EU Direct Tax Newsalert

CJEU rules on the application of the fundamental freedoms to transfer pricing adjustments on permanent establishments

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On 8 October 2020, in the *Impresa Pizzarotti* case (Case C-558/19), the Court of Justice of the European Union (CJEU) confirmed that the legislation that provides for transfer rules allowing pricing adjustments for notional transactions carried out between a branch from a Member State and its parent company from another Member State is not necessarily incompatible with the fundamental freedoms, even if the rule does not apply in domestic situation, i.e. when both the branch and the parent company are resident within the same Member State.

Background and facts

Impresa Pizzarotti, the Romanian branch of SC Impresa Pizzarotti & C S.p.A. ('Pizzarotti Italia'), established in Italy, granted two loans to its Italian parent company. The loans were active between 2011 and 2014.

The two loans did not carry any interest on the loans granted.

During 2016 – 2017, the audit unit of the local tax office performed an inspection and assessed a transfer pricing adjustment on the Romanian Branch, which became liable to tax on the interest revenue for the two loans as a result of the local transfer pricing legislation requiring that branches of non-resident companies to be treated under the separate entity approach and to perform notional transactions at market price.

Impresa Pizzarotti subsequently brought an action before the national courts in Romania that the transfer pricing was unfounded. The national courts decided to stay the proceedings and to refer the following question to the CJEU for a preliminary ruling on the following question:

- Do fundamental freedoms within the EU preclude the application of the transfer pricing legislation to transfers of money between branches in one Member State and their parent company from another Member States, when this does not apply to branches and parent companies when both are resident within the same Member State?

CJEU's Judgment

The CJEU ruled the following:

- The merits of the case have to be judged based on the freedom of establishment, enshrined in Article 49 TFEU, and not on the freedom of capital (Article 63 TFEU), even if it were to be accepted that the tax regime at issue in the main proceedings has restrictive effects on the free movement of capital. The legislation does provide for a difference of treatment between cross-border situation (subject to transfer pricing rules) and domestic situation (not subject to the said rule), leading to a restriction to the freedom of establishment.

- The restriction at issue in the main proceedings is justified by the need to ensure the balanced allocation of the power to tax between Member States, which constitutes an overriding reason in the public interest.

- The CJEU also assessed whether the legislation at issue does not go beyond what is necessary to attain the objective pursued. As the legislation allows taxpayer, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction and as it appears (but would have to be confirmed by the domestic court) only the part exceeding what would have been agreed under fully competitive conditions is subject to a reassessment, the restriction is proportionate to the goal pursued and therefore compatible with EU law.

Takeaway

The CJEU Judgment confirms the approach already taken by the CJEU in the *SGI* (C-311/08) and *Hornbach-Baumarkt* (C-382/16) cases and confirms that, subject to the proportionality assessment, transfer pricing rules are not necessarily incompatible with EU law.