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No bad debt deduction on tax-free sale of shares

The Supreme Tax Court has held that irrecoverable proceeds from the tax-free sale of shares reduce the tax-free gain and are not a deductible bad debt.

A GmbH sold shares in its Mexican subsidiary at a substantial profit. This gain was tax-free. Later, most of the proceeds proved to be irrecoverable and the seller was forced to take up an even larger bad debt. He claimed a deduction for this loss on the grounds that it was separate from the gain, not having been incurred until a later year and then for reasons unconnected with the sale of the shares. The tax office refused on the grounds that the two events were interlinked and should be treated alike. There is a wealth of professional literature on the subject, most of which tends to the view that there should be no deduction for the loss of tax-free income, though there are voices calling for the approach taken by the taxpayer.

The Supreme Tax Court has now held that the bad debt and the tax-free gain are part of the same transaction. The net gain is based on the proceeds finally received by the seller, without regard to the reasons for any departure from the contract. Thus, the tax-free gain is to be adjusted with any later sales price adjustments - this is consistent with a Supreme Tax Court ruling on a comparable provision in the Income Tax Act - and there is no reason to treat a loss from the buyer's default any differently. Rather, all aspects of the transaction - including the 5% add-back to taxable income for deemed effectively connected expenses - should be treated consistently. The transaction ends with the receipt - or write-off - of the consideration.

Keywords

bad debt, capital gain