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# Successful constitutional complaint against income correction affecting freedom of establishment

**The German Constitutional Court overturned a 2019 judgment of the Supreme Tax Court regarding the erstwhile change in its case law on the issue of the income correction with respect to an unsecured group loan because the tax court failed to submit the facts of the case to the European Court of Justice (ECJ) for final clarification and thus violated the complainant's right to the lawful judge under Article 101(1) of the Constitutional Statute.**

## Background: Supreme Tax Court changes its prior case law

In its judgment of 27 February 2019 (case ref. I R 73/16) published on 15 May 2019, the German Supreme Tax Court reversed its previous case law on the so called "blocking effect" of Article 9(1) of the OECD Model Tax Convention and held that this does not prohibit an income adjustment under domestic transfer pricing rules pursuant to Section 1 (1) of the German *Foreign Tax Act*, where the write-off of an unsecured group loan is not recognised as a deduction from taxable profits.

In the case of dispute a German GmbH operated an unsecured clearing account for a Belgian subsidiary. After the Belgian subsidiary had run into financial difficulties, the GmbH waived its claims arising from the clearing account and wrote off the receivable in 2005 (year of dispute). The tax office neutralised this reduction in profits according to the transfer pricing rules. The Lower Tax Court, following the previous case law of the Supreme Tax Court, upheld the GmbH's appeal and the case went to the Supreme Tax Court. This time, however, the Supreme Tax Court viewed the matter differently and thus set aside the judgment of the Lower Tax Court. A more detailed analyses of this judgment to be found in our [Tax & Legal Newsflash](#) of 16 May 2019.

In a further step the case was brought before the Constitutional Court on the grounds that the judgment violated the general guarantee of the right to equality in Art. 3(1) of the *Basic Statute (Grundgesetz)* in its manifestation as prohibition of arbitrary measures and its fundamental procedural right to one's lawful judge as in Art. 101(2) *Grundgesetz*.

## Decision of the Constitutional Court

The challenged judgment violates the complainant's fundamental procedural right to one's lawful judge under Art. 101(1) second sentence *Grundgesetz* because the Supreme Tax Court failed to refer the case to the ECJ for further clarification on the matter of the EU rules on the fundamental freedom of establishment and pursuant to Art. 267(3) TFEU.

The decision of the Constitutional Court is actually based on purely procedural aspects rather than on material reasons. The Second Senate of the Constitutional Court thus upheld the complaint and overturned the 2019 ruling of the Supreme Tax Court (I R 73/16) because the latter had failed to submit the facts of the case to the ECJ for clarification whether the violation of the freedom of establishment was justified. In particular it does not fully address the question whether the income correction with regard to unsecured claims is justified in order to safeguard a balanced allocation of taxation powers between the Member States, which the ECJ considers to be a legitimate reason for such a restriction. The Supreme Tax Court presumed without further detailed explanation that such a justification existed, without giving further thought to the matter.

Neither the fact that the loan was unsecured – the basis upon which the Supreme Tax Court considers the transaction to be on non-arm's-length terms –, nor the subsequent depreciation of the claim per se lead to a transfer of profits in the sense that profits are "transferred outside the tax jurisdiction" and without being taxed, which, according to the ECJ decision of 31 May 2018 ([C-382/16 - Hornbach-Baumarkt](#)) could

undermine the balanced allocation of the power to tax between the Member States.

After all, the appropriate application of EU law with regard to the granting of an unsecured loan under non-arm's-length terms was in the opinion of the Constitutional Court not so obvious as to leave no scope for reasonable doubt, at least not in light of the case-law of the ECJ, and therefore the Supreme Tax Court had not comprehensively looked at the question of the requirements applicable to the freedom of establishment (Art. 49 TFEU). Against this background the Supreme Tax Court would have had a duty under Article 267(3) TFEU to submit the facts of the case to the ECJ. The failure to do so leads to the annulment of the judgment and the referral back to the Supreme Tax Court.

Finally, the Constitutional Court went on to say that the Supreme Tax Court made an arm's length comparison that was in no way supported by factual evidence: This may not only represent a simple legal error, but be in violation of the constitution.

**It should be noted** that the decision relates to loans to EU subsidiaries provided prior to the 2008 tax year. For subsequent periods Section 8b (3) sentences 4 et seq. Corporation Tax Act applies. This provision applies to purely domestic cases, so that unequal treatment in breach of EU law can be excluded.

**Source:**

Second Senate of the Constitutional Court judgment on 4 March 2021 (2 BvR 1161/19); **Press Release No. 25/2021** of 31 March 2021.

**Keywords**

allocation of taxing rights, blocking effect, income correction, unsecured group loan