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Key factors for rescuing a bad debt deduction

It is very often the case that unpaid debts owed to a business can have a significant impact on cash flow and the ongoing profitability of a business. In a taxation context the characterisation of a particular debt as either "doubtful" or "bad" is key as to whether or not the writing off of that debt would be deductible.

Generally, the characterisation of a debt would be premised on the following principles:

- Doubtful debt - is a receivable amount that might eventuate to be a bad debt in future. Doubtful debt often represents a mere accounting provision and is not deductible for tax purposes for the current financial year but may evolve into a bad debt the following year.
- Bad debt - is a receivable amount that has been identified as not collectible and on being written off may well be deductible for tax purposes.

Written into the tax law are certain specific conditions that must be met in order to claim an income tax deduction for bad debts written off by businesses. (Importantly, the businesses referred to are not in the business of money-lending, as money lenders can often claim a deduction for bad debts written off under the general business deduction rules as a non-capital loss necessarily incurred in the course of carrying on its business.)

In broad terms, for any other business to claim a bad debt deduction, the following requirements are posed:

1. The debt must be written off as bad during the year of income in which the deduction is claimed.
2. Except in the case of taxpayers in the business of lending money, the debt must have been brought to account by the taxpayer as assessable income.

In regard to the first requirement, it should be noted that there must be a physical writing off of the debt - not necessarily a book entry, but something in writing to indicate that the creditor has treated the debt as bad. It is not sufficient that the debt is written off when the accounts are completed after the close of the income year (in conformity with usual accounting practice) and merely relates back to the income year just closed.

Furthermore, the second requirement will not be satisfied by a taxpayer who lodges returns on a cash basis, because those debts will not have been brought to account as assessable income.

The key components of the ATO's views on the treatment of bad debts are:

- a debt must exist before it can be written off
- the question of whether a debt is bad is a matter of judgement having taken into account all relevant facts
- debt is written off as a bad debt in the year of income and deduction is claimed, and it is recommended that some form of written record is kept to evidence the decision to write off the debt
- the debt must be written-off before the financial year ends
- the amount of debt must previously have been included as assessable income.

As a matter of course, the Tax Commissioner will generally require a taxpayer to have taken appropriate steps to attempt to recover a debt, including the obtaining and enforcement of a judgement against the debtor and valuation of any securities held against the debt.

It should also be noted that, specifically for companies wanting to claim bad debt deductions, there is an additional requirement to comply with the so-called continuity of ownership test or same business test, which is also a prerequisite for the carrying forward and utilisation of company tax losses.

Case Study

Ace Fitting Pty Ltd operates a business in industrial kitchen fitouts. The company provides kitchen fitouts to various cafes and restaurants. Ace acquired a new customer in August 2016. Ace quoted the job for $45,000 with an arrangement for payment upon completion of the job. The fitout of the kitchen was completed in November 2016 and invoiced accordingly with a 30 day term. The sale was recorded (August 2016) by Ace, but no payment was received within the 30 day term.

Subsequent phone calls, emails and demand letters for payment were unsuccessful. In March 2017, Ace found out that the customer had closed the business and the premises had been abandoned. The owner had fled overseas with no contact details.

Ace would be entitled to write off the relevant debt as a bad debt and could claim a deduction for the financial year ending 30 June 2017.

That is, Ace followed all available measures in order to recoup the debt of $45,000 and can, in light of the prevailing circumstances, make the decision to write off the debt as there is seemingly little or no prospect of recovering the debt. As a consequence such writing off of this debt would crystallise an income tax deduction for Ace.

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