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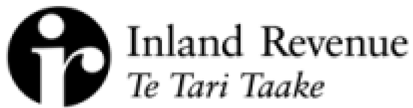

Bad debts are individually identifiable debts that are unlikely to be recovered (in practical terms). The provision for doubtful debts is an estimate of the amount that will become bad debts in the future. The Income Tax Act and the GST Act do not allow any deduction for provisions for doubtful debts.

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 bad or 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

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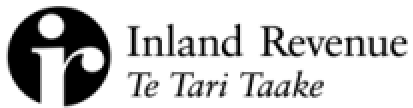

debt. However, if the sum involved was somewhat larger, it may be reasonable to expect the dairy to make some further enquiry.

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.

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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 show clearly that the debt has been actually written off as bad rather than just making a decision in their mind. To meet the legislative requirement, there must be something written down in the books of account of the business stating that the debt is written off. Case law indicates that the minimum writing 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

WITHDRAWN

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. It is the writing off of the bad debt which converts it into a deductible debt.

What will be sufficient to meet the *written off* test for various classes of taxpayer are as follows. The classes and the writing requirements are based largely on *Case N69, Case T48* and the earlier *Case P53*. The bad debt is "written off" in accordance with the accounting and record keeping systems maintained by the taxpayer if:

- 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; or

- 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; or

- 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; or

- 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.

There may be very exceptional cases where less than the above writing off requirement is acceptable, such as in *Case S73*, where the taxpayer was unable to access the accounting records and a letter was sent to the Commissioner stating that the debt had been written off. Nevertheless, there remains a writing requirement in all cases.

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 relation to 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.

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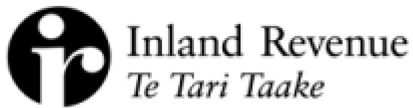

In all cases the business records kept by the taxpayer must comply with the requirements of section 22 of the Tax Administration Act 1994 and section 75 of the GST Act.

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/entries 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.

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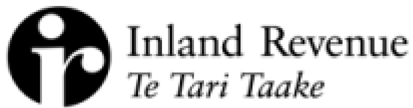

As long as these records are quite separate from the accounting base records they will not affect the write-off. If the creditor ceases to recognise the debt as an asset for accounting purposes by removing it from the accounting base records, it is written off.

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 or 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.

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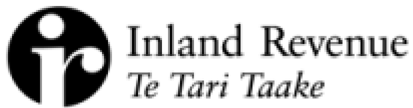

- The supply has been included in the taxpayer's gross income for income tax purposes.

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 2003. The entries made include the journal entry writing off the bad debt.

The bad debt is deductible in the year ending 31 March 2003.

Example 2

The taxpayer maintains a debtors ledger and is not registered for GST. The debtors ledger is written up on 1 April 2003. The entries written up include the journal entry writing off the bad debt.

The bad debt is deductible in the year ending 31 March 2004.

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 2003. That return was prepared in February 2003.

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 2003. 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 2003, putting a line

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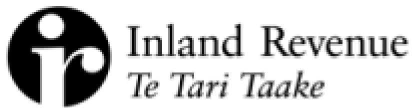

across the copy of the last statement sent out in respect of the debt and marking it "Final" and leaves it in the unpaid debtors' file.

The taxpayer is not entitled to a deduction for the bad debt in the year ended 31 March 2003. 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 2003 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 2003. 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 2003".

The taxpayer is allowed a deduction for the bad debt in the year ending 31 March 2003. 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 2003. The entries written up include a journal entry writing off a bad debt. Her accountant prepares her accounts in June 2003. 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 2003.

The bad debt is deductible in the year ending 31 March 2003, because the underlying accounting record of the debt was altered to recognise the bad debt on 31 March 2003.

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 2003 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 15/3/03". The amount of trade creditors in the taxpayer's balance sheet as at 31 March 2003 includes the bad debt. The taxpayer's profit and loss statement for the year ending 31 March 2003 includes as income the sale

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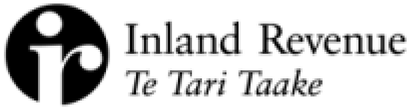

that has become a bad debt. The profit and loss statement does not recognise any expense for bad or doubtful debts.

