

BAD DEBTS - WRITING OFF DEBTS AS BAD FOR GST AND INCOME TAX PURPOSES

PUBLIC RULING - BR Pub 00/03

Note (not part of ruling): This ruling is essentially the same as public ruling BR Pub 96/3A, published in TIB Volume 8, No. 10 of December 1996, but this ruling's period of application is from 1 April 1999 to 31 March 2004. Some formatting changes have also been made. BR Pub 96/3A applies up until the end of the 1998-1999 income year.

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references to the Income Tax Act are to the Income Tax Act 1994 and all references to the GST Act are to the Goods and Services Tax Act 1985.

This Ruling applies in respect of section DJ 1(a)(iii) of the Income Tax Act and section 26(1)(c) of the GST Act.

The Arrangement to which this Ruling applies

The Arrangement is the writing off of a debt (or part of a debt) as a bad debt, for income tax and/or GST purposes, in the following circumstances:

- An existing debt is owing to the taxpayer; and
- The debt is adjudged as “bad” when, having considered the facts objectively, a reasonably prudent business person would conclude that there is no reasonable likelihood that the debt will be paid; and
- The records kept by the taxpayer comply with the record keeping requirements contained in the Tax Administration Act 1994 and the GST Act; and
- The bad debt is “written off” in accordance with the accounting and record keeping systems maintained by the taxpayer, involving, at a minimum, write-off:
 - in the case of a large corporate or business taxpayer who maintains a computerised bad debts system, by an authorised person making the appropriate entry in that system recording the debt as written off; and
 - in the case of a company (other than one falling within the above class), by an executive or other responsible officer of the company with the authority to do so, making the appropriate bookkeeping entries in the books of account of the company recording the debt as written off; and

- in the case of a taxpayer (other than a company) that maintains double-entry accounts, by an authorised person making the appropriate bookkeeping entries in the books of account of the business recording the debt as written off; and
- in the case of a taxpayer who is an unincorporated sole trader or small unincorporated business taxpayer who does not maintain double-entry accounts, by the taxpayer noting, in the bookkeeping records of the taxpayer setting out the amount owed by the bad debtor, that the debt has been written off, and the date of the writing off.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

1. An income tax deduction is permitted in terms of section DJ 1(a)(iii) of the Income Tax Act.
2. A deduction from GST output tax is permitted in terms of section 26(1)(c) of the GST Act.

The period for which this Ruling applies

This Ruling will apply for the period 1 April 1999 to 31 March 2004.

This Ruling is signed by me on the 20th day of April 2000.

Martin Smith

General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR Pub 00/03

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 00/03 (“the Ruling”).

Background

The Income Tax Act and the GST Act allow taxpayers and/or registered persons a deduction for bad debts if certain criteria are met. Criteria common to both Acts are the requirements that a debt must be both bad and written off before any deduction can be made. The issues that arise when claiming a bad debt deduction are: when a debt is considered bad, and what is required to write off a debt as bad.

These issues were previously dealt with in public ruling BR Pub 96/3A and that ruling has been replaced by this Ruling from 1 April 1999. The previous ruling concluded that a debt (or part of a debt) must be both bad and written off before any person can claim an income tax deduction or a deduction from GST output tax (assuming that other legislative requirements in the GST Act and the Income Tax Act are also satisfied).

The Ruling sets out the tests to apply in deciding whether or not a debt is “bad” and what is sufficient “writing-off” of a bad debt.

Legislation - Income Tax Act

Section BD 2(1)(b) allows a deduction for any expenditure or loss incurred by a taxpayer in deriving the taxpayer’s gross income or necessarily incurred in carrying on a business for the purpose of deriving the taxpayer’s gross income.

However, notwithstanding section BD 2(1)(b), section DJ 1(a) prohibits the deduction of bad debts, except where and to the extent that a number of requirements are met.

Section DJ 1

The relevant part of section DJ 1 of the Income Tax Act, in force at the date of commencement of this Ruling (1 April 1999), states:

Except as expressly provided in this Act, no deduction is allowed to a taxpayer in respect of any of the following sums or matters:

- (a) Bad debts, except where and to the extent that,—
 - (i) In the case of a debt which is an amount owing to the taxpayer in respect of a financial arrangement where the accruals rules apply to the taxpayer in respect of the financial arrangement, a deduction is allowed under section EH 5; and

(ii) In any case other than that of a debt which is an amount owing to the taxpayer in respect of a financial arrangement where the accruals rules apply to the taxpayer in respect of the financial arrangement, the bad debt is not a loss of capital subject to section BD 2(2)(e); and

(iii) The debt is proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year; and

(iv) In any case where-

(A) The taxpayer is a company; and

(B) The debt is owed by a company (referred to in this subparagraph as the “debtor”); and

(C) The application of the amount giving rise to the debt is taken into account in calculating a net loss (referred to in this subparagraph as the “resultant loss”) of the debtor or any other company funded (directly or indirectly) by the debtor; and

(D) Any one or more amounts have been offset under section IG 2 of this Act or section 191A of the Income Tax Act 1976 by the taxpayer (or by any other company which is at any time in the income year in which the resultant loss is incurred in the same group of companies as the taxpayer), in any income year commencing on or after 1 April 1993 and preceding the income year in which the bad debt is written off, in respect of the resultant loss,--

the debt exceeds the aggregate of the amounts so offset.

