

INTERNATIONAL TAX REVIEW

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European Court's Hornbach-Baumarkt ruling gives clarity on arm's-length principle

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Taxpayers will be able to argue more effectively against transfer pricing readjustments following a key ruling on the arm's-length principle in the Hornbach-Baumarkt case.

The ECJ ruled that member state tax rules are proportionate (and therefore in line with EU law), saying taxpayers in the EU have the right to demonstrate that they may have had commercial reasons for failing to meet the standard required of the arm's-length principle.

"This is an important point because the issue has been litigated extensively before," said Kelly Stricklin-Coutinho, barrister at 39 Essex Chambers in London.

Facts of the case

This time, the ECJ ruled on a transfer pricing dispute between Hornbach-Baumarkt-AG and the Finanzamt Landau in Germany.

Hornbach had provided free loan guarantees to its Dutch foreign subsidiary. The German parent, in turn, was audited, with the tax authorities adjusting the company's profits upwards.

The German parent company then challenged this at the Landau tax court, alleging that Germany's tax rules breached the EU's freedom of establishment clause because German tax authorities were only applying the rules on cross-border transactions, but not on similar national transactions. Also, the German tax law didn't allow taxpayers to supply evidence justifying the transfer pricing issue.

"The ECJ went further than prior case law," said Mario Tenore of Maisto e Associati in Milan. "Previously, courts have held that transfer pricing legislation could be restrictive in some cases."

"The wording of the ECJ's judgment in the *Thin Cap [group litigation]* was sufficiently ambiguous that the parties were willing to litigate this to the Court of Appeal," said Stricklin-Coutinho. The ECJ has dealt with this issue again, in the *Société de Gestion Industrielle (SGI) case*. The ECJ appears to take a different approach in this case than it did previously."

Though earlier rulings were seen as contrary to the EU's freedom of establishment rule, national tax courts in the EU went along with this logic in order to prevent profit shifting and tax evasion. In *Hornbach-Baumarkt*, the court actually affirmed this principle, saying that as long as taxpayer is given the right to provide evidence of a commercial justification behind the setting of intra-group pricing at a level lower than what would be agreed upon between unrelated parties, then some restrictions are justified.

Impact for taxpayers

Tax practitioners told *ITR* that the ruling can be seen as an opening from the ECJ giving leeway to taxpayers to raise an argument based on shareholder or group benefit during the course of an audit. To that end, it could give companies the chance to explain why prices have been set below market rates or why there wasn't specific remuneration for a given intragroup services, like the provision of guarantees.

Furthermore, the court opened the door for taxpayers to argue that they have set prices below the arm's-length principle due to their own specific shareholder situations. It doesn't oblige tax authorities to except the taxpayer's justification, though.

"Again, what the ECJ ruling really does is confirm the *SGI* case," said Diana Weyrauch, senior manager of business tax at Deloitte in Munich. "To that end, it's not surprising."

Weyrauch suggested that, ultimately, the ruling will mean that certain German-based multinationals may not have to apply the arm's-length principle if there are good economic reasons to avoid doing so. Those reasons needn't be tax justifications; they could be other economic reasons. Ultimately, though, the decision to accept the tax rationale will be that of a local tax court, Weyrauch explained.

"[The ECJ] said clearly it's up to local courts to decide," Weyrauch said. "But there is always a risk that tax authorities will attack what they are doing unless they can receive guidance from tax authorities."

Stricklin-Coutinho agreed, adding: "No doubt multinationals will consider the judgment carefully for its implications on their current arrangements. While the case refers specifically to guarantees, the principle in the case will be of broad application."

Although *Hornbach-Baumarkt* specifically concerned a guarantee given without consideration, the issue of a taxpayer's ability to prove commercial purpose to a transaction even if they do not comply with the arm's-length principle "is one which goes to the heart of transfer pricing law", said Stricklin-Coutinho. "It is also relevant to other taxes where commercial purpose is a feature of the rules, such as CFC rules."

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