

# Client Alert

Latham & Watkins  
Tax Department

## Restructuring Tax in Germany: Recent Court Rulings, Decrees and Practice Developments

"A must for banks, equity sponsors and companies dealing with restructuring scenarios."

Restructurings have become an integral part of the reality of the German debt and equity markets. In any restructuring, the tax impact of the chosen steps is an essential part of the overall structure considerations. In the last months both German tax courts and the German tax administration have issued several rulings that have an impact on restructuring scenarios involving German entities. Some of these rulings deal with rather „classical“ issues, such as the ruling of the German Federal Fiscal Court on the so called Restructuring Decree (See I. below) discussing the question whether the Restructuring Decree lacks a sufficient basis in legislation and the interpretation of certain credit agreement clauses in the context of German withholding tax (See VI. below) or the ruling on the use of NOLs after a change of ownership (See III. below). Others raise new questions with interesting consequences for restructurings, e.g. the tax consequences of converting loans into *jouissance* rights (See II. below). Furthermore, the German legislator issued new provisions which need to be taken into account in restructuring situations (See V. below on the new German Inheritance and Gift Tax Law).

To be successful, any measures in restructuring situations require integrated civil and tax law advice. The drafting of subordination clauses (See IV. below on a recent court ruling in this respect) is a case in point. In this Tax Alert, the German Tax Team of Latham & Watkins analyzes recent developments which banks, equity sponsors and companies involved in restructuring scenarios need to be aware of and puts them into context with the current realities of corporate restructurings.

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## **I. Equity Waiver of Taxes on Restructuring Profits**

### **1. Background**

The waiver by creditors of their claims against a company in distress is an essential restructuring tool. However, there are tax risks: the result of the waiver is generally a profit at the level of the owing company. In exceptional cases — the creditor is at the same time a shareholder and the claim is still (partially) collectible — such profit is (partially) neutralized by way of qualification of the waiver as a tax neutral shareholder's contribution. In other cases, the waiver results in a tax burden for the company. The tax administration takes from the company what the creditors intended to give to it. The willingness of creditors to take part in a restructuring is reduced.

Against this background, there was once a specific provision in Sec. 3 No. 66 ITA which exempted the respective restructuring gains from tax. However, such exemption was abolished by the end of 1996.

### **2. Restructuring Decree issued by the Federal Ministry of Tax**

Since then, the tax administration helps. In a circular dated 27 March 2003, the so-called Restructuring Decree, the Federal Ministry of Tax provides for equity measures which shall encounter the restructuring-hostile effects described above. In order for the Restructuring Decree to apply, there must be qualified restructuring profits. These require the need and the ability of the company to be restructured as well as the intention of the creditor(s) to restructure the company and the ability of the waiver to result in the restructuring. If these conditions are met, the tax administration shall defer taxes in a first step and waive them in the long run. Sec. 222 and 227 of the General Tax Act (GTA) which provide for the defer and waiver of taxes generally provide for equity measures in the discretion of the competent tax office. However, the tax administration has reduced its own discretion for cases of restructuring profits by way of the Restructuring Decree.

### **3. Dispute regarding lawfulness of the Restructuring Decree**

It is disputed whether the administrative practice in line with the Restructuring Decree is lawful. The Munich Fiscal Court has denied the question (Ruling of 12 December 2007 (I K 4487/06)). It argues that the abolition of the exemption of restructuring profits by the legislator (and of sec. 3 No.66 ITA in 1996) must not be thwarted by the practice of the tax offices.

The Fiscal Court of Cologne (Ruling of 24 April 2008 (6 K 2488/06)) and the 10th Federal Fiscal Court Senat (Ruling of 14 July 2010 (X R 34/08)) are of the opposed opinion. However, the 8th Federal Fiscal Court Senat has followed the Fiscal Court of Munich in a recent decision (Ruling of 28 February 2012 (VIII R 2/08)) and expressed doubts regarding the Restructuring Decree. However, this new decision was rendered in summary proceedings (stay of execution). Therefore, the 8th Senat has only carried out a limited examination of the legal situation

After the above decisions were rendered, the tax administration has clarified that it will continue to follow the Restructuring Decree (e.g., Ministry of Finance Schleswig-Holstein, circular of 17 April 2012 (VI 304 - S 2140 - 017/05)). This is convincing from a legal perspective. Politically, it must be emphasized that the complete abolition of the exemption of restructuring profits from taxes would have disastrous consequences in many cases. It would result in the insolvency of businesses although a sustainable restructuring concept exists and although the creditors are generally ready to participate in it.

