# e-CIRCULAR TO MEMBERS

## CHARTERED TAX INSTITUTE OF MALAYSIA (225750-T)

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**TO ALL MEMBERS**

**TECHNICAL**

**Direct Taxation**

## PUBLIC RULING N0. 4/2019
## TAX TREATMENT OF WHOLLY & PARTLY IRRECOVERABLE DEBTS AND DEBT RECOVERIES

This PR was published on 24 September 2019 (reported in our e-CTIM TECH-DT 83/2019 dated 11 October 2019). It replaces PR No. 1/2002 dated 2 April 2002.

The contents of the PR are summarized below:

| Para. # | All sections quoted below refer to sections of the ITA unless otherwise stated. |
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| 1 | **Objective**<br>This PR explains the tax treatment of –<br>• The deduction of wholly or partly irrecoverable debts from gross income from a business for the basis period (BP) for a year of assessment (YA);<br>• Recoveries of such irrecoverable debts where a deduction has been made in an earlier YA. |
| 2 | **Relevant Provisions of the Law**<br>This PR is based on the provisions of S2, S22(2), S24(5), S30 and S34. |
| 3 | **Interpretation**<br>The meanings of words and phrases used in this PR are given in this paragraph. (The meanings of words underlined below are found here.) |
| 4 | **Introduction**<br>Salient points under this paragraph are –<br>• Trade debts arising from the sale of goods and services that are considered to be wholly or partly irrecoverable, may be written off as a 'bad debt' but reasonable steps to recover the debt must be taken before writing it off.<br>• Under S 34(2), a trade debt which is reasonably estimated to be irrecoverable either wholly or partly, may be deducted from gross income in computing the adjusted income of the business.<br>• Where a bad debt that has been written off or an amount estimated to be irrecoverable is subsequently received, the amount recovered shall be included as gross income of the business since the deduction for the write-off or provision relating to that debt has been given. |
| 5 | **Irrecoverable Debts** |

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| | 5.2 | Typically trade debts written off as bad are claimed as deductions in determining adjusted income. 2 conditions that must be met in allowing the deduction are –<br>• The amount of the debt must have been included in gross income of the business in the basis period for a year of assessment prior to the relevant YA; and<br>• The debt must be an irrecoverable debt. |
| | 5.3 | The emphasis is on taking "sound consideration" of all circumstances before making a decision to write off a debt as irrecoverable.<br>• Subpara. 5.3.1 provides a list of examples of "reasonable steps" [items (a) to (e)] that must be shown (by submission of evidence in the event of a tax audit) to have been taken to recover the debt before writing it off. These steps range from issuing reminder notices [item (a)] to taking legal action in a court of law [item (e)] against the debtor.<br>• To qualify for deduction, the debt write-off should be based on valid commercial considerations and not for personal, private or other reasons. In the event of a tax audit, evidence must be made available to show (amongst others) that each debt was evaluated separately as well as the nature of the information evaluated.<br>• Subpara. 5.3.2 lists examples of events, the occurrences of which may be accepted as leading to the conclusion that a debt is irrecoverable or bad [items (a) to (f)]. (E.g. the debtor has died, or has been declared bankrupt, without having any assets from which the debt can be recovered.)<br>(See Examples 1 and 2)<br>• Recoveries of bad debts for which a deduction has been allowed in a previous YA must be included in the gross income of the business in the BP in which the amount is received [S22(2)(a)]. (Example 3)<br>• If the nature of the business is making loans (e.g. a bank or a money lender) S34(3) provides that both the loan and the interest earned are considered as a debt. Any such loan and related interest earned that are written off are allowed to be deducted in ascertaining adjusted income of the business, provided that the requirements/ conditions to show irrecoverability of the debt mentioned above have been satisfied. |
| 6 | | **Doubtful Debts** |
| | 6.1 | When a provision is made for debts which are doubtful, the provision is not allowable because it is not an expense which has been "incurred". However S34(2) allows a provision made for trade debts which are reasonably estimated to be irrecoverable as a deduction in ascertaining the adjusted income of a business. The debt must be one which has been included in gross income of the business for a YA prior to the relevant YA. [S34(3)] |
| | 6.2 | Doubtful debts are trade debts which are reasonably estimated to be partly irrecoverable (i.e. part of the debt is recoverable). There are 2 types of provisions for doubtful debts – specific and general (explained in detail in |

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| | | subparas. 6.2.1 and 6.2.2 respectively).<br>*Specific provisions for doubtful debts*<br>• A specific provision made at the end of the accounting period for an amount of a debt which is estimated to be irrecoverable based on reasonable grounds is allowed to be deducted against gross income of the relevant period.<br>• For the claim for the provision to be allowed, evidence must be made available to show that certain requirements (set out under subpara. 6.2.1.1) relating to the method of determining the amount of provision have been satisfied.<br>• Each debt has to be separately evaluated and the aggregate of the specific provision for each debt constitutes the specific provision for doubtful debts of the business which qualifies for deduction in that year.<br>• If in the current accounting period, there is an increase or decrease in the amount of a specific provision for a debt which was made in a previous accounting period and allowed to be deducted in that BP, an adjustment may have to be made to gross income in arriving at adjusted income. Examples 4 and 5 explain the process of determining whether an adjustment is needed.<br>*General provision for doubtful debt.*<br>• No separate evaluation for each debtor is done when making a general provision for doubtful debts.  It is generally made based on a specific percentage of debtor balances, sales or any other general grounds and is not allowed as a deduction.<br>• Any increase in the general provision is not allowable, and any decrease is not taxable. |
| | 6.3 | When a deduction has been allowed under S34(2), any sum recovered in a basis period shall be treated as gross income from the business for the relevant period [S30(1)]. |
| 7 | | **Circumstances Where Irrecoverable Debts Are Not Allowed as Deductions**<br>The following are the circumstances listed under this paragraph where a deduction for an irrecoverable debt is not allowed – |
| | 7.1 | • Forgiving or waiving payment of a trade debt is not regarded as a valid business or commercial consideration for tax purposes. (Example 6) |
| | 7.2 | • Write-off of non-trade debts. |
| | 7.3 | • Write-off of trade debts arising from a related or connected person and specific provisions for doubtful debts for such debts. (No deduction is allowed unless evidence is available to prove that the decision made to write off a trade debt is made at an arm's length basis and for valid business or commercial reasons. (Examples 7, 8 and 9) |

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| 8 | **Settlement of Trade Debt With Assets**<br>An example of such a settlement is the foreclosure of an asset held as security for the debt or the giving of an asset (such as a property or shares in a company) in exchange for the debt.<br>• 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.<br>• Any balance of the debt still outstanding can be claimed as a bad debt if one of the circumstances mentioned in paragraph 5.3.2 is satisfied. (Example 10) |
| 9 | **Updates and Amendments**<br>This PR replaces PR No. 1/2002 dated 2 April 2002. |
| 10 | **Disclaimer**<br>The examples in this PR are for illustration purposes only and are not exhaustive. |

Members may read the above PR in full at the websites of the Institute and the LHDNM.

You may write to the Institute at technical@ctim.org.my or secretariat@ctim.org.my in respect of any suggestions, concern or comments you may have on the above PR so that we may raise them to the LHDNM.

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