

## **The Current Status of Deductions for Losses Arising from the Sale of Subsidiary Shares (Corporate Tax Law Article 5/1-e Exemption)**

### **I. Introduction**

As is well known, Article 5, paragraph 1, subparagraph (e) of the Corporate Tax Law No. 5520<sup>1</sup> (KVK) provides that:

*“Seventy-five percent (75%) of the income derived from the sale of subsidiary shares held in the company’s assets for at least two full years, as well as founder’s shares, usufruct rights, pre-emptive rights, and participation units of investment funds generating exempt income under subparagraph (a) of this paragraph, are exempt from corporate tax” (as amended by Article 89 of Law No. 7061, dated 28 November 2017).*

Furthermore, paragraph 3 of the same article states:

*“Expenses related to income exempt from corporate tax or losses arising from activities within the scope of the exemption may not be deducted from taxable corporate income. However, financing expenses associated with the acquisition of subsidiary shares, including those incurred following transfer transactions performed under Article 19 of this Law, may be deducted from corporate income” (as amended by Article 20 of Law No. 7440, dated 9 March 2023).*

Notably, while the law explicitly regulates income and expenses associated with the sale of subsidiary shares, it does not contain any provision addressing the treatment of losses incurred from such sales. This legislative gap has given rise to prolonged debates and inconsistencies in judicial rulings over the years.

This article evaluates the current legal and practical status of whether losses arising from the sale of subsidiary shares can be deducted from the corporate tax base. Specific cases involving adjustments for inflation are excluded from the scope of this discussion.

### **II. Current Status of Private Rulings and Judicial Precedents on the Deductibility of Losses Arising from the Sale of Subsidiary Shares**

**The Revenue Administration (Gelir İdaresi Başkanlığı)**, in a private ruling dated 23 August 2007, briefly expressed the view that the entirety of the losses arising from the sale of subsidiary shares resulting in a loss could be considered in determining corporate income. However, in subsequent private rulings, an opposite stance has been adopted, suggesting that such losses may not be deductible.

Yet, as emphasized in decisions of the Constitutional Court, taxation practices based on administrative changes in interpretation that are not founded on legislative amendments are in clear violation of the principles of legal certainty and clarity, which are integral to the constitutional state and the principle of legality of taxation.

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<sup>1</sup> Official Gazette dated 21 June 2006, No. 26205.

## **Judicial Precedents: Divergences Between Chamber Decisions and VDDK Rulings**

Upon examining the judicial precedents, it becomes evident that a long-standing divergence exists between the decisions of the Chambers of the Council of State and those of the Tax Litigation Chambers Board (VDDK).

### **For instance:**

**In the decisions of the 3<sup>rd</sup> Chamber of the Council of State<sup>2</sup>**, it has been consistently held that losses arising from the sale of subsidiary shares essentially stem from the commercial enterprise's failure to generate profit and can therefore be treated as deductible expenses.

**Similarly, the 4<sup>th</sup> Chamber**, in its limited number of decisions, has adopted the same position. Below is an excerpt from one such decision in favour of the taxpayer:

*“From the examination of the case file, it appears that the plaintiff company initiated the present case to challenge the assessment of TRY 588,227 in corporate tax, imposed based on an excess tax base resulting from the disallowance of a loss recorded in the 2010 corporate tax return submitted with a reservation. This loss arose following the removal of the subsidiary shares from the plaintiff's assets due to the liquidation of the subsidiary in 2010. The tax authority justified the disallowance of this loss as a non-deductible expense on the grounds that the loss resulted from the liquidation of the subsidiary.*

*The subsidiary company named ‘F1,’ affiliated with the plaintiff, was liquidated in 2010. As a result of the legal dissolution of the subsidiary, a loss was recorded in the plaintiff's ‘subsidiary accounts’ equivalent to the acquisition cost of the shares and the additional amounts paid to fulfil the subsidiary's capital obligations. In other words, the complete devaluation of these shares registered as assets caused a proportional reduction in the company's equity. Recognising such losses as deductible aligns with the provisions of the applicable legislation.*

*Under these circumstances, the loss incurred due to the liquidation of the subsidiary company in 2010 should be considered a deductible expense. The assessment of TRY 588,227 in corporate tax, based on the disallowance of this loss as a non-deductible expense in the tax return submitted with a reservation, is legally unjustified. Therefore, the court decision rejecting the cancellation of this assessment lacks legal conformity.*

