DEFUSE THE TICKING
TAX BOMBS

Division 245: The potential income tax cost of a forgiven debt

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WA Division
Tuesday 1 December 2015
City West Receptions, West Perth

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1 Introduction

This paper discusses the commercial debt forgiveness rules (Division 245) and their tax consequences for debtors. Whilst the forgiveness of a debt is often good news for a debtor, the tax implications need to be considered because they are potentially adverse. A taxpayer, or their adviser, may not appreciate the technical operation of Division 245, particularly if they have not regularly dealt with it previously. This paper focuses on the operation of Division 245, but also notes how it can interact with other sets of rules – which will also need to be taken into account.

An outline of the paper is as follows.

- Section 1: background and rationale for the commercial debt forgiveness rules;
- Section 2: what debts will be covered by and excluded from the rules;
- Section 3: what constitutes the forgiveness of a debt;
- Section 4: determining the value of the debt and the offsetting amount, to arrive at the gross forgiven amount;
- Section 5: determining the net forgiven amount, and the use of common ownership agreements;
- Section 6: applying the net forgiven amount to reduce other income tax ‘benefits’ of the debtor; and
- Section 7: special record keeping requirements for debts.

1.1 Former Schedule 2C and current Division 245

The commercial debt forgiveness rules were originally introduced in 1996, as Schedule 2C to the Income Tax Assessment Act 1936 (ITAA36). In 2010 the rules were re-written and transferred to Division 245 of the Income Tax Assessment Act 1997.1 Division 245 applies to debts forgiven from the 2010-11 income year onwards, including where the debt first came into existence prior to 2010-11.2

In most cases, the effect of the rules under Division 245 is the same as, or similar to, the former Schedule 2C.3 Australian Taxation Office (ATO) interpretative materials on the former provisions can therefore continue to be relevant guidance. However, the specific operation of the new provisions will always need to be checked.

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1 Unless otherwise stated, all statutory references are to this Act.
3 For clarity, note that the commercial debt forgiveness provisions in Schedule 2C had similar section numbering (commencing with 245).
The Explanatory Memorandum to the 1996 amendment Bill\(^4\) that introduced Schedule 2C (1996 EM) set out the underlying rationale for the rules:

6.2 The amendments will ensure that there are appropriate taxation outcomes when a commercial debt is forgiven. The present law contains no specific rules relating to debt forgiveness, with the result that, in general, there are no taxation consequences to the debtor while the creditor usually is entitled to a tax deduction or capital loss for the amount of debt forgiven. The amendments will not treat the debtor as having received a taxable gain, but will apply the forgiven amount in reduction of certain amounts otherwise taken into account in calculating the debtor’s taxable income.

The “certain amounts otherwise taken into account in calculating the debtor’s taxable income” are the debtor’s (carried forward) tax losses, (carried forward) net capital losses, availability of capital allowances and similar deductible amounts in respect of prior expenditure, and cost bases of existing CGT assets. In the forgiveness income year these items are reduced, in that order, to use up the total ‘net forgiven amount’ of the forgiven debt(s). By reducing these items, the debtor’s taxable income in the current year or future years should be higher compared to a base case (i.e. absent operation of Division 245).

The ATO does not need to make a specific determination in order for Division 245 to apply. The parties’ underlying motives for a transaction, or notions of objective purpose, are ordinarily not relevant if the criteria of the particular provision have been satisfied. The debtor and creditor are not required to be related parties, although in practice a forgiveness may be more common in this context.

There are rules designed to cover where an in-substance debt forgiveness is structured in a different or atypical manner. However, Division 245 can operate even if the forgiveness or deemed forgiveness transaction is a genuine commercial one. Sometimes particular rules expressly require the parties to be associates, or not acting at arm’s length, in order to apply. For many others though, there is no such requirement.

1.2 Position of creditor and debtor

The 1996 EM explained that a debtor benefits from a forgiven debt through being relieved of the economic burden of having to pay it in full.\(^5\) A loss is borne by the creditor, and so it is appropriate for the creditor to be entitled to either a tax (revenue) deduction or capital loss, as applicable, in respect of a forgiven debt.\(^6\)

1.2.1 Creditor

In certain (perhaps rarer) cases, a creditor could be entitled to a general deduction under s.8-1 or a bad debt deduction under s.25-35 in respect of the forgiven debt. For a general deduction, the negative limbs of s.8-1 would need to be inapplicable to the creditor (loss of a capital, private or

\(^4\) Taxation Laws Amendment Act (No. 2) 1996 (Cth).
\(^5\) Paragraph 6.5 of the 1996 EM.
\(^6\) Paragraph 6.6 of the 1996 EM.
domestic nature, or incurred in respect of exempt income or non-assessable non-exempt income). Similarly, to be a revenue deduction under s.25-35, a debt that is written off as bad must have been:

- included in the creditor's assessable income (e.g. a completed prior sale or provision of services, where the income was assessed on an accruals basis prior to payment);
- in respect of money the creditor lent in the ordinary course of its business of lending money; or
- acquired by the creditor in the ordinary course of its business of lending money.

A business of lending money is not limited to financial institutions. It could include a special purpose vehicle in a corporate group that arranges finance for other entities (sometimes colloquially referred to as a ‘Fin Co’).

For most creditors, a debt 'asset' – the right to payment – will often be held on capital account. A debt forgiveness would normally constitute CGT event C2 for the creditor. Under s.104-25, CGT event C2 happens if your ownership of an intangible asset ends by the asset (amongst other things):

a. being redeemed or cancelled;
b. being released, discharged or satisfied; or
c. being abandoned, surrendered or forfeited.

In certain circumstances an assignment of a debt (i.e. the right to receive payment) to another party can be treated as a deemed forgiveness under Division 245. In this case, the relevant CGT event for the creditor should be A1 under s.104-5 – the disposal of a CGT asset.

If the creditor’s capital proceeds for the CGT event are less than the amount of debt owing, the creditor may make a capital loss on the debt. In contrast, the ordinary payment of the debt in full should normally not result in a capital gain or loss for the creditor. The first element of the creditor’s cost base should usually be the face value of the debt (absent application of the market value substitution rule).

A company or trust creditor will need to consider the application of the indirect value shifting rules in Division 727 in respect of a forgiveness. A forgiveness may cause a net shift in value from the creditor (the ‘losing entity’) to the debtor (the ‘gaining entity’). If applicable, Division 727 can result in a cost base adjustment (reduction) for equity or loan interests in the creditor.

1.2.2 Debtor

When the debt was incurred, this may have itself given rise to a debtor deduction (e.g. for an acquisition of goods or services). Alternatively, the debt could have arisen under a loan, with the funds received by the debtor used to incur deductible expenditure, acquire a depreciating asset (giving rise to future capital allowance deductions), or acquire a CGT asset (giving rise to future cost base recognition).

However, the debtor will normally not derive an amount of assessable income, or make a capital gain, in respect of the debt either when it initially arose, or when the debtor obtains an economic (notional)
gain when it is forgiven. Therefore, prior to the introduction of Schedule 2C, the government revenue could be in an asymmetric (negative) position in respect of the forgiven debt.

The commercial debt forgiveness rules are intended to overcome this asymmetry, although the timing of the impacts on the debtor's and creditor's respective taxable incomes will not necessarily align in practice. For example, a reduction in the debtor's tax losses may result in it paying greater tax in the current income year, whilst a creditor may be unable to presently utilise a revenue deduction\(^7\) or a capital loss\(^8\). Alternatively, a revenue deduction or capital loss may be presently utilisable by the creditor, but a reduction in the cost base of a debtor's CGT asset may only affect the size of a capital gain or loss when the debtor disposes of the asset in the future.

