

PUBLIC RULING

Goods and Services Tax – Debt factoring arrangements

Issued: 17 June 2021

BR Pub 21/03

This Public Ruling considers whether a GST input tax deduction can be claimed for a bad debt write-off when a debt is factored.

All legislative references are to the Goods and Services Tax Act 1985 (the GSTA) unless otherwise stated.

START DATE

10/08/2021

REPLACES

This is an update and reissue of BR Pub 06/01. For more information about earlier publications of this Public Ruling see the Commentary to this Ruling.

Public Ruling BR Pub 21/03: GST – Debt factoring arrangements

This is a public ruling made under s 91D of the Tax Administration Act 1994.

Taxation laws

This Ruling applies in respect of ss 20(3)(i) and 26.

The arrangement to which this Ruling applies

The arrangement is the sale, by a GST registered person (the Assignor), to a third party (the Factor), on a recourse or non-recourse basis, of an outstanding debt at a price less than the debt's face value.

How the taxation laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- The difference between the face value of the debt and the price received from the Factor is not a bad debt for the purposes of s 26. Accordingly, s 26 has no application and the registered person cannot claim an input tax deduction under s 20(3)(i); and
- If a portion of a debt is written-off before it is sold to the Factor, then whether this write-off meets the requirements of s 26(1) depends on whether the amount written off was "bad" according to the conventional tests as outlined in Public Ruling "BR Pub 18/07: Income tax and goods and services tax – writing off debts as bad" *Tax Information Bulletin* Vol 30, No 9 (October 2018) (BR Pub 18/07).

The period or tax year for which this Ruling applies

This Ruling will apply for an indefinite period beginning on 10 August 2021.

This Ruling is signed by me on 17 June 2021.

Susan Price

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Tax Counsel Office

Commentary on Public Ruling BR Pub 21/03

This commentary is not a legally binding statement. The commentary is intended to help readers understand and apply the conclusions reached in Public Ruling BR Pub 21/03 (“the Ruling”).

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Summary

1. When a registered person factors a debt owing for less than its face value, the issue arises whether the difference between the face value of the debt and the amount received from the Factor can be an amount “written off as a bad debt” under s 26(1).
2. The Commissioner considers that the difference between the face value of the debt and the amount received from the Factor cannot be an amount written off as a bad debt under s 26(1) and consequently no deduction from output tax can be claimed under s 20(3)(i). Rather than being a bad debt, the discount from face value is simply a

result of the process of agreeing the consideration for the debt that is acceptable to both the Assignor and the Factor.

3. Whether a debt is written off as “bad” under s 26(1) depends on the application of the tests outlined in BR Pub 18/07.

Background

4. BR Pub 21/03 is a reissue of BR Pub 06/01. This Ruling is essentially the same as BR Pub 06/01, which applied indefinitely from 1 August 2005. BR Pub 06/01 is withdrawn and this Ruling is reissued with updated legislative references and a refreshed commentary.
5. Sections 26 and 20(3)(i) of the GSTA allow a registered person to make a deduction from output tax if the registered person has made a taxable supply, returned output tax in respect of that taxable supply, and subsequently written off as a bad debt, all or part of the debt.
6. If a registered person factors (i.e. sells) a debt owing for less than its face value to a third party (the Factor), the issue arises whether the difference between the face value of the debt and the amount received from the Factor can be an amount written off as a bad debt.
7. A debt can be factored either on a recourse basis or on a non-recourse basis. Debt factoring on a non-recourse basis means that the Factor has no claim back to the Assignor if the debts sold to them become doubtful or uncollectable (i.e. the Factor assumes all of the risk). In contrast, debt factoring on a recourse basis means that the Factor has some form of claim back to the Assignor if the debts sold to them prove to be doubtful or uncollectable.
8. Historically, debt factoring was dealt with in PIB No 164 (August 1987) “GST and debt collection agencies – debt factoring” and in Technical Rulings paragraph 104.9.4 under an identical heading. Those statements concluded that if a registered person accounting for GST on an invoice basis subsequently sold a debt for less than its face value, the Commissioner would allow the registered person a bad debt deduction under s 26 for the difference between the debt’s face value and the sale proceeds. The inference being that the difference between the two amounts was a bad debt.
9. At that time, a person accounting for GST on an invoice basis was required to return GST on the full amount from the sale of goods or services at the time of supply, whereas a person accounting for GST on a payments basis was only required to return GST on the discounted amount received on the sale of the debt. The policy set out in

