

Tax on Forgiven Debts: Fiji Income Tax Act Vs Islamic Perspective

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Abstract

An uncollected tax is a debt to the state. In Fiji, individuals' pay income tax if they earn more than FJD\$30,000 under the Income Tax Act 2015 (ITA). Thus, the purpose of this paper is to critically evaluate the stand of debt forgiveness by the lender to the borrower in the Fiji Income Tax Act 2015. Furthermore, the paper has discussed the Islamic viewpoint of debt that is forgiven. The findings indicated that Fiji looks upon the forgiven debts as income in the hand of the borrower and thus is taxed whereas the Islamic view is that such taxes should not be imposed taking into account the verse of the *Quran* (2:280).

Keywords: Debt Forgiveness, Tax, Legislation, Income, Gift.

Cite this article: Raj, S. K., & Azam, M. R. (2020). Tax on Forgiven Debts: Fiji Income Tax Act Vs Islamic Perspective. *International Journal of Management, Accounting and Economics*, 7(6), 298-304.

Introduction

Tax should be imposed fairly, in the sense that the obligation is fairly distributed among the people. Indeed the tax burden should not be on the poor but the wealthy. A debt instrument is a common means of finance which requires repayment of capital and interest at a specified period. However, Muslims must forgo the interest on the capital amount. This is supported by the following verse of the Holy *Quran*:

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O you who believe, do not practice usury, charging doubled and redoubled (interest); but have fear of God: you may well attain your goal (*Quran*: 3:130).

However, debt forgiveness arises when the borrower's debt is forgiven by the lender. According to the Islamic faith, forgiving debt is highly valued by God. This is supported by the Holy *Quran*:

If a debtor is in want, give him time until his circumstances improve; but if you forego (the debt) as a charity, that will be to your good, if you understand (*Quran*:2:280).

When the debt is forgiven, it means that the borrower (individual, entity) does not have to pay back the liability it took. The accounting treatment on this by the lender will be to classify the debt forgiveness as an expense. This makes sense. However, will the entity whose debt has been forgiven, will classify this sum as income? To answer this, we need to look at the substance over form concept. If a tax consequence is taken into account, then for the lender, who has waived the debt will disclose the information for a tax deduction. However, the debt forgiven entity (borrower) will be reluctant to disclose such income as the debt forgiven entity will have to pay tax on it with reference to the Fiji Income Tax Act 2015.

Furthermore, if "a lender writes off a debt, this will give rise to a financial gain to the borrower who will book the amount forgiven as a credit in its profit and loss account and as a debit to the relevant creditor's liability account in its balance sheet. Whilst a lender may be entitled to a tax deduction or a capital loss when a debt is forgiven, the borrower will not generally include the amount credited in the profit and loss account in their assessable income as the borrower is merely being relieved of a liability" (CPA Australia, 2018, p.1).

Moreover, some of the situations that may incur debt forgiveness are when the lender of the business agrees to forgive the debt which the business owes and when "a person subscribes for shares in the company to enable the company to repay a debt it owes to that person. The amount paid from the share capital subscribed will be taken to be an amount forgiven at the time it is so applied" (CPA, 2018, p.2).

Debt forgiveness is defined as a debt which has been forgiven whereby the obligation of paying it is no more (Australian Tax Office, 2018). Commercial debt is a type of debt where interest payments are allowed as deductions for tax. Debt forgiveness is also the same as debt relief. Harvey (2012) stated that if the borrower gets relief from debt, then the borrower should disclose it as income for tax purpose.

In Fiji's case, debt forgiveness means if a business has undertaken a liability and does not have to pay because a lender has forgiven it, the recording process should be the same. For the lender, the records will show it as an expense which will be deemed an allowable deduction for tax purposes. From the borrower's point of view, if a debt has been forgiven, then surely it has to be income for tax purposes. If the business does not recognize it as income, then from a tax point of view, there is no balance as per the overall tax consequence. The tax paid and the deduction allowed to reduce the tax from the debt forgiven amount will not match. This will trigger that the tax system has been taken

advantage of in reducing the amount of tax paid since that amount is not disclosed as income and the balance in the tax system is not achieved. However, is it justified to tax on the borrower's forgiven debts that are already facing financial hardship?

Analysis of International Cases on Debt Forgiveness

Wright (1951) stated that in the American Dental case, immunity was provided to debtors because they used the payments for liabilities due to tax deductions. From an economic point of view, debtors received greater tax benefits since the debt is forgiven was classified as a gift. With reference to Kirby case, debtors still benefited from past tax deductions due to the obligations due.

