the valuation of related party transactions. Qualifying small and medium-sized companies must prepare and maintain this documentation.[69]

Himenez find the requirement that only the Master file that contains all the information required under Spanish legislation is admitted and permits the taxpayer to avoid sanctions goes beyond

[69] IBFD Tax Research Platform, News, Spain, New Transfer Pricing Rules-details, 31 December 2008, http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=/data/tns/docs/html/tns_2008-12-31_es_1.html&WT.z_nav=Navigation&colid=4913

what is necessary and probably falls short of meeting EU Law requirements as defined in Futura, Thin Cap and SGI. [70]

Firstly, these requirements do not go beyond what was stated in The Code of conduct on transfer pricing documentation for associated enterprises:

EU TPD should contain enough details to allow the tax administration to make a risk assessment for case selection purposes or at the beginning of tax audit, ask relevant and precise questions regarding MNE's transfer pricing and assess the transfer prices of the inter company transactions.[71]

Secondly, it is hard to agree with Himenez because the Spanish transfer pricing provisions are formulated broadly enough to make it possible for Spanish tax authorities to interpret them in the light of EU Law requirements as given in Thin Cap[72] and SGI[73] but also in the light of the Meilicke[74] and Accor ruling[75].

4.1.2. Special procedure for transfer pricing cases in Greek transfer pricing legislation

In July 2009, Greece adopted new legislation on transfer prices. The procedural rule was imposed which stipulates that if an infringement of the arm's length principle is envisaged by an audit, the issue is referred to a special audit committee which may take a reasoned decision on the adjustment taking into account the internationally accepted OECD Guidelines on Transfer Pricing. The adjustment is subject to a fine equal to 10 %.[76]

Mavraganis criticizes the provision. He outlines that this procedure seldom favors an enterprise and it is extremely bureaucratic and formalistic.[77] If this is true, such a procedure is not compatible with EU Law, since it was held in Accor judgment that tax assessment may not be conducted too formalistically.[78] The State organs during a tax audit and in possible subsequent court dispute

[70] Adolfo Martin Himenez, Transfer Pricing and EU Law Following the ECJ Judgment in SGI: Some Thoughts on Controversial Issues, Bulletin for International Taxation, May 2010, Journals IBFD page 281

[71] Resolution of the Council and of the representatives of the governments of the Member States meeting within the Council, of 27 June 2006 on a code of conduct on transfer pricing documentation for associated enterprises in the European Union, 2006/C 176/01, Official Journal of the European Union

[72] Case C-524/04

[73] Case C-311/08

[74] Case C-262/09

[75] Case C-310/09

[76] IBFD Tax Research Platform, News, Greece, New Transfer pricing rules; First time Thin capitalization rules, 24 July 2009 http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=/data/tns/docs/html/tns_2009-07-24_gr_1.html&WT.z_nav=Navigation&colid=4913

[77] George S. Mavraganis, New Tax Legislation and its Compatibility with EU Law, International Transfer Pricing Journal, January/February 2010, oage 76, Journals IBFD

[78] Case C-310/09, paragraph 99

should take into account these considerations because EU law is breached not only when national legislation in itself is contrary to it but also when domestic provisions are applied in a way that is contrary to Community Law. In other words, conduct of The EU Member States administration and courts are relevant as well. If these requirements are fulfilled, then it would not be contrary to Community law to have procedure that would be conducted only in a case of cross-border groups of companies as long the taxpayer has an opportunity to demonstrate that transactions he was involved in were arm's length.

4.2 Transfer Pricing Adjustments and EU Law

4.2.1 National provisions and Supreme Court decisions of certain Member States

Some Member States give broad authorization to their tax authorities when it comes to transfer pricing adjustments. Accordingly, in this section legislative provisions and court judgments of certain Member States that concern this issue will be contrasted with EU Law requirements analyzed in part 2.

