A CRITICAL ANALYSIS OF THE DEDUCTIBILITY OF BAD DEBTS FOR INCOME TAX PURPOSES

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ABSTRACT

The objective of this thesis was to critically analyse the deductibility of bad debts for income tax purposes. This was achieved by applying a doctrinal research methodology to the data, which consisted of local and international legislation and case law, as well as other relevant writings. In setting out to achieve this primary objective, this thesis addressed certain subsidiary goals. The requirements of section 11(i) of the South African Income Tax Act that provides for the deduction of bad debts were examined with reference to local case law, together with case law from selected international jurisdictions. To clarify the requirement of section 11(i) that a debt must have become bad, this thesis set out to ascribe a meaning to the term "bad debt" which is currently not defined in the South African Income Tax Act and to ascertain the principles applicable in determining when a debt will be regarded as having become bad. The research also addressed the timing in relation to the identification of a debt as bad, as well as other commercial considerations. This research concluded that there is a need for further guidance in this area and provided brief recommendations that could provide more certainty in relation to the deductibility of bad debts.

Key words: South African Income Tax Act; bad debts; carrying on a trade

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TABLE OF CONTENTS **PAGE**

CHAPTER 1: INTRODUCTION

1.1 CONTEXT OF THE RESEARCH

The objective of this research was to critically analyse the deductibility of bad debts for income tax purposes and in doing so, set out a general framework in terms of the which the provisions of section 11(i) of the South African Income Tax Act No. 58 of 1962 (referred to as "the Income Tax Act"), which provide for a deduction of bad debts, may be applied.

The preamble to section 11 and section 11(i) of the Income Tax Act states that:

> For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –
> (i) the amount of any debt due to the taxpayer which has during the year of assessment become bad, provided such amount is included in the current year of assessment or was included in previous years of assessment in the taxpayer's income.

The purpose of a special deduction provision in respect of debts that have become bad, as provided in section 11(i) of the Income Tax Act, is to permit a deduction of an amount that would not have qualified for deduction as a result of the restrictive provisions of the general deduction formula comprising of the preamble to section 11, section 11(a), which sets out what may be deducted, and section 23(g), which lays down what may not be deducted. (Stiglingh, Koekemoer, van Zyl, Wilcocks and de Swardt: 2017). A debt represents a capital asset and the write-off of an unpaid debt may be classified as a capital loss and would not qualify for deduction.

To qualify for deduction in terms of section 11(i) the bad debt must also satisfy the requirements of the preamble to section 11, which only permits a deduction if the taxpayer is engaged in the carrying on of a trade, that is, the bad debt must be an ordinary trade debt (*ITC 95*, (1927) 3 SATC 242 (U)). Trade is defined in section 1 of the Income Tax Act as:

> …every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use

> any patent as defined in the Patents Act, or any design as defined in the Designs Act, or any trade mark as defined in the Trade Marks Act, or any copyright as defined in the Copyright Act, or any other property which is of a similar nature.

In *SIR v Kempton Furnishers (Pty) Ltd*, 1974 (3) SA 36 (AD) 36 SATC 67, the court held that debts ceded to a purchaser as part of the sale of a business, and which were subject to a resolutive condition that such debts that the purchaser was unable to collect within a specified period would be re-ceded to the seller, were admissible as a deduction from the income of the seller once they had been re-ceded to him. In respect of the contention by the revenue authorities that section 11(i) was applicable only in respect of debts incurred and written off in the ordinary course of trade and not to trading debts which became irrecoverable after the disposal of a business, the court held the sale of a trade debt subject to a resolutive condition did not alter the nature of ordinary trading debts. In addition, it was conceded by counsel for the revenue authority that debts written off as bad after cessation of trade could be regarded as having been written off in the ordinary course of trade.

The Income Tax Act does not provide a definition of the term "bad debt". In *Venter v Rex,* 1907 TS 910 (at 913), it was held that where no specific meaning can be attributed to a term, that term must be given its ordinary meaning, provided that such ordinary meaning does not give rise to an absurdity that could not have been intended by legislation. The "ordinary meaning" of a "bad debt" referred to in *Venter v Rex* can be inferred from dictionary meanings:

- the *Oxford Dictionary* (Online) defines a "bad debt" as "a debt that cannot be recovered";
- a "bad debt" is defined in *The Macmillan Dictionary of Accounting* (Parker, 1992) as "an amount owing which is not expected to be received …"; and
- the *Oxford Learners Dictionary* (Online) defines a "bad debt" as "a debt that is unlikely to be paid".

Whilst the definition provided in the *Oxford Dictionary* implies that a debt must be absolutely irrecoverable before it can be regarded as a "bad debt", the meaning inferred from both the *Macmillan Dictionary of Accounting* and the *Oxford Learners Dictionary* implies by the use of the words "expected" and "unlikely", that an assessment as to the recoverability of the debt is required.

The term "bad debt" has also been considered in international tax jurisdictions.

- ➢ The United States of America Department of the Treasury Inland Revenue Service (2016, 39) defines a business bad debt as "a loss from the worthlessness of a debt".
- ➢ An exception to this rule is provided by the United States of America Department of the Treasury Inland Revenue Service in terms of Regulation 26 CFR 1.166-2(d)(3), which allows certain financial institutions to claim a deduction of a bad debt written off when it is charged off for accounting purposes. In rationalising this decision, the United States of America Department of the Treasury Inland Revenue Service (1991) stated that the nature of the entity and the loan should be considered in determining when a debt is considered to be bad.
- ➢ In an Australian ruling, TR92/18 (Australian Taxation Office: 1992), the following was stated in respect of claiming a bad debt deduction:
- ▪ the question as to whether a debt is bad is a matter of judgement having regard to all the relevant facts and circumstances at the time;
- ▪ provided that a *bona fide* decision is taken as to the recoverability of the debt, it will be accepted that the debt is bad;
- ▪ the debt will not be accepted as bad merely because a certain period has lapsed; and
- ▪ the debt need not be bad in the strict sense.
- ➢ In a New Zealand ruling, BR Pub 05/01 (Inland Revenue: 2005), it was established that the question as to whether a debt is bad was an objective one and should not be based on the subjective opinion of any particular individual.

A debt which has become bad is deductible only if it is an amount due to the taxpayer, that is, it must be an amount that is owing to the taxpayer on the last day of the year of assessment. In *ITC 451*, (1939) 11 SATC 103 (U), the court held that bad debts included as part of the sale of a business were not admissible as a deduction from the income of the seller, as such debts no longer belonged to him and did therefore not meet the requirements set out in section 11(2)(g) (now section 11(i)) to qualify for deduction.

Clegg and Stretch (2017: §11.6.3) state that:

> The determination as to whether a debt is bad must be made at the time that it is claimed as bad, and this is not affected by subsequent events. In practice the

> determination is often made at the time of the preparation of the annual financial statements rather than at the end of the year of assessment.

A bad debt must be deducted in the year of assessment in which it becomes bad. In *ITC 181*, (1930) 5 SATC 258 (U), a taxpayer sought to deduct an amount, being an accumulation of bad debts, from his income. The court, in dismissing the appeal, held that the amounts were not admissible as a deduction in view of the fact that the taxpayer had known they were irrecoverable prior to the year of assessment.

In *CIR v Delfos*, 1933 AD 242 6 SATC 92, it was held (at 106) that:

> When a debt has been allowed as a bad debt in the year of assessment, it does not lose its character as a bad debt for that year, even though it may happen that after the lapse of some years the financial position of the debtor has so much improved that he is able to pay the debt in full. Whether or not it was a bad debt during the year of assessment could only be decided according to the conditions then existing; subsequent events cannot influence the determination made in the year of assessment.

In terms of the proviso to section 11(i) of the Income Tax Act, a debt that has become bad must have been included in the taxpayer's income in the current or previous year of assessment to qualify for deduction. Income is defined in section 1 of the Income Tax Act as "… the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax …", and "gross income" in respect of a resident taxpayer is defined as "the total amount, in cash or otherwise, received by or accrued to or in favour of such resident … during such year or period of assessment excluding receipts or accruals of a capital nature." An amount owing that becomes "bad" and that comprised an amount that was exempt from normal tax (for example, dividends received that are exempt in terms of section 10(1)(k) of the Income Tax Act) would therefore not qualify for the section 11(i) deduction. Amounts that were excluded from "gross income" as they were of a capital nature would also not qualify for deduction in terms of section 11(i) (but would be subject to the capital gains tax provisions in the Eighth Schedule to the Income Tax Act).

The United States of America Department of the Treasury Inland Revenue Service (2016, 39) regards a business bad debt as a "debt that was either created or acquired in your trade or business, or closely related to your trade or business when it became partly or totally worthless." In *ITC 95*, it was stated (at 243) that: "It had to be proved satisfactorily by the taxpayer that he was a trader and that the debt he sought to deduct was bad, and further that the debt was incurred during his trading operations and by reason of his trading operations." It is submitted that an amount that has been earned in the ordinary course of trading operations carried out with a profit-making motive would fall within the ambit of the definition of gross income and income and when the debt subsequently becomes bad, it would meet the "income" requirement as contemplated in section 11(i).

A bad debt that would never have been included in income would not qualify for deduction in terms of section 11(i). In *ITC 95*, the court held that debts taken over as part of a purchase of a business, which became "bad", were not deductible as such trade debts acquired were capital assets and therefore constituted a loss of a capital nature. Due to its capital nature, such debt would therefore never have formed part of the income of the purchaser. In *Stone v SIR,* 1974 (3) SA 584 (AD), 36 SATC 117, it was explained (at 45) that a loan granted by the taxpayer and which had become irrecoverable could not be deducted as a bad debt in terms of section 11(i) as the capital portion of such loan would not have been included in the taxpayer's income.

Stiglingh, Koekemoer, van Zyl, Wilcocks and de Swardt (2017) explain that where a new partner joins a partnership and acquires a proportionate share of the debts owing to the partnership, any portion of the debts acquired that subsequently become bad will not be admissible as a deduction in terms of section 11(i) in determining the taxable income of the new partner, as the amounts would not have been included in the new partner's income in the current or previous year of assessment. The authors also submit that where a partner exits a partnership and the remaining partners acquire the interest in the debt owing to the exiting partner and such debt becomes bad, the remaining partners will not be entitled to claim a section 11(i) allowance on the portion of debt which was acquired from the exiting partner as it would not have been included in their income in the current or previous years of assessment.

Where a taxpayer is not entitled to a deduction in terms of section 11(i) due to the bad debt not having been included in income, the write off of such debt will give rise to a capital loss as the write of a bad debt falls within the ambit of the definition of "disposal" as contemplated in paragraphs 1 and 11 of the Eighth Schedule to the Income Tax Act. In terms of section 22 of the Value-Added Tax Act, No. 89 of 1991 (the VAT Act), where output tax has been levied on an amount that becomes irrecoverable, the taxpayer is entitled to an input tax deduction of an amount that bears to the total value-added tax (VAT) levied the same proportion as the portion that is irrecoverable bears to the total amount of the debt on which output VAT was levied. It is therefore the "net" amount of the debt that is written off for Income Tax purposes.

Due to the element of uncertainty surrounding the deductibility of bad debts under various circumstances, including the definition of a bad debt and the timing of when a debt will be regarded as bad, the courts have, on numerous occasions, been called upon to confirm the deductibility of a bad debt. The question that this thesis will address, therefore, is under what circumstances a taxpayer may claim a deduction for debts that have become bad.

This research focused on the deduction of bad debts as provided for in terms of section 11(i), or the "forgiveness" of debts as dealt with in section 19 of the Income Tax Act and paragraph 12A of the Eighth Schedule to the Income Tax Act and did not extend to a consideration of the tax treatment of doubtful debts. The scope of the research was limited to South African debts and did not take into consideration cross border transactions or foreign exchange aspects.

1.2 THE GOALS OF THE RESEARCH

The primary goal of the research is to critically analyse the deductibility of bad debts in arriving at a taxpayer's taxable income. The sub-goals are as follows:

- to clarify the meaning to be attributed to the term "bad debt";

- to determine the principles established by the courts, both local and in selected international jurisdictions, by the South African Revenue Service (SARS) and other relevant tax authorities, when dealing with bad debt deductions under various circumstances, including:

  - at what stage a debt becomes "bad";
  - the nature of the debts that will qualify for deduction from a taxpayer's income;
  - debts arising when a business is acquired, or disposed of, becomes insolvent or is wound up or deregistered;
  - debts that are ceded; and
  - partnership debts; and

- to provide a framework that will assist in identifying bad debts that will be deductible from income.

1.3 METHODS, PROCEDURES AND TECHNIQUES

A legal interpretative research approach was adopted for the present research as it seeks to understand and describe (Babbie and Mouton: 2009). The research methodology can be described as *doctrinal* research. This methodology involves the "systematic process of identifying, analysing, organising and synthesizing statutes, judicial decisions and commentary" (McKerchar, 2008:18-19). In adopting a doctrinal research methodology inductive logic was applied to the documentary evidence in a critical analysis of the principles and practices that relate to the deductibility of bad debts.

The research is conducted in the form of an extended natural language argument, supported by documentary evidence. The documentary data used for the research consists of tax legislation, local and international case law, journal articles, textbooks and other relevant writings.

The validity and reliability of the research and the conclusions was promoted by:

- adhering to the rules of the statutory interpretation, as established in terms of statute and common law;
- placing reliance on legislation, case law which creates precedent, or which is of persuasive value (primary data) and the writings of acknowledged experts in the field;
- discussing opposing viewpoints and concluding, based on credible evidence; and
- the rigour of the arguments.

As all the data are publicly available, no ethical considerations arose in relation to their use. Interviews were not conducted; opinions were considered in their written form. All sources of data were appropriately acknowledged, and full references provided.

1.4 OVERVIEW OF THE RESEARCH

This chapter introduced the area of research being undertaken and the uncertainty relating to the deductibility of bad debts. A brief discussion of the principles applicable to the research, the goals and sub-goals and a description of the research methodology applied in carrying out this research, were set out.

The goal of Chapter Two was to establish, based on legislation and the principles set out in relevant case law, a general framework in terms of which a deduction of bad debts may be claimed. In setting out to achieve this goal, this chapter analysed the concepts referred to in section 11(i) of the Income Tax Act to determine when the provisions of the section may successfully be applied to the deduction of bad debts.

With the general framework in terms of which a deduction of bad debts may be claimed having been established in Chapter Two, Chapter Three elaborated on the requirement of section 11(i) that requires a debt to have become bad to qualify for deduction. Chapter Three set out to ascribe a meaning to the term "bad debt" and to describe the principles applicable, as established in local and selected international legislation and case law, in determining when a debt will be regarded as having become bad. In ascribing a meaning to the term "bad debt", Chapter Three also referred briefly to the general rules of statutory interpretation to be applied in the interpretation of a word or term. Based on an analysis of local and selected international legislation and case law, this chapter also set out the tests and other relevant factors to be applied in determining when a debt will be regarded as having become bad.

In Chapter Four, the principles applicable to the timing of when a debt must be identified as bad, as well as other commercial considerations applicable to the deductibility of bad debts, were determined. The concepts established in international jurisdictions in respect of the conformity in the treatment of bad debts from a tax and accounting perspective were considered to determine the applicability in a South African context.

Chapter Five provides a conclusion on the research carried out in respect of the uncertainty relating to the deductibility of bad debts and makes recommendations relating to addressing the uncertainty in this regard.

CHAPTER 2: THE BASIS FOR THE DEDUCTION OF BAD DEBTS

2.1 INTRODUCTION

The preamble to section 11 and section 11(i) of the Income Tax Act state that:

> For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –
> (i) the amount of any debt due to the taxpayer which has during the year of assessment become bad, provided such amount is included in the current year of assessment or was included in previous years of assessment in the taxpayer's income.

The deduction of bad debts has, however, been the subject of many court decisions due to the uncertainty relating to applying the provisions of section 11(i). This chapter will examine the concepts included in section 11(i), in conjunction with relevant case law, to set out a general framework in terms of which a deduction of bad debts will generally be allowed. The goal of this chapter is therefore to set out the general principles that form the basis of the bad debt deduction. In setting out to achieve this goal, this chapter will address the principles applicable to the deduction of bad debts under various situations, including the deductibility of bad debts on acquisition, disposal and cessation of a business, cession of debts, and treatment of the bad debts of a partnership.

2.2 THE TRADE REQUIREMENT

The preamble to section 11 states that "for the purpose of determining the taxable income derived by any person from ***carrying on any trade***, there shall be allowed as deductions from the income of such person so derived …" (emphasis added). Williams states (2009:253) that: "Where the taxpayer claims expenditure as a deduction in terms of section 11(a) or any other sub-section of section 11, the question whether that taxpayer was engaged in trading is of immediate importance …". To qualify for deduction in terms of section 11(i) a bad debt must therefore also satisfy the requirements of the preamble to section 11, which only permits a deduction against income if the taxpayer is engaged in the carrying on of a trade, that is, the bad debt must be an ordinary trade debt (*ITC 95*).

Trade is defined in section 1 of the Income Tax Act as:

> …every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act, or any design as defined in the Designs Act, or any trade mark as defined in the Trade Marks Act, or any copyright as defined in the Copyright Act, or any other property which is of a similar nature.

In *Burgess v CIR*, 1993 (4) SA 161 (A) 55 SATC 185, EM Grosskopf JA stated the following (at 196):

> It is well established that the definition of trade, which I have quoted above, should be given a wide interpretation. In ITC 770 (1953) 19 SATC 216 at p 217 Dowling J said, dealing with the similar definition of 'trade' in Act 31 of 1941, that it was 'obviously intended to embrace every profitable activity and …I think should be given the widest possible interpretation.'

In determining whether a taxpayer is carrying on a trade, Stiglingh *et al* (2017) explain that the continuity of the activities and the long-term intention to earn a profit need to be examined. The authors acknowledge (2017: §7.2), however, that: "Continuity and profit motive are not pre-requisites … for the carrying on of a trade." In *De Beers Holdings (Pty) Ltd v CIR,* 1986 (1) SA 8 (A) 47 SATC 229, Corbett JA stated the following (at 260):

> …the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer's trade; and correspondingly moneys laid out in a non-profitable transaction may nevertheless be wholly or exclusively expended for the purposes of trade …. Such moneys may well be disbursed on grounds of commercial expediency or in order indirectly to facilitate the carrying on of the taxpayer's trade …

It is submitted that the facts and circumstances of each case must be examined as a whole in order to establish whether a taxpayer is carrying on a trade and that a taxpayer may nevertheless be regarded as carrying on a trade even though there is no profit motive or where the activities are carried out at a loss in order to gain some other commercial advantage that will support the carrying on of a taxpayer's trade.

The term “trade”, although widely defined, does not include activities which produce passive income in the form of interest, dividends, annuities and pensions (Stiglingh *et al*: 2017). Where passive income owing to the taxpayer subsequently becomes bad, such amount will not qualify as a deduction in terms of section 11(i) as the debt has not met the trade requirement as contemplated in the preamble to section 11 of the Income Tax Act. It is, however, the practice of the Commissioner in terms of Practice Note 31 (SARS: 1994) to allow a deduction of interest incurred in the production of interest income earned by taxpayers other than moneylenders, to the extent that such expenditure does not exceed the interest income, and this concession may be extended to the deduction of a bad debt in respect of other passive forms of income.

