IT 2538 - Income tax: factoring of debts

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TAXATION RULING NO. IT 2538

INCOME TAX: FACTORING OF DEBTS

F.O.I. EMBARGO: May be released

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F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1011310	FACTORING OF DEBTS	25(1)
	ASSIGNMENT OF DEBTS OF MEDICAL PRACTICE	51(1) 260
	FAMILY TRUST - DEBTS ASSIGNED TO	Part IVA

OTHER RULINGS ON TOPIC : IT 276, 2432

PREAMBLE This Ruling outlines the circumstances in which factoring of debts is effective for income tax purposes and, in particular, consolidates the guidelines set out in Taxation Ruling IT 2432, Canberra Income Tax Circular Memorandum No. 827 (CITCM 827), and paragraphs 2.4.17 to 2.4.20 of the A.T.O. Assessing Handbook (Volume 2 Business).

2. CITCM 827 outlines the basic form of a debt factoring arrangement:

> "2. In the present context, factoring consists of the sale by a trader or manufacturer to a factoring company, on a regular and continuing basis, of accounts receivable for goods sold to customers on credit terms. The object of the transaction is to maintain an immediate supply of working capital for the trader or manufacturer.
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> 3. Upon being approached by a trader or manufacturer, the factoring company makes a comprehensive survey of the prospective client's debtors' ledger and allots credit ratings to the various debtors. A written agreement is then entered into and the client offers his trade debts, supported by invoices, for sale to the factoring company at weekly or other regular intervals.
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> 4. On acceptance of the offer by the factoring company, the client is paid the face value of the debts less an agreed discount or factoring charge. As the debts fall due for payment, collections are made by the client in the normal course of the business and the proceeds are passed over in full to the factoring company.
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> 5. The end result is, therefore, that the factoring company receives the full amount of the debt, of which the amount of the factoring charge represents a profit in its

hands. The client, on the other hand, having originally brought the full amount of the debt to account as sales, incurs a loss on collection equal to the amount of the factoring charge.

6. In principle, it is clear that the amount of the factoring charge represents assessable income in the hands of the factoring company. On the side of the client, it is considered that, where the factoring arrangement is shown to be a continuing feature of the business operations of the client, the factoring charge is analogous to a trade discount and is accordingly deductible as a business loss under section 51(1)."

3. The CITCM went on to outline one arrangement.

"8. The arrangement adopted by the first company concerned in the examination provides for the debts of the client to be purchased at a substantial discount, say, 30%, and for the balance of 70% to be paid over immediately to the client. Out of the discount of 30%, a factoring charge of up to 2% of the face value of the debt is retained by the factoring company and the balance of 28% is paid to the client progressively as commission on collection of the debt under a separate agency agreement entered into by the parties. Under the agency agreement, the commission payable is subject to reduction by 1% for every month beyond the agreed collection date during which the debt remains unpaid, thus increasing the net earnings of the factoring company where delay in collection occurs."

This form of arrangement is considered to be acceptable.

4. The Assessing Handbook states:

"2.4.17 Factoring of Debts

The usual reason for the factorising of debts is the obtaining of immediate cash funds. For this reason factoring is usually found in that area involving the sale of goods on credit where funds are needed to finance stock and new purchases. Because of the existence of medical benefits funds the medical profession do not normally resort to factorising except in special circumstances.

2.4.18 The commercial factoring of debts of, for example, a doctor, would normally be undertaken on the following basis:

(a) where the doctor issues his own accounts with payments to be made to a nominated address usually something like "AB Accounting Services" with a post office box number - 4% to 6% to be charged, the doctor providing or paying for the receipt forms;

(b) where the factoring firm issues the accounts and receives payments, 15% to 17.5% with the doctor providing or paying for account and receipt forms;

(c) any bad debts would be sold back to the doctor at full face value, i.e. the factoring firm still receives its fee but takes no responsibility for bad debts;

(d) all cash receipts, i.e. payments by patients in cash at the time of service, would not be part of the arrangement - these remain with the doctor. It would be commercially unreal to factorise cash.

2.4.19 Where this form of debt collection is resorted to by a taxpayer, factoring fees are an allowable deduction (CITCM 827). The fact that a taxpayer may enter into an arrangement with an associated person (e.g. his wife) for the factoring of his business debts does not materially alter the deductibility of the factoring fees. However, deductions in these instances should be allowed only after the material facts have been examined and it has been established that the amounts being claimed are reasonable for the purposes of S.65.

2.4.20 When the taxpayer concerned lodges his returns on a cash basis, his entry into a factoring arrangement is likely to produce an extraordinary increase in the receipts of the year during which the arrangement commences. Care should therefore be exercised to ensure that all receipts have been brought to account as income."

5. IT 2432 dealt with a case where it was considered that the factoring fees ought not to be allowed as income tax deductions under subsection 51(1). The parties involved - the taxpayer and the trustee of the taxpayer's family trust - were not considered to be operating at arm's length. The Ruling illustrated the sorts of considerations which must be taken into account in determining whether income tax deductions ought to be allowed for debt factoring fees arising out of non-arm's length arrangements and the need for the arrangements to be explicable by reference to ordinary business or commercial standards.

RULING

6. Debt factoring arrangements may be accepted where the arrangement is explicable by reference to ordinary business or commercial standards. Parties not at arm's length are not disqualified from entering into such arrangements.

7. Guidance as to the commercial factoring of debts is contained in paragraph 2.4.18 of the Assessing Handbook quoted above in paragraph 4.

8. IT 2432 is consistent with these guidelines. The thrust of the Ruling was to emphasise that in non-arm's length factoring arrangements each case must be examined in the light of its own facts, as stressed in paragraph 2.4.19 of the Assessing

Handbook. Matters of importance would include whether the factoring entity has adequate funds to purchase the debts, whether the discount rate is reasonable taking into account whether debts are paid promptly and bad debts' patterns, what genuine commercial benefits are sought and generally whether the arrangement is commercially realistic.

COMMISSIONER OF TAXATION
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