RESTRUCTURING AND TURNAROUND: TAX IMPLICATIONS OF FINANCIAL RESTRUCTURINGS (GERMANY)

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Legal Briefings

INTRODUCTION

Businesses are struggling. Many have lost a significant portion of their annual revenue as a result of lockdowns and other measures to prevent the spread of Covid19 during the first half of 2020.

While the German government, like many others, provided immediate relief, most of the measures were in the form of government backed loans. Loans, however, result in an increase of the indebtedness of businesses and, of course, have to be repaid at some point.

Germany also temporarily suspended the obligation to file for insolvency, from 1 March 2020 until 30 September 2020 for cases of illiquidity and over-indebtedness, and from 1 October 2020 to 31 December 2020 only for cases of over-indebtedness

All of this cannot, however, mask the fact the liability sides of the balance sheets of many businesses look grim after having relied on government backed loans and/or drawn additional amounts on existing loan facilities. Many businesses, even with inherently sustainable business models, which needed to take up additional loans earlier this year, may therefore find themselves in a situation of over-indebtedness or impending over-indebtedness.

Many of these may need to consider a financial restructuring, and some of them may look forward to Germany implementing the EU restructuring directive which is likely to make it easier for them to restructure the liability side of their balance sheet (even in situations where some of their creditors are unwilling to participate).

Changes to the liability side of a business' balance sheet, however, often come with adverse tax consequence resulting in cash-outs that can undermine otherwise successful restructuring efforts. Debtors and creditors involved in a financial restructuring should therefore always carefully consider any tax effects of their plans, involve tax experts at an early stage and, if possible, seek advance clearance with the tax authorities.

THE GENERAL PROBLEM: TAX TREATMENT OF CANCELLATION OF DEBT GAINS

Apart from many other tax issues to be considered depending on the specific financial restructuring instruments used, there is one point that is almost always relevant: Whenever a liability is de-recognized in a balance sheet of a business this results in an accounting gain which does, however, not correspond to additional cash for the debtor.

BACKGROUND

As early as in 1927, the then highest German Tax Court concluded that such a mere accounting gain shall not result in a tax charge if certain requirements are met, in particular if the debt is cancelled in order to help a struggling business recover. Since then, German tax rules have most of the time provided for some sort of tax relief in respect of cancellation of debt gains.

Until a few years ago, the relevant rules were included in specific guidance issued by the tax authorities, and many taxpayers successfully relied on these rules in financial restructurings that followed the global financial crisis in 2007/2008.

In 2016, the German Federal Tax Court (the *Bundesfinanzhof*) decided that for the rules on the taxation of the cancellation of debt gain to be legally effective, these need to be included in an Act of parliament (and not merely in tax authorities' guidance).

As a consequence, the German rules on the tax treatment of cancellation of debt gains have been substantially rewritten and adopted by the German parliament in 2017. These new rules are now likely to be tested for the first time in financial restructurings as result of the Covid-19 crisis.

In a nutshell, what do they say?

Requirements to qualify for relief

- The cancellation of debt must take place in the form of a debt waiver (*Forderungsverzicht*).
- It must be part of a business-related (*unternehmensbezogen*) restructuring, i.e. not

based on a corporate relationship between debtor and creditor.

- The business must:
  - require a restructuring (*Sanierungsbedürftigkeit*); and
  - be capable of being restructed (*Sanierungsfähigkeit*).
- The proposed measures must be suitability for restructuring (*Sanierungseignung*).
- It must be the intention of the creditors participating to restructure the business (*Sanierungsabsicht*).

TAX CONSEQUENCES

- The cancellation of debt gain is tax exempt.
- This, however, comes at a cost:
  - Tax elections must be exercised to reduce the taxable income of the FY in which the cancellation of debt gain accrues and the following FY.
  - A large number of tax assets (e.g. tax losses and tax loss carry forwards etc.) largely fall away.
  - Expenses related to the restructuring are not tax deductible.

ANYTHING ELSE TO BE AWARE OF?

While the most common transaction that leads to a de-recognition of a liability is indeed the cancellation of debt as a result of a creditor waiving its repayment claim, there are a number of other situations that can result in a de-recognition of a liability. Moreover, not all waivers of debt would necessarily be part of a business-related restructuring. As the new rules are largely untested it is currently unclear if and how these would apply to such other situations.