In Denmark the Section 2(1) of the Tax Assessment Act stipulates that the tax authorities can make transfer pricing adjustment of controlled transactions on the basis of the arm's length principle. In its recent judgment, from 2 February 2012, the Danish Supreme Court adopted following interpretation of the Section 2(1) of the Tax Assessment Act: '*The authority to make an adjustment covers all economic elements and other terms of relevance for taxation purposes including, for example, also due date, recognition of interest and capital losses and the legal qualification of transaction*.'[79] Further, The Greek legislation stipulates that in the case of domestic enterprises the arm's length principle applies on the basis of consideration for the sale of goods or supply of services whereas in the case of international groups the arm's length principle is applied on the basis of the economic terms of the cross-border sale of goods or supply of services.[80] In Germany arm's length principle applies to contractual arrangements in addition to prices. [81]

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[79] Jens Wittendorf, Darkness Descends on Danish Tax Law: Supreme Court decision in Swiss Re, International Transfer Pricing Journal, May/June 2012 pp. 217-221

[80] IBFD Tax Research Platform, News, Greece, New Transfer pricing rules; First time Thin capitalization rules, 24 July 2009 http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=/data/tns/docs/html/tns_2009-07-24_gr_1.html&WT.z_nav=Navigation&colid=4913

[81] Patrick Cauwenbergh and Mayra O. Lucas Mas, The New German Transfer Pricing Rules on Cross-Border Relocation of Functions: A Preliminary Analysis, European Taxation, October 2008, page 520 Journals IBFD

As it was argued by CFE Fiscal Committee, if tax administrations are free to first reinvent the controlled transaction, the essential nature of the arm's length principle is subverted. The threshold for doing so is correctly and accurately stated in the existing guidelines, i.e. where the normal transfer pricing rules cannot properly be applied. The proposed watering down of this principle not only subverts the arm's length principle but also undermines certainty and threatens the rule of law as it heightens the risk of taxation by administrative discretion and arbitrary application. It also increases the risks of double taxation requiring recourse to the mutual agreements procedure[82].As it was concluded in section 2.1, transfer pricing rules of the EU Member States, if applied only cross-border, impose restrictions to cross-border movements of economic operators and, accordingly, should satisfy the proportionality test in order to be compatible with Community Law. Consequently, these approach breaches Community Law on several grounds:

Firstly, the re-characterization of transactions (the rejection of transactions as well) is an anti-avoidance measure. It applies when the form of a transaction differs from its substance. In such situation tax authorities should be allowed to re-characterize transactions between related parties in order to determine properly what would be agreed between related parties. If this authorization is given to the tax authorities unconditionally, then a general presumption of artificiality is introduced which is against The Community law as judged by the ECJ. It is settled case-law that anti-avoidance measures should specifically target only wholly artificial arrangements.[83]

Secondly, it was held in SIAT that when tax avoidance is the matter the burden of proof initially lies with the tax authorities. More precisely they should show the '*prima facie evidence'* of tax evasion or avoidance. [84] .

Thirdly, with regard to the allocation of burden of proof, such approach could be used as an excuse for the tax authorities not to try to find comparable transactions to those of the related parties observed (which can be really problematic in some situations, for instance with intellectual property rights) when the burden of proof is allocated to them (initially or subsequently when appropriate adjustment to the profits of a company are necessary) and try to make appropriate adjustments but to reject or re-characterize transaction made between related parties from the start as artificial and in that way transfer the burden of proof to the taxpayer in a subsequent procedure. Consequently, the taxpayers will be subject to undue administrative constraints[85], which is contrary to Community Law.

Finally, such broad authorization on the side of tax authorities is contrary to the TP Guidelines as well (see part 3). Since many EU countries apply those guidelines in the course of a tax audit, such

[82] CFE Fiscal Committee, Opinion Statement of the CFE Fiscal Committee on the OECD Discussion Draft on Transfer Pricing Aspects of Business Restructuring, European Taxation, June 2009, Journals IBFD, page 328
[83] Case C-264/96 Case C-524/04, Case C-311/08,
[84], Case C-318/10
[85] Case C-524/04, Case 311/08

difference in approach could lead to double taxation. In that regard, the ECJ ruled that possibility to avoid double taxation, given to the EU companies under the Arbitration Convention, does not neutralize breach of Community Law by a Member State.[86]

Overall, to give the tax authorities unconditional authorization to adjust the profits of an enterprise is unacceptable at this stage of development of EU Law.

