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Upheaval in the German Restructuring Market: Need-to-Know Facts, Alternative Tools, and New Draft Law

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This article discusses the decision of the German Federal Fiscal Court, limiting the debt waiver option to restructure German-based companies, the consequences of the decision, alternatives to the Restructuring Decree, the new draft law, and the potential legislative path ahead.

To date, a debt waiver has been frequently used as a tool to successfully restructure German-based companies in financial difficulties. A decision of the German Federal Fiscal Court (*Bundesfinanzhof*) published on February 8, 2017 currently limits the debt waiver option. The court held that one of the main instruments used by tax authorities to grant relief from an otherwise taxable cancellation of debt income ("CODI")—in the form of the so-called Restructuring Decree (*Sanierungserlass*)—violates fundamental constitutional rights. Less than one month after the publication of the decision, a new bill addressing tax exemptions in restructuring scenarios has been introduced into the legislative process.

The purpose of this article is to point out the background to the decision of the German Federal Fiscal Court, the consequences of the decision, possible alternatives to the Restructuring Decree as well as to give insight into the new draft law and the potential legislative path ahead.

BACKGROUND

A waiver of debt (or, if the waiver is effected by a shareholder, the impaired portion of the debt) results in CODI, which is generally subject to both corporate income tax and trade tax at ordinary tax rates so that the entire restructuring success may be put at risk due to cash tax payments (even in the presence of tax loss carry-forwards). In a restructuring scenario, avoidance or at least reduction of CODI is essential and of primary importance.

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As the tax burden on the CODI is a severe obstacle to recapitalizing German entities, the German Federal Ministry of Finance (*Bundesfinanzministerium*) released its so-called Restructuring Decree (*Sanierungserlass*) in 2003 to allow a beneficial tax treatment of the CODI in certain circumstances. Under the decree, the German tax authorities were provided with the option to defer and ultimately cancel the tax payable on the CODI if, *inter alia*, the debt waivers (together with any other contributions by the stakeholders) provided a sufficient going-concern for the restructured company.

THE DECISION OF THE GERMAN FEDERAL FISCAL COURT (*BUNDESFINANZHOF*)

In the underlying case, the plaintiff challenged a tax assessment notice which imposed a duty to pay income tax. The tax authority argued that the plaintiff generated profit as a result of a waiver of (otherwise uncollectible) debt which the plaintiff and his local bank had agreed upon. The plaintiff, however, argued that this waiver was part of a restructuring plan and would, therefore, qualify as a tax-privileged restructuring profit under the so-called Restructuring Decree. Hence, the duty to pay income taxes could not be based on such profits.

In a decision published on February 8, 2017 the German Federal Fiscal Court, being the highest jurisprudence authority in Germany for taxes, held that the so-called Restructuring Decree violates the constitutional principle of legality of administrative actions. In essence, the court argued that the Ministry of Finance was not allowed to base the so-called Restructuring Decree on two exceptional provisions in the German Income Tax Act (*EStG*) that allow—on a case-by-case basis—for a tax exemption or reduction in the event of undue/unfair hardship. According to the court, these provisions are only relevant if the hardship results from the application of specific tax laws and if the hardship is determined on the basis of the individual case. The general duty to pay taxes or reasons outside of tax law (*e.g.* general economic, social or other restructuring considerations) may not be taken into account. Due to this lack of a legal basis for the Restructuring Decree, the German Ministry of Finance was, therefore, by-passing parliament, especially, since parliament had previously decided to abolish a statutory law provision that allowed for a tax exemption in restructuring scenarios.

IMPLICATIONS OF THE COURT'S DECISION

While the German tax authorities may still take measures to grant tax relief based on undue/unfair hardship on an case-by-case basis, the court's decision will nonetheless often impede a tax-efficient deleverage in the course of a restructuring due to the inapplicability of the Restructuring Decree for the time being. Therefore, it is necessary to look for other restructuring measures to achieve a similar economic result without incurring the tax implications resulting from CODI.

There are a number of tax structures, which may provide an alternative to the Restructuring Decree.

One that has been used in the past is a debt-to-mezzanine swap. Under a debt-to-mezzanine swap the debt converted into a mezzanine instrument by novation, which was typically structured in such a way that it qualified as equity for German GAAP purposes and as debt for German tax accounting purposes. However, a debt-to-mezzanine swap is also generally no longer considered a viable solution for a distressed company in need of deleverage. The reason is that on May 12, 2016 the German tax authorities issued a decree, according to which a debt-to-mezzanine swap—if the mezzanine instrument is structured as equity for German GAAP purposes—in fact triggers taxable CODI based on the general principle that tax accounting follows commercial accounting.

Nevertheless, other alternative structures, described below, still work, including:

1) a debt push-up;
2) a debt-asset swap;
3) an internalization of the excess debt; or
4) a deep subordination.

However, it should be understood that a tax efficient structure primarily depends on the actual circumstances of the distressed company and may, therefore, only be assessed on a case-by-case basis.

