IN THE TAX COURT
AT SUVA

HBT Action No: 2 of 2017

BETWEEN : RAINBOW REEF ENTERPRISES LIMITED

APPLICANT

AND : FIJI REVENUE AND CUSTOMS AUTHORITY

RESPONDENT

Coram : The Hon. Mr Justice David Alfred

Counsel : Mr H. Nagin for the Applicant
Mr R. Singh, Mr O. Verebalavu with him, for the Respondent

Date of Hearing : 6 February 2018

Date of Judgment : 25 July 2018

JUDGMENT

1. This is the Applicant's Application for Review (application) which was transferred to this Court by the Tax Tribunal on 19 May 2017.

2. The Applicant is seeking the following Orders:

(1) To vary or set aside the Respondent's Decision (Objection Decision) dated 16 January 2017 wholly disallowing the Applicant's Objection to Assessment dated 17 August 2016. The Objection was in relation to the Notice of Amended Assessment dated 30 June 2016 for the year ended 31 December 2014 which made an adjustment of $533,717 to taxable income on the ground that forgiven debt is income to be taxed under section 11 of the Income Tax Act (ITA).

(2) That the Respondent refund with interest any tax paid by the Applicant pursuant to the Assessment.

3. The grounds for the Application are as follows:

(1) The Objection Decision was erroneous for the following reasons:

(a) The Respondent failed to properly consider the Sale and Purchase Agreement (SPA) for the sale of sales in the Applicant by L.G. Hastings (LGH) and S.B. Hastings (SBH) to W. J. Maston (WJM) and K. T. Maston (KTM).

(b) Prior to the SPA the liabilities in question were recorded by the Applicant as part of its liabilities. On the basis of the SPA the said liabilities were no longer payable by the Applicant and therefore transferred to capital reserve.

(c) There was no forgiveness by the Applicant or alternatively the forgiveness of debt was not part of the Applicant's ordinary course of business. [This ground is patently wrong. It is the shareholders who have forgiven the debt due to them from the Applicant]

(d) The transaction in question was not a revenue transaction but of a capital nature.

(e) Section 11 of the ITA did not give the Respondent any basis or authority to deem a capital transaction as a revenue transaction.

(f) The Respondent wrongly treated this as:
   (i) Profits from a trade.....or other business.....
   (ii) Profits derived from an investment, whether such gains were distributed or not.

4. The Statement of Agreed Facts and Issues (SAFI) include the following:

Agreed Facts include:

(1) The Applicant's taxable activity is to own land, develop and sell land.

(2) On 22 October 2012, the original shareholders of the Applicant, LGH and SBH sold all their shares in the Applicant to WJM and KTM pursuant to a SPA of that date.

(3) The Applicant was audited in 2016 and a schedule of discrepancy was issued by the Respondent (Revenue) on 17 June 2016 stating that the forgiveness of the Applicant's debt was considered income to the Applicant.

Issues for Determination

(1) Whether the forgiveness of debt can be regarded as taxable income under s.11 ITA when here it was not in the ordinary course of business?

(2) Whether forgiveness of debt here should be regarded as a capital transaction.

5. The hearing commenced with the Applicant's first witness (PW1) giving his evidence. He is Gardiner Henri Whiteside, accountant for the applicant since the late 1990s. He said the figure of $169, 894 is for the loans made by LGH and SBH who are the 2 shareholders and the 2 directors. They wanted to sell their shares in the Applicant. He prepared the accounts and the tax return was signed by WJM, one of the purchasers of the shares who became a director and a shareholder of the Applicant.

6. PW1 signed as tax agent. He moved the loans and advances to the capital reserves. The $511,812 is made up of land deposits loans and advances and some

offset for liability of the Applicant not taken over by the incoming shareholders. In 2002 there were no capital reserve only negative shareholders equity.

7. He said as a result of the SPA the Applicant would not have any liability to the 2 Hasting (LGH and SBH). The maintenance of the capital reserve means it is on the credit side of the Applicant as part of its equity. He took the stand that forgiveness of debt is a capital transaction and the sale and purchase of shares is a capital transaction. Advances by a shareholder to the company is a capital transaction. He is not aware of the statutory provision why forgiveness of debt should be revenue transaction.

8. Under cross-examination PW1 said the Applicant is not a party to the SPA. The sale and purchase of the shares operates outside of the company. The previous shareholders of the company take all the liabilities. The bank overdraft, land deposits, loan and advances are liabilities incurred for the day to day running of the business of the Applicant. The funds provided by the shareholder is a benefit to the company.

9. During re-examination DW1 said the parties could forego claims against the company. Debt to the previous shareholders remained as capital in nature. A loan can be taken to acquire capital assets and would still be a liability of the company.

10. The next witness was William James Maston (WJM)(PW2). He said he purchased 2 lots and signed the SPA and it was completed in 2003. He and his wife became directors. The agreement was Mr and Mrs Hastings were to take over the liabilities of the Applicant. The tax return of the Applicant was signed by him and show that the overdraft, land and deposits, loans and deposits are zero. The loan taken over by the previous shareholder are treated as capital reserve and treated the same way to 2016. He was aware an audit was done in 2016, 13 years after they purchased the shares in the Applicant. His understanding was it was capital and not revenue and that the Hastings would take over the liabilities determined the final price that PW2 would pay.

11. With that the Applicant closed its case. The Respondent was not calling any witness. I therefore asked Counsel to make their submissions.

