Austria

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Tax Issues in Consensual Debt Restructuring

In this article the authors provide an overview on some options for Austrian distressed debtors that are at risk of defaulting under a regular loan instrument and are considering to remedy the situation in a consensual manner with the creditor. The focus here is on the primary Austrian tax consequences related to their options and the possibilities for proper structuring in order to minimize taxation at the level of the debtor and/or creditor.

1. Introduction

Austrian income tax law does not provide for neutrality of a type of financing.[1] Thus, it is necessary to distinguish between equity and debt. The major different tax consequence is that consideration for debt, especially interest payments, is deductible from the corporate income tax base as a business expense, whereas dividend payments are not. Although Austrian income tax law does not provide for an explicit definition of equity and debt, some regulations provide guidance for the correct classification.

This fact must be observed against the background that a large number of Austrian corporations used to be – and still are – financed by debt, often provided by commercial banks and by their shareholders. Over the years, a broad range of hybrid instruments has been developed by the market that enjoy popularity especially due to their flexibility. Moreover, Austrian statutory tax law does not provide for explicit thin capitalization rules. Under certain conditions, Austrian tax authorities, however, deny deductibility of interest payments if debt is – economically speaking – substituting equity.

Before the global financial crises, substantial sums of money were borrowed by Austrian corporations for acquisitions and investments. In the meantime, the world has changed and many corporations are facing financial difficulties due to declining profits or even losses, as well as diminished asset values. In addition, Austrian commercial banks not only have a considerable market exposure in Central Eastern Europe, but also must comply with Basel III. Thus, commercial banks need to strengthen their capital base and have therefore not only increased their lending spreads, but are in general more conservative in lending (new) money. As a consequence, corporations and banks must look for financing alternatives, such as consensual debt restructuring.

This article will focus on the distinction between equity and debt for Austrian tax purposes, as well as the related tax consequences, and will briefly highlight accounting issues. Moreover, the following options for consensual debt restructuring will be illustrated and discussed, especially as regards their income tax consequences:

- amendments to the terms and conditions of a debt instrument;
- replacement of existing debt instruments by new debt instruments with different terms and conditions (*novation*);
- debt buy-backs;
- convertible bonds;
- warrant bonds;
- conversion of existing debt instruments into (new) equity; and
- full or partial debt waivers.

Possible capital and stamp duty issues related to consensual debt restructuring will also be discussed.

2. What Is Debt for Tax Purposes?

2.1. Differentiation between equity and debt for tax purposes

The distinction between equity and debt concerns different fields of law, namely commercial and corporate law, insolvency law, statutory accounting as well as tax law. Although parallels exist between the criteria that are decisive for the distinction in each field of law, the criteria applied vary from one to the next. Thus, the legal consequences also differ.[2]

Under Austrian income tax law, the distinction is significant due to the different treatment of equity and debt.[3] Consideration for debt, especially interest payments, is deductible from the corporate income tax base as a business expense, whereas dividend payments are not.[4] This advantage of debt financing is even more significant in an international context, because interest income is not

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1. *See* Achatz, *Eigenkapitalersatz im Ertragsteuerrecht*, in Achatz, Jabornegg & Karollus (eds.), *Eigenkapitalersatz im Gesellschafts-, Steuer- und Arbeitsrecht* (Vienna: Manz, 1999), at 91; Ressler, *International Fiscal Association (IFA) Austria Branch Report*, in IFA (ed.), *The Debt-Equity Conundrum*, Cahiers de droit fiscal international, vol. 97b (The Hague: Sdu Uitgevers, 2012), at 91; *see also* Eberhartinger, *IFA Austria Branch Report*, in IFA (ed.), *The Tax Consequences of Restructuring of Indebtedness (Debt Work-Outs)*, Cahiers de droit fiscal international, vol. 91a (The Hague: Sdu Fiscale & Financiële Uitgevers, 2006), at 119 et seq.
2. *See* Eberhartinger, *Finanzierung durch hybride Finanzierungsmittel*, in Bertl, Djanani, Kofler & Tumpel (eds.), *Handbuch der österreichischen SteuerlehreBd IV* (Vienna: LexisNexis, 2004), at 87, 88.
3. *See* Ruppe, Swoboda & Nitsche, *Die Abgrenzung von Eigenkapital und Fremdkapital*, in *Schriftenreihe des Österreichischen Forschungsinstitutes für Sparkassenwesen* (Sparkassenverlag) Sonderband (Vienna, 1985), at 6.
4. For details, *see* next section.

subject to limited tax liability (except interest payments for loans that are directly or indirectly secured by rights in the land register and not issued as a bond). Moreover, Austrian income tax treaties assign the taxing right as regards consideration for equity to the source state, while the taxing right as regards consideration for debt is assigned to the state of residence. Austrian income tax law does not include any explicit criteria for the classification of equity and debt. However, section 23(2) of the Income Tax Act (*Einkommensteuergesetz*, EStG) and section 8 of the Corporate Income Tax Act (*Körperschaftsteuergesetz*, KStG) give an indication as regards the tax treatment of the contribution of equity for Austrian tax purposes.

