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New Rules regarding Restructuring Profits

After a decision of the Federal Fiscal Court's Joint Senate was published earlier this year declaring the Restructuring Decree of the tax authorities null and void, there was a lot of uncertainty in the German restructuring practice. The German legislator has reacted unusually fast. The law has already been approved by the Federal Assambly (*Bundesrat*). It basically converts the Restructuring Decree into law although it has technical flaws. Further, the law will be notified to the European Commission to avoid potential state aid risks and in the meantime the uncertainty remains.

The new law has basically the same prerequisites as the Restructuring Decree, but the consequences are set out in much more detail than in the Restructuring Decree. In particular, the law provides for an extensive forfeiture of all kinds of hidden or carried forward losses. One substantial improvement: it will no longer be required to negotiate the tax waiver with all relevant municipalities as the tax office will also be competent to rule on trade tax.

Restructuring of defaulted businesses often requires a reduction of liabilities in order to make the business viable again. If such reduction is achieved by way of a debt waiver, taxable profits may accrue. While such profits were tax-exempt by law (§ 3 no. 66 Income Tax Act – "**ITA**") until 1997, they were since then subject to a decision of the tax authorities using equitable discretion. By taking such decisions, the tax authorities had to follow a tax decree issued by the Federal Tax Ministry (*BMF-Schreiben* dated 27 March 2003 – the "**Restructuring Decree**"), which effectively carved out waiver profits from taxation. The Restructuring Decree became a decisive and crucial feature of German restructuring practice. For trade tax (as opposed to corporate tax), the Restructuring Decree was not binding since the municipalities cannot be instructed by the Federal Tax Ministry. Rather, the company had to apply and negotiate with all relevant municipalities where it had a permanent establishment, and while the local governments often followed the decision of the tax authorities, this was not always the case.

On 12 December 2007, the Munich fiscal court (FG München – 1 K 4487/06) ruled that the Restructuring Decree is an infringement of the Constitution as the Federal Ministry of Finance lacks the necessary competence. Other courts followed (including the VIII. Senat of the Federal Fiscal Court (*Bundesfinanzhof*), 28 February 2012 – VIII R 2/08). However, there were other courts (including the X. Senat of the Federal Fiscal Court, 14 July 2010 – X R 34/08 and 25 March 2015 – X R 23/13) taking the opposite view. According to their justification, the legislator did not want to preclude the possibility to exempt waiver profits from taxation, in fact the purpose of the law reform in 1997 was to prevent any dual benefits. As a consequence, some tax authorities no longer applied the Restructuring Decree while others still did. This already led to uncertainty in German restructuring practice, and in particular, to unequal treatment throughout Germany, as the tax consequences of a restructuring were dependent on which tax office was competent.

On 28 November 2016, the Joint Senate of the Federal Fiscal Court held that while the tax administration may waive taxes when assessing an individual case taking into account the particularities of the individual situation (using equitable discretion), the Federal Tax Ministry does not carry legal capacity to order a generally applicable tax-exemption of waiver profits irrespective of the individual case (decision published on 8 February 2017 – GrS 1/15). Following that court ruling, waiver profits could only be tax-exempt on the basis of an individual decision of the local tax authorities, since the court decision declared the former Restructuring Decree null and void.

German insolvency experts urged the government to remedy the situation without delay and stipulate by law the legal routes for rescuing businesses without counterproductive tax burdens.

The government's legislative proposal as refined by the financial committee of the German parliament (*Finanzausschuss*) proposed new legislation with the scope to keep profits and capital gains tax free to the extent they were triggered by restructurings of businesses in default (*BT Drucksache* 18/12128, dated 26 April 2017). The concept of the new law is as follows:

Profits stemming from debt waivers ("**waiver profits**") are tax-exempt provided the debt waiver served the purpose of restructuring a defaulted business (§ 3a para 1 ITA). Such purpose is satisfied provided that at the time the waiver becomes effective evidence confirms that there was

(i) a need to restructure the defaulted business,

(ii) a well founded prospect for a successful restructuring,

(iii) suitability of the waiver to achieve a successful restructuring, and

(iv) the intention of the creditor(s) to successfully restructure the defaulted business.

In principle, these are the same prerequisites as were stipulated in the Restructuring Decree. And like the Restructuring Decree, the law does not provide for a definition when there is a need to restructure a business. However, it can be drawn from the official reasoning that a need for restructuring arises where the business otherwise goes insolvent or missing profitability has to be restored.

In order to eliminate a dual benefit for the restructured business, losses and loss-carryforwards relating to periods prior to the restructuring are extinguished. The concept is realised by means of a set of new rules, whereby the technical details are not clear.

The first rule (the Impairment Rule) relates to the realisation of loss potentials. While the recognition of an impairment is generally optional for tax purposes when the fair market value of an asset falls permanently below capitalised cost, impairment becomes mandatory when a business opts for tax-exempt waiver profits. Mandatory impairment only applies in the year where waiver profits accrue (the "**restructuring year**") and in the following year.

It should be noted that, where a mandatory write-down has occurred, the restructured business has to provide evidence that the fair market value of the respective asset has fallen permanently below capitalised cost. Such evidence has to be presented to the tax authorities in the year of the write-down and in subsequent years. Otherwise the write-down is reversed, resulting in a taxable profit.

Subject to the **Impairment Rule** are all classes of assets including, for example, shares, where the impairment loss is non-deductible for tax purposes and thus does not have an impact on the annual profit for tax purposes. Nevertheless future write-ups of the shares (after the restructuring year) would result in a 5% taxation.

The second rule (the **Restructuring Cost Rule**) regards costs and expenses in conjunction with the restructuring (e.g. fees for accountants and lawyers, but also costs incurred as a result of debtor warrants being triggered after the restructuring).

