BINDING RULINGS

PUBLIC RULING BR PUB 18/07: INCOME TAX AND GOODS AND SERVICES TAX – WRITING OFF DEBTS AS BAD

This is an update and reissue of BR Pub 05/01. For more information about earlier publications of this Public Ruling see the Commentary to this Ruling.

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

Taxation laws

All legislative references to the ITA are to the Income Tax Act 2007 and all references to the GST Act are to the Goods and Services Tax Act 1985, unless otherwise stated.

This Ruling applies in respect of s DB 31(1)(a) of the ITA and s 26(1) 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 has been adjudged as "bad" by a reasonably prudent commercial person who has concluded that there is no reasonable likelihood that the debt will be paid in whole or in part by the debtor or by anyone else (either on behalf of the debtor or otherwise); and
- the bad debt has been "written off" (in the income year or GST taxable period for which a deduction is claimed), in accordance with the accounting and record-keeping systems maintained by the taxpayer, in one of the following ways:
  - in the case of a taxpayer who maintains a computer-based accounting software system, an authorised person has made the appropriate entry in that system recording the debt as written off; or
  - in the case of a company taxpayer (other than one set out above), an executive or other responsible officer of the company with the authority to do so, has made the appropriate bookkeeping entries in the company's account books recording the debt as written off; or
  - in the case of a taxpayer (other than a company) who maintains double-entry accounts, an authorised person has made the appropriate bookkeeping entries in the business's account books 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, the taxpayer has made a note in their bookkeeping records setting out the amount owed by the bad debtor, stating that the debt has been written off, and recording the date of the writing off.

For the avoidance of doubt, the Arrangement does not include arrangements where subpart BG of the ITA and/or s 76 of the GST Act applies to void the arrangement.

How the taxation laws apply to the Arrangement

The taxation laws apply to the Arrangement as follows:

- The requirements of s DB 31(1)(a)(i) of the ITA will be satisfied and a deduction will be permitted for the amount of the bad debt that has been written off, provided that all the other requirements of s DB 31 are met.

- The requirements of s 26(1)(c) of the GST Act will be satisfied and a deduction will be permitted for the amount of the bad debt that has been written off, provided that all the other requirements of s 26 are met.

The period or tax year for which this Ruling applies

This Ruling will apply for an indefinite period beginning on 1 September 2018.

This Ruling is signed by me on 29 August 2018.

Fiona Wellgreen
Senior Tax Counsel, Taxpayer Rulings

COMMENTARY ON PUBLIC RULING BR PUB 18/07

This commentary is not a legally binding statement. The commentary is intended to help readers understand and apply the conclusions reached in Public Ruling BR Pub 18/07 (the Ruling).

Legislative references are to the Income Tax Act 2007 (ITA) and the Goods and Services Tax Act 1985 (GST Act) unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this commentary.

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Summary

1. The ITA 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 the debt must be both bad and written off. There are other circumstances when a bad debt deduction can be claimed and other requirements that must be satisfied before a bad debt deduction will be allowed. This Ruling only considers the questions of when a debt becomes "bad" and when the bad debt will have been "written off". It does not consider any of the other legislative requirements relating to deductibility of bad debts such as the application of the capital limitation.

2. These issues were previously the subject of Public Ruling BR Pub 05/01. BR Pub 05/01 is replaced by this Ruling from 1 September 2018. BR Pub 05/01 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 ITA and GST Act were also satisfied). This Ruling updates the earlier ruling but does not change the Commissioner's position.

Application of the legislation

3. Section DB 31(1)(a) of the ITA provides:

> **DB 31 Bad debts**
>
> *No deduction (with exception)*
>
> (1) A person is denied a deduction in an income year for a bad debt, except to the extent to which—
>
> (a) the debt is a debt—
>
> (i) written off as bad in the income year:
>
> (ii) for which the debtor is released from making all remaining payments under the Insolvency Act 2006

excluding Part 5, subparts 1 and 2 of that Act, or under the Companies Act 1993, or under the laws of a country or territory other than New Zealand, and the person is required to calculate a base price adjustment by section EW 29 (When calculation of base price adjustment required) for the debt for the income year:

(iii) for which the debtor is a company that is released from making all remaining payments by a deed or agreement of composition, and the person is required to calculate a base price adjustment by section EW 29 for the debt for the income year; and

...

