[Insert DD Month YYYY]

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[Insert Client Name]

[Insert Client Position]

[Insert Company Name]

[Insert Company Address]

[Suburb State Post Code]

Dear [Insert Client Name]

**Re: Commercial debt forgiveness**

Whenever a debt is forgiven, assigned or otherwise dealt with, consideration should always be given to the application of the Commercial Debt Forgiveness (**CDF**) rules contained in Division 245 of the *Income Tax Assessment Act 1997* (**ITAA 1997**), as these rules can reduce the value of certain tax attributes of the borrower.

**Executive Summary**

When the CDF Rules apply to a debtor entity (being the borrower), they can progressively reduce the tax balance of the following items of the debtor (in the order detailed below):

1. income tax losses of a prior income year
2. capital losses of a prior income year
3. certain deductible expenditures, and
4. cost base of certain CGT assets.

**Rationale for CDF Rules**

When a creditor (i.e. lender) writes off a debt this will give rise to a financial gain to the debtor (i.e. borrower) who will book the amount forgiven as a credit in its profit and loss account and as a debit to the relevant creditor’s liability account in its balance sheet.

Whilst a creditor may be entitled to a tax deduction or a capital loss when a debt is forgiven, the debtor will not generally include the gain in its assessable income as the debtor is merely being relieved of a liability. Nor will such an amount generally constitute ordinary income derived in the course of business or be specifically assessed to the debtor as statutory income. Having said that, a forgiven debt may be assessed as ordinary income if it is inextricably linked to the ordinary business of the debtor.

There may also be consequences under section 109F of Division 7A of the *Income Tax Assessment Act 1936* (**ITAA 1936**) where a private company forgives a debt owed by:

* a shareholder
* an associate of a shareholder, or
* a former shareholder or former associate of a shareholder if a reasonable person would conclude the amount was forgiven because the entity had been a shareholder or associate at some time.

Where Division 7A applies to a debt forgiveness, a dividend is deemed to have been paid to the debtor entity at the end of the year in which the debt was forgiven, subject to the company’s distributable surplus and any exceptions that may apply.

Where an amount is not otherwise included in the assessable income of the debtor (e.g. as a deemed dividend under Division 7A), the CDF rules will potentially apply to reduce the tax attributes of the debtor equal to the economic gain received by the debtor as a result of the forgiveness.

**Commercial Debt Forgiveness Rules**

The CDF provisions require the debtor to work out the total of any net forgiven amount for the year which will be applied to reduce the balance of the following tax attributes (in the order shown below):

1. income tax losses of a prior income year
2. capital losses of a prior income year
3. certain deductible expenditures, and
4. cost base of certain CGT assets.

The end result is that tax will eventually be borne by the debtor as there will be a reduction in losses, deductions and asset cost bases available to reduce future assessable income or capital gains that the debtor may derive.

Any part of the net forgiven amount which remains after being applied against the balance of all the above tax attributes is disregarded.

The steps to be applied in determining whether the CDF provisions apply are discussed further below.

1. **Is there a commercial debt?**

The CDF provisions only apply where the relevant debt is a ‘commercial debt’. Firstly, the liability being forgiven must be a debt. An example of liabilities that are not debts for the purpose of the CDF rules include an unpaid present entitlement.

A debt is a commercial debt if any interest paid or payable on that debt would have been allowable under the general deductibility provisions of section 8-1 of the ITAA 1997. Furthermore, interest free debt will also be regarded as being a commercial debt if such interest would have been deductible had it been charged.

In applying this test any other provision denying interest deductibility is ignored including, amongst others, the thin capitalisation and capital protected loan provisions.

1. **Has there been a forgiveness of a debt?**

A debt is forgiven if the debtor’s obligation to pay the debt is ‘released, waived or otherwise extinguished’ other than by repaying the debt in full. This will typically occur under a deed or an agreement but may be inferred in certain circumstances (see *FCT v* *Tasman Group Services Pty Ltd* [2009] FCAFC 148).

A debt forgiveness may also occur where:

* the debt is irrecoverable due to the operation of a statute of limitations as a forgiveness will arise where the creditor’s right of recovery expires at the end of the relevant recovery period. The period of time over which such a debt may become statute barred is typically six years, but it can be as low as three years in certain jurisdictions
* the debtor and creditor agree that the obligation to repay a debt will cease at a future time without the debtor incurring any financial obligation (other than a nominal amount) in which case the debt is forgiven when the agreement is entered into and any later forgiveness is ignored
* a creditor assigns its rights to receive payments to a new creditor who is an associate of the debtor, or the debt is assigned under an agreement to which the new creditor and the debtor are both parties. In either case the debt will be taken to have been forgiven at the time the debt was assigned except where the debt was acquired by the new creditor in the ordinary course of trading on a securities market, or
* a person subscribes for shares in the company to enable the company to repay a debt it owes to that person. The amount paid from the share capital subscribed will be taken to be an amount forgiven at the time it is so applied.
1. **Is there an excluded debt forgiveness?**

It should also be noted that debt forgiveness effected under a bankruptcy law, by will or for reasons of natural love and affection, will be excluded from the operation of the CDF provisions. In Taxation Determination TD 2022/1 the Commissioner opines that debt forgiveness for reasons of natural love and affection requires that the creditor be a natural person, meaning this exclusion is not available for companies that forgive debts. Only in very limited circumstances could a natural person acting in a trustee or partnership capacity satisfy the exclusion of the CDF provisions for reasons of natural love and affection.

