HENGELER MUELLER

Current developments relating to the taxation of distressed German companies

Two major developments in German tax law could result in significant tax reliefs for distressed companies in Germany and put an end to years of uncertainty for market participants.

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Should both of these developments result in changes of the German tax law as currently expected, the restructuring of a distressed company (see 1. below) as well as the acquisition of such a company (see 2. below) would – if certain conditions are met – become possible again without incurring substantial (or even prohibitive) tax charges.

In detail:

Tax exemption for restructuring gains

Information recently emerged that Germany received a letter of comfort by the European Commission, stating that a tax exemption for gains related to certain restructuring measures ("**Restructuring Exemption**") should not constitute illegal state aid within the meaning of Art. 107 of the Treaty on the Functioning of the European Union ("**TFEU**", *Vertrag über die Arbeitsweise der Europäischen Gemeinschaft*).

The Restructuring Exemption is already laid down in sec. 3a of the German Income Tax Act ("**GITA**", *Einkommensteuergesetz*) and sec. 7b of the German Trade Tax Act ("**GTTA**", *Gewerbesteuergesetz*), but the application of these provisions had been made conditional upon a formal approval by the European Commission. While the letter of comfort is not such formal approval, it is still widely expected that new draft legislation removing that condition from the law and thereby confirming the application of the Restructuring Exemption will be published soon and will likely be applied with retroactive effect (albeit its reach is not yet entirely clear).

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The Restructuring Exemption deals with a fundamental tax problem for all distressed companies in Germany: Pursuant to case law by the German Federal Fiscal Court ("**BFH**", *Bundesfinanzhof*), a distressed company realizes a generally taxable gain (i) if a non-shareholder creditor waives outstanding loans, with the gain amounting to the full nominal value of the loan, or (ii) if a shareholder waives shareholder loans or makes a contribution to the company by way of transferring his shareholder loans to the company, with the gain amounting to the impaired portion of the shareholder loan since the BFH assumes a non-taxable contribution only to the extent that the shareholder loan is fully recoverable.

Once effective, the Restructuring Exemption would replace a previous administrative circular ("**Restructuring Decree**") which had requirements comparable to the ones under the new regime, but resulted in an only equity ruling in favor of the taxpayer, a practice that the BFH had held unconstitutional previously.

The requirements for the Restructuring Exemption are: The taxpayer has to (1) waive debt and (2) provide evidence for (a) the necessity of restructuring at the level of the enterprise, (b) the restructuring potential of the enterprise, (c) the adequacy of the debt waiver as restructuring measure, and (d) the creditors' commitment to the restructuring, all at the moment of the debt waiver. Under the Restructuring Decree such evidence had to be given in the form of a restructuring plan which evidence, in any event, was deemed to be present if a certified audior had rendered a restructuring opinion in conformity with certain standards established by the *Institut der Wirtschaftsprüfer e.V.* (so-called IDW S6 opinion). While formal evidence requirements are not set out under the new legislation, we would expect them to be comparable in future administrative practice.

As a main consequence of the application of the Restructuring Exemption, the restructuring gain would be tax exempt. The application of the Restructuring Exemption, however, entails further consequences which – to the detriment of the taxpayer – sometimes go beyond the previous situation under the Restructuring Decree:

— All tax accounting options have to be exercised in a way that they decrease any gain in the fiscal year of the restructuring and the year after (i.e., otherwise optional write-offs become mandatory). While there is no immediate increase of the tax burden in the year of the restructuring, a latter appreciation reversing the previous write-off would have a tax effect in the year of the appreciation.

— All expenses relating to the restructuring are not tax deductible irrespective of the fiscal year in which they were made. These restructuring expenses are effectively non-deductible since they can only be deducted from the restructuring gain that is anyway tax exempt.

