Federal Fiscal Court decision of 27 February 2019, I R 51/17
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Income adjustment pursuant to section 1 (1) of the External Tax Relations Act in the case of profit-reducing write-offs and write-downs to the going-concern value of unsecured claims from supply relationships within a group

Guiding principles

1. A lack of collateral for a claim from supply relationships is fundamentally regarded as a non-arm's-length "term" as referred to in section 1 (1) of the External Tax Relations Act. This is also the case with regard to Article 9 (1) of the OECD Model Convention (here: Article 9 of the 1985 German-Chinese DTA).

2. Article 9 (1) of the OECD Model Convention (here: Article 9 of the 1985 German-Chinese DTA) does not limit the scope of the adjustment pursuant to section 1 (1) of the External Tax Relations Act to price adjustments; instead, it also makes it possible to neutralise a profit-reducing write-off or write-down of a loan (contrary to Senate judgments of 24 June 2015 I R 29/14, Decisions of the Federal Fiscal Court (BFHE) 250, 386, Federal Tax Gazette II 2016, 258, and of 17 December 2014 I R 23/13, BFHE 248, 170, Federal Tax Gazette II 2016, 261).

3. European Union law does not preclude an income adjustment pursuant to section 1 (1) of the External Tax Relations Act in connection with subsidiaries in third countries.

Operative provisions

On appeal by the plaintiff, the judgment of Cologne Fiscal Court of 17 May 2017 9 K 1361/14 is annulled.

The matter is referred back to Cologne Fiscal Court.

Responsibility for the decision on the costs of the proceedings is transferred to Cologne Fiscal Court.

Facts of the case

I.

1 The participants disagree over the lawfulness of an income adjustment pursuant to section 1 of the External Tax Relations Act (*Außensteuergesetz*), as amended by the 2008 Business Taxation Reform Act (*Unternehmensteuerreformgesetz*) of 14 August 2007 (Federal Law Gazette I 2007, 1912, Federal Tax Gazette I 2007, 630).

2 The plaintiff and appellee (plaintiff) is a *Kommanditgesellschaft* (limited partnership) with a financial year that deviates from the calendar year, running from 1 July to 30 June. The company A GmbH held a 10% stake in the *Kommanditgesellschaft* as an unlimited partner, and natural persons held stakes as limited partners (indirectly, via additional co-entrepreneurships). In the year under dispute (2008), the plaintiff was the sole shareholder of the Chinese company A Ltd. A claim in the amount of €... against this company, which originated from supplies in 2004 and 2005, was still open in 2007 and in 2008. The claim was unsecured and did not bear interest.

3 On 20 December 2007, the plaintiff first of all waived part of its claim in the amount of €... in exchange for a debtor warrant (*Besserungsschein*) and wrote off this part of the claim on its commercial balance sheet with a profit-reducing effect. With effect as of 30 June 2008, the plaintiff

wrote down the claim on its commercial balance sheet by € ..., due to the fact that it was still worthless, and finally declared a debt waiver on 6 December 2008.

4 The defendant and appellant (the Tax Office) did not recognise the value adjustment within the scope of the separate and joint determination of the tax bases and increased the profit off-balance-sheet in the amount of 3% of the claim, due to the fact that no interest had been charged on the claim.

5 In its objection ruling, the Tax Office recognised, with regard to the earnings covered by section 3 no 40 and section 3c (2) of the Income Tax Act (*Einkommensteuergesetz*), section 8b of the Corporation Tax Act (*Körperschaftsteuergesetz*) and section 4 (7) of the Transformation Tax Act (*Umwandlungssteuergesetz*) – each in the version applicable in the year under dispute – a previously disputed write-down of a claim against a British subsidiary in the nominal amount of €... at a rate of 100%.

6 The action was successful in terms of the write-off and write-down of the claim (judgment of Cologne Fiscal Court of 17 May 2017 9 K 1361/14, Decisions of the Fiscal Courts 2017, 1738). However, with regard to the claim upon which no interest was charged, Cologne Fiscal Court considered an interest rate of 10.5% to be appropriate, and increased the profit accordingly – limited to the period before the debt waiver – by a further 7.5% of its nominal amount. In addition, it reduced the write-down to the going-concern value of the claim against the British subsidiary to the extent that a public limited company in the form of A GmbH has a holding in the plaintiff itself, and therefore by 10% of € ... (= € ...).

7 In its appeal, the Tax Office submits that substantive legal arrangements have been violated and requests that the challenged judgment be annulled and the action dismissed.

8 The plaintiff requests that the appeal be dismissed.

Grounds

II.