The taxpayer's income tax return for the year ending 31 March 2003 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.

Accrual(s) 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 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 "the debt is 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

WITHDRAWN

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 subparagraph 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.

WITHDRAWN

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

WITHDRAWN

- 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 "the debt is 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. Section OB 1 provides that "Trade credit" is defined in section EH 14 for Part EH Division 1. Section EH 14 provides that, "trade credit", in the qualified accruals rules means 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 "the debt is actually written off as a bad debt by the taxpayer in the income year" before any deduction can be claimed.

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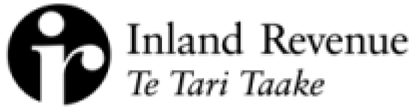

Security payments

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

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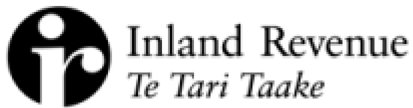

Section EH 54(2) permits a person to deduct an amount written off as a bad debt in respect of a financial arrangement where and to the extent that:

- 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).

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Income Tax Act 2004

The Ruling is not in respect of the Income Tax Act 2004. However, section YA 3(3) of the Income Tax Act 2004 provides that the provisions of this Act are the provisions of the Income Tax Act 1994 in rewritten form, and are intended to have the same effect as the corresponding provisions of the Income Tax Act 1994 except in the case of a new law specified in Schedule 22A (identified policy changes). Section YA 3 provides:

> **YA 3 Transitional provisions—**
>
> *Reference to this Act can include earlier Act*
>
> (1) A reference in an enactment or document to this Act, or to a provision of it, is to be interpreted as a reference to the Income Tax Act 1994 (or to the Income Tax Act 1976), or to the corresponding provision of the earlier Act, to the extent necessary to reflect sensibly the intent of the enactment or document.
>
> *Reference to earlier Act can include this Act*
>
> (2) A reference in an enactment or document to the Income Tax Act 1994 (or to the Income Tax Act 1976), or to a provision of that earlier Act, is to be interpreted as a reference to this Act, or to the corresponding provision in this Act, to the extent necessary to reflect sensibly the intent of the enactment or document.
>
> *Intention of new law*
>
> (3) Except when subsection (5) applies, the provisions of this Act are the provisions of the Income Tax Act 1994 in rewritten form, and are intended to have the same effect as the corresponding provisions of the Income Tax Act 1994.
>
> *Old law is interpretation guide*
>
> (4) Except when subsection (5) applies, in circumstances where the meaning of a taxation law that comes into force at the commencement of this Act (new law) is unclear or gives rise to absurdity,—
> (a) the wording of a taxation law that is repealed by section YA 1 and that corresponds to the new law (old law) must be used to determine the correct meaning of the new law; and
> (b) it can be assumed that a corresponding old law provision exists for each new law provision.
>
> *Limits to subsections (3) and (4)*
>
> (5) Subsections (3) and (4) do not apply in the case of—
> (a) a new law specified in schedule 22A (Identified policy changes); or
> (b) a new law that is amended after the commencement of this Act, with effect from the date on which the amendment comes into force.

Section DB 23(1)(a) in the Income Tax Act 2004 corresponds with section DJ 1(a)(iii) and provides for the same legal tests in that a debt must be both bad and written off in the income year for a deduction to be allowed. The requirements in section DB 23(1) are

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referred to in section EZ 37 (which concerns accrued income written off) and correspond with section EH 6 of the Income Tax Act 1994. Sections DB 23 and EZ 37 of the Income Tax Act 2004 provide:

Bad debts

DB 23 Bad debts

DB 23(1) No deduction (with exception)
A person is denied a deduction in an income year for a bad debt, except to the extent to which—
(a) the debt is written off as bad in the income year; and
(b) in the case of the bad debts described in subsections (2) to (5), the requirements of the relevant subsection are satisfied.

