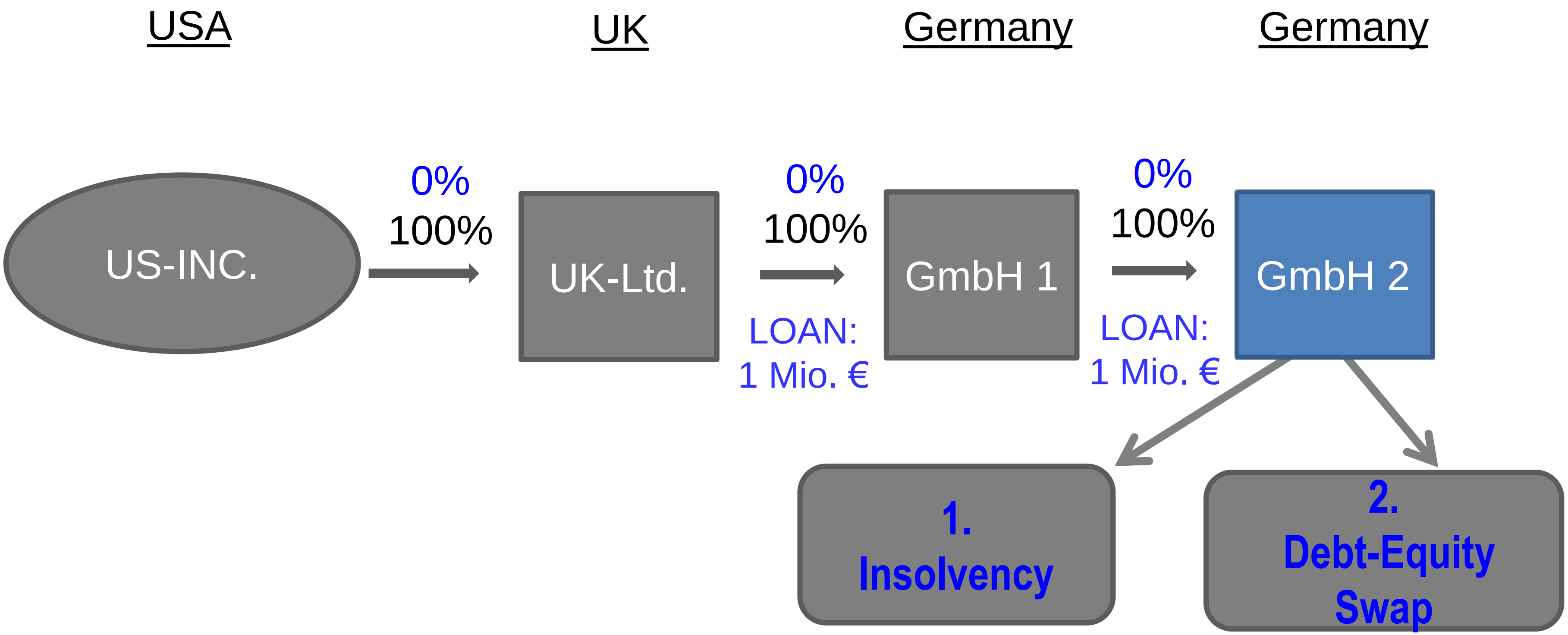
FACT

CORPORATIONS IN CRISIS:

FROM A TAX PERSPECTIVE IN GERMANY

CASE


USA
UK
Germany
Germany
US-INC.
0%
100%
UK-Ltd.
0%
100%
LOAN:
1 Mio. €
GmbH 1
0%
100%
LOAN:
1 Mio. €
GmbH 2
1.
Insolvency
2.
Debt-Equity
Swap

CRISIS

1.
Insolvency

OR

2.
Debt-Equity
Swap (DES)

FACT

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1. INSOLVENCY

- **Insolvency for companies, in Germany, means:**

  - inability to pay outstanding debts or

  - over-indebtedness.

