Public Ruling No. 1/2002

DEDUCTION FOR BAD &DOUBTFUL DEBTSAND TREATMENT OF RECOVERIES

1.0 TAX LAW

This Ruling applies in respect of the deduction for bad and doubtful debts under section 34 and the treatment of recoveries under section 30 of the **Income Tax Act 1967** . It is effective for year of assessment 2002 and subsequent years of assessment.

2.0 THE APPLICATION OF THIS RULING

This Ruling considers:

2.1 the deduction for bad debts [*see paragraph 4.1*];
2.2 the deduction for doubtful debts [*see paragraphs 4.2 & 4.3*];
2.3 the taxation of any recoveries [*see paragraph 4.4*] arising from bad debts which have been given a tax deduction in an earlier year; and
2.4 other related matters.

3.0 HOW THE TAX LAW APPLIES

3.1 Bad Debts

3.1.1 *General*

Trade debts written off as bad are generally allowable as a deduction against gross income in computing the adjusted income of a business for the basis period for a year of assessment [*Y/A*].

3.1.2 *Basis for writing off a debt as bad*

The writing off of a trade debt as bad requires judgement on the part of the person [*see paragraphs 4.5*] carrying on the business. All circumstances of the debt as to the likelihood and cost of its recovery should be considered before a decision is taken to write off the debt.

3.1.3 *Action taken to recover the debt*

A. All reasonable steps based on sound commercial considerations [*see paragraph 4.6*] should be taken to recover the debt. To

support a claim for deduction of a bad debt written off for tax purposes, there should be sufficient evidence of such steps taken, including one or more of the following:

a. issuing reminder notices;

b. debt restructuring scheme;

c. rescheduling of debt settlement;

d. negotiation or arbitration of a disputed debt; and

e. legal action (filing of civil suit, obtaining of judgement

from the court and execution of the judgement).

B. The steps that should be taken depend on the size of the debt and / or the anticipated cost effectiveness of each action. If a decision is made not to take any further action to pursue a debt, the reasons should be documented.

C. To support a claim for deduction for tax purposes, the decision should be based upon valid commercial considerations and not personal, private or other reasons. It should be considered a reasonable basis if it can be shown that the anticipated cost of any legal action is prohibitive in relation to the amount of the debt.

D. To qualify for deduction for tax purposes, there should also be evidence to show:

a. that each debt has been evaluated separately;

b. when and by whom this was done; and

c. what specific information was used in arriving at that

evaluation.

3.1.4 ***Circumstances when a debt can be considered bad***

After reasonable steps for recovery [*see paragraph 3.1.3 above*] have been taken, a debt can be considered bad on the occurrence of any one of the following:

A. the debtor has died without leaving any assets from which the debt can be recover ed;

B. the debtor is a bankrupt or in liquidation and there are no assets from which the debt can be recovered;

C. the debt is statute-barred;

D. the debtor cannot be traced despite various attempts and there are no known assets from which the debt can be recovered;

E. attempts at negotiation or arbitration of a disputed debt have failed and the anticipated cost of litigation is prohibitive; or

F. any other circumstances where there is no likelihood of cost effective recovery.

3.1.5 *Debt has been included in gross income*

To qualify for deduction for tax purposes, the debt should be of a kind where the amount of such debt has been included in the gross income of the person for the basis period for the relevant year of assessment or for a prior year of assessment.

Example 1
Syarikat A Sdn. Bhd., a wholesaler, supplies goods worth a total of RM10,000 on various dates in 2002 to B Mini Market. Various payments totalling RM6,500 are received. It is later discovered that the mini market has closed down and the sole proprietor cannot be contacted. As it is unable to trace the debtor despite visits to his last known business and residential addresses, the company decides to write off this debt in its profit & loss account for the year ended 31.12.2002.

A deduction can be allowed for the bad debt of RM3,500 as the debt has arisen from transactions that have been included in the gross income and all reasonable steps have been taken to recover the debt.

