Inland Revenue
Te Tari Taake

DEBT FACTORING ARRANGEMENTS AND GST

PUBLIC RULING - BR Pub 00/07

This is a Public Ruling made under section 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.

This Ruling applies in respect of sections 8(1), 20(3), and 26(1).

The Arrangement to which this Ruling applies

The Arrangement is the sale, by a GST registered person (the "Assignor") on an invoice basis, to a third party ("the Factor"), on a recourse or non-recourse basis, of an outstanding debt at a price less than the debt's face value.

Debt factoring on a non-recourse basis means that the Factor has no claim back to the Assignor if the debts sold to him or her become doubtful or uncollectable (that is, the Factor assumes all of the risk). In contrast, debt factoring on a recourse basis means that the Factor has some form of claim back to the Assignor if the debts sold to him or her prove to be doubtful or uncollectable, for example under a put option at the transfer price.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- The difference between the face value of the debt and the price received from the Factor is not a bad debt for the purposes of section 26. Accordingly, section 26 has no application and the registered person cannot claim an output tax deduction under section 20(3)(a)(iii); and

- If a portion of a debt is written-off before it is sold to the Factor, then whether this write-off meets the requirements of section 26(1) depends on whether the amount written off was "bad" according to the conventional tests (outlined in public ruling BR Pub 00/03, entitled "Bad debts – writing off debts as bad for GST and income tax purposes").

The period for which this Ruling applies

This Ruling will apply to taxable periods commencing on or after 1 August 2000 to 31 July 2005.

This Ruling is signed by me on the 19th day of July 2000.

Martin Smith
General Manager (Adjudication & Rulings)

Inland Revenue
Te Tari Taake

COMMENTARY ON PUBLIC RULING BR Pub 00/07

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 00/07 (“the Ruling”).

Background

Section 26 and section 20(3)(a)(iii) of the Goods and Services Tax Act 1985 (“the Act”) allow a registered person to make a deduction from output tax if the registered person has made a taxable supply, returned output tax in respect of that taxable supply, and subsequently written off as a bad debt all or part of the debt.

If a registered person factors (i.e. sells) a debt owing for less than its face value to a third party (“the Factor”), the issue arises whether the difference between the face value of the debt and the amount received from the Factor can be an amount written off as a bad debt.

This issue was previously dealt with in PIB No 164 (August 1987) at page 27 under the heading “GST and debt collection agencies – debt factoring” and in Technical Rulings paragraph 104.9.4 under an identical heading. Those statements concluded that if a registered person accounting for GST on an invoice basis subsequently sold a debt for less than its face value, the Commissioner would allow the registered person a bad debt deduction under section 26 for the difference between the debt’s face value and the sale proceeds. The inference being that the difference between the two amounts was a bad debt.

Barber DJ in *Case T27* (1997) 18 NZTC 8,188 reached a different conclusion from that set out in PIB No 164 and Technical Rulings paragraph 104.9.4. In particular, the Taxation Review Authority (“TRA”) concluded that if a registered person factors a debt owing for less than its face value, the difference between the face value of the debt and the amount received from the Factor is not a bad debt.

The Ruling confirms that the Commissioner accepts the view of Barber DJ in *Case T27*. In particular, it is now the Commissioner’s view that if a registered person factors a debt owing for less than its face value, the difference between the face value of the debt and the amount received from the Factor is not a bad debt. Accordingly, section 26 has no application, and a registered person cannot claim a deduction from output tax under section 20(3)(a)(iii).

The Ruling changes and supersedes the earlier policy set out in PIB No 164 and Technical Rulings paragraph 104.9.4.

This issue only arises in respect of taxpayers registered for GST on an invoice basis, because taxpayers registered for GST on a payments basis are only required to return, as output tax, any payment received. However, it is noted that the Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill includes an amendment to section 26 which, if enacted, will establish parity between the two GST accounting bases. Under the amendment, a registered person who sells a debt to a third party must pay tax on

the remaining book value of the debt on the date that the debt is sold if the registered person accounts for tax payable on a payments basis.

