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By PwC Deutschland | 17 March 2023

Retroactive effects of over-surrenders from periods prior to tax consolidation in part unconstitutional

The Federal Constitutional Court held that the retroactive introduction of Sec. 14 (3) Corporation Tax Act concerning the treatment of over-surrenders arising from periods prior to the membership in an Organschaft (tax consolidation group) to be in part unconstitutional and thus invalid.

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Background

The plaintiffs in the two cases brought before the Constitutional Court are housing development companies who until the end of the year 1990 had been non-profit entities and were thus exempt from corporation tax. In 2004 through 2006 (the periods of dispute) they were members of consolidated tax groups. One of the plaintiffs had been part of a tax group since 1991. In the second case, the profit transfer agreement was not concluded until October 2002. In both cases, surplus profit transfers (over-surrenders) resulting from events prior to the tax consolidation were treated by the tax authorities as profit distributions which led to higher corporation tax assessments. Appeals against these assessments were dismissed by the courts of first instance. The subsequent appeals were suspended by the Supreme Tax Court, which referred the cases to the Federal Constitutional Court by order of 27 November 2013 (case reference: R 36/13) and 6 June 2013 (case reference: I R 38/11).

Decision

According to Section 14(3) Corporation Tax Act (CTA) over-surrenders arising from periods prior to the *Organschaft* rank as dividends of the subsidiary to the parent (…). Over-surrenders and under-surrenders are deemed to occur at the end of the business year of the subsidiary. According to § 34(9) no. 4 CTA in the version valid at the time, Sec. 14(3) CTA - which has the potential to increase a corporation's tax liability - is applicable to over-surrenders (resulting from events prior to tax consolidation) by controlled companies (subsidiaries) whose financial year ends after 31 December 2003. The resulting effects are under certain constellations an infringement of the principle of legal protection (legitimate expectations).

The Constitutional Court sees inconsistencies regarding three groups of cases.

- Over-surrenders that were made within a fiscal year ending no later than 15 December 2004 (i. e. the date the contested new regulation was announced).

- The effects of the contested legislation are incompatible with the constitutional principle of the protection of legitimate expectations insofar as they apply to over-surrenders by a controlled company to its parent before 1 January 2007 and are based on a profit-and-loss transfer agreement that was concluded between the time the Supreme Tax Court judgment of 18 December 2002 was published (on 5 March 2003) and the introduction of the new bill in the *Bundesrat* on 13 August 2004. During that period, the parties could legitimately expect that over-surrenders / surplus profit transfers resulting from events prior to tax consolidation would be classified as tax-neutral profit transfers within the meaning Sections 14 ff. CTA.

- The effects of the legal provision in question are also incompatible with the principle of the protection of legitimate expectations based on profit-and-loss transfer agreements concluded before 5 March 2003 insofar as they apply

- to over-surrenders / surplus profit transfers made by a controlled company to its parent during 2004 financial year endings and if the agreement would have allowed for ordinary termination between 5 March 2003 until no later than 31 December 2003, and

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- to over surrenders / surplus profit transfers made at the close of the first financial year ending in 2005 if the agreement would have allowed for ordinary termination from 5 March 2003 until no later than 31 December 2004.

In such cases, and prior to the Supreme Tax Court ruling of 18 December 2002, parties concluding a profit-and-loss transfer agreement could not yet legitimately expect to be dealing with a settled legal situation. However, their expectations regarding the legal situation do warrant protection if, in 2003 or 2004, the contracting parties had allowed a then existing possibility of ordinary termination to expire in view of the judgment of the Supreme Tax Court which had been delivered in the meantime.

(Note: In its *ruling of 18 December 2002, the Supreme Tax Court decided* that contrary to the view of the tax authorities at the time, over surrenders did not constitute profit distributions, but rather tax-neutral profit transfers)

Source:

Federal Constitutional Court, Press Release No. 32/2023 of 17 March 2023 (decision of 14 December 2023 – **joint cases 2 BvL 7/13, 2 BvL 18/14**).

Keywords

Organschaft, tax consolidation group, tax group