Taxpayers in financial difficulties

Section 177, Tax Administration Act 1994

1. Introduction

1.1 This item sets out the Commissioner's policy in applying section 177 of the Tax Administration Act 1994. Section 177 provides the Commissioner with the power to remit and/or defer the payment of certain taxes owed by taxpayers who are in "financial difficulties". A copy of section 177 is attached as Addendum A.

1.2 In preparing any policy statement, we consult with the NZ Society of Accountants, the NZ Law Society, the Tax Education Office and the Corporate Taxpayer Group if it is possible to do so. We did so in preparing this item. However, the policy statement represents the views of the Commissioner of Inland Revenue.

1.3 The policy statement explains how we will use our powers under section 177 to enable taxpayers who are in financial difficulties to settle or rearrange their outstanding obligations. Section 177 allows the Crown to derive an effective return, and may enhance the taxpayer's prospects for financial recovery.

1.4 Individuals, self-employed persons, companies, trustees, incorporated societies, or any other taxpayer can use section 177.

1.5 It is important that taxpayers who may not be able to meet their tax liabilities see us at an early stage about using section 177. This allows us to explain their options to them. If they allow their financial problems to become too pressing they may be unable to make appropriate restructuring arrangements. Section 177 may help us preserve a taxpayer's future earning capacity and thus prevent recovery being hampered by increased tax liabilities.

If we can provide relief under section 177, the taxpayer's other creditors may join in a settlement arrangement and not resort to bankrupting the taxpayer or applying to the court to have the company put into liquidation.

1.6 Unlike most other creditors, Inland Revenue is under a strict statutory duty to keep a taxpayer's affairs confidential. However, section 81(1)(a) of the Tax Administration Act 1994 authorises the Commissioner to communicate such matters or information to other persons for the purpose of carrying into effect the Inland Revenue Acts and the Accident Compensation Act 1982, Accident Rehabilitation and Compensation Insurance Act 1992 and the New Zealand Superannuation Act 1974. This means that we are able to, and may well want to, discuss any proposed relief arrangement with the taxpayer's other creditors.

We will, however, advise taxpayers if we are going to discuss their tax affairs with their other creditors.

1.7 We do not charge for our advice or services. However, we do ask taxpayers to support their application with certain information - see Addendum B "Information required in an application for relief under section 177, Tax Administration Act 1994.

1.8 Compiling the necessary information will probably involve some work on the taxpayer's part. However, we expect that the information may also be useful in seeking to negotiate arrangements with other creditors.

2. When section 177 can be used

2.1 Section 177 gives us some of the flexibility that other unsecured creditors have. It allows us to crystallise a taxpayer's tax liabilities and to arrange with the taxpayer the best way of settling them. We can remit or defer the payment of some or all of the tax owing by taxpayers in financial difficulties. It also allows us to deal with tax that may arise from any restructuring arrangements.

2.2 The key part of section 177 is subsection (1) which reads:

(1) Subject to this section, on application for relief made in writing by or on behalf of any taxpayer who:

(a) Is, or is likely to become, liable for payment of -

(i) Any amount of income tax levied under section BB 1 of the Income Tax Act 1994 in respect of the income derived by that taxpayer (whether that income is income derived or deemed to be derived under the qualified accruals rules or otherwise); or

(ii) Any amount of fringe benefit tax; and

(b) Is at the time of the application in financial difficulties,-

the Commissioner may, if the Commissioner considers it necessary or desirable to do so in order to maximise the net present value (calculated as at the date of application) of any recovery or likely recovery from the taxpayer of that amount of income tax or fringe benefit tax, or any part of the income tax or fringe benefit tax, grant relief to the taxpayer by either or both of -

(c) The remission of the whole or part of that amount of income tax or fringe benefit tax; or

(d) Entering into an arrangement with the taxpayer for the payment of the whole or part of that amount of income tax or fringe benefit tax.

2.3 Section 177 (1)(a)(i) specifically refers to tax on income derived under the qualified accruals rules of the Income Tax Act 1994. Section 177 (1)(a)(i) is particularly relevant to any income that arises by virtue of debts being forgiven.

The reference ensures that we can remit this assessable income as part of the arrangement.

2.4 Section 177 can be used if:

- A taxpayer (or someone acting on behalf of the taxpayer) makes written application to us; and
- The taxpayer is or is likely to be liable to pay income tax levied under section BB 1 of the Income Tax Act 1994 or fringe benefit tax ("FBT"); and
- The taxpayer is in "financial difficulties"; and
- The Commissioner considers it necessary or desirable to provide relief in order to maximise the net present value of any recovery or likely recovery from the taxpayer of that amount of income tax or FBT.

2.5 Application in writing

We can only use section 177 if a taxpayer (or agent) applies to us for relief in writing.

2.6 Scope of section's application

We can use section 177 to provide relief from existing tax liabilities. We can also use it to provide relief from liabilities that are likely to arise. Thus we can also use it to remit taxes that are likely to arise from any debt remission that occurs under a debt restructuring arrangement.

We will not normally use section 177 to remit future taxes yet to be incurred in the normal course of the taxpayer's business. We are unlikely to have sufficient information to reliably assess the taxpayer's long-term prospects. If future tax liabilities impact on the taxpayer's recovery, the taxpayer can submit a subsequent application when those liabilities are incurred.

2.7 The applicable taxes

Section 177 provides relief for income tax and for FBT. That includes:

- Income tax.
- Fringe benefit tax.
- Interest on FBT (sections 123 and 3(1) of the Tax Administration Act 1994).
- Recovery of any family support tax credit given to reduce income tax.
- Any retirement tax part of any income tax (section 257A of the Income Tax Act 1976 (repealed)).
- Any penal tax on any of the above (section 187 of the Tax Administration Act 1994).
- Additional tax added to income tax (section 139 of the Tax Administration Act 1994) or FBT (section 144(1) of the Tax Administration Act 1994).
- However, section 177 does not allow us to deal with any outstanding liability for:
- GST.
- New Zealand superannuitant surcharge.
- Withholding tax deductions.
- Any other "income tax" that is not levied under section BB 1 of the Income Tax Act 1994.

(Not all taxes imposed under the Income Tax Act are levied under section BB 1.)

2.8 "In financial difficulties"

2.8.1 Section 177 can only be applied where the taxpayer is *in financial difficulties*. This is not a defined term, nor is it an accepted legal or accounting concept. We will interpret the term in an expansive manner.

2.8.2 We consider that a taxpayer is *in financial difficulties* if the person's financial situation is such that debts cannot be paid on time, and *either*

- There is a real prospect that creditors will be able to have the taxpayer put into liquidation, or adjudged bankrupt; *or*
- The taxpayer's debts are a substantial limitation on carrying out normal income producing activities.

2.8.3 We will take account of contingent liabilities (that is, present liabilities to pay money on the happening of some future event at some future date) or term liabilities (that is, those that have yet to mature, e.g., debentures payable 2 years from now) that the taxpayer may have. However, we will only take these into account where we can reliably estimate them and are satisfied that the taxpayer is obliged to pay them when they occur or mature. We will take a similar approach to any future income.

We will be careful about contingencies. Sometimes contingent creditors can have a taxpayer put into liquidation or bankrupted. Also current creditors may have concerns if a taxpayer has large contingent debts. They may seek to bankrupt or put the taxpayer into liquidation when otherwise they would let the debt continue. Although these situations will not stop us from using section 177 to grant relief, we would expect the taxpayer to ensure that the contingent liability will not affect the payments to be made to us in the proposed debt restructuring.

2.8.4 In order to confirm that the taxpayer is having, or will have, difficulties in meeting financial obligations, we require the information referred to in Addendum B "Information required in an application for relief under section 177 of the Tax Administration Act 1994" to be supplied. We will need:

- A full list of the taxpayer's creditors.
- A list of the amounts owing to the creditors.
- A complete statement of the resources the taxpayer has available to pay those liabilities.

2.8.5 Taxpayers will need to produce budgets, and explain the assumptions on which they base those budgets. They need to indicate if any assets will not be sold, and if so, explain why.

