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By PwC Deutschland | 06. Juni 2018

German CFC rules may be compatible with EU law

The European Court of Justice held that the German CFC regulations – as such – do not generally pose a restriction on the freedom of establishment.

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It is up to the referring court, however, to decide whether the legislation did in fact give the taxpayer the chance to prove that the terms were agreed on for commercial reasons resulting from its status as a shareholder of the non-resident company.

On 31 May 2018, the European Court for Justice (ECJ) published its decision in the *Hornbach-Baumarkt* case. The case revolves around the question as to whether Section 1 of the Foreign Transaction Tax Act ("FTTA" – in the version in force in 2003) – which calls for income corrections to be made on related party transactions, which were not concluded at arm's length – is considered compatible with EU law. The ECJ held that whilst the German rule did, in principle, constitute a restriction on the freedom of establishment, it could be justified by the principle of territoriality. However, any measure devised to preserve the balanced allocation of the power to tax may not go beyond what is necessary to achieve this objective. According to the Court, the provision under review could be regarded as meeting this latter criterion, provided that the taxpayer was given the opportunity to prove that the terms were agreed on for commercial reasons, which may also include its status as a shareholder in the non-resident company.

Background

Hornbach-Baumarkt AG, held an indirect shareholding of 100% in two companies established in the Netherlands ('the foreign group companies'). These companies both were in negative equity and required money in order to continue their business operations and as well as to finance the planned construction of a DIY store and garden centre.

The bank ensuring the financing of those companies had made the granting of the loans contingent on the provision of comfort letters containing a guarantee statement from Hornbach-Baumarkt AG. Hornbach-Baumarkt AG subsequently provided those comfort letters gratuitously.

Following a tax assessment, the tax office held that the comfort letters had not been granted on arm's-length terms and therefore increased Hornbach's tax base to reflect the notional remuneration that it considered would normally have been paid to Hornbach by an unconnected third party in consideration for the comfort letters.

The case appeared before the Rhineland Palatinate tax court, which referred the case to the ECJ.

Does Section 1 of the Foreign Transaction Tax Act restrict the freedom of establishment?

In principle the Court found that the measure did violate the right to freedom of establishment in that a German parent company holding an interest in a company resident in another Member State was treated less favourably than one with a shareholding in a German resident company. However, this could be justified by overriding reasons of public interest, namely the need to preserve a balanced allocation of the power to tax between the Member States.

Following established case law the Court noted that allowing companies resident in a Member State to transfer their profits, in the form of unusual or gratuitous advantages, to related companies established in other Member States may well undermine the balanced allocation of the power to tax between the Member

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States. As such national legislation, such as the measure under review, which allows a Member State to redress this situation may be considered as pursuing legitimate objectives compatible with the Treaty and constitute an overriding reason in the public interest. However, the Court noted, such legislation should not go beyond what is necessary to achieve the objective pursued.

Principle of proportionality

Following its previous case law, the Court noted that national legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction can be considered artificial may be regarded as proportionate where, inter alia, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction.

In the present case, the Court, referencing the facts of the case, noted that there may be a commercial justification by virtue of the fact that Hornbach-Baumarkt AG is a shareholder in the foreign group companies, which could justify the conclusion of the transaction on non-arm's-length terms. In particular since the continuation and expansion of the business operations of those foreign companies was, due to a lack of sufficient equity, dependent upon the availability of financing, the gratis issue of letters of comfort, could be explained by Hornbach-Baumarkt AG's own economic interest in the financial success of the foreign group companies, in which it participates through the distribution of profits, as well as by its responsibilities as a shareholder for the financing of those companies.

However, the question as to whether the legislation did in fact give the taxpayer the chance to prove that the terms were agreed on for commercial reasons resulting from its status as a shareholder of the non-resident company, should be decided by the referring court.

Source: ECJ decision of 31 May 2018 (C-382/16)

Schlagwörter

CFC provisions, freedom of establishment, income correction