TR 92/18 - Income tax: bad debts

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This ruling is being reviewed as a result of a recent court/tribunal decision. Refer to Decision Impact Statements: Commissioner of Taxation v Ashwick (Qld) No 127 Pty Ltd & Ors (Published 20 December 2011) and Commissioner of Taxation v BHP Billiton Finance Limited; Commissioner of Taxation v BHP Billiton Limited (Published 20 December 2011).

Taxation Ruling
Income tax: bad debts

*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part . Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

contents para

What this Ruling is about 1

Ruling 2

Date of effect 22

Explanations 23

What this Ruling is about

1. This Ruling clarifies the circumstances in which a deduction for bad debts will be allowable. In particular, the Ruling explains the operation of paragraph 63(1)(b) of the Income Tax Assessment Act 1936 (the Act) in relation to taxpayers in the business of the lending of money. **The Ruling does not attempt to provide guidance on bad debts in relation to consumer lending such as small personal loans or credit card debts.** A separate Ruling will issue on consumer lending.

Ruling

SECTION 63

Debt (paragraph 25)

2. To obtain a bad debt deduction under section 63 of the Act, a debt must exist before it can be written off as bad. A debt exists for the purposes of section 63 where a taxpayer is entitled to receive a sum of money from another either at law or in equity.

Bad debt (paragraphs 26 - 33)

3. A debt need not necessarily be bad in the strict sense as described in paragraph 26. The question of whether a debt is bad is a matter of judgment having regard to all the relevant facts. Guidelines for deciding when a debt is bad are at paragraphs 31-32. Generally, provided a bona fide commercial decision is taken by a taxpayer as to the likelihood of non-recovery of a debt, it will be accepted that the debt is bad for section 63 purposes. The debt, however, must not be merely doubtful.

4. Where a trustee in bankruptcy, receiver or liquidator advises a creditor of the amount expected to be paid in respect of a debt, the remainder of the debt (i.e. the extent to which the amount likely to be received is less than the debt) is accepted as bad when the advice is given.

Writing-off of bad debts (paragraphs 34 - 39)

5. The bad debt has to be written off in the year of income before a bad debt deduction is allowable under section 63. The writing-off of a bad debt does not necessarily require highly technical accounting entries. It is sufficient that some form of **written** record is kept to evidence the decision of the taxpayer to write off the debt from the accounts.

Debt brought to account as assessable income - paragraph 63(1)(a) (paragraphs 40 - 41)

6. If a taxpayer is not carrying on a business of money lending, a bad debt deduction is not allowable under paragraph 63(1)(a) unless the debt has been previously included in assessable income. A taxpayer who is not a money lender and returns income on the basis of cash receipts will not be entitled to a deduction for bad debts because the debts have not been brought to account by the taxpayer as assessable income.

Money-lending business - paragraph 63(1)(b) (paragraphs 42 - 46)

7. Paragraph 63(1)(b) applies to taxpayers who are engaged in a money lending business. The question of whether a taxpayer is carrying on a money-lending business is a question of fact. For the purposes of paragraph 63(1)(b), a money lender need not necessarily be ready and willing to lend moneys to the public at large or to a wide class of borrowers. It would be sufficient if the taxpayer lends moneys to certain classes of borrowers provided the taxpayer does so in a businesslike manner with a view to yielding a profit from it.

'In respect of' (paragraphs 47 - 48)

8. The term 'in respect of money lent' in paragraph 63(1)(b) is to be given its widest meaning and it includes not only the principal of the loan, but also any capitalised interest and associated costs, charges, fees etc. incurred in the course of lending money.

Money-lending business at the time of lending (paragraphs 49 - 52)

9. For the purposes of paragraph 63(1)(b), the taxpayer must be carrying on a money lending business at the time the loan was made. However, it is accepted that a taxpayer does not have to be carrying on a business of money lending at the time the debt is written off in order to satisfy the requirements of paragraph 63(1)(b).

SECTION 51 (paragraphs 57 - 68)

10. Certain taxpayers who fail to satisfy the requirements under section 63 may be entitled to a bad debt deduction under subsection 51(1). Any business losses or outgoings of a revenue nature are an allowable deduction under subsection 51(1) when incurred. Whether or not a loss occasioned by a bad debt is of a revenue or capital nature depends upon a consideration of the facts and circumstances in each case.

11. A loss occasioned by a bad debt is clearly incurred when the loan is disposed of, settled, compromised or otherwise extinguished. Where a debt is not disposed of, settled, compromised or otherwise extinguished, it is accepted that the loss of the debt is incurred under subsection 51(1) when it is written off as bad in the same way as in section 63.

SUBSECTION 63(3) (paragraphs 69 - 71)

12. Where a taxpayer recoups an amount which has previously been allowed as a bad debt deduction under either of subsections 63(1) or 51(1) the taxpayer will have to include this amount in assessable income pursuant to subsection 63(3).

