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By PwC Deutschland | 12 April 2018

Constitutional complaint regarding the trade tax treatment of gains from the disposal of partnership interests unsuccessful

In a decision on 10 April 2018, the German Constitutional Court concluded that the complaint that the trade tax treatment of gains from the disposal of partnership interests was unconstitutional because it contravened the principle of equality was not justified.

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Background

Specifically, the case concerned trade tax, which is payable by partnerships if they sell a business or operational unit or its partners sell their interest in the partnership. The provision which was the subject of the appeal - introduced into the Trade Tax Act with effect from the 2002 period of assessment - taxes the resulting capital gain at the level of the partnership, except where the gain is attributable to an individual with a direct participation in the partnership.

The appellant, which was a limited partnership in which shares had been disposed of, saw in the calculation of the trade tax base a breach of the principle of equality because the tax exemption was dependant on the legal form of the partner: on the one hand the capital gain on the disposal of a direct partnership interest by an individual was tax free but on the other hand the capital gain on any disposals by a corporation or by a partnership was taxable.

Furthermore, the appellant complained about a breach of the ban on retroactivity, because, whilst the sale of shares was completed in 2002, the contract was concluded in 2001, and thus before the legislative procedure for the introduction of the rule had begun.

However neither the Supreme Tax Court in its judgment of 22 July 2010 (IV R 29/07), nor the First Senate of the Constitutional Court in its judgment on 10 April 2018 (1 BvR 1236/11) considered that such breaches had occurred.

Taxation remains in accordance with the principle of capacity

The Karlsruhe judges did not see a sweeping conflict with the principle of capacity; the fact that the partnership is charged to tax on a capital gain realised by its shareholder does not have an impact on capacity. This is because the interest (i.e. in the assets of the partnership sold by the exiting partner) does not actually leave the partnership but rather remains with it through the interest held by the acquiring partner. Thus the capacity of the partnership remains basically unchanged. Where the exiting partner has realised a gain through the release of any hidden reserves, the acquiring partner will assume the increased book value in his supplementary tax balance sheet (“Ergänzungsbilanz”) and thus carrying that increase into the partnership. If the partnership later sells the relevant assets, a double taxation will be avoided through the release in the supplementary tax balance sheet by the acquiring partner.

No breach of the principle of equality

The principle of equality is not breached because the capital gain realised by an individual is excluded from trade tax. This regulation is indeed disadvantageous, to the extent that partnerships and corporations hold interests in the partnership. However, like the Supreme Tax Court, the Constitutional Court takes the view that there are reasonable grounds to justify this, namely the prevention of tax avoidance schemes. The legislature is entitled to assume the potential for tax avoidance is lower in individuals than in corporations or partnerships.

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No breach of the principle legitimate expectation in the law

The relevant provision was introduced in July 2002 with retroactive effect to 1 January 2002. The principles of legitimate expectation in the law can only be relied upon in cases of artificial retroactivity – such as in the present case – where, at the time of publication of the new regulation, the person affected can claim to have achieved or realised a fixed expectation of capital appreciation under the previous rule, or where a fixed expectation of capital appreciation could have been realised or where the person affected had concluded a binding agreement prior to the introduction of the new law into the Bundestag.

The Constitutional Court has decided recently on several occasions that the introduction of a bill into the Bundestag can destroy the confidence of those affected in the continuity of the previous legal position and therefore a new regulation may produce an artificial retroactivity. Once introduced a concrete outline of future legislative changes is foreseeable. In the view of the Constitutional Court the same considerations can also apply where the federal government passes on a draft bill to the Bundesrat. The publication provides the persons affected with the opportunity to prepare for potential changes in the law.

In the case before the Court, whilst the agreement had been signed before the legislation was introduced into the Bundestag, the government draft had already passed to the Bundesrat before the contract was made legally binding through the agreement of the partners.

Source:

First Senate of the Constitutional Court judgment on 10 April 2018 (1 BvR 1236/11)

Keywords

Ban on retroactivity, Principle of capacity, Principle of equality, trade tax