1.1 FINANCIAL INSOLVENCY

If, for a period **of three weeks,**
at least 10% of liabilities due, cannot be settled, thus:

Obliged to file for insolvency

- Whether insolvency threatens or is given, must be determined by creating a **liquidity status.**

1.2 THREATENING FINANCIAL INSOLVENCY

FACT

- It is unlikely that **the debtor is able to fulfill his payment obligations.**
- Threatening means: **insolvency is more likely to occur than non-occurrence.**
- The decisive factor is a period-related forecast of future solvency, based on the financial and liquidity plan.
- The forecast should take **at least one year** into account as the planning period.
- In case of a threatening insolvency: **only the debtor himself** is allowed to file for insolvency.

1.3 EXCESSIVE INDEBTEDNESS

FACT

- Over-indebtedness occurs when the debtor's assets no longer cover the existing liability.
- In case of over-indebtedness: obliged to file for insolvency

BUT:

- In case of a positive going-concern forecast :
  - **No obligation to file for insolvency.**

1.3.1 TO AVOID OVER-INDEBTNESS

GmbH 2 is over-indebted / GmbH 1 to waive on its loan to strenghten equity in subsidiary

<u>GmbH 2</u>

- Loan waived by parent company:
- non-taxable income with ist fair value / taxable= difference between fair value and nominal value
- Under certain conditions: to apply for tax exemption (as a part of restructuring)

<u>GmbH 1</u>

- (former) loan to be treated as part of aquisition costs of the participation

1.4 TAXES IN INSOLVENCY

FACT

- **Principle: "Insolvency law takes precedence over tax law“**
- **The start of insolvency proceedings shall not affect the debtor's tax obligations.**
- **With the transfer of the administrative and disposal rights, the insolvency administrator also assumes the task of fulfilling the tax obligations of the insolvency debtor (filing tax returns).**

1.4.1 TAXES

- **With the opening of insolvency proceedings, a new tax liability relationship arises. This is expressed in the issuing of new tax numbers for**
- **the debtor (GmbH 2)**
- **the administration of the assets involved in the insolvency proceedings by the insolvency administrator**
- the income tax and turnover tax for the continuation of the business enterprise

- The tax liabilities arising from the opening of the proceedings are **considered new liabilities**. They are not part of the insolvency proceedings and must therefore be paid on time.

1.4.2 CONSEQUENCES FOR GMBH 1

- Due to insolvency of GmbH 2:

GmbH 1 as a shareholder :

- loss of its participation in GmbH 2 : - not tax-deductible in Germany

GmbH 1 provided loan to GmbH 2:

- loss of the loan: - not tax-deductible in Germany
- even if GmbH 1 secured a loan bank loan to GmbH 2, loss is not deductible

1.4.3 CONSEQUENCES FOR UK-LTD.

FACT

- As its subsidiary, GmbH 1 Germany, suffered a loss:

  - UK-Ltd. not entitled to claim a loss in value of GmbH 1 for tax purposes in UK

AND:

  - UK-Ltd. not entitled to claim a loss in value of the loan for tax purposes in UK

2. Debt-Equity Swap

2.1 DEFINITION/ PROCEDURE

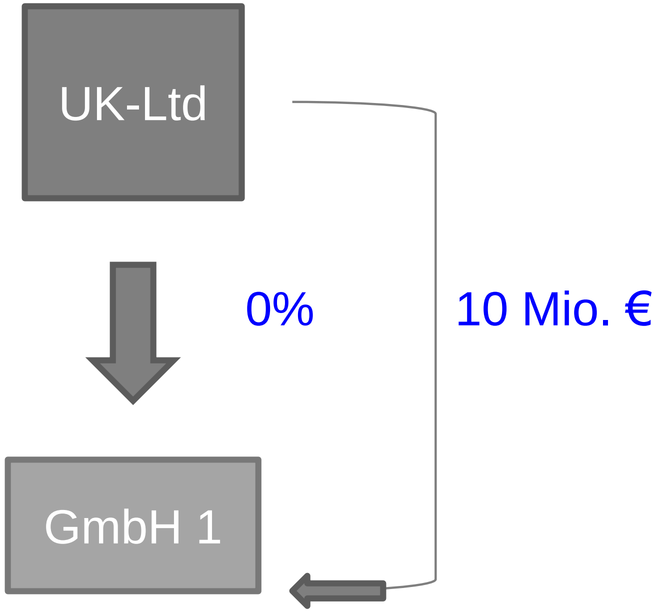
FACT

- An alternative to file for bankruptcy:

- The implementation of a Debt-Equity Swap (DES) is usually discussed when **the company's indebtedness is substantial and there is a risk of over-indebtedness.**
- In a DES, a creditor's claim against the debtor company is converted into a participation in the debtor company.
- DES is a possible type of balance sheet **reorganization.**

- UK-Ltd granted GmbH 1 a loan of €10 million
- UK-Ltd does not own any shares in GmbH 1

- NOW: the equity of the GmbH 1 is reduced due to losses, that creditor claim can no longer be adequately serviced.



GmbH 1: FY 01   10 million Equity
FY 02-04:   - 12 million loss

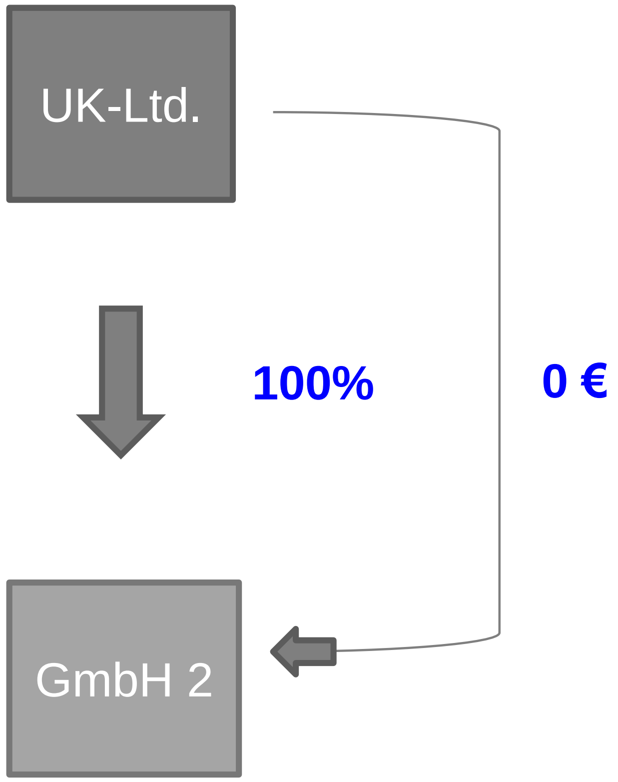
=   - 2 million over-indebted

→ time to discuss: **Debt-Equity Swap !**

To implement DES:

- The loan is converted into equity

- UK-Ltd. received 100% of the shares in GmbH 1



2.2 ADVANTAGES OF DES

FACT

- Over-indebtedness can be limited or even prevented
- As a result of the restructuring:
  - Increase of equity
  - Liquidity increases (interest payments / repayments no longer apply)
  - Creditworthiness and rating increase -> Opportunities for debt financing improve
  - Banks are more willing to give loans
  - Creditors who become shareholders can contribute additional know-how to the restructuring process
  - Involved creditors have a strong motivation to help the company back up high

2.3 WHEN IS A DES ADVISABLE FOR A CREDITOR?

FACT

- For creditors:
  - The lower the values contained in the requirement, the more reasonable a DES
  - If the default risk is higher, it is advisable to sell the receivable at a discount in order to avoid a total loss.

2.3. WHEN IS A DES ADVISABLE FOR AN INVESTOR?

FACT

- Investors:
  - Always risky corporate investment
  - Restructuring not going according to plan -> Investment lost
  - ✓ BUT great potential, if the condition of the U improves, the shares of investors will increase significantly.
  - ✓ Investors continue to have an influence on corporate governance

2.4 TAX LAW PERSPECTIVE

FACT

In Germany:

- Profits from restructuring are generally subject to income tax, corporate income tax and trade tax.
- **BUT the levying of taxes represents a material hardship for the company, the tax can be lowered on request or a deferral can be considered**
- The prerequisite is that the company is in need of restructuring.
- Since 4 weeks: EU Commissioner stated, that the relevant tax law in Germany is in accordance with EU requirements (no prohibited EU-subsidy)

Thanks

for your attention!

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