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After CJEU now EFTA Court too embraces arm's-length standard as a beacon; what's next?

Maarten de Wilde (Erasmus School of Law, PwC) and Ciska Wisman (affiliated with the University of Amsterdam (UoA), Amsterdam, the Netherlands, and EY, Rotterdam, the Netherlands) · Friday, June 10th, 2022

Summary

The Court of the European Free Trade Association – the EFTA equivalent of the CJEU – now also is demarcating the room for manoeuvre for the Member States in company tax matters within the scope of the EEA Treaty freedoms by reference to the arm's-length standard. The EFTA Court does so in the same way as the Court of Justice EU did in relation to the EU treaty freedoms last year in the Lexel case. Consequences may be far-reaching for the Member States' room for manoeuvre in cases involving a unilaterally addressing of corporate tax avoidance.

1 Introduction

In its judgment of 1 June 2022 in the *PRA Group Europe AS* case, the EFTA Court embraced and interpretatively adhered to the CJEU's approach in *Lexel*.[1] The EFTA Court assessed a restrictive Norwegian national anti-tax abuse mechanism against the proportionality requirement in EEA Treaty law by reference to the at arm's length standard, thereby creating a transfer pricing safe harbour in EEA law in the same way as the CJEU did in *Lexel* a year and a half ago.[2] Now we have judgments of both European courts involving the interpretation of EU law and EEA law in which 'at arm's length' is used as a benchmark criterion for interpreting and defining EU law and EEA law doctrines of abuse of law in the field of business income taxation. Although we still feel some caution as we felt immediately after the CJEU ruling in *Lexel* last year, we also believe that this development in European tax jurisprudence cannot be ignored. This holds even if this development, indeed, could have some potentially far-reaching consequences for the Member States' room for manoeuvre when it comes to effectively addressing company tax avoidance on a unilateral basis. In this contribution we will discuss the developments in some detail.

2 Room for manoeuvre

What room for manoeuvre do the Member States of the European Union (EU) and the Member States of the European Economic Area (EEA) have to unilaterally combat tax avoidance in the company tax area by reference to the doctrines of abuse of EU law and abuse of EEA law? What room for manoeuvre do economic operators within the EU and the EEA have when it comes to any exercising of their rights of free movement in a tax-induced manner? It is established case law of the CJEU and EFTA courts that a restrictive national anti-tax avoidance measure may be justified

under EU/EEA law in the case of an addressing of an abuse of law. However, this only applies if the measure at hand is suitable (economically effective) and, moreover, proportionate (economically efficient). Within the scope of operation of EU law, Member States both have a legal right as well as a legal obligation under primary EU law to combat any abuses of EU law. Member States accordingly have a duty and responsibility to liberalise the internal market without internal frontiers, and thereby to secure the absence of any hindrances unilaterally imposed, however save for any cases of abuse. Economic operators have a fundamental right under EU law to make any unhindered use of the liberalised internal market without internal borders, however, save for any cases of abuse, for instance in the form of any aggressive tax planning arrangements.

Market liberalisation, therefore, indeed, and except for cases of tax abuse – a tax-induced arranging of business affairs that is, lacking any underlying economic foundation except for tax cost saving objectives – which may and must be combated. The same applies to the Member States of the European Free Trade Association (EFTA) that fall within the scope of operation of EEA law (Norway, Iceland Liechtenstein) as regards the pursuit of a 'homogeneous European Economic Area' and the establishment in this context of a single market on the basis of the fundamental freedoms of movement as interpreted and guaranteed in compliance with the EU's acquis by the Court of the European Free Trade Association (EFTA Court), the EFTA equivalent that is of the Court of Justice of the European Union (CJEU).[3]

3 Arm's length as a beacon?

The EFTA Court, now too, is demarcating the room for the Member State's discretion within the scope of the EEA Treaty freedoms in company tax matters by reference to the arm's-length standard. The Court does so in the same way as the Court of Justice EU did in relation to the EU treaty freedoms last year in the *Lexel* case. A further reasoning along the CJEU's argumentative lines in *Lexel*, and now also those of the EFTA Court's, leads to a drawing of the necessary conclusion that any national de jure or de facto restrictive tax measures within the EU/EEA cannot be admitted under the justification ground of addressing tax abuse, if and to the extent that any arm's length company tax base components are being affected (i.e., a transfer pricing safe harbour).[4]