*For this reason, the appeal request is accepted...”<sup>3</sup>*

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<sup>2</sup> Council of State, 3<sup>rd</sup> Chamber, Case No. 2016/5196, Decision No. 2018/3577, Date: 26 June 2018; Council of State, 3<sup>rd</sup> Chamber, Case No. 2020/4659, Decision No. 2023/1500, Date: 27 April 2023; Council of State, 3<sup>rd</sup> Chamber, Case No. 2020/1429, Decision No. 2023/1501, Date: 27 April 2023. (Lexpera, Accessed: 20 November 2024)

<sup>3</sup> Council of State, 4<sup>th</sup> Chamber, Case No. 2012/6305, Decision No. 2016/1337, Date: 30 March 2016. (Lexpera, Accessed: 20 November 2024)

**The 9<sup>th</sup> Chamber** has also issued a limited number of decisions in favour of taxpayers. Below is a relevant excerpt from one of these decisions:

*“For corporate tax taxpayers, it is necessary to consider collectively the provisions on deductible expenses set forth in Article 8 of the Corporate Tax Law and other laws that regulate expense deductions. Accordingly, whether an expense can be deducted in determining taxable commercial income depends on whether it is specified in Article 40 of the Income Tax Law, Article 8 of the Corporate Tax Law, or in specific regulations.*

*Based on these provisions, to determine whether expenses not explicitly mentioned as deductible or non-deductible in the legislation may be recorded as expenses, it is crucial to evaluate whether the expenses constitute a cost element and whether they are incurred to generate and sustain commercial income. The most significant criterion for determining whether an expense is business-related is whether the corporation has borne the expense. Conversely, to establish that an expense is not business-related, it must be shown that the expense is unrelated to the business activities and is personal in nature, incurred by the corporate officers for private purposes.*

*As is well known, for any corporation, income earned in return for participation in the capital of another corporation is referred to as ‘subsidiary income.’ The account where shares or partnership interests acquired for the purpose of participating directly or indirectly in the management and policymaking of other companies are tracked is called the ‘subsidiary account.’ Today, such relationships between companies are common, and it is evident that expenses incurred for such transactions are related to commercial activities.*

*In the case at hand, due to the legal dissolution and liquidation of the subsidiary company, the cost of shares recorded under the plaintiff company’s subsidiary account and the amount of uncollectible receivables resulted in a loss. In other words, the devaluation of the shares recorded in the company’s assets caused a proportional reduction in the company’s equity. Recognising this as a loss aligns with the provisions of the applicable legislation.*

*Consequently, as there is no legal inconsistency in treating the loss arising from the liquidation of the plaintiff company’s subsidiary shares in 2014 as a deductible expense, the assessment imposed based on the additional tax declared in the corporate tax return submitted with a reservation should have been cancelled. Therefore, the Tax Court’s decision rejecting this claim is erroneous.*

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*For the aforementioned reasons, the plaintiff’s appeal is accepted...”<sup>4</sup>*

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<sup>4</sup> Council of State, 9<sup>th</sup> Chamber, Case No. 2016/20721, Decision No. 2019/6986, Date: 16 December 2019. (Lexpera, Accessed: 20 November 2024)

However, the decisions of the 4<sup>th</sup> Chamber<sup>5</sup> have predominantly been against taxpayers, and the 9<sup>th</sup> Chamber has also started to render decisions unfavourable to taxpayers.<sup>6</sup>

In a decision<sup>7</sup> that we were able to identify from the Council of State's Tax Litigation Chambers Board (VDDK), an interpretation in favour of the taxpayer was adopted. However, in four more recent decisions,<sup>8</sup> the VDDK ruled against taxpayers, with two dissenting opinions recorded. To better understand the underlying reasons for this dispute, we have attempted to outline below the key interpretive differences between the judicial authorities and the members of the VDDK.

### Decisions in Favour of Taxpayers

In decisions that favour taxpayers, the reasoning generally includes the following points:

- The law imposes certain conditions for benefiting from the subsidiary income exemption, indicating that the exemption is not absolute but conditional and discretionary.
- Taxpayers, even if they meet all the conditions for the exemption, may choose not to claim the exemption due to their subjective circumstances.
- In such cases, it is not acceptable to assume that taxpayers must necessarily benefit from the exemption.
- Furthermore, the law contains no provision preventing the deduction of losses from taxable corporate income in cases of a loss-making sale.
- Therefore, there is no legal inconsistency in treating the entirety of the loss arising from such sales as a deductible expense when determining the corporate tax base.