Under section 23(2) of the EStG, income realized by a partnership is attributed to each partner pro rata to the share of the partner in the partnership. From this provision, one can draw the conclusion that providing capital to a partnership must be classified as equity.[5] The two kinds of partnerships expressly mentioned in section 23(2) of the EStG, the general partnership (*offene Personengesellschaft*) and the limited partnership (*Kommanditgesellschaft*), form a guideline for the distinction between equity and debt for individual income tax law. According to case law, the existence of business initiative and business risk is decisive.[6] The first criterion is fulfilled if the co-entrepreneur has influence on the course of the business by running the business personally or jointly with others and/or by executing voting, supervisory or objection rights.[7] Business risk means participation in the business's success or failure (i.e. profit or loss) and also in the business's substance (i.e. hidden reserves and goodwill) during the entire existence of the participation in the partnership.[8] For the question as to whether in a particular case a person can be regarded as a partner of a partnership, the overall picture is decisive.[9] However, case law places particular emphasis on the business risk criterion.[10] In a nutshell, the participation in the overall business's performance is a decisive criterion for the existence of the contribution of equity from a tax perspective. If the analysis provides a different picture, the co-entrepreneur must be regarded as lender.

Other important provisions for the distinction between equity and debt are the provisions regulating jouissance rights (*Genussrechte*). The Austrian Stock Corporation Act (*Aktiengesetz*) refers to *Genussrechte* in section 174(3), section 220(2) and section 226(3) without defining the term. In this context, *Genussrechte* are regulated together with certain instruments that are of a contractual nature from a civil/corporate law perspective, such as convertible bonds. These instruments – and in particular the *Genussrecht* – may also be structured in a way comparable to shares (e.g. participation in profits/losses and unrealized capital gains/liquidation profits, for a limited or unlimited period of time and subordination). The precise determination of *Genussrechte* is thus subject to the agreement of the parties and varies significantly in practice. The classification as equity or debt is subject to the concrete terms and conditions used in these agreements.

The classification of *Genussrechte* for tax purposes is explicitly codified in section 8(3)(1) of the KStG. The participation in current profits and liquidation profits is a prerequisite for the classification as an equity-like participation right at the level of the issuer. If the criteria are not cumulatively satisfied, the *Genussrecht* would generally be accounted for as debt for corporate income tax purposes. A participation in losses is not required by the provision.[11]

Participation in current profits implies participating in business risks, which implies variability. A variable participation in current profits (as e.g. shown in the statutory accounts) is therefore a prerequisite for a *Genussrecht*. However, the participation in current profits needs not necessarily to be proportionate to the amount of capital invested and can e.g. be granted on the basis of a stepped interest rate or an adjustment clause (subject always to distributable profits).[12] According to administrative practice by the Austrian tax authorities, the precise amount of the participation in current profits needs not to be determined by the parties; timing aspects or comprehensive terms and conditions must, however, be fixed.[13] Also, a limitation to a maximum amount is possible. If a guaranteed minimum return, paid out also in years of losses, is granted, the *Genussrecht* is regarded as debt by the Austrian tax authorities.[14] This view, however, is not shared by a number of scholars, who argue that the economic perspective is decisive and thus that a *Genussrecht* still exists if – at issuance – it was likely that the payment of the guaranteed minimum return would be substantially less than the expected permanent pro rata participation in the issuer's profitability.[15] A guaranteed return comparable to market interest rates, however, indicates debt.[16]

Section 8(3)(1) of the KStG requires also a variable participation in liquidation profits, i.e. in hidden reserves released upon liquidation. The participation may be limited to a maximum amount. A fixed lump-sum par-

5. *See* Staringer, *Eigen- und Fremdkapital im Steuerrecht*, in Bertl, Eberhartinger, Egger, Gassner, Kalss, Lang, Nowotny, Riegler, Schuch & Staringer (eds.), *Eigenkapital* (Vienna: Linde, 2004), at 253, 256 et seq.
6. *See* Supreme Administrative Court (*Verwaltungsgerichtshof*, VwGH) 2 Apr. 1982, 2641/80 and 29 June 1995, 94/15/0103.
7. *See* VwGH 2 Apr. 1982, 2641/80; 15 June 1988, 86/13/0082 and 29 June 1995, 94/15/0103.
8. *See* VwGH 13 Dec. 1995, 93/13/0253.
9. *See* Achatz, in Achatz et al. (eds.), *Eigenkapitalersatz*, at 93.
10. *See* VwGH 13 Dec. 1995, 93/13/0253; Achatz, in Achatz et al. (eds.), *Eigenkapitalersatz*, at 94; Staringer, in Bertl et al. (eds.), *Eigenkapital*, at 258.
11. *See* Kirchmayr, in Achatz & Kirchmayr (eds.), *Körperschaftsteuergesetz* (Facultas: Vienna, 2011), § 8, para. 463; Günther, *Die Abgrenzung von Eigen- und Fremdkapital im Körperschaftsteuerrecht am Beispiel von Genussrechten*, Finanzjournal (2008), at 46, 49.
12. *See* Kirchmayr, *Besteuerung von Beteiligungserträgen* (Linde: Vienna, 2004), at 62 et seq.
13. BMF, *KStR 2001*, para. 540.
14. BMF, *KStR 2001*, para. 540; *see also* VwGH 24 Feb. 2004, 98/14/0131 and 29 March 2006, 2005/14/0018.
15. *See* Ressler & Stürzlinger, in Lang, Schuch & Staringer (eds.), *KStG* (Linde: Vienna, 2009), § 8, para. 188; Kirchmayr, *Die steuerliche Behandlung von Genussrechten an Kapitalgesellschaften*, in Nowotny, Mayer & Hassler (eds.), *Rechnungslegung, Prüfung und Beratung – Festschrift KPMG* (Vienna: Orac, 1996), at 125, 131; Günther, *Finanzjournal* (2008), at 48 et seq.
16. Eberhartinger, *Bilanzierung und Besteuerung von Genussrechten, stillen Gesellschaften und Gesellschafterdarlehen* (Vienna: Orac, 1996), at 156.