### 1.3 Tax consolidated groups

At the outset the position of tax consolidated groups should be noted. Specifically, the scenario where the debtor and creditor are both members of the same income tax consolidated group\(^9\) under Part 3-90 at the time of the forgiveness. Division 245 should have no practical operation to the debtor in such a case, even if one or both of the parties was not part of the consolidated group when the debt arose.\(^10\) Most transactions between members of an income tax consolidated group are effectively disregarded due to the operation of the single entity rule. For income tax purposes a debt between consolidated group members is effectively regarded as not existing. The revenue deduction / capital loss for the creditor will therefore also be unavailable, so tax neutrality should be achieved.

Whilst Division 245 should not apply to the forgiveness of an intra-consolidated group debt, note that the share capital tainting rules in Division 197 can still apply, notwithstanding the single entity rule. This is relevant if an intra-group debt is converted into shares, which may result in the transfer of an amount to the debtor's share capital account. See section 4.4.6 of this paper – the issue is primarily whether the market value of the shares is less than the transferred amount.

If there is a tainting, and the debtor is still a member of the consolidated group by the end of the dividend franking period in which the forgiveness occurs,\(^11\) the share capital account of the head company will be tainted. If the debtor has left the group by this time, then its share capital account will be tainted. For this reason, it is often preferable for an intra-consolidated group debt to simply be cancelled, rather than converted into equity.

Of course, not all consolidatable (eligible) groups will have made the irrevocable election to the ATO to consolidate for income tax. This should be distinguished from consolidating for accounting or other purposes. Alternatively, it will often not be possible to consolidate a commonly owned group that includes both the debtor and the creditor. For example, if they are sister companies sitting alongside

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\(^7\) E.g. if the creditor is already in a tax loss position.
\(^8\) E.g. if the creditor does not presently have any realised capital gains.
\(^9\) Including a multiple entry consolidated (‘MEC’) group.
\(^10\) ATO ID 2005/344.
\(^11\) For a private company, the franking period is the income year – s.203-45. Otherwise it is a period of up to 6 months during the income year – s.203-40.
each other. They might not be wholly owned by the same ultimate parent company, but each by the same individual shareholders, or by related shareholders.

Division 245 will need to be considered in these cases, although the possibility of a common ownership agreement may be available.
2 Debts subject to the rules

2.1 Debt

The now repealed Schedule 2C defined a ‘debt’ as a legally enforceable obligation on a person to pay an amount to another person. Division 245 does not define the term ‘debt’, which therefore takes its ordinary meaning. A debt can be defined as a sum of money which is now payable, or will become payable in the future by reason of a present obligation. In particular, it is not limited to a loan – for example, it could include an outstanding payment for a supply of goods or services by the creditor.

Schedule 2C contained an express provision that accrued but unpaid interest was treated as part of the principal debt. This provision was deliberately omitted from Division 245 – such interest is now treated as a separate debt. The ‘interest debt’ is likely to arise at a different time to the ‘principal debt’. Schedule 2C deemed the interest to be part of the underlying debt and arising at the same time, but this was deliberately changed under Division 245.

Division 245 does not apply to all types of forgiven debts. Where Division 245 does not trigger a tax consequence for the debtor, this does not in and of itself prevent the creditor from claiming a revenue deduction or capital loss, if it is entitled to do so.

2.2 Specifically excluded types of debts

The following types of forgiven debts are specifically excluded from the application of the operative rules of Division 245:

a. the debt is waived and the waiver constitutes a ‘fringe benefit’ (in respect of an employment relationship under the fringe benefits tax legislation) – of course, this is likely to have FBT consequences for the employer / creditor, rather than the employee / debtor;

b. the amount of the debt has been, or will be, included in the assessable income of the debtor in any year – as Division 245 should be unnecessary in such a case;

c. the forgiveness is effected under an Act relating to bankruptcy (i.e. for a natural person debtor) – there is no equivalent carve-out in respect of receivership, administration, liquidation or similar arrangement for a corporate entity debtor;

d. the forgiveness is effected by will;

e. the forgiveness is for reasons of natural love and affection; or

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12 Butterworths Concise Australian Legal Dictionary.
14 Subdivisions 245-C to 245-G.
15 See s.245-40.
16 See ATO ID 2003/281.
f. the debt is a tax-related liability, arising under a Commonwealth taxation law\textsuperscript{17} i.e. it was otherwise owed to the Commonwealth.

2.2.1 Other tax provisions

An example of s.245-40(b) is under Division 7A of the ITAA36. The making of a ‘loan’\textsuperscript{18} under s.109D or s.109E, or the forgiveness of a debt under s.109F, by a private company may be treated as an assessable dividend to a shareholder or their associate. Similarly, there are the unpaid present entitlement and interposed entity provisions in subdivisions E, EA and EB of Division 7A.

Fringe benefits tax and Division 7A thus need to be considered before applying Division 245. A detailed analysis of FBT and Division 7A is beyond the scope of this paper. In passing, note that the ‘amount of the debt’ may not be entirely included as assessable income. It could be a lesser amount e.g. with reference to the distributable surplus cap in Division 7A. In such a case, a debtor should still be able to rely on s.245-20 and s.245-40(b) to avoid effective double taxation in respect of the assessable part. Division 245 applies to part of a debt in the same way as it applies to a whole debt.

In contrast, the taxation of financial arrangement (‘TOFA’) provisions in Division 230, if applicable to the debtor, operate after Division 245. The debtor may make a TOFA gain from a financial arrangement on the forgiveness of a debt. The TOFA gain is reduced by the Division 245 ‘net forgiven amount’, or the provisional net forgiven amount if a common ownership agreement applies under s.245-90.\textsuperscript{19} Division 230 could still apply to any remaining balance.

2.2.2 Natural love and affection

Interestingly, the ATO has previously taken the view that the equivalent of paragraph (d), under Schedule 2C, could apply where the creditor is a company. The ATO, in interpretative decision ATO ID 2003/589,\textsuperscript{20} decided that the creditor does not have to be a natural person, only that the reason for forgiveness be ‘natural love and affection’. This could be satisfied by the company’s directors.

ATO ID 2003/589 has not been withdrawn, and therefore presumably still represents the ATO’s view under Division 245. However, the reasoning explains that the debtor had the ability to repay the (entire) debt at the time of the forgiveness. In ATO ID 2003/590 the facts were similar, except that the debtor only had the ability to repay one third of the debt. The ATO decided that for this one third, Schedule 2C did not apply – it was forgiven for reasons of natural love and affection.

For the other two thirds of the debt, the ATO decided that Schedule 2C could apply. The ATO reasoned the creditor had 2 distinct reasons for the forgiveness, and so 2 acts of forgiveness effectively occurred, in relation to the 2 respective parts of the overall debt. It appears that where a

\textsuperscript{17} See s.250-10 and s.255-1 of Schedule 1 to the \textit{Taxation Administration Act 1953} (Cth).
\textsuperscript{18} As broadly defined by s.109D(3) of the ITAA36.
\textsuperscript{19} s.230-470.
\textsuperscript{20} An interpretative decision is often based on a private ruling, the reasoning of which the ATO believes can have more general application to other taxpayers.
debt, or a part of a debt, is forgiven because of the debtor’s inability to repay, this precludes the natural love and affection exception from applying.

An inability to repay should not preclude any of the other exceptions in s.245-40 from applying, where relevant. They identify circumstances, rather than underlying reasons for forgiveness of the debt.

2.3 Interest deductibility

For a debt that is not specifically excluded under s.245-40, it must also be regarded as a ‘commercial’ debt under s.245-10 in order for Division 245 to apply. Primarily, this requires the whole or any part of interest payable on the debt to be deductible. Interest includes an amount in the nature of interest, for example a discount on a security that does not have coupon payments. If the interest is only partly deductible, Division 245 still applies to the entire debt, and not on a pro-rata basis.

