Analysis

Commercial purpose: a new standard in EU law?

Speed read

The CJEU in *Hornbach-Baumarkt* (Case C-382/16) considers the principle of proportionality in cases where the taxpayer's arrangements are not on arm's length terms, but there is nonetheless a commercial reason for making them. The CJEU's judgment is that tax rules will be proportionate where they take account of those reasons, and that the taxpayer's characteristics are relevant to assessment of commercial purpose. This appears to be at odds with the English courts' interpretation of this line of case law. The relevance of the ruling is not confined to arm's length cases but will also impact on other areas where commercial purpose is concerned.

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The significance of *Hornbach-Baumarkt* (Case C-382/16) is that the CJEU has looked again at the arm's length principle and commercial purpose as a matter of EU law, and the conclusion it reaches may be more generous towards taxpayers than the interpretation given to the case law by the English courts. On a fundamental issue where the arm's length principle is relevant; it considers the relevance of the characteristics of the taxpayer in assessing commerciality.

This case may therefore present an opportunity for taxpayers to consider whether this broader principle applies to them, and whether their arrangements align with it.

The case

The case was a reference for a preliminary ruling on the compatibility of the German transfer pricing rules with article 49 (the freedom of establishment) of the Treaty on the Functioning of the European Union (TFEU). The relevant German provision provided for a 'correction of income' in the following terms:

> 'If a taxpayer's income from business relations with a related party is reduced as a result of the fact that, in connection with such business relations abroad, it agrees to terms that depart from those that would have been agreed on by unrelated third parties under the same or similar circumstances, then, without prejudice to other provisions, its income must be declared as if it had been earned under terms agreed upon between unrelated third parties.'

Hornbach-Baumarkt AG ('Hornbach-Baumarkt') is a German public limited company operating DIY and building materials shops in Germany and other member states. Hornbach-Baumarkt held indirect 100% shareholdings in two Dutch companies. The Dutch companies had negative equity capital. The Dutch companies required bank loans (totalling about €15m) in order to continue their business operations and to finance the planned construction of a DIY store and a garden centre. The lending bank was prepared to make the loans, but contingent upon the provision of comfort letters providing Hornbach-Baumarkt's guarantee. The comfort letters undertook to the lending bank to refrain from divesting or changing Hornbach-Baumarkt's shareholding in the intermediate holding company, and to ensure that the intermediate holding company would also refrain from divesting or changing its shareholding in the Dutch companies, without written notice of at least three weeks. Hornbach-Baumarkt also undertook on an irrevocable and unconditional basis to fund the Dutch companies so that they could meet all of their liabilities, in particular by making funds available to the companies to satisfy their liabilities to the lending bank. It also undertook to ensure that funds would in fact be used to settle liabilities towards the bank. These undertakings were made gratuitously.

The German tax authority considered that unrelated third parties in similar circumstances would require remuneration in exchange for the guarantees, so it determined that the level of German income should be increased by an amount corresponding to what it assessed the remuneration for the guarantees would have been. The correction to the tax computation was for a total of approximately €37,000.

Hornbach-Baumarkt argued that the German provisions led to unequal treatment when comparing domestic and foreign transactions because in purely domestic transactions there would be no correction of foreign income. Pursuant to *SGI* (Case C-311/08), it argued that the German provision was a restriction on the freedom of establishment which was disproportionate. Hornbach-Baumarkt argued that *SGI* required a provision providing 'the opportunity to present commercial justification in order to explain a non-arm's length transaction'. It argued that commercial reasons explain why no remuneration was given for the comfort letters.

The German tax authority argued that although German law did not contain a specific provision to the effect that evidence of commercial justification could be presented, the taxpayer nonetheless had the opportunity to present evidence of the reasonableness of the transaction.

On referral to the CJEU, the German court made reference to the proportionality principle in *SGI*. The judgment records that the referring court is 'uncertain as to whether commercial justification may be presented as evidence to explain why a transaction concluded on non-arm's length terms could be connected to the fact that Hornbach-Baumarkt has a shareholding in the foreign group companies'. The referring court noted that the parent company has its own financial interest in the commercial success of its subsidiary and would assume, where necessary, financial responsibility for that subsidiary. Finally, the referring court pointed out that while the taxpayer has the opportunity to explain why terms agreed on are in line with what would have been agreed by unrelated third parties, the law does not allow taxpayers to present evidence of a commercial justification for a transaction concluded on non-arm's length terms, where the justification is based on the relationship of interdependence between the parties.

The way in which the referring court has presented the facts and the legislation is noteworthy, particularly given the context in the UK where the Court of Appeal in the *Thin Cap GLO* [2011] EWCA Civ 127 applied the reasoning in *SGI* to a different effect.

The judgment

The CJEU held that there was a restriction on the freedom of establishment because the income of a resident taxpayer is only reduced where it was agreed on non-arm's length terms if

the connected party is established outside Germany, whereas there will be no such correction where the party is a German established entity. This is less favourable treatment and has a deterrent effect.

The court held that the measure was justified by the need to ensure the preservation of the allocation of powers of taxation between member states.