ticipation is regarded as insufficient for the classification as equity.[17]

Recent case law requires – even though not explicitly codified in section 8(3)(1) of the KStG – a predominance of equity-typical features, such as subordination or supervisory rights, for the classification of the *Genussrecht* as equity.[18] The relevance of these criteria has been intensively discussed in literature, where it is argued that the equity-typical features should not form a stand-alone criterion, but should be regarded as subordinated to the total profit participation.[19] The view of the Austrian tax authorities on this question is still unclear.

According to the administrative practice of the Austrian tax authorities, *Genussrechte* must be issued for the entire existence of the issuing corporation. The premature redemption of the jouissance rights capital is, however, possible.[20] If the jouissance right capital is reduced before the liquidation of the issuing corporation, an approach to calculate the (fictitious) liquidation profit equivalent to the participation in the liquidation profit must be agreed by the parties.[21]

2.2. Different tax treatment of equity and debt

Under section 8(1) of the KStG, contributions of any kind to a corporation made by persons in their capacity as shareholders of the corporation are not be taken into account for the calculation of taxable profit. As a consequence, any increase in the assets of a corporation is tax neutral, and any return on equity is not deductible from the corporate income tax base as a business expense at the level of the issuer.

Section 10 of the KStG provides for a participation exemption on dividends.[22] This provision deals not only with shareholdings in domestic, but also in EU and international corporations. Dividend distributions, but e.g. also distributions relating to *Genussrechte* and participation capital, received by Austrian corporations from other Austrian corporations are exempt unconditionally, i.e. irrespective of the size of the shareholding or any holding period, from corporate income tax. Dividend distributions from portfolio shareholdings (i.e. of less than 10%) in corporations resident in the EU are tax exempt if the type of corporation is expressly mentioned in a specific annex to the EStG, which transforms article 2 of the Parent-Subsidiary Directive (90/435) (as amended through 2006),[23] into national law (section 10(1)(5) of the KStG). Moreover, portfolio dividend distributions from shareholdings in non-EU corporations are tax exempt if these corporations are comparable to Austrian corporations and comprehensive mutual assistance according to the OECD standard of transparency and exchange of information is agreed with the respective foreign state (mutual assistance in the collection of taxes is no longer required[24]) (section 10(1)(6) of the KStG). The international participation exemption applies to shareholdings in non-Austrian corporations of at least 10%, provided that the shares have been held for at least one year (section 10(1)(7) of the KStG). Also, an applicable income tax treaty may exempt certain dividend distributions from taxation.

A shift from the exemption method to the credit method takes place in certain cases of tax avoidance or abuse of law. Dividend distributions under section 10(1)(5) and section 10(1)(6) of the KStG are credited only if the non-resident corporation is neither directly nor indirectly subject to any income tax comparable to the Austrian corporate income tax. Moreover, the switch-over to the credit method is provided, if the applicable corporate income tax rate is lower than 15% or if the corporation is subject to a broad personal or objective tax exemption. Dividends from international shareholding participations (section 10(1)(7) of the KStG) are taxable with a credit of non-Austrian tax on those dividends only if the focus of the business operations consists, directly or indirectly, in deriving passive income and if the determination of the tax base or the applicable tax rate in the state of residence of the non-resident corporation is not comparable to the respective Austrian corporate income tax provisions.

Recently, also an anti-tax arbitrage provision (section 10(7) of the KStG) has been introduced that will prevent double-dip structures with hybrid instruments.[25] For financial years starting after 31 December 2010, the exemption from Austrian corporate income tax for inbound dividends received by an Austrian corporation under the international participation exemption, and, with respect to portfolio participations under the general participation exemption, does not apply if such payments are deductible at the level of the non-Austrian corporation making the payment. The law does not provide for a switch-over from the exemption to the credit method in this case.

