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Transfer pricing rules as trade restrictions: Is the OECD's HTVI approach compatible with the EU fundamental freedoms?

by

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Preface

I would like to extend sincere thanks to Professor Cécile Brokelind, whose passionate and animated teaching made the master's programme thoroughly enjoyable. I was also fortunate to have classmates whose good spirits and diverse academic backgrounds contributed to a great year in Lund.

To a lawyer, transfer pricing is, in the words of Professor Brokelind, "a different language". Therefore, an expression of gratitude is due also to Professor Jérôme Monsenego of Stockholm University, whose supervision provided an excellent introduction to this most fascinating subject.

List of abbreviations

BEPS	base erosion and profit shifting
CFC	controlled foreign corporation
EU	European Union
HTVI	hard-to-value intangible
IP	intellectual property
MC	OECD Model Convention
OECD	Organization for Economic Cooperation and Development
PE	permanent establishment
R&D	research and development
TFEU	Treaty on the Functioning of the European Union
TP	transfer pricing

Summary

This thesis considers whether the OECD's HTVI approach is compatible with the EU fundamental freedoms. Its conclusions are of relevance to EU Member States who have implemented, or are looking to implement, the HTVI approach as part of a national transfer pricing regime.

Because it is incompatible with the ALP as promulgated by the OECD, the HTVI approach cannot be declared compatible with the fundamental freedoms pursuant to previous transfer pricing cases decided by the EU Court of Justice. Therefore, compatibility must be considered anew.

Although a taxpayer may sometimes be able to invoke the freedom of capital to obtain protection also in relation to third states, application of the HTVI approach to such facts may be justified pursuant to the Court's case law on national anti-avoidance measures.

In an intra-EU context, however, the HTVI approach may not be justified as an anti-avoidance measure. That being said, the EU doctrine of 'abuse of law' might provide some support for intra-EU application of the HTVI approach.

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1. Introduction

1.1 Background

While the OECD has assumed responsibility for coordinating states' collective fight against cross-border tax avoidance, the TFEU, as enforced by the Court of justice of the EU (hereinafter: the Court), remains committed to the removal of tax measures that constitute discriminatory obstacles to cross-border trade. One area where the OECD and the TFEU have locked horns is the question of the compatibility of the ALP with the fundamental freedoms. In the recent case of *Hornbach*, the Court largely endorsed said compatibility, subject to some important caveats.

Simultaneously, academics have debated whether the OECD's HTVI approach is compatible with the ALP as enshrined in Art. 9(1) MC. This in turn raises questions about the compatibility of the HTVI approach with the fundamental freedoms.

1.2 Aim

The aim of this thesis is to answer the following question: To what extent is enforcement of the OECD's HTVI approach by an EU Member State compatible with the EU fundamental freedoms? At present, the answer to this question is not clear. This may cause problems for a taxpayer against whom the HTVI approach is enforced, since that taxpayer may be unable to determine whether it may use the fundamental freedoms to protect itself. This may, in turn, jeopardise taxpayers' interests and hamper the functioning of the internal market. It is therefore important to devote academic treatment to this issue.

1.3 Method

The above aim is achieved by analysing the requirements imposed by the fundamental freedoms on TP rules and, separately, analysing the debate about whether the HTVI approach is compatible with Art. 9(1) MC. The core contribution of this thesis lies in the subsequent *synthesis* of the two aforementioned debates, analysing the extent to which the HTVI approach is compatible with the fundamental freedoms.

The method chosen is to rely on the HTVI approach as set out in OECD sources which, although not legally binding *per se*, may be enacted as part of

the TP regimes of EU Member States, or carry interpretive value. In other words, the OECD sources operate as a short-hand for, or representation of, national TP rules that EU Member States already observe or may wish to introduce.

1.4 Delimitation

This thesis will not consider non-discriminatory TP rules, i.e. those prescribing arm's length adjustments in respect of cross-border transactions as well as domestic transactions, examples being found in the TP regimes of Belgium and Spain.[1] Such treatment would entail a considerable discussion of the current status of non-discriminatory restrictions of the fundamental freedoms in the Court's case law on direct taxation, which exceeds the scope of this thesis. The thesis remains relevant despite this omission, given that various Member States employ *prima facie* discriminatory TP rules, applicable only to cross-border transactions, examples including France and Germany.[2]

The thesis will also not consider in detail the nature of the requirement that Member States offer the taxpayer an opportunity to justify commercially its non-compliance with national TP rules. That requirement is the subject of an academic debate in its own right, which entails an in-depth discussion of the various justificatory grounds that may be adduced in support of an arm's length adjustment restricting the fundamental freedoms, and which far exceeds the scope of the present contribution.

Similarly, the thesis will not embark on a normative evaluation of the HTVI approach, which has been criticised by commentators as giving rise to uncertainty and, possibly, double taxation.[3] This thesis is strictly limited to the compatibility of the HTVI approach with the EU fundamental freedoms.

1.5 Outline

First, the thesis analyses the main legal sources in terms of their content and their significance to the research question (Section 2). Then, the thesis sets out the requirements imposed on TP rules by the fundamental freedoms, and analyses why an arm's length adjustment may constitute a restriction of the

[1] Buriak, S., Petruzzi, R., 'Transfer Pricing Rules under the ECJ's Scrutiny: Green Light for Non-Arm's Length Transactions?' (2018) 25 No. 5 ITPJ, 349, 352
[2] Buriak, Petruzzi, supra 1, 352
[3] For a critical and informative analysis, see Fedusiv, O., 'Transactions with Hard-to-Value Intangibles: Is BEPS Action 8 Based on the Arm's Length Principle?' (2016) 23 No. 6 ITPJ, 483, 488-489.

fundamental freedoms, drawing on case law and literature. (Section 3) This is followed by an analysis of whether the HTVI approach is compatible with Art. 9(1) MC. Having concluded that it is incompatible with Art. 9(1) MC, the thesis sets out what this means from an EU law perspective. (Section 4)

This is followed by an assessment of the compatibility of the HTVI approach on two alternative, separate grounds. Firstly, it is considered whether it may be justified as an anti-avoidance measure, concluding that the answer depends on whether the HTVI approach is applied in intra-EU or in relation to a third state. (Section 5) Secondly, it is considered whether the EU 'abuse of law' doctrine may support it. It is suggested that this might be a feasible route to compatibility with the fundamental freedoms. (Section 6) The final section concludes and seeks to paint a broader picture around the research question investigated. (Section 7)

2. Analysis of main sources

2.1 The ALP

2.1.1 Content

A (reasonably) authoritative conception of the ALP is enshrined in Art. 9(1) MC. It provides, in respect of associated enterprises, that where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly". In other words, Art. 9(1) MC allows one state to make an upward adjustment of the profits of an enterprise pursuant to the ALP (hereinafter: arm's length adjustment). Art. 9(1) MC is substantiated and concretised by the OECD Commentary[4] and the OECD Guidelines[5].

While Art. 9(1) MC does not proclaim legally binding effect, it is largely replicated in most tax treaties and represented in national TP rules. For the sake of simplicity, this paper will speak in terms of the ALP, referring in essence to Art. 9(1) MC, although the ALP is formulated in different terms in different jurisdictions. Given that the basic mechanism of an ALP adjustment is largely invariable across jurisdictions, its potential infringement of the

[4] OECD Commentary on the Articles of the Model Tax Convention
[5] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017

fundamental freedoms operates in a similar fashion, which justifies collective treatment for present purposes.

While formulations differ considerably, the gist is largely the same, namely allowing tax authorities to include in a company's tax base any profits which have failed to materialise as a result of that company's association with other companies with whom the company has entered into transactions.[6] While Art. 9(1) MC enquires about commercial and financial relations, said relations are in practice taken to be expressed in *transactions*.[7] It is therefore *transactions* which must be remunerated as if the enterprises had been independent. Application of the ALP is practically effected by applying (one or more of) established transfer pricing methods.[8]

2.1.2 The nature of the ALP: empirical and hypothetical conceptions

Historically, there has been some debate about the fundamental nature of the ALP. On the one hand, the ALP may be seen as intrinsically comparables-based and *empirical*.[9] On the other hand, the ALP may be seen as generally empirical in practice, but ultimately *hypothetical*.[10] This thesis concludes that the latter view is conceptually preferable, for reasons which will be set out below. That being said, both views are prevalent throughout the world of international tax law.

The ALP proceeds on an ultimately *hypothetical* basis because it invites the tax authority to construct a hypothetical counterfactual in which the two enterprises are not associated but independent (hereinafter: independence counterfactual) and determine what profits would then have accrued to the enterprise under scrutiny. As known by most lawyers, counterfactuals present notorious evidentiary difficulties. It is, simply put, difficult to prove or

[6] For simplicity, this paper will speak in terms of companies and transactions, although the term 'enterprise' in Art. 9(1) MC is equally applicable to PEs, to which the corresponding term is 'dealings'.
[7] OECD Guidelines, 1.35
[8] *Id.*, 1.40-41; These methods will not be set out in detail as part of this thesis, but may occasionally be referred to as examples or to illustrate points.
[9] See, for example, Avi-Yonah, R. S., 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation' (1995)15 Va Tax Rev, 89, 134; *Altera Corp. et al. v. Commissioner*, 4, <https://www.supremecourt.gov/DocketPDF/19/19-1009/132586/20200210174654698_Altera%20Petition%20-%20final.pdf> accessed on 31 May 2020; While both sources concern the US 'arm's length standard', which is not necessarily interpreted in line with Art. 9(1) MC, their standpoint serves an illustrative purpose.
[10] Finley, R., 'Altera's Supreme Court Petition Creates More Questions Than Answers' [2020] Tax Notes International, 277, 280-281; While Finley does not use this precise terminology, his points are largely aligned with the framework relied on in this thesis.

disprove what would have occurred in a hypothetical scenario in which the facts are tweaked compared to reality.

While Art. 9(1) MC does not lay down rules of proof or procedure in order to address this difficulty, the TPG set out the approach recommended by the OECD. That approach is "usually" to compare transactions between associated enterprises to comparable transactions between independent enterprises.[11] In other words, assessment of the features of actual transactions between independent enterprises provides evidence of the features which would have obtained, had the relevant associated enterprises been independent.[12] The TP methods, some of which make use of comparables, also constitute evidentiary tools used to determine the features of the independence counterfactual. While this approach allows the ALP in practice to proceed on an *empirical* basis, this alignment of controlled transactions with actual uncontrolled transactions is arguably not an end in itself, but a means to the end of establishing an independence counterfactual, with which the controlled transaction must ultimately comply.