Furthermore, Surrey (1940) stated that the Kirby Lumber Company case was decided in 1931 by the Supreme Court in the United States of America. The case was about this company issuing bonds at a higher price and later bought some of the bonds at a lower price. The Supreme Court deemed the difference in the value as income for tax purposes. Any form of indebtedness was regarded as income for tax purposes. The simple logic could be applied for debt forgiveness. If the creditor has forgiven the debt, then the difference between the debt and the debt paid will be deemed as income for tax purposes. The Kirby Lumber Company case of America is very much relevant to Fiji and as per sections 14 and 17 of Fiji Income Tax Act 2015, debt forgiveness is classified as income for tax purposes and not a gift as stated in the American Dental case which classifies debt forgiveness as a gift which is not taxable. This case affects the overall tax consequence since one party claims tax deductions and the debt relieved party does not pay tax. Therefore, an imbalance in the overall tax system if that was the case in Fiji with reference to the American Dental case.

Moreover, Bittker and Thompson (1978) stated that “the Kirby Lumber case established the general rule that the cancellation of indebtedness by a creditor for less than the amount owed results in income to the debtor”. In terms of accounting transactions, when you are borrowing money, they are not classified as part of income because the transactions do not produce any gain since the money coming in is classified as the debtor's assets and the other result is that the obligation to pay that is the liabilities also increases on the other side as well. There is a balance if the point is from double-entry perspective. This fact is further validated since money borrowed will be repaid on the due date. Sometimes the debt is discharged at an amount lower than the actual amount. The difference would be regarded as income with reference to Kirby Lumber case.

To add further, in the case of *Walker vs. Commissioner (n.d)*, a partnership business had its debt forgiven by the creditor. It was held that each partner for the number of shares of the debt forgiven was liable for income tax. Debt forgiveness may have many types of tax consequences. The benefits of debt forgiveness may be in the form of service money which was due, taxable dividend, capital contribution, gift, and increase in total assets. The main focus is whether a gift is an income-based on changes in total assets (Heinonline.org, 2018). The gift concept in the debt forgiveness was based on American Dental rule, formative period and the Jacobson rule (Heinonline.org, 2018).

Is Debt Forgiveness Income or Gift?

There are two international landmark cases, namely, *United States vs. Kirby Lumber Company (1931)* and *Helvering vs. American Dental Company (1943)*. In the *United States vs. Kirby Lumber Company (1931)*, the Supreme Court held that the selling and buying of bonds less than the par value of the obligations, the difference between the amounts and cancellation of debt resulted in taxable income. For so many years, this case set precedent to debt cancellations. However, in the *Helvering vs. American Dental Company (1943)*, the taxpayer (American Dental Company) received benefits in the form of interest and rent cancellations. The Supreme Court held that the debts forgiven were gifts rather than income. Thus, not subject to income tax.

Bingham (1949) stated that in the case of *Commissioner vs. Jacobson (1947)*, it brought the same issue of whether or not to tax debt forgiveness. The question is, what standard rule is applied when it comes to debt cancellation. Jacobson bought his mortgage bonds at a cheaper price. Some of the bonds were purchased through direct negotiations and some indirectly through agents. The commissioner said the two buying methods constituted income for tax purpose under the Kirby precedent. Jacobson argued based on American Dental case that these were merely gifts therefore not taxable. However, the tax court decided that direct negotiation transactions were gifts and not liable for income tax whereas indirect negotiation through agents constituted income for tax purposes.

Thus, when it comes to debt forgiveness; international cases such as the above sets precedents whether it is a gift or income for tax purposes. With reference to Fiji's tax regime, it is very much clear that any debt forgiveness is regarded as income for tax purposes and one of the reasons could be for the overall tax system consistency and balance.

Analysis of Fiji's Matasau Holdings Limited Vs. Chief Executive Officer (Fiji Islands Revenue And Customs Authority) (2016) Case

The court case is about reviewing the decision of the Chief Executive Officer (CEO) of Fiji Revenue and Customs Authority (FRCA) on the income tax assessment against Matasau Holdings Limited. The issue was regarding the transfer of finance provided to the company by the main shareholders. The repayment was not made however it was converted into equity of the company. The company then had merged with Sustainable. The company owed the debts however, Sustainable purchased the debt and the company's position was that the debt was forgiven. The company made partial payments of the debt.