### **4. Consequences**

In practice, it should always be verified whether restructuring profits qualified under the Restructuring Decree will arise verified before measures are taken by way of an application for a binding ruling of the tax administration.

## II. Tax Treatment of Conversion of Loans into Jouissance Rights

The conversion of debt into equity is often an important tool in the restructuring of companies. However, such debt-to-equity swaps may trigger a tax burden: the waiver of a loan granted by a third party results in a profit of the owing company in the full amount of the respective loan. The waiver of a shareholder loan results in a profit to the extent the loan is collectible (the tax administration may grant an equity relief under the so-called Restructuring Decree, See above I.). Moreover, interest and loss carry-forwards often extinguish when new shares are issued.

### 1. Debt-to-Mezzanine Swap

An instrument to avoid these negative consequences is the so-called Debt-to-Mezzanine Swap, the conversion of debt into jouissance rights. The parties to a jouissance right may freely determine its conditions. In our context, the conditions are chosen so that the instrument qualifies as equity for commercial accounting while interest expenses are deductible for tax purposes in line with the general restrictions applying to the deduction of interest expenses (inter alia, the earnings stripping rules, §§ 4h Income Tax Act (ITA), 8a Corporate Income Tax Act (CITA), and the addition rules for Trade Tax purposes, § 8 No. 1 Trade Tax Act (TTA)).

The Debt-to-Mezzanine Swap means — as regards commercial accounting — the conversion of debt into equity. Thereby, balance sheet ratios and the financial strength of the company are improved. However, taxwise, the Swap leaves the debt character of the respective instrument unaltered. There is — for tax purposes — no relevant transaction and therefore no profit. That is why the interest in Debt-to-Mezzanine Swaps has increased significantly lately.

### 2. The Opinion of the Regional Tax Office Rhineland

The Regional Tax Office (RTO) Rhineland (and allegedly also the RTO Münster) have now expressed a deviating point of view. In a writ dated 14 December 2011 ("Short Information Corporate Income Tax" no. 56/2011), the RTO Rhineland argues that the commercial accounting conversion of debt into equity must result in a corresponding conversion for tax accounting purposes under the so-called decisiveness principle (*Maßgeblichkeitsprinzip*). The result of such conversion for tax purposes would be a tax profit.

The RTO Rhineland bases its opinion on § 8 (3) s. 2 CITA. Under such provision, payments of any kind on jouissance rights providing for a participation in the profits and in the liquidation proceeds of the company do not reduce the taxable income. According to the RTO Rhineland, the provision only deals with the calculation of taxable income. It shall have no relevance for the tax accounting qualification of the jouissance rights. Under the decisiveness principle a jouissance right that qualifies as equity for commercial accounting principles shall qualify likewise for tax purposes. The RTO Rhineland argues that § 8 (3) s. 2 CITA only provides for income calculation consequences outside the balance sheet.

With its writ, the RTO Rhineland opposes to the general practice of the tax offices which has been confirmed in various binding rulings, and to the prevailing opinion in literature. Court decisions have not yet been rendered. According to the RTO Rhineland, a Debt-to-Mezzanine Swap (conversion of loans into commercial accounting equity) shall have the same consequences as a Debt-to-Equity Swap.

### **3. Our Opinion**

The view of the RTO Rhineland is very doubtful.

Under German taxation principles, *jouissance* rights do not qualify as equity unless they meet the requirements set forth in § 8 (3) s. 2 CITA. Tax law acts autonomously when it comes to the qualification of *jouissance* rights as equity or debt; as a result, *jouissance* rights similar to debt liabilities qualify as debt. Section 8 (3) s. 2 CITA contains an implicit qualification for tax accounting purposes, whereby the decisiveness principle is not applicable in our context and whereby tax law provides for an autonomous qualification of *jouissance* rights as debt, even if those qualify as equity for commercial accounting purposes.

