

# *IMPRESA PIZZAROTTI*: ROMANIAN TRANSFER PRICING RULES UPHELD BY THE COURT OF JUSTICE

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## Part I

### Introduction

In *Impresa Pizzarotti*,<sup>2</sup> the Court determined that Romanian transfer pricing rules that applied to a Romanian branch of an Italian company, but not to a Romanian branch of a Romanian company, were compatible with the freedom of establishment. In coming to its conclusion, the Court of Justice applied its earlier reasoning seen in *SGI*<sup>3</sup> and *Hornbach-Baumarkt*.<sup>4</sup>

### Background

Impresa Pizzarotti is a Romanian branch of an Italian company ("Pizzarotti Italia"). The branch concluded two loan agreements in 2012 with its head office. The loan agreements did not contain any clause for charging interest payments. Both loans

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<sup>2</sup> *Impresa Pizzarotti (Avantage anormal consenti à une société non-résidente)* ("*Impresa Pizzarotti*"), C-558/19, ECLI:EU:C:2020:806.

<sup>3</sup> *Société de Gestion Industrielle (SGI) v Belgian State* ("*SGI*"), C-311/08, ECLI:EU:C:2010:26. For a detailed analysis of this case, see Tom O'Shea, "ECJ Upholds Belgian Transfer Pricing Regime", 2010 WTD 19-1 and Tom O'Shea, "CFC Reforms in the UK – Some EU Law Comments, ECTJ, 13, (2012-13), 65-89 at p72.

<sup>4</sup> *Hornbach-Baumarkt-AG v Finanzamt Landau* ("*Hornbach*"), C-382/16, ECLI:EU:C:2018:366. For analysis of this case, see Tom O'Shea, "CJEU Allows Non-Arm's-Length Transactions if Supported by Commercial Justification", Tax Notes International, July 16, 2018, 243-248 and Tom O'Shea, "A Critical Analysis of the Advocate General's Opinion in *Hornbach-Baumarkt*", Tax Notes International, July 23, 2018, 373-383.

had been repaid by April 2014. Under Romanian law, the branch was treated as a “Romanian person”. Consequently, the tax authorities submitted that Romanian transfer pricing rules applied to the loans in question and a market rate of interest should have been charged.

The branch complained that this treatment was contrary to the freedom of establishment and the free movement of capital because these transfer pricing rules did not apply when a Romanian branch entered into a similar loan agreement with a Romanian company. Accordingly, the matter was appealed to the regional court which decided to refer the matter for a preliminary ruling to the Court of Justice.

### **Purpose of the Romanian Transfer Pricing Rules**

The Court noted that the purpose of the Romanian transfer pricing rules was to allow the Romanian authorities to correct the taxable amount in transfer pricing situations. This prevented resident companies from providing goods or services to non-resident companies at an undervalue or free of charge, thus reducing the tax base in Romania. The Court accepted that the legislation at issue affected payments made by a Romanian branch to its head office established in another Member State. Accordingly, the Court pointed out that such rules had to be examined in the light of the freedom of establishment only.

### **Restriction on the Freedom of Establishment**

In paragraph 23 of *Impresa Pizzarotti*, the Court highlighted that –

“Acceptance of the proposition that the Member State in which a resident branch is established may freely apply different treatment merely by reason of the fact that the registered office of the parent company is situated in another Member State would deprive Article 49 TFEU of all meaning”.

The Court accepted, in paragraph 26, that –

“a branch of a non-resident company such as *Impresa Pizzarotti* enjoys less favourable treatment than that enjoyed by a branch of a resident company carrying out similar transactions with its parent company”.

The Court concluded that such a difference in tax treatment constituted a restriction on the freedom of establishment. The Court explained, in paragraph 27, that –

“The parent company might thereby be deterred from acquiring, creating or maintaining a branch in a Member State other than its Member State of residence because of the tax burden imposed, in a cross-border situation, on transactions entered into on non-arm’s-length terms”.

## **Justification**

The Romanian authorities argued that the transfer pricing legislation at issue was justified by the need to ensure the balanced allocation of taxing rights between the Member States. The Court acknowledged, in paragraph 29, that –

“the rules on transfer pricing laid down in the Tax Code are intended to prevent the taxable amount in the State of residence of a non-resident company’s permanent establishment from being reduced on account of transactions carried out by that permanent establishment with its parent company which are not in line with market conditions”.