Section DJ 1(a)(iii) sets out one of the requirements to be satisfied to get a bad debt deduction, namely that the debt must be proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year. It is this part of the income tax bad debt deduction provision that is addressed in the Ruling and discussed more fully in the *Application of the Legislation* section of this commentary.

Other section DJ 1(a) requirements (in summary form) that must also be satisfied are:

- Section DJ 1(a)(i) - If the debt is an amount owing under a financial arrangement and the accruals rules apply to the taxpayer in respect of the financial arrangement, a deduction must be allowed under section EH 5. However, any such bad debt deduction is still conditional on satisfaction of the section DJ 1(a)(iii) requirement that the debt is proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year. [NOTE: *The accruals rules have recently been rewritten by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999. Section DJ 1 as set out above has also been amended with effect from 20 May 1999 to take account of consequential changes made by that Act. A more detailed discussion about bad debts that arise where the accruals rules apply, and the changes made by the above Act, appears at the end of this commentary.*]; and
- Section DJ 1(a)(ii) - If the debt is **not** an amount owing in respect of a financial arrangement to which the accruals rules apply, the bad debt must not be a loss of capital that is subject to section BD 2(2)(e); and

- Section DJ 1(a)(iv) - If the taxpayer is a company and the debt is owed to that company by another company (“the debtor”) and
 - The amount giving rise to the debt is taken into account in calculating a loss incurred by the debtor or any other company funded by the debtor; and
 - Any amounts of that loss have been offset under the group company loss offset provisions in section IG 2, or section 191A of the Income Tax Act 1976, by the taxpayer (or any other company in the same group as the taxpayer in the year the loss is incurred), in any income years from 1993/94 and preceding that in which the bad debt is written off, -

the deduction allowed for the bad debt is the amount by which the debt exceeds the total amounts offset.

Bad debts recovered

Under section CE 1(1)(d), amounts received by a person on account of a bad debt for which a deduction has previously been allowed to the person are included as gross income of the person.

Legislation - GST Act

Section 26

The relevant part of section 26(1) of the GST Act states:

Where a registered person -

- (a) Has made a taxable supply for consideration in money; and
- (b) Has furnished a return in relation to the taxable period during which the output tax on the supply was attributable and has properly accounted for the output tax on that supply as required under this Act; and
- (c) Has written off as a bad debt the whole or part of the consideration not paid to that person,-

that registered person shall make a deduction under section 20(3) of this Act of that portion of the amount of tax charged in relation to that supply as the amount written off as a bad debt bears to the total consideration for the supply:

Section 26 is the main provision applying to bad debts for GST purposes. The section applies to registered persons who account for GST on an invoice or hybrid basis. It also applies to registered persons who account for GST on a payments basis when the relevant supply is by way of a hire purchase sale or a door to door sale.

Section 26(1) allows a registered person to make a deduction from output tax for that portion of the amount of tax charged in relation to a supply as the amount written off as a bad debt bears to the total consideration for the supply. To claim the deduction, the registered person must satisfy a number of criteria. Section 26(1)(c) sets out one of these, namely that the registered person must have written off as a bad debt the whole or part of the consideration not paid to that person.

The other section 26(1) criteria (in summary form) also to be satisfied are that the registered person must have:

- Section 26(1)(a) - Made a taxable supply for consideration in money (from which the bad debt arose); and
- Section 26(1)(b) - Furnished a return in relation to the taxable period during which the output tax on the supply was attributable, and properly accounted for the output tax on the supply.

A proviso is effective if goods are supplied under a hire purchase agreement to which the Hire Purchase Act 1971 applies. In this case the registered person makes a deduction from output tax of the tax fraction (being the tax fraction applicable at the time the hire purchase agreement was entered into) of that portion of the amount written off as a bad debt as the cash price bears to the total amount payable under the hire purchase agreement.

A special provision exists for registered persons who supply contracts of insurance relating to earthquakes, wars, and fires (see section 26(1A)).

Application of the Legislation

As indicated earlier, criteria common to both the Income Tax and GST Acts are the requirements that a debt must be both bad and actually written off before any deduction can be made. This section of the commentary is therefore divided into two parts, discussing firstly the tests to apply in deciding whether or not a debt is “bad”, and secondly what is sufficient “writing-off” of a bad debt.

First requirement - Debt must be “bad”

A debt must be “bad” before it can be written off and before any deduction can be claimed for that debt. Whether or not a debt (or part of a debt) is bad is a question to be determined objectively, rather than a question to be determined by the subjective opinion of any particular individual. The objective test that any person should ask himself or herself in deciding whether or not a debt is bad, is whether a reasonably prudent business person would conclude that there is no reasonable likelihood that the debt will be paid.

This objective test was outlined by Tompkins J in the High Court decision of *Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263, at 12,269:

The term “bad debt” is not defined in the Act. It, therefore, should be given its normal commercial meaning. It is a question of fact to be determined objectively. A debt becomes a bad debt when a reasonably prudent commercial person would conclude that there is no reasonable likelihood that the debt will be paid in whole or in part by the debtor or by someone else either on behalf of the debtor or otherwise.

