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By PwC Deutschland | 05 April 2011

Restrictions on write-offs of receivables from foreign related parties

The finance ministry has reacted to a Supreme Tax Court case allowing a write-down on a receivable from a domestic subsidiary with a decree to the effect that an unsecured loan to a foreign related party would not generally be at arm's length.

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From 2008 onwards, the Corporation Tax Act excludes a tax deduction for the write-off of related-party receivables (common shareholding of more than 25%) unless the taxpayer can show that an independent third-party in similar circumstances would also have allowed the debt to remain outstanding. There was no such explicit exclusion prior thereto. In 2009, the Supreme Tax Court held in a case based on earlier circumstances, that a troubled loan to an under-capitalised subsidiary could be written down with tax effect for want of an express prohibition. The finance ministry has now reacted with a decree pointing out that the Foreign Tax Act provides for income adjustment in respect of transactions with foreign related parties that were other than at arm's length. The ministry concludes from this that a bad debt loss on a receivable from a foreign related party is only allowable where the taxpayer can show that a third-party would not have taken steps beforehand to recover or secure the outstanding. It suggests that this could be the case where it was clearly in the business interests of the lender not to pursue vigorously debt recovery in order to maintain trading relationships. However, it offers no other examples of an acceptable write-down.

The ministry's reasoning is based on the arm's length requirement of the Foreign Tax Act. This includes adequate security for a related party debt. Adequate security can, however, be seen in overall group support to enable a subsidiary to meet its debts as they fall due. Accordingly, no charge can be made for enhanced risk of default within a group. On the other hand, a default, itself, demonstrates the failure of that support. Hence the debt would have arisen, or been allowed to remain, in other than arm's length circumstances. Its write-off is therefore *per se* disallowable. In effect, the ministry is seeking to apply the present, 2008, prohibition on related-party bad debt losses to write-downs of foreign related-party debt in all years still open.

Keywords

bad debt, foreign related parties