Distressed M&A faces new tax challenge -

German supreme tax court judged tax relief for recapitalization gain illegal

Tax Alert

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By:

The German Tax Authorities' common instrument to grant relief from an taxable recapitalization gain - the Recapitalization Decree (Sanierungserlass) - violates constitutional rights according to a recent decision of the German Federal Fiscal Court (Bundesfinanzhof). The response of the German Tax Authorities has not yet been issued.

Consequently structures frequently used in Germany to recapitalize distressed companies by a "debt waiver" or a "debt-to-equity-swap", cannot be executed anymore without triggering a corporate tax and trade tax burden.

Implications on recapitalizations already executed need to be analyzed and alternative structures like such as "debt-hive-up" or "deep subordination agreements" must be considered for future recapitalization measures.

Background

The deleverage of companies in Germany by way of debt waivers or debt-to-equity-swaps is common but rather complex. This is because the waiver of third party debt triggers a gain in full amount of the waived debt and the waiver of shareholder debt or its conversion into equity triggers a gain in the impaired amount of debt at the level of the recapitalized company (recapitalization gain). According to a 1997 decision by the Grand Senate of the German Federal Fiscal Court, this recapitalization gain is generally subject to corporate and trade tax.

Obviously the tax burden on a recapitalization gain thwarts the recapitalization of distressed companies. In order to avoid this tax effect, in 2003 the German Tax Authorities published a Recapitalization Decree, which provided for tax relief on a recapitalization gain if specific criteria, like a sufficient going-concern projection for the recapitalized company, have been met. In practice the application of the Recapitalization Decree has often been agreed with the tax authorities in advance of the recapitalization, by way of a binding ruling.

The Grand Senate of the German Federal Fiscal Court judged in a decision published on 8 February 2017 that the Recapitalization Decree violates the constitutional principle of legality of administrative actions, but generally admitted a tax relief for recapitalization gain. In essence, the German Federal Fiscal Court argued that the Ministry of Finance was not competent to decree an exemption from the general duty to pay taxes on a recapitalization gain, as this competence lay with the German legislator only (ie requiring an according basis in German tax law).

Implications and alternatives
Unless and until the German legislator initiates a change to the current tax law, a tax efficient recapitalization of a company by way of a debt waiver or debt-to-equity-swap is in most cases not feasible anymore without adverse tax effects. As a consequence the tax implications of recapitalizations already executed should be analyzed. For intended recapitalizations alternative structures must be considered.

Common and tested alternative structures to achieve a tax efficient recapitalization include the "debt-hive-up", that is, an assumption of debt by a shareholder of the distressed company without the right of recourse (befreiende Schuldübernahme) and a "deep subordination" of the distressed debt (Rangrücktrittsvereinbarung). Further alternatives structures might be available depending on the specific facts and circumstances.

Outlook

A response of the German Tax Authorities is currently outstanding. A change of the German tax law - as required due to the German Federal Fiscal Court decision - may require some time considering potential approval requirements of the EU commission under EU state aid rules and the election in Germany in autumn this year. An interim solution may be provided shortly by a new Decree of the German Tax Authorities.

In case you have questions about this news alert please contact the authors.