

## Transfer Pricing and Community Law: The SGI Case

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*This editorial has been written four days after the European Court of Justice (ECJ) released its judgment in the SGI case.<sup>1</sup> By the time it is published, much may well have been written about that case. However, here are some preliminary observations.*

*Some cases have the potential to become seminal judgments and leading cases: this is perhaps one of those. At issue in the case was that compatibility of cross-border transfer pricing legislation within the European Union (EU) where no similar legislation operated in a domestic context. Had the case been decided the other way, Member States would have had to re-think both their transfer pricing legislation and other cross-border anti-avoidance legislation. Even so, there are important details in the judgment that may have wider ramifications.*

### 1. THE BACKGROUND TO THE JUDGMENT

The background facts are quite straightforward. SGI was a Belgium company that held 65% of the shares in a French company, Recydem SA; SGI was also one of the directors of that company. SGI granted an interest-free loan to Recydem. Thirty-four percent of the shares in SGI were held by a Luxembourg company, Cobelpin SA and Cobelpin was also a director and managing director of SGI. SGI paid Cobelpin over EUR 8,000 per month as director's remuneration, even though the Cobelpin representative on the board of SGI was already a member of that board in his own right.

Following an audit, the Belgium revenue authorities deemed SGI to have received notional interest on the loan to Recydem and adjusted the profits of SGI under Article 26 of the Belgium Income Tax Code. This article permits an adjustment wherein a Belgium company grants an unusual or gratuitous advantage to another company with which it has a relationship of interdependence. Article 26 is limited so that it applies in practice only to advantages granted to a company resident outside of Belgium and not to a company resident in Belgium. In addition, the Belgium revenue authorities disallowed the deduction of the directors' fees paid to Cobelpin under Article 49 of the Code and made an adjustment also under Article 26.

### 2. THE REFERENCE

The court in Mons was uncertain whether Article 26 was compatible with the freedom of establishment and the

free movement of capital and referred that question to the ECJ. The ECJ first determined that it was appropriate to examine this question under the freedom of establishment since Article 26 applied where there was a relationship of interdependence and (certainly with respect to Recydem, wherein SGI had a 65% holding) SGI had substantial influence over the affairs of that company. The Court therefore concluded that it was only necessary to consider the freedom of establishment.

The Court then concluded quite briefly that Article 26 was liable to have a restrictive effect on the exercise of the freedom of establishment, since it might have a tendency to deter companies in Belgium from establishing companies outside of the country. The Belgium and the German governments both argued that the legislation was not liable to infringe the freedom of establishment since there were provisions for a corresponding adjustment to be made in the other country, specifically under the provisions of the Arbitration Convention, which require an adjustment in the other Member State.<sup>2</sup> Interestingly, the Court rejected this argument on several grounds. First, the argument relies upon treating the group of companies as a whole rather than respecting the fact that they are separate taxable persons; an adjustment may still mean different companies paying different amounts of tax. As the Advocate General had pointed out, this was particularly relevant given that there were minority shareholders in the different companies. Secondly, even if an adjustment was possible under the Arbitration Convention, the Belgium company would incur additional administrative and financial burdens in submitting its case through such a procedure, and

#### Notes

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<sup>1</sup> The full name of the case is *Société de Gestion Industrielle SA v. Belgium*, Case-311/08, judgment of 21 Jan. 2010. The Advocate General's opinion (Advocate General Kokott) was released on 10 Sep. 2009.

<sup>2</sup> Convention 90/436/EEC of 23 Jul. 1990 on the elimination of double taxation in connection with the adjustment of associated enterprises.

the procedure might take several years during which it would have suffered an excess tax burden. Thus, despite the provision for binding arbitration to ensure a corresponding adjustment, the Court concluded that the legislation constituted a restriction on the freedom of establishment. This is an interesting recognition of the practical problems of seeking a corresponding adjustment and a reaffirmation that compatibility with EU law should be established for each company and not on a group basis.

### 3. JUSTIFICATION

The Court then moved to discuss whether the legislation could be justified for overriding reasons in the public interest. This issue of justification has become, perhaps, the most significant question in direct tax cases before the ECJ. It is an area where the law is still developing, with the Court elaborating on the scope and meaning on justifications that have been put forward.

The governments concerned sought to justify the legislation on the basis of the need to ensure a balanced allocation of the power to tax between Member States – a justification which was first propounded in the *Marks & Spencer case*<sup>3</sup> – also the need to combat tax avoidance and abusive practices.