We believe that the RTO Rhineland tries an illegitimate “cherry picking”: the Federal Tax Office (which, allegedly, does not plan to issue an own writ on the issue dealt with here) has expressed in its writ relating to the earnings stripping rules (4 July 2008 - IV C 7 - S 2742 - a/07/10001) the opinion that *jouissance* rights (with the exception of *jouissance* rights within the scope of § 8 (3) s. 2 CITA) do not qualify as equity for tax purposes. Thereby, an autonomous qualification is expressly made as regards the earnings stripping rules. Such autonomous qualification should apply for tax accounting in general.

The RTO Rhineland writ increases the insecurity in restructuring cases (which was significant even before the writ). It will be interesting to see how the other German states, the Federal Tax Office and the Tax Courts will deal with the issue.

### **4. Structuring Considerations**

Regarding the structuring practice, please note the following:

A Debt-to-Mezzanine Swap should (as before) only be effected based on a binding ruling. We believe that general rulings must still be granted in line with the past practice of the tax offices.

However, in North Rhine-Westphalia, binding rulings will only be obtained in exceptional cases as the tax offices will adhere to the “Short Information” dealt with above (albeit such information has no binding effect in a strict sense).

## **III. Use of NOLs in Case of a Change in Ownership During a Fiscal Year**

### **1. Decision by the Federal Fiscal Court**

In a restructuring scenario typically the question as to the possibility to use net operation losses (NOLs) arises. In respect of an ownership change during a fiscal year the Federal Fiscal Court now held in its ruling dated 30 November 2011 (I R 14/11) that profits generated in the period up to the change in ownership can be set-off against NOLs carried forward from preceding fiscal years. This is of particular relevance in a restructuring scenario where cancellation of debt income (CODI) is incurred. However, the minimum taxation rules may still create major roadblocks for a successful restructuring.

The ruling of the Federal Fiscal Court is based on the ownership-change rules, Sec. 8c CTA. Under these rules a change in ownership of more than 25 percent or more than 50 percent, as the case may be, in a corporate entity (so-called harmful ownership change) results in a (pro rata) forfeiture of NOLs. In their decree dated 4 July 2008 (IV C 7-S 2745-a/08/10001, 2008/0349554) the tax authorities took the view that in case of a harmful ownership change during a fiscal year NOLs carried forward from preceding fiscal years cannot be used to set-off profits derived in the period up to such ownership change. This view has been overruled by the Federal Fiscal Court in its aforementioned ruling.

This ruling is in line with the prevailing view in German tax literature and the view of some local fiscal courts (e.g. FG Hessen dated 7 October 2010 – 4 V 1489/10). Given the — in view of the Federal Fiscal Court — unclear wording of the change-in-ownership rules the court argues, based on the object and the purpose of these rules, that according to the reasons given by the legislator the forfeiture of losses would be justified if the “economic identity” of the relevant entity were changed as a result of the “economic engagement” by a different shareholder. Such shareholder should not be able to make use of NOLs incurred in the period preceding his own “economic engagement”. On this basis the Federal Fiscal Court argues — in contrast to the view of the tax authorities — that profits derived in the period up to the change in ownership have to be taken into account, because such profits would be attributable to the “former” (and not the “new”) economic engagement. Therefore, according to the view of the Federal Fiscal Court only the surplus of NOLs carried forward from preceding years over profits derived in the period up to the change in ownership falls within the scope of the change-in-ownership rules set forth in Sec. 8c CTA.

While the underlying facts of the ruling related to a pro rata forfeiture of NOLs (i.e. an ownership change of >25 percent ≤50 percent) only the ruling, according to our view, should also apply to an ownership change of >50 percent generally resulting in a forfeiture of the NOLs in their entirety.

## **2. Consequences**

As mentioned above, the ruling is thus of utmost importance in a restructuring scenario since enterprises in a crisis typically incur losses. So far a set-off against profits was not allowed, e.g., in case of a debt-to-equity swap resulting in a harmful ownership change and CODI deriving from the cancellation of debt. In such a scenario, the tax authorities usually deny the possibility to set-off profits against NOLs on the basis of no. 31 of the aforementioned decree dated 4 July 2008. However, on the basis of the ruling of the Federal Fiscal Court, the taxpayer can now argue that a set-off must be provided for. This is true at least if the cancellation of debt can be attributed to the “former” economic engagement which, in our view, should be the case. Hence, the ruling should have a positive effect on restructurings. In particular, it will no longer be required to change the business year in the course of a restructuring which will certainly facilitate restructuring processes.