In doing so, now also the EFTA Court is firmly putting the anti-abuse and anti-mismatch instrumentation of the Member States into the wind.[5] Namely, the courts' observations cast a shadow of potential EU/EEA law incompatibility over all restrictive anti-abuse provisions and anti-mismatch provisions in scope of EU/EEA law that extend their operation beyond the operation of the arm's length principle, as did the Swedish interest limitation rule at hand in Lexel and as did the Norwegian EBITDA-rules in conjunction with the group contribution rules at hand in *PRA Group Europe AS*. In the authors' home country, the Netherlands, as an example, this basically holds for all provisions to that end that have been put in place by the Dutch tax legislator in the legislative acts consecutively after the taxable profit provision in Article 3.8 of the Dutch Individual Income Tax Act 2001 and Article 8 of the Dutch Corporate Income Tax Act 1969. That is, as the taxable profit concept in Netherlands business taxation ('totaalwinst' in Dutch) embodies the at arm's length principle, establishing that any (non-)payments or (non-)receipts that do not originate from the business operations carried but should be considered having non-businesslike motives and are hence excluded from the tax base (i.e., save for the application of the per 1 January 2022 newly introduced anti-transfer-pricing mismatch rules in the Dutch company tax legislation). Under established Dutch business income tax doctrines any advantages or disadvantages that originate from affiliation – and hence are not undertaken on an at arm's length basis – are

considered non-businesslike and accordingly do not affect corporate profit for tax base determination purposes. This would mean that any restrictive provision that go beyond arm's length pricing as an integral part of the taxable profit concept would potentially fall foul under the internal market's fundamental freedoms. The EFTA court's observations in *PRA Group Europe AS* and their implications may be far-reaching, indeed, as were those of the CJEU in *Lexel*. Undesirable, indeed. But that doesn't make it any less valid.

4 EFTA Court in PRA: arm's length as a beacon, just like CJEU in Lexel

The EFTA Court delivered its judgment in the *PRA Group Europe AS* case some days ago, on 1 June 2022.[6] The case concerned the question as to its compatibility with the freedom of establishment under primary EEA law of the conjunct operation of the Norwegian group-contribution rules and the BEPS Action 4 akin earnings-stripping rules.[7] The EFTA Court recognised an obstacle in the Norwegian tax legislation at hand – as the base broadening rules in their conjunct operation basically bite harder cross border than domestically and hence operate restrictively to market operators that expand their business activities in the single market across the internal frontiers – and assessed whether such a restrictive tax-treatment can be justified by reference to any anti-tax abuse objectives or aims pursued to that end by the country involved. More generally, it should be noted here that, according to consistent case law of the EFTA Court, the prohibition of abuse of law constitutes an essential characteristic of primary EEA law, as is the case in primary EU law.[8] The EFTA Court also and consistently linked up with the case-law of the CJEU for its interpretation of EEA law in this regard.[9]

Much of the EEA law pain in *PRA Group Europe AS* lies in the absence of any counter-evidence eligibility for taxpayers under the Norwegian tax legislation. Although we have seen the problem of such an approach in the case law of the CJEU as well, in *Deister/Juhler* for example,[10] this is not the most important point at issue in this case. Of a particular relevance here is that the EFTA Court considered that primary EEA law as it currently stands requires that any taxpayers involved should not only be able to provide evidence to the contrary, but – and this is the notable element of importance in the case at hand – that this means that these taxpayers should be allowed to demonstrate that the related transactions in question are genuine and on arm's length terms.[11] In doing so, the EFTA Court placed a decisive emphasis on the arm's-length conditions of the inter-affiliate transactions engaged in. According to the EFTA Court, in order to justify on the basis of EEA law a restrictive interest deduction limitation under domestic tax law for anti-abuse reasons, such a domestic measure must focus on 'the proportion of interest which exceeds what would have been agreed had the relationship between the parties been one at arm's length'.[12] This means that the Norwegian interest deduction limitation measure falls foul under primary EEA law and will need to be abolished to the extent that it hits arm's length interest payments that would not have been affected in a comparable domestic situation (or, alternatively, the Norwegian tax system could move in the opposite direction by introducing an equivalent cap on interest deductibility in purely domestic scenarios).

