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Tax Exemption Offers Relief in the German Restructuring Market

German legislator introduces tax exemption for income resulting from debt waivers in restructuring scenarios with retroactive effect.

On 23 November 2018, the German legislator approved legislation regarding tax exemption of cancellation-of-debt-income (COD income) resulting from debt waivers in restructuring scenarios. The tax exemption will apply with retroactive effect to debt waivers effected on or after 9 February 2016 and, upon a specific filing of the taxpayer, to debt waivers effected prior to that date. This *Client Alert* will outline the background, the preconditions, and the consequences of the newly introduced tax exemption, and provide insight into its application in practice.

Background

On 8 February 2016, the German Federal Fiscal Court (*Bundesfinanzhof* or *BFH*) published its ruling on the so-called Restructuring Decree (*Sanierungserlass*), a practice of German tax authorities established in and applied since 2003. Pursuant to the Restructuring Decree, German tax authorities could defer, and ultimately waive, the tax liability payable with respect to COD income, if, *inter alia*, the debt waivers (together with any other contributions by the stakeholders) resulted in a sufficiently reasonable going-concern prognosis for the restructured business. The BFH held that the application of the Restructuring Decree by German tax authorities violates fundamental constitutional rights (see Latham's 2017 *Client Alert*).

In reaction to the BFH ruling, the German legislator implemented an explicit tax exemption for COD income applicable to individuals, partnerships, and corporations for income tax as well as trade tax purposes with respect to debt waivers effected after 8 February 2016. However, the application of this tax exemption was made subject to the acknowledgement of the European Commission that the tax relief does not qualify as an illegal state aid. Contextually, the German Federal Ministry of Finance (*Bundesfinanzministerium*) published a circular letter stating that the Restructuring Decree shall continue to be applicable to:

- Debt waivers prior to 8 February 2016
- Cases in which tax authorities issued a binding ruling on the application of the Restructuring Decree prior to 8 February 2016

The rationale for this extension was taxpayers' legitimate expectations regarding the application of the Restructuring Decree prior to the BFH ruling. In a subsequent ruling, however, the BFH disapproved of the circular letter and held that its application would require an explicit regulation from the German legislator.

The European Commission did not issue a formal and binding approval under EU state aid regulations, further increasing existing uncertainties. In contradiction of the expectations of the German legislator and government, the European Commission merely sent a "letter of comfort" setting out the Commission's opinion that the tax relief for COD income qualifies as a state aid that has existed prior to the foundation of the European Communities by way of the Treaties of Rome in 1957. Thus this tax relief falls outside of the authority of EU state aid rules. As the application of tax exemption was conditional on the issuance of such a formal approval, the exemption could not come into effect as the German legislator expected.

On 23 November 2018, the German legislator rectified its first attempt to address the tax treatment of COD income and approved legislation finally introducing a tax exemption for COD income, applicable with retroactive effect to:

- Debt waivers effected on or after 9 February 2016
- Debt waivers effected on or prior to 8 February 2016 upon a specific filing of the taxpayer

Preconditions for the Tax Exemption

The newly implemented tax exemption applies to gains at the level of the debtor resulting from (a) a full or partial debt waiver, whereby (b) such waiver to be effected for purposes of restructuring the debtor's business. The new rule provides for relief from both income and trade tax, and is applicable to individuals carrying out a business, partnerships, and corporations.

Debt Waiver: The law does not set out a list of specific measures indicating which type of debt waivers qualify for the tax exemption. However, according to the legislative materials, qualifying debt waivers are:

- Waivers pursuant to a waiver agreement in accordance with Section 397 para. 1 German Civil Code (*Bürgerliches Gesetzbuch — BGB*)
- Negative acknowledgements of debt in accordance with Section 397 para. 2 German Civil Code
- Debt waivers as part of insolvency proceedings pursuant to Section. 217 et seq. German Insolvency Act (*Insolvenzordnung — InsO*), which are not aimed at liquidating the business

Restructuring Purposes: The debt waiver is deemed to be made for restructuring purposes if the taxpayer can prove all of the below:

- The need of the business to be restructured (*Sanierungsbedürftigkeit*)
- The ability of the business to be restructured (*Sanierungsfähigkeit*)
- The ability of the waiver to result in a going-concern for the restructured business (*Sanierungseignung*)
- The creditors' intention to restructure the business (*Sanierungsabsicht*)

Satisfactory evidence for the criteria above should include, for example, a restructuring plan or an insolvency plan in cases of insolvency proceedings pursuant to Sections 217 et seq. German Insolvency Act. The burden of proof is placed on the taxpayer. Thus, if the taxpayer fails to present sufficient evidence, German tax authorities can deny the tax exemption.

Consequence: Reduction of Tax Loss Carry Forwards and Tax Losses

As a consequence of the application of the new tax exemption provision, any capital gain realised as a result of a qualifying debt waiver needs to be offset with tax loss carry forwards and other tax assets in a defined sequence. The new law provides, *inter alia*, for the following items to be offset with COD income:

- Tax loss carry forwards available at the end of the fiscal year preceding the year of the debt waiver
- Losses incurred in the year of the debt waiver and the following year
- Any existing interest or EBITDA carry forwards resulting from the German interest barrier rule (*Zinsschranke*) of the year of the debt waiver and the preceding year

To the extent the above offset does not fully absorb the COD income, the remaining portion needs to be offset with existing loss carry forwards and other tax assets of a person related to the taxpayer (*e.g.*, a shareholder of the debtor or a family member), if the liabilities subject to the debt waiver were transferred from the related person to the company within five years prior to the debt waiver.