9 The appeal is justified. As a result, the preliminary decision is annulled and the matter is referred back to Cologne Fiscal Court for another hearing and decision (section 126 (3), first sentence, number 2 of the Code of Procedure for Fiscal Courts (*Finanzgerichtsordnung*)).

10 The findings made by the judges of fact in the lower court are not sufficient to allow an assessment to be made regarding whether the profit reductions relating to the write-off and write-down of the claim are to be adjusted off-balance-sheet pursuant to section 1 of the External Tax Relations Act.

11 1. 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 international business relations, it agrees to terms that diverge from those which independent third parties would have agreed under the same or similar circumstances, then, pursuant to section 1 (1) of the External Tax Relations Act, the taxpayer's income must, without prejudice to other provisions, be assessed to be as it would be under terms agreed between unrelated third parties. Business relations in this sense are, pursuant to section 1 (4) of the External Tax Relations Act, defined as any contractual relationship upon which the income is based, which is not agreed in the company statutes and which is part of an activity of either the taxpayer or the related party to which sections 13, 15, 18 or 21 of the Income Tax Act apply or which, in the case of a non-resident related party, would have applied if the activity had taken place in Germany.

12 2. In accordance with the above, an off-balance inclusion of the respective profit reduction in the case under dispute may be considered pursuant to section 1 of the External Tax Relations Act.

13 a) The supply relationship between the plaintiff and A Ltd. is this type of business relationship, whose terms include the non-provision of collateral for claims (left open in the Senate judgment of 17 December 2014 I R 23/13, BFHE 248, 170, Federal Tax Gazette II 2016, 261, paragraph 15). Although the word "terms" is not legally defined, in typical business transactions it can, however, be expected to usually also include, in the case of supply relationships, agreements about any collateral that must be provided To avoid repetition, reference is hereby made to the comments in the Senate judgment on the parallel proceedings (of 27 February 2019 I R 73/16, BFHE 263, 525, Federal Tax Gazette II 2019, 394, paragraph 21).

14 b) Cologne Fiscal Court did not reach any findings regarding the question of whether the lack of collateral for the payment claims arising from the supply relationship corresponds to what an unrelated supplier that was not connected with the purchaser through a corporate relationship would have agreed (ex ante) with A Ltd. in the specific supply relationship (purchase price of €..., no interest). It can also not be derived from the disputed judgment whether and when an unrelated third party would possibly have insisted on valuable collateral for the outstanding amounts (at least) at a later time (after the supply) (cf. Senate judgment of 15 May 2018 I B 114/17, Federal Fiscal Court/Not Published (BFH/NV) 2018, 1092 on "abandoned" claims from supplies and services).

15 Cologne Fiscal Court did not examine the problem of the arm's length principle in more detail – which was, in its opinion, logical – because it followed the Senate's previous case-law (judgments in BFHE 248, 170, Federal Tax Gazette II 2016, 261, and of 24 June 2015 I R 29/14, BFHE 250, 386, Federal Tax Gazette II 2016, 258). Based on this case-law, under provisions that are based on Article 9 (1) of the Model Convention of the Organisation for Economic Co-operation and Development (OECD Model Convention), which also include Article 9 of the Agreement between the Federal Republic of Germany and the People's Republic of China for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital of 10 June 1985 (Federal Law Gazette II, 1986, 447, Federal Tax Gazette I 1986, 330) (1985 German-Chinese DTA), which is relevant in the case under dispute, an income adjustment pursuant to section 1 (1) of the External Tax Relations Act should only be possible if the price agreed between the associated companies did not pass the arm's length test in terms of its amount (its appropriateness). However, the Senate does not adhere to this case-law. Rather, the scope of the adjustment pursuant to Article 9 (1) of the OECD Model Convention also makes it possible to neutralise a profit-reducing write-off of a claim in respect of a loan or a write-down to the going-concern value. For the rationale, please refer once more to the Senate judgment in BFHE 263, 525, Federal Tax Gazette II 2019, 394 (paragraph 24 et seqq.). Article 9 of the 1985 German-Chinese DTA does not lead to a different result in this respect.

16 c) The carrying out of an arm's-length test within the scope of section 1 (1) of the External Tax Relations Act is not rendered unnecessary by other reasons.

17 aa) If an unrelated third party as supplier in the plaintiff's situation would not be prepared to supply the goods upfront without obtaining a valuable guarantee for the payment claims, then the factor known as "group support" (*Rückhalt im Konzern*) would not prevent the criteria in section 1 of the External Tax Relations Act from being fulfilled. The term "group support" only describes the legal and economic structure of links between companies and expresses the fact that it is customary for loans within a group of companies to not be secured in the same way as they would be if they were between unrelated parties. However, the mere fact that the controlling shareholder has the possibility of exerting influence on the borrower cannot be viewed as an arm's-length (valuable) guarantee of repayment in the sense of an active guarantee. Here, too, reference is made to the

Senate judgment in the parallel proceedings (BFHE 263, 525, Federal Tax Gazette II 2019, 394, paragraphs 13, 18).