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— The restructuring gain, reduced by the non-deductible expenses, decreases any tax reduction potentials (e.g., loss carry-forwards) in the year of the restructuring. The decrease of tax reduction potential can also "spill over" in two directions: (1) to a third party related to the restructuring taxpayer if (a) the third party has transferred the debt within the last five years and (b) the tax reduction potential has already existed in the year of the transfer, or (2) to a company that used to be the parent company in a tax group with the distressed company within the last five years before the year of the restructuring, even if the parent company has sold the distressed company in the meanwhile.

While some of the technical details are still unclear, the new German legislation should provide much needed relief for German distressed companies and their shareholders after years of uncertainty. We expect that once the now provisions on the Restructuring Exemption have become effective, German tax authorities would resume issuing binding rulings in respect of restructuring transactions again.

Tax Loss Carry Forwards after the purchase of a majority (or significant minority) stake and the Restructuring Clause

Tax Loss Carry Forwards ("**Tax LCFs**") are often among the most valuable assets of a distressed company. As a general rule, such Tax LCFs are wiped out completely if more than 50% of the shares in the company are acquired by one investor or a group of investors acting in concert ("**Full-Wipe-Out-Rule**"). Tax LCFs are wiped out on a pro rata basis if the investor (or group of investors) purchases more than 25% but not more than 50% of the shares, e.g. 30% of the Tax LCFs are wiped out when 30% of the shares are acquired ("**Pro-Rata-Rule**"). While the Pro-Rata-Rule is likely to be challenged in the German Federal Constitutional Court since the same court struck down a similar rule for transactions prior to 2016, this will most likely not occur any time soon and is unlikely to affect the Full-Wipe-Out-Rule.

Already in 2009, an exemption to this regime had been introduced for restructuring cases ("**Restructuring Clause**"). Accordingly, the Full-Wipe-Out-Rule and the Pro-Rata-Rule were suspended when a new investor purchased a majority (or significant minority) stake in a company with the intention to restructure. This could provide relief for instance in debt-to-equity-swap transactions. Pursuant to the Restructuring Clause, "restructuring" was defined as a measure (1) aimed at avoiding or overcoming illiquidity or over-indebtedness (2) while maintaining the company structure. The company structure is maintained if (a) a bargaining agreement relating to the employment situation is struck, or (b) the annual payroll of the corporation stays on average over 80% of the annual payroll prior to the acquisition for the next five years, or (c) there is a substantial addition of new assets or the waiver of loans by the new shareholder to the extent that loans are not impaired. In any case, the company structure is not maintained if the company has discontinued its operations at the time of the acquisition or has moved to a new field of business within five years after the acquisition.

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However, in 2011, already two years after the Restructuring Clause had been introduced, it was deemed to constitute illegal state aid within the meaning of sec. 107 TFEU by the European Commission. As a consequence, the Restructuring Clause was suspended and became the subject of proceedings in various European court cases. These finally ended this summer when the European Court of Justice held in essence that the Restructuring Clause did not constitute state aid. The German legislative reacted to this development and published draft legislation pursuant to which, if enacted, the Restructuring Clause would become applicable with retroactive effect for acquisitions after 2007. Taxpayers should therefore check open cases if they could rely on the Restructuring Clause for relief.

Next steps

We expect the necessary legislation to be enacted with the current tax draft legislation ("Act against Tax Fraud in E-Commerce Transactions") by the end of 2018 with the aforementioned retroactive effects. Taxpayers are advised to monitor the legislative process and contact their tax advisors for further guidance.

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About our practice Area: TAX

We advise on all aspects of domestic and international corporate taxation with a strong focus on M&A, corporate reorganizations, financing transactions (including structured finance, and securitizations), family-owned businesses and succession planning as well as international/cross-border tax law.

Our tax practice also has extensive experience in advising clients on tax audits, disputes and investigations.

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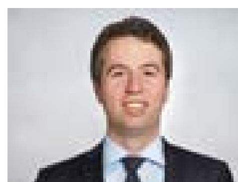

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