Wittendorff has explored *subjective* and *objective* conceptions of the ALP - a distinction which is reminiscent of that proposed in this thesis.[13] However, the present distinction is preferable when it comes to assessing the compatibility of TP measures with the ALP. This is because it clearly identifies the *evidentiary* role of comparables, which is important because the role of comparables tends to feature in such compatibility debates.

2.1.3 Problems of evidence

Where associated enterprises enter into types of transactions that are generally not entered into by independent enterprises, the strength of the empirical approach is undermined.[14] If the empirical approach is used in such a case, the standard of comparability must be diluted, weakening the evidentiary value of the comparables and casting doubt on the conclusion about what conditions would have obtained in the independence counterfactual.

Alternatively, the tax authority may use a different method, which does not rely on comparables to determine what conditions would have been agreed in

[11] OECD Guidelines, 1.6, 1.13. This empirical exercise is briefly described at para 1.33 and forms the subject of the majority of the content of the OECD Guidelines.
[12] *Id.*, 1.11
[13] Wittendorff, J., 'The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?' [April 18, 2011] Tax Notes International, 223, 225
[14] OECD Guidelines, 1.11

the independence counterfactual.[15] Although this avoids having to use unreliable comparables, such a method is inherently speculative, due to the general difficulty of determining the conditions obtaining in a hypothetical scenario.

While there is a debate about whether Art. 9(1) MC imposes particular requirements in respect of burden of proof, i.e. whether the tax authority or the taxpayer must adduce evidence of (*prima facie*) (non-)compliance with the ALP,[16] Art. 9(1) MC for the most part does not contain rules of proof. As will be seen below, however, the HTVI approach *does* contain rules of proof.

2.1.4 Legal status

The legal interpretive value of the OECD Commentary and the TPG varies from one jurisdiction to another. For example, UK TP rules make explicit statutory reference to the interpretive value of OECD sources.[17] For purposes of Swedish TP rules, on the other hand, the interpretive value of OECD sources has been recognised only in case law.[18]

The concept of "associated enterprises" as referred to in Art. 9(1) MC is defined differently by different national TP regimes, since the constituent concepts, such as participation in management or control, are undefined in the MC and therefore defined according to national law in accordance with Art. 3(2) MC. National TP regimes may therefore in principle be applicable to any situation where the interests of two enterprises are aligned.

2.2 The HTVI approach

2.2.1 Intangibles may give rise to profit shifting under the ALP

An intangible asset typically displays four important characteristics. Firstly, it is in some way responsible for a considerable part of the income of an MNE group. Secondly, it is readily mobile. Thirdly, it is difficult to value accurately and objectively. Fourthly, it lacks, by its nature, reliable comparables. These

[15] An example of such a method is the transactional profit split method, on which see OECD Guidelines, 2.114 *et seq.*

[16] Commentary on Art. 9 of the OECD MC, para 4, see also the preamble to the OECD Guidelines, para 18

[17] Taxation (International and Other Provisions) Act 2010, s. 164

[18] Wittendorff, J., 'The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?' [2011] Tax Notes International, 223, 235

characteristics may cause intangibles to give rise to profit shifting under the ALP.

In a typical example, an R&D company may create an intangible in a high tax jurisdiction, benefiting from its favourable environment in terms of, for example, labour market and infrastructure. Then, the intangible may be transferred to an associated holding company in a low tax jurisdiction, made possible due to the intangible's ease of mobility.[19] The transfer price charged in this transfer may be deflated, and the relevant tax authority may be unable to justify an arm's length adjustment in respect of the intangible's transfer, due to the absence of comparables and difficulty in valuing the intangible. The problem may be exacerbated due to information asymmetry, since the tax authority may lack access to alternative information, thus being forced to rely on the taxpayer's own expertise for determining the intangible's value.

Then, the associated holding company in the low tax jurisdiction may enter into licence agreements with operational companies belonging to the same MNE group. This time, the value of the intangible may be inflated, and for the aforementioned reasons, the relevant tax authorities may be unable to justify subjecting the operational companies to arm's length adjustments in respect of the licence agreements. The result is that a considerable part of the MNE group's profit is shifted to the holding company in the low tax jurisdiction. While MNE group structures are near-infinitely variable, this example sets out, in crude terms, an example of the basic mechanics of the role of intangibles in profit shifting.

2.2.2 The HTVI approach as a solution to the above problem

The overarching goal of Actions 8-10 of the OECD BEPS Project was to realign TP outcomes with value creation.[20] Action 8 addressed the aforementioned difficulties relating to intangibles *inter alia* by adding a section D.4 to Chapter VI of the OECD Guidelines. Section D.4 is titled "Hard-to-value intangibles (HTVI)" and sets out the so-called HTVI approach. Following the amendment to the Guidelines, the OECD published a further document aiming to clarify certain aspects of the HTVI approach (hereinafter: HTVI Guidance).[21]

[19] Although note that a mere holding company may not be entitled to a residual return where it does not carry out any significant functions in relation to the intangible. This is apparent from examples 1 and 15 of the Annex to Ch. VI of the OECD Guidelines.
[20] OECD, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), International Organizations' Documentation IBFD, 9
[21] OECD (2018), *Guidance for Tax Administrations on the Application of the Approach to Hard-to- Value Intangibles - BEPS Actions 8-10,* OECD/G20 Base Erosion and Profit

The HTVI approach seeks to remedy the information asymmetry between taxpayer and tax authority.[22] An HTVI is defined as an intangible which lacks reliable comparables and the valuation of which is based on assumptions, or projections of future cashflow, which are highly uncertain.[23] It ensures that the tax authority, when conducting a TP audit in respect of the taxpayer's transfer of an HTVI, may consider any major discrepancy between the value ascribed to the HTVI as part of the *ex ante* pricing, and the subsequent *ex post* income generated by the HTVI, as presumptive evidence that uncertainty existed at the time of the *ex ante* pricing. This, in turn, raises the question as to "whether the taxpayer appropriately took into account reasonably foreseeable developments or events at the time of the transaction" and as to "the reliability of the information used ex ante in determining the transfer price".[24]

Thus, the core of the HTVI approach consists in a presumption, shifting the burden of proof to the taxpayer, who must successfully invoke one of four exemptions by demonstrating that:[25] (i) the *ex ante* pricing was arm's length, supported by rigorous economic analysis based on the probability of future developments, (ii) the transaction was covered by an advance pricing arrangement, (iii) the *ex post* outcome is between 80% and 120% of the *ex ante* valuation, or (iv) five years have passed since commercialisation and the *ex post* outcome during that period was between 80% and 120% of the *ex ante* valuation. This thesis will focus on the first exemption, because it is more integral to the HTVI approach, and because the compatibility of the HTVI approach with the ALP will depend partly on its treatment of unforeseeable profits, which are to be expected in uncontrolled intangible transfers.

It is important to note that the HTVI approach does not seek to justify amendment of *ex ante* pricing based on *ex post* outcomes.[26] Rather, the HTVI approach entitles the tax authority assessing the transfer price in an HTVI transfer to rely on presumptive evidence in order to place the burden of proof with the taxpayer. The HTVI guidance states that "*ex post* evidence should not be used without considering whether the information on which the *ex post* results are based could or should reasonably have been considered by the associated enterprises at the time the transaction was entered into".[27]

Shifting Project, OECD, Paris. http://www.oecd.org/tax/beps/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf

[22] HTVI Guidance, para 2
[23] OECD Guidelines, 6.189
[24] *Id.*, 6.188
[25] *Id.*, 6.193
[26] *Id.*, 6.188
[27] HTVI Guidance, para 2

2.3 EU fundamental freedoms

2.3.1 Basic content and relevance to the HTVI approach

2.3.1.1 The freedom of establishment: Art. 49 TFEU

Juncto Art. 54, Art. 49 TFEU confers on a company established in one Member State the right to establish a subsidiary or a PE in another Member State.[28] Any national measure which renders more burdensome a cross-border establishment within the EU as compared to a domestic establishment may constitute a restriction of Art. 49. This encompasses not only obstacles to the initial establishment, but also measures rendering such establishment less attractive compared to a domestic establishment.[29] Art. 49 is applicable to both outbound establishments and inbound establishments, such that a Member State may not restrict the rights of its own residents from establishing in other Member States, nor the rights of residents of those other Member States from establishing in its own territory.[30]

An arm's length adjustment made pursuant to the HTVI approach (hereinafter: HTVI adjustment) is applicable to a situation where a company established in one Member State transfers an HTVI to an associated company established in another Member State, and where the value of that HTVI increases significantly following said transfer. An HTVI adjustment may then serve to increase the taxable profits of the company in the first Member State, which is likely to render less attractive both inbound and outbound establishments, since a parent company will be unable to effect an HTVI transfer to a subsidiary in another Member State (and *vice versa*) on the same terms as those enjoyed by HTVI transfers between domestic associated companies.

2.3.1.2 The free movement of capital: Art. 63 TFEU

Arts. 63, 65 TFEU prohibit restrictions on the movement of capital to and from a Member State, whether vis-a-vis another Member State or a third country. A transfer of an intangible asset involves a capital movement, since an asset constitutes capital.

An HTVI adjustment may restrict the aforementioned capital movement, since it prevents a company in a Member State from transferring an intangible

[28] Judgment of 13 December 2005, *M&S,* C-446/03, EU:C:2005:763, para 30
[29] *Id.*, paras 32-34
[30] *Id.*, para 31

to an overseas associated company on the same terms as those enjoyed by intangible transfers between domestic associated companies.

2.3.2 The applicable freedom

2.3.2.1 Introduction

The Court's main cases dealing with the compatibility of TP rules with the fundamental freedoms are *Lankhorst*[31], *Thin Cap*[32], *SGI*[33], and *Hornbach*[34]. In all four cases, the Court examined said compatibility considering only Art. 49 TFEU. However, Art. 63 TFEU may in some instances be engaged by TP rules, which might grant a taxpayer protection also in relation to third states.

2.3.2.2 The scope of Arts. 63 and 49 TFEU and implications for third state protection

Two transactions are impacted by an HTVI adjustment. The investment in a cross-border shareholding (hereinafter: the initial transaction) is impacted indirectly since any subsequent restrictions on transactions with the foreign subsidiary may reduce the attractiveness of the cross-border shareholding relative to a domestic shareholding. Furthermore, the transfer of the HTVI (hereinafter: the controlled transaction) is impacted directly, since the HTVI adjustment imposes pricing limits not imposed on domestic controlled transactions.