18 bb) As set out in section 1 of the External Tax Relations Act, the income reduction would be caused by ("as a result of") the lack of collateral (left open in the Senate judgments in BFHE 250, 386, Federal Tax Gazette II 2016, 258, paragraph 16, and in BFHE 248, 170, Federal Tax Gazette II 2016, 261, paragraph 15). In this context, the key aspect is – in accordance with the causation principle (see Senate judgment of 18 April 2018 I R 37/16, BFHE 261, 166, Federal Tax Gazette II 2019, 73, paragraph 23) – the "triggering factor" for the profit-reducing loan write-off and write-down. The evaluating assessment that is required for this purpose is therefore to be based not on the insolvency of A Ltd. but primarily on the lack of collateral, because the plaintiff as a result linked its payment claim to the economic performance of its subsidiary, and this type of "mixing of asset risks" would not have happened if valuable collateral rights had been provided.

19 cc) Ultimately there is also no conflict between EU law and an income adjustment pursuant to section 1 (1) of the External Tax Relations Act.

20 To the extent that, with a view to the "substantial stake" that is required pursuant to section 1 (2) of the External Tax Relations Act, the freedom of establishment applies (Article 43 of the Treaty Establishing the European Community as amended by the Treaty of Nice amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts (EC Treaty), Official Journal of the European Communities 2002, C 325, 1, now Article 49 of the Treaty on the Functioning of the European Union as amended by the Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community (TFEU), Official Journal of the European Union, C 115, 47), it is not applicable in the case under dispute, because the freedom of establishment is only guaranteed within the territory of the member states of the European Union, to which the People's Republic of China does not belong.

21 The freedom of movement of capital, which is fundamentally protected, including in trade with third countries (Article 56 of the EC Treaty, now Article 63 of the TFEU), is not applicable to the legal consequences of section 1 (1) of the External Tax Relations Act, due to the "standstill" clause in Article 57(1) of the EC Treaty (now Article 64(1) of the TFEU). Pursuant to Article 57(1) of the EC Treaty, the provisions of Article 56 of the EC Treaty shall be without prejudice to the application to third countries of any restrictions which exist on 31 December 1993 under national or Community law adopted in respect of the movement of capital to or from third countries involving direct investment – including in real estate –, establishment, the provision of financial services or the admission of securities to capital markets. The standstill clause applies in the cases where section 1 (1) of the External Tax Relations Act applies, because this provision already existed on 31 December 1993 and has essentially remained unchanged.

22 Given that the application of section 1 (1) of the External Tax Relations Act requires as a condition, pursuant to section 1 (2) nos 1-3 of the External Tax Relations Act, a "substantial stake" in the taxpayer amounting to at least 25% or a controlling influence on the foreign company, the case in question entirely involves direct investments as referred to in Article 57(1) of the EC Treaty. To be classified as direct investment, it is sufficient that the investor is able, on the basis of the investment, to participate effectively in the management of the subsidiary or in its control (e.g. judgment of the Court of Justice of the European Union, formerly the European Court of Justice, Holböck of 24 May 2007 - C-157/05, EU:C:2007:297; paragraph 35, ECR 2007, I-4051; Senate judgment of 12 October 2016 I R 80/14, BFHE 256, 223, Federal Tax Gazette II 2017, 615, paragraph 44). In other respects, there is no doubt that the plaintiff's 100% holding in A Ltd., which exists in the case under dispute, is a direct investment.

23 3. The challenged judgment is based on a divergent legal assessment. It must therefore be annulled. The case is to be referred back to Cologne Fiscal Court, so that it can reach the necessary findings regarding whether the lack of collateral for the claims satisfies the arm's length principle. Should the lack of collateral satisfy the arm's length principle, Cologne Fiscal Court will have to examine, with regard to its decision regarding the write-down of the claim against the Chinese subsidiary, whether the plaintiff's income is to be determined, as part of the separate and joint determination of profits, before or only after application of section 8b (3) of the Corporation Tax Act, or whether the income is only to be communicated for informational purposes in the profit determination notice (see Herlinghaus in Rödder/Herlinghaus/Neumann, *Körperschaftsteuergesetz*, section 8b paragraph 502).

24 4. The transfer of responsibility for the decision concerning costs is based on section 143 (2) of the Code of Procedure for Fiscal Courts.