There has been some uncertainty as to when a debt that has become bad will be regarded as having arisen in the course of the taxpayer’s trade. The relevant case law establishes the principles and factors that the courts have referred to in determining when a debt will be regarded as having become irrecoverable in the ordinary course of the taxpayer’s trade. In *ITC 95,* the taxpayer acquired a business lock, stock and barrel. In terms of the sale agreement, the taxpayer acquired certain debts due to the seller in respect of advances that had been made by the seller to a certain company in the ordinary course of his business operations. The taxpayer continued to make advances to the same company subsequent to its acquisition of the business. During the year of assessment in question the debts taken over by the taxpayer in terms of the sale agreement, as well the debts actually advanced by the taxpayer, proved to be irrecoverable and were written off as bad debts. The taxpayer sought to claim a deduction of these bad debts. In respect of the debts acquired by the taxpayer on purchase of the business it was held that when the company purchased the business lock, stock and barrel it took over the assets of the company, including the book debts, and as the taxpayer was not in the business of buying book debts such loss could not be regarded as a trade loss. It was stated (at 243) that: “It had to be proved satisfactorily by the taxpayer that he was a trader and that the debt he sought to deduct was bad, and further that the debt was incurred during his trading operations and by reason of his trading operations.” Consequently, it was held that the bad debt acquired was not admissible as a deduction in terms of section 11(2)(g) (now section 11(i)) as the taxpayer had not lent the money, that is, these loans, although book debts due to the company, did not represent amounts that were incurred in the ordinary trading operations of the company. In respect of the advances actually made by the taxpayer, which became bad during the year of assessment, the court held that such bad debts were allowable as a deduction in terms of section 11(2)(g) as such advances were made by the taxpayer in the ordinary course of the taxpayer's business operations and could therefore be regarded as an ordinary trade loss.

In *Curtis v J and G Oldfield Ltd,* 1925 9 TC 319, a case decided in the United Kingdom, the company claimed a deduction of bad debts which had arisen as a result of several private transactions of the managing director recorded in the company's books. This debt had only been established after the managing director had passed away, at which point the debt was deemed to be valueless and was therefore written off as a bad debt in the company's books of account. The court disallowed the deduction on the basis that the money appropriated was an amount that had arisen outside the carrying on of that trade. Rowlatt J explained (at 330) the concept of a bad debt that has arisen in the course of trade:

> When the Rule speaks of a bad debt it means a debt which is a debt that would have come into the balance sheet as a trading debt in the trade that is in question and that it is bad. It does not really mean any bad debt which, when it was a good debt, would not have come in to swell the profits.

In *SIR v Kempton Furnishers (Pty) Ltd* (referred to in Chapter 1), the taxpayer disposed of, as a going concern, a furniture retail business. The assets forming part of the agreement of sale included certain trade debts that were sold at face value. These trade debts were subject to a resolutive condition in that debts that the purchaser was unable to collect within a specified period would be re-ceded to the seller. In the event that this occurred the taxpayer would be required to refund the purchaser the face value of the outstanding debts. During the year of assessment in question the taxpayer repossessed certain debts that the purchaser was unable to collect and refunded the face value of such debts to the purchaser. The debts that had been re-ceded to the taxpayer by the purchaser were re-entered as assets in the books of the taxpayer and were subsequently written off as bad debts. In submitting its return for the year of assessment in question the taxpayer claimed a deduction in terms of section 11(i) in respect of bad debts that had been re-ceded to it by the purchaser, being amounts that were irrecoverable at the point that the debts were repossessed.

The Commissioner sought to disallow the deduction on the basis that section 11(i) was not applicable in respect of debts that had been sold, whether under guarantee or not, and he contended that, as the loss suffered by the taxpayer represented a reduction in the selling price of the business, this represented a capital loss that was not deductible for income tax purposes. In respect of this contention by the Commissioner, reliance was placed on *ITC 449,* (1939) 11 SATC 98 (U) and *ITC 466,* (1940) 11 SATC 251 (U). In *ITC 449* the taxpayer sold his business as a going concern, including book debts that he undertook to guarantee if such debts proved to be bad. The taxpayer subsequently paid the purchaser an amount in respect of debts that had proved to be irrecoverable, accepted re-cession of such debts and claimed a deduction of these bad debts in the determination of his taxable income for the year of assessment in question. The Commissioner disallowed the deduction, against which the taxpayer appealed. The court disallowed the deduction on the basis that the profit earned from the sale of the business was capital in nature and the payment by the taxpayer to the purchaser of an amount equivalent to the bad debts had the effect of reducing the purchase price, therefore resulting in a capital loss that was not deductible. In *ITC 466* it was also held that the amount paid was not deductible, being a reduction of the purchase price of the business and as such a capital loss. In respect of these cases, Botha JA, in *SIR v Kempton Furnishers (Pty) Ltd* stated (at 69-70) that:

> The *ratio decidendi* in each case was that since the profit earned by the appellant on the sale of his business to the purchaser company was a capital profit, and the effect of the payment by the appellant to the purchaser company in terms of the guarantee was to diminish the purchase price by the amount of the payment, the sum so paid was a capital loss and so inadmissible as a deduction.
>
> In my respectful opinion, the reasoning in those cases is open to question. The effect of the payment and of the recession was not only to diminish the purchase price, but also to alter the subject-matter of the sale. The appellant was revested with the book debts concerned, and the purchaser was repaid the amount he had paid for such book debts. In effect the amount repaid to the purchaser was not a loss (whether capital or otherwise) but a readjustment of the purchase price and of the merx in terms of the provisions of the contract of sale. From a practical point of view, the position was no different from what it would have been if the book debts concerned had not originally been included in the sale.

It was further stated (at 70):

> …that the real underlying cause for the loss which the taxpayer sought to deduct from his income, was the irrecoverability of the trade debts, and not the reduction of the

> purchase price at which the business, including the debts, had been sold, which reduction was merely an effect of the irrecoverability of the debts.

It was also submitted on behalf of the revenue authorities that section 11(i) was only applicable in respect of debts that had been incurred and written off in the ordinary course of trade and not to trading debts that became irrecoverable after the disposal of business, or to trading debts written off as bad after re-cession to the seller in terms of an agreement of sale. In respect of this submission, the court held that the sale of a trade debt subject to a resolutive condition did not alter the nature of an ordinary trading debt. In respect of the contention by counsel for the revenue authorities that section 11(i) was only applicable in respect of bad debts that had originally been incurred in the carrying on of any trade and thereafter written off without the nature of the debt being altered from an ordinary trade debt, the court stated (at 71) that:

> Assuming the correctness of this submission, it may be that where a trader sells a trading debt outright and unconditionally, and thereafter voluntarily buys it back, the debt would lose its character as an ordinary trading debt, and that it would not, if thereafter written off as bad by the trader, be deductible in terms of s 11(i). It seems to me, however, that where the sale of a trading debt, subject to a resolutive condition, is dissolved by reason of the fulfilment of the condition, the sale of the debt must for all practical purposes, including the purposes of s 11(i), be regarded as not having taken place, although the sale, when concluded, was *perfecta*. In such a case the debt cannot be regarded as having changed its character from that of an ordinary trading debt.

The bad debts re-ceded to the seller were consequently held to be admissible as a deduction. In addition, it was conceded by counsel for the revenue authority that debts written off as bad after cessation of trade could be regarded as having been written off in the ordinary course of trade.

In respect of the deductibility of expenditure after the cessation of trade, the impact of the cessation of trading operations and when the expenditure was incurred will be examined in more detail. Although the cases discussed do not deal with bad debts, they establish principles that apply to the cessation of trade. In *ITC 411*, (1938) 10 SATC 238 (U), the court distinguished between a continuing business and a business that has completely ceased, in holding that interest expenditure incurred after the complete cessation of trading operations was not deductible. The concept of continuity in relation to deductibility of expenditure incurred on the cessation of trade was also considered in *ITC 1013*, (1963) 25 SATC 321 (F), where the taxpayer, an accountant, in partnership with another accountant entered into a lease agreement to obtain suitable premises in which to carry out their practice. The partnership was subsequently dissolved following which the taxpayer joined another firm and continued his profession as an accountant. Despite the dissolution of the partnership, the partners were nevertheless bound by the lease of the premises, which still had some time to expire. During the year of assessment in question, the taxpayer claimed a deduction of the rental expenditure that was his portion of the amount by which the rental expense had exceeded the rental income for the year of assessment in question. The Commissioner sought to disallow the deduction on the basis that the expenditure had not been laid out for the purposes of trade, being an obligation that was incurred by the original partnership. In arriving at its decision, the court stated that the partnership was not a legal persona but merely a vehicle of association through which the taxpayer carried out his profession and the dissolution thereof did not have the effect of precluding the rental from being an allowable deduction. It was stated (at 324-325) that:

> … in my view, with an individual who can carry on his profession either on his own or in partnership with others, there is a continuity of action even if he changes partners in the course of time, sufficient to warrant one saying that obligations incurred under one partnership which carry on even after the formation of a new partnership are obligations incurred for the purpose of trade and not necessarily capital obligations.

The fact that the taxpayer continued to carry on his profession as an accountant, although under a new firm after the dissolution of the partnership, was therefore a significant factor in determining that the rental expenditure incurred after dissolution of the partnership was allowable as a deduction.

In *ITC 1135*, (1969) 31 SATC 228 (R), it was stated (at 233) that:

> The weight of authority appears to indicate that a deduction is not allowable in respect of an expenditure incurred after the cessation of a business, unless there is continuity or link between the expenditure and the business income from which the deduction is sought to be made.

Based on the principles established in the above cases, it can therefore be concluded that the deduction of expenditure incurred after the cessation of trade will be prohibited if such expenditure relates specifically to the trade that has ceased. However, where on cessation of trade a taxpayer continues to carry on activities associated with that trade under a different name, new premises or other circumstances, then the trade requirement will nevertheless be regarded as having been met.

In respect of when the expenditure has been incurred and the deductibility thereof after the cessation of trade, the principles established in *COT v Cathcart*, 1965 (1) SA 507 (SRAD) 27 SATC 1 are relevant. In *COT v Cathcart,* the taxpayer, a retired architect, claimed a deduction in respect of damages and costs arising as a result of the settlement of a claim to compensate a client who had sued the taxpayer and his previous partner for breach of guarantee. The partnership had provided a guarantee that a building that it had designed would be waterproof. In the precursor to *COT v Cathcart*, *ITC 1029*, (1963) 26 SATC 54 (F) the Commissioner sought to disallow the deduction on the following basis:

- that the expenditure was not wholly and exclusively laid out for the purposes of the taxpayer's trade or in the production of his income;
- alternatively, that the amount was capital in nature;
- alternatively, that since the expense had been incurred after his retirement he was not entitled to a deduction of expenditure from his current income;
- alternatively, that if such expenditure was deductible, that the taxpayer was only entitled to a deduction of the portion that represents his share of the partnership existing at the time the contract was entered into with the client.

In respect of the first contention by the Commissioner, it was common cause that the provision of the guarantee for the waterproofing of the building designed by the partnership was given in respect of the taxpayer's trade as an architect. The guarantee was an obligation undertaken by the partnership in return for the employment of their services and could therefore be regarded as incidental to the income producing activities of the partnership. The court held that the payment in terms of the guarantee was not capital in nature, being expenditure incurred in the production of income. In respect of the third contention, the court referred to the judgement in *ITC 1013*, where it was held that expenditure incurred after dissolution of a partnership was regarded as an obligation having been incurred for the purpose of trade as the taxpayer had continued his profession following such dissolution. In *ITC 1029,* it was stated (at 58) that:

> Accordingly, I consider that if expenditure is deductible by a taxpayer while he carries on business, the fact that he ceases to carry on that business does not render such expenditure non-deductible provided that it arises out of the taxpayer's activities prior to the cessation of his business operations.

In respect of the final contention by the Commissioner, the court held that the taxpayer was only entitled to a deduction of a proportion of the damages and costs that he was obliged to pay in terms of the partnership agreement. Although it was subsequently held in *COT v Cathcart* that, in the absence of evidence indicating that the amount had been paid in respect of repairs or consequential damages, the taxpayer was not entitled to a deduction, the court stated (at 5) that:

> It does not seem to me, therefore, that it is a correct approach to look solely to the period when the event which gives rise to the expenditure occurs in order to determine whether it is expenditure solely and exclusively made in the production of income or for the purposes of trade. If the risk of incurring the particular type of expenditure in question is deliberately undertaken by contract in order to earn the income then, when that risk is fulfilled and the expenditure is in fact incurred, it is so closely connected with the performance of the business operation that it would be proper, natural or reasonable to regard it as part of the cost of performing the operation. It seems to me that such expenditure is properly deductible …

Based on the principles established in *COT v Cathcart* and *ITC 1029,* it can be concluded that on cessation of trade, expenditure that can be linked to the trade activities carried on prior to cessation of trading operations will be deductible.

De Koker and Williams (2017 §:7.17) state that:

> …it would appear that the general principle in operation is that an expenditure incurred under an obligation assumed – in the production of income and wholly and exclusively for the purposes of the trade conducted in that business – during the course of its existence will continue to be deductible despite the cessation of the business.

In respect of moneys lent by a taxpayer in the course of a money lending business, an Australian Tax Ruling, TR92/18 (Australian Taxation Office: 1992) considered whether a taxpayer was required to be in the business of lending money both at the time that the money was lent and when the debt was written off as bad. It was accepted that the taxpayer need not be in the business of lending money at the time the debt was written off to satisfy the requirements of the relevant provision of the Act. In support of this view, the ruling cited *Fairway Estates Pty Ltd v Federal Commissioner of Taxation,* (1970) 123 CLR 153, 1ATR 726, where Barwick CJ held (at ATC p. 4066, ATR p. 732) 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." The ruling also cited *Federal Commissioner of Taxation v Marshall and Brougham Pty Ltd*, (1987) 87 ATC 4522, 17 FCR 541, where Bowen CJ stated (at ATC p. 4528, ATR p. 866) that: "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."

Based on the principles established in relation to bad debts and the requirement of the preamble to section 11, a bad debt must meet the requirements of the preamble to section 11 to qualify for deduction in terms of section 11(i). It was established that the definition of trade is to be given the widest possible meaning and that the facts and circumstances of each case must be analysed to determine whether a trade is in fact being carried on. In respect of the factors that would be considered in determining if a trade was being carried out, Stiglingh *et al* (2017) explain that the continuity of activities and the long-term intention of the business to earn a profit needed to be established. The authors did, however, go on to state that although the intention to earn a profit was considered to be a significant factor in establishing whether a taxpayer was in fact carrying in a trade, these factors were not decisive. The decision in *De Beers Holdings (Pty) Ltd v CIR* (referred to in Chapter 1), where the court held that it was possible for an amount to be regarded as having been expended for the purposes of carrying on a trade where the activities were carried out at a loss to gain some other commercial advantage, provided judicial support for this view.

In determining when a bad debt will be regarded as having arisen in the ordinary course of a taxpayer's trade, in *ITC 95* it was held that debts acquired by a taxpayer in terms of a sale agreement and which subsequently became bad were not admissible as a deduction in terms of section 11(2)(g) (now section 11(i)) as such debts had not arisen as a result of the ordinary trading operations carried on by the taxpayer. In *SIR v Kempton Furnishers (Pty) Ltd* it was stated, in response to the contention by the revenue authorities that section 11(i) was applicable only in respect of debts incurred and written off in the ordinary course of trade and not to trading debts that became irrecoverable after the disposal of the business, including debts that were written off as bad after re-cession to the seller in consequence of the terms of the sale agreement, that the sale of a trade debt subject to a resolutive condition did not alter the nature of an ordinary trading debt.

Where trade had ceased, the impact of trading operations and the timing of the expenditure were considered to determine the deductibility of expenditure after the cessation of trade. On analysis of the relevant case law applicable it was established that expenditure incurred after the cessation of trade will not be deductible unless the expenditure can be linked to a continuing trade or profession carried on. The court held in *ITC 1029* and *COT v Cathcart* that expenditure incurred whilst a taxpayer carries on a business will be deductible on or after cessation of trade provided that such expenditure relates to the business carried out by the taxpayer prior to cessation of trade. In applying these principles to the deductibility of bad debts, it is submitted that bad debts will therefore be deductible after the cessation of trade where the debt that has become bad arose in consequence of the trade carried on prior to the cessation of trading activities. It is submitted that the bad debts of a moneylender will meet the trade requirement where such debt arose as a result of moneys lent in the course of a money-lending business.

2.3 DUE TO THE TAXPAYER

To claim a deduction of bad debts in terms of section 11(i) of the Income Tax Act the debt that has become bad must be an amount that is due to the taxpayer, that is, the amount must be owing to the taxpayer who is seeking to claim such deduction. In *CIR v People's Stores (Walvis Bay) Pty Ltd*, 1990 2 SA 353 (A) the court held that (at 10):

> That income, although expressed as an 'amount' in the definition of gross income' need not be an actual amount of money but may be 'every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value …including debts and rights of action.

The court went on to state (at 19-20) that: "…the words in the Act, "has accrued to or in favour of any person", merely mean "to which he has become entitled"."

In accordance with the principles set out in *CIR v People's Stores (Walvis Bay) (Pty) Ltd,* a debt will be owing to a taxpayer when he has become entitled to claim payment of the amount due.

Where a taxpayer disposes of his business including book debts, any debt included in the sale agreement that subsequently becomes bad will not be allowed as a deduction in terms of section 11(i) as such debt is ceded to the purchaser in terms of the sale agreement and is therefore not an amount that is due to the seller. In *ITC 451*, (1939) 11 SATC 103 (U), the taxpayer entered into an agreement in terms of which it sold its business to a company together with all its assets, including sundry debtors, less a reserve. During the year of assessment in question the taxpayer claimed a deduction in respect of certain debts that had become bad. The Commissioner sought to disallow the deduction, which decision was appealed by the taxpayer on the basis that the debts for which it sought to claim a deduction were debts that had been incurred in the ordinary course of trade and which were irrecoverable by the date of the sale agreement. The court dismissed the appeal holding that the sale of the business was entered into lock, stock and barrel and, as such, the debts for which the taxpayer sought to claim a deduction were no longer its property, being debts that had in terms of the sale agreement become the property of the new owner. It was stated (at 107) that "…the assets are all vested in the new company, and therefore the old company, the seller, which has received the advantage of the sale including the bad debts, cannot possibly be heard to say that it can set off bad debts, which are not its property." The court further stated that, as the sale of the business represented a transaction that was of a capital nature, there could be no deduction of the bad debts even if the debts had remained the property of the seller. In support of this contention the court made reference to *ITC 332*, (1935) 8 SATC 269 (U), where the sale of a business as a whole, together with all the assets, was considered to be a slump sale, a slump sale being defined as "the transfer of the whole, or part of a business undertaking that is capable of carrying out operations independently, for a lump sum consideration without assigning values to individual assets and liabilities" (Ramanujam, 2012: Online). It was held that bad debts sold as a capital item and which had not been incurred in the carrying on of the purchaser's trade could only be deducted against income and not capital.