5 CJEU in Lexel: arm's length as a beacon

In substantiation to and in support of its considerations, the EFTA Court referred in detail to the observations that the CJEU delivered in its ruling in the *Lexel* case on 20 January 2021.[13] In *Lexel*, the CJEU considered that any inter-affiliated transactions that adhere to market-based conditions – i.e., any such transactions that are at arm's length – are not entirely artificial, so that in such cases there can be no question of abuse of law, and so that in such cases any restrictive

domestic anti-tax abuse provision accordingly cannot be justified by reference to any anti-tax abuse considerations. The CJEU considered that it follows from EU law that (even) in the event of a lack of a commercial justification for a (legal) structure entered into, the proportionality requirement under EU law requires that a deduction limitation measure in such cases only covers the part of the interest payments that are not to be considered ‘at arm’s length’.[14]

Although the CJEU’s considerations in *Lexel*, accordingly establishing a transfer-pricing safe harbour for primary EU law purposes, leave little to the imagination, the *Lexel* judgment has been received in practice with some despair. That is not surprising, and also almost a battle even between the head and the heart, since we very well know and if honest also feel that the arm’s length standard by no means actually is enough to effectively address any tax avoidance activities by multinational firms, and any incentives or nudges created for that purpose by some countries for that matter. There is a reason why the 2015 BEPS Initiative has some more action points than only just those involving a functions-oriented transfer pricing paradigm. In fact, in a more legal philosophical sense, this says something about the foundational correctness, or not, of the arm’s length standard as a company tax base division concept. Whatever the case may be, all this does not alter the reality that the text of the CJEU judgment is pretty clear-cut, and so is the wording used by the EFTA court: arm’s length and tax-abuse cancel each other out; and the only ones institutionally positioned and thereby able to change this reality are the CJEU and EFTA Court themselves.

6 Spillovers

The operation of the EU law’s abuse of law doctrine in the field of direct taxation does not only affect the sub-area of company income taxation. The doctrine is also equivalently applied in the withholding tax area, and (at least potentially) also in the context of the operation of the Member States’ double tax treaty networks. The lines and observations set out in *Lexel* (TP-based-functional-analysis-substance-based safe harbour) creates some tensions in relation to and in interaction with other lines of reasoning adopted by the CJEU in some other subareas of tax law such as those in the *Danish Cases* involving source taxation and the addressing of any treaty shopping arrangements in that regard (no TP-based-functional-analysis-substance-based safe harbour).[15] The same holds when it comes to any influence and impact of the CJEU’s observations in *Lexel* on the interpretation of any anti-abuse provisions and mechanisms – the general anti abuse rules; GAARs, that is) in existing and developing secondary EU law (from the Parent-Subsidiary Directive and the Anti-Avoidance Directive (ATAD) to the pending Pillar 2 and Unshell Directive proposals). One may also think of the impact of *Lexel* on anti-tax abuse approaches in the domestic case law of the EU/EEA Member States, for example in relation to any interpretation – possibly in EU law conformity – of any domestic anti-abuse doctrines such as fraus legis and/or fraus tractatus. Worthy of mentioning in this regard, too, are any potential interactions with developments we see in the field of EU State Aid law in relation to anti-tax abuse approaches, for instance considering the observations of the General Court in the *Engie* case submitting that EU State Aid law too requires the Member States to address tax abuse.[16] We will not go into any detailed or substantive analyses at this place and limit ourselves to the observation that by the creation of a TP safe harbour similar to what the CJEU did in *Lexel* the EFTA Court’s judgment in *PRA Group Europe AS* now put some additional pressure on all these aspects.

