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BALANCE SHEET AND TAX ASPECTS OF BANK DEBT REMISSION

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Key words: bank accounting, bank debts, release from debt, receivables remission.

A b s t r a c t

Tax and balance sheet aspects of bank debt redemption. This paper is devoted to the redemption of bank liabilities, which constitutes one of the tools used by banks in the re-structuring of borrowers' debts. This is not an optimal form of shaping the relationship between the creditor and the debtor but under certain conditions, in the case of a partial redemption or redemption of a certain components of the debt, it may at least partially off-set the outstanding claims of the creditor. From the point of view of the banks, in the case of debt relief, tax laws should be considered restrictive as they contain a very limited cost catalogue qualifying them to be considered as revenue costs. From the perspective of the balance sheet, liability redemption tends to be the most neutral because the banks are obligated to perform regular write-downs on receivables. Debt redemption usually occurs after possible execution alternatives against the debtor have been pursued, and therefore when a full write-down has been created on bank's liability.

BILANSOWE I PODATKOWE ASPEKTY UMORZENIA WIERZYTELNOŚCI BANKOWYCH

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Słowo kluczowe: rachunkowość bankowa, wierzytelności bankowe, zwolnienie z długu, umorzenie wierzytelności.

A b s t r a k t

Artykuł poświęcono umorzeniu wierzytelności bankowych, które jest jednym z narzędzi stosowanych przez banki w procesie restrukturyzacji zadłużenia kredytobiorców. Nie jest to optymalna forma ukształtowania relacji między wierzycielem a dłużnikiem, pod pewnymi warunkami

jednak, w przypadku umorzenia częściowego lub niektórych składników zadłużenia, może ona przynajmniej w części zniwelować niezaspokojone roszczenia wierzyciela. Z punktu widzenia banków w przypadku zwolnienia z długu przepisy podatkowe należy uznać za restrykcyjne, ponieważ zawarty jest w nich bardzo ograniczony katalog kosztów uprawniający do zaliczenia ich w skład kosztów uzyskania przychodu. Z bilansowego punktu widzenia umorzenie wierzytelności jest najczęściej neutralne, ponieważ banki są zobowiązane do bieżącego dokonywania odpisów aktualizacyjnych na należności. Zwolnienie z długu występuje często po wykorzystaniu możliwości egzekucyjnych w stosunku do dłużnika, wówczas więc, gdy na wierzytelność banku utworzono pełny odpis aktualizacyjny.

Introduction

Bank debt remission (release from the debt¹) is one of tools used by banks in the process of restructuring of indebtedness these institutions are not able to recover. The reasons for this state of affairs can be traced back to both unreliability of debtors themselves, caused by aware intention not to repay their liabilities, and factors beyond their control, either as a result of careless or incompetent action of banks themselves, which, as a result of improper creditworthiness assessment, inadequate collateral in relation to the risk borne or too late debt collection actions are not able to recover their receivables, and the probability to change this state of affairs is equal to or close to zero.

According to the data of the Polish Financial Supervision Authority as of 31.12.2013, the share of overdue receivables towards the non – financial sector in the whole portfolio of receivables amounted to 5.8%, which should be considered a value that does not threaten the stability of the bank sector, however, the share of receivables overdue for more than 180 days (doubtful and lost receivables) was 49.5% of the overall balance of these receivables (KNF 2014). For instance, in 2000 these ratios amounted to 15.3% and 70.0%, respectively (NBP 2001). The value of endangered receivables at the end of 2013 was al-most PLN 98 billion; including doubtful and lost receivables amounted to PLN 48.5 billion, which justifies the importance of the subject undertaken.

For obvious reasons, receivables remission is not an optimum form of final cooperation between the bank and the debtor, however, under some conditions, in the case of partial remission or remission of some debt components, release from debt may, at least partly, reduce losses sustained by the bank. The purpose of the article is to point out the differences in the approach to the issue

¹ In the article the following terms are used interchangeably: bank debt or receivables remission, release from debt or release from obligations.

of debt remission in the area of accounting, focused on reliable and faithful economic image, and in the tax law, which – substantially – does not acknowledge negative effects of the economic risk borne. The applied research methods include studies of literature, legal acts and judicial decisions related to the adopted issues.

Debt remission in civil law

The notion of debt remission has not been defined on the ground of domestic and inter-national balance sheet law as well as tax regulations. It should be thus implied, according to system interpretation, that remission corresponds to the structure of release from debt, included in the Polish Civil Code, which in Article 508 says that a debt expires when the creditor release the debtor from debt, and the debtor accepts this release (k.c. 1964).