We may want to see the taxpayer's bills and speak to any other creditors. We may also want to verify the budgets and the assumptions upon which they are based.

2.8.6 We will want to know the priority of any outstanding debts. For example, the taxpayer must pay secured creditors before unsecured creditors such as us.

We also want to know what money the taxpayer has available for paying bills. Taxpayers cannot put money aside for other purposes unless there is a legal requirement to do so. An example of this would be PAYE deductions and GST which are moneys held in trust for the Crown. These are not available to taxpayers to satisfy their own debts.

Examples of "in financial difficulties"

A. A taxpayer is not likely to be in financial difficulties if:

(a) Bills cannot be paid on time, but the taxpayer expects to be able to pay them late and creditors are not complaining.

(b) Bills cannot be paid on time, but some creditors have complained (although none have threatened legal action.)

(c) Bills cannot be paid on time and, although a creditor has threatened legal action, it is expected that the creditor can be paid in the very near future.

(d) Bills cannot be paid on time, but the taxpayer disputes that the debt is owed and will defend the legal proceedings.

(e) Bills are currently paid on time, but the taxpayer wants to expand the business, e.g., the taxpayer needs to buy another vehicle and some equipment to do so. A detailed budget shows that for the first few months of this expansion the taxpayer cannot pay bills on time, but will be able to pay them late.

B. A Taxpayer may be in financial difficulties if:

(a) The taxpayer cannot pay bills on time, but expects to be able to pay them late. Some creditors have complained. Some are taking legal action. This late payment practice is known locally and some suppliers refuse to supply on credit. As a result the taxpayer regularly cannot source supplies. This results in the taxpayer failing to fulfil some contracts that otherwise would be fulfilled. The taxpayer's staff are often idle as a result.

(b) The taxpayer is a company that cannot meet its current debts without selling a fixed asset. Because the sale would be urgent, it would realise less than the normal sale price. The sale of the asset would threaten the future of the business.

(c) A customer who owes the taxpayer a lot of money is in severe financial difficulty and is likely to close down. The taxpayer's budget shows that if the customer does not pay the taxpayer, the taxpayer cannot pay bills.

We can't tell if this taxpayer is in financial difficulties without more information about what, and when, the customer is likely to be able to pay.

(d) As in (c) above, but the taxpayer knows that payment will not be made for at least seven months. The taxpayer will not be able to meet liabilities until the payment is made.

In a case such as this the taxpayer may be in financial difficulties. Other factors will also be considered (e.g., the impact of the liquidity problem on operations). The time to expected payment is not necessarily the key problem. The taxpayer may be able to survive the liquidity problem for more than seven months, or might not be able to survive it for one month, depending on the circumstances of the case. If Inland Revenue is the only significant creditor, we might be prepared to consider deferring collection action until the insolvent debtor's position is clear and the applicant has received whatever payments the insolvent debtor is able to make.

(e) Lenders have refused to advance any further funds to the taxpayer. As a result, the taxpayer cannot pay bills and is unable to source supplies reliably. This causes a failure to fulfil some contracts that otherwise would be fulfilled. The taxpayer's staff are often idle as a result of the taxpayer's financial position.

(f) The taxpayer is a company and has not been able to pay its bills for some months. Its shareholders will not support it. It has received notice that one of its creditors is seeking to have it put into liquidation.

(g) The taxpayer is an individual who has been unable to pay bills for some months. A judgment creditor serves a bankruptcy notice on the taxpayer who pays the debt owing to the judgment creditor but cannot pay other creditors.

(h) As in example B(d), and the taxpayer company's major shareholder fails and cannot honour the guarantee given to the bank for the company's overdraft.

2.9 Living costs, including housing

2.9.1 Where an individual applies for relief under section 177, we will need to consider how the taxpayer's living costs affect the ability to pay bills. We expect applicants to have prepared a personal budget based on reasonable living costs. We will not force the taxpayer into hardship, but section 177 only lets us consider "financial" difficulties. We cannot take into account any social difficulties that may result from the taxpayer's financial position.

For example, housing is important. It is a big part of the cost of living for most people. Within reason, we will try to assist taxpayers who own a house and want to try to keep it. However, if the house is particularly valuable and its sale could be used to meet debts without depriving the taxpayer of adequate housing elsewhere, or affecting the rights of any secured creditors, we would consider asking the taxpayer to sell it. We will, however, recognise a spouse's "protected interest" in a matrimonial home under section 20(2) of the Matrimonial Property Act 1976. The value of this "protected interest" will not be regarded as part of the taxpayer's available assets. We will also recognise any rights protected by the Joint Family Homes Act 1964.

Where a couple or a family (whether a legal marriage or otherwise) depends on the taxpayer's housing, we will consider proposals to protect their interests. In any case we will take into account any other person's legal or equitable interest in property when considering any proposal put to us.

2.9.2 A taxpayer may live in, or use, a property owned by a trust or a company that the taxpayer controls, is related to, or derives benefit from. We would examine such an arrangement and consider any proposal made for using that property to meet some of the debts.

2.9.3 Where an individual makes an application for relief, we expect the application to identify any sources of financial support. We will want to know the extent to which those sources may be able to be used to support the taxpayer. We may ask potential contributors of support for details of the extent to which they are willing, or able (in the case for example of a trust) to meet the taxpayer's living costs, and which liabilities they could meet to prevent the taxpayer from being bankrupted or subjected to any other financial limitation.

2.9.4 Each case will depend upon its particular circumstances. As we said above, we will not force a taxpayer into hardship. But as a creditor, the Crown cannot be expected to remit or defer outstanding tax obligations to allow the taxpayer or dependants to maintain a certain lifestyle. We will expect taxpayers to organise their affairs in good faith and in a manner consistent with their financial position.

2.9.5 We will, therefore, examine any arrangement that appears designed to prejudice the rights of any creditor before we grant any relief under this section.

3. What we can do under section 177

3.1 We can grant relief under section 177 by either or both:

- Remitting the whole or part of the amount of income tax or FBT:
- Entering into an arrangement with the taxpayer for the payment of the whole or part of that amount of the income tax or FBT in two or more instalments.

3.2 We discuss the details of the relief available further in paragraph 6 of this item.

3.3 In entering into such an arrangement we must ensure that we seek the best possible return for the Crown. Section 177(1) says the Commissioner may grant relief if the Commissioner "considers it necessary or desirable to do so in order to *maximise the net present value ...of any recovery or likely recovery from the taxpayer* of that amount of income tax or fringe benefit tax, ..., or any part thereof...". (emphasis added).

The net present value of the recoveries and likely recoveries under any proposal will be the total of the present values of all the payments that will be made (or can reasonably be expected to be made) if we accept the proposal. Addendum C, "Calculating the Net Present Value", sets out the procedure for calculating the net present value. The net present value of the recovery is calculated at the date that the taxpayer lodges the section 177 application.

3.4 This means we compare the net present values of the various options available to us. We will take the option that provides the greatest net present value. We discount each expected recovery (including what we would get if we sought immediate payment) for the time value of money and for the likelihood of receiving the money. Therefore, we need to work out the amount, date, and probability of each recovery that the option will provide, and apply an appropriate discount rate. In determining the appropriate "discount rate" for the net present value calculation, we use the rate of government securities for the appropriate term. Addendum D "Calculating the Discount Rate", explains the method of calculation.

3.5 Where any payments are secured over, or rely on the realisation of assets, we expect an independent valuation of those assets to accompany the written application. The assets should have been valued no later than three months before the date of the application.

3.6 If the net present value calculation is very close to what we would get if we sought immediate payment and we agree it is a "borderline" case, we will:

- Accept - if the net present value of the proposal is equal to or only just above the net present value of what we'd get if we sought immediate payment.
- Decline - if the net present value of the proposal is below the net present value of what we'd get if we sought immediate payment taking account of the time and expense of taking proceedings for immediate recovery.

Where the net present value of the proposal is only just less than the net present value of enforcing judgment, we will be prepared to negotiate with the taxpayer and ask whether the value of the proposal can be increased so that it exceeds what we would get if we sought immediate recovery.