To the extent such tax assets are utilised, they are no longer available to the taxpayer and, if applicable, to the related person.

Further Consequences

In addition to the forfeiture of tax loss carry forwards, the tax exemption also means that any tax election rights have to be exercised in a way that results in a reduction in taxable income for the year during which the respective COD income is realised, as well as for the following year (*e.g.*, write-downs of assets to a fair market value below amortised acquisition costs or depreciation methods leading to higher depreciation amounts).

Moreover, restructuring expenses directly relating to the tax exempt restructuring gains (*e.g.*, costs for a restructuring plan or external advice from consultants, lawyers, *etc*.) cannot be deducted from taxable income. The non-deductibility not only applies to expenses up to the amount of the tax exempt gains, but in principle also to any exceeding amounts. This applies regardless of whether the expenses are incurred in the tax period in which the tax exempt gains are realised or in a preceding or following tax period. However, restructuring expenses remain deductible in cases of expenses incurred in preceding tax periods, if the expenses lead to tax loss carry forwards that are forfeited as a consequence of the tax exemption. Moreover, the taxpayer may deduct restructuring expenses that are incurred in subsequent tax periods, to the extent the expense amount exceeds the amount of the restructuring gain remaining after the offset with tax loss carry forwards and other tax assets.

Application of Tax Exemption in Practice

As outlined above, the tax exemption applies to COD income stemming from either of the following:

- Full or partial debt waivers effected on or after 9 February 2016

- Full or partial debt waivers effected on or prior to 8 February 2016, only upon a specific filing of the taxpayer.

Thus, the legislator decided to apply the tax exemption with retroactive active effect to debt waivers effected prior, on as well as after the publication of the BFH's landmark ruling on 8 February 2016. As regards debt waivers on or prior to 8 February 2016, the new rule is applicable only if the respective case is still open, *i.e.*, taxes for the relevant period are not assessed in a final and non-appealable way. The legislator's decision to grandfather restructurings before the BFH's 2016 ruling, in our opinion clearly means that — contrary to the opinion of the Federal Ministry of Finance and compliant with the BFH ruling — the former practice under the Restructuring Decree should no longer be applicable to such cases.

When seeking relief under the new rules, taxpayers should apply for a binding ruling on whether the contemplated restructuring satisfies the criteria required by the new rules (this corresponds to past practice under the Restructuring Decree). In contrast to a tax waiver under the Restructuring Decree, the newly introduced tax exemption has the advantage that only one binding ruling will be required in future, whereas taxpayers previously had to apply for at least two binding rulings — and even more rulings if the company had permanent establishments in different municipalities.

While the new rules generally constitute a substantial improvement in restructuring scenarios, the taxpayer may benefit from not applying the new tax exemption rules to restructuring gains. For example, not applying the new rules is more advantageous in cases in which expenses connected to the restructuring exceed the restructuring gains. As regards debt waivers on or after 9 February 2016, however, the tax exemption and its consequences (*e.g.*, the forfeiture of tax loss carry forwards and the non-deductibility of expenses in the full amount) are self-executing and, hence, technically their application is not subject to a filing of the taxpayer. From a practical perspective, however, there is a *de facto* discretion of the taxpayer. In fact, the new regulation requires that the taxpayer provides evidence for the satisfaction of the above preconditions (*inter alia*, the ability of the waiver to result in a going-concern for the restructured business, see above). Hence, the tax exemption will not apply if the taxpayer cannot or does not (want to) provide sufficient evidence. Therefore, the taxpayer should have discretion to provide such evidence.

Finally, there remains a risk that the European Court of Justice (ECJ) may take a different view than the European Commission and deem the tax relief as an illegal state aid pursuant to Articles 107 et seq. of the Treaty on the Functioning of the European Union. Such a ruling would mean that German tax authorities would be required to recover the amount of taxes the taxpayer saves as a result of the tax exemption, regardless of a final and binding tax assessment or statute of limitations in German tax law. This would not be the case if the European Commission had approved the tax relief as a legal state aid in a formal and binding way and had not merely issued a comfort letter. However, this risk would only materialise if a fiscal court in Germany dealing with the application of the tax exemption referred the question of whether the tax relief is compliant with EU state aid rules to the ECJ in a preliminary ruling procedure.

Summary

The key characteristics of the newly introduced tax exemption are:

- The tax exemption is applicable with retroactive effect to (i) full or partial debt waivers effected on or after 9 February 2016, and (ii) upon a specific filing of the taxpayer, to full or partial debt waivers effected on or before 8 February 2016. The past practice under the Restructuring Decree should not apply to still open cases of debt waivers prior 8 February 2016.

- Any gains stemming from debt waivers must be offset with tax loss carry forwards, current and future losses and other tax assets of the taxpayer, and, in limited cases, of related persons. To the extent such tax assets are utilised, they are no longer available to the taxpayer and, if applicable, to the related person.
- Tax election rights must be exercised in a way that leads to a reduction in taxable income for the year in which the restructuring gain is realised, and for the following year.
- Restructuring expenses directly relating to the tax exempt gains (*e.g.*, costs for a restructuring plan or external advice from consultants, lawyers, *etc*.) may, in principle, not be deducted from taxable income, regardless of whether the expenses are incurred in the tax period in which the tax exempt gains are realised or in a preceding or following tax period.

However, the European Commission did not approve the tax relief as a legal state aid in a formal and binding way. Rather, the Commission merely set out its opinion in a letter of comfort. Hence, the ECJ can still take an opposing view in a future case dealing with the tax exemption. Whether this risk is merely theoretical, remains to be seen.

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