Art. 63 is engaged by a movement of capital. As demonstrated by Schön, the initial transaction invariably constitutes a movement of capital.[35] Furthermore, as set out above, the controlled transaction necessarily involves an intangible asset, and therefore invariably constitutes a movement of capital. It is therefore clear that an HTVI adjustment engages Art. 63 both indirectly by rendering the initial transaction less attractive and directly by imposing limits on the pricing of the controlled transaction.

Next, it must be considered whether Art. 49 is engaged by the indirect effect of the HTVI approach on the initial transaction. The Court will consider the purpose of the national legislation at issue in order to determine whether Art. 49 is engaged.[36] *Baars* states that "a national … who has a holding … which gives him *definite influence over the company's decisions* and *allows him to*

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[31] Judgment of 12 December 2002, *Lankhorst-Hohorst,* C-324/00, EU:C:2002:749
[32] Judgment of 13 March 2007, *Thin Cap GLO*, C-524/04, EU:C:2007:161
[33] Judgment of 21 January 2010, *SGI,* C-311/08, EU:C:2010:26
[34] Judgment of 31 May 2018, *Hornbach-Baumarkt,* C-382/16, EU:C:2018:366
[35] Schön, W., Free Movement of Capital and Freedom of Establishment, Eur Bus Org Law Rev (2016) 17, 229, 242
[36] Judgment of 12 September 2006, *Cadbury Schweppes*, C-196/04, EU:C:2006:544 paras 31-33

determine its activities is exercising his right of establishment".[37] Consequently, Art. 49 is generally engaged by a national law targeting holdings exceeding 50%,[38] but not by one targeting holdings of less than 10%.[39] If the national law is capable of affecting both direct investment (establishment) and portfolio investment (capital movement), the Court considers not the purpose of the national rule, but the actual facts of the case, to determine whether Art. 49 is engaged.[40]

It is clear from the two preceding paragraphs that the same facts, for example the transfer of an HTVI to a subsidiary, may engage both Arts. 49 and 63. For this reason, the Court has recognised (what might be referred to as) the *suppressing effect* of Art. 49, according to which Art. 63 will not protect a third state transaction if Art. 49 would have applied to an otherwise identical intra-EU transaction. The justification for the *suppressing effect* is that extension of Art. 63 to protecting third state operators' access to the internal market (and *vice versa*) would undermine the limited geographical scope of Art. 49 as intended by the EU legislator.[41]

The *suppressive effect* is supported also by the second paragraphs of Arts. 49 and 65 respectively, which state essentially that an admissible restriction on one freedom may not be circumvented by reliance on the other freedom.[42] Art. 49(2) provides: "Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings … *subject to the provisions of the Chapter relating to capital*" (present author's emphasis). Art. 65(2) provides: "The provisions of this Chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with the Treaties".

The question is therefore whether the HTVI approach targets facts which constitute a movement of capital, engaging Art. 63, without constituting an entrepreneurial investment and an establishment for purposes of Art. 49. This question must be answered in the affirmative. Indeed, an HTVI transfer between related parties that are not connected by any shareholding, or connected by a shareholding not exceeding 10%,[43] and which does not

[37] Judgment of 13 April 2000, *Baars*, C-251/98, EU:C:2000:205, para 22 (present author's emphases)
[38] Judgment of 19 July 2012, *A Oy,* C-48/11, EU:C:2012:485, para 19
[39] Judgment of 10 February 2011, *Haribo & Salinen*, Joined Cases C-436/08 and C-437/08, EU:C:2011:61, para 36
[40] *SGI*, supra 33, paras 29-36
[41] Schön, supra 35, 253; See also Judgment of 13 November 2012, *FII GLO II,* C-35/11, EU:C:2012:707, paras 96-100.
[42] Schön, supra 35, 255
[43] *Baars*, supra 37, para 22

involve a PE,[44] would engage Art. 63 without simultaneously engaging Art. 49. Art. 63 would therefore not be suppressed, and Art. 63 would grant protection also in respect of a third state HTVI transfer.

The following example may illustrate the above. Parent company P has subsidiaries S1 in MS1 and S2 in a third state. S1 transfers to S2 an HTVI which subsequently increases dramatically in value. Because P participates in the capital of both S1 and S2, the latter are associated enterprises for purposes of MS1's TP rules, and an HTVI adjustment is imposed by MS1 on S1 on account of said transfer. S1's freedom of establishment is not impacted by the HTVI adjustment, whereas the movement of capital is impacted. Thus, S1 will *prima facie* be able to rely on Art. 63 to challenge the HTVI adjustment.

The upshot is that, although the restrictive measures before the Court have so far engaged only Art. 49, there are situations where the TP rules of EU Member States may not engage Art. 49, in which case Art. 63 will grant protection also in respect of HTVI adjustments made in relation to third states.

3. Why might an arm's length adjustment constitute a restriction of the fundamental freedoms and what are the conditions for compatibility?

3.1 Introduction to the Court's fundamental freedoms enquiry and the *Hornbach* case

When faced with a national measure which is alleged to constitute an unjustified restriction of (one of) the fundamental freedoms, the Court's enquiry tends to follow a familiar route.[45] Firstly, there must be a *restriction* of a freedom. In the field of direct taxes, the Court requires the restriction to be discriminatory as between cross-border situations and purely internal situations, giving rise to a twofold enquiry: whether a relative disadvantage is imposed on cross-border situations, and whether the situations are objectively comparable.[46] If a restriction is evident, the Member State may, in the second place, *justify* the restrictive measure by reference to an

[44] Judgment of 15 May 2008, *Lidl Belgium*, C-414/06, EU:C:2008:278, paras 15-17

[45] For a particularly lucid example of this method of reasoning, see Judgment of 22 February 2018, *X BV*, C-398/16, EU:C:2018:110.

[46] Jiménez, A.M., 'Transfer Pricing and EU Law Following the ECJ Judgement in SGI: Some Thoughts on Controversial Issues' (2010) 64 No. 5 Bulletin for International Taxation, 271, 274

overriding reason in the public interest.[47] Thirdly, the restrictive measure must actually pursue the overriding reason and may not go beyond what is necessary to attain it, i.e. the restrictive measure must be *proportionate*.

Hornbach[48] illustrates the way in which an arm's length adjustment may constitute a restriction of Art. 49 TFEU. In *Hornbach,* the taxpayer was a German parent company which had two (indirectly) wholly-owned subsidiaries in the Netherlands.[49] The subsidiaries were financially distressed and, in order to sustain commercial activities, sought debt financing from an independent bank, which made grant of the debt financing contingent on the bank obtaining from the taxpayer a set of comfort letters in which the taxpayer undertook, in essence, to ensure the solvency of the subsidiaries. The taxpayer issued the comfort letters without obtaining any remuneration from the subsidiaries.[50] The German tax authority made an arm's length adjustment to the taxpayer's taxable profits, taking the view that it would not have provided such comfort letters gratuitously if the parties had been independent.[51]

The earlier case of *SGI* involved similar facts: an arm's length adjustment was imposed in respect of an interest free loan and director's fees that were considered to be excessive.[52]

3.2 Restriction

3.2.1 Relative disadvantage for cross-border situations

National rules allowing for an arm's length adjustment often apply only to cross-border transactions.[53] This may constitute a restriction of a fundamental freedom, since a company which enters into a transaction with a related company in a different Member State is treated less favourably than a company which enters into an otherwise identical transaction with a related company in the same Member State. *Hornbach* states that such an adjustment constitutes a restriction of Art. 49 TFEU, confirming *SGI*.[54] *SGI* had previously held that the restriction is not alleviated by a corresponding downward adjustment of profits in the other Member State, due to the

[47] In literature, this is sometimes referred to as the 'rule of reason', and this term will feature in this thesis.
[48] *Hornbach,* supra 34
[49] *Id.,* para 5
[50] *Id.,* paras 6-10
[51] *Id.,* para 11
[52] *SGI*, supra 33, paras 12-13
[53] Buriak, Petruzzi, supra 1, 352
[54] *Hornbach*, supra 34, para 35; *SGI,* supra 33, para 44

remaining administrative compliance burden and temporary economic double taxation,[55] and there is no indication that *Hornbach* has changed this.

It is useful, in this connection, to touch on the difference between allocation of taxing *rights* and allocation of taxing *powers*. It is clear from the Court's case law that a Member State is free to delineate its taxing jurisdiction, both in terms of its unilateral tax claims and its bilateral taxing rights allocation by means of tax treaties. In other words, allocation of taxing rights may not constitute a restriction of the fundamental freedoms.[56] The reason TP rules remain subject to the fundamental freedoms is that TP rules allocate taxing rights indirectly by augmenting the taxable profits. Thus, TP rules form part of the *exercise* of taxing rights, rather than the initial *definition* of said taxing rights.[57]

3.2.2 Comparability of cross-border situations and purely internal situations

A relative disadvantage which *prima facie* discriminates against cross-border situations is not a restriction where the situations differentiated are not objectively comparable.[58] The question of comparability was not directly addressed in *SGI*, and only briefly in *Hornbach*.[59] Objective comparability is assessed from the perspective of the aim pursued by the contested measure.[60] The purpose of the German TP rule at issue in *Hornbach*, namely Section 1(1) AStG, is tax base protection, i.e. safeguarding Germany's taxing powers.[61] The German government thus made the argument, accepted by A-G Bobek,[62] that the aforementioned cross-border situation and purely internal situation are not comparable from a tax base integrity perspective; A controlled transaction between domestic related companies need not be remunerated in line with comparable uncontrolled transactions, since both

[55] *SGI,* supra 33, para 54; Schön, W. 'Transfer Pricing, the Arm's Length Standard and European Union Law', Max Planck Institute for Tax Law and Public Finance Working Paper 2011

[56] For an often-cited statement, see Judgment of 12 May 1998, *Gilly*, C-336/96, ECLI:EU:C:1998:221, paras 23 *et seq*.

[57] This is why the justificatory ground discussed in section 3.3 refers to allocation of taxing *powers*, rather than taxing *rights,* on which see *Thin Cap*, supra 32, paras 49-52 and *SGI*, supra 33, paras 38 *et seq*; For elaborate discussion of the distinction between allocation of taxing rights and allocation of taxing powers, See Schön, W., 'Transfer Pricing Issues of BEPS in the Light of EU Law' [2015] 3 BTR, 417, 422.

[58] *Hornbach*, supra 34, para 36

[59] *Hornbach,* supra 34, paras 37-40

[60] See, for example, Judgment of 25 February 2010, *X Holding*, C-337/08, EU:C:2010:89, paras 22 *et seq*.