4. Section 26(1) of the GST Act provides:

26 Bad debts

(1) 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 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:

provided that where goods are supplied under a hire purchase agreement, the registered person shall only make a deduction under section 20(3) of the tax fraction (being the tax fraction applicable at the time that 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:

5. Each of s DB 31 of the ITA and s 26 of the GST Act requires that:

- there must be a "bad debt"; and
- the bad debt must have been "written off" (unless one of the circumstances described in s DB 31(1)(a)(ii) or (iii) of the ITA applies).

6. This commentary will discuss firstly the tests to apply in deciding whether or not a debt is "bad", and secondly what actions are sufficient to "write off" a bad debt. As stated above, we are not considering any of the other legislative requirements relating to deductibility of bad debts. The tests for whether or not a debt is "bad" and what is sufficient "writing off" of a bad debt, apply whether the debt is subject to the financial arrangements rules or not.

First requirement – debt must be "bad"

7. Whether a debt is bad depends on an objective, factual consideration of all the relevant circumstances of each case. When determining whether a debt is bad, the relevant time of inquiry is the time when the decision is made to write off the debt (*Case 45/93* 93 ATC 486, 27 ATR 1022).

8. A debt must be bad before it can be written off for the purposes of s DB 31 of the ITA and s 26 of the GST Act. 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 anyone else (either on behalf of the debtor or otherwise). The term "commercial person" refers to people who are concerned with or engaged in commerce or business and would include people who have professional knowledge of commerce such as directors of a company, a loans manager of a bank, accountants, a business consultant, and lawyers with business experience. The onus of proof is on the taxpayer. The standard to which the test must be proved is on the balance of probabilities: see ***Budget Rent A Car Ltd v CIR*** (***Budget Rent-A-Car***) (1995) 17 NZTC 12,263, at page 12,269; ***Case N69*** (1991) 13 NZTC 3,541, at page 3,548; ***Graham v CIR, Edwards Graham Ltd & Edwards v CIR*** (1995) 17 NZTC 12,107, at page 12,111; ***Case T27*** (1997) 18 NZTC 8,188, at page 8,194; ***Case W3*** (2003) 21 NZTC 11,014 at page 11,029.

9. To determine whether a debt is bad, there must be sufficient information to enable a reasonably prudent commercial person to form the view that there is no reasonable likelihood that the debt will be paid. This requires a bona fide assessment based on sound commercial considerations that the debt is bad. Payment of the debt must be more than merely doubtful. For example, a debt will not be accepted as bad merely because a certain set period of time for payment (eg, 90 days or 180 days) has elapsed with no payment or contact having been made by the debtor. A debt is not bad if there is still a real and continuing dispute about payment of the debt (***Case 45/93***). However, a debtor does not need to be insolvent for a debt to be bad (***Case N69***).

Factors to consider whether a debt is bad

10. Determining whether a debt is bad is a question of fact and will depend on the circumstances surrounding any particular case. However, the following factors may be relevant when considering whether a debt is bad (although no one factor is decisive):

- The length of time a debt is outstanding – the longer a debt is outstanding the more likely it is that a reasonably prudent commercial person would consider the debt to be bad. This will of necessity vary depending on the amount of debt outstanding and the taxpayer's credit arrangements (eg, 90, 120 or 150 days overdue). However, a debt will not be considered bad merely because a set period of time for payment has elapsed with no payment or contact having been made by the debtor. Similarly, a debt may have only been outstanding for a short period and still be regarded as bad where other evidence exists that the debt will not be collected.

- 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 commercial person would consider the debt to be bad.

- Other information obtained by a creditor – a creditor may have obtained particular information about a debtor, for example through business or personal networks, of the kind that would lead a reasonably prudent commercial 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.

- The debtor has died leaving no, or insufficient, assets out of which the debt may be satisfied.

- The debtor cannot be traced – the creditor has been unable to ascertain the existence of, or whereabouts of, any assets against which action could be taken.

- Where the debt has become statute barred and the debtor is relying on this defence (or it is reasonable to assume that the debtor will do so) for non-payment.

