
German loss forfeiture rules declared unconstitutional by German Federal Constitutional Court

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In Brief

The German Federal Constitutional Court, in a decision published May 12, 2017, has held that the German tax loss forfeiture rules violate the German Constitution to the extent they anticipate a partial forfeiture of a company's current and carried-forward tax losses upon a transfer of more than 25% but less than 50% of its shares.

The German legislature by December 31, 2018, must amend the tax loss forfeiture rules relating to the transfer of such qualified minority interests so they are consistent with the German Constitution.

In detail

The German tax loss forfeiture rules cover two scenarios:

- The transfer of shares representing more than 50% of the issued capital or voting rights in a corporation ('majority interest') within a period of five years leads to a full forfeiture of current and carried-forward tax losses.
- The transfer of shares representing more than 25% but less than 50% % of the issued capital or voting rights in a corporation ('qualified minority interest') within the same period results in a partial forfeiture of the losses on a pro rata basis, unless an exception, such as the intra-group exception or the built-in gains exception, applies.

Beginning January 1, 2016, a corporation could prevent the tax loss forfeiture rules from applying by continuing its business activities and not engaging in certain harmful events during the three tax years prior to the tax year in which the harmful share transfer occurred and the tax year in which the losses have been utilized.

The court decided that the rule under which substantial share transfers result in a change of the 'identity of the corporation,' making it necessary to restrict or disallow the utilization of losses following such share transfers, is not reasonable to the extent the rules anticipate a partial loss forfeiture upon the transfer of a qualified minority interest and do not take into account continuation of the company's business.

The court therefore held that the loss forfeiture rules for transfers of qualified minority interests are unconstitutional insofar as they do not take into account criteria such as the continuation of the company's business or the structure of its assets.

The takeaway

The court held that the tax loss forfeiture rules for the transfer of qualified minority interests that applied through December 31, 2015, are unconstitutional.

The tax loss forfeiture rules for the transfer of majority interests are not directly affected by the decision.

Further, since January 1, 2016, application of the rules has eased because a new exception now takes into account additional criteria such as the continuity of the company's business activity.

Since the decision directly affects only the loss forfeiture rules for qualified minority interests applicable through December 31, 2015, the decision should not immediately impact the current rules for the transfer of qualified minority interests.

The German legislature, however, must implement new tax loss forfeiture rules or amend the existing rules for transfers of qualified minority interests from January 1, 2008, to December 31, 2015, so that they are consistent with the German Constitution.

It is not yet clear what the amended tax loss forfeiture rules will look like. Taxpayers therefore should keep open all assessments for years in which a harmful share transfer has occurred. This would allow them to keep the opportunity to benefit from the amended rules.

Contact

Uwe Stoschek
Global Real Estate Tax Leader
Phone: +49 30 2636-5286
uwe.stoschek@de.pwc.com

Jeroen Elink Schuurman
EMEA Real Estate Tax Leader
Phone: +31 88 792-6428
jeroen.elink.schuurman@nl.pwc.com

International Tax Services, Germany

Dr Volker Käbisch
Partner, Düsseldorf
Phone: +49 211 981-1527
volker.kaebisch@de.pwc.com

Dr Arne Schnitger
Partner, Berlin
Phone: +49 30 2636-5466
arne.schnitger@de.pwc.com

Real Estate Tax, Germany

Sven Behrends
Partner, München
Phone: +49 89 5790-5887
sven.behrends@de.pwc.com

Helge Dammann
Partner, Berlin
Phone: +49 30 2636-5222
helge.dammann@de.pwc.com

Marcel Mies
Partner, Düsseldorf
Phone: +49 211 981-2294
marcel.mies@de.pwc.com

Dr Michael A. Müller
Partner, Berlin
Phone: +49 30 2636-5572
mueller.michael@de.pwc.com

Josip Oreskovic-Rips
Partner, Frankfurt am Main
Phone: +49 69 9585-6255
josip.oreskovic-rips@de.pwc.com

Uwe Stoschek
Partner, Berlin
Phone: +49 30 2636-5286
uwe.stoschek@de.pwc.com