The decision in *ITC 451*, aligns with the principle established in *ITC 342*, (1935) 8 SATC 368 (U). In this case the taxpayer disposed of his business and included in the assets sold were book debts. In terms of the sale agreement the taxpayer accepted liability for any loss suffered by the purchaser arising as a result of any book debts becoming bad. During the year of assessment in question the taxpayer sought to claim a deduction of debts for which it had provided a guarantee, and which had during the year become irrecoverable. The Commissioner disallowed the deduction, which decision was subsequently appealed by the taxpayer. The court stated (at 369) that:

> He could not, however, write this loss off as a loss of bad debts. The bad debts were no longer his; they had passed to the company. Therefore he cannot avail himself of the provisions of sec 11(2)(g) of Act 40 of 1925. There is no question here of proving debts to be bad to the satisfaction of the Commissioner, or of the Commissioner applying his mind to the question whether the debts were bad or not, because there were no bad debts at all which the Commissioner could take into consideration. These bad debts were clearly the bad debts of the company, which had become the cessionary of the bad debts by virtue of the deed of sale. Therefore the appellant could not claim to write them off. Consequently his contention that he is entitled to deduct this amount has no foundation in law. Accordingly, the appeal is dismissed and the assessment confirmed.

The court therefore dismissed the appeal, holding that the sale agreement had the effect of ceding the debts to the purchaser and as there had been no resale or re-cession of such debts to the taxpayer, he was not entitled to claim a deduction of the bad debts as debts due to him that had become irrecoverable.

This principle of ownership of the debt as a pre-requisite in claiming a deduction of debts that have during the year of assessment become bad was further established in *Cooper v Commissioner of Taxes,* (SR) 18 SATC 259 1952 (4) SA 277 (SR) where the court held that the taxpayer who had sold all of the assets of his business, including outstanding debts, was not entitled to a deduction of such debts that had become bad as they had become the property of the purchasing company. The court held (at 260) that:

> …the appellant had during the year of assessment in question, disposed of his entire assets and liabilities to the company. He had ceded by virtue of the sale of his business all his debts, good, bad or doubtful, to the company. They had become the property of the company and no longer belonged to him. Accordingly he no longer possessed any debts in respect of which he could make any claim …

In contrast to the above cases, the taxpayer in *SIR v Kempton Furnishers (Pty) Ltd,* who had sold his business together with book debts, subject to a resolutive condition that such debts which the purchaser was unable to collect within a specified period would be re-ceded to the seller, was successful in claiming a deduction of debts that had been re-ceded to him and which had subsequently become bad. The court held that (at 68): "The company had been revested with the ownership of the debts which had been incurred in the course of its trade and was entitled to write them off as bad."

In respect of debts that have been waived, Stiglingh *et al* (2017) explain that where a taxpayer negotiates with a debtor and waives the right to receive a portion of or the entire amount of payment from a debtor, such debt that has been waived is no longer an amount due to the taxpayer. Where a debt that has been waived is written off as bad, the taxpayer will not be entitled to claim a deduction in terms of section 11(i) in respect of the portion of the debt that has been waived as it is no longer an amount that is due to him. The authors go on to state that it is the practice of the Commissioner to allow a taxpayer to write off as a bad debt a loss that has arisen as a result of the compromise of a debt (Stiglingh *et al*: 2017). The compromise of a debt owing must be distinguished from the reversal of a debt by way of credit note, which would not fall within the scope of section 11(i) of the Income Tax Act.

In respect of the practice of the Commissioner, section 5 of the Tax Administration Act No. 28 of 2011 (referred to as "the Tax Administration Act") states that: "A practice generally prevailing is a practice set out in an official publication regarding the application or interpretation of a tax Act."

The Tax Administration Act states that an "official publication means a binding general ruling, interpretation note, practice note, or public notice issued by a senior SARS official or the Commissioner."

With respect to the authors' submission in respect of debts that have waived, it is submitted that, as the practice of the Commissioner to allow a deduction of bad debts where the debts have been compromised, does not constitute a "practice generally prevailing" that has been set out in an "official publication", this practice should not be relied upon and that the wording of section 11(i), that is, "debt due to the taxpayer", be adhered to within the parameters set out by legislation and legal precedent in order to give effect to the intention of the legislation.

In support of this view, paragraph 38 of the Australian tax ruling, TR92/18 (Australian Taxation Office: 1992) states (at 10) that: "it is essential that a debt be in existence in order that it may be written off as bad". The ruling cited *Point v Federal Commissioner of Taxes,* 1970 ATC 4021, that established that a debt that has been settled, compromised, extinguished or otherwise assigned cannot be written off as a bad debt. The court held that there could be no write-off of a debt as there was no debt in existence, the debt in question having been extinguished in the previous year of assessment. This outcome was also determined in *GE Crane Sales Pty Ltd* v *Federal Commissioner of Taxes,* 1971 71 ATC 4268, where the taxpayer had entered into an arrangement in terms of which the taxpayer gave up any beneficial interest in the debt owing to it. The taxpayer sought to claim a deduction of bad debts, being the difference between the amounts originally owing to him and the amount that had been accepted in full settlement of the claim for such debts. The Commissioner submitted that once the taxpayer accepted the claim in full and final settlement of the debt owing, the balance of the amount was not an amount still owing, that is, by acceptance of the claim, the balance of the debt was extinguished and could not be regarded as a debt due to the taxpayer. Consequently, it was held that the taxpayer was neither owed the debts nor was he entitled to them and as such the debts in question were not deductible as they were no longer bad debts that were owing to him. The court did go on to state that, if the irrecoverable portion of the debt had been written off before the settlement arrangement had been entered into, the balance would have been deductible, whereas once the settlement arrangement had been entered into the balance of the debts owing to the taxpayer were extinguished and could therefore not be claimed as a deduction as it was no longer an amount owing to the taxpayer.

To qualify for deduction in terms of section 11(i) the debt that has become bad must be an amount that is owing to the taxpayer. Based on the principles established in case law as detailed above, it is submitted that the seller of a business will not be entitled to claim a deduction of debts that have been ceded to the purchaser in terms of a sale agreement and that have subsequently become bad, as they are no longer an amount due to the seller.

Similarly, where a debt has been waived, compromised or dealt with in any other way, such that the taxpayer is no longer entitled to repayment thereof, then the taxpayer will not be entitled to claim a deduction of such debts as the debt is not an amount owing to the taxpayer.

2.4 A DEBT THAT HAS BECOME BAD DURING THE YEAR OF ASSESSMENT

The next chapter will explore the meaning to be attributed to the term "bad debt". Assuming the amount constitutes a "bad debt", this section of the chapter will establish when a taxpayer is entitled to claim a deduction of bad debts, based on legislation and relevant case law applicable. In terms of section 11(i), a taxpayer is entitled to claim a deduction of bad debts that have become bad during the year of assessment, subject to the other requirements of the provision.

In *ITC 592*, (1945) 14 SATC 243 (U), the court dealt with the question of when a taxpayer was entitled to claim a deduction of bad debts. The taxpayer claimed as a deduction, certain debts that were written off as bad during the year, such debts having arisen many years ago and for which no payments had been received for a considerable period. The Commissioner sought to disallow the deduction on the basis that the debts should have been established as bad prior to the year of assessment. The Commissioner acknowledged that while the requisites of section 11(2)(g) had been met, it was implied or to be gathered from the general terms of the Income Tax Act that a taxpayer should only be allowed to claim the deduction in terms of this section when he first ascertained or should have ascertained that the debts were bad. The court referred to the decision in *ITC 181*, where it was established that a deduction of bad debts must be claimed by a taxpayer when he first regards the debt as bad and cannot be brought in as a deduction in a later year. In the present case evidence was presented establishing that the taxpayer had a practice of giving his customers extended terms of credit and that payments were frequently made over several years. When questioned about this practice, the taxpayer indicated that he gave extended credit terms to his customers in the hope that he would be able to recover the amount owing to him and that it was only during the year of assessment in question that he finally determined that these debts were in fact bad. The court therefore held that the taxpayer was entitled to a deduction of the bad debts in question based on the manner in which he carried out his business and the fact that the taxpayer had established that he had only come to the conclusion that the debts, claimed as a deduction in terms of section 11(2)(g), were bad during the year of assessment in question.

In *ITC 181*, (1930) 5 SATC 258 (U), the taxpayer, a manager of an insurance company, incurred bad debts for many years in respect of commission advanced to sub-agents that he was unable to recover from the sub-agents when the stop orders and premiums on which basis the commission had been paid were dishonoured or revoked. The taxpayer claimed an accumulation of these bad debts as a deduction from his income for the year of assessment in question. The Commissioner sought to disallow the deduction on the basis that the taxpayer had known that the advances made to the sub-agents were irrecoverable in the years of assessment in which they had failed to make payment and it was in these years that the taxpayer should have written off the debt as bad and claimed a deduction of the bad debts in terms of section 11(2)(g) of the Income Tax Act. The court held that the amounts were not admissible as a deduction in view of that fact that the taxpayer had known that the amounts were irrecoverable prior to the year of assessment.

In *ITC 253,* (1932) 7 SATC 53 (U), another case that dealt with the timing of a bad debt deduction, the taxpayer who carried on business as a trust company made an advance to an industrial company in the course of its business. A few years later, upon realising that the industrial company was in financial difficulty and that it would not be able to recover the amount of debt due to it, the taxpayer transferred the debt to a contingency account and wrote off amounts to it occasionally. In its books of account a few years later, the taxpayer sought to transfer the balance in the contingency account and to claim a deduction of bad debts in that year of assessment. The Commissioner disallowed the deduction on the basis that the debts had not become bad during the year of assessment during which the taxpayer was seeking to claim the deduction. The taxpayer appealed against the Commissioner's decision. The court dismissed the appeal on the grounds that section 11(2)(g) was not applicable in the present case as the debts in question had proved to be bad prior to the enactment of the Income Tax Act in South Africa and that the amounts would not have qualified for deduction in any case as the debts had proved to be irrecoverable prior to the year of assessment.

Clegg and Stretch (2017: §11.6.3) state that:

> The determination as to whether a debt is bad must be made at the time that it is claimed as bad, and this is not affected by subsequent events. In practice the determination is often made at the time of the preparation of the annual financial statements rather than at the end of the year of assessment.

In *CIR v Delfos*, the taxpayer, a managing director of a company, was entitled to certain remuneration and fees in terms of his appointment, of which only a portion was received by him for the years of assessment in question owing to the financial position of the company. In respect of each of these years of assessment the amounts owing to the taxpayer were credited to him in the books of the company. The taxpayer was subsequently paid the balance of the amount, being the accumulated arrears owing to him. During the years of assessment during which the taxpayer was not paid the full amount due to him in respect of remuneration and fees, the taxpayer submitted in his return only the amount that had actually been received by him. When this was queried by the revenue authorities, the public officer of the company advised that due to the financial position of the company it was likely that the taxpayer would never receive the money owing to him but that in the event that the company paid the amount in whole or in part it undertook to notify the Commissioner. The taxpayer was therefore assessed for tax for the years of assessment in question on the amounts that had actually been received by him with the amounts owing to the taxpayer being treated by the revenue authority as a bad debt in terms of the section 11(2)(g).

In respect of the year of assessment in which the taxpayer received payment of the accumulated arrears the Commissioner included in his taxable income the amount that had been received by him. The taxpayer appealed against the assessment on the grounds that the amounts should be assessed for tax in each of the years in which such amounts had accrued to the taxpayer, that is, additional assessments should be raised in respect of each of the years of assessment to which the balance of fees and remuneration related. The Commissioner contested the appeal on the basis that the arrears had been allowed as bad debts for the years of assessment in question and that the recovery of such debts constituted income in the year of assessment in which they were received by the taxpayer. The Special Court found that, as the amounts received by the taxpayer in respect of accumulated arrears had accrued to the taxpayer in those years, it was only in those years of assessment in which such amounts could be assessed as income. The Court further stated that the only remedy available to Commissioner was to exercise his powers in terms of section 45(1) of the Income Tax Act No 40 of 1925. The Commissioner, on the premise that such decision had been erroneously made, submitted the following questions for consideration to the Transvaal Provincial division (at 93):

(a) Did the amounts which were credited to the appellant in the books of the Company in the previous years which were not paid to him in those years accrue to or in favour of the appellant in those years?

(b) If the amounts accrued to the appellant in the previous years and were allowed as bad debts, did they in the subsequent year in which they were received become portion of the appellant's income for that year and as such taxable for that year?

The Transvaal Provincial Division answered question (a) in the affirmative and question (b) in the negative stating (at 93) that "a debt which had accrued in a particular year of assessment must be considered as appropriated to that year, and that subsequent changes with regard to that debt would not bring it into the income of a subsequent year." The Commissioner appealed against this decision. The issue in question was whether the bad debts, when recovered in a subsequent year, should be regarded as the income in the year in which it was received or in the year when it should have been received. In respect of the submission that section 45(1) of the Income Tax Act No 40 of 1925 was available as a remedy it was stated (at 100) that:

> Section 45(1) does not contemplate bad debts at all. It provides that if at any time the Commissioner is satisfied that any amounts *which should have been subject to tax* have not been assessed to tax, then even if assessments may have been made in former years upon the taxpayer, the Commissioner will not be prevented from raising an assessment in respect of such amounts as should have been subject to tax but were not in fact taxed. Now when a portion of a debt which has actually accrued during the year of assessment is left out of the assessment because in the opinion of the Commissioner it is a bad debt which is not likely to be recovered, then it is not an amount which "should have been subject to tax". It is in fact an amount deducted from the gross income and never forms part of the taxable income (sec 11(2)(g). Therefore sec 45(1) cannot be invoked in order to reopen the assessments of the years … and to bring into those past years the unpaid portion of the respondent's salary.

On appeal by the Commissioner, it was stated that, in respect of each of the years of assessment during which the taxpayer had been paid only a portion of the fees and remuneration owing to him, it was the full amount that had accrued to him that the Commissioner was entitled to levy tax upon. However, where there was any doubt as to whether any portion of the amount owing would actually be paid to him, then such amount could be deducted as a bad debt in terms of section 11(2)(g). It was also stated that there was no provision in the Income Tax Act in terms of which the Commissioner could assess the taxpayer for the portion of the salary received and then at a later stage assess the balance of the salary due for that year when actually received. It was stated (at 103) that:

> The Legislature could never have intended that where bad debts of past years are paid in a future year, the whole matter should be re-opened, for if it did so intend, it would have said so, knowing full well, as we must assume, how impracticable that would be from a bookkeeping and business point of view.

The uncertainty in this case arose partly due to the impression that a bad debt allowed as deduction and which was subsequently recovered ceased to be a bad debt for that year, and partly due to the misconception that in terms of section 45(1) of the Income Tax Act No 40 of 1925 the Commissioner had the authority to subject a bad debt that has subsequently been recovered to tax in the year in which the debt originally accrued, effectively negating the claim for a bad debt deduction in the year of assessment in which it was claimed. In respect of the question as to whether bad debts allowed as a deduction in previous years became income in the year of assessment in which such debts were subsequently recovered, Curlewis, J.A. stated (at 105-106) that:

> Whether a debt is bad or not must be decided at the time when the debt is returned as an accrual for the income tax year and according to the then existing financial circumstances of the debtor. And if it is proved to the satisfaction of the Commissioner that it is a bad debt and is allowed to be deducted from the "income" of the taxpayer and the assessment is then made and the tax levied on the "taxable income" is calculated on the "taxable amount", the assessment becomes final and conclusive under sec 56(5) if no appeal takes place. And as far as this bad debt is concerned it is final and conclusive not only as against the taxpayer but also against the Commissioner, notwithstanding sec 45(1), because that section cannot relate to an amount which has been allowed by the Commissioner as a bad debt and thus deducted from "income" to arrive at "taxable income". Sec 45(1) only applies to an amount which the Commissioner is satisfied "should have been subject to tax", whereas by having allowed the amount of the bad debt to be deducted in the assessment the Commissioner confessedly makes that amount one that should not be subject to tax, and therefore that amount can never come within the scope of sec 45(1). When a debt has been allowed as a bad debt in the year of assessment, it does not lose its character as a bad debt for that year, even though it may happen that after the lapse of some

> years the financial position of the debtor has so much improved that he is able to pay the debt in full. Whether or not it was a bad debt during the year of assessment could only be decided according to the conditions then existing; subsequent events cannot influence the determination made in the year of assessment.

The court referred to an English case, *Anderton and Halstead Ltd v Birrell,* (1932) 1 KB 271, in support of the contention that the determination of when a debt is bad must be made at the time the bad debt is claimed as a deduction and quoted the following extract (at 209):

> What the statute requires, therefore, is an estimate to what extent a debt is bad, and this is for the purposes of a profit and loss account. Such an estimate is not a prophecy to be judged as to its truth by after events, but a valuation of an asset *de praesenti* upon an uncertain future to be judged with regard to its soundness as an estimate upon the then facts and probabilities.

The questions posed by the Commissioner were therefore answered in the affirmative upon appeal and it was held that the bad debts that were subsequently recovered constituted gross income for that year of assessment being an "amount received" as contemplated in the definition of gross income in section 1 of the Income Tax Act.

Where a debtor becomes insolvent in a specific year of assessment, a section 11(i) deduction may only be claimed in the year of assessment in which the debtor went insolvent or earlier if the debt became bad prior to insolvency (Stiglingh *et al*: 2017). The authors go on to state that if a taxpayer has not claimed such deduction in the year of assessment in which it has become bad then the only remedy available to the taxpayer is to request a correction of the assessment in the year in which the debt became bad (Stiglingh *et al*: 2017).

Based on the principles established by the courts in respect of the timing of a bad debt deduction, it has been established that a deduction of bad debts may only be claimed in the year of assessment in which such debt is finally regarded as bad. In *ITC 592* the court found that it was necessary to take into consideration the manner in which the taxpayer carried out his business and the reasons provided by the taxpayer for not having found that the debt was bad in previous years of assessment. In *ITC 181* the bad debts were found to be inadmissible as a deduction for the year of assessment, as the debts in question were known by the taxpayer to be irrecoverable prior to the year of assessment in which such debts were claimed as a deduction. It was therefore established by the courts that a taxpayer is not entitled to accumulate bad debts and claim them in a later year of assessment, that is, the debt must have become bad during the year of assessment for it to be claimed as a deduction in that year. This principle was reiterated in *ITC 253*, where it was held that the Income Tax Act was not applicable to the debts in question as they had become bad prior to the enactment of the Income Tax Act and had it been applicable the debts in question would not have qualified for deduction as they had become irrecoverable prior to the year of assessment. The determination as to when a debt is regarded as having become bad must be made at the time that it is claimed as bad, based on the knowledge existing at the time, and cannot be amended or corrected based on subsequent events. In *CIR v Delfos* it was held that where a debt is found to be bad and claimed as a bad debt deduction in a year of assessment, the fact that this may subsequently be recovered does not affect the assessment for the year in which such bad debt was claimed as a deduction. The principle established in this case is that in determining whether a debt is bad, the financial circumstances prevailing at the time must be considered and the fact that the financial position of the debtor may improve in a subsequent year should have no bearing on the assessment of the debt as bad in the year in which it was claimed as a deduction.

