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Full income tax deduction for shareholder loan write-off

The Supreme Tax Court has held that the write-off of a shareholder loan held as a business asset is fully deductible by the income taxpaying holder even if the loan is to be seen as a substitute for share capital

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The Income Tax Act contains no provision corresponding to the Corporation Tax Act exclusion of bad debt losses of shareholders with more than 25% on their claims on the company. The Supreme Tax Court has just ruled on two cases brought by natural person shareholders faced with a partial refusal of the tax office to allow them a deduction of their write-offs of company debt held as business assets.

In the first case, the shareholder had originally granted his company a loan at a market rate of interest. The company fell on difficult times later and the shareholder agreed to reduce the interest to a purely nominal amount until the company had returned to profitability. Profits did not, however, materialise and two years later the shareholder was forced to put part of his claim for repayment of the principal into abeyance in order to prevent insolvency. The tax office agreed that the amount concerned should be regarded as a bad debt, but maintained that this bad debt had been incurred by the shareholder acting for the protection of his investment in the share capital and that the tax deduction for the write-down should be limited to the proportion in which the dividend income from the holding would be charged to income tax (currently 60%). It based this contention on the low interest now being earned on the loan, leaving the dividend expectation as the shareholder's sole remaining hope of earning income at some point in the future. It also pointed out that the loan was effectively a substitute for share capital and had thus been allowed to remain outstanding by the creditor acting as a shareholder.

The Supreme Tax Court found, however, in favour of the taxpayer. A shareholding was a different type of asset than a debt, and the write-off was of a debt. The write-off, as such, did not improve the company's earning capacity and would not therefore lead to improved dividends in the future. As a secondary point, the court pointed out that the provisions in the agreement for returning to the old interest rate, and for restoring the original amount of the principal, once the business had recovered, suggested a continued intention to treat the debt as such and to earn from it interest rather than a dividend. Lastly, the court made the point that a write-back of the loan, should its value improve, would be fully taxable income so it would be inconsistent to allow only a partial deduction of the expense. For the tax office' suggestion – supported by a finance ministry decree – that both income and expense should be taken into account in the "dividend proportion" of 60% there was no basis in law.

In a second case, the court extended the principle to cover the write-off of a recovery claim on the company from having met a guarantee claim as shareholder as well as a provision for the expected cost of meeting a further guarantee. In both cases the court emphasised that its findings applied regardless of whether the transactions had been at arm's length, and regardless of their motivation from shareholder considerations.

Supreme Tax Court judgments X R 7/10 (loan) and X R 5/10 (guarantee) of April 18, 2012 published on July 4

Schlagwörter

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