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German Tax and Legal News

Local tax court rules on subordination-of-claims agreement

The Local Tax Court of Lower Saxony ruled on 12 June 2014 (6 K 324/12) that a subordination-of-claims agreement does not lead to de-recognition of a loan liability in the debtor's tax balance sheet where the agreement specifically refers to repayment in the case of "retained earnings."

Under German income tax law, a loan liability must be "de-recognized" (i.e. released) in the debtor's tax balance sheet if the loan agreement (or side letters) contain a provision indicating that the repayment of the loan is dependent on whether the debtor realizes future profits/revenue. De-recognition of a loan generally triggers taxable income at the level of the debtor.

A similar provision often is included in subordination-of-claims agreements under which the creditor and debtor try to avoid the debtor's over-indebtedness from an insolvency law perspective. According to official guidance issued by the tax authorities, de-recognition need not be carried out where the subordination-of-claims-agreement specifically refers to "other available assets" as a means for repayment.

The case before the Local Tax Court of Lower Saxony involved a subordination-of-claims agreement under which the debtor was required to repay the loan only in the case of future "retained earnings." The agreement did not include a reference to "other available assets."

The tax authorities took the position that the loan liability should be de-recognized in the debtor's tax balance sheet because the wording of the agreement implied only a profit-related repayment, and that a reference to "other available assets" was not included.

The tax court denied the de-recognition of the loan liability and referred to the broader definition of the term "retained earnings" under German GAAP rules. Under such rules, "retained earnings" include not only future profits, but also include withdrawals from capital or revenue reserves. The court held that the repayment consequently was not dependent only on future profits, but also depended on other, non-profit-related items, such as withdrawals from capital reserves.

The decision of the Local Tax Court provides welcome clarification of when de-recognition of loan liabilities must be carried out for income tax purposes, but also illustrates that the wording of subordination-of-claims agreements must be chosen carefully and is of upmost importance in order to decide whether a de-recognition has to take place. The tax authorities are expected to appeal the decision to the Federal Tax Court.

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