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## **COMPLIANCE OF THE TAXPAYER WITH THE PRINCIPLE OF INDEPENDENCE OF PARTIES**

The headline “Independence of Parties” tempts to give an overview of the law struggling between wishful thinking and hard reality. Independence presupposes and requires --apart from the absence of violence of course-- economic, personal and moral independence. The lack of real independence reduces legal independence to a shell.

1. This problem exists everywhere and maybe notably in the international sphere with its inequalities. We may assume that many cross-border contracts are gag contracts. We cannot discuss the problems set up by an imbalanced market on the whole but want to focus on the subtle kind of dependence special relationships between the parties may create. *For companies within a group structure the corporate network allows to design special conditions and prices not in line with the free market for reasons whichever.* There is often a tax-efficient choice reducing the assessment basis and/or the taxes in the high-tax country, often shifting it to low-tax countries, sometimes charming patches of earth with a special attitude towards taxes. As Germany is a high-tax country we consider this habit, base erosion and profit shifting (BEPS), a bad habit.

2. If the law of double taxation allocates the right of taxation to us we have to consider whether contractual network and especially prices may be accepted for tax purposes. We only accept conditions which comply with the arm’s length principle, that is, if these conditions would be usual for third parties as well. As for the question whether parties comply: They are not obliged to use arm’s length conditions. This is

essential for our approach. They can do what they want and they do. However, they must accept taxation which does not exactly comply with their wishes.

a) Our legislative bodies were busy creating rules on testing contracts for compatibility with the arm's length principle. *The "Außensteuergesetz" (let me translate it "foreign tax law" --FTL--)* contains some fundamental rules on taxation in cross-border cases. It dates from the year 1972 but was changed several times since.

aa) § 1 FTL regulates the correction of income if the arm's length principle isn't complied with. The basic rule in § 1 para. 1 sent. 1 FTL says --rough translation-- the following: If the taxpayer's income from a business relationship abroad with a person close to him is reduced by the fact that he takes as a basis for the calculation of his income other conditions, especially prices (transfer prices), than independent third parties would have agreed under the same or comparable circumstances (arm's length principle), then --without prejudice to other regulations-- his income is fixed just as if the income would have accrued under conditions agreed between independent third parties. Briefly: *If third parties would not have chosen conditions, they are not accepted for taxation purpose.* Then correction of income takes place. § 1 FTL provides a lot of further definitions and specifications trying to fix as precisely as possible how to find out the conditions which really comply with the arm's length principle, too long to quote all. § 1 para. 2 FTL gives a detailed definition of "person close to him". Its main topic is the question whether someone exercises dominant influence within a corporate network, starting with corporate participation of at least one quarter of capital or shares.

bb) *The principal method to determine arm's length prices is the comparison with real or fictitious contracts between unrelated third parties.* According to § 1 para. 3 FTL the actual circumstances of the respective business transaction, the function of those involved in the transaction and the risk distribution must be considered and form the benchmark for the test of comparability with business transactions between third parties. If a comparable value cannot be found, economically recognized valuation

methods must be used. § 1 para. 3a FTL even prescribes how to find the appropriate value amidst a range of values.

b) The FTL doesn't seem complicated enough. § 1 para. 6 FTL has entitled the Federal Ministry of Finance to regulate details on the arm's length principle. They did, and the outcome was the "Betriebsstättengewinnaufteilungsverordnung" (rough translation: regulation concerning profit-splitting between places of business) enacted in 2014 with 41 articles.

3. Our laws also tell us how to obtain all information necessary. The administrative procedure in tax matters is regulated in the "Abgabenordnung" (simply translated perhaps "tax code" --TC--). According to § 90 para. 2 TC the taxpayer generally has to provide all relevant information relating to what occurs abroad. § 90 para. 3 TC contains elaborated instructions on the records the taxpayer has to create concerning his business relationships abroad. § 90 para. 3 sent. 11 TC has entitled the Federal Ministry of Finance to regulate details on the records required, and this has been done by the "Gewinnabgrenzungsaufzeichnungs-Verordnung" (rough translation: regulation concerning records on profit-splitting), latest version of 2017, fulfilling any regulation wish. There is no doubt that doubts arise however detailed regulation is.