However, the Federal Fiscal Court does not answer the question as to how the profits are to be determined in case of an ownership change during a fiscal year. Obviously, the court sees a determination on the basis of interim financial statements as a viable option. Another approach could be the determination on a pro rata temporis basis which is allowed under the aforementioned decree of the tax authorities (no. 32 for the determination of losses). In addition, the tax authorities take the view that other methods, which come to an economically appropriate allocation, are permissible. Furthermore, the determination on the basis of interim financial statements (which in a restructuring scenario should often prove as the preferable approach) should fulfil such criteria.

It remains to be seen how the tax authorities will react to the ruling of the Federal Fiscal Court. Up to now, only a statement of the Ministry of Finance of the state Schleswig-Holstein (Corporate Income Tax Information 2011 no. 10 dated 10 November 2011, VI 3011-S 2745-069) is available according to which the tax offices are instructed to put current proceedings relating to this topic on hold (and grant according suspensions of payment) until an official view of the tax authorities has been reached. A statement on the substantive issue is, however, not available.

With a view to the restructuring practice it should be noted that the ruling described above does not have an impact on the concept of minimum taxation which provides for a similar roadblock in restructuring scenarios. Under this concept NOLs carried

forward can be set-off against profits derived from the cancellation of debt up to an amount of €1 million only. Thereafter, regardless of the amount of NOLs at least 40 percent of the profits exceeding EUR 1m are subject to tax. In light of these rules the ruling described above can only be seen as a first success in an ongoing battle.

## **IV. New Decision of German Federal Fiscal Court Regarding a Subordination Agreement**

With publication of its decision dated 30 November 2011 (I R 100/10) on 29 February 2012, the German Federal Fiscal Court caused some uncertainty within the restructuring scene. The reason for that is the unclear headline of this decision "No recognition of a liability in case of a qualified subordination". On the merits, the court simply confirmed the longstanding practice of the fiscal authorities and therewith provides a higher level of legal certainty in this respect. What is it about?

### **1. Background**

Under a subordination agreement, the creditor subordinates its claim either to any claim of any other creditor (basic subordination) or puts it to the level of the shareholders' claims (qualified subordination). Prior to the amendment of the German Insolvency Act by the so-called MoMiG, only a qualified subordination resulted, according to the German Federal Court of Justice, in the desired effect, *i.e.*, the non-consideration of the respective liability in the insolvency balance sheet.

A subordination agreement in general does not change the quality of the liability for civil law purposes; the liabilities therewith are to be reflected in the commercial as well as in the tax balance sheet. This has also been confirmed in Sec. 4 of the Circular Letter of the German Federal Ministry of Finance dated 8 September 2006 (IV B 2 – S 2133 – 10/06) according to which the agreement of a basic or qualified subordination does not impact the quality of a liability in the balance sheet.

However, according to decisions of the German Federal Fiscal Court to which the decision dated 30 November 2011 refers to, a liability shall not be reflected as such in the balance sheet if it does not result in an economic burden of the company. This is also the basic idea of Sec. 5 para. 2a German Income Tax Code which provides for a deferral of the reflection of liabilities which shall only be settled out of future profit or earnings. According to the German fiscal authorities, the application of such rule in case of a subordination shall depend on the structure of the grace period agreement which generally is part of a subordination agreement. If the parties agree in connection with a basic subordination that the creditor may only request a payment of the subordinated claim out of net profits, liquidation proceeds or out of any unbound assets, Sec. 5 para. 2a German Income Tax Code shall, according to the opinion of the German fiscal authorities, not apply. However, if the grace period agreement lacks a reference to unbound assets, the liability shall not be reflected as such in the balance sheet. If the parties agree in connection with a qualified subordination that it shall be effective until the crisis is prevented, the fiscal authorities consider this as a temporal suspension of a settlement which shall also not be harmful and shall not result in an application of Sec. 5 para. 2a German Income Tax Act. In practice, both forms of grace periods are often combined. To which extent no explicit referral to liquidation proceeds or unbound assets in the case of a basic subordination is harmful is disputed between the fiscal authorities and the German Federal Fiscal Court. The tax authorities seem to demand an explicit reference.