The balanced allocation of jurisdiction to tax is a somewhat problematic justification, partly because it is so new. The Court explained the justification as follows:<sup>4</sup>

Such a justification may be accepted, in particular, where the system in question is designed to prevent conduct capable of jeopardising a Member State to exercise its tax jurisdiction in relation to activities carried out in its territory.

This formulation clearly links the balanced allocation with the justification of territoriality<sup>5</sup> and the right of a State to tax income arising within that State. The Court considered that if companies were able to grant unusual and gratuitous advantages to related companies in other territories without the possibility of States making adjustments, then companies could in effect move their taxable profits between one Member State and another. This notion that companies might be free to move their taxable profits from State to State was clearly rejected in the *Oy AA case*<sup>6</sup> and the Court was again concerned in *SGI* to ensure that this could not happen.

On the question of combating tax avoidance, the judgment is possibly a little confusing. On the one hand, the Court repeated its clear jurisprudence that legislative measures targeted at wholly artificial arrangements designed to circumvent the tax legislation of a Member State are justified. On the other hand, following *Marks & Spencer* and *Oy AA*, the Court also considered that the objective of preventing tax avoidance taken together with preserving the balanced allocation of the power to tax could be a justification. The Court could have been a little clearer on this point, but it does appear that the Court is recognizing a difference between combating wholly artificial arrangements (which is a justification by itself) and combating tax avoidance (which is a justification when taken together with the need to preserve the balanced allocation of the power to impose taxes). No doubt this interrelationship will be developed further in future cases.

The interim conclusion of the Court was that the need to maintain the balanced allocation of the power to tax and to prevent tax avoidance, taken together, was a legitimate objective and constituted an overriding reason in the public interests.

### 4. PROPORTIONALITY

That, however, was not the end of the matter. It was still necessary for the Belgium government to show that the legislation did not go beyond what was necessary to attain the objectives pursued. In that context, the Court emphasized first that it was necessary that the legislation should proceed only on the basis of objective and verifiable elements, which could be examined to determine whether a transaction represented an artificial arrangement, and the taxpayer should be given an opportunity (without undue administrative constraints) to provide any evidence of any commercial justification for the transaction. Secondly, if the transaction was to be countered by legislation, the corrective tax measure shall be confined to what was necessary to establish a result that companies would have agreed if acting at arm's length.

In response to this, the Belgium government emphasized that the burden of proof as to the existence of an unusual or gratuitous advantage rested with the national tax authorities, and the taxpayer was given an opportunity to provide evidence of any commercial justification. Also, if the legislation applied, only the unusual or gratuitous part of the advantage was added back to the

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#### Notes

<sup>3</sup> Case C-446/03, [2005] ECR I-10837.

<sup>4</sup> See para. 60 of the judgment.

<sup>5</sup> On which see *Futura Participations v. Singer*, Case C-250/95, [1997] ECR I-2471.

<sup>6</sup> Case C-231/05, [2007] ECR I-6373.

profits. Interestingly, the European Court referred back to the national court the issue of verification of these last two points, since they concerned the interpretation of Belgium law. Only if those points were found to be correct could it be concluded that the Belgium legislation was proportionate.

This may point to a particularly significant implication of the case. In particular, the Belgium government emphasized that the burden lay on their national tax administration to prove that the advantage was unusual or gratuitous. The European Court seemed to consider that the burden of proof was significant as part of the test of proportionality. It may indicate that the European Court will only consider that similar provisions in national legislation are proportionate if the initial burden of proof falls on the revenue authorities. That is not the case, for example, in all Member States (e.g., it is not the case in the United Kingdom), this detail on the burden of proof may end up being one of the particularly significant aspects of the case.

## 5. CONCLUDING COMMENTS

Had it been decided the other way, the *SGI* case would have raised serious issues as to the continued application of transfer pricing legislation and other cross-border anti-avoidance provisions. That might not have been a bad thing. Transfer pricing within Europe might have been limited to wholly abusive transactions designed to circumvent the national tax systems, and an impetus might have been given to Common Consolidated Corporate Tax Base (CCCTB). Clearly the judgment confirms that such cross-border transfer pricing provisions may be justified, even if they operate only cross-border and even if they have a restrictive affect, provided that they secure the balanced allocation of tax jurisdiction and they are necessary for combating tax avoidance. However, this is subject to important considerations of proportionality in the practical operation of the legislation. In that respect, *SGI* may prove to be a particularly significant case for the future development of EU tax law.