2.5 INCOME AND EXEMPT INCOME

In terms of the proviso to section 11(i) of the Income Tax Act, a debt that has become bad must have been included in the taxpayer's income in the current or previous year of assessment to qualify for deduction. "Income" is defined in section 1 of the Income Tax Act as "… the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax" and "Gross income" is defined as:

> Gross income, in relation to any year or period of assessment means-
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,
> during such year or period of assessment, excluding receipts or accruals of a capital nature …

An amount that has been received or accrued to a taxpayer may therefore form part of gross income, but such amount may be excluded from income and hence not subject to the imposition of normal tax, due an exemption provided in terms sections 10, 10A, 10B or 10C of the Income Tax Act. The United States of America Department of the Treasury Inland Revenue Service (2016) defines a business bad debt (at 39) as a "debt that was either created or acquired in your trade or business, or closely related to your trade or business when it became partly or totally worthless." In determining what amount will constitute income, Stiglingh *et al* (2017: §8.5) state that "a bad debt arising from the sale of goods is deductible, since the amount of the debt will have been included in the seller's income when the debt arose." It was established in *CIR v Pick 'n Pay Employee Share Purchase Trust,* 1992 (4) SA 39 (A) 54 SATC 271, that the proceeds from carrying on of a trade will form part of income, where such trade is carried out with a profit-making purpose. It is therefore submitted than an amount that has been earned by a taxpayer in the ordinary course of trading operations carried out as part of a profit-making scheme would fall within the ambit of the gross income definition and when the debt subsequently becomes bad, it would meet the income requirement as contemplated in the proviso to section 11(i).

An amount that would never have formed part of a taxpayer's income, either due to that fact that it did not meet the definition of gross income in section 1 of the Income Tax Act or because such amount was exempt from normal tax, will not qualify for deduction in terms of section 11(i). An amount due to a taxpayer that has become "bad" and that consisted of an amount that was exempt from normal tax (for example, dividends that are exempt from tax in terms of section 10(1)(k) of the Income Tax Act) would therefore not qualify for deduction in terms of section 11(i). In *ITC 95*, the court held that debts acquired by the taxpayer on purchase of the company represented capital assets and when such debts subsequently became bad such loss was of a capital nature and therefore not admissible as a deduction in terms of section 11(2)(g). Due to their capital nature these debts would therefore never have formed part of the gross income or the income of the purchaser of the business. Where the amount that has become bad comprises an amount lent by an employer to an employee, this will not be admissible as a deduction in terms of section 11(i) as this amount would never have been included in the income of the employer. In *Stone v SIR,* it was explained (at 45) that a loan granted by the taxpayer and which had become irrecoverable could not be deducted as a bad debt in terms of section 11(i) as the capital portion of such loan would not have been included in the taxpayer's income.

An irrecoverable loan to an employee must be distinguished from a loan granted by a taxpayer who is engaged in carrying out a money lending business, as an amount lent by a taxpayer in the course of carrying on a money lending business that subsequently becomes bad will be allowed as a deduction in terms of section 11(i) as the amount due would have been included in the taxpayer's income in the current or previous year of assessment.

Regarding whether a loss incurred by a moneylender in respect of loans granted may be deducted in terms of section 11(a), Stiglingh *et al* (2017: §8.5) state that:

> Section 11(*i*) does not prevent a finance company or a moneylender from writing off moneys lent that prove to be bad. Such losses are, however, deductible in terms of s 11(*a*) as losses incurred in the production of income and not of a capital nature. Similarly, when it is satisfactorily established that it is the custom of a business or profession to make advances to customers or clients as an integral part of the business carried on for the purpose of securing or retaining business, losses arising from these advances that prove irrecoverable are allowable deductions in terms of s 11(a).

The assertion by Stiglingh *et al* that the bad debts may be claimed in terms of section 11(a) is, with respect, submitted to be incorrect, as section 23B(3) prohibits the deduction of any expenditure or loss in terms of section 11(a), where an allowance may be granted under any other provision of the Act. The loss of an irrecoverable advance by a moneylender or by the businesses or professions referred to in the above quotation, are nevertheless deductible in terms of section 11(i).

In determining the deductibility of bad debts by a partner who has entered a partnership, Stiglingh *et al* (2017) explain that where a new partner joins a partnership and acquires a proportionate share of the debt owing to the partnership, any portion of such debts that subsequently become bad will not be admissible as a deduction from the income of the new partner. The authors go on to explain that section 11(i) would not be applicable in determining the taxable income of the partner as no portion of the debt acquired that subsequently becomes bad would have been included in the taxpayer's income in the current or previous year of assessment. It is further submitted by the authors that upon a partner's exit from a partnership, the remaining partners who have acquired the exiting partner's interest and any debt owing will not be entitled to a bad debt deduction in terms of section 11(i) if such debt becomes bad, as the portion of the debts acquired would not have been included in their income in the current or previous year of assessment.

2.6 BURDEN OF PROOF

In terms of section 102 of the Tax Administration Act No. 28 of 2011:

> A taxpayer bears the burden of proving-
> (a) that an amount, transaction, event or item is exempt or otherwise not taxable;
> (b) that an amount or item is deductible or may be set-off;
> (c) the rate applicable to a transaction, event, item or class of taxpayer;
> (d) that an amount qualifies as a reduction of tax payable;
> (e) that a valuation is correct; or
> (f) whether a 'decision' that is subject to objection and appeal under a tax Act, is incorrect.

In applying this principle to the deductibility of bad debts, it was found in *ITC 933*, (1960) 24 SATC 347 (C), that the taxpayer had not discharged this onus. The taxpayer, having derived income from employment as the manager of a business in addition to rental, interest and dividends, sought to claim a deduction of a bad debt in respect of the capital and interest owing on a loan that it had advanced to H in the carrying on of business as a moneylender. The Commissioner disallowed the deduction claimed. The taxpayer objected on the grounds that he had carried out a money-lending business for a number of years and that as the bad debt had been incurred in the course of carrying out this business he should be allowed to claim the irrecoverable loan as a bad debt. To determine whether the taxpayer was in fact carrying on business of a money lender, the court stated that it was necessary to look into certain factors, that is, the continuity of operations and rate of interest, amongst others, as it was necessary to establish whether the income had been derived from investment of the money or the business of lending money. Based on a review of the taxpayer's loan transactions it was established that the main features of the loans were of an investment nature and not of money lending. Van Winsen J. stated (at 352) that:

> There is no evidence before the Court from which it can be deduced on a balance of probabilities that these loans constituted money-lending transactions. They may do so,

> of course, but the appellant has certainly not discharged the onus of proving this. This leaves one with the H transactions. Of all the loan transactions undertaken by appellant these appear to be closest to the type of transaction which one would expect to take place in the course of a money lending business.

The court took into consideration whether a number of loans to a single client could be considered as having been carried out in the course of a money lending business and reference was made to the judgement in *CIR v Stott*, 1928 AD. 252 3 SATC 253, where the court acknowledged that an isolated activity could be regarded as the carrying on of a business. It was stated that the loan to H should be considered in light of the taxpayer's loan transactions as a whole. Based on this, the court held that the taxpayer had not discharged the onus of proving that the bad debt had been incurred in the course of carrying out a money lending business and as such the bad debt was not deductible.

2.7 OTHER TAX CONSIDERATIONS

2.7.1 RECOUPMENT OF BAD DEBTS IN TERMS OF SECTION 8(4)(a)

In terms of section 8(4)(a) of the Income Tax Act:

> There shall be included in the taxpayer's income all amounts allowed to be deducted or set off under the provisions of sections 11 to 20 … or under the corresponding provisions of any previous Income Tax Act, whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment …

In applying this provision to bad debts that have, in terms of section 11(i), been claimed as a deduction in the current or previous year of assessment, the whole of or portion of such debt that has been recovered will be included in the taxpayer's income in the year of assessment in which such debt is recovered. In *ITC 1318,* (1980) 42 SATC 256 (T), the taxpayer company engaged in prospecting for minerals through subsidiary companies. In terms of its arrangement with the subsidiary companies the taxpayer would loan the subsidiary amounts required to carry out this activity. Where these operations proved to be unsuccessful the taxpayer was entitled to capitalise the loan by the issue of shares in the subsidiary. The funds generated from such issue would be utilised by the subsidiary to repay the taxpayer's loan, thus enabling the taxpayer to deregister the subsidiary, which was considered to be an easier process than applying for liquidation. The taxpayer, having incurred a loss in this regard where the efforts of a subsidiary proved to unsuccessful, claimed a deduction of bad debts in its determination of taxable income. An amount was subsequently paid by the subsidiary to the taxpayer arising as a result of the issue of shares in the subsidiary to the taxpayer. The court held that the amount recovered represented a recovery of bad debts that had previously been written off and as such the bad debts recovered must be included in the taxpayer's income in terms of section 8(4)(a) of the Income Tax Act for the year of assessment in which it was so recovered.

2.7.2 VALUE-ADDED TAX

A taxpayer registered as a vendor levies output tax in terms of section 7(1)(a) of the Value-Added Tax Act No. 89 of 1991 (referred to as the VAT Act), on the supply of goods or services in the course or furtherance of an enterprise. The VAT Act provides for two types of taxable supplies, namely, taxable supplies on which VAT is levied at the standard rate, which is presently 14%, or zero-rated supplies to which a zero rate is applied (Stiglingh *et al*: 2017). In the course of carrying on its business, where output tax has been levied by a taxpayer on an amount that subsequently becomes bad, section 22 of the VAT Act provides that the taxpayer will be entitled to claim an input tax deduction, in terms of section 16(3) of the VAT Act, of an amount that bears to the total VAT levied the same proportion as the portion that is irrecoverable bears to the total amount of the debt on which output VAT was levied. It is therefore the "net" amount of the debt that is written off for Income Tax purposes, that is, the VAT claimable as an input tax credit is excluded when claiming a deduction in terms of section 11(i) as the VAT portion will never be a bad debt.

2.7.3 CAPITAL GAINS TAX

The Eighth Schedule to the Income Tax Act provides that: "A person's capital loss for a year of assessment in respect of the disposal of an asset – (a) during that year, is equal to the amount by which the base cost of that asset exceeds the proceeds received or accrued in respect of that disposal …".

An asset is defined in Part I of the Eighth Schedule to the Income Tax Act as:

> (a) property of whatever nature, whether movable or immovable, corporeal or incorporeal excluding any currency, but including any coin made mainly from gold or platinum; and
> (b) a right or interest of whatever nature to or in such property;

The Comprehensive Guide to Capital Gains Tax (Issue 6) (SARS, Online: 43) states that: "The definition of 'asset' is of importance because CGT is not triggered until an asset is disposed of. A wide definition has been ascribed to the term, which includes all forms of property and all rights or interests in such property …" In respect of the definition of property, the court held in *CIR v Estate CP Crewe and another*, 1943 AD 656 12 SATC 344 (at 352) that:

> One would expect that when the estate of a person is described as consisting of property, what is meant by property is all rights vested in him which have a pecuniary or economic value. Such right can conveniently be referred to as proprietary rights and they include *jura in rem*, real rights such as rights of ownership in both immovable and movable property, and also *jura in personam* such as debts and rights of action.

SARS (Online: 43) states that "It is therefore submitted that the word 'property' refers to anything that can be disposed of and turned into money". Based on this, it is submitted that a debt owing to a taxpayer arising in the ordinary course of trading operations would fall within the scope of the definition of asset as provided in Part I of the Eighth Schedule to the Income Tax Act as the debt owing represents a right to collect such amount and is a right that can be turned into money.

A disposal is defined in terms of paragraph 11 of the Eighth Schedule to the Income Tax Act as follows:

> …a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes-
> (a) the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset;
> (b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;
> (c) the scrapping, loss, or destruction of an asset; …

Where a taxpayer is denied a deduction of a bad debt in terms of section 11(i) as a result of such debt not having been included in the taxpayer's income, it is submitted that the write off of such a bad debt will fall within the ambit of the definition of a disposal in terms of paragraph 1 of the Eighth Schedule to the Income Tax Act, consequently giving rise to a capital loss that the taxpayer will be entitled to offset against any capital gains. In terms of the time of disposal rules under paragraph 13 of the Eighth Schedule to the Income Tax Act, the time of disposal in relation to the extinction of an asset by way of forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment will be the date of the extinction of the asset. The timing of disposal of a debt that has become bad will therefore be when the debt has been written off in the books of account.

2.8 CONCLUSION

To qualify as a deduction from income, a bad debt must meet the requirements of the preamble to section 11 and section 11(i) of the Income Tax Act. A bad debt that has satisfied the requirements of section 11(i) must therefore also meet the requirements of the preamble to section 11 of the Income Tax Act to qualify for deduction, that is, the bad debt must be an ordinary trade debt. Trade is widely defined in section 1 of the Income Tax Act and should be given the widest possible interpretation (*Burgess v CIR*). In respect of when a debt will be regarded as having arisen in the ordinary course of trading activities, the court stated in *ITC 95* (at 243) that: "It had to be proved satisfactorily by the taxpayer that he was a trader and that the debt he sought to deduct was bad, and further that the debt was incurred during his trading operations and by reason of his trading operations".

The earning of passive income in the form of interest, dividends, annuities and a pension is excluded from the definition of trade. An amount owing to the taxpayer in respect of passive income that becomes irrecoverable will not qualify for deduction, the amount not having met the requirements of the preamble to section 11 of the Income Tax Act.

In *SIR v Kempton Park Furnishers (Pty) Ltd* the court considered whether the sale of a book debt subject to a resolutive condition had the effect of changing the nature of the debt from that of an ordinary trade debt. In this regard the court held that where a taxpayer sells a debt and then voluntarily buys it back, such a debt would no longer be characterised as an ordinary trade debt, but where the debt was re-ceded to a seller as a result of a resolutive condition such debt retained its nature as an ordinary trade debt.

Based on the principles set out in respect of the deductibility of expenditure on cessation of trade, it is submitted that where trading activities have ceased, a bad debt will be allowed as a deduction provided that the debt has arisen in the course of trading activities carried on prior to the cessation of trade (*ITC 1029* and *COT v Cathcart*).

In order to qualify for deduction in terms of section 11(i) the debt that has become bad must be an amount that is owing to the taxpayer. Based on the principles established in terms of the case law discussed, a taxpayer who has sold his business lock, stock and barrel will not be entitled to a deduction of debts ceded to the purchaser in terms of a sale agreement as such debts are no longer an amount owing to him. A debt that has been waived, compromised or otherwise dealt with does not represent an amount owing to the taxpayer and as such will not qualify for deduction in terms of section 11(i).

Based on the requirements of section 11(i) a debt must have become bad during the year of assessment in which the taxpayer is seeking to claim a deduction. In respect of the timing of a bad debt deduction, the courts have established that debts may not be accumulated and deducted in a later year of assessment, that is, where a debt has been identified as bad it can only be claimed as a deduction in the year of assessment in which it is considered to be bad. It has also been established by the court that the manner in which the taxpayer conducts his business was relevant in assessing whether a taxpayer had identified a debt as bad in the correct year of assessment.

The proviso to section 11(i) of the Income Tax Act states that a bad debt must have been included in the taxpayer's income in the current or previous year of assessment to qualify as a deduction. For an amount to fall within the ambit of the definition of income and gross income as provided in section 1 of the Income Tax Act, the amount must have received by or accrued to a taxpayer and must not be of a capital nature and not an amount that is exempt from tax in terms of sections 10, 10A, 10B or 10C of the Income Tax Act. It is submitted that an amount earned by a taxpayer in the ordinary course of trading activities carried out with a profit-making motive will fall within the ambit of the definition of gross income and hence income and where such amount becomes irrecoverable it will qualify for deduction in terms of section 11(i) having met the requirements of the proviso to section 11(i) of the Income Tax Act.

Where any uncertainty exists in respect of the deductibility of an amount, section 102 of the Tax Administration Act imposes the burden on the taxpayer to prove that such amount is in fact deductible.

This chapter also considered the effect of other provisions of the Income Tax Act and other taxing Acts that may be applicable to bad debts. Where a bad debt is subsequently recovered, section 8(4)(a) of the Income Tax Act requires that the portion of the debt that has been recovered must be included in income in the year of assessment in which it is recovered. Where a debt includes VAT, which may be claimed by the taxpayer upon the debt becoming bad, only the portion of the debt excluding VAT may be claimed as a deduction under section 11(i) of the Income Tax Act. In respect of bad debts denied as a deduction, such debts will be regarded as a capital loss as the write-off of a bad debt falls within the ambit of the definition of disposal as contemplated in paragraph 11 of the Eighth Schedule to the Income Tax Act.

In setting out a general framework in terms of which a deduction of bad debts may be claimed, this chapter has set the foundation for Chapter 3, which will elaborate on the aspect of section 11(i) that requires a debt to have become bad, by ascribing a meaning to the term "bad debt" and to establish when a debt will be regarded as having become bad. The Income Tax Act does not provide a meaning for the term "bad debt". It is therefore necessary to ascertain the meaning to be attributed to the term based on the general rules of interpretation. Where the Income Tax Act does not provide the meaning of a term, the ordinary meaning must be adopted, provided that such meaning does not give rise to an absurdity that could not have been intended by legislation (*Venter v Rex* 1907 TS 910). This is discussed in Chapter 3.

CHAPTER 3: MEANING ATTRIBUTED TO THE TERM "BAD DEBT"

3.1 INTRODUCTION

The previous chapter established the general principles in terms of which a deduction of bad debts may be claimed under section 11(i) of the Income Tax Act. In addressing the general principles, the second chapter discussed the requirement of section 11(i) that a debt must have become bad during the year of assessment to qualify for deduction. There is still uncertainty in relation to the deductibility of bad debts, in particular the definition of a "bad debt" and timing of when a debt is regarded as having become bad. This chapter will elaborate on this requirement by establishing the meaning to be attributed to the term "bad debt". In ascribing a meaning to the term "bad debt" this chapter will also establish at what stage a debt will be regarded as having become bad.

The meaning to be attributed to a term is governed by the general rules of statutory interpretation. To establish the meaning to be attributed to the term "bad debt" it is necessary to examine the general principles of statutory interpretation, and this is addressed in this chapter.

The chapter also considers the meaning ascribed to a "bad debt" in various other jurisdictions.

3.2 GENERAL PRINCIPLES OF STATUTORY INTERPRETATION

In terms of the general principles of statutory interpretation, where the Income Tax Act specifically contains a word, or a phrase, and the wording of the legislation is clear, precise and unambiguous, then effect must be given to the literal meaning of the language of the legislation. The literal rule of fiscal interpretation was described by Lord Cairns in *Partington v The Attorney General*, 21 LT 370, (at 375) as follows:

> If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be. In other words, if there be an equitable construction, certainly such a

> construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.

De Koker and Williams explain that, although this statement has been articulated and approved by the South African courts (2017: §25.1A):

> The reference in this dictum to the irrelevance of 'hardship' must, however, in the context of South Africa's tax system, now be read as subject to the overarching protection of fundamental rights in terms of the Constitution. Thus, if 'the letter of the law' results in a form of 'hardship' that is in breach of a constitutionally entrenched right, the letter of the law will have to yield to the overriding dictates of the Constitution.

The literal meaning attributed to a term by legislation must therefore be given effect where such meaning is clear and unambiguous, provided that such meaning does not lead to an illogical effect that could not have intended by legislation. Where the application of the literal meaning to a term gives rise to an illogical effect, then the ordinary meaning of the word or phrase may be departed from in order to give effect to the true intention of the legislation (De Koker and Williams: 2017). In *Venter v Rex,* Innes CJ stated that (at 914-915):

> … when to give the plain words of the statute their ordinary meaning would lead to absurdity so glaring that it could never have been contemplated by the legislature or where it would lead to a result contrary to the intention of the legislature, as shown by the context or by such other considerations as the court is justified in taking into account, the court may depart from the ordinary effect of the words to the extent necessary to remove the absurdity and to give effect to the true intention of the legislature.

