KPMG

Euro Tax Flash from KPMG's EU Tax Centre

AG Opinion in the Hornbach Baumarkt Case on German transfer pricing adjustment provisions

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

On December 14, 2017, Advocate General (AG) Bobek of the Court of Justice of the European Union (CJEU) published his opinion in the Hornbach Baumarkt Case (C 328/16). The case deals with German legislation, according to which income of a German taxpayer resulting from its business relationships with non-resident related companies is adjusted, as far as they differ from the arm's length principle, whereas such adjustment is not made in the case of business relationships between German related companies. The AG is of the view that the German rules in question do not constitute an infringement to the freedom of establishment.

Background

The case concerns a German parent company, which 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 any fee for the comfort letters in question. Referring to section 1, paragraph 1 of the German Foreign Tax Act, the German tax authorities considered that, due to the associated liability risk, unrelated parties would have agreed on remuneration for 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 to the freedom of establishment. Finally,

it noted that the German legislation is not proportionate as it excludes any possibilities to bring forward commercial justifications for transactions that are not made at arm's length.

The AG Opinion

Following the "discrimination approach", the AG first assesses whether the situations of resident companies with non-resident subsidiaries on one hand and resident companies with resident subsidiaries on the other are objectively comparable. Referring to the aim pursued by the national provisions at issue to ensure that profits generated in Germany are not transferred abroad without being taxed, which specifically targets cross-border situations, he concludes that foreign and domestic situations are objectively different and therefore not comparable. Relying on the "zero-sum" argument, the AG further reasons that, even if it were considered that cross-border and domestic situations are in fact comparable, there is no discrimination in the sense of a less favorable treatment. Following the German Government argumentation, he notes that no disadvantage can be evidenced, since – taking into account the situation of the group as a whole – in both the domestic and the cross-border situation the profits generated in Germany are taxed there. Thus, in a purely domestic situation, the profits in question are taxed in the hands of the subsidiary, as the tax base of the latter has not been decreased by the arm's length payment. With respect to the risk of double taxation, the AG concludes that this is merely the result of the coexistence of different tax systems and the territoriality principle. As such, it cannot be considered as a difference in treatment.

Pursuing his analysis with the "restriction approach", the AG concludes that the requirement for related companies to respect the arm's length principle in their business relationships cannot be viewed as a restriction to the freedom of establishment, since such principle simply reflects a jurisdiction's right to tax profits generated in its territory. As a consequence, the German legislation cannot have a deterrent effect on a company's decision to exercise its freedom of establishment.

Finally, in the AG's view, any restriction would be justified by the balanced allocation of the powers of taxation between Member States, since the national legislation in question is designed to prevent profit shifting outside of Germany's tax jurisdiction. In addition such legislation meets the requirements of proportionality. Dismissing the argument that the taxpayer should have the possibility to present commercial justifications for transactions that are not at arm's length, the AG estimates that there is no room for less restrictive measures, as the only relevant question when applying the German provisions is whether or not the transaction should be fully taxed.

EU Tax Centre Comment

Starting his argumentation from a more academic perspective, the AG provides useful clarification on the different approaches to analyzing infringement situations according to settled case law from the CJEU. However, it remains to be seen whether the Court will agree with the AG's rationale on the comparability analysis and on the "zero-sum" argument, as his opinion seems to differ from previous case law of the CJEU in this respect. While many Member States have implemented similar rules, the CJEU decision may shed more 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.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre or, as

appropriate, your local KPMG tax advisor.

Robert van der Jagt
Chairman, KPMG's EU Tax Centre and
Partner,
Meijburg & Co