The key element of the judgment concerns the court's ruling on proportionality. The court noted that the referring court's question relates to 'whether any commercial justification may include economic reasons resulting from the very existence of a relationship of interdependence between the parent company … and its subsidiaries'. The concept of 'commercial justification' within para 71 of the judgment in *SGI*, argued the German government, must be interpreted in the light of the principle of free competition, which rules out acceptance of economic reasons resulting from the position of the shareholder.

In response to that submission, the court held that:

'In 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, there may be commercial reasons for a parent company to agree to provide capital on non-arm's length terms.' (para 54)

The court noted that no argument as to the risk of tax avoidance had been advanced, that no artificial arrangement had been identified within the meaning of the case law, and that no desire on the part of the taxpayer had been identified to reduce its taxable profit.

The court held that there may be a justification based on Hornbach-Baumarkt's position as a shareholder of the Dutch companies, which could justify the conclusion of the transaction. The position could be explained by the economic interest of Hornbach-Baumarkt in the financial success of its subsidiaries (its participation being through the distribution of profits), and by its responsibility to finance the Dutch subsidiaries.

The CJEU remitted to the referring court whether Hornbach-Baumarkt did have the opportunity to put forward commercial justifications without it being precluded that economic reasons resulting from its position as a shareholder might be taken into account.

Consistency with earlier case law: *Thin Cap GLO* and *SGI*

In *Thin Cap GLO*, the Court of Appeal held that the objectives of ensuring the balanced allocation between member states of the power to tax, together with the prevention of tax avoidance, may justify legislation that would otherwise be an unlawful interference with the freedom of establishment, and that the application of an arm's length test is appropriate and sufficient for the purpose because it is proportionate. The Court of Appeal also held that the arm's length test is what would have been agreed under fully competitive conditions. It rejected the taxpayers' argument that where the transaction was not on arm's length terms, EU law required the UK to allow taxpayers to prove that it was nonetheless done for a commercial purpose.

In response to the taxpayers' argument that, when applying the arm's length test to a subsidiary within a group of companies, it was necessary to take account of the fact the subsidiary is within the group, the Court of Appeal held that there was nothing in the *Thin Cap GLO* judgment in the CJEU (Case C-524/04) to suggest that UK legislation might be incompatible because of its failure to take into account a subsidiary's membership of a non-UK group of companies.

Dissenting, Arden LJ held that: 'While it might be tempting to think that, if a transaction fails to meet a test of arm's length, it cannot be commercial, it is necessary to recall the jurisprudence of the court prior to *Thin Cap* [i.e. *Lankhorst-Hohorst*] and *the context in which the question of what is commercial arises*' (emphasis added).

Despite Arden LJ's dissent, English case law appears as though it might be at odds with this judgment.

An argument which might appear attractive on first blush is that *Hornbach-Baumarkt* might be distinguished from *Thin Cap* because there was no allegation of tax avoidance in *Hornbach-Baumarkt*, and the justification of the prevention of tax avoidance was not raised.

However, that argument is unlikely to hold much water. The facts arising in *Thin Cap GLO* concerned a group of test claimants, in respect of which the findings – and in some cases, concessions – were that their motivations were commercial. The claimants were successful in establishing commercial reasons for acting; the issue was the meaning of the arm's length principle in this context.

Volvo concerned a loan by Volvo's treasury company to a subsidiary in the group, in order to allow Volvo to make an investment in a UK listed multinational. HMRC accepted in that case that the interest rate on the loan 'prima facie … seemed to be a reasonable deal' and that Volvo was 'not seeking to obtain an unfair tax advantage'.

Lafarge had launched a hostile takeover bid and made another major UK corporate acquisition, which required substantial intra-group lending. The first instance judgment records that: 'The underlying commerciality of the two acquisitions has never been in doubt, and was accepted [by HMRC] in cross-examination.'

IBM's UK subsidiaries borrowed substantially in order to keep the UK group afloat, and it was held that 'the loans were made for purely commercial reasons to sustain a business in crisis.'

Moreover, this judgment seems to deal directly with the question which the Court of Appeal addressed, which was whether *Thin Cap* and *SGI* should be read to mean that where the transactions concerned were not on arm's length terms, the taxpayer could nonetheless have commercial reasons for making them.

The CJEU does not appear to distinguish *SGI*, and cites it approvingly before it goes on to give its judgment as set out above.

Application of the judgment

Proportionality requires that where taxpayers have commercial reasons for being in breach of the arm's length principle, they are given an opportunity to do so, and their economic characteristics should be taken into account when assessing commerciality. This will be relevant to those dealing with the arm's length principle, but it may also be relevant in other contexts where demonstrating commercial purpose is relevant (such as in relation to CFCs).

There is a broad range of ways in which this case might be used to taxpayers' benefit: taxpayers should consider its application to the terms of advance pricing arrangements (current and to be negotiated), filing positions in forthcoming computations and whether there is merit in challenging assessments for recent periods.

In addition, how this principle applies in state aid matters should be considered; there is English precedent on state aid law which supports the CJEU's interpretation. ■

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▶ Cases: *Hornbach-Baumarkt v Finanzamt Landau* (5.6.18)