Example 2
Syarikat C Sdn. Bhd. takes over the retail business of an existing partnership. Among the assets taken over are trade debts amounting to RM30,000. During its first 2 years of operation, the company manages to collect all the debts that had been taken over from the partnership, except for a debt of RM1,000 as the debtor cannot be traced. The company decides to write off this debt in the profit & loss

account for the second year.

Although the debt was originally a trade debt in the accounts of the partnership, the amount constitutes a non-trade debt of the company (arising from taking over of the assets of the partnership and not from a transaction included as gross income of the company). Therefore, the amount of RM1,000 written off as a bad debt ***cannot*** *be allowed as a deduction in computing the adjusted income. Conversely, the recoveries amounting to RM29,000 should not be regar ded as taxab le.*

3.1.6 *Exception for loans made in the ordinary course of business*

The condition that the debt should have been included in the gross income of the person prior to it being written off [*see paragraph 3.1.5*] should **not** be applied in a case where the person habitually makes loans or advances in the ordinary course of his business (for example, a moneylender). In such a case, both the interest (which has been included as gross income from the business) and the loan (granted in the ordinary course of carrying on the business) should be considered as debts which, if written off as bad after taking into consideration all the circumstances, should be allowed as a deduction in arriving at the adjusted income of the business.

3.2 Specific provision for doubtful debts

3.2.1 *General*

Where there are reasonable grounds (based on valid commercial considerations but not personal, private or other reasons) to believe that a trade debt is doubtful of being recovered, a specific provision can be made at the end of the accounting period for the amount of the debt that is not expected to be recovered. The amount that is reasonably determined to be irrecoverable [*see paragraph 3.2.3*] can be allowed as a deduction against gross income for the relevant basis period.

3.2.2 *Debt has been included in gross income*

To qualify for deduction for tax purposes, the debt should be of a kind where the amount of such debt has been included in the gross income of the person for the basis period for the relevant year of assessment or for a prior year of assessment. [*See Example 1 in paragraph 3.1.5*

for a clarification of this aspect .]

3.2.3***Making the specific provision***

A. The making of a specific provision for doubtful debts requires the determination of the likelihood of recovery of each debt. This should be done at the end of the particular accounting period (i.e. at or soon after the time of closing the accounts).

B. To qualify for a deduction for tax purposes, there should be evidence to show:

a. that each debt has been evaluated separately;

b. how the extent of its doubtfulness was evaluated;

c. when and by whom this was done; and

d. what specific information was used in arriving at that evaluation.

C. Circumstances for evaluating a debt as doubtful should include:

a. the period over which the debt has been outstanding;

b. the current financial status of the debtor; and

c. the credit record of the debtor.

D. For each doubtful debt, the specific proportion or amount of the debt that is regarded as doubtful should be determined after taking into consideration the following:

a. the person's history of bad debts,

b. the experience for the particular trade/industry; and/or

c. the age-analysis of the debts.

E. Subject to paragraph 3.2.4, the aggregate of the specific provision for each debt constitutes the specific provision for doubtful debts of the business for the year which qualifies for deduction

3.2.4***I n crease or decrease in the specific provision***

Where a specific provision for doubtful debts has been made for a

particular accounting period and the amount has been allowed in the relevant basis period for a particular year of assessment [*see paragraph 3.2.3*], and there is a change in the amount of the specific provision in a subsequent year:

A. a deduction (in the amount of the increase in the specific provision) should be made against the gross income for the subsequent year; or

B. an addition (in the amount of the decrease in the specific provision) should be made to the gross income for the subsequent year.

- *Example 3*

Syarikat D Sdn. Bhd. makes a specific provision for doubtful debts of RM3,500 for the financial year ending 30.06.2001. For the financial year ending 30.06.2002, the specific provision for doubtful debts is RM4,300. In its profit & loss account, the company shows the specific provision of RM3,500 for the year ending 30.06.2001 and the increase in specific provision of RM800 (RM4,300 - RM3,500) for the year ending 30.06.2002.

