Bundesverfassungsgericht

Successful constitutional complaint against correction of a company's taxable income resulting in restrictions on freedom of establishment without prior referral to the CJEU

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Order of 4 March 2021
2 BvR 1161/19

In an order published today, the Third Chamber of the Second Senate of the Federal Constitutional Court granted relief in constitutional complaint proceedings in which a corporation challenged a judgment of the Federal Finance Court (*Bundesfinanzhof*). In that judgment, the Federal Finance Court had declared lawful an income correction made on the basis of § 1(1) of the Foreign Transaction Tax Act (*Außensteuergesetz* – AStG) in respect of the partial write-down of an unsecured, defaulted intra-group loan. The judgment violates the complainant's right to one's lawful judge under Art. 101(1) second sentence of the Basic Law (*Grundgesetz* – GG) given that the Federal Finance Court did not refer the case to the Court of Justice of the European Union (CJEU) for a preliminary ruling pursuant to Art. 267(3) of the Treaty on the Functioning of the European Union (TFEU).

Facts of the case:

The complainant is the sole shareholder and parent company of a German limited liability company (*Gesellschaft mit beschränkter Haftung* – GmbH), which, in the year at issue, had a 99.98% holding in a corporation based in Belgium. The German limited liability company had an offset account for the Belgian corporation with a per annum interest rate of 6%. The loan granted through the offset account was unsecured. In 2005, the year at issue, the complainant paid 3.14% interest per annum on a capital loan of several million euros taken out from a bank. In September 2005, the German limited liability company and the Belgian corporation agreed on a debt waiver against agreement to repay the waived loan with future profits in the amount of the worthless part of the claims against the Belgian corporation from the offset account. The German limited liability company declared this debt waiver as an item reducing taxable profits in its balance sheet, but following a tax audit carried out for the year at issue (among others), the tax office increased taxable income, correcting for the current value depreciation – initially on the basis of § 8b(3) third sentence of the Corporation Tax Act (*Körperschaftsteuergesetz* – KStG), in the version applicable in the year at issue, in conjunction with § 15 no. 2 KStG. In the subsequent out-of-court proceedings, the tax office based the income correction on § 1(1) AStG instead.

The complainant successfully challenged this income correction before the Finance Court (*Finanzgericht*). Upon the tax office's appeal on points of law (*Revision*), the Federal Finance Court reversed the judgment of the Finance Court and rejected the complainant's action. In its reasoning, the Federal Finance Court essentially stated that the full amount of the reduction in profits resulting from the unsecured loan and from the current value depreciation was subject to correction pursuant to § 1(1) AStG. It held that EU law did not preclude such correction. The Federal Finance Court stated that, according to the case-law of the CJEU, legislation comparable to § 1(1) AStG that served to maintain the balanced allocation of the power to tax between Member States constituted a justified restriction on freedom of establishment (Art. 49 TFEU). According to the Federal Finance Court, the CJEU had stated that the parent company's economic interest in the success of its group companies and its responsibility as a shareholder in the financing of those companies may be capable of justifying the conclusion of transactions under terms that deviated from arm's-length terms. The Federal Finance Court held that this reservation was, however, not applicable in the present case. It found that, according to the CJEU's case-law, the domestic court had to take into account such justification and conduct a balancing of interests (in the individual case) weighing the encroachment on the principle of territoriality against the

deviation from the standard of arm's-length terms and the allocation of taxing rights based thereon. The Federal Finance Court found that on the basis of these standards, there were no grounds for departing from the correction made pursuant to § 1 AStG in the present case, given that the lending of borrowed capital served to compensate for insufficient equity capital.

The complainant asserts that this judgment violates the general guarantee of the right to equality (Art. 3(1) GG) in its manifestation as prohibition of arbitrary measures and its fundamental procedural right to one's lawful judge (Art. 101(2) second sentence GG).

Key considerations of the Chamber:

The constitutional complaint is admissible and well-founded.

There is no need to decide here whether the challenged judgment violates Art. 3(1) GG in its manifestation as prohibition of arbitrary measures on the grounds that the Federal Finance Court, in applying the arm's length principle as required by § 1 AStG, appears to presume that fully secured loans are the arm's length standard, without providing any reasons regarding the usual amount of collateral for the specific offsetting agreement and a possible correlation between this amount and the agreed interest rate.

In any case, the judgment violates the complainant's fundamental procedural right to one's lawful judge under Art. 101(1) second sentence GG because of the way the Federal Finance Court handled its duty of referral to the CJEU pursuant to Art. 267(3) TFEU.