The following will also be excluded from the CDF provisions:

* the waiver of a debt constituting a fringe benefit, and
* a debt that is included in the debtor’s assessable income, such as a deemed dividend under Division 7A of the ITAA 1936.
1. **How much has been forgiven (‘net forgiven amount’)**

The amount that a debtor must apply against the balance of its tax attributes (if any) is called the ‘net forgiven amount’. The net forgiven amount is equal to the gross forgiven amount adjusted for certain amounts (e.g. amounts included in assessable income).

*Gross forgiven amount*

The gross forgiven amount is equal to the notional value of the debt less any consideration provided or deemed to have been provided (i.e. the offsetting amount) by the debtor in respect of the forgiveness.

*Value of the debt*

The notional value of a debt is its market value at the forgiveness time, assuming that, at the time the debt is incurred and at the time it is forgiven, the debtor was solvent (the solvency assumption). The solvency assumption is the assumption that the debtor was able to repay that debt and all debts, as and when they fell due, at the time the debt was incurred and when the debt was forgiven.

There are adjustments that must be taken into account in circumstances where the value of the debt is affected by market variables, such as movements in interest and foreign exchange rates. There are also special rules for calculating the notional value of a non-recourse debt and a previously assigned debt.

The solvency assumption will not apply where the creditor and debtor were not dealing at arm’s length at the time the debt was incurred, and the debt was not a money lending debt (being a debt made in the ordinary course of a money lending business). In this case, the market value of the debt will be based on the debtor’s financial capacity at the time the debt was incurred, which may be for a lesser amount than its face value.

*Offsetting amount*

The debt’s notional value will then be reduced by any consideration provided by the debtor at the time of the debt forgiveness, being any cash paid and/or the market value of any property provided.

It may also be reduced by deemed consideration equal to the debt’s market value where there is no consideration in respect of the forgiveness, or the consideration is greater or less than its market value, and the parties are not acting at arm’s length.

In order to ensure symmetry, the CGT provisions under section 116-30 of the ITAA 1997 contain a corresponding market value substitution rule which deems the creditor to have received market value consideration in each of these scenarios thereby reducing the creditor’s capital loss.

After applying actual or deemed consideration against a debt’s notional value any resulting balance is known as the gross forgiven amount of the debt.

*Calculating the net forgiven amount*

Before arriving at the net forgiven amount, the gross forgiven amount of the debt is reduced for:

* any amount included in the debtor’s assessable income that the debtor is required to include in assessable income in any year as a result of the forgiveness
* any reduction in allowable deductions for the debtor for any income year which have been reduced as a result of the forgiveness, and
* any reduction in the cost bases of the debtor’s CGT assets which has been reduced because of the debt forgiveness.

Where there is a forgiveness of an intra-group debt, being a debt owed by one company to another company under 100% common ownership, the companies can enter into an agreement whereby the creditor company will forego an entitlement to a capital loss or a bad debt deduction arising from the forgiveness in return for a corresponding reduction of the provisional net forgiven amount for the benefit of the debtor company. Such agreement must be in writing to be effective.

1. **Application of total net forgiven amount to tax attributes**

Where a net forgiven amount arises under the CDF rules, the net forgiven amount will be applied at the commencement of the income year in which the forgiveness takes place to progressively reduce the debtor’s tax attributes in the following order:

1. prior year income tax losses
2. unapplied net capital losses
3. certain deductible expenditures, including the opening adjustable value of depreciating assets, and
4. cost bases of certain CGT assets.

Within each of the above four categories of tax attributes, the debtor can choose the relevant loss, deductible expenditure or asset cost base against which the net forgiven amount is to be applied and the amount to be applied, but the net forgiven amount must be applied to the maximum extent possible within each category in the above order of priority.

Any amount remaining after exhausting all such tax attributes is not included in the assessable income of the debtor.

Some common examples of deductible expenditures are deductions relating to:

* depreciating assets subject to Division 40
* blackhole expenditure under section 40-880
* assessable income producing buildings and capital works subject to Division 43
* borrowing costs incurred under section 25-25 of the ITAA 1997
* research and development expenditure under Division 355 of the ITAA 1997
* prepaid expenditure
* expenditure on scientific research, and
* expenditure on Australian films.

Such deductible expenditures are reduced to the extent that they were deductible in the year in which the forgiveness occurred or would be deductible in a later year if no event or circumstance occurred which would affect their deductibility. For example, the application of a net forgiven amount will not only apply to a deduction for a decline in value of depreciating assets in the year in which the debt was forgiven but also potentially to the closing adjustable value of such depreciating assets that would otherwise be depreciable in later years. However, there would be no adjustment to the closing written down value of assets acquired in the forgiveness year.

The cost base of most CGT assets will also be subject to a reduction unless it is specifically excluded under section 245-175 of the ITAA 1997. These excluded CGT assets include:

* CGT assets acquired after the start of the forgiveness income year
* pre-CGT acquired assets
* personal use assets
* main residence
* goodwill
* superannuation interests, and
* trading stock.

Importantly, CGT assets whose cost base may be potentially reduced include cash like assets that would tend to be realised regularly. Such assets would include:

* debtors (e.g. from trading)
* bank deposits
* term deposits, and
* short term loans assets.

As such, where a debtor has a total net forgiven amount careful consideration must be given to how the amount is applied against the cost base of assets (if applicable).

We note that the practical application of these rules can often be difficult and it is very important to consider the possible application of the CDF provisions before forgiving a debt at year end.

If you have further queries on any details contained within this letter or have any other tax planning issues, please contact me on [insert telephone number of Partner].

Yours faithfully

**[Insert name of Partner]**