- If the debtor is a company in liquidation or receivership reports from the liquidator or receiver indicate there are insufficient funds to pay the whole debt, or the part claimed as a bad debt.

Taxpayer's information about the debt

11. A debt becomes a bad debt when a reasonably prudent commercial person concludes that there is no reasonable likelihood that the debt will be paid. In those circumstances a taxpayer's considered opinion will suffice so long as the view they have reached is the view that a reasonably prudent commercial person would reach.

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

    - a deduction in calculating income for income tax purposes, worth up to 33% of the debt, depending on the taxpayer's marginal income tax rate; and/or

    - a GST deduction from output tax of the tax fraction of the debt.

13. Therefore, in the course of tax audits or other enquiries, the Commissioner may inquire into the taxpayer's decision to treat a debt as bad. In a dispute, it is up to the taxpayer to prove that, on the balance of probabilities, the debt was bad. Therefore, it is recommended that taxpayers document and retain relevant evidence to show that the decision to treat the debt as bad was a reasonable commercial decision. Documentation may include noting down the relevant information that gave rise to the decision that the debt was bad, and copies of any correspondence kept relating to the debt.

14. The amount of information required to decide whether a debt is bad will depend on the particular circumstances of each case. If the sum involved is small, a reasonably prudent commercial 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. However, the test is always whether the taxpayer has sufficient information to conclude, as any reasonably prudent commercial person would, that there is no reasonable likelihood that the debt will be paid, even if further or any recovery actions were to be taken.

Recovery steps taken

15. In most cases, before claiming a deduction for a bad debt, a creditor will have taken legal steps to recover the debt. It is through taking recovery action that most creditors will form an opinion that a debt is bad. However, recovery action does not need to be taken before deciding that a debt is bad. While recovery action is being taken, a debt can only be considered bad to the extent that a reasonably prudent commercial person would consider that there is no reasonable likelihood that the debt will be paid.

16. To establish that there is no reasonable likelihood that the debt will be paid, a reasonably prudent commercial person would, in most situations, take steps to

recover the debt instead of simply writing it off. This may include a range of actions including legal proceedings. The appropriate steps undertaken will vary according to the size of the debt and the resources available to the creditor to pursue the debt. A creditor might not take any steps to recover the debt where the information suggests there is no hope of payment.

17. The steps taken to recover the debt would generally include one or more of the following:

- issuing reminder notices;
- attempting to make contact by telephone, mail, or email;
- allowing a reasonable period of time to elapse since the original due date for payment of the debt – this will vary depending on the amount of the debt outstanding and the taxpayer's credit arrangements;
- serving a formal demand notice;
- commencing legal proceedings for debt recovery;
- judgment being entered against the debtor;
- executing proceedings to enforce judgment;
- ceasing calculation and charging of interest and closing the account (a tracing file may be kept open, also, in the case of a partial write-off, the account may remain open);
- valuation of any security held against the debt;
- sale of any seized or repossessed assets.

18. While the above factors are indicative of the circumstances in which a debt may be considered bad, ultimately the question is one of fact and will depend on all the circumstances surrounding the transactions.

19. 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 will depend on the circumstances.

20. Conversely recovery action may be taken even when the creditor believes there is no reasonable likelihood that the debt will be recovered and has formed a reasonable view that the debt is bad. This may be the case, for example, when the creditor has a policy of pursuing all debtors to discourage other customers from defaulting.

Accounting provision for doubtful debts

21. Persons in business who provide credit often find it prudent to make some accounting 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.

22. However, for tax purposes, bad debts are individually identifiable debts that are unlikely to be recovered (in practical terms). For accounting purposes, the provision for doubtful debts is an estimate of the amount that will become bad debts in the future. The ITA and the GST Act do not allow any deduction for provisions for doubtful debts.

Debts that are partially bad

23. 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 instance, it is only that part of the debt that the creditor has no reasonable expectation of recovering that the creditor is entitled to write off as bad and (if all other relevant requirements are satisfied) to claim as a deduction for income tax and GST purposes.

Bad debts recovered

24. Under s CG 3 of the ITA, when a person receives an amount on account of a bad debt for which a deduction for income tax has previously been allowed, they must include the amount as income in the income tax return for the year in which it is received.

