Federal Fiscal Court decision of 27 February 2019, I R 81/17
ECLI:DE:BFH:2019:U.270219.IR81.17.0

Income adjustment pursuant to section 1 (1) of the External Tax Relations Act in the case of write-downs to the going-concern value for loan claims that exist within a group of companies and in the case of a setting-up of a liability reserve due to a claim resulting from a surety bond (*Bürgschaft*)

Guiding principles

1. Providing insufficient collateral for a loan or for a right of recourse relating to a claim resulting from a surety bond are fundamentally regarded as non-arm's-length "terms" as referred to in section 1 (1) of the External Tax Relations Act. The same applies to Article 9 (1) of the OECD Model Convention (here: Article 9 (1) of the 2000 German-Austrian DTA).

2. Article 9 (1) of the OECD Model Convention (here: Article 9 (1) of the 2000 German-Austrian DTA) does not limit the scope of the adjustment pursuant to section 1 (1) of the External Tax Relations Act to price adjustments; rather, it makes it possible to also neutralise a profit-reducing write-off of a claim in respect of a loan or a write-down to the going-concern value (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 IR 23/13, BFHE 248, 170, Federal Tax Gazette II 2016, 261).

3. Whether an adjustment pursuant to section 1 (1) of the External Tax Relations Act is in conflict with the principle of proportionality under EU law is determined in accordance with an overall assessment of the circumstances of the respective individual case. When adjusting shareholder claims from loans or surety bonds, the economic interest and the financing responsibility, on the one hand, as well as the structural similarity to a supply of equity capital and the change to the status of the assets and liquidity of the lender or guarantor, on the other hand, must be taken into consideration.

Operative provisions

On appeal by the plaintiff, the judgment of Baden-Württemberg Fiscal Court, Freiburg External Senate, of 23 November 2017 3 K 2804/15 is annulled.
The matter is referred back to Baden-Württemberg Fiscal Court, Freiburg External Senate.
Responsibility for the decision on the costs of the proceedings is transferred to Baden-Württemberg Fiscal Court, Freiburg External Senate.

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 Tax Concessions Reduction Act (*Steuervergünstigungsabbaugesetz*) of 16 May 2003 (Federal Law Gazette I 2003, 660, Federal Tax Gazette I 2003, 321).

2 The plaintiff and appellee (plaintiff), a German limited liability company (GmbH), had held a 50% stake in company A GmbH, which was resident in Austria, since May 2001. The other 50% was held by natural persons who were unrelated to the plaintiff, who at the same time worked for A GmbH in a managerial capacity. The plaintiff granted A GmbH a total of five loans with maturities ranging from nine to 362 days for a total amount of €... . Interest of 5.5% per annum was charged on each of the loans. Ownership of various machines was transferred in each case as collateral. Furthermore, the plaintiff, by means of a contract dated 9 April 2003, entered into a surety bond (*Bürgschaft*) in the amount of €... for a loan from B Bank in Austria to A GmbH.

3 On 22 January 2002, A GmbH repaid part of its debt to the plaintiff in the amount of €..., followed by a further part repayment in the amount of €... on 16 June 2002. A GmbH's business suffered a downturn, causing the plaintiff to carry out a write-down to the going-concern value for the loans in the amount of €... on 31 December 2003. After bankruptcy proceedings were opened for A GmbH's assets on 7 December 2004, B Bank, in a letter dated 17 December 2004, issued a claim in the amount of €... against the plaintiff on the basis of the surety bond agreement. In this connection, the plaintiff set up a liability reserve as of 31 December 2004. In addition, it wrote down the remaining value of the loans to A GmbH in the amount of €... . The defendant and appellant (the Tax Office) neutralised, pursuant to section 1 (1) of the External Tax Relations Act, the profit reductions caused by the write-downs to going-concern value and by the liability reserve, by means of off-balance inclusions, and increased the taxable income by €... (2003) and €... (2004).

4 The action was successful (judgment of Baden-Württemberg Fiscal Court, Freiburg External Senate (the Fiscal Court), of 23 November 2017 3 K 2804/15, Decisions of the Fiscal Courts (EFG) 2018, 269).

5 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.

6 The plaintiff requests that the appeal be dismissed.

7 The Federal Ministry of Finance joined the proceedings (section 122 (2) of the Code of Procedure for Fiscal Courts (*Finanzgerichtsordnung*)). It supports the Tax Office's appeal without submitting its own petition.

