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Global Tax Alert

South African Revenue Service focuses on bad debt deductions during audits

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Under South Africa's income tax law, provided that an amount has been previously included in the taxpayer's income (in the current or a prior year of assessment), a taxpayer is entitled to claim a tax deduction[1] for "any debt due to the taxpayer which has during the year of assessment become bad."

The *Income Tax Act* does not, however, provide clarity on when a debt is considered "bad" as contemplated in section 11(i) (the bad debt deduction).

In the absence of strong precedence under South African case law on this issue, the South African Revenue Service (SARS) has, together with the ordinary meaning of the phrase "bad debt," sought guidance from selective international interpretation and has formulated the following shaped view:

- The writing off a debt as "bad" for tax purposes requires that all the appropriate steps to collect the debt must have occurred. These steps would include exhausting both in-house and external agency efforts; and
- A debt is only 'bad' when every reasonable avenue of recovery has been exhausted and there is no reasonable hope of collecting the debt. If there is a chance of collecting the debt, however, remote the possibility, then the debt should be considered "doubtful" rather than "bad."

SARS has been applying this relatively newly-formed view regularly in its integrated audits. And, where taxpayers have not been able to adequately defend the manner in which their bad debts have been written off, SARS has been disallowing the bad debt deduction claimed by the taxpayer.

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Where a bad debt deduction is disallowed, the debt that was previously considered "bad" is then generally considered "doubtful" and a taxpayer may then be entitled to claim a "doubtful debt allowance.[2]"

Significant amendments have recently been made to the doubtful debt allowance. These amendments are effective for years of assessment beginning on or after 1 January 2019.

Before the amendments, the doubtful debt allowance was at the discretion of the Commissioner[3] and was dependent on the circumstances of each case. If a detailed list of doubtful debts could be provided, the SARS generally allowed an allowance of 25% of the doubtful debts so listed. Where, however, the SARS was satisfied that the volume or size of the business concerned made the compilation of a detailed list of doubtful debts impracticable, then the SARS granted an allowance based on the following formula:

Y = M X N, in which:

- "Y" represents the allowance to be determined.
- "M" represents the average of bad debts, less recoveries, written off in the current year of assessment and the four immediately preceding years, expressed as a percentage of credit sales.
- "N" represents the outstanding debts at the end of the year of assessment, less those written off.

Since the above-mentioned formula was not capped, in certain circumstances it turned out that the net tax effect of writing of a debt off as "bad" or classifying the debt as "doubtful" and then claiming a doubtful debt allowance in accordance with the formula was not in fact that different. Taxpayers that were not, however, able to draw on the above-mentioned formula were impacted more substantially.

Following the amendments, the criteria for determining the doubtful debt allowance are now specifically set out in the *Income Tax Act* and are dependent on whether International Financial Reporting Standards 9 (IFRS 9) is applied by the taxpayer to the debt for financial reporting purposes.

Where **IFRS 9 is applied** to the debt for financial reporting purposes, the doubtful allowance is calculated as:

- 40% of the loss allowance relating to impairment that is measured at an amount equal to the lifetime expected credit loss, as contemplated in IFRS 9, in respect of debt other than in respect of lease receivables;[4] plus
- 40% of the amounts of debts disclosed as bad debts written off for financial reporting purposes that have not been allowed as a deduction under section 11(i) for the current or any previous year of assessment and the debt is included in the income of the taxpayer in the current or any previous year of assessment; plus
- 25% of the loss allowance relating to impairment (as contemplated in IFRS 9) in respect of debt other than in respect of lease receivables as defined in IFRS 9 or debt taken into account above.

Where **IFRS 9 is not applied** for financial reporting purposes, the doubtful allowance is calculated as:

- 40% of the debt if that debt is 120 days or more in arrears; plus
- 25% of the debt (other than a debt contemplated above) if that debt is 60 days or more in arrears.

Notwithstanding the above, the Commissioner may issue a directive that the 40% above be increased to 85% if certain criteria are met.

Until the matter has been tested in a South African court, taxpayers need to be vigilant and carefully consider the manner in which bad debts are written off. Further, while we note that the difference is merely a timing difference (which may to an extent be sheltered by a section 11(j) allowance) failure to revisit the manner in which bad debts are written of may lead to additional tax, penalties and interest.

Endnotes

1. In accordance with section 11(i) of the *Income Tax Act*.
2. In accordance with section 11(j) of the *Income Tax Act*.
3. Income Tax Code 273 7 SATC 232.
4. As defined in IFRS 9.

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