7 Closing remarks

So, what’s next? The EFTA Court embraced and endorsed *Lexel*, that much is clear. According to

the EFTA Court too, any third party market-based conditions that adhere to the arm's length standard do not appear to constitute an abuse of EEA law. This raises questions. What does this mean for the Member States' anti-abuse and anti-mismatch instrumentation to the extent that these operate beyond the arm's length standard? We think that after this judgment it will become more complicated for the Member States of the EU and EEA to uphold the operation of any unilaterally imposed (de facto) restrictive anti-abuse and mismatch-elimination measures beyond arm's length, or any such measures beyond a tax base division under a functional analysis for that matter. This especially holds if and insofar as these measures are not based on an obligation to implement an EU Directive such as the Anti-Tax Avoidance Directive.

Developments are also adding pressure to the highest national courts of the EU Member States to refer questions for a preliminary ruling on the functioning and interpretation of the doctrine of abuse under EU/EEA law in relation to the operation of anti-tax avoidance mechanisms in cases where the transfer pricing nevertheless is at arm's length. We think a lot can be said about the EU's abuse of law doctrine, but we do not think that the interpretation of EU law in this area is so evidently clear that there can reasonably be no room for any doubt here (acte claire/acte éclairé). The CJEU's CILFIT-doctrine then requires the highest courts of the Member States to refer questions for a preliminary ruling.[17] It seems that after the CJEU now the EFTA Court too, cast a stone in the pond. More clarity seems desirable. The CJEU has the floor.

Maarten de Wilde is affiliated with the Erasmus School of Law (ESL) of Erasmus University Rotterdam, the Netherlands, and PwC, Rotterdam, the

Netherlands. The author can be contacted at dewilde@law.eur.nl.

Ciska Wisman is affiliated with the University of Amsterdam (UoA), Amsterdam, the Netherlands, and EY, Rotterdam, the Netherlands. The author can be contacted at c.wisman@uva.nl.

[1] See EFTA Court, 1 June 2022, Case E-3/21, (PRA Group Europe AS), available on https://eftacourt.int/wp-content/uploads/2022/05/3_21_Judgment_EN.pdf.

[2] *See* CJEU, 20 January 2021, Case C-484/19 (*Lexel AB*).

[3] *See* Article 1 EEA Agreement.

[4] *See* for a comparison CFE ECJ Task Force: Opinion Statement ECJ-TF 1/2021 on the ECJ Decision of 20 January 2021 in Lexel AB (Case C-484/19) Concerning the Application of the Swedish Interest Deductibility Rules.

[5] *See* for some overviews and analyses on the combating of tax-abuse in corporate income taxation and withholding taxation in a more general sense in countries Ana Paula Dourado (Ed.), *Tax Avoidance Revisited in the EU BEPS Context*, EATLP International Tax Series (Vol. 15), IBFD, 2016, Amsterdam, the Netherlands, and for an overview of efforts undertaken in this regard in relation to the Netherlands company tax system see Chapter 19 of the book authored by M.F. de Wilde and C. Wisman.

[6] *See* EFTA Court in *PRA Group Europe AS*, *supra note* 1.

[7] *See* Articles 31 and 34 EEA Agreement. The European Commission (EC) has expressed its position in the *PRA Group Europe AS* case. The EC said: "A*rticle 31 EEA, read in conjunction*

with Article 34, must be interpreted as not precluding national legislation, such as that at issue in the main proceeding, pursuant to which group contributions from domestic companies increase the interest deduction cap set at 30% of tax EBITDA and thus the entitlement to deduction of interests on debt to affiliated parties, a possibility which, under national tax rules, is not available for investments by or in EEA companies.", see Report For The Hearing in Case E-3/21, E 3/21-17, p. 10, section 28, as provided on 16 September 2021. We do not have the underlying analysis of the EC. However, we note that secondary EU law provides for a comparable limitation on interest deductions. See Article 4 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (EU ATAD), by which the EU Member States have implemented the outcomes of the OECD's BEPS Action item 4 into their company tax systems in a quasi-harmonised manner; see on this, substantively, OECD (2015), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Norway pointed out in the proceedings that Article 4 EU ATAD (also) does not provide for a counter-evidence scheme for taxpayers. The EFTA Court however did not go into any details in this regard and shortly noted: "[T]his directive has neither been incorporated into the EEA Agreement nor was it in force in the EU at the material time.", see *PRA Group Europe AS*, observation 56. See for a comparison the 'Additional formal notice' in which the EC asks Sweden to comply with the *Lexel*-judgment: INFR(2013)4206 and the Commission's press release *June infringements Package: Key decisions*, Brussels, 9 June 2021.