25. Under s 26(2) of the GST Act, when a person recovers an amount on account of a bad debt (whether it is for the whole or part of the debt) in respect of which a deduction from output tax has previously been allowed, that portion of the amount of the deduction previously allowed, as the amount that the bad debt recovered bears to the bad debt written off, shall be deemed to be the GST charged in relation to a taxable supply made during the taxable period in which the bad debt is wholly or partially recovered.

Examples of when a debt is bad

26. The following examples are included to assist in explaining the application of the law.

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 Forwarding 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 of it) 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 further enquiries.

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 four 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"

27. Subject to all other relevant legislative requirements being satisfied, both the ITA and the GST Act allow taxpayers and/or registered persons a deduction for a bad debt that has been written off. It is not sufficient that a debt is bad – the bad debt must also have been actually written off. Writing off the bad debt is important because the time this occurs establishes the relevant income year or GST taxable period in which a deduction becomes available. Judge Barber stated in ***Case Z21*** (2010) 24 NZTC 14,286 that:

> Three elements must be satisfied: the debt is bad; a decision has been made to write off the bad debt; and the appropriate bookkeeping entries have been made to record that the bad debt has been written off.
>
> …
>
> The purpose of the requirement, that bookkeeping records show the debt to actually be written off, is to provide certainty as to the very point of [time] when the write-off actually occurred.

28. Note that there is no requirement that a debt be written off in the year it becomes bad. As Tompkins J stated in the High Court decision of ***Budget Rent A Car***:

> 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)[s DB 31(1)(a)(i)] 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 …

29. Judge Barber discussed the requirement to write off bad debts in the Taxation Review Authority (TRA) decision ***Case N69*** and stated:

> I consider it that it is 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 s 106(1)(b) [s DB 31(1)(a)(i)], 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 corporation or business to merely make the appropriate book 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.

30. In ***Case T48*** (1998) 18 NCTC 8,325 the TRA 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 a bad debt. The taxpayers did not have to meet any other bookkeeping requirements. Judge Barber stated:

> In *Case N69* I contemplated that the businessperson concerned … would decide that a debt was bad in good faith and in terms of his (or her) business knowledge, and

make an authorised journal entry in his books of account. He could simply record his decision somewhere in the records of the business. In the case of a company one might expect a resolution of the directors confirming a decision or report of management to write off a debt as bad; although, as I said in ***Case N69*** the executive personnel would normally have the authority to write off bad debts. As already indicated, the notation on the ledger cards written at some stage by T is less than I had contemplated in ***Case N69***, but in the circumstances of this case is adequate to show an actual writing off. As Judge Willy said in ***Case P53*** [(1992) 14 NZTC 4,370], there is no one formula for the mechanics of writing off a debt, but the taxpayer [must] satisfy the Court, on the balance of probabilities, that the debt has, in fact, been written off in whatever books of account or accounting procedures are kept by the taxpayer.

31. Therefore, to meet the legislative requirements in s DB 31(1)(a)(i) of the ITA and s 26(1)(c) of the GST Act, rather than just making a decision that the debt is bad, taxpayers must be able to show clearly that the debt has actually been written off. To show that this is the case, there must be something written down in the business's account books stating that the debt is written off.

32. Case law indicates that the minimum written requirements necessary to satisfy the "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 account books or accounting records may take, those existing for 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. Writing off the bad debt is what converts it into a potentially deductible debt (depending on whether the other legislative requirements relating to deductibility of bad debts, such as the capital limitation are met).

33. What will be sufficient to meet the "written off" test for various classes of taxpayer are set out below. The classes and the written requirements are based largely on *Case N69*, *Case T48* and the earlier *Case P53* (1992) 14 NZTC 4,370. The bad debt is "written off" in accordance with the accounting and record keeping systems maintained by the taxpayer when:

- in the case of a large corporate or business taxpayer who maintains a computerised bad debts system, an authorised person makes the appropriate entry in that system recording the debt as written off; or
- in the case of a company (other than one set out as above), an executive or other responsible officer of the company with the authority to do so, makes the appropriate bookkeeping entries in the company's account books recording the debt as written off; or
- in the case of a taxpayer (other than a company) who maintains double-entry accounts, an authorised person makes the appropriate bookkeeping entries in the business's account books 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, the taxpayer makes a note in their bookkeeping records setting out the amount owed by the bad debtor, stating that the debt has been written off, and recording the date of the writing off.