The concept of a commercial debt is further expanded to cover 2 other types of cases. Firstly, no interest may in fact be payable on the debt. In such a case, the deductibility test is applied on a hypothetical basis. If interest was payable, and the whole or any part of it would be deductible, then Division 245 can apply to the underlying debt, notwithstanding no interest is in fact payable.

Secondly, there may be a specific provision in the income tax legislation that denies deductibility of interest. Just one example is s.26-25 (there are many others). To enable collection by the government revenue, a deduction is not available where the debtor fails (when required) to withhold and remit interest withholding tax on an interest payment to a foreign recipient (assuming the withholding tax is not itself paid to the ATO by the foreign resident).

Such a specific ‘denial provision’ does not preclude the application of Division 245 to the underlying debt. It is only where a general deduction is denied under the negative limbs of s.8-1, and a deduction is not otherwise available, that the underlying debt is excluded from the operation of Division 245. That is, where the interest, in its entirety:

a. is a loss or outgoing of capital, or of a capital nature;

b. is a loss or outgoing of a private and domestic nature; or

c. is incurred in relation to the debtor gaining or producing exempt income or non-assessable non-exempt (NANE) income,

and a deduction is not otherwise available.

For example, even if there is no deduction under s.8-1, a deduction may still be available under, for example, s.25-85 (profit shares on debt interests) or s.25-90 (debt deductions relating to certain foreign sourced NANE income), enabling Division 245 to apply.

As explained in section 2.2.2, the ATO view is that a debt (or part of a debt) that is forgiven because of the debtor’s inability to pay is not a debt forgiven for reasons of natural love and affection. However, it is possible that interest (or hypothetical interest) on this type of debt is not deductible under s.8-1 – in particular note paragraph (b) above.
It is possible for legal form shares to be subject to Division 245. Broadly, the rules for characterising debt and equity in Division 974 focus on the economic substance of a financing arrangement in terms of its impact on the issuer’s position. The statutory concept of a ‘non-equity share’ covers a legal form share that under the Division 974 rules is characterised as debt for income tax purposes. A potential example is a redeemable preference share, although the application of Division 974 will always depend on the particular terms and conditions of the financing arrangement.

Section 245-15 confirms that the commercial debt forgiveness rules can apply, as if a non-equity share was in fact legal form debt owed by the company to the shareholder. It is not necessary to consider whether a non-equity share would satisfy the ordinary meaning of ‘debt’, but it still must be a commercial debt. Whilst dividends on shares are normally not deductible, a dividend on a non-equity share may be deductible under s.25-85.

The opposite of a ‘non-equity share’ is the statutory concept of ‘non-share equity’. This type of arrangement is regarded as in economic substance equity financing under Division 974, but is not a legal form share. Therefore, it may come within the ordinary meaning of (a legal) ‘debt’ – this was the ATO’s view in ATO ID 2004/377. Although this decision was in respect of the former Schedule 2C, it has not been withdrawn since the introduction of Division 245.

An example of non-share equity is a loan at no interest and a term to maturity of more than 10 years. This should fail the debt test in Division 974, but Division 245 can still apply to it as a legal form debt. Hypothetical interest may be deductible under s.8-1, and s.26-26 (which prevents deductions for distributions on tax law equity) would not prevent Division 245 from applying.

The policy rationale for this position is unclear. One would expect Division 245 to utilise the operation of Division 974 and carve out non-share equity, the converse of specifically including non-equity shares. However, the implications of the broader coverage should therefore be kept in mind.
3 Forgiveness

3.1 Section 245-35

What constitutes forgiveness of a debt is specifically set out in Division 245. Section 245-35 covers the ‘ordinary’ cases:

a. the debtor’s obligation to pay the debt is released or waived, or is otherwise extinguished otherwise than by repaying the debt in full; or

b. the period within which the creditor is entitled to sue for the recovery of the debt ends, because of the operation of a statute of limitations, without the debt having been paid.

Paragraph (a) covers a formal forgiveness – this would typically be documented by the parties, for example in a deed of release. In *Tasman Group Services Pty Ltd v Federal Commissioner of Taxation*,[@21] the Federal Court held that paragraph (a) can operate even without an express written forgiveness, explaining the following points. A ‘waiver’ may be by conduct – it is an intentional act done with knowledge whereby a person abandons a right by acting in a manner inconsistent with that right. Secondly, the expression ‘otherwise extinguished’ is wide and would cover an agreement, enforceable in equity, that the creditor would not set up a cause of action for the debt.

In any event maintaining the status quo, by leaving the debt outstanding, does not indefinitely defer the operation of Division 245. Paragraph (b) of s.245-35 should not be overlooked by a debtor where a creditor has practically given up trying to recover a debt (and may even have written it off as bad), without a release or waiver. Generally in Western Australia the limitation period for a civil debt is 6 years. This is a considerable period of time from when the debt became due and payable.

Paragraph (a) could also cover a ‘novation’ of a debt – where a debt is replaced (e.g. refinanced) by a new debt. That is, the old debt comes to an end at law, commonly under a tripartite agreement between the debtor, the old creditor and a new creditor. A debt defeasance type arrangement should also constitute a forgiveness of the old debtor. This is where a new debtor is substituted to take on the payment obligation vis-à-vis the creditor (typically in exchange for a payment by the old debtor to the new debtor of a lower amount, such as the present value of a future debt).

Section 245-20 should again also be noted – it provides that Division 245 applies to part of a debt in the same way as it applies to a whole debt. The entire debt does not need to be forgiven in order for the rules to be enlivened.

Payment to the creditor by a guarantor may not of itself amount to a forgiveness of the debtor. The issue is whether the debtor’s obligation to pay the debt is released, waived or otherwise extinguished. This should not be the case if the guarantor is subrogated to the position of the creditor – which can occur automatically by operation of law.[@22] That is, the debtor’s obligation in respect of the debt remains on foot, but it becomes payable to and enforceable by the guarantor instead of the creditor.

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[@21]: [2008] FCA 23, [51] (further references omitted). This case dealt with the former Schedule 2C.
[@22]: ATO tax determination TD 2004/17.
Subrogation might be expressly excluded under the original guarantee documentation. If there is not a subrogation, there should be a forgiveness, and the payment by the guarantor will not be an offsetting amount for the debtor.\(^{23}\) This makes sense when you consider the economic gain obtained by the debtor in this scenario. Even if there is a subrogation, in practice the guarantor may then choose to forgive the debt vis-à-vis the debtor.

### 3.2 Section 245-36 – debt parking

The concept of forgiveness is expanded under s.245-36 and s.245-37 to cover scenarios which would not come within its ordinary meaning, but have the potential to result in an in-substance economic gain for the debtor.

Section 245-36 deals with what is commonly referred to as ‘debt parking’. This is where the creditor assigns the right to receive payment to another entity in either of the following circumstances:

a. the new creditor is an ‘associate’\(^ {24}\) of the debtor; or

b. the assignment occurred under an ‘arrangement’\(^ {25}\) in which the new creditor and debtor were parties to.

The concern under (a) is that an associate of the debtor may not seek to recover the debt, or may even extend the time for payment. Paragraph (b) is designed to cover similar ‘artificial’ cases, where the new creditor is technically not an associate of the debtor. Under s.245-36, the forgiveness is deemed to occur at the time of the assignment.

