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Subordinated debt not a liability whilst debtor’s liabilities exceed assets

The Supreme Tax Court has followed its previous case law in holding that a company financed by subordinated shareholder loans may not take up a liability until the conditions for repayment are met. However, the subordination is a shareholder’s capital contribution to be taken to capital reserve rather than income to the extent the debt had value as an asset at the time.

A company with a negative net shareholder's equity was largely financed by shareholder loans. In order to avoid opening insolvency proceedings, the (sole) shareholder agreed to subordinate the debt to the claims of all other creditors. In particular, the debt could only be serviced from future annual profits or liquidation surplus. Because these terms meant that the debt could only be repaid on the occurrence of a future event, it could not be taken up as a present liability. The existing balance should therefore be written back to income in the year of subordination. In this, the Supreme Tax Court has followed its existing case law.

However, the court has now added a new facet to the calculation. Insofar as the subordinated loan had a market value, the subordination – given that it followed from a shareholder acting as such – should be seen as a (tax-free) capital contribution, rather than as an item of net income. The income from the release of the liability should be reduced accordingly.

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Keywords

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