[61] Glahe, M., 'Transfer Pricing and EU Fundamental Freedoms' (2013) 22 No. 5 ECTR, 222, 224, footnote 33

[62] Opinion of A-G Bobek of 14 December 2017, *Hornbach-Baumarkt,* C-382/16, EU:C:2017:974, paras 57 *et seq*.

companies are subject to tax in Germany so that the controlled transaction does not affect the German tax base.[63]

However, allowing the cross-border nature of a transaction to bar comparability would stifle the Court's enquiry at birth, and prevent the proportionality of the measure from being properly examined - a prospect which has been criticised.[64] This criticism is likely to have influenced the Court, which relegated the German argument to the justification stage.[65] In any event, the Court has previously rejected an inherently discriminatory purpose from undermining comparability.[66] The upshot is that the Court considers the aforementioned cross-border situation and purely internal situation to be comparable for purposes of the fundamental freedoms.

An argument advanced in the literature is that the aforementioned cross-border situation and purely internal situation are comparable if the ALP is conceived as an anti-avoidance measure, since tax avoidance by means of transfer mispricing may occur also domestically by, for example, shifting profits to loss-making group companies in jurisdictions where group consolidation is limited or non-existent.[67] However, this argument is questionable; The potency of tax avoidance by means of transfer mispricing is amplified considerably in a cross-border context, since the MNE group in question has access to entirely different tax regimes which are more likely to differ substantially in terms of tax base and tax rate. Thus, the fact that the aforementioned cross-border situation poses a greater threat in terms of tax avoidance suggests that it is not comparable to an otherwise identical purely internal situation.

Furthermore, where the purpose of the ALP is considered to be anti-avoidance, that purpose ought to be conceived as geared specifically towards prevention of cross-border tax avoidance. Thirdly, although tax avoidance is prevented for reasons of political morality and maintenance of public trust in the tax system, an important aspect of the ulterior motive is arguably protection of the tax base, which may cause one to question conceptually

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[63] *Hornbach*, supra 34, para 38
[64] Opinion of A-G Kokott of 13 March 2014, *Nordea*, C-48/13, EU:C:2014:153, paras 26-28. See also Glahe, supra 61, 224
[65] *Hornbach*, supra 34, para 40
[66] Judgment of 16 June 2011, *Commission v Austria*, C-10/10, EU:C:2011:399, paras 34 *et seq*; Note the interesting similarity with State Aid law, where the Court has held that the reference system may be 'selective by design', i.e. inherently discriminatory; The inherently discriminatory purpose of such a reference system may similarly not prevent a finding of comparability for State Aid purposes. See, for example, Judgment of 15 November 2011, *Gibraltar*, Joined cases C-106/09 P and C-107/09 P, EU:C:2011:732.
[67] Buriak, S., Lazarov, I., 'Between State Aid and the Fundamental Freedoms: The Arm's Length Principle and EU Law' (2019) 56 No. 4 CMLR, 905, 936

whether cross-border situations are ever comparable to otherwise identical purely internal situations from the perspective of an anti-avoidance purpose.

However, such a conclusion would render the fundamental freedoms largely inapplicable to anti-avoidance measures disadvantaging cross-border situations, and so it is understandable that the Court has maintained its unwavering stance in favour of the comparability of cross-border situations and purely internal situations, for purposes of TP rules and (other) anti-avoidance rules.

3.3 Justification

It is established law that a restriction may be justified by an overriding reason in the public interest.[68] The question is what justificatory ground may be put forward in support of the restriction created by an arm's length adjustment. This often matters a great deal, given that different justificatory grounds are subject to different constraints at the proportionality stage.

In terms of the limits imposed by the fundamental freedoms on TP rules, the choice of justificatory ground has enormous implications for the extent to which a Member State must allow the taxpayer to justify commercially its departure from the ALP. However, the choice of justificatory ground has little impact on the requirement that the arm's length adjustment must be confined to the portion by which the transaction the ALP.[69] While this thesis will not offer in-depth discussion of what justificatory grounds may be adduced in favour of an arm's length adjustment and the consequences for the commercial justification requirement, it is necessary to set out the nature of the two grounds that have been accepted to justify an arm's length adjustment: the need to maintain a balanced allocation of taxing powers (hereinafter: the allocation ground) and the prevention of tax-avoidance (hereinafter: the anti-avoidance ground).

In *SGI*, the Court accepted that an ALP adjustment may be justified by the two aforementioned justificatory grounds, taken together.[70] In *Hornbach*, the German government sought to rely on the allocation ground alone.[71] The Court accepted that the allocation ground may justify a system which "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

[68] See, for example, *SGI*, supra 33, para 56
[69] See further on these requirements in section 3.4.
[70] *SGI*, supra 33, para 69
[71] *Hornbach*, supra 34, para 41

territory"[72] and that a national law "which seeks to prevent profits generated in the Member State concerned from being transferred outside the tax jurisdiction of that Member State via transactions that are not in accordance with market conditions, without being taxed, is appropriate" in pursuit of the allocation ground.[73]

However, the Court subsequently subjected the German TP rule to the proportionality enquiry normally associated with the anti-avoidance ground.[74] One may deduce from this that the Court raised the anti-avoidance ground *ex officio.*[75] It is therefore concluded, for purposes of this thesis, that the allocation ground *and* the anti-avoidance ground must be relied on when justifying an arm's length adjustment.

3.4 Proportionality

3.4.1 Two criteria

It is similarly uncontroversial that a national measure must not go beyond what is necessary for attainment of the overriding reason in the public interest.[76] Two criteria have emerged as necessary for ensuring the proportionality of an arm's length adjustment. Proportionality requires, firstly, that "on each occasion on which there is a suspicion that a 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 have been for that transaction" (hereinafter: commercial justification criterion) and, secondly, that "the corrective tax measure must be confined to the part which exceeds what would have been agreed if the companies did not have a relationship of interdependence" (hereinafter: arm's length criterion).[77]

3.4.2 Commercial justification criterion

The requirement that the national transfer pricing rule offer the taxpayer an opportunity to justify commercially its departure from the ALP will not be considered in depth as part of this thesis, but a few brief comments appear in order. Following *SGI*, there was considerable literary debate as to whether the

[72] *Id.*, para 44
[73] *Id.,* para 47
[74] *Id.*, para 49, See further on this in section 3.4.
[75] Although note that other authors have been more cautious in making this conclusion. Buriak and Petruzzi state that "it is unclear whether the Court in the end accepted the balanced allocation of powers of taxation as a sole justification", Buriak, Petruzzi, supra 1, 353.
[76] See, for example, *Hornbach*, supra 34, para 48
[77] *SGI*, supra 33, paras 71-72

taxpayer was able to resist an arm's length adjustment only by showing that it had, in fact, complied with the ALP, or whether it was able so to resist by adducing any commercial justification.[78] The latter option might severely curtail the operation of the ALP inside the EU. Following *Hornbach*, it appears the latter option is the more likely, though the position is not without controversy.[79]

3.4.3 Arm's length criterion

3.4.3.1 The meaning of the arm's length criterion

The above formulation from *SGI*, laying down the limitation on the extent of an arm's length adjustment, does not refer *verbatim* to Art. 9(1) MC or the concept of 'arm's length'. The same goes for *Hornbach*, where it was formulated as requiring that the measure "be confined to the part which exceeds what would have been agreed between the companies in question under market conditions".[80] However, in *Thin Cap*, the term 'arm's length' was explicitly referred to.[81] This raises questions in terms of what the arm's length criterion really requires. This is particularly the case since the ALP is formulated in different terms in different Member States.

Fulfilment of the arm's length criterion was not contested before the Court in *Hornbach*,[82] which suggests that the Court did not proceed on the basis of any autonomous EU law conception of the ALP, but arguably referred to the German conception of the ALP. Note that the possibility of an autonomous EU law ALP is not farfetched, given that such a concept has been recognised by the EU General Court as flowing from Art. 107 TFEU which, like the fundamental freedoms, ultimately deals with non-discrimination.[83]

One view might be that the nature of the arm's length criterion depends on the view of the ALP which is ascribed to by the Member State in question. It has been set out above that the ALP may be viewed as being of a hypothetical

[78] Some notable contributions are: Schön, supra 57; Schön, supra 55; Meussen, G.T.K., 'The SGI Case: ECJ Approves Belgian System of Selective Profit Corrections in Relation to Foreign Group Companies' [2010] EuroTax, 245; Glahe, supra 61; Boone, P. et al, 'SGI Case: The Impact of the Decision of the European Court of Justice from a European Perspective' [2010] 3 ITPJ, 183; CFE ECJ Task Force, '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)' (2012) 52 No. 6 EuroTax, 311; Jiménez, supra 46.
[79] Buriak, Petruzzi, supra 1, 359 *et seq.*; Calderon, J.M. and Ribeiro, J.S., 'Transfer Pricing Rules and the European Commercial Motives Test: A Discussion of Hornbach-Baumarkt' [2018] TNI, 1325, 1330
[80] *Hornbach*, supra 34, para 49
[81] *Thin Cap,* supra 32, para 83
[82] *Hornbach,* supra 34, para 50
[83] See Judgment of 24 September 2019, *Starbucks*, Joined cases T-760/15, T-636/16, EU:T:2019:669, para 157

or an empirical nature.[84] If a Member State takes a particular view of the ALP, that conception of the ALP is linked to the purpose that the Member State is aiming to achieve, and so it seems logical that the arm's length criterion at the proportionality stage should reflect that purpose. For example, if a Member State were to hold the empirical view of the ALP, an arm's length adjustment would have to be confined to any portion outside the range of comparables.

The problem with the aforementioned view is that the arm's length criterion arguably becomes self-fulfilling and meaningless, since the admissible scope of the rule is then assessed by reference to the rule itself. It is therefore unlikely that the Court intended the criterion to have such a meaning. An uneasy conclusion emerges from this discussion. On the one hand, the arm's length criterion does not appear to be a free-standing concept of EU law. On the other hand, it cannot depend on the Member State's views of the ALP, since the criterion would then be meaningless.

This thesis proposes that the arm's length criterion ought to be interpreted in line with Art. 9(1) MC. Firstly, in *Thin Cap*, the term "arm's length" was explicitly referred to, and Art. 9(1) MC constitutes the perhaps most accepted formulation of the ALP.[85] Secondly, in *SGI*, the criterion was expressed as fundamentally concerned with profits which have failed to materialise as a result of the relatedness of transactional parties. This hypothetical conception accords with Art. 9(1) MC.

