

URL: <http://www.deloitte-tax-news.de/german-tax-legal-news/draft-letter-published-by-the-german-ministry-of-finance-regarding-bad-debt-adjustments-for-credit-institutes-dated-12th-april-2023.html>

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*German Tax and Legal News*

## **Draft letter published by the German Ministry of Finance regarding bad debt adjustments for credit institutes dated 12th April 2023**

In its draft letter on bad debt adjustments for credit institutes, the German Federal Ministry of Finance has for the first time commented on the specific requirements for the respective recognition in the tax accounts. Associations now have the opportunity to position themselves and comment on the draft letter until 10th May 2023.

### **1. Specific bad debt allowances on the merits**

Credit institutions are subject not only to the general accounting standards according to the German Commercial Code (Handelsgesetzbuch "HGB"), but also to the special standards according to the Ordinance on Accounting for Banks (Kreditinstituts-Rechnungslegungsverordnung "RechKredV") of 11th December 1998.

For the tax balance sheet, receivables from customers within the meaning of Sec. 15 RechKredV are generally to be recognized at their acquisition cost i.e., at their nominal amount (Sec. 253 (1) HGB in conjunction with Sec. 5 (6) German Income Tax Act (Einkommensteuergesetz "EStG"), Sec. 6 (1) no. 2 sent. 1 EStG). Doubtful receivables for which there is an acute risk of default must be written down to the lower value as of balance sheet date under German commercial law (so called strict lower-of-cost-or-market principle according to Sec. 253 (4) HGB). This also applies to temporary impairments. Generally, each receivable must be valued individually according to Sec. 252 no. 3 HGB.

For tax purposes, on the other hand, according to Sec. 5 (6) EStG in conjunction with Sec. 6 (1) no. 2 sent. 2 EStG, there is an option to consider the lower going-concern value as of balance sheet date if and to the extent that the impairment is expected to be permanently lower. The going-concern value is intended to reflect the abstract amount that a purchaser of the entire business would pay for the individual asset if the purchaser were to continue the business thereafter. A permanent lower value can only be considered if the underlying reasons for the impairment last until the date of preparation of the annual balance sheet. The balance sheet must be prepared (at the latest) by the end of the third month following the balance sheet date (Sec. 26 (1) German Banking Act (Kreditwesengesetz "KWG")).

The value adjustment for doubtful receivables can either be made by means of a specific bad debt allowance ("Einzelwertberichtigung "EWB") or a flat-rate specific bad debt allowance (pauschale Einzelwertberichtigung "pEWB"). For this to be the case, it must first be possible to make a specific valuation allowance on the merits. The BMF clarifies that, in contrast to the general bad debt allowance (Pauschalwertberichtigung "PWB"), there must be a concrete indication that the debtor will not be able to service the outstanding receivable in full or at all. In paragraph 9 of the draft letter, the BMF defines the following criteria for a specific bad debt allowance:

- a) 90 days of uninterrupted arrears on the balance sheet date and up to the date of preparation of the balance sheet (uninterrupted arrears no longer exist if three agreed payments are made in succession up to the date of preparation of the balance sheet);
- b) three consecutive installments in arrears per loan account on the balance sheet date and up to the date of preparation of the balance sheet (uninterrupted arrears no longer exist if three agreed payments are made in succession up to the date of preparation of the balance sheet);
- c) filing for insolvency on the balance sheet date;
- d) submission of a statement of assets and liabilities pursuant to Sec. 802c German Civil Process Ordinance (Zivilprozessordnung "ZPO") by the debtor on the balance sheet date; or
- e) death of the debtor in the case of an overindebted estate on the balance sheet date.

The BMF also allows for the possibility of using criteria other than those mentioned above to

determine an acute payment disruption. A, however, the respective credit institution must then prove that the value of the receivable is permanently reduced on the balance sheet date. The BMF does not specify what this proof must look like in concrete terms and is therefore likely to lead to uncertainties in practice.

The requirement to reinstate original values under Sec. 6 (1) no. 2 sent. 3 in conjunction with no. 1 sent. 4 EStG must also be observed on the following balance sheet dates.