Legislation

Section 8(1) states:

Subject to this Act, a tax, to be known as goods and services tax, shall be charged in accordance with the provisions of this Act at the rate of 12.5 percent on the supply (but not including an exempt supply) in New Zealand of goods and services, on or after the 1st day of October 1986, by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.

Section 9(1) states:

Subject to this Act, for the purposes of this Act a supply of goods and services shall be deemed to take place at the earlier of the time an invoice is issued by the supplier or the recipient or the time any payment is received by the supplier, in respect of that supply.

Section 20 states:

(1) In respect of each taxable period every registered person shall calculate the amount of tax payable by that registered person in accordance with the provisions of this section.

…

(3) Subject to this section, in calculating the amount of tax payable in respect of each taxable period, there shall be deducted from the amount of output tax of a registered person attributable to the taxable period-

(a) In the case of a registered person who is required to account for tax payable on an invoice basis pursuant to section 19 of this Act, the amount of input tax-

(i) In relation to the supply of goods and services (not being a supply of secondhand goods to which paragraph (c) of the definition of the term “input tax” in section 2(1) of this Act applies), made to that registered person during that taxable period:

(ia) In relation to the supply of secondhand goods to which paragraph (c) of the definition of the term “input tax” in section 2(1) of this Act applies, to the extent that a payment in respect of that supply has been made during that taxable period:

(ii) Invoiced or paid, whichever is the earlier, pursuant to section 12 of this Act during that taxable period:

(iii) Calculated in accordance with section 25(2)(b) or section 25(5) or section 26 of this Act; and

(b) In the case of a registered person who is required to account for tax payable on a payments basis or a hybrid basis pursuant to section 19 of this Act, the amount of input tax-

(i) In relation to the supply of goods and services made to that registered person, being a supply of goods and services which is deemed to take place pursuant to section 9(1) or section 9(3)(a) or section 9(3)(aa) or section 9(6) of this Act, to the extent that a payment in respect of that supply has been made during the taxable period:

(ii) Paid pursuant to section 12 of this Act during that taxable period:

(iii) In relation to the supply of goods and services made during that taxable period to that registered person, not being a supply of goods and services to which subparagraph (i) of this paragraph applies:

(iv) Calculated in accordance with section 25(2)(b) or section 25(5) of this Act, to the extent that a payment has been made in respect of that amount, or section 26 of this Act; …

The provision relating to bad debts is in section 26, which states:

(1) Where a registered person-

(a) Has made a taxable supply for consideration in money; and

(b) Has furnished a return in relation to the taxable period during which the output tax on the supply was attributable and has properly accounted for the output tax on that supply as required under this Act; and

(c) Has written off as a bad debt the whole or part of the consideration not paid to that person,-

that registered person shall make a deduction under section 20(3) of this Act of that portion of the amount of tax charged in relation to that supply as the amount written off as a bad debt bears to the total consideration for the supply:

…

Section 3(1) defines "financial services" as follows:

For the purposes of this Act, the term "financial services" means any one or more of the following activities:

(a) The exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise):

(b) The issue, payment, collection, or transfer of ownership of a cheque or letter of credit:

(c) The issue, allotment, drawing, acceptance, endorsement, or transfer of ownership of a debt security:

(d) The issue, allotment, or transfer of ownership of an equity security or a participatory security:

(e) Underwriting or sub-underwriting the issue of an equity security, debt security, or participatory security:

(f) The provision of credit under a credit contract:

(g) The renewal or variation of a debt security, equity security, participatory security, or credit contract:

(h) The provision, taking, variation, or release of a guarantee, indemnity, security, or bond in respect of the performance of obligations under a cheque, credit contract, equity security, debt security, or participatory security, or in respect of the activities specified in paragraphs (b) to (g) of this subsection:

(i) The provision, or transfer of ownership, of a life insurance contract or the provision of re-insurance in respect of any such contract:

(j) The provision, or transfer of ownership, of an interest in a superannuation scheme, or the management of a superannuation scheme:

(k) The provision or assignment of a futures contract through a futures exchange:

(ka) The payment or collection of any amount of interest, principal, dividend, or other amount whatever in respect of any debt security, equity security, participatory security, credit contract, contract of life insurance, superannuation scheme, or futures contract:

(l) Agreeing to do, or arranging, any of the activities specified in paragraphs (a) to (ka) of this subsection, other than advising thereon.

