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Regional Tax Court: The conversion of a foreign currency loan to a loan with identical currency can trigger gain realization

By judgment of February 23, 2016 (file no. 8 K 272/14), the regional tax court of Lower Saxony decided that the conversion of a foreign currency loan taken out by a business to a loan with identical currency results in a gain realization on the part of the business if the new loan is economically not identical with the previous loan.

Background

In the case of foreign currency liabilities, the financial burden of the liabilities depends on the exchange rate, with the result that a profit or loss can arise latest upon repayment of the loan. The same should apply if a foreign currency loan is replaced by a Euro loan and, as a consequence, an exchange gain or loss is generated. In the above court case, however, the question had arisen whether a gain realization also occurs if a foreign currency loan is converted into a loan with identical currency by way of a novation agreement.

Facts

In the case at hand, a German limited partnership in the legal form of a GmbH & Co. KG ("Partnership") took out a USD 26.5m long term loan with a bank syndicate in 2002 to finance the construction of a new ship ("Loan I"). This loan was secured by a senior ship mortgage, by assignment of all claims under charter and freight contracts and insurance contracts, and by a guarantee (*Bürgschaft*). Apart therefrom, the bank syndicate extended a EUR 7.15m loan to a partner of the Partnership ("M") under a separate loan agreement to finance the partner's contribution to the Partnership ("Loan II").

The bank syndicate, which originally consisted of L Bank and K Bank, was subsequently dissolved and L Bank became the sole creditor of all loan receivables. In 2006, Loans I & II were restructured. In the course of the debt restructuring process, the Partnership entered into a USD 29m loan agreement with L Bank ("Loan III"). According to the preamble of the loan agreement, Loans I & II were intended to be "converted into" Loan III. A partial amount of Loan III was designed to replace the outstanding Loans I & II (validating in the amounts of USD 20,396,000 and USD 7,125,400, respectively, by that time). The remaining amount of USD 1,478,000 was intended to strengthen the Partnership's cash position. Loan III was secured by a (higher) senior ship mortgage and the original (lower) ship mortgage was cancelled. Furthermore, all claims under charter and freight contracts and insurance contracts were assigned to L Bank under a new assignment agreement; a bank guarantee was not provided.

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A partial amount of USD 20,396,000 of Loan III was used to replace Loan I on August 31, 2006. The residual of USD 8,604,000 was paid to an account of the Partnership. On the same August 31, 2006, M repaid its loan obligation of USD 7,125,000 under Loan II.

At the time of the debt restructuring, the USD/EUR exchange rate had developed favorably for the Euro. The tax office determined a taxable exchange gain in the amount of approx. EUR 6m.

Decision of the tax court of Lower Saxony

The regional tax court dismissed the action filed by the Partnership and concluded that, due to the novation of the loan agreements and, in any case, from an economic perspective, there had been a gain realization (section 252(1) no. 4 of the German Commercial Code (*Handelsgesetzbuch*; "HGB")), which fed into the determination of profits under tax law.

- From the perspective of the tax court, the novation of a foreign currency loan taken out by a business into a loan of identical same currency results in a gain realization if the novated legal relationship is *legally not* identical with the previous legal relationship and if the exchange rate has developed favorably by the time of the novation. According to the court, the relationships are not to be deemed legally identical if the term of the original loans is not simply renewed but, instead, a new legal basis is established for the debt (*Schuldgrund*). Pursuant to the court, the parties had established a new legal basis for the debt in the present case because (i) both the creditor and the debtor had changed, (ii) other security had been agreed, and (iii) the purpose of Loan III deviated from the purpose of Loans I & II in that Loan III was also intended to strengthen the Partnership's cash position.
- Furthermore, in view of the court the novation or restructuring of the loans led to a gain realization also from an economic perspective because the original and the new loan were *economically not identical*. The original USD Loans I & II had not just been replaced by a different USD loan. Rather, from an economic perspective, the court held that the novation and the resulting change of circumstances had led to a loan or contractual relationship deviating from the original loan or contractual relationship which could no longer be deemed economically identical.

Outlook

It remains to be seen whether the Federal Tax Court (*Bundesfinanzhof*) will fully confirm the decision of the regional tax court. An appeal against this decision is pending under file number IV R 18/16. The Federal Tax Court might assess the legal situation differently because the fact that the Partnership's creditors have changed should, in itself, not affect the legal or economic identity of the contractual relationship. Nor should any change in the security provided for the debt – in particular if it seems to be a minor change only – have such an effect.

The tax court could very well have considered to split the novation theoretically into (i) a (tax-neutral) debt restructuring, to the extent that a partial amount of USD 20,396,000 of Loan III was used to replace Loan I, and (ii) a (possibly non-tax-neutral) debt restructuring to the extent that a partial amount of Loan III was used to redeem Loan II and to provide cash resources.

In light of the above decision, taxpayers planning to restructure their debt should review in detail whether the changes might lead to taxable exchange gains and should, if in doubt, have the question clarified by an upfront binding ruling.

If you have further questions, please contact our experts:



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