

Tax Aspects of Debt Settlement: A Primer

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The *Income Tax Act* (Canada) ("ITA") contains a number of complex rules dealing with what happens to the debtor when a debt (including interest) is repaid at less than 100 cents on the dollar. These rules are particularly relevant in a situation such as a BIA proposal or a CCAA restructuring, where one of the objectives is to preserve the debtor's ongoing viability. Managing the application of the tax debt settlement rules can make a significant economic difference to a debtor (and its stakeholders). These rules can have surprising results, because in some circumstances they *deem* a debt that remains legally outstanding to have been settled for tax purposes. This article briefly summarizes the most important of these rules at a general, non-technical level.

General Principles

For tax purposes, when a debtor receives value (say as a loan) and is able to avoid repaying it, this is akin to receiving income. The tax system treats the debtor as having received a benefit that could result in more income for tax purposes or a reduction in favourable tax attributes (such as tax losses or the cost of property for tax purposes).¹ Thus, the settlement of a debt by less than full payment (a "debt forgiveness") typically has negative income tax consequences for the debtor. The impact of these tax consequences depends on the debtor's particular facts: for example, if a debtor is not paying income tax because it is operating at a loss for the year, extra income for tax purposes resulting from a debt forgiveness may not create an immediate cash cost (although it will reduce the loss for the year that could be carried forward or backward to offset taxable income from another year).

The ITA has various rules that apply to debt forgiveness in different cases. Certain rules apply in fairly specific circumstances, and a more general rule (§80 ITA) usually applies if none of the more specific rules apply. Briefly, some of more important specific rules are as follows:

- *Non-Arm's-Length Debts*: where the debtor and creditor do not deal at arm's length and the debt is deductible for tax purposes, if the debt remains unpaid more than two years after the end of the year it was incurred, the debtor is required to reverse the deduction by

taking the amount back into income in the next taxation year.² This rule prevents the debtor from claiming deductions for non-arm's-length expenses and deferring payment indefinitely.

- *Employee/Shareholder Debt*: debt incurred by virtue of the debtor's position as an employee or shareholder of the creditor (e.g., a housing loan) and later forgiven is simply included in the debtor's income as an employee or shareholder benefit. This rule treats forgiven loans the same as other forms of employee compensation or shareholder returns.
- *Trade Payables*: where trade payables that are deductible for tax purposes are settled for less than the face amount, the tax deduction is simply reversed to the extent of the forgiven amount, reflecting the fact that the debtor's actual expense turned out to be lower than originally claimed.

In addition, special rules apply where the creditor acquires ownership of some or all of the debtor's property (other than money) as a result of the debtor's failure to pay a debt (e.g., a foreclosure or repossession). Essentially, these rules deem the debtor to have disposed of the surrendered property for proceeds equal to the amount of the debt (interest and principal), plus in some cases any prior-ranking debt secured by the surrendered property or any other debt that ceases to be owing because of the surrender. As a result, the debtor will typically have increased income resulting from the deemed profit or capital gain on the disposition of the property.

§80 ITA Debt Forgiveness

The various foregoing specific rules will (if applicable to a debt forgiveness) take precedence over the more general rule in §80 ITA (although anomalous results can occur if different rules apply in different years). Where none of the more specific rules described above apply, the residual debt forgiveness rule in §80 ITA must be considered. Briefly, where §80 ITA applies, it takes the forgiven amount of the debt and applies it to grind down various favourable tax attributes of the debtor, such as unused tax loss carryforwards

(losses from earlier years that can be applied against income in later years) and the cost of property for tax purposes. This will typically result in increased income for tax purposes in later years (due to prior years' loss carryforwards being unavailable), or for property whose tax cost has been reduced smaller depreciation deductions or higher gains realized when the property is sold. To the extent that the debt forgiveness exceeds the reduction in the debtor's tax attributes, 50% of the excess is added to the debtor's income for tax purposes, potentially increasing its taxes payable.

For example, assume that a debtor settles a \$10,000 debt for \$7,000 (i.e., a \$3,000 forgiven amount), and that the debtor has a \$1,500 loss carryforward from a previous year and a property with a cost for tax purposes of \$1,000. Section 80 ITA could apply the \$3,000 forgiven amount to completely eliminate the loss carryforward (\$1,500), and reduce the tax cost of the debtor's property down to zero (\$1,000). Fifty percent of the remaining unapplied \$500 of the debt forgiveness would be added to the debtor's income for the year of the debt settlement, which (depending on the debtor's circumstances) could result in taxes owing. While the actual §80 ITA rules are much more complex, this simplified example nonetheless illustrates the essence of the provisions.

When Does §80 ITA Apply?

There are three basic pre-conditions to the application of §80 ITA. First, this provision applies only to debts incurred as part of a business or investment, not debts of a personal nature. This is accomplished by limiting the application of the rule to debts the interest on which is tax-deductible (or would be, if interest were charged).

