

# Welcome back tax exemption for restructuring gains!

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On 28 November 2016 the German Federal Fiscal Court (FFC) (GrS BFH 1/15, published on 8 February 2017) held that the guidance on a reorganisation tax privilege (Reorganization Decree (Sanierungserlass)) issued by the German Federal Ministry of Finance (FMF) in 2003 was invalid. The ruling has created great uncertainty for the restructuring practice in Germany regarding the proper tax treatment of restructuring gains. On 23 November 2018 the Federal Council (Bundesrat) has approved the „Gesetz zur Vermeidung von Umsatzsteuerausfällen beim Handel mit Waren im Internet und zur Änderung weiterer steuerlicher Vorschriften“ (hereafter “Act 2018”) which had already been passed by the German Parliament (Bundestag) on 8 November 2018 and which will again allow tax exemption for restructuring gains.

The Act 2018 retroactively implements the provisions concerning tax exemption for restructuring gains already passed in the “Gesetz gegen schädliche Steuerpraktiken im Zusammenhang mit Rechteüberlassungen” on 27 June 2017 (Federal Law Gazette, BGBl I 2017, p. 2074; hereafter „Act 2017“). The provisions on tax exemption for restructuring gains may thus be applied upon filing of an application on waivers of debt before 9 February 2017.

Under the EU reservation set out in Art. 6 sect. 2 of the Act 2017 all provisions concerning tax exemption for restructuring gains (these were the new Art. 3a of the German Income Tax Act (*Einkommensteuergesetz*, “EStG”) “Restructuring gains”, Art. 3c sect. 4 EStG “Prorated deductions”, Art. 7b of the German Trade Tax Act (*Gewerbesteuer-gesetz*, “GewStG”) “Special provision for determining the trade income in case of corporate restructuring” as well as consequential changes to Art. 8, 8c, 8d and 15 of the German Corporation Tax Act (*Körperschaftsteuergesetz*, “KStG”) were supposed to become effective only after the European Commission had declared that these provisions did not constitute state aid or state aid which is compatible with the common market. The FMF was expected to then separately announce the date of the decision by the European Commission as well as the effective date regarding the tax exemption. However, this never happened.

Instead, according to a notice issued by the FMF on 7 September 2018, the European Commission’s Competition Directorate General has informed the Federal Republic of Germany that it regards tax exemption for restructuring gains pursuant to Art. 3a EStG and Art. 7b GewStG as existing measures. The Directorate General argues that the tax exemption has been implemented in Germany before the TFEU (Treaty on the Functioning of the European Union) came into force and is still applicable thereafter. Hence, the new provisions would simply be successors of the tax exemption for restructuring gains according to Art. 3 no. 66 EStG old version (until 1998) respectively of the preferential tax treatments of restructuring gains on grounds

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of fairness which the financial administration already accepted until 8 February 2017 based on its Reorganization Decree.

This means the following:

On the day after the soon expected implementation of the Act 2018, the previous EU reservation (Art. 6 sect. 2 of the Act 2017) will be lifted and all provisions concerning tax exemption for restructuring gains (Art. 2, 3 no. 1 to 4 and Art. 4 no. 1 to 3 lit. a of the Act 2017) will become effective as from 5 July 2017 (the day after the implementation of the Act 2017, BGBl I 2017, p. 2074 on 4 July 2017). This is particularly the case for the new Art. 3a EStG and Art. 7b GewStG as well as the present transitory provisions.

However, due to the present transitory provisions, the provisions concerning tax exemption for restructuring gains (Art. 3a EStG and Art. 7b GewStG), “shall apply for the first time in cases where debts have been partially or completely waived after 8 February 2017”. This does not apply if, “preferential tax treatments of restructuring gains on grounds of fairness in order to protect legitimate expectations have to be granted to the taxable person upon request based on Art. 163 sect. 1 sentence 2 and Art. 222, 227 of the the German Fiscal Code (*Abgabenordnung*)” (Art. 52 sect. 4a sentences 1 and 2 EStG and Art. 36 sect. 2c sentences 1 and 2 GewStG).