Care should be taken for an ‘ordinary’ debt assignment, so that (b) is not inadvertently triggered e.g. by a tripartite agreement between all 3 parties. At law, the debtor should not normally need to be a party to the assignment documentation itself. The old creditor providing written notice of the assignment to the debtor should be sufficient for the assignment to be valid and effective.\(^ {26}\)

In an unusual case where the consent of the debtor is contractually required for the assignment, it should be obtained separately by the old creditor first. Where the terms of the debt are to be amended, again separate (unconditional) documentation is preferable e.g. an amendment deed between the new creditor and the debtor, after the assignment has taken place.

There is a limited carve-out from s.245-36 if the creditor acquires the right in the ordinary course of trading on a securities market. There will not be a debt forgiveness in that case.

For completeness, note that forgiveness of a debt under Division 7A also includes debt parking. However in Division 7A there is a further requirement: that a reasonable person would conclude (having regard to all the circumstances) that the new creditor will not exercise the assigned right. This

\(^{23}\) Unless the debtor and the guarantor are members of the same tax consolidated group.

\(^{24}\) The definition of ‘associate’ is very broad – see s.318 of the ITAA36.

\(^{25}\) The definition of ‘arrangement’ is also very broad – see s.995.

\(^{26}\) Property Law Act 1969 (WA), s.20.
is not a requirement under s.245-36. A forgiveness could be triggered under s.245-36 even if it is intended, and reasonably justifiable, that the debt will be subsequently paid or enforced.

3.3 Section 245-37 – debt for equity swap

Section 245-37 deals with debt for equity swap or conversion type arrangements. It only applies in respect of a debt owed by a company, and not for example to a debt owed by a trust or a partnership. There is no equivalent provision for trusts or partnerships.

Where a creditor subscribes for shares in a company to enable it to make a payment towards the discharge of a debt (to the creditor), the debt is regarded as forgiven when the subscription money is so applied. Commercially this seems to make sense, as there is no legal obligation or right to the repayment of ordinary equity capital. The net assets of the company (assets minus liabilities) will increase from the swap, which benefits the existing ordinary shareholders. Section 245-37 does not require cash transfers between the parties – it can apply if the amounts are set-off against each other.

Note though that s.245-37 simply refers to the broader concept of ‘shares’, which could include a conversion into shares that are more akin (in-substance) to debt, including non-equity shares. Conversely, it does not refer to non-share equity i.e. the creation of tax law equity that could be legal form debt may be outside the scope of s.245-37. However, the other types of forgiveness would still need to be considered. Once again, it is not clear why s.245-37 refers to (legal form) shares rather than equity (as determined under Division 974).

3.4 Section 245-45 – deferral arrangements

Section 245-45 covers arrangements entered into by the parties under which the debtor’s obligation to pay effectively ceases immediately, even if legally it will not formally cease until a future point in time. That is, where the debtor is still required to provide a financial or other obligation, but this is nominal or insignificant in the circumstances.

The 1996 EM indicates that regard should be had, at the time the arrangement is entered into, of the amount of the debt, the amount of the obligation at the (formal future) cessation time, and the likelihood of the obligation being met. The 1996 EM also referred to the debtor and creditor not acting at arm’s length in respect of the arrangement. Whilst this is likely to in fact be the case, it is not actually a requirement under s.245-45, nor was it under the equivalent provision in the former Schedule 2C.

If s.245-45 applies, the debt is regarded as forgiven at the time the arrangement is entered into. This means the relevant forgiveness time for the purposes of Division 245 cannot be deferred by such an arrangement. If the debt is actually forgiven at a later time, the subsequent deferral is disregarded (s.245-45(2)).

Consider a case where the time for repayment of an existing debt is extended by mutual agreement of the parties. The original debt remains on foot – its terms have been amended, rather than the debt being released, waived or extinguished under s.245-35 and a new debt created. That is, there should not normally be a s.245-35 forgiveness, if the changed arrangement is properly documented.

If the original debt remains repayable (legally owing) in full, the debtor should still make a factual inquiry at the time of the amendment. That is, whether there is a justifiable possibility the debtor would be willing and able to pay more than a nominal or insignificant amount by the extended due date. If the answer is no, then s.245-45 could immediately apply.

Even if the answer is yes, such that s.245-45 did not apply, other changes and matters may also need to be considered. For example, if a full recourse debt became limited recourse, there could be a forgiveness under s.245-35, depending on the change to the creditor’s rights. An extension of the payment date will also trigger a new test under the debt-equity rules in Division 974. If the total term now exceeds 10 years, the debt test may no longer be satisfied going forward, depending on the interest payable.
4 Gross forgiven amount

Somewhat counter-intuitively, what is called the ‘gross’ amount of forgiveness is normally the difference between the following amounts (s.245-55(1)):

- the market value of the debt when it was forgiven (considered as an asset of the creditor), assuming:
  - the debtor is solvent at that time; and
  - had the same capacity to pay at the forgiveness time as when it previously incurred the debt,

- less the ‘consideration’ paid or given (if any) for the forgiveness itself – however in certain cases this offsetting amount is modified (see section 4.4 below).

Where multiple parties are jointly liable for a debt, the gross forgiven amount is pro-rated equally amongst them under s.245-77. However this does not apply to partnership debts – they are applied at the partnership level first (see section 6.4).

Section 245-50 deals with the extent of the forgiveness if consideration is given. Its wording is somewhat difficult to follow, and rather than setting it out, its application is better demonstrated by the example given below it. The paragraph references are to the statutory provision.

Daniel owes Samara $100. Samara agrees to accept $60 in full payment of the debt.

If their agreement specifies that Samara forgives the whole debt in return for $60, paragraph (a) provides that the forgiven debt is $100.

If their agreement instead requires Daniel to repay $60 and specifies that Samara forgives the remaining $40, paragraph (a) would deal with the $40 and paragraph (b) would add the remaining $60, again producing a forgiven amount of $100.

In either case, the $60 Daniel pays is offset against the forgiven amount of $100 in working out the forgiven amount of the debt: see sections 245-65 and 245-75.

In other words, the gross forgiven amount would be ($100 - $60) = $40, subject to any of the modifications described below (to either item).

There are special rules for working out the market value of a limited recourse debt (s.245-60), or a debt that has been parked under s.245-36 and is later forgiven by the new creditor (s.245-61). To clarify, s.245-61 applies in respect of a subsequent forgiveness by the new creditor, not the deemed forgiveness by the old creditor. That is, a subsequent forgiveness and application of Division 245 can occur for a parked debt (with modified rules), in contrast to where s.245-45 has previously applied.

The assumption of solvency – that the debtor can pay all of its debts as and when they fall due – must ordinarily be made even if the debtor is in fact insolvent at that time. In the ordinary case, this means the market value of the debt should be equal to its face value. Interest, or an amount in the nature of
interest, that has accrued but not been paid can be regarded as a separate debt due to the application of s.245-20.

Section 245-55 provides for adjustments to the market value of the debt in several cases.

4.1 Effect of movements in currency or interest rates

Section 245-55(2) firstly covers cases where a debt is in a foreign currency. Movements in the exchange rate could result in the market value of the debt increasing compared to a base case if the exchange rate had remained constant over the life of the debt. For example, the debt is in USD, and the AUD depreciates against the USD. In AUD terms, the value of the debt will increase in the hands of the creditor.

Section 245-55(2) can also apply to a fixed interest rate debt, where market interest rates move over the life of the debt. For example, the value of the debt should increase if equivalent market rates significantly decrease, where the creditor is still entitled to receive a higher rate.

Therefore, the market value of the debt may end up higher than its face value. In these cases, a debtor is entitled to use a lower ‘base case’ market value – normally the face value. However, if an (incremental) amount that is attributable to such a change has been deducted, or is able to be deducted, by the debtor, the deductible amount must be added to the base case market value.

