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Compensation upon reversal of loan contract not subject to income tax

According to a ruling of the Supreme Tax Court, the compensation for use received in the context of the reversal of a consumer loan agreement after revocation is not subject to income tax.

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Background

In the case of dispute, the married spouses had concluded a loan agreement in 2008 to finance a residential property for their own use. In 2016 they revoked the loan agreement, citing incorrect instructions for withdrawal. Based on a civil court settlement, the bank paid the couple compensation of €14,500 for interest and repayments made until the revocation date. The tax office took the compensation as income from capital investment.

Decision

The compensation for use is not taxable as capital investment income pursuant to Section 20 (1) no. 7 of the German Income Tax Act (ITA). The reversal of a loan agreement revoked by the borrower (prior to the applicability of Section 357a (3) sentence 1 of the German Civil Code (BGB)in the version at the time; now Section 357b) is not a taxable event. From an economic point of view the obligation for restitution is to be viewed as a whole for income tax purposes, which is why the resulting individual (single) claims could not be part of a taxable gain. The sole intention under the claim for restitution is for reversal of the original contract and the exchange of services agreed at the time.

It is for that reason that the compensation was also not taxable as other income (Section 22 no. 3 ITA). This is because – when taking the uniform approach - the individual payments received following the reversal of the loan agreement were not incurred in the context of generating income. This would be different if the mutual services rendered not only result in the reversal of the original contract, but also served other purposes. Whether this is the case must be determined by the tax court of first instance based on the circumstances of the individual case.

If the given condition is that of a true transaction for reversal, it is irrelevant whether the reversal was carried out by mutual agreement, by settlement, by civil court judgment or in any other way.

Reference:

Supreme Tax Court, judgment of 7 November 2023 (VIII R 7/21), published on 21 March 2024.

Keywords

capital investment income, compensation payment, loan