The Act 2018 has extended the transitory provisions again for the benefit of the restructuring practice as it stipulates that both Art. 3a EStG and Art. 7b GewStG, “shall also apply in cases where debts have been waived before 9 February 2017” upon request of the taxable person (Art. 52 sect. 4a sentence 3 EStG and Art. 36 sect. 2c sentence 3 GewStG).

Briefly summarised in terms of content, the to be applicable provisions concerning tax exemption for restructuring gains prescribe the following:

### **Art. 3a EStG (“Restructuring gains”):**

The extensive new provision of Art. 3a EStG is largely based on the FMF’s Reorganization Decree. It aims to provide for legal certainty in restructuring processes as the tax exemption is no longer at the discretion of the fiscal administration and to approximate the taxing and the insolvency procedures:

- Sect. 1 refers to tax exemption for so-called “restructuring gains” resulting from a waiver of debt granted for the purpose of a “corporate restructuring” pursuant to Sect. 2. A partial or complete waiver of debt granted for restructuring through the existing creditors is considered as a waiver of debt in this sense. Inter alia, release agreements (Art. 397 sect. 1 of the German Civil Code (*Bürgerliches Gesetzbuch*, “BGB”; *Erlassverträge*)), acknowledgements of non-indebtedness (Art. 397 sect. 2 BGB (*negative Schuldanerkenntnisse*)), or waivers in the context of insolvency plan procedures (Art. 217 et seq. of the German Insolvency Statute (*Insolvenzordnung*, “InsO”) are treated as preferential; however, in the first and second year of on-going restructuring proceedings, tax-related options (for example partial value depreciations (*Teilwert-Abschreibungen*)) must be exercised in the most profit-reducing manner possible so that the greatest possible loss compensation volume is available to reduce the tax-free restructuring gains.
- Sect. 2 defines the privileged “corporate restructuring”. A corporate restructuring is deemed privileged if “the taxable person proves the need for and the feasibility of corporate restructuring, that the waiver of debt given for operational reasons is suitable for restructuring, and the creditors’ intention to restructure at the date of the waiver of debt”.
- Pursuant to sect. 3, the restructuring gains must first be reduced by the non-deductible restructuring costs (Art. 3c sect. 4 EStG) and then by all existing loss-offsetting potentials; sect. 3 with its 13 sub-items is very detailed and elaborated.
- Sect. 4, amongst other things, governs the separate determination of restructuring gains of a partnership (*Mitunternehmenschaften*).
- According to sect. 5, the tax exemption shall be applicable *mutatis mutandis* to revenues from a discharge of residual debt (Art. 286 et seq. InsO (*Restschuldbefreiung*)) as well as in case of a waiver of debt on the basis of an out-of-court plan for the settlement of debts to avoid a consumer insolvency proceeding (Art. 304 et seq. InsO (*Verbraucherinsolvenzverfahren*)).

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### **Art. 3c sect. 4 EStG (“Prorated deductions”):**

Art. 3c sect. 4 EStG prohibits the deduction of operating expenses and asset reductions which have a direct economic connection to tax-exempted restructuring gains (for example, payments on agreements to repay the waived loans with future profits (*Besserungsscheine*), costs related to the restructuring plan or consulting fees).

### **Numerous consequential changes in the KStG because of Art. 3a EStG:**

Changes in Art. 8 sect. 8 and 9, Art. 8c sect. 2, Art. 8d sect. 1, Art. 15 sentence 1 no. 1 and no. 1a KStG.

### **Art. 7b GewStG (“Special provision for determining the trade income in case of corporate restructuring”)**

Art. 7b GewStG transposes the principles of Art. 3a, 3c sect. 4 EStG into the GewStG.

All in all, the Act 2018 hence provides the long awaited legal certainty for restructurings after 8 February 2017 and, on application, even for the time period prior to 9 February 2017, and will be greatly appreciated by the restructuring practice.

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