News International

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Dear Sir/Madam,

In its judgement of 31 May 2018 (C-382/16) in the case of "Hornbach Baumarkt AG", the European Court of Justice (ECJ) ruled that **transfer pricing adjustments in accordance with section 1 of the German Foreign Transaction Tax Law (AStG)** were admissible under Union law. Thus, an income adjustment provision for non-arm's length business transactions between associates as per section 1 AStG complies with European law in principle. However, the ECJ ruled in its current judgement that **commercial reasons** relating to the status of the taxpayers as shareholders might justify a departure from the arm's length priciple.

The ECJ was asked for a decision on the following facts:

The domestic group parent Hornbach Baumarkt AG gratuitously issued guarantees and comfort letters in favour of its two Dutch subsidiaries to safeguard their bank loans. As the two wholly owned subsidiaries each had negative equity, the financing bank had made the granting of loans for the continuation of the business operations and for the establishment of a DIY and garden centre contingent upon the provision of the comfort letters. The tax office therefore increased the taxable income of the domestic parent for 2003 to account for an arm's-length liability remuneration of approximately EUR 38,000 with reference to section 1 (1) and (4) AStG.

The domestic parent objected to this, arguing that it was being discriminated against under section 1 AStG, since in a purely domestic scenario there would be no adjustment of taxable income. It also said

If the taxpayer is able to prove that the infringement of the arm's-length principle is for **commercial (not tax) reasons**, a transfer pricing adjustment must be ruled out. The ECJ has thus made it clear that it is up to the national authorities and courts to determine whether the taxpayer has been given the opportunity to provide proof of possible commercial reasons for concluding the transactions, **without being subject to undue administrative constraints**. In particular, commercial reasons arising from their status as shareholder of the non-resident company should be taken into account. This also applies for the future and therefore to a possible change in the German legal position.

The judgement opens up the possibility for taxpayers to contest taxable income adjustments carried out by the tax authorities if and insofar as commercial reasons can be cited for determining the disputed transfer price. The ECJ initially and expressly specifies the status of shareholder, which entails a corresponding economic self-interest, as a commercial reason for agreeing non-arm's-length conditions with subsidiaries. This is because a shareholder participates in the success and in the assets of its (subsidiary) company via the distribution of profits. Therefore, preventative measures to avoid further impairments of capital could also be seen as economically justified.

The judgement certainly has a high degree of practical relevance, since the ECJ also recognises reasons based on the status as shareholder as being relevant, thus displaying significant understanding, and

that this discrimination was not justified or proportionate because section 1 AStG does not provide for the provision of commercial reasons for non-arm's-length transactions.

The ECJ has now decided that section 1 AStG only applies to cross-border cases and consequently leads to a **restriction on the freedom of establishment**. This restriction on the freedom of establishment can only be justified, however, if section 1 AStG does not go beyond what is necessary to achieve a reasonable distribution of tax jurisdiction and to prevent tax avoidance in general.

could therefore prevent a transfer pricing adjustment that increases taxable proft in many cases, in contrast to the existing case law of the German Financial Court of Finance (BFH).

Contact us, we would be happy to support and advise you.

Best regards

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After completing his studies in business management, specialising in taxation in 1995, Rolf Groß went on to complete his tax consultancy examination in 1999. In 2004, Mr Goß qualified as a certified auditor and in 2008 as a chartered accountant. Since 2014 he has also held the title of "Specialist Advisor for International Tax Law".

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Company presentation

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