[8] See EFTA Court, 13 September 2017, Case E-15/16 (*Yara International ASA*), wherein it EFTA Court to that end it next Considering: "*The Court recalls that* EEE *States remain free to enact rules which have the objective of precluding wholly artificial arrangements leading to tax avoidance (see Joined Cases E-3/13 and E-20/13 Olsen and Others [2014] EFTA Ct. Rep. 400, paragraph 166). This is a corollary of the prohibition of abuse of rights, an essential feature of EEA law, which aims, inter alia, at preventing companies established in an EEA State from attempting, under cover of the rights created by the EEA Agreement, to circumvent their national legislation, or improperly or fraudulently take advantage of provisions of EEA law (see Case E-15/11 Arcade Drilling [2012] EFTA Ct. Rep. 676 paragraph 87).*".

[9] The EFTA Court for example refers in *Yara International ASA* to CJEU 12 September 2006, case C-196/04 (*Cadbury Schweppes and Cadbury Schweppes Overseas*) and to CJEU 13 December 2005, Case C-446/03 (*Marks & Spencer*).

[10] See CJEU, 20 December 2017, Case C-504/16 (*Deister Holding company and Juhler Holding company*).

[11] *See* EFTA Court in *PRA Group Europe AS*, *supra note* 1, observations 49-55.

[12] *See* EFTA Court in *PRA Group Europe AS*, *supra note* 1, observation 54.

[13] *See* CJEU in *Lexel, supra note* 2.

[14] *See* CJEU in *Lexel, supra note* 2, observation 51; "Secondly, where the consideration of those elements leads to the conclusion that the transaction in question represents a purely artificial arrangement without any underlying commercial justification, the principle of proportionality requires that the refusal of the right to a deduction should be limited to the proportion of that interest which exceeds what would have been agreed had the relationship between the parties been

one at arm's length (judgment of 13 March 2007, *Test Claimants in the Thin Cap Group Litigation*, C?524/04, EU:C:2007:161, paragraph 83)."

[15] *See* CJEU 26 February 2019, Joined Cases C-115/16 (*N Luxembourg 1*), C-118/16 (*X Denmark*), C-119/16 (*C Danmark I*) and C-299/16 (*Z Denmark*), as well as CJEU 26 February 2019, Joined Cases C-116/16 (*T Danmark*) and C-117/16 (*Y Denmark*).

[16] *See* General Court, Joined Cases T?516/18 and T?525/18 (*Luxembourg and Others ? Commission*). For a strong analysis of this case see Joachim Englisch, 'State Aid Prohibition: The New GAAR in Town', EC Tax Review, Vol. 30, Issue 4 (July 2021), p. 144-149.

[17] *See*, most recently, CJEU, 6 October 2021, Case C-561/19 (*Consorzio Italian Management e Catania Multiservizi and Catania Multiservizi*).

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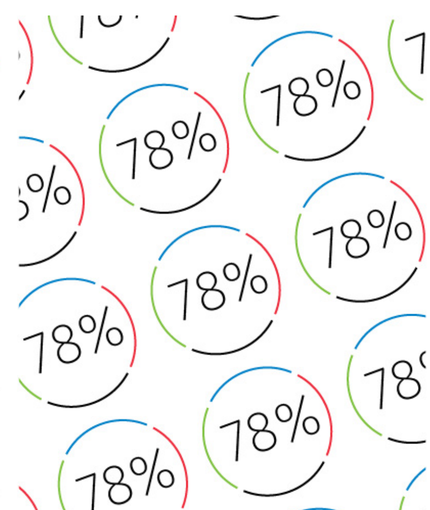

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