4.2.2. Examples of good and bad practice from EU Law perspective

In this subsection two cases from judicial practices of two different Member States will be used in order to show more clearly what conduct of pursuing arm's length principle by the tax authorities is compatible with EU Law and what is not. Facts of this case and decision brought by the Dutch Court were found in an article of Jaap Reyenvald and Mark Bonekamp[87] and will be summarized in the next paragraph:

The case concerned a group of companies that where providing leisure services and with it offered its clients the possibility to insure themselves in the case of cancelation of travel (further: group A). At one moment group A lost the possibility to sell insurance policies in Netherlands since it was not capable to fulfill requirements under the Dutch civil Law. After that, this group A entered into arrangement with unrelated group of insurance companies (further: group B) that provided the insurance services instead of it. The Dutch subsidiary of Group A provided intermediary services consisting of the selling insurance policies, collecting the insurance premiums, settling insurance claims, handling damage payments and drafting three monthly financial statements all on behalf of Group B. The B group company that was selling insurance policies was reinsured by related company while that company was reinsured with the company that belonged to A Group and that was established in Ireland. Irish affiliate of the A group did not have any employees and management of that company was conducted by another Irish company that was part of the B

[86] Case C-311/08

[87] District Court of Hague (MK 11 July 2011, AWB08/9105) found in Jaap Reyneveld and Mark Bonekamp, Recent Case Law on Captive Insurance Companies: What Is the Right Transfer Pricing Approach, International Transfer Pricing Journal, January/ February 2012, page 93-100, Journals IBFD

Group. For the Services provided to B Group Dutch affiliate of Group A was entitled to remuneration 3.5 % of the insurance premiums due in calendar year concerned. Under the same arrangement A Group was entitled to 5% of insurance premiums due per year. Every three months 80 % of insurance premiums were transferred to Dutch subsidiary of B group which were subsequently transferred to Irish subsidiary of group A as remuneration for reinsuring the risk of B group. When the Dutch tax authorities assessed the Dutch subsidiary of Group A they attributed profit earned by the Irish subsidiary to it. Furthermore, the tax authorities held that Irish subsidiary lacks essential characteristics of an insurance company. The reasoning of the Dutch tax authorities was confirmed by the District Court of Hague which held that the risk to which the Irish subsidiary of Group A was exposed to was negligible. Furthermore, the Court held that the Irish subsidiary of group A preformed only administrative activities and that compensation to this subsidiary should only be given for these services. The negligible insurance risk did not require additional remuneration. The taxpayer appealed to the upper Court. [88]

This decision should be rejected on the grounds of EU Law. Firstly, the Irish company did actually bore the insurance risk. Accordingly, there was a commercial justification for the transactions in question (the Irish company was not just a 'letterbox company') within the meaning of Cadbury Schweppes[89], Thin Cap[90] and SGI[91]. Thus, group A was not involved in wholly artificial arrangement. Secondly, the tax authorities should have first shown that there is a reasonable doubt of tax avoidance before the existence of insurance transactions was rejected. Accordingly, SIAT requirements[92] were breached because the transaction between related parties was re-characterized as transactions that increase the tax base of a taxpayer without showing satisfactory evidence of tax avoidance.

On the other hand, when it comes to burden of proof during an tax audit, it appears that French Council d' Etat has approach that is in line with Community Law. The decision at issue is The French Counseil d'Etat judgment from 12 March 2010 Case number: 307235. The secondary source for this decision was a doctrinal article from Pierre-Yves Bourtourault and Marc Bernard[93]. The facts will be summarized in the next paragraph:

A Luxembourgian company was involved in business of selling perfumes, cosmetic and fashion products the French subsidiary of that company was held to provide marketing services. The French Tax Authorities held that all of the substantive activity was in fact preformed from France. Namely, they noted that the Luxembourgian company had only one part time employee in

