

BFH rules on tax relief for cancellation of debt income

The German Federal Tax Court ([BFH](#)) has ruled that tax relief for the cancellation of debt income does not need to be granted in certain cases based on official guidance issued by the Federal Ministry of Finance (case reference: [X R 34/08](#)). However, the decision also confirms that the tax authorities can grant tax relief if the facts of the case fall within the scope of the guidance.

The cancellation of the debt of an enterprise from its balance sheet, for example, by way of a debt waiver or a debt-equity swap, in principle gives rise to taxable income in the hands of the debtor even if the write-off is designed to help the debtor enterprise avoid insolvency (or over-indebtedness) or to emerge from insolvency (or over-indebtedness). However, according to official guidance issued by the Federal Ministry of Finance ([BMF](#)) in March 2003, the tax imposed on the cancellation of debt income ("COD income") may be deferred or – following a final assessment – even waived, if all of the following requirements are met:

- The enterprise is in need of financial restructuring and insolvency proceedings have not yet been initiated;
- It is still possible to financially restructure the company, so that it can emerge from its financial crisis;
- The measures adopted (e.g. the debt waiver) are appropriate for financially restructuring the enterprise; and
- The creditors waiving their claims intend to financially restructure the enterprise.

All four requirements are deemed to be met in case of an existing restructuring plan. The deferral or waiver of tax due only relates to the (corporate) income tax on net income, i.e. the tax on income after all available losses have been deducted. Limitations on the offset of losses that apply under normal circumstances – such as the minimum taxation rules – are suspended for this purpose.

The recent BFH decision settles the first of two appeals from lower tax court decisions relating to the taxation of the cancellation of debt income; the second decision is expected to be handed down in early 2011 by a different chamber of the BFH. In both cases, the BFH has been asked to rule on whether the practice of the tax authorities is in line with what the German legislator intended when giving the tax authorities discretion to grant a tax deferral or a waiver of tax due.

The decisions of the lower courts (i.e. the lower tax court of Munich (case reference: 1 K 4487/06) and the lower tax court of Cologne (case reference: 6 K 2488/06)) were contradictory. The Munich court concluded that the legislature did not intend to grant any kind of tax relief for the cancellation of debt income since it abolished a previously available tax exemption. The Cologne court, however, found that the tax relief provided in the BMF guidance does not go far enough, i.e. it does not cover all restructuring cases that should be covered.

The July 2010 decision of the BFH addresses the decision of the Cologne court. In its decision, the BFH rejected the claimant's view as supported by the Cologne court and held that the specific case did not fall within the scope of the guidance because it relates to a private settlement of an insolvency case. The BFH also decided that the BMF guidance is sufficiently comprehensive, which is why the claimant may not benefit from a waiver of tax on the COD income. Although the BFH decision may appear adverse to taxpayers at first glance, the effect of the decision is positive. The BFH clearly rejects the view taken by the lower tax court of Munich and affirms the tax authorities' practice of granting tax relief for the cancellation of debt income by way of a tax deferral or abatement. The BFH limited its decision, however, by stating that it did not have to rule on every statement in the BMF guidance or whether the official guidance is too broad as compared to the legislative intent.

The BFH decision is helpful because it generally confirms that the tax authorities may grant tax relief for the cancellation of debt income by way of a tax deferral or a waiver of the tax due. More clarity can be expected when a decision on the Munich court case is issued. Nevertheless, there are some practical issues in connection with the cancellation of debt income that still need to be clarified (e.g. tax relief in the case of a debt waiver by only one or a few creditors, the definition of a restructuring plan within the meaning of the BMF guidance, the effect of a discretionary decision by the municipal authorities to defer or waive trade tax).

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