PARTIAL DEBT WRITE-OFFS (paragraphs 72 - 83)

13. It is not necessary for a taxpayer to write off an entire debt to obtain a bad debt deduction under section 63. A taxpayer is entitled to a deduction for that part of a debt which is bad and is written off. The same tests for deductibility apply as for the whole of a debt.

14. A partial bad debt deduction may arise where debt is secured by property. Where the debt is discharged only to the extent of the net amount realised from the sale of the security and the remaining debt is still outstanding, the remaining debt (i.e. any deficiency between the net proceeds of the sale of the security and the amount of the debt) would be deductible as a partial bad debt **only if and when** it is found

that the remaining debt could not be recovered from the debtor (i.e. the requirements of section 63 are met). The same principle applies where the security is held, for example as mortgagee in possession, rather than sold. In this situation, the remaining debt that may be written off as bad is the deficiency between the market value of the security and the amount of debt.

15. Where the security is taken in **full satisfaction of the debt**, no bad debt deduction is allowable under section 63 **unless** the bad debt is written off **before** the debt is extinguished.

16. If a deduction is not available under subsection 63(1) any deficiency between the market value of the security and the amount of the debt may, depending upon the circumstances, be an allowable deduction under subsection 51(1) or taken into account as a capital loss under Part IIIA of the Act.

17. Any profit or loss on the subsequent disposal of the security will need to be taken into account under sections 25 and 51 or Part IIIA.

DEBT/EQUITY SWAPS (paragraphs 84 - 91)

18. Sections 63E and 63F are specific provisions allowing deductions for losses arising out of debt for equity swaps entered into after 26 February 1992. The allowable deduction is the amount by which the amount of the debt exceeds the value of the equity received in the swap.

19. Prior to 27 February 1992 a bad debt deduction arising out of a debt for equity swap may, depending on the circumstances, be allowable under either of subsections 63(1) or 51(1).

20. A deduction is allowable under subsection 63(1) if the taxpayer had written off that portion of the debt that was bad (ie. the deficiency between the debt owed and the market value of the equity to be issued) before the equity was issued and the debt was extinguished.

21. Where a bad debt deduction is not allowable under subsection 63(1) a deduction may, depending upon the circumstances, be allowable under subsection 51(1) for the loss arising out of a debt for equity swap.

Date of effect

22. This Ruling applies (subject to any limitations imposed by statute) for years of income commencing both before and after the date on which it is issued.

Explanations

23. Subsection 63(1) provides that:

> 'Debts which are bad debts and are written off as such during the year of income, and;
>
> (a) have been brought to account as assessable income of any year; or
>
> (b) are in respect of money lent in the ordinary course of the business of the lending of money by a taxpayer who carries on that business,
>
> shall be allowable deductions.'

24. Four conditions must be satisfied in order to qualify for a bad debt deduction. **First**, a debt must exist. **Second**, the debt must be bad. **Third**, the debt must be written off as a bad debt during the year of income in which the deduction is claimed. **Fourth**, the debt must have been brought to account as assessable income in any year or, in the case of a money lender, the debt must be in respect of money lent in the ordinary course of the business of lending of money by a taxpayer who carries on that business.

What constitutes a 'debt' for section 63?

25. A debt may be defined as a sum of money due from one person to another. As a general rule where a taxpayer is entitled to receive a sum of money from another either at law or in equity, it is accepted that a debt exists for the purposes of section 63. There is a debt for the purposes of section 63 where a taxpayer has merely an equitable entitlement to the debt (*G.E. Crane Sales Pty Ltd v. F.C. of T.* (1971) 126 CLR 177, 71 ATC 4268, 2 ATR 692).

When will a debt be bad?

26. Whether a debt is bad depends upon an objective consideration of all the relevant circumstances of each case. **Strictly speaking**, in the case of an individual debtor, a debt is not 'bad' until

the debtor has died without assets, or has become insolvent and his estate has been distributed, or the debt has become statute barred. In the case of a corporate debtor a similar situation would arise on receipt of the liquidator's final distribution or when the company is completely wound up.

27. However, because subsection 63(3) contemplates that an amount may subsequently be received in respect of a debt previously written off as bad, it is considered that, for the purposes of section 63, the debt need not necessarily be 'bad' in the strict sense as indicated in paragraph 26 above.