34. There may be very exceptional cases where something less than the writing-off requirements set out above are acceptable. In *Case S73* (1996) 17 NZTC 7,454, the taxpayer was unable to access their accounting records and a letter was sent to the Commissioner stating that the debt had been written off. The TRA stated

that it was a question of fact whether a particular debt had been written off and was satisfied on the evidence before it that it clearly had been. Nevertheless, there remains a written requirement in all cases.

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

36. The time a debt is written off determines when a deduction can be claimed. Therefore, the necessary writing-off must take place before the end of the income year or GST taxable period when the bad debt deduction is claimed. Writing off a bad debt cannot be backdated. If there are numerous debts, it is important to allow sufficient time to review them and complete all necessary "writing-off" accounting entries before the end of an income year or GST taxable period, to enable any bad debt deductions to be claimed in that year or GST taxable period.

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

Accounts kept by taxpayers

38. 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 clearly shown by appropriate bookkeeping entries in the debtors ledger by authorised persons. Generally, this means 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 when preparing a taxpayer's double-entry accounts, having made the decision that the debt is bad (in accordance with the tests already outlined), it is essential to make the appropriate authorised entry/entries writing off the debt before claiming a deduction.

39. In cases where a taxpayer does not keep double-entry accounting records and/or does not keep a debtors ledger, the taxpayer 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.

40. Particular examples of bad debts accepted by the Commissioner as having been written off include the following:

- If a taxpayer's only records of debts are copies of invoices issued, placing the invoice in a "bad debts" file and indicating by way of a dated written note on the invoice whether all or part of the invoiced amount is bad, 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

41. For a variety of reasons, a creditor may keep a separate record of written-off bad debts. 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.

42. 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

43. 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 1993; and
- management accounts as a basis for management decision-making and control.

44. The sets of accounts may be prepared in quite different ways. For example, statutory requirements are set out in the Financial Reporting Act 2013 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 to provide very quick reports.

45. 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.

46. 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 Companies Act 1993.

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

47. The following examples are included to assist in explaining the application of the law.

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 relating to the deductibility of the debt for income tax and GST purposes 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 2017. The entries made include the journal entry writing off the bad debt.

The bad debt will have been written off in the year ending 31 March 2017.

Example 2

The taxpayer maintains a debtors ledger and is not registered for GST. The debtors ledger is written up on 1 April 2017. The entries written up include the journal entry writing off the bad debt.

The bad debt will have been written off in the year ending 31 March 2018.

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 2017. That return was prepared in February 2017.

The taxpayer is not entitled to the deduction from GST output tax. Claiming the deduction from output tax for GST purposes is not a sufficient writing-off of the bad debt for either GST or income tax purposes. She is not allowed a deduction for the bad debt in the income year ending 31 March 2017.

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 account books 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 2017, putting a line across the copy of the last statement sent out for the debt and marking it “Final” and leaves it in the unpaid debtors’ file.

The bad debt will not have been written off in the year ended 31 March 2017. Simply marking the last statement issued as “Final” and leaving it in the unpaid debtors’ file does not amount to writing off 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 2017 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 2017. 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 for the debt, circling the amount payable and marking it "bad debt – written off – February 2017".

The bad debt will have been written off in the year ending 31 March 2017. 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 2017. The entries written up include a journal entry writing off a bad debt. Her accountant prepares her accounts in June 2017. 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 2017.

The bad debt will have been written off in the year ending 31 March 2017 because the underlying accounting record of the debt was altered to recognise the bad debt on 31 March 2017.

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 2017 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 15/3/17". The amount of trade debtors in the taxpayer's balance sheet as at 31 March 2017 includes the bad debt. The taxpayer's profit and loss statement for the year ending 31 March 2017 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 2017 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.

The taxpayer would be allowed a tax deduction in the 2017 year if they used an accountant to complete their accounts for the year, perhaps to complete their income tax return, and that person made the required journal entries through the profit and loss statement and balance sheet to give effect to the write off of the bad debt made by the taxpayer on 15 March 2017. In that case the bad debt write off will be included in the profit and loss statement and balance sheet for the 2017 year and there would be no tax adjustment required in the tax reconciliation statement.