## **2. Specific bad debt allowances according to the amount**

The upper limit for the going-concern value is the acquisition cost (nominal value) and the lower limit is the recoverable amount in the event of disposal. In practice, the determination of the lower going-concern value due to an acute risk of default can only be made on basis of an appropriate estimate. This must be based on objective evidence (past experience) and must not include future developments. The information required for this can be determined with the aid of an IT-supported system. However, regarding future tax audits - it must always be ensured that the data is electronically analyzable and comprehensible for the tax authorities. The principles for keeping electronic records and documents (GoBD) must be observed.

The amount of the specific bad debt allowance is therefore derived from the institution-specific historical values and is influenced in particular by the following factors:

- available collateral,
- duration of the payment default, and
- extent of repayment portions still to be expected.

Also to be taken into account are the recoverable insolvency ratio at the time of insolvency, existing residual debt insurance policies, the recoverable proceeds from the sale of the doubtful receivables to collection agencies and the bank's own measures to recover the outstanding receivables.

The going-concern value is calculated as follows:

### a) Unsecured loans

Nominal value of the receivable  $\cdot$  expected repayment = value adjustment

Nominal value of the receivable  $\cdot$  value adjustment = going-concern value

The going-concern value therefore corresponds to the expected repayment.

### b) Secured loans

Nominal value of the receivable  $\cdot$  collateral value  $\cdot$  expected repayment = value adjustment

Nominal value of the receivable  $\cdot$  value adjustment = going-concern value

Thus, the going-concern value corresponds to the expected repayment plus the value of the collateral, which is directly or indirectly related to the receivable. The BMF also comments on the valuation of various forms of collateral (e.g., land debt, guarantees or securities based on the transfer of ownership).

## **3. Flat-rate specific bad debt allowance (pEWB)**

Due to the large number of receivables (especially in the context of the mass-credit procedure), the specific bad debt allowance for each individual receivable is often systematically too costly. Therefore, homogeneous groups or portfolios can be created which are written down at a uniform impairment rate. The portfolio creation must be based on uniform and institution-specific criteria and must be disclosed to the tax authorities at a comprehensible manner.

For the flat-rate specific bad debt allowances, the aforementioned requirements for specific bad debt allowances must be met on the merits (see 1. above).

The procedure for determining the impairment rate can also be determined and documented with the aid of IT-systems. The scoring procedure used in the credit assessment must meet the requirements set out in the BMF letter in order to be applied. The flat-rate specific bad debt allowances can be determined according to the calculation scheme for general bad debt allowances (published letter from the Ministry of Finance dated 10th January 1994) and must not exceed this amount as an upper limit.

## **4. Simplification procedure for tax purposes**

No objections are raised if a standardized impairment rate is used instead of the procedure described above for determining the specific bad debt allowance for all receivables from customers within the meaning of Sec. 15 RechKredV. The impairment rate is applied

uniformly to all costumer receivables. The value must meet at least the commercial balance sheet value.

Different impairment rates must be applied to secured and unsecured receivables, so the breakdown into the two groups must be documented. A residual debt insurance is to be regarded as a collateral in this context.

If payment is overdue by less than 90 days, no allowance is recognized. If the payment is overdue by more than 90 days, the uniform allowance rates listed in the table in Paragraph 58 apply (e.g., allowance rate for 180-day payment delay: unsecured receivables 40%, secured receivables 4%). For unsecured receivables, the allowance starts at 10% and increases by further 10% every 30 days until full write-off after 360 days of default. For secured receivables, the allowance starts at 1% and increases by further 1% every 30 days (until 660 days of payment default, max. 20% of the nominal value of the receivable on the flat-rate collateral value). If the collateral has been fully realized, the remaining receivable must be written down completely.

The simplification procedure may be used for the first time for fiscal years ending after the publication of the final letter from the Ministry of Finance in the Federal Tax Gazette and is applicable for the last time for fiscal years ending before 1st January 2031.

### **Recommendation for action**

Within the framework of the expected letter, the tax authorities will finally provide clear criteria that credit institutions can use as a guide with regard to specific bad debt allowances, thus creating more certainty for future tax audits. Banks should now examine individually to what extent the procedure used today for determining the bad debt allowances can be retained or needs to be adapted. In addition, the optimal procedure for recognition in the tax balance sheet should be evaluated at institution level from both an accounting and an organizational perspective. In this context, it should also be checked whether the current IT systems provide all the necessary data for traceability and whether the documentation requirements of the GoBD are met.

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