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OPINION STATEMENT

Opinion Statement ECJ-TF 1/2019 on the CJEU decision of 31 May 2018, in Case C-382/16, *Hornbach-Baumarkt*, concerning the application of transfer pricing rules to transactions between resident and non-resident associated enterprises

Prepared by the CFE ECJ Task Force
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CFE Tax Advisers Europe welcomes the Court's decision in *Hornbach* as an important clarification of the conditional compatibility of arm's length-based domestic transfer pricing legislation with the freedom of establishment. *Hornbach* follows and confirms the previous doctrine formulated in the *SGI* judgment and did not adopt the Advocate General's approach that would have denied comparability of domestic and cross-border situations in transfer pricing cases and, hence, preventing scrutiny of domestic transfer pricing legislation under the fundamental freedoms.

CFE Tax Advisers Europe welcomes the requirement that Member States have to grant taxpayers the opportunity to provide evidence "of any commercial justification" for non-arm's length transactions, so that denial of that opportunity through automatic transfer pricing adjustments would render these incompatible with EU Law. In that context it is further welcomed that "commercial justifications" may include "economic reasons resulting from its position as a shareholder of the non-resident company". At least in cases of non-arm's length transactions such as interest-free loans or gratuitous guarantees that are aimed at replacing equity, the *Hornbach* judgment clearly suggests that such a shareholder interest in the financial success of the foreign subsidiary may serve as such justification.

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This is an Opinion Statement prepared by the CFE ECJ Task Force[1] on Case C-382/16, Hornbach-Baumarkt, in which the Court of Justice of the EU (Second Chamber) (ECJ) delivered its judgment on 31 May 2018.[2] In general terms, the ECJ did not follow the opinion given by Advocate General Bobek on 14 December 2017.[3]

The case concerned the compatibility of the German transfer pricing legislation referring to the remuneration of the comfort letter given by a German parent company to a financing bank in support of its foreign EU subsidiaries when it does not accommodate to the arm's length terms. German transfer pricing legislation only foresees an adjustment of taxation where foreign related companies are involved, it does not apply to pure domestic situations and does not allow taxpayers to invoke commercial justifications for transactions not carried on at arm's length prices. The referring German Court asked whether the relevant German tax rules were compatible with the EU Treaty provisions on freedom of establishment, especially as regards to whether (im)possibility to present evidence of the commercial reasons of the transactions carried out complied with the requirements of the principle of proportionality.

In its judgment, the Court follows the approach taken in the previous case SGI (C-311/08) as regards the possibility to justify the restriction of the freedom of establishment by domestic transfer pricing legislation, and clarifies that the principle of proportionality is not satisfied if the domestic legislation does not afford the resident taxpayer the opportunity to prove that the terms agreed in related transactions have commercial reasons resulting from its status as a shareholder of the non-resident company.

Background and Issues

1. Hornbach-Baumarkt AG (Hornbach) is a German resident parent company with a 100% indirect shareholding in two Dutch resident subsidiaries with negative equity capital. In order to guarantee external financing of the Dutch subsidiaries granted by a non-related bank, Hornbach provided comfort letters to the bank agreeing (1) to refrain from disposing of or changing its shareholding in Hornbach Holding BV and of the shareholding of Hornbach Holding BV in the foreign group companies; and (2) to irrevocably and unconditionally undertake to fund the foreign group companies in such a way as to enable them to meet all of their liabilities. Hornbach did not receive any remuneration from the subsidiaries for the issuing of the comfort letters.
2. The German Tax Administration considered that the comfort letters had not been granted on at arm's length basis and increased the income of Hornbach to reflect the notional remuneration that an unconnected third party would normally have paid in consideration for the comfort letters. Hornbach brought an action before the referring Court considering that the German provision violates EU freedom of establishment, since it only applies where foreign related companies are involved and the rule does not allow justifications to be invoked when the transaction is not carried out at arm's length.
3. The applicable version of the German Foreign Transaction Tax Law (Gesetz über die Besteuerung bei Auslandsbeziehungen, Aussensteuergesetz – ("AStG")) establishes that when income from business

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[2] DE: ECJ, 31 May 2018, Case C-382/16, *Hornbach-Baumarkt-AG v. Finanzamt Landau*, ECJ Case Law IBFD.