### **2. Decision by the Federal Fiscal Court**

In the case the decision dated 30 November 2011 is based on, the parties agreed that in case of an over indebtedness the liability shall automatically be subordinated in the amount of the over indebtedness to the claims of any other creditors and that

the creditor may request the repayment only out of future profits to the extent they exceed the loss carry forwards or, if the case may be, out of liquidation proceeds. The decision of the German Federal Fiscal Court therefore actually dealt with a basic subordination. As the grace period agreement lacked a reference to a repayment out of unbound assets, the tax authorities — in accordance with the Circular Letter — denied the reflection as a liability in the case at hand.

The German Federal Fiscal Court confirmed this view and held, also in accordance with the Circular Letter of 2006, that a liability shall not be reflected as such in the balance sheet even if the creditor may not only request a repayment out of a future profit but also out of liquidation proceeds. In that case, the company is not yet economically burdened as well.

The court held that payment obligations out of liquidation proceeds may affect the current assets of the company; however, they do not yet burden the assets of the company. According to the principle of going concerns, the liquidation shall not yet be considered and the capital reserves are at this point in time available for setting off losses and the settlement of liabilities of other creditors. As a result, a subordination agreement, according to which the liabilities may only be settled out of future profits or liquidation proceeds does not burden the debtor more than it would have been burdened in case of the creditor waiving a claim in combination with a grace period agreement. In this context, the German Federal Fiscal Court explicitly refers to its decisions and remarks that the situation is different if a subordination agreement also provides for a repayment out of unbound assets. In such case a current burden is given and therewith a reflection as liability is possible.

### **3. Consequences**

Has everything stayed the same? Generally yes, but the amendments of the German Insolvency Act by the MoMiG have changed the language of subordination agreements in part.

Now, subordination agreements are generally geared to Sec. 19 para. 2 in connection with Sec. 39 para. 2 German Insolvency Act which explicitly only provides for a subordination in the insolvency procedure. Such (simple) agreement in the meaning of Sec. 39 para. 2 German Insolvency Act should not result in an application of Sec. 5 para. 2 German Income Tax Code because the subordination is only agreed in the insolvency procedure. After clearance of the over indebtedness, liabilities may be repaid out of any assets of the debtor and not only out of future profits. However, some opinions in the literature consider a subordination agreement which is strongly aligned to the language of Sec. 39 para. 2 German Insolvency Act as not sufficient. A subordination only in the insolvency procedure could not avoid the over indebtedness prior to the insolvency procedure which is necessary not to enter into an insolvency procedure. The language of the law is, according to these opinions, not clear.

If one follows this opinion and uses a language for the subordination which also applies outside of an insolvency procedure the question regarding the language of the grace period agreement arises (as it was prior to the MoMiG). Should such grace period agreement be included in the subordination agreement, it should be in line with the Circular Letter dated 8 September 2006. As the grace period agreement has not been affected by the amendments to the German Insolvency Act by the MoMiG, the Circular Letter should apply further on. The only difference which resulted from the amendments by the MoMiG is that a basic subordination is sufficient for the avoidance of an over indebtedness and, insofar, the statements in the Circular Letter regarding the basic subordination should apply. Against the background of the decision of the German Federal Fiscal Court dated 30 November 2011, the grace period agreement should provide for a repayment also out of unbound assets and not only out of profits and liquidation proceeds.

Only such grace period agreement would be in line with the Circular Letter and would therewith not be harmful for tax purposes, *i.e.*, would not result in a non-recognition of the liability pursuant to Sec. 5 para. 2a German Income Tax Act.

## V. New Provisions in the German Inheritance and Gift Tax Law as Further Obstacle for Restructuring Cases?

### 1. Introduction

A recent amendment to the German Inheritance and Gift Tax Act (the IGTA) (ErbStG) (sec. 7 para. 8 clause 1 IGTA) introduced by the act to implement the directive on mutual assistance might be of importance with respect to the restructuring of corporations in financial crises. By introducing the new provision, the German legislator has — in addition to existing restructuring obstacles under German income tax law (*e.g.* taxation of so-called waiver gains) — further increased the legal uncertainty in respect of the tax treatment of restructuring measures. In particular, this could be the case in the event that the shareholders and/or third parties (*e.g.* banks) are providing disproportional restructuring measures.

### Background of the New Provision

According to the previous position of the fiscal authorities, a disproportional (hidden) contribution of a shareholder (*i.e.* a contribution exceeding the respective percentage of shareholding) into a corporation was to be qualified as a gift to the other shareholders, if the contribution had the purpose to enrich the other shareholders by increasing the value of the shareholding (cf. R 18 guideline to the IGTA 2003).

