

## APPENDIX C TO TIB NO.3, SEPTEMBER 1989

### EXPLANATION OF INCOME TAX TREATMENT OF BAD DEBTS SINCE THE INTRODUCTION OF ACCRUALS RULES

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## **BAD DEBT DEDUCTIONS**

### **1.0 Introduction**

1.1 This bulletin deals with bad debts in respect of the creditor, and in particular how bad debts are to be treated under the accruals regime.

### **2.0 Bad Debts outside the Accruals Regime**

2.1 Debts which do not form part of a financial arrangement are not subject to the accruals provisions of the Act. The Department has not changed its policy on such bad debts.

2.2 For a bad debt to be an allowable deduction it must be actually written off the books as such. Mere provision for bad debts is not deductible under section 106(1)(b). It is not necessary to exhaust all available legal remedies before deciding a debt is bad in whole or in part, but there must be no reasonable or probable expectation of recovery before a creditor is justified in regarding a debt or part thereof as bad. The debt must be genuinely irrecoverable at the point when the decision is made. A bad debt which is of a capital nature is not deductible under section 106(1)(a).

### **3.0 Bad Debts Within the Accruals Regime**

3.1 The accrual tax accounting regime applies to financial arrangements. Thus -

- (a) Debt that arose before the relevant implementation date; and
- (b) Debt that is an excepted financial arrangement

is not affected by the accrual tax accounting regime.

3.2 While debts generally are financial arrangements, short term trade credits are excepted financial arrangements. A short term trade credit is any debt for goods or services where payment is required by the vendor within 63 days after the supply of the goods or services (refer section 64B(1) "excepted financial arrangement", "financial arrangement", "short term trade credit" and "trade credit").

### **4.0 Relevant Legislation**

4.1 Section 64L(1) provides that where an amount of income or expenditure in respect of a financial arrangement is to be taken into account in calculating a person's assessable income, the amount (i.e. quantum) is to be calculated according to sections 64B to 64M.

4.2 A loss in the nature of a bad debt is not expenditure; it is a loss. Expenditure may have been incurred in creating the financial arrangement that is a bad debt, but in dealing with the loss we are not concerned with that expenditure directly. Thus, except to the extent that a provision in sections 64B to 64M relates to bad debt in its terms, the accrual tax accounting regime does not affect the income tax treatment of bad debts.

4.3 Excluding the concessionary provisions at sections 64F(7), (7A), (7B), 64FA and 64FB, and dealt with in T.P.C's 88/2 Part 6 paragraphs 36 - 40 and 49 - 61, and 88/2 Part 7 Sections 3 & 4, the Income Tax Act 1976 provides for bad debts suffered by providers of credit at -

- (a) Paragraph "a"(i) of the base price adjustment (bpa) in section 64F(2) in relation to the payments receivable whether received or not, including amounts remitted (this provision determines the amount taken into account in calculating the quantum of income or expenditure under sections 64B to 64M in the income year in which the financial arrangement matures or is remitted, sold or otherwise transferred); and
- (b) Section 64F(6) in relation to loss on sale (this provision determines the amount taken into account in calculating the quantum of income or expenditure under sections 64B, to 64M); and
- (c) Section 64G(1) in relation to accrued income that is not recoverable (this provision explicitly authorises a deduction); and
- (d) Section 64G(2) in relation to principal where accrued income has been derived and is not recoverable (this provision explicitly authorises a deduction); and
- (e) Section 64G(3) which allows a deduction for a loss made good by a "security payment" (this provision explicitly authorises a deduction); and
- (f) Section 77(2) in relation to capitalised mortgage interest (this provision explicitly authorises a deduction); and
- (g) Section 78 in relation to any expenditure or loss that has been taken into account in calculating assessable income and is later remitted or cancelled (this provision explicitly includes such amounts within assessable income); and
- (h) Section 106(1)(a) in relation to losses of capital (which explicitly forbids a deduction for a loss of capital, subject to the proviso that this does not affect amounts deemed to be expenditure under sections 64B to 64M); and

- (i) Section 106(1)(b) (which explicitly disallows a deduction for bad debts, except bad debts which are proved to the satisfaction of the Commissioner to have been actually written off); and
- (j) Section 188(4) (which requires an adjustment to losses carried forward where an amount is received in respect of a bad debt taken into account in calculating a loss); and
- (k) Section 233 (which explicitly authorises a deduction, but is limited in its application to certain circumstances involving the estates of deceased taxpayers).