Of course, in the above examples the AUD may appreciate, or market interest rates may increase. If movements in these variables decrease the market value of the debt compared to the base case, the debtor is still entitled to use the decreased market value (less than the face value). The inclusion of the ‘incremental’ amounts in the debtor’s assessable income is not a pre-condition to doing so. See ATO ID 2011/22.

4.2 Non-arm’s length debts

In working out the debt value, the solvency assumption (see the first bullet point at the start of section 4) does not apply if each of the following three conditions are satisfied:

- the debtor and creditor were not dealing at arm’s length when the debt initially arose;
- the debt was not a moneylending debt; and
- either:
  - the creditor was an Australian resident for tax purposes at the forgiveness time; or
  - the forgiveness of the debt was a CGT event involving a CGT asset that was taxable Australian property.

28 For example, under the foreign currency provisions.
A moneylending debt is a debt resulting from a loan of money in the ordinary course of a business of lending money carried on by the creditor, e.g. a ‘Fin Co’. A creditor could often be entitled to a revenue deduction in respect of the forgiveness of a moneylending loan, but not otherwise.

If these 3 conditions are satisfied, the creditor should be entitled to a capital loss, but it could be less than the market value of the debt determined under the solvency assumption in 245-55(1)(a) (minus the consideration for the forgiveness). This is because the creditor’s cost base in the debt under the CGT rules should be the actual market value at the time the debt arose, without the solvency assumption. Presumably the market value should have been much lower if the debtor was in fact insolvent or near insolvent initially. If the creditor’s capital loss is lower, then it is appropriate to use a correspondingly lower gross forgiven amount under Division 245.

There is a similar rule in respect of a debt that has already been parked – i.e. previously deemed to be forgiven under s.245-36. Section 245-61 applies where there is a subsequent further forgiveness of a parked debt.

Where both of the following are satisfied:

- the debt is a non-moneylending debt; and
- the old and new creditors (to the parking i.e. assignment) were not dealing at arm’s length,

the value of the debt is its market value at the time of the assignment (s.245-61(a)). This is without applying the solvency and repayment capacity assumptions listed in s.245-55(1). This amount should reflect the new creditor’s CGT cost base in the parked debt (specifically the first element of the cost base). So its Division 245 value for the debtor on a subsequent forgiveness should mirror this.

If both of the conditions in s.245-61(a) are not satisfied, the value of the debt is the sum of:

- the amount or market value of the consideration (if any) the debtor paid or gave, or is required to pay or give, to the old creditor in respect of the assignment; and
- the amount or market value of the consideration (if any) the new creditor paid or gave to the old creditor in respect of the assignment.

4.3 Limited recourse debts

Section 245-60 has a special rule for limited recourse debts. This rule only applies where the debt was incurred directly by the debtor in respect of financing the acquisition, construction or development of certain property (but not including the manufacture of goods). To be regarded as limited recourse, the creditor’s rights on a payment default must be limited to all or any of the following, as opposed to full payment:

- rights (including the right to money payable) in relation to:

29 The second part of the assumption – that the debtor’s capacity to pay the debt is the same at the forgiveness time as when it was incurred – is still applied for the debtor.
the property or use of the property;
- goods produced, supplied, carried, transmitted or delivered by means of the property;
- services provided by means of the property; or
- the loss or disposal of the whole or a part of the debtor’s interest in the property;
- rights in respect of a mortgage or other security over the property; or
- rights arising out of any arrangement relating to the financial obligations, in relation to the property, of the end user of the property to the debtor.

The ‘property’ can include intangible property, e.g. intellectual property, contractual rights, shares, or another debt owing by a third party to the primary debtor.31

Whilst s.245-60 uses the word ‘directly’, the ATO has accepted that it can apply to debt that was used to repay bridging finance that was actually used to acquire the underlying property.32

The value of a non-recourse debt when it is forgiven is the lesser of:

a. the amount of the debt outstanding at that time; or
b. the market value at that time of the creditor’s rights against the debtor in the event of default of payment.

It is possible that (b) could be much lower than (a) at the time of the forgiveness, even if this was not the case initially. For example, if the value of the underlying property significantly decreased during that period. This could result in a somewhat favourable tax outcome for the debtor if the property is a CGT asset and the cost base is higher than the subsequent market value, applicable for Division 245 purposes. This deemed value of the debt (under (b)) should normally not exceed the offsetting amount, which is discussed below.

However, the CGT cost base of the property is not reduced due to the limited recourse nature of the financing – the debtor may still make a capital loss in respect of it on disposal. Of course, a creditor may not wish to commercially agree (initially) to make a debt limited recourse.

Where capital allowance deductions were available in respect of the property, Division 243 will apply. Division 243 is designed to cap such deductions where the debtor has not been fully at risk in respect of the property, because of the limited recourse nature of the debt. Excessive deductions can even be reversed out, by including the excess as assessable income on termination of the debt. It should be noted that under s.243-75, Division 243 applies in priority to Division 245. Amounts already dealt with under Division 243 are effectively disregarded from the net forgiven amount under Division 245 – discussed below.

30 The ‘end user’ of an asset is defined in s.250-50. Broadly, the end user is / will be able to use or effectively control (directly or indirectly) the use of an asset. For example, an end user may hold such rights as a lessee of the asset.
31 ATO ID 2007/167.
32 ATO ID 2007/168.
4.4 Consideration or other offsetting amount

The ‘consideration’ to offset against (i.e. reduce) the value of the debt is worked out under s.245-65. One of six items will apply to determine the offsetting amount. The items contain ordering rules (for where more than one could otherwise apply) and are not elective – the taxpayer will need to carefully consider which one is appropriate to its circumstances.

Items 1, 2 and 4 refer to amounts paid or property given by the debtor. Item 4 also refers to such things paid or given by the new creditor. They do not seem to cover things provided by another party e.g. a related party of the debtor. In contrast, there is no requirement that the amounts be paid or given to the ‘old’ creditor, so long as they are provided in respect of the forgiveness / assignment. An amount that the debtor applies for the benefit of the creditor, or at the creditor’s direction, to another party should still be counted. This was expressly provided for under the former Schedule 2C. The 2010 EM indicates at paragraph 3.20 that the same approach applies under Division 245, explaining that the former provision was considered redundant.

If the offsetting amount is equal to or greater than the value of the debt, the remainder of Division 245 is effectively switched off; s.245-75. The debtor will not have a net forgiven amount for this debt.

4.4.1 Item 1 – moneylending debt, and neither of items 4 and 6 apply

The offsetting amount is the sum of:

a. each amount the debtor has paid;

b. the market value, at the time of the forgiveness, of each item of property that the debtor has given; and

c. the market value, at that time, of each obligation of the debtor to pay an amount, or give such an item of property,

as a result of, or in respect of, the forgiveness of the debt.

The market value test referred to in (c) is designed to take into account the time value of money and the creditworthiness of the debtor (1996 EM paragraph 6.58). The present value of a future obligation should therefore be less than its face value – effectively increasing the gross forgiven amount (because the offsetting amount will be lower). Note that this can apply where a debt has been replaced by a new debt (payable in the future) – i.e. there has been a forgiveness of the old debt.

4.4.2 Item 2 – non-moneylending debt, and items 3-6 do not apply

The offsetting amount is the sum of:

a. each amount the debtor has paid, or is required to pay; and

b. the market value, at the time of the forgiveness, of each item of property that the debtor has given, or is required to give,
as a result of, or in respect of, the forgiveness of the debt.

Unlike Item 1, there is no paragraph (c) here. Those items are considered in (a) and (b) of Item 2 – the ‘required to pay / give’ wording. In other words, under Item 2, a future obligation of the debtor is not discounted to reflect the time value of money or the creditworthiness of the debtor – the nominal amount (or current property value) can be used to reduce the gross forgiven amount. The offsetting amount is designed to mirror the creditor’s capital proceeds for the forgiveness of the debt under CGT event C2. The CGT capital proceeds does not take into account the time value of money or credit risk.

