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WEEKLY COMMENT: FRIDAY 7 FEBRUARY 2014

1. The *Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill* ("the Bill") was reported from the Finance and Expenditure Committee on 28 November 2013, and contains a number of changes from the rules as originally introduced on 20 May 2013. Over the past weeks I have looked at the foreign superannuation withdrawals rules and financial reporting requirements for tax purposes.

2. This week I complete my review of the Bill by looking at bad debt deductions and notional interest deductions under IFRS. These proposed changes were also discussed in *Weekly Comment* 31 May 2013 when they were introduced. There have been some significant amendments as a result of the review by the Finance and Expenditure Committee.

3. The topics covered this week are:

   (a) Bad debt deductions for holders of debt where the debt is released by law or deed;

   (b) Bad debt deduction limitations affecting dealers in financial arrangements;

   (c) Why not just rely on the financial arrangements rules and the base price adjustment;

   (d) A debt that a limited recourse arrangement relates to;

   (e) Example of how the proposed bad debt deduction limitations for dealers will operate;

   (f) Notional interest adjustments under IFRS will not have a tax effect.

Bad debt deductions for holders of debt where the debtor is released by law or deed

4. Under existing s. DB 31(1)(a), a deduction for a bad debt is denied unless the debt is written off as bad in the income year. Clause 29 of the Bill contains a proposed amendment which will relax this requirement, and allow a person a deduction for a bad debt not only if it is written of as bad in the income year, but also if:

   (a) The debtor is released from making all remaining payments under the *Insolvency Act 2006* (excluding Part 5, subparts 1 and 2), or under the *Companies Act 1993*, or under the laws of a foreign country and the person is required, under s. EW 29, to calculate a base price adjustment for the debt for the income year; or

   (b) The debtor is a company that is released from making all remaining payments by a deed or agreement of composition, and the person is required, under s. EW 29, to calculate a base price adjustment for the debt for the income year.

5. The proposed amendment will mean that a creditor can take a deduction for a debt that is a bad debt, without having written the debt off, if a debtor goes into liquidation or bankruptcy,

or when a debtor company has entered into a composition with them. A requirement for the deduction is that a base price adjustment must be performed.

6. The stated background to this amendment in the *Commentary* is that the requirement to write off a debt as bad can be unnecessarily onerous for example, for "mum and dad" investors in failed finance companies, who may not have up-to-date knowledge of the financial state of the debtor. It is highly likely that such a debt is a bad debt, so officials consider it should not be necessary to prove the debt is bad by first writing it off.

7. This amendment will apply retrospectively to a debt that went bad in the 2008-09 income year or later. Officials accepted submissions that, to ensure a fair result, the proposed change should extend to taxpayers who failed to write off the debt in time and returned income under current law in years from 2008-09. Such taxpayers will not be prevented from reopening historic positions to take advantage of the amendment.

8. Officials also agreed that, where a taxpayer has filed an income tax return prior to the date of Royal Assent, and claimed a bad debt deduction when the debt was not written off in time, that taxpayer will be entitled to access the new rules. The retrospective application date will confirm tax filing positions previously adopted, even though taxpayers who previously took such filing positions were technically non-compliant with the law when the filing positions were taken.

9. Officials declined a submission that the proposed amendments be extended to include other situations where a debt has been compromised, namely when a financial arrangement has been discharged without consideration, or has become irrevocable or unenforceable through the lapse of time. Officials considered that creditors in these situations should have adequate notice that the debtor is unable to meet their obligations in full and have sufficient time to write off the debt as bad under current rules. Moreover, such debts may not be bad debts, and the compliance criteria requiring creditors to confirm such debts are bad by writing them off should remain.

Bad debt deduction limitations affecting dealers in financial arrangements

10. Proposed amendments relating to bad debt deductions for dealers in financial arrangements are to apply from the date of introduction of the Bill: 20 May 2013:

    (a) Clause 29 contains:

        (i) New s. DB 31(4B), under which a dealer will be allowed a deduction, for a debt acquired for less than its face value, only to the extent of the consideration the dealer pays for acquiring the debt.

