

DEBT FACTORING ARRANGEMENTS AND GST

PUBLIC RULING - BR Pub 06/01

Note (not part of ruling): This Ruling is essentially the same as Public Ruling BR Pub 00/07, previously published in *Tax Information Bulletin* Vol 12, No 8 (August 2000). BR Pub 00/07 applied from 1 August 2000 to 31 July 2005. Some minor changes have been made to the description of the arrangement in the new ruling. Some issues that were covered in the commentary to the previous ruling are now covered comprehensively in Public Ruling BR Pub 05/01 “Bad debts – writing off debts as bad for GST and income tax purposes” published in *Tax Information Bulletin* Vol 17, No 2 (March 2005). BR Pub 06/01 is to apply on 1 August 2005 for an indefinite period.

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.

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 as outlined in Public Ruling BR Pub 05/01.

The period for which this Ruling applies

This Ruling will apply on 1 August 2005 for an indefinite period.

This Ruling is signed by me on the 19th day of April 2006.

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COMMENTARY ON PUBLIC RULING BR Pub 06/01

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 06/01 (“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.

A debt can be factored either on a recourse basis or on a non-recourse basis. 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 (i.e. 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 them prove to be doubtful or uncollectible.

Debt factoring was previously dealt with in PIB No 164 (August 1987) “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.

Public Ruling BR Pub 00/07 changed and superseded the earlier policy set out in PIB No 164 and Technical Rulings paragraph 104.9.4. BR Pub 00/07 confirmed that the Commissioner accepted 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). This Ruling replaces BR Pub 00/07.

The Ruling only applies in respect of taxpayers registered for GST on an invoice basis. Under section 26A taxpayers registered for GST on a payments basis are required to pay GST on the remaining book value of a debt when it is factored. Section 26A, therefore, establishes parity between the two GST accounting bases.

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 the following:
 - (i) Input tax in relation to the supply of goods and services (not being a supply of secondhand goods to which section 3A(1)(c) of the **input tax** definition applies), made to that registered person during that taxable period:
 - (ia) Input tax in relation to the supply of secondhand goods to which section 3A(1)(c) of the **input tax** definition applies, to the extent that a payment in respect of that supply has been made during that taxable period:
 - (ii) Input tax invoiced or paid, whichever is the earlier, pursuant to section 12 of this Act during that taxable period:
 - (iii) Any amount calculated in accordance with any one of sections 25(2)(b), 25(5), 25AA(2)(b) or 25AA(3)(b); 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 the following:
 - (i) Input tax 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) Input tax paid pursuant to section 12 of this Act during that taxable period:
- (iii) Input tax 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) Any amount calculated in accordance with any one of sections 25(2)(b), 25(5), 25AA(2)(b) or 25AA(3)(b), to the extent that a payment has been made in respect of that amount, ...

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:

Provided that where goods are supplied under a hire purchase agreement, the registered person shall only make a deduction under section 20(3) of this Act of the tax fraction (being the tax fraction applicable at the time that the hire purchase agreement was entered into) of that portion of the amount written off as a bad debt as the cash price bears to the total amount payable under the hire purchase agreement:

- (1AA) Subsection (1) also applies if a registered person sells a debt to a third party and then reacquires the debt.

...

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 defined market or at arm's length if—
 - (i) The contract does not provide for the delivery of a commodity; or
 - (ii) The contract provides for the delivery of a commodity and the supply of the commodity is an exempt supply; or
 - (iii) The contract provides for the delivery of money:
- (kaa) The provision of a financial option:
- (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 same 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 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 term “bad debt” is not defined in the Act. 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 05/01 “Bad debts – writing off debts as bad for GST and income tax purposes” published in *Tax Information Bulletin* Vol 17, No 2 (March 2005).

Public Ruling BR Pub 05/01 confirms that a debt (or part of a debt) is a bad debt where:

- an existing debt is owing to the taxpayer; and
- the debt is adjudged as “bad” when a reasonably prudent commercial person would conclude that there is no reasonable likelihood that the debt will be paid; and
- the bad debt is “written off” in accordance with the accounting and record keeping systems maintained by the taxpayer.

The debt must exist

Cases indicate that before a debt can be written off, a debt must be in existence at the time the debt is written off (*Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263 and *GE Crane Sales Pty Ltd v FC of T* 71 ATC 4268). 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 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, 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 tests for determining whether a debt is bad in BR Pub 05/01.

The debt must be “bad”

When assessing whether a bad debt exists, BR Pub 05/01 indicates that a debt is bad when a reasonably prudent commercial 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).

The debt must be “written off”

BR Pub 05/01 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 05/01, the GST Act does not allow a deduction for the provision for doubtful debts.

Writing off the debt before sale to the Factor

In the past we have received submissions which 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 05/01.

In conclusion, 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:

- 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.

- 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.