Where a word or phrase is not specifically defined in the Income Tax Act, such word or phrase must be interpreted according to their ordinary meaning (De Koker and Williams: 2017). In *Coopers and Lybrand v Bryant*, 1995 (3) SA 761 (A), the court held (at 640) that: "According to the 'golden rule' of interpretation the language in the document is to be given its grammatical and ordinary meaning, unless this would result in some absurdity, or some repugnancy or inconsistency with the rest of the instrument." The court did, however, go on to state (at 640) that: "The mode of construction should never be to interpret the particular word or phrase in isolation (*in vacuo*) by itself."

Where ambiguity arises in the interpretation of a word or phrase not defined in the Income Tax Act, that is, such word or phrase is capable of bearing two meanings, an examination of the context in which such word or phrase is used may be necessary in order to determine the meaning to be attributed to such word or phrase. In the case of ambiguity, it was stated in *Badenhorst and others v CIR*, 1955 (2) SA 207 (N) 20 SATC 39, (at 215) that:

> In the case of ambiguity arising during the interpretation of fiscal legislation, the contra fiscum rule will be applicable. Should a taxing provision reveal an ambiguity, the ambiguous provision must be interpreted in a manner that favours a taxpayer. When a taxing provision is reasonably capable of two constructions, the court will adopt the construction that imposes a smaller burden on the taxpayer.

In respect of the interpretation of a word or term where ambiguity arises, Clegg and Stretch (2017: §2.1) state that:

> Where equally possible alternative meanings can be ascribed to a word or passage of text on a purely grammatical or 'plain wording' basis, the interpretation should favour that meaning which conforms to the principle that 'a sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results …'

In *Natal Joint Municipal Pension Fund v Endumeni Municipality*, 2012 2 All SA 262 (SCA), the court stated that (at 273):

> Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective

> not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document. Judges must be alert to, and guard against, the temptation to substitute what they regard as reasonable, sensible or businesslike for the words actually used. To do so in regard to a statute or statutory instrument is to cross the divide between interpretation and legislation. In a contractual context it is to make a contract for the parties other than the one they in fact made. The "inevitable point of departure is the language of the provision itself", read in context and having regard to the purpose of the provision and the background to the preparation and production of the document.

3.3 ORDINARY MEANING

The general principles of interpretation as set out above will be applied in determining the ordinary meaning to be ascribed to the term "bad debt". The meaning of the term "bad debt" is not set out in the Income Tax Act. Where a term has not been specifically defined in the Income Tax Act that term should be accorded the ordinary meaning given to it, based on established dictionaries, provided that such ordinary meaning does not give rise to an absurdity that could not have been intended by legislation. The ordinary meaning of the term "bad debt" as established in the following dictionary references is as follows:

- the *Oxford Dictionary* (Online) defines a "bad debt" as "a debt that cannot be recovered";
- a "bad debt" is defined in *The Macmillan Dictionary of Accounting* (Parker, 1992) as "an amount owing which is not expected to be received …"; and
- the *Oxford Learners Dictionary* (Online) defines a "bad debt" as "a debt that is unlikely to be paid".

In the definition in the *Oxford Dictionary* (Online) it is implied that a "bad debt" is one that is absolutely irrecoverable, whereas the definitions provided by the *Macmillan Dictionary of Accounting* (Parker, 1992) and the *Oxford Learners Dictionary* (Online) acknowledge by the use of the words "expected" and "unlikely" that the definition requires a degree of judgement in assessing the recoverability of the debt.

It is apparent that there is a degree of ambiguity in the ordinary meaning attributed to the term "bad debt" in terms of the dictionary references noted. Based on the general principles of interpretation, where ambiguity arises on the interpretation of a term that is not specifically defined in the Income Tax Act, an examination of the context in which the term is used will assist in determining the intent or purpose of the legislation and what the legislation actually intended such term to mean (Clegg and Stretch: 2017). Where there is still ambiguity in the meaning following an examination of the contextual approach, then such term must be construed in such a manner that imposes a smaller burden on the taxpayer.

The concept of when a debt is regarded as having become bad has also been considered by international tax jurisdictions. An analysis will be made of the relevant case law and principles established in South Africa and in the selected international jurisdictions in order to determine the meaning to be ascribed to the term "bad debt", that is, whether a debt is required to be absolutely irrecoverable or if an element of judgement is an acceptable benchmark in assessing when a debt will be regarded as having become bad.

3.4 CONTEXTUAL ANALYSIS

In performing a contextual analysis, research was undertaken into the difficulties encountered in various international jurisdictions relating to the deductibility of bad debts. These countries were selected as they provided guidance in respect of the gaps that currently exist in the South African legislation in relation to the meaning to be attributed to the term "bad debt" and when a debt will be regarded as having become bad.

3.4.1 AUSTRALIA

The meaning attributed to the term "bad debt" by the New South Wales Supreme Court in *Elder Smith and Co Ltd v Commissioner of Taxation,* (NSW) (1931) 31SR (NSW) 639 (at 643) was that: "…bad debts, means, debts which are conjecturally bad and that it is not necessary to establish that the debts are debts in respect of which nothing can ever be recovered."

An Australian Taxation Ruling, TR92/18 (Australian Taxation Office: 1992), clarified the circumstances under which a deduction of bad debts may be claimed. This discussion will focus on the aspect of the ruling dealing specifically with when a debt is regarded as being "bad". In terms of paragraph 26 of the Australian tax ruling, TR92/18 (Australian Taxation Office: 1992), the question as to whether a debt is bad depends on an objective analysis of the facts and circumstances of each case. In the case of an individual debtor, although a debt is not regarded as bad until it is bad in the strict sense, that is, where the debtor dies without assets, the debtor has become insolvent and the estate has been distributed, or where the debt has become statute barred, the ruling states that it is not necessary for a debt to be bad in the strict sense as it is contemplated that a debt that has previously been written off as bad may subsequently be recovered.

In support of this view, reference was made to an English case, *Anderton and Halstead Ltd v Birrell,* where in relation to the English legislative provision for bad debts, Rowlatt J, stated that an estimate was required as to whether a debt was bad and such an estimate is an assessment of the recoverability of the debt based on the facts and circumstances existing at the time the debt is written off. The ruling also referred to *Case 26*, 1945 11 CTBR OS 94, where it was stated that where by some turn of fortune a bad debt is recovered, this should not have any effect on the determination of the debt as bad when it was claimed as a deduction.

In respect of when a debt will be regarded as having become bad, the Australian Taxation Ruling, TR 92/18 (Australian Taxation Office: 1992), stated the following (at 6):

> As long as the commercial judgement pointing to the relevant facts indicates that a debt is bad for the time being, the debt is accepted as bad…It is not essential that a creditor take all the 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.
>
> Although the debt need not be bad in the strict sense it must nonetheless be more than merely doubtful …a debt will not be accepted as bad merely because a certain period of time for payment (e.g. 180 or 270 days) has elapsed with no payment or contact having been made by the debtor.

The Australian ruling, TR 92/18 (Australian Taxation Office: 1992), provided for the following circumstances that would indicate that a debt has become bad (at 6):

> (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.

Depending on the facts and circumstances of a specific case, it will be accepted that a debt is bad where a taxpayer has objectively determined that the outstanding amount is irrecoverable after having taken the appropriate steps to recover the debt. In terms of paragraph 32 of the ruling (TR92/18, Australian Taxation Office: 1992), the steps carried out by the taxpayer to recover an outstanding debt may vary depending on the amount outstanding and the resources available to the taxpayer to collect the debt and may or may not include the following (at 7):

> (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 taxpayer's credit arrangements (e.g. 90,120 or 150 days overdue);
> (iii) [a] formal demand notice is served;
> (iv) issue of, and service of a summons;
> (v) judgement against the delinquent debtor;
> (vi) execution proceedings to enforce judgement;
> (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.

In respect of these factors, the Australian Ruling (TR92/18, Australian Taxation Office: 1992), states the following (at 8):

> 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.

In terms of paragraph 69 and 70 of the Australian tax ruling, TR92/18 (Australian Taxation Office: 1992), it is stated that (at 16):

> In recognition of the difficulties in determining the extent to which a debt may be bad the Act contains a specific provision ….to recoup any excessive write off of a debt …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.

3.4.2 NEW ZEALAND

A New Zealand Public Ruling, BR Pub 05/01 (Inland Revenue: 2005), applicable to the writing off of a bad debt for income tax and GST purposes, sets out guidelines to address the issue of when a debt is considered to be bad, amongst other issues. In terms of this ruling, it was stated that an inquiry as to whether a debt is bad must be made at the time that a decision is made to write off the debt and that a debt must be regarded as "bad" before it can be written off and claimed as a deduction. The principles established in this ruling state that an inquiry as to whether or not a debt is bad is a question of fact to be determined objectively. The onus of proving that a debt is bad rests with the taxpayer. The principal test to be applied in establishing if a debt is bad is whether a reasonably prudent commercial person would, on a balance of probabilities, determine that the debt was unlikely to be recovered.

In setting out the principles that govern the determination of when a debt is regarded as having become bad, reference was made to *Budget Rent A Car Ltd v CIR*, 1995 17 NZTC 12 263, where it was stated (at 12 269) that:

> The term "bad debt" is not defined in the Act. It, therefore, should be given its normal commercial meaning. It is a question of fact to be determined objectively. 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 someone else either on behalf of the debtor or otherwise … (emphasis added).

In respect of recovery action carried out, the New Zealand Inland Revenue Department explains in the Tax Information Bulletin, Volume Twelve, No 5 (2000) (at 9) that:

> A creditor is likely to have taken recovery action in most cases before a deduction for a bad debt is made, although it is not a requirement that such action be taken before a decision is made that a debt is bad. However, it is through taking recovery action that most creditors will form an opinion as to whether a debt is bad. While recovery action is being taken, a debt can only be considered bad to the extent that a reasonably prudent business person would consider there is no reasonable likelihood that the debt will be paid.
>
> 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 depends on the circumstances.
>
> Conversely, the creditor may take recovery action even when a reasonable view has been formed that the debt is bad. For a number of reasons the creditor might take recovery action even when it is believed that there is no reasonable likelihood that the debt will be recovered. This may be the case, for example, when the creditor has a policy of pursuing debtors to a certain extent to discourage customers defaulting on the debt.

A debt must be more than merely doubtful before it can be regarded as bad. The determination of whether a debt is bad is a question of fact depending on the circumstances surrounding a specific case. Whilst there is no single factor that is decisive on its own, the ruling, BR Pub 05/01 (Inland Revenue: 2005), indicated that the following factors are relevant when making an assessment as to the recoverability of a debt, some of which were derived from the Australian tax ruling, TR92/18 (Australian Taxation Office: 1992):

- The length of time that has elapsed – The longer the period that a debt is outstanding the more likely it is that the debt is bad. This does not however indicate that a debt will be regarded as bad simply because a set period of time has elapsed without any payment being received from the debtor. There may circumstances where a debt will be regarded as bad after a short period of time has elapsed but there are other extenuating factors which prove that a debt is bad.
- The efforts undertaken to collect the debt. Where the taxpayer has undertaken extensive efforts in attempting to collect a debt without being successful then it more likely that such debt will be regarded as bad by a reasonably prudent commercial person.
- Other applicable information which may affect the decision as to whether or not a debt is bad, for example, a taxpayer may obtain information that a debtor is in the process of becoming insolvent.
- Where a debtor has died without leaving assets with which to settle outstanding debts, such debt may be regarded as bad.
- The taxpayer cannot trace the debtor or obtain evidence of assets which could settle the outstanding debt.
- The debt has been prescribed.
- In the case of a company, where the company is in liquidation and there are no funds to settle the debt.

The New Zealand ruling noted that insolvency is not a pre-requisite for a debt to be regarded as bad, that is, a debtor does not have to be insolvent for a debt to be bad. In certain instances, a taxpayer may continue with recovery procedures after a debt is established as bad to discourage customers from not paying outstanding debts.

The objective test defined in *Budget Rent A Car Ltd v CIR* was also articulated by Barber DJ in *Case N69*, (1991) 13 NZTC 3 541, where it was stated (at 3 548) that:

> Naturally, the debts in question must be "bad" to be written off as bad …This is a question of fact. Generally, an application of that criterion will not be difficult as the debtor will be insolvent. However, the debtor does not need to be insolvent for the debt to be bad. It is only necessary that there be a bona fide assessment that the debtor is unlikely to make payment of the debt. If there is a clear understanding or arrangement that there be long term credit, and if the taxpayer believes that the terms

of the credit will be met, then the debt cannot be treated as bad because it is merely a situation of deferred payment. In my view, as well as the need for the writing off to be made bona fide, the circumstances must indicate to a reasonable and prudent business person that, on the balance of probability, the debt is unlikely to be recovered. This is an objective test.

The creditor taxpayer may, of course still hope for recovery and is quite entitled to institute recovery procedures. It is not necessary to have taken recovery or legal steps. ... It does not follow from the taxpayer hoping for or seeking recovery that a debt is not bad. However, usually, when a debt is assessed as bad, in terms of the type of criteria I have outlined, hopes or efforts of recovery will be futile.

3.4.3 ZIMBABWE

In *BT (PVT) v Zimbabwe Revenue Authority,* 2015 77 SATC 204, the taxpayer, a producer of gold bullion in Zimbabwe, had during the 2008 year of assessment sold gold bullion to Fidelity Printers and Refiners (Pty) Ltd (Fidelity), a wholly owned subsidiary of the Reserve Bank of Zimbabwe (the central bank). The central bank was obliged to pay the taxpayer for all the gold bullion delivered to Fidelity. The settlement of the amount owing was to be made in terms of a two-tier system of payment, one component of which was in local currency and the other in United States dollars. The payment of the foreign currency component was slow and was not paid in terms of the contract for all deliveries of gold bullion made to Fidelity during the 2008 year of assessment. During the 2009 year of assessment the governor of the central bank made a unilateral decision to convert all outstanding amounts owing to the gold sector into "Special Goldbacked Foreign Exchange bonds" with a tenor of twelve months. The central bank undertook to pay the full principal amount owing together with interest to the holders of the bonds. Upon issue of the bonds the taxpayer investigated the marketability of the bonds and, after having established that the bonds were perceived to be high risk and susceptible to non-payment, took the decision not to trade in the bonds at a discount and to wait for payment at face value. The bonds issued were not redeemed by the central bank by the due date. In its financial statements for the 2009 year of assessment, the taxpayer claimed a provision for doubtful debts of a portion of the amount owing, whilst the balance of the amount owing was claimed as a bad debt during the 2010 year of assessment. The taxpayer held that where the bonds were subsequently honoured, this would be included in income and assessed for tax accordingly. The revenue authority, having disallowed the claims, contended that the issue of bonds by the central bank converted the debt to an investment and that as acceptance of such conversion constituted full payment of the debt, the taxpayer was precluded from the application of the provisions of the Act to the amounts claimed as a doubtful debt and a bad debt respectively. The court held that as the central bank did not have the legal authority to issue bonds, the bonds were not legal tender and could therefore not be regarded as having discharged the debt owing by the central bank. The issue in question was whether the debt due by the central bank had been correctly claimed by the taxpayer as a doubtful debt and bad debt for the years of assessment in terms of the relevant provisions of the Act. It was stated (at 207) that:

> That the essential factors for proof on a balance of probability for a claim for both doubtful and bad debts were that: (1) the amount claimed must be due and payable; (2) the Commissioner is satisfied that the amount is unlikely to have been recovered at the end of the financial year; (3) the amount must have been included in the taxable income of the taxpayer in the current or any previous year of assessment; and (4) once the claim is allowed it will have to be added back to income in the following year of assessment.

The court, having established that these requirements had been met, stated the following in respect of whether the debt was unlikely to be recovered (at 208):

> …The amount claimed had been outstanding for up to two years and the central bank had demonstrated its inability to pay and was in poor standing in the local market.
>
> That, accordingly, Appellant had established on a balance of probabilities that there was a likelihood that the debt would not be paid by the central bank in the course of 2009.
>
> That, in the court's view, any reasonable person submitting the return … would have doubted the likelihood of the debt being paid even though he might recognise an outside and remote possibility that such payment might take place. There was no reasonable probability of payment occurring but this did not completely exclude that payment might happen – a likelihood of lack of collectability existed and it was a doubt as opposed to a certainty.

Consequently, it was held that the taxpayer had proven on a balance of probabilities that the requirements of the relevant provision of the Act had been satisfied and the deduction of the doubtful debts for the years of assessment in question should therefore be allowed. In respect of the claim for bad debts for the 2010 year of assessment, the court stated that for the reasons discussed in relation to the provision for bad debts, it was held that the requirements had in fact been met. The court stated (at 208-209) that:

> The purported gold bonds were null and void and they were of no force or effect and did not exist in law. They could not therefore constitute a payment for the debt and, even if they were valid, the court would have found them to be akin to mere rescheduled acknowledgements of debt and did not constitute payment of the debt, a debt does not become an investment merely because it also records terms of payment. The debt remained and still remained due and payable, writing it off as a bad debt did not extinguish it.
>
> …The Act did not define a bad debt but it is however defined in ordinary commercial and accounting practice as an amount that is unlikely to be paid. Appellant had established on a balance of probabilities that …the claimed amount has been outstanding for more than 26 months. The purported gold bonds had been issued and rolled over time …it was clear that it was unable to pay and had no funds to pay.

The requisites of the relevant provision had therefore been met and the deduction of bad debts in the 2010 year of assessment was held to be admissible.

3.4.4 THE UNITED STATES OF AMERICA

The United States of America Department of the Treasury Inland Revenue Service (2016: 38) explains that a "bad debt is either a business bad debt or a nonbusiness bad debt …Generally, a business bad debt is one that comes from operating your trade or business … All other bad debts are nonbusiness bad debts and are deductible only as short-term capital losses" and defines a business bad debt (2016: 39) as "a loss from the worthlessness of a debt that was either:

- created or acquired in your trade or business, or
- closely related to your trade or business when it became partly or totally worthless."

To claim a deduction of bad debts, the taxpayer must therefore first establish that the debt is worthless. In respect of the criteria to be considered in the determination of the worthlessness of a debt, Blasi (2009: 435) explains that:

> Whether an obligation is worthless in whole or in part is a question of fact, and the determination will turn on "all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor." …The IRS acknowledges that no precise test exists for determining whether a debt is worthless. Furthermore, it is not uncommon that no single factor or event clearly demonstrates whether a debt has become worthless. Usually, a series of factors or events in the aggregate establishes whether the debt is worthless. The IRS has ruled that among the factors indicating worthlessness are: a debtor's serious financial reserves, insolvency, lack of assets, continued refusal to respond to demands for payment, ill health, death, disappearance, abandonment of business, bankruptcy, a debt's unsecured or subordinated status, and expiration of the statute of limitations. However, factors suggesting that the debt is not worthless include the availability of collateral or third party guarantees, a debtor's earning capacity, payment of interest, a creditor's failure to press for payments, and a creditor's willingness to make further advances.
>
> It is unnecessary for a creditor to pursue legal action, if to do so would, in all probability, not result in the satisfaction of execution on a judgement. Moreover, a creditor need not be an "incorrigible optimist" in reaching its conclusion. Bankruptcy is generally an indication of the worthlessness of at least part of any unsecured and unpreferred debt; however, even when bankruptcy occurs, factors such as insurance, collateral, and guarantees are to be taken into account in determining at least the amount of worthlessness.