A similar test was outlined by Barber DJ in *Case N69* (1991) 13 NZTC 3,541, at 3,548:

Naturally, the debts in question must be “bad” to be written off as bad in terms of s. 106(1)(b). This is a question of fact. Generally, an application of that criterion will not be difficult as the debtor will be insolvent. However, the debtor does not need to be insolvent for the debt to be bad. It is only necessary that there be a bona fide assessment that the debtor is unlikely to make payment of the debt. If there is a clear understanding or arrangement that there be long term credit, and if the taxpayer believes that the terms of the credit will be met, then the debt cannot be treated as bad because it is merely a situation of deferred payment. In my view, as well as the need for the writing off to be made bona fide, the circumstances must indicate to a reasonable and prudent business person that, on the balance of probability, the debt is unlikely to be recovered. This is an objective test.

The creditor taxpayer may, of course still hope for recovery and is quite entitled to institute recovery procedures. It is not necessary to have taken recovery or legal steps. ... It does not follow from the taxpayer hoping for or seeking recovery that a debt is not bad. However, usually, when a debt is assessed as bad, in terms of the type of criteria I have outlined, hopes or efforts of recovery will be futile.

The decision in *Case N69* was cited with approval by Doogue J in the High Court decision of *Graham v CIR, Edwards Graham Ltd & Edwards v CIR* (1995) 17 NZTC 12,107, at 12,111.

As is evident from the quotations above, different wording is used by the High Court in *Budget Rent A Car* and the TRA in *Case N69* to describe the test of when a debt can be considered written off as bad. To summarise these differences, in *Budget Rent A Car* the words used were “**no reasonable likelihood**” that the debt (or part of the debt) will be paid, whereas in *Case N69* the words used were that “**on the balance of probability, the debt is unlikely to be recovered**”.

Despite the apparent difference between the words used in the tests applied in *Case N69* and in *Budget Rent A Car*, Barber DJ in *Case T27* (1997) 18 NZTC 8,188, at 8,194 stated that his approach in *Case N69* was confirmed in *Budget Rent A Car*. In saying this Barber DJ first cited his own statement containing the test referred to from *Case N69* and immediately followed this by stating:

That approach was confirmed in *Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263 and on that point Tompkins J said at 12,269:

and then citing the objective test from that case included above. Barber DJ regards the “tests” as the same. The Commissioner agrees with this view.

At the time of deciding whether a debt is bad, a person will therefore need to have sufficient information to enable a reasonably prudent business person to form the view that there is no reasonable likelihood that the debt will be paid. The facts needing to be gathered depend on the circumstances surrounding any particular case. While no factor is decisive in itself, factors that are likely to be relevant in most instances are:

- The length of time a debt is outstanding - the longer a debt is outstanding the more likely it is that a reasonably prudent business person would consider the debt to be bad.
- The efforts that a creditor has taken to collect a debt - the greater the extent to which a person has tried (unsuccessfully) to collect a debt, the more likely it is that a reasonably prudent business person would consider the debt to be bad.
- Other information obtained by a creditor - a creditor may have obtained particular information about a debtor, e.g. through business or personal networks, that would be a factor in leading a reasonably prudent business person to conclude that a debt is bad. For example, a creditor may know that the debtor is in financial difficulties and has defaulted on debts owed to other creditors.

A debtor does not need to be insolvent for a debt to be bad (although this will often be the case).

Taxpayer's opinion

A debt becomes a bad debt when a reasonably prudent business person objectively concludes that there is no reasonable likelihood that the debt will be paid. In many instances, a taxpayer's considered opinion will suffice.

However, the Commissioner also recognises that taxpayers have a financial interest in treating a debt as bad. Writing off a debt as bad entitles a taxpayer to:

- A deduction in calculating income for income tax purposes, worth up to 39% of the debt, depending on the taxpayer's marginal income tax rate:
- A GST deduction from output tax of the tax fraction of the debt.

Because of this, the Commissioner may inquire into the decision to treat a debt as bad in the course of tax audits or other enquiries. It is desirable, therefore, that taxpayers document and retain evidence in relation to their decisions to treat debts as bad to show that they made reasonable decisions. Documentation may include noting down the information from which the decision was made that the debt was bad, and keeping copies of any correspondence relating to the debt.

Information required

The amount of information required to decide whether a debt is bad depends on the particular circumstances of each case. If the amount involved is small, a reasonably prudent business person is likely to make limited enquiries and take limited recovery action. Particular knowledge or information obtained by a taxpayer may also reduce the need for enquiry. In the final analysis however, the test is always whether the taxpayer has sufficient information to reasonably draw the conclusion that there is no reasonable likelihood that the debt will be paid, even if further or any recovery action were to be taken.

Recovery action

A creditor is likely to have taken recovery action in most cases before a deduction for a bad debt is made, although it is not a requirement that such action be taken before a decision is made that a debt is bad. However, it is through taking recovery action that most creditors will form an opinion as to whether a debt is bad. While recovery action is being taken, a debt can only be considered bad to the extent that a reasonably prudent business person would consider there is no reasonable likelihood that the debt will be paid.

In some instances, taking recovery action may carry with it the reasonable expectation of recovery of some part of the amount involved. However, this will not always be the case. The decision to take recovery action and the extent of that action will depend on the circumstances surrounding any particular case. In some cases, the creditor may take no or only limited recovery action because enough information is held to form a reasonable view that the debt is bad. The amount of information needed depends on the circumstances.