1. The CJEU is a lawful judge within the meaning of Art. 101(1) second sentence GG. Nevertheless, according to the Federal Constitutional Court's established case-law, failure to comply with the duty of referral under Art. 267(3) TFEU does not always amount to a violation of Art. 101(1) second sentence GG. The Federal Constitutional Court limits its review to whether the allocation of jurisdiction set out in Art. 267(3) TFEU is interpreted and applied in a manner that does not seem comprehensible and must be considered manifestly untenable when critically appraising the Basic Law's central notions (standard of arbitrariness). If a question of EU law that is relevant for a court decision is yet to be addressed in the CJEU's case-law or if it appears possible that the existing case-law does not exhaustively address the relevant question, a violation of Art. 101(1) second sentence GG can only be found if the competent court against whose decisions no judicial remedy is available untenably exceeds the margin of assessment that must be afforded to it in such cases. In its application and interpretation of substantive EU law, the competent court must reach the reasonable conclusion that the applicable legal standards are either clear from the outset ("acte clair") or clarified beyond reasonable doubt in the case-law of the CJEU ("acte éclairé"). If the issue has not yet been fully resolved in the CJEU's case-law, Art. 267(3) TFEU is applied in an untenable manner particularly if the competent ordinary court concludes that the legal situation is clear from the outset or clarified beyond any reasonable doubt without providing objective reasons supporting this conclusion.

2. This is the case here. The correct application of EU law with regard to the granting of an unsecured loan under non-arm's-length terms – which the Federal Finance Court found (for the first time) to fall under § 1 AStG – was not so obvious as to leave no scope for reasonable doubt, at least not on the basis of the Federal Finance Court's reasoning and in light of the case-law of the CJEU, which had not fully resolved the question of the requirements applicable to freedom of establishment (Art. 49 TFEU).

a) The Federal Finance Court rightly assumes that the income correction made pursuant to § 1(1) AStG restricts freedom of establishment under Art. 49 TFEU. The unequal treatment resulting from this restriction is only permissible if it is justified by overriding reasons in the public interest recognised by EU law.

b) Yet the challenged judgment of the Federal Finance Court does not address the question whether the income correction made on the basis of its interpretation of § 1 AStG with regard to unsecured claims even serves the preservation of the balanced allocation of the power to tax between the Member States, which the CJEU considers to be a legitimate reason for such a restriction. The Federal Finance Court simply presumes that the preservation of the balanced allocation of the power to tax is the reason justifying the restriction, even though this would have required further elaboration. Neither the fact that the loan was unsecured – the basis upon which the Federal Finance Court considers the transaction to be on non-arm's-length terms –, nor the subsequent depreciation of the claim per se lead to a transfer of profits in the sense that profits are "transferred outside the tax jurisdiction" concerned without being taxed, which, according to the CJEU decision of 31 May 2018 (C-382/16 - Hornbach-Baumarkt) could undermine the balanced allocation of the power to tax between the Member States.

c) The Federal Finance Court only examines the conditions subject to which the CJEU, in its Hornbach decision, considers the provision at issue to be necessary; the CJEU set out these conditions following its finding that the provision at issue is suitable for maintaining the balanced allocation of the power to tax. For each occasion on which there is a suspicion that a transaction goes beyond what the companies concerned would have agreed under market conditions, the CJEU requires that the taxpayer be given an opportunity to provide evidence of any commercial justification for that transaction that is capable of justifying the non-arm's-length terms. The Federal Finance Court holds that no such commercial justification exists for granting an unsecured loan if this loan is structurally related to the injection of equity capital.

It does not amount to an arbitrary decision that the Federal Finance Court did not derive from the case-law of the CJEU an automatic mechanism under which territorial taxing rights must always stand back if there is commercial justification for non-arm's-length terms but instead saw room for a balancing of interests. However, the Federal Finance Court failed to provide objective reasons supporting its conclusion that the legal situation is clarified beyond any reasonable doubt, also with regard to the outcome of its balancing. In doing so, the Federal Finance Court failed to consider that, in the CJEU's view, there may be commercial reasons for concluding a non-arm's-length transaction in particular where a subsidiary requires additional capital because it lacks sufficient equity capital. This view is contrary to the balancing conducted by the Federal Finance Court, and the court did not resolve this contradiction.

d) Lastly, according to the CJEU's case-law, a domestic provision that serves to maintain the balanced allocation of the power to tax only satisfies the element of necessity insofar as the corrective tax measure is confined to the part which exceeds what would have been agreed between the companies in question under market conditions. It is unclear whether the challenged decision is in accordance with the legal standards as clarified by the CJEU in this respect, given that, when applying the arm's length principle as required by § 1 AStG, the Federal Finance Court failed to provide any reasons for its assumption that the loan would be fully secured under market conditions.