[3] DE: Opinion of Advocate General Bobek, 14 Dec. 2017, Case C-382/16, *Hornbach-Baumarkt-AG v. Finanzamt Landau*, ECJ Case Law IBFD.

relations with a related party is reduced in connection with business relations abroad as a result of agreements that depart from those that would have been agreed on by unrelated third parties under the same or similar circumstances, income must be declared as if it had been earned under terms agreed upon between unrelated third parties. The applicable German law provides that, inter alia, when the taxpayer has a direct or indirect shareholding in that party of at least 25%, it is a related party.

4. Hornbach argued that the increase of its taxable income was a punishment leading to unequal treatment of cases involving domestic and foreign transactions contrary to the freedom of establishment, since a notional increase of income is not applicable to purely domestic transactions. The taxpayer referred to the *SGI* ECJ judgment [4], considering the need to provide proportionate restrictions to the freedom of establishment, giving the taxpayer the opportunity to provide evidence of commercial justification for any transaction that may not be consistent with the arm's length principle [5].

5. The German court hearing the dispute (Finanzgericht Rheinland-Pfalz) doubted the compatibility of German tax law with EU Law, especially with the principle of proportionality, since there is no *formal* opportunity to present evidence of the commercial justification for concluding an agreement of non-arm's length terms for the taxpayer, and referred the following question to the ECJ:

   "Does Article 49 TFEU (formerly Article 43 EC), in conjunction with Article 54 TFEU (formerly Article 48 EC), preclude legislation of a Member State which provides that income of a resident taxpayer derived from business relations with a company established in another Member State in which that taxpayer has a direct or indirect shareholding of at least 25% and with which that taxpayer has agreed terms that depart from those that would have been agreed on by unrelated third parties under the same or similar circumstances must be calculated as if that income had been earned pursuant to terms agreed on between unrelated third parties, if such a correction is not made in respect of income from business relations with a resident company and the legislation in question does not afford the resident taxpayer the opportunity to present evidence that the terms were agreed on for commercial reasons resulting from its status as a shareholder of the company?"

II. The Judgment of the Court of Justice

6. It is important to mention that the ECJ did not follow the conclusions of Advocate General Bobek. According to the AG, the German transfer pricing legislation imposed no relevant restriction on taxpayers' freedom of establishment. In the AG's view, the provisions are neither discriminatory nor do they impose a non-discriminatory restriction, and even if a restriction could be identified, he argued that any such restriction would not go beyond what is necessary to protect Germany's legitimate interest in preserving its balanced allocation of taxing powers. The AG denied discrimination on the basis that domestic and cross-border situations are not comparable as regards the application of transfer pricing legislation and, moreover, cross-border situations do not therefore suffer from less favourable treatment.[6] Considering the possibility that tax rules could also violate the freedoms if they impose non-discriminatory burdens on cross-border investment (which would make a comparability analysis unnecessary), the AG concluded that an arm's length adjustment cannot be held to be such a restriction: first, he considered it merely an expression of the principle of territoriality; second, he argued that holding such adjustments to be a non-discriminatory restriction would mean that any tax imposed by a Member State would effectively fall under the definition of a restriction.[7] In case the Court decided differently, the AG nevertheless explored possible grounds of justification, concluding that it would be justified by the need to preserve the

[4] BE: ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*, ECJ Case Law IBFD.

[5] According to the AG, supra n. 3, para. 14, the taxpayer recognized, however, that it is always open to the taxpayer to present evidence of reasonableness despite the lack of a specific separate provision in that respect.

[6] AG Opinion, supra n. 3, para. 56 to 69 and para. 70-86.

[7] AG Opinion, *supra* n. 3, para. 87 to 93.

balanced allocation of taxing powers which allows Member States to prevent companies from freely shifting their profits between jurisdictions at their leisure.[8] The different treatment would not be disproportionate either, in the AG's view: invoking the Court's ruling in *SGI*, he argued that an arm's length adjustment was indeed necessary only for cross-border relations, as price manipulation between domestic companies would (typically) lead to a zero-sum result that needed no deterrence from the Member State's perspective.[9]

7. The ECJ's reasoning differs from the AG's Opinion, both with regard to the existence of a restriction (it held the German rules to be restrictive) and the details of the proportionality analysis (it required further scrutiny of the German rules as regards the taxpayer's possibility to bring forward reasons to escape an adjustment).