Conversely, the creditor may take recovery action even when a reasonable view has been formed that the debt is bad. For a number of reasons the creditor might take recovery action even when it is believed that there is no reasonable likelihood that the debt will be recovered. This may be the case, for example, when the creditor has a policy of pursuing debtors to a certain extent to discourage customers defaulting on debt.

Provision for doubtful debts

Persons in business who provide credit often find it prudent to make some provision for the likelihood that some of their debtors will not pay. This allowance is generally calculated by estimating a percentage on the basis of past history, and applying that percentage to the total amount of debts owed to the business at balance date.

Bad debts are individually identifiable debts that are unlikely to be recovered (in practical terms). The provision for doubtful debts is an estimate of the amount that will become

bad debts in the future. The Income Tax Act and the GST Act do not allow any deduction for provisions for doubtful debts.

Debts that are partially bad

In some cases there may be no reasonable expectation that the debt will be fully recovered, but there may be a reasonable expectation of partial recovery. In this case the part that the creditor has no reasonable expectation of recovering is a bad debt. It is only that part of the debt that the creditor is entitled to write off as bad and claim as a deduction for income tax and GST purposes.

Examples of when a debt is/is not bad

Example 1

A supplier has supplied goods on credit to Mr B. Mr B owes the supplier \$2,000 for the goods. The supplier knows that Mr B has left town, and that mail addressed to him is returned marked "Gone No Address".

In this case it is reasonable to assume that the debt will not be recovered. The money owed by Mr B is a bad debt.

Example 2

C owes \$100,000 to a company. The credit controller for the company has considered the likelihood of default on every loan currently owing to the company. The credit controller has estimated the likelihood of default for C to be 5%, and wants to know if the company can consider \$5,000 of that loan (5% of the \$100,000 owing) to be a bad debt.

Making an estimate of the likelihood of default on debts is not sufficient for a debt (or a percentage thereof) to be bad. It is not reasonable to assume that the debt is bad.

Example 3

A local dairy has supplied \$64 worth of bread and cigarettes to Mrs D on credit. Mrs D used to call into the shop every other day, but has not called into the shop for eight weeks and the dairy has heard that someone else is living in the house Mrs D used to rent. The \$64 is still owing.

Given the relatively small amount owing and the information known to the dairy, it is reasonable for the dairy to make no further enquiries. On the basis of the dairy's information, it can be assumed that the money is unlikely to be recovered. It is a bad debt. However, if the sum involved was somewhat larger, it may be reasonable to expect the dairy to make some further enquiry.

Example 4

A solicitor has done work for Mr O and billed him for \$1,700. The solicitor is on the Board of Trustees of the school attended by Mr O's children. The solicitor has sent out a number of reminder bills because the bill is 4-months overdue, but has had no response. Several of the solicitor's friends and associates have mentioned that Mr O is in financial difficulty and has had one of his vehicles repossessed. The solicitor's office clerk has noted that Mr O's name has been cited in the *Gazette* several times over recent months in respect of court action for unpaid debts.

It is reasonable for the solicitor to characterise Mr O's debt as a bad debt.

Example 5

A debtor of Mr F is a company in liquidation. Mr F has given the liquidator notice of a debt of \$10,000 owed for goods and services supplied. Mr F is an unsecured creditor. The liquidator has held a meeting of creditors. Mr F attended the meeting and received formal notice of the outcome of the meeting. The liquidator has stated that unsecured creditors will probably receive something between 45 and 50 cents in the dollar.

It is reasonable for Mr F to assume that \$5,000 of the total debt is bad. He is entitled to write off that part of the debt that is bad in the income year in which he received the formal notice, and to claim a deduction for income tax and GST purposes.

Example 6

The same facts exist as in Example 5, but at a later date Mr F receives a letter from the liquidator who advises that the estimate of the likely recovery has been revised. It is now expected that unsecured creditors will be paid between 70 and 75 cents in the dollar.

This does not affect the answer given above in Example 5. Also, it has no effect on Mr F's GST return or income tax return if Mr F has claimed a deduction for the bad debt. If at any stage Mr F receives payment of any part of the 50 cents in the dollar written off, Mr F must:

- Include it as gross income in the income tax return for the year in which it is received (this will give rise to an income tax liability unless there are losses to offset against it, and may give rise to a provisional tax liability, depending on the taxpayer's circumstances); and
- Account for GST on the amount recovered in the same proportion as Mr F was allowed a deduction from output tax when the bad debt was written off.

Second requirement - Debt must be "written off"

The Income Tax Act and the GST Act allow taxpayers and/or registered persons deductions for writing off bad debts. It is not enough that a debt is bad: the bad debt must also be actually written off. Writing off the bad debt is important because this will fix the time at which the deduction can be made. Note that there is no requirement that a debt be written off in the year it becomes bad. As Tompkins J in the High Court decision of *Budget Rent A Car Ltd v CIR* (supra) at 12,271 stated:

A debt is not normally deductible. It does not become a deductible debt if and when it becomes a bad debt. It becomes a deductible debt, if it has been incurred in the production of assessable income, when it is written off. It is the writing off that converts the debt into a deductible debt. It follows that the crucial time is the time of the writing off, not the time the debt becomes a bad debt. It also follows that the income year referred to in s 106(1)(b) is not the year the debt became bad. In my view, the income year referred to is the year during which the bad debt was “actually written off”.

There is no provision in the Act that requires the bad debt to be written off in the year the debt became bad. Had that been the intention of the legislature, it would have said so ...

