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By PwC Deutschland | 21 August 2013

Related party by ownership despite restrictions on exercise of ownership rights

The Supreme Tax Court has held that internal or other restrictions on the excise of ownership rights do not obviate an association by common shareholding of more than 25%. It has also held that the application of the transfer pricing documentation rules to cross-border transactions only is, while discriminatory, justified by the need to protect tax revenue.

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A German asset management subsidiary of a Luxembourg investment fund management company paid substantial fees to a Luxembourg service company. Both Luxembourg companies were wholly-owned by a Luxembourg holding company. The investment fund management company was obliged to follow the policies of the fund. These could only be revised by a two-thirds majority resolution of the investors. The German subsidiary argued that this restriction meant that its Luxembourg shareholder could not be forced to follow a common business policy with the service provider. Accordingly the two were not related parties within the meaning of the Foreign Tax Act and there was no requirement for it to furnish the extensive documentation in support of its transactions with associated enterprises as required by the Tax Management Act. In any case, the fact that these documentation requirements only applied to cross-border transactions was a hindrance on the freedom to provide (receive) services and thus contrary to community law.

The Supreme Tax Court has now rejected both contentions. It has also refused to lay the case before the ECJ, as it sees no doubt as to the community law acceptability of the German transfer pricing documentation provisions. Its main point is that the Foreign Tax Act defines a related party relationship by shareholding at a capital share of more than one-quarter. There is no mention of voting rights or of restrictions on the right of a shareholder to act in respect of its investment. Other parts of the related party definition, such as a relationship by contract, complemented the shareholding criterion, but did not restrict it. Accordingly, an obligation not to set management policy for the German subsidiary against the wishes of the members of the fund did not destroy a shareholding-based relationship. Even if such an obligation did exist, a breach would not invalidate the measure at issue; it would merely make the Luxembourg shareholder liable for damages. The court emphasised that the reason for the shareholding was also irrelevant; even if the shares were held in trust for the investors in the fund, the company remained the related party of the service provider and was subject to the transfer pricing documentation rules.

The court accepted that the application of the transfer pricing documentation rules to foreign relationships only was fundamentally a discrimination restricting the freedom to provide services. Clearly a domestic business would be discouraged from purchasing services from a foreign related party if it could do so within the country without having to accept the burden of complying with the transfer pricing documentation rules. However, this restriction was justified by the need to protect the public revenue from abuses to the tax system. The enhanced duty of cooperation of those with relationships abroad was justified by the consideration that such relationships were best explained and documented by those that had entered into them. The court also pointed out that 26 of the 28 member states of the EU (Croatia and Cyprus being the exceptions) had introduced comparable rules into their own systems (though, it should be noted, not always exclusively in respect of foreign transactions) without apparent legal problems and that the European Commission had published its own summary explaining and supporting such schemes. Clearly, transfer pricing documentation rules were to be regarded as generally acceptable.

Supreme Tax Court judgment I R 45/11 of April 10, 2013 published on August 21

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