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By PwC Deutschland | 15 October 2012

No abuse in sale of worthless debt to new shareholder

The Supreme Tax Court has allowed a manoeuvre effectively avoiding forfeiture of a loss carry-forward on change of shareholder through the sale of a worthless shareholder loan to a new shareholder followed by recovery from the injection of new capital.

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A sole trader incorporated his business, becoming the sole shareholder of the new GmbH. Later, the company fell upon difficult times and ultimately ceased business operations. In the meantime, the shareholder financed the growing losses with loans to the company rising to a total of €200,000 by the time trading ceased. Since the company then held no significant assets, it was unable to repay the loan, which was therefore worthless as an asset. Recognising this, the shareholder/creditor forgave the debt on condition of future revival if and when repayment became feasible. The company took the debt cancellation to income, setting the resulting net profit for the year against the roughly similar loss brought forward. The shareholder then put the company into liquidation, appointing himself as liquidator. He split his share into two, selling both halves to two new shareholders for a purely nominal amount of €1. He also sold his debt (including the right of revival) to one of the new shareholders for €2,500. The two new shareholders then merged a second jointly-owned, but this time flourishing, company onto their recent acquisition. This brought an immediate return to profitability leading to a revival of most of the debt in that year alone. The company booked this revival as an expense, bringing its taxable income for the year to almost zero, and repaid the revived amount.

The tax office refused to accept the tax return as filed, disallowing the debt revival charge against income as a hidden distribution of profits. The lower tax court took the same view, adding that the entire transaction with the loan was abusive.

The Supreme Tax Court, on the other hand, took the side of the taxpayer. The sale of the debt did not change its character of an operational liability, so its repayment could not be a hidden distribution of profits. The court also did not regard the arrangement as abusive since each step in the chain of transactions had a genuine economic background and had been processed and booked correctly. The primary purpose had not been to illegitimately save taxes, even though the same business result could have been achieved in a less tax efficient manner. The initial debt forgiveness was effectively compelling in order to return the company to solvency. The debt was, though, effectively worthless, so the company had to take the release from the liability to income – a shareholder's capital contribution cannot be taken up at more than the market value of the asset contributed. The subsequent sale of the worthless debt to the new shareholder for only a very low amount was economically plausible. The same applied to the motives of the purchaser – as a new shareholder, it was reasonable for him to pay a small amount to free the company from any remaining influence of its former owner. The revival followed from the relevant provisions in the loan contract within the limits of the capital repayment prohibitions of company law. Its treatment by the company as a business expense mirrored the previous treatment of the forgiveness as income.

The tax office attempted to argue that the entire arrangement was abusive as it effectively circumvented the forfeiture of loss carry-forward on change of shareholder. The Court, however, held that the forfeiture provision was intended to curb the trade in "tax-loss" or "shell" companies, but was not subject to any limitations on its application in other situations. Since disallowance of loss relief on a change of shareholder was accepted regardless of actual abuse in the given case, the provision could not be seen as embodying a point of principle. Action taken to avoid its effects through otherwise appropriate legal vehicles was thus not

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of itself abusive, as there was no relevant principle at risk.

The loss forfeiture provision has been completely overhauled in the meantime, although the essential points of this judgment remain relevant.

Supreme Tax Court judgment I R 23/11 of July 12, 2012, published on October 10

Keywords

abuse of legal forms, change of shareholders, forfeiture of a loss, worthless debt