4.4.3 Item 3 – non-moneylending debt, and items 4-6 do not apply

Item 3 also requires the conditions in s.245-65(2) to be met (otherwise, Item 2 is likely to apply). The conditions require:

- at least one of the following to be satisfied:
  - the creditor was an Australian resident for tax purposes at the forgiveness time; or
  - the forgiveness of the debt was a CGT event involving a CGT asset that was taxable Australian property; and
- at least one of the following to be satisfied:
  - there is no offsetting amount as referred to for Item 2 (i.e. no consideration provided by the debtor); or
  - what would be the offsetting amount under Item 2 (the consideration provided by the debtor) is greater or less than the market value of the debt at the time of forgiveness, and the debtor and creditor did not deal with each other at arm’s length in connection with the forgiveness.

Under Item 3, the offsetting amount that is used is then the ‘actual’ market value of the debt at the time of the forgiveness.

In determining this market value, no hypothetical assumptions are made about the debtor’s solvency or capacity to pay. The offsetting market value may therefore be less than the hypothetical solvency market value – resulting in a positive gross forgiven amount.

The offsetting amount is designed to mirror the creditor’s deemed capital proceeds for the forgiveness of the debt under CGT event C2. Where either limb of the second condition is satisfied, the CGT market value substitution rule should apply to the creditor in determining its capital proceeds.33

In brief, the non-arm’s length requirement does not require the debtor and the creditor to be associates or otherwise related. Parties who are in an arm’s length relationship may not act at arm’s length for a particular transaction, although this may be less likely. Conversely, it is possible for

33 See s.116-30.
associates or related parties (i.e. parties who are not in an arm’s length relationship) to act at arm’s length for a particular transaction, although again this probably less likely.

If the first condition is not satisfied, the creditor’s capital loss should be disregarded under Division 855. Capital gains or losses made by foreign residents are disregarded unless the underlying asset is taxable Australian property (TAP). An ordinary debt would normally not be expected to be TAP e.g. it should not be an indirect Australian real property interest.

However, it might be an asset used by the creditor in carrying on a business through a permanent establishment in Australia, which is another category of TAP. The creditor, not the debtor, must have an Australian permanent establishment through which it carries on an enterprise and in which the debt asset is used e.g. an Australian branch. Practically, the debtor may have difficulty ascertaining this attribute of an unrelated creditor.

4.4.4 Item 4 – debt parking, and item 5 does not apply

Item 4 applies where the debt is assigned as per s.245-36, and item 5 does not apply.

The offsetting amount is the sum of:

a. the amount or market value of the consideration (if any) that the debtor has paid or given, or is required to pay or give, in respect of the assignment; and

b. the amount or market value of the consideration (if any) paid or given by the new creditor in respect of the assignment.

Once again, the offsetting amount is broadly designed to reflect the outgoing creditor’s capital proceeds for the forgiveness of the debt under CGT event A1. This is analogous to item 2 and CGT event C2.

4.4.5 Item 5 – debt parking with non-arm’s length creditors

Item 5 applies where three conditions are met. Firstly, the debt is assigned as per s.245-36. Secondly, the debt is not a money-lending debt. Thirdly, the old creditor and the new creditor were not dealing with each other at arm’s length in respect of the assignment.

The offsetting amount is the market value of the debt at the time of the assignment. This is analogous to the offsetting amount for item 3.

4.4.6 Item 6 – debt for equity swap

Item 6 applies where there is a debt for equity swap as per s.245-37. The offsetting amount is worked out using the following formula:

(‘amount applied’ / ‘amount subscribed’) x ‘market value of shares subscribed for’
The amount subscribed is the payment by the creditor to subscribe for shares in the company. The amount applied is the amount that is paid back to the creditor by the debtor company accordingly, including on a notional or set-off basis.

The market value of the shares is determined immediately after the shares were issued. The accounting book value may not be appropriate to use. The market value of the new shares may be less than the value of the debt, particularly where the value of the debt was equal to or greater than the market value of the company’s assets (less the market value of its other liabilities). Therefore, this lower offsetting amount can give rise to a gross forgiven amount.

In such a case, the company should also consider the potential application of the share capital tainting rules under Division 197. A company’s share capital account may become tainted if an amount is ‘transferred’ into it from another of the company’s accounts. In other words, under a debt for equity swap the company’s liabilities have decreased (debited) and its share capital has increased (credited). Share capital tainting is undesirable – it results in a franking debit, and potentially untainting tax in order to untaint the share capital account. A distribution from a tainted share capital account is treated as an unfrankable dividend.

There is a carve-out under s.197-15 for a debt for equity swap. However, the transferred amount may exceed the lesser of the market value of the shares issued, and so much of the debt as is discharged, released or extinguished in return for the shares. In which case, tainting can still apply to the excess. As noted above, the market value of the shares issued may be less than the ‘forgiven’ debt amount.
5 Net forgiven amount

5.1 Items that reduce the gross forgiven amount

Further amounts can potentially be subtracted from the ‘gross forgiven amount’ to arrive at the ‘net forgiven amount’. The rationale is to prevent double taxation, if these amounts are otherwise dealt with for income tax. Section 245-85 enables the following amounts to be subtracted:

a. an amount that has been or will be included in the debtor’s assessable income (for any income year) as a result of the forgiveness;

b. an amount which could otherwise be deducted (for any income year) has been or will be reduced as a result of the forgiveness (other than under Division 245 itself, or Division 727, which deals with indirect value shifting); or

c. an amount by which the cost base of any of the debtor’s CGT assets has been, or will be, reduced under Part 3-1 or 3-3 as a result of the forgiveness (again this excludes indirect value shifting, because Division 727 is not in Part 3-1 or 3-3).

An example of (a) is an amount included in assessable income under Division 243 in respect of limited recourse debts used to finance the acquisition of a depreciating asset.\(^{34}\) Division 243 could also reduce capital allowance deductions – an example of (b).

The exclusion with respect to Division 727 appears somewhat unusual, given that the debtor is the gaining entity – interests in it may be uplifted under Division 727. However, the indirect value shift rules could also apply to reduce deductions or cost bases for an equity interest in the creditor held by the debtor. This effect on the debtor’s asset is not taken into account under s.245-85.

ATO ID 2014/33 is an example of where (a) does not apply. The amount must be included as income as a result of the forgiveness itself – there needs to be a causal connection between the two. In that case, Party A owed a commercial debt to the unrelated Party B under a business arrangement. Party A threatened to sue Party B for misrepresentation in respect of the arrangement. The parties agreed to settle, under which the debt was forgiven, and Party B paid a compensatory amount to Party A in respect of the alleged misrepresentation. This amount was assessable income of Party A, but could not be used to reduce its gross forgiven amount for the debt. The forgiveness and the payment were separate items under a global settlement – the payment was not made as a result of the forgiveness.

As identified in the 1996 EM, an amount of ordinary income or a capital gain will not normally be made by the debtor on the forgiveness of a debt. However this is not an absolute rule – particularly if

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\(^{34}\) This appears technically distinguishable from s.245-40(b), under which an amount of the debt itself (or a part of the debt) is included in assessable income. An amount of assessable income under Division 243 is calculated with reference to the unpaid amount of the debt.
the debtor is a moneylender, or the debt arrangement is unusual (e.g. if forgiveness was expressly contemplated initially). This issue has been considered in other Tax Institute papers. 35

5.2 Common ownership agreement

In certain limited circumstances, a creditor can agree with a debtor to forgo the tax benefit resulting from a debt forgiveness. The net forgiven amount of the debtor will be correspondingly reduced by an amount equivalent to the revenue deduction or capital loss foregone by the creditor. There is no obligation on the creditor, or the debtor, to agree to such an arrangement. It could be worthwhile if the creditor cannot immediately utilise the deduction or loss, but net forgiven amount would increase the debtor’s taxable income in the forgiveness year.

