

Limitation of Corporate Loss Carryforward Affecting Only Particular Share Transfers Declared Unconstitutional

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The Federal Constitutional Court of Germany held that the forfeiture of tax loss carryforwards under Sec. 8c para. 1 sent. 1 CITA is inconsistent with the principle of equal treatment pursuant to German Constitutional Law.

On 29 March 2017 the Federal Constitutional Court of Germany (*Bundesverfassungsgericht*) held that Sec. 8c para. 1 sent. 1 Corporate Income Tax Act ("CITA") (*Körperschaftsteuergesetz*) providing for a pro rata restriction on tax loss carryforwards with regard to particular share transfers (25 %-50 %) is inconsistent with German Constitutional Law, in particular the principle of equal treatment.

Loss Limitation Rules Partly Violate the German Constitution

Under the current rule tax loss carryforwards generally forfeit on a pro rata basis in case of (direct or indirect) share transfers within a five year period representing more than 25 % of the share capital of the Company. In case of a share transfer of more than 50 % of the share capital the entire amount of tax loss carryforwards will generally forfeit. The Federal Constitutional Court has ruled that the German loss limitation rules in case of share transfers of more than 25 % but at a maximum of 50 % leads to unequal treatment of companies and violates the German Constitution. The loss limitation in case of a share transfer of more than 50 % (Sec. 8c para. 1 sent. 2 CITA) is not directly affected by this decision. However, there is another case pending (I R 31/11) at the Federal Tax Court (*Bundesfinanzhof*) in respect of a share transfer of more than 50 % (change of control) which has been suspended by the Federal Tax Court in light of the expected decision of the Federal Constitutional Court. Insofar it is worth monitoring the further reaction of the Federal Tax Court.

According to German Constitutional Law an infringement of equal treatment needs to be objectively justified. The arguments of justification addressed by the German tax administration, however, have been rejected by the Federal Constitutional Court. Share transfers of less than 50 % cannot be considered *per se* as abusive structures undertaken with the intention to trade with "loss shelves". Also the argument that such share transfers lead to a change of the legal or commercial identity of the loss making company, does not comply with the German corporate tax regime which differentiates between the sphere of the company and of the shareholders.

The German legislature is now requested to introduce amended provisions until 31 December 2018 complying with the principles stipulated by the Federal Constitutional Court. Such amended law would retroactively apply to all open assessment periods between 2008 and 2015, unless and to the extent a tax assessment has already become final and binding. If the legislator has not implemented constitutional compliant loss limitation provisions by 31 December 2018, the relevant provisions applicable in the relevant years will automatically become void and tax loss carryforwards would remain unaffected by the underlying share transfers.

Practical Consequences

Companies and their shareholders affected in the past by German loss limitation rules should note that only share transfers of not more than 50 % are directly covered by the court case of the Federal Constitutional Court. However, in light of the pending case at the Federal Tax Court it cannot be excluded that the principles may be extended to share transfers of more than 50 %. For the time being the response of the German legislator is unclear and, therefore, taxpayers need to await the legislative proposal which is expected only after the federal elections in September 2017. Only tax assessments already containing a notice of its provisional status (Sec. 165 German Tax Code (AO)) or which are already subject to an appeal of the taxpayer will generally not become binding and no action would insofar be required by a taxpayer at this stage. In respect of all other tax assessments, taxpayers will need to analyze whether, when and to what extent such assessments already are or will become binding. Taxpayers may need to take procedural actions to suspend the statutory limitation period in order to potentially benefit from a retroactive change of loss limitation rules. For precaution it is advisable to keep all tax assessments open, irrespective of whether share transfers of less or more than 50 % are concerned.

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