28. In support of the view expressed in paragraph 27, Harvey ACJ in *Elder Smith & Co Ltd v. Commissioner of Taxation* (NSW) (1931) 1 ATD 241, (affirmed in *Elder Smith v. F.C. of T.* (1932) 47 CLR 471) considered a similar bad debts provision in the State Income Tax (Management) Act 1928 (NSW). He made an **obiter** observation that the legislation contemplated a debt being bad where it was 'a conjectural bad debt for the time being' (at p. 242). Similarly, in *Anderson and Halstead Ltd v. Birrell* (1932) 16 TC 200 Rowlatt J, in considering the English legislative provision for bad debts, said that an 'estimate' was required as to the extent a debt is bad for the purpose of a profit and loss account. Such an estimate he said 'was a valuation of an asset (the debt) upon the facts and probabilities at the time the writing off of the debt takes place'. The Taxation Board of Review in *Case 26* (1945) 11 CTBR (OS) 94 also observed at p.94 that '[i]t may happen - although it seems quite improbable - that through some turn of fortune portion of the amount in question will yet be recovered, but any such consideration cannot affect the issue.'

29. As long as the commercial judgment pointing to the relevant facts indicates that a debt is bad for the time being, the debt is accepted as bad for section 63 purposes. It is not essential that a creditor take all legally available steps to recover the debt. What is necessary is that the creditor make a bona fide assessment, based on sound commercial considerations, of the extent to which the debt is bad.

30. Although the debt need not be bad in the strict sense it must nonetheless 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 (e.g. 180 days or 270 days) has elapsed with no payment or contact having been made by the debtor.

31. A debt may be considered to have become bad in any of the following circumstances:

(a) the debtor has died leaving no, or insufficient, assets out of which the debt may be satisfied;

(b) the debtor cannot be traced and the creditor has been unable to ascertain the existence of, or whereabouts of, any assets against which action could be taken;

(c) 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;

(d) if the debtor is a company, it is in liquidation or receivership and there are insufficient funds to pay the whole debt, or the part claimed as a bad debt;

(e) where, on an objective view of all the facts or on the probabilities existing at the time the debt, or a part of the debt, is alleged to have become bad, there is little or no likelihood of the debt, or the part of the debt, being recovered.

32. While individual cases may vary, as a practical guide a debt will be accepted as bad under category (e) above where, depending on the particular facts of the case, a taxpayer has taken the appropriate steps in an attempt to recover the debt and not simply written it off as bad. Generally speaking such steps would include some or all of the following, although the steps undertaken will vary depending upon the size of the debt and the resources available to the creditor to pursue the debt:

(i) reminder notices issued and telephone/mail contact is attempted;

(ii) a reasonable period of time has elapsed since the original due date for payment of the debt. This will of necessity vary depending upon the amount of the debt outstanding and the taxpayers' credit arrangements (e.g. 90, 120 or 150 days overdue);

(iii) formal demand notice is served;

(iv) issue of, and service of, a summons;

(v) judgment entered against the delinquent debtor;

(vi) execution proceedings to enforce judgment;

` (vii) the calculation and charging of interest is ceased and the account is closed, (a tracing file may be kept open; also, in the case of a partial debt write-off, the account may remain open);

(viii) valuation of any security held against the debt;

(ix) sale of any seized or repossessed assets.

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 facts and circumstances surrounding the transactions. All pertinent evidence including the value of collateral securing the debt and the financial condition of the debtor should be considered. Ultimately, the taxpayer is responsible for establishing that a debt is bad and bears the onus of proof in this regard.

33. Subsection 63(2) provides for a debt being bad where the debtor has become bankrupt or has executed a deed of assignment or scheme of arrangement. The debt will be bad to the extent to which the amount of the debt owed to a taxpayer exceeds the amount, if any, which will be received by the taxpayer. Where the trustee in bankruptcy, receiver or liquidator advises the creditor of the amount expected to be paid in respect of the debt, the remainder of the debt can be written off as bad when the advice is given.

A deduction for a bad debt is allowable in the year of income in which the debt is written off

34. It is not enough to simply make a provision for a bad debt. The debt has to be written off as a bad debt and it has to be written off before year's end. The question has often arisen as to what the term 'written off' means. In *Case 33* (1941) 10 TBRD 101 the Taxation Board of Review expressed at p.103 the view that:

> '... the writing off of a bad debt does not necessitate a particular form of book entry or even a book entry at all. It is sufficient, we think, if there are written particulars - there must, of course, be something in writing - which indicates that the creditor has treated the debt as bad.'