4.4 In business the relevant provisions in the accrual tax accounting regime are likely to be

- (a) Section 64F(2)“a”(i); and
- (b) Section 64F(6); and
- (c) Section 64G(1); and
- (d) Section 64G(2); and
- (e) Section 64G(3); and
- (f) Section 106(1)(a); and
- (g) Section 106(1)(b).

5. **Examples of the Combined Application of These Provisions**

5.1

THIS IS A SUMMARY ONLY, REFERENCE TO DETAILED EXPLANATION WILL BE REQUIRED TO CONFIRM THE APPLICATION IN ANY PARTICULAR CASE

(a) Debt Forgiven

In the ordinary course of their business A advances money to B.  
A and B are not cash basis holders.

In year 1, assessable income is derived in terms of section 65(2)(jb) but no payment is receivable.

In year 2, B becomes unable to make any payment on the advance, the debt is written off and forgiven in its entirety.

A’s Position

Year 1

Assessable income calculated according to sections 64B to 64M.

Year 2

A & B are Associated Persons		A & B are not Associated Persons	
A a dealer	Not a dealer	A a dealer	Not a dealer

Income: Section 64G(1) provides a deduction for an amount equal to the income returned in year 1.

Principal: ND under bpa (see 64F(2)“a”(i)(A) & (B))

ND under accruals bad debts [64G(2)(c)]		D under 64G(2)	ND under accruals bad debts 64G(1)(a)
D under ordinary bad debts, not capital so 106(1)(a) satisfied	ND under ordinary bad debts proviso to 106(1)(a) not satisfied	D under ordinary bad debts, not capital so 106(1)(a) satisfied	ND under ordinary bad debts proviso to 106(1)(a) not satisfied

NOTE: D = Deductible; ND = Non-Deductible

(b) Debt sold

In the ordinary course of their business A advances money to B.

A and B are not cash basis holders.

In year 1, assessable income is derived in terms of section 65(2)(jb) but no payment is receivable.

In year 2, B becomes unable to make any payment on the advance, and A sells the debt for \$1 and writes off the balance.

A’s Position

Year 1

Assessable income calculated according to sections 64B to 64M.

Year 2

A & B are Associated Persons		A & B are not Associated Persons	
A a dealer	Not a dealer	A a dealer	Not a dealer

Income: Section 64G(1) provides a deduction for an amount equal to the income returned in year 1.

Principal:

D under bpa (see proviso to 64F(6)) D under 104 & Levin & co	ND under bpa 64F(6)	D under bpa proviso to 64F(6) D under 104 & 106(1)(b)	ND under bpa (64F(6))

6. **Capital Amounts that become Bad Debts - Section 106(1)(a)**

6.1 Where an amount that is capital becomes a bad debt, section 106(1)(a) forbids a deduction for the bad debt unless -

- (a) The proviso to section 106(1)(a) is satisfied; or
- (b) There is explicit provision for a deduction elsewhere in the Act.

6.2 The proviso to section 106(1)(a) excludes from the effect of section 106(1)(a) any amount that is deemed to be expenditure under sections 64B to 64M. A bad debt is a loss, not expenditure, and therefore cannot satisfy this proviso.

6.3 The other specific provisions relevant to the subject matter of this TIB item are discussed below. Some of these have the effect of turning the amount of a bad debt into expenditure, in which case the proviso to section 106(1)(a) is satisfied.

## 7. **Recognition of Bad Debts on an Accruals Basis**

7.1 Where a determination applies to a financial arrangement, the financial arrangement is to be accounted for on the basis of the determination. Unless provided for in the determination, recognition of bad debts is a separate issue.

7.2 Where the tax accounting treatment of a financial arrangement is dependent upon commercially acceptable practice (e.g. Determination G12, section 64C(3)(b), and section 64C(4)) and commercially acceptable practice is to recognise bad debts on an accruals basis, bad debts are to be recognised for tax purposes on the same basis subject to any requirement or prohibition elsewhere in the Act.

## 8. **Writing Off Bad Debts and Remission of Debt**

8.1 Remission of a financial arrangement is not the same as remission of any particular amount owing under a financial arrangement. Section 64F(1)(c) sets out the circumstances in which a debt is deemed to be remitted. It has the particular purpose of defining one of the sets of circumstances in which the base price adjustment (section 64F(2)) or cash base price adjustment (section 64F(3)) is to be performed. However this definition does not apply to the remission of any amount owing or to be paid, whether under a financial arrangement or otherwise.