Example 8

The taxpayer has a computer-based accounting software system where they enter all business receipts and invoices. The accounting software automatically updates the underlying ledger accounts when each transaction is entered.

The taxpayer considers an invoice a bad debt on 5 February 2017, and she enters a "Bad Debt" transaction into her accounting software on the same day.

The taxpayer is allowed a deduction for the bad debt. Entering a "Bad Debt" transaction into her accounting software system will automatically update the underlying accounting records as at that date, and the debt will no longer be recognised as an asset in the accounts produced for the 2017 year ie, it will have gone through the profit and loss account and be removed from debtors in the balance sheet.

References

Expired rulings

BR Pub 96/3A: Bad debts – Writing off debts for GST and Income Tax Purposes (which applied for a three year period)

BR Pub 00/03: Bad debts – Writing off debts for GST and Income Tax Purposes (which applied for a five year period)

BR Pub 05/01: Bad debts – Writing off debts for GST and Income Tax Purposes (which applied for an indefinite period)

Subject references

Bad debt, written off

Legislative references

Income Tax Act 2007 – ss CG 3, DB 31

Goods and Services Tax Act 1985 – ss 26, 75

Tax Administration Act 1994 – s 22

Case references

Budget Rent A Car Ltd v CIR (1995) 17 NZTC 12,263

Case 45/93 93 ATC 486, 27 ATR 1022

Case N69 (1991) 13 NZTC 3,541

Case P53 (1992) 14 NZTC 4,370

Case S73 (1996) 17 NZTC 7,454

Case T27 (1997) 18 NZTC 8,188

Case T48 (1998) 18 NCTC 8,325

Case W3 (2003) 21 NZTC 11,014

Case Z21 (2010) 24 NZTC 14,286

Graham v CIR, Edwards Graham Ltd & Edwards v CIR (1995) 17 NZTC 12,107

Appendix – Legislation

Income Tax Act 2007

1. Section CG 3 provides:

CG 3 Bad debt repayment

An amount received by a person for a bad debt for which the person has been allowed a deduction is income of the person.

2. Section DB 31 provides:

DB 31 Bad debts

No deduction (with exception)

(1) A person is denied a deduction in an income year for a bad debt, except to the extent to which—

(a) the debt is a debt—

(i) written off as bad in the income year:

(ii) for which the debtor is released from making all remaining payments under the Insolvency Act 2006 excluding Part 5, subparts 1 and 2 of that Act, or under the Companies Act 1993, or under the laws of a country or territory other than New Zealand, and the person is required to calculate a base price adjustment by section EW 29 (When calculation of base price adjustment required) for the debt for the income year:

(iii) for which the debtor is a company that is released from making all remaining payments by a deed or agreement of composition, and the person is required to calculate a base price adjustment by section EW 29 for the debt for 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 met.

Deduction: financial arrangement debt: amount of income

(2) 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 a requirement of subsection (1)(a) is met; and

(b) the amount is attributable to the income; and

(bb) the person is not associated with the debtor, or is associated with the debtor but the debtor has no deductions for the financial arrangement; and

(c) subsection (5) does not limit the deduction.

Deduction: financial arrangement debt: dealers and holders

(3) A person is allowed a deduction, quantified in subsection (3B), for an amount of a bad debt owing under a financial arrangement to which the financial arrangement rules apply, if—

(a) the person carries on a business for the purpose of deriving assessable income; and

(b) the business includes dealing in or holding financial arrangements that are the same as, or similar to, the financial arrangement; and

(c) a requirement of subsection (1)(a) is met for the bad debt; and

(d) the person is not associated with the person owing the amount written off.

Amount of deduction under subsection (3)

(3B) For the purposes of subsection (3), the amount of the deduction for the amount owing under the financial arrangement is the lesser of—

(a) the amount provided by subsection (4B); and

(b) the amount provided by subsection (5).

Deduction: financial arrangement debt: dealers in property or services

(4) 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 the requirement of subsection (1)(a)(i) is met; 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.