Apart from the tax treatment of a potential cancellation of debt gains, there are a number of other tax effects of various instruments used in the course of a financial restructuring which a taxpayer should take into account as follows:

SPECIFIC ISSUES: MOST COMMONLY USED INSTRUMENTS IN FINANCIAL RESTRUCTURINGS

DEFERRAL OF PAYMENTS

One of the first steps that are usually taken if businesses face financial difficulties is agreeing a deferral of the business's payment obligations under loans agreements (or other debt instruments). While the mere deferral of payment obligations should generally not result in adverse tax consequences for the debtor, caution is required in particular in the following circumstances:

- **Interest-free loans**: If loans (or other debt instruments) are amended in order to no longer bear any interest and their remaining term as of a fiscal year-end is one year or more, debtors are required to discount the respective liabilities at 5.5% p.a. in their balance sheets which results in a partial de-recognition of these triggering a taxable accounting gain. No discounting should be required of the relevant loans bear a minimal interest or if interest payment are merely deferred.

- **PIYC loans (**"**Pay if you can loans**"**)**: If debtors and creditors agree that the debtor shall only be required to make interest payments if he is able to do so, caution is required in order to make sure that the relevant payment obligations are not (only) based on the debtor's profit position. Otherwise, PIYC loans could qualify as profit-participation loans and attract German withholding tax on interest payments.

- **Foreign currency loans**: If foreign currency denominated loan agreements are not merely amended but if an existing loan agreement is replaced by a new one, the debtor will be required in its balance sheet to de-recognize the existing loan liability and recognize a new liability. To the extent that the relevant foreign exchange rate has changed since the existing loan liability had first been recognized, this can result in a taxable forex gain or loss.

SUBORDINATION OF LOANS

Another one of the first steps if businesses face financial difficulties is agreeing with creditors that these subordinate their loan claims in relation to other liabilities of such debtor. If certain requirements are met, this avoids over-indebtedness within the meaning of the German insolvency rules. The following tax aspects should be taken into account, however:

- **Drafting**: If a subordination agreement is not drafted properly (in particular if the language regarding a potential repayment obligation does not make reference to "other free reserves" of the debtor), it results also in a de-recognition of the relevant liability for the purposes of the debtor's (tax) balance sheet which triggers a generally taxable accounting gain.

- **Availability of relief**: As the new rules on the taxation of cancellation of debt income are largely untested, while there are good arguments in favor of their applicability, it is currently unclear if these would indeed apply to an accounting gain resulting from a subordination of loans.

- **Shareholder loans**: On the basis of a decision of the German Federal Tax Court a taxable accounting gain resulting from de-recognition may be mitigated partially in case of a subordinated shareholder loan, but only to the extent that such shareholder loan is recoverable (which is unlikely to be the full nominal amount if subordination was required).

CANCELLATION OF DEBT / DEBT WAIVER

While deferrals of payment and the subordinations of loans provide some relief to distressed businesses, they do not fundamentally improve the liability side of their balance sheets. This only changes if debt is effectively cancelled or waived. Cancellation of debt and debt waivers can, however, have significant tax implications and need to be structured carefully:

- **Availability of relief**: Generally, relief should be available under the new rules on the taxation of cancellation of debt gains. The new rules, however, require *inter alia* that the cancellation of the relevant debt is business-related (*unternehmenbezogen*) and not based on a corporate relationship between the debtor and creditor. This requirement can be difficult to satisfy if only shareholder loan (and no third-party loans) are waived.

- **Tax losses and tax loss carry forwards**: Tax losses and tax loss carry forwards will largely fall away if the new rule on the taxation of cancellation of debt gains applies.

- **Shareholder loans**: The cancellation of a shareholder loan may be tax-neutral, but only to the extent that such shareholder loans is recoverable (which is unlikely to be the full nominal amount if restructuring was required). As tax neutrality on that basis, however, requires a corporate relationship between the debtor and creditor, it is currently unclear if it would be possible to apply the new rules on the taxation of cancellation of debt gains to the extent that a shareholder loan is not recoverable. Moreover, specific rules apply to shareholder loans if the debtor is a partnership.

- **Non-German subsidiaries**: If loans taken out by a taxpayer's non-German subsidiaries are waived, any potential cancellation of debt gains may be caught by the German CFC-rules if the jurisdiction in which the non-German subsidiary is tax resident provides tax relief in respect of such gains. This could also result in a German tax charge.