On December 9, 2009, the German Federal Tax Court (*Bundesfinanzhof* or BFH) (docket-no II R 28/08) ruled — in contrast to the position of the fiscal authorities — that the increase in value of a shareholding caused by a disproportional contribution of another shareholder would not qualify as a gift.

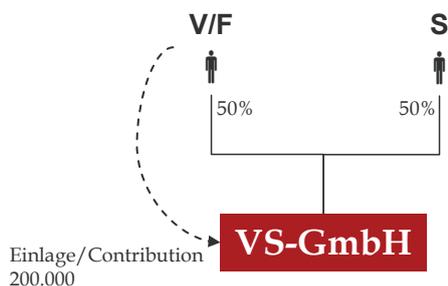
### Amendment to the IGTA

By introducing the amendment the legislator intends to close the “tax loop hole” resulting from the jurisprudence of the Federal Fiscal Court by considering the increase in value of the shareholding to be qualified as a gift. The wording of sec. 7 para. 8 clause 1 IGTA reads as follows:

“The increase in value of the shareholding in a corporation which is received by a natural person being direct or indirect shareholder or a trust (the donee) through a contribution of another person (the donor) to such corporation, is to be qualified as a gift.”

According to the explanatory memorandum to the law, sec. 7 para. 8 clause 1 IGTA intends to cover the following case in particular:

Example: Father F and son S are both holding 50 percent in FS-GmbH, a German limited liability company and have each paid up €50,000 into the company at the time of the formation. Now, F contributes additional €200,000 into the corporation. As a consequence, the value of the participation in the FS-GmbH held by S increases from €50,000 to €150,000.



Although the legislator had not directly intended restructuring measures to be within the scope of application, negative tax effects on disproportional restructuring measures can not be excluded. Indeed, the explanatory memorandum to the amendment indicates that the legislator has the view that in the event of restructuring measures certain side letters under corporate law between the unrelated parties would prevent any shifting of assets among the shareholders. However, on the one hand, it is not entirely clear from the explanatory memorandum whether the legislator intended to exclude all restructuring measures from the application of the new provision and, on the other hand, there is no such reference in the wording of the law. Irrespective of that, it remains unclear how the wording of such a side letter would have to be drafted to exclude the application of the new provision. In the meantime, the fiscal authorities have issued a decree regarding the new rules dated 14 March 2012. However, many questions remain unanswered; in particular the tax consequences of restructuring measures under the IGTA remain highly uncertain.

The new provision applies to increases in values in the shareholding for which the tax becomes due after 13 December 2011 (sec. 37 para. 7 IGTA).

## **2. Details of New Provision**

The new provision is of particular importance due to the fact that (i) according to the wording of sec. 7 para. 8 clause 1 IGTA, the provision is applicable irrespective of an intention to enrich the donee (donation will) as a subjective element and (ii) the wording of the provision is broadly phrased. However, the rules provide for an exception for certain measures within a corporate group.

### **“Contribution” into a Corporation**

Although the legislator intended — by introducing the new provision — to cover the scenarios of a disproportional contribution as described above, the wording refers to the broad term of “contribution” as tax triggering event. This term is rather broadly phrased as it does not only include contributions by shareholders but rather covers any allocation of third parties (*i.e.* non-shareholders) or any allocations which are so-called non-contributable assets (see no. 3.3.1 of the decree) *e.g.* benefits from low-interest bearing loans). Thus, such broad term of contribution could, for example, also include restructuring measures of third-party creditors.

### **The Donor**

Any natural person or any legal entity may qualify as a donor to the extent such person is not the donee at the same time. Consequently, contributions by shareholders and by related persons to such shareholders as well as contributions of third parties fall within the scope of application (*See* no. 3.2 of the decree).

### **The Donee**

Only natural persons or trusts qualify as donee. However, as the law applies to both, direct shareholdings in a corporation and indirect shareholdings in a corporation through other entities, shareholders of multi-tier structures also fall — irrespective of any minimum participation threshold — within the scope of application. Thus, in structures with a larger number of shareholders, the new law is likely to cause substantial problems from a practical perspective.

### **Increase in Value of the Shareholding in the Corporation**

The contribution has to be causal for an increase in value of the donee's shareholding in the corporation. The increase in value in the shareholding — which is limited to the fair value of the contribution (*See* 3.4.2 of the decree) — is deemed to qualify as a gift.