3.7 We must make our own decision in evaluating any proposal under section 177. We may come up with a different result than that suggested by the taxpayer. For example, we might disagree about the probability of a payment being made. Where such a disagreement occurs, we will discuss the matter with the taxpayer and explain why we disagree with the calculations. We will revise our assessment if it can be shown that our evaluation or calculations were wrong.

3.8 The following are examples of assessments of the probabilities of payment being made in particular circumstances. They are intended to enable both Inland Revenue staff and applicants to approach the assessment of the probability of payment in a systematic manner. They are not categories into which applications will be placed. Each payment will be assessed in accordance with its own particular circumstances.

The examples are:

Probability of repayment

100% Cash or any short-term asset held by or payable to the taxpayer on or before the date the Commissioner is to be paid.

100% Cash or any other short-term near-cash asset held in trust if the trustee has agreed to pay the amount to the Commissioner, alone or together with other creditors (where the trustee is in the Commissioner's view bona fide and controls net assets clearly sufficient to meet the payment).

100% The payment to the Commissioner is unconditionally guaranteed by a person whose net assets are clearly sufficient to meet the payment.

90% The payment is secured to the Commissioner over assets to be realised within a year. The amount of all payments that are reasonably expected to be funded from that realisation is not more than 80% of the current market value of those assets.

80% The payment is secured to the Commissioner over assets that are readily realisable before the date of payment, which is more than a year away. The amount of all payments that are to be funded from that realisation is not more than 80% of the current market value of those assets.

60% The payment will be made within one year. It will be funded by a budgeted cash surplus from a currently trading business. The business has the written support of those creditors and major clients who could be reasonably expected to be crucial to the viability of the business over the term to the date of payment.

45-55% The payment will be made between one year and two years out. It is to be funded by a budgeted cash surplus from a currently trading business. The business has no major clients so it cannot rely for viability on the support of individual creditors and major clients (50%). However, having survived the first year of restructuring it should be capable of continuing, provided market conditions do not deteriorate and the management is sound (55%). On the other hand, if the original problems were caused by poor management and market forecasts are only mediocre, the probability of the payment being made would only be about 45%.

20-30% The taxpayer expects to secure a sub-contract on a building development which is planned to commence between one year and two years out. The building industry is depressed and the taxpayer's plant is at the end of its economic life.

3.9 Where this probability assessment is being attributed to the expected returns on a future project (such as completion of a construction contract), the assessment should be applied to the expected net cash flows from that project or contract - see Addendum C.

4. The application

4.1 We can only use the powers in section 177 when the taxpayer (or the applicant, making application on the taxpayer's behalf) applies for relief *in writing*.

4.2 There is a form (IR 40E) that can accompany any application. While using this form is not a statutory requirement, it details the information that we seek from the taxpayer.

4.3 The application should outline the taxpayer's relief request. It should outline the payments for which remittance is requested. It should also outline the payments that the taxpayer proposes to make and when they are to be made. As previously indicated in paragraph 1.7 above, a more complete explanation of the information we require is set out in Addendum B.

We do not expect taxpayers to undertake the calculations involved in determining either the discount rates or net present value of their proposals. Our staff will undertake those calculations. However, there is no reason why taxpayers should not undertake the calculation if they wish - Addenda C and D, at the end of the item, set out the formulae.

4.4 Where another person makes the application on behalf of a taxpayer, we require evidence that the person has the necessary authority or legal right to act for the taxpayer. We must ensure that the person has the necessary authority to negotiate with us and to enter the taxpayer into a legally binding arrangement. This authority can take any of a number of forms, some of which include:

- Written instructions signed by the taxpayer or directors (if the taxpayer is a company). A copy should be provided with the application.
- An agent of the taxpayer should provide a copy of the agency agreement (unless already provided for other tax matters).
- Someone with a power of attorney for the taxpayer should provide a copy of the power of attorney *plus* a certificate signed by the holder of the power of attorney to the effect that it has not been revoked.
- If the application is made by the taxpayer's employee, he or she should provide a signed copy of his or her employer's instructions with the application.
- An officer of the taxpayer with the power to act for the taxpayer (for example, a managing director of a company may have the right to bind the company) should provide a copy of his or her appointment to the office, (e.g., the articles of association, the company constitution, the company resolution authorising the officer to act or the contract under which the officer holds office).

- An applicant who is a trustee of the affairs of a taxpayer under a legal disability (e.g., mental incapacity), should provide a copy of the order or document appointing him or her as trustee, plus a statement to the effect that it remains in force.

4.5 The net present value is "*calculated as at the date of application*", the day that we receive the application, not when we decide whether to give relief under section 177(1). This means that the longer it takes to finalise the restructuring and negotiate with other creditors, the greater the discount factor will be. This will, in turn, reduce the net present value of the proposal. That is because the net present value of a payment decreases as the time of payment is deferred.

Taxpayers should settle as much as possible of any debt restructuring proposal (including negotiations with us) before they make a formal application for relief. It may be helpful to discuss the restructuring proposal with us before an application is lodged. Our staff can also help with any questions about the procedure for making the application.

4.6 The taxpayer is not required to give us notice of an intended application. However, discussing the matter with us prior to making the application may prove beneficial to both parties. Ideally, for an arrangement to remit or accept instalment payments for tax up to $50,000 we would like at least:

- 5 working days notice of the intention to make an application and a general description of the proposal; and
- 10 working days from receiving the application (and all the required supporting information) to the day on which the arrangement takes effect.

4.7 We cannot approve any arrangement to remit tax in excess of $50,000 without approval from the Minister of Finance. As this approval may take longer than 10 days, we suggest that we be given as much prior notice as possible of the intention to make such an application.

4.8 There may be some cases where we will not be able to make our decision in the time indicated here. However, they should be rare. We will make every effort to review the application within this time frame. Where the likelihood of a delay is possible, we will endeavour to give the taxpayer prior warning of that fact.

4.9 Declaration

We require the taxpayer (or the applicant on the taxpayer's behalf) to sign a declaration that will accompany the section 177 application. That declaration is to the effect that the information contained in the application is, to the best of the taxpayer's knowledge, correct and not misleading whether by failure to disclose information or otherwise. Section 177(3) provides that we can cancel any relief granted where the information provided by the taxpayer in the application was misleading. Although there is no statutory requirement for such a declaration, we consider that it is an indication of good faith on the taxpayer's behalf. If neither the applicant nor the taxpayer is prepared to sign the declaration, we will not be able to take the information supplied at face value. It will certainly affect our assessment of the likelihood of success in the proposed debt restructuring.

The taxpayer may either sign the declaration in the IR 40E (which may be used as, or can accompany the application) or incorporate the declaration as part of the application. The specific requirements for the declaration are set out in Addendum B.

5. Crystallising the income tax liability - section 177(2)

5.1 Section 177(2) allows us to "crystallise" a taxpayer's income tax and FBT liabilities for any relevant period. The section provides that:

The Commissioner may, if the Commissioner thinks fit, at any time after receipt of the application referred to in subsection (1), require any taxpayer to whom this section applies to make a return of income derived from any specified transaction or transactions, or during any specified period, and may assess the taxpayer for income tax on the income so returned and shall give notice of the assessment to the person so assessed, and subsections (3) to (6) of section 44 shall apply to such an assessment as if it were an assessment made in accordance with subsection (2) of that section.

5.2 Section 177(2) enables us to determine the taxpayer's current tax position. This allows us to include all current liabilities in the relief arrangement. However, it may not always be either appropriate or necessary that we require a part-year return. Filing a part-year return is not a requirement of an application. Whether we require one will be determined on a case by case basis.

5.3 Generally, we will seek to ensure that all the taxpayer's tax returns are filed up to date and that the taxpayer provides:

- A return for the income year in which the arrangement takes place, for the period from the beginning of the income year and ending near the time at which the arrangement takes place (we will negotiate an appropriate accounting period with the taxpayer); and/or
- A list of all debt remissions proposed under the arrangement in future income years (including those proposed by other creditors).