Reasons for the decision

II.

8 The appeal is justified. It leads to the annulment of the preliminary decision and to the referral of the matter back to the Fiscal Court for another hearing and decision (section 126 (3), first sentence, number 2 of the Code of Procedure for Fiscal Courts).

9 The findings made by the judges of fact in the lower court are not sufficient in order to assess whether the profit reductions that relate to the write-downs to going-concern value and to the liability reserve are to be adjusted off-balance-sheet pursuant to section 1 of the External Tax Relations Act.

10 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.

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

12 a) The loan relationship between the plaintiff and A GmbH, and their contractual and unremunerated agency relationships which form the basis for the surety bond, are those types of business relationships 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 addition to agreements on the maturity, type and method of repayment and the amount and the payment date for interest – agreements about the 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).

13 b) The Fiscal Court did not reach any findings regarding the question of whether the securing of the repayment claims from the loans with the machinery that was assigned as collateral and the lack of collateral for the guarantor's recourse claims – including taking into consideration Austrian law – corresponds to what an unrelated lender or guarantor that was not connected with A GmbH through a corporate relationship would have agreed (ex ante). It did not examine the problem of the arm's length principle in more detail – which was logical in its opinion – 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 (1) of the Agreement between the Federal Republic of Germany and the Republic of Austria for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital of 24 August 2000 (Federal Law Gazette II, 2002, 735, Federal Tax Gazette I 2002, 585) (2000 German-Austrian 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 again refer to the Senate judgment in BFHE 263, 525, Federal Tax Gazette II 2019, 394 (paragraph 24 et seqq.). Article 9 (1) of the 2000 German-Austrian DTA does not lead to a different result in this respect.

14 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.

15 aa) If an unrelated third party as lender or guarantor in the plaintiff's situation would not be prepared to accept as sufficient the loans to A GmbH that were secured with machinery assigned as collateral, or to enter into the surety bond in relation to B Bank without valuable collateral being provided for its recourse claim, 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. First, the plaintiff, with its 50% holding, did not have a majority stake in A GmbH, which means that, apart from anything else, it is doubtful whether a group relationship existed. Second, 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).

16 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 or by the provision of insufficient 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 the setting up of a liability reserve. The evaluating assessment that is required for this purpose is therefore to be based not on the insolvency of A GmbH but primarily on the lack of collateral, because the plaintiff as a result linked its claim to the repayment of the loans, and its claim to recourse, 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.

17 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.

18 (1) Pursuant to the case-law of the Court of Justice of the European Union – formerly known as the European Court of Justice (ECJ) – an arrangement such as that of section 1 (1) of the External Tax Relations Act represents a restriction on freedom of establishment which is justified for the purposes of preserving a balanced allocation of taxing rights among the Member States (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, 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, Official Journal of the European Union 2008, C 115, 47; ECJ judgment in the Hornbach-Baumarkt case of 31 May 2018, C-382/16, EU:C:2018:366, Case-Law of the Federal Fiscal Court (HFR) 2018, 580).

19 (2) To the extent that the ECJ, in the form of its judgment in favour of the gratuitous assumption of guarantee commitments and comfort letters, recognised, as part of its deliberations on proportionality, that the economic interest of the ultimate parent entity in its associated companies, as well as a certain responsibility as a shareholder for the financing of those companies, could justify ("explain") transactions under terms that deviated from arm's-length terms, and hence could preclude an adjustment pursuant to section 1 of the External Tax Relations Act, this restriction does not apply in the current case.

20 In its judgment on the parallel proceedings (BFHE 263, 525, Federal Tax Gazette II 2019, 394, paragraph 13, 18), the Senate explained that if the provision of loan capital by a shareholder compensates for an insufficient supply of equity capital for the company, and if this financing is a precondition for the company receiving the loan being able to (continue to) fulfil its intended economic function, a different treatment of contributions and loan defaults with regard to the right – which is also recognised under EU law – to the allocation of profits in accordance with arm's-length terms is precluded. This would apply accordingly to the case under dispute.

21 3. The challenged judgment is based on a different legal assessment. It must therefore be annulled. The case is to be referred back to the Fiscal Court, so that it can reach the required findings on arm's-length terms.

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