Barber DJ in the Taxation Review Authority discussed the requirement to write off bad debts in *Case N69* (1991) 13 NZTC 3,541. Barber DJ said at 3,547:

I consider it elementary that the writing off of a debt as bad requires something more than the mere recognition by the taxpayer, or one or more of its executives, that a debt is unlikely to be paid. It could be reasoned that only a decision of the taxpayer to write off a debt is needed, subject to the debt being bad. However, I consider that, in terms of sec 106(1)(b), book-keeping steps must also be taken to record that the debt has been written off. Desirably, the steps would comprise a directors’ resolution, if the taxpayer is a corporate, and appropriate book-keeping entries. However, it would be adequate for a responsible officer or executive of a corporate or business to merely make the appropriate book-keeping entries if he or she has that authority. An unincorporated sole trader or small unincorporated business would not, of course, have a directorate so that book entries by the trader or his or her manager will suffice. In my view, it is not possible to write off a debt as bad without the making of authorised journal entries in the books of account of the business.

In *Case T48* (1998) 18 NCTC 8,325 the Taxation Review Authority held that for a private individual trader, as distinct from an incorporated company, words on ledger cards such as “written off” with the relevant date are sufficient to indicate that the debt had been actually written off as bad. The taxpayers did not have to meet any other book-keeping requirements.

Taxpayers must therefore be able to clearly show that the debt has been actually written off as bad. Case law indicates that the minimum requirements to satisfy the *actually written off as bad* test may vary for different classes of taxpayer based on the differing nature and level of sophistication of the taxpayer’s accounting records. However, no matter what form a taxpayer’s books of account or accounting records may take, those existing in respect of a debt owed by a bad debtor must record that the taxpayer, or an authorised person on behalf of the taxpayer, having decided the debt is bad, has written off the debt accordingly.

The minimum requirements considered necessary to meet the *written off* test for various classes of taxpayer are as follows. The bad debt is “written off” in accordance with the

accounting and record keeping systems maintained by the taxpayer, involving, at a minimum, write-off:

- in the case of a large corporate or business taxpayer who maintains a computerised bad debts system, by an authorised person making the appropriate entry in that system recording the debt as written off; and
- in the case of a company (other than one falling within the above class), by an executive or other responsible officer of the company with the authority to do so, making the appropriate bookkeeping entries in the books of account of the company recording the debt as written off; and
- in the case of a taxpayer (other than a company) that maintains double-entry accounts, by an authorised person making the appropriate bookkeeping entries in the books of account of the business recording the debt as written off; and
- in the case of a taxpayer who is an unincorporated sole trader or small unincorporated business taxpayer who does not maintain double-entry accounts, by the taxpayer noting, in the bookkeeping records of the taxpayer setting out the amount owed by the bad debtor, that the debt has been written off, and the date of the writing off.

Further details of the specific form the necessary write off of a bad debt may take in the creditor taxpayer's books are outlined in the next section of this commentary.

It is the writing-off that determines the time when a deduction for a bad debt can be claimed. The necessary writing-off must therefore take place before the end of the income year or GST taxable period in which the bad debt deduction is claimed. Writing-off a bad debt cannot be backdated. Therefore, if there are numerous debts to review, it is important to allow sufficient time for this exercise, as well as for completing all necessary "writing-off" accounting entries before the end of an income year or GST taxable period, to enable any bad debts to be deducted in that year or GST taxable period.

In all cases the business records kept by the taxpayer must comply with the requirements of section 22 of the Tax Administration Act 1994 and section 75 of the GST Act.

Accounts kept by taxpayers

Most taxpayers in business keep double-entry accounts. If a person keeps double-entry accounting records, the bad debt must be struck out of the records on which the double-entry accounts are based. If debtors ledgers are maintained, the writing-off will be able to be clearly shown by the appropriate bookkeeping entries having been made in the debtors ledger by authorised persons. Generally, this means that the balance in the debtors ledger for the individual debtor must be reduced by the amount of the bad debt. No matter what processes are followed in the course of preparing a person's double-entry accounts, it is the completion of the appropriate authorised entry(s) actually writing-off a

debt (which it has been decided is bad in accordance with the tests already outlined) that is essential to deductibility.

In cases where a taxpayer does not keep double-entry accounting records and/or does not keep a debtors ledger, the person must write the debt off according to the form of records used. This means that whatever the form of records used, those showing the amount owed by the bad debtor must clearly record that the creditor, having made the decision that the debt is bad (in accordance with the tests already outlined), has written the debt off accordingly.

Particular examples of bad debts accepted by the Commissioner as having been written off are:

- If a taxpayer's only records of debts are copies of invoices issued, placing the invoice in a "bad debts" file and indicating on the invoice whether all or part of the invoiced amount is bad and the date, is sufficient.
- If a taxpayer's only records of debts are copies of invoices and copies of statements of account issued from a duplicate account book, marking the copy of the final statement sent out "bad debt – written off" (noting the amount of the debt that is bad and the date) is sufficient. Alternatively, it would also be sufficient for the taxpayer to place the relevant invoice in a "bad debts" file indicating on the invoice whether all or part of the invoiced amount is bad and the date this was done.

Keeping records for credit control or other purposes

For a variety of reasons, a creditor may keep a separate record of bad debts written off. For example, the records may be necessary if the creditor should ever have the opportunity of collecting the debt in the future, or the creditor may want to keep a record of problem customers to avoid future difficulties.

