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No sale of debts where bad debt risk remains with seller

The Supreme Tax Court has held that economic ownership in a company's trade debtors did not pass where the buyer agreed to refund the unneeded portion of an excessive discount for bad debts.

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A wholesaler sold his trade receivables to a special purpose Cayman Islands subsidiary of a Guernsey company wholly-owned by a Guernsey trust. The sale was without recourse, so the Cayman Island purchaser assumed, on paper, the full risks and rewards of ownership. However, the seller remained responsible for collection and did not inform his customers that their creditor was, in fact another party. The sale was at a 7.5 per cent discount to take account of the bad-debt and customer claim risks. This discount was far higher than past experience and current circumstances warranted. The buyer took the discount to expense against which he charged actual shortfalls as and when they occurred. He regularly drew a balance and refunded the surplus to the seller. The seller also paid a handling fee to the buyer to cover the administrative and other costs.

The Supreme Tax Court has now agreed with the tax office in holding that the wholesaler had not truly sold his receivables. Rather, he continued to bear, effectively, the business risk associated with their ownership and thus ranked as their economic owner. The "non-recourse" provision in the contract was unlikely to be invoked in practice, and was thus not relevant to the classification of the transaction. The court also rejected a suggestion that the high discount was to be seen as a payment on account of a future loss, followed by a settlement to reduce the loss borne to its actual amount. The transfer of ownership was at the time of transfer of the risks and rewards of ownership, so if the seller continued to bear the risk, ownership had not been transferred. The court confirmed the lower court's ruling that the transaction be recast as a loan secured by the transfer of formal, legal ownership in the receivables. This loan, though revolving and fluctuating, was essentially permanent, so the handling fees paid to the Cayman Islands company were to rank as long-term debt interest. The consequence was disallowance of one-half of the amount for trade tax.

This case remains relevant under present law - trade tax disallowance of one-quarter of all interest paid over €100.000 - as it turns on the classification, but not the term, of the transaction. (AM)

Supreme Tax Court judgment I R 17/09 of August 26, 2010 published on December 1

Keywords

Non-recourse sale, bad debt, economic owner, risk, sale of debts