PIB No 164 and Technical Rulings paragraph 104.9.4 addressed the mismatch of GST treatments between the two accounting bases under the GSTA.

10. Barber DJ in *Case T27* (1997) 18 NZTC 8,188, however, reached a different conclusion from that set out in PIB No 164 and Technical Rulings paragraph 104.9.4. In particular, the Taxation Review Authority concluded that if a registered person factors a debt owing for less than its face value, the difference between the face value of the debt and the amount received from the Factor is not a bad debt.
11. Consequently, Public Ruling "BR Pub 00/07: Debt factoring arrangements and GST" (BR Pub 00/07) was published in 2000, which confirmed that the Commissioner accepted the view of Barber DJ in *Case T27*. The Ruling changed and superseded the earlier policy set out in PIB No 164 and Technical Rulings paragraph 104.9.4.
12. Further, section 26A was enacted in 2000 to require a person accounting for GST on a payments basis to return GST on the remaining book value of a debt when it is factored. Section 26A, therefore, establishes parity between the two GST accounting bases.
13. It is the Commissioner's view that if a registered person factors a debt owing for less than its face value, the difference between the face value of the debt and the amount received from the Factor is not a bad debt. Accordingly, s 26 has no application, and a registered person cannot claim a deduction from output tax under s 20(3)(i).
14. BR Pub 00/07 was replaced by "BR Pub 06/01: Debt factoring arrangements" (BR Pub 06/01) and GST in 2006 after BR Pub 00/07 expired. Both Public Rulings are essentially the same. This Ruling replaces BR Pub 06/01.

Application of the legislation

15. This part of the commentary will briefly discuss the GST consequences for an Assignor when a debt is factored. It will then set out the reasons why the price difference between the face value of the debt and the price received from the Factor is not a bad debt amount.

GST consequences when a debt is factored

16. When a debt is factored for less than its face value, there are differences in the way the GSTA operates for an Assignor, depending on whether the Assignor accounts for GST on an invoice basis or a payments basis. Despite these differences, the outcome since the enactment of s 26A is the same for both accounting bases ie, the Assignor is required to pay output tax on the face value of the debt and cannot claim an input tax

deduction for a bad debt write off simply by accepting a lesser value by factoring the debt.

Invoice basis

17. A person registered to account for GST on an invoice basis is liable for output tax on the supply of goods or services at the time an invoice is issued.
18. The subsequent factoring of the debt from the Assignor to the Factor would be considered a financial service under s 3(1)(c), being a transfer of ownership of a debt security. It is, therefore, an exempt supply under s 14(1).
19. Consequently, for an Assignor accounting for GST on an invoice basis, no GST liability is incurred at the time the debt is factored.

Payments basis

20. A registered person accounting for GST on a payments basis, who has not received a payment for the supply of goods or services, is not liable for GST output tax at the time the goods or services was originally supplied.
21. The subsequent factoring of the debt for less than its face value would not be considered a supply of "financial services" under s 3(1) because of s 3(4)(a). Section 3(4)(a) applies where, as a result of the transfer of a debt, no output tax for the supply would be attributable to a taxable period. This means an Assignor accounting for GST on a payments basis would be required to return GST on the amount received from the sale because s 3(4)(a) makes that transaction a taxable supply when it would otherwise have been a financial service.
22. Furthermore, s 26A specifically requires a person registered to account for GST on a payments basis to return GST on the remaining book value of the debt when the debt is factored.
23. Therefore, by virtue of ss 3(4)(a) and 26A, the full face value of the debt is considered a taxable supply and an Assignor accounting for GST on a payments basis is liable for GST on the full amount of the debt at the time the debt is factored.