12. The Applicant's Counsel submitted that the SPA provided the liabilities would be taken over by the previous shareholders. The Applicant is not obliged to pay the liabilities.

13. Counsel for Revenue then submitted. He said the gain was recognized by the Applicant and confirmed by PW1 that it was a benefit to the Applicant. S.11 ITA makes this gain part of income. The debt was forgiven in order to create equity. The new shareholders and the previous shareholders agree that there is forgiveness of debt and this is captured in the financial statements. He referred to s.21(2) of the Tax Administration Decree (TAD). The issues regarding the timing of the amended assessment and the imposition of penalties were not raised in the objection letter, nor in the application for review. Therefore the Court cannot consider them. The assessment is based on the 2014 returns and Revenue has not amended the 2003 assessments.

14. The Applicant's Counsel in his reply said all gain is not taxable. Capital gain is not taxable under the ITA. If there are issues outside the application then the court can disallow them.

15. At the conclusion of the arguments I informed I would take time for consideration. Having done so I now deliver my decision. The pivotal issue is whether forgiveness of debt is taxable income under s.11 ITA when it was not in the ordinary course of business, and whether it should regarded as a capital transaction. I shall therefore start by perusing the SPA between LGH and SBH, both company directors as vendors and WJM and KTM as purchasers. The preamble states that the Vendors are the beneficial owners of all the issued shares of the company which they have agreed to sell and the Purchasers have agreed to purchase. Clause 2.01 states the purchase price is US$408,000. Clause 3.02(c) provides the Vendors shall "Hand to the Purchasers if necessary an acknowledgment that neither the directors nor secretary have any claim against the Company on any account whatsoever". To my mind this is the clearest acknowledgement by both Vendors that their claims against the Applicant for repayment of loans have been extinguished.

16. The whole basis for the accounting treatment of the transaction concerned appear to have been misconstrued by the Applicant's tax agent. They state their position in the Objection to Assessment dated 17 August 2016. On page 2 at para 1 they say under the terms of the SPA all liabilities of the Applicant are to remain with and be the responsibility of the outgoing shareholders (Vendors). Then at para 2

they say the scenario adopted was that the liabilities were not to be payable by the Applicant but to remain with the outgoing shareholders. This flys in the face of clause 3.02(c) of the SPA which I have found to establish the extinction of any claim by the Vendors/shareholders against the Applicant. Therefore it cannot be true that there is any liabilities extant. Nor can there be any sound economic reason to consider this now non-existent liability as worthy of being considered as capital under any name.

17. The accountants are attempting to characterize this transaction as a capital transaction. But if I may say so with respect, they have to provide the legal cover for it to escape being considered as a revenue transaction. In my opinion they cannot try to achieve their objective by clothing the transaction as one which is capital in nature. The plain unvarnished truth is that by the Agreement for Sale and Purchase of Shares the Vendors have taken upon themselves the responsibility of shouldering the Applicant's liabilities and freeing the Applicant of these liabilities. They have thus obtained a greater gain then they would otherwise have obtained.

18. Be that as it may, to my mind the end result of the transaction is that the Applicant now has a source of income for it to utilize in the generation of income in the course of their business. That this also simultaneously is a financial relief for the new shareholders/owners of the Applicant does not by some accounting sleight of hand convert it into capital as opposed to revenue in nature.

19. I am of opinion that while an accountant might consider forgiveness of debts as capital for accounting purposes, the court does not have to follow suit. This is because "It is well settled, however, that the mere way in which a company keeps its accounts is not conclusive in the matter" per Cameron J. in : Geo. T. Davie and Sons Limited v. Minister of National Revenue (54 DTC 1045) 1954. For tax purposes I am constrained to treat it as revenue and therefore subject to be taxed.

20. The Shareholders/Vendors have in effect forgiven any obligation on the Applicant's part to repay to them (the Vendors) the monies due by it to them. How then can the Applicant qua taxpayer say it is not liable to pay the tax on this accretion or addition to its income. It must be borne in mind that it is not the purchasers qua (new) shareholders who are asked to pay the tax.

21. The accountants recorded as the Applicant's liabilities, the amounts owed to the outgoing Shareholders/Vendors. When these liabilities ceased to exist as a result of the SPA, the accountants transferred these liabilities to a capital reserve. In my view this could not be a justifiable exercise in law for the following reasons. First the Applicant did not need to repay the outgoing shareholders. Second there was nothing to pay to the incoming shareholders. Consequently there was no longer any need for a capital reserve.

22. That the Applicant, had to pay the tax, should have been obvious to those who ran the financial affairs of the Applicant and their accountants or auditors, right from the start. Thus the Applicant cannot be excused from paying the penalty which the Revenue has correctly imposed when it failed to pay the tax.

23. At the end of the day I am of opinion that the forgiveness of debt was a source of income that made it a part of the total income under s.11 ITA upon which tax is leviable.

24. It is inexpedient for me to refer to the cases cited by Counsel for the Applicant. This is because upon close perusal of them, I am unable to discern how they may assist the Applicant here when their factual situations differ from the factual matrix here. Here there was no cancellation of a trade debt. But here was a sum now available to the Applicant.

25. In the result, the Application for Review is dismissed, the Objection Decision is affirmed and I shall order each party to bear its own costs.

Delivered at Suva this 25th day of July 2018.

HIGH COURT OF FIJI
SUVA

David Alfred
JUDGE
High Court of Fiji