

Improving the tax treatment of bad debts in related party financing

Discussion paper
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The Government seeks your feedback and comments on the issue outlined in this consultation paper. To assist those wishing to make a submission, questions for consultation are located at the end of each section. However, you should feel free to address any issue raised in this paper, and should not feel obliged to address every question. The information obtained through this process will inform the Government's approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

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While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

Closing date for submissions: 10 August 2012

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1. BACKGROUND

1. In the 2012-13 Budget, the Government announced that it will amend the income tax laws in relation to bad debts written-off between related parties outside of a consolidated group.
2. The measure will deny the creditor a tax deduction for a bad debt written-off, where the debtor is a related party. In addition, the corresponding gain to the debtor will be disregarded.
3. It is intended that the measure will introduce better symmetry between the tax treatments of the creditor and the borrower where they are related parties.
4. Broadly, a consolidated group comprises an Australian resident head company and its wholly-owned subsidiaries. A consolidated group is treated as a single entity for the purpose of working out the head company's income tax liability. Consequently, the bad debt and commercial debt forgiveness rules discussed above do not need apply to the members of a consolidated group.

2. OUTLINE OF CURRENT LAW

5. Legislative references are to the *Income Tax Assessment Act 1997* unless otherwise stated.

2.1 BAD DEBTS

2.1.1 Section 25-35 — specific deduction for bad debts

6. Under this provision, a taxpayer can deduct a debt (or part of a debt) that they write off as bad in an income year if:
 - it was included in the taxpayer's assessable income for the income year or an earlier income year (paragraph 23-35(1)(a)); or
 - it is in respect of money that the taxpayer lent in the ordinary course of their business of lending money (paragraph 23-35(1)(b)).
7. A deduction allowed under this provision can extend to the write-off in respect of the principal of a loan.
8. Section 25-35 lists special rules that may affect the entitlement to or the amounts of, bad debt deductions or may result in a deduction being reversed (subsection 25-35(5)). These provisions are unaffected by the proposed changes.

2.1.2 Section 8-1 — general deduction principle

9. A deduction for a bad debt that is revenue in nature may be available under the general deduction provision, even if it is not deductible under section 25-35.

10. Section 8-1 allows a deduction from a taxpayer's assessable income for any loss or outgoing to the extent that it is incurred in gaining or producing the taxpayer's assessable income, or is necessarily incurred in carrying on a business for the purpose of gaining or producing the taxpayer's assessable income. However, deductions are not allowable under section 8-1 for capital losses or outgoings.

2.2 COMMERCIAL DEBT FORGIVENESS

11. Section 245-10 defines a commercial debt as being a debt which:
 - bears interest and the interest is deductible;
 - does not bear interest, but had it been interest bearing, that interest would have been deductible; or
 - is interest or an amount mentioned in the first two dot points, that could have been deducted by you but for the operation of a provision of the Income Tax Act.
12. For the purposes of the commercial debt forgiveness rules, Subdivision 245-B provides that a debt is forgiven if and when:
 - the debtor's obligation to pay the debt is released or waived, or is otherwise extinguished other than by repaying the debt in full;
 - the period within which the creditor is entitled to sue for the recovery of the debt ends, because of the operation of a statute of limitations, without the debt having been paid;
 - the debt is assigned by the creditor to a new creditor under an arrangement where:
 - either the new creditor is an associate of the debtor or the assignment occurred under an arrangement to which the new creditor and debtor were parties; and
 - the right to receive payment of the debt was not acquired by the new creditor in the ordinary course of trading in a place where offers to sell, buy or exchange securities are made;
 - the creditor subscribes for shares in the borrower company in order to enable to borrow to make payment towards the discharge of a debt the borrower company owes to the creditor to the extent the borrower applies any of the money subscribed towards the payment of the debt (a debt for equity swap); or
 - the debtor and creditor enter into an arrangement where the obligation of the debt ceases at a particular future time, without the debtor incurring any financial or other obligation.
13. Where a commercial debt is forgiven, the borrower obtains an economic gain from not having to repay the loan in full.
14. The commercial debt forgiveness rules provide concessional treatment of the borrower's gain, by allowing them to offset it against current and future expenditure deductions rather than including the gain in the borrower's assessable income.