In terms of Publication 535 (United States of America Department of the Treasury Inland Revenue Service: 2016), a debt is considered to be worthless when there is no longer any chance that the debt will be paid, and evidence of such worthlessness may become apparent on the date that the debt is due or prior to the due date. It was also explained that, in order to show that a debt was worthless, it was not necessary to go to court to prove that a debt would be uncollectible, that is, where reasonable steps had been taken to collect a debt and these efforts proved to be unsuccessful this would sufficient to prove the worthlessness of a debt.

The United States of America Department of the Treasury Inland Revenue Service has provided an exception to the application of this rule in relation to financial institutions that may either choose to determine its bad debt deduction in terms of the conclusive presumption rule or the conformity election rule, as provided in terms of Regulation 26 CFR 1.166-2. In terms of the conclusive presumption rule set out in Regulation 26 CFR 1.166-2 (d)(1), worthlessness will be presumed in the year of charge off:

> If a bank or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, charges off a debt in whole or in part, either-
> (i) In obedience to the specific orders of such authorities, or
> (ii) In accordance with established policies of such authorities, and upon their first audit of the bank or other corporation subsequent to the charge-off, such authorities confirm in writing that the charge off would have been subject to such specific orders if the audit had been made on the date of the charge-off, then the debt shall, to the extent charged off during the taxable year, be conclusively presumed to have become worthless, or worthless only in part, as the case may be, during such taxable year.

Alternatively, a financial institution may elect to adopt the conformity election in terms of Regulation 26 CFR 1.166-2 (d)(3)(i) which states that:

> … a bank … that is subject to supervision by Federal authorities, or by state authorities maintaining substantially equivalent standards, may elect under this paragraph (d)(3) to use a method of accounting that establishes a conclusive presumption of worthlessness for debts, provided that the bank meets the express determination requirement of paragraph (d)(3)(iii)(D) of this section for the taxable year of the election.

In relation to the "express determination requirement", the bank's supervisory authority must have made an express determination that the bank has complied with the regulatory standards applicable to loan loss classification (Regulation 26 CFR 1.166-2). A loan will be classified as a loss asset for regulatory purposes where it is deemed to be irrecoverable, based on specific criteria (United States of America Department of the Treasury Inland Revenue Service: 1991). In respect of the meaning of charge-off for the purpose of the conclusive presumption rules, Blasi (2009: 436) states that: "Neither the statute nor the regulations provide that a specific procedure must be followed for charging off a debt. What appears to be required is that some action be taken that eliminates the debt from the bank's books."

Where a financial institution has complied with the conditions of the rules as provided in terms of Regulation 26 CFR 1.166-2, the effect of adopting either the conclusive presumption rule or the conformity election rule is that the financial institution will be entitled to claim a deduction for bad debts when the debts are charged off for financial statement/regulatory purposes. This is based on the presumption that debts charged off for regulatory purposes are worthless for tax purposes. In effect, debts charged off for regulatory purposes are presumed to be worthless for the purpose of a bad debt deduction, subject to the fulfilment of certain conditions.

3.4.5 INDIA

In *Abdul Hameed Khan vs Commissioner of Income Tax,* AIR 1967 AP 211, it was held that the question as to whether a debt was bad and the point at which a debt would be regarded as having become bad were questions of fact to be determined after due consideration of all the relevant facts and circumstances. It was stated that, although the length of time that a debt was outstanding was a relevant factor to be considered in the determination of when a debt was bad, where a debt was statute barred, this did not automatically render such debt as bad nor did this indicate that a debt that was not statute barred was good. In assessing when a debt will be regarded as having become bad, the court stated that a debt becomes bad when the taxpayer has no reasonable expectation or hope that the debt will be recovered. Based on these principles, the court held that the taxpayer had correctly assessed the debt to be bad after he had made the necessary enquiries and had established that there was no reasonable expectation that the debt would be recovered.

To reduce litigation relating to the deductibility of bad debts, in 1989 the Indian legislature made an amendment to the Direct Tax Laws (Amendment) Act, 1987, which effectively removed the condition requiring that a bad debt be proved to be irrecoverable before it could be claimed as a deduction for income tax purposes. In terms of the amendment, a deduction of bad debts may be claimed when it is written off as irrecoverable in the taxpayer's books of account, subject to the other conditions prescribed in the relevant section of the Direct Tax Laws (Amendment) Act, 1987, without the taxpayer having to establish that the debt was in fact irrecoverable (PWC: 2016).

Despite this amendment to the legislation, the revenue authorities continued to dispute the deductibility of bad debts on the basis that they had not been proven to be irrecoverable. The decision in *TRF Limited v CIT*, 2010 323 ITR 397, addressed this issue, where the Supreme Court held that a bad debt may be claimed as a deduction upon write-off of the debt in the taxpayer's book of accounts, without the taxpayer having to establish that the debt was irrecoverable.

To give effect to the decision taken by the Supreme Court, the Central Board of Direct Tax has instructed that a bad debt deduction be allowed in respect of any debt that has been written off as irrecoverable in the taxpayer's books of account, subject to the other conditions specified in relation to the deduction of bad debts (PWC: 2016).

3.4.6 THE UNITED KINGDOM

In *Anderton and Halstead v Birell*, the effect of subsequent events on a bad debt claimed in a previous year of assessment was considered. The taxpayer claimed a deduction of certain debts that had been written off during the year of assessment in question. The revenue authorities, having allowed the deduction of bad debts during the relevant year of assessment, subsequently raised a revised assessment against the taxpayer in view of the subsequent conduct of the taxpayer. The revenue authority contended that the debts could not be regarded as bad based on the fact that the taxpayer had continued to trade with the debtor concerned and had extended further credit to him. The court stated that the extent to which a debt was bad was an estimate to be determined based upon facts and circumstances existing at the time that such determination is made and that such estimate was not a forecast to be evaluated based on the outcome of subsequent events. The court therefore held that a bad debt deduction could not disallowed retrospectively based on information arising from subsequent events.

3.4.7 SOUTH AFRICA

In *CIR v Delfos,* the court stated that the determination as to whether a debt is bad must be made at the time that it is claimed as a deduction and such determination must be based on the debtor's existing financial circumstances. It was held that where the financial circumstances of the debtor improve to such an extent that a portion of or the whole amount claimed as a deduction is subsequently recovered, such recovery does not change the character of the bad debt. Curlewis, J.A. stated the following in this respect (at 105-106):

> When a debt has been allowed as a bad debt in the year of assessment, it does not lose its character as a bad debt for that year, even though it may happen that after the lapse of some years the financial position of the debtor has so much improved that he is able to pay the debt in full. Whether or not it was a bad debt during the year of assessment could only be decided according to the conditions then existing; subsequent events cannot influence the determination made in the year of assessment.

The court also stated (at 103) that:

> The Legislature could never have intended that where bad debts of past years are paid in a future year, the whole matter should be re-opened, for if it did so intend, it would have said so, knowing full well, as we must assume, how impracticable that would be from a bookkeeping and business point of view.

3.5 MEANING ATTRIBUTED TO THE TERM "DEBT"

Whilst the concept of when a debt will be regarded as having become bad has been discussed, the meaning attributed to the term "debt" has not been elaborated on. The term "debt" is not defined in the Income Tax Act and, as such, the term should be accorded the ordinary meaning ascribed to it by dictionary sources in accordance with the general principles of statutory interpretation, provided that the adoption of such meaning does not give rise to an absurdity that could not have been intended by legislation (*Venter v Rex).*

The *Business Dictionary* (Online) defines a "debt" as "a duty or obligation to pay money, deliver goods, or render service under an express or implied agreement …".
In *Joint Liquidators of Glen Anil Development Corporation Ltd (In Liquidation) v Hill Samuel (SA) Ltd*, 1982 1 All SA 105 (A), 1982 (1) SA 103, Holmes AJA held (at 110) that "the ordinary meaning of debt is that which is owed or due; anything (as money, goods or services) which one person is under obligation to pay or render to another".

An amount owing by one person to another, whether under an obligation to pay or deliver money, goods or services, will therefore fall within the ambit of the definition of the term "debt", and where such amount becomes bad within the context of the analysis in the discussion above, such amount will be regarded as a bad debt as contemplated in section 11(i) of the Income Tax Act.

3.6 EVIDENCE IN SUPPORT OF A CLAIM FOR BAD DEBTS

Where it has been established that a debt is bad based on the applicable principles and guidelines illustrated in the various jurisdictions, the taxpayer will be required to provide certain evidence in support of this claim. De Koker and Williams (2017: § 8.37) state that:

> In making a claim for bad debts, the taxpayer is required to furnish a statement giving the following details of each debt claimed as bad:
>
> - The name of the debtor.
> - The date the debt was incurred.
> - The amount written off.
> - His reasons for writing off the debt.
> - The circumstances in which the debt became due, for example, for goods supplied, services or work performed, money lent or as a result of the purchase of the assets of a business, including the debts due to it.

3.7 CONCLUSION

Based on the general principles of statutory interpretation, where no meaning is attributed to a term by legislation, such term must be accorded its ordinary meaning. The meaning attributed the term "bad debt" by the *Oxford Dictionary* (Online) implies that a debt must be absolutely irrecoverable in order to regarded as bad, whereas the meaning attributed to the term by *The Macmillan Dictionary of Accounting* (Parker, 1992) and the *Oxford Learners Dictionary* (Online) acknowledges by the use of the words "expected" and "unlikely" that an element of judgement is required in the assessment of whether a debt is bad. Based on the definitions provided by these dictionary sources, it is therefore apparent that there is ambiguity in the interpretation of the term "bad debt". Where a term is capable of bearing more than one meaning, each possibility must be evaluated based on an understanding of the relevant section in the context of the Income Tax Act as a whole, the purpose and any other applicable information that may have a bearing on its interpretation (*Natal Joint Municipal Pension Fund v Endumeni Municipality)*.

A contextual analysis of the relevant information, both locally and internationally, was undertaken to ascertain the meaning to be ascribed to the term "bad debt" and to determine when a debt will be regarded as having become bad. Certain principles emerged from the analysis of the legislation and case law in the various jurisdictions.

In respect of when a debt will be regarded as bad, an Australian tax ruling, TR 92/18 (Australian Taxation Office: 1992), stated that, although a debt need not be bad in the strict sense, that is, absolutely irrecoverable, it must be more than more than merely doubtful. The ruling referred to the decision in *Anderton and Halstead Ltd v Birrell* and *Case 26* in support of the view that subsequent events should not affect the determination of a debt as bad at the time that it is assessed as bad. In respect of a recovery action, the Australian ruling, TR92/18 (Australian Taxation Office: 1992), stated that it was not necessary for a taxpayer to exhaust all avenues of recovery before classifying a debt as bad and that the extent of the recovery action undertaken would depend on the amount outstanding. Whilst the presence of certain factors would indicate that a debt was bad, the question as to whether a debt was bad was one of fact to be determined objectively. The principal test established in this ruling is that a debt will be accepted as bad where based on an objective analysis of the relevant facts and circumstances existing at the time the taxpayer makes a *bona fide* assessment that the debt or part thereof is unlikely to be recovered. The responsibility for discharging this onus of proof rests with the taxpayer seeking to claim the deduction.

The objective test was also set out in a New Zealand ruling, BR Pub 05/01 (Inland Revenue: 2005), and confirmed in *Budget Rent a Car Ltd v CIR* and *Case N69.* It was established that the test to be applied in determining the likelihood that a debt will be recovered was whether a reasonably prudent commercial person would conclude, on a balance of probabilities, that the debt was unlikely to be recovered, the burden of proving this test ultimately being the responsibility of the taxpayer. The debt must however be more than merely doubtful. The New Zealand Inland Revenue Department stated in Volume Twelve, No. 5 of the Tax Information Bulletin (2000), that although a debt would in most instances be regarded as bad after reasonable steps had been carried out to recover a debt, this was not a pre-requisite to writing off a debt as bad. The extent of the recovery action taken would depend on the facts of a case and whilst carrying out recovery actions would carry with it a reasonable expectation that the amount would be recovered, in some instances recovery action would be carried out even after a view has been formed that the debt is unlikely to be recovered. A taxpayer making this assessment of whether a debt was bad would need to be provided with sufficient information to enable this assessment. The extent of the information would depend on the value of the outstanding debt. The availability of information would have an impact on the extent of recovery action undertaken, for example, where there is sufficient information to determine that a debt is bad the taxpayer is unlikely to take extensive steps to recover the debt. The test is, however, whether there is sufficient information available to enable the taxpayer to draw the conclusion that on a balance of probability it is unlikely that the debt will be recovered. The New Zealand ruling listed certain factors that would indicate that a debt was bad and recognised that, although insolvency was a factor that would indicate that a debt was bad, it was not a pre-requisite to a debt being regarded as bad.

In another case that reiterated the objective principle, the court in a case decided in Zimbabwe, *BT (PVT) v Zimbabwe Revenue Authority*, held that when determining whether a debt is bad, it must be proven on a balance of probabilities that the debt was not likely to be paid and that such assessment of a debt as bad did not exclude the probability that the debt may be recovered.

The United States of America Department of the Treasury Inland Revenue Service (2016) considers a business debt to be bad where it has become partially or totally worthless. The question as to whether a debt is worthless is one of fact to be established based on all relevant evidence. Whilst there were certain factors that would indicate that a debt was worthless there was no specific factor or test that in isolation clearly demonstrated that a debt was worthless (Blasi: 2009). In terms of Publication 535 (United States of America Department of the Treasury Inland Revenue Service: 2016) it was established that a debt would be considered worthless when there is no chance that the debt will be recovered; however, where reasonable recovery steps have been taken and these efforts have proven to be futile, this would be adequate to prove that the debt is irrecoverable, that is, a taxpayer would not be required to go to court if judgement would not result in the recovery of the debt. An exception to this rule is provided for certain financial institutions in terms of Regulation 26 CFR 1.166-2, which provides that a debt will be presumed to be worthless for tax purposes where it is charged off for regulatory/financial statement purposes, subject to compliance with certain conditions.

In *Abdul Hammed Khan vs Commissioner of Income Tax*, the court in India held that a debt will be regarded as bad when there is no longer any hope that the debt will be recovered. This principle has since been overruled by the amendment to the Direct Tax Laws (Amendment) Act, 1987, in terms of which a deduction for bad debts may be claimed without the taxpayer having to prove that such debt is irrecoverable. Despite this amendment to the legislation having been enacted to reduce the litigation arising in relation the deductibility of bad debts, the revenue authorities continued to question the deductibility of bad debts. This question was finally addressed in *TRF Limited v CIT* where it was held that a deduction of bad debts may be claimed for income tax purposes when it is written off in the books of account without the taxpayer having to establish that the debt is irrecoverable. In order to give effect to this decision of the Supreme Court, the Central Board of Direct Tax issued an instruction that a debt that has been written off as irrecoverable in the books of account must be allowed as a deduction for tax purposes. (PWC: 2016)

It was established in South Africa, in *CIR v Delfos* that an assessment of whether a debt has become bad must be made at the time that it is claimed as a deduction, based on the existing facts and circumstances. It was held that subsequent events, which may include an improvement in the financial circumstances of the debtor, will not affect the classification of the debt as bad. This principle was also applied in the English case of *Anderton and Halstead v Birrell,* where the court held that an estimate as to the likelihood of recovery was required in determining if a debt was bad and that such estimate could not be revised based on subsequent events.

On application of the principles and guidelines established in the various jurisdictions to the questions as to when a debt will be regarded as having become bad and the meaning to be ascribed to the term bad debt, it is submitted that a debt is not required to be absolutely irrecoverable in order to be regarded as bad, that is, the debt need not be bad in the strict sense. The dominant principle established in the various jurisdictions is that a debt will be accepted as bad if a reasonably prudent commercial person would determine on a balance of probabilities that the debt was unlikely to be recovered. This interpretation aligns with the general principles of statutory interpretation, which state that where no meaning is attributed to a term by legislation, such term must be given its ordinary meaning, provided this does not give rise to an absurdity that could not have been intended by legislation or ambiguity in the interpretation thereof. Where ambiguity arises in the interpretation, the term must be interpreted in favour of the taxpayer. It is submitted that the application of the *contra fiscum* rule supports this, as this interpretation provides a practical and business-like approach.

It is submitted that, as the definitions provided by The *Macmillan Dictionary of Accounting* (Online) and the *Oxford Learners Dictionary* (Online) take cognisance of the element of judgement required, the meanings attributed to a "bad debt" by these dictionaries should therefore be given effect. This also aligns with the principle that a term should be interpreted in light of the Income Tax Act as a whole as it takes into consideration section 8(4)(a), which provides for an inclusion in income of a bad debt that is subsequently recovered. In support of the submission that effect should be given to the meaning that a debt is not required to be absolutely irrecoverable, is the premise that to give effect to the meaning that requires the debt to be strictly irrecoverable would not reconcile to a reading of the Income Tax Act as a whole.

In determining when a debt will be regarded as having become bad, it was established that there is no precise test to determine when a debt will be regarded as having become bad. A debt will be regarded as bad where a reasonably prudent business person, having all the pertinent information on hand, determines on a balance of probability that the debt is unlikely to be recovered. A taxpayer's continued efforts to recover a debt and subsequent events will not affect the determination of whether a debt is bad. Where a debt is accepted as bad and is claimed as a deduction, the taxpayer is required to provide documentary evidence in support of this write off that details, inter alia, information about the debt and the circumstances in which the debt arose.

This chapter, having set out the meaning to be ascribed to be term "bad debt" and the guidelines to be considered in assessing when a debt will be regarded as having become bad, has elaborated further on the requirement of section 11(i) that a debt must become bad in the year of assessment to qualify for deduction. The next chapter will seek to establish the nature of the debt that will qualify for deduction in terms of section 11(i) and other commercial principles to be considered.

CHAPTER 4: THE NATURE OF AND COMMERCIAL CONSIDERATIONS RELATING TO BAD DEBTS

4.1 INTRODUCTION

The previous chapters of this thesis focused on the general principles in terms of which a deduction of bad debts may be claimed, attributing a definition to the term "bad debt" and establishing guidelines to ascertain when a debt will be regarded as having become bad.

This chapter will elaborate on the nature of bad debts that will qualify for deduction from a taxpayer's income, the timing of when a debt is required to be identified as bad and whether the nature of the entity could have an impact on the timing of when a debt should be assessed as bad. In addition, based on the discussion in the previous chapter of the definition of a bad debt and when it will be regarded as having become bad, an analysis will be performed of the conformity of treating bad debts for accounting and tax purposes and the merits of this approach.