8. First, the ECJ confirmed, following its settled case-law, that national legislation was intended to apply only to those shareholdings which enable the holder to exert a definite influence on a company's decisions and to determine its activities fall within the scope of freedom of establishment.[10] Hornbach has an indirect 100% shareholding in its Dutch resident subsidiaries[11] and the AStG applies to 'at least 25% shareholding in a company established in a Member State other than the Member State in which it is a resident'[12]; so both legally and factually the situation is protected by the freedom of establishment.[13]

9. Contrary to the AG's Opinion, but without referring to his arguments, the ECJ held that the German transfer pricing legislation constituted a restriction of the freedom of establishment, based on its settled case-law. As the ECJ clarified in the previous decision of *SGI*,[14] when a taxpayer that has a shareholding in a company established in another Member State is treated less favourably than if it had a shareholding in a resident company, this taxpayer suffers a restriction on its freedom of establishment. The taxpayer might be deterred from acquiring, creating or maintaining a subsidiary in a Member State other than its Member State of residence or from acquiring or maintaining a substantial holding in a company established in that other Member State because of the tax burden imposed.[15]

10. The German Government had argued that German parents of resident and non-resident subsidiaries are not comparable because Germany had no power to tax the non-resident subsidiary. The Court confined those arguments to the realm of justifications derived from the principle of territoriality and balanced allocation of taxing rights.[16] Thus, the existence of such justifications does not prevent the comparability of the situations from the freedom of establishment perspective.

11. Analysing the possible justification of such a restriction, the ECJ followed its earlier decision in the *SGI* case[17] and confirmed its consistent case law that the need to maintain the balanced allocation of the power to tax could justify a difference in treatment where the system in question is designed to prevent conduct liable to jeopardise the right of a Member State to exercise its power to tax in relation to activities carried out in its territory.[18] Accordingly, it held that national legislation seeking to prevent profits generated in the Member State concerned from being transferred tax-free outside that State's tax jurisdiction via transactions that are not in accordance with market conditions was appropriate for ensuring the preservation of the allocation of powers of taxation between the Member States.[19]

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[8] AG Opinion *supra* n. 3, para. 94 to 103.
[9] AG Opinion, *supra* n. 3, para. 104 to 126.
[10] *Hornbach* (C-382/16), para. 28
[11] *Id*., para. 30.
[12] *Id*., para. 29.
[13] *Id*., para. 31.
[14] *SGI* (C-311/08), para. 44.
[15] *Hornbach* (C-382/16), para 35.
[16] *Id*., para. 40.
[17] Id., para. 44.
[18] Id., para. 43.
[19] Id., para. 47.

12. In order to verify the proportionality of the German tax measure to achieve the objective of the balanced allocation of taxing powers, the ECJ addressed three main aspects of the measure: (a) the amount of income correction; (b) the opportunity to provide evidence of any commercial justification; and (c) the undue administrative constraints to do so.

    a. As regards, first, the amount of income correction, the ECJ ruled it proportionate as long as it is confined to the part which exceeds what would have been agreed if the companies in question did not have a relationship of interdependence.[20]

    b. As regards, second, the opportunity for taxpayers to provide evidence of any commercial justification, the Court provided further guidance on the meaning of the latter term.[21] It explained that a commercial justification may result from the very existence of a relationship of interdependence between the parent and its subsidiary: for instance, in the situation where the subsidiary lacks sufficient equity, that very interdependence would establish a commercial reason for the parent company to provide capital on non-arm's-length terms.[22] The Court concluded therefrom that the gratuitous granting of comfort letters containing a guarantee statement could be explained by the economic interest of Hornbach in the financial success of its foreign subsidiaries (in which it participates through the distribution of profits) and also by a certain responsibility of Hornbach as a shareholder, in the financing of those companies.[23] This was held notwithstanding the likelihood that independent companies would have agreed on remuneration for such guarantees.

    c. As regards, third, administrative constraints put on a taxpayer to provide evidence of such commercial justification, the ECJ held, without providing further guidance on that standard, that it was for the national court to determine if any such constraints were undue.[24]

13. In light of the analysis, the ECJ concluded that German transfer pricing legislation did not go beyond what was necessary to achieve the objective which it pursued, *provided* that the authorities responsible for the enforcement of that legislation afforded the resident taxpayer the opportunity to prove that the terms were agreed on for commercial reasons which could result from its status as a shareholder in the non-resident company.[25] The Court thus held:

    > "Article 43 EC (now Article 49 TFEU), in conjunction with Article 48 EC (now Article 54 TFEU), must be interpreted as, in principle, not precluding national legislation, such as that at issue in the main proceedings, pursuant to which the income of a company resident in a Member State which granted to a company established in another Member State with which it has a relationship of interdependence advantages under terms that depart from those that would have been agreed on by unrelated third parties under the same or similar circumstances, must be calculated as it would have been if the terms which would have been agreed with unrelated third parties had been applicable, and be corrected, despite the fact that such a correction is not made in respect of taxable income when the same advantages are granted by a resident company to another resident company with which it has a relationship of interdependence. However, it is for the national court to determine whether the legislation at issue in the main proceedings affords the resident taxpayer the opportunity to prove that the terms were agreed on for commercial reasons resulting from its status as a shareholder of the non-resident company."

[20] Id., para. 50.
[21] Id., para. 51-57.
[22] Id., para. 54.
[23] Id., para. 56.
[24] Id., para. 57.
[25] Id., para. 58 and 59.

III. Comments

14. Generally speaking, the ECJ relies on the interpretative doctrine formulated in *SGI*[26] regarding the compatibility of domestic transfer pricing rules with the freedom of establishment when these rules only apply in cross-border situations. The referring court had asked the ECJ to clarify paragraph 71 of this decision, in which the Court had accepted the application of transfer pricing adjustments solely applicable to cross-border transactions under the condition that the taxpayer would be given the opportunity 'to provide evidence of any commercial justification that there may have been for that transaction'. This Task Force has already had the opportunity to comment on the case law of the Court relating to domestic transfer pricing legislation related to inter-company loans.[27]
15. The Hornbach decision leaves important issues for consideration, relating to the applicable freedom, the comparability analysis, the proportionality analysis of the accepted justification criteria, the implications attached to the evidence and meaning of 'commercial reasons', and the scope of the decision (either limited to the specific circumstances of comfort letters or related to a more general alternative approach).
16. A question arises with respect to the Court's decision to examine the case exclusively under the freedom of establishment. The Court invoked its settled case law, according to which the freedom of establishment is used to test national legislation intended to apply only to shareholdings which enable the holder to exert definite influence on a company's decisions.[28] Unlike in previous decisions,[29] however, it only took into account a specific subsection of the relevant national rules[30] to analyse its scope and therefore decided exclusively to consider the freedom of establishment. Despite the fact that the free movement of capital was thus not tested, there is no reason to believe that the same reasoning would not be followed in that context.
17. Contrary to the AG Opinion, the ECJ did not separately examine discrimination and (non-discriminatory) restriction approach, but followed its oft-repeated approach where it identifies a restriction as a result of a comparability analysis.
18. In this respect, while the ECJ did not explicitly address the AG's "zero-sum argument",[31] it effectively denied its relevance for the determination of comparability. The Court indicated that only taxation in one country is relevant for the analysis at that stage, confirming a single Member State approach instead of a global one.[32] It is unclear whether this can hold true in all circumstances, considering the consistent case law of the Court according to which comparability has to be examined having regard to the aim pursued

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[26] *SGI* (C-311/08), n. 4.

[27] See CFE Fiscal Committee, Opinion Statement of the CFE on the Case Law of the European Court of Justice on Transfer Pricing Related to Loans (Decision of 21 January 2010 in Case C-311/08, SGI): Submitted to the European Institutions in February 2012, 52 Eur. Taxn. 6 (2012), Journals IBFD.

[28] *Hornbach* (C- 382/16), para. 28.

[29] See in particular *SGI* (C-311/08), paras 29-30, where it held that, since the relevant national legislation covered situations of interdependence that would not amount to definite influence of one company over another, the freedom of capital movement would, in principle, be also applicable. While the Court, in SGI, had then gone on anyway to conclude that only the freedom of establishment would apply due to the factual circumstances of that case, its more recent case law clearly indicates that the decision ought to be made only on the basis of the legislative purpose in relation to third countries (*FII Group Litigation* [C-35/11], para. 96).

[30] In this case Art. 1(2)(1) of the AStG, without considering, for instance, Art. 1(2)(3) of AStG, which clearly does not require "definite influence" (see *Hornbach* [C- 382/16], para. 3).

[31] According to AG Bobek, the zero-sum argument is based on the idea that in the case of transactions that are not at arm's-length between parent and subsidiary companies, which are both resident in one state, profits are not taxed in the hands of the parent but they will be in the hands of the subsidiary. As a result, on a global view of the group, the tax burden remains the same (see AG Opinion, *supra* n. 3, para. 71).