Capital gains derived by corporations from non-Austrian shareholdings, but not from portfolio shareholdings (as

17. BMF, *KStR 2001*, para. 542; Konezny & Tumpel, *Genussrechte im Konzernsteuerrecht*, in Achatz, Aigner, Kofler & Tumpel (eds.), *Praxisfragen der Unternehmensbesteuerung* (Linde: Vienna, 2011), at 13, 18 et seq.
18. VwGH 26 Mar. 2006, 2005/14/0018.
19. *See* Kirchmayr, in Achatz & Kirchmayr (eds.), *Körperschaftsteuergesetz* § 8, para. 457 et seq.; Ressler & Stürzlinger, in Lang, Schuch & Staringer (eds.), *KStG* § 8, para. 197.
20. BMF, *KStR 2001*, para. 541.
21. *See* BMF, *KStR 2001*, para. 541; Ressler & Stürzlinger, in Lang, Schuch & Staringer (eds.), *KStG* § 8, para. 194; Cerha & Ludwig, *Die Qualifikation von Eigen- und Fremdkapital bei der Kapitalgesellschaft und ihre Auswirkungen auf die Einkommensermittlung*, in Bergmann (ed.), *Praxisfragen des Körperschaftsteuerrechts – Festschrift Werilly* (Vienna: LexisNexis, 2000), at 101, 114; Günther, *Finanzjournal* (2008), at 50.
22. *Seein detail* Haslinger, in Lang, Schuch & Staringer (eds.), *KStG* (Linde: Vienna, 2009), § 10, para. 1 et seq.; Kirchmayr & Kofler, in Achatz & Kirchmayr (eds.), *Körperschaftsteuergesetz* (Facultas: Vienna, 2011), § 10, para. 1 et seq.
23. Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (90/435/EEC), OJ L225 (1990), EU Law IBFD, at 6.
24. AT: ECJ, 10 Feb. 2011, joint cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel BetriebsgmbH and Österreichische Salinen AG v. Finanzamt Linz*, ECJ Case Law IBFD.
25. *See* e.g. Marchgraber & Titz, *Die Wirkungsweise des § 10 Abs 7 KStG im System der Beteilungsertragsbefreiung*, Österreichische Steuerzeitung (2011), at 373 et seq.; Kirchmayr & Kofler, *Beteiligungsertragsbefreiung und Internationale Steuerarbitrage*, Zeitschrift für Gesellschaftsrecht und angrenzendes Steuerrecht (2011), at 449 et seq.; Stefaner, *Konsequenzen der Anwendung von § 10 Abs 7 KStG*, Steuer und Wirtschaft International (2012), at 370 et seq.

well as losses and depreciation) are exempt from corporate income tax (section 10(3) of the KStG), whereas Austrian shareholdings are not. In the latter case, a flat corporate income tax rate of 25% applies (section 22(1) of the KStG). The taxpayer has the possibility to opt out from tax neutrality. Under the general principles contained in section 6(2)(a) of the EStG, the value of an equity participation may effectively be written down to its lower going concern value (*Teilwertabschreibung*). This principle also applies where the interest is disposed of, upon liquidation or where the capital of a non-resident or resident subsidiary is reduced. If capital gains are subject to corporate income tax, capital losses and depreciation on shares from shareholdings qualifying under section 10 of the KStG are deductible from the corporate income tax base as a business expense, but must be spread over seven years (section 12(3)(2) of the KStG). Under section 12(3)(1) of the KStG, depreciation caused by the distribution of a dividend or the repayment of equity by the corporation in which the participation is held (*ausschüttungsbedingteTeilwertabschreibung*) is never deductible.[26]

In contrast to the return on equity, consideration for debt, regardless of whether provided by related or third parties, is fully deductible for corporate income tax purposes if the expenses can be attributed to the business sphere.[27] Thus, income tax law does not provide for neutrality of a type of financing.[28] However, certain exceptions apply, e.g. under section 12(2) of the KStG for interest expense incurred and directly connected to the acquisition of assets that lead to tax-exempt income (other than shareholdings qualifying under the domestic or international participation exemption). Since 2005, interest incurred in the debt financing of the acquisition of a shareholding within the meaning of section 10 of the KStG is, however, deductible under section 11(1)(4) of the KStG, provided that the shareholding is attributable as a business asset. Currently, it is disputed whether or not this exception is restricted to interest construed narrowly.[29] The Austrian tax authorities support a narrow view. Thus, other expenses such as banking fees, other payments to third parties (e.g. notaries public, lawyers) are not tax deductible.[30] Recent case law, however, states that the term "interest" must be interpreted from an economic perspective. Thus, the term "interest" within the context of section 11(1)(4) of the KStG covers ancillary costs.[31] Due to an increase in intra-group tax planning, the Austrian parliament recently amended section 11(1)(4) of the KStG regarding interest for intra-group debt financing, i.e. directly or indirectly by a related enterprise or a controlling shareholder. Such expenses are no longer deductible for the acquisition of shareholdings within the meaning of section 10 of the KStG.[32]

Dividend distributions to non-Austrian corporations are subject to Austrian withholding tax (*Kapitalertragsteuer*) currently at a rate of 25% of the gross amount withheld by the party making the consideration. No withholding tax needs to be levied on dividend distributions to corporations resident in EU/EEA countries if the shareholding is at least 10% of the share capital and has been held continuously for at least one year. Under section 21(1)(1a) of the KStG, also corporations that are subject to limited tax liability in Austria and are resident in a Member State of the EU or the EEA that has agreed on comprehensive mutual assistance for the exchange of information and the collection of taxes with Austria, may request repayment of withholding tax levied in Austria that could not be credited in the residence state of the corporation under the applicable income tax treaty. Moreover, a number of Austrian tax treaties limit the withholding tax rate. A corporation making a consideration for *Genussrechte* is, however, not in the position to refrain from levying Austrian withholding tax under section 94 of the EStG, as this exemption does not cover equity-like participation rights within the meaning of section 8(3)(1) of the KStG. Any withholding tax levied in excess may be claimed back as a refund.