Accordingly, the Court accepted, in paragraph 30, that the need to ensure the balanced allocation of taxing rights between the Member States could justify the restriction at issue where –

“the system in question is designed to prevent conduct liable to jeopardise the right of a Member State to exercise its power to tax in relation to activities carried out in its territory”.

The Court explained, in paragraph 32, that –

“to permit the branches of non-resident companies to transfer their profits in the form of unusual or gratuitous advantages to their parent companies may well undermine the balanced allocation of the power to tax between Member States. It would be liable to undermine the very system of the allocation of the power to tax between Member States because the Member State of the branch granting unusual or gratuitous advantages would be forced to renounce its right, in its capacity as the State of residence of that permanent establishment, to tax the branch’s income in favour, possibly, of the Member State in which the recipient parent company has its registered office”.

Therefore, the Court held that the Romanian transfer pricing legislation ensured that Romania can exercise the power to tax activities carried out on its territory. Having determined that a potential justification existed for the Romanian rules at issue, the Court, next, had to determine whether the transfer pricing rules at issue were proportionate.

## **Principle of Proportionality**

Finally, the Court investigated whether the Romanian transfer pricing rules went beyond what was necessary to achieve their objectives. The Court noted, in paragraph 36, that –

“national legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents an

artificial arrangement, entered into for tax reasons, is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to maintain the balanced allocation of the power to tax between Member States and to prevent tax avoidance where, first, 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. Second, where the consideration of such elements leads to the conclusion that the transaction in question goes beyond what the companies concerned would have agreed under fully competitive conditions, the corrective tax measure must be confined to the part which exceeds what would have been agreed if the companies did not have a relationship of interdependence”.

Thus, the Court applied its normal proportionality test, which in relation to transfer pricing, comprised a two-part test. First, the taxpayer had to be given an opportunity to provide evidence of commercial justification in situations where the transactions in question did not meet the arm’s length principle (the amount that companies “would have agreed under fully competitive conditions”). Second, any extra tax charged had to be limited to the part which exceeded the arm’s length amount (the amount which “would have been agreed if the companies did not have a relationship of interdependence”).

### **The Court’s Conclusion**

The Court concluded, in paragraph 37, that –

“the income adjustment ... concerns only the difference between the market price of the transaction at issue, which would have been charged under fully competitive conditions, and the price actually applied by the parties. Similarly, it would always be open to the taxpayer to demonstrate that there were objective reasons for concluding the transaction at a price which did not reflect the market price”.

Accordingly, subject to verification by the national court, the Court held that the Romanian transfer pricing rules did not go beyond what was necessary to achieve the objectives of the national legislation. Therefore, the Romanian rules did not breach the freedom of establishment.

## Part II

### Analysis

The *Impresa Pizzarotti* judgment adds little to the Court's existing jurisprudence on transfer pricing, since it follows the approach adopted by the Court in 2010, in the *SGI* case. The purpose of transfer pricing legislation is to ensure that transactions involving cross-border situations are carried out in line with full market conditions unless the taxpayer can show objective reasons for concluding the transaction at a price which did not reflect the market price. This was also in line with the Court's more recent decision in *Hornbach-Baumarkt*. Accordingly, Member States may maintain transfer pricing rules that apply in purely cross-border situations without having to introduce similar transfer pricing rules to cover purely domestic situations. Although such rules constitute a restriction on the freedom of establishment, they are justified by the need to ensure that the balanced allocation of taxing rights between the Member States is preserved.

### National Treatment

The *Impresa Pizzarotti* judgment is another example of the national treatment principle<sup>5</sup> being applied by the Court in a host State environment. The Italian company established its permanent establishment (or branch) in Romania. In doing so, the Italian company exercised its freedom of establishment in Romania, the host Member State. The Court applied its *Avoir Fiscal*<sup>6</sup> reasoning, in paragraph 23, where it stated that –

“Freedom of establishment thus seeks to guarantee the benefit of national treatment in the branch's host Member State, by prohibiting any discrimination, even minimal, based on the place in which companies have their seat”.

### Justification

Since transfer pricing rules operate in a cross-border setting only, generally speaking, they constitute a restriction on the freedom of establishment, as in *Impresa Pizzarotti*. The need to ensure the balanced allocation of taxing rights between the Member States is a primary excuse offered as a general interest justification for such rules: Member States maintain transfer pricing rules to prevent conduct liable to jeopardise the right of a Member State to exercise its power to tax economic activities carried out on its territory.

