COMMENTARY

The following decision by the Finanzgericht Münster deals with two interesting aspects of international taxation, namely the application of transfer pricing rules in the EU and the application of tax treaty rules on hidden distributions of profits (constructive dividends).

First, the court decided that company X's income had to be adjusted under German domestic law (s 1 of the Taxation of Foreign Transactions Act—§ 1 AStG). If X had received a security for the loan given to its Dutch subsidiary S as required under the arm's length principle, it would not have been necessary to write down the loan and interest claims.

However, the Finanzgericht Münster disapplied § 1 AStG, because the law violates the freedom of establishment of the EC treaty. Had X concluded a loan agreement without security with a German subsidiary, the conditions of § 1 AStG would not have met the scope of the law being limited to cross-border transactions and consequently no adjustment of income would be possible. Hence, X was discriminated against because it had a business relationship with a foreign instead of a domestic subsidiary. Moreover, the court held that the discrimination could not be justified by the arm's length principle (art 6(1) of the German-Dutch double tax treaty (DTT) which corresponds to art 9(1) of the OECD Model), because rules in tax treaties were not appropriate to justify a breach of one of the fundamental freedoms of the EC treaty.

It is worth mentioning that the Finanzgericht Münster only dealt with art 6(1) of the DTT, i e the arm's length principle as a possible justification for the discrimination, because transfer pricing adjustments can also be justified by the preservation of the allocation of the powers to impose taxes and by the prevention of tax avoidance. The crucial issue is rather the proportionality of the law. Advocate General Kokott demonstrated this in her opinion which she delivered on 10 September 2009 in the *Société de Gestion Industrielle* (*SGI*) case (C-311/08). Probably, the Finanzgericht Münster did not mention the two grounds because they had not been raised by the German tax authorities. Yet, it is questionable whether the two grounds can be invoked only if the stipulation of non-arm's length terms between affiliated companies actually shifts income from the domestic company to the foreign affiliated company. From a German perspective, this was not clear in the case at hand. In contrast to an interest payment which is too low, for example, the write-down of a loan does not necessarily shift a respective amount of income to the borrowing subsidiary.

Secondly, the court held that the sale of the premises from X's Dutch subsidiary S and Dutch second-tier subsidiary L to H, another Dutch second-tier subsidiary, at book value was a hidden profit distribution from S to X which was taxable as a dividend received by X under German domestic law.

However, the court also concluded that Germany had no right to tax the hidden profit distribution under the German-Dutch DTT. Since the treaty does not include a definition of the term dividend and does not provide that income constitutes a dividend if it is treated as income from shares by the source state (unlike art 10(3) of the OECD Model), the Finanzgericht Münster applied the general rule that any term not defined in the treaty shall have the meaning that it has under the tax laws of the applicant state (art 2(2) DTT corresponding to art 3(2) of the OECD Model). Consequently, the dividend article was applicable to the hidden profit distribution.

The court's conclusions (at p 291 *h* to 293 *b* (of the original judgment), and p 307 *e* to 308 *i* (of the translation), below) as to the non-deductibility of expenses in connection with tax-exempt dividend income relate to outdated German law that was in force until 2000. The question whether these rules were in conformity with EU law had already been decided by the European Court of Justice in the *Keller Holding* case (judgment of 23 February 2006, C-471/04). The Finanzgericht Münster followed the ECJ and held that the laws needed to be disapplied because they infringed the freedom of establishment.

Although the reasoning of the Finanzgericht Münster is not doubtless as far as it concerns the justification of the discrimination caused by § 1 AStG, the tax authorities have withdrawn the appeal which they had filed with the Supreme Tax Court (Bundesfinanzhof). Hence the judgment is final.

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