Section 245-90 can apply in respect of a forgiven debt where the debtor and the creditor are companies under common ownership. Note that this does not include where a company is acting in a trustee capacity i.e. where, loosely speaking, the trust is the debtor or creditor. Even where the company shareholders and trust beneficiaries align, s.245-90 does not apply. Section 245-90 also does not apply where one of the parties is a company and the other is its sole shareholder (assuming the shareholder is not itself a company).

It should not be necessary to rely on s.245-90 where the debtor and creditor are members of the same income tax consolidated group at the time of the forgiveness. See section 1.3 of this paper.

The common ownership test must be satisfied for the entire time from when the debt was incurred until the time it is forgiven. ‘Under common ownership’ refers to where the 2 companies:

a. are members of the same wholly-owned group; or

b. are owned by the same natural persons in the same proportions (after tracing the direct and indirect ownership of the shares in each of the companies, through any interposed companies and trusts, to the natural persons who ultimately hold it).

It is not required that the creditor forgo the entire revenue deduction or capital loss they are entitled to – the parties may agree that only part is forgone. The amount to be forgone cannot exceed the debtor’s net forgiven amount.

A common ownership agreement must be in writing, signed by the public officer of each company. The agreement should be made before the first of those companies lodges its income tax return for the forgiveness year. If it is not, the agreement will only be effective if the ATO, in its discretion, agrees to extend the date for compliance.

Unsurprisingly, a common ownership agreement cannot be made if the creditor would have been denied from utilising the tax deduction or capital loss under another statutory provision in any event. 36

35 See both Adrian Varrasso and Robert Yunan, 2013 National Convention Session 5/2: Distressed debt transactions; and Michael Hine, 2005 National Convention ‘Forgiven not forgotten’.
36 ATO ID 2004/981.
6 Application of net forgiven amount

In a particular income year, a debtor must determine its total net forgiven amount – for all debts that are forgiven in that year. The total net forgiven amount is then applied to reduce 4 classes of amounts of the debtor, in the following order:

a. tax losses from previous income years (step 1);

b. net capital losses from previous income years (step 2);

c. capital allowances and other similar deductible amounts (deductible in the current and future income years, because of expenditure in a previous year) (step 3); and

d. cost bases of CGT assets acquired in previous income years (step 4).

If all of the amounts in all 4 classes are reduced to nil, any remaining balance of the net forgiven amount is not carried forward to the next income year, but is disregarded for the debtor – s.245-195. This does not affect the creditor’s tax position. However, there is a special rule for partnership debts, which is discussed below.

A member of a consolidated tax group may have a debt owed to an outside party that is forgiven. Under the single entity rule, this debt is deemed to have been owed by the head company of the group. Effectively, the net forgiven amount may be applied in respect of the entire group.

6.1 Tax losses (category 1) and net capital losses (category 2)

A carried forward tax loss to be reduced must be otherwise deductible – in the forgiveness year or a later year – assuming the debtor made sufficient assessable income. A tax loss cannot be reduced if another provision of the income tax legislation would already prevent it from being deducted. An example is where both the continuity of ownership test and the same business test have already been failed in respect of the loss for a company debtor. Such an un-utilisable loss is effectively quarantined and wasted.

Subject to this deductibility qualification, tax losses must be reduced to the greatest extent possible. However, the debtor may choose the order in which the tax losses are reduced, and the quantum of the amounts applied to reduce each of those losses (within category 1). The debtor may wish to consider the potential for differently losses to potentially become un-utilisable in the future. If the debtor does not make such a choice, the ATO may do so in a reasonable way.

The total net forgiven amount remaining after step 1 is then applied to reduce carried forward net capital losses. That is, net capital losses from previous years that could be used by the debtor in working out its net capital gain for the forgiveness year – assuming the debtor made enough capital gains. Analogous rules apply in respect of how the debtor may choose to apply the net forgiven amount to reduce net capital losses.

Note that a net capital loss made in the forgiveness year cannot be reduced. Practically, the net forgiven amount is only applied at the end of the forgiveness year, when such a net capital loss could
be ascertained. However, s.245-130(2) explicitly provides that the net capital loss must be from an income year before the forgiveness year.

The statutory drafting is less clear for a tax loss made in the forgiveness year (i.e. not already carried forward from a prior year). Section 245-115 refers to tax losses ‘for any income years’. On one view, this could apply for the forgiveness year. However, on a strict reading, there is no ‘tax loss’ itself ever created in such a hypothetical case. Rather, there are only amounts that would be ordinarily deductible – not deductible as a tax loss. The 1996 EM indicates this is the intended position – a loss in the forgiveness year is not reduced, and the 2010 EM is silent on this issue.

This is consistent with the other 3 categories. In essence, the total net forgiven amount for a particular income year (worked at its end) is effectively then notionally applied at the very beginning of that income year. Carried forward tax losses and net capital losses, certain deductible expenditure incurred and cost bases for CGT assets acquired in prior years (but not in the forgiveness year itself) are potentially reduced.

6.2 Reduction of expenditure

The relevant amounts of expenditure under step 3 are as follows:

a. expenditure deductible under Division 40 (capital allowances for depreciating assets);

b. expenditure incurred for the borrowing of money to produce assessable income (that is deductible under s.25-25);

c. expenditure on scientific research (that is deductible under s.73A(2) of the ITAA36);

d. expenditure deductible under Division 355 (research & development);

e. advance revenue expenditure (that is deductible under Part III Division 3 Subdivision H of the ITAA36);

f. expenditure on acquiring a unit of industrial property to produce assessable income (that is deductible under s.124M(1) of the ITAA36);

g. expenditure on Australian films (that is deductible under s.124ZAFA of the ITAA36); or

h. expenditure on assessable income-producing buildings and other capital works (that is deductible under s.43-10).

The specific debt does not have to be related to the incurring of the expenditure. The expenditure must have been incurred by the debtor before the forgiveness year, and be deductible in the forgiveness year or a future year (or both). Again, expenditure incurred in the forgiveness year is not included. Analogous rules apply in respect of how the debtor may choose to apply the net forgiven amount to reduce capital expenditures within category 3.

Deductions in the forgiveness year and future years are reduced. How this is done depends upon whether the deductions are ‘straight line’ or ‘diminishing balance’.
6.2.1 Straight line deductions

An example of ‘straight line’ deductions is the prime cost method for depreciating assets under Division 40. The adjustment in s.245-155 is illustrated by the following example.

- At the start of year 1, an asset is acquired for $20,000 and is to be depreciated at 25% ($20,000 / 4 = $5,000) a year for 4 years.
- In year 2, a net forgiven amount of a debt of $6,000 is applied in respect of the asset.
- This reduces the ‘base amount’ for the asset to $14,000 ($20,000 - $6,000).
- The deduction in year 1 is unaffected.
- In each of years 2 and 3, the depreciation deduction becomes $3,500 per year (($20,000 – 6,000) / 4) rather than $5,000 per year.
- As the total of the deductions for years 1-3 is $12,000 ($5,000 + $3,500 + $3,500), the deduction in year 4 is ‘capped’ at only $2,000.
- The total of the deductions is thus $14,000 i.e. $6,000 less than the cost.
- The reduction of $6,000 is also taken into account if there is a balancing adjustment event under Division 40 (e.g. disposal of the asset) – s.40-90.

