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German Tax and Legal News

BFH introduces new doctrine on subordination agreements

The BFH has confirmed its opinion regarding the required wording of subordination agreement and introduced a new doctrine regarding the consequences for failure to include the required wording.

In a decision dated 15 April 2015 (I R 44/14), Germany's federal tax court (BFH) confirmed its opinion regarding the wording required for a tax effective subordination agreement, but also introduced a new favorable doctrine for situations in which the required wording is not provided. The BFH overturned the decision of the lower tax court of Lower Saxony (see Deloitte Tax-News for a summary).

Under German income tax law, a loan liability must be released from the debtor's tax balance sheet if the loan agreement or supplementary correspondence contain a provision that the repayment of the loan is dependent on whether the debtor realizes future profits/revenue. According to previous decisions of the BFH, such a release of a liability generally triggers taxable income at the level of the debtor.

The same issue exists in the case of subordination agreements where the creditor and debtor try to avoid the debtor's over-indebtedness from an insolvency law perspective. According to official guidance issued by the German tax authorities, a release of the liability will not take place if the subordination agreement specifically refers to a repayment of the loan out of "other available assets."

In the case before the BFH, the subordination agreement did not include any reference to a loan repayment out of "other available assets" of the company; instead, it referred only to a repayment out of future profits and a liquidation gain. The lower tax court of Lower-Saxony took the position that this reference was sufficient to enable the loan payable to be recognized in the debtor's tax balance sheet. The tax authorities appealed the decision of the lower court.

Relying on previous jurisprudence, the BFH ruled against the taxpayer, concluding that the omitted reference to the other available assets does result in a release of the liability for tax purposes. However, the court did not decide that such a release automatically leads to a profit at the level of the debtor. Instead, the BFH introduced a new doctrine, according to which the release of the liability as a result of a (misworded) subordination agreement qualifies as a contribution provided the agreement is based on the relationship between the company and its shareholder(s). In this case, no taxable gain will be triggered to the extent the relevant receivable (that has been subordinated) is still valuable and, therefore, the subordination agreement should lead to a tax neutral contribution by the shareholder into the debtor.

The BFH's new doctrine may provide some opportunities for taxpayers, although each case will need to be analyzed on its own merits as to whether, and to what extent, loans that are subject to the subordination agreement are still of value. In most cases, these loans might already be impaired, in which case the new doctrine likely will not be applicable.

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