8.2 When a creditor takes a deduction for a debt written off as bad, it is the Commissioner's expectation that the taxpayer will have

- (a) Made some enquiry regarding the likelihood of collecting the debt; and
- (b) Ascertained that the debt will not be collected; and

- (c) Removed the debt from the taxpayer's debtors ledger and from any calculation of total assets for financial reporting or income tax purposes during the income year in which the deduction is taken

and that the amount written off is -

- (d) Working capital of the taxpayer; or
- (e) Income derived in the current income year or a prior year.

8.3 However the taxpayer may well keep a record of the amount owing for other purposes (e.g. credit control, litigation). Having written off the debt, the taxpayer does not necessarily give up all hope of collection, and the taxpayer may pursue the debt for reasons that have more to do with a particular credit control policy than with realistic expectations of collection. In particular, the taxpayer will not necessarily forgive (i.e. remit, see section 64F(1)(c)(i)) a debt that is perceived to be uncollectable.

8.4 This is explicitly recognised in section 64F(2) in the words "... where ... a financial arrangement ... is remitted (otherwise than by way of being written off as a bad debt)...". These words have no purpose other than to emphasise the difference between

- (a) Writing a debt off as a bad debt (which does not trigger the base price adjustment or cash base price adjustment); and
- (b) Remitting a debt (which does trigger the base price adjustment or cash base price adjustment).

## 9.0 **Time for the Calculation of Base Price Adjustment for Bad Debts**

9.1 The base price adjustment is intended to apply at the end of the taxpayer's involvement with the financial arrangement.

"Once a taxpayer ceases to hold an instrument, or ceases to be liable under it, the base price adjustment is calculated."

Information Release from the Office of the Minister of Finance - Income Tax Amendment Bill (No.2) 1986, page 11, issued at the time the Bill was introduced into the House of Representatives and reproduced in the Report of the Consultative Committee on the Accrual Tax treatment of Income and Expenditure, April 1987

Section 64F(2) requires that the base price adjustment be performed in the income year in which a financial arrangement -

- (a) Matures, or

- (b) Is remitted or,
- (c) Sold, or
- (d) Otherwise transferred.

## 10. Maturity

10.1 Section 64F(1)(e) provides that a financial arrangement matures when the last payment contingent upon the financial arrangement is made, subject to the proviso that if

- (a) The financial arrangement has not matured; and
- (b) The amount yet to be paid is immaterial; and
- (c) The financial arrangement “has been structured to avoid the application of” section 64F -  
the financial arrangement is deemed to have matured.

10.2 Presuming that the proviso does not affect the case, a financial arrangement matures when the last payment under the financial arrangement is made. In this context “payment” must be presumed to mean the delivery of any valuable consideration. Otherwise it would be necessary to calculate the base price adjustment for an agreement for the sale and purchase of property before the quantum of the “acquisition price” is known where payment is made before the delivery of rights in the property (refer section 64BA(1)(c) and (d), “core acquisition price” for an agreement for the sale and purchase of property that has lapsed or does not proceed).

## 11. Remission

11.1 Section 64F(1)(c) sets out the circumstances in which a financial arrangement is deemed to be remitted. This is another set of circumstances on which the base price adjustment is to be calculated. These are

- (i) Where the debtor has been discharged from making all remaining payments under the debt without fully adequate consideration;
- (ii) Where the debtor has been released from the debt due to operation of the insolvency legislation or by any deed of composition with creditors; or
- (iii) The debt is irrecoverable through the lapse of time (i.e. “statute barred”, more than 6 years since the debtor last received notice of the liability).

11.2 In addition a debt is actually remitted when it is remitted within the ordinary meaning of the word. It is anticipated that this is within the meaning of section 64F(1)(c)(i).

## 12. Sale

12.1 In this context “sold” has its ordinary meaning.

## 13. “Otherwise Transferred”

13.1 At law “transfer” is normally used in relation to transfer of property - a right or a collection of rights. However a person’s interests in a financial arrangement may comprise, wholly or in part, obligations (e.g. a debtor who, at the time appointed for repayment, has only an obligation to repay). In this context “transferred” is to be given the widest possible meaning so that the base price adjustment achieves its purpose - a “wash up” to ensure that all cashflows have been taken into account in calculating the total income or expenditure over the life of a financial arrangement.

