Question marks on capital – Is nothing what it seems?

This issue of our newsletter might just as well be entitled "Exclamation Marks", since herein we are drawing attention primarily to practical issues relating to capital requirements as well as to relevant legislative changes. The current issue is also unusual in that it deals with company law questions rather than those for accounting, which may, however, have serious taxation and accounting consequences.

In the May 2012 issue of our newsletter on a similar subject matter we summarised the options of capital replenishment based on the legal regulations valid at that time. However, legislative amendments have not left this field unchanged either. Focusing on the amendments it is therefore worthwhile considering the obligations and options we have if our company's equity decreases by more than the desired amount, or we want to raise capital for other reasons.

Minimum registered capital of limited liability companies HUF 3 million once again

The new Hungarian Civil Code, which sets a higher capital requirement for limited liability companies, has been in force since 15 March 2014. No need to worry though, as it is not too late to raise funds, because transitional provisions provide for a 2-year grace period – in an optimal scenario. Why in an optimal scenario? This 2-year grace period only applies if the company does not intend to amend its deed of foundation in the meantime so that the provisions of the new Civil Code are included. Because if it does, the capital increase also has to be addressed.

What exactly does raising capital mean? Is it sufficient to decide on raising capital by the legislative deadline then apply to the Court of Registration for the change to be registered before the statutory deadline? What deadline should be set for paying the consideration for the capital increase? Should the transitional provisions of the Civil Code perhaps be understood that not only must the decision be made by the given deadline, but should the consideration also be paid?

Supplementary payments using owner loans

In the above section we referred to the provisions of the new Civil Code that may be attractive for companies. Such provisions include the options for supplementary payments for example. According to the new regulation, supplementary payments may also be made through in-kind contributions. This could be a good solution if the owner does not have the cash funds necessary for such purpose.

Many companies provide a substantial amount of owner loans to operate smoothly. This raises the question of whether supplementary payments can be made using receivables from owner loans. If so, then what value can be defined as an in-kind contribution? Can the carrying amount of the receivable be fully regarded as a supplementary payment? Since there is no set practice in this context yet, supplementary payments using owner loans may represent a considerable tax risk. The risk is that, pursuant to the Act on Accounting, supplementary payments can be recognised directly in equity by the receiving party, whereas they must be recognised in profit or loss if the tax authority reclassifies the supplementary payments as a forgiven liability.

In practice we find that the tax authority regularly questions the actual content of the transaction, and suggests treating it as a forgiven liability in similar circumstances upon the in-kind contribution of the owner's receivable. Of course, if the company can be *"enriched"* through profit or loss with the carrying amount of the liability, is it unclear why this same value cannot be accepted as the value of the in-kind contribution recognised in capital?

This argument is even more justified if we look at the requirements of International Financial Reporting Standards (IFRS). According to IFRS, if a company settles a bank loan by issuing equity instruments (i.e. the bank loan is converted into equity), then the fair value of the equity instruments transferred to settle the loan liability, or in lieu of this the fair value of the settled loan obligation (the value at which somebody would have assumed the given liability) must be recognised as a capital increase.

Looking at supplementary payments, there are uncertainties in terms of both payment and repayment:

- What should trigger the repayment of the supplementary payment received? In principle this must be set out in the original owner resolution, but these terms are often unclear or even missing. We usually become uncertain as to how

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the phrase *"no longer required"* should be interpreted. Can owners determine this at their discretion? What if the company's equity without the prior supplementary payment is sufficient to meet the capital requirements of the regulations? Does this mean it is *"no longer required"*? Does the repayment require a separate owner resolution? Should the conditions for repayment be set in an owner resolution at all?

- Can the contribution received earlier as an in-kind contribution be repaid in cash as well, or should it be settled by means of a transfer of an asset other than cash? If the company distributes the contribution by means of an asset transfer, can this involve the return of the original asset? In such cases should the market value or the carrying amount of the asset be accounted for as the repayment, or can other values be determined by the company?

Capital increase using receivables from owner loans, but when?

We cannot rest on our laurels, even if capital is planned to be raised with an in-kind contribution of owner receivables, because the aforementioned risks still apply.

Let us take a closer look at this. What other questions and problems can arise? Companies often become aware of a loss of equity when the reporting date approaches, and then the owners promptly decide to raise capital. With an in-kind contribution of receivables from owner loans they kill two birds with one stone. They can meet capital requirements on the one hand, and, if the owner loans are in foreign exchange, any exchange losses will not deteriorate further the profit or loss on the other.

In many cases the owner resolution on the capital increase is prepared in the month prior to the reporting date but the increase is only registered by the Court of Registration after the reporting date. Although the company fulfils the capital requirements in such cases, the capital increase can only be accounted for and the receivables received as an in-kind contribution can only be offset with the liability to the owner after the reporting date. So if your aim is not only to comply with the legislation but also to eliminate the liability to the owner from the financial statements on the reporting date, you should arrange the capital settlement in time.

Voluntary liquidation with substantial owner loans

Companies under voluntary liquidation face risks similar to those mentioned in relation to supplementary payments when there are significant liabilities to their owners but no liquidation procedure is launched, claiming that in the worst-case scenario the owner does not receive the originally invested capital back. It seems the tax authority takes a different stance, even expressing this in a guideline which summarises the important information relating to voluntary liquidation.

"Voluntary liquidation procedures may not be completed as long as the company has a recognised receivable or debt not covered in an asset distribution resolution. Based on this, if the taxpayer's books contain a so-called member loan liability upon completion of the voluntary liquidation the taxpayer must repay it or, if this is impossible, then arrange for the settlement of the liability by other means.

If the debt is not repaid but the asset distribution proposal provides for the debt to be forgiven, it must be recognised under extraordinary income. Forgiving the liability qualifies as a gift, for which a property acquisition duty shall also be paid by the taxpayer.[1]"

Thus the tax authority does not enable the owner to provide its owner loan receivable as a non-cash contribution during the voluntary liquidation period in the form of a supplementary payment or in-kind contribution. This opinion quickly spread among professionals as demonstrated by question No. 20/2015/3 in the March 2015 issue of the *"SZAKma"* journal published under the auspices of the Ministry for National Economy, the Hungarian Chamber of Auditors and the Association of Hungarian Accounting Professionals. It is therefore definitely worthwhile considering how the given situation can be handled in the most optimal way before the voluntary liquidation procedure is launched.

Option of disregarding unrealised exchange rate losses no longer available

After 31 May 2014, companies may no longer disregard unrealised foreign exchange rate losses recognised in 2011 and 2012 when there is an equity deficit, as was enabled by the transitional provision of the old Act on Business Associations.

If a company avoided the consequences of a capital loss (capital replenishment, transformation, dissolution, etc.) by applying this regulation, then a decision to resolve the situation can no longer be deferred.

Postscript

This newsletter is not designed to reveal every possible issue that may arise in connection with the various topics outlined. If you expect to encounter a situation similar to the above, we recommend you contact your legal, tax or accounting advisor, or us, as soon as possible because you could end up skating on thin ice by applying an ill-timed solution adopted with undue care.

1 http://nav.gov.hu//data/cms357036/60._szamu_informacios_fuzet_Vegelszamolas_2015_06_ho_vegleges_(3).pdf

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