

By PwC Deutschland | 08 February 2023

Update: Provision for transition from imputation system to half-income method in part incompatible with Basic Law

The German Federal Constitutional Court has ruled that the transitional provision from the imputation system to the so-called half-income method in the course of the Annual Tax Act 2010 is partially incompatible with the German Basic Law and obliges the legislator to retroactively eliminate the identified constitutional violation by 31 December 2023.

The Constitutional Court is convinced that the contested provision deprives corporations with a certain equity structure of potential to reduce their corporation tax burden. To the extent that the reduction potential could have been realized at the time of the transition from the 'imputation system' (*Anrechnungsverfahren*) to the half-income method which in the following is referred to as 'half-income system' (*Halbeinkünfteverfahren*), it falls within the scope of protection of Art. 14(1) Basic Law (*Grundgesetz*). The interference with this protected legal interest is not justified under constitutional law.

Imputation system versus "half-income system"

Under the imputation system, which was in place until the end of the year 2000, a corporation's undistributed taxable profits were subject to corporation tax at the 'retention rate' of (most recently) 40%. If profits were later distributed, the corporation tax was reduced to the 'distribution rate' of (most recently) 30%. In view of this split tax rate, where profits were retained, a potential for reduction of corporation tax was accrued at the corporate level until the time when profits were distributed. The amount of the reduction potential was determined by the difference between the retention rate and the distribution rate, which most recently amounted to 10 percentage points. At the level of shareholders, distributions were taxed at their personal income tax rate, with the tax paid by the corporation credited towards the personal income tax payable by the shareholder. Under the half-income system, corporate profits are subject to a uniform and final corporation tax rate of 15% (since 2008). At the shareholder level, only half (since 2009: 60%) of the dividends distributed are subject to personal income tax.

Decision

With its decision the Constitutional Court overturned the erstwhile judgment of the Supreme Tax Court from 25 February 2015 (case ref. I R 86/12).

The Constitutional Court held that the complaint is well-founded. Sec. 36(4) Corporation Tax Act (CTA) is incompatible with Art. 14(1) Basic Law in conjunction with Art. 3(1) Basic Law to the extent that the provision leads to a loss of reduction potential regarding the corporation tax burden, as it does not consider the portion of equity allocated to the untaxed income category "EK 04" when offsetting the equity portions stemming from tax-exempt increases in capital against one another.

For corporations with a certain equity structure, Sec. 36(4) CTA interferes with the potential to reduce corporation tax that existed at the time of the transition from the imputation system to the half-income system.

The interference with the reduction potential protected by Art. 14(1) Basic Law that results from this is not justified by the public interest in accordance with the principle of proportionality.

The Constitutional Court concludes by pointing out that, in an overall assessment, the challenged provision exceeds the limits of what is reasonable, both regarding Art. 14(1) first sentence Basic Law and regarding Art. 3(1) Basic Law. This assessment is not altered by the broad leeway granted to the legislator when creating transitional rules for existing legal frameworks and entitlements.

Outlook

The legislator is required to remedy the violation of constitutional law by 31 December 2023 with retroactive effect. This affects all decisions which rely on the unconstitutional provision and that have not yet become final. To the extent that the challenged provision is incompatible with the Basic Law, the courts and administrative authorities may no longer apply it until new provisions have been enacted; pending proceedings must be suspended.

More details to be found in the [press release No. 11/2023](#) published by the Constitutional Court on 26 January 2023

Update (8 February 2023)

Further rule introduced in 2010 concerning the transition from the imputation system to the half-income system incompatible with the Basic Law

Following a referral for judicial review from the Muenster Tax Court, the Second Senate of the Federal Constitutional Court held in an order published on 26 January 2023 that **Sec. 36(6a) of the Corporation Tax Act** in the version of § 34(13f) KStG as amended by the Tax Act 2010 **is also incompatible with Art. 14(1) in conjunction with Art. 3(1) of the Basic Law**. The provision can result in a loss of potential to reduce a company's corporation tax that could have been realized at the time of the transition from the 'imputation system' (Anrechnungsverfahren) to the 'half-income system'. The fact that the provision simultaneously leads to a reduction of potential to increase corporation tax does not fully compensate for this loss.

As in the recently published decision 2 BvR 1424/15, which concerned Section 36 (4) of the German Corporate Income Tax Act (KStG), the legislator is obliged to retroactively eliminate the identified constitutional violation by December 31, 2023.

Read more:

<https://www.bundesverfassungsgericht.de/SharedDocs/Pressemitteilungen/EN/2023/bvg23-016.html>

Source:

Second Senate of the Constitutional Court judgment (order) of 24 November 2022 (2 BvR 1424/15) published on 26 Januar 2023.

Keywords

imputation system