Case C-382/16 *Hornbach-Baumarkt*

CJEU rules on compatibility of German transfer pricing legislation with the freedom of establishment

The CJEU issued today its judgment in case C-382/16 *Hornbach-Baumarkt* (see also our EU Tax Alert No. 7/2017), dealing with the compatibility of German transfer pricing ("TP") legislation with the freedom of establishment.

The case concerns a parent company tax resident of Germany, which provided – free of any remuneration – guarantees and comfort letters in favour of its foreign subsidiaries. The German tax authorities applied TP legislation and adjusted upwards the profits of the parent company under the assumption that unrelated parties would have agreed on a remuneration in a similar situation. The parent company challenged the tax authorities' decision before the referring court, where it questioned the compatibility of the German TP legislation with the freedom of establishment on the basis of the fact that such legislation (i) applied only to cross-border situations and not to purely domestic situations and (ii) did not allow the taxpayer to rely on commercial reasons resulting from its status as a shareholder of the foreign subsidiary in order to justify the absence of any remuneration.

With reference to the first issue, the Court recalled its *SGI* decision (C-311/08) and reiterated that TP legislation constitutes a restriction to the freedom of establishment under Art. 43 TFEU (§ 35). However, the Court went on to observe that such restriction is justified by the need to preserve a balanced allocation of taxing rights between the Member States, provided that TP legislation is aimed at preventing profit shifting via transactions that are not in accordance with market conditions (§ 43-45).

Subsequently the Court dealt with the second issue in the assessment of proportionality of German TP legislation. In this regard the Court relied again on its decision in *SGI* in which it held that TP legislation can be considered proportionate insofar as (i) 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 and (ii) the income adjustment must be limited to the part which exceeds what would have been agreed between the companies in question under market conditions (*SGI*, C-311/08, paragraphs 71 and 72).

The Court noted that in the case at stake it was not disputed that the income adjustment made by the German tax authorities was limited to the portion of the income which exceeds what would have been agreed between unrelated companies (§ 50). This stated, the Court went on to clarify the meaning of the concept of "commercial justification" as already used in *SGI* (§ 51). On this point, the German government maintained that economic reasons resulting from the position of the shareholder should not be taken into account (§ 52). The Court took a contrary position and clarified that in a situation, such as that of

the case, where the expansion of the business operations of a subsidiary requires additional capital, due to the fact that the latter lacks sufficient equity capital, there may be commercial reasons for a parent company to agree to provide capital on non-arm's-length terms (§ 54). Hence, the Court concluded that the gratuitous granting of comfort letters containing a guarantee statement could be explained by the economic interest of the shareholder in the financial success of the foreign group subsidiaries (§ 56).

Based on the above, the Court affirmed that German TP legislation does not go beyond what is necessary to achieve the objective which it pursues, insofar as the taxpayer is allowed to provide evidence that the agreed terms are justified by commercial reasons, which could also result from the status as a shareholder in the non-resident company (§ 58).

For further information: **Maisto e Associati**

Milan
Piazza F. Meda 5
20121
T: +39.02.776931

Rome
Piazza d'Aracoeli 1
00186
T: +39.06.45441410

London
2, Throgmorton Avenue
EC2N 2DG
T: +44.207.3740299