5.4 Section 177(2) allows us to deal with any tax that might result from a debt forgiveness arrangement. Where a creditor forgives a debt owed by the taxpayer, the amount of the debt forgiven constitutes income in the taxpayer's hands. The taxpayer is assessable on that income.

Section 177 allows us to ensure that the income tax arising from this debt forgiveness is remitted as part of the relief arrangements. We will not take advantage of other creditors' remittances by pursuing extra tax.

5.5 If the taxpayer's business is seasonal, a part-year return up to the date of the debt restructuring arrangement might not give a true reflection of the person's income-earning process. It may, for example, represent a disproportionate part of the annual income flow or expenditures. In such a case we may seek a return for the transactions that relate specifically to the debt restructuring arrangement. This will focus on any forgiveness of debt, expenditure or income relating to the debt restructuring arrangements. Other income or expenditure will be dealt with in the end-of-year return and assessment - see paragraph 5.8.

5.6 Fringe benefit tax

Section 177(2) enables us to issue an assessment for FBT on fringe benefits provided right up to the date of application. If we remit an amount of FBT and originally the taxpayer took a tax deduction for that FBT, the amount must be added back to the income of the year of the deduction.

No deduction for FBT was available until 1 April 1989.

After 1 April 1989 the deduction should have been taken in the year the fringe benefit was paid. This "add back" may impact on the taxpayer's income tax liability. If it does it should be taken into account in formulating the proposal put to us.

5.7 Notice of assessment and objection rights

Where we require a return to be filed, we will provide the taxpayer with an assessment. Unlike our decisions to grant or remit relief under sections 177(1) and (3), normal objection rights apply to such an assessment. We discuss objection rights later in paragraph 9.

5.8 Later end of year return

At the end of the income year in which any debt restructuring arrangement occurs, the taxpayer must file an income tax return for the whole income year in the normal way. This is the case even where a part-year return was required. The end-of-year return must include all income derived and expenditure incurred in the income year in question. That will include any income or expenditure included in the part-year assessment for the period up to the date on which the debt reconstruction arrangement took place. While the final assessment for the income year includes such income and expenditure, a tax credit will be given for tax already paid or remitted under the relief arrangement. This ensures that income tax is not paid twice on the same income.

Example

In the 1993 income year P Ltd underwent a debt restructuring. That restructuring arrangement came into effect on 1 June 1992. Because of the circumstances of P Ltd's case, the Commissioner required P Ltd to file a return for the period 1 April 1992 to and including 31 May 1992. An assessment was issued for that period.

In that period P Ltd derived assessable income of $3,000, thereby resulting in an income tax liability of $1,000. Under the restructuring arrangement, the Commissioner has agreed to remit the $1,000 income tax arising in the period.

Assessable income	$3,000
Income tax	1,000
Less amount remitted	1,000
Income tax "payable"	nil

At the end of the 1993 income year (31 March), P Ltd is required to file a return that covers the whole income year. In the 1993 income year P Ltd derived assessable income of $12,000 (including the $3,000 in the period to the end of May). An income tax liability arises on that income of $4,000. However, the Commissioner has already remitted $1,000 of that liability, which is treated as if it was a tax credit for an amount paid:

Assessable income	$12,000
Income tax	4,000
Less amount remitted	1,000
Income tax "payable"	$ 3,000

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6. The relief: remitting tax or deferring payment

6.1 We can grant relief by remitting all or part of the income tax or FBT owing, or by agreeing to an instalment arrangement, or both. We will advise the taxpayer in writing of the relief granted. The notice will explain the relief granted for each payment of tax for which the taxpayer is liable or likely to be liable (that is, income tax arising from future debt remissions by creditors pursuant to the restructuring arrangements). We will only deal with the proposals in the application for relief. The application must specify the relief sought.

Only the relief specified in the letter is granted. The taxpayer is still liable for any outstanding liabilities which are not specified in the relief notice.

6.2 If we agree to an instalment payment arrangement under section 177, we will seek the shortest possible deferral. We will remit any penal tax and "use of money" interest that arise on the tax that is subject to the instalment arrangement, if the taxpayer pays the instalments on time.

6.3 Tax arising from the remission of other debts

6.3.1 If a taxpayer proposes a debt restructuring that will result in creditors forgiving their debts, income tax may arise on the amounts forgiven. This can happen in two different types of situation.

6.3.1.1 First, if the taxpayer took a deduction for the debt when it originally incurred and the creditor later forgives the debt, the amount is added back to the income in the year the deduction was taken.

6.3.1.2 Secondly, if the debt is a financial arrangement, the situation can be a little more complicated. Generally though, if a lender later forgives the debt the debtor must include the amount forgiven as income for income tax purposes in the year in which it is forgiven. However, if a material part of the debt remains outstanding, and either the amount forgiven is not material, or the taxpayer is a "*cash basis holder*", the amount forgiven is included in income for income tax purposes when the debt is finally disposed of. The local Inland Revenue office or a tax adviser can advise whether the taxpayer is a "*cash basis holder*".

6.3.2 If the taxpayer had to pay income tax on the debt forgiven, the whole purpose of section 177 might be defeated. The other creditors may take the view that they have given up some of their rights, only for the Crown to get a tax benefit as a result. We will use section 177 to remit such tax. This prevents the taxpayer's reconstruction from being hindered by these further taxes.

6.3.3 If the taxpayer and the other creditors are acting in good faith and they are dealing at arm's length, we will remit any income tax arising from the debt forgiveness under the restructuring arrangements. If a creditor is associated with the taxpayer (a relative, by a trust arrangement, or through control of ownership (for companies)), we will accept that they are dealing at arm's length if we can see that they will not gain any advantage over other creditors from the arrangement. We will presume that the parties are dealing at arm's length unless evidence to the contrary exists.

6.3.4 There are occasions when our conditional approval of a proposed restructuring scheme may be useful in dealing with other creditors. Where such a situation arises, we will provide such a conditional approval of the scheme. We stress, however, that our approval of the final arrangements is required before section 177 relief is granted.

6.3.5 Where the debt forgiveness is conditional on the taxpayer fulfilling certain obligations to the creditors under the restructuring arrangement, we cannot know at the time of application whether there will ever be an actual tax liability. We explained at paragraph 2.8.3 how we will be cautious in dealing with contingencies.

6.3.6 If we agree to remit any income tax arising from a debt forgiveness arrangement (that is, where other creditors agree to remit moneys owed to them as part of this arrangement), we will give the taxpayer a letter stating:

- That the creditor's debt remission will constitute assessable income; and
- That the income tax will be remitted; and
- That if the taxpayer suffers an income tax liability for the income year in which the debt is remitted by the creditor, the amount of the liability will be reduced by the amount of the income tax attributable to the debt forgiveness.

The letter will identify the debt in question and the arrangements under which it will be forgiven.

6.3.7 Keep the letter. Attach a copy to the income tax return for the relevant period. We will attribute the tax to the debt forgiveness on the basis that gives the greatest possible reduction in the taxpayer's tax liabilities.

6.3.8 Section 177 does not, however, allow us to reduce assessable income by the amount of the debt forgiveness that is included in assessable income. Any carry forward losses available in the ordinary course will be applied against assessable income before the income tax liability is calculated. Losses available from other taxpayers will not be taken into account in calculating the assessable income.

7. Our aims: the Commissioner's discretion and how we will use it

7.1 The discretion

7.1.1 Subsection 177(1) provides that:

... the Commissioner may, if the Commissioner considers it necessary or desirable to do so in order to maximise the net present value...., grant relief ...

7.1.2 This indicates that the provision provides a very wide discretionary power. We are obliged to exercise this power fairly and in good faith. We must give fair and reasonable consideration to any application for relief under section 177.

7.2 Internal procedures and the taxpayer's opportunity to comment

7.2.1 Any decision on an application for relief of less than $50,000 under section 177 will be made in the taxpayer's local Inland Revenue office. Where the relief sought exceeds $50,000, we have to get approval from the Minister of Finance to grant the relief. The applications in both cases should be sent to the Debt and Return Management Section of the taxpayer's local Inland Revenue office.