On the other hand, interest payments for loans granted by non-Austrian corporations are not subject to Austrian withholding tax. The reason is that such interest income is not subject to limited tax liability (except for interest payments for loans that are directly or indirectly secured by rights in the land register and not issued as a bond).

2.3. Hidden equity

As mentioned above, consideration for debt – regardless of whether provided by related or third parties – is fully deductible from the corporate income tax base as a business expense in Austria. However, the tax authorities may – under certain conditions – reclassify shareholder loans as "hidden equity" by applying the general rules for tax treatment of shareholder contributions (section 8(1) of the KStG). "Hidden shareholder contribution" is defined as the contribution of a benefit by a shareholder to a corporation that does not appear to be a shareholder contribution, but actually is such a contribution in light of the contributor's status as a shareholder, i.e. *causa societatis*. Hidden shareholder contributions are treated from a corporate income tax perspective like other shareholder

26. For details, *see* Achatz & Bieber, in Achatz & Kirchmayr (eds.), *Körperschaftsteuergesetz* (Facultas: Vienna, 2011), § 12, para. 208 et seq.; Plansky, in Lang, Schuch & Staringer (eds.), *KStG* (Linde: Vienna, 2009), § 12, para. 87 et seq.
27. VwGH 10 Feb. 1987, 86/14/0028.
28. *See supra* n. 1.
29. *See* e.g. Bieber, in Achatz & Kirchmayr, *Körperschaftsteuergesetz* (Facultas: Vienna, 2011), § 11, para. 51 et seq.; Plansky, in Lang, Schuch & Staringer, *KStG* (Linde: Vienna, 2009), § 11 para. 44 et seq.; Wiesner, Kirchmayr & Mayr (eds.), *Gruppenbesteuerung* 2 (Vienna: LexisNexis, 2009), at K 61 et seq.; Nowotny, in Quantschnigg, Achatz, Haidenthaler, Trenkwalder & Tumpel (eds.), *Gruppenbesteuerung* (Vienna: Linde, 2005), § 11, para. 10 et seq.
30. BMF, *KStR 2001*, para. 1204 et seq.
31. Independent Tax Tribunal (*Unabhängiger Finanzsenat*) 16 Nov. 2011, RV/1351-L/10; currently pending at the VwGH; *see also* Hristov, *Weite Interpretation des Zinsbegriffs in § 11 Abs 1 Z 4 KStG durch den UFS Linz*, taxlex (2012), at 13 et seq.
32. *See* Mayr, *Fremdfinanzierungszinsen für Beteiligungen*, in Kirchmayr & Mayr (eds.), *Besteuerung der grenzüberschreitenden Konzernfinanzierung* (Linde: Vienna, 2012), at 15, 16 et seq.; Polster-Grüll & Puchner, *Der neue Konzernausschluss* in § 11 Abs 1 Z 4 KStG, in Achatz, Aigner, Kofler & Tumpel (eds.), *Praxisfragen der Unternehmensbesteuerung* (Linde: Vienna, 2011), at 389 et seq.; Plott, Einschränkung des Zinsabzuges in § 11 Abs 1 Z 4 KStG – Auswirkungen des Budgetbegleitgesetzes 2011 auf die Konzernfinanzierung, *Österreichische Steuerzeitung* (2011), at 18 et seq.

contributions, i.e. they are not taken into account for the calculation of taxable profit; any increase in the assets of a corporation is tax neutral, and any return on equity is not deductible from the corporate income tax base as a business expense at the level of the issuer.

Due to the fact that Austrian statutory tax law does not provide for explicit thin capitalization rules and that the KStG does not contain safe harbour rules, only the following rules – which are based on (restrictive) case law and the position of the Austrian tax authorities – may be applied for the classification of a shareholder loan as an ordinary loan for Austrian tax purposes: [33]
- a shareholder loan must meet arm's length standards and must be properly documented (e.g. interest rate, maturity, repayment terms);[34]
- further, a thin capitalization scenario may be indicated – on a case-by-case basis – if the debt/equity ratio of a company is not comparable with the capitalization of a similar company within the same business field, based on industry average benchmarks. However, neither case law nor the Austrian tax authorities define such a "reasonable" capitalization;[35]
- the supply of equity would have been necessary from an economic perspective at the time the debt financing was granted.[36] Provided that the supply of equity was not necessary, a reclassification should not be based on the fact that subsequent interest payments cause the thin capitalization;[37] and
- the subsidiary is not able to receive debt financing from third parties other than the shareholders.[38]