Contrary to what the name may suggest, release from debt is not a unilateral legal activity, since it may arise only as a result of a contract concluded between the creditor and the debtor. The constitutive condition of release from debt is not only declaration of the creditor, but also active action on the part of the debtor, who is obliged to accept the generally beneficial solution. The reference here is made to the „generally” beneficial solution for the debtor, since after signing the contract of debt expiry, they are released from the need to pay the benefit (WIŚNIEWSKI 2013). Although the legislator has not reserved a specific form for the contract of release from debt, it is difficult to imagine a situation when it takes the oral form. It seems that since the contract with the bank (e.g. credit facility contract) must be made in writing, then *per analogiam*, release from debt also should have a written form (Prawo bankowe 1997). It is very important from the point of view of banks, since it often happens that contacts with unreliable debtors are difficult or there is no contact at all. At this point, it is necessary to point out that release from debt may be paid or free-of-charge.

Unless the parties have agreed otherwise, it should be assumed that debt expires as of concluding the contract with *ex nunc* effect. A different moment may refer both to a prior or later date.

Contractual release from debt includes in principle the whole debt, however, the bank in consultation with the debtor may reduce it, for example to interest. Along with debt expiry also accessory rights expire, in particular pledge and surety, however, not the other way round: debt does not expire, in spite of release of the pledger or guarantor. Owing to tax consequences, we should also differentiate between a contract of release from debt and a contract whereby the creditor undertook not to claim from the debtor due benefit. In

the latter case, the contract does not lead to debt expiry, but only prohibits the creditor to seek claims in a certain way or time, or even at all (WIŚNIEWSKI 2013).

It is also possible to consider behaviour of the creditor towards the debtor similar to re-lease from debt, on the ground of procedural law. Pursuant to Article 203 § 1 of the Code of Civil Procedure (k.p.c. 1964), a lawsuit may be withdrawn without permission of the defendant (the debtor), if the withdrawal is connected with renunciation of claims by the plaintiff (the bank). As it was pointed out by the Supreme Court (Wyrok Sądu Najwyższego z 3 lutego 2009 r.), withdrawal of the lawsuit renouncing the claim has double effect: trial and material. Withdrawal of the lawsuit as trial activity means resignation from trial continuation, while the consequence of waiver of claims is release from debt that will never be the object of trial again, which does not mean release from debt regulated by Article 508 of the Polish Civil Code.

To sum up the above discussion, depending on the purpose and method of shaping the contractual relation between the creditor and the debtor, a contract can be qualified as resulting in release from debt, or not meeting such a condition. This condition is of essential importance for tax recognition of reduced debt.

Corporate income tax and accounting

The provisions of the Corporate Income Tax Act do not contain the definition of revenue (uopdp 1992). In Article 12, section 1, item 1–10 of this regulation, the legislator indicated only examples of benefits categories, the receipt of which creates taxable revenue. These are in particular the value of amortized or overdue debts, including credits and loans, except for amortized loans from the Labor Fund. At the same time, the Act reserves that revenue does not include amounts which constitute the equivalent of remitted debts, including credits and loans, if remission is connected with the following events (Article 12 section 4 item 8):

- a) bank settlement procedure as defined by the regulations on financial restructuring of companies and banks,
- b) bankruptcy procedure with the possibility of entering into arrangement,
- c) execution of a restructuring program on the basis of separate acts.

Substantially, the value of economic benefit in the form of credit or loan remission leads, on the part of the debtor, to taxable revenue, and an exception from this rule are situations enumerated in Article 12, section 4 items 4–20. Pursuant to the structure of re-lease from debt in the Polish Civil Code, tax revenue can be created at the debtor's no sooner than as of concluding the

contract with the bank. Until that time debt is not remitted, since the creditor is bound only by the offer submitted to the debtor, namely then the bank might conduct actions related to seeking debt repayment.

In bank practice, often during ordering credit portfolio, understood as cessation of showing bank receivables in the accounting books, it may lead to bad debt write-off. This is not, however, debt remission as defined by Article 508 of the Polish Civil Code, because it is a unilateral action of the bank which has no association with release from debt. It results from the fact that the debt lost for which a full intentional reserve was created without reducing reserve base with approved security, as well as interest derecognized to the account of overdue interest, have no effect on the economic image of the entity. In such a situation we should remember about simultaneous removal from off-balance sheet register the assets used as collateral (e.g. mortgage on property).