13.2 There may be circumstances where rights held by a person become held by another person without any transfer at law. It has been suggested that this is the case where:

- (a) The executors or administrators of an estate take up control over that estate; or
- (b) Trust assets vest in a beneficiary.

The IRD has commenced a project to deal with these questions, among others, in relation to trusts and estates

13.3 It may appear to be necessary for a person to calculate the base price adjustment more than once in relation to the same financial arrangement in certain cases. For example where:

- (a) In the year ending 31 March 1988 Holder advances funds to Issuer and Issuer makes no payments to Holder; and
- (b) In the year ending 31 March 1989 Issuer makes no payments to Holder and Holder writes the debt off as a bad debt; and
- (c) In the year ending 31 March 1990, and for no consideration, Holder completely forgives the debt owed by Issuer

it may appear to be necessary for Holder and Issuer to calculate the base price adjustment

- (d) In the year ending 31 March 1988, during which the last payment contingent on the financial arrangement is

made (in this case the advance itself is the last payment made that is contingent on the financial arrangement); and

- (e) In the year ending 31 March 1990, when the debt is remitted.

13.4 In such cases the conflict is to be resolved by reference to the principle set out at paragraph 9.1. Thus the conflict in the case set out in paragraph 13.3 is resolved as follows:

- (a) Although the financial arrangement matures in the year ended 31 March 1988 Holder still holds, and Issuer still has liabilities under, the financial arrangement, so the base price adjustment is to be performed in the later income year; and
- (b) When the financial arrangement is remitted in the year ended 31 March 1989 Holder ceases to hold, and Issuer ceases to have any liability under, the financial arrangement, so the base price adjustment is required to be performed.

13.5 This analysis is required only where a conflict arises as to which income year the base price adjustment is to be calculated in. In particular

- (a) It does not apply where it is clear that there is no prospect of recovery;
- (b) It does not apply to non-recourse loans where there is no liability to repay; and
- (c) It does not apply to limited recourse loans where it is clear that avenues for recourse are exhausted in practical terms.

#### 14. The Base Price Adjustment and Bad Debts

14.1 On remission of a debt the holder does not take into account the amount that was receivable, but is required to include in "a" any amounts that have been remitted by the holder. For example:

Holder has 31 March balance date

Holder advances	\$1,000 on 1 June 19x8
Issuer - required to pay	\$1,120 on 31 Dec 19x8
- pays	nil
Holder after recovery action remits	\$1,120 on 31 March 19x9

Holder's Base Price Adjustment on 31 March 19x9

a - (b + c)

\$1,120 - (\$1,000 = 0) = (+ve) \$120 income to holder

14.2 A deduction -

- (a) Will be allowed elsewhere for the loss to the extent that it represents the \$120 income assessable under the base price adjustment:
- (b) May be allowed elsewhere for the loss to the extent that it represents a loss of principal i.e. the \$1000.

14.3 In calculating the base price adjustment on remission of the debt the issuer does not take into account the amount that was payable but was not paid. For example, using the facts in paragraph 14.1.

Issuer's Base Price Adjustment

a - (b + c)

0 - (\$1,000 + 0) = (-ve) \$1,000 income to holder

#### 15. Sale at a Discount Due to Debt being Bad

15.1 Where a debt is sold for a consideration lower than it would otherwise be sold for because of

- (a) A decline in the creditworthiness of the debtor; or
- (b) An increase in the likelihood that the debtor will not be able to repay the debt; or
- (c) Some reduction or cancellation of the debt (without equivalent consideration)

the base price adjustment is to be calculated as if the debt were sold at a price that did not reflect any of those matters (see section 64F(6)). The only exception to this rule is where:

- (a) The holder is in the business of holding or dealing in financial arrangements of the same class (see also paragraphs 17.1 and 17.2); and
- (b) The holder and the issuer are not associated persons.

In such cases this adjustment is not required (see the proviso to section 64F(Q)).

15.2 For example, on 1 April 1989 Holder advances to Issuer \$1m (the exception in paragraph 13.1 does not apply). Issuer is to pay

\$0.2m on 31 March 1990

\$1.2m on 31 March 1991.

