

Lower tax court rules on treatment of remaining liabilities of company initiating liquidation procedure

Initiation of liquidation process did not automatically result in cancellation-of-debt income.

In a decision dated 23 July 2020 and published in September 2020, Germany's lower tax court of Muenster provided welcome clarification and support for taxpayers relating to a long-disputed issue regarding the treatment of shareholder liabilities at the level of a company entering into the liquidation process. Contrary to the position of the tax authorities, the lower tax court decided that the initiation of the liquidation procedure and the set-up of the opening balance sheet for the liquidation period does not automatically result in cancellation-of-debt (COD) income from liabilities to shareholders.

The case decided by the lower tax court concerned a company that ceased its activities and had sold all of its assets when the shareholder decided to start the formal liquidating process for the company. The company still had a liability outstanding to its shareholder, which had been written-off as bad debt at the level of the shareholder. The company still showed the liability toward its shareholder at face value in its opening balance sheet for the liquidation period.

In a tax audit, the tax authorities treated the liability in the opening balance sheet as cancelled and, as a result, assessed COD income for the taxpayer on the basis that there was no serious intent of the creditor (the shareholder) to enforce its claim against the company. The taxpayer appealed the assessment to the lower tax court.

The tax court found that there was no explicit waiver of the receivable by the shareholder and that the mere initiation of the liquidation process could not result in a deemed waiver of the receivable; therefore, the liability still had to be shown at face value in the company's opening balance sheet for the liquidation period. The tax court rejected the tax authorities' view that the initiation of the liquidation procedure resulted in COD income at the level of the company.

The decision of the lower tax court of Muenster is in line with a decision of the lower tax court of Cologne dated 6 March 2012, in which the court rejected the tax authorities' view that the final liquidation of a company triggers COD income for outstanding shareholder liabilities. Although the fact patterns in the two decisions are slightly different (the 2020 decision relates to the initiation of the liquidation process, whereas the 2012 decision relates to the conclusion of the liquidation process), the key principles that are set forth by the tax courts are the same, i.e., that a liquidation of a company does not automatically result in COD income at the level of the company from outstanding liabilities to shareholders. The 2012 decision of the lower tax court of Cologne was appealed to the federal tax court (BFH), but the BFH's final decision in 2014 did not provide any clarification on the issue due to procedural limitations (see [GTLN dated 20 June 2014](#)).

A decree was issued by the tax authorities on 30 June 2017 on the tax consequences of the liquidation of a company that still shows a payable from its corporate shareholder in its final liquidation balance sheet (see [GTLN dated 28 August 2017](#)). The decree confirms that the final liquidation of the subsidiary should not result in COD income and that the corporate shareholder's approval of the company's liquidation cannot be deemed to be a waiver of the receivable. The lower tax court of Muenster's decision mentions the decree and the 2014 BFH decision; however, it concludes that neither is on point in the case at hand, as both refer only to the tax consequences of a final liquidation of a company.

The lower tax court of Muenster's decision is final and cannot be appealed to the BFH.

The lower tax court's decision provides support for arguments against COD income for

liquidating companies, and should be applicable in the same way for shareholder liabilities that exist in the beginning of the liquidation process and at the end of the liquidation process. However, taxpayers that do not wish to trigger COD income in such a situation should not explicitly cancel or waive existing receivables against the company that is being liquidated.

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