In the future, one of the major practical problems with respect to the new rules may be seen in the determination of the amount of the increase in value: according to the explanatory memorandum to the law, the legislator assumes that the value of the shares held by S in the example case described in the introduction is increased by €100,000; *i.e.* the legislator applies the so-called fixed/net-asset valuation. For inheritance tax and valuation law purposes, this valuation method is, however, subsidiary to the gross receipts method (sec. 11 para. 2 valuation law). On the basis of the overriding gross receipts method however, a cash injection to the capital surplus of a corporation by a shareholder as a general rule does not affect the share value.

#### **Exception for Measures Within a Corporate Group**

Sec. 7 para. 8 clause 2 IGTA includes an exemption for measures within a corporate group (*See* no. 4 of the decree). According to such exemption, payments made between corporations shall only be subject to the general rule of sec. 7 para. 8 clause 1 IGTA to the extent (i) the corporations are not held (directly or indirectly) by the same shareholders and (ii) the payment was made with intention to enrich the shareholders.

#### **Legal Consequences**

The increase in value of the shareholding in the corporation is subject to taxation at the level of the donee.

Unlike a transfer of shares in corporations, the cases of a disproportional contribution to a corporation cannot benefit from the tax exemptions for business assets such as secs. 13a, 13b and 19a IGTA with a view to the wording of these rules, as there is no transfer of shares, but an increase in value of shares that had already been held before the increase (*See* no. 3.5 of the decree). The refusal of the tax privilege for business assets does not seem to be appropriate.

If the donee is not related to the donor, the taxable event is subject to tax at a rate between 30 percent and 50 percent under tax category III (sec. 15 para. 1 IGTA)

The donee and the donor are jointly and severally liable for the tax payment. This can be of particular importance, if the donee is resident abroad.

### **3. Possible Solutions**

According to the explanatory memorandum to the law, *e.g.* in restructuring cases there are generally additional agreements in amendment of the corporation's articles excluding a definite shift of values between the shareholders. However, as the wording of the law does not provide for an exception to the new rules in these cases, it remains to be seen how the tax authorities will react in these restructuring cases. Additional agreements (if any) should in any case be documented for evidence purposes.

In literature the following possible approaches are discussed for achieving the restructuring objective without triggering inheritance/gift tax:

- (i) Amendment of the share in profits (sec. 29 para. 3 clause 2 German limited liability companies act, or GmbHG) or agreement on a distribution of assets deviating from the shareholding quotas in case of a liquidation of the company (sec. 72 clause 2 GmbHG)
- (ii) Claim disposals to (fellow) shareholders followed by a proportional contribution / waiver
- (iii) Debt / equity swap (in connection with a capital increase)
- (iv) Modification of the shareholding quotas by way of share transfers before the contribution

The fiscal authorities have approved the measures (i) and (ii) in the new decree (See no. 3.3.5 and 3.3.6 of the decree).

A debt/equity swap (See above (iii)) by way of a contribution of claims may be hindered by the need for an impairment test regarding the contributed claim in case of an increase of nominal equity, as such impairment test can hardly be met in restructuring cases. Finally, it remains subject to further analysis in each particular restructuring case if any and which of the measures described above would be viable restructuring options for the involved parties.

#### **4. Future Prospects**

In preparation of restructuring measures, it may be advisable to try to receive a binding ruling from the tax authorities (against a charge) with respect to the inheritance/gift tax treatment of the measures at issue. For the future, it seems to be of special importance to prepare a sufficient documentation on the values the parties have based their decisions on and — in case of contribution by several parties — evidence for the parties' assumption that their contributions are well-balanced.

## **VI. Withholding Tax in Case of “Pay If You Can” Structures?**

In its judgment dated 22 June 2010 (I R 78/09) the Federal Fiscal Court (*Bundesfinanzhof* — BFH) held that loans may be characterized as profit participating loans if interest payments are due and payable only if and to the extent the borrower has sufficient liquidity for such payments. Such characterization as profit participating loans would result in the interest being subject to withholding tax (WHT) and — in case of tax-resident borrowers — to a limited tax liability for foreign lenders in Germany.

Furthermore according to some double taxation treaties (e.g. with France and the US) such interest from participating loans qualifies for the dividend article and therefore may even under the treaties become subject to German WHT.