### Decisions Against Taxpayers

Conversely, decisions that rule against taxpayers typically argue:

- Within the general framework of taxation, losses from transactions that are not subject to income taxation cannot be treated as deductible expenses when determining the tax base.
- Since 75% of the gains arising from the sale of subsidiary shares, usufruct rights, and pre-emptive rights held for at least two full years by corporations are exempt under the Corporate Tax Law, Article 5, the Board concludes that, in the case of a loss arising from such activities, 75% of the loss cannot be deducted from the taxable corporate income, as per the final paragraph of Article 5.

## III. Proposed Solution to Address the Divergence in Practice

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<sup>5</sup> Council of State, 4<sup>th</sup> Chamber, Case No. 2014/4680, Decision No. 2018/4570, Date: 15 May 2018; Council of State, 4<sup>th</sup> Chamber, Case No. 2021/1506, Decision No. 2023/1340, Date: 13 March 2023. (Lexpera, Accessed: 20 November 2024)

<sup>6</sup> Council of State, 9<sup>th</sup> Chamber, Case No. 2018/630, Decision No. 2021/4957, Date: 21 October 2021. (Lexpera, Accessed: 20 November 2024)

<sup>7</sup> Tax Litigation Chambers Board (VDDK), Case No. 2021/609, Decision No. 2023/142, Date: 8 March 2023. (Lexpera, Accessed: 21 November 2024)

<sup>8</sup> Tax Litigation Chambers Board (VDDK), Case No. 2022/865, Decision No. 2024/134, Date: 6 March 2024; Tax Litigation Chambers Board (VDDK), Case No. 2022/866, Decision No. 2024/135, Date: 6 March 2024; Tax Litigation Chambers Board (VDDK), Case No. 2022/864, Decision No. 2024/133, Date: 6 March 2024; Tax Litigation Chambers Board (VDDK), Case No. 2022/867, Decision No. 2024/136, Date: 6 March 2024. (Lexpera, Accessed: 21 November 2024)

As mentioned in the previous section of this article, while the decisions of the 3<sup>rd</sup> Chamber (despite dissenting opinions) have long demonstrated consistent support for taxpayers, it is clear that there is no consistency within the jurisprudence of the now-defunct 4<sup>th</sup> Chamber and the active 9<sup>th</sup> Chamber. Additionally, their rulings conflict with those of the 3<sup>rd</sup> Chamber, and contradictions are also evident among the decisions of the Tax Litigation Chambers Board (VDDK).

As is well known, conflicting rulings on the same issue by Higher Judicial Bodies are considered a violation of the right to a fair trial under both the Turkish Constitutional Court and the European Court of Human Rights.

Therefore, in response to the four VDDK decisions cited above, which are unfavourable to taxpayers, we have petitioned both the VDDK and the Presidency of the Council of State **to resolve these inconsistencies in jurisprudence through a Unification of Judgments Decision.**

Considering that only two dissenting opinions were recorded in the VDDK rulings, it can be said that the likelihood of a unification decision being issued against taxpayers is high.

Even if a ruling in favour of taxpayers is issued, it remains uncertain whether this will subsequently lead to the enactment of legislation that would disadvantage taxpayers.

For example, in the case challenging the validity of the provisions introduced by the General Communiqué on VAT Implementation, published in the Official Gazette on 26 April 2014, which included exchange rate differences in the VAT base under Article 24/c of the VAT Law, the 4<sup>th</sup> Chamber's ruling dismissing the challenge was overturned by the VDDK on 13 December 2017 (Case No. 2017/548, Decision No. 2017/606) with a 6-7 majority. Subsequently, the 4<sup>th</sup> Chamber complied with the overturning decision, annulling the provision with its decision dated 13 March 2019 (Case No. 2018/6584, Decision No. 2019/1881). The VDDK later unanimously upheld this annulment in its ruling dated 23 October 2019 (Case No. 2019/902, Decision No. 2019/707) (Private Archive).

However, shortly thereafter, Article 18 of Law No. 7161, enacted on 17 January 2019, amended Article 24/c of the VAT Law by adding the term “exchange rate differences” immediately following the phrase “price differences”, ultimately resolving the issue against taxpayers.

#### **IV. Conclusion**

The existence of jurisprudential inconsistencies regarding whether losses incurred from the sale of subsidiary shares held in corporate assets for two years can be deducted from the corporate tax base undermines taxpayers' rights to equality and a fair trial.

We hope that a Unification of Judgments Decision favouring taxpayers will be issued on this matter and that this shift in interpretation, which has developed against taxpayers without legislative amendments, will be reversed, taking into account higher legal norms.

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### **Disclaimer**

This article is intended to provide readers with a general overview of the topic discussed. Each specific case should be assessed based on its unique circumstances.