

Tax talk - Taxation of commercial debts that are forgiven

FT: Tax on forgiven commercial debts – how is this applied?

ACEO: This refers to a debt, where the borrower and lender are associates, and the debt is forgiven or written off by the lender. When this event takes place, the amount forgiven is treated as the borrower's income and is subject to income tax. It applies to debts forgiven on or after 1 August 2016, which is the date the relevant provision, Section 17(1) (f) of the Income Tax Act (Act), came into effect.

FT: What is a 'commercial debt'?

ACEO: A 'commercial debt' is a business debt for which the interest, if it is paid or payable by the borrower, is a deductible expense. If the debt is interest-free, it is still a commercial debt if interest charged would have been deductible.

For example- Hari (borrower) obtained a loan from an associate company XCo (lender) to finance his business operations. The income from that business is taxable and Hari can claim any interest expense charged by HariCo. If HariCo provides the loan interest-free to Hari, the loan is still a commercial debt for the purpose of Section 17 (1) (f) of the Act because if interest was paid, it would have been a deductible expense for Hari. If however the loan obtained by Hari was to fund a non-business expense such as a personal computer, it is not a 'commercial debt'.

FT: How do you define 'associate'?

ACEO: 'Associate' is defined in Section 4 of the Act. In general, two persons are associates if they have family or business connections and the relationship puts one in a position of influence over the other or both can be influenced by a third person. Some of the specific relationships covered in the Act are (i) individuals and a relative of the individual (ii) a partner in a partnership and the partnership (iii) a trust and a beneficiary (iv) a member of a company and the company (v), and two companies. For partnerships and companies an associate is a person who has controlling interests (more than 50%) for example in rights to dividends, income, capital or voting rights.

FT: How would you define forgiven?

ACEO: Forgiven, in the case of a commercial debt, means a debt where the borrower's obligation to pay it is waived or the lender's legal right to recover it under the Limitation Act (Cap 35) has expired.

Example - RCo is an associate of XCo and owes XCo \$3000. It is a commercial debt that remained unpaid for 3 years. XCo wrote-off the debt on 4 April 2017. The amount forgiven is treated as RCo's business income and will be included in its gross income for the tax year 2017.

A debt is also forgiven if under an arrangement made by the lender and borrower, the borrower is no longer required to pay all or part of it. The debt is treated as forgiven at the time the agreement is made.

Example: JCo lends \$6,000 to an associate of the company, YCo, on 20th December 2016. Under the terms of the agreement, the loan is interest free and repayment is \$1000 a month from January 2017. The balance will be written off in April 2017. Since an arrangement has been made for part payment and waiver of the remaining debt (\$3,000), this amount will be treated as business income and included in YCo's gross income for the tax year 2016 (i.e. it is treated as forgiven on 20 December 2016; the time the agreement is made).

FT: What if the commercial debt forgiven is between related parties who are not associates

ACEO: An amount of commercial debt forgiven is only taxable under the provisions of section 17 (1) (f) of the Act if the lender and borrower are associates. However this does not mean that the gain derived from the forgiven debt by the borrower is not taxable. Forgiven loans can also be taxed under other provisions of the Act. It can be a deemed dividend or treated as a fringe benefit particularly if the borrower is an individual. It may even be treated as ordinary income if we find that the borrower's gains from forgiven debts appear to be recurrent.

Example - Alice holds 49% shareholding interest in XCo. Alice owes XCo \$2000. It is a commercial debt, forgiven in October 2016. Since Alice is a minority shareholder and therefore not an associate of XCo for tax purposes; the amount forgiven is not taxable under section 17 (1) (f) of the Act. However, the amount forgiven may be treated as a deemed dividend for which XCo will be required to pay dividend withholding tax.

FT: What is the general treatment of commercial debts forgiven between un-related parties?

ACEO: The commercial debt forgiven rules in section 17 (1) (f) of Act only apply if the lender and borrower are associates, therefore this section does not apply to the situation described above. Example - SCo owes ZBank \$3000. It is a commercial debt and forgiven in October 2017. Although the debt is a commercial debt, SCo is not an associate or member of ZBank, therefore the amount forgiven is not taxable.

FT: How will FRCA treat bankruptcy cases considering that the courts would have determined that the person does not have the ability to pay?

ACEO: The operation of Section 17 (1) (f) of the Act is such that a person that has been declared bankrupt will still be required to pay tax on the amount forgiven if it falls under this Section.

Example - JCo loaned \$10,000 to an associate of the company, Ben in 2013. It was a commercial debt and Ben paid \$7000. JCo was able to take legal action and in 2017, Ben is declared bankrupt. JCo will write –off the debt because it is irrecoverable. For tax purposes, the debt is forgiven and \$3000 will be included in Ben's gross income for 2017.

If JCo is unable to sue Ben and \$3000 remains unpaid within 6 years from 2013 (i.e. by 2019), for tax purposes , the debt will treated as forgiven in 2019 and included in Ben's business income. The debt forgiven may be a deemed dividend under other provisions of the Act as well.

FT: How would you treat a situation where a non-commercial debt is forgiven, and the borrower is an “associate” who has been declared bankrupt?

ACEO: Since it is not a commercial debt, the amount forgiven will not be taxable under section 17 (1) (f) of the Act. However, it may be treated as a deemed dividend if the associate is an individual.

Example - JCo lent \$10,000 to Len, an associate of the company, in 2013. The loan was used to buy Len's personal car. In 2016 JCo sued Len for \$4000. Len was declared bankrupt and the amount was written off. If the amount is treated as a deemed dividend, JCo will be required to pay the dividend tax payable on the deemed dividend.

FT: How about Commercial debt forgiven where the borrower is an employee?

ACEO: Since the borrower and the lender are not associates, the amount forgiven will not be treated as the employee's business income. However, the employer will be required to pay the Fringe Benefit Tax as the waived debt is a fringe benefit.

Example - JCo lends \$4,000 to Sera an employee. The loan was for her small business. She retires 3 years later and the remaining debt is forgiven. Although the debt forgiven is a 'commercial debt', Sera is not an associate of JCo therefore the commercial debt forgiveness rules does not apply. JCo will be required to pay Fringe Benefit Tax on the \$4000 debt waived.

FT: How does a person who has a forgiven commercial debt, report this?

ACEO: A person who has made a gain due to a forgiven commercial debt and the amount is taxable under section 17 (1) (f) of the Act, must include the amount forgiven in the person's gross income. It is taxable in the year in which the debt was forgiven so must be reported in the tax return for that year. Lenders who have written off debts covered under the relevant section will also be required to report this information in income tax returns.