If only one (apart from the last criterion) or more of the conditions are not met, debt may be reclassified as equity for Austrian tax purposes. According to case law, the arm's length conformity in a formal (e.g. documentation of rights and obligations) and material (e.g. economic parameters) sense is of particular importance, whereas debt/equity ratios and the possibility of debt financing by third parties seems to be of minor relevance.[39] As a consequence, payments with respect to the excessive debt portion would be treated as (non-deductible) dividends, rather than (deductible) interest. Such reclassification usually applies to shareholder loans. Loans from third parties may be reclassified as equity contributions only if a shareholder had an influence on the granting of the loan (assuming the shareholder and the third party are related).[40] It is important to bear in mind that the use of an asset of a shareholder by a corporation for an inadequate consideration is not treated as a shareholder contribution. This is because the tax authorities deem the use of such an asset to be a valuable asset that may be separately accounted for.[41]

2.4. Accounting issues

Section 229 of the Austrian Commercial Code (*Unternehmensgesetzbuch*) regulates the treatment of capital and revenue reserves, as well as restricted reserves on the balance sheet. In contrast, the Commercial Code does not provide for such explicit rules on the accounting treatment of hybrid capital. Reference can be made, for example, to accounting standard KFS/RL 13, *Bilanzierung von Genussrechten und von Hybridkapital* as amended on 10 December 2010 of the Austrian Chamber of Accountants (*Kammer der Wirtschaftstreuhänder*), which provides that a *Genussrecht* may be treated as equity for accounting purposes, i.e. shown as equity on the balance sheet, subject to the following criteria being cumulatively met:
- the instrument is subordinated to all other instruments that do not qualify as equity for accounting purposes, and the *Genussrecht* must not be redeemed until all other creditors are fully satisfied;
- the return is subject to sufficient distributable profits being available for distribution under the Commercial Code. A postponed payment of the return in a subsequent financial year is possible if sufficient distributable profits are available at this later stage;
- the instrument fully participates in the issuer's losses; and
- the instrument is undated, i.e. the *Genussrecht* does not provide for a stated maturity. If the *Genussrecht* is redeemed prior to the liquidation of the issuer, either (1) the procedural rules for the redemption of ordinary shares must be adhered to or (2) the repaid capital under the *Genussrecht* must be mandatorily replaced by other (external) equity or by the transformation of unrestricted reserves into equity in at least the same amount in the same financial year. In any case, the *Genussrecht* must not provide for a holder's redemption right.

3. Amendments to the Terms and Conditions: Novation

Amendments to the terms and conditions of agreements between distressed debtors and their creditors in a consensual manner can take various forms, including:
- the maturity is extended;
- the repayment dates and/or period are extended;
- the interest rate is increased;
- the interest payments are deferred (the deferral interest may be charged or not);

33. *Seein detail* Ressler, *Die Unterkapitalisierung im Körperschaftsteuerrecht* (LexisNexis: Vienna, 2008), at 28 et seq.; Ressler & Sauer, *Das verdeckte Eigenkapital im Körperschaftsteuerrecht*, in Kirchmayr & Mayr, *Besteuerung der grenzüberschreitenden Konzernfinanzierung* (Linde: Vienna, 2012), at 35, 37 et seq.
34. *See* VwGH 28 Apr. 1990, 97/13/0068; 14. Dec. 2000, 95/15/0127 and 21 Oct. 2004, 2000/13/0179; BMF, *KStR 2001*, para. 708.
35. *See* VwGH 23. Oct. 1984, 83/14/0257; BMF, *KStR 2001*, para. 709; the missing legal basis for the criterion "reasonable capitalization" has been opposed in literature for years, but has not yet been abandoned by the Austrian Supreme Court (see in detail Ressler, in IFA (ed.), *The debt-equity conundrum*, Cahiers de droit fiscal international, at 107).
36. *See* VwGH 20 Apr. 1982, 81/14/0195; BMF, *KStR 2001*, para. 709.
37. BMF, *Körperschaft- und Kapitalertragsteuerprotokoll 2005*, published on 11 Nov. 2005.
38. VwGH 20 Apr. 1982, 81/14/0195; BMF, *KStR 2001*, para. 709.
39. VwGH 28 Dec. 1999, 97/13/0068 and 14 Dec. 2000, 95/15/0127.
40. VwGH 18 Dec. 1990, 89/14/0133, 0134; BMF, *KStR 2001*, para. 710.
41. BMF, *EStR 2000*, 2496 et seq. and 2605; *see in detail* Aigner & Aigner, *Nutzungs- und Leistungseinlagen in Kapitalgesellschaften*, in Achatz, Aigner, Kofler & Tumpel (eds.), *Praxisfragen der Unternehmensbesteuerung* (Linde: Vienna, 2011), at 159 et seq.

- the loan is repaid subject to the realization of profits;
- the liability is subordinated; and
- additional collateral/security is granted.

In general all these amendments to the terms and conditions should not lead to income tax consequences for the debtor if the changes negotiated by the debtor and the creditor are arm's length. This is especially the case if the changes are part of a reorganization in which third parties are also involved. If the amendments to the terms and conditions would not be arm's length and are thus made in the function as a shareholder (*causa societatis*), which must be determined on a case-by-case basis, the changes can affect the legal classification of the instrument and thus bear the risk of reclassification (e.g. replacement of a debt instrument by a new debt instrument; reclassification of a debt instrument as equity).[42]

Distressed debtors and creditors can also remedy the situation in a consensual manner by replacing existing debt instruments with new debt instruments having different terms and conditions (*novation*). This measure does not lead to income tax consequences for the debtor; the interest accrued for the primarily raised debt remains deductible from the corporate income tax base as a business expense, and the interest for the recently contracted debt is deductible, as well. Only if a shareholder were to make the contribution in light of its status as a shareholder (*causa societatis*), the contribution might be reclassified as "hidden equity".