7.2.2 Irrespective of the amount of relief sought, where we decline an application we will provide the taxpayer with the reasons for the rejection. Taxpayers are free to discuss the decision with us and to renegotiate the proposed arrangements.

7.3 How the Commissioner will exercise the discretion

7.3.1 We will be trying to get the best recovery for the Crown, so:

- We will want to have the least possible deferral; and
- We will want the least possible remission.

We do not have a preference for deferred payment over remission (either partial or complete) or vice versa. We will look at each proposal as a whole.

7.3.2 Legally we do not have an obligation to consider the likely prospects for payment to any other person who may be a party to the proposed agreement. We are simply responsible to the Crown for dealing with the outstanding income tax and FBT debts. However, we

will always negotiate in good faith. We will not intentionally enter into arrangements that disadvantage other creditors. We will always want to know that:

- Any creditor who might be disadvantaged by the proposed arrangement; and
- Any creditor who might reasonably be expected to affect the success of the proposed arrangement,

agrees to any arrangement that the taxpayer makes with us. This agreement will protect both us (that is, our arrangement with the taxpayer) and the taxpayer (by preventing the creditors petitioning for the taxpayer to be bankrupted or wound up).

7.3.3 If a taxpayer has other tax or duty debts with a higher priority than income tax or FBT (such as PAYE or GST which are moneys held on trust for the Crown), we may insist that these are paid. This will not affect our consideration of the application for relief under section 177(1).

7.4 Priorities

Where we agree to remit an amount of tax that is outstanding, we will remit that tax owing in the following order:

First: FBT on which late payment penalties are accruing.

Second: Any other FBT liabilities.

Third: Income tax upon which late payment penalties are accruing.

Fourth: Any other income tax liabilities.

We will remit outstanding FBT liabilities first because the remission of FBT results in the derivation of assessable income in the income year to which the FBT related. This may affect the taxpayer's income tax liability. As a result, consideration has to be given to remitting a greater income tax liability.

Example

T Ltd is a small printing firm that is in "financial difficulties". For the income year ended 31 March 1993, it derived assessable income of $60,000, having an income tax liability of $19,800. For the FBT quarter ending 31 December 1992, T Ltd has a FBT liability of $1,000 for which it took an expenditure deduction in the 1993 income year.

The Commissioner grants section 177 relief, and calculates the remittance as follows:

Step 1: Remit the FBT for the quarter ended 31/3/94.

Step 2: Recalculate T Ltd's assessable income for the 1993 income year (the FBT was paid in the 1993 income year)

assessable income	$60,000
plus FBT remitted	1,000
reassessed 1993 assessable income	$61,000

Step 3: Remit 1993 income tax liability of $20,130 (61,000 x 0.33)

7.5 Tax Losses

7.5.1 Section 177 only allows us to remit or defer a taxpayer's income tax or FBT liability. It does not allow us to reduce the person's assessable income by the amount of any debt forgiveness that is included in that assessable income. Any available losses carried forward will be applied against the assessable income in determining the income tax liability.

Section 177 does not require the taxpayer to surrender tax losses. If there are sufficient tax losses available to be carried forward following the assessment process, that will not affect whether we will grant relief or the extent to which we will grant it. The exception to this rule is that if the losses carried forward affect the taxpayer's potential cashflows or are a potential source of cash, we will take that into account.

7.5.2 Complications arise if the taxpayer seeking relief is a company (or other body corporate) that:

- is a member of a group of companies for tax purposes; or
- could become a member of a group of companies for tax purposes without losing losses carried forward,

and the other members of the group or potential group have profits that may be offset against the losses or anticipate such profits in the current income year.

In these cases we will not grant relief until the losses have been extinguished and the company has received reasonable compensation for the tax relief that is lost by the company and gained by other group members as a result. Tax losses can be valuable and, as a creditor, we want to share in that value. We would expect that those tax losses would have a value to the parties of somewhere between 16.5 and 33 cents in the dollar.

8. Can we cancel the relief?

8.1 Section 177(3) allows us to cancel all or part of the relief granted under section 177(1). We expect that we will only use this power if the taxpayer (or a person acting on their behalf) has intentionally mislead us.

8.1.1 Section 177(3) reads:

Where -

(a) The Commissioner has reason to believe that the information provided by the taxpayer to the Commissioner for the purposes of application of this section is misleading in any respect to an extent which, in the opinion of the Commissioner, renders it inappropriate for the Commissioner to have granted the whole or part of any relief granted under this section; or

(b) The Commissioner receives further information relating to the taxpayer's affairs at the date relief was granted which, in the opinion of the Commissioner, renders it inappropriate for the Commissioner to have granted the whole or part of any relief granted under this section,-

the Commissioner may, in relation to any amount of income tax or fringe benefit tax, cancel the whole or any part of any relief granted in accordance with subsection (1) (and this Act and the Income Tax Act 1994) shall apply as if such relief had never been granted.

8.2 When we can cancel relief

8.2.1 Before we cancel any relief given under section 177(1), either of the tests in section 177(3)(a) or section 177(3)(b) must be satisfied. If either is met, the extent to which the relief is varied or cancelled is entirely at the Commissioner's discretion.

8.2.2 Section 177(3)(a) deals with cases where the taxpayer has misled us. We must have reason to believe that the taxpayer has supplied us with information for the purposes of section 177 that is misleading. In cancelling or varying the extent of the relief, we must be of the opinion that it is inappropriate for the relief that was granted to have been granted.

When considering whether we should cancel or vary the relief granted, we will give the taxpayer the opportunity to comment. The exception to this rule is where the delay would place the expected recovery unreasonably at risk, or where we cannot locate the taxpayer after reasonable enquiries.

8.2.3 A taxpayer may mislead us unintentionally. For example, there may be an inadvertent error in the calculations. Section 177(3)(a) requires only that we are misled. There is no requirement that the taxpayer intended to do so. However, we will generally not cancel or vary the relief granted where we are mislead by an innocent error and the error does not result in a significant misstatement of the taxpayer's financial situation.

8.3 When we will cancel relief

8.3.1 We acknowledge that debt restructuring for persons in financial difficulties is an unpredictable science. There are few certainties involved, as the risks of business for such people are increased by their financial position. Slight variances in amounts distributed may therefore occur. We accept that such variances would not render it inappropriate for us to have granted relief.

8.3.2 If we are considering applying section 177(3)(a), we will have entered into an arrangement with the taxpayer under section 177. We will expect to receive payments with a calculated net present value. Generally, we will not apply section 177(3) if the difference between the net present value of the recovery, given the new information, and the amount we expect to receive under the arrangement we have entered into is less than:

- $10,000; or
- 10% of the amount that we expect to receive under the arrangement,

whichever is greater in the particular case.

8.3.3 However, this is only a guideline. Ultimately the decision will depend on the circumstances of the particular case.

8.4 What happens if the relief is cancelled

8.4.1 If the relief granted under section 177(1) is cancelled, it will be as if it were never granted in the first place. The original payment dates and penalties for late payment will apply.

Example

On 30 September 1991 X Ltd owed the Commissioner $100,000 in terminal tax due on 7 November 1991. There were no other tax liabilities. On 30 September 1991 the Commissioner agreed to remit $70,000 and accept the following payments for the remainder:

7 November 1991	$10,000
7 February 1992	$10,000
May 1992	$10,000

plus accrued additional tax for late payment of the $20,000 that was not remitted and was not paid by 7 November 1991.

On 15 January 1992 the Commissioner cancelled the remission and the arrangement for payment in instalments. We cancelled the relief after we found that the taxpayer had failed to disclose the proceeds from the sale of its interests in an offshore company. The proceeds had been held offshore.

The $90,000 unpaid of the $100,000 originally due on 7 November 1991 and deferred under the arrangement is once again due on 7 November 1991, along with accumulated additional tax and late payment penalties.

8.4.2 Where we cancel the relief, we will attempt to maximise the net present value of any recovery or likely recovery. However, in doing so we will endeavour not to damage the interests of other creditors who are party to the restructuring arrangements. In turn we expect those creditors to act in good faith and not to jeopardise our interests as a creditor.