In the event Issuer pays nothing and Holder sells the debt ex interest on 31 March 1990 (i.e. without entitlement to interest due 31 March 1990) for \$0.9m, the price being influenced by the debtor's perceived inability to pay and an increase in market interest rates.

15.3 Holder is required to calculate the base price adjustment as if there had been no change in Issuer's creditworthiness or likely ability to pay. The price that would have been received in such circumstances must be ascertained. This will involve some conditional valuation of the debt.

15.4 For fixed interest debt, valuation by discounting using a rate based on

- (a) Government stock rates at the time of sale; and
- (b) A margin based on the difference between
  - (i) The yield to maturity of the debt when issued; and
  - (ii) Government stock rates at the time at which the terms for issue were determined -

will be acceptable to the Commissioner.

15.5 For variable rate debt issued at or about face value, face value will be acceptable. It will also be acceptable to adjust for any movement in base rates since the last interest rate review, so long as the adjustment recognises that interest rates can be adjusted back to market rates at the next review.

15.6 If in this case the conditional valuation of the debt is \$970,000, the base price adjustment for the holder is calculated as follows

$$a - (b + c)$$

(i.e. 0.20m coupon + (\$1m original advance) 0.97m conditional valuation)

$$\begin{aligned} & \$1.17m - (\$1m + 0) = (+ve) \\ & \$0.17m, \text{ income to Holder.} \end{aligned}$$

15.7 A deduction -

- (a) Will be allowed elsewhere for the loss to the extent that it represents the \$0.17m income assessable under the base price adjustment:
- (b) May be allowed elsewhere for the loss to the extent that it represents a loss of principal.

## 16. The Cash Base Price Adjustment

16.1 The base price adjustment does not apply where the taxpayer is a cash basis holder in relation to the financial arrangement when it matures or is remitted, sold or otherwise transferred. In such cases the cash base price adjustment (section 64F(3)) is to be calculated.

16.2 In calculating the cash base price adjustment the holder is not required to take into account amounts not received unless the amount not received was remitted by the holder, e.g.,

Cash Basis Holder advances	\$1,000
Issuer - required to pay	\$1,120
- pays	nil

The debt is not remitted and there is no prospect of payment.

### Holder's Cash Base Price Adjustment

$$a - (b + c)$$

$$0 - (\$1,000 + 0)$$

= (-ve) \$1,000, an allowable deduction to Holder (section 64F(5)(h) refers).

16.3 In other respects the law regarding the treatment of bad debts applies to cash basis holders essentially as it does to persons who are not cash basis holders.

16.4 It should be noted that a cash basis holder will not generally have "income" bad debts (as opposed to "principal" bad debts), as the cash basis holder will not recognise income unless it is derived in terms of section 75(1). Such amounts are capital once derived.

## 17. The Business of Holding or Dealing in Financial Arrangements of the Same Type

17.1 A person is in the business of holding financial arrangements of a particular class if -

- (a) The person buys such financial arrangements for investment purposes in the course of business (e.g. buying government stock for the purposes of a sinking fund established as a part of the person's business activities); or
- (b) The person creates such financial arrangements (or such a financial arrangement) for the purposes of or in the course of business (e.g., trade debtors of a person in trade or business, advances made by a bank or moneylender).

17.2 A person is in the business of dealing in financial arrangements of a particular class if

- (a) The person buys (or creates) and sells such financial arrangements; and
- (b) The person's activities in buying and selling such financial arrangements constitute a business.

17.3 The question of whether or not activities constitute a business is dealt with in terms of the normal tests for income tax purposes (*Grieve v CIR* (1983) 6 NZTC 61,682; TPC 84/24)

17.4 The question of what constitutes a "class" of financial arrangements is determined by considering -

- (a) Commonality of characteristics (some precision is required here in order to give effect to the restrictions intended in section 64C (6)(a) and (c), 64D(2), 64F(6) etc, see *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573,583); and
- (b) Comparative quality, particularly in terms of the creditworthiness of the issuer (other things being equal, are the financial arrangements substitutable one for another in the operations of the taxpayer).

The same considerations are to be borne in mind when considering the meaning of "such financial arrangements" in any particular case (e.g., sections 64C(2)(b), 64C(3)(a)(ii), 64C (4)(b) and (c)(i), 64G(2), 64I(1)(c), and 64J(3)).