4. Debt Buy-Back and Exchange for Debt/Equity

Debt buy-backs are another form of consensual debt restructuring. Recently, increasing use was made of this option, which can occur in many different scenarios, as illustrated by way of the example discussed below.

Before the economic crises, an offshore company of Bank XYZ issued preferred securities to third parties and utilized the generated proceeds to purchase regulatory capital issued by Bank XYZ, which must – for the functioning of the structure – be classified as debt rather than as equity for Austrian tax purposes. During the economic crises, the value of the preferred securities decreased. Bank XYZ now invites the holders of the preferred securities to sell them to the bank for cash. The bank plans to assign and transfer the securities held by the offshore company against a commensurate reduction of the nominal amount of its liabilities under the supplementary capital. The unwinding of the hybrid capital transaction is classified as an exchange of assets for tax purposes, i.e. as a transfer of the securities in exchange for the receivable under the supplementary capital. Bank XYZ will be deemed to have sold the securities at fair market value and should at the same time be deemed to have acquired the respective portion of the supplementary capital for the fair market value of the securities. Simultaneously with such acquisition, the supplementary capital will disappear from Bank XYZ's balance sheet at its nominal amount, so that the bank may record a book profit amounting to the difference between the face value of the disappearing supplementary capital and the fair market value of the securities at the time the exchange was effected. From a tax perspective, it is essential that the exchange be effected at arm's length conditions, and this requires that the market value of the supplementary capital received by the bank be equal to the market value of the securities given in exchange for it.

Another option for Austrian distressed debtors is to issue convertible or warrant bonds. Convertible bonds are accounted for as debt at nominal repayment amount for Austrian tax purposes (with the exception that the accounting and depreciation of a *disagio* in the amount of the difference between the higher repayment amount and the pure bond element is mandatory in case of no or below market interest rates).[43] The option or the obligation to convert the debt (partly) into shares at a predetermined exchange ratio is intrinsically tied to the bond. As regards the situation where the investor exercises the conversion option at maturity, the tax authorities recently changed their view and now consider the conversion not as an exchange of assets giving rise to taxation for the investor, such that the conversion has no immediate tax effect.[44] Viewed from the perspective of the issuer of the convertible, the conversion should have been regarded as tax neutral only in case of an increase of the nominal share capital in an amount identical to the repayment value of the convertible.[45] No statement can yet be found for the debtor, but the changed view of the Austrian tax authorities regarding the conversion for the holder could be an indication of tax neutrality also for the debtor (at least if the bond element is fully exchanged for share capital). If the conversion does not take place at maturity, the bond may be repaid tax neutrally, whereas according to the Austrian tax authorities, the option will be accounted for as a profit by the issuer.[46] However, good arguments can be found for tax neutrality based on German case law on comparable tax law provisions.[47]

Like convertible bonds, warrant bonds consist of a bond and an option, but the option may be separated and traded independently from the bond. Thus, the bond and the option must be regarded as separate assets. However, the tax authorities assign the entire acquisition costs to the bond if the bond and the option are acquired together.[48] If the bond and the option are sold together prior to maturity, the bond is sold at a loss, whereas the option realizes a profit (due to no acquisition costs having been assigned).

42. *See* e.g. VwGH 14 Dec. 2000, 95/15/0127 in the case of subordination of liabilities.
43. *See* BMF, *KStR 2001*, para. 673.
44. *See* Statement of the Austrian Ministry of Finance of 7 Mar. 2012, GZ BMF-010203/0107-VI/6/2012, para. 1.2.4.2.1.
45. This view follows from the corporate perspective, where the par value of the convertible bond is decisive for the amount of the capital increase. *Seein detail* Winner, in Doralt, Nowotny & Kalss (eds.), *Kommentar zum Aktiengesetz* 2 (Vienna: Linde, 2012), § 166, para. 21 et seq.
46. BMF, *KStR 2001*, para. 673.
47. *See* Federal Tax Court (*Bundesfinanzhof*) 30 Nov. 2005, I R 3/04; 30 Nov. 2005, I R 26/04. *Seein detail* Aigner & Sedlaczek, Die handels- und steuerrechtliche Behandlung der Wandlungs- und Optionsprämie bei Nichtausübung von Wandel- und Optionsrechten, *Recht der Wirtschaft* (2006), at 111 et seq.
48. *See* Statement of the Austrian Ministry of Finance of 7 Mar. 2012, GZ BMF-010203/0107-VI/6/2012, para. 1.2.4.1.1.