Debt waivers can be combined with **debtor warrants** (*Besserungsschein*) under which the waived loan claims would be reinstated if certain requirements are met. Such arrangements will also need to be carefully analyzed for potential adverse tax consequences. The same is true for alternative structures that aim at not triggering accounting gains at all, including for instance so-called **cash-circle** structures, in which a shareholders makes a cash contribution into the debtor-subsidiary and (after some time) the latter used the received cash to repay the shareholder loan.

DEBT-TO-EQUITY-SWAP

In particular when a number of non-shareholder third party creditors are asked to waive (a portion) of their loan claims, they may ask to receive an equity participation in the debtor in return. This can be achieved by way of a debt-to-equity-swap as part of which, usually, the debtor entity first resolves on a capital decrease (*Kapitalherabsetzung*) which is immediately followed by a capital increase (*Kapitalerhöhung*) as part of which the debtor would either waive or contribute their loan claims into the debtor entity. Tax points to consider with respect to a debt-to-equity swap include:

- **Tax neutral contribution**: The waiver or contribution of the loan claims as part of the capital increase may be treated as a tax-neutral, but only to the extent that such loans are recoverable (which is unlikely to be the full nominal amount if restructuring was required).

- **Availability of relief**: The new rules on the taxation of cancellation of debt gains require *inter alia* (i) that the cancellation of the relevant debt is business-related (*unternehmenbezogen*) and not based on a corporate relationship between the debtor and creditor and (ii) a cancellation of debt on the basis of a debt waiver. Both requirements can be difficult to satisfy in case of a debt-to-equity swap as (i) the capital increase will be based on a corporate relationship and (ii) in a scenario where the loan claims are contributed into the debtor entity, the relevant debt is not cancelled as a result of a waiver but by operation of law because after the contribution the debtor and creditor in respect of the relevant loan claims would be the same entity.

- **Tax losses and tax loss carry forwards**: Tax losses and tax loss carry forwards generally fall away if more than 50% of the shares in a company are directly or indirectly transferred to a new shareholder (or a group of affiliated new shareholder or new shareholder acting in concert). While relief from these rules is available for cases of debt-to-equity swaps if certain requirements are met, tax losses and tax loss carry forwards are still likely to fall away if the new rules on the taxation of cancellation of debt gains apply.

Alternative structures include **debt-to-hybrid-swaps** and **reverse debt-to-equity-swaps** which also need to be structure carefully from a tax perspective.

DEBT-BUY-BACK

In a debt-buy-back either the debtor or an affiliate of the debtor agrees to buy back the relevant loan receivables from third party creditors. The tax effects of these two alternatives are to be distinguished as follows:

- **Debtor buy-back**: If the debtor buys back the relevant loan receivables, the underlying liabilities fall away by operation of law as the debtor and the creditor of the relevant receivable are then the same entity. This generally results in an accounting gain to the extent that the repurchase price is lower than the nominal value of the relevant receivable. Again, as the new rules on the taxation of a cancellation of debt gain are largely untested, it is currently unclear if these could be applied here.
- **Affiliate buy-back**: If an affiliate of the debtor buys back the receivable, as the debtor and creditor remain different legal entities, this does not lead to immediate tax charge at the level of the debtor or its affiliate. To the extent, however, that repurchase price is lower than the nominal value of the receivable and the debtor company at some point pays back an amount exceeding that purchase price there will be a future (deferred) tax charge, on which the new rules on the taxation of a cancellation of debt gain are unlikely to apply.

DEBT-PUSH-UP

Debt-push-ups are usually considered if the parent company of the debtor-subsidiary still finds itself in financially good shape. The parent then assumes the liabilities of its subsidiary (which generally required the creditors’ consent). Tax points to consider with respect to debt-push-ups include:

- **No recourse claim**: A debt push-up can be deducted tax neutrally, if tax-wise it is treated as capital contribution by the parent company into the subsidiary in the full nominal amount of the assumed liability. In order to achieve this, it is important that the parent and subsidiary agree that the parent assumes the liabilities free of charge, i.e. does at no time acquire any recourse claim against the subsidiary.

- **Waiver of recourse claim**: Absent of such agreement between parent and subsidiary to a exclude a recourse claim, a debt-push-up could be considered as a waiver by the parent of its recourse claim vis-à-vis the subsidiary. This would be treated as any other debt waiver, i.e. would only be tax neutral to the extent that the recourse claim is recoverable (which is unlikely to be the full nominal amount if restructuring was required).

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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