In the case of restructurings the decision may be relevant if the interest payable for existing or new loans is subject to sufficient liquidity of the borrower, if it is distributed among the different creditors under a waterfall provision in the case of insufficient liquidity or if it is only due upon maturity.

### **1. Background**

Interest on loans is, in principle, not subject to withholding tax in Germany if the loans are not securitized and the interest is not profit-related. Loans bearing a profit-related interest include in particular profit participation rights and profit participating loans. According to the Federal Fiscal Court, profit participating loans are characterized by a consideration for the provision of capital that represents a participation in the economic performance of the borrower.

### **2. Decision by the Federal Fiscal Court**

The Federal Fiscal Court held that in the present case, which concerned a closed-end fund in the form of a public partnership holding a container ship, such participation in the economic performance existed. The partnership had entered as a borrower into an agreement on a loan that was explicitly characterized as profit participating. Under the agreement, interest only became due and payable if the available liquidity of the partnership (taking into account distributions to the equity holders and subject to the maintenance of sufficient liquidity reserves) allowed such interest payment. Upon the sale of the container ship by the partnership, the lender was entitled to receive a participation in the excess of the sale proceeds, net of any other liabilities of the partnership. To the extent the sale proceeds were not sufficient for the payment of the principal amount and interest payments, the respective amounts were deemed to be waived.

The BFH upheld the decision of the tax court of first instance that the loan represented a profit participating loan. This was not only based on the participation of the lender in the capital gains after a sale of the ship. In its judgment, the BFH argued that the fact that interest payments only become due and payable if and to the extent the borrower has sufficient liquidity also may constitute a participation in the economic performance of the borrower. As this provision of the loan agreement effectively results in a principally in a deferral for an unlimited time, the lender only has an enforceable claim for interest payments if the borrower generates corresponding earnings and liquidity.

### **3. Interpretation of the Decision**

Due to the broad wording used by the BFH in its arguments, the judgment causes significant uncertainty with respect to the treatment of loans providing for a deferral of interest payments with regard to the liquidity of the borrower (or similar criteria). Structures potentially affected by this uncertainty are for instance typical mezzanine financings or loans providing for so-called "pay if you can" clauses, but also structures in which interest payments are deferred until the borrower's lack of liquidity has been cured.

Practical consequences of the court's decision depend on how broadly the arguments of the court can be interpreted. In our opinion, the judgment's wording is misleading. For the qualification of a loan as a profit participating loan it is in our view irrelevant whether and under which conditions interest payments are deferred during the term of the loan. The crucial question is rather whether the lender has an enforceable claim for payment of interest accrued at least at the end of the term of the loan. Insofar, the BFH does not make clear enough in the relevant section of its ruling that one crucial aspect of the case is that accrued interest was be deemed to be waived if the proceeds derived from the sale of the borrower's sole asset do not suffice for paying the interest accrued under the loan. The BFH more clearly points out the critical relevance of the lack of an enforceable claim for the payment of the (principally non profit-related) consideration especially at the end of the term of a loan in its judgment dated 26 August 2010 (I R 53/09), which deals with the similar question whether interest payments under a profit participation right qualify as a "profit participation" under the double taxation convention between Germany and Austria, contrasting the profit participation with "mere conditions for a deferral".

### **4. Consequences**

Applying a reasonable and therefore narrow interpretation of the court's decision, plain vanilla PIK loans providing for the interest to become unconditionally due and payable at the end of the term of the loan should therefore not be affected by the judgment. In contrast, with respect to loans bearing bullet interest or interest deferred under certain conditions, any clause providing for such interest to be waived at the end of the term of the loan if at this point in time there are no sufficient funds available for paying the interest should be detrimental. It is currently unclear whether the same applies if the interest claim is not waived at the end of the term but may in fact not be enforceable because the interest claim is subordinated to other liabilities of the borrower. As far as subordinated loans are concerned, we expect such loans to be held profit participating if the interest on the loan is only payable out of future profits and liquidation proceeds (but not out of other capital available for distribution). Please also note the article dealing with recent decisions on subordination clauses in this publication.

As long as the tax authorities have not yet published their view on the general application of the principles stated in the discussed judgment, such provisions should be avoided, their treatment covered by a binding ruling from the tax authorities or, if a binding ruling is not available, the risk of the deduction of withholding tax should be reflected adequately in the loan agreement.

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