As long as these records are quite separate from the accounting base records they will not affect the write-off. If the creditor ceases to recognise the debt as an asset for accounting purposes by removing it from the accounting base records, it is written off.

More than one set of accounts

Some businesses have more than one set of accounts. For example, a company may prepare:

- Financial accounts for financial reporting purposes to satisfy the requirements of the Companies Act 1955 or 1993; and
- Management accounts as a basis for management decision-making and control.

The sets of accounts may be prepared in quite different ways. For example, statutory requirements are set out in the Financial Reporting Act 1993 for preparing financial reports that are not required when preparing management accounts; and management accounts may be prepared on the basis of estimates for some elements in order to provide very quick reports.

When the different sets of accounts rely on the same underlying debtor records, no difficulty arises. As long as the creditor ceases to recognise the debt as an asset for accounting purposes by removing it from the accounting base records, it is written off. However, if the debt is still recognised as an asset in the underlying records, it is not written off.

If the different sets of accounts rely on different underlying debtor records (which is very rare), the creditor should refer to the accounts that are relied on to represent the firm's financial position. For a company, these will be the accounts used to satisfy the company's financial reporting obligations under the relevant Companies Act.

Examples of when a bad debt is/is not written off

General facts

The following facts apply to all the following examples:

- The taxpayer's income tax balance date is 31 March.
- The only question is whether a debt has been written off. All other criteria are satisfied.
- The debt is for goods and services supplied for money.
- The supply has been included in the taxpayer's gross income for income tax purposes.

In the examples where the taxpayer is a GST registered person, the following additional facts apply:

- GST returns are filed on a two-monthly invoice basis.
- The supply has been included in a GST return.

Example 1

The taxpayer maintains a debtors ledger and is not registered for GST. The debtors ledger is updated on 31 March 1999. The entries made include the journal entry writing off the bad debt.

The bad debt is deductible in the year ending 31 March 1999.

Example 2

The taxpayer maintains a debtors ledger and is not registered for GST. The debtors ledger is written up on 1 April 1999. The entries written up include the journal entry writing off the bad debt.

The bad debt is deductible in the year ending 31 March 2000.

Example 3

The taxpayer does not maintain a debtors ledger and is registered for GST. There is no indication on her underlying debtor records to show the status of the debt. She has claimed a deduction from output tax for the bad debt in her GST return for the taxable period ending 31 January 1999. That return was prepared in February 1999.

The taxpayer is not entitled to the deduction from GST output tax. She is not allowed a deduction for the bad debt in the income year ending 31 March 1999. Claiming the deduction from output tax for GST purposes is not a sufficient writing-off of the bad debt.

Example 4

The taxpayer does not maintain a debtors ledger and is not registered for GST. The taxpayer's only records of debts owing to him are copies of issued invoices. The taxpayer maintains only rudimentary books of account, and his unpaid debtors are represented by loose-leaf filing of accounts and/or invoices issued in a ring-binder file. When a debt is paid it (the account and/or invoice) is transferred to a separate file. The taxpayer ceases sending accounts for the debt in question in February 1999, putting a line across the copy of the last statement sent out in respect of the debt and marking it "Final" and leaves it in the unpaid debtors' file.

The taxpayer is not entitled to a deduction for the bad debt in the year ended 31 March 1999. Simply marking the last statement issued as "Final" and leaving it in the unpaid debtors' file does not amount to writing off of the debt.

Example 5

The taxpayer does not maintain a debtors ledger and is not registered for GST. His only records of debts owing are copies of invoices and statements issued. In February 1999 the taxpayer became aware that a debt was bad. He stopped sending out statements for the debt and took no other action on it. In particular, he sent out no statements on the account in February and March 1999. The taxpayer continued to send out statements on all the other debts owing, including overdue accounts. The taxpayer keeps carbon copies of the statements of account in the duplicate account book from which the statements for issue are prepared. The taxpayer has tagged the final statement sent out in respect of the debt, circling the amount payable and marking it "bad debt - written off - February 1999".

The taxpayer is allowed a deduction for the bad debt in the year ending 31 March 1999. The cessation of statements of account, recorded by their absence in the duplicate account book, and the tagging and marking of the final statement, amount to writing off the debt in his accounting system.

Example 6

The taxpayer maintains a debtors ledger and is not registered for GST. She wrote up the debtors ledger on 31 March 1999. The entries written up include a journal entry writing off a bad debt. Her accountant prepares her accounts in June 1999. In the course of preparing the accounts, the accountant makes a general ledger entry recognising the bad debt as a result of the debtors ledger entry made by the taxpayer on 31 March 1999.

The bad debt is deductible in the year ending 31 March 1999, because the underlying accounting record of the debt was altered to recognise the bad debt on 31 March 1999.

Example 7

The taxpayer does not maintain a debtors ledger and is not registered for GST. Her only records of debts owing are copies of invoices issued. On 15 March 1999 she placed the invoice for the debt in question in a file marked “BAD DEBTS” noting on the invoice next to the total amount “debt bad – filed 15/3/99”. The amount of trade creditors in the taxpayer’s balance sheet as at 31 March 1999 includes the bad debt. The taxpayer’s profit and loss statement for the year ending 31 March 1999 includes as income the sale that has become a bad debt. The profit and loss statement does not recognise any expense for bad or doubtful debts.

