

German Supreme Tax Court Endorses Equitable Relief from Taxation of Debt-Equity Swaps

Restructurings of German companies through debt waivers or debt-equity swaps are regularly complicated by the fact that the waiver gain realized by the distressed company is subject to taxation in full or in part. The ensuing tax liability generally threatens to defeat the purpose of the restructuring.

To address this problem, the German tax administration adopted the practice of granting equitable relief and deferring and eventually releasing the tax on the waiver gain if the waiver or debt-equity swap occurs as part of a restructuring (*Sanierung*). The detailed requirements are laid down in a circular of March 27, 2003, the so-called *Sanierungserlass*.

This practice was overshadowed by doubts as to the legality of the *Sanierungserlass*. In 2007, the local tax court in Munich expressed the view that statutory law does not authorize the equitable measures under the *Sanierungserlass*. Other tax courts reached the opposite conclusion, which created significant uncertainty in the market.

While the appeal against the Munich decision is still pending (VIII R 2/08), the Supreme Tax Court now held in a decision published on September 1, 2010 in a different matter (X R 34/08) that these doubts are generally unfounded and that equitable measures under the *Sanierungserlass* are generally covered by the statutory authority. The court left open whether, in particular cases, relief measures under the *Sanierungserlass* could go too far. In addition, the decision does not solve the practical difficulties (*e.g.*, timing) that may be associated with obtaining relief from the tax authorities (or the municipalities as far as local trade tax is concerned). Nevertheless, the Supreme Tax Court decision is a significant step forward because it can be expected to facilitate future applications for binding tax rulings in respect of relief measures under the *Sanierungserlass*.

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