Provided that the conditions mentioned in paragraphs 3.2.1, 3.2.2 & 3.2.3 have been met. the specific provisions made in the accounts are allowable for the relevant years and no adjustment is required in the tax computation [see paragraph 4.7 *].*

Example 4

Syarikat E Sdn. Bhd. makes a specific provision for doubtful debts of RM3,500 for the financial year ending 30.06.2001. For the financial year ending 30.06.2002, the specific provision is reduced to RM2,000 because some payments have been received. The decrease in the specific provision of RM1,500 (RM3,500 - RM2,000) is shown as 'specific provision written back' in the profit & loss account.
No adjustment is required in the tax computation since the decrease in the specific provision of RM1,500 should be taxed.

3.3 Circumstances where write off or provision not allowed as deduction

3.3.1 *General provision for doubtful debts*

A. A general provision made in respect of doubtful debts (for example, based on a percentage of total sales or of all trade debts)

is not allowable for tax purposes, even if there is a legal requirement or an accounting convention for the particular trade or industry to make such a provision.

B. Any increase in the general provision is not allowable and any decrease is not taxable.

C. An adjustment should be made in the tax computation for any such general provision in the profit and loss account.

3.3.2 ***Forgiving or waiving payment of debt***

A decision to forgive or to waive payment of a trade debt (either wholly or in part) should not be regarded as a valid business or commercial consideration for tax purposes. Such an amount should **not** be allowed as a deduction in the tax computation.

Example 5

Syarikat F Holdings Sdn. Bhd. is negotiating the take-over of one of its subsidiaries, Syarikat G Sdn. Bhd., by a consortium of businessmen. At the request of the consortium and in order to facilitate the deal, the directors of Syarikat F Holdings Sdn. Bhd. decide to forgive an accumulated debt on account of goods and services supplied amounting to RM100,000 owed by Syarikat G Sdn. Bhd. A letter to that effect (enclosing a copy of the directors' resolution) is issued to Syarikat G Sdn. Bhd., which then proceeds to extinguish the debt in its balance sheet as at 30.09.2002. In its accounts for the year ending 30.09.2002, Syarikat F Holdings Sdn. Bhd. writes off the amount as a bad debt.

*In its tax computation for the relevant year of assessment, Syarikat F Holdings Sdn. Bhd. should **not** be allowed a deduction for the amount written off as the decision is made for reasons other than in the ordinary course of business and on the basis of considerations other than the likelihood of recovery.*

In the accounts of Syarikat G Sdn. Bhd., the forgiveness of the debt should, by normal accounting convention, be reflected in its profit & loss account. No adjustment is required in the tax computation since the amount written back is taxable, being a reduction in the cost of goods and services previously charged in full in the profit & loss account.

3.3.3 ***Non-trade debts***

Non-trade debts [*see paragraph 4.8*] that are written off as bad, or

specific or general provisions made in respect of non-trade debts that are doubtful, are not deductible in the computation of adjusted income. Similarly, recoveries relating to non-trade debts written off earlier are not taxable. Suitable adjustments should be made in the tax computation if such amounts are included in the profit & loss account.

3.4 **Debt due from related or connected person**

3.4.1 Any decision to write off (or to extinguish by any other means) or to make a specific provision for a trade debt due from a related or connected person [*see paragraph 4.9*] should be subject to stringent examination before it can be considered for deduction for tax purposes.

3.4.2 In addition to all the conditions mentioned in paragraph 3.1 or 3.2, respectively, there should also be evidence to prove that the decision is made on an arm's length basis [*see paragraph 4.14*] and for valid business or commercial reasons [*see paragraph 4.* 6], rather than private, personal or other non-commercial reasons.

Example 6

Syarikat H Holdings Sdn. Bhd. provides colour separation and other ancillary services to one of its subsidiaries, Syarikat J Printers Sdn. Bhd.. Based on the draft accounts for the financial year ending 31.10.2002, Syarikat J Printers Sdn. Bhd. is expected to incur a substantial loss in respect of its printing business. To avert adverse publicity, the directors of Syarikat H Holdings Sdn. Bhd. (who are also directors of Syarikat J Printers Sdn. Bhd.) decide to waive payment of an amount of RM20,000 from the total amount owing by the subsidiary company on account of services rendered. Syarikat J Printers Sdn. Bhd. is informed of this by way of a letter and it proceeds to reflect this in its final accounts which show a small net profit. In the profit & loss account of Syarikat H Holdings Sdn. Bhd for the financial year ending 31.10.2002, the amount is written off as a 'trade discount'.