At this point, we should also point out that taxable revenue is not created in two situations: deferment of interest payment deadlines or commission and reduction in interest and even abandoning calculating interest in a given period, or spreading payments of interest or capital according to another schedule than stipulated in the original credit contract. These activities do not result in remission of receivables, and only alter the way of the credit contract implementation.

It is different in the case of the debtor concluding a settlement with the creditor. Since Corporate Income Tax Act limits the catalogue of events not being revenue, a civil-law settlement or a settlement before the court creates benefits for the debtor. On the grounds of the tax regulations, the basis for taxation should be the difference between the estimated expenses prior to the date of concluding the settlement and following its concluding. The reference here is made to expenses, since the subject of settlement may be also remission of part of credit capital and not only interest and other bank receivables.

The consequences of component parts of credit debt remission

In each debt of credit nature² we can distinguish:

- a) capital, namely the principal amount of debt,
- b) interest – charged (unpaid) and capitalized that after capitalization increase the credit capital,
- c) costs of debt collection procedure, in particular adjudged and recognized as due taxable revenue.

² Including: debt acquired by bank, debt limits, debts under cheques and bills of exchange, used guarantees.

Pursuant to Article 12, section 1, item 3 of the Corporate Income Tax Act, revenues related to business activities earned in a financial year are deemed due revenue, even if they have not been earned yet, after excluding returned goods and granted discounts. The category of due revenue related to business operations undoubtedly includes interests from credits or loans that are charged by banks. Due revenue are receivables constituting the effect of economic activities of the taxpayer, the payment of which they could request from the other party to the contract and these revenues will be due even if the taxpayer does not receive them or resigns from them or defers term of payment (Wyrok Wojewódzkiego Sądu Administracyjnego w Opolu z 22 kwietnia 2009 r.). With regard to this revenue category, tax regulations do not provide for their memorial examination, since pursuant to Article 12 section 4 item 2 of Corporate Income Tax Act, due revenue do not include calculated amounts but not received interest, including from granted credits or loans. Therefore, a question arises whether the value of amortized interest on the part of the debtor is taxable revenue. Despite the lack of formal legal basis, it should be assumed that, in accordance with the principle of tax neutrality, interests charged will not cause tax effects neither on the part of the creditor, nor on the part of the debtor. Such a conclusion, although not referring to a general principle, may be drawn from one of interpretations of the Ministry of Finance, stating that since there is not created intentional interest provision, its remission or distribution into installments does not have a tax effect (pismo Ministerstwa Finansów z 23 czerwca 1993 r.).

We should treat capitalized interest differently, since this interest becomes part of the capital, so debt remission creates benefits for the debtor, which means that capitalized interest will be taxed.

The third constituent part of the amortized debt, causing tax consequences on the part of the debtor, are costs adjudged by the court for the benefit of the creditor. These costs are subject to taxation on the cash basis (Article 3a of the Corporate Income Tax Act), so on the date of their receipt they will not generate the obligation of the debtor to present revenue for taxation.

Relatively rare events, but actually reported in banking practice of the author, were voluntary payments made by the debtor as repayment of a remitted debt, even several years after signing the contract. The reasons for this state of affairs were improved debtor's financial standing and, first of all, the intention to re-initiate economic contacts with the bank, which amortized the debt before. It is an interesting issue as both in the civil law and tax regulations there are no regulations in this scope. A question should be asked: what debt repayment may occur since debt expired before? The answer seems simple and obvious: since on the date of effective release from debt it ceased to exist, there is no ground for legal basis for „historical” consideration of the debtor to

operate. In the case of the bank accepting any repayment under the non-existing debt, the amount should be refunded to the payer because in other case a charge of unjustified enrichment may be filed (Article 405 of the Polish Civil Code). In practice „good will of the bank” may be presented by a bank accepting cash from other legal titles, depending on the amount of repayment. This may be both disproportionately high, in relation to other, amount of commission or fee under given new debt, or significantly higher amount of interest paid in advance than used by the bank on average.

Banks keeping accounting on the basis of the Accounting Act (uor 1994) are obliged to conduct revaluation pursuant to the Regulation of the Minister of Finance concerning the rules of establishment of provisions for risk associated with banks operations (rozporządzenie Ministra Finansów w sprawie zasad tworzenia... 2008). On the other hand, banks keeping accounting based on the International Accounting Standards (IAS-MSR) are obliged to determine as at each balance sheet date whether there are objective evidence of debt impairment. Write-down for expressed in value debt surplus over its recoverable value will be made in the case of the mentioned objective premises for impairment whose broad catalogue is included in IAS 39 and the Regulation of Ministry of Finance (MSR 39 2008). The premises of impairment mostly occur as the effect of many events which occurred from the date of initial recognition of asset until the balance sheet date. The measurement of value of debt at risk should be credible enough to reflect current, as of the balance sheet date, and expected changes in cash flows between the bank ↔ the debtor (POPOWSKA, WĄSOWSKI 2008). The principles binding so far do not stipulate including losses expected at valuation of financial instruments. It is supposed to change in 2015 (WISZNIOWSKI 2013).

