



## **Germany issues new administrative guidance on deviations from arm's length principle in specific restructuring situations**

### **Global Transfer Pricing Alert 2019-002**

On 6 December 2018, Germany's Federal Ministry of Finance released a two-page circular with new administrative guidance that allows German taxpayers to justify a deviation from the arm's length principle under specific circumstances.

The scope of the circular is limited to cases in which an intercompany transaction within the EU is directly related to a "financial recovery measure" taken by the taxpayer to support the corporate group or a specific company within that group. If a German taxpayer can prove that a financial recovery measure is required and that there is a possibility of a successful recovery, then the taxpayer can justify a deviation from the arm's length principle with regard to its cross-border intercompany transactions (that are related to the financial recovery measure within the EU). In those cases, the German tax authorities will not impose an income adjustment despite the non-arm's length pricing.

This circular is the first administrative reaction in Germany to the European Court of Justice's (ECJ's) 31 May 2018 ruling in the Hornbach-Baumarkt case (C 382/16, Hornbach-Baumarkt). The court had ruled that one of the core German transfer pricing laws (sec. 1 of the German Foreign Tax Code (FTC)) must include an option for taxpayers to justify potential deviations from the arm's length principle with "economic reasons." Otherwise, income adjustments based on sec. 1. FTC might conflict with the EU's freedom of establishment.

The court also clarified that “economic reasons” may include reasons that are based on the shareholder relationships between the related parties. This comment caused considerable uncertainty among taxpayers and tax advisors in Germany, because the arm’s length principle so far has been understood to require taxpayers to disregard any shareholder relationships when determining appropriate transfer prices.

With the issuance of the new circular, the German tax authorities have now reacted to this court ruling. In their response, they appear to suggest a narrow interpretation of the court’s comments by linking them only to financial recovery measures.

### **Background: Concerns regarding the German FTC’s compliance with European law**

Germany’s transfer pricing laws are manifold. Sec. 1 FTC generally applies to all types of intercompany transactions, but is limited to cross-border situations. Other regulations, such as sec. 8 para. 3 of the German Corporate Tax Code (CTC) also apply to domestic transactions within Germany, but those regulations do not cover all kinds of intercompany transactions. For example, the pricing of domestic transactions such as the granting of guarantees or the provision of services by the parent company to a subsidiary are generally not covered by these regulations. Hence, intercompany transactions (such as free-of-charge intercompany downstream guarantees or services) between related parties in a cross-border context may receive less favorable legal treatment than otherwise identical transactions in a domestic context.

In the EU context (group parent company in Germany and subsidiary in another EU country), such unequal treatment of domestic transactions and cross-border transactions can give rise to concerns regarding German law’s compliance with the EU’s fundamental freedoms, in particular the freedom of establishment. The freedom of establishment allows all EU companies to establish subsidiaries, branches, and agencies in any other EU member state (without discriminatory treatment compared to domestic subsidiaries, branches, or agencies).

The ECJ addressed those concerns in its 31 May 2018 judgement. The ECJ concluded that a restriction of the freedom of establishment may be appropriate if it is necessary to ensure an appropriate allocation of taxation rights among countries. In this respect, sec. 1 FTC was found not to be in fundamental conflict with European law. However, the court found that compliance with European fundamental laws is ensured only if a taxpayer has a chance to demonstrate that its deviation from the arm's length principle is due to “economic reasons” (that is, non-tax reasons).

### **Implications of the ECJ decision**

The Hornbach-Baumarkt judgment was unclear as to which types of (shareholder-related) "economic reasons" would be accepted by the German tax authorities, and in which cases would these economic reasons justify a deviation from the

arm's length principle. Some observers commented that the ruling might effectively downgrade sec. 1 FTC so that it only prevents purely artificial arrangements in the EU context in the future (because "economic reasons" can likely be put forward by taxpayers for all other arrangements).

Commentators also discussed whether extending the scope of sec. 1 FTC (so that it also covers domestic transactions) or of sec. 8 para. 3 CTC (so that it also covers downstream services and financial guarantees) would remove the unequal treatment of domestic transactions and intra-EU transactions, and thus remove any concerns with regard to the EU's freedom of establishment. However, both changes would create major disruptions in German taxation principles and might create significant additional compliance burdens and uncertainty for taxpayers.

### **Contents of the new circular**

The administrative circular issued on 6 December 2018 adopts none of the measures discussed above. Instead of changing any of the tax laws involved, the German Federal Ministry of Finance is taking a relatively quick but small first step to resolve the matter.

The circular's unofficial translation reads as follows:

*In its ruling of 31 May 2018 in Case C-382/16 "Hornbach-Baumarkt," the European Court of Justice ruled that a provision such as the one in section 1 FTC must allow a resident taxpayer to prove that conditions have been agreed upon for economic reasons resulting from its position as shareholder of the nonresident company. In the present case, a subsidiary was reliant on the injection of capital to expand its business activities. In such a case, economic reasons could justify the granting of capital by the parent company under non-arm's length conditions.*

*Accordingly, an income adjustment based on section 1, paragraph 1 FTC cannot be imposed if the taxpayer can prove factual, economic reasons that require conditions deviating from the arm's length principle to secure the otherwise threatened economic existence of the group of companies as such or the entity affiliated to the taxpayer ("financial recovery measure"). Financial recovery measures are aimed at avoiding over-indebtedness or insolvency, and ensuring the going concern of the related party or group of companies. The taxpayer must provide [firstly] evidence of the requirement for a financial recovery measure [in German "Sanierungsbedürftigkeit"], in particular the need for a financial recovery and [secondly] the possibility of a successful financial recovery [In German "Sanierungsfähigkeit"] with regard to the affiliated entity or group of companies.*

*In its decision, the ECJ refers to the freedom of establishment; hence, its decision does not apply to cases involving non-EU countries.*

### **Conclusion**

With the new administrative circular, the German tax authorities are likely attempting to limit the potential

applicability of the court's ruling to a narrow set of situations -- financial recovery situations within the EU. Given that the court did not limit the scope of its comments to such cases, commentators expect further administrative or legislative changes and/or further court decisions that hopefully will provide more clarity. It is important to note that the administrative guidance is binding only on the tax authorities, not on taxpayers or the courts.

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