Bad debt deduction

24. Under s 26, a registered person can make a deduction under s 20(3)(i) if that person has:
 - made a taxable supply for consideration; and

- furnished a return in relation to the taxable period during which the output tax on the supply was attributable and has properly accounted for the output tax on that supply as required under GSTA; and
 - written off as a bad debt the whole or part of the consideration not paid to that person.
25. The amount that may be deducted is the same amount of GST charged as the amount written off bears to the total consideration for the supply. If the supply is the supply of goods under a hire purchase agreement, the proviso to s 26 limits the deduction to the portion of the amount written off as the cash price bears to the total amount payable under the hire purchase agreement.
26. Section 26(1AB) specifies that a registered person accounting for GST on a payments basis can apply s 26 to the supplies to which s 9(2)(b) (door to door sales), s 9(3)(b) (hire purchase agreements), or s 26A (accounting for GST on the remaining book value of a factored debt) applies.
27. If a registered person factors a debt owing for less than its face value, the issue arises whether the difference between the face value of the debt and the amount received from the Factor can be an amount "written off as a bad debt".
28. The term "bad debt" is not defined in the GSTA. Whether the debt is written off as "bad", according to the requirements in s 26(1), depends on the application of the tests outlined in BR Pub 18/07:
29. BR Pub 18/07 confirms that a debt (or part of a debt) is a bad debt where:
- an existing debt is owing to the taxpayer; and
 - the debt is adjudged as "bad" by a reasonably prudent commercial person who concluded that there is no reasonable likelihood that the debt will be paid in whole or in part by the debtor or by anyone else; and
 - the bad debt is "written off" in accordance with the accounting and record keeping systems maintained by the taxpayer.

The debt must exist

30. Cases indicate that before a debt can be written off, a debt must be in existence at the time the debt is written off (*Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263 and *GE Crane Sales Pty Ltd v FC of T* 71 ATC 4268). Accordingly, for s 26 to apply, the registered person must be able to show that at the time of writing off the debt, a debt was then in existence.

31. In terms of non-recourse debt factoring, at the time the debt is sold, the debt between the registered person and debtor is extinguished and replaced with a separate and distinct debt between the Factor and debtor. In such situations no debt exists at the time the amount is written off, which will be after sale of the debt. Therefore, after the sale of the debt to the Factor, no further debt exists and according to both *Budget Rent A Car Ltd* and *G E Crane Sales Pty Ltd* no amount can be written off as a bad debt.
32. In terms of recourse debt factoring arrangements when a debt is sold by the Assignor on a recourse basis, the title to the debt passes to the Factor unless the Factor exercises a recourse option or right by which the debt can be transferred back to the Assignor. Therefore, until the recourse is exercised and the debt is transferred back, a bad debt deduction is not available under s 26(1), as after the sale there is no debt owed to the Assignor.
33. However, if the Factor exercises an option or right to transfer some portion of the debt back to the Assignor after the sale then, once this has occurred, a debt exists that is owed to the Assignor that may be able to be written off by the Assignor. Under s 26(1AA), s 26(1) applies if a registered person sells a debt and then reacquires it. Whether it can be written off depends on the application of the tests for determining whether a debt is bad in BR Pub 18/07.

The debt must be “bad”

34. When assessing whether a bad debt exists, BR Pub 18/07 indicates that a debt is bad when a reasonably prudent commercial person would have concluded, based on the information available about the debtor’s ability to repay the debt, that there is no reasonable likelihood that the debt will be paid. In the absence of such a circumstance, if a registered person chooses to sell a debt for below its face value, no bad debt exists and no deduction is available under s 20(3)i).