Application of the Legislation

Under section 26, a registered person can make a deduction under section 20(3)(a)(iii) if that person has:

- made a taxable supply for consideration; and
- furnished a return in relation to the taxable period during which the output tax on the supply was attributable and has properly accounted for the output tax on that supply as required under the Act; and
- written off as a bad debt the whole or part of the consideration not paid to that person.

The amount that may be deducted is the amount of GST charged as the amount written off bears to the total consideration for the supply. If the supply is the supply of goods under a hire purchase agreement, the first proviso to section 26 limits the deduction to the portion of the amount written off as the cash price bears to the total amount payable under the hire purchase agreement.

Further, section 26 does not apply to a registered person accounting on a payments basis under section 19 or 19A, unless either section 9(2)(b) (door to door sales) or section 9(3)(b) (hire purchase agreements) applies to the supply.

Section 26 only applies when the registered person has already accounted for GST on a supply and subsequently "Has written off as a bad debt the whole or part of the consideration not paid to that person".

If a registered person factors a debt owing for less than its face value, the issue arises whether the difference between the face value of the debt and the amount received from the Factor can be an amount "written off as a bad debt".

The Commissioner believes that the difference between the face value of the debt and the amount received from the Factor cannot be an amount written off as a bad debt under section 26. Rather than being a bad debt, the discount from face value is simply a result of the process of agreeing the consideration for the debts that is acceptable to both the Assignor and the Factor. The reasons for this view are:

1. Cases considering the meaning of bad debt focus on whether the creditor can recover the outstanding amounts owing. That is, a bad debt arises when the

creditor is unable or unlikely to recover the debt owing. If the creditor could recover the full amount owing but chooses not to (as in a debt factoring situation), any "loss" suffered by the creditor is not due to a bad debt.

2. Cases also indicate that for an amount to be written off as a bad debt, a debt must exist at the time the debt is written off. If a registered person factors a debt, no further debt exists between the registered person and debtor, and no amount can be written off as a bad debt.

In considering the second of these factors, with regard to recourse debt factoring arrangements (where the Factor has some form of claim back to the Assignor if he or she is unable to collect some of the debts purchased), it is the Commissioner's view that when a debt is sold by the Assignor on a recourse basis, the title to the debt passes to the Factor unless the Factor exercises a recourse option or right. Therefore, until the recourse is exercised and the debt is transferred back, a bad debt deduction is not available under section 26(1), as after the sale there is no debt owed to the Assignor.

However, if the Factor exercises an option or right to transfer some portion of the debt back to the Assignor after the sale then, once this has occurred, a debt exists that is owed to the Assignor that may be able to be written off by the Assignor. Whether it can be written off depends on the application of the ordinary tests for determining whether a debt is bad as noted below, under the heading "Whether the creditor can recover the amount owing".

Whether the creditor can recover the amount owing

The term "bad debt" is not defined in the Act. However, in *Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263 Tompkins J discussed the meaning of bad debt in the context of the Income Tax Act. He stated at page 12,269:

> When did the debt become bad? The term "bad debt" is not defined in the Act. It, therefore, should be given its normal commercial meaning. It is a question of fact to be determined objectively. A debt becomes a bad debt when a reasonably prudent commercial person would conclude that there is no reasonable likelihood that the debt will be paid in whole or in part by the debtor or by someone else either on behalf of the debtor or otherwise.