If the net forgiven amount arose in year 4, the written down value of the asset would already have been $5,000 (i.e. $20,000 – (3 x $5,000)). The $5,000 deduction in year 4 would then be reduced to nil, and the remaining net forgiven amount, to be applied elsewhere, would be $1,000 (i.e. $6,000 - $5,000).

6.2.2 Diminishing balance deductions

An example of ‘diminishing balance’ deductions is the 200% diminishing value method for depreciating assets under Division 40. The difference to the straight line method is that the deduction for a particular year is affected by amounts you previously deducted, not just the overall cost.

- Adapting the above example, the deduction in year 1 would be $10,000 ($20,000 x 2 / 4).
- In years 2-4, the deductions would have been as follows:
  - ($20,000 – $10,000) x 2 / 4 = $5,000;
  - ($20,000 – $10,000 – $5,000) x 2 / 4 = $2,500;
  - ($20,000 – $10,000 – $5,000 – $2,500) x 2 / 4 = $1,250;
  - The undeducted remaining amount at the end of year 4 is (($20,000 – $10,000 – $5,000 – $2,500 – $1,250) = $1,250.
- In year 2, the undeducted component of the cost is reduced to $4,000, because of the $6,000 net forgiven amount applied ($20,000 – $10,000 – $6,000).
The deductions in years 2 to 4 become $2,000, $1,000 and $500 respectively, rather than $5,000, $2,500 and $1,250.

The undeducted amount at the end of year 4 (that can be further depreciated) is also $500 rather than $1,250.

Again, the reduction of $6,000 is taken into account if there is a balancing adjustment event.

6.3 Cost bases of CGT assets

The cost bases and reduced cost bases of certain CGT assets are then reduced. However, the cost bases and reduced cost bases of the following ‘ineligible’ CGT assets are not reduced (s.245-175(2)), even if there is a residual amount remaining after reducing to nil for all other ‘eligible’ CGT assets:

a. a pre-CGT asset;

b. a CGT asset the debtor acquires after the start of forgiveness income year – analogous to categories 1-3;

c. a personal use asset;

d. a dwelling that was the debtor’s main residence at any time before the forgiveness income year;

e. goodwill;

f. a right of the debtor’s covered by s.118-305 (which exempts from CGT certain rights relating to a superannuation fund or approved deposit fund);

g. a CGT asset that, throughout the period before the forgiveness income year when it was owned by the debtor, was the debtor’s trading stock;

h. a CGT asset if:
   - capital expenditure (of a kind which is subject to a capital allowance reduction under step 3) relates to the asset; and
   - a CGT event in relation to the asset would result in an amount being included in the debtor’s assessable income, or in the debtor being able to deduct an amount;

i. if the debtor is a foreign resident at the beginning of the forgiveness income year, an asset that is not taxable Australian property.

In most cases, a capital gain or loss made on such ineligible assets should be subject to a CGT concession or exemption in any event. A taxpayer would obviously prefer to apply the net forgiven amount to such assets in preference to non-concessional CGT assets – hence the ineligibility.

In respect of eligible CGT assets, analogous rules apply in respect of how the debtor may choose to apply the net forgiven amount to reduce cost bases and reduced cost bases within category 4.

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37 That is, not under the CGT provisions e.g. a balancing adjustment event for a depreciating asset under Division 40.
However, this is subject to a special rule, in respect of CGT assets that are investments in, or in relation to, an associate of the debtor. These include both membership (equity) interests and debt interests in the associate. Membership interests include partnership and trust interests (as a partner or beneficiary respectively). The cost bases and reduced cost bases of these assets must be reduced last, after the cost bases and reduced cost bases of all other eligible CGT assets are reduced to the maximum extent possible (s.245-185).

Both the cost base and the reduced cost base of an eligible CGT asset is reduced by the same amount (for the purpose of determining a future capital gain or loss), but the quantum of the reduction is only counted once in applying the net forgiven amount.

The cost base or reduced cost base at the start of the forgiveness year is normally reduced. However, if the cost base or reduced cost base is reduced during the forgiveness year (for some other reason e.g. a return of capital on a share or unit), there is a modification. That other reduction applies first, followed by an application of the net forgiven amount.

The maximum reduction for a particular asset is its ‘current’ reduced cost base – a cost base may therefore not be completed reduced to nil, if it is greater than the reduced cost base.

6.4 Partnerships

A partnership is not an entity at general law, but a relationship between persons. However, a partnership is normally treated as a (flow-through) entity for income tax. There is a special rule that applies to forgiven debts of a partnership.

A ‘partnership’ for income tax includes a general law partnership and a tax law partnership. That is, an association of persons carrying on business as partners, or in receipt of ordinary income or statutory income jointly. A tax law partnership may not amount a partnership at general law.

However, the reference to a partnership does not include a company, or a corporate limited partnership – see s.94D and s.94K of the ITAA36. A corporate limited partnership is taxed as if it were a company – i.e. not as a flow-through entity. However, a limited partnership that is not a corporate limited partnership (certain venture capital type partnerships) is still treated as a (flow-through) partnership for income tax. Further, under Division 830, certain foreign hybrid companies and partnerships can be treated as partnerships for Australian income tax purposes.

Division 245 applies at the partnership level first. The forgiveness of a partnership debt will involve determining the partnership’s net forgiven amount, and applying it to partnership revenue losses and net capital losses, capital allowance type deductions and CGT asset cost bases. That is, in determining the partnership’s taxable income or loss to be split amongst the partners.

If there is a residual net forgiven amount, it is then divided amongst the partners, rather than being disregarded. A partner’s individual amount of the residual is calculated pro-rata by reference to the partner’s share of the partnership’s net income or loss in the forgiveness year – s.245-215. It is not possible for the partners to agree to split the residual net forgiven amount in a way that is different to the net income / loss split. The income / loss split would normally be set out in the partnership documentation.
A partner’s ‘pro-rata’ residual can then be applied to its other (non-partnership) tax affairs. That is, it can reduce the partner’s other revenue losses, net capital losses, expenditure deductions or CGT asset cost bases. If there is still a residual, it is then disregarded, and not applied to other partners in that partnership.
7 Record keeping

Finally, note there are special record keeping requirements in section 245-265. Failure to comply is an offence of strict liability with a penalty of 30 penalty units (currently $5,400). A strict liability offence does not require a fault element, such as intention, to be demonstrated.

A taxpayer that incurs a debt must keep records that enable the following matters to be readily ascertained (s.245-265(1)):

a. the date on which the debt was incurred;

b. the creditor’s identity;

c. the amount of the debt;

d. the terms of repayment;

e. if it is not a moneylending debt and the debtor and creditor were not dealing at arm’s length, the debtor’s capacity (i.e. assessment of its ability), at the time when the debt was incurred, to pay the debt when it falls due; and

f. if the debt is forgiven, the date of the forgiveness and the offsetting amount calculated under s.245-65.

Normally, these records must be kept for at least 5 years after the debt was forgiven (s.245-265(4)(a)). Where the ATO has commenced an audit, the amendment period may be extended under s.170(7) of the ITAA36. In this case, the records must be kept for the later of 5 years and the end of the extended amendment period (s.245-65(4)(b)).

However, the records do not need to be kept after the debt is paid (s.245-65(5)), if there is not a forgiveness.

There are additional requirements in respect of a debt between 2 companies under common ownership. Where a company ceases to be under common ownership, each company must keep records necessary to enable the following matters to be readily found out: the common ownership cessation date, and the identity of each entity that was a ‘controller (for CGT purposes)’38 of the company immediately before and immediately after the cessation date (s.245-265(2)). Under s.245-265(6) and (7), these records must be kept:

- ordinarily, until the end of the second income year after the cessation date income year;

- if a debt of either company was forgiven during the above period, then for the applicable period under s.245-265(4).

38 See Division 975.