4.2 NATURE OF A BAD DEBT

In terms of the proviso to section 11(i) of the Income Tax Act a debt that has become bad must have been included in the taxpayer's income in the current or previous year of assessment to qualify for deduction. For an amount to be included in income, the amount must be income in nature having met the requirements of the definitions of gross income and of income, as set out in section 1 of the Income Tax Act. Gross income is defined in section 1 of the Income Tax Act as:

> Gross income, in relation to any year or period of assessment means-
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,
> during such year or period of assessment, excluding receipts or accruals of a capital nature …

An amount that has been beneficially received by a taxpayer on his or her own behalf and for his or her own benefit (*Geldenhuys v CIR*, 1947 (3) SA 256 (C), 14 SATC 419) or which he is unconditionally entitled to receive (*Mooi v SIR*, 1972 (1) SA 675 (A), 34 SATC 1) will fall within the ambit of the definition of gross income, provided that it is not an amount that is capital in nature. The Income Tax Act does not define the term capital. In *CIR v Visser*, 1937 TPD 77 8 SATC 271, Maritz J stated (at 276) that "Income is what capital produces, or is something in the nature of interest or fruit as opposed to principal or tree." It is therefore submitted that the proceeds on disposal of an income producing asset will be capital in nature and will not fall within the ambit of the definition of income, whilst an amount earned by a taxpayer in the course of carrying on ordinary trading operations undertaken with a profit making motive (*CIR v Pick 'n Pay Employee Share Purchase Trust*) will be income in nature and will therefore fall within the ambit of the definition of gross income.

A debt owing to the taxpayer that has become bad will qualify for deduction in terms of section 11(i) of the Income Tax Act if such amount has arisen in the ordinary course of trading operations carried out with a profit-making motive. A debt owing to a taxpayer that has not been earned in the course of carrying on normal trading activities, for example, a loan granted by an employer, who is not engaged in carrying on money lending activities, to an employee will therefore not qualify for deduction in terms of section 11(i) as such amount would not have been included in the income of the taxpayer, not having been earned in the ordinary course of a taxpayer's trade carried out with a profit making motive. Similarly, an amount owing to a taxpayer on disposal of a capital asset that subsequently becomes bad will not qualify for deduction in terms of section 11(i) as such amount, being capital in nature, would not have been included in the income of the taxpayer, not having met the criteria required to be regarded as gross income.

The Income Tax Act defines "income" as "… the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax". Any amounts that are exempt from income and that subsequently become bad will also not qualify for deduction in terms of section 11(i) as such amounts would never have been included in the taxpayer's income in the current or previous year of assessment. For example, dividend income that is irrecoverable will not qualify for deduction in terms of section 11(i), being income that is exempt from tax in terms of section 10(1)(k).

In the case of a moneylender the nature of a bad debt that would qualify for deduction from income would include not only the principal amount of the loan but also interest and any associated charges in respect of the loan made (TR92/18, Australian Taxation Office: 1992). The Australian ruling, TR92/18 (Australian Taxation Office: 1992), states that the term "in respect of money lent" should be given the widest possible interpretation and should include the principal amount of the loan, together with interest and any associated charges. The ruling (TR92/18, Australian Taxation Office: 1992), in paragraph 47, cited *Federal Commissioner of Taxation v National Commercial Banking Corporation of Australia Ltd*, (1983) 83 ATC 4715, 15 ATR 21, where it was observed (at ATC p. 4719, ATR p. 25) 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 …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.

4.3 TIMING OF THE IDENTIFICATION OF THE DEBT AS BAD

In terms of the requirements of section 11(i) of the Income Tax Act a debt must have become bad during the year of assessment to qualify for deduction. Chapter 2 established the principles that determine when a deduction of bad debts may be claimed, whilst Chapter 3 set out the grounds in terms of when a debt will be regarded as having become bad.

In respect of when a debt must be ascertained to be bad, De Koker and Williams (2017: §8.37) state that: "In practice the taxpayer is permitted to make his determination at the time when his financial statements are prepared and not necessarily on the last day of his year of assessment". The question as to when a debt is required to be ascertained as bad was considered in *BT (PVT) Ltd v Zimbabwe Revenue Authority,* where the court referred to the decision in *Commissioner of Taxes v A Company*, 1979 41 SATC 59. In *Commissioner of Taxes v A Company*, the taxpayer who had prepared its books of account in accordance with normal accounting practice, did not write off any debts as bad debts before the end of the year in question. At the time the financial statements for the year of assessment in question were being prepared, the managing director of the company made the decision to write off certain debts. The bad debts written off in the company's financial statements were then claimed as a deduction in the tax return for the year of assessment in question. In respect of whether a deduction of bad debts could be claimed for a debt that was ascertained as bad after the year of assessment in question, Lewis JP (at 412A – 413A) held "that a bad debt could be written off during the preparation of the financial statements for the year-end to which it related and claimed as an allowable deduction for that tax year, as it was not a necessary prerequisite that it be formally written off in that tax year."

In *CIR v Delfos*, the court stated (at 105) that:

> The object of making provision for a bad debt is to enable a "trader" (as defined) to arrive at a statement of his profit and loss for the income tax year. And if in drawing up his balance sheet and profit and loss account for the income tax year a business man has found it necessary to write off an amount …as a bad debt, and if in rendering his return he proves to the satisfaction of the Commissioner that such debt …is indeed a bad debt, the amount …will be deducted from his "income" (as defined) in order to arrive at his "taxable income" (as defined).

In *CIR v Delfos*, reference was made to *Anderton and Halstead v Birell*, where it was stated that in determining the profit or loss, an estimate of the extent to which a debt was bad was required to be made. It is therefore not required that a debt be ascertained as bad during the year of assessment in which it is claimed as a deduction for income tax purposes, that is, a debt may be assessed as bad after the year of assessment when the financial statements are being prepared.

In respect of whether the nature of the entity should be considered in determining when a debt will be regarded as having become bad, the United States of America Department of the Treasury Inland Revenue Service has specific guidelines (Regulation 26 CFR 1.166-2) to address the deductibility of debts for financial institutions. Although the South African legislation does not currently provide for guidelines specific to certain entities, it is submitted that the application of specific guidelines for certain entities, in particular where the volume of debts is high, and the individual values are low, would provide for a consistent approach to the application of the legislation, without imposing an onerous requirement on the taxpayer to assess each individual debt. The application of conformity to the deduction of bad debts from an accounting and tax perspective and the possible merits thereof are discussed in further detail in the next section.

4.4 BAD DEBTS AND CONFORMITY FOR ACCOUNTING AND TAX PURPOSES

In terms of the criteria applied by the United States of America Department of the Treasury Inland Revenue Service (Publication 535: 2016), a debt is regarded as having become bad when it is considered to be worthless. An exception to this rule is provided in terms of Regulation 26 CFR 1.166-2(d)(3), which allows banks to classify a debt as worthless for tax purposes when it is charged off for regulatory and/or financial statement purposes. The rationale behind the enactment of the election was to provide financial institutions with consistency in the treatment of bad debts from a regulatory, financial and tax perspective, that is, to align the treatment of bad debts for regulated financial institutions from an accounting and tax perspective. Blasi (2009: 440) states that:

> The conformity election was designed to provide a bank with greater certainty in the tax treatment of its bad debts by providing for a conclusive presumption of worthlessness based on the application of a single set of standards for both regulatory and tax purposes. It was added to regulations following a Treasury Department study because taxpayers argued that a determination of worthlessness for regulatory purposes entitles a bank to a conclusive presumption of worthlessness for tax purposes.

Regarding the question whether the criteria utilised by the regulatory authorities were sufficiently similar to the criteria for determining the worthlessness of a debt, the United States of America Department of the Treasury Inland Revenue Service (1991:19-22) stated that:

> … ease of administration is not enough to justify a regulatory/tax conformity rule. Such a conformity rule is, however, desirable to the extent that the regulatory criteria governing the charge-off of debts are similar enough to the criteria for worthlessness under section 166 to make regulatory criteria and examination by the regulatory authorities an acceptable surrogate for an independent investigation by the Internal Revenue Service.

In assessing the extent of the tax and regulatory conformity, the United States of America Department of the Treasury Inland Revenue Service (1991) undertook a comparison of the regulations governing loss classification with the tax criteria for determining the worthlessness of a debt and stated that (1991:22):

> The proximity of these two standards of worthlessness can be analysed at several levels. First, to what extent are the objective definitions of loss assets and worthless debts compatible? Second, is the factual basis on which a regulatory loss classification rests similar to that which would be required to support a deduction under section 166? Finally, is a bank examiner's assessment (or the assessment of a bank officer applying regulatory criteria) of whether an asset is a loss asset a satisfactory substitute for that of a tax auditor?

In respect of the definition of worthlessness employed for regulatory and tax purposes, the United States of America Department of the Treasury Inland Revenue Service stated in the *Report to The Congress on The Tax Treatment of Bad Debts by Financial Institutions* (1991:22) that:

> For regulatory purposes, loss assets are those that, on the basis of specific factual criteria, are deemed "uncollectible" and of such little value that their retention as bankable assets is not warranted. Classification as a loss asset does not preclude the possibility of partial recovery, but deems the possibility too small to provide a sufficient reason for deferring a write-off.
>
> Worthlessness for section 166 purposes has no succinct definition; it is determined on the basis of "all pertinent evidence". In making the determination of worthlessness, however, "the taxpayer must follow a rule of reason … The taxpayer is not required to postpone his entitlement to a deduction in the expectancy of uncertain future events nor is he called to wait until some turn of the wheel of fortune may bring the debtor into affluence." Thus, the regulatory and tax definitions of assets that should be charged off are quite similar in that they are both based on apparent uncollectibility, notwithstanding the possibility of partial recovery at some time in the future.

The next issue to be considered was whether the facts supporting the classification of an asset as a loss asset for regulatory purposes would be similar to the facts considered in determining that a debt is worthless for tax purposes (United States of America Department of the Treasury Inland Revenue Service: 1991). In this respect, the United States of America Department of the Treasury Inland Revenue Service (1991: 22-23) stated that:

> In general, institutions classify commercial and real estate loans on the basis of the borrower's financial statements, the borrower's condition compared to the industry average, whether a borrower has complied with the repayment terms of the loan, the adequacy of the collateral or income stream that secures repayment, the existence of contingent liabilities, the likelihood of the borrower's business success, and the overall economic conditions affecting the borrower. By contrast, high volume consumer installment loans and credit card plans are classified solely on the basis of the length of delinquency. The breadth of circumstances taken into account in classifying commercial and real estate loans for regulatory purposes is comparable to the inquiry that would be appropriate for a finding of worthlessness for purposes of section 166. Although the classification of consumer installment loans and credit card plans depends on a single fact, length of delinquency, the unsecured (or as may be the case with consumer loans secured by household items, undersecured) nature of these loans may cause that single fact to be an adequate measure of worthlessness for tax purposes. In any event, the high volume of such loans and their comparatively low face value would make an in-depth inquiry into all relevant facts and circumstances a very burdensome task for the lending institution. In the absence of persuasive evidence, such as an unusually high recovery rate for such loans, that the automatic charge-off criteria for these types of high volume loans results in overstated losses, it is appropriate to permit the regulatory loss classification to determine the worthlessness of such debts for tax purposes.

The final issue is whether the timing when a person who has classified a loan as a loss asset for regulatory purposes would correspond to the classification of the debt as worthless for tax purposes (United States of America Department of the Treasury Inland Revenue Service: 1991). It was stated by the United States of America Department of the Treasury Inland Revenue Service (1991) that although the preference of the two parties may be contradictory, the adoption of the conformity rule would favour a conservative approach of viewing a debt as a loss asset upon the first signs of weakness. It was, however, explained that it is unlikely that this approach would be exploited to the detriment of the tax system, given that excessive bad debt write offs would result in negative consequences and perceptions of the financial soundness of an entity.

An amendment to the Indian legislation, which was introduced to reduce the litigation relating to the deductibility of bad debts, also provides for consistency in the deduction of bad debts from an accounting and tax perspective. The amendment to the Direct Tax Laws (Amendment) Act, 1987, in India provides that a deduction of bad debts may be claimed for income tax purposes when it is written off in the taxpayer's books of account, without the taxpayer having to prove that the debt is in fact irrecoverable.

It is submitted that although the South African legislation does not provide for conformity between accounting and tax in respect of the deduction of bad debts, an analysis and comparison of the criteria applied in establishing whether a debt is bad for accounting purposes and tax purposes would be beneficial as the application of specific criteria would reduce the uncertainty as to when a debt will be regarded as bad. This analysis will be undertaken in further detail below. The amendment to the Indian legislation also provides a level of certainty in the deductibility of bad debts. It is submitted that, as the assessment of when a debt is regarded as bad is merely a timing difference, an application of principles similar to those set out by the United States of America Department of the Treasury Inland Revenue Service (Regulation 26 CFR 1.166-2) and the Indian legislation (Direct Tax Laws (Amendment) Act, 1987) would provide specific guidelines and reduce the uncertainty that currently exists in respect of the deductibility of bad debts.

4.5 ANALYSIS OF THE CONFORMITY APPROACH IN THE SOUTH AFRICAN CONTEXT

Although the South African legislation does not currently provide for conformity in the treatment of bad debts from an accounting and tax perspective, it is submitted that further analysis and comparison of the guidelines adopted for accounting and tax purposes would be warranted given that this may provide both the taxpayer and the SARS with a level of certainty in dealing with the deductibility of bad debts.

In setting out to perform an analysis of the conformity in treatment of bad debts from an accounting and tax perspective, the criteria to be utilised and the reasoning is as follows:

- From an accounting perspective the factors listed in the International Accounting Standards 39 (IAS 39): Financial Instruments: Paragraph 59 (SAICA: 2011), which provides a list of objective factors that indicate the impairment of a financial asset, will be considered; and
- From a tax perspective the factors listed in the Australian tax ruling, TR92/18 (Australian Taxation Office: 1992) and the New Zealand tax ruling, BR Pub 05/01 (Inland Revenue: 2005), which provide criteria that would be indicative that a debt was bad, will be considered. The South African legislation and case law does not at present provide a list of objective factors to be considered in the determination of when a debt will be regarded as bad. It was submitted above that a debt will be regarded as having become bad when on an objective analysis of the relevant factors a debt is regarded as bad by a reasonably prudent commercial person, as set out in both the Australian tax ruling, TR92/18 (Australian Taxation Office: 1992) and the New Zealand tax ruling, BR Pub 05/01 (Inland Revenue: 2005). Based on the principles established, it is submitted that the objective factors considered in both the New Zealand and Australian tax rulings are acceptable benchmarks against which to test the conformity rule.

Trade receivables are classified, in terms of IAS 39 (SAICA: 2011), as a financial asset, being an asset that is a contractual right to receive cash or some other form of financial asset in respect of the amount receivable. In terms of paragraph 59 of IAS 39 (SAICA, 2011: A1172 – A1173), the following list of objective factors provides an indication of the impairment of a financial asset:

> a) significant financial difficulty of the issuer or obligor;
> b) a breach of contract, such as a default or delinquency in interest or principal payments;
> c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
> d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
> e) the disappearance of an active market for that financial asset because of financial difficulties;
> f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets,

although the decrease cannot yet be identified with the individual financial assets in the group, including;

(i) adverse changes in the payment status of borrowers in the group (e.g., an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or

(ii) national or local economic conditions that correlate with defaults on the assets in the group (e.g., an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

In comparing the criteria listed in IAS 39 (SAICA: 2011) to the criteria listed in the Australian tax ruling, TR92/18 (Australian Taxation Office: 1992), and the New Zealand ruling, BR Pub 05/01 (Inland Revenue: 2005), it is apparent that the factors considered from an accounting and tax perspective are similar. Although the factors all consider that a debt will be regarded as bad in the strict sense when a debtor has died, it becomes statute barred or the debtor cannot be traced, the tax rulings and IAS 39 (SAICA: 2011) also take cognisance of the element of objectivity that will be required in the assessment of the factors to be considered in determining whether a debt is bad. The criteria set out in both the Australian tax ruling, TR92/18 (Australian Taxation Office: 1992), and the New Zealand tax ruling, BR Pub 05/01 (Inland Revenue: 2005), as well as the criteria noted in IAS 39 (SAICA: 2011) require an assessment of criteria applicable to the debtor itself and other economic factors that would provide an indication, from an objective viewpoint, that a debt was bad.

IAS 39 will be replaced by International Financial Reporting Standard 9 (IFRS 9) with effect from 1 January 2018, the primary difference in the impairment of a financial asset between IAS 39 and IFRS 9 being that an impairment in a financial asset is recognised in terms of IAS 39 upon the occurrence of a credit event, that is, when a credit loss is actually incurred, whilst IFRS 9 provides that a credit loss may be recognised based on expected credit losses (IRBA: Online). IFRS 9 has established a three-stage approach in determining the impairment of a financial asset (BDO: Online):

- Stage one – Where the credit risk of a financial asset has not increased significantly since initial recognition then the impairment to be recognised must be based on the 12-month expected credit loss;
- Stage two – Where the credit risk of the financial asset has increased significantly since initial recognition, the impairment to be recognised must be based on the lifetime expected credit loss with expected credit loss being defined as the expected losses over the life of the financial asset; and
- Stage three –Where there is objective evidence of impairment, the impairment to be recognised is the lifetime expected credit loss.

In terms of IFRS 9, a financial asset will be regarded as credit impaired based on evidence of the following factors (Deloitte, Online: 9):

- significant financial difficulty of the issuer or borrower;
- a breach of contract, such as a default or past-due event;
- the lenders for economic or contractual reasons relating to the borrower's financial difficulty granting the borrower a concession that would not otherwise be considered;
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for the financial asset because of financial difficulties; or
- the purchase or origination of a financial asset at a deep discount that reflects incurred credit losses.

To establish whether the credit risk of a financial asset has increased significantly it was stated (PWC, 2014: Online) that:

> …management should consider reasonable and supportable best information available without undue cost or effort. This information should include actual and expected changes in external market indicators, internal factors and borrower specific information.

Based on the analysis performed, it is submitted that the objective factors listed in IAS 39 are sufficiently similar to the factors considered in determining when a debt will be regarded as bad from a tax perspective, to regard a write off of a bad debt for accounting purposes as an adequate benchmark to claim a deduction for tax purposes. With IFRS 9 replacing IAS 39 from 1 January 2018, it is submitted that the comparison of the criteria between IAS 39 and the tax rulings as set out above will nevertheless be applicable to those financial assets that have been credit impaired in terms of stage three, as the factors listed in IFRS 9 that indicate the credit impairment of a financial asset are consistent with those included in IAS 39 for identifying objective evidence of impairment (Deloitte: Online). In respect of financial assets that are impaired by IFRS 9 in terms of stage one and stage two, it is submitted that in determining whether conformity in the treatment of bad debts from an accounting and tax perspective may be applied, a comparison of the criteria considered in establishing the credit risk to the objective list of factors that a reasonably prudent commercial person would rely on to determine that a debt is bad must be undertaken. Based on an analysis of the criteria applied in establishing the credit risk at the time, it is possible that conformity in the treatment of bad debts from a tax and accounting perspective may be applicable.

4.6 CONCLUSION

For a debt to qualify for deduction in terms of section 11(i) the amount must be income in nature. An amount that has met the requirements of the definition of gross income and income in section 1 of the Income Tax Act will qualify for inclusion in the income of a taxpayer. Where a taxpayer has received an amount that has been earned in the ordinary course of trading operations carried out with a profit-making motive, such amount will fall within the ambit of the definition of gross income and would qualify for deduction in terms of section 11(i) having met the income requirement. An amount that is not income in nature and that subsequently becomes bad will give rise to a capital loss as such amount will not be admissible as a deduction in terms of section 11(i).