DB 23(2) Deduction: financial arrangement debt: amount of income
A person who derives assessable income from a financial arrangement to which the financial arrangements rules apply is allowed a deduction for an amount owing under the financial arrangement, but only to the extent to which—
(a) the amount is a bad debt and subsection (1)(a) is satisfied; and
(b) the amount is attributable to the income; and
(c) subsection (5) does not limit the deduction.

DB 23(3) Deduction: financial arrangement debt: dealers in arrangements
A person is allowed a deduction for an amount owing under a financial arrangement to which the financial arrangements rules apply, but only to the extent to which—
(a) the amount is a bad debt and subsection (1)(a) is satisfied; and
(b) the person carries on a business for the purpose of deriving assessable income that includes dealing in or holding financial arrangements that are the same as, or similar to, the financial arrangement; and
(c) the person is not associated with the person owing the amount written off; and
(d) subsection (5) does not limit the deduction.

DB 23(4) Deduction: financial arrangement debt: dealers in property or services sold
A person is allowed a deduction for an amount owing under a financial arrangement to which the financial arrangements rules apply, but only to the extent to which—
(a) the amount is a bad debt and subsection (1)(a) is satisfied; and
(b) the financial arrangement is an agreement for the sale and purchase of property or services; and
(c) the person carries on a business of dealing in the property or services that are the subject of the agreement; and
(d) the person carries on the business for the purpose of deriving assessable income; and
(e) subsection (5) does not limit the deduction.

DB 23(5) Deduction: bad debt representing loss already offset
A person is allowed a deduction for a bad debt only to the extent to which it is more than the total of the amounts offset under section IG 2 (Net loss offset between group companies) that are described in paragraphs (e) and (f) if—
(a) the person writing off the amount of debt is a company (company A); and
(b) the debt is owed to it by another company (company B); and
(c) company B—
    (i) itself uses the amount giving rise to the debt; or

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- (ii) uses it to fund directly or indirectly another company (company C) that uses the amount; and
- (d) company B or company C has a net loss, in the calculation of which the amount used is taken into account; and
- (e) company A, or a company that is in the same group of companies as company A at any time in the income year in which company B or company C has the net loss, offsets an amount for the net loss under section IG 2 (Net loss offset between group companies); and
- (f) the offset is in a tax year before the tax year that corresponds to the income year in which company A writes off the amount of debt (but not before the 1993–94 tax year).

DB 23(6) Link with subpart DA

The link between this section and subpart DA (General rules) is as follows:

- (a) subsection (1) overrides the general permission; and
- (b) for subsections (2) to (5),—
  - (i) they supplement the general permission, to the extent to which they allow a deduction that is denied under the general permission; and
  - (ii) they override the general permission, to the extent to which they deny a deduction that is allowed under the general permission; and
  - (iii) the other general limitations still apply.

Defined in this Act: agreement for the sale and purchase of property or services, amount, assessable income, associated person, business, company, deduction, financial arrangement, financial arrangements rules, general limitation, general permission, group of companies, income year, net loss, supplement, tax year

EZ 37 Accrued income written off

EZ 37(1) [Deduction for bad debt — general]

A deduction is allowed to a person for an amount written off by the person as a bad debt in respect of a financial arrangement where and to the extent that—

- (a) the person derives income in respect of the financial arrangement under any of sections EZ 32, EZ 34(4), EZ 35, and EZ 39; and
- (b) the amount written off is attributable to that income.

EZ 37(2) [Deduction for bad debt — dealers]

A deduction is allowed to a person for an amount written off by the person as a bad debt in respect of a financial arrangement (not being an amount allowed as a deduction under subsection (1)) where—

- (a) the person—
  - (i) carries on a business which comprises holding or dealing in such financial arrangements; and
  - (ii) is not associated with the person owing the amount written off; or
- (b) the financial arrangement is a trade credit and the person carries on a business of dealing in the goods or services for which the trade credit is a debt.

EZ 37(3) [Deduction for security payment]

Where a person receives a security payment in relation to a loss and a deduction is denied to the person for the loss other than under this subsection, the person is allowed a deduction for the loss no greater than the amount of the security payment.