[32] *Hornbach* (C- 382/16), para. 32: "Freedom of establishment is hindered if, under ***a*** Member State's system, a resident company having a subsidiary in another Member State suffers a disadvantageous difference in treatment for tax purposes compared with a resident company having a subsidiary in the first Member State."

by the national provisions at issue.[33] In *Hornbach*, the ECJ also defied the AG to conclude that the comparison is to be made with respect to the taxes imposed on the parent company only. As a result, the tax position of the subsidiary was not relevant for the comparability analysis.

19. The Court thereby confirmed its approach in most previous case law as a result of which tax norms specifically targeting cross-border transactions and arrangements will typically require justification.[34] Furthermore, the decision clarifies that balanced allocation of taxing powers and territoriality principle are not relevant for the comparability analysis, but are part of the justification test.

20. With respect to justification, both the taxpayer and the German authorities relied on the previous *SGI* judgment, which included a specific proportionality test, on which the domestic court sought clarification. In *SGI*, the ECJ held that:

    "[n]ational legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents an artificial arrangement, entered into for tax reasons, is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to maintain the balanced allocation of the power to tax between the Member States and to prevent tax avoidance where, first, on each occasion on which there is a suspicion that a transaction goes beyond what the companies concerned would have agreed under fully competitive conditions, 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 […]".[35]

21. In *SGI*, the ECJ held that a restrictive measure could be justified based on two cumulative criteria: the balanced allocation of taxing powers and the need to prevent tax avoidance. In *Hornbach*, however, the German and Swedish governments did not raise the argument of prevention of tax avoidance, despite the fact that on many occasions transfer pricing legislation is being used as a tool to counteract tax avoidance and base erosion schemes. Despite the fact that it is for the Member States to provide arguments that support the necessity of the measures implemented to respect the public interest criteria, the ECJ should not make its analysis dependent on Member States raising relevant arguments. Instead, it ought to take into account all relevant grounds of justification ex officio[36] as it did, for example, in its recent *Bevola* decision.[37]

22. In any event, the ECJ confirmed in *Hornbach* that the balanced allocation of taxing rights may serve as a stand-alone justification criterion, as it had already accepted in *X Holding*,[38] and even if tax avoidance had been invoked in *Hornbach*, it would appear likely that the outcome would have been the same: the Court follows the same proportionality analysis in *SGI* and in *Hornbach*, holding that national legislation needs to safeguard the taxpayer's right to provide evidence of commercial reasons whether or not a risk of tax avoidance was explicitly considered. This is of great relevance, since transfer pricing regulations may provide for automatic market price valuation without granting the taxpayer the possibility to provide evidence of the commercial reasonableness of departure of the outcome from pure arm's length standards.

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[33] DK: ECJ, 21 Dec. 2016, Case C-593/14, Masco Denmark and Damixa, para. 29, ECJ Case Law IBFD, referring to referring to (AT) ECJ, 6 Oct. 2015, C-66/14, Finanzamt Linz, para. 31, ECJ Case Law IBFD, and cited case-law; NL: ECJ, 25 Feb. 2010, C-337/08, X Holding, para. 22, ECJ Case Law IBFD.

[34] *SGI* (C-311/08), para. 41-44.

[35] *SGI* (C-311/08), para. 71.

[36] With due respect to article 127.1 of the Rules of Procedure before the ECJ, according to which "no new plea in law may be introduced in the course of proceedings unless it is based on matters of law or of fact which come to light in the course of the procedure".

[37] DK: ECJ, 12 Jun. 2018, C-650/16, *Bevola*, ECJ Case Law IBFD, para. 52: "Furthermore, the prevention of the risk of the double use of losses, while not expressly relied on by the Danish Government, is also capable of justifying a restriction of freedom of establishment such as that at issue in the present case"

[38] *X Holding* (C-337/08), para. 33.

