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*German Tax and Legal News*

## **Tax court rules on tax treatment of cancellation of debt income related to real estate investment loan**

The local tax court of Berlin-Brandenburg has ruled that cancellation-of-debt income relating to a nonresident corporation's real estate investment loan is not subject to German income tax.

The local tax court of Berlin-Brandenburg ruled on November 12, 2014 that a nonresident corporation's cancellation-of-debt income ("COD income") related to a real estate investment is not subject to German income tax.

The case before the tax court involved a foreign corporation ("Lux Sarl") that invested in German real property, 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. Under the Germany-Luxembourg tax treaty, rental income derived by Lux Sarl on the property was subject to tax in Germany because the property was located in Germany (such income is subject to German corporate income tax at a rate of 15.825%, but it is not subject to German trade tax). Under German tax law, the rental income is deemed to be business income.

After a couple years, Lux Sarl sold the property for a loss; the sales proceeds were less than the outstanding loans on the property. Lux Sarl repaid the bank loan, but did not have sufficient assets to repay the intercompany loan. The creditor of the intercompany loan subsequently waived Lux Sarl's obligation to repay that loan, triggering COD income at the level of Lux Sarl.

Under German tax law, cod-income generally is subject to income tax (at the level of the debtor) to the extent the underlying loan was impaired (from the viewpoint of the creditor). Given that Lux Sarl did not have sufficient assets to repay the intercompany loan, the German tax authorities took the position that the loan was impaired and that consequently Lux Sarl's COD income was subject to German income tax.

The local tax court disagreed with the German tax authorities and held that COD income could be taxed in Germany if the underlying loan liability was related to a permanent establishment (PE) of Lux Sarl in Germany. The court found that Lux Sarl's property did not give rise to a German PE since no business activities were performed in Germany, and the fact that rental income is deemed to be business income for German income tax purposes did not create a PE. The treaty with Luxembourg allocates respective taxing rights to Germany only if a German PE to which the loan was related existed. Thus, the court ruled in favor of Lux Sarl that the COD income was not subject to German income tax.

The decision may provide opportunities for nonresident investors in distressed German real estate situations. The case is currently on appeal to the Federal Tax Court.

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