The amount written off should be disallowed in the tax computation of Syarikat H Holdings Sdn. Bhd. for the relevant Y/A since there is no commercial basis for the 'discount' and the decision cannot in any way be regarded as being made at arm's length in view of the relationship of the 2 companies and the status of the directors.

No adjustment is necessary in the tax computation of Syarikat J Printers Sdn. Bhd. since the discount has been correctly treated for

both accounting and tax purposes.

Example 7

Encik K, a sundry goods wholesaler, has been supplying goods on a regular basis to Encik L, a sundry shopkeeper, for the past 25 years. In the course of their long business relationship, they have become good friends. In 1993, Encik L married Encik K's sister. Since 1998, the business of Encik L has been in steady decline (amongst other reasons, due to the opening of a hypermarket in the vicinity) and in 2002, Encik K decides to write off the whole amount of the accumulated debts of Encik L (who is being sued by several of his other creditors).

In view of their relationship as brothers-in-law, the decision by Encik K to write off the debt of Encik L should be regarded as more for personal rather than for valid commercial reasons and should ***not*** *, therefore, be allowed as a deduction for tax purposes.*

If, however, it could be shown that the financial position of the debtor is the criterion for the decision (for example, Encik L has already been adjudged a bankrupt at the time the decision is made to write off the debt), then a deduction should be allowed since the write off is based on a valid commercial consideration.

Example 8

Syarikat M Bhd. writes off RM15,000 in its profit & loss account for the year ending 31.07.2002, being the trade debt of its subsidiary Syarikat N Sdn Bhd., which has been liquidated and deregistered in the same period.

Since the trade debt is written off due entirely to the financial position of the debtor (the liquidation of Syarikat N Sdn Bhd.), the amount should be allowed notwithstanding the relationship between the 2 companies.

3.5 **Recoveries**

Specific and general provisions do not alter the amount owing in the debtors accounts; on the other hand, a bad debt written off reduces the balance in the relevant debtor's account. Therefore, any recovery of a trade debt previously written off as bad should be shown in the profit and loss account for the period in which it is received. If the recovery is not entered into the profit & loss account but is instead entered into a reserve

or other account, an adjustment is required in the tax computation.

Example 9

Syarikat P Sdn. Bhd. writes off RM2,700 being the trade debt of Encik Q (who has passed away) for the year ending 30.09.2002. During the same financial year, the company receives RM2,000 from Encik R, whose trade debt had been written off and allowed for tax purposes 3 years ago because he could not then be contacted.

The RM2,700 written off as a bad debt is allowable as a deduction and the recovery of RM2,000 is taxable. If both these amounts are shown in the profit & loss account for the year ending 30.09.2002, no adjustment is required in the tax computation.

If the recovery of RM2,000 is not entered into the profit & loss account, an adjustment for that amount should be made in the tax computation .

3.6 **Settlement of trade debt with assets**

3.6.1 A debt may be settled by the foreclosure of an asset held as security for the debt or by an asset (such as a property or shares in a company) given in exchange for the debt. In such a case, the net proceeds from the sale of the asset or the market value of the asset given in exchange is the value to be taken as settlement for the debt.

3.6.2 Any balance of the debt still outstanding can be claimed as a bad debt if one of the circumstances mentioned in paragraph 3.1.4 is satisfied.

Example 10

Syarikat S Sdn. Bhd., a construction company, is owed RM300,000 by Syarikat T Development Sdn. Bhd., a property developer which has many unsold houses in its stock. After some negotiation and in view of the severe cashflow problems of the debtor, Syarikat S Sdn. Bhd. agrees to accept a completed shophouse (which Syarikat T Development Sdn. Bhd. normally sells at RM280,000) as full settlement of the debt. However, soon after the agreement is reached, the market for properties sharply weakens. On completion of the transfer, Syarikat S Sdn. Bhd. decides not to sell the shophouse immediately. Instead, the shophouse is let out. In the transfer documents for the property, the consideration is shown as RM280,000 and stamp duty based upon that value is duly assessed and paid. In its profit & loss account, Syarikat S Sdn. Bhd. writes off RM20,000 (RM300,000 - RM280,000) as a bad debt.

