Case C-382/16 *Hornbach-Baumarkt*

AG Bobek issues his opinion on compatibility of German transfer pricing legislation with the freedom of establishment

On 14 December 2017, AG Bobek issued his opinion in the Case C-382/16 *Hornbach-Baumarkt*. 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 transfer pricing ("TP") legislation and adjusted upwards the profits of the parent company under the assumption that two 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.

The AG approaches the case from two perspectives: (i) by assuming that the analysis of compatibility with the freedom of establishment requires a "discrimination approach" and, alternatively, (ii) by assuming that such analysis requires a "restriction approach". Under the first perspective, the AG holds that German TP legislation is designed to ensure that profits realized in Germany are not artificially shifted outside Germany. In the light of such objective, AG concludes that cross-border situations and domestic situations are not comparable since, in the latter case, there is no risk that profits generated in Germany are transferred outside such jurisdiction. As a result, the application of the German TP legislation in the case at stake would be compatible with the freedom of establishment.

Under the alternative "restriction approach", the AG excludes the infringement of the freedom based on the argument that the taxation of a company on the arm's length profits stemming from the transactions incurred with its foreign subsidiaries is an expression of the principle of territoriality, which reflects the Member States' right to tax profits generated in their territories

and which cannot be considered a deterrent for German companies wishing to establish subsidiaries in other Member States.

Finally, according to the AG, if the Court were to conclude that the German TP legislation restricts the freedom of establishment, such restriction would be in any case justified by the need to preserve the balanced allocation of taxing powers between Member States. In particular, the AG dismisses the argument put forward by the taxpayer and the Commission, according to which the German TP legislation should enable taxpayers to adduce commercial reasons based on the particular relationship existing between parent and subsidiary companies in order to justify the non-arm's length price of a certain transaction. According to the AG, if such argument were accepted, the arm's length principle would be deprived of any meaning, as a parent company could always rely on its interest in ensuring the success of its subsidiary.

In general terms, the AG's conclusions appear particularly relevant for the following reasons. On the one hand, the AG explicitly invites the Court to clarify whether the application of the freedom of establishment in the area of direct taxation should be based on the "discrimination approach", which the AG appears to prefer, or on the "restriction approach". On the other hand, he requests the Court to unambiguously base the "discrimination approach" on a comparability analysis, so that, since purely domestic and cross-border transactions are not comparable with regard to the purpose of the German TP legislation (i.e. to avoid profit shifting outside Germany), the application to such transactions of different tax rules should be regarded, at least in principle, as not entailing any breach of the freedom of establishment.

According to the AG, this conclusion might only be different where the transactions between resident companies somehow enjoyed lower overall taxation, due for instance to the application of different tax rules to the parent and the subsidiary. In such a case, cross-border tax distortions and purely domestic tax distortions would not be tackled in a comparable manner, and that could trigger a tax discrimination restricting the freedom of establishment.

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