The debt must be “written off”

35. BR Pub 18/07 establishes that, to write-off a debt as bad under s 26(1), reasonable steps must be taken to determine whether that particular debt owed by that particular debtor is likely to be paid (*Case P53* (1992) 14 NZTC 4370 and *Budget Rent A Car v C of IR* (1995) 17 NZTC 12263).
36. Writing-off a portion of debt on this basis involves seeking a deduction for the provision for doubtful debts. As noted in BR Pub 18/07, the GSTA does not allow a deduction for the provision for doubtful debts.

Writing off the debt before sale to the Factor

37. In the past we have received submissions which noted that the issue of whether the discount to the Factor might be written off as a bad debt under s 26(1) would not arise if this amount were written off prior to the sale of the debt to the Factor.
38. The Commissioner agrees that this is the case. If a portion of a debt is written off before it is sold to the Factor, then whether the debt is written off as bad according to the requirements in s 26(1) depends on the application of the tests outlined in Public Ruling BR Pub 18/07.
39. This could happen where the registered person sells its bad debts to a Factor whose core business is to purchase bad debts in bulk from various vendors for a small fraction of the bad debts' face value. This is beneficial to both the Assignor, who is able to recover some money for the debt, and the Factor, who has the advantage of economies of scale to recover the debts that would otherwise be irrecoverable.
40. In these circumstances, the sale of the debt to the Factor will give rise to a full or partial recovery of the amount written off, and output tax will be payable by the Assignor on the portion of the debt recovered in the period when the amount is recovered under s 26(2).

Conclusion

41. In conclusion, the Commissioner considers that the difference between the face value of the debt and the amount received from the Factor cannot be an amount written off as a bad debt under s 26. Rather than being a bad debt, the discount from face value is simply a result of the process of agreeing the consideration for the debt that is acceptable to both the Assignor and the Factor. The reasons for this view are:
 - Cases considering the meaning of bad debt focus on whether the creditor can recover the outstanding amounts owing. That is, a bad debt arises when the creditor is unable or unlikely to recover the debt owing. If the creditor could recover the full amount owing but chooses not to (as in a debt factoring situation), any "loss" suffered by the creditor is not due to a bad debt.
 - Cases also indicate that for an amount to be written off as a bad debt, a debt must exist at the time the debt is written off. If a registered person factors a debt, no further debt exists between the registered person and debtor, and no amount can be written off as a bad debt. However, if a debt has been sold and then reacquired, an input tax deduction may be available if the tests in BR Pub 18/07 are subsequently met.

Examples

42. The following example illustrates the consequence of this ruling.

Example 1 – Invoice basis

VendorIn Co accounts for GST on an invoice basis. It sells 100 widgets to its customers for \$100 on a buy now, pay later basis, and pays output tax for the sale of the widgets.

VendorIn Co sells the debts relating to the sale of the widgets to Factor Co for \$80. The sale of the debts to Factor Co is considered a “financial service” under s 3(1)(c) and it is, therefore, an exempt supply under s 14(1).

At the time VendorIn Co sells the debts to Factor Co those debts were not “bad”. As such Vendor Co is not entitled to an input tax deduction under ss 26 and 20(3)(i).

Example 2 – Payments basis

VendorPay Co accounts for GST on a payments basis. It sells 100 widgets to its customers for \$100 on a buy now, pay later basis. VendorPay Co has no output tax on the sale of the 100 widgets because it has not received a payment for the sale.

VendorPay Co sells the debts relating to the sale of the widgets to Factor Co for \$80. The sale of the debts to Factor Co is excluded from being a “financial service” under s 3(4)(a). Therefore, VendorPay Co is required to pay output tax on the \$80 received from Factor Co. Further, s 26A requires VendorPay Co to account for output tax on the remaining book value of the debt of \$20. Consequently, VendorPay Co is required to pay output tax on the full value of the debt of \$100 at the time it sells its debts to Factor Co.