Tax law, on the whole, does not consider specific purpose provisions (receivable write-offs) for tax deductible costs (Article 26 of the Corporate Income Tax Act). However, it should be noted that if a given credit debt a specific purpose provision was established on the date debt remission, it should be terminated, which, depending on the tax assignment of costs, should be reflected in tax statement. When the provision was previously classified as tax deductible costs (e.g. documented unsuccessful debt collection), these costs will be reduced and simultaneously increased, but only in the event when the amortized debt amount is deductible costs.

Debt remission and personal income tax

The Personal Income Tax Act refers to natural persons not running business operations and people who run such operations (uopdf 1991). In

general, taxation covers all sources of revenue, except for these that are defined as „tax free” (Article 21, 52, 52a and 52c) and those whose tax collection was abandoned (Ordynacja podatkowa 1997). It can be said that economic benefit in the form of debt remission will generate for the taxpayer, being a natural person, benefit in the form of revenue for taxation.

In the case of entrepreneurs, the value of amortized credit debts or under incurred loans is revenue on business operations (Wyrok Naczelnego Sądu Administracyjnego z 28 maja 1999 r.). An exception from this rule is a situation when remission applies to bankruptcy procedure with the possibility of entering into arrangement as defined by the Bankruptcy and Reorganization Law (poin 2003). This principle applies also to people using the taxation in the form of lump sum on recorded revenues (Wyrok Naczelnego Sądu Administracyjnego z 28 stycznia 1998 r.).

Analyzing the issues of credit debt remission with regard to natural persons not running business operations, due to open scope and very general description of events regarded as tax revenue, the indication of sources of revenue should be settled. The Act does not acknowledge debt remission as a source of revenue in the case of natural persons not running business operations, however, in its content it indicates release referring to student grants given by banks on the basis of separate regulations (uopiks 1998). Since the legislators' will was release of strictly defined cases of debt remission, it should be assumed that in other cases remission will create value subject to taxation.

Owing to the complexity of restructured debt, the practical problem related to their reduction is assessment whether remission of each debt component has the same tax effect. While credit capital remission should not cause larger controversy, doubts may be raised by the bank's resignation from charged interest. It is expressed in conflicting with jurisdiction assessment of tax qualifications by tax offices (Wyrok Naczelnego Sądu Administracyjnego z 14 listopada 2000 r.). Since only the paid interest is tax deductible costs, interests charged should not be the subject of taxation. Tax offices are of different opinion, although in this case we may indicate different interpretations. This conflict of views may lead to misunderstandings between banks and their clients, who are subject to indebtedness restructuring. A bank that takes into account the interest of its client and ensures, at the same time, its tax safety, when transferring information about the resignation from part of interest charged, is exposed, at the same time, to misunderstanding of the problem by the debtor, which may hinder effective and beneficial for both parties procedure, completion of restructuring procedure.

Conclusion

As opposed to the balance sheet approach, tax effects of credit debt remission have a complex and often ambiguous character, which results from the lack of precise tax regulations. The operation of a bank without appropriate legal examination, expressed even in individual inquiry to the Tax Office, stimulates the risk of making mistake and exposure to charges of acting only in its own interest. As far as the balance sheet is concerned the debt waivers is beneficial for banks because it enforces an order in the records of claims contained in the resources of those entities. Even though this action, assuming a correct previous update of receivables, does not affect the final profit or loss (although it may affect the outcome of tax) ultimately, due to the waiver and cadastral reduction of debt it improves the so-called arrears rate, which describes the relationship between impaired loans and the total loan portfolio. The debtor's point of view however, is quite different. The rules and tax interpretations are often vague or contradictory which may consequently result in the Tax Authority's interpretation of the debt waiver as a taxable income.

In the light of the presented discussion, banks should incline towards other solutions than debt remission, e.g. bad debt remission, on the basis of ineffective enforcement steps. Not only has such an approach to the problem has a positive impact on any possible tax obligations of the bank, but it does not generate negative effects for debtors.

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