23. One core development in *Hornbach* was the clarification of the proportionality criteria established in *SGI*,[39] specifically the last criterion under which the taxpayer must be "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". After *SGI* it was unclear, e.g., *(1)* if a "commercial justification" can be demonstrated by showing that a transaction that might otherwise fail the arm's length test is nevertheless genuinely commercial (i.e., neither a sham nor abusive); *(2)* if it is merely another expression that the taxpayer must be given an opportunity to prove that the arrangement satisfies, in whole or in part, the arm's length standard;[40] or *(3)* if a "commercial" justification – which seems to be even narrower than the German expression "wirtschaftliche Gründe"[41] – might also include reasons for a deviation from arm's length that are based on the shareholder relationship between the associated enterprises. The latter idea was heavily rejected by Germany, which argued that the notion of "commercial justification" "must be interpreted in the light of the principle of free competition which, by its nature, rules out acceptance of economic reasons resulting from the position of the shareholder",[42] implying that transfer pricing rules' purpose is exactly to correct distortions in pricing that are based on that shareholder relationship.

24. At this point it seems necessary to put the German legal framework and the position of the German government in context. German transfer pricing rules apply only to "business relationships", a term that, of course, requires interpretation.

    a. A business relationship under § 1(4) AStG exists between a taxpayer and a related party if the relationship is based on the law of obligations. Any such business relationship must be scrutinized under the arm's length principle regardless of whether it is induced by operational business matters or a company law relationship. Most clearly, however, the contribution of equity is not a "business relationship" – the parallel notion to "commercial" or "financial" relations in a treaty context – that is subject to transfer pricing adjustments;[43] as the Bundesfinanzhof noted, "[t]he conclusion that the contribution of equity is not a business relationship between the company and its shareholders is mainly derived from the spirit and purpose of § 1 AStG. That rule should permit the tax assessment of an appropriate remuneration in cases of a cross-border exchanges of services or goods between related parties. In contrast, it is not aimed at covering events that are not to be qualified as such exchange but are rather caused by the private sphere or the company law relationship".[44] This extends, e.g., to in-kind capital contributions or additional capital contributions. A "business

[39] *SGI* (C-311/08), para. 71.

[40] See in that direction, e.g., Opinion of AG Kokott in *SGI* (C-311/08), para. 78 (noting that the taxpayer "must prove that the contested transaction is in fact economically justified, and that independent companies acting at arm's length would have concluded the transaction on the same terms"), and England and Wales Court of Appeal (Civil Division), 18 February 2011, *Test Claimants in the Thin Cap Group Litigation v. HMRC*, [2011] EWCA Civ 127 (holding that "[l]egislation that involves the application of the arm's length test, as embodied in Article 9 of the OECD Model Convention, does not unlawfully interfere with [Article 49 TFEU], provided the taxpayer is given an adequate opportunity to present his case to the tax authority that the transaction in question was on arm's length terms, and may challenge the decision of the tax authority before the national court, and, secondly, that the effect of the legislation is limited to those aspects of the advantage conferred by the taxpayer company that do not satisfy that test").

[41] Despite the fact that the English version of the decision uses the words "commercial reasons", the original German version refers to a broader term "wirtschaftliche Gründe" ("economic grounds"), more related to economic than to pure commercial reasons. A similar relationship exists in the wording of Article 6 of the ATAD (GAAR), clarifying that valid commercial reasons are those which reflect economic reality.

[42] *Hornbach* (C-382/16), para. 52.

[43] See, e.g., BFH, 30 May 1990, I R 97/88; BFH, 29 November 2000, I R 85/99; BFH, 27 August 2008, I R 28/07; Fiscal Court of Baden-Württemberg, 4 December 2001, 1 K 250/99. Along the same lines the guidance issued by the German tax administration in para. 1.4.2 of the "Grundsätze zur Anwendung des Außensteuergesetzes" (Principles of Application of the Foreign Transactions Tax Law), BMF IV B 4 - S 1340 - 11/04, BStBl I 2004/1, 3.

[44] BFH, 29 November 2000, I R 85/99 (authors' translation from the German original: "Dass die Gewährung von Eigenkapital keine Geschäftsbeziehung zwischen Gesellschaft und Gesellschafter darstellt, ist vor allem aus dem Sinn und Zweck des § 1 AStG abzuleiten. Die Vorschrift soll bei einem grenzüberschreitenden Leistungsaustausch zwischen nahestehenden Personen, dessen Bedingungen einem Fremdvergleich nicht standhalten, den steuerlichen Ansatz eines angemessenen Entgelts ermöglichen. Sie will jedoch nicht darüber hinaus diejenigen Vorgänge erfassen, die nicht als Leistungsaustausch zu qualifizieren, sondern im privaten Bereich oder im Gesellschaftsverhältnis veranlasst sind.").