        (ii) New s. DB 31(4C), under which a dealer will be allowed a deduction, for a debt that a *limited recourse arrangement*, as defined in s. DB 31(5B), relates to, only to the extent to which the amount of the debt, after being limited to the consideration paid for acquiring it under the above rule in s. DB 31(4B), exceeds the consideration paid to the person under the limited recourse arrangement in relation to the debt.

        (iii) New s. DB 31(4D) under which, if the above rule in s. DB 31(4C) applies for a debt, a deduction is permitted at the time the base price adjustment is performed for the relevant limited recourse arrangement equal to the positive amount by which the consideration paid to the person exceeds the consideration paid by the person.

(b) Clause 26 contains new s. CZ 27 which provides for a claw-back, as income in the 2014-15 income year, of the amount by which previous bad debt deductions (**prior bad debt deductions**) that were claimed on a debt, from the date the dealer first acquired the debt, exceed the bad debt deductions available under proposed new sections DB 31(4B), (4C) and (5B), for a dealer who still holds, on the first day of the 2014-15 income year, a debt:

(i) Which the dealer acquired before the introduction date of the Bill; and

(ii) Which exists on the first day of the 2014-15 income year and a base price adjustment under s. EW 31 is not calculated for the debt in the 2014-15 income year or an earlier income year; and

(iii) For which the dealer has been taken, in a tax return for an income year that started before the date of introduction of the Bill, a bad debt deduction under s. DB 31 (**a prior bad debt deduction**); and

(iv) For which the prior bad debt deduction arose before the introduction day; and

(v) In relation to which the dealer does not have a dispute with the Commissioner on the introduction day for any prior bad debt deduction.

11. This amendment is explained in the *Commentary* to the Bill on page 47 as follows:

"Both original and subsequent holders of debt who carry on a business of dealing in or holding the same or similar financial arrangements will be limited to taking bad debt deductions up to the true economic loss. This means original holders will be able to take bad debt deductions up to the amount lent, and subsequent holders will be able to take bad debt deductions up to the purchase price.

Deductions for amounts greater than the economic loss will be allowed if the amounts have previously been returned as income.

As an anti-avoidance measure, a holder of debt who deals in or holds the same or similar financial arrangements will only be able to take bad debt deductions for the true money at risk. This means that if the purchase of a debt was funded by a limited recourse arrangement, a bad debt deduction will only be allowed to the extent to which the limited recourse arrangement does not relate to the debt."

Why not just rely on the financial arrangements rules and the base price adjustment

12. Officials agreed that the base price adjustment ("BPA") - a wash-up calculation that is performed when the financial arrangement comes to an end - will mean the correct tax outcome will eventually be reached under current law. However, it is the timing advantage before the BPA that officials are keen to eliminate.

13. This is also the reason for the retrospective claw-back rule to require taxpayers who have taken excess deductions (that is, deductions exceeding the cost of acquisition and any income returned), to return those amounts as income in the 2014-15 year. There is no concern with financial arrangements that have ended prior to the 2014–15 year, as the BPA that would have been performed should have squared-up any excess deductions taken. This will also be the case if the BPA is performed in the 2014-15 income year, and the claw-back will not apply in such circumstances. Officials have inserted a savings provision for taxpayers who are involved in assessments that are subject to the tax disputes process.

14. Apparently, officials considered amending the financial arrangements rules. However, they note that bad debt deductions have always been outside the financial arrangement rules for two reasons:

    (a) Firstly they apply to debts other than financial arrangements; and

    (b) Secondly, deductions for bad debts are not part of the usual income/expenditure on financial arrangements and need to be dealt with separately as bad debts.

A debt that a limited recourse arrangement relates to

15. A *limited recourse arrangement* is defined in proposed s. DB 31(5B), in relation to a debt, as an arrangement:

    (a) That is for the person's business of dealing in or holding financial arrangements; and

    (b) That provides for payment or non-payment by the person, contingent upon:

        (i) Payment of some or all the debt to the person; or

        (ii) Failure to make payment of some or all of the debt to the person.

16. Under a limited recourse arrangement the full amount of the loan does not need to be repaid. For example, Peter, a dealer in financial arrangements may have financed a loan to Paul by a loan from Mary. However, Peter only has to repay Mary the amount that Paul repays. Therefore, if Paul defaults on repayment, Peter will have no liability to Mary. Under such circumstances, the proposed new rules will deny Peter a deduction for the bad debt. However, in recognition that Peter will have income when he performs the BPA for the limited recourse loan from Mary, the proposed new rules will allow Peter an equivalent deduction at that time.

Example of how the proposed bad debt deduction limitations for dealers will operate

17. Let's consider a debt owed by Paul Company, with a face value of $100, which was purchased by Peter Company, a dealer in financial arrangements, for $75. Peter Co has financed the purchase of the debt by a limited recourse loan of $75 from Mary Company. Under the limited recourse arrangement, Peter Co only has to repay Mary Co what is repaid by Paul Co. Paul Co defaults on the entire debt in Year 1, and Peter Co writes off the debt as a bad debt in Year 1. In the following Year, Year 2, the debt is remitted by operation of law and Peter Co is required to perform a BPA under the financial arrangements rules for both the debt owed by Paul Co and the limited recourse arrangement with Mary Co.

18. In Year 1, Peter Co claims a deduction for the bad debt under s. DB 31(3). The proposed new rules will have the following effects:

    (a) New s. DB 31(4B) will limit Peter Co's deduction for a bad debt in Year 1 to $75, the amount that Peter Co paid for the debt;

    (b) New s. DB 31(4C) will further limit Peter Co's bad deduction in Year 1 to zero because the limited bad debt deduction of $75 available to Peter Co under s. DB 31(4B) does not exceed the consideration paid to Peter Co by Mary Co under the limited recourse arrangement (i.e. the amount of the debt funded by the limited recourse arrangement).

19. In the following year, Year 2 Peter Co performs BPAs for the debt owed by Paul Co and for the limited recourse loan from Mary Co. This will have the following effects:

(a) There has been no income or expenditure from the debt, so the BPA on the debt owed by Paul Co will be zero:

(Consideration paid to Peter Co – consideration paid by Peter Co) + (amount remitted)

= (0 - $75) + $75 = 0

(b) The BPA on the limited recourse arrangement with Mary Co will result in $75 of income under the financial arrangements rules:

(Consideration paid to Peter Co – consideration paid by Peter Co) = $75 – 0 = $75

(c) However, the new s. DB 31(4C) will allow Peter Co a deduction for $75 at the time the BPA on the limited recourse arrangement is performed:

(Consideration paid to Peter Co – consideration paid by Peter Co) = $75 – 0 = $75 deduction

Notional interest adjustments under IFRS will not have a tax effect

20. Effective from the 2014-15 income year onwards, further modifications to the IFRS rules, when the IFRS financial reporting method under s. EW 15D is used, will prevent notional interest or adjustments to a loan's fair value from being recognised for tax purposes:

(a) Under clause 38:

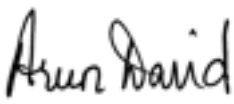
(i) New s. EW 15D(2)(ac) will mean that no interest can be recognised for tax purposes in relation to an interest-free loan; and

(ii) New s. EW 15D(2)(ad) provides that where a loan has an initial value (i.e. a fair value) that is less than the consideration initially provided (i.e. the face value) because of a concessional interest rate, the initial difference and any subsequent movements that relate solely to the initial difference, will not be recognised as an expense for tax purposes.

(b) Under clause 55, new s. EZ 69 will mean that a change of spreading method adjustment under s. EW 26(2) will apply to a loan for which notional interest was recognised in the 2013-14 income year, and for which notional interest is not allowed to be recognised from the 2014-15 income year under new s. EW 15D(2)(ac) or (ad). The change of spreading method adjustment must be undertaken in the 2014-15 income year.

21. Officials stated that the purpose of requiring the change of spreading method adjustment is to reverse any deductions a taxpayer has previously taken under an interest-free loan. Without this requirement, taxpayers will not have to reverse these deductions until the loan expires, which may not be for many years. This could provide a significant timing advantage.

22. However, officials agreed that the adjustments need only be undertaken from the 2014-15 income year onwards.



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