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EZ 37(4) [Requirements for bad debt deduction]
A deduction for bad debts is allowed under this section only where the requirements of section DB 23(1) and (5) have been met.

EZ 37(5) [Requirements for share loss deduction]
A deduction for a share loss (within the meaning of section DB 18) is allowed under subsection (3) only where the requirements of section DB 18 have been met.

Section EZ 37 of the Income Tax Act 2004 is identical word for word with section EH 6 of the Income Tax Act 1994, other than in respect of section cross-references where the section numbers have changed. The new section DB 23 is an amalgam of sections DJ 1(a)(i), (iii), (iv) and EH 54 – there are some wording and layout changes, but it does not appear that the law has changed. The Ruling applies in respect of section DJ 1(a)(iii) of the Income Tax Act 1994 which sets out one of the requirements to be satisfied for a bad debt deduction to be allowed: that "the debt is actually written off as a bad debt by the taxpayer in the income year". In the Income Tax Act 2004 section DB 23(1)(a) states the requirement in the following terms: that "the debt is written off as bad in the income year". While the word "actually" is not included in the rewritten provision, the two provisions provide for the same legal tests that a debt must be both bad and written off in the income year for a deduction to be allowed. The conclusion that these are corresponding provisions is confirmed as sections DB 23 and EZ 37 are not listed in schedule 22A of the Income Tax Act 2004 which sets out any identified policy changes in the new Act. While this commentary is concerned with the deductibility of bad debts for the creditor, not remission income of the debtor, it is noted, however, that there has been a change implemented in section CG 2(3) of the Income Tax Act 2004 such that an amount that is remitted is treated as income in the year it is recovered, rather than in the year the deduction was allowed.

Saving of binding rulings

The new Income Tax Act 2004 states in section YA 4 that certain binding rulings issued in relation to the Income Tax Act 1994 are preserved and continued. This applies where a binding public ruling is issued before 1 April 2005 in relation to a provision in the Income Tax Act 1994 (old law) that corresponds to the Income Tax Act 2004 (new law). The binding ruling about the old law is treated as if it were made about the corresponding provision in the Income Tax Act 2004. In such circumstances where the application of the binding ruling is continued, a binding ruling on how the new law applies cannot be made. Section YA 4 provides:

YA 4 Saving of binding rulings

YA 4(1) When, and extent to which, this section applies
This section applies when, and to the extent to which,—
(a) either—
  (i) an applicant has applied for a private ruling, a product ruling, or a status ruling before 1 April 2005 on an arrangement that is entered into, or that the applicant seriously contemplates will be entered into, before the commencement of this Act; or
  (ii) a public ruling is issued before 1 April 2005; and

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(b) the binding ruling is about a taxation law that is repealed by section YA 1 (old law); and

(c) a new taxation law that corresponds to the old law (new law) comes into force at the commencement of this Act; and

(d) if this section did not exist, the commencement of this Act would mean that the binding ruling would cease to apply because of section 91G of the Tax Administration Act 1994.

YA 4(2) Ruling about new law

The binding ruling is treated as if it were made about the new law, so that the effect of the ruling at the commencement of this Act is the same as its effect before the commencement.

YA 4(3) No confirmation rulings

To the extent to which a binding ruling continued by subsection (2) applies to an arrangement, or to a person and an arrangement, the Commissioner must not make a binding ruling on how—

(a) the new law applies to the arrangement or to the person and the arrangement; or

(b) this subsection applies to the arrangement or to the person and the arrangement.

Therefore, because it is considered that sections DJ 1(a)(iii) and EH 6 in the Income Tax Act 1994 are corresponding provisions to sections DB 23(1)(a) and EZ 37 in the Income Tax Act 2004, the Ruling and the reasoning in this commentary which relate to section DJ 1(a)(iii) in the Income Tax Act 1994 will be deemed to also relate to section DB 23(1)(a) in the Income Tax Act 2004 from the date the 2004 Act comes into force.