relationship" that is subject to transfer pricing adjustments is hence to be distinguished from relations that lead to the association of enterprises in the first place,[45] i.e., an adjustable "business relationship" can only exist when there is an independent exchange relationship in addition to the shareholder relationship between the associated enterprises.

b. German case law went even further: in 1990, the German Supreme Tax Court (Bundesfinanzhof) dealt with German domestic law and held that an interest-free loan by a German parent company to its foreign subsidiary might lie outside the sphere of "business relationships" (so that no imputation of hypothetical interest income would be possible) if such a loan is effectively an equity contribution (so that the amount of the loan would rather increase the cost basis of the shareholding and, as might be noted, would henceforth be excluded from a tax-effective write-down).[46] Decisions by the Bundesfinanzhof in 2000[47] and 2008[48] have later expanded this interpretation to other transactions that have their causation in the shareholder relationship rather than in business dealings. The Court held, e.g., that an (unconditional and irrevocable) guarantee that effectively replaces an equity contribution by creating the credit-worthiness of a finance subsidiary (i.e., to put it in the position to fulfill its function in the group) is not a "business relationship". Thus, it cannot be subject to transfer pricing adjustments (e.g., the imputation of a hypothetical remuneration for the guarantee).[49]

c. This case law was largely supported by legal scholarship in Germany and also the German tax administration has – after some hesitation and an initial notice that it would not acquiesce[50] – decided to follow it (for taxable periods until 2002).[51] However, this broad case law went too far for the German legislator, which, effective from 2003, defined a "business relationship" by including the reference to "any relationship falling within the law of obligations, which is not agreed in the company statutes".[52] This definition was meant to subject to transfer pricing adjustments binding guarantees, interest-free loans or the unremunerated rendering of services irrespective of whether these are aimed at replacing equity or otherwise strengthen the economic activity of the subsidiary.[53] Thus § 1(4) AStG and the issue presented in *Hornbach* may be seen against the background of distinguishing what is a "business relationship" that is subject to transfer pricing adjustments and what is a shareholder relationship – such as a contribution to equity – that is necessarily outside the arm's length standard.

25. In *Hornbach*, the Court considered that there might indeed be "commercial" reasons that could explain granting the letters of comfort without remuneration. It first noted that "the foreign group companies had negative equity capital and the financing bank made the granting of the loans required for the continuation and expansion of business operations contingent on the provision of comfort letters by

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[45] BFH, 30 May 1990, I R 97/88; BFH, 29 November 2000, I R 85/99.

[46] BFH, 30 May 1990, I R 97/88; see also, e.g., Fiscal Court of Baden-Württemberg, 4 December 2001, 1 K 250/99. The Bundesfinanzhof established a number of criteria that have to be fulfilled to find that equity has been contributed, i.e., *(1)* that it is a "value" that can be contributed (e.g., cash), *(2)* that the capital is "bound" (i.e., is excluded from cancellation) and *(3)* that the contribution cannot be withdrawn in case of bankruptcy; these criteria have to be assessed based on (foreign) company law.

[47] BFH, 29 November 2000, I R 85/99.

[48] BFH, 27 August 2008, I R 28/07.

[49] See also Fiscal Court of Baden-Württemberg, 4 December 2001, 1 K 250/99; Fiscal Court of Münster, 24 August 2006, 6 K 2655/03 E. Cf. BFH, 23 June 2010, I R 37/09, and BFH, 25 June 2014, I R 88/12 (essentially limiting that case law to situations where *(1)* the transaction is viewed as an equity contribution under company law or *(2)* where the transaction is sufficiently close to an equity contribution to warrant equal treatment, especially when a loan effectively replaces an equity contribution to an under-capitalized subsidiary to enable it to assume its economic functions).

[50] See German Federal Ministry of Finance (BMF), 17 October 2002, IV B 4 – S 13/41 – 14/02, BStBl I 2002, 1025, which was, however, materially rejected by BFH, 27 August 2008, I R 28/07.

[51] German Federal Ministry of Finance (BMF), 12 January 2010, IV B 5 – S 1341/07/10009, BStBl I 2010, 34.

[52] See § 1(4) of the Foreign Tax Act (AStG) as amended by the "Gesetz zum Abbau von Steuervergünstigungen und Ausnahmeregeln (StVergAbG)", BGBl I 2003, 660.