Second, §80 ITA applies only where a debt has been settled or extinguished. Generally a debt is settled when the debtor no longer has any liability to pay it. In a situation where a debt is being restructured and its terms changed, consideration must be given to whether the existing debt has been settled and a new debt created in its place, although for §80 ITA purposes where the debtor issues a new debt to repay an old one, no forgiveness should arise if the principal amount of the new debt is no less than the principal amount of the old one (interest is treated as a separate debt from the principal). The §80 ITA rules also *deem* a debt to have been settled in certain other situations, such as where the debt is purchased in some circumstances (described below) or where enforcement becomes statute-barred.

Finally, there must be a "forgiven amount" (i.e., extinguished principal or interest in excess of the amount paid by the debtor). The "forgiven amount" is also reduced by amounts paid by the debtor to another person to assume the debt. Where a debtor issues shares to repay a debt, it is considered to have paid an amount on the debt equal to the value of the shares issued (plus any increase in the value of other shares of the debtor held by the creditor). Bankrupts are deemed to have no "forgiven amount".

When a debtor and creditor amalgamate or where one is wound up into the other, deeming rules basically provide that no debt forgiveness will arise as long as the creditor's cost of the debt for tax purposes equals the principal amount. However, since for tax purposes the creditor's cost of a debt may be written down to its value where the creditor has undergone an acquisition of control, it is important to confirm the creditor's tax cost of the debt before effecting the amalgamation or wind-up. Amalgamations and wind-ups can often be very useful for managing debt forgiveness issues between members of a related group.

§80 ITA Debt Parking

Under older versions of §80 ITA, instead of settling a debt at a discount, taxpayers would sometimes avoid §80 ITA by having the debt purchased by a related entity who simply let it remain outstanding indefinitely without ever enforcing repayment: without a formal extinguishment of the debt, §80 ITA would not apply. This practice of "debt parking" is directly targeted by specific rules in the current version of §80 ITA that deem a debt to have been settled in some circumstances. Since these rules go beyond the simple debt parking situation described above and sometimes deem a debt settlement to occur in situations where the transaction is not tax-motivated, it is always important on a debt restructuring or acquisition of debt and/or shares to ensure that these rules do not apply.

The debt parking rules are fairly complex; however, in general terms where the following conditions apply these rules *deem* a debt to have been settled for tax purposes *even though it remains legally outstanding*:

- the debt was previously either (1) owned by a person who dealt at arm's length with the debtor or (2) acquired by the current holder from a person unrelated to the current holder;³ and
- the current holder does not deal at arm's length with the debtor, and its cost of the debt is less than 80% of its principal amount.

These rules might therefore apply when a subsidiary or parent of the debtor purchases the debt from a bank or other arm's-length creditor at a substantial discount. It can also apply where an arm's-length acquiror purchases both the shares of the debtor and its debt owing to the shareholders. For example, where the value of the debtor's assets is less than its outstanding debt, an acquiror will typically purchase the debtor's shares at a nominal amount and the debtor's debts at an amount less than face. If the discount at which the debt is acquired is big enough (i.e., such that the amount the acquiror pays for the debt is less than 80% of its principal amount), the debt will be deemed to have been settled immediately after the shares and debt are acquired (since the acquiror and debtor will not deal at arm's length at that time). There are structuring strategies that can prevent this from occurring if the problem is spotted in time. However, it is common for the debt parking issues in these situations to be overlooked, since the rules are rather complex and the rationale for deeming debt forgiveness to have occurred in these situations is not always straightforward. As such, the debt parking rules often represent a trap for the unwary.

When a debt is deemed to have been settled under the debt parking rules, the debtor is deemed to have paid an amount equal to the current holder's cost of the debt in satisfaction of the principal. Since the creditor must have a cost of the debt that is less than 80% of the principal amount for this rule to apply, a "forgiven amount" will result, causing a reduction in the favourable tax attributes of the debtor and/or extra taxable income for the debtor. This will be of concern to the debtor and its shareholders on a debt restructuring, and to the acquiror of the debtor in an acquisition.

Conclusion

The debt forgiveness rules apply in a variety of circumstances, such as on a debt restructuring or on the purchase and sale of debt and/or shares. Determining when and how these complex rules apply often requires considerable analysis, and the implications for debtors and their securityholders can be significant. In particular, the debt parking rules that deem debts to have been settled may apply in seemingly innocuous situations. Insolvency practitioners are advised to consider the application of these rules whenever they are seeking to preserve the ongoing value of a debtor (such as on a proposal or restructuring).

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¹ Tax losses are valuable because they can often be applied to reduce income in profitable taxation years, while having a higher cost of property for tax purposes is also beneficial because (1) some tax deductions (like depreciation) are computed as a percentage of a property's cost, and (2) the higher the tax cost of a property the lower the profit for tax purposes when it is sold.

² Alternatively, an election can be made to treat the non-arm's-length creditor as having been paid and as having subsequently made a loan back to the debtor. A similar rule applies to the debtor's employee remuneration expenses that remain unpaid 180 days after the year in which the expenses were incurred.

³ For the purposes of the debt parking rules, a shareholder of the debtor who holds 25% or more of the votes or value of the debtor's shares (including shares held by non-arm's-length persons) is deemed not to deal at arm's length with the debtor. Generally, two parties will be related where one has legal control of the other or where both are under common legal control. Certain elective bad debt write-downs can also trigger the debt parking rules.