15. The gain is used to reduce expenditure in respect of an asset that you have disposed of (that would be deductible in the current or future income years), in following order:
 - tax losses from previous income years;
 - net capital losses from previous income years;
 - current or future income year deductions from expenditure in a previous year;
 - cost bases of certain Capital Gains Tax (CGT) assets.
16. The gain cannot be used to reduce expenditure in respect of an asset that you have disposed of, if a provision of the Income Tax Assessment Act includes an amount in the taxpayer's assessable income or allows them a deduction as a result of the disposal.
17. If all amounts in these four classes are reduced to zero, any remaining portion of the gain is disregarded.

2.3 DIVISION 230 — TAXATION OF FINANCIAL ARRANGEMENTS

18. Division 230 concerns the tax treatment of gains and losses from financial arrangements, where gains are generally assessable and losses are generally deductible. The provisions apply generally to large business taxpayers, managed funds, and industry and corporate superannuation funds.

2.3.1 Bad Debts

Default Tax Timing Methods

19. Where a loss is brought to account under the realisation method upon a bad debt being written off, a deduction is allowed but only in situations where the amount was taken into account in determining assessable income or where it arose in the course of a business of lending money (see subsection 230-180(3)).
20. A loss realised under such circumstances is treated as a bad debt deduction (subsection 230-180(6)) and as a result the limits in subsection 25-35(5) apply.
21. Where a loss is brought to account under the accruals method upon a bad debt being written off, a deduction is also only allowed in situations where the amount was taken into account in determining assessable income, or where it arose in the course of a business of lending money (see subsection 230-195(3)).
22. The Government also announced an intention to amend Division 230, such that where gains or losses are brought to account using the running balancing adjustment provisions of the accruals method, deductions under that method are also subject to similar bad debt provisions as under the realisation method (Item 9 of the Attachment to the then Assistant Treasurer, Senator Sherry's Media Release No. 145 of 29 June 2010).

Fair Value Method

23. Where gains or losses are brought to account under the fair value method, there are no provisions that explicitly deal with bad debts.
24. However, for tax purposes, the fair value of a financial arrangement must be determined in accordance with the applicable accounting principles, which may be, for example a standard of the Australian Accounting Standards Board (AASB).
25. AASB 139 provides that the fair value of a financial arrangement might be the quoted price in an active market (AASB 139 (48A), (AG71)). If there is no active market, one of the factors that may be considered in valuing the financial arrangement is credit risk (AASB 139 (AG79), (AG82)(b)).
26. Therefore, in either situation, if it is considered with sufficient probability that an obligation under a financial arrangement would not be satisfied — that is, it is a bad debt — the fair value of the arrangement should reflect this. This may result in the recognition of a loss.
27. Therefore, a deduction may effectively be allowed for the loss resulting from a bad debt, if the fair value method applies to the financial arrangement.

Reliance on Financial Reports Method

28. Where gains or losses are brought to account under the reliance on financial reports method, there are no provisions that explicitly deal with bad debts.
29. However, this method may only be applied to a financial arrangement if, as determined in accordance with the financial reports:
 - the overall gain or loss would be the same; and
 - the timing would reasonably be expected to be not substantially different to the timing of the gains or losses;
 - as that between the reliance on financial reports method and the result under Division 230 if that method did not apply (paragraphs 230-410(1)(e) and (f)).
30. Therefore, this implies that a deduction for a loss resulting from a bad debt is only allowed under the reliance on financial reports method if such a deduction would be allowed under the method the taxpayer would be required to apply, if it did not apply the reliance on financial reports method.

Balancing Adjustments

31. Unless a deduction for a loss resulting from a bad debt was allowable under the method applying to a financial arrangement, a balancing adjustment cannot be made upon the writing off of a bad debt, to bring such a loss to account for tax purposes (paragraph 230-440(3)(a)).