Thirdly, although *Hornbach* referred to "market conditions", which appears to suggest a more empirical and comparables-based conception, the criterion is concerned with "the companies in question", and not the conditions of actual uncontrolled transactions in an actual market.[86] Thus, the concept of 'market conditions' ought to be interpreted as 'independence', such that the arm's length criterion indeed limits an adjustment to the portion which exceeds what the enterprises would have agreed if they had been independent. Therefore, when analysing the compatibility of the HTVI approach with the arm's length criterion, this thesis will analyse the compatibility of the HTVI approach with a hypothetical view of the ALP.[87] The hypothetical view will find support also in the next section, which seeks to explain the arm's length criterion conceptually.

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[84] See section 2.1.2.

[85] *Thin Cap*, supra 32, para 83

[86] *Hornbach,* supra 34, para 49

[87] See section 4.

3.4.3.2 Origin and conceptual basis of the arm's length criterion

The *Thin Cap* case, where the requirement was first enunciated, concerned thin capitalisation rules, the justification of which was sought by the Member State in the anti-avoidance ground alone.[88] In order to comply with the principle of proportionality, the Court requires an anti-avoidance measure to be limited to targeting "wholly artificial arrangements".[89] The concept of wholly artificial arrangements, as famously laid down in *Cadbury Schweppes*, denotes physical non-existence.[90] However, in *Thin Cap,* the Court adapted that concept to a TP context, stating that non-compliance with the ALP constitutes an objective and verifiable circumstance indicating that an arrangement is wholly artificial.[91] The arm's length criterion is, therefore, a specialised form of the artificiality requirement.

But why is it that non-compliance with the ALP indicates that an arrangement is wholly artificial? In *Cadbury Schweppes*, a wholly artificial arrangement was described as "a fictitious establishment not carrying out any genuine economic activity" and held to comprise, in particular, "a 'letterbox' or 'front' subsidiary".[92] Transposing this reasoning from physically non-existent *corporate entities* to the context of *transactions*, one might conclude that a payment which is made pursuant to a transaction which exists only on paper would constitute a wholly artificial arrangement. This allows for a sensible rationalisation of the decision in *Thin Cap*; The portion of a payment which is aligned with such remuneration as would have been charged by the enterprises had they been independent *does* correspond to genuine economic activity, whereas the portion by which the payment exceeds the ALP does, by definition, not correspond to any genuine economic activity. In other words, the excess may be described as an outright gratuity amounting to a wholly artificial arrangement.

SGI concerned not thin capitalisation rules, but an arm's length adjustment *per se.* This was justified pursuant to the allocation ground and the anti-avoidance ground, taken together, which resulted in more lenient treatment; The measure was lawfully applicable beyond *wholly artificial* arrangements, covering also *artificial* arrangements.[93] Unlike wholly artificial arrangements, artificial arrangements, while physically existent, lack commercial justification.[94] Although the measure was no longer confined to

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[88] *Thin Cap*, supra 32, paras 71-77
[89] *Id.*, para 72 (and the case law cited)
[90] *Cadbury Schweppes*, supra 36, paras 51
[91] *Thin Cap*, supra 32, para 81; The Court uses the words 'purely artificial', but these are for present purposes treated as synonymous with 'wholly artificial'.
[92] *Cadbury Schweppes*, supra 36, para 68
[93] *SGI*, supra 33, paras 66-67
[94] *Hornbach,* supra 34, para 49

wholly artificial arrangements, from which the arm's length criterion arguably originated, the Court nonetheless retained the arm's length criterion, and there are arguably two good reasons for this.

Firstly, the reasoning pertaining to wholly artificial arrangements remains applicable by analogy to artificial arrangements. In particular, the portion of a payment which is in line with that which would be agreed by independent (and therefore commercially motivated) parties may be taken to be commercially motivated, whereas that which exceeds such conditions may not be taken to be commercially motivated. Secondly, while additional reliance on the allocation ground somewhat relaxes the artificiality requirement, that ground may not be invoked in support of a Treaty override, as concluded in this thesis.[95] Therefore, the arm's length criterion necessarily follows from reliance on the allocation ground. These conclusions support a hypothetical view of the arm's length criterion.

4. The HTVI approach is incompatible with the arm's length criterion as set out in *SGI* and *Hornbach*

4.1 Introduction

It has been set out above that the fundamental freedoms, as interpreted in *SGI* and *Hornbach*, require an arm's length adjustment to be in line with the ALP. Therefore, if the HTVI approach is inconsistent with the ALP, an HTVI adjustment will fall foul of *SGI* and *Hornbach*, in turn calling into question its compatibility with the fundamental freedoms. The (in)compatibility of the HTVI approach with the ALP has frequently been the subject of academic scholarship.[96] The key question in that debate is whether reliance by the tax authority on the HTVI approach may result in an arm's length adjustment mandating a transfer price which is higher than that which would have been charged had the associated enterprises been independent.

Drawing on TP literature, this section will consider several ways in which the HTVI approach may transgress the ALP. As concluded above, albeit with some doubt, the arm's length criterion as laid down by the Court is, like Art.

[95] See further in section 5.2.
[96] Some notable contributions are: Wittendorff, J., 'BEPS Actions 8-10: Birth of a New Arm's-Length Principle' [2016] TNI, 331; Fedusiv, supra 3; Ballivet, L., 'Use of Non-Arm's Length Approaches within the Arm's Length Principle: Heading towards a New Standard?' (2020) 27 No. 2 ITPJ, 124; Hagelin, J., 'Ex Post Facto Considerations in Transfer Pricing of Hard-to-Value Intangibles: Practical and Methodical Issues with the HTVI Approach' (2019) 26 No. 1 ITPJ, 50.

9(1) MC, hypothetical in its formulation. Whether one views the ALP as hypothetical or empirical plays an important role in determining whether the HTVI approach is incompatible. If the HTVI approach undermines the use of comparables, it may transgress the empirical view of the ALP. If the HTVI approach imposes additional requirements in the independence counterfactual, beyond imagining the two enterprises as independent, it may transgress the hypothetical view of the ALP. However, since the hypothetical view is generally more allowing, any transgression of the hypothetical view is likely to constitute a transgression also of the empirical view.

4.2 Whether the HTVI approach entails retroactivity (or any use of 'hindsight')

It has been suggested by several authors that the HTVI approach is inconsistent with the ALP because the HTVI approach allows the tax authority to adjust *ex ante* pricing by reference to *ex post* outcomes.[97] This is understandable, given the OECD's statement that "a tax administration is entitled to use, in evaluating the *ex ante* pricing arrangements, the *ex post* evidence about financial outcomes to *inform the determination of the arm's length pricing arrangements* that would have been made between independent enterprises at the time of the transaction".[98]

The argument, which is eloquently articulated by Fedusiv, may be summarised in terms of the following two prongs. Firstly, the ALP requires the conditions in controlled transactions to be aligned with the conditions in comparable uncontrolled transactions. Independent enterprises would, by definition, be unaware of the *ex post* outcomes of their uncontrolled transactions and would therefore not consider said outcomes when setting the *ex ante* prices of those transactions. Therefore, requiring associated enterprises to set *ex ante* transfer prices by reference to *ex post* outcomes constitutes a departure from the ALP. Secondly, there are numerous instances where the OECD Guidelines are explicit in generally prohibiting the use of hindsight when assessing the pricing of controlled transactions. For example, in relation to comparability, the Guidelines state that "care must be taken to avoid the use of hindsight".[99]

The argument, set out in the preceding paragraph, that hindsight may not inform an arm's length adjustment is convincing; When the tax authority

[97] See, for example, Wittendorff, supra 96, 351 and Fedusiv, supra 3, 485.
[98] HTVI Guidance, para 2 (present author's emphasis)
[99] Fedusiv, supra 3, 485-486, citing TPG 3.74; Other examples cited by Fedusiv are 3.73 (on comparability), 6.181 (on the HTVI approach), and 6.141-6.152 (on the transactional profit-split method).

constructs the independence counterfactual, there is no reason to endow either party with knowledge of the future. However, the HTVI approach arguably requires no such thing. The availability of the first exemption requires the taxpayer to demonstrate by reference to economic analysis that the *ex ante* valuation of the intangible was justified *at the time of the transaction*.[100] The role of *ex post* outcomes is limited to designating an *ex ante* transfer price as suspect, which justifies placing the burden of proof with the taxpayer to justify economically the value ascribed to the intangible *ex ante.*

Hagelin has furthermore argued that consideration of *ex post* outcomes may, *in practice*, skew the tax authority's perceptions of the *ex ante* probability of those outcomes occurring.[101] Hagelin's contention that that which has already occurred may appear self-evident in hindsight, while arguably correct, does not imply that the HTVI approach is based on hindsight. The taxpayer is given an opportunity to justify economically its *ex ante* pricing by reference to the information available at the time of the transaction, to the exclusion of any information not available at the time.[102] If the tax authority seeks to inflate the *ex ante* probability of a certain *ex post* outcome by reference to that outcome already having occurred, this would be precisely contrary to the HTVI approach.

A third argument seeking to demonstrate that the HTVI approach inappropriately uses hindsight is based on the similarity of the HTVI approach and the so-called commensurate-with-income (hereinafter: CWI) standard which is found in s. 482 of the US Internal Revenue Code (IRC). This argument, also put forward by Fedusiv, provides, firstly, that the CWI standard has long been criticised as incompatible with the ALP due to retroactivity. Secondly, the HTVI approach is similar to the CWI standard. *Ergo*, that criticism is applicable also to the HTVI approach.[103]

However, there is a key difference between the HTVI approach and the CWI standard. S. 482 IRC provides that "[i]n the case of any transfer (or license) of intangible property […], the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible". This was confirmed by an often-cited White Paper of the Internal Revenue Services (IRS) as meaning that the "transfer price shall be commensurate with the *actual* income".[104]

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[100] OECD Guidelines, 6.193
[101] Hagelin, supra 96, 52
[102] OECD Guidelines, 6.188
[103] Fedusiv, supra 3, 487-488
[104] IRS (1988), A Study of Intercompany Pricing under Section 482 of the Code, notice 88-123, Washington D.C., section 8.B (present author's emphasis)

Unlike the CWI standard, the HTVI approach does not require that an *ex ante* transfer price correspond to the actual *ex post* income, since that income may not have been possible to predict even if the parties had been independent. Rather, as set out above, it designates a significant *ex post* increase in value as suspect, and therefore places under increased scrutiny the *ex ante* transfer price. Furthermore, there is some support in literature for the position that the CWI standard entails retroactive valuation whereas the HTVI approach does not.[105]

However, a modified version of the retroactivity argument might be put forward. The HTVI approach involves placing the *ex ante* transfer price under additional scrutiny, by means (*inter alia*) of reversing the burden of proof. The additional scrutiny requires the associated enterprises to behave more diligently (as well as independently) when valuing HTVIs *ex ante*. However, the requirement of additional diligence is imposed only if the value of the intangible increases significantly *ex post*. Therefore, there is undeniably an element of retroactivity, albeit a slightly subtler one than that which is proposed by Fedusiv.

