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Foreign Tax Act: Income adjustment in accordance with community law?

The Lower Tax Court of Rhineland Palatinate has asked the ECJ to rule on the income adjustment provision of the Foreign Tax Act as amended in 2003 as it might not be in accordance with EU-law. The focus of the judicial review is on the tax consequences of a business relationship with a related party and where the terms do not meet the third party comparison test. The ECJ advocate general has suggested the court decide that the German rules for profit adjustment under Sec. 1 Foreign Tax Act are not in violation of the freedom of establishment.

Can a Member State prevent companies from shifting profits out of its jurisdiction by requiring income to be declared on the basis of ‘arm’s-length conditions’? Can it impose such a requirement only in relation to cross-border transactions and not domestic ones (that is, between two resident companies) without falling foul of the Treaty rules on freedom of establishment?

The ECJ advocate general says yes to both points. He does not consider that the German rules in question give rise to any restriction on the freedom of establishment. However, to the extent that they do, they are, in his view, justified.

The case involved a German AG which issued letters of comfort for its foreign subsidiaries for which no fee had been agreed and charged. The tax office increased the income of the AG for the notional remuneration. According to the Lower Tax Court such treatment (i. e. giving rise to a higher tax burden) may be an infringement of freedom of establishment as it would prevent taxpayers from establishing a subsidiary in another member state. Under an arm’s length review the taxpayer may present valid reasons as to why the conditions agreed with the foreign related company correspond to those which would have been agreed between mutually independent third parties. However, under the regime of Sec. 1 Foreign Tax Act (FTA) the taxpayer is not given an opportunity to provide evidence of any commercial justification for the transaction being below market while considering the specific shareholder relationship of the parties involved. Thus, the provision in the FTA does not sufficiently take account of the fact that the shareholder might have a personal interest in “his” company being successful as he then would participate by higher profit distributions.

The advocate general considers this latter argument – in his own words - clearly incorrect. Because otherwise, the notion of arm’s-length transaction would no longer have any bearing. It would effectively mean a full exclusion of any business transactions with subsidiaries from the application of the principle, because a parent will always have an interest in seeing its subsidiary prosper. There would thus always be, by definition, a justification.

The ECJ case reference C-382/16 *Hornbach-Baumarkt opinion of 14 December 2017*

Schlagwörter

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