[88] District Court of Hague (MK 11 July 2011, AWB08/9105) found in Jaap Reyneveld and Mark Bonekamp, Recent Case Law on Captive Insurance Companies: What Is the Right Transfer Pricing Approach, International Transfer Pricing Journal, January/ February 2012, page 93-100, Journals IBFD
[89] Case C-196/04
[90] Case C-524/04
[91] Case C-311/08
[92] Case C-318/10
[93] Pierre-Yves Bourtourault and Marc Bernard, French Tax Aspects of Cross Border Restructurings, Bulletin for International Taxation, April/May 2011, Journals IBFD

Luxembourg during the audited period. Further, the premises of the French subsidiary were searched and the tax authorities seized various documents produced on the letterhead of the Luxembourgian company: invoices, business mails, customer account extracts, goods delivery and bank statements for accounts in France. The French company had also pretended that it was acting as a service provider on account of the Luxembourgian company. However, no such agreement had been concluded and no corresponding compensation had been paid or booked. Consequently, the tax authorities held that a Luxembourgian company had a permanent establishment on the premises of French company. The decision of the tax authorities was confirmed by the Couseil D'Etat.[94]

Contrary to the Dutch case discussed above the taxpayer did not provide any evidence that the setting up a company in Luxembourg was not wholly artificial arrangement and that French subsidiary actually provided marketing services (form was not accorded to substance) On the other hand, the tax authorities first found evidence of artificiality and, subsequently, rejected that marketing services were provided and ruled that Luxembourgian company had a permanent establishment on the premises of a French Company .

5. Conclusion

From the considerations made above it can be inferred that, as the EU Law stands today, the burden of proof that the arm's length principle was (not) satisfied may be allocated to taxpayers. The EU Member States may impose reasonable compliance measures and make appropriate adjustments to the prices of transactions between related parties. These are acceptable measures necessary for the Member States to exercise their fiscal sovereignty. However, when it comes to proving artificiality element of non arm's length transaction the tax authorities should produce reasonable evidence of artificiality before applying measures that should counteract tax avoidance. In other words, tax payers should not initially carry the burden of proof that they were not involved in artificial arrangements. On the contrary, taxpayers should produce evidence that their transactions with related parties are satisfying the arm's length standard. On the other hand, tax authorities should determine whether there are any elements of artificiality in those transactions. If they determine that artificiality is present they can apply anti-avoidance measures, such as rejection or re-characterization of transactions and the burden of proof is then allocated back on a taxpayer. However, as it was determined in chapter 4.1 not all EU Member States follow this approach. They rather give their tax authorities unconditional authorization to adjust

[94] Pierre-Yves Bourtourault and Marc Bernard, French Tax Aspects of Cross Border Restructurings, Bulletin for International Taxation, April/May 2011, Journals IBFD, page 186

not only profits but also other elements of transactions between related parties. My opinion is that such transfer pricing regimes will be eventually disputed before the ECJ (either by infringement proceedings or by referring a question for a preliminary ruling) and be precluded as incompatible with EU Law.

Table of Cases of the European Court of Justice in chronological order

Judgments:

1) Case C-250/95 Futura Participationis Singer and Adminstration des Contributions [1997]

2) Case C-28/95 A.Leur Bloem v. Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2 [1997]

3) Case C-264/96 Imperial Chemical Industries and Kenneth Hall Colmer (Her Majesty's Inspector of Taxes) [1998]

4) Case C-212/97 Centros Ltd v Erhvevrs-og Selskabsstyrelsen [1999]

5) C-110/99 Emsland-Starke GmbH and Hauptzollamt-Jonas [2000]

6) Case 324/00 Lankhorst Hohorst GmbH v Finanzamt Steinfurt [2002]

7) C-446/03 Marks and Spencer plc v David Halsey (Her Majesty's Inspector of taxes) [2005]

8) Case 252/02 Halifax plc, Leeds Permanent Development Services Ltd and Country wide Property Investments Ltd v Commissioners of Customs and Excise [2006]

9) Case 196/04 Cadbury Schweppes Ltd V Commissioners of Inland revenues [2006]

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