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CJEU decision in the Hornbach Baumarkt case on German transfer pricing adjustment provisions

Freedom of Establishment -Transfer Pricing - Arm's Length Principle - Income Adjustment Provisions - Comparability - Balanced Allocation of Powers to Tax

On May 31, 2018, the Court of Justice of the European Union (CJEU) rendered its decision in the Hornbach Baumarkt case (C 328/16). The case deals with German legislation, according to which the income of a German taxpayer resulting from its business relationships with non-resident related companies is adjusted, as far as the relationships are not in line with the arm's length principle, whereas such adjustment is not made in the case of business relationships between German related companies. In line with the Advocate General's Opinion in the case at hand (see ETF 347), the Court decided that the German rules in question are not, in principle, contrary to the freedom of establishment.

Background

The case concerns a German parent company that issued comfort letters providing financial guarantees to external creditors and banks, in respect of loans granted to two wholly-owned Dutch subsidiaries. The parent company did not charge a fee for these comfort letters. Referring to section 1, paragraph 1 of the German Foreign Tax Act, the German tax authorities concluded that, due to the associated liability risk, unrelated parties would have agreed to remunerate the provider of the comfort letters, and consequently increased the parent company's income to an amount equal to the notional liability remuneration.

The taxpayer challenged the tax assessments, arguing that the German rule contradicts the freedom of establishment, as the income adjustment is only made in the case of cross-border business relationships. In a purely domestic situation and under otherwise identical conditions, no upward adjustment would have been made at the level of the parent company. Relying on the CJEU decision in the SGI case (C-311/08), the taxpayer further argued that this difference in treatment is liable to deter German parent companies from establishing subsidiaries in other

Member States, and therefore constitutes a restriction of the freedom of establishment. Lastly, it noted that the German legislation is not proportionate as it excludes any possibility of putting forward commercial justifications for transactions that are not at arm's length.

The CJEU decision

The Court first examined the application of the freedom of establishment to the case at hand. Referring to settled case law in that area, the Court stated that the German rules in question cover situations where a resident taxpayer is able to exert a definite influence on a company established in another Member State. As a consequence, the German legislation must be examined in the light of the freedom of establishment.

The Court further observed that a German parent company with a Dutch subsidiary is, in the circumstances at hand, treated less favorably than if it had a German subsidiary, as no income adjustment would have been made in this case. As such a difference in treatment is liable to constitute a restriction of the freedom of establishment, it must be further assessed if it relates to situations which are objectively comparable or if it can be justified by overriding reasons in the public interest.

Examining possible justifications, the Court followed the argumentation put forward by the German and the Swedish governments that the arm's length principle ensures that Germany exercises its tax jurisdiction as regards activities performed within its territory and therefore preserves the balanced allocation of the power to tax between Germany and the Netherlands. As the German legislation at issue seeks to prevent profits generated in Germany from being transferred to another Member State without being taxed, the Court concluded that it is appropriate for ensuring the preservation of the allocation of powers to tax between Member States.

The Court then assessed whether the German legislation goes beyond what is necessary to achieve the objective pursued. Referring to settled case law, the Court noted that the German legislation may be proportionate to the extent that the taxpayer was given the opportunity to provide commercial justification for agreeing to terms that are not at arm's length. Although it is for the referring court to decide whether or not this is the case, the Court considered that there may be commercial reasons for a parent company agreeing to provide capital on terms that are different from market conditions. In particular, the gratuitous granting of comfort letters could be explained by the parent company's economic interest in the continuation and expansion of the foreign subsidiaries' business operations.

The Court therefore concluded that the German rules do not go beyond what is necessary to achieve the objective pursued, provided that the taxpayer is given the opportunity to prove that the terms of the transaction at hand were agreed for commercial reasons.

EU Tax Centre Comment

The CJEU decision sheds some light on the compatibility with EU law of national rules allowing for the adjustment of income from transactions between related parties, based on the arm's length principle. In particular, the Court provides some clarity on possible commercial justification of a transaction which differs from market conditions, also having consideration for the economic interests of the group as a whole in the financial success of its foreign

subsidiaries. It will be interesting to see whether and how the German referring court will take this into account in its decision.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre or, as appropriate, your local KPMG tax advisor.

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