## 18. "Income" or "Coupon" Bad Debts - Section 64G(1)

18.1 Section 64G(1) applies in respect of bad debts suffered for income derived under

- (a) Section 64C, the provision that -
  - (i) Requires use of the accruals provisions in respect of financial arrangements in the general case; and
  - (ii) Provides for a non-accrual basis in certain cases (refer section 64C(5)); or
- (b) Section 64D(3), the accruals basis adjustment on ceasing to be a cash basis holder in respect of a financial arrangement; or
- (c) Section 64F(4), the base price adjustment; or
- (d) Section 64I, the post facto adjustment

(Note that this relief is not available in respect of the cash base price adjustment as it is not necessary. The cash base price adjustment only takes into account "consideration derived" and amounts remitted.)

18.2 Where such a bad debt is suffered and -

- (a) The income has been derived; and
- (b) The income is attributable to the amount in respect of which a deduction for a bad debt is claimed; and
- (c) The amount is written off in the year in which the deduction is claimed -

a deduction is allowable to the extent that the income is attributable to the amount in respect of which a deduction for a bad debt is claimed. If the bad debt is actually paid, the amount paid is assessable income in the year in which it is received.

18.3 In summary, a deduction under section 64G(1) is available for bad debts for income derived and calculated according to the accrual tax accounting regime in any circumstance except under the cash base price adjustment and the cash basis adjustment, but note the point made at paragraph 16.4 above in relation to cash basis holders.

18.4 Whether and to what extent income is attributable to the amount in respect of which a deduction for a bad debt is claimed is a matter to be ascertained according to the facts of each case. Factors to be taken into account include the nature of the arrangement between the parties (e.g. a current account that has fluctuated between DR and CR balance would not be treated the same as a term loan) and any express instructions given by the debtor in relation to the order of priority among amounts owing. Subject to such matters of fact, the provision is to be interpreted liberally for the benefit of the taxpayer -

- (a) Setting bad debts off against "income" before "principal"; and
- (b) Setting payments on account of bad debts off against bad debts for "income" before bad debts for "principal".

18.5 Note that careful consideration of individual circumstances will be required - in a receivership it may be inappropriate to apply the general rule set out in subparagraph (b) above as there may be no prospect of repaying all of the "principal", let alone any of the "income".

## 19. "Income" Bad Debts - Section 106(1)(b)

19.1 A bad debt in relation to a financial arrangement may be a bad debt of income where the financial arrangement is a debt that is working capital of the creditor - e.g. trade credits for sales. Such bad debts are dealt with under sections 104 and 106(1)(b) as they have been in the past. In addition any income bad debt not

dealt with under sections 64B to 64M (e.g. income under the cash basis adjustment or the cash base price adjustment, or bad debts from associated persons) is to be dealt with under 106(1)(b).

**20 “Capital” or “Principal” Bad Debts - Section 64G(2)**

- 20.1 Where a person who is in the business of holding or dealing in financial arrangements of a particular type (see paragraphs 17.1 and 17.2) suffers a bad debt in respect of such a financial arrangement section 64G(2) will generally provide a deduction where section 64G(1) does not unless debtor and creditor are associated persons. It is primarily a relief for loss of principal.
- 20.2 Where a person suffers a bad debt in respect of a financial arrangement from which the person derives income under -
- (a) Section 64C; or
  - (b) Section 64D(3); or
  - (c) Section 64F (note that in this case section 64F(5), the cash base price adjustment, is included); or
  - (d) section 64I -

and the person is in the business of holding or dealing in such financial arrangements, section 64G(2) applies.

- 20.3 Section 64G(2) allows a deduction where and to the extent that -
- (a) The bad debt is not deductible under section 64G(1); and
  - (b) The amount is written off in the year in which the deduction is claimed; and
  - (c) The issuer and the holder are not associated persons.
- 20.4 Note that the amount of the deduction is only limited -
- (a) By excluding amounts written off under section 64G(1), and
  - (b) To the amount actually written off

Thus, subject to section 106(1)(o) and the general limitation imposed by the nature of bad debts (see paragraph 8.2(a), (b) and (c) above), section 64G(2) allows deductions for bad debts in respect of principal amounts for persons in the business of holding or dealing in such financial arrangements if the debtor and the creditor are not associated persons.