For years up to and including the restructuring year, such costs and expenses shall be fully non-deductible unless they have increased tax loss carry forwards which expire upon restructuring (see the Forfeiture Rule below). The law refers explicitly to loss-carryforwards, but may actually intend to include forfeited current losses as well. Due to the Restructuring Cost Rule past years need to be re-assessed to the extent non-deductible items have arisen. The non-deductible items increase the taxable profit. In this case the restructured business suffers tax as well as interest for late payment of such tax.

For years following the restructuring year, post-restructuring costs and expenses shall remain tax-deductible to the extent they exceed the final waiver profit which remains after its set-off with loss (or similar) positions.

The third rule is the **Forfeiture Rule**. Pursuant to the official reasoning, the intention of the legislator is to forfeit loss positions, e.g. loss carry forwards, of the restructured business up to an amount equal to the waiver profit reduced by non-deductible costs and expenses for the restructuring years and before. The limitation "up to an amount equal to the waiver profit" is an improvement compared to the innitial draft, which had provided for an unlimited forfeiture.

After deduction of non-deductible items the waiver profit is set off against various loss and similar positions according to the following order of priority:

(i) deferred losses which result from a transfer of liabilities which are recorded in the tax accounts below their settlement amount and had to be spread over 15 years pursuant to § 4f ITA, unless the transferee records a corresponding income item over the term of 15 years. This is a reasonable interpretation of the wording of the legislation which is far from being unequivocal.

(ii) current losses and losses carried forward according to

§ 15a ITA (losses from an investment in a limited partnership);

(iii) current losses and losses carried forward according to § 15b ITA (losses from tax saving schemes);

(iv) current losses and losses carried forward according to § 15 para 4 (mainly losses from derivative contracts);

(v) the current loss of the restructuring year which is decreased by the non-deductible items (Restructuring Cost Rule);

(vi) to the extent the business is run by an individual, all current losses from other income baskets (presumably including losses from investment income, which can generally not be offset against other income baskets);

(vii) the tax loss carry forward assessed as of the end of the year preceding the restructuring (the law explicitely states that the minimum taxation rules do not apply although they would not apply anyway as the tax loss carry forward will not be offset against an annual profit but an isolated income item (waiver profit) and further the tax loss carry forward will forfeit);

(viii) loss-carryfowards as well as negative income pursuant to §§ 15a, 15b, 15 para 4, 2a, 2b, 23 para 3 ITA and pursuant to "other rules" (*sonstige Vorschriften*). The fact that §§ 15a, 15b and 15 para 4 ITA are mentioned again seems to be due to the fact that the legislator wanted to distinguish between losses at the level of the restructured business and those at the level of the respective entrepreneur (which should be irrelevant in the case of a corporation). However, the wording is again unclear;

(ix) the losses of the year following the restructuring year;

(x) the interest carry forward and the EBITDA carry forward pursuant to the interest barrier rule (*Zinsschranke*).

If and to the extent the waiver profit (reduced by non-deductible items) exceeds the amount of the aggregate losses ((i) through (x)), the losses and loss carry forwards of a related party to the restructured business shall forfeit provided (i) the related party has within the last five years transferred liabilities to the restructured business which is subject to the waiver and (ii) the losses and loss carry forwards of the related party have arisen at the latest in the year during which the debt assumption occurred.

In case of a restructuring of a company which is or was fiscally integrated into a parent company (*Organschaft*), for corporate income tax purposes the waiver profit forfeits loss positions first at the level of that integrated subsidiary (covering loss positions from periods before the fiscal unity and/or, if the fiscal unity is already terminated, after the fiscal unity) and thereafter on the level of the parent company (*Organträger*). If the fiscal unity was in place at any time during the last five years before the restructuring year, the above loss forfeiture applies. This means that a former parent company may be affected by a loss forfeiture although the fiscal unity is no longer in place. The loss forfeiture is not limited to the losses which were transferred to the parent company (*Organträger*) during the fiscal unity, but also affects loss positions not arising out of the fiscal unity.

Where the parent company of a fiscal unity is restructured, integrated subsidiaries (*Organgesellschaften*) are, however, not exposed to a forfeiture of losses.

The new rules are applicable for trade tax purposes as well, however, with slight modifications. In a first step the waiver profit is reduced by non-deducible expenses and by deferred losses stemming from a transfer of liabilities. The residual waiver profit reduces the current loss for trade tax purposes, frozen loss carry forwards due to a fiscal unity and loss carry forwards. If a waiver profit remains, it forfeits the loss position of a commercial party (Unternehmen) which has transferred liabilities within the last five years to the restructured business which is subject to the waiver, but limited to the loss positions which have arisen at the end of the restructuring year at the latest. Insofar the trade tax rules deviate from a similar regulation in the general loss forfeiture rules outlined above.

Since the tax-exemption is now provided for in the law, the tax office (instead of the local government / municipality) will be competent to assess the trade tax-exemption already in the trade tax base assessment (*Gewerbesteuermessbescheid*).

The new rule shall apply retrospectively to profits arising from debt waived after 8 February 2017, which was the date when the decision of the Federal Fiscal Court was published which rendered the Restructuring Decree unlawful. The reasoning of the law mentions that waiver profits crystallising before

8 February 2017 shall still benefit from the Restructuring Decree.

The bill has already passed the Federal Parliament (*Bundestag)* and has been approved by the Federal Assembly (*Bundesrat*) on 2 June 2017.

The government will notify the new law to the EU Commission to establish that the new bill does not constitute state aid. As long as the EU notification process is not finalised, a reliable legal basis for the tax neutral restructuring of businesses will not be available in Germany.

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