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By PwC Deutschland | 18 June 2014

Tax-free gains on sale of shares are net of direct costs of sale

The Supreme Tax Court has held that the tax-free gain on the sale of shares is net of direct costs of sale. The additional disallowance of 5% of the tax-free amount is to cover indirect costs.

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The gain on the sale of shares held by a corporation is tax-free. The gain is defined as the excess of the net proceeds over the base cost (usually, the book value). The net proceeds of sale are after deduction of the selling expenses. An amount equivalent to 5% of the tax-free income is also disallowed. The Supreme Tax Court has heard two cases querying the apparent conflict between the two effective disallowances of costs and also querying the classification of costs as direct selling expenses.

Deducting expenses from tax-free income effectively disallows them. If an amount equivalent to 5% of the tax-free income is also disallowed, the disallowance is effectively doubled, so the sellers. The court, however, held that the disallowance is not doubled. Rather, the exemption of the net gain disallows the direct selling costs, whilst the 5% rule covers the indirect costs of sale that are not specifically identifiable. This rule is general and therefore may not accurately reflect the circumstances in a given case. However, this does not invalidate it as long as its application continues to be reasonable overall.

In the first case, the court held that legal and professional costs incurred in the sale of a subsidiary were direct costs of sale reducing the tax-free gain. However, a bonus paid to a managing director on the occasion of the sale as a reward for long service to the group was not necessarily so. It could be a delayed reward for past service, or it could be, in this case and given a close family relationship, a hidden distribution of profits. That question of fact was referred back to the lower court.

The second case was brought by a company that had speculated in shares on the stock market as a sideline. It hedged its risks with forward contracts in share certificates, but miscalculated its hedges. In the event, its hedging costs exceeded its gains. The tax office saw the two sets of transactions as interlinked and disallowed the net loss. The company saw them as separate and claimed exemption for the gains and a tax deduction for the costs. The court sided with the tax office on the grounds that though the costs arose from legally separate transactions, they would not have been incurred without the speculations. Their only purpose was to contain the risk and therefore the two were economically inseparable.

Supreme Tax Court cases I R 45/13 of March 12, 2014 (costs of sale and golden handshake) and I R 52/12 of April 9, 2014 (hedging costs), both published on June 18

Keywords

Sale of shares, direct costs of sale, tax-free gain