4. *The jurisprudence of the Federal Fiscal Court (FFC) in Germany, the I. Senate dealing with the matter, is consistently based on the wording of rules. Examples only:*

a) *The correction of income isn't limited to prices.* § 1 para. 1 FTL says "especially prices" which doesn't mean "only prices". Therefore correction may extend to all other accounting measures influencing the income like the correction of accounted values (FFC-judgment from 19<sup>th</sup> of February 2020 - I R 19/17, point 33).

b) A good example as well is a judgment concerning profit shifting. Superficial consideration suggests that the correction of income because of non-compliance with

the arm's length principle only takes place when the agreed condition reduces the German income and (!) at the same time increases the income abroad. This is wrong. § 1 FTL only requires the reduction of the taxpayer's income due to conditions not meeting the arm's length principle. The rule doesn't require a rise of the taxpayer's income anywhere else (FFC-judgment from 09<sup>th</sup> of June 2021 - I R 32/17, point 17). That means: We don't have to check whether and to what extent the questionable condition affects any foreign taxation.

c) An example for a practical implementation of the arm's length principle is a loan without valuable mortgage or at least personal guarantees or similar. *There may be exceptions but generally we can assume that giving a loan just for good faith isn't the typical loan agreement between independent third parties.* This is especially true if there are some risks in the business. *Being part of a corporate group doesn't make a difference* (FFC-judgment from 18<sup>th</sup> of December 2019 - I R 72/17, point 15, 16). The parent company not being legally obliged will not want to know anything about the loan once it turns to be a bad loan.

5. Last not least we often have to look beyond our national law, to be precise, to the European Law, and this is often a difficult task - and often crucial:

a) The Treaty on the Functioning of the European Union knows the so-called freedom of establishment. In general, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State are prohibited. The wording:

“Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.“

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital.“ (Art. 49 of the Treaty on the Functioning of the European Union)

b) *If the cross-border business takes place within the European Union the correction of income according to § 1 para. 1 FTL is a restriction on the freedom of establishment. If exactly the same business had taken place within Germany only, there would be no correction of income. According to the jurisprudence of the Court of Justice of the European Union (CJEU) restrictions are permitted under strict conditions. The CJEU has already decided to accept § 1 FTL in principle but has added that 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 (CJEU-judgment from 31<sup>st</sup> of May 2018 - C-382/16 “Hornbach-Baumarkt”).*

c) This isn't just a formality. The Federal Constitutional Court (FCC) in Germany has quite recently overturned a FFC's judgment. The FCC thinks that the FFC had not properly implemented the legal opinion of the CJEU (FCC-decision from 04<sup>th</sup> of March 2021 - 2 BvR 1161/19). This should not happen but happens. The case was remitted to the FFC for a new decision. Meanwhile it is indeed decided again (FFC-judgment from 13<sup>th</sup> of January 2022 - I R 15/21), and the judgment is published, publication being a precondition to be allowed to talk about it. There is no knowledge gain concerning the point of interest: The Federal Fiscal Court did *not* answer the question whether correction of income complies with European Law. The colleagues found that the facts were not sufficient to decide whether --according to the standards of the FTL-- the

correction should take place at all. This is logical: Only if the FTL demands a correction, the compliance of the FTL with European Law is decisive.

6. So far - a tiny glimpse on a matter a scientist, a lawyer or a tax advisor certainly can devote all his professional life to.

**Dear colleagues, thank you for listening - I hope for another opportunity for all of us to discuss tax matters, other legal matters or any other matters, and I very much hope this will take place offline in Kyiv.**