

Lower tax court rules on cash-roundtripping structure to avoid cancellation-on-indebtedness income

Cash-roundtripping might be seen as abusive if not implemented in the right way.

Germany's lower tax court of Duesseldorf in a decision dated 22 December 2021 and published in May 2022 ruled that a structure to avoid cancellation of debt (COD) income was abusive pursuant to the general anti-avoidance rule (GAAR) under section 42 (2) of the General Tax Code. The court determined that a shareholder's contribution to its wholly-owned German limited liability company (GmbH) and immediate repayment of the GmbH's payables to the shareholder qualified as a waiver of the payables, which resulted in COD income at the level of the GmbH to the extent the amount of the payables was deemed to be impaired, i.e., exceeded the value of the shareholder's equity in the GmbH.

Background

The taxpayer, a GmbH, was in the process of being liquidated. The GmbH was part of a multinational group and also part of the group's cash pooling and intercompany account settlement arrangement. The GmbH had significant payables to its sole shareholder. The shareholder resolved to contribute funds to the GmbH and designated the use of the funds to the repayment of such payables. The contribution and the repayment of the payables took place almost simultaneously and were recorded in the books of the GmbH without the actual movement of cash.

The tax authorities qualified the contribution and repayment of the payables as being abusive and treated the transaction as a waiver of the payables based on the GmbH being wholly owned by the shareholder. As a result, the tax authorities treated the waiver as a tax neutral deemed contribution to the GmbH to the extent the receivables against the GmbH were not impaired and assessed COD income to the extent the receivables were impaired (i.e., in the amount the receivables exceeded the equity value of the GmbH).

Lower tax court decision

The lower tax court of Duesseldorf agreed with the tax authorities and rejected the taxpayer's arguments on all counts. The lower tax court stated that the conditions of the GAAR pursuant to section 42 (2) of the General Tax Code are fulfilled if an inappropriate legal structure is chosen that results in a tax benefit for the taxpayer or a third party that is not foreseen by law when compared with an appropriate legal structure, and if there are no significant non-tax reasons for the chosen structure. In rejecting the taxpayer's argument that the contribution alternative rather than a waiver of the payables was appropriate and chosen to improve the GmbH's balance sheet, the lower tax court stated the tax consequences must be determined as if a structure was chosen to reflect the economic purpose of the transaction.

Comments

This case touches on a common issue that arises when an over-indebted subsidiary has significant payables to its shareholders or other related parties. Solving the over-indebtedness issue requires careful planning based on certain considerations as described in the decision of the lower tax court and similar decisions of other tax courts (e.g., actual movement of cash, unrestricted discretion of a company over the funds received from its shareholder, etc.).

The taxpayer has filed an appeal against the decision of the lower tax court, which is currently pending at the federal tax court.

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