35. There is a requirement that the debt has to be physically written off. Note the following relevant comments of the Chairman of the Taxation Board of Review in *Case 28* (1947) 13 TBRD 223 at p.239:

> '"Bad debts written off as such in the year of income": I am unable to share the view that the condition denoted by these words can be satisfied where, in respect of a debt owed to the taxpayer concerned, there is no evidence whatever that anything was put in writing, in the year of income, from which it could be gathered that the taxpayer intended to treat the debt as bad. The words are plain and positive and they are so clearly objective that their very purpose seems to me to be to put the onus upon any taxpayer who seeks to obtain the benefit provided by the section to prove (if so required) by sufficient evidence that there was a physical writing off of the debt in the year of income..... However, the need for the

> condition as to the writing off of bad debts is fairly apparent. Against any suggestion that the condition that the debts must be bad makes the further condition superfluous, it has to be borne in mind that in the average case that taxpayer must be allowed a considerable latitude in the exercise of his judgment as to the extent to which any particular debt is bad, the reason being that it is frequently impossible to foresee future events which might affect the worth of the debt. The Commissioner is in no better position and, although Section 63(3) is the logical and necessarily intended corrective of the excessive writing off of bad debts by reason of errors of judgment or the unavoidable failure of careful forecasts, the statutory condition as to writing off is a necessary corrective of the difficulties which would arise ... as to which year among several a debt is to be claimed or treated as bad.'

36. The requirements of section 63 may be satisfied even though a debt is **not written off in the books of account**, for example, section 63 will still be satisfied in the following circumstances:

(a) a Board meeting authorises the writing off of a debt and there is a physical recording of the written particulars of the debt and Board's decision before year end but the writing off of the debt in the taxpayer's books of account occurs subsequent to year end;

(b) a written recommendation by the financial controller to write off a debt which is agreed to by the managing director in writing prior to year end followed by a physical writing off in the books of account subsequent to year end.

37. No deduction will be allowed in a year, if the debt is written off after the year's end at the time when the books of account are being prepared (i.e. as a balance day adjustment made after the close of the income year). The decision of Owen J in *Point v. F.C. of T.* (1970) 119 CLR 453, 70 ATC 4021, 1 ATR 577 makes this requirement quite clear. At CLR p. 458, ATC p. 4023, ATR p. 580 Owen J said:

> 'The fact is, however, that during that year neither that nor any other figure was written off by the appellant as a bad debt. The entry purporting to write off $X as a bad debt was not made until many months after the end of that year and, in my opinion, the Commissioner rightly refused to apply section 63. For the appellant, however, it was argued that the words in the section, "written off as such during the year of income", are not to be given what appears to me to be their plain meaning and that the section is sufficiently complied with if the debt is not written off "during the year of income" but at some later date, provided that the writing off relates back to the year of income. I am unable to accept this proposition. "During the year of income" means in my

> opinion "in the course of the year of income". No doubt if a debt is written off as bad after a year of income has passed, it will be allowable as a deduction in the year in which the writing off takes place, provided of course that the other conditions laid down by the section are fulfilled.'

38. Furthermore, it is essential that a debt be in existence in order that it may be written off as bad. *Point v. F.C. of T.* (supra) also demonstrates that a debt cannot be written off after it has been settled, compromised, otherwise extinguished or assigned. In that case, the taxpayer released a debtor from a debt under a scheme of arrangement in the 1964 income year. In the following income year the taxpayer purported to write off the debt as bad under section 63. Owen J held that at the time of the purported writing off there was simply no debt in existence because it had been extinguished in the previous income year. A similar conclusion was reached in *Franklin's Selfserve Pty Ltd v. F.C. of T.* (1970) 125 CLR 52, 70 ATC 4079, 1 ATR 673 and *G.E. Crane Sales Pty Ltd v. F.C. of T.* (supra). Therefore, once a debt has been settled, compromised, otherwise extinguished or assigned no further amounts can be claimed as bad debts for the purposes of section 63. This principle equally applies where the extinguishment of the debt and the writing off of the debt occur in the same financial year. If the writing-off of the debt occurred after the extinguishment or the disposal of the debt, no deduction is allowable under section 63. It is, therefore, important that a creditor should not delay the writing-off process until after the debt is extinguished.

39. The mere writing-off of a debt does not necessarily relieve the debtor from ever having to pay the liability. If the financial position of the debtor subsequently improves or the circumstances which led to the debt being written off alter, action may be taken to collect the debt. However, no amount is to be treated as assessable income under subsection 63(3) until such time as the debt (or part of it) is recovered.

The debt must have been brought to account as assessable income

40. The requirement of paragraph 63(1)(a) that the debt was previously brought to account as assessable income presupposes a non-cash basis of returning income for tax purposes. For a taxpayer who operates on a cash receipts basis and lodges returns of income on that basis the taxpayer is not entitled to a deduction for bad debts. As the outstanding amount has not been received it has never been included in the assessable income of the taxpayer. Support for this view can be found in *Case P78* 82 ATC 381; 26CTBR(NS)Case10 (at ATC p.385, CTBR p. 92) which states that '[s]peaking generally, it is impossible for a taxpayer to properly claim a bad debt as a deduction

under sec.63 if he is conducting his business on a cash basis; the requirement of sec.63(1)(a) simply cannot operate in regard to such a business.'.