[53] See the legislative explanation in BT-Drucksache 15/119, at p. 53.

Hornbach-Baumarkt AG".[54] Referring then to the very specific situation in *Hornbach*, i.e., "a situation where the expansion of the business operations of a subsidiary requires additional capital due to the fact that it lacks sufficient equity capital", the Court accepted that "there may be commercial reasons for a parent company to agree to provide capital on non-arm's-length terms".[55] This is a spectacular conclusion insofar as the Court accepts that the position of *Hornbach* as a shareholder of a subsidiary in need of funding may justify terms and conditions of such funding deviate from an arm's length price. This means, as the Court put it, that a taxpayer is not precluded from arguing "economic reasons resulting from its position as a shareholder of the non-resident company".[56] Accordingly, the Court explains:

> "there may be a commercial justification by virtue of the fact that Hornbach-Baumarkt AG is a shareholder in the foreign group companies, which would justify the conclusion of the transaction at issue in the main proceedings under terms that deviated from arm's-length terms. Since the continuation and expansion of the business operations of those foreign companies was contingent, due to a lack of sufficient equity capital, upon a provision of capital, the gratuitous granting of comfort letters containing a guarantee statement, even though companies independent from one another would have agreed on remuneration for such guarantees, could be explained by the economic interest of Hornbach-Baumarkt AG itself in the financial success of the foreign group companies, in which it participates through the distribution of profits, as well as by a certain responsibility of the applicant in the main proceedings, as a shareholder, in the financing of those companies."[57]

However, the ECJ left open the decision for the domestic court to determine whether Hornbach-Baumarkt AG was in a position, without being subject to undue administrative constraints, to put forward elements attesting to a possible commercial justification for the transactions at issue in the main proceedings.

26. Even after *Hornbach*, however, one is left with the question of how far potential "commercial justifications" might go. One might argue that the Court's language was quite restricted and narrow[58] to merely address the specific situation that the transaction (e.g., the guarantee or a loan) deviates from arm's length because it economically replaces an equity contribution. Such limited reading would also be in line with the historical development of German case law and the definition of a "business relationship" in § 1(4) AStG, which, in 2003, broadened the scope of transfer pricing adjustments to situations that could otherwise be viewed as replacing equity. However, the Court also uses the notion that Hornbach-Baumarkt AG had "an economic interest […] in the financial success of the foreign group companies, in which it participates through the distribution of profits".[59] However, we think it would go way too far to accept a taxpayer's "commercial" justification based on the argument that it sells too cheaply to its subsidiary to have it generate more profits that would come back as dividends.

IV. The Statement

27. CFE Tax Advisers Europe welcomes the Court's decision in *Hornbach* as an important clarification of the conditional compatibility of arm's length-based domestic transfer pricing legislation with the freedom of establishment. *Hornbach* follows and confirms the previous doctrine formulated in the *SGI* judgment and did not adopt the Advocate General's approach that would have denied comparability of domestic and cross-border situations in transfer pricing cases and, hence, preventing scrutiny of domestic transfer pricing legislation under the fundamental freedoms.

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[54] *Hornbach* (C-382/16), para. 53.

[55] *Hornbach* (C-382/16), para. 54.

[56] *Hornbach* (C-382/16), para. 57.

[57] *Hornbach* (C-382/16), para. 56.

[58] See, e.g., "[i|n a situation where the expansion of the business operations of a subsidiary requires additional capital due to the fact that it lacks sufficient equity capital" (in para. 54), "lack of sufficient equity capital" for expansion (para. 56).

[59] *Hornbach* (C-382/16), para. 56.

28. CFE Tax Advisers Europe welcomes the requirement that Member States have to grant taxpayers the opportunity to provide evidence "of any commercial justification" for non-arm's length transactions, so that denial of that opportunity through automatic transfer pricing adjustments would render these incompatible with EU Law. *Hornbach* hence confirms that the automatic application of the arm's length standard is not proportional *per se* simply because it accommodates internationally accepted standards, and it is hoped that this will stimulate a broader judicial control leading to the identification of the economic substance of a transaction. In that context it is further welcomed that "commercial justifications" may include "economic reasons resulting from its position as a shareholder of the non-resident company". At least in cases of non-arm's length transactions such as interest-free loans or gratuitous guarantees that are aimed at replacing equity, the *Hornbach* judgment clearly suggests that such a shareholder interest in the financial success of the foreign subsidiary may serve as such justification.