At the time VendorPay Co sells the debts to Factor Co those debts were not “bad”. As such VendorPay Co is not entitled to an input tax deduction under ss 26 and 20(3)(i).

Legislation

43. The relevant provisions in the Goods and Services Tax Act 1985 are as follows:

3 Meaning of term financial services

(1) For the purposes of this Act, the term **financial services** means any 1 or more of the following activities:

...

(c) the issue, allotment, drawing, acceptance, endorsement, or transfer of ownership of a debt security:

...

(4) Despite this section, **financial services** does not include—

(a) the assignment or other transfer of a right to receive payment in relation to a taxable supply if, as a result of the assignment or transfer, output tax for the supply would not be or become attributable to a taxable period for the purpose of section 20(4):

...

14 Exempt supplies

(1) The following supplies of goods and services shall be exempt from tax:

(a) the supply of any financial services (together with the supply of any other goods and services, supplied by the supplier of those financial services, which are reasonably incidental and necessary to that supply of financial services), not being a supply referred to in subsection (1B):

...

20 Calculation of tax payable

(2) In respect of each taxable period every registered person shall calculate the amount of tax payable by that registered person in accordance with the provisions of this section.

...

(3) Subject to this section, in calculating the amount of tax payable in respect of each taxable period, there shall be deducted from the amount of output tax of a registered person attributable to the taxable period—

...

(i) any amount calculated in accordance with section 26; ...

...

26 Bad debts

(1) Where a registered person—

(a) has made a taxable supply for consideration in money; and

- (b) has furnished a return in relation to the taxable period during which the output tax on the supply was attributable and has properly accounted for the output tax on that supply as required under this Act; and
- (c) has written off as a bad debt the whole or part of the consideration not paid to that person,—

that registered person shall make a deduction under section 20(3) of that portion of the amount of tax charged in relation to that supply as the amount written off as a bad debt bears to the total consideration for the supply:

provided that where goods are supplied under a hire purchase agreement, the registered person shall only make a deduction under section 20(3) of the tax fraction (being the tax fraction applicable at the time that the hire purchase agreement was entered into) of that portion of the amount written off as a bad debt as the cash price bears to the total amount payable under the hire purchase agreement:

- (1AA) Subsection (1) also applies if a registered person sells a debt to a third party and then reacquires the debt.
- (1AB) A registered person who is required to account for tax payable on a payments basis under either section 19 or section 19A must apply this section only to supplies made by the person to which any one of sections 9(2)(b), 9(3)(b) and 26A applies.

...

- (2) Where any amount in respect of which a deduction has been made in accordance with subsection (1) is at any time wholly or partly recovered by the registered person, that portion of the amount of the deduction allowable under subsection (1) as the amount of the bad debt recovered bears to the bad debt written off shall be deemed to be the tax charged in relation to a taxable supply made during the taxable period in which the bad debt is wholly or partly recovered.

...

26A Factored debts

- (1) This section applies to a registered person who—
 - (a) sells a debt to another person during a taxable period; and
 - (b) is required to account for tax payable on a payments basis.
- (2) The sale of the debt is treated as being a taxable supply—
 - (a) That is made by the registered person during the taxable period; and
 - (b) on which the amount of tax charged is the tax fraction of the remaining book value of the debt.

References

Expired Rulings

Public Ruling "BR Pub 00/07: Debt factoring arrangements and GST" *Tax Information Bulletin* Vol 12, No 8 (August 2000)

Public Ruling "BR Pub 06/01: Debt factoring arrangements and GST" *Tax Information Bulletin* Vol 18, No 5 (June 2006)

Related Rulings

Public Ruling "BR Pub 18/07: Income Tax and Goods and Services Tax – writing off debts as bad" *Tax Information Bulletin* Vol 30, No 9 (October 2018)

Case References

Case T27 (1997) 18 NZTC 8,188

Legislative References

Goods and Services Tax Act 1985 – ss 3(1), 3(4), 14(1), 20(3)(i), 26 and 26A

About this document

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