Cessation Losses

32. Where a taxpayer makes a loss from ceasing to have a financial arrangement, and it can be objectively concluded that the cessation is due to an apprehension or belief that the other party (or parties) to the financial arrangement were, or would be likely to be, unable or unwilling to discharge all their liabilities to pay amounts under the financial arrangement, the amount of the loss must be reduced to the extent that the loss is one of capital or capital in nature (see section 230-465).

Forgiveness of commercial debts

33. Where a taxpayer makes a gain from a financial arrangement from the forgiveness of a debt in accordance with the commercial debt forgiveness provisions, that gain is decreased by certain amounts (see section 230-470).
34. If the creditor and debtor companies are under common ownership, and they agree to forgo capital losses or deductions, the gain is reduced by an amount *that does not exceed* the amount that is used to offset prior capital losses and other tax attributes under the commercial debt forgiveness rules.
35. If the creditor and debtor companies are not under common ownership, the gain is reduced by the amount that is used to offset prior capital losses and other tax attributes under the commercial debt forgiveness rules.

2.3.2 Impairment losses

36. Impairment is a term that covers bad debts and doubtful debts.
37. Outside Division 230, tax deductions are not available for doubtful debts, but are available for bad debts that have been written off. Doubtful debts fall short of the circumstances that need to be established for a debt to be considered as bad.
38. Under the accruals and realisation tax timing methods in Division 230, a tax deduction may be claimed only if an impairment loss arises from a bad debt that has been written off (that is, being merely doubtful is not enough).
39. Under the fair value tax timing method, losses from impairments, including doubtful debts, may be deducted. This is where impairment results in the fair value of a financial arrangement decreasing from one income tax year to the next.
40. Therefore, if a related party lender is within the scope of Division 230 and is denied a bad debt deduction as a result of the proposed amendment, the lender could still obtain a revenue deduction, through the recognition of impairment losses under the fair value tax timing method.

3. IMPROVING THE TAX TREATMENT OF BAD DEBTS IN RELATED PARTY FINANCING

41. Currently, there is an asymmetry between the treatment of the creditor and the debtor. The creditor can be entitled to revenue deductions for a bad debt while the debtor may not have to include the debt forgiveness gain in their assessable income (although they may have reduced expenditure in respect of an asset that they have disposed of, that would be deductible in the current or future income years).

Taxation of loan interest

- Currently, for lenders, unpaid accrued interest that will not be received may be deductible (see sections 8-1 and 25-35, and Division 230) against assessable income.
- For debtors, unless a specific provision includes the unpaid accrued interest in their assessable income, the amount will be treated under the commercial debt forgiveness rules.

Taxation of loan principal

- Generally, the lender is not entitled to a tax deduction on a debt that is a principal amount, except where the debt is in respect of money that was lent in the ordinary course of the taxpayer's business of lending money (a money lender), and therefore on revenue account.
 - Similarly, for the debtor, the amount forgiven will generally not be on revenue account (except where the debtor is a money lender). The debtor's gain will be treated under the commercial debt forgiveness rules unless a specific provision includes the amount in assessable income.
42. For parties that are sufficiently related, a loss to the lender can be offset by the gain to the borrower. In these situations, given that the commercial outcome is largely neutral, the current asymmetrical tax treatment is not appropriate.
43. A better symmetry could be achieved by ensuring that related party creditors and debtors treat the unpaid accrued interest and principal amount on capital account, irrespective of whether the parties are money lenders or not. This would be closer to the symmetrical outcome achieved for related party borrowings and bad debts within a consolidated group.

3.1 RELATED PARTIES

44. As bad debt deductions are available to all taxpayers, it is not appropriate to restrict the related party rules to corporate tax entities and similar structures.
45. It is intended that the measure will apply to parties that are outside of a consolidated group, where asymmetrical treatment is not appropriate. For example:
- the creditor is a partner of the debtor;

- one party, whether the creditor or the borrower (and that party's affiliates), directly or indirectly, is able to sufficiently influence the affairs of the other party; or is entitled to acquire a majority voting interest in the other party; or
 - an entity (including the entity's affiliates) is able to sufficiently influence the affairs of the creditor and the borrower; or is entitled to acquire a majority voting interest in the creditor and the borrower.
46. The principle for this approach is to exclude immaterial relationships (for example, where a person has a very insignificant shareholding) from the scope of the measure but include situations where a party has significant ownership and control, but does not wholly-own the other party.
47. The definition of related parties is intended to include non-resident borrowers and lenders within the related party bad debt rules. The effect of this would be that a domestic creditor lending to a non-resident borrower will not be able to "bring home" foreign losses, for example, bad debts arising as a result of the global financial crisis.