41. If a taxpayer is carrying on the business of lending money, it is not necessary that the debt be previously brought to account as assessable income provided it is in respect of money lent by the taxpayer in the ordinary course of a money lending business (paragraph 63(1)(b)).

Who is a 'money-lender'?

42. Paragraph 63(1)(b) is a specific provision relating directly to taxpayers who carry on the business of lending money and in the ordinary course of that business suffer a bad debt in respect of any money lent.

43. The question of whether a taxpayer is carrying on the business of lending money is necessarily a question of fact. However, the following passage of Bowen CJ in *F.C. of T. v. Marshall and Brougham Pty Ltd* 17 FCR 541, 87 ATC 4522, 18 ATR 859 at ATC p. 4528, ATR p. 866 provides some useful general guidelines on determining whether a taxpayer is a money-lender:

> 'It is generally accepted that in order to be regarded as carrying on a business one must demonstrate continuity and system in one's dealings. In the case of money lending it has been said that a person must hold himself out as willing to lend money generally to all and sundry (subject to credit-worthiness): see *Litchfield v. Dreyfus* [1906] 1 KB 584. It is not decisive whether the lender is a registered money-lender or not, although this will be a factor to take into account. It should be mentioned that it need not be the only business or the principal business of the taxpayer. It will be insufficient, however, if it is merely ancillary or incidental to the primary business. In the end, it will be a question of fact for the court to decide by looking at all the circumstances involved: see *Newton v. Pyke* (1908) 25 TLR 127.'

44. The frequently quoted statement of Farwell J in *Litchfield v. Dreyfus* [1906] 1 KB 584 at p. 589 that:

> 'Speaking generally, a man who carries on a money-lending business is one who is ready and willing to lend to all and sundry, provided that they are from his point of view eligible'

should not restrict the meaning of 'money-lender' for taxation purposes in light of the more recent Australian cases of *Fairway Estates Pty Ltd v. F.C. of T.* (1970) 123 CLR 153, 70 ATC 4061, 1 ATR 726; *F.C. of*

T. v. Marshall and Brougham Pty Ltd (supra); and *F.C. of T. v. Bivona Pty Ltd* 90 ATC 4168, 21 ATR 151.

45. These recent cases have highlighted the differences between the laws relating to the **control** of money-lenders and the laws relating to the **taxing** of money-lenders. In particular, the joint judgment in *FCT v. Bivona Pty Ltd* (supra) at ATC p.4173, ATR p.156 concluded that '[w]hether Farwell J.'s statement (in the *Litchfield* case) is consistent with modern authority is not a matter for us to consider because it is used in the context of moneylending legislation, whereas a different inquiry is involved in this case.'. *Litchfield v. Dreyfus* (supra) was a case under the Moneylenders Act 1900 (UK) and not under a taxing statute.

46. Accordingly, for the purposes of paragraph 63(1)(b), a money lender need not necessarily be ready and willing to lend moneys to the public at large or to a wide class of borrowers. It would be sufficient if the taxpayer lends moneys to certain classes of borrowers provided the taxpayer does so in a businesslike manner with a view to yielding a profit from it.

What does 'in respect of' mean?

47. The term 'in respect of' in the context of paragraph 63(1)(b) was considered by the Full Federal Court in *F.C. of T. v. National Commercial Banking Corporation of Australia Ltd* 83 ATC 4715,15 ATR 21. At ATC p. 4719, ATR p. 25 Bowen CJ, Fisher and Lockhart JJ in a joint judgment observed that:

> 'Bad debts which are "in respect of money lent in the ordinary course" of a money-lending business would in ordinary parlance encompass all constituents of the debt including principal and interest. To exclude interest from the subject matter of para. (b) is to depart from the natural and ordinary sense of the provisions. ... Once it is clear that the principal amount of the loan is within the scope of the paragraph then it becomes impossible in our view to construe the paragraph by including items such as costs and charges but excluding a basic component of the loan, namely interest.'

48. The term 'in respect of money lent' in paragraph 63(1)(b) is, therefore, to be given its widest meaning, and it includes not only the principal of the loan, but also any capitalised interest and associated costs, charges, fees etc.

Money lent in the ordinary course of the business of lending money by a taxpayer who carries on that business

49. The question has been raised as to whether the test that 'a taxpayer who carries on that business' in paragraph 63(1)(b) requires the taxpayer to be in the business of a money lender both at the time the loan was made and also when the bad debt is written off. It is clear that the money lending business must have been carried on at the time the loan was made. In *Fairway Estates* (supra) Barwick CJ (at ATC p. 4066, ATR p. 732) gave judicial support to this view. He took the view '... that the advance of the money in question should have been made by the claimant taxpayer in the ordinary course of the business of lending money **then** carried on by him.' [emphasis added]

50. In *Marshall and Brougham* (supra) Bowen CJ took a similar view (at ATC p. 4528, ATR p. 866):

> '...the taxpayer must be in the business of lending money **at the time of making the advance** in respect of which the deduction is claimed.' [emphasis added]

51. It is not so clear that a taxpayer must also be carrying on a money lending business at the time the debt is written off. There is some support from old Board of Review decisions that paragraph 63(1)(b) requires that a business of money lending be carried on at the time of writing off the debt. However, statements by Bowen CJ in *Marshall and Brougham* (supra) and Barwick CJ in *Fairway Estates* (supra) at ATC 4063, ATR 728, indicate that a taxpayer must only be in the business of money lending at the time the loan was made.