8.4.3 Where a taxpayer has acted in bad faith, we will have no reason to believe that the person will deal with us in good faith in the future. Depending on the circumstances of the case, we may decide to initiate bankruptcy proceedings or apply to the Court to have a company put into liquidation. Alternatively, we may simply seek to examine the taxpayer's tax affairs more closely in future, or enter into a practically enforceable agreement that will ensure future compliance.

8.5 What if things don't work out?

8.5.1 If a taxpayer acts in good faith and the restructuring fails we will not, and cannot, cancel the relief we have granted. That is the risk we take when we accept a proposal. There is only one exception to this: where the taxpayer has unintentionally mislead us, even if acting in good faith, section 177(3)(a) may allow the Commissioner to cancel or vary the relief (but see paragraph 8.2.3 above).

8.5.2 If the restructuring fails, other creditors may seek payment of their debts in full. We will, however, only pursue the amount due under the arrangement. Also, we will not pursue any penalties that were remitted under the arrangements.

9. Objection rights

9.1 Where the Act provides objection rights those avenues must be used. However, the objection rights for section 177 are very limited:

- Section 125(j)(iv) of the Tax Administration Act 1994 provides that there is no right of objection to any provision in section 177 of the Tax Administration Act 1994 that is left to the discretion, judgment, opinion, approval, consent, or determination of the Commissioner.
- Section 125(b) provides that there is no right of objection to any decision of the Minister of Finance under the Act (including in relation to relief granted in excess of $50,000 under section 177).
- Section 177(4) provides that there is no right of objection to any decision of the Commissioner to grant relief under section 177(1) or to cancel relief under section 177(3).

9.2 The only objection right in relation to section 177 relief is the right to object to an assessment issued under section 177(2) (see paragraph 5.6).

9.3 Although there are no rights of objection under section 177(1) and (3), where the taxpayer considers that we may have been unfair in our decision, we will discuss the case with the taxpayer and consider renegotiating the proposed arrangements.

10. Examples of applying section 177

We have included some examples, in Addendum E, of how section 177 would apply in the specific fact situations that are outlined.

Addendum A

The Law: Section 177, Tax Administration Act 1994

Discretion to grant relief from income tax or fringe benefit tax in cases of financial hardship

(1) Subject to this section, on application for relief made in writing by or on behalf of any taxpayer who-

(a) Is, or is likely to become, liable for payment of -

(i) Any amount of income tax levied under section BB 1 of the Income Tax Act 1994 in respect of the income derived by that taxpayer (whether that income is income derived or deemed to be derived under the qualified accruals rules or otherwise); or

(ii) Any amount of fringe benefit tax; and

(b) Is at the time of the application in financial difficulties,-

the Commissioner may, if the Commissioner considers it necessary or desirable to do so in order to maximise the net present value (calculated as at the date of application) of any recovery or likely recovery from the taxpayer of that amount of income tax or fringe benefit tax, or any part of the income tax or fringe benefit tax, grant relief to the taxpayer by either or both of -

(c) The remission of the whole or part of that amount of income tax or fringe benefit tax; or

(d) Entering into an arrangement with the taxpayer for the payment of the whole or part of that amount of income tax or fringe benefit tax in 2 or more instalments.

(2) The Commissioner may, if the Commissioner thinks fit, at any time after receipt of the application referred to in subsection (1), require any taxpayer to whom this section applies to make a return of income derived from any specified transaction or transactions, or during any specified period, and may assess the taxpayer for income tax on the income so returned and shall give notice of the assessment to the person so assessed, and subsections (3) to (6) of section 44 shall apply to such an assessment as if it were an assessment made in accordance with subsection (2) of that section.

(3) Where -

(a) The Commissioner has reason to believe that the information provided by the taxpayer to the Commissioner for the purposes of application of this section is misleading in any respect to an extent which, in the opinion of the Commissioner, renders it inappropriate for the Commissioner to have granted the whole or part of any relief granted under this section; or

(b) The Commissioner receives further information relating to the taxpayer's affairs at the date relief was granted which, in the opinion of the Commissioner, renders it inappropriate for the Commissioner to have granted the whole or part of any relief granted under this section,-

the Commissioner may, in relation to any amount of income tax or fringe benefit tax, cancel the whole or any part of any relief granted in accordance with subsection (1) and this Act and the Income Tax Act 1994 shall apply as if such relief had never been granted.

(4) There shall be no right of objection to any decision of the Commissioner -

(a) To grant relief in accordance with subsection (1); or

(b) To cancel relief in accordance with subsection (3).

(5) No amount of income tax or fringe benefit tax in excess of $50,000 in any case shall be remitted or be subjected to an arrangement for payment by instalments under this section except with the approval of the Minister, given either specifically with respect to that case, or generally with respect to any class or classes of cases.

Addendum B

Information required in an application for relief under section 177, Tax Administration Act 1994

B.1 You can use form IR 40E to make your application. It is available from the Debt and Return Management staff at your local Inland Revenue office.

Use of IR 40E is not compulsory or a prerequisite to a section 177 application. However, the application is required to be in writing.

Identification

B.2 Taxpayer's name

B.3 Taxpayer's IRD number

B.4 Applicant's name (if applying on behalf of the taxpayer)

B.5 Evidence of the applicant's authority to act (see paragraph 4.4 of the policy statement).

Contacts

B.6 Business and residential addresses and telephone numbers for the taxpayer, the applicant, and any other of the taxpayer's representatives.

B.7 Addresses where official documents can be served on the taxpayer and the applicant.

Financial position

B.8 Balance sheet or (for individuals) a statement of all of the taxpayer's assets and liabilities dated no earlier than three months prior to the date of the application. Provide:

- A detailed balance sheet or statement of assets and liabilities; and
- A summary; and
- A certificate to the effect that the taxpayer's financial position has not changed materially since the date and time of the balance sheet or statement of assets and liabilities.

B.9 A list of creditors showing (in order of the significance of the debt):

(Note: a creditor owed even a small amount may be "significant" if he or she can affect the taxpayer's operations disproportionately to the size of the debt).

- Name.
- Address.
- The amounts owing and due dates.
- Proposed payments and dates.
- Amount, date, and conditions for any proposed remission of the debt or any part of it.
- Any other material information, e.g., whether the debt is disputed, whether the creditor owes any amounts to the taxpayer, brief details of any legal actions taken by the creditor to recover the property.

B.10 Profit and loss statements for the last two complete accounting years.

B.11 Profit and loss statement for the period from the end of the last accounting year to the date of the balance sheet or statement of the taxpayer's assets and liabilities sought in paragraph B.8 above, accompanied by a statement of the movements in the taxpayer's cash and other assets since the date and time of that balance sheet or statement.

B.12 Budgeted cash flow statements, profit and loss statements, and balance sheets for each quarter and year during the term of the proposed arrangement and the year following it.

B.13 A written explanation of the factors critical to the success of the budgets and of the assumptions underlying the budgets.

B.14 A list of all significant assets (costing or worth more than $10,000) that have left the taxpayer's control in the two years prior to the date on which the application is made, showing for each asset:

- Cost to the taxpayer (including improvements).
- Date of acquisition.
- Date it left the taxpayer's control.
- Realisable value at that time (including improvements by the taxpayer).
- Nature and value of compensation received by the taxpayer in exchange (this effectively requires the taxpayer to advise whether any cash, shares, trade-in value, or other benefits were received as compensation for the disposition).

Tax position and relief sought

B.15 A list of the payments that are or will become owing to Inland Revenue. This should include all taxes and imposts (e.g., income tax, PAYE and other tax deductions, Accident Compensation levies, GST, FBT, and Child Support), not just those for which remission is sought, and should state for each:

- The nature of the debt.
- The amount.
- The amount of remission sought under section 177.
- The dates and amounts of any proposed deferred payments under section 177(1).

B.16 A list of returns and other tax obligations that are not filed or otherwise fulfilled.

Sources of financial support

B.17 List each associated person (and in the case of companies, each director), giving:

- Name and address.
- IRD number (where known).
- Relationship to the taxpayer.