The question arises whether that debt has to be paid or not. If the debt is not going to be paid, then it is regarded as a gain (income) to Matasau Holdings Limited on which they should pay tax as per the CEO of FRCA. The court held that the loan was forgiven and was regarded as again with reference to the Fiji Income Tax Act. The reference was also made to the Australian tax regime which did not require income tax to be paid for forgiven debts, however, in Fiji's case, there was no such provision. Therefore, the appeal was dismissed and the court ruled in favour of FRCA. Thus, Matasau Holdings Limited had to pay the imposed tax figure by the tax office.

Analysis of Fiji's Rainbow Reef Enterprises Limited Vs. Fiji Revenue and Customs Authority (2018) Case

The case is about the applicant (Rainbow Reef Enterprises Limited's) objection to the amended assessment dismissed by the tax office because of a debt which was forgiven was deemed part of income to be taxed with reference to the Fiji Income Tax Act. The applicant is seeking redress in terms of reducing the income tax amount and to refund with interest any tax paid. The issue here is that the main shareholders of the company (LGH and SBH) sold all their shares to the applicant (Rainbow Reef) and had forgiven the debt to create equity. This means Rainbow Reef does not have to pay back for the shares which it bought. Now the question is whether the debts forgiven was taxable income or was it a capital transaction? The court held that the debt which was forgiven as part of income for which tax has to be paid with reference to Fiji Income Tax Act. The court dismissed the application for review and the objection decision of FRCA was reaffirmed.

Islamic Perspective on Debt

There exist numerous sayings of the Prophet Mohammad (peace and blessings of God be upon him) on debts. To begin with, the debtor is a prisoner, as the Prophet (peace and blessings of God be upon him) said, "Your companion is being detained by his debt", narrated by Abu Dawood (3341).

Secondly, Islam takes the matter of debt very seriously and warns against it and urges the Muslim to avoid it as much as possible. Al-Nasaa'i (4367) narrated that the Prophet Muhammad (peace and blessings of God be upon him) said, "by the One in whose hand is my soul, if a man were killed in the battle for the sake of God, then brought back to life, then killed and brought back to life again, then killed, and he owed a debt, he would not enter Paradise until his debt was paid off". Furthermore, It was narrated from Thawbaan (may God be pleased with him) that the Messenger of God (peace and blessings of God be upon him) said, "Whoever dies free from three things – arrogance, cheating and debt – will enter Paradise", narrated by Al-Tirmidhi (1572).

It was narrated that Abu Hurayrah said: The Messenger of God (peace and blessings of God be upon him) said, "The soul of the believer is suspended because of his debt until it is paid off", narrated by Al-Tirmidhi (1078). Scholars say that the phrase "the soul of the believer is suspended" meant that it is detained and kept from reaching its noble destination and that no judgment is passed as to whether it will be saved or doomed until it is determined whether his debt will be paid off or not.

These stern warnings about debt only came because of the negative consequences to which it leads. It is a disgrace and a humiliation because it preoccupies the mind and makes one worried about paying it off, and makes one feel humiliated before the lender when meeting him, and feeling that he is doing one a favour when accepting a delay in payment. Perhaps he may promise himself that he will pay it off then break that promise, or speak to the lender and lie to him, or swear an oath to him then break it, and so on. Moreover, he may die without having paid off the debt so he will be held hostage because of it, as the Prophet (peace and blessings of God be upon him) said, "The soul of the

believer is held hostage by his debt in his grave until it is paid off”, narrated by Al-Tirmidhi, 1078. All of that undermines one’s religious commitment. However, these sayings of the Prophet (peace and blessings of God be upon him) are correct for those debts that have been taken by the person.

Islamic Perspective on Taxing Forgiven Tax and Final Remark

A debt that is forgiven by the lender should not be taxed as there is a common understanding that the borrower was indeed in financial hardship. Even on ethical ground, it is inappropriate for the tax office to charge tax on borrower’s forgiven debts by the lender. God (He be exalted) says (interpretation of the meaning), “but do not help one another in sin and transgression” (*Quran: 5:2*). This indeed is a sinful act by the tax office according to the Islamic perspective.

Therefore, in Fiji’s context, a debt forgiven to the borrower is considered to be income on which tax has to be paid with reference to section 14 and section 17 of the Fiji Income Tax Act 2015. The broad definition of income under section 14 of the Fiji Income Tax Act 2015 very well covers that debt forgiveness is regarded as income for tax purposes. With reference to section 14 and 17 of the Fiji Income Tax Act 2015, debt forgiveness forms part of gross income and income from the business which is income for tax purposes. Thus, from the above discussion, it can be concluded that the Fijian Tax regime does not have a provision for the forgiveness of debts, unlike the Islamic ruling.

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