Amount for purposes of subsections (3) and (3B)

(4B) For the purposes of subsections (3) and (3B), the amount is the least of—

(a) the amount of consideration that the person pays for acquiring the financial arrangement:

(b) the amount owing under the financial arrangement:

(c) the amount calculated using the following formula, treating the calculation of a negative amount as zero:

amount owing − limited recourse consideration + adjustment amount.

Definition of items in formula

(4C) In the formula in subsection (4B)(c),—

(a) amount owing is the lesser of—

(i) the amount of consideration that the person pays for acquiring the financial arrangement:

(ii) the amount owing under the financial arrangement:

(b) limited recourse consideration is the amount of consideration paid to the person under a limited-recourse arrangement that relates to the financial arrangement:

(c) adjustment amount is an amount allocated for the income year under section EW 15D (IFRS financial reporting method) for the limited-recourse arrangement, to the extent to which the amount arises solely because of the reduction in the value of the limited-recourse arrangement due to the **financial arrangement's relevant bad debt amount.**

Limited recourse: base price adjustment

(4D) If subsection (4B)(c) applies for an amount owing under a financial arrangement, then the person is allowed a deduction, at the time the person performs a base price adjustment for the related limited-recourse arrangement, of an amount equal to the amount owing under the financial arrangement minus the total amount of deductions for the financial arrangement under subsections (2) and (3) that have arisen before the base price adjustment.

Definition of items in formula [Repealed]

(4E) *[Repealed]*

Deduction: bad debt representing loss already offset

(5) 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 IC 1 (Company A making tax loss available to company B) 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

(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 tax loss, in the calculation of which the amount used is taken into account; and

(e) company A, or a company that is part of the same group of companies as company A at any time in the income year in which company B or company C has the tax loss, offsets an amount for the tax loss under section IC 1; 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.

A definition

(5B) In this section, limited-recourse arrangement means, in relation to an amount owing under a financial arrangement (the debt), an arrangement that is for the person's business of dealing in or holding financial arrangements, and that provides for payment or non-payment by the person, contingent upon—

(a) payment of some or all of the debt to the person:

(b) failure to make payment of some or all of the debt to the person.

Link with subpart DA

(6) 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 general limitations still apply, except that subsections (3) and (4D) override the capital limitation for a financial arrangement held as part of a business that includes dealing in or holding financial arrangements.

Goods and Services Tax Act 1985

3. Section 26 provides:

26 Bad debts

(1) 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 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:

provided that where goods are supplied under a hire purchase agreement, the registered person shall only make a deduction under section 20(3) of the tax fraction (being the tax fraction applicable at the time that 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:

(1AA) Subsection (1) also applies if a registered person sells a debt to a third party and then reacquires the debt.

(1AB) A registered person who is required to account for tax payable on a payments basis under either section 19 or section 19A must apply this section only to supplies made by the person to which any one of sections 9(2)(b), 9(3)(b) and 26A applies.

(1A) Where a registered person has, in respect of the supply by that registered person of any contract of insurance (being a supply charged with tax pursuant to section 8(1)),—

(a) paid any amount to the Earthquake and War Damage Commission pursuant to the Earthquake and War Damage Act 1944 or to the Fire Service Commission pursuant to the Fire Service Act 1975 or to Fire and Emergency New Zealand pursuant to the Fire and Emergency New Zealand Act 2017; and

(b) sought to recover that amount, together with the consideration for that supply, from the recipient of that supply; and

(c) written off as a bad debt the whole or part of that amount not paid to that registered person,—

that registered person shall make a deduction under section 20(3) of the tax fraction of that amount or that part of that amount written off.

(2) Where any amount in respect of which a deduction has been made in accordance with subsection (1) is at any time wholly or partly recovered by the registered person, that portion of the amount of the deduction allowable under subsection (1) as the amount of the bad debt recovered bears to the bad debt written off shall be deemed to be the tax charged in relation to a taxable supply made during the taxable period in which the bad debt is wholly or partly recovered.

(3) This section does not apply when the taxable supply is one made by a principal to an agent as described in section 60(1B)(a) if the agent has been paid for the supply described in section 60(1B)(b).

(4) This section does not apply when the taxable supply is made by an agent to a principal as described in section 60(2B)(b).