52. On balance we accept that a taxpayer does not have to be carrying on a business of money lending at the time the debt is written off in order to satisfy the requirements of paragraph 63(1)(b).

Sections 63A, 63B and 63C

53. Where the taxpayer claiming the bad debt deduction is a company the deductibility under either section 63 or section 51 is subject to the operation of sections 63A, 63B and 63C.

54. The effect of sections 63A and 63B is that a bad debt is not deductible unless there is a continuity of beneficial ownership of the company existing at all times both in the year the debt arose and in the year when the bad debt is written off or the loss is incurred.

55. Section 63C qualifies the operation of sections 63A and 63B in that where there is a continuity of carrying on the same business existing at the time immediately before the change in ownership and in the year in which the bad debt is written off or the loss is incurred, sections 63A and 63B will not operate to deny the deduction.

56. It is, therefore, clear that one or other of the tests outlined above must be satisfied by a company if it is to qualify for a deduction in respect of bad debts.

Section 51

57. Where a deduction for a bad debt is not allowable under section 63 it may nevertheless be allowable under section 51. Support for this view can be found in the following comments made by Jacobs J in *Marshall and Brougham Pty Ltd v. F.C. of T.* 86 ATC 4469 at p. 4474; 17 ATR 834 at p. 840:

> 'It is now well settled that a loss being a bad debt which may not be an allowable deduction under sec. 63(1) may nevertheless be an allowable deduction under sec. 51(1)...'

On appeal the Full Federal Court (87 ATC 4522, 18 ATR 859) endorsed the view of Jacobs J.

58. For a loss to be an allowable deduction pursuant to subsection 51(1) it must have been incurred in gaining or producing assessable income or in carrying on a business for the purpose of gaining or producing assessable income. In addition, the loss must not be of a capital, private or domestic nature.

59. In the circumstances of this Ruling the two important considerations will be whether a loss occasioned by a bad debt has been incurred and whether it is of a capital nature.

60. If a creditor realises a loss at the time it disposes of, settles, compromises or otherwise extinguishes a debt such a loss will, for the purposes of subsection 51(1), be incurred at that time.

61. Where, however, a debt could be considered to be bad but has not been disposed of, settled, compromised or otherwise extinguished a question may arise as to whether a loss has been incurred for the purposes of subsection 51(1). Dicta of Barwick CJ and Mason J (as he then was) in *AGC (Advances) Ltd. v. F.C. of T.* 75 ATC 4057; 5 ATR 243 suggest that a bad debt deduction is allowable under subsection 51(1) provided that the debt has been written off.

62. In *AGC (Advances)* Barwick CJ observed (at ATC p. 4065, ATR p. 252) that:

> 'The loss from **an accounting point of view** must occur at the time when the appellant accepts the position that the debt is irrecoverable. If a hire purchase company decided to wind up and to discontinue the granting of hire purchase agreements in a particular year, and in a subsequent year the company in liquidation found itself unable to recover instalment of hire on the goods in

> circumstances which caused it **to write the amount off as a bad debt**, it seems to me not merely unjust but unacceptable to hold that it could not deduct that loss as a loss which it had incurred in the course of gaining assessable income.' (emphasis added)

63. Comments of Mason J (ATC pp. 4071-4072, ATR p. 260) are also relevant. His Honour observed that:

> 'a loss constituted by the writing off of a bad debt is no doubt incurred, in the sense that it is sustained, at the time when the debt is written off . . . the loss may be said to be one which was incurred in the carrying on of a business . . . notwithstanding that its true character as a loss is not finally ascertained until the debt is written off'.

64. Support for the view that a bad debt deduction is not allowable under subsection 51(1) until such time as the debt is written off can also be found in the wording of sections 63A to 63C. These sections deny a bad debt deduction to companies under subsections 51(1) and 63(1) unless certain conditions are met. These conditions include the requirements that the debt be bad and be written off as such.

65. We are of the view, therefore, that a bad debt deduction is allowable under subsection 51(1) when it is written off. The tests in section 63 will apply in this situation (see paragraphs 31 to 36).

66. The availability of a deduction under subsection 51(1) for a loss occasioned by a bad debt is also dependant upon the loss not being of a capital nature.

