

BFH rules on hidden profit distribution on merger and revival of debt

Revival of receivables after a merger can lead to hidden profit distribution

In a decision dated 21 February 2018 (and published on 20 June 2018), Germany's Federal Tax Court (BFH) held that a revival of receivables in connection with a merger after the waiver of a claim with a recovery agreement can lead to a hidden profit distribution.

The shareholders of an over-indebted and inactive company had waived their loans granted to the company subject to "debtor warrants," which provided that if specified conditions were fulfilled (including that the company recovered), the debts would revive. The company subsequently merged with a financially sound sister company, resulting in the recovery of the first company and consequent revival of the receivables. This gave rise to a question whether the obligation to carry the loans as a liability that was triggered by the acquisition by the sister company had to be corrected by an off-balance sheet addition via a hidden profit distribution.

The lower court determined that there was a hidden profit distribution because the assets of the acquiring entity had been reduced as a result of the rebooking of the (conditional) loan liabilities transferred during the merger. The sole purpose of the reorganization arrangement, namely, the takeover of the transferred entity as an "empty shell" encumbered by liabilities, was to resurrect the liabilities from the recovery agreement in favor of the shareholders to ensure the shareholders were repaid the amounts owed to them. The reduction in assets, therefore, resulted solely from the shareholders' relationship.

The crux of the dispute was not simply a revival of an existing debt between the same persons or a change of creditor following the reinstatement of the debt, but a change in the debtor, an issue that the BFH had not yet ruled on.

The BFH held that there are no provisions in the reorganization law (which allows a tax neutral transfer of assets) or in the relevant loan agreements that preclude the assumption of a hidden profit distribution. The reduction in assets that triggered the hidden profit distribution was outside the scope of the reorganization law and further that the merger and the revival of the receivables did not take place as part of the transaction or at the same point in time. The hidden profit distribution was triggered by the "occurrence of the recovery," which was a condition that was fulfilled following the merger. The reduction in assets occurred only when it became clear at the end of the year that the sister company actually had generated a balance sheet profit that year, i.e. that new assets had accrued.

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