Therefore, one might argue that the HTVI approach contains a certain retroactive element, since actual *ex post* outcomes will have some effect on the treatment of *ex ante* transfer prices.

4.3 Relevance of recharacterisation

The OECD Guidelines endorse the use of recharacterisation of the payment structure in a controlled transaction involving an intangible, so as better to reflect the uncertainty of the intangible's value.[106] Under such an approach, the tax authority may, for example, replace a lump sum payment with a running royalty which is contingent on the financial success of the intangible, or other price variation clauses. This endorsement is particularly relevant to the HTVI approach, since it is one of the tools granted to the tax authority for adjusting transfer prices in relation to HTVIs.[107]

By means of an analysis of the interrelationship between tax treaties and national law, Wittendorff has demonstrated that the ALP as set out in Art. 9(1) MC does not justify recharacterisation of a controlled transaction, but is limited to adjusting the *pricing* of said transaction.[108] The argument, briefly summarised, demonstrates that qualification of the taxable object, in this case

[105] See, for example, Hagelin, supra 96, 51-52
[106] OECD Guidelines, 6.185
[107] HTVI Guidance, para 16
[108] Wittendorff, supra 96, 334-335

business profits, is governed by national law, and not by Art. 9(1) MC. This is so for two reasons. Firstly, "commercial or financial relations" as referred to in Art. 9(1) is undefined in the MC, such that Art. 3(2) prescribes definition according to national law. Secondly, Art. 9(1) operates in the context of Art. 7(1), and "business profits" is explicitly said to be defined according to national law.[109] It follows that the existence, form, and content of a controlled transaction is determined by domestic law, *before* Art. 9(1) is applied.

While convincing, Wittendorff's argument is of limited relevance for purposes of assessing the compatibility of the HTVI approach with the fundamental freedoms. The arm's length criterion does not make reference to Art. 9(1) MC directly, although its content is largely aligned therewith. The arm's length criterion states in abstract terms that an arm's length adjustment must be limited to that part of the transaction by which the transaction exceeds that which would have been agreed had the parties been independent.[110] This wording arguably does not rule out recharacterisation.

Put differently, EU law does not consider the intricate relationship between tax treaties and national law which is relied on by Wittendorff. Wittendorff states merely that Art. 9(1) MC does not provide any legal basis for recharacterisation, which must instead be sought in national law.[111] However, it is also important to note that the MC does not prohibit recharacterisation, since object qualification is the business of national law - if it were otherwise, then recharacterisation pursuant to national law would constitute a Treaty override, which in turn could not be justified pursuant to the allocation ground, as argued in this thesis.[112]

That being said, it may be the case that *SGI* and *Hornbach* do, in fact, preclude recharacterisation, albeit for a slightly different reason. The formulation used in *SGI* and *Hornbach* enquires what would have been agreed by the parties to the controlled transaction if they were independent from one another.[113] This entails a comparison between, on the one hand, the parties to the controlled transaction and, on the other hand, independent parties facing circumstances *comparable to those of the controlled transaction* at issue. Therefore, the Court's formulation still presupposes a comparability analysis. Such an analysis is arguably undermined by circularity if the tax authority may

[109] Commentary on article 3 of the OECD model, at paras 4 and 10.2
[110] *SGI*, supra 33, para 72 and *Hornbach*, supra 34, para 49
[111] Wittendorff, supra 96, 334-335
[112] See section 5.2.
[113] *SGI*, supra 33, para 72 and *Hornbach*, supra 34, para 49

simultaneously reconfigure the transaction, since comparability factors, such as risk exposure, are thereby manipulated.

To illustrate using an example, suppose enterprise A purchases an intangible from associated enterprise B. A assumes the entire risk that the intangible might fail, and so pays a lower price to B in consideration. The risk distribution in the controlled transaction will impact the price considerably and must therefore be accurately delineated alongside other comparability factors.[114] When comparing the controlled transaction to a comparable uncontrolled transaction (assuming one exists), the latter transaction must in principle be comparable to the former in terms of the risk distribution. If the tax authority recharacterises the risk distribution of the controlled transaction, the risk distributions are suddenly different, and the transactions are no longer comparable. Similarly, if the tax authority recharacterises the risk distribution so as better to reflect an uncontrolled transaction with a different risk distribution, that uncontrolled transaction cannot have been comparable to the controlled transaction to begin with. In any event, recharacterisation short-circuits the logic of the ALP enquiry, which is based on identifying comparable transactions.

However, the above argument must be qualified. Since the argument provides that recharacterisation is incompatible with the comparables-based logic of the ALP, it is mainly relevant on an empirical view of the ALP. This thesis has concluded that the arm's length criterion reflects a hypothetical view of the ALP, according to which the role of comparables is only evidentiary and not a conceptual necessity. The fact that this argument is limited to the empirical view of the ALP somewhat limits its importance.

4.4 Imputing rationality to a controlled transaction

An arm's length assessment of the *ex ante* pricing in light of *ex post* financial outcomes, pursuant to the HTVI approach, focusses on ensuring appropriate probability weighting. In assessing the *ex ante* prediction made by the taxpayer as to the intangible's future value, the tax authority will consider the reliability of the information relied on and require that the taxpayer "satisfactorily demonstrate what was foreseeable at the time of the transaction and reflected in the pricing assumptions".[115]

The probability standard imposed is whether the information giving rise to *ex post* financial outcomes "could or should reasonably have been known and

[114] OECD Guidelines, 1.40
[115] OECD Guidelines, 6.192, 6.194

considered" by the taxpayer at the time of the *ex ante* pricing.[116] Fedusiv has interpreted this formulation as introducing a two-stage test: First, it is considered whether an *ex post* result was reasonably foreseeable. If it was, it is considered whether that result was appropriately factored into the *ex ante* transfer price. If it was not, the tax authority may adjust the *ex ante* transfer to account for the *ex post* outcome.[117]

This interpretation ought to be doubted, since the first step constitutes a false dichotomy, in asking whether an outcome is either reasonably foreseeable or not. A better interpretation is that the taxpayer ought to provide the tax authority with a rigorous economic analysis of various reasonably foreseeable financial outcomes with attached probabilities of occurrence; The aggregate would then indicate the expected value of the intangible. Two points should be made in relation to the interpretation suggested. Firstly, the inclusion of both "could" and "should" is surprising; The most sensible interpretation is an invitation to the tax authority to consider first, whether the information *could* (*reasonably*) have been known. If it could not, that is the end of the matter. If it could have been known, the second question is whether it *should reasonably* have been known.

Secondly, and more importantly, the use of the term "reasonably" appears to introduce an objective standard which subjects the taxpayer's *ex ante* probability weighting to an assessment by reference to what a reasonable taxpayer would have done. While this, in a sense, measures the taxpayer's weighting against a hypothetical third party weighting, it arguably ascribes a standard of rationality to said third party. It is common experience that the independent parties, with whose transactions a related party transaction is compared pursuant to the ALP, are not rational.[118] It is perfectly possible to envisage a probability weighting which is conducted as part of an uncontrolled transaction, and which is not conducted to a standard of rationality. Therefore, requiring that controlled transactions invariably be informed by a rationality standard arguably causes the HTVI approach to depart from the ALP. Art. 9(1) MC does not justify inclusion in the tax base profits which would have materialised had the parties acted rationally, only profits which would have materialised had the parties been independent. This argument applies regardless whether one takes a hypothetical or empirical view of the ALP.

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[116] HTVI Guidance, para 2; OECD Guidelines, 6.188

[117] Fedusiv, supra 3, 485

[118] de Lange, M.A.; Lankhorst, P.W.H.; Hafkenscheid, R.P.F.M., 'Non-Recognition of Transactions between Associated Enterprises: On Behaving in a Commercially Rational Manner, Decision-Making Traps and BEPS' (2015) 22 No. 2 ITPJ, section 6.1.2 (and literature cited)

The practical consequence of imputed rationality standard may be illustrated by an example. Suppose an HTVI increases significantly in value following a transfer from the taxpayer to an associated enterprise, and the tax authority seeks to impose an HTVI adjustment, shifting the burden of proof to the taxpayer to demonstrate that the transfer price was at arm's length. Suppose further that the taxpayer is able to furnish proof of a certain industry practice, whereby the valuation of intangibles excludes a certain factor from the prediction. Then, the taxpayer will be unable to rely on that industry practice if the tax authority takes the view that exclusion of that factor was not rational. The problem is arguably exacerbated since the tax authority has limited expertise to determine what is rational in the context of complex and uncertain valuations of intangible assets in highly specialised industry sectors, such as software or pharmaceuticals.

The above leads to the inescapable conclusion that the imputation of an objective standard causes the HTVI approach to exceed the ALP. Tying this conclusion back to the fundamental freedoms, one might state that an HTVI adjustment is likely to apply beyond the part of the controlled transaction by which that transaction exceeds what would have been agreed between independent enterprises. It therefore offends the arm's length criterion.

4.5 Relevance of the burden of proof

One clear effect of the HTVI approach is to shift the burden of proof onto the taxpayer, who must then justify the value ascribed to the intangible as part of the *ex ante* pricing. This is of great significance in practice; Since it is, by definition, very difficult to prove and disprove that a transfer of an HTVI complies with the ALP, the burden of proof weighs particularly heavily on the party with whom it rests. However, the arm's length criterion, as enunciated by the Court in *SGI* and *Hornbach*, entails no requirements with respect to burden of proof.

4.6 Relevance of the two views of the ALP: hypothetical and empirical

Some of the arguments put forward in this section state that the HTVI approach exceeds the ALP, in essence, because it may result in an adjustment demanding remuneration which exceeds what would have been agreed in a comparable uncontrolled transaction. However, on a hypothetical view of the ALP, in which the use of comparables is simply an evidentiary tool used to determine the features of the independence counterfactual, then it may be argued that comparables are no different from other evidentiary tools.

