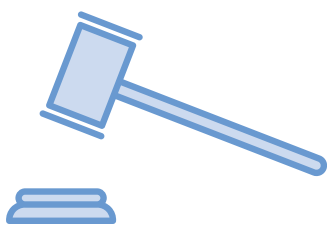


SECTION 1j GERMAN FOREIGN TAX ACT (AStG) – ECJ DECISION ON TRANSFER PRICE CORRECTIONS

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“SEC. 1 GERMAN FOREIGN TAX ACT (AStG) ONLY PARTIALLY COMPLIANT WITH EU LAW”



In its ruling dated 31 May 2018, the ECJ adopted a position on the admissibility under EU law of transfer price corrections in accordance with Sec. 1 AStG. The Court ruled that economic reasons may justify a departure from the arm's length principle. From the point of view of taxpayers, this offers new opportunities to challenge transfer price corrections by the tax authorities.

BACKGROUND

The plaintiff was Hornbach-Baumarkt AG, which operates hardware stores both in Germany and in other EU countries. In 2003, it held an indirect 100% interest in two Dutch corporations which were dependent on bank loans for the continuation of their business operations and for the intended construction of a hardware and garden store. Due to negative equity, the financing bank made the granting of the loans dependent on the provision of guarantees and letters of comfort by the plaintiff.

In the letters of comfort, the plaintiff undertook, among other things, to keep the foreign group companies financially equip-

ped in such a way that they would be able to meet all their liabilities and, if necessary, to provide the companies with the financial means necessary to meet their liabilities. The German tax authority then increased the plaintiff's income pursuant to sec. 1 (1) and (3) AStG (old version) on the grounds that independent third parties would have agreed to a liability remuneration under the same or similar circumstances.

After unsuccessful opposition proceedings, an action was filed against this. The Fiscal Court of Rhineland-Palatinate (decision of 28.6.2016, 1 K 1472/13) recognized the necessity of an income correction according to sec. 1 AStG, but had doubts as to the compatibility of this correction with the freedom of

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establishment. In particular, the Fiscal Court considered it necessary to clarify whether the income correction pursuant to sec. 1 AStG satisfies the requirements of EU law regarding the possibility of submitting economic reasons for the deviation of a business relationship established between related parties from the arm's length principle.

ECJ DECISION

Due to the exclusive applicability of sec. 1 AStG in foreign matters, it constitutes a restriction on freedom of establishment. However, that restriction of the fundamental freedom could in principle be justified by the need to maintain a balanced division of taxation powers between Member States. The balanced sharing of taxation powers between Member States could be affected if resident companies were allowed to transfer their profits to related companies established in other Member States in the form of exceptional or gratuitous benefits. This also applies to the relevant provision of sec. 1 AStG in the event of a dispute, which is suitable for ensuring that the division of tax sovereignty between the Member States is maintained by creating a situation corresponding to market conditions.

However, for such a national regulation to comply with EU law, it must also be proportionate. This would require the taxpayer, without subjecting them to excessive administrative constraints, to be given the opportunity to provide evidence of any economic reasons for the conclusion of that transaction. In this regard, according to the ECJ, the provision of capital by a parent company under conditions that are not customary for third parties could be justified if the subsidiary is dependent on the injection of capital because it has negative equity. The fact that guarantees and letters of comfort are issued free of charge can be explained by the plaintiff's economic self-interest in the success of the Group companies and by a certain responsibility of the plaintiff as shareholder in the financing of the foreign companies. It was the task of the national court to examine whether German law allowed the submission of such grounds.

PRACTICAL NOTE



Transfer prices are becoming increasingly important from a tax point of view in the context of cross-border business activities. In addition to the regulations on hidden distribution of profits and hidden capital contributions (sec. 8 (3) sentence 2 f. of the German Corporation Tax Act (KStG)), which can also be applied in the context of domestic matters – and are therefore unproblematic from the point of view of EU law – the legal basis is, in particular, the income correction standard in sec. 1 AStG. The latter only concerns cross-border situations, which is why an interference with fundamental freedoms is clear. While the ECJ, in an earlier decision (ECJ, dated 21.1.2010, C-311/08, SGI), considered a comparable income correction standard under Belgian law compatible with Union law, the decision of 31 May 2018 further developed the case law in an extremely significant way!

The Court explicitly states the possibility of, on the basis of economic reasons, negotiating conditions between related parties which do not correspond with the arm's length principle. In contrast to the German Federal Fiscal Court (decision dated 25.6.2014, I R 88/12), according to which sec. 1 AStG merely opens up the possibility of submitting arguments proving compliance with the arm's length principle even under special circumstances (e.g. non-interest-bearing loans), the European Court of Justice takes a significant step further: It restricts the need for a balanced distribution of taxation powers between the Member States in favor of the so-called motive test. As a result, it is possible to deviate from the arm's length principle in some EU cases.

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For taxpayers, this means that income corrections made by the tax authorities can be challenged if there are economic justifications. This applies equally to outstanding notices as well as to future circumstances. In particular, an economic reason may be a self-interest in the maintenance of the business operations of a foreign subsidiary if it is experiencing economic difficulties. The appeal of this judgement lies in the fact that the ECJ, in recognizing that reasons based on the shareholder position are also relevant, shows a broad understanding and thus, in deviation from the previous BFH jurisprudence, in many cases puts a stop to a profit-increasing transfer price correction.

CONTACTS



Gertrud R. Bergmann

Wirtschaftsprüfer,
Steuerberater Partner

Tel: +49 30 208 88-1954
gertrud.bergmann@mazars.de



Prof. Dr. Adrian Cloer

Rechtsanwalt, Steuerberater
Partner

Tel: +49 30 208 88-1262
adrian.cloer@mazars.de



Dr. Tobias Hagemann

Steuerberater
Manager

Tel: +49 30 208 88-2079
tobias.hagemann@mazars.de