The taxpayer’s income tax return for the year ending 31 March 1999 includes the profit and loss statement and a “tax reconciliation statement” showing the difference between the accounting income and the amount she believes to be income for income tax purposes. The tax reconciliation statement includes a deduction for the bad debt.

The taxpayer is not allowed a deduction for the bad debt. Although the debt has arguably been written off in the underlying accounting records, she has not ceased to recognise the debt as an asset for accounting purposes.

ACCRUALS RULES

General

The accruals rules in Subpart EH of the Income Tax Act provide rules for the timing and recognition of income derived and expenditure incurred in respect of “financial arrangements”.

The accruals rules have recently been rewritten by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999. The amendments made by this Act apply, in general, to financial arrangements entered into on or after 20 May 1999. The changes made in relation to the allowable deductions for bad debts are discussed later in this item. Two general changes made by the amendment Act are:

- The creation of divisions of rules, one applying to financial arrangements entered into before 20 May 1999, and those that were entered into on or after 20 May 1999. These are referred to as Division 1 and Division 2 respectively.
- Division 1 financial arrangements are referred to as coming within the *accruals rules*, while Division 2 financial arrangements are referred to as coming within the *accrual rules*.

The requirement in section DJ 1(a)(iii) that a debt “is proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year”, must be satisfied before any deduction can be claimed for a bad debt under the accrual(s) rules (sections EH 6(4) and EH 54(1)). Accordingly, the tests used in deciding whether or not a debt is “bad” and what is sufficient “writing-off” of a bad debt, apply equally to debts for which a bad debt deduction arises under the accrual(s) rules.

DIVISION 1: Financial arrangements entered into before 20 May 1999

Although the significant accrual(s) rules changes made by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 apply to financial arrangements entered into on or after 20 May 1999, the rules as they affect arrangements entered into before that date have also been rewritten. As part of this process, the accruals bad debt deduction provisions, formerly in section EH 5, have been re-enacted as section EH 6. Apart from the inclusion of headings for each sub-paragraph and necessary updating of some references to other new section and subsection numbers referred to, there are no wording changes between the former section EH 5 and the new section EH 6.

What is a financial arrangement?

A “financial arrangement” is widely defined and means a debt or debt instrument or an arrangement under which a person receives money in consideration for the provision of money to any person, either at a future time, or when an event occurs (or does not occur) in the future. Essentially, a financial arrangement is any transaction that involves deferral of the giving of consideration. Mortgages, bank and other loans, commercial bills, and treasury stock are examples of debt type financial arrangements.

Certain specific exceptions are created, and they are designated as “excepted financial arrangements”. This category includes equity type instruments (debentures, shares), insurance contracts, employment contracts, games of chance, short term credit

agreements and options. Those debts falling within the “excepted financial arrangement” definition have their deductibility as bad debts considered under section DJ 1(a).

The main type of financial arrangement, in relation to bad debts, that is excluded from the Division 1 definition of “financial arrangement”, is likely to be a short term trade credit. Short term trade credits are an “excepted financial arrangement”. “Short term trade credit” is defined as:

.... any debt for goods or services where payment is required by the vendor-

- (a) Within 63 days after the supply of the goods or services; or
- (b) Because the supply of the goods or services is continuous and the vendor renders periodic invoices for the goods or services, within 63 days after the date of an invoice rendered for those goods or services:

Therefore, a short term trade credit is a debt for goods or services owed to a vendor within 63 days after supply or, where the supply is continuous, the vendor expects payment within 63 days after the date an invoice is issued for those goods and services.

Arrangements entered into before the introduction of the accruals rules are also excluded from the definition of “financial arrangement”.

What this means as far as a deduction for bad debts is concerned is that the deduction for bad debts arising in respect of a short term trade credit is considered under the general bad debt deduction provision in section DJ 1(a) and not under the accruals rules’ section EH 6.

Revenue bad debts

Section EH 6(1) will only apply in limited circumstances to a cash basis holder. A cash basis holder is a natural person for whom either the total value of all financial arrangements held by that person will not exceed \$600,000 or the income derived during the income year from financial arrangements does not exceed \$70,000. Furthermore, the difference between the income that would be returned under the accruals rules, and the income returned as a cash basis holder, must not exceed a \$20,000 deferral threshold.

Section EH 6(1) permits a person to deduct an amount written off as a bad debt in respect of a financial arrangement where and to the extent that:

- The person derives gross income in respect of the financial arrangement under:
 - Section EH 1 - one of the methods of calculating accrual income; or
 - Section EH 3(4) - the adjustment required in any year when a person ceases to be a cash basis holder; or

- Section EH 4 - the base price adjustment calculated in the year a financial arrangement matures or is transferred; or
- Section EH 8 - the post facto adjustment for financial arrangements which have the effect of defeating the intent and application of the accruals regime; and
- The amount written off is attributable to that gross income.

In other words, a bad debt comprising income from a financial arrangement previously returned by the taxpayer under the accruals rules is allowed as a deduction under section EH 6(1).

The purpose of the base price adjustment is to ensure that all income derived and all expenditure incurred is taken account of for that financial arrangement when it is either sold, matures, is remitted, or transferred.