In respect of the timing of when a debt is required to be ascertained as bad, the guidelines set out in *CIR v Delfos* and *BT (PVT) Ltd v Zimbabwe Revenue Authority* established that a debt need not be assessed as bad in the year in which a deduction is claimed for income tax purposes, that is, such assessment may be made after the year of assessment when the financial statements in respect of that year are being prepared.

In terms of the principles established by the United States of America Department of the Treasury Inland Revenue Service (1991), the nature of the entity should be taken into consideration in determining when a debt will be regarded as having become bad, as this principle would provide for conformity in the deduction of bad debts by financial institutions from an accounting and tax perspective. An amendment to the Indian legislation (Direct Tax Laws (Amendment) Act, 1987), where a bad debt is allowed as a deduction for tax purposes when it is written off as irrecoverable in the books of account, also provides for consistency in the treatment of bad debts from an accounting and tax perspective as the taxpayer is not required to establish that the debt is irrecoverable.

The South African legislation does not provide for conformity between accounting and tax principles in respect of the deduction of bad debts. A comparison of the guidelines adopted for accounting and tax purposes was undertaken, as further research was warranted given that the principles established would provide clear guidelines that would offer both SARS and the taxpayer a level of certainty in dealing with the deductibility of bad debts and would reduce any litigation arising as a result of the doubt that currently exists. Based on the analysis performed between the criteria applicable in determining when a debt is bad from an accounting and tax perspective, it is submitted that the criteria in IAS 39 are sufficiently similar to the criteria considered for tax purposes in order to regard the criteria for a write-off for accounting purposes as a reasonable benchmark in determining the deductibility of a bad debt for tax purposes. In respect of the criteria contained in IFRS 9, it is submitted that conformity in the treatment of bad debts from an accounting and tax perspective can be applied to debts impaired in terms of stage three, whilst application of conformity to debts impaired in terms of stage one and two may only be determined at the stage when the credit risk of such debt is determined and based on the factors in terms of which it is determined.

This chapter has provided guidelines on the nature of bad debts that will qualify for deduction from income and has considered other relevant commercial considerations applicable to the deductibility of bad debts. The next chapter will conclude the study carried out in this and the previous chapters and will provide a summary of the conclusions reached in respect of each of the goals that this research sought to address.

5. CONCLUSION

5.1 INTRODUCTION

The courts have on numerous occasions been called upon to confirm the deductibility of bad debts, owing to the uncertainty relating to certain principles, in particular the definition and timing of a bad debt deduction. The primary goal of this research was to critically analyse the deductibility of bad debts in arriving at taxable income, whilst also setting out to achieve the following sub goals:

- to clarify the meaning to be attributed to the term "bad debt";
- to determine the principles established by the courts, both local and in selected international jurisdictions, by SARS and other relevant tax authorities, when dealing with bad debt deductions under various circumstances, including:
  - at what stage a debt becomes "bad";
  - the nature of the debts that will qualify for deduction from a taxpayer's income;
  - debts arising when a business is acquired, or disposed of, becomes insolvent or is wound up or deregistered;
  - debts that are ceded; and
  - partnership debts; and
- to provide a framework that will assist in identifying bad debts that will be deductible from income.

This chapter concludes the critical analysis of the deductibility of bad debts for income tax purposes and will set out how the goals of the research were achieved, by drawing on the principles established in the previous chapters. Based on the study of the principles set out in both local and selected international case law and legislation, this chapter will also provide recommendations and suggestions to address the challenges in relation to the deductibility of bad debts.

5.2 THE BASIS FOR THE DEDUCTION OF BAD DEBTS

The goal of Chapter Two was to determine the principles established by the courts, by SARS and other relevant tax authorities when dealing with the deduction of bad debts under various circumstances. In achieving this goal, Chapter Two established a general framework in terms of which a deduction of bad debts may be claimed, based on the principles and criteria set out in section 11(i) and by the courts.

To qualify for deduction in terms of section 11(i) a bad debt must satisfy the requirements of the preamble to section 11, that is, the debt that has become bad must have arisen in the carrying on of any trade. The definition of trade in section 1 of the Income Tax Act includes a broad spectrum of activities and is meant to be given the widest possible interpretation (*Burgess v CIR*). Although the term "trade" is widely defined, it does not include the earning of passive income. An amount owing to the taxpayer in respect of passive income, that is, interest, dividends, annuities and a pension that subsequently becomes bad will therefore not be allowed as a deduction as the earning of passive income does not meet the requirements of the preamble to section 11 of the Income Tax Act. An exception is, however, applicable in terms of Practice Note 31 (SARS: 1994) in respect of the expenditure deductible from interest income. Where the taxpayer is not a moneylender, SARS' practice allows a deduction of expenditure incurred, to the extent that it does not exceed such interest income. Whether this practice would extend to a bad debt arising in this instance, is submitted to be doubtful.

In establishing the factors to be considered in determining whether a bad debt has arisen in the course of carrying on ordinary trading activities, it was held in *ITC 95* (at 243) that: "It had to be proved satisfactorily by the taxpayer that he was a trader and that the debt he sought to deduct was bad, and further that the debt was incurred during his trading operations and by reason of his trading operations." On cessation of trade, a bad debt will be admissible as a deduction provided that the debt arose from trading operations carried on prior to the cessation of trade (*ITC 1029* and *COT v Cathcart*).

In addition to meeting the requirements of the preamble to section 11 of the Income Tax Act, a bad debt must also fulfil the following requirements of section 11(i) to qualify as a deduction from income:

- the debt must be an amount owing to the taxpayer;
- the debt must have become bad during the year of assessment; and
- the debt must have been included in the income of the taxpayer in the current or previous year of assessment.

The first requirement will be met if at the end of the year of assessment a debt that has become bad is an amount due to the taxpayer. Where a taxpayer has disposed of his business together with its book debts and such debts subsequently become bad, the taxpayer will not be allowed a deduction of such debts as they are no longer an amount owing to him. Similarly, where a debt has been waived or compromised then such debt will not be admissible as a deduction in terms of section 11(i) as the debt is not an amount that is owing to the taxpayer.

In establishing the principles applicable to the second requirement, this analysis was undertaken separately to determine:

- the definition of the term "bad debt";
- when a debt will be regarded as having become bad;
- the timing of the identification of the debt as bad; and
- the timing of the deduction of a bad debt.

The first three aspects are discussed in further detail below. In respect of the fourth aspect, that is, the timing of when a deduction of bad debts may be claimed, it was established in *ITC 181* that a deduction of bad debts must be claimed in the year of assessment in which they are first considered to be irrecoverable and that a taxpayer may not accumulate bad debts and claim a deduction in a later year of assessment.

In respect of the third requirement, the proviso to section 11(i) states that a debt that has become bad must have been included in income in the current or previous year of assessment to qualify for deduction. An amount that has been earned by a taxpayer in the course of ordinary trading activities carried on with a profit-making motive will meet the income requirement as contemplated in section 11(i) should such amount become irrecoverable. An amount received by or accrued to a taxpayer that falls outside the ambit of the definition of income in section 1 of the Income Tax Act and that subsequently becomes irrecoverable will not qualify for deduction in terms of section 11(i). This would occur, for example, when an employer lends an amount to an employee. The loss in respect of the non-repayment of the loan would not be included in income as it would represent a capital loss (unless the lender carries on business as a money-lender) and would therefore not qualify for deduction in terms of section 11(i) (*Stone v SIR)*. An amount that is exempt from normal tax (for example, dividends that are exempt from tax in terms of section 10(1)(k) of the Income Tax Act) would also not meet the requirements to qualify for deduction should such amount prove to be bad as such amount would never have formed part of income.

In terms of section 102 of the Tax Administration Act, where any uncertainty exists in respect of the deductibility of a bad debt, the taxpayer bears the onus of proving that the requirements of the preamble to section 11 and section 11(i) of the Income Tax Act have been met and that the bad debt is admissible as a deduction.

This research also took into consideration any other provisions of the Income Tax Act and other taxing Acts that may be applicable in relation to the deductibility of a bad debt. In terms of the Income Tax Act, section 8(4)(a) provides that the recovery or recoupment of any amounts that have previously been allowed as a deduction under section 11 (including a bad debt written off in terms of section 11(i)) will be included in income in the year of assessment in which it is recovered (*CIR v Delfos*). In respect of the VAT consequences of a bad debt, the VAT Act provides, in terms of section 22, that where a debt on which output tax was levied subsequently becomes bad, the taxpayer will be entitled to claim an input tax deduction of an amount that bears to the total VAT levied the same proportion as the portion of the debt that is irrecoverable bears to the total amount of the debt.

The write-off of a bad debt falls within the scope of the definition of a disposal as contemplated in the Eighth Schedule to the Income Tax Act and where the deduction of a bad debt is disallowed in terms of section 11(i), by reason of the income requirement not having been met, such disposal will give rise to a capital loss.

5.3 MEANING ATTRIBUTED TO THE TERM "BAD DEBT"

The goal of Chapter Three was to ascribe a meaning to the term "bad debt" and to determine the principles to be applied in assessing when a debt will be regarded as having become bad.

The term "bad debt" is not specifically defined in the Income Tax Act. The general rules of interpretation dictate that the term "bad debt" must be given its ordinary meaning. The ordinary meaning attributed to the term "bad debt" by the *Oxford Dictionary* (Online) implies that the debt must be bad in the strict sense, that is, the debt must be absolutely irrecoverable, whilst the meaning attributed to the term "bad debt" by the *Macmillan Dictionary of Accounting*

(Parker, 1992) and the *Oxford Learners Dictionary* (Online) acknowledge by the use of the words "expected" and "unlikely" that a degree of judgement is required in the assessment of whether a debt is bad. The interpretation of the term "bad debt" is therefore subject to uncertainty as a result of the ambiguity in the meaning of the term as provided by the dictionary sources quoted.

From the contextual analysis of the relevant legislation and case law in various foreign jurisdictions, certain principles emerged. Based on the dominant principle as set out in various jurisdictions, it was established that the primary test to be applied in determining when a debt will be regarded as having become bad was an objective one. In the Australian ruling, TR92/18 (Australian Taxation Office: 1992), it was stated that a debt would generally be accepted as bad where, on an objective analysis of the facts and circumstances existing at the time, the taxpayer makes a *bona fide* assessment that the debt or part thereof is irrecoverable. A New Zealand ruling, BR Pub 05/01 (Inland Revenue: 2005), also set out an objective test to ascertain when a debt will be regarded as having become bad. This principle was confirmed by the courts in *Budget Rent a Car Ltd v CIR* where it was held that the test to be applied in determining whether a debt was bad was whether a reasonably prudent commercial person would conclude, on a balance of probabilities, that the debt was unlikely to be recovered. This objective test was also applied in *Case N69,* where the court held that a debtor need not be insolvent for a debt to be regarded as bad. In *Case N69*, the court stated (at 3 548) that "It does not follow from the taxpayer hoping for or seeking recovery that a debt is not bad". In another case that applied this objective test, *BT (PVT) v Zimbabwe Revenue Authority,* it was held that the assessment of the debt as bad did not exclude the possibility that the debt may be recovered.

For a reasonably prudent business person to make this objective assessment of the likelihood that the debt will be recovered, sufficient information would be required to enable this assessment. The extent of information required would depend on the value of the debt outstanding. The New Zealand Inland Revenue Department stated in Volume Twelve, No. 5 of the Tax Information Bulletin (2000), that attempts to recover a debt were not a pre-requisite to a debt being assessed as bad and that in certain instances the recovery action may be carried out even after a taxpayer has made a *bona fide* assessment that the debt is unlikely to be recovered. The Australian ruling, TR92/18 (Australian Taxation Office: 1992), also noted that a taxpayer need not exhaust all avenues of recovery before a debt could be regarded as bad and that the extent of the recovery action taken would depend on the value of the debt.

The United States of America Department of the Treasury Inland Revenue Service (2016) defined a business bad debt as one that has become partially or totally worthless. It was explained in the US Master Bank Tax Guide (2009) that there was no specific test or factor that indicated that a debt was worthless. The United States of America Department of the Treasury Inland Revenue Service stated in Publication 535 (2016) that a debt would be considered to be worthless when there was no chance of recovery and that where reasonable steps of recovery have proved to be futile, this would be adequate to substantiate that the debt was bad.

The United States of America Department of the Treasury Inland Revenue Service does, however, provide for an exception to this in Regulation 26 CFR 1.166-2 in terms of which a financial institution may claim a deduction for tax purposes when it is written off as bad for regulatory/financial statement purposes.

In response to the uncertainty and court cases arising in relation to the deductibility of bad debts, the Indian legal system amended the Direct Tax Laws (Amendment) Act, 1987, in terms of which a deduction for bad debts may now be claimed for tax purposes when it is written off for accounting purposes, without the taxpayer having to prove that the debt was irrecoverable.

In respect of whether subsequent events should affect the assessment of whether a debt was bad, that court held in *CIR v Delfos* that a bad debt should be determined according to the facts and circumstances existing at the time and that subsequent events should not have an effect of the classification of the debt as bad. This principle was also established in the Australian ruling, TR 92/18 (Australian Taxation Office: 1992), where it was stated that a debt is not required to be bad in the strict sense but must be more than merely doubtful to qualify as a deduction for income tax purposes. In support of this contention, the ruling made reference to *Anderton and Halstead Ltd v Birrell,* where it was held that an estimate of the extent to which a debt was bad was required in determining whether or not a debt was bad, and that such estimate was to be based on the facts and circumstances existing at the time that such determination was made, that is, this assessment should not be affected by subsequent events. In another case that supported this view, *Case 26,* the court held that subsequent recovery of a bad debt should not affect the determination of the debt as bad when it was claimed as a deduction.

Based on the principles and guidelines established in the various jurisdictions in relation to the question as to when a debt will be regarded as having become bad and the meaning to be ascribed to the term "bad debt", it is submitted that a debt is not required to be bad in the strict sense and that a debt should be accepted as bad where a reasonably prudent commercial person determines on a balance of probabilities that a debt is bad based on sound commercial considerations. A taxpayer need not exhaust all avenues of recovery for a debt to be regarded as bad. This interpretation aligns with the *contra fiscum* principle that states that where a term is capable of being interpreted in alternate ways then the interpretation that favours the taxpayer and which imposes a smaller burden on the taxpayer should be favoured. The adoption of the strict interpretation of the term "bad debt", which in effect is only a timing difference, would impose an impractical onus on the taxpayer to exhaust all avenues of recovery and to ensure that a debt is absolutely irrecoverable before it can be regarded as having become bad. It is submitted that adoption of the strict interpretation of the term "bad debt" would be contrary to the intention of the legislation as the enactment of section 8(4)(a), which provides for a bad debt to be included in gross income upon recovery, would have been unnecessary.

On application of the principles established on the interpretation of when a debt will be regarded as having become bad to the definition to be ascribed to the term "bad debt", it is submitted that the definitions provided by The *Macmillan Dictionary of Accounting* (Online) and the *Oxford Learners Dictionary* (Online) should be adopted as these definitions support the approach that a debt need not be bad in the strict sense and that an element of judgement is required in the assessment of when a debt will be regarded as having become bad. The adoption of this meaning aligns with the rules of statutory interpretation that state that where no definition is provided, the ordinary meaning read in the context of the Income Tax Act as a whole, should be adopted.

5.4 THE NATURE OF AND COMMERCIAL CONSIDERATIONS RELATING TO BAD DEBTS

The goal of Chapter Four was to establish the nature of bad debts that will qualify as a deduction and other commercial considerations applicable to the deductibility of bad debts.

In respect of the nature of bad debts that will be deductible, the proviso to section 11(i) of the Income Tax Act states that an amount must have been included in income in the current or previous year of assessment to qualify for deduction. For an amount to have been included in the income of a taxpayer, the amount must meet the requirements of the definition of "income" and “gross income” in section 1 of the Income Tax Act. An amount will fall within the ambit of the definition of gross income if it is an amount, in cash or otherwise, that has been received by or has accrued to the taxpayer, excluding receipts or accruals of a capital nature. In determining whether an amount is capital or income in nature, an amount will be regarded as income in nature where such amount has been derived by a taxpayer as a result of the income earning operations carried out as part of a scheme of profit making.

In respect of when a debt is required to be identified as bad, it was established that a debt need not be ascertained as bad during the year of assessment in which it is claimed as bad, that is, this assessment may be made after the year of assessment when the financial statements of an entity are being prepared.

In determining whether the nature of an entity should be considered in relation to the timing of when a debt will be regarded as having become bad, an analysis of the principles applicable to financial institutions in terms of the United States of America Department of the Treasury Internal Revenue Service Regulation 26 CFR 1.166-2(d)(3) were undertaken. Although SARS does not currently provide for specific guidelines relating to the deductibility of bad debts for certain entities, it is submitted that the application of guidelines specific to certain types of entities would support a business-like and practical method of treating bad debts, particularly in respect of entities with high volume of debts and low individual values, as the cost of attempting to recover and assessing such debt as bad should not exceed to the value to be derived from the recovery of the debt. This recommendation is favourable in that it allows the taxpayer to consistently apply the provisions of the legislation without imposing an onerous requirement on the taxpayer to assess each individual debt.

The presumption of worthlessness applicable in terms of the United States of America Department of the Treasury Internal Revenue Service Regulation 26 CFR 1.166-2 was enacted in order to align the treatment of bad debts for financial institutions from an accounting and tax perspective and was deemed to be appropriate to the extent that the criteria for determining the charge off for accounting purposes was sufficiently similar to the criteria used to determine the worthlessness of a debt for tax purposes.

The South African legislation does not currently provide for conformity in the treatment of bad debts from an accounting and tax perspective. It is submitted that conformity in the treatment of bad debts from an accounting and tax perspective would be beneficial, as the application of specific criteria would provide for a level of certainty in determining when a debt will be regarded as bad, thereby reducing potential litigation.

To determine whether this approach could be applied in the South African context, a comparison of the criteria applicable in determining when a debt will be regarded as bad from an accounting and a tax perspective was undertaken. Based on the analysis performed it is submitted that the criteria are sufficiently similar to justify a write off of bad debts for tax purposes, when the debts were written off as bad for accounting purposes, based on criteria currently applicable in terms of IAS 39. In respect of IFRS 9 it is submitted that conformity may be applied to the extent that the impairment is determined in terms of stage three. Where the impairment is determined according to stage one and two, an assessment as to whether conformity may be applied can only be determined according to an analysis of the factors considered in establishing the credit risk at the time.

5.5 RECOMMENDATIONS

Based on the principles and guidelines established in the previous sections, it is submitted that the issue of an interpretation note that deals with the deductibility of bad debts, would be beneficial, as this would reduce the uncertainty in relation to the deductibility of bad debts. It is submitted that the following factors should be considered by SARS:

- the conformity of treating bad debts from an accounting and tax perspective;
- the adoption of a definition of the term bad debt;
- setting out a general framework in terms of which a deduction of bad debts may be claimed, taking into account the principles and guidelines established by local and international precedent detailed above; and
- the application of standard criteria for certain types of entities, especially those that have a high volume of debts with low individual values.

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