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Supreme Tax Court Abolishes German Restructuring Privilege

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Cancellation of debt – a key element of most restructurings – generally triggers taxable income. The German tax authorities had issued an administrative decree (the “**Tax Restructuring Decree**” - *Sanierungserlass*), however, declaring that, upon the satisfaction of certain requirements and conditioned on forfeiture of any loss carry forwards, the cancellation of debt income (“**CODI**”) would not be taxed. Reliance on the administrative decree was essential for restructurings since the utilization of loss carryforwards in Germany is limited to 60% of the income to the extent the deductible base amount of EUR 1 Mio. is exceeded. Thus, a significant tax liability might otherwise be incurred.

Under a recent court ruling, the Federal Fiscal Court’s Grand Senate (the “**German FFC**” and such ruling, the “**FFC Ruling**”) has now held that the Tax Restructuring Decree is not an interpretation of law and thus has no basis in applicable law. Waiving a tax in specific cases for equitable reasons may be justifiable for individual cases, but a general decree subsidizing restructurings without evaluating the specifics of the individual case needs a basis in law.

WHAT RESULTS FROM THE COURT RULING FOR CORPORATE RESTRUCTURINGS IN PRACTICE?

For existing cases where the restructuring has or is in the process of being implemented, there are four different scenarios that need to be reviewed:

- 1) In cases where a binding letter ruling applying the Tax Restructuring Decree (a “**Binding Tax Ruling**”) was obtained *and* the company’s debt has actually been restructured or otherwise cancelled, the Binding Tax Ruling can in principle no longer be withdrawn. There is a risk, however, that in such cases the waiver of the tax constitutes unlawful state aid (since the waiver of the respective tax on the CODI was not notified with the EU Commission). This would require that the European Commission exercises its right under the EU treaties against Germany to demand the alteration or abolishment of the waiver. Presently we have no indication that this will happen. In a recent decision, however, the European Court of Justice (“**ECJ**”) has interpreted state aid to encompass a broader scope of beneficial tax regimes, thus increasing the risk that the tax relief provided by the Tax Restructuring Decree (including restructurings for which a Binding Tax Ruling was received) is deemed an unlawful tax subsidy.
- 2) In cases where as of the publication of the FFC Ruling a Binding Tax Ruling was obtained but the restructuring or cancellation of debt has not yet occurred, there is a risk that the Binding Tax Ruling can be revoked on the basis of the FFC Ruling.

- 3) In cases of past restructurings that did not have a Binding Tax Ruling, the Restructuring Tax Decree can no longer be applied and it is very unlikely that the now applicable tax will be waived on equitable grounds.
- 4) Tax relief from CODI is no longer available for future restructurings based on the criteria set out in the Tax Restructuring Decree but only if the specific circumstances of the individual case justify a tax relief.

Thus, the FFC Ruling currently prevents the German tax authorities from issuing further favorable rulings based on the Tax Restructuring Decree until the German Parliament (*Bundestag* and *Bundesrat*) has provided sufficient legal basis for future tax exemptions on corporate restructuring measures. According to Government sources, experts from the federal and state tax administrations are expected to come up soon with a joint proposal for new rules considering both the needs of market participants and EU law implications in respect of state aid.

WHAT CAN BE DONE IN THE INTERIM UNTIL NEW RULES FOR TAX EXEMPT CODI ARE RELEASED?

In the interim, it is unlikely that a favorable ruling on the tax exemption of CODI can be obtained from the German tax authorities even if the circumstances of a particular case might otherwise justify an exemption on equitable grounds. We therefore recommend an alternative approach to avoiding or minimizing CODI.

Depending on a client's particular situation, we have developed alternative routes to commercially achieve a debt restructuring without triggering taxable CODI.

A few examples illustrate the potential (interim) solutions:

- Creation of new holding company: A restructuring of the debt can be achieved by contributing the debt together with the existing equity of the debtor company to a new holding company in return for new securities (debt and stock) reflecting the waterfall intended by the stakeholders.
- Subordination of claims: Claims can be subordinated to the most extent legally possible to come near to equity qualification without triggering a capital gain. Deferring the payment of principal and interest on the debt can achieve the desired economic outcome in many cases without losing the characterization of debt for tax purposes.
- Tranching of shareholder loans: Taxable CODI is triggered only in respect of the worthless, non-recoverable portion of the debt. If debt is split into a first ranking portion that is still in the money and a second ranking portion that is not in the money – the first ranking portion can be waived without triggering CODI. The tranching is only an option for shareholder loans, since a waiver of a third party claim triggers CODI in either case. However, the sale of a third party loan to a shareholder (even with an earn out in case of betterment) could be considered to allow for tranching. The option of tranching and waiving of loans is open to all shareholders regardless of the percentage of their shareholdings.

These are just some examples. There may be other ways as well, depending on a company's particular situation, to plan around or manage taxable CODI. Accordingly, although losing the benefit of the Tax Restructuring Decree does make tax optimized German restructurings more challenging; it is often still possible to achieve a restructuring with minimal or no taxable CODI for German tax purposes.

We expect the abovementioned structures to become more popular in the aftermath of the German FFC Ruling and until the two houses of the German parliament (*Bundestag* and *Bundesrat*) have provided legal comfort, which can take some time in light of the upcoming elections to the *Bundestag* later in September 2017.

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