If the bond and the option are sold in different accounting periods, the tax effect becomes even more apparent, leading to a taxable profit in one and a deductible loss in the other accounting period. If the option is exercised, the acquisition costs of the option are regarded as acquisition costs for the shares. The exercise of the option does not have any immediate tax affect according to the tax authorities.[49]

Last, but not least, the debtor and the creditor may reach a consensual agreement that the existing debt instrument be transformed into (new) equity (debt-equity swap). The previous creditor would thus become a shareholder or at least hold an equity-like participation right, e.g. if a *Genussrecht* would be issued. In contrast to such convertible and warrant bonds, the debtor and the creditor have not agreed on an option prior to the swap. The debt-equity swap is regarded as a contribution of a non-recoverable debt claim to the corporation in the amount of the actual value of the liability. In the subsequent logical second the debt disappears from the debtor's balance sheet, creating a taxable book profit amounting to the difference between the fair market value of the contribution and the former debt that has disappeared. Thus, if the liability were to be still fully recoverable, the contribution would be tax neutral.

5. Debt Waivers

Distressed Austrian debtors can also agree with the creditor in a consensual manner that the outstanding debt be fully or partially waived. The waiver may be combined with an earn-out provision, i.e. if the economic situation of the debtor develops significantly in later years, the former debt will be reinstated.

Debt waivers by third parties are subject to Austrian corporate income tax at the level of the debtor under section 23a of the KStG. The tax is calculated on the basis of the difference between the repayment value of the liability and the book value of the debt waived. However, distressed debtors are usually facing losses that exceed such a profit. Thus, only the amount of the loss carry-forward, i.e. the possibility of a set-off for losses incurred in connection with business income against income of future years, for which Austrian tax law provides in section 8(4) of the KStG, is reduced. The loss carry-forward is generally restricted to 75% of the current income of the future year concerned. Excess losses are not lost, but may be carried forward for set off indefinitely, always subject to the 75% current income restriction. Under section 2(2b)(3) of the EStG, the carry-forward of losses incurred due to debt waivers by third parties is not subject to the 75% restriction. If the former debt is reinstated due to the application of an earn-out provision, a business expense arises and thus may be deducted from the corporate income tax base.

Pursuant to section 8(1) of the KStG, a shareholder's waiver of a receivable against "its" company is tax effective at the level of the company to the extent the receivable is not recoverable. Accordingly, the waiver of receivables under a shareholder loan must be split for Austrian corporate income tax purposes into a portion that is recoverable and a portion that is not. To the extent that the receivable is recoverable, the waiver is treated as a (hidden) contribution, which is tax neutral(the contribution must be accounted for as an unrestricted capital reserve, *ungebundene Kapitalrücklage*), while the portion that is not recoverable is tax effective.[50]

6. Capital and Stamp Duties

Pursuant to the Capital Duty Act (*Kapitalverkehrsteuergesetz*, KVG), the issuance of a "corporate right" (*Gesellschaftsrecht*) by an Austrian corporation triggers 1% Austrian capital duty (*Gesellschaftsteuer*) based on the consideration paid by the subscriber of that corporate right. Pursuant to section 5(1) of the KVG, the term "corporate right" covers not only ordinary or preference shares, but equally (1) participation rights and (2) equity or debt instruments which provide for a profit linked return *or* a participation in the liquidation proceeds of the Austrian corporation. Consequently, for example *Genussrechte* qualify as a corporate right for capital duty purposes. This is in line with article 3(d) of Council Directive 2008/7/EC of 12 February 2008 concerning indirect taxes of capital[51] (the Capital Duty Directive), under which a contribution of capital (which a Member State, including Austria, may subject to capital duty) includes any "increase in the assets of a capital company by contribution of assets of any kind, in consideration not of shares in the capital or assets of that company, but of rights of the same kind as those of members, such as voting rights, a share in the profits or a share in the surplus upon liquidation".

The Stamp Duty Act (*Gebührengesetz*) subjects to stamp duty certain agreements enumerated in such Act if documented in a dutiable manner, i.e.documented in writing in Austria. As from 1 January 2011, loan agreements are no longer subject to stamp duty.

7. Conclusion

Consensual debt restructuring with the creditor is one of the options for distressed debtors that are at risk of defaulting under a regular loan instrument. Due to the financial crisis and its effect on the overall economic situation, corporations have recently more often considered remedying their financing situation in a consensual manner with their creditors. Apart from amendments to the terms and conditions of a debt instrument and/or the replacement of an existing debt instrument by a new debt instrument with different terms and conditions, debtors and creditors can agree e.g. on

49. Id.

50. *See* Ressler & Stürzlinger, in Lang, Schuch & Staringer (eds.), *KStG*, § 8, para. 69 et seq.; Kirchmayr, in Achatz & Kirchmayr (eds.), *Körperschaftsteuergesetz*, §, para. 114 et seq.; Kofler, *Der unbedingte Forderungsverzicht des Gesellschafters*, in Achatz, Ehrke-Rabel, Heinrich, Leitner & Taucher (eds.), *Steuerrecht – Verfassungsrecht – Europarecht – Festschrift Ruppe* (Facultas: Vienna, 2007), at 273 et seq.

51. OJ L 363, 20 Dec. 2006, at 129.

a debt buy-back or the debtor can issue convertible and/or warrant bonds. Moreover, the creditor has the option to convert a debt instrument into equity or fully or partially waive the provided debt. These options lead to different income tax consequences in Austria due to different tax treatment of equity and debt, as well as capital and stamp duties.