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German Federal Tax Court Decision: Non-resident Corporations not Subject to Tax for Gains from Cancellation of Debt Incurred for the Acquisition of Real Property in Germany

Decision relevant for non-resident investors with real estate in Germany

The Federal Tax Court recently released its [decision of Dec. 7, 2016 - I R 76/14](#) (*in German only*) regarding the tax treatment of a gain of a non-resident corporation from cancellation of debt incurred for the acquisition of real estate located in Germany. Provided the corporation does not have a permanent establishment in the federal republic, such gain does not qualify as income subject to tax in Germany.

With its decision, the Federal Tax Court rejected the tax office's appeal against the ruling of the local tax court of Berlin-Brandenburg of Nov. 12, 2014.

The **underlying case** involved a foreign corporation ("Lux Sarl") that invested in German real estate, financing the acquisition with bank and intercompany loans. Interest on the loans was considered a deductible expense and, therefore, decreased Lux Sarl's taxable base in Germany. After a couple of years, Lux Sarl sold the property for a loss. The sales proceeds were not sufficient to repay all outstanding loans. Lux Sarl repaid the bank loan, but the intercompany loan remained outstanding. The creditor of the intercompany loan subsequently waived Lux Sarl's obligation to repay that loan.

Under domestic German tax law, rental income of a non-resident corporation is deemed to be business income. If business income is calculated based on balance sheets (and not on a cash basis), a waiver of debt results in a gain. Such gain is considered income for tax purposes, to the extent that the waiver does not qualify as a capital contribution.

The German tax authorities took the position that Lux Sarl's gain from the waiver was subject to German income tax, because Lux Sarl calculated its income on the basis of balance sheets. The relevant balance sheets also included the debt to repay the intercompany loan, as it related to the acquisition of the German property. Given that Lux Sarl did not have sufficient assets to repay the intercompany loan, the waiver of the loan could not qualify as a capital contribution. Therefore, in view of the tax office, the eschewal resulted in income subject to German tax.

In its decision cited above, the Federal Tax Court held that the gain from the waiver of debt was not subject to tax in Germany. Lux Sarl did not have a permanent establishment in Germany, therefore, only its income from renting and selling the property was subject to tax in Germany. The court found that the gain incurred due to a reduction or a waiver of debt does not qualify as rental income or as profit from a sale.

The decision may be relevant for all non-resident investors with real estate in Germany, in particular in distressed situations. Provided there is no permanent establishment in Germany, the tax liability is limited to rental income and profits from the sale of the German real estate. However, this does not include gains from a change in value of liabilities, even if such liabilities relate to the German real estate. This is in particular relevant in distressed situations, when creditors may agree to reduce or waive claims or a debt equity swap in order to contribute to a consolidation of the debtor. As the decision is based on an interpretation of domestic law, it is irrelevant whether or not the debtor is entitled to protection under a double tax treaty.

It remains to be seen whether the decision will be published in the Federal Tax Gazette or whether the tax administration will initiate a change of the income tax code in order to make the law compliant with its previous interpretation. **Only upon a publication in the Federal Tax Gazette can it be expected that the tax offices will apply this decision.**

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