67. The question of whether or not such a loss is of a revenue or capital nature depends upon a consideration of the facts and circumstances in each case. It is necessary to ascertain the circumstances which occasioned the loss and the relation that these circumstances bear to the taxpayer's income earning activities. If the loss is an ordinary incident of the taxpayer's income earning activities then the loss will be on revenue account. For example, a bad debt loss incurred by a financial institution would generally be expected to be a revenue loss.

68. In *Marshall and Brougham Pty Ltd v. F.C. of T.* (supra), for example, the taxpayer carried on business as a building contractor. The taxpayer frequently had to handle substantial cash funds in excess of its immediate needs. It placed these surpluses in interest bearing deposits, usually at call. An amount of $500 000 was placed on deposit with a finance company which subsequently collapsed. The loss was not an allowable deduction under subsection 63(1) because the Court did not consider that the taxpayer was carrying on the business of a moneylender. The Court determined, however, that the

loss was an allowable deduction pursuant to subsection 51(1) because of the connection between the loss and the activities of the taxpayer which where productive of assessable income.

Subsection 63(3)

69. In recognition of the difficulties in determining the extent to which a debt may be bad the Act contains a specific provision in subsection 63(3) to recoup any excessive write off of a debt.

70. Where a debt has been written off as bad but the whole debt or some portion of it is subsequently received, the receipt will constitute assessable income of the taxpayer in the year of receipt.

71. The allowance of a bad debt deduction under section 51, in lieu of section 63, does not affect the operation of subsection 63(3) to bring into assessable income any amount of the debt recovered by the taxpayer. A recent amendment made to subsection 63(3) clarifies that where a taxpayer receives an amount in respect of a debt for which a deduction has been previously allowed under section 51, the recovered amount is assessable under subsection 63(3). Although the amendment only applies after 26 February 1992, it does no more than confirm our view of the law before the amendment was made.

Partial debt write-offs

72. A taxpayer may write off a bad portion of a debt (partial debt) and be entitled to a deduction for that part only. Subsection 63(4) clarifies this position. Although the amendment only applies after 26 February 1992, it does no more than confirm our view of the law before the amendment was made.

Securities and partial debt write-offs

73. Generally, property in assets may be transferred to the creditor as security against the debt, or in satisfaction of the debt when the debt or a part of the debt becomes irrecoverable. Where the property is held as security against the debt, the legal title may be transferred to the creditor or the creditor may become a mortgagee in possession and obtain an equitable interest in the security (this would occur, for example, where a creditor enters into a power of sale arrangement). The right to deal with the security property does not usually crystallise until the debt cannot be paid (i.e. generally when the debt becomes bad). On the other hand, where the property is transferred to the creditor in satisfaction of the debt, the creditor is able to deal with it upon transfer.

74. Once the creditor is able to deal with the property, several options are open to the creditor. One option that is generally adopted is to sell the property immediately to recover the debt. The other options include the holding of the property expecting a more favourable market situation, or to further develop the property for future sale or retain for own use.

75. In any of these situations, the provision of the property may either:

(1) **satisfy the debt only to the extent of the net amount** realised from the sale or the value of the property if it is not sold immediately; or

(2) **fully satisfy the existing debt**.

(1) Partial satisfaction of the debt

76. Where property held as security against a debt is sold and the debt is discharged only to the extent of the net proceeds realised from the sale and the remaining debt is still outstanding, the remaining debt will be deductible as a partial bad debt **if the requirements of section 63 are met**. The remaining debt is any deficiency between the net proceeds of the sale of the property and the amount of the debt.

77. Where the property is valued but **not sold** and its market value is less than the debt outstanding, the difference between the market value of the property and the amount of the debt may be allowed as a partial bad debt deduction **provided also the requirements of section 63 are met**.

78. A deduction may also be available under subsection 51(1) in the circumstances outlined in paragraphs 76 & 77.. Whether or not such a deduction would be allowable under subsection 51(1) will depend upon the requirements in paragraphs 65 to 67 being met.

79. Upon eventual sale or disposal of the property, subsection 63(3) would operate to bring to account as assessable income any amount received that was in excess of the value of the property as determined when the debt was written off as bad. The subsection 63(3) amount is, however, limited to the amount previously allowed as a deduction. If the amount received upon the sale or disposal of the property exceeds the sum of the market value of the property at the time the debt was written off and the subsection 63(3) amount, the excess would generally be assessable under the ordinary income or capital gains provisions depending on the nature of the business carried on by the taxpayer.

(2) Full satisfaction of the debt

80. If property is taken **in full satisfaction of the debt** in such a way that the debt is fully discharged or extinguished (e.g. by foreclosure) and the market value of the property is less than the debt outstanding, the difference between the market value of the property and the amount of the debt is allowable as a partial bad debt deduction **provided the requirements of section 63 are met**. This means that a bad debt must be written off **before the debt is extinguished** (see paragraph 38 above). If this test is not met no deduction is allowable under section 63.