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<sup>5</sup> For a full discussion of the national treatment principle, see Tom O'Shea, *Understanding EU Tax 2020* (ISBN 978-09559164-6-5).

<sup>6</sup> *Commission v France* (“*Avoir Fiscal*”), Case 270/83, ECLI:EU:C:1986:37.

In the *Impresa Pizzarotti* case, the Court accepted that the balanced allocation of taxing rights between the Member States could be undermined by the conduct of the taxpayer in question, since the granting of gratuitous loans by the Romanian permanent establishment to its head office, located in Italy, reduced that permanent establishment's taxable income in Romania. The Court explained that the Romanian transfer pricing rules prevented this from happening because they allowed the tax authorities to adjust the taxable income of the permanent establishment in accordance with market conditions. This allowed Romania to exercise its powers to tax activities carried out on its territory. As such, the Romanian rules were justified, subject to compliance with the principle of proportionality.

## Proportionality

It is clear from *SGL*, *Hornbach-Baumarkt* and *Impresa Pizzarotti* that the principle of proportionality plays a key role in determining the outcome of these cases. The Member States can maintain transfer pricing rules but they must limit those rules to taxing the difference between the market price of the transaction (which would have been charged under fully competitive conditions - "arm's length amount") and the price actually applied by the parties. Secondly, the taxpayer must be given an opportunity to provide evidence of commercial justification for its transaction in situations where the arm's length amount is breached. If the taxpayer is successful in providing evidence of the commercial justification for its transaction, even though the market price is different to what it should be, the transfer pricing rules are applicable no longer to that transaction, because the principle of proportionality would be breached if they were applied in such a case.

The Court's proportionality tests are set out in *Impresa Pizzarotti*, paragraph 36. The same tests are applied in paragraphs 71 and 72 of *SGL*. Indeed, the same proportionality test is applied by the Court in *Thin Cap GLO*,<sup>7</sup> paragraphs 82 and 83, in relation to the United Kingdom's thin capitalisation legislation which was challenged in that case. Similar proportionality tests were applied in *Cadbury Schweppes*<sup>8</sup> in relation to the United Kingdom's controlled foreign company (CFC) regime.

In my 2012 article *CFC Reforms in the UK – Some EU Law Comments*, noted above, I pointed out that the Court's emphasis, in relation to CFC, thin cap and transfer

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<sup>7</sup> *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* ("*Thin Cap GLO*"), C-524/04, ECLI:EU:C:2007:161. For prior analysis, see Tom O'Shea, "CFC Reforms in the UK – Some EU Law Comments", ECTJ, 13, (2012-13), 65-89 at p71 et seq.

<sup>8</sup> See *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* ("*Cadbury Schweppes*"), C-196/04, ECLI:EU:C:2006:544, paragraphs 65-74. For a comprehensive analysis, see Tom O'Shea, "The UK's CFC rules and the freedom of establishment: Cadbury Schweppes plc and its IFSC subsidiaries – tax avoidance or tax mitigation?" ECT Rev. 2007, 1, 13-33.

pricing rules, is on the national anti-abuse legislation. If these anti-avoidance rules apply only in a cross-border context, they may constitute a restriction on a fundamental freedom as seen in *Cadbury Schweppes*, *Thin Cap GLO*, *SGI*, *Hornbach* and *Impresa Pizzarotti*. However, such rules may be justified by the need to preserve the balanced allocation of taxing rights between the Member States, provided that they comply with the principle of proportionality.<sup>9</sup>

## **Final thoughts**

Usually, a branch or a permanent establishment is merely a part of a company and is not, as such, a resident of the host Member State. In *Impresa Pizzarotti*, the Romanian rules treated the branch of the Italian company as a Romanian “person” for tax purposes. Thus, the Court’s references to the State of residence of that permanent establishment (such as paragraph 32) must be understood in that context.

The Court’s understanding of the arm’s length principle amounts to “in accordance with market conditions” (paragraphs 29 and 33), “fully competitive conditions” (paragraph 37) or “the market price” (paragraph 37). Although the Court makes no reference to “arm’s length principle”, it is obvious that this is what it is referring to in these paragraphs. The Court’s approach is similar to that which it adopted in the *SGI* case, paragraph 72 (“what the companies would have agreed under fully competitive conditions”).

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<sup>9</sup> For a recent, comprehensive discussion on abuse of EU law, see Tom O’Shea, “European Tax Controversies: Abuse of Law – a Response to Professor Schön”, ECTJ, 19, July 2020, 11-150.