ALTERNATIVES TO THE USE OF A RESTRUCTURING DECREE

Option 1: Debt Push-Up

A popular tax-driven restructuring tool is the shareholder of a distressed company assuming debt with a discharging effect with the prior exclusion of any claims for recourse against the debtor. The concept of debt assumption is based on a decision made by the German Federal Fiscal Court in 2001. Upon agreement of the debt assumption between the distressed company and its shareholder, the company receives a respective relief claim against the shareholder by way of a hidden contribution equal to the nominal amount of the debt assumed. Once the creditor has approved the assumption of debt, the debtor is fully released from its obligations under the assumed debt, in fulfilment of the relief claim.

If structured properly, this technique should not generate any taxable CODI at the level of the distressed company. In addition, the tax equity account of the company is increased accordingly. Prior to implementation, however, the relevant stakeholders should liaise with the competent tax office to first apply for a binding ruling on the tax implications of the intended structure, since there are various pitfalls including the absence of official recognition of the mentioned court ruling of 2001 by the tax authorities. Also notably, the assumption of debt obviously does not eliminate the debt as such, but rather transfers the debt to the parent level. While the distressed company has the benefit of a financially restructured balance sheet, the treatment of the assumed debt at the level of the parent should be planned diligently as part of the overall restructuring concept.

Option 2: Debt-Asset Swap

In particular circumstances a distressed company might also contemplate separating the assets together with a sustainable portion of the debt by way of a transfer into a new corporate structure together with a deep subordination of the unsustainable part of the debt, followed by a silent liquidation of the old structure. However, potential secondary liabilities of the new structure for tax liabilities of the old structure, as well as uncertainties and difficulties in achieving a silent liquidation out of insolvency, need to be addressed and factored into the overall assessment of such a structure's viability.

Option 3: Internalization of Excess Debt

If neither a debt push-up nor a debt-asset swap are viable options, a quick and easy fix is often the internalization of the excess debt portion, if the shareholder is located in a suitable jurisdiction. In such a structure, the lenders would sell the excess debt portion to the shareholder of the distressed company followed by a deep subordination of such excess debt portion. As part of the consideration for the excess debt, the shareholder would grant tracking notes to the lenders under which the shareholder is obliged to pass on any recouped amounts under the excess debt (less an applicable margin) to the lenders.

Again, the internalization obviously does not eliminate the debt at the level of the distressed company as such, but only provides for an increased consolidated equity for the entire group, so that the benefit of a financially restructured balance sheet will only be available at a consolidated level. The structural risk of a taxable CODI going forward, if the individual balance sheet of the distressed company needs to be financially restructured, is not eliminated, so that the caveats of Option 4 apply accordingly.

Option 4: Deep Subordination

Another rather straightforward option exists in the deep subordination of any unsustainable debt directly by the lenders. Such deep subordination would have no immediate taxable consequences. In addition, when making an illiquidity or over-indebtedness assessment of the company under German insolvency law, such subordinated debt may be disregarded as a (due and payable) debt item. However, even if deeply subordinated, such debt would still be regarded as a debt item on the balance sheet, which may lead to difficulties when looking for refinancing following a restructuring.

OUTLOOK: THE ROAD AHEAD (RE: THE RESTRUCTURING DECREE)

In the past, the German Ministry of Finance has issued so-called non-applicability decrees (*Nichtanwendungserlass*) in specific cases. By such decree the ministry declares that the tax authorities do not have to follow a certain court decision in general and the decision may be regarded as an individual court decision only. However, given that the German Federal Fiscal Court held that the Restructuring Decree violates fundamental constitutional law principles, it is rather doubtful that the German Ministry of Finance would issue such a decree.

Due to the current unsatisfactory situation following the German Federal Fiscal Court's decision and the difficulties distressed companies face in order to achieve a successful financial restructuring without the benefits the Restructuring Decree offered, the German legislator has seen the need for urgent action. On February 27, 2017 the Federal Council (*Bundesrat*) proposed new statutory rules under the German Income Tax Act (*EStG*) and the German Trade Tax Act (*GewStG*) providing for a statutory tax exemption for debt waivers in a restructuring scenario.

Once introduced, the requirements for a debt waiver under the new provisions largely follow along the same lines as the Restructuring Decree. However, in contrast to the Restructuring Decree, existing tax loss carry-forwards and tax losses generated in the year of the restructuring would be completely extinguished. Therefore, it would no longer be possible to make use of the restructuring exemption and to utilize remaining tax loss carry-forwards in later assessment periods to shield future income.

Despite the Federal Council's fast reaction to the decision of the German Federal Fiscal Court, the new rules likely will not be introduced in the near future. Because any rule must comply with EU state aid law, the German legislator has already announced that it intends to formally notify the EU Commission of the new laws and postpone the implementation of such laws until the EU Commission grants approval. However, it is not clear, (i) whether the relevant rules and their economic effects will be regarded as subsidies in the meaning of the EU state aid law and (ii) whether, if qualified as subsidies, the

EU Commission will approve such rules. For the time being, the restructuring market in Germany will need to cope with the situation on the basis of the current set of rules and the remaining alternatives.

SUMMARY

The decision of the German Federal Fiscal Court (*Bundesfinanzhof*) on the non-applicability of the Restructuring Decree (*Sanierungserlass*) may impede a tax-neutral restructuring of distressed companies. The legislator has reacted to this legislative vacuum. However, until these new rules become effective, other tax-efficient restructuring options are at-hand, which need to be assessed on a case-by-case basis.