An example may illustrate. In later years, the IRS has maintained that the CWI standard is compatible with the ALP, by arguing that the term 'income' as referred to in s. 482 IRC means income which the taxpayers would reasonably and conscientiously have projected *ex ante*. However, actual *ex post* income constitutes the best evidence of such a projection.[119] Expressed differently, because comparables and *ex ante* valuations are so unreliable in the intangibles context, the actual income which an intangible turns out to generate constitutes the least unreliable evidence of what the enterprises would have agreed had they been independent. An attempt to dismiss this approach as incompatible with the ALP would simply be an argument about the relative strength of competing categories of evidence used to prove or disprove highly uncertain facts.

However, this assertion by the IRS with respect to the evidentiary value requires imposition of a rationality standard, which is conceptually problematic for reasons which are set out above.

4.7 Conclusion

One may conclude from the foregoing that the HTVI approach is incompatible with the ALP as enshrined in Art. 9(1) MC and, therefore, also with the arm's length criterion which is imposed by the fundamental freedoms on national transfer pricing rules. Therefore, the HTVI approach may not be held incompatible with the fundamental freedoms by reliance on *SGI* and *Hornbach*.

However, this conclusion ought to be viewed in light of the two competing views of the ALP and the fact that it is not entirely clear which view is reflected in the arm's length criterion. If the criterion reflects an empirical and necessarily comparables-based view, the HTVI approach definitely exceeds the criterion. However, the conclusion is less forceful of the criterion reflects a hypothetical view of the ALP.

[119] Office of Chief Counsel, Internal Revenue Service Memorandum, Taxpayer Use of Section 482 and the Commensurate With Income Standard, Release number AM-2007-007, 2007-03-23, 3

5. Whether the HTVI approach may be justified as an anti-avoidance measure

5.1 Introduction and normative framework

The incompatibility of the HTVI approach with *SGI* and *Hornbach* was contemplated by Schön, as part of an examination of the EU law implications of the BEPS proposals. He suggested that the compatibility with the fundamental freedoms of any TP rule exceeding the ALP must be considered anew and cannot be declared compatible pursuant to *SGI* and *Hornbach*.[120]

Schön's preliminary argument was that the limits of the fundamental freedoms are informed by the basic aim of the internal market, which is efficient resource allocation by means of market forces. The ALP is compatible with the fundamental freedoms because it serves to weed out contractual arrangements seeking to circumvent tax rules, and which do not further economically efficient resource allocation. This is why the anti-avoidance ground is limited to preventing artificial arrangements, since the allocation resulting from a transaction is economically efficient only if it is commercially motivated.[121]

5.2 Rule of reason requirements

The question, therefore, is whether the HTVI approach may be justified outside the *Hornbach* case law. If a restrictive measure is to be justified pursuant to the anti-avoidance ground, the measure must apply only to wholly artificial arrangements and the taxpayer must be offered an opportunity to show that the arrangement is genuine.[122] As mentioned above, an arm's length adjustment has been justified pursuant to the anti-avoidance ground taken together with the allocation ground. The *addition* of the allocation ground has several consequences.

Firstly, the measure may apply beyond wholly artificial arrangements also to artificial arrangements.[123] The distinction is an important one, since wholly artificial arrangements are those which are physically non-existent,[124] whereas artificial arrangements may be physically existent but motivated by

[120] Schön, supra 57, 424-426
[121] *Ibid.*
[122] *Cadbury Schweppes*, supra 36, paras 51, 70
[123] *SGI*, supra 33, para 66
[124] *Cadbury Schweppes*, supra 36, paras 67-68

tax considerations instead of commercial considerations.[125] Secondly, however, the measure must still offer the taxpayer an opportunity to adduce a commercial justification, in order to demonstrate that its arrangement is, in fact, commercially motivated.[126]

Thirdly, this thesis proposes that the need to rely on the allocation ground means that the measure cannot constitute a Treaty override. This is so because the allocation ground seeks to preserve the Member State's taxing powers, i.e. its ability to exercise its taxing rights. Briefly put, it ought logically to be impossible for a Member State to justify a restrictive measure by reference to the need to ensure the appropriate exercise of a taxing right which that Member State does not have in the first place. This finding has significant implications for present purposes; Since the HTVI approach arguably exceeds the ALP as enshrined in Art. 9(1) MC, an arm's length adjustment made by a Member State pursuant to the HTVI approach is likely to constitute a Treaty override. This means that the HTVI approach may not be justified pursuant to the allocation ground. This finding is largely in line with other conclusions drawn in this thesis, since it overlaps with the arm's length criterion.

5.3 Feasibility of justification

The question remains whether an arm's length adjustment may be justified by reference to the anti-avoidance ground alone.[127] This route is arguably quite intuitive, and for two reasons. Firstly, the thin capitalisation rules at issue in *Thin Cap* were justified pursuant to the anti-avoidance ground alone.[128] The HTVI approach may be conceived as an anti-avoidance rule which is similarly connected to the ALP. Indeed, the HTVI approach is presented as part of the ALP, *and* it is based on the findings of BEPS Action 8, which undeniably has a prominent anti-avoidance focus.

Secondly, the *SGI* and *Hornbach* case law proceeds on the principle that non-compliance with the ALP constitutes an objective and verifiable circumstance which indicates tax avoidance, such that non-compliance with the ALP becomes a specialised conception of the artificiality requirement.[129]

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[125] *SGI*, supra 33, paras 66-67

[126] *Hornbach*, supra 34, para 49; Note that the commercial justification criterion will not be addressed at length in this thesis.

[127] Indeed, it may be queried whether an arm's length adjustment may be justified by reference to other justificatory grounds, such as fiscal cohesion. However, such a discussion exceeds the scope of this thesis.

[128] *Thin Cap*, supra 32, paras 72-77; Note, however, that the Court mentioned the allocation ground in passing, at paras 75-76.

[129] *Thin Cap*, supra 32, para 81; While the Courts used the words "purely artificial", these will be treated as synonymous with 'wholly artificial' for present purposes. See further on the conceptual explanation of the origin of the arm's length criterion in section 3.4.3.2.

However, as argued in this thesis, non-compliance with the HTVI approach does not necessarily entail non-compliance with the ALP. Therefore, it must be pointed out that the Court has not stated that non-compliance with the HTVI approach constitutes such a circumstance.

Indeed, it arguably does not so constitute, for the reasons set out above, namely that it is to be expected that independent and commercially motivated enterprises engage in uncontrolled transactions, where the pricing is not necessarily informed by a rational probability weighting. Since a substantial increase in value following the transfer may be attributable to unforeseen developments, an HTVI adjustment offends the requirement that the measure is imposed only on the basis of objective and verifiable circumstances indicating artificiality. This means that the HTVI approach arguably does not engage the *SGI* and *Hornbach* case law. Therefore, it is necessary to consider whether the HTVI approach targets 'wholly artificial arrangements' as defined in relation to anti-avoidance measures which are not based on the ALP.

5.4 Does the HTVI approach target only wholly artificial arrangements?

5.4.1 Distinction between intra-EU adjustments and third state adjustments

The first point to note is that the meaning of wholly artificial arrangements varies depending on whether the cross-border situation is between two Member States or between a Member State and a third state. The reason is that the Court has introduced a new definition of wholly artificial arrangements, which applies only to third states, in the context of Art. 63 TFEU.[130] As set out above, there are certain circumstances where Art. 63 TFEU will be engaged by TP rules and offer the taxpayer protection also in relation to third states.[131]

5.4.2 Intra-EU HTVI adjustments

The concept of wholly artificial arrangements was famously articulated in *Cadbury Schweppes*, where such arrangements were described as those "which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory".[132] An arrangement is not wholly artificial where it constitutes "genuine economic activity",[133] which is determined "with regard, in

[130] Judgment of 26 February 2019, *X GmbH*, C-135/17, ECLI:EU:C:2019:136, para 84
[131] See section 2.3.2.
[132] *Cadbury Schweppes*, supra 36, paras 55, 66
[133] *Id.*, para 54

particular, to the extent to which the [entity] physically exists in terms of premises, staff and equipment".[134] *Cadbury Schweppes* concerned CFC rules, and so the relevant arrangements in that case were group structures whereby passive income is assigned to foreign companies in low tax jurisdictions. However, the reasoning is similarly applicable to controlled transactions: Where the economic activity is physically existent, rather than contrived on paper, the transaction is genuine.

In light of this, it is arguable that the HTVI approach does not target wholly artificial arrangements. The HTVI approach is engaged where the value of an intangible has increased considerably following the transfer of that intangible, then shifting the burden of proof onto the taxpayer to justify the initial valuation of the intangible. Although the transfer of the intangible at a deflated price may be motivated by tax considerations, the transfer at a deflated price is nonetheless genuine. The intangible has, as a matter of economic fact, moved to the recipient company.

An alternative argument might be made as follows. While the transfer as a whole constitutes a genuine economic activity, any gratuitous component of the transaction is non-genuine. In the context of the HTVI approach, that would mean that the portion of the intangible's value that is transferred gratuitously, due to undervaluation, is non-genuine.[135] However, this argument ultimately falters, because whether any portion constitutes a gratuity would arguably have to be assessed according to the ALP, and the HTVI approach is not consistent with the ALP. It is clear from the foregoing that an intra-EU HTVI adjustment does not target wholly artificial arrangements.

5.4.3 Third state HTVI adjustments

In the context of Art. 63 TFEU, the relatively recent case of *X GmbH* has introduced a new definition of wholly artificial arrangements, which is applicable only to third states: "[T]hat concept is also capable of covering, in the context of the free movement of capital, any scheme which has as its primary objective or one of its primary objectives the artificial transfer of the profits made by way of activities carried out in the territory of a Member State to third countries with a low tax rate".[136] Although this definition still requires that the arrangement in question be 'artificial', it is clear from *SGI* that assessment of whether an arrangement is 'artificial' depends on its purpose,[137]

[134] *Id.*, paras 66-67
[135] Note the connection to the conceptual explanation of the arm's length criterion, at section 3.4.3.2 above.
[136] *X GmbH*, supra 130, para 84
[137] *SGI*, supra 33, paras 66-67

unlike the term 'wholly artificial', which concerns an arrangement's existence beyond paper.[138]

The question is whether the HTVI approach approximates this definition. Consider a typical example of an arrangement that will be caught by the HTVI approach: An R&D company in a Member State develops an HTVI, which is then transferred to an associated IP holding company in a third state which applies a low tax rate to intangible profits. The transfer price pertaining to the transfer is deflated by means of ascribing a low value to the HTVI. Then, the IP holding company enters into licence agreements which makes available the HTVI for use by associated operational companies, this time ascribing a high value to the HTVI, resulting in an inflated transfer price. The IP holding company collects royalties under the licence agreements which are subject to a low rate of tax, resulting in considerable tax savings for the group as a whole.

