

TAX TALKS

Australia's Tax News Podcast - The Podcast for Australian Tax Professionals

The following information is only of a general nature and should not be taken as professional advice.

3 | Commercial Debt Forgiveness

Commercial Debt Forgiveness

Commercial debt forgiveness plays a big role in insolvency. But is not a top-of-mind topic – bankruptcy sounds more dramatic. Nevertheless the tax treatment of commercial debt forgiveness is important. Get it wrong and you could tip an entity into insolvency – the exact opposite of what debt forgiveness is trying to achieve.

To listen while you drive, walk or work, just access the episode through a podcast app on your mobile phone.

Creditor

The creditor usually incurs a revenue or capital loss and claims a corresponding tax deduction for the forgiven debt, if the debtor made the loan to derive future assessable income.

Debtor

If you didn't recognise any tax effect on the debtor side, you would have a tax deduction on the creditor side with no offsetting effect on the debtor side – throwing the doors wide open to manipulate the system. Related parties could pretend to be dealing at arm's length and forgive huge amounts of artificial debts with a tax deduction on one side and nothing on the other.

But if Australian tax law forced debtors to fully recognise a forgiven debt straight away as assessable income, it could easily tip struggling entities into insolvency.

So the commercial debt forgiveness rules aim for a compromise between these two extremes. There is a tax effect on the debtor side – not straight away but later.

Commercial Debt

When it comes to forgiven debts, there are two sets of rules – one for commercial debts forgiven after 27 June 1996 and one for non-commercial debts or debts forgiven before 27 June 1996. Let's ignore the later since non-commercial debts often don't have a tax effect – forgiven or not – and 1996 is a long time ago anyway.

The rules for commercial debt forgiveness apply to commercial debts forgiven after 27 June 1996 – bingo – that's our date. Commercial debts are debts with deductible interest or, if interest free, interest would have been deductible if interest had been charged.

Forgiveness

Forgiveness arises where the taxpayer's obligation is

TAX TALKS

- Released, waived or otherwise extinguished
- Statute barred or
- Subject to 'Debt Parking' – debt assigned to a related party

Exclusions

Commercial debt forgiveness rules do not apply to:

- Debt waivers treated as a fringe benefit
- Amounts included in assessable income (including Div 7A)
- Actions under Bankruptcy Law
- Deceased Wills
- Natural love and affection
- Tax Debts

Net Forgiven Amount

The net forgiven amount is the market value at the time of forgiveness and is deducted from (in that order):

- Prior year revenue losses
- Prior year capital losses
- Deductible expenditure
- Cost base of assets

Whatever is left over after all this, you can disregard (except for partnerships where the excess is distributed to the partners).

Where a private company forgives a debt owed by a shareholder or their associates, the net forgiven amount maybe treated as a Division 7A dividend.

Summary

So if we had to summarise the commercial debt forgiveness in one sentence: Creditors claim a tax deduction and debtors reduce their prior year loss, tax deduction or cost base for the net forgiven amount.

If you want to read more, here is some [ATO guidance](#).

MORE

[Tax Residency of Individuals and Companies](#)

[The Story behind the Bywater Case](#)

[Risk Reviews & Tax Audit](#)

Disclaimer: *Tax Talks does not provide financial or tax advice. This applies to these show notes as well as the actual podcast interview. All information on Tax Talks is provided for entertainment purposes only and might no longer be up to date. You should seek professional accredited tax and financial advice when considering whether the information is suitable to your or your client's personal circumstances.*

TAX TALKS

The information above is for general information only and should not be taken as constituting professional advice from Tax Talks. We are not a financial, legal or tax adviser. You should consider seeking independent legal, financial, taxation or other advice to check how the above information relates to your unique circumstances.