Proposed changes

48. It is proposed to insert a definition of 'related party' which includes:
- an associate (defined in section 318 of the *Income Tax Assessment Act 1936*); and
 - an associated entity (defined in section 820-905).
49. The proposed definition of related parties would include non-residents.

3.2 ALIGNING CHARACTERISATION OF BAD DEBT

50. Part of the asymmetry arising in the treatment of bad debts occurs because of the policy of treating the deduction to the lender on revenue account without assessing the gain to the borrower on revenue account.
51. For bad debts written-off between related parties outside of a consolidated group, the measure aims to reduce the asymmetry by characterising both sides of the transaction the same way.

Proposed changes

52. An amendment is proposed to deny a related party creditor a tax deduction (on revenue account) for a bad debt written-off (where the debtor is a related party that is not in the same consolidated group).
53. The creditor will however, have a capital loss in respect of the written-off bad debt.
54. A further proposed amendment is to treat the corresponding gain on capital account, so that no amount of the gain is characterised as assessable income, even if the Act would do so otherwise.

55. It is also proposed to insert a provision so that the borrower's gains and the creditor's losses arise at the same time.

3.3 BAD DEBTS, IMPAIRMENT AND FORGIVENESS OF COMMERCIAL GAIN

3.3.1 Bad Debt Deduction

56. To achieve symmetry between related parties, a creditor will be denied a deduction on revenue account for writing off a bad debt where:
- the borrower is a related party; and
 - the amount that gives rise to the bad debt has not been included in the creditor's assessable income.
57. The measure effectively disregards the writing off of the bad debt, for the purposes of denying a deduction to the creditor.
58. It does not affect the creditor's ability to use a capital loss to reduce future tax attributes where that loss arises from a capital gains tax event that is triggered by the bad debt being written off.

Proposed changes

59. An amendment will be inserted so that deductions under section 8-1 and section 25-35 are denied to the creditor where:
- the borrower is a related party (either resident or non-resident); and
 - the amount that gives rise to the bad debt has not been included in the creditor's assessable income.
- A capital loss will arise in respect of the asset (or financial arrangement in the context of Division 230) instead.

3.3.2 Deduction for losses due to impairment

60. To achieve symmetry between related parties, a creditor will be denied a deduction on revenue account for losses resulting from impairment, to the extent the loss results from impairment, where:
- the borrower is a related party (either resident or non-resident); and
 - the amount that is impaired has not been included in the creditor's assessable income.

Proposed changes

61. An amendment will be inserted so that deductions under Division 230 are denied to the creditor where:
- the borrower is a related party (either resident or non-resident); and

- the amount that gives rise to the bad debt has not been included in the creditor's assessable income.
62. A capital loss will arise in respect of the asset (or financial arrangement in the context of Division 230) instead.
63. An amendment will also be inserted such that to the extent a deduction is denied for a loss resulting from impairment, a gain resulting from a reversal of the impairment will not be assessable.

3.3.3 Treatment of forgiveness gain

64. As the proposed amendment will deny a revenue deduction to the creditor, the symmetrical position would appear to be one that does not require the debtor to be assessed on revenue account. Consequently, it is intended that the commercial debt forgiveness rules in Division 245 would apply instead of provisions that would otherwise make the amount assessable.

Proposed changes

65. Division 245 will be amended to apply to an amount that is a forgiveness gain so that the amount is not assessable under another provision, except where the amount is a limited recourse debt and the debtor's taxable income has to be firstly, adjusted under Division 243.

3.4 DATE OF EFFECT

66. As announced, the proposed amendments will have effect from 7.30pm (AEST) on 8 May 2012.