For this purpose, associated persons include relatives of the taxpayer within the first degree, and companies linked by ownership to the taxpayer. Local Inland Revenue offices or tax advisers can provide more information about this if needed.

B.18 Details of all trust arrangements known to the taxpayer where the taxpayer or any associated person is a beneficiary, or where the trustee has a discretion to benefit the taxpayer or any associated person. The details should include (where known):

- Names, addresses, and telephone numbers of trustees.
- IRD number of the trust.
- An explanation of how the trust was established and how it came into possession of its assets.
- An explanation of the taxpayer's and any associated person's rights and prospects from the trust.
- A copy of the trust deed and any other instructions to the trustees, if available.

Date of restructuring

B.19 The date on which all the taxpayer's creditors affected by any proposed debt restructuring are expected to agree to it.

Declaration

B.20 We require the taxpayer (or an applicant making application on the taxpayer's behalf) to sign the declaration contained in IR 40E. That declaration is to the effect that the information contained in the application is, to the best of the taxpayer's knowledge, correct and not misleading whether by failure to disclose information or otherwise.

The declaration is required in the following form:

i. Where the taxpayer is making application on his or her own behalf (that is, an individual, a self-employed person, or a trustee):

I have read all the information contained in and referred to in this application. To the best of my knowledge and understanding I declare that I am satisfied that:

a. The information provided represents a true and complete statement of my current financial and taxation positions;

b. The application contains a realistic and reasonable assessment of my future prospects;

c. The assumptions upon which those future prospects are based are well founded and able to be substantiated; and

d. No material information has been knowingly omitted from the application.

ii. Where the taxpayer is a body corporate such as a company or incorporated society:

We the directors [or other persons who control the taxpayer's financial affairs] are duly authorised to act for [the name of the body corporate]. We have read all the information contained in and referred to in this application. To the best of our knowledge and understanding we declare that we are satisfied that:

a. The information provided represents a true and complete statement of [name of the body corporate] current financial and taxation positions;

b. The application contains a realistic and reasonable assessment of [name of the body corporate] future prospects;

c. The assumptions upon which those future prospects are based are well founded and able to be substantiated; and

d. No material information has been knowingly omitted from the application.

In the case of a body corporate, all the body's officers (e.g. company directors) should sign the declaration. If an officer declines to sign the declaration, the taxpayer can still lodge the application. However, we would expect to be informed if an officer refuses to sign the declaration. We would also expect that an explanation of the reasons for the refusal would accompany the declaration. We may wish to discuss it with the officer concerned.

Addendum C

Calculating the net present value

C.1 In calculating the net present value ("NPV"), we allow for the time value of money interest. We also allow for the probability of payment: risk. We use a simple method to reduce the likelihood of misunderstanding. This calculation involves:

- The amount of the payment, multiplied by
- The probability of payment (for risk), divided by
- The discount factor appropriate to the term (for interest).

Example

Expanding Example 3 in Addendum D (the one involving the calculation of the Government Stock rate) - at 1 May 1992 the applicant proposes two payments: one of $38,000 on 30 September 1992 and one of $135,000 on 31 January 1994. The first payment will be made from a business cash surplus. The second will be made from the sale of a property to a person who is considered by the applicant and the creditors (including us) to be financially sound and reliable.

1. Take the two discount rates: (for 30 September 1992 and for 31 January 1994) in Addendum D, i.e., the rate for 30 September 1992 is 1.029 and the rate for 31 January 1994 is 1.131.

2. Find the probability of each payment being made.

   The first payment is being made in 5 months, somewhat less than the year referred to in the 60 % probability example at paragraph 3.8 of the policy statement. It will be financed from a cash surplus in the business. The applicant gives this a probability of 75%, starting with 60% for a payment up to a year out and adding 15%:

   - Because the proposed payment is only 5 months out; and
   - Because of the nature of the applicant's business there is a greater degree of certainty that the payment will be made.

   The second payment is to be funded by a sale of property that can reasonably be expected to proceed because there is a long-term agreement for sale. However, settlement is a year and 9 months away. This could have a probability of 90%, starting at 90% and recognising:

   - That the sale has already been arranged (which increases the probability of payment); and
   - That it will not be settled for some time (which is a source of increased uncertainty).

3. Now calculate the NPVs:

	Amount	x	Probability/Discount	=	NPV
1.	$38,000	x	75%/1.029	=	$27,696.79
2.	$135,000	x	90%/1.131	=	$107,427.06

3. To work out the NPV of the proposal, add the two NPVs together:

1.		$ 27,696.79
2.	plus	$107,427.06
Total		$135,123.85

Note

The method we have chosen to use as a general rule for calculating net present values is a simplified technique. There are methods that adjust for the probability of receiving a payment in setting the discount rate. The discount rate is then described as a "risk-adjusted" discount rate. These methods require a little more information, in particular some reliable means of estimating the risk adjustment. We are happy to use such methods of calculating net present value in any particular case if the information required to do so is available.

Addendum D

Calculating the discount rate

D.1 Taxpayers (or applicants on their behalf) are not obliged to calculate either the discount rate or the net present value of their proposal in submitting their application. However, they may do so if they wish - it may be helpful for the taxpayer to evaluate the likelihood of the proposal being accepted.

We will use the following relatively simple method of calculating the discount rate.

Requirements for the calculation

D2.
- The time (in years and days) between the date of application and the date of the payment; and
- The market yield for Government stock with the same term; and
- A calculator capable of performing exponential calculations (it will have an "xy" key or "yx" or something similar. If you haven't got one, ring our Debt and Return Management staff with the necessary information and they will do the calculation for you).

In order to perform this calculation it is necessary to first calculate the *Government Stock Rate*. This is discussed at D5 and D6.

The basic calculation

D.3 The steps in calculating the discount rate are:

Step 1: Add 100 to the Government stock rate

Step 2: Divide the result by 100

Step 3: Calculate the term in years and fractions of years (using decimals)

Step 4: Raise the result in step 2 to the power of the result in step 3 (easier with a calculator).

D4. ***Example 1***

The term is 1 year and 63 days and the Government stock rate is 7.25%.

Step 1: Add 100 to the Government stock rate
7.25 + 100 = 107.25

Step 2: Divide the result by 100
107.25 / 100 = 1.0725

Step 3: Calculate the term in years and fractions of years (using decimals)
The term is 1 year and 63 days.
63 days divided into 365 days is 0.173
(0.172602739726 rounded to 3 decimal places)
The term is 1.173 years.

Step 4: Raise the result in step 2 to the power of the result in step 3
$1.0725^{1.173} = 1.086$
(Rounded to 3 decimal places - the actual result on our calculator was 1.085566550301).

Example 2

If: (i) the Government Stock rate is 5.3%
(then the rate per step 2 is 1.053); and

(ii) if the term is 2 years, 61 days
(then the term per step 3 is 2.167)

the discount rate is calculated as follows:

$1.053^{2.167}$ (that is 1.053 to the power of 2.167)
which equals 1.11843131902 or 1.118

The Government stock rate

D.5 The relevant rates can be obtained from a bank or from the business pages of a newspaper or from us. The "bid" rates should be used.

D.6 Often there is no rate for the exact term. In these cases interpolate or extrapolate the rate by:

Rule 1: Taking the rate for the shortest term if all the terms are longer than the one required; or

Rule 2: Taking a weighted average of the rates for the terms each side of the required term; or

Rule 3: Taking the rate for the longest term if all the terms are shorter than the one required.

Example 3

On 1 May 1992 the taxpayer proposed offering the Commissioner an arrangement with two payments: one on 30 September 1992 and one on 31 January 1994.

A discount rate for each payment date is needed.

Newspapers for 1 May 1992 had no rates for either of those days, but had rates for:

"Nov. 1993 7.18 (7.24)
Feb. 1995 7.58 (7.64)
Nov. 1995 7.80 (7.85)
Nov. 1996 8.27 (8.31)
Jul. 1997 8.37 (8.42)
Mar 2002 9.90 (8.92)"

The rate in brackets is the previous day's rate.