The post facto adjustment is used to recalculate assessable income or any loss incurred in respect of the financial arrangement using the yield to maturity method in certain circumstances where:

- any amount payable under the financial arrangement is determined, according to the terms of the financial arrangement, at the discretion of the holder or the issuer, or any other person who is an associated person of the holder or the issuer; and
- when exercising this discretion the change in the amounts payable under the financial arrangement does not reflect changes in economic, commodity, industrial or financial indices or banking or commercial rates; and
- the making of such a financial arrangement is not a generally accepted commercial practice; and
- the effect of the arrangement is to defeat the intent and application of the accruals rules.

“Yield to maturity” is a method of spreading income and expenditure over the life of the financial arrangement.

Under the Income Tax Act, where the parties to a transaction are in a close relationship with each other they are classed as associated persons: for example relatives, partnerships, and individuals that hold majority interests or voting rights in a company. Association is measured by reference to voting and, where applicable, market value interests, rather than to nominal and paid-up capital. The relationship of association is defined in section OD 7(1).

Section EH 6(4) provides that the requirement in section DJ 1(a)(iii), that a debt “is proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year”, must still be satisfied before any deduction can be claimed.

Capital bad debts

Section EH 6(2) provides for the deduction of the capital or principal element of a financial arrangement in certain circumstances. Section EH 6(2) allows a person a deduction for an amount written off as a bad debt in respect of a financial arrangement (not being an amount deductible under section EH 6(1)) where:

- The person carries on a business comprising the holding or dealing in such financial arrangements and the person is not associated with the person owing the amount written off (see section OD 7 for test of association); or
- The financial arrangement is a trade credit and the person carries on the business of dealing in the goods or services for which the trade credit is a debt. “Trade credit” is defined in section OB 1 to mean any debt for goods and services, other than a short term trade credit.

As with *Revenue bad debts* above, section EH 6(4) requires (through section DJ 1(a)(iii)) that a debt “is proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year” before any deduction can be claimed.

Security payments

Under section EH 6(3), if a person receives a security payment for a loss and a deduction is not otherwise allowable for the loss, the person may be allowed a deduction for the loss up to the amount of the security payment. The purpose of section EH 6(3) is to avoid the situation where the person is taxed on the security payment but does not receive a deduction for the loss incurred.

A “security payment” means money received by, and that is gross income of, the holder of a security arrangement for any loss suffered because that arrangement is not performed. A “security arrangement” is a financial arrangement that secures the holder against failure of a person to perform their obligations under another arrangement. That other arrangement does not need to be a financial arrangement. A payment made under a guarantee is a security payment.

DIVISION 2: Financial arrangements entered into on or after 20 May 1999

This section briefly outlines the effect of the changes made by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 in the context of deductions allowed for

bad debts under the accrual rules. As stated above, the amendments apply, in general, to financial arrangements entered into on or after 20 May 1999.

Allowable deductions for bad debts

Deductions for bad debts under the accrual rules are now contained in section EH 54. Section EH 54, by and large, replicates the bad debt deduction provisions from the former section EH 5 (now re-enacted as section EH 6), while the security payments and share loss deduction provisions from these sections are now contained in section EH 55. The most significant changes as they relate to the deduction of bad debts, are:

- The cash basis threshold is increased from \$600,000 to \$1,000,000 and income from investments from \$70,000 to \$100,000. In addition, the \$20,000 deferral threshold, the maximum allowable difference between the income that would be returned under the accruals rules and the income returned as a cash basis holder, has been increased to \$40,000.
- There is only one excepted financial arrangement for short-term agreements for the sale and purchase of property or services, unless a person elects otherwise, and this is for those agreements where settlement or performance must occur within 93 days.
- Deductions are allowed for dealers or providers of goods and services when credit is extended under an agreement for the sale and purchase of property or services.

Revenue bad debts

Section EH 54(2) permits a person to deduct an amount written off as a bad debt in respect of a financial arrangement where and to the extent that:

- The person derives gross income in respect of the financial arrangement; and
- The amount written off is attributable to the income.

Capital bad debts

Section EH 54(3) provides for the deduction of the capital or principal element of a financial arrangement in certain circumstances. Section EH 54(3) allows a person a deduction for an amount written off as a bad debt in respect of a financial arrangement (not being an amount deductible under section EH 54(2)) where:

- The person carries on a business that includes holding or dealing in financial arrangements that are the same or similar; and
- The person is not associated with the person owing the amount written off.

Bad debts - agreements for sale and purchase of property or services

Section EH 54(4) allows a person a bad debt deduction (for an amount that is not allowed as a deduction under section EH 54(2) or (3)) where:

- The financial arrangement is an agreement for the sale and purchase of property or services; and
- The person carries on a business of dealing in the property or services that are the subject of the agreement.

Previous rules applying to trade credits have been integrated with the rules for agreements for the sale and purchase of property, and these have also been extended to apply to the provision of services. As a result of the integration, the bad debt provisions are extended to taxpayers in the business of dealing in the goods or services that are the subject of the agreements for the sale and purchase of property or services.

Transitional adjustments

As mentioned earlier, the amended accrual rules (Division 2) apply to financial arrangements entered into on or after 20 May 1999. However, under section EH 17 taxpayers are able to elect to apply these new rules to financial arrangements entered into before that date (i.e. Division 1 financial arrangements). This will be useful if taxpayers wish to account for all arrangements on a similar basis. Further details of this option, and other changes to the accruals rules, are included in the full discussion on the amending legislation in TIB Vol.11, No.6 (July 1999).