The write off amounting to RM20,000 should be allowed for tax purposes as the market value of the asset accepted in exchange for the debt is RM280,000, as evidenced by its acceptance by the Collector of Stamp Duty.

4.0 INTERPRETATION

For the purpose of this Ruling:

4 .1 A "bad debt" is a debt that is considered not recoverable after appropriate steps have been taken to recover it.

4.2 A "specific provision for doubtful debts" means a reasonable determination of the amount of particular debts that is doubtful of being recovered.

4.3 A "general provision for doubtful debts" means an estimate of the amount that is doubtful of being recovered, usually made without separate evaluation of each debt and calculated as a percentage of all debts or of total sales or some other general basis.

4.4 "Recoveries" are money or assets received in connection with a trade debt that has been written off as bad in an earlier period.

4.5 A "person" includes a company, a co-operative, an individual, a Hindu joint family, a trust, an estate under administration, a club and an association.

4.6 "Business or commercial considerations" refer to the information, factors and circumstances that any other person in that particular person's business and/ or position acting at arm's length [*see paragraph 4.14*] would have taken into consideration in making that business or commercial decision.

4.7 "Tax computation" means the computation of the adjusted income, statutory income, aggregate income, and / or total income in accordance with the requirements of Chapters 4, 5 and 6 of the Act and, where the context so permits or requires, includes the working sheets, statements, schedules, calculations and other supporting documents forming the basis upon which an income tax return is made.

4.8 "Non-trade debts" mean debts other than those specified in paragraphs 3.1.5 and 3.1.6.

4.9 "Related or connected person" means any person who is in a position to influence or be influenced by the other person in any significant way or to any substantial degree, or to control or be controlled by the other

person, and includes:

4.9.1 In the case of an individual: a relative [*see paragraph 4.10*], an asso-ciate [*see paragraph 4.11*] or a person controlled by a relative or associate;

4.9.2 In the case of a company: a director [*see paragraph 4.12*], a related company [*see paragraph 4.13*] or its directors, a relative of a director, or a person who controls or is controlled by the company;

4.9.3 In the case of a partnership: a partner, a relative of a partner, or a person who controls or is controlled by a partner;

4.9.4 In the case of a co-operative society: a member of the board, committee or other governing body of the co-operative society, or a person who controls or is controlled by the co-operative society;

4.9.5 In the case of any other body, association or group of persons: a person having the direction or control of the management of its business or affairs, including an administrator; a beneficiary; a karta; a member of the board, committee, council or other governing body; a trustee; or a person who controls or is controlled by that body, association or group of persons.

4.10 "Relative", in relation to a person, includes

4.10.1 a spouse;

4.10.2 a parent or a grandparent;

4.10.3 a child (including stepchild or adopted child) or a grandchild;

4.10.4 a brother or a sister;

4.10.5 an uncle or an aunt;

4.10.6 a nephew or a niece; and

4.10.7 a cousin

4.11 "Associate", in relation to a person, means:

A. a relative [*see paragraph 4.10*] of that person;
B. a company of which that person is a director;
C. a person who is a partner of that person; or
D. if that person is a company, a director or subsidiary of that company and a director of
that subsidiary.

4.12"Director" includes a person who occupies the position of a director or a person in accordance with whose directions or instructions the directors or staff of a company are accustomed to act.

4.13"Related company' means the situation where one company holds not less than 20% of the ordinary shares or preference shares of the other.

4.14"Arm's length basis" refers to the circumstances, decisions or outcomes that would have been arrived at if unrelated or unconnected persons were to deal with each other wholly independently and out of reach of personal influence.

(Issue Date: 02 April 2002)