To Our Clients and Friends

Memorandum

German Tax Reform Act 2018 – A Speed Read on Tax Treatment of Restructuring Measures

On November 23, 2018 the German Federal Council (*Bundesrat*) approved the Tax Reform Act of 2018 (the "**Tax Reform Act**"; *Gesetz zur Vermeidung von Umsatzsteuerausfällen beim Handel mit Waren im Internet und zur Änderung weiterer steuerlicher Vorschriften*), which was passed by the German Parliament (*Bundestag*) on November 8, 2018.

The Tax Reform Act ends a long period of uncertainty about the tax implications of restructuring measures, which previously had significantly impeded and limited restructuring efforts. Amongst other provisions, the Tax Reform Act establishes a valid legal basis to exempt restructuring gains from German (corporate) income tax and trade tax. In addition, the Tax Reform Act reinstates the provision under which a change of control in a corporation does not lead to the forfeiture of loss or interest carry forwards of the respective entity if such transfer of control occurs for restructuring reasons.

1. Tax treatment of restructuring gains

a) Background

After the provision regarding the tax exemption of restructuring gains was abolished effective January 1, 1998, the tax-privileged treatment of such gains was based on the March 27, 2003 decree of the Federal Ministry of Finance. The Federal Tax Court challenged this established practice (resolution of November 28, 2016, GrS 1/15) as not being in line with German constitutional law, based on the premise that a tax exemption must be legislated by statutue and may not be based on an administrative decree.

b) Introduction of new legal provisions on treatment of restructuring gains

With the law of June 27, 2017 (which was published in the Federal Gazette 2017, part I, p. 2074 on July 4, 2017), sec. 3a German Income Tax Act (**ITA**) and sec. 7b German Trade Tax Act (**TTA**) were introduced.

Under these regulations and rules, gains from debt relief are exempt from German (corporate) income and trade taxation if the relief is granted to recapitalize and restructure an ailing business. The tax exemption, however, only applies if, at the time of the issuance of a waiver of debt, (i) the business is in need of restructuring (*sanierungsbedürftig*), i.e. the waiver is required to continue the business and (ii) the business is capable of being restructured (*sanierungsfähig*), hence, the waiver must be a suitable measure to restructure the business. Further, the borrower must waive the debt with the intention to restructure the business (*Sanierungsabsicht des*

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Gläubigers). These requirements have to be assessed on a case-by-case basis. The regulations and rules apply to resident and non-resident individuals and corporations alike.

At the time of the issuance, it was contemplated that sec. 3a ITA and sec. 7b TTA would come into effect on July 5, 2017 (the day after the publication of the law in the Federal Gazette). However, the effectiveness of these new regulations and rules was conditional upon the confirmation of the EU Commission that the tax exemption does not constitute state aid (*Beihilfe*) under EU law. The EU Commission issued the confirmation in August 2018.

c) Commencement

The Tax Reform Act sets sec. 3a ITA and sec. 7b TTA into force with retroactive effect of July 5, 2017. The regulations and rules provide that they apply for the first time in cases in which debt was fully or partially waived after February 8, 2017 (the publication date of the Federal Tax Court decision).

2. Transfer of shares for restructuring purposes

a) Background

If more than 25% of the shares in a corporation are transferred directly or indirectly to an acquirerer, the existing tax loss and interest carry forwards partially or fully cease to exist.

Pursuant to sec. 8c para. 1a Corporate Income Tax Act (**CITA**), this general rule does not apply if the share transfer occurs in order to restructure the business of an ailing corporation (the "**Restructuring Exception**"; *Sanierungsklausel*). The Restructuring Exception only applies if the restructuring measures are appropriate to avoid or eliminate the illiquidity or the over-indebtedness of the corporation and to maintain its basic operational structure. The basic operational structure is maintained if the respective corporation receives material working capital injections and meets certain requirements with respect to the level of employment. Generally, the Restructuring Exception applies to share transfers that occurred after December 31, 2007.

In January 2011, the EU Commission issued a resolution on state aid (*Beihilfebeschluss*) stating that sec. 8c para. 1a CITA is not in line with EU law. Consequently, the application of sec. 8c para. 1a CITA was suspended while the invalidity of the resolution was appealed to the European Court of Justice.

On June 28, 2018 the European Court of Justice declared the EU Commission's resolution invalid and held that the Restructuring Exception did not constitute unlawful state aid.

b) Commencement

Sec. 8c para. 1a CITA is reinstated and becomes effective retroactively, and applies to share transfers that took place after December 31, 2007.

3. Practical consequences of the Tax Reform

Going forward, restructuring measures should be considerably more simplified, as the legal uncertainties about the taxation of restructuring gains have been eliminated. Also, the reinstatement of the Restructuring Exception finally brings long awaited clarity on the tax consequences of the transfer of shares for restructuring purposes.

It should be assessed whether gains from debt relief issued after February 8, 2017 were recognized in 2017, to which the tax exemption applies, and the tax returns should be filed accordingly. In cases where tax assessment notices for fiscal year 2017 have already been issued and gains from debt relief were taxed, those assessment notices should be appealed to the extent possible.

In cases where tax assessment notices for previous tax periods (dating back to fiscal year 2008) are still open to amendments, it should be reviewed on a case-by-case basis whether a taxpayer can benefit from the retroactively instated Restructuring Clause.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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