Case N69 (1991) 13 NZTC 3,541 also discusses the meaning of bad debt. In that case the taxpayer was a private limited liability company carrying on the business as a timber merchant. Following the receipt of a letter from one of the company's debtors, the managing director realised that there was no likelihood of recovery of a debt owing and that the debt should be written off. The taxpayer physically wrote the appropriate entries into the journal and books of the company in May 1988 to write off the debt as at 31 March 1988. The taxpayer claimed a bad debt deduction for the income year ending 31 March 1988, but this was disallowed by the TRA on the basis that the relevant journal entries had not been made by 31 March 1988. The TRA (Barber DJ) discussed the meaning of bad debt and at page 3,548 stated:

> Naturally, the debts in question must be "bad" to be written off as bad in terms of sec 106(1)(b). This is a question of fact. Generally, an application of that criterion will not be difficult as the debtor will be

insolvent. However, the debtor does not need to be insolvent for the debt to be bad. It is only necessary that there be a bona fide assessment that the debtor is unlikely to make payment of the debt. If there is a clear understanding or arrangement that there be long term credit, and if the taxpayer believes that the terms of the credit will be met, then the debt cannot be treated as bad because it is merely a situation of deferred payment. In my view, as well as the need for the writing off to be made bona fide, the circumstances must indicate to a reasonable and prudent business person, that, on the balance of probability, the debt is unlikely to be recovered. This is an objective test.

As is evident from the quotations above, different wording is used by the High Court in *Budget Rent A Car* and the TRA in *Case N69* to describe the test of when a debt can be written off as bad. To summarise these differences, in *Budget Rent A Car* the words used were "**no reasonable likelihood**" that the debt (or part of the debt) would be recovered, whereas in *Case N69* the words used were that "**on the balance of probability, the debt is unlikely to be repaid**".

The wording used in *Case N69* may appear to include two standards into the test. That is, that the debt will not be repaid "on the balance of probabilities" and that the debt is "unlikely" to be repaid. These standards are potentially conflicting as the first of them provides a lower standard than the second.

However, the Commissioner considers that the test provided by Barber DJ in *Case N69* requires that for a debt to be written off as bad it must be unlikely to be repaid. This is clear from his Honour's statement at page 3,548 of the judgment:

Even if the executives had come to a formal business decision or assessment by 31 March 1988 that the debts *were unlikely to be recovered and therefore should be written off as bad debts…* [Emphasis added]

Furthermore, the Commissioner considers that the words "no reasonable likelihood" and "unlikely" have the same meaning. Therefore, on this basis the Commissioner regards the decisions in *Budget Rent A Car* and *Case N69* as applying the same test, and both cases as authority for the conclusion that a reasonably prudent commercial person must determine that there is no reasonable likelihood of recovering a debt before it can be written off as bad.

The Commissioner prefers the wording used in *Budget Rent A Car* as this is the higher authority and this wording is supported by the way in which the High Court applied the test in *Graham* v *Commissioner of Inland Revenue* (1995) 17 NZTC 12,107. Also adopting this wording removes the risk of misinterpreting the wording of the test in *Case N69* as meaning that a debt can be written off as bad if, on the balance of probabilities, it will not be repaid.

The emphasis of the discussion above is on the **inability** of the debtor to pay due to the debtor's financial position. To reiterate, in order for a debt to be bad, the creditor must have sufficient information to enable a reasonably prudent business person to form the view that there is no reasonable likelihood that the debt will be paid.

Case T27 specifically considered the issue in respect of section 26 and debt factoring arrangements.

In *Case T27* the taxpayer sought a bad debt deduction for the difference between the amount invoiced and amount received from a debt factor, on the basis that the difference was a bad debt. The TRA determined that the debt was not a bad debt, but in actual fact a "good debt". At page 8,192 the TRA stated:

> A pivotal submission for the objector is that the discounts it allows the franchiser are bad debts which it may write off as such and, hence, claim an input tax refund for GST purposes under s 26(1) and s 20(3) of the Act. It is also pivotal to the objector's case that it has been factoring the hireage debts to its franchiser and that such process has constituted the writing off of bad debts regarding the discount.
>
> It seems to me that the provision of such a discount could not possibly constitute the incurring of a bad debt by the objector. The essence of the arrangement between the objector and the franchiser is that the hireage debt from the customer is a *good* debt, but that the objector prefers early payment of that debt and to avoid the administration process and normal risks of its recovery.