Tax considerations aside, it would arguably be similarly commercially sensible for the MNE group to retain the intangible in the Member State. While it may be commercially and administratively expedient for an MNE group to maintain a separate IP holding company which is the legal owner of the group's intangibles, it is difficult to envisage a commercial reason for maintaining that holding company in a separate jurisdiction, since a cross-border structure is likely to result in increased administrative complexity compared to a domestic structure. Similarly, although the third state might also have a system of company law or IP law which suits the MNE group's commercial aims, it would certainly be feasible for the tax authority to argue that the arrangement has as "*one of* its primary objectives the artificial transfer of the profits made by way of activities carried out in the territory of a Member State to third countries with a low tax rate"[139]. The R&D activity in the Member State would then constitute the "profits made by way of activities carried out in the territory of a Member State". As a result of the deflated transfer price due to the low value ascribed to the hard-to-value intangible, some portion of the income from an otherwise profitable R&D activity would be transferred to a third state with a low tax rate, in line with the definition of a wholly artificial arrangement.

In light of the above, it is arguable that at least some of the arrangements targeted by a third state HTVI adjustment ought to be considered wholly artificial arrangements in accordance with the definition of that concept for purposes of Art. 63 TFEU.

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[138] *Cadbury Schweppes*, supra 36, paras 67-68
[139] *X GmbH*, supra 130, para 84 (present author's emphasis)

5.4.4 Conclusion

As was demonstrated in section [insert] of this thesis, an HTVI adjustment may engage Art. 63 TFEU without simultaneously engaging Art. 49 TFEU, such that a Member State's HTVI adjustment vis-a-vis third states may also be subject to the fundamental freedoms. However, the definition of wholly artificial arrangements is more lenient in that context, and so a Member State might be able to justify an HTVI adjustment relying on the anti-avoidance ground alone, despite being unable to simultaneously rely on the allocation ground. However, in an intra-EU context, the HTVI approach does not target wholly artificial arrangements. It is therefore worth considering the EU doctrine of abuse of law, which is the topic of the next section.

In passing, it may be worth noting that the commercial justification criterion is more relaxed vis-a-vis third states. It applies only where a well-functioning system of administrative cooperation puts the tax authority in a position where it is able to verify the commercial evidence adduced by the taxpayer.[140]

6. Whether the 'abuse of law' doctrine may support the HTVI approach

6.1 Introduction

EU law recognises a doctrine of abuse of law, according to which an economic operator may not rely on EU law, for example the fundamental freedoms, for abusive ends. This is separate from the 'rule of reason' doctrine, which is discussed above, and which involves the justification of a measure which *prima facie* restricts the fundamental freedoms. For present purposes, the mechanism of this doctrine operates as follows: Where a taxpayer is subject to an HTVI adjustment, but the scheme used by the taxpayer means that reliance on the fundamental freedoms would amount to an abuse of those freedoms, then the taxpayer will be barred from invoking those freedoms in order to resist the HTVI adjustment.

6.2 What constitutes an abuse of EU law?

According to *Emsland-Stärke,* an abuse of EU law requires "first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by the [EU] rules, the purpose of those rules has not been achieved" and "second, a subjective element consisting in the

[140] *Id.*, para 94

intention to obtain an advantage from the [EU] rules by creating artificially the conditions laid down for obtaining it".[141] In the recent so-called *Danish Beneficial Ownership* (hereinafter: *DBO*) cases[142], the Court updated the definition, stating that both requirements are fulfilled, where "economic operators have carried out purely formal or artificial transactions devoid of any economic and commercial justification, with the essential aim of benefiting from an improper advantage".[143]

The Court offered guidance in the form of six economic hallmarks that may be considered in order to determine whether the definition is met in a specific set of circumstances.[144] It is clear from these hallmarks that actual performance of the economic activity in question does not prevent a finding of abuse, which is instead concerned with the *purpose* of the activity. Baerentzen has described the reformulation in the *DBO* cases as marking a shift from legal substance to economic substance or, in other words, from whether the scheme is actually carried out in practice to whether the scheme makes sense from a commercial point of view.[145]

Since the *DBO* cases concerned conduit companies, the economic hallmarks are somewhat tailored to that fact pattern, with limited applicability to the types of arrangements targeted by the HTVI approach. However, the first hallmark is arguably relevant, since it considers whether the group structure was put in place in order to achieve a tax advantage.[146] The fourth hallmark is arguably also relevant; In the context of conduit companies, it considers whether the sole activity of the conduit company was to receive and redistribute interest or dividends, as reflected in its lack of (for example) management, expenses, balance sheets, employees, and premises.[147] If the fourth hallmark were to be adapted to the HTVI context, it might consider whether the activity of the associated IP holding company is limited to receiving and holding the relevant intangible and making that intangible available to associated operational companies.

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[141] Judgment of 14 December 2000, *Emsland-Stärke*, C-110/99, ECLI:EU:C:2000:695, paras 52-53

[142] Judgment of 26 February 2019, *N Luxembourg 1 and others*, Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16, EU:C:2019:134; and Judgment of 26 February 2019, *T Denmark et al*, Joined Cases C-116/16 and C-117/16, EU:C:2019:135; For convenience, the present thesis will refer only to *N Luxembourg 1 and others*, since the relevant formulations in the two cases are almost identical.

[143] *N Luxembourg 1 and others*, supra 142, para 125

[144] *Id.*, paras 127-133

[145] Baerentzen, S.H., 'Danish Cases on the Use of Holding Companies for Cross-Border Dividends and Interest – A New Test to Disentangle Abuse from Real Economic Activity?' (2020) 12 No. 1 World Tax Journal, 13, 25

[146] *N Luxembourg 1 and others*, supra 142, para 127

[147] *N Luxembourg 1 and others*, supra 142, para 131

6.3 Do schemes targeted by the HTVI approach amount to abuse of the fundamental freedoms?

For the same reasons as those put forward above in relation to wholly artificial arrangements in a third state context,[148] it is possible to envisage situations where an arrangement involving the transfer of an HTVI to an associated IP holding company at a deflated value and licensed to associated operational companies at an inflated value might constitute an abuse of Arts. 49 or 63 TFEU. According to the definition proposed in the *DBO* cases, it may be argued that the establishment of an IP holding company in another Member State or a third state, and the transfer to that company of an intangible at deflated value, constitutes a set of "purely formal or artificial transactions devoid of any economic and commercial justification, with the essential aim of benefiting from an improper advantage", with the advantage being the freedom of establishment (Art. 49 TFEU) or freedom of capital (Art. 63 TFEU).

7. Conclusion and final remarks

Wittendorff has pointed out that an OECD measure which is incompatible with the ALP, such as the HTVI, may be inapplicable pursuant to existing tax treaties as a matter of national law.[149] The conclusion in this thesis has further implications for international tax law: Even if the HTVI approach is considered to be applicable as part of a Member State's TP regime, EU law may prevent such application. This may, by implication, cast into doubt the compatibility with EU law of other features that stem from BEPS Actions 8-10, since authors have questioned their compatibility with the ALP. This might constitute a topic for further research. Another aspect which warrants academic attention is the commercial justification criterion, which has not been addressed at length in this thesis.

Indeed, from the point of view of Member States' TP regimes, the commercial justification criterion potentially poses a greater threat than the arm's length criterion, in part due to the latter's somewhat diffuse nature. This diffuse nature will form the subject of the final remarks of this thesis.

As demonstrated by Petruzzi, the ALP is an evolving concept, which has changed gradually over time in order to adapt to changing economic

[148] See section 5.4.3.
[149] Wittendorff, supra 96, 333

practices.[150] There are two main views of this phenomenon: Petruzzi has noted changes in the application of the ALP and concluded that the nature of the ALP has thereby been changed.[151] Other authors similarly emphasise a divergence between the ALP's application and its nature, concluding instead that said application is incompatible with the ALP and ought to be precluded. For example, Avi-Yonah stated in the 1980s that the TNMM method is inconsistent with the ALP,[152] although few authors would maintain such a stance today.

This leads to a meta-conclusion, namely that there is disagreement about the fundamental nature of the ALP's normative force: Is the ALP a descriptive concept denoting the current political consensus on the allocation of profits to associated enterprises, as collectively understood by the international tax community? Alternatively, is the ALP a prescriptive concept, with which any profit allocation mechanisms must comply? The answer is likely to be a combination of both, and the precise balance is likely to differ considerably from one country to the next. The difference may perhaps be attributable to the different status of the Guidelines in relation to different national TP regimes and tax treaties - if the Guidelines are given greater interpretive weight, that might lead to the conclusion that the ALP forms a malleable product thereof. If the Guidelines are given less weight, the ALP may be seen as a static concept which is not subject to change over time.[153]

It is also worth remembering, in this connection, that the arm's length *principle* is, indeed, a *principle.* In traditional jurisprudence, principles may be distinguished from rules; Principles apply by weighing in different directions, whereas rules apply in an all-or-nothing fashion.[154]

Against this background, one may perhaps question altogether the utility of the Court's arm's length criterion. The elusive nature of the ALP, i.e. the elusive answer to the question of what would have happened in the independence counterfactual, makes it unsuitable as a strict legal requirement monitored by the Court of Justice. This is so in particular because it has not set out in greater detail what its understanding of the ALP is. The upshot is that authorities, advisors, and taxpayers in EU Member States ought to tread lightly when dealing with the HTVI approach, as well as when navigating the

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[150] Petruzzi, R., 'The Arm's Length Principle: Between Legal Fiction and Economic Reality' in Lang, M. Storck, A., Petruzzi, R. (eds.) *Transfer Pricing in a Post-BEPS World* (2016) (ISBN 978-90-411-6710-1)

[151] *Ibid.*

[152] Avi-Yonah, supra 9, 144

[153] For a similar conclusion, albeit in a slightly different context, see Wittendorff, supra 13, 238.

[154] Dworkin, R. M., 'The Model of Rules' (1967) 35 No. 1 The University of Chicago Law Review, 14, 25-29

transfer pricing jungle that results from implementation of BEPS Actions 8-10 more generally. The key takeaway is that, alongside the complexity of other parameters, such as the relationship between tax treaties, national law and the Guidelines, the EU law ought dimension must not be forgotten in the area of TP.

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