81. Where a bad debt deduction is not allowable under section 63, the loss may nonetheless be deductible under subsection 51(1) if the loss is of a revenue nature or taken into account under the capital gains tax provisions if it is of a capital nature.

82. When the property is subsequently sold, any profit or loss on disposal will be taken into account in the calculation of taxable income either under the general income/deduction provisions or under the capital gains tax provisions. Whether a deduction for any loss is allowable under section 51 will necessarily turn on the nature of the taxpayer's business and the property sold. The same considerations will need to be given to the inclusion of any profit on sale of the security under section 25. In the event that sections 25 and 51 do not apply the capital gains tax provisions may apply.

83. Assume, for example, that a financial institution forecloses a debt of $150 and receives property with a market value of $100 at that time. The $50 loss will be an allowable deduction under subsection 63(1) provided that the institution has written off $50 as a bad debt prior to the foreclosure. In the circumstances of this case the loss will also be an allowable deduction pursuant to subsection 51(1), although a deduction could not be claimed twice. For the purposes of calculating any gain or loss in respect of a subsequent disposal of the property the property will have an acquisition cost of $100.

Debt for equity swaps

84. A debt for equity swap occurs in circumstances where the debtor is unable to repay a debt, or part of a debt, and, after agreement with the lender, issues equity (usually shares) to replace the debt outstanding. The effect of the agreement is that the issue of the equity to the creditor is **in full satisfaction of the debt** such that the debt is discharged.

85. Sections 63E and 63F are specific provisions allowing deductions for losses (called "swap losses") in respect of debts extinguished in this manner after 26 February 1992. The allowable

loss is the amount by which the amount of the debt exceeds the value of the equity received in the swap.

86. Sections 63E and 63F only apply in respect of debt for equity swaps in which the debtor is a company, a trading trust, or a public unit trust and the debtor issues shares or units, as the case may be. The explanatory memorandum accompanying the introduction of sections 63E and 63F contains step by step examples which illustrate the operation of these provisions.

87. Prior to 27 February 1992 a bad debt loss arising out of a debt for equity swap may, depending on the circumstances, be an allowable deduction under either of subsections 63(1) or 51(1).

88. A deduction is allowable under subsection 63(1) provided that the requirements of section 63 are met, i.e., if the taxpayer had written off that portion of the debt that was bad (the deficiency between the debt owed and the market value of the equity to be issued) before the debt was discharged under the debt for equity swap agreement.

89. The following examples demonstrate the application of section 63 to debt for equity swaps carried out before 27 February 1992.

> **A**. A financial institution has a debt of $150, none of which has been written off as a bad debt. The institution and the borrower agree to enter into a debt for equity swap whereby $100 of the debt is to be applied in issuing the institution with 100 shares, with a par value of $1.00 each, in the borrower. These shares have a market value of $25.00 at the time of the swap. The remaining $50 of debt, which is not involved in the debt for equity swap, is clearly a bad debt. The tax treatment of the institution is:
>
> - $50 can be written off as a bad debt and a deduction claimed under paragraph 63(1)(b).
> - a further deduction would be allowable under paragraph 63(1)(b) for $75 (the difference between the amount of the debt involved in the debt for equity swap and the market value of the equity obtained in the swap) if the debt was written off as bad prior to the discharge of the debt under the debt for equity swap agreement.
> - for the purposes of determining whether a gain or loss is made on the subsequent disposal of the shares, the shares will have a cost of $25.
>
> **B**. A financial institution has a debt of $150 which has been written off as bad and in respect of which a deduction has

been allowed under section 63. Subsequently the institution and the borrower enter into a debt for equity swap agreement whereby $100 of the debt is applied in issuing the institution with 100 shares, with a par value of $1.00 each, in the borrower. These shares have a market value of $25.00 at the time of the swap. In this case the tax treatment of the institution is:

- $25 will be included in the institution's assessable income pursuant to subsection 63(3). The market value of the shares ($25) received in the debt for equity swap is a recovery in respect of a debt for the purposes of subsection 63(3).
- for the purposes of determining whether a gain or loss is made on the subsequent disposal of the shares, the shares will have a cost of $25.

90. Where a bad debt deduction is not allowable under subsection 63(1) a deduction may be allowable under subsection 51(1) for the loss arising out of a debt for equity swap. The availability of a deduction in these circumstances depends upon considerations such as the nature of the taxpayer's business and the degree of connection between the loss and the activities of the taxpayer which are productive of assessable income. For example, it is expected that a financial institution would generally be entitled to a deduction under subsection 51(1).

91. The explanation at paragraphs 80 to 83 above is also applicable to debt for equity swaps undertaken before 27 February 1992.

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