The Government stock redemption dates are always the 15th of the month. The "Nov. 93" rate was therefore the rate of the Government stock maturing 15 November 1993; the "Feb. 95" rate is for the stock maturing 15 February 1995; and so on.

All the terms are longer than 30 September 1992 so using rule 1, the shortest, ("Nov. 93") rate (the rate of the Government stock rate maturing 15 November 1993), gives 7.18%. That is a discount factor of 1.0718 for a whole year.

However, the period is only 152 days (1 May 1992 to 30 September 1992), or 0.416 years. The discount rate is therefore $1.0718^{0.416}$, or 1.029 (rounded to 3 decimal places).

31 January 1994 is between 15 November 1993 and 15 February 1995. Interpolate between the rates for those two days.

There are 77 days between 15 November 1993 and 31 January 1994. This is the weighting for the rate for 15 February 1995.

There are 380 days between 31 January 1994 and 15 February 1995. That is the weighting for the rate for 15 November 1993.

The number of days for the first date is the weighting for the second, and vice versa.

There are 457 days in total. This is the divisor.

The calculation is:

$$\frac{(380 \times 7.18) + (77 \times 7.58)}{457} = 7.25$$

The answer is 7.24739607127, rounded to 2 decimal places: 7.25%. That is a discount rate of 1.0725 for a year.

However, the period is 1 year and 275 days (from 1 May 1992 to 31 January 1994), or 1.753 years. The discount factor is therefore $1.0725^{1.753}$, or 1.131 (rounded to 3 decimal places).

Addendum E

Some examples

1. We seek the best possible deal

G is a lawyer and has the following assets and liabilities:

Statement of assets and liabilities†

Assets	Time for sale		Liabilities	
Kiwifruit farm	6 months	$1,000,000	Mortgage over farm*	$1,900,000
Plant for farm	6 months	135,000	Mortgage over residence*	150,000
Fruit in store	1 month	183,000	Chattels security for hire purchase on car‡	18,000
Cash in bank	immediate	23,000	Overdraft secured over residence, farm and cash in bank*	15,000
Private car	immediate	32,000		
Residence	6 months	250,000	Unsecured debts	1,122,000
Personal effects	1 month	15,000	Wages	5,000
			Income tax	43,000
Total assets		$1,638,000	Total liabilities	$3,253,000

* To bank

‡ To dealer

† Assets and liabilities are valued on the basis of an orderly sale commencing at the earliest reasonable time and taking into account holding costs (other than interest on borrowings) and costs of sale. The estimated time for sale is set alongside each asset. The income tax is overdue. G has $43,000 in tax losses available to carry forward.

The estimated annual income from the kiwifruit farm before depreciation, interest and taxes is $300,000. Depreciation and interest total $450,000. If G is bankrupted he will be unable to practise as a lawyer. He could get a job at a lower salary, about $60,000 per annum.

G's income and living expenses are:

Income and living costs

Income		Living costs	
Salary	$93,000	Residential mortgage	$20,000
Kiwifruit farm	(150,000)	Hire purchase on car	11,000
		Food, power, insurance, etc.	15,000
		School fees	14,000
Total income	$(57,000)	Total living costs	$60,000

G proposes the following arrangement to his creditors:

Realisation of assets and use of funds

Asset	When	Expected proceeds	To bank	To dealer	Other creditors
Cash in bank	Now	$23,000	$15,000		$8,000
Car	Now	32,000		$18,000	14,000
Fruit in store	1 month	183,000			183,000
Plant	6 months	135,000	90,000		45,000
Farm	6 months	1,000,000	1,000,000		
Residence	6 months	250,000	250,000		
Personal effects	1 month	15,000	15,000		
Total		$1,638,000	$1,370,000	$18,000	$250,000

Employees' wages will be paid in full from the cash in bank. This will leave G owing the bank $695,000 and other creditors $920,000.

In addition G proposes to pay the following amounts for unsecured debts from his salary:

This year	$46,000
Next year	$21,000
Year 3	$18,000

The applicant's calculations for the amount were:

For the first year

After tax income, after taking into account:

Tax losses, approx		$93,000
Rent	$18,200	
School fees	$14,000	
Living Costs	$14,800	
		$47,000
		$46,000

For the second year

After tax income, taking into account:

Tax losses, approx		$93,000
Rent	$18,200	
School fees	$14,000	
Living Costs	$16,000	
		$48,200
		$44,800

For the third year

After tax income, taking into account:

Tax losses, approx		$67,400
Rent	$18,200	
School fees	$14,000	
Living Costs	$17,200	
		$49,400
		$18,000

The amounts he is offering are the remainder of his salary after living costs, rent of $350 per week and school fees. The higher amounts are available in the first and second years because tax losses carried forward will result in higher incomes after tax in those years.

In exchange he asks:

- The bank to cease charging interest immediately.
- All creditors to forgive the balance owing once he has made the last of the proposed payments.
- Inland Revenue to forgive any tax that may arise when the debts are eventually forgiven.

We expect that if we pressed G to bankruptcy:

- We would receive a smaller share from the disposal of his assets, at much the same time.
- He would be released from bankruptcy after about three years, having made the following payments for unsecured debts:

First year	$27,000
Second year	$25,800
Third year	$10,000

  These amounts are the remainder of his likely salary in the new job after living costs and rent of $350 per week. Again, the higher amounts are available in the first and second years because the tax losses carried forward will result in higher incomes after tax in those years. The amounts available will be calculated in the same way as the calculations opposite, but the income is $60,000 and the school fees are excluded.
- G would pay no tax on the cancellation of his debts when he is released from bankruptcy.

It is clear that every payment offered under the arrangement is greater than the payment that would be available at the same time if we pressed G to bankruptcy. We don't have to do the calculations to see that the net present value of G's offer is higher than what we would get if we pressed him to bankruptcy. G is offering more in every year. The difference is in the likely payments from his salary. He is offering more because he expects to be able to continue in practice.

The advantages G will secure from his proposal are that he will retain his present position and his qualification to practise law and he could continue to meet his children's school fees.

Although the net present value of G's proposal is higher than the net present value of pressing him to bankruptcy, we would not accept it. Clearly G could further reduce his living costs by reducing the amounts spent on education and rent. We would agree if the proposed payments from his salary were increased by about $14,000 a year.

2. We will negotiate in good faith with all involved and we will press for compensation for the use of tax losses

X Ltd is a manufacturing company with:

Total assets	$10 million
Total liabilities	$50 million
Tax losses brought forward	$8 million

All assets are unencumbered and can be realised almost immediately. The total liabilities include $85,000 in overdue PAYE, $560,000 in overdue GST and $12,000 in overdue FBT. There is no income tax liability.

X Ltd is a 100% owned subsidiary of K Ltd, which has taxable profits in excess of $8 million.

The directors of X Ltd proposed that X Ltd pay 20 cents in the dollar to all creditors, and ask that creditors forgive the balance owing, $40 million in total. They offer separately to Inland Revenue that the company will pay all that is owing to Inland Revenue and ask that Inland Revenue agree to remit any tax that may arise when the other creditors forgive their debts.

We could press X Ltd and K Ltd to come to an arrangement whereby K Ltd will use X Ltd's losses and will pay X Ltd a sum of money in compensation. With the current tax rate of 33% we would expect that K Ltd would pay X Ltd something between 16.5 and 33 cents in the dollar. At the very least we would expect to recover:

- All of the PAYE (from the company or from the person responsible for the company's PAYE); plus
- $128,500 (about 22.47 cents in the dollar) for the balance of the debt.

We would not accept the directors' proposal as it appears that it will bar other creditors gaining the benefit of the recompense for K Ltd's use of the tax losses while advantaging Inland Revenue. We will not participate in any arrangement that might be contrary to the Companies Act or that will disadvantage other creditors without their knowledge of the arrangement.

Policy Statement

Section 177, Tax Administration Act 1994

Taxpayers in Financial Difficulties

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INLAND REVENUE
TE TARI TAAKE

Taxpayers in financial difficulties

Section 177, Tax Administration Act 1994