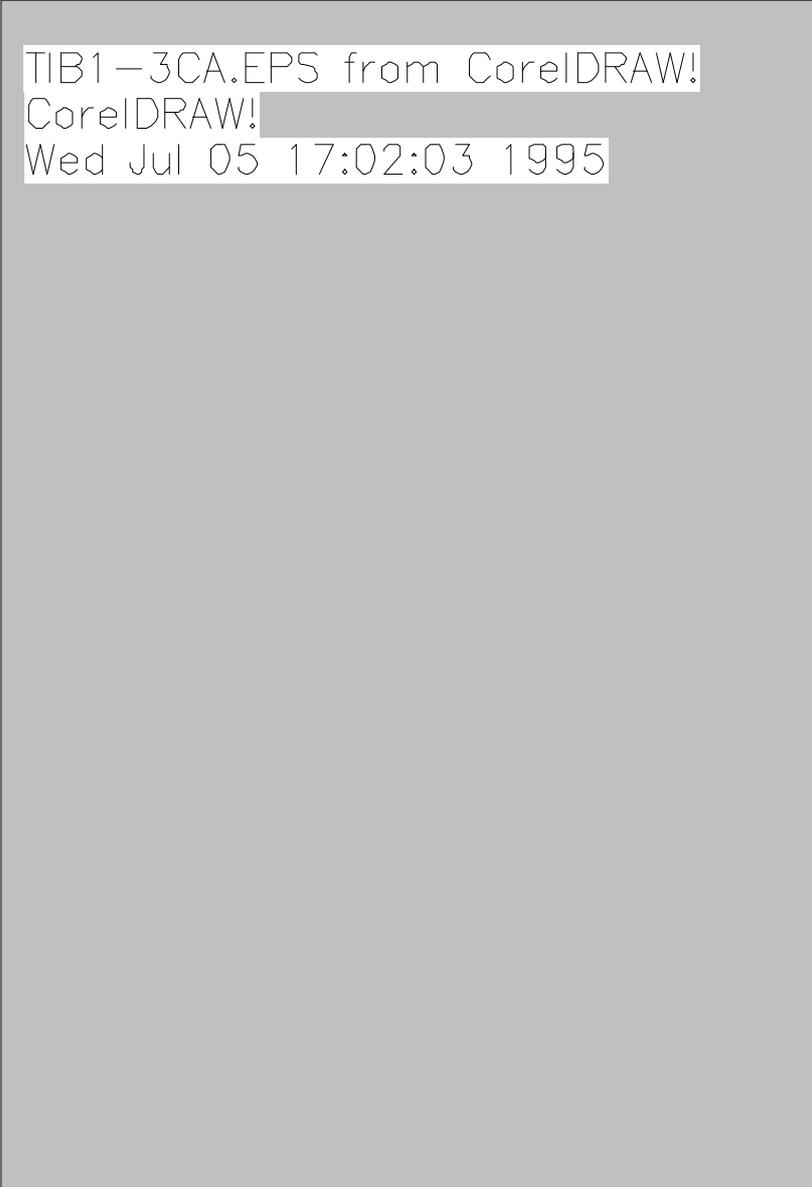
20.5 The deduction is allowed in the year in which the debt is written off. If the bad debt is actually paid, the amount paid is assessable income in the year in which it is received.

**21. Security Payments**

21.1 If a debtor fails to pay a debt and the creditor calls on a guarantee, indemnity, letter of credit, bond or other security payment, the creditor may be separately assessable for the gain on the security arrangement viewed in isolation. In such cases, if no deduction is provided for elsewhere, section 64G(3) will provide a deduction for the bad debt to the extent of the gain on the security arrangement. This ensures that the net effect of the two arrangements (the debt and the guarantee or other security arrangement) is the same as if the debtor had fulfilled the obligations under the loan to the extent of the security payment.

**22. Associated Persons - Sections 104 and 106(1)(b)**

- 22.1 Where debtor and creditor are associated persons -
- (a) The relief provided in the proviso to section 64F(6) is not available; and
  - (b) The relief for losses of principal under section 64G(2) is not available.
- However section 106(1)(b) applies to such losses. It has no associated persons limitation, but is subject to -
- (a) Section 106(1)(a); and
  - (b) The requirements briefly outlined at paragraph 2.2 above; and
  - (c) The limitation (stated in *Levin & Co v CIR* [1963] NZLR 801) that an advance to an associated person may be written off as a bad debt only if the advance was made in the ordinary course of the parties' business.



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