Moreover, at page 8,194 the TRA reaffirmed its view that such a debt could not be bad. The TRA stated:

> There were submissions by counsel as to whether a bad debt exists for the purposes of s 26(1) including references to case law. Counsel particularly referred to my decision in *Case N69* (1991) 13 NZTC 3,541 where I considered the wording of s 106(1)(b)(iii) of the Income Tax Act 1976 relating to the deductibility of bad debts for income tax purposes. There, I emphasised that a bad debt deduction was only available if the debt was in fact "bad" and had been actually written off. The present case is not a situation where there could be any sensible assessment that the debts (assigned by the objector to the franchiser) were, in any particular sense, bad or uncollectable or unlikely to be paid. Accordingly, the provisions of s 26(1)(c) of the Act are irrelevant to the issues before me. I appreciate that, in terms of my views in *Case N69*, the objector in the present case had made appropriate journal entries to write off the discounts as bad debts and had, no doubt, done so in good faith, but that was a quite erroneous procedure because, on any objective test, the debts were not bad.

Consistent with *Budget Rent A Car* and *Case N69*, the TRA appears to take the view that where a creditor chooses to sell a perfectly collectable debt for below its face value, no bad debt can arise. In no way can such a debt be regarded as bad or uncollectable or unlikely to be paid. Accordingly, any difference between the face value of the debt and amount actually received is due to factors other than the debt being a bad debt.

In summary, when assessing whether a bad debt exists, the cases indicate that a debt is bad when a reasonably prudent business person would have concluded, based on the information available about the debtor's ability to repay the debt, that there is no reasonable likelihood that the debt will be paid. In the absence of such a circumstance, if a registered person chooses to sell a debt for below its face value, no bad debt exists and no deduction is available under section 20(3)(a)(iii).

Finally in this regard, in response to submissions received on the first draft of the Ruling, it is useful to clarify that in the Commissioner's view when a portion of debt is written-off on the basis of experience of the collectability of similar types of debts, without investigating the likelihood of each debtor repaying the debt, the requirements of section 26(1) have not been met. This is because case law establishes that, to write-off a debt as bad under section 26(1), reasonable steps must be taken to determine whether that particular debt owed by that particular debtor is likely to be

paid (*Case P53* (1992) 14 NZTC 4370 and *Budget Rent A Car* v *C of IR* (1995) 17 NZTC 12263).

Writing-off a portion of debt on this basis involves seeking a deduction for the provision for doubtful debts. As noted in BR Pub 00/03, the GST Act does not allow a deduction for the provision for doubtful debts.

Must a debt be in existence at the time it is written off?

Case law also indicates that before an amount can be written off as a bad debt, a bad debt must be in existence at the time the amount is written off.

In *Budget Rent A Car* the taxpayer company carried on business in New Zealand as a motor vehicle rental company. A sum of money ($2,767,695.48) was owed to it by an Australian company (BRACS). In May 1989, BRACS developed financial problems and was purchased by a consortium. In July 1990, Budget Rent A Car ("Budget") entered a deed of covenant with BRACS and covenanted that it would not bring any proceedings against or prove in the liquidation of BRACS for any claim Budget might have. The debt, however, remained outstanding.

In November 1990, Budget's directors wrote off the debt owing by BRACS and claimed a bad debt deduction for the amount. The Commissioner argued that there was no bad debt and no bad debt deduction was allowed. In particular, the Commissioner argued that for there to be a bad debt, there must at the time of the write-off be a debt in existence. As any debt due by BRACS to Budget had been remitted or extinguished by the deed of covenant, no debt thereafter existed and none could be written off. Accepting the Commissioner's argument in this respect Tompkins J stated at page 12,267:

> I accept Mr Wood's submission that for a taxpayer to be entitled to deduct from its assessable income the amount of a bad debt written off, there must at the time of the write off be a debt in existence. If a debt has been effectively released, the effect is to extinguish it or put an end to its existence. Thereafter there cannot be a write off of that debt for tax purposes. This accords with the view expressed by Owen J in *Point v FC of T* 70 ACT 4021; (1970) 1 ATR 577 at ATC p 4023; ATR p 580. …
>
> The issue therefore becomes whether the parties, when they entered into the deed of covenant and in particular cl 2.1, intended to extinguish the debt. In accordance with the normal canons of contractual interpretation, this is to be determined having regard to the words the parties used, viewed in the light of the surrounding circumstances.

However, on the facts Tompkins J found that a debt did exist, and allowed Budget a bad debt deduction. The following Australian case illustrates a similar point.

In *GE Crane Sales Pty Ltd v FC of T* 71 ATC 4268 the High Court of Australia considered a claim by the taxpayer to write off certain bad debts. The Court held that it could not do so because the taxpayer was not a creditor in respect of these debts. Whereas some had been accepted in full satisfaction of a debt owing, the taxpayer's rights to recover the balance had been extinguished and it could not claim to write off as a bad debt the balance of the amount. Menzies J at page 4,272 expressed the

opinion that a taxpayer cannot write off as a bad debt an amount that is no longer a debt. Moreover, at page 4,272 he stated:

> I have therefore come to the conclusion, both as to the factored debts which were extinguished and those in which the appellant gave up any beneficial interest which it had to the receiver and manager under the scheme of arrangement, that sec. 63 does not apply because at the time the writing off occurred there did not exist, in any sense, debts owing to the appellant. To write off as bad debts amounts which are owing but which cannot be recovered is a sensible commercial exercise and one to which taxation significance is naturally enough given, but to write off a non-existent debt as a bad debt is hardly sensible commercially and, in my opinion, to do so has no significance for the purposes of sec. 63 …

Section 26 requires that the registered person "Has written off as a bad debt the whole or part of the consideration not paid to that person". Both *Budget Rent A Car* and *G E Crane Sales Pty Ltd* indicate that before a debt can be written off a debt must be in existence at the time the debt is written off. Although these cases were determined in an income tax context, the wording of section 26 makes them no less applicable for GST purposes. Accordingly, for section 26 to apply, the registered person must be able to show that at the time of writing off the debt, a debt was then in existence.

In terms of non-recourse debt factoring, at the time the debt is sold, the debt between the registered person and debtor is extinguished and replaced with a separate and distinct debt between the Factor and debtor. In such situations no debt exists at the time the amount is written off, which will be after sale of the debt. Therefore, after the sale of the debt to the Factor, no further debt exists and according to both *Budget Rent A Car Ltd* and *G E Crane Sales Pty Ltd* no amount can be written off as a bad debt.

In terms of recourse debt factoring arrangements (where the Factor has some form of claim back to the Assignor if he or she is unable to collect some of the debts purchased) when a debt is sold by the Assignor on a recourse basis, the title to the debt passes to the Factor unless the Factor exercises a recourse option or right by which the debt can be transferred back to the Assignor. Therefore, after the sale of the debt to the Factor (until the recourse is exercised and the debt is transferred back) no further debt exists, and according to both *Budget Rent A Car Ltd* and *G E Crane Sales Pty Ltd* no amount can be written off as a bad debt.

However, if the Factor exercises an option or right to transfer some portion of the debt back to the Assignor after the sale then, once this has occurred, a debt exists that is owed to the Assignor that may be able to be written off by the Assignor. Whether it can be written off depends on the application of the ordinary tests for determining whether a debt is bad as noted above, under the heading "Whether the creditor can recover the amount owing".

Writing off the debt before sale to the Factor

Several submissions received on the first draft of the Ruling noted that the issue of whether the discount to the Factor might be written off as a bad debt under section 26(1) would not arise if this amount were written off prior to the sale of the debt to the Factor.

The Commissioner agrees that this is the case. If a portion of a debt is written off before it is sold to the Factor, then whether the debt is written off as bad according to the requirements in section 26(1) depends on the application of the tests outlined in Public Ruling BR Pub 00/03 entitled "Bad